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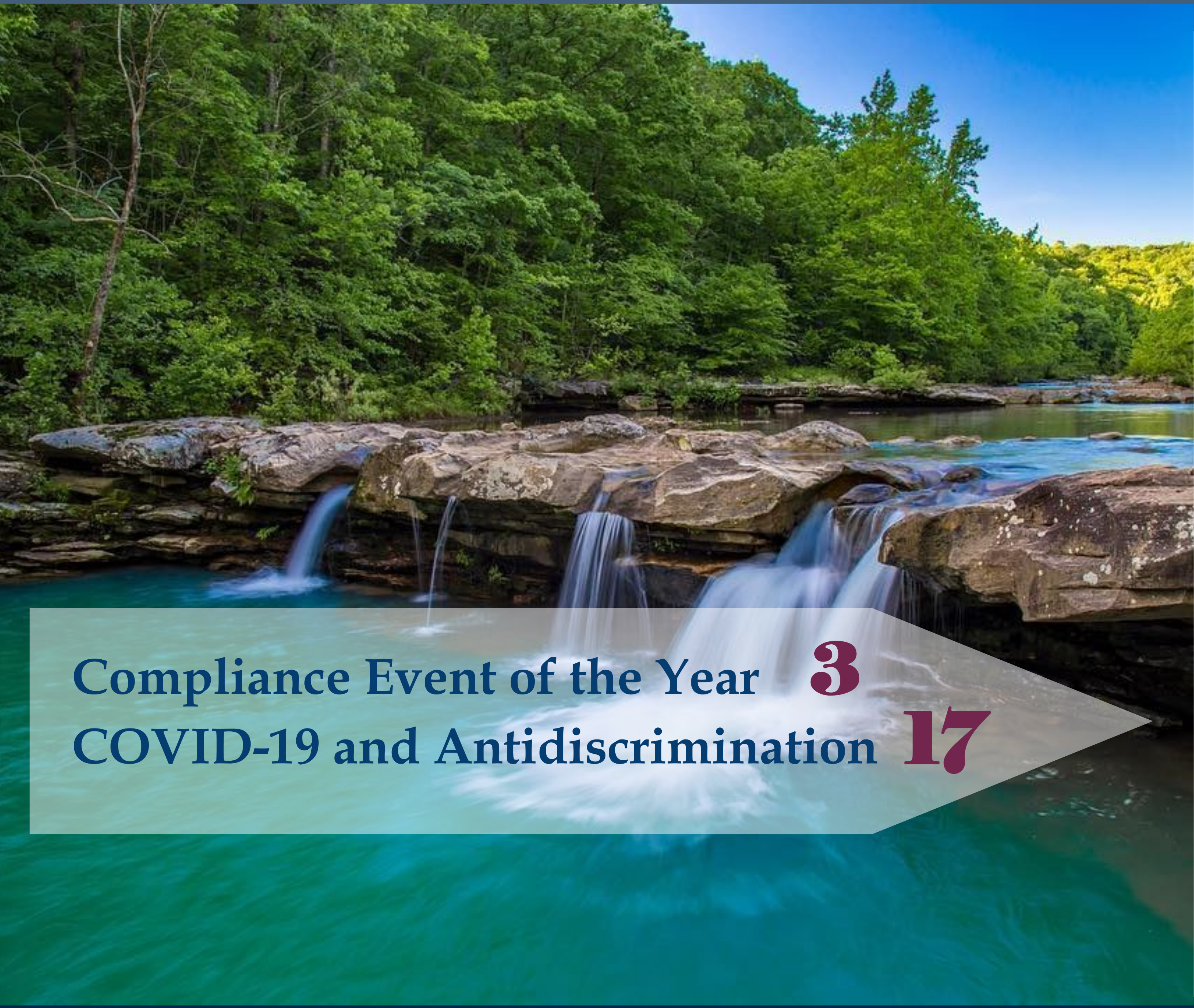

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Arkansas Supreme Court Pierces Corporate Veil

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New entities, same problems. The Arkansas Supreme Court pierces the corporate veil and rules 'first in time' still means 'first in right,' even with different corporate forms.

