

FACING THE ISSUES®

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

Creditors' Corner

Wednesday, February 2, 2011
Volume 11, Number 2

CREDIT BIDDING IN BANKRUPTCY SALES

In these times, secured lenders are intensely concerned about the value obtained from the liquidation of their collateral. This is particularly true when the proceeds derive from sales occurring in a bankruptcy proceeding. A secured creditor is allowed to make a "credit bid" in bankruptcy sales whether in a Chapter 11 or Chapter 7 proceeding. The lender can bid all or some of its debt for the property being sold. The general rule has been "your first loss is your best loss" but these days some lenders are willing to credit bid an amount of their debt that is higher than actual market value of the asset. This issue can become a tricky one if the loan is a participation loan. Many participation agreements require voting or agreement on collection action. While the bankruptcy court will not interject itself into the propriety of the bid of the lead bank, there may be other court proceedings. If the participation or intercreditor agreement raises doubt of the lead bank's rights a participant may seek to disallow a credit bid. This leads to uncertainty in the sales process.

Practice Pointer: Participation and intercreditor agreements should provide for resolution of credit bidding issues. The lender can then decide the business issues supporting the amount of a credit bid. MCM attorneys are familiar with the drafting and enforcement of intercreditor and participation agreements and can help the lender navigate these issues.

COURT HOLDS THAT SALE OF ACCOUNTS IS A PREFERENTIAL DISGUISED LOAN

In *Lange v. Inova Capital Funding, LLC*, (8th Cir. BAP, 2011), the court ruled that an agreement for the sale of receivables was in fact a financing arrangement, and that perfection of a security interest in the seller's receivable pool to secure charge backs occurred within the preference period. Inova Capital Funding purchased accounts from the debtor Qualia Clinical Services, Inc. on an ongoing basis and at a

discount under a contract referred to as an “invoice purchase agreement.” The contract also pledged Qualia’s accounts, inventory, instruments, records and general intangibles to Inova as collateral to protect Inova from any chargeback of disputed or unpaid invoices. Inova sought to perfect this security interest by initially filing a UCC financing statement in Nebraska, Qualia’s principal place of business. But Qualia was a Nevada Corporation, so two years after its initial filing, Inova filed a new UCC financing statement in Nevada. Qualia filed for bankruptcy within 90 days after the Nevada UCC filing.

The trustee challenged the Nevada filing as preferential and argued that Inova did not have a secured claim against Qualia’s remaining accounts to be liquidated in the bankruptcy. The court agreed. The court first found that the invoice purchase agreement was a disguised loan rather than a true sale. The pivotal fact was that the agreement contained a full recourse provision which required Qualia to repurchase, with very limited exception, any non-performing account. The court found that where the agreement “completely shifts the risk of uncollectibility of the account” to the seller, it is a loan, not a sale. Second, the court found that Inova must perfect the UCC filing in the state of incorporation, and that its Nevada filing was clearly within the preference period.

Practice Pointer: Inova failed to take proper steps to fully protect its arrangement from a preference attack. While many parties in Inova’s position would prefer a full recourse arrangement and forego extra protections to assure that it is treated as a true sale, there would be no excuse for the improper UCC filing. This publication has frequently commented on the nuances in UCC filings against multi-state companies and those companies that change names. The attorneys at MCM are available to provide advice on such matters when they arise.

FARMER’S DEBT NON-DISCHARGEABLE WHERE HE PROVIDED FALSE ASSET AND LIABILITY ESTIMATES AND FED THE COOPERATIVE’S COLLATERAL TO HIS HERD

In *Southeast Nebraska Cooperative Corporation v. Schnuelle*, (8th Cir. BAP 2011), the court ruled that a farmer’s debt to his cooperative was non-dischargeable due to his actual fraud and submission of a materially false financial statement. The cooperative financed the Debtor’s 2004 and 2005 corn crop in exchange for a first- and second-lien position on the crop. Each year the cooperative required the debtor to submit a balance sheet, collateral sheet, and an affidavit disclosing any other collection actions against him. The court found that in 2004 and 2005, the balance sheets had overstated the amount of the

debtor's crop insurance by 25%. In early 2005, the debtor also submitted the affidavit, which omitted several pending lawsuits and judgments that had been obtained against him. The debtor also failed to inform the cooperative that he had fed large portions of his 2004 and 2005 corn crop to his cattle herd. Not aware of the feeding or other inaccuracies on the financial statements or affidavit, the cooperative renewed the credit in 2005 and advanced additional funds.

In debtor's bankruptcy, the cooperative successfully defeated his discharge for the debts incurred. Although the debtor asserted that he did not intend to provide false statements and claimed he was "in a hurry" each time he submitted the statements, the court found that he acted with reckless indifference, which would be enough to show he acted with intent to defraud the cooperative. The debtor argued that the cooperative could not have reasonably relied on the written statements and needed to conduct more due diligence, but the court found that the financial statements and affidavit did not show any suspicious "red flags" that would have required the cooperative to conduct a further investigation.

The court also based its ruling on the debtor's feeding of the cooperative's collateral to his cattle herd. The court found that the debtor had a duty to disclose this use of the collateral to the cooperative before seeking advance of new funds, and that a material omission can constitute actual fraud. The debtor argued that the cooperative knew that the debtor had cattle and that he would need to feed the cattle. The debtor also argued that the cooperative failed to conduct any inspections of the corn crop, indicating that the status of the collateral must not have been important to the cooperative when it refinanced the credit. Again, the court ruled that absent any suspicious red-flags, the cooperative did not have a duty to inspect or inquire.

Practice Pointer: This decision represents another brick in the ever-solidifying wall of the court's ability to deny discharges based on dishonesty. The past few years have seen a number of decisions that have made it easier for lenders to preserve their credits in bankruptcy, where there is evidence of a dishonest debtor. While there still are many impediments to challenging a discharge, and each case is different, the recent trend of decisions has made lenders' decisions to challenge discharges more predictable. The attorneys at MCM have been successful in recent years in challenging discharges based on these grounds.

If you have any questions, please call one of the attorneys in our MCM Creditors' Remedies group:

Timothy D. Moratzka
(612) 305-1456
tdm@mcmlaw.com

Stacy A. Woods
(612) 305-1409
saw@mcmlaw.com

Andrew P. Moratzka
(612) 305-1418
apm@mcmlaw.com

Allen E. Christy, Jr.
(612) 305-1490
aec@mcmlaw.com

Patrick C. Summers
(612) 305-1473
pcs@mcmlaw.com

Matthew A. Anderson
(612) 305-1401
maa@mcmlaw.com

Mychal A. Bruggeman
(612) 305-1478
mab@mcmlaw.com

“MCM has prepared these materials for informational purposes only and not as legal advice or **recommendations for specific situations**. Receipt of this information does not create an attorney-client relationship. You should not act upon this information without seeking professional counsel **for specific legal guidance.**” If you do not wish to receive future newsletters from Mackall, Crouse & Moore, please email mcmlaw@mcmlaw.com with the subject of “Unsubscribe.”

IMPORTANT NOTICE: Any tax information contained in this email or its attachments is not intended, and cannot be used by the taxpayer or any other person, to avoid any civil or criminal tax penalties which the Internal Revenue Service or another governmental agency may impose on the taxpayer or any other person for acting in reliance upon information contained in this email or its attachments.



1400 AT&T Tower · 901 Marquette Avenue · Minneapolis, MN 55402

Telephone: 612.305.1400 · Fax: 612.305.1414

E-mail: mcmlaw@mcmlaw.com · Web: www.mcmlaw.com