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

Creditors' Corner

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UNSECURED CREDITORS MAY CLAIM POST-BANKRUPTCY ATTORNEYS' FEES

The United States Court of Appeals for the Second Circuit has allowed an unsecured bank to recover post-bankruptcy attorneys' fees under state contract law in the case of *Ogle v. Fidelity and Deposit Co.* In this case Fidelity had entered into pre-bankruptcy agreements with the Debtor requiring the Debtor to indemnify Fidelity on certain bonds for any attorneys' fees required to enforce the bonds. The issue presented on appeal to the Second Circuit was whether under the bankruptcy code, an unsecured creditor can recover attorney fees incurred post-bankruptcy on a prepetition contract. Discussing the statutory provisions that do not allow post-bankruptcy attorneys' fees the court held that there was a valid contract as a matter of state substantive law and found that none of the prohibitions in the bankruptcy code applied. Thus an unsecured claim may be made for attorneys' fees accruing post-bankruptcy IF the Debtor has agreed prepetition, in an enforceable contract, to indemnify the creditor.

Practice Pointer: Creditors would be well advised to assert an unliquidated, contingent claim accruing post-bankruptcy against a Debtor who has indemnified the creditor by contract. MCM attorneys are able to assist creditors in the drafting and filing of these claims in order to preserve our clients' rights.

BANK POTENTIALLY LIABLE TO GENERAL CONTRACTOR FOR BREACH OF FIDUCIARY DUTY

In the case *Shearin Family Investments, LLC*, 418 BR 870 Bankruptcy Eastern District, North Carolina, EDNC, 2009, the Court found that a general contractor could maintain a claim against a bank for breach of fiduciary duty. The facts in this case were a typical construction project where lender entered into a contract with the owner to improve the land. The lender did not have a relationship with the general contractor. The project faced financial difficulties, but in several times the lender assured the general contractor that it would be paid after the general contractor had threatened to discontinue working. This went on for several months and the records showed there had been numerous communications directly from the lender to the general contractor whereby the lender assured that at some point the general

contractor would be paid. The general contractor relied on these promises and continued working. Eventually, the project failed and the lender did not pay the general contractor.

The general contractor was able to maintain a suit against the lender for breach of fiduciary duty, even though the lender did not have a direct contract with the general contractor. The Court found that the lender, with control of the funds, could have had superiority and influence over the general contractor in where there is a relationship of trust and confidence between the parties. The Court found that the repeated reassurances by the lender allowed the lender potentially to take advantage of his position of trust to hurt the general contractor. While the case did not formally determine there was a breach of fiduciary duty, it did state that the general contractor could maintain the action.

Practice Pointer: It is very rare to have breaches of fiduciary duties between two sophisticated commercial parties such as a lender and a general contractor. The same holds true as between banks and participation lending context, where the fiduciary duty concept frequently arises but fails. Nonetheless, the law surrounding fiduciary duties as between commercial parties has been liberalized to some extent over the years. In any event, fiduciary duty or not, lenders should always be cautious and reserved regarding which promises they make, particularly those promises that are repeated and where a person will incur significant costs in reliance upon them, such as a contractor on a construction project. Even if fiduciary duties are difficult to prove in commercial contexts, the fact that a claim may be alleged and sustained throughout a trial has potential significant impact on settlement negotiations between the parties.

COURT UPHOLDS MORTGAGE ON HOMESTEAD WHERE WIFE SIGNS A WAIVER IN THE HOMESTEAD

In another case decided by the Minnesota Court of Appeals involving irregularities on a mortgage encumbering a jointly-held homestead property, the Court of Appeals upheld the mortgage for the bank. In this case, the husband was the only party to sign the promissory note and the only obligor. Husband also signed the mortgage. Curiously, the bank also required the wife to sign the mortgage as a “non-borrower.” Further, after signing as a non-borrower, the mortgage had additional language stating that the wife was “signing solely for the purpose of waiving any and all homestead rights.” The Trial Court initially determined that the wife had not consented to a conveyance of the homestead through this act, and that under Minn. Stat. § 507.02, the conveyance was invalid because the mortgage was without the signatures of both spouses.

The Court of Appeals reversed this decision and determined that in fact the wife had signed the mortgage and that it was permissible under Minnesota law to waive homestead rights. The Court found that the purpose of Minn. Stat. § 507.02 is to ensure a “secure homestead for families” by “protecting the alienation of the homestead without the willing signature of both spouses.” Here since the wife signed the mortgage, and affirmatively waived her rights, the purpose of the Statute is preserved. Further, the Court found that the wife waived her rights by participating in the mortgage application process, attending the closing, and benefitting from the mortgage without complaining about the mortgage until it went into default.

Practice Pointer: Simply requiring a spouse to sign the mortgage does not necessarily make the spouse liable for the debt. The issue, and a significant chunk of litigation, could have been avoided simply by requiring the wife to sign the mortgage.

BANKRUPTCY COURT SETS ASIDE LENDER’S CREDIT BID SET ASIDE AS AN AVOIDABLE PREFERENCE

A recent decision out of the United States Bankruptcy Court for the Southern District of Texas, determined that a lender who credit bid its lien at a state foreclosure sale could be subject to attack in a subsequent bankruptcy proceeding under the voidable preference provisions of the Bankruptcy Code. In *In Re Villarreal*, 413 B.R. 633, a creditor had a third lien position against an insolvent party’s real property. The creditor scheduled a foreclosure sale under state law and the sale was regularly conducted. The creditor’s claim was only for \$70,000 and creditor obtained property through a credit bid in that amount.

Subsequently, the debtor filed for bankruptcy protection. In the bankruptcy, debtor commenced an action to set aside the prior foreclosure sale as a voidable preference. The evidence showed the property was, in fact, worth approximately \$4,000,000, and there was only approximately \$750,000 of debt ahead of the third lien position. The creditor, therefore, received a benefit of approximately \$3,200,000. The creditor argued that the transfer was not avoidable as a preference because the foreclosure sale was regularly conducted. This may be a defense as against a fraudulent transfer claim, as has been recognized previously by the United States Supreme Court. Under a fraudulent transfer analysis, the creditor must show that at the time of the exchange, the debtor received reasonably equivalent value. So long as the sale is regularly conducted, the overwhelming presumption is that there existed no manner for which the debtor to receive more value than what was bid at the sale.

The analysis changes under an avoidable preference claim. In that case, the credit bid is compared to the amount the creditor would receive *at a later time* from Chapter 7 bankruptcy liquidation. Thus, the court found that in liquidation, a trustee would have likely marketed the property and recovered a far greater price for the property. In liquidation under Chapter 7, the creditor still would have only received \$70,000, plus attorneys' fees and interest, as opposed to receiving value of the property of \$3,000,000. Thus, the transfer at the foreclosure sale via the credit bid was far superior for the creditor than what it would have received in Chapter 7 liquidation and the sale could be set aside in the bankruptcy.

Practice Pointer. This is a relatively new theory for attacking a foreclosure sale where a lender may be receiving a windfall through a credit bid. Certainly, with the amount of consumer and commercial foreclosures currently pending, this is an issue where lenders that could previously feel comforted that following procedures prevented a fraudulent transfer claim, now have unpredictability in terms of what a bankruptcy court may later do in a preference analysis. The *In Re Villarreal* case is a new case and it is unclear whether its analysis will gain support in other bankruptcy districts, including Minnesota.

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