

Priority of State Law Possessory Liens over Perfected Security Interests: *In re Borden*

Written by:

Joshua T. Klein

Fox Rothschild LLP; Philadelphia

jklein@foxrothschild.com

The Bankruptcy Code¹ recognizes three types of liens: judicial,² statutory³ and consensual.⁴ Recently, the Eighth Circuit Bankruptcy Appellate Panel (BAP) issued an opinion regarding priorities between a lender with a valid consensual blanket lien on a debtor's assets and a party asserting a state law statutory artisan's lien.



Joshua T. Klein

In *In re Borden*, 361 B.R. 489 (8th Cir. 2007), the main issue before the BAP was the priority dispute, but in order to determine the priorities among the parties it initially had to determine if a party's rights under a possessory lien are extinguished if the lienholder loses possession of the assets subject to the lien and then regains possession. This was an issue of first impression in the Eighth Circuit and in Nebraska. The decision is instructive because it discusses the priority of state law possessory liens over prior security interests perfected under Article 9 of the Uniform Commercial Code (UCC).

Interplay Between UCC Article 9 Security Interests and State Law Possessory Liens

UCC §9-333, entitled "Priority of Certain Liens Arising by Operation of Law," provides as follows:

(a) ["**Possessory lien.**"] In this section, "possessory lien" means an interest, other than a security interest or an agricultural lien:

(1) which secures payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of the person's business;

About the Author

Joshua Klein is an attorney with the law firm of Fox Rothschild LLP in its Financial Restructuring and Bankruptcy Department, where he represents corporate debtors and creditors in a variety of financial restructurings, bankruptcy proceedings and commercial workouts.

(2) which is created by statute or rule of law in favor of the person; and
(3) whose effectiveness depends on the person's possession of the goods.

(b) [**Priority of possessory lien.**]

A possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise.⁵

Lien on Me

Simply stated, a state law possessory lien may override an Article 9 security interest if it the requirements of §9-333.

Possessory liens arising under state law (statutory or common law) vary from state to state. However, several commonalities exist among most state law possessory liens. First, the property that is subject to the lien has to come into the lienholder's possession. Second, the lienholder is entitled to retain the property. Third, there typically is some enhancement in the value of the property subject to the lien. Common types of state law possessory liens include warehouseman liens, common carrier liens, artisan liens and mechanics' liens.⁶

The Decision: Background

On June 25, 2002, Michael Borden (debtor), a farmer, and his wife borrowed certain funds from Genoa National Bank (lender) and in return granted the lender a blanket security interest on all of their personal property, including machinery

and equipment then owned and thereafter acquired. The lender filed a UCC financing statement with the Nebraska Secretary of State on June 26, 2002, perfecting its blanket security interest.

In late 2004, the debtor took a tractor and another piece of farming equipment (collectively, the equipment) to Bellamy's Inc. (artisan) for repairs. The artisan completed the necessary repairs and ultimately billed the debtor \$5,092.80 for the work performed on the equipment. The debtor had insufficient funds to pay for the repairs, so the artisan refused to release the equipment and it remained in the artisan's possession under the Nebraska artisan lien statute.⁷

On April 1, 2005 (the petition date), the debtor and his wife filed a joint voluntary petition for relief under chapter 12 of the Code. As of the petition date, the equipment remained in the artisan's possession. However, in June 2005, the debtor entered the artisan's lot, took the

tractor without the artisan's permission, drove it to his farm and used it in connection with his farming operations. Obviously, the artisan noticed the missing tractor and contacted the debtor to see if he had taken it from the lot. The debtor admitted that he had taken the tractor because he needed it for his farming operations, but advised that he would return the tractor to the artisan as soon as he finished using it. Eventually, the tractor broke down again and was returned by the debtor to the artisan in the fall of 2005.

In September 2005, the debtor took the other piece of equipment from the artisan's lot without permission. Once again, the artisan contacted the debtor concerning the missing piece of equipment, and again, the debtor admitted taking the piece of equipment but claimed he would return it sometime in November 2005. In April 2006, the lender filed a motion to determine the priority of the respective liens asserted by the lender and the artisan in the equipment.

⁵ UCC §9-333 (former §9-310).

