EXPECT THE UNEXPECTED:

SECRET LIENS ON MANUFACTURING COMPANIES AND THEIR ASSETS

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As the trade war between United States and China persists and competition abroad continues to grow, U.S.-based manufacturers have faced diminished profits and uncertain financial futures. In fact, Deloitte projects the U.S. manufacturing sector's GDP growth levels for 2019 trended downward, adjusting from 3.7% to 2.7% during the year, while its projections for 2020 anticipate an additional downward trend to 1.3%.

These financial challenges have placed additional importance on the priority of security interests in these companies and their assets. These priorities have implications for the manufacturing companies, their existing or future lenders or trade vendors, and potential purchasers.

From the time initial operations begin to the time their products are delivered to their ultimate purchasers, manufacturers become subject to lien claims, many of which are secret or unanticipated. That is, these liens—which may include unpaid wage claims, materialman's liens, and warehouse liens, among many others—often do not require a public notice filing, as is the case with a filing of a Uniform Commercial Code financing statement.

Because of the potential scope and impact of these nonpublic liens, they ultimately concern all types of professionals, including the manufacturer's financial and legal advisors as they relate to the company's future cash flows, creditors' advisors as they relate to priority of claims against the

company and other creditors, and the professionals for any potential purchasers of the company's assets that may be burdened by such liens. All of these professionals must therefore become familiar with these secret liens and each of their distinct characteristics to best support their clients as they weather the uncertain future within the manufacturing industry.

Materialman's or Mechanic's Liens

A manufacturer relies upon materials and outside labor to build and retrofit its physical building and operation. However, if the manufacturer fails to pay the for such goods or services, that supplier may file a lien for the labor or materials it provided so long as the supplier satisfies the requisite notice and filing requirements, if any, mandated under state law.[1]

For example, an equipment supplier or tradesman that installs, maintains, or fixes a piece of equipment to be used in the manufacturer's production of goods may receive a lien on that piece of equipment as security for the furnished piece. This lien arises as of the time that the materialman began providing its materials or services to the company manufacturer. A materialman's lien may receive priority over any other liens on the burdened property that have not yet been recorded. If the materialman remains unpaid, it may foreclose on and sell the property subject to the

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lien after receiving an order from the relevant court allowing it to do so.

Unpaid Wages

Manufacturers collectively employ roughly 12.9 million people across the U.S.,[2] and individual manufacturing companies often rely upon an extensive workforce. If a manufacturer fails to pay its employees, it can significantly and adversely affect its ability and that of any lender or buyer to sell the manufactured product. The failure to pay wages triggers a violation of the Fair Labor Standards Act (FLSA).[3] In such a situation, the U.S. Department of Labor may obtain a court order prohibiting that manufacturer from putting any of its goods manufactured under the substandard labor conditions (the "hot goods") into interstate commerce.[4]

The FLSA does not grant the affected employees or any other party any priority or liens in the hot goods. An existing secured lender with its interest secured by the hot goods may still foreclose on the goods in the event of a default by the company manufacturer under an underlying promissory note or loan agreement.

However, the FLSA does prohibit the secured party from selling those hot goods in interstate commerce. Only if the purchaser or creditor is a common carrier or relied in good faith on the producer's written assurance that it has met the FLSA minimum wage and overtime requirements, or the back wages are paid to the company's employees, will the prohibition be lifted, allowing a secured creditor or the manufacturer to sell the hot goods.

In addition to giving rise to hot goods, the failure to pay wages may also subject the manufacturer's officers to personal liability under the FLSA if the manufacturer's actions were willful.[5]

Warehouse Liens

Once a manufacturer ships its product, the goods will likely find their way into a warehouse or other storage facility on their way to their ultimate destination. Once the manufacturer's goods are in the actual possession of a warehouse, that facility may hold a lien on the goods under the law of the state where the warehouse is located.

The extent of the lien and the process for enforcing it may vary from state to state. As an example, under Minnesota law a warehouse lien arises when goods come into the possession of the warehouse and are covered by a warehouse receipt or storage agreement.[6] This lien protects the warehouse by securing any of its present or future charges for the storage, distribution, or safeguarding of the goods. This lien receives priority over any preexisting secured interests in the goods so long as the secured party gave the goods to the bailor with actual or apparent authority to ship, sell, or store them.

A warehouse loses its lien on any goods in its possession if it voluntarily delivers, or unjustifiably refuses to deliver, the goods and, depending on state law, may be unable to later perfect its previously held security interest.

Transportation Liens

Whether sending its goods to a warehouse for later distribution or shipping them directly to their final destination, a manufacturer will likely need to use the services of a carrier or transport service. To protect the carrier from nonpayment for its services and any expenses it accrues that are necessary for preservation of the goods during their transportation after it takes possession of them, the carrier typically receives a lien on any goods in its possession that are covered by a bill of lading or the proceeds thereof.[7]

The lien is generally effective against the consignor or any other person entitled to the goods—which may include priority over other parties with secured interests in the goods—unless the carrier knew that the consignor lacked the authority to burden the goods with the carrier's charges or expenses. A carrier loses its transportation lien on any goods that it voluntarily delivers or unjustifiably refuses to deliver.

Federal Tax Liens

At any point in the manufacturing process, a manufacturer may also face challenges with the federal government for not paying its taxes. In that case, the company may face federal tax liens on all of its property, including its goods or accounts receivable, as security for its unpaid tax debts. Such tax liens arise when a manufacturer fails to pay any federal taxes it is subject to after receiving a demand from the federal government for payment.[8]

Once the IRS files a notice of the lien in the correct office (which is determined by state law), the tax lien receives priority against certain competing lien interests in the company's property, including those of the purchasers of the burdened property. Such a lien will relate back to the date that the tax was originally assessed against the company and survives until the underlying tax debt is paid or it becomes unenforceable due to the passage of time. Additionally, the transfer of any of the burdened property does not affect the lien and instead will attach to whatever the company manufacturer substitutes it for.

Conclusion

While not a comprehensive list, the liens described in this article are examples of those that may secretly burden a manufacturer in distress. Becoming familiar with these liens, at a minimum, will provide turnaround professionals with the basic knowledge they need to effectively advise their clients—be it the company, its creditors, or potential purchasers of the manufacturer or its assets. J

[1] See, *e.g.,* Tex. Prop. Code Ann. Section 53.021, .055.

[2] bls.gov/iag/tgs/iag31-33.htm#workforce

[3] 29 U.S.C. Section 215(a)(1).

[4] dol.gov/whd/regs/compliance/whdfs80.pdf

[5] 29 U.S.C. Section 216(a).

[6] Minn. Stat. Section 336.7-209.

[7] U.C.C. Section 7-307.

[8] 26 U.S. Code Section 6321

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