

Taking Stock of Liens While There Is Still Time – Do You Really Have the Collateral?

Although trade creditors often find themselves lumped in with the mass of “general unsecured creditors” when a customer files for bankruptcy, some enjoy liens that have been contractually negotiated or statutorily granted, potentially elevating the priority of their claims above unsecured creditors. To gain that priority, though, the lien must be properly granted and perfected under applicable law. In most instances, these steps must occur before the customer files for bankruptcy and in a way that does not expose the lien to avoidance as a “preferential transfer.” Understanding your lien rights and taking steps from the outset to ensure that the lien is and remains valid, perfected, and unavoidable, can avert costly disappointments down the road.

Key Issues

- **Common Trade Creditor Liens.** Trade creditors sometimes hold collateral to secure their trade claims. Common collateral arrangements include consensual liens granted on specified assets, including purchase money security interests (PMSI); consignment arrangements; mechanics’ liens and shippers’ liens, among others.
- **Lien Must Be Valid, Perfected, and Unavoidable.** For a lien to receive treatment as a secured claim in bankruptcy, it must be valid, properly perfected, and unavoidable, and there must be value to the creditor’s interest in the collateral. Validity and perfection of the secured claim will be determined under state law.
 - With certain limited exceptions for liens that relate back in time to take priority over after arising liens (such as mechanics’ liens), validity and perfection will be assessed as of the date the bankruptcy case is filed.
 - If the acts necessary to perfect a lien have not been taken and kept up to date before the customer files for bankruptcy, the lien will not be treated as secured in bankruptcy.
 - Under the Uniform Commercial Code (UCC), liens on most types of personal property are perfected by filing a properly completed financing statement with the appropriate recording office, or by possession of the collateral. Common foot-faults include:
 - The financing statement may be improperly completed or filed in the wrong place, rendering it ineffective.

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- Financing statements will lapse after five years unless a continuation statement is timely filed.
 - Financing statements may need to be updated periodically to remain effective, including to reflect changes in the customer's address, place of incorporation, or name.
 - The UCC or other applicable law may require perfection by means other than filing a financing statement (e.g., by recording a properly completed and executed mortgage in the proper recording office for liens on real property and leasehold interests, or by obtaining a properly completed and executed deposit control agreement in the case of bank accounts). These steps must also be undertaken pre-bankruptcy to be effective.
 - Consignment arrangements and PMSIs contain their own special requirements for perfection¹. If not timely and properly perfected, they will not be enforceable in bankruptcy.
 - Subject to certain defenses, if the lien of a noninsider creditor is not properly perfected at the start of the 90th day before bankruptcy, and the creditor thereafter takes steps to remedy the perfection problem, the perfection of the lien may be avoidable in bankruptcy as a "preferential transfer." Similarly, if the documentation granting the lien is deficient, and that documentation is corrected within the 90-day preference period (e.g., by having a previously un-executed or defective security agreement, mortgage, or other governing document executed or corrected by the debtor), that corrective measure also may be avoided in bankruptcy as a preferential transfer.

Takeaway

It is critical that creditors who believe they have collateral carefully examine and confirm the documentation and perfection status of their secured claims. While this is best done at the outset of a credit relationship, ideally with a checklist suited to the particular credit and collateral relationship and a calendaring system for future actions, it also should be revisited as soon as the creditor learns that the customer may be experiencing financial distress. As always, experienced counsel can assist in understanding and proactively optimizing your secured position

¹ See Can I Enhance My Prospects for Payment Through a Purchase Money Security Interest? [tp_creditors-rights-toolkit_can-i-enhance-my-prospects.pdf](https://www.troutman.com/wp-content/uploads/2018/05/tp_creditors-rights-toolkit_can-i-enhance-my-prospects.pdf) (troutman.com)

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