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

Creditors' Corner

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DAMNED IF YOU DO AND DAMNED IF YOU DON'T

One of the questions facing a lender who has repossessed collateral is whether or not the standard of commercial reasonableness requires the creditor to repair or improve the collateral before selling it. This issue arises when dealing with creative debtor lawyers, who argue that the deficiency judgment award should be lower either because the lender who did not repair the collateral could have sold the property for more, net of cost of repairs, or that the lender who did repair the collateral spent too much. The Eighth Circuit Court of Appeals follows the UCC literally and has held that "a creditor may, but is not required to, repair, improve or otherwise spruce up collateral before it is sold." *CIT Corp. v. Duncan*, 739 F.2d 359,361 (8th Cir. 1984). However some courts have taken the position that a lender must use "best efforts" to improve the collateral in order to meet the standard of commercial reasonableness.

Practice Pointer: The issue can be easily addressed by utilizing Section 9-603(a) of the UCC which allows the debtor and the lender to enter into an agreement as to the disposition of the collateral, although in such agreement the debtor cannot be required to waive the standard of commercial reasonableness. MCM attorneys are familiar with the drafting requirements in these situations and can assist lenders to maximize the recovery from the collateral and any deficiency from the debtor or guarantors.

PRIORITY RULES FOR SIMULTANEOUS PURCHASE MONEY MORTGAGES

The Minnesota Court of Appeals recently established the priority rule where two purchase money mortgages are recorded simultaneously as part of the same transaction. In *Slattengren & Sons Properties, LLC v. RTS River Bluff, LLC*, Case No. A11-322 (Minn. App. Oct. 11, 2011), a real estate developer obtained a \$2.3 million loan for the acquisition and development of three parcels in Chisago County. The developer also financed the purchase of one of the parcels through the vendor, and granted the vendor a mortgage of \$210,823. The title company recorded the mortgages sequentially in the county land records, filing the lender's mortgage one document ahead of the vendor's mortgage.

The vendor argued that its mortgage, even though technically filed later, took priority over the lender's mortgage because the vendor did not have notice of the lender's mortgage. The court held for the lender based on "first in time, first in right." Under Minnesota law, purchase money mortgages, whether claimed by a lender or vendor, become effective at the moment property transfers to the purchaser. Thus, the

mortgages became effective simultaneously. Other states have awarded the vendor priority in this situation, but Minnesota has never adopted this principle. Having no other precedent or equitable principles to rely on, the court simply applied the Recording Act which awards the earlier-recorded mortgage priority unless the first mortgagee to file has knowledge of a superior interest. In this case, the lender recorded first and did not have notice of a superior interest because the law deemed the vendor and lender's mortgages to become effective simultaneously.

Practice Pointer: This was an issue of first impression for the court under Minnesota law. This case requires lenders to be attentive in closing transactions involving multiple mortgages. Usually where other banks are involved the parties prearrange priority through subordination agreements. Such arrangements should also be considered with vendors who may sell on a contract for deed or finance part of the purchase of the bank's collateral. MCM employs several sophisticated real estate attorneys who routinely navigate recording as well as inter-creditor issues relating to priority.

BANKRUPTCY APPELLATE PANEL REJECTS "NO HARM, NO FOUL" RULE ON PRE-BANKRUPTCY TRANSFERS OF EXEMPT PROPERTY

The Eighth Circuit Bankruptcy Appellate Panel overruled the Bankruptcy Court in Minnesota and held that a Chapter 7 trustee could avoid the Debtor's transfer of an exempt asset prior to bankruptcy. In doing so, it rejected the "no harm, no foul" rule that many courts have applied in declining to avoid transfers of exempt assets prior to the bankruptcy.

The transfer at issue in *In re Lumbar*, No. 11-6018, (8th Cir. BAP, Oct. 12, 2011) resulted from a complex marital settlement. During the marriage, the couple entered into a contract for deed for the purchase of their homestead from the wife's parents. In 2006, the husband filed for divorce and the parents sought to cancel the contract. At the time, the property's tax assessed value was \$562,300, but only \$188,426.15 remained owing under the contract. After protracted litigation, the husband agreed to surrender his interest in the property to his wife. At this time, wife also deeded the property to her parents. A year later, the wife filed bankruptcy. The trustee sought to avoid the transfer of the property to her parents.

