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

Creditors' Corner

Tuesday, July 6, 2010
Volume 10, Number 6

EROSION OF SECURED CREDITORS' RIGHTS

In recent years, several bankruptcy courts have rendered decisions which could be considered an assault on the rights previously enjoyed by secured lenders. This article summarizes those decisions in order to sound the warning bell to our clients and friends. The bankruptcy reform that occurred in 2005 sought to strengthen creditors' rights, but the courts have since taken a different tack, creating rough waters for the secured lender. There are five court decisions which support this concern.

In the New York bankruptcy of *General Growth Properties, Inc.*, (Case No. 09-11977, Bankr. S.D.N.Y.), which involved hundreds of commercial real estate properties, the bankruptcy court permitted healthy single asset real estate entities to upstream excess cash flow (cash collateral) to the parent company so that this cash could be used to prop up the affiliates with a negative cash flow. The court refused to find that this action was in bad faith to the creditors of the healthy entities.

In the Florida bankruptcy of *TOUSA, Inc.*, (Case No. 08-10928, Bankr. S.D. Fla.), the court ordered the debtor's former lenders to disgorge \$420 million and further set aside upstream guaranties because the "savings clauses" in the loan documents were unenforceable. The purpose of the "savings clauses" was to protect against an argument that a payment on secured debt which rendered the payer insolvent was not a fraudulent conveyance. Even though the debt was owed under the loan documents the court required the secured lenders to disgorge.

In the Montana bankruptcy of *Yellowstone Mountain Club, LLC*, (Case No. 08-61570, Bankr. D. Mon.), the unsecured creditors' committee sued the secured lender for loaning the debtor too much money (debtor could not possibly have been able to repay the debt) so that the lender could earn fees. The court held that the lender's \$375 million debt should be equitably subordinated to the general unsecured creditors even though the lender did not exercise any control over the debtor.

In the Fifth Circuit case of *Pacific Lumber Co.*, (Case No. 08-40746), initially decided by a bankruptcy court in Texas, secured note holders were owed \$740 million. The court determined that only \$510 million of the claim was secured. The court confirmed a plan which paid the secured creditor \$510 million and provided that the \$230 million deficiency could be paid anywhere from zero on up, depending on the outcome of certain other litigation. The important thing to note is that the court refused to allow the secured note holders to credit bid and determined the value of the asset judicially rather than by a market auction process.

Finally, in the Third Circuit case of *Philadelphia Newspapers, LLC*, (Case No. 09-11204), the debtor proposed a plan under which insiders would serve as stalking-horse bidders to sell all of the debtor's assets at auction. A key provision of the plan was that secured lenders would not be allowed to credit bid their approximate \$300 million in debt. The stalking horse bid had a value of \$66.5 million. The court approved the procedure finding that secured creditors do not have an absolute right to credit bid when their collateral is being sold under a reorganization plan.

These decisions completely gut years of decisions, will have a severe impact on credit markets, and deny secured lenders control over their collateral. In our September 2010 issue of Creditors' Corner, the attorneys at MCM will set forth some steps that can be taken to reduce the impact that these decisions may have on our clients' transactions.

RECENT MINNESOTA CASE FURTHER FRUSTRATES LENDER'S RIGHTS AT FORECLOSURE SALE

A recent case in the Minnesota Court of Appeals held that a borrower has the right to a surplus from a sheriff's sale, even if the borrower owes additional debt to the lender. The decision also highlights some of the complexity in foreclosing a mortgage against multiple parcels and determining the proper amount to bid.

In the recent surplus case, *First Minnesota Bank v. Overby Development, Inc.*, (Case No. A09-1708), a lender began foreclosure on over 60 lots owned by its borrower, a residential developer. After negotiations, the borrower consented to the foreclosure of most of the lots, but not those where there were pending sales. In addition, the lender never included all of the lots in the foreclosure. The lender and the borrower agreed to a judgment amount for the foreclosure that was less than the remaining indebtedness. The intent of the parties was to foreclose a proportion of the indebtedness roughly equivalent to the value of the lots included in the action.

At the sale, the lender overbid the judgment amount by approximately \$275,000. The court's opinion does not explain why the lender bid this amount but suggested that the lender sought to drive up the redemption amount. The overbid created a surplus, which the borrower claimed. The lender argued that there could be no surplus because the borrower still remained indebted to the lender after the sale as to the other properties not foreclosed. The court rejected that argument and found that the creation of the surplus is viewed by looking only at the portion of the mortgage debt that is actually foreclosed at the specific sale.

Thus, the lender would have to pay the surplus over to the borrower. Because the lender almost certainly did not have a judgment in place at the time for the remaining indebtedness, the borrower would have received the funds and had comfort that they could not be immediately garnished by the lender.

The lender also argued that it had a security interest under its real estate mortgage in the surplus as "proceeds" of the real property, but the court likewise rejected this argument. The foreclosure sale extinguished that mortgage lien, as well as any lien against any proceeds arising from the real property. The court did not address whether a separate security agreement could have covered those proceeds, or whether reference to a cross-collateralization or separate default provision in the underlying loan agreements could have produced a separate outcome.

The attorneys at Mackall, Crouse & Moore, PLC, routinely handle foreclosures and are familiar with various pitfalls that arise in the bidding process where there are multiple properties, where property values arguably exceed the indebtedness, or where the property values are well-below the indebtedness and pursuit of a deficiency is worthwhile.

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