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Feature

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Pssst, Can You Keep a Secret?

Unperfected "Secret" Liens as a Preference Defense

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A school saying holds that "secrets, secrets are no fun/secrets, secrets hurt someone." Commercial law tends to agree with this law of the playground inasmuch as it generally requires possession or public filings to perfect liens.

A recent decision highlights an important split of authority on whether to recognize secret, unperfected statutory liens in preference actions. More specifically, in *Pidcock v. Mo-Tech Corp. (In re E.D.C. Liquidating)*,[1] the bankruptcy court held that pre-petition transfers to the holder of a secret, unperfected statutory lien could not be avoided as preferential transfers based on its view that the transferee did not receive more than it would have in a hypothetical chapter 7 liquidation. The decision is a useful reminder that there are conflicting views as to whether payments to a creditor who holds a secret lien are avoidable as preferences, and that the specific mechanics of statutory liens under state law should be reviewed closely.

Facts and Procedural Background

The dispute in *E.D.C. Liquidating* centered on whether a debtor's pre-petition payments to the holder of an unperfected statutory lien could be avoided as preferential transfers under § 547 of the Bankruptcy Code. The issue arose in the context of a post-confirmation adversary proceeding initiated by a plan liquidating trustee seeking to avoid and recover five pre-petition transfers totaling at least $231,000.[2]

Prior to its bankruptcy filing, the debtor provided tool-and-die manufacturing, storage and related services.[3] In the course of this business, the debtor ordered two custom molds from Mo-Tech Corp. (the defendant/transferee).[4] Due to financial difficulties, the debtor was unable to pay for the molds, so the parties negotiated new payment terms before Mo-Tech would deliver the molds. The debtor agreed to pay $151,600 in full satisfaction of the balance owed on one mold and to secure release of both molds, and then pay the balance, approximately $102,100, in weekly payments over a period of five weeks.[5]

The debtor made the initial payment (securing the release of both molds) and paid all but about $22,100 of the remaining balance owed before filing for bankruptcy. All of these payments were made during the 90 days immediately prior to the commencement of the debtor's bankruptcy case.

Following plan confirmation, the trustee initiated an adversary proceeding to avoid and recover the value of the debtor's transfers to Mo-Tech during the 90-day preference period, among other things. Mo-Tech subsequently moved for a summary judgment contending, among other things, that the trustee could not meet one of the *prima facie* elements of his preference case: proving that the transfers to Mo-Tech were more than Mo-Tech would have received in a chapter 7 liquidation.[6]

Mo-Tech contended that because the transfers were payments to satisfy a fully secured lien, it did not receive more than it would have in a liquidation case. Specifically, Mo-Tech argued that under Ohio statutes that provide protections similar to statutory mechanics' liens, it held a lien in molds it manufactured for the debtor to secure payment for its work.

Ohio law gives moldbuilders two types of liens that attach to molds they produce. While the molder

1 Case No. 14-61086, Adv. No. 15-6060, 2017 Bankr. LEXIS 341 (Bankr. N.D. Ohio Feb. 7, 2017) (the "Opinion").
2 *Pidcock v. Mo-Tech Corp. (In re E.D.C. Liquidating)*, Adv. No. 15-6060 (Bankr. N.D. Ohio 2015), at Docket No. 1 (the "Complaint").
3 *Id.* at ¶ 13.
4 *Id.* at ¶ 5.
5 Opinion at *2.
6 Adv. No. 15-6060 Docket No. 25. To satisfy his burden, the trustee had to prove, among other things, that the allegedly preferential transfers "enable[d Mo-Tech] to receive more than [it] would receive if — (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) [Mo-Tech] received payment of such debt to the extent provided by the provisions of this title." 11 U.S.C. § 547(b)(5).

has possession of the mold and before the customer has paid for it, the molder has a lien that is perfected by possession.[7] After delivery of the mold to the customer and before the customer pays for the mold, the molder retains a lien in the mold that must be perfected by filing a financing statement.[8] Mo-Tech delivered the molds to the debtor but failed to file a financing statement. Mo-Tech argued that even in light of the unperfected nature of its lien, each of the transfers was on account of a fully secured claim because at the time of each transfer, it had a right to file a financing statement under Ohio's moldbuilder's lien laws. Thus, the transfers were shielded from avoidance.