⁶ Used here, "mechanics' lien" means a lien for work performed on a vehicle or piece of equipment. This should not be confused with nonpossessory state law mechanics' liens that provide a contractor or sub-contractor with a lien that usually includes specific filing requirements in order to perfect and enforce the mechanics' lien.

⁷ Neb. Rev. Stat. §52-201 (providing for artisan's lien with priority over other prior perfected security interests in the same collateral).

¹ Title 11 of the U.S. Code, 11 U.S.C. §§101 *et seq.*

² 11 U.S.C. §101(36).

³ 11 U.S.C. §101(53).

⁴ 11 U.S.C. §101(51); *In re Schick*, 418 F.3d 321, 323 (3d Cir. 2005).

continued on page 70

Lien on Me: Priority of State Law Possessory Liens

from page 32

Bankruptcy Court Decision

The bankruptcy court determined that there was no controlling law in Nebraska governing the facts before it—competing liens where an artisan loses possession of the property through action of the property owner. The court looked to other jurisdictions for guidance and discovered that other courts faced with the issue had reached conflicting results. Ultimately, the bankruptcy court determined that the lender's security interest in the equipment had priority over the artisan's lien in the equipment. The bankruptcy court concluded that continuous possession is required to maintain an artisan's lien. The court reasoned that in the alternative, even if continuous possession were not required, the automatic stay under Code §362 prevented the artisan from regaining possession of the equipment post-petition. Accordingly, the artisan could not have had a possessory artisan's lien on the equipment. The artisan then filed a motion to reconsider. The bankruptcy court denied the motion. The artisan appealed to the BAP.

BAP Decision

The BAP first discussed artisan's liens and the applicable priority provisions of the Nebraska UCC. In Nebraska, any person who repairs vehicles, machinery or farm implement enjoys a lien on such equipment while in his or her possession until the owner pays the repair charges.⁸ Nebraska recognizes the priority of a possessory lien over other security interests if the provisions of §9-333 are fulfilled.⁹ The BAP determined that the artisan's lien statute met the requirements of §9-333 and that, consequently, an artisan's lien has priority over a previously perfected security interest in the same property.¹⁰

Therefore, the BAP was faced with the task of deciding whether the artisan had a valid artisan's lien under Nebraska law, because if so, it would have priority over the lender's liens under §9-333. In order to do so, the issue became whether the artisan had a valid possessory lien under the circumstances of the case (*i.e.*, where it involuntarily lost but later regained possession of the equipment

without court authority following the petition date). The issue was one of first impression under Nebraska law and in the Eighth Circuit.

The BAP began its analysis with a discussion of how other jurisdictions have addressed the circumstances where an artisan loses possession of the property and asserted a lien either: (1) without ever regaining possession or (2) after regaining possession. The principles the BAP culled from the decisions of other courts are summarized as follows:¹¹

1. Possession is generally required for a possessory lien.¹²
2. An artisan no longer has a possessory lien with priority over pre-existing security interests if the artisan surrenders possession of the property.¹³
3. Some courts have upheld an artisan lien after return of possession to the owner; however, such a lien does not have priority over pre-existing security interests.¹⁴
4. Other courts treat the lien as being in a state of suspended animation upon release of the goods, and the artisan cannot enforce the lien while it is in such state. If the artisan lawfully regains possession, the artisan can once again enforce a lien in the property.¹⁵
5. When an artisan loses possession involuntarily, the artisan does not necessarily lose the artisan's lien.¹⁶
6. A conditional release of the goods does not necessarily defeat an artisan's lien, usually with respect of holders of pre-existing security interests who are not impaired by the release.¹⁷
7. An artisan's lien lost when possession is lost is revived upon repossession of the property. In such a situation, the priority over pre-existing security interests is retained but it is subordinate to a *bona fide* purchaser.¹⁸

The BAP concluded that the artisan did not lose its artisan's lien on the

equipment when the debtor took the equipment without the knowledge or consent of the artisan. The BAP was not persuaded that the artisan's failure to proceed with any action to recover possession of the equipment could be after-the-fact consent by the artisan. Instead, the BAP concluded that, even if it was considered consent, it was conditional consent that provided for the return of the equipment to the artisan upon the debtor's completion of its use, and such conditional consent to a prior taking of the property did not defeat the artisan's lien.¹⁹

