

The Inchoate Lien Preference Defense: **SOMETHING TO “LIEN” ON**



GOODS AND SERVICE PROVIDERS IN CERTAIN INDUSTRIES HAVE ENFORCEABLE STATE LAW LIEN RIGHTS IF THEY SATISFY THE REQUIREMENTS FOR OBTAINING AND PERFECTING THOSE LIENS. FOR EXAMPLE, MANY STATES GRANT LIEN RIGHTS FOR SUPPLIERS THAT PROVIDE GOODS OR SERVICES IN CONNECTION WITH THE CONSTRUCTION OR IMPROVEMENT OF REAL PROPERTY. THESE LIEN RIGHTS GRANT THE CREDITOR COLLATERAL TO FORECLOSE ON IN THE EVENT OF A FINANCIALLY DISTRESSED CUSTOMER'S NONPAYMENT.

Creditors may also "lien on" their lien rights as a defense to preference liability in the event a customer files for bankruptcy protection. In addition to the various other defenses available in a creditor's preference-defense-toolkit (such as the subsequent new value, ordinary course of business and contemporaneous-exchange defenses), creditors with valid and perfectible lien rights and fully secured claims might also have a full defense to preference liability. These creditors may successfully rebut the greater-than-liquidation element of a preference claim, which requires proof that the alleged preference payment enabled the creditor to recover more than they would have recovered in a hypothetical Chapter 7 case.

Courts have coined this additional preference defense the "inchoate lien defense," which has been upheld by the majority of courts to have published an opinion on the applicability of the defense. In a huge win for trade creditors, a bankruptcy court in the Southern District of Texas (where many large commercial Chapter 11 cases are filed) recently joined this majority, with its decision in the Chapter 11 case of *In re Lilis Energy, Inc.*

THE ELEMENTS OF A PREFERENCE CLAIM AND THE INCHOATE LIEN DEFENSE

Section 547(b) of the Bankruptcy Code creates a statutory cause of action by a debtor, trustee or other estate fiduciary in a bankruptcy case to recover, as a "preference," certain transfers by a debtor to a creditor before the bankruptcy filing. The plaintiff must prove all of the following to avoid and recover a pre-petition transfer as a "preference:"

1. The debtor had transferred property of the debtor's estate (such as a debtor's payment from its bank account);
2. To or for the benefit of a creditor;
3. On account of an antecedent debt (such as credit extended to a debtor—so cash in advance payments are not preferences!);
4. On or within the 90 days before the bankruptcy filing (or within a year before the filing, if the transfer was to an "insider");

KEY POINTS

- ▶ **Certain industries, such as construction, allow goods and service providers to obtain enforceable lien rights under state law if they meet specific requirements, providing creditors with collateral in case of customer nonpayment.**
- ▶ **A creditor may "lien on" these rights as a defense against preference claims in bankruptcy, potentially preventing the recovery of payments made to the creditor within 90 days before the bankruptcy filing.**
- ▶ **A bankruptcy court in the Southern District of Texas recently joined the majority of courts that have upheld the "inchoate lien defense", where a creditor may rebut the "greater-than-liquidation" element of a preference claim if the creditor had valid and perfectible lien rights under state law when the creditor received the alleged preference payment and the lien was not avoidable under the Bankruptcy Code.**
- ▶ **While the court sided with ICT on the inchoate lien defense, issues remain regarding the timing of the lien's perfection and the value of the equipment involved—i.e., whether ICT would have been fully secured by the lien—which must be resolved at trial.**

5. While the debtor was insolvent (which is presumed during the 90-day preference period); and
6. The transfer enabled the creditor to recover more than the creditor otherwise would have received in a hypothetical Chapter 7 bankruptcy case (frequently referred to as the "greater-than-liquidation" requirement).

The greater-than-liquidation requirement under § 547(b)(5) of the Bankruptcy Code was at issue in the *Lilis Energy* case. A prepetition transfer to a fully-secured creditor cannot be recovered as a preference because the creditor would have been paid in full in a hypothetical Chapter 7 liquidation by recovering the assets subject to its lien. As such, preference defendants have successfully argued that the greater-than-liquidation element cannot be satisfied where they had state law lien rights that could have been perfected had the defendant not received the preference payment. This is frequently referred to as the "inchoate lien defense."

