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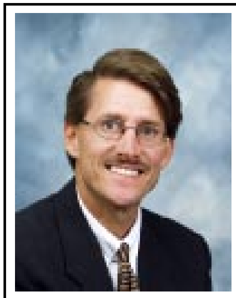
Developments in Commercial, Creditors' Rights, E-Commerce and Bankruptcy Law of Interest to the Credit and Financial Professional

BEATING THE SECURED CREDITOR: THE "AVOIDANCE" POWERS CAN BE VENDORS' BEST FRIEND



Scott Blakeley

A sophisticated credit executive is well aware of the risks of selling on open account to a debtor who has a lender holding a blanket lien on all of the debtor's assets, including the debtor's inventory. A credit executive may find that goods sold to a debtor on open account end up in the hands of the debtor's lender when the debtor defaults on its bank financing and the lender forecloses on the debtor's assets. The lender sells your goods to satisfy its secured claim. It seems equally true with bankruptcies that the secured creditor takes everything with the "crumbs of the business" left for unsecured vendors. What may a vendor do to protect its sales? Prior to a sale, for example, a vendor may negotiate with the debtor for a purchase money security interest in the goods it sells; the vendor may negotiate a consignment sale; the vendor may obtain collateral, such as an letter of credit or personal or corporate guarantee, to protect the sale.

However, are there any protections available for a vendor after an open account sale is made and the debtor files Chapter 11 bankruptcy with a preexisting inventory lender, or a creditor asserting a security interest in all of the debtor's assets? Often, the only steps a vendor may take is to file a proof of claim with the Bankruptcy Court and hope that the secured creditor with a blanket lien does not take all of the assets.

Vendors acting collectively, however, may have the opportunity to unseat a secured creditor's lien in a Chapter 11 bankruptcy. In two cases in which we serve as counsel to official creditors' committees in Chapter 11, we have "avoided" the liens of secured creditors, allowing assets to be freed up to pay unsecured creditors. What are the rules that allow unsecured creditors to act collectively and, in the right situation, unseat a secured creditor's lien?

Vendors Acting Collectively

Upon the filing of a Chapter 11 bankruptcy petition, payments to unsecured vendors are suspended and vendors are entitled to assert claims for the unpaid value of their goods and services against the debtor. All collection efforts by a vendor against the debtor must cease, or the vendor risks being hauled to bankruptcy court by the debtor for violating the automatic stay.

With the Chapter 11 filing, an unsecured vendor's individual efforts to collect on the delinquent account shifts to working collectively with other vendors, as a general rule, to collect on the prepetition obligations. There are three reasons for a vendor to shift its focus and work collectively with other vendors: (1) in a Chapter 11, vendors will receive "bankruptcy dollars" on account of their prepetition claims. This means vendors receive something less than one hundred cents on the dollar, generally significantly less, and individual efforts to maximize payment are not cost effect; (2) in a Chapter 11, an unsecured vendor cannot get a "leg up" on other vendors. Vendors holding unsecured claims, generally, are treated as a class under a plan of reorganization and receive the same treatment; (3) in a Chapter 11, a committee of unsecured creditors is appointed. The typical chapter 11 bankruptcy often has hundreds, even thousands, of unsecured vendors, many of whom hold claims of relatively modest amounts. A creditors' committee is intended to deal with the debtor in a more manageable fashion than the entire body of unsecured creditors could, permitting them to speak in one voice.

Duty to Investigate Secured Status

A creditors' committee's general powers and duties include investigating the debtor's liabilities. This requires a committee to review the security documents of the debtor's secured creditors to independently determine whether a creditor has taken the necessary steps to perfect its secured claim. The committee must undertake this investigation as there may be a conflict with the corporate debtor performing such analysis. If the debtor's principal has personal guaranteed the secured creditor's obligation (as is often the case with a lender), the principal wants the secured creditor paid out of the corporate

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WHAT IS ALL THE TALK ABOUT LIMITED LIABILITY COMPANIES?

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When considering selling a new account on terms, an experienced credit executive investigates the legal form of the enterprise requesting credit. Is the enterprise a corporation, partnership, joint venture or sole proprietorship? The form of enterprise is a factor in determining whether to extend credit. Over the last decade state legislatures have rushed to enact limited liability companies (LLCs) legislation for the purpose of attracting more business to their state. LLCs have become especially attractive as they combine two features of organizations: corporate form of limited liability to its "members", with the partnership form of pass through taxation. Does the form of an LLC create special credit risks for a credit executive? What is the authority of an LLC member to enter into binding agreements on its behalf? Is there recourse against an LLC member in the event of default?

