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

Creditors' Corner

Friday, May 01, 2009
Volume 9, Number 4

RISKS TO CONSIDER IN THE PENDING AUTOMOTIVE INSOLVENCIES

Talk of bankruptcies and bailouts in the automotive industry abound at the various water coolers and watering holes. Dealers are filing Chapter 11 or closing their doors. Even Toyota is seeking Japanese bailout money for its financial services arm. Whether the resolution is bankruptcy or bailout, there is a potentially huge disruption lurking behind all of this chatter. The automotive world will go through a wrenching change and some lenders may not realize how deeply they could be impacted.

A lender must identify who is impacted in their community beyond the manufacturers and their financing arms. Primarily, lenders should also focus on the dealers and supply chain and its related elements: warehousing, shipping, transportation, component and raw material providers.

Supplier and dealer insolvencies have increased the past nine months, and private equity funds are no longer looking to invest in these entities. This may mean that "production" is no longer king of the auto industry. While we wait to see if the resolution is bailout or bankruptcy, the manufacturers still try to maintain production at any cost. If a lender has any credits with a borrower in the automotive supply chain, that borrower is most likely reporting a higher ratio of receivables.

Suppliers used to protect themselves by purchasing other sources of supply to protect price leverage. Unfortunately, in these times the number of overall sellers is dwindling. Another problem is that Chapter 11 reorganization has become much more expensive, and there is less financing to fund a successful reorganization. One element of increased costs are enhanced protections for supply chain creditors imposed by the 2005 Bankruptcy Amendments (BAPCPA), which now create a priority administrative claim for goods shipped to a manufacturer within 20 days of the bankruptcy. (see 11 USC Sec. 503(b)(9)). Any manufacturer of parts will have to pay its chain of supply for goods delivered 20 days prior to the bankruptcy in order to confirm a reorganization plan. This would normally be a huge expense for which there is not likely to be much financing to pay. While it provides some additional protection for suppliers, it creates an additional difficulty in obtaining sufficient capital to confirm a plan.

Dealers are protected under state laws which prohibit cancellation of franchises in certain instances, but those statutes will be negated in any bankruptcy of an automobile manufacturer. It is estimated that upwards of 40% of dealerships for American manufacturers will be terminated and closed.

As a result of these legal and practical impediments to Chapter 11 reorganizations, non-bankruptcy liquidations are increasingly likely. In this environment, the value of the collateral is likely to be depressed. If a lender has a borrower whose source of loan repayment includes income from the automotive supply chain, close attention to the credit is required. MCM attorneys are able to document modifications to the loan agreements and workouts in order to preserve the best opportunity for the lender and are experienced in bankruptcy litigation matters as well as Chapter 11 creditor representation.

NO RESIDENTIAL MORTGAGE MODIFACTIONS IN MINNESOTA COURTS OR CONGRESS

The Minnesota Bankruptcy Court recently affirmed a long-standing rule in Chapter 13 cases that a debtor cannot modify the rights of a secured claimant that holds a mortgagee's interest against debtor's principal residence. In *In re Hughes*, (Bky-08-36020, March 16, 2009), TCF National Bank held a second mortgage on debtor's principal residence. Debtor's proposed Chapter 13 plan did not propose any payments to TCF, other than including TCF in a class of unsecured creditors that would received some residual distributions. Debtor argued that the first mortgage encumbering her homestead exceeded the value of the property – although the county property tax valuation was higher. Debtor argued TCF's mortgage and debt was unsecured. TCF requested that the Court lift the automatic stay to permit TCF to foreclose its mortgage, since the loan was delinquent, debtor was not making payments, and the plan did not provide for payments.

The Court lifted the stay. Primarily the court held that a Chapter 13 plan may not modify "a claim secured only by a security interest in real property that is the debtor's principal residence." As noted by the Court, "the purpose of the statute is to protect the stability and affordability of the residential lending market by excluding cram down of residential loans." While residential mortgage lenders are presently protected by the Code, there have long been proposals in Congress to change these rules to grant the Bankruptcy Court the ability to re-write residential mortgage to assist a re-organizing debtor. On April 30, 2009, the Senate rejected such a proposal, but the democratic sponsor of the bill promised that it would return.

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CREDITORS MUST PROVE DEBTOR'S OWNERSHIP OF FUNDS WHEN LEVYING A JOINT ACCOUNT

If a creditor levies a joint bank account, and one of the joint account holders is a non-debtor who challenges the levy, the creditor must prove that the funds it levied, if deposited by the non-debtor, were intended to be owned by the debtor. The creditor's obligation in this regard was recently confirmed in *Phillips v. Messerli & Kramer*, *P.A.,* Civ. No. 08-4419 (D. Minn., April 20, 2009).

Under the Minnesota Multiparty Account Act, "a joint account belongs, during the lifetime of all parties, to the parties in proportion to the net contributions by each to the sums on deposit, unless there is clear and convincing evidence of a different intent." The non-debtor depositor can simply show his ownership in the funds under this Act by demonstrating his contribution to the account. The creditor has the burden to show that the non-debtor actually intended to pass ownership of any funds to the joint account holder. As a practical matter, this allocation of the burden will make it difficult for a creditor to attach funds in a joint account which are not traceable to a direct contribution to the account by the debtor. Many times the evidence for intent is inconclusive, and when that is the case, the party with the burden of proof loses. In other words, the "tie" goes to the party that does not have the burden of proof.

The court noted that other states, such as Indiana and Nebraska, differ from Minnesota, and require the depositor to establish intent of ownership.

MORTGAGE RECORDED IN THE GRANTOR-GRANTEE INDEX BUT NOT IN THE TRACT INDEX IS STILL CONSTRUCTIVE NOTICE TO SUBSEQUENT PURCHASER

In *MidCountry Bank f/k/a/ First Federal FSB v. Krueger,* (A08-0534, March 10 2009), the Minnesota Court of Appeals held that recording a mortgage in the grantor-grantee index was sufficient to impart constructive notice on a subsequent purchaser, even though the mortgage was not properly recorded in the tract index. MidCountry Bank had received a mortgage on three parcels of property, and delivered the mortgage for recording to the County Recorder's Office in Scott County. The mortgages were stamped as received by the County Recorder's office in May 2004.

One of the three parcels was subsequently sold to an unrelated purchaser. The abstractor hired by the purchaser did not locate the MidCountry mortgage when it searched the tract index of the property, but did not search the grantor-grantee index. The title company closed on the sale, which was financed by a new lender, PHH Homes Loans, LLC. The sellers of the property did not disclose that they had granted a prior mortgage to MidCountry. The MidCountry mortgage was not paid or satisfied at closing. Months later, the sellers stopped paying MidCountry and MidCountry foreclosed on its mortgage.

During the foreclosures suit, it became known that the county had failed to properly index the MidCountry mortgage in the tract index. But the county had properly recorded the mortgage in the grantor-grantee index. The Court found that the abstractor should have also searched that index, which would have disclosed the mortgage. Reviewing the mortgage document itself as recorded would have disclosed that the mortgage encumbered the parcel at issue. Since the mortgage was properly recorded in at least one of the indexes, and the actual document recorded identified the property encumbered, the purchaser purchased the property subject to the MidCountry mortgage. That purchaser will now likely be forced to recover from the abstractor who did not perform the complete search, or from the sellers, who delivered a warranty deed knowing the property was subject to the MidCountry mortgage.

Mackall, Crounse & Moore PLC routinely handles similar and more complex types of real estate disputes through its real estate litigation and title insurance practice groups.

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