In a recent intercreditor dispute, the Arkansas Supreme Court ruled that the 'first in time, first in right' rule still stands even when a debtor establishes new entities to hold debt.[1]

The issue began when a Desha County row crop farmer ("Debtor") defaulted on his loan with Bank 1 for the 2014 growing season. The loan was held by three separate partnerships (collectively, the "Old Entities"), for whom Debtor was the key decision maker and controlled all operations, including financial decisions and signing on behalf of the other partners. Bank 1's loan, however, was only secured by the Old Entities' crops, and there were no personal guarantors. In light of the default, Bank 1 refused to finance the 2015 growing season, which led Debtor to seek financing with Bank 2.

As soon as Bank 2 began looking into Debtor, it became clear there were issues from previous growing seasons. Bank 2 admitted it found "a pile of UCC's from [Bank 1]" and additional liens related to the Old Entities. Bank 2 attempted to negotiate a subordination agreement with Bank 1. In the process of negotiations between Debtor, Bank 2, and Bank 1, Debtor repeatedly concealed information about other creditors and the financial condition of the Old Entities. In an attempt to convince Bank 1 to sign the subordination agreements, Bank 2 warned Bank 1 that Debtor would pursue using different entities to finance the 2015 growing season if Bank 1 did not agree to subordinate. Bank 1 still refused to sign the subordination agreements, and Debtor set up new partnerships for the 2015 growing season (collectively, the "New Entities"), for whom Debtor was the sole decision maker. Bank 2 perfected its lien against both the New Entities' 2015 crops and Debtor individually.

At the close of the 2015 season, Debtor again defaulted on his loans. A host of creditors, including Bank 1 and Bank 2, claimed security interest in the 2015 crop proceeds.

Bank 2 argued that it was first to perfect its security interest in the New Entities and Debtor individually, and thus it should have priority over Bank 1, who only had a security interest in the Old Entities' crops.

The Court, however, did not agree.

Electing to 'pierce the corporate veil,' the Court disregarded the corporate forms of both the Old and New Entities due to the fact that they were merely the alter egos of Debtor. The Court reasoned that a corporate form may be discarded when an entity attempts to "hinder, delay, or defraud creditors, evade a contract obligation, or perpetuate fraud and injustice generally." Debtor ultimately used the New Entities to get around his issues with Bank 1 and the Old Entities. Furthermore, Bank 2 was aware of the issues prior to entering into the loan agreement with the New Entities, and it was aware of Debtor's dishonesty regarding other creditors. The court characterized Bank 2's actions in attempting to get the Old Entity loans subordinated as "unbusinesslike and imprudent."

Bank 2 further argued that creditors who financed the 2015 growing season should have been given priority over those who did not. Again, the Court highlighted that Bank 2's actions in negotiations with Bank 1 and Debtor and its prior knowledge of the issues did not permit it to claim it was treated unfairly. Bank 1 may not have been involved in the 2015 loans, but both the Old Entities and the New Entities were merely alter egos of Debtor himself. Bank 1 thus had priority by perfecting its lien with Debtor in 2014.

One Justice disagreed with the majority and argued that Bank 1 should not have prevailed because its security interest was solely in crops produced by the Old Entities. The Justice reasoned that there was no evidence of any impropriety in the formation of the loan agreement between Bank 1 and Debtor, and thus no reason to disturb the terms of that agreement. Extending the security interest to crop proceeds of the New Entities, "undermines the confidence that a lending institution can have in the required recording of financial documents." The Justice alternatively reasoned that even if both the Old and New Entities were disregarded, Bank 2 was still first to perfect its interest in Debtor individually and should be granted priority regarding the 2015 crop proceeds.

This case highlights an important doctrine that courts can invoke to prevent abuse of corporate forms and injustice. The 'piercing of the corporate veil' could again be used by a court in response to corporate actions that attempt to (1) evade the payment of income taxes, (2) hinder, delay, and defraud creditors, (3) evade a contract or tort obligation, (4) evade the obligations of a federal or state statute, or (5) perpetrate fraud and injustice generally.[2] Prior to entering into a loan agreement with any entity, lenders should conduct adequate due diligence to ensure that a debtor is not engaging in such actions. As Bank 2 learned, failure to do so could put the lender's security interest at risk.

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[1] *AgriFund, LLC v. Regions Bank, 2020 Ark. 246 (2020).*
[2] *Anderson v. Stewart, 366 Ark. 203, 206–07, 234 S.W.3d 295, 298 (2006).*