Originally, the Bankruptcy Court denied the trustee's avoidance claim and held that under Minnesota law exempt property cannot be recovered through a fraudulent transfer claim. The BAP overruled this holding and noted that the trustee sought to avoid the property under the Bankruptcy Code's fraudulent transfer provisions. In this situation, state law determined what property interest the debtor held, but federal law governed whether avoidance was barred due to the potential exemption. While some federal courts have applied the "no harm, no foul" rule to deny avoidance actions to recover property that would otherwise be exempt, the BAP rejected that rule stating, "all property, including potentially exempt property, is part of the bankruptcy estate until the debtor claims an exemption in it, and that exemption is approved." The BAP also noted that Section 522(g) of the Code provides that where property is recovered through a fraudulent transfer, "the debtor may claim an exemption in the recovered property unless the transfer by the debtor was a voluntary one." The BAP remanded the case for further findings.

Practice Pointer: This case represents another strict application of the avoidance remedies. While those remedies augment the estate, they can also ensnare creditors or other parties who appear to be innocent parties in a transaction. There are a number of defenses available to the transferees in any avoidance action, although there are also some strict statutory requirements that defendants many times believe are unfair. The attorneys at MCM have experience in both pursuing and defending fraudulent transfer and other avoidance claims under the Bankruptcy Code.

LIVESTOCK PRODUCER DENIED DISCHARGE FOR FAILING TO EXPLAIN LOSS OF CATTLE

The Eighth Circuit BAP recently affirmed the denial of a discharge of a livestock producer for failing to explain a material loss of his cattle herd during his Chapter 11 bankruptcy. In *in re Vilhauer*, No. 11-6038 (8th Cir. BAP, Oct. 11, 2011), a Chapter 7 Trustee appointed after the conversion of the case to a Chapter 7 found that a livestock producer's herd was 117 head of cattle short of what the debtor had represented that he owned two months earlier. The Trustee filed suit to deny the debtor's discharge under Section 727(a)(5) of the Bankruptcy Code which allows the court to deny a discharge if "the debtor has failed to adequately explain ...any loss of assets or deficiency of assets to meet the debtor's liabilities."

At the trial, the debtor stated that 117 animals died due to extreme winter weather and he produced photographs showing 103 dead animals, although the photos could not verify whether the dead cattle shown belonged to the debtor. Neighbors also testified seeing dead livestock on the debtor's property, but could not verify an amount. The debtor also testified that all carcasses were burned in a burn pit on the farm.

The trustee hired a licensed veterinarian and exhumed the burn pit. The veterinarian found only 56 carcasses in the pit, and no evidence of burning. The veterinarian testified that even if a prior burn incinerated carcasses, some bones would have likely remained to evidence the burn. The veterinarian also testified that the normal loss rate for cattle in the area during the time period debtor described was one to two percent, not the 10% debtor reported. Further, the veterinarian found that based on the decomposition, most of the carcasses appeared to have been placed in the burn pit after July 2010, not the previous winter. Based on the evidence, the Bankruptcy Court found the debtor failed to sufficiently explain the loss of cattle and the BAP did not disturb that finding of fact.

Practice Pointer: The Bankruptcy Code provides a number of remedies which prevent a debtor from achieving the benefits of a bankruptcy. Many times pursuing such remedies can be costly and time consuming, and provide no guaranty of immediate recovery. Bankruptcy trustees many times may pursue these types of claims, but there is no guaranty given that many estates have very limited assets to support claims that require substantial expense. It is therefore important for creditors who have any information of debtor dishonesty or potentially hidden or transferred assets to bring those issues to the bankruptcy trustee's attention and to follow-up to confirm whether there will be any pursuit. In cases of debtor dishonesty, creditors also have standing to bring non-discharge claims. The attorneys at MCM have pursued non-discharge claims.

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