

DEBTOR/CREDITOR

October 2001

Stealth Lien Removal

Secured creditors must examine the contents of a Chapter 11 plan, or they may find their liens on collateral stripped off without their knowledge.

A federal appeals court in Richmond recently decided that a Chapter 11 plan must specifically preserve any lien on property of the debtor. If the plan is silent, the former collateral will continue as property of the reorganized debtor after confirmation of the Chapter 11 plan, free and clear of any lien.

In order to protect itself, a secured creditor should carefully review any Chapter 11 plan proposed by a borrower and object to confirmation unless the plan specifically states that the creditor's lien on the debtor's property continues post-confirmation.

Universal Suppliers, Inc. v. Regional Building Systems, Inc. (In re *Regional Building Systems, Inc.*), 254 F.3d 528 (4th Cir. 2001).

Faulty Escrow Exposes Funds

Most courts regard money held in escrow to be outside the bankruptcy estate. Thus, escrows can be a valuable tool to prevent funds from becoming tied up in a bankruptcy case should one of the parties fall into financial difficulties. However, if the escrow is not set up properly, it provides no protection.

This is illustrated by the decision of a Florida bankruptcy judge. Chicago Title created an "escrow" funded by a real estate developer to secure the developer's indemnification against title defects which might arise during construction, such as mechanics liens. After the developer filed a Chapter 11 petition, Chicago Title was required to disgorge the remaining funds to the bankruptcy estate despite the "escrow", because the funds were not held

by a neutral party. Rather, they were held by Chicago Title, which had a claim to them.

Twin Eagles Land Group I v. Chicago Title Insurance Co. (In re *Section 20 Land Group*), 261 B.R. 721 (Bankr. M.D. Fla. 2001).

Empty Reclamation Rights

Where a seller of goods on credit discovers that the purchaser is insolvent, the Uniform Commercial Code permits the seller to "reclaim" the goods by making a written demand within 10 days after the buyer receives the goods. Where the 10-day period expires after the commencement of a bankruptcy case, the federal bankruptcy statute gives the seller an additional 10 days to demand return of the goods.

Disagreeing with other courts, a Delaware bankruptcy judge determined that this reclamation right is junior to the rights of the buyer's secured lender, which has previously obtained a lien on all the buyer's property, including after-acquired property. The court opined that a seller's timely reclamation demand does not entitle the seller to either a return of the goods or to their value, if the goods were delivered before bankruptcy and became subject to the lender's prior security interest.

Allegiance Healthcare Corp. v. Primary Health Systems (In re Primary Health Systems), 258 B.R. 111 (Bankr. D. Del. 2001).

○ ○ ○

This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

Prepared by James C. Olson, Attorney and Counselor at Law