In support of its conclusion, the BAP next addressed several points concerning the policy underlying the creation and priority of security interests and of artisan's liens. First, the BAP noted that the purpose of perfecting a security interest is to put the world on notice of such security interest, which may occur in one of three ways: (1) registration with the appropriate government agency, (2) notation on certificate of title or (3) possession by the lienholder.²⁰ Artisan liens, such as the one at issue, are perfected by the artisan retaining possession of the property upon which it performed work, repairs or other services. A third party is on notice of the artisan's security interest in the property because the artisan retains possession; if the third party chooses to enter into a transaction concerning the property with the property owner, it does so at its own peril.²¹

In addition, the notice of lien permits holders of competing security interests in the same collateral to determine the priority among the parties with respect to their security interests.²² The general rule concerning recorded interests is that first in time has priority, but there are exceptions to that rule, such as is provided by UCC §9-333. For artisan's liens, the BAP looked to the purpose behind the priority given to possessory liens such as artisan's liens. First, the "[c]ourts and legislatures generally recognize that a party who provides labor and materials to property enhances the value of the property."²³ Thus, the

¹¹ *Id.* at 494.

¹² See, e.g., *Mack Fin. Corp. v. Pterbilt of Chattangooga Inc.* (In re Glenn), 20 B.R. 98, 99-100 (Bankr. E.D. Tenn. 1982).

¹³ See *Yellow Mfg. Acceptance Corp. v. Bristol*, 193 Or. 24, 236 P.2d 939, 946 (1951).

¹⁴ See, e.g., *Forrest Cate Ford Inc. v. Fryar*, 62 Tenn.App. 572, 465 S.W.2d 882, 883-84 (1970).

¹⁵ See *Godon v. Sullivan*, 188 F.2d 980, 981-82 (D.C. Cir. 1951).

¹⁶ See e.g., *Smith v. Cooper Chevrolet Inc.*, 404 So.2d 49, 51 (Ala. 1981).

¹⁷ *Id.*

¹⁸ See *M&I W. State Bank v. Wilson*, 172 Wis. 2d 357, 493 N.W.2d 387, 390 (1992).

¹⁹ *Id.*

²⁰ See *Borden*, 361 B.R. at 495.

²¹ *Id.*

²² *Id.*

⁸ See *Borden*, 361 B.R. at 493; Neb. Rev. Stat. §52-201.

⁹ See *Borden*, 361 B.R. at 493; Neb. Rev. Stat. UCC §9-333 (former §9-310).

¹⁰ See *Borden*, 361 B.R. at 493.

court reasoned, the party providing such an enhancement to property should be paid for such services, and if not paid, then it should retain the property until receipt of payment.²⁴ For this reason, the BAP determined that the Nebraska artisan lien statute provided for such an outcome and served the equitable purpose of assisting materialmen and laborers to obtain payment for their services that enhance the value of the property upon which they have performed such services.²⁵

The BAP highlighted the issue regarding the priority of artisan liens over prior perfected security interests provided by UCC §9-333. The court noted that repair or maintenance performed by an artisan is actually in the best interests of a prior secured lender because collateral is clearly worth less when in a state of disrepair. In other words, maintenance benefits the secured lender because it prevents a decline in the lender's collateral package. With regard to the specific facts in this case, the BAP found that the artisan's repairs to the equipment did in fact enhance the value of the equipment, with such enhancement increasing the value of the lender's collateral.²⁶ Therefore, "[r]ecognizing the superpriority of the artisan's lien over the lender's security interest is consistent with the policy underlying artisan lien law."²⁷

The final arguments put forth by the lender and relied upon by the bankruptcy court were then dismissed by the BAP. The first of these arguments was that continuous possession is strictly required to maintain a priority artisan's lien. The BAP determined that the cases relied on by the bankruptcy court did not involve the same set of facts concerning the unauthorized taking by the debtor.²⁸ Second, the BAP concluded that recognition of the artisan's lien and its priority over the lender's security interest did not give the artisan control over the priorities of the Code. In fact, the BAP found that by its decision, the bankruptcy court actually permitted the debtor to dictate the priorities between the artisan and the lender by "permitting the debtor's wrongful taking of the equipment to

determine the outcome of the priority dispute at trial level."²⁹

Finally, the BAP addressed the bankruptcy court's determination that the automatic stay provisions of Code §362 prevented the artisan from gaining possession of the equipment or from perfecting a lien after the petition date. The BAP agreed that while this was technically true, the analysis should not end with that conclusion. Rather, the BAP looked at the facts and the Code provisions concerning claims against a bankruptcy estate. Specifically, under Code §502(b) the petition date in a case controls the allowance of claims in bankruptcy.³⁰ Because the artisan had possession of the equipment as of the petition date, it had a claim secured by an artisan's lien in the debtor's bankruptcy case with priority over the lender's secured claim under Nebraska UCC §9-333.³¹

On the surface, it appears that the BAP has created a bright-line rule with respect to possessory liens where possession is lost without the consent of the lienholder, and is then regained.

