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Legal Briefs from the Attorneys of
Mackall, Crouse & Moore, PLC

Creditors' Corner

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LENDERS SHOULD EXERCISE CAUTION WHEN IDENTIFYING DEBTORS BY A TRADE NAME OR D/B/A IN A UCC FILING

A lender that incorrectly identifies a debtor's trade name in its UCC filing risks a later finding that its security interest is unperfected, even if it uses the debtor's correct legal name in the same filing. The test is whether a junior creditor can locate the UCC filing in the Secretary of State's search engine using the debtor's correct legal name.

In *In re EDM Corporation*, 2009 WL 3677773 (Bankr. D. Neb., 2009), a lender filed a UCC statement in the Secretary of State's office identifying the debtor as "EDM Corporation d/b/a EDM Equipment." Although EDM Corporation was the company's legal name, EDM Equipment was not a registered trade name. Applying Article 9 of the UCC, the court found that that a UCC filing is "seriously misleading" and unenforceable if it incorrectly identifies the debtor, "unless a search under the debtor's correct name, using a filing office's standard search logic would reveal the financing statement." Here, a junior creditor searched under the name EDM Corporation but did not locate the senior lender's financing statement. Thus, the court subordinated the senior lender's security interest.

Practice Pointer: Although the court acknowledged that the lender "acted in a manner many would consider to be prudent [by including] debtor's true legal name as well as another name by which the debtor was apparently known," the court's holding requires a prudent secured lender using a trade name to identify the debtor in any way to double-check that its financing statement can be found on a Secretary of State's search engine by searching under the debtor's correct legal name.

MORTGAGE ENFORCEABLE AGAINST NON-SIGNING SPOUSE WHERE SPOUSE KNEW OF MORTGAGE AND DID NOT PROTEST FOR FOUR YEARS

In *Karnitz v. Wells Fargo Bank, NA*, (No. 08-2100), the Eighth Circuit Court of Appeals held that under Minnesota law a spouse who does not sign a mortgage granted against her joint homestead, but knew of the mortgage and did not protest against the mortgage for four years cannot later claim that the mortgage is void.

Minnesota Statute § 507.02 provides that “if the owner is married, no conveyance of the homestead... shall be valid without the signatures of both spouses.” Thus, mortgages against a homestead must be signed by both spouses. But there is a line of Minnesota cases holding that a lender can claim that a non-signing spouse is estopped and prevented from claiming a mortgage is void where: (1) the non-signing spouse consents to and has prior knowledge of the transaction; (2) the non-signing spouse retains the benefits of the transaction; and (3) the party seeking to invoke estoppel has sufficiently changed its position to invoke the equities of estoppel.

In this case, the non-signing spouse testified that she knew of the mortgage, approved of the mortgage, and retained the benefits of the mortgage until she and her spouse later defaulted on the mortgage. The court found that in this situation avoiding the mortgage would “flaunt” the purpose of the statute by turning it into a sword against the lender as opposed to a shield for the innocent borrower. Therefore, the court protected the lender.

Practice Pointer: It is always best to follow the strict requirements of a statute and immediately take steps to correct errors when they become known. As this was a federal court decision it is not binding precedent on Minnesota state courts, and therefore a Minnesota state court judge could rule differently when presented with these facts. At least one Justice on the court believed that Wells Fargo had not shown that it changed its position or acted in direct reliance of the wife’s silence after Wells Fargo advanced the funds. As a result that dissenting Justice would have avoided the mortgage because Wells Fargo did not demonstrate the detrimental reliance element of establishing estoppel.

TRANSFERS TO AN LLC QUALIFY AS INDIRECT GIFTS

An indirect gift includes a transfer of property for less than adequate consideration to a corporation, since it results in an indirect gift to each shareholder of the corporation to the extent of their proportionate shareholdings. Lenders need to be aware of the risks these transactions bear for their high net worth borrowers. Those risks include avoidance of the transfer by a bankruptcy trustee as well as substantial gift tax liability to the grantor.

The case of *Linton v. United States*, 2009 WL 1913255, (D. Wash., July 1, 2009) takes this analysis one step further and applies it to gifts made to a family partnership organized as an LLC. In *Linton*, the court found that the taxpayers made an indirect gift of real estate, cash and securities to their children’s trusts where the taxpayers contemporaneously transferred the property to the LLC and then gifted shares of the LLC to the trusts. The court went on to say that the “step transaction doctrine” also applied requiring the court to treat the series of single step transactions in transferring property to an LLC and then gifting the shares in the LLC as a single transaction.

Either way the court denied the taxpayers any tax advantage and burdened them with full gift tax liability.

Practice Pointer: If these assets are collateral for either a debt or guarantee in favor of a lender, their value is impacted. If an insolvency proceeding follows within 10 years, a bankruptcy trustee may also seek avoidance since the transfers were to insiders. The attorneys at MCM are familiar with both the tax aspects and insolvency aspects of these transactions and can audit transactions proposed or completed by borrowers.

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