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Mackall, Crouse & Moore, PLC

Creditors' Corner

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SEEKING A LIFT OF THE AUTOMATIC STAY ON A MULTI-COLLATERAL CREDIT

A number of commercial credits may involve multiple items of real and personal property collateral. When the borrower (and possibly affiliated entities and individuals) files Chapter 11 bankruptcy, the lender may want to seek relief from stay to commence or continue foreclosure against certain assets. There are a number of grounds for relief from stay given a variety of scenarios but the two general grounds are: (1) for cause, which generally means that the creditor does not have an equity cushion in its assets and the assets are depreciating; or (2) where the debtor lacks equity in the asset the creditor seeks to lift the stay against and that asset is not necessary for the debtor's reorganization.

A recent Massachusetts bankruptcy decision, *In re SW Boston Hotel Venture*, 2011 WL 309060 (Bank. Mass., Jan. 28., 2011), provides a good outline of a creditor's basic lift stay remedies early-on in a complex Chapter 11 case. In *SW Boston Hotel Venture*, the debtors operated a property containing a W Hotel, condominiums, restaurants, retail centers and spas (collectively, the "Hotel Properties").

Prudential Insurance Company of America became the primary lender for the operation, and had first-position mortgages and security interests against the Hotel Property. In addition to the main development, the debtors and certain guarantors also pledged a number of other personal and commercial parcels of real property to secure Prudential's loans. The court found that the appraised value of the Hotel Property was less than the debt owed to Prudential, but that the sum of the appraised values of all collateral pledged by the borrower and guarantors exceeded the debt owed by Prudential. The debtor had not filed a plan, but had the overwhelming support of its creditors (except Prudential) for a reorganization and was making good faith progress towards a plan that would service secured lenders, cover administrative expenses, and make some payments to unsecured creditors.

Under these basic facts, the court denied relief from stay with respect to Hotel Property. When assessing the “for cause” prong, the court found that by including all of the debtors’ assets Prudential had a clear equity cushion for its loan, and therefore it was adequately protected for the debtors’ use of those assets in bankruptcy. But with respect to the second prong, the court ruled that the debtors did not have equity in the Hotel Property subject to the motion, and could not count unrelated properties in the equity equation. Nonetheless, the court found that the Hotel Property remained vital to the debtor’s reorganization efforts and that the debtor was making progress towards reorganization.

Practice Pointer: A motion for relief from stay is one remedy a secured creditor may employ early-on in a bankruptcy. While the court views a variety of factors, the most important will be the tangible evidence the debtor can provide that shows it will likely reorganize and emerge from bankruptcy. Senior secured lenders who have had long-standing relationships with the borrowers are generally in a strong position to assess the debtor’s long-term survival, but where there is a strong collateral cushion, the court may favor an honest debtor’s opinion earlier in the case. The attorneys at Mackall, Crouse & Moore, PLC routinely represent secured lenders in Chapter 11 bankruptcies, and have employed lift stays and similar remedies successfully early in the bankruptcy.

INCOMPLETE FINANCIAL STATEMENTS TO BANK NOT FRAUDULENT

One basis for a lender to successfully challenge a discharge of its borrower’s unpaid loan is if the borrower provides a false financial statement to the lender, which the lender then relies upon to advance money or credit. An unpaid loan may not be excepted from discharge if the borrower lists its assets and liabilities, but still fails to “connect the dots” as to whether certain assets are collateral to secure other liabilities, identify the true ownership of the assets, or indicate whether some assets could be exempt from forced collection. Such instances arose in the case *Northland National Bank v. Lindsey*, (*In re Lindsey*), 8th Cir. BAP, No. 10-6045.

In *Lindsey*, the debtor had provided financial statements to Northland National Bank on multiple occasions which identified debtor’s interest in approximately \$160,000 worth of gold, and mutual funds (which debtor listed as owned by he and his spouse). In the debtor’s bankruptcy, it became known that the gold had been previously transferred to a company owned by the debtor, and pledged as collateral to another lender. It also became apparent that the mutual funds were part of the debtor and his spouse’s

self-employed pension plan, and therefore would be exempt from any collection action. These details were not clearly disclosed in the financial statements.

Nonetheless, the trial court, as affirmed by the Bankruptcy Appellate Panel, did not find that the financial statements were materially false or that the incomplete disclosures warranted excepting the bank's loan from discharge. A financial statement is materially false if it "paints a substantially untruthful picture of the debtor's financial condition by misrepresenting information that would normally affect the lender's decision to extend credit."

In this case, the financial statements did in fact disclose all assets and liabilities, but did not provide complete details for each asset. The lender with a lien on the gold coins was identified, although its specific security interest in certain assets was not. The court also found that it was unreasonable for the bank to assume that the debt to the other lender was unsecured. The court also found that since the debtor controlled the company owning the gold coins, that those gold coins could be available to the debtor for repayment, which is all the financial statements sought to disclose. The same was true of the mutual funds, which the debtor could draw upon to pay the lender – even though those assets would be exempt from collection.

The final blow for the lender was its own testimony which indicated that the financial statements were not an important part of the credit decision. The court found that the lender relied upon the debtor's strong relationship with the bank, his good credit history, and his track record of paying debts. As stated by a former bank officer testifying at trial, "it's basically character capacity and the credit history of the borrower when you're doing an analysis of a loan. In this case, we had credit history, which was good."

Practice Pointer: Fraud cases are fact intensive and as noted above many times require more than incomplete disclosure by the borrower. Lenders can take additional steps in the wording of financial statements that borrowers execute to make sure it is clear to the borrower that the lender is relying on full and complete disclosure in extending credit or making a loan. A financial statement should also require a certification of the debtor that he owns all the assets on the financial statement free and clear of other liens and encumbrances, except as otherwise disclosed in the financial statement. This would require the borrower to identify other liens. Lenders should also be aware of possible exempt assets, such as certain retirement funds, so as not to overrate the borrower's capacity for repayment.

Finally, the lender should make sure it is fully prepared to conduct a fraud trial. The testimony that harmed the bank in this case was by a former bank officer, who may not have prepared for trial to the same extent a current employee would. The lender probably did materially rely on the financial statements, but the record presented at trial failed to properly indicate its reliance. If the bank truly did not rely on the financial statements, then the case would likely not have been worth pursuing. The attorneys at Mackall, Crouse & Moore, PLC have experience conducting fraud trials in bankruptcy court and preparing witnesses for such trials.

PROPER INVESTIGATION AND RESPONSE BY LENDER TO CONSUMER DISPUTE NOTICE FROM CREDIT AGENCY RESULTS IN DISMISSAL OF FCRA CLAIM

In *Anderson v. EMC Mortgage Corp.*, a recent decision from the Eighth Circuit Court of Appeals, a borrower claimed that EMC violated the Fair Credit Reporting Act ("FCRA") by furnishing inaccurate information about his loan account status. The Court noted that the duty to respond of EMC, a furnisher of credit information, was triggered by notice of a dispute from a credit reporting agency ("CRA"), not from the consumer, and that the duty to investigate was limited to what it learned about the nature of the dispute from such notice. EMC submitted the responses to the Automated Consumer Dispute Verification ("ACDV") forms it received from multiple CRAs. The Court held that EMC properly reviewed and responded to the ACDV notices and dismissed the borrower's FCRA claim against EMC.

Practice Pointer: It is important for a lender or other furnisher of credit information to promptly and accurately investigate an ACDV or other notice from a CRA of a dispute to items reported to the CRA. The attorneys at Mackall, Crouse & Moore have extensive experience in the FCRA and other similar consumer statutes and can advise lenders on proper procedures and responses to disputes or claims.

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