A. Brief History Of LLCs

The first LLC legislation in the United States was enacted in 1977. However, it was not until the IRS ruled in 1988 that an LLC would be classified as a partnership for federal income tax purposes, has there been strong interest in LLCs. Over the last decade, all states have adopted LLC legislation.

B. Nature Of LLCs

1. Limited Liability of Members

Members, or owners, of an LLC have limited liability protection similar to shareholders of a corporation. However, it is possible to "pierce the corporate veil" of an LLC and hold a member personally liable for a LLC debt. As with corporations, it must be demonstrated that the LLC disregarded its LLC formalities to pierce the veil. Accordingly, a credit executive seeking personal liability for its debt should obtain a personal guarantee of the LLC's member or manager.

2. Binding the LLC

An LLC is controlled by managers, who in turn may appoint officers like a corporation. The LLC's articles of organization define whether it is (1) managed by members; or (2) managed by non-members, e.g., the owners of the LLC select managers to operate the business. With LLC's managed by members, the member may bind the LLC to ordinary course business transactions, whether or not the member has actual authority. With non-ordinary course transactions, the member must have actual authority. With LLC's managed by non-members, a member does not have actual authority to bind the LLC.

In determining whether to extend credit to an LLC, the credit executive should obtain the articles of organization and operating agreement of the LLC. The operating agreement is not a public document. These documents should identify the authority of parties to bind the LLC to agreements.

3. Tax Benefits

An LLC is taxed as a partnership. The LLC's income is subject to only one level of federal income tax. Only the LLC's members or owners are subject to federal income tax, not the business.

C. Some Distinctions Between LLCs, Corporations And Partnerships

An LLC is a separate legal entity, capable of suing and being sued. LLCs are not subject to the same formalities as corporations, such as the requirements for conducting meetings and electing directors and officers. Managers of an LLC can be removed in accordance with the terms of the operating agreement. By comparison, there are significant restrictions on the ability of shareholders of a corporation to remove its directors.

As noted, an important distinction between LLCs and general partnerships is that the partners of a general partnership are personally liable for the debts of the general partnership whereas the members of an LLC generally have limited liability. Both general partnerships and LLCs are managed by the partners or members (absent an agreement with a partnership). Partners acting in the ordinary course of business may bind the general partnership, a member of an LLC who is not acting as a manager cannot bind the LLC.

A general partner in a general partnership may dissolve the general partnership (absent an agreement), while a member of an LLC cannot. Limited partnerships must have at least one general partner who is liable for the debts of the partnership. LLCs have no such requirement.

Limited partners may jeopardize their limited liability status if they actively participate in the business of the limited partnership. However, all members of an LLC have limited liability, regardless of whether they actively participate in management of the LLC's business.

LLCs are formed by filing articles of organization with the secretary of state or other appropriate office. In comparison, general partnerships are formed by the agreement of the partners and are not subject to any filing requirements. An LLC must have an operating agreement (verbal or written), entered into by at least two persons, which governs the LLC.

D. LLCs In Bankruptcy

LLCs are eligible to file bankruptcy. Equally true, trade creditors of an LLC may file an involuntary petition, provided the established criteria for commencing a petition are met.

FROM THE PUBLISHER:

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If you have a hot topic affecting the credit and financial professional, e-mail this to Scott.

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debtor's assets not theirs. A committee may employ counsel to represents its interests, who are compensated by the bankruptcy estate. Committee counsel reviews whether a creditor's secured claim should be challenged.

The Avoidance Powers

Upon a bankruptcy filing, a number of rights and powers are created for the benefit of unsecured creditors. Those powers include the ability of a trustee, debtor in possession, or creditors' committee in appropriate circumstances, to avoid the fixing of a lien on a debtor's property. The avoidance powers may allow for unseating a lien not properly perfected prior to the commencement of the bankruptcy filing, as well as a lien that was properly perfected but recorded during the preference period.