The trustee disagreed, and in his cross-motion for summary judgment, he contended that Mo-Tech's failure to file a financing statement after delivery of the two molds meant that its lien was unperfected. As a result, the pre-petition transfers allowed Mo-Tech to receive more than it would have had the transfers not been made and its claim been treated as an unsecured claim in a chapter 7 liquidation.[9]

The *E.D.C. Liquidation* Court's Decision

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The bankruptcy court agreed with Mo-Tech, concluding that the transfers made to it after delivering both molds could not be avoided as preferential transfers. Thus, the court denied the trustee's motion and granted Mo-Tech's motion.

As a preliminary matter, the parties' briefing streamlined the issues for the court in two significant ways. First, the trustee conceded that the first transfer of $151,600 could not be avoided because it was made at a time when Mo-Tech's lien was perfected by possession.[10] Second, the trustee apparently did not refute Mo-Tech's evidence that it was fully secured, an important point in light of circuit-level authority holding that "payments to a creditor who is fully secured are not preferential since the creditor would receive payment up to the full value of his collateral in a chapter 7 liquidation."[11] This left the court to focus on what effect Mo-Tech's failure to perfect its lien following delivery of the molds had on the preference analysis.

The trustee argued that Mo-Tech did not have a perfected lien and that Mo-Tech should not be found to have possessed "inchoate" lien rights that could have been — but were not — perfected as of the commencement of the chapter 11 case.[12] In support, the trustee primarily relied on *Precision Walls Inc. v. Crampton*,[13] a case in which the district court affirmed the bankruptcy court's decision that the debtor's payments to a drywall subcontractor were recoverable as preferences because it failed to provide the written notice required to perfect its lien under North Carolina law.[14] While the drywall subcontractor alleged that it should have been treated as a secured creditor "because it could have perfected its liens, but chose not to after it received payment," the district court concluded that the drywall subcontractor could not claim priority over others because it failed to perfect its lien.[15] Thus, according to the *Precision Walls* court, "[d]ue to [the drywall subcontractor's] status as an unsecured creditor, its receipt of 100 [percent] of its claim [pre-petition] amounted to a preference over other unsecured creditors."[16]

The *E.D.C. Liquidation* court characterized *Precision Walls* as representing a minority position that would have required it to ignore the fact that state law gave Mo-Tech a lien against the debtor. Instead, the court relied on cases cited by Mo-Tech that held that pre-petition payments are not avoidable "[i]f the creditor could perfect the lien under state law at the time payment is made, and the perfection of the lien is not avoidable under the Bankruptcy Code."[17] The "payment itself should not be less secure than the lien which could have secured it."[18] The fact that Mo-Tech had not perfected its lien at the time of the transfers was not material to the court's analysis:

> While perfection would have established [Mo-Tech's] lien rights against others, it did not diminish its interest against [the] Debtor. The court concludes that as a secured creditor, the payments made to [Mo-Tech] did not allow it to receive more than it would have received in a hypothetical liquidation.[19]

Thus, according to the court, the trustee failed to meet a key element of his *prima facie* case. While the court did recognize that a "policy argument could be made that such 'secret' liens should not be permitted because they may mislead secured lenders and other creditors as to the available assets of debtors," its view was that "[m]odern commercial realities moot this concern."[20] According to the

7 *See* Ohio Revised Code § 1333.31 (providing moldbuilder's perfected lien "on a ... mold ... that is in his possession and that belongs to a customer" for "[t]he amount due from the customer for ... work performed with the .... mold, or for making or improving the ... mold," along with certain other costs, as long as molds remain in moldbuilder's possession).

8 *See* Ohio Revised Code § 1333.33(A)(1) ("A moldbuilder has a lien on all molds produced by it and on all proceeds from the assignment, sale, transfer, exchange, or other disposition of the molds produced by it until the moldbuilder is paid in full all amounts due the moldbuilder for the production of the mold or these proceeds. The lien described in this division attaches when the mold is delivered from the moldbuilder to the customer.") and § 1333.33(B) ("A moldbuilder perfects a lien described in division (A) of this section by filing a financing statement in accordance with the requirements of section 1309.502 of the Revised Code, which filing constitutes constructive notice of the lien described in division (A) of this section.").