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THE PRIMARY QUESTION THE *LILIS* COURT ADDRESSED WAS **WHETHER ICT COULD HAVE PERFECTED ITS MINERAL LIEN WHEN ICT HAD RECEIVED THE ALLEGED PREFERENCE PAYMENT AND SUCH PERFECTION OF THE LIEN WOULD NOT HAVE BEEN AVOIDABLE UNDER THE BANKRUPTCY CODE.**

RELEVANT BACKGROUND REGARDING THE LILIS ENERGY DECISION: THE ALLEGED PREFERENCE CLAIM

Lilis Energy Solutions, LLC (the “Debtor”) and its affiliates—which were operators of a business engaged in oil and gas exploration, development and production in the Permian Basin—filed their Chapter 11 bankruptcy cases on June 28, 2020. Before the bankruptcy filing, ICT Energy Solutions, LLC (ICT) manufactured and delivered oil and gas production equipment to the Debtor pursuant to a master services agreement it had entered into with one of the debtor-affiliates. However, the Debtor initially refused to pay for the equipment, claiming it did not conform to the specifications required by the master services agreement. The parties ultimately entered into an agreement to resolve the dispute on April 15, 2020, which provided that the Debtor would pay \$165,622.63 to ICT in exchange for mutual releases. The Debtor made the payment to ICT on April 30, 2020—i.e., within the 90-day period before the Debtor’s bankruptcy filing.

On June 27, 2022, the trustee appointed under the Debtor’s Chapter 11 plan commenced an action to recover the \$165,622.63 payment as a preference under § 547.

After completing discovery, the parties filed competing motions for summary judgment. The trustee argued that there was no genuine issue of material fact that precluded a finding that the payment was an avoidable preference under § 547. On the other hand, ICT asserted the inchoate lien defense.¹ ICT argued the transfer could not be recovered as a preference because the trustee could not prove § 547(b)(5)’s greater-than-liquidation requirement because ICT was entitled to perfect a statutory mineral lien under Texas law when it had received the alleged preference payment.²

MINERAL LIEN RIGHTS UNDER TEXAS LAW

According to Texas Property Code § 56.002, “[a] mineral contractor or subcontractor has a lien to secure payment for labor or services related to mineral activities.” This lien is imposed on “the material, machinery and supplies furnished or hauled by the lien claimant.” Diving a little deeper into some relevant terms of the statute:

- Section 56.001(1) defines “mineral activities” as “digging, drilling, torpedoing, operating, completing, maintaining or repairing an oil, gas or water well, an oil or gas pipeline or a mine or quarry.”

- Section 56.001(2) defines a “mineral contractor” as “a person who performs labor or furnishes or hauls material, machinery or supplies used in mineral activities under an express or implied contract with a mineral property owner or with a trustee, agent or receiver of a mineral property owner.”
- Section 56.001(3) defines a “mineral property owner” as “an owner of land, an oil, gas or other mineral leasehold, an oil or gas pipeline, or an oil or gas pipeline right-of-way.”

The primary question the *Lilis* court addressed was whether ICT could have perfected a mineral lien when ICT had received the alleged preference payment and such perfection of the lien would not have been avoidable under the Bankruptcy Code. Perfection is governed by § 56.021(a) of the Texas Property Code, which deals with the perfection of a mineral lien. It requires that “[n]ot later than six months after the day the indebtedness accrues, a person claiming the lien must file an affidavit with the county clerk in the county in which the property is located.”