As a general rule, outside of bankruptcy, an unperfected security interest is binding between a debtor and vendors. Thus, a secured creditor has priority over unsecured vendors even if the creditor has not strictly complied with the state (Article 9 of the Uniform Commercial Code, for example) or federal statutory scheme to perfect its claim. The lack of perfection creates a problem for the alleged secured creditor only when an intervening third party obtains a perfected security interest that trumps the unperfected interest. This means that upon the bankruptcy filing, a debtor, or a creditors' committee (in Chapter 11), may act as a hypothetical judgment lien creditor with the ability to unseat prior, unperfected liens. With the assignment of the avoidance powers by the debtor or trustee, a creditors' committee may use the "strong arm" powers to unseat the creditor's alleged lien.

A creditor's lien may also be avoided even if properly perfected but recorded during the preference period, in certain circumstances. The Bankruptcy Code's preference law, which is part of the avoidance powers, provides for the recapture of payments made to creditors within the 90 days prior to a debtor's bankruptcy filing. The preference law also provides for unseating a creditor's lien recorded during the preference period, if the recordation of the lien -- for example, filing of a UCC-1 with the appropriate filing office when the collateral is the debtor's personal property -- is untimely.

Secured Creditors' Mistakes Are Vendors' Gain

Below is a brief discussion of two recent examples of Chapter 11 creditors' committees (in which we serve as counsel to the committees) have used the avoidance powers to unseat liens of secured creditors to free up assets for unsecured creditors.

In One Case, Financing Statement "Super Generic" And Lien Avoidable

The debtor in this Chapter 11 case had supposedly granted the creditor a security interest in all assets. The secured creditor forced the debtor into bankruptcy when the debtor defaulted on the payment obligations. A committee of unsecured creditors was appointed. We reviewed the creditor's security documentation. We found several defects in the documentation. For example, the UCC-1 financing statement described the collateral as "[a]ll assets of debtor now owned or the proceeds of the sale of said assets." A creditor files a UCC-1 with the recording office (usually the secretary of state) to perfect its interest in a debtor's personal property collateral. The Uniform Commercial Code and reported cases generally require a UCC-1 to adequately describe the collateral. A description of collateral need not be detailed or exact, but it must reasonably identify what is described. Where the description of collateral is too general to reasonably identify the collateral, it may be deemed inadequate to perfect a security interest. Courts generally disfavor the super generic description of collateral contained in a UCC-1 as it does not adequately notify subsequent creditors of the extent of a creditor's lien.

The debtor agreed to assign the avoidance powers to the creditors' committee. We filed a lawsuit with the bankruptcy court against the secured creditor contending that the creditor did not have a validly perfected lien. We requested that the court unseat the lien as the creditors' committee, using the "strong arm" powers of the Bankruptcy Code, was a hypothetical judgment lien creditor that took precedence over the creditor's lien. The court granted our summary judgment motion, and the bankruptcy estate was rid of the liens.

In Another Case, Financing Statement Recorded Within Preference Period And Outside Safe Harbor Time Period, And Lien Avoidable

The debtor in this Chapter 11 case had granted a security interest in certain assets for the benefit of the lender. The creditors' committee reviewed the loan documents. The loan documents revealed that the debtor had signed a security agreement granting the security interest in certain assets, and signed a UCC-1 for the lender to perfect its interest in the collateral. The security agreement and UCC-1 were signed by the debtor prior to the preference period (90 days prior to a debtor's bankruptcy filing). The lender attempted to file the UCC-1 with the secretary of state, but the filing office rejected the initial filing. The lender was finally able to file its
UCC-1 with the secretary of state. However, the UCC-1 was recorded during the preference period.

The debtor's principal had personally guaranteed the lender's obligation. The principal controlled the debtor. Thus, the debtor expressed no interest in scrutinizing the loan documents for defects, as the lender would look to the principal for payment if its liens against the corporation were avoided. The debtor assigned the avoidance powers to the creditors' committee.

We filed a lawsuit with the bankruptcy court against the lender contending that the lien was avoidable as it was recorded during the preference period and outside the 20 day safe harbor recording provision which may serve as a preference defense for creditors. The court agreed, finding that the lien was not recorded "substantially contemporaneous" with the creation of the security agreement. The court granted our summary judgment motion, and the bankruptcy estate was rid of the lien.

Secured Creditors Make Mistakes, So Investigate

Too often with a bankrupt company, a secured creditor is the only creditor who receives payment on its claim. But a secured creditor may make mistakes in documenting its security documents. The Bankruptcy Code provides unsecured vendors a "second bite at the apple" to determine whether a secured creditor's documentation is in order. If not, vendors -- generally through the creditors' committee -- may be able to unseat the lien and free up assets to pay their claims.