Accordingly, the artisan's lien on the equipment has priority over the lender's security interest in the same equipment.³² Furthermore, the BAP thought that it was "fundamentally unfair to punish the artisan for a technical violation of the automatic stay which occurred as a result of the debtor's actions, not the artisan's actions."³³ The BAP noted that the debtor had a mechanism to attempt to obtain turnover of the equipment through Code §542, but that the debtor chose not use it and took the equipment without any authority.

The Dissent

One member of the BAP dissented. The dissenting justice stated that in the absence of any authority from the

Nebraska Supreme Court, the BAP must interpret the statute before it by giving it its plain and ordinary meaning.³⁴ The dissenting justice felt that the majority added to the Neb. Rev. Stat. §52-201 "a concept of continued perfection, notwithstanding loss of possession" that simply was not in the statute, and by doing so engaged in a legislative function.³⁵ Therefore, the dissenting judge's position was that the Nebraska statute "unequivocally provides for a first-priority possessory lien only until possession is lost."³⁶

Furthermore, the dissenting judge agreed that the result reached by the majority was fair, but it envisioned situations where the BAP's ruling could lead to unfairness for certain parties. For example a *bona fide* purchaser of equipment subject to an artisan's lien, but not in the lienholder's possession, would have no notice of the security interest in the equipment.³⁷ Under the majority's holding, the dissenting judge thought that this situation would result in a *bona fide* purchaser unknowingly buying equipment subject to the artisan's lien, which is also unfair. The dissenting justice believed that the balancing of issues such as these and their solutions is best left to the legislature.³⁸

Conclusion

On the surface, it appears that the BAP has created a bright-line rule with respect to possessory liens where possession is lost without the consent of the lienholder, and is then regained. However, throughout the decision, the fact that the debtor took the equipment from the artisan without authority to do so is a very strong theme and appears to be an underlying basis for the BAP's general holding and the defeat of most of the lender's arguments, including permitting a "technical" stay violation. Therefore the line created might not actually be as bright as it seems. Nevertheless, the decision provides a good discussion of the issues that arise in a priority disputes between Article 9 security interests and state law possessory liens. It will be interesting to see how courts in other circuits deal with the issues presented in *Borden* going forward and whether they create a bright-line approach, defer to the legislature or deal with the issue on a case-by-case basis. ■

²³ *Id.*

²⁴ *Id.* (citing *Gen. Motors Acceptance Corp. v. Colwell Diesel Serv. & Garage Inc.*, 302 A.2d at 596-97).

²⁵ See *Borden*, 361 B.R. at 495-6.

²⁶ *Id.* at 496.

²⁷ *Id.*

²⁸ *Id.* The bankruptcy court relied on *In re Glenn* for its support that loss of possession destroys the artisan lien. However, as the BAP pointed out, even the *Glenn* court "expressly acknowledged that wrongfully obtaining possession of the property subject to the lien dispute might change the result." *Id.*

²⁹ See *Borden*, 361 B.R. at 497.

³⁰ See *Borden*, 361 B.R. at 497; 11 U.S.C. §502(b).

³¹ *Id.*

³² *Id.*

³³ *Id.* This "fairness" point by the BAP also included mention of the benefit to the lender that flowed from the debtor's use of the equipment, which permitted crops to be harvested that produced funds to pay the lender's claim. *Id.*

³⁴ See *Borden*, 361 B.R. at 498; *Ferguson v. Union Pac. R.R.*, 258 Neb. 78, 601 N.W.2d 907 (1999).

³⁵ See *Borden*, 361 B.R. at 498.

³⁶ *Id.* at 499.

³⁷ *Id.*

³⁸ *Id.* at 498.