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LEGAL BRIEFS FROM THE ATTORNEYS OF MACKALL, CROUNSE & MOORE, PLC

Creditors' Corner

Preferential Mortgage Not Cured by Refinancing; Judgment Entered Against Lenders for Amount of Mortgage.

In re Schwartz, __ B.R. __, 2008 WL 613113 (8th Cir. BAP (Minn.)).

Lenders recording a preferential mortgage cannot defeat a preference action when the debtor refinances the mortgage with a new lender after filing bankruptcy. To remedy the preference, the court may enter judgment against lenders in the amount of the mortgage. In *Swartz*, the debtor granted mortgages to two lenders on certain real property on January 14, 2005. Both mortgages designated MERS as a nominee, but MERS did not record the mortgages until February 24, 2005. On May 3, 2005 the debtor filed Chapter 7 Bankruptcy. In January 2006, the debtor refinanced the property with another lender to satisfy the two mortgages.

By recording the mortgages within 90 days of the debtor's bankruptcy, the lenders received a preference. The refinancing did not cure the preferences because: (1) the refinance did not restore any rights to the estate in the property because it remained subject to an encumbrance; and (2) the lenders, by receiving the subsequent payoff upon refinance, received more than they would as unsecured creditors. The court stated that "avoidance is necessary to prevent the lenders from receiving a windfall while other similarly situated creditors receive nothing."

While the bankruptcy code recognizes certain defenses to preferences, such as new value for the debtor or a contemporaneous exchange of property, the code does not recognize a post-petition refinance to release the preferential lien.

The code authorizes entry of judgment against the lenders if undoing the preference would not restore the preferred value to the bankruptcy estate. Here, undoing the original preference had no effect because the property remained subject to the refinanced mortgage. Therefore, the court entered judgment against the lenders for \$230,000, the approximate amount of the original mortgages. The lenders argued that the trustee should instead seek recourse from the lender who refinanced the loans, but the court found that the trustee is not required to sue the post-petition lenders in this situation.

Lending to Contractors and Independent Contractors

Effective **July 1, 2008** persons performing work in the Minnesota commercial or residential construction improvement industry will be considered employees of the company they are working for unless they obtain an independent contractor exemption from the Minnesota Department of Labor and Industry.

Without the exemption certificate these persons will be employees, covered by the company's workmen's compensation and subject to wage and OSHA regulations. This may or may not be a loan underwriting consideration but it would seem prudent for a bank lending policy to require some inquiry of the construction industry borrower on these matters since failure to obtain the exemption may impact cash flow projections.

Inter-creditor Agreements and Bankruptcy

There is tension in negotiation of the inter-creditor agreement over permitting the lead or senior lender to have authority in insolvency situations. Many times the inter-creditor agreement may designate the senior lender the attorney-in-fact for the junior lenders. This involves granting authority to file proofs of claim, make decisions on use of cash collateral and other credit decisions. From the perspective of the senior lender control is essential, particularly since the senior lender may be the only party willing to provide financing to the debtor-in-possession. A junior lender may be willing to give up control on some of these issues, but the decision should always be based upon the funding ratios. To protect its collateral, a junior lender should not allow the insolvency financing to further subordinate its position. Giving up the right to vote independently on any plan of reorganization should also be a negotiated item in the inter-creditor agreement.

Bankruptcy can alter the rights of creditors. If there are liens on depository accounts the junior lenders may wish to require inter-creditor control to prevent an immediate set-off by the senior lender. In addition, replacing current cash access with debtor-in-possession financing that provides for priority over junior lenders can dilute junior lender positions.



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