9 Adv. Docket No. 15-6060, Docket No. 27 at 10-14.

10 Opinion at *3.

11 Opinion at *4 (quoting *Ray v. City Bank and Tr. Co. (In re C-L Cartage Co. Inc.)*, 899 F.2d 1490, 1493 (6th Cir. 1990)).

12 Adv. Docket No. 15-6060, Docket No. 27 at 11-12. There is no indication from the court's decision that § 546(b)(1) of the Bankruptcy Code applied under the facts of this case.

13 *Id.* (citing *Precision Walls Inc. v. Crampton*, 196 B.R. 299 (E.D.N.C. 1996)).

14 *Precision Walls*, 196 B.R. at 301-03, 305.

15 *Id.* at 302-03.

16 *Id.* at 303.

17 Opinion at *5 (citing *Johnson Mem'l Hosp. Inc. v. New England Radiator Works*, 470 B.R. 119 (Bankr. D. Conn. 2012); *Off. Comm. of Unsecured Creditors of 360Networks (USA) Inc. v. AAF-Mcquay Inc. (In re 360Networks (USA) Inc.)*, 327 B.R. 187 (Bankr. S.D.N.Y. 2005)).

18 *Id.* (internal quotations omitted).

19 *Id.*

20 *Id.* at *6.

court, lenders and creditors "with a lick of sense" know these industries and how they operate, and understand the applicable lien laws.[21] In other words, according to the court, no one was ambushed by Mo-Tech's "secret" lien, and this result "encourages vendors to continue dealing with troubled enterprises, one of the pole stars of modern commercial law."[22]

Analysis

The *E.D.C. Liquidation* decision provides several useful reminders for practitioners. First, there are competing views on whether pre-petition transfers to the holders of unperfected statutory liens are avoidable as preferential transfers. While the court characterized the trustee's view as being in the minority, the only circuit-level authority cited by the court as representing the majority view dates to the 1950s, and there might be room for further developments of the law in this area. That being said, bankruptcy courts in the Second Circuit continue to apply one of these older, pre-Bankruptcy Code decisions, which makes it less likely that the minority view would be adopted there.[23]

Second, in order to protect their secured position in the event of a preference action, lien claimants should consider perfecting their liens prior to receiving payment from the customer — even when they have agreed to a payment plan. Also, parties extending credit to debtors can better protect themselves against secret liens by reviewing the debtors' business, other accounts payable and prior transactions on a regular basis, in addition to conducting a standard lien search.

Third, the policy arguments in this case cut both ways — and there is no clear answer as to who is harmed most from secret, unperfected statutory liens in the context of a preference case. Allowing preferential transfers to be avoided should discourage secret liens[24] and promote equality of distribution among the creditors.[25] However, the bankruptcy court here was quick to suggest that any lender or creditor with "a lick of sense" should know that a tool-and-die company could be subject to a secret lien. Does that place too great a burden on ordinary trade creditors? Perhaps.

Fourth, it is vital for the party with the burden of proof to offer at least some evidence on key factual issues to survive summary judgment. In this case, the trustee had the ultimate burden of proof, yet he did not offer evidence to refute Mo-Tech's contention that its claim was fully secured. This evidentiary concession, which could have been appropriate, provided the court with an opportunity to resolve the issue on a purely legal basis.

Conclusion

"Secrets, secrets are no fun/secrets, secrets hurt someone." In this case, the court ruled that Mo-Tech did not receive any preferential transfers and should not be harmed by having a secret, unperfected lien. However, the trustee and unsecured creditors were harmed and could not benefit from avoidance and recovery of the transfers. Who will be harmed next by a secret lien? abi

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21 *Id.*
22 *Id.*
23 *See, e.g., 360Networks*, 327 B.R. 187.
24 *In re Arnett*, 731 F.2d 358, 363 (6th Cir. 1984) ("One of the principal purposes of the Bankruptcy Reform Act is to discourage the creation of 'secret liens' by invalidating all transfers occurring within 90 days prior to the filing of the petitions.").
25 *Begier v. IRS*, 496 U.S. 53, 54 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code that is furthered by § 547(b) to the extent that it permits a trustee to avoid pre-petition preferential transfers of 'property of the debtor.'").