THE BANKRUPTCY COURT’S ANALYSIS AND RULING

The court denied the trustee’s summary judgment motion. The court held that the trustee cannot satisfy § 547(b)(5) and avoid the payment as a preference if ICT proves that it could have perfected a fully secured statutory mineral lien when it had received the payment and perfection of the lien would not have been avoidable under the Bankruptcy Code. The court acknowledged the division among the courts as to whether an inchoate lien right is sufficient to defeat a preference claim. However, the majority of courts have upheld the inchoate lien defense, and the *Lilis* court joined that majority, stating that if “the creditor could perfect the lien under state law at the time payment is made, and the perfection of the lien is not avoidable under the Bankruptcy Code, then the payments are not recoverable.” Quoting the United States Bankruptcy Court for the Southern District of New York (in its 2005 decision in *In re 360Networks (USA) Inc.*), the court stated:

The inchoate lien defense to § 547(b)(5) recognizes that, since the holder of inchoate lien cannot perfect its lien after being paid in full, a court’s refusal to protect such transfers from avoidance exposes the holder to “an unreasonable Hobson’s choice between accepting payment (with the attendant risk that it

could be avoided if the payor enters bankruptcy) or taking the commercially unreasonable step of declining payment in order to perfect an inchoate statutory lien.”

The court also held that ICT’s asserted mineral lien could not be avoided under the Bankruptcy Code. The Texas mineral lien statute provides a statutory lien that arises *automatically by operation of Texas law* to secure payment for the manufactured equipment. The statute further provides that this lien “takes priority over an earlier encumbrance on the land or leasehold on which the material, machinery, supplies, or improvement is placed or located.” In other words, the statute provides an automatic right to a first-priority lien, and there is no basis under the Bankruptcy Code for avoiding that lien if perfected.

The *Lilis* court concluded that the trustee could not satisfy § 547(b)(5)’s greater-than-liquidation requirement if ICT had valid mineral lien rights, could have perfected its inchoate lien when it had received the alleged preference payment, and the lien would not have been avoidable under the Bankruptcy Code. The court also noted that ICT’s release of its lien rights was conditioned on its receipt of the payment. ICT would not have released its lien rights and would have had the right to perfect its lien had ICT not received the payment.

While this is a big win for trade creditors, the case is not over for ICT, as the court also denied ICT’s motion for summary judgment based on some issues of fact as to whether ICT was entitled to Texas law’s statutory mineral lien rights. There was no meaningful dispute that ICT was a mineral contractor, the Debtor was a mineral property owner, and that the equipment was used in mineral activities. ICT also proved it had “furnished” (i.e., delivered) the equipment as required under the statute. However, the court held there remained two factual issues that must be determined at trial:

- (a) **Whether the asserted mineral lien was subject to perfection at the time of the transfer**—Texas law requires the lien to be perfected by filing an affidavit with the county clerk where the property is located within six months after the day the relevant indebtedness accrued—i.e., the date on which the material or services were last furnished. The court held there was an issue of fact as to when the last delivery date had occurred.
- (b) **Whether the value of the equipment subject to the lien equaled (or exceeded) the amount of the alleged preference claim**—In order to succeed on an inchoate lien defense, the value of the ICT’s collateral would have to equal or exceed the amount of the alleged preferential claim; otherwise, the transfer would have enabled the

ICT to receive more than it would have received if it had foreclosed on its lien in a hypothetical Chapter 7 liquidation. Here, the trustee argued the equipment that ICT had delivered to the Debtor was worth less than the \$165,622.63 payment because the equipment was defective. However, the court noted that neither side had presented sufficient evidence to prove (or in ICT’s case, rebut) that position. **BC**

1 ICT also asserted the contemporaneous-exchange-for-new-value and ordinary course of business (OCB) defenses under § 547(c)(1) and (2). However, the court ruled that ICT could not prove either defense. The court held the release of an inchoate lien right does not constitute the requisite “new value” to prove the contemporaneous exchange defense. Regarding the OCB defense, the court held that the alleged preference payment was not a “regular” payment but was instead a payment made pursuant to a settlement of potential litigation, and ICT did not present any evidence that the settlement payment was ordinary between the parties or in accordance with ordinary industry terms.

2 ICT had also argued it was entitled to an implied vendor’s lien under Texas law. However, the court rejected this argument because such liens only apply in the context of real property transfers.



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WHILE THIS IS A BIG WIN FOR TRADE CREDITORS, THE CASE IS NOT OVER FOR ICT, AS THE COURT ALSO DENIED ICT’S MOTION FOR SUMMARY JUDGMENT BASED ON SOME ISSUES OF FACT AS TO WHETHER ICT WAS ENTITLED TO TEXAS LAW’S STATUTORY MINERAL LIEN RIGHTS.