When a Statutory Lien Becomes a Secret Lien

By Harold S. Berzow*, Esq.* and Michael S. Amato*, Esq.*

The Bankruptcy Court for the Eastern District of New York recently decided in In re R.F. Cunningham & Co., Inc., 355 B.R. 408 (Bankr. EDNY 2006), in the context of a motion to lift the stay, that a statutory lien under Ohio law was susceptible to being avoided as a secret lien under §544(a)(1) of the Bankruptcy Code. Champaign Landmark, an Ohio vendor, was owed approximately $150,000 for grain picked up by the New York debtor. Pursuant to the Ohio statute, Champaign claimed it had a statutory lien on the grain sold and its proceeds and asked permission to enforce the lien against the debtor's assets. The debtor and the creditors committee opposed the motion and offered several reasons as grounds to deny it, chief of which was that the Ohio lien was a secret lien.

The Ohio statute provided that, to the extent a seller of agricultural commodities was not paid, it had a lien on the proceeds and any other property or funds of the debtor wherever located. The debtor claimed that this was nothing more than a secret lien and thus avoidable under §544(a)(1) of the Bankruptcy Code. The creditors committee took the additional position that the Ohio statute could not be enforced against the debtor's property outside the state because the doctrine of extraterritoriality limits its reach.

The court first examined the Ohio statute and the standing of the Ohio creditor to enforce its application as distinguished from the Ohio Department of Agriculture and concluded that, under the facts in the case, Champaign had the requisite standing.

On the more substantive issue, the court concluded that the Ohio statute was too broad and thus was susceptible to being avoided under the strong-arm provisions of §544 of the Code. The bankruptcy court relied on In re Canney, 284 F.3d 362 (2d Cir 2002), for the general proposition that "...the purpose of the 'strong arm clause' is to cut off unperfected security interests, secret liens and undisclosed pre-petition claims against the debtor's property...."

The bankruptcy judge observed, “Simply put, creditors would have no idea whether monies that were given to them pre-petition, or monies held by the debtor at this time, were encumbered by reason of the wide reaching lien arising from [the Ohio statute].” Interestingly, the bankruptcy court came to its conclusion after distinguishing this case from In re Merchants Grain, 937 F.3d 1347 (7th Cir 1996), cert. denied, 519 US 1111 (1997), a case where the Seventh Circuit did not avoid the Ohio lien. The court in Merchants Grain was faced with whether Ohio farmers had been preferred when they received funds in accordance with the Ohio statute, and the issue was whether the statutory lien was voidable under §545 of the Code. The bankruptcy court in Cunningham had a different emphasis and was concerned that recognition of the statutory lien would disrupt the equitable distribution scheme envisioned by Congress in enactment of the Bankruptcy Code.

Alternatively, the court determined that even if the lien contained in the Ohio statute was not avoidable, the principles of extraterritoriality prohibit the enforcement of the lien beyond Ohio’s boundary. The Ohio statute in question was inoperative with respect to property outside the state, relying in part on Marshal v. New York, 254 US 380 (1920). The argument by Champaign that principles of comity should control to permit the Ohio statute’s application was unavailing, because the injury to the debtor and the interests of the creditors were paramount, and because of the disruption that would result to the congressional scheme laid out in the Bankruptcy Code.

Lastly, the court also accepted the debtor’s argument that New York law and not Ohio law controlled the transaction because the contract so provided and the Ohio law permitted the parties to select a choice of law in their agreement.

Harold S. Berzow, Esq. is a partner at Ruskin Moscou Faltischek, where he is a member of the firm's Financial Services, Banking & Bankruptcy Department and chair of the Business Reorganization Practice Group. He can be reached at (516) 663-6596 or hberzow@rmfpc.com.

Michael Amato, Esq. is Of Counsel to Ruskin Moscou Faltischek P.C., where he is a member of the firm's Financial Services, Banking & Bankruptcy Department and the Business Reorganization Practice Group. He can be reached at (516) 663-6517 or mamato@rmfpc.com.