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Motor Carrier Hidden Liens: What Secured Lenders Need to Know

Secured lenders must prepare to conduct more due diligence than ever before when lending to motor carriers. As a result of the March 3, 2011 Sixth Circuit decision *In re: Arctic Express Inc.*, owner-operators (independent drivers) may have enforceable "hidden" liens on certain assets of motor carriers that would require restitution, not only from the motor carriers but from the motor carriers' secured lenders as well.

Arctic Express Inc. (Arctic) and its affiliated leasing company D&A Associates Ltd. (D&A) were sued in a class action filed by the Owner Operator Independent Drivers Association, Inc. (OOIDA). Each independent driver entered into two agreements with Arctic and D&A: an independent contractor agreement, and a lease agreement. Under these agreements, the independent drivers were entitled to compensation as a percentage of revenue generated from the associated transportation and were required to make equipment rental payments. Also, the agreements permitted Arctic to deduct a fee of nine cents per mile from the compensation paid to the independent drivers to be kept in a "maintenance escrow fund," for purposes of repair and maintenance to the leased equipment. If the fund balance exceeded maintenance expenses, the net was to be paid to the independent driver upon the expiration of the agreements.

The class action resulted in a $5.5 million settlement in favor of OOIDA, whereupon Arctic and D&A filed for bankruptcy in October 2003. Throughout the term of the agreements, however, Arctic had a secured lending relationship with Comerica Bank (Comerica). The relationship involved a revolving line of credit tied to a borrowing base. As is customary in asset-based lending arrangements, receipts from Arctic's customers were deposited into a cash collateral account controlled entirely by Comerica. Comerica swept such funds regularly to pay down the line of credit. When Arctic needed cash, it would draw on the line of credit and funds were deposited into its general operating account. Arctic compensated the independent drivers by writing checks on a controlled disbursement account that pulled the needed funds directly from the operating account.

OOIDA filed suit in January 2004 against Arctic and Comerica seeking restitution from each on the theory that the funds from Arctic's customers, which had been deposited into the cash collateral account and then used to pay down the line of credit, were encumbered by a statutory trust in favor of each independent driver under Truth-in-Leasing regulations. The district court held that the statutory trust attached only to the funds in Arctic's depository/operating account, not to funds in the cash collateral account. Thus, the district court granted summary judgment in favor of Comerica because, that court held, Arctic had not breached any fiduciary duty to the independent drivers by using the cash collateral account funds to pay down the line of credit.

The Sixth Circuit agreed in part. The court first examined statutory trusts under other acts, including PACA, the PSA, and the IRC, and then for guidance turned to cases where courts had held that statutory trusts exist "despite the absence of such express terminology." Comerica argued that Arctic had a debt to the independent drivers, but not a trust, so in turn Arctic had no duty to segregate funds. This did not sway the Sixth Circuit. Applying its reasoning to the Truth-In-Leasing regulations, the court held that the regulations "through their comprehensive delineation of responsibilities, impose strict fiduciary obligations on motor carriers, such that they place the motor carriers in a position of trust vis-à-vis [independent drivers] with regard to the handling of escrow funds." In short, a trust existed even absent any funds-segregation requirement.

Having determined that the necessary trust relationship existed, the Sixth Circuit turned to whether Arctic had breached such trust so as to afford OOIDA recovery from Comerica. After again analyzing PACA and common law trust principles, the Sixth Circuit disagreed with the district court. The court held that the independent drivers' "trust interest in the maintenance escrows attached when the customers' payment for services, Arctic's accounts receivable, were deposited into the cash collateral account … Comerica collected the nine cents per mile in maintenance escrows along with Arctic's receivables and, in sweeping Arctic's cash collateral account, used the maintenance escrows to repay amounts borrowed by Arctic under the loan agreements. Consequently, Arctic breached its trust obligations to plaintiffs by encumbering the escrow funds, and dissipating the trust assets, through its lending relationship with Comerica. Comerica must therefore disgorge the trust property received in breach of trust unless it can establish a viable defense."

Well, what does Arctic Express mean for secured lenders?

Secured lenders who extend credit to motor carriers should consider increasing the breadth and depth of their due diligence to analyze any potentially hidden liens and trust relationships that may encumber their proposed collateral. In addition, secured lenders who establish revolving line of credit relationships with motor carriers should consider requiring covenants that the motor carriers segregate the trust-encumbered portion of the funds. Secured lenders may also want to reserve from the borrowing base the amount of such "escrow fund" payables to the independent drivers. In light of *Arctic Express*, secured lenders should seek the advice of knowledgeable counsel to determine their best course of action in structuring credit extensions to the motor carrier industry. Additionally, this decision may have implications for motor carriers and their management.