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

### Creditors' Corner

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#### **LOSING THE UPPER HAND IN SUBORDINATION AGREEMENTS**

Subordination agreements have become common in multi-creditor lending relationships and Section 9-339 of the UCC expressly states “{t}his article does not preclude subordination by agreement by a person entitled to priority.” Nonetheless, there are few reported court decisions involving disputes about the interpretation of subordination agreements, or where the senior but subordinate creditor believes it is damaged by the actions of the junior lender. This specifically arises if the subordination agreement is silent on agreed-upon methodologies of disposing of collateral or determining damages, leaving the parties only to rely on the provisions of the UCC. Section 9-625(b) of the UCC states in part that there is liability for damages resulting from or “...caused by a failure to comply...” with article 9. If there is no specific provision in the subordination agreement defining requirements for recovery or applications of assets, say as to actions in collecting accounts, there may be a dispute about the cause of the damages asserted by the senior lender. Such a dispute leads to costly litigation, with the senior lender holding the burden to prove economic loss arising from the junior lender’s actions.

***Practice Pointer:*** Always include a provision in any subordination agreement that defines the expectations of the senior lender who is subordinating as to the recovery and application of the collateral involved. MCM attorneys are experienced in drafting contractual language to maximize protection for lenders who elect to subordinate their interests in order to facilitate a broader credit arrangement.

#### **SIGNIFICANT AMENDMENTS TO BANKRUPTCY RULES AND REVISED FORMS**

A number of Bankruptcy Rules and forms have been revised or created, effective December 1, 2011 as to all pending and new cases. Of particular relevance to lenders, additional information and documentation must now be provided when filing a proof of claim. In cases involving individual debtors, among other requirements, a claim must include an itemized statement of all pre-petition interest, fees, expenses or other charges. If the secured property is the debtor’s principal residence, the creditor must complete and file a new form with the proof of claim, which includes detailed information on amounts due, interest rates, fees, past due payments and a present cure amount. These are similar requirements that presently exist for secured lenders when they file a motion for relief from the automatic stay to foreclose their interest against the debtor’s principal residence. The amended rule provides for significant sanctions if a creditor fails to comply.

New Rule 3002.1 provides new procedures for lenders holding mortgages on the debtor's principal residence where the debtor seeks to cure delinquencies and retain the residence as part of its Chapter 13 plan. The new disclosures require the creditor to supplement its claim during the performance of the plan upon changes to the debt. For instance, the creditor must now provide at least 21 days advance notice of any changes in the post-petition payment amount based on interest rate changes or otherwise, and itemize and disclose within 180 days of being incurred all post-petition fees, expenses and charges. This information is to be included on new forms which must be completed, executed under oath and filed as a supplement to the proof of claim. The procedures allow the debtor to challenge the claim to fees if they are not afforded by the underlying credit agreement. The procedures also now require the Chapter 13 trustee or the debtor to file a final statement when they believe that the debtor has cured all pre-petition defaults, and permit the creditor to object to the claim that the delinquencies have been cured.

The amendments also provide that any party can seek an extension of the ability to contest the debtor's discharge after the deadline to object has expired if the party acquired new evidence, so long as the motion to extend is brought before the court grants the discharge.

On the business side, Congress substantially expanded disclosures of economic interests in Chapter 9 or Chapter 11 cases where committees, groups, or entities advocate on behalf of multiple creditors or equity security holders. The aim of the rule is to determine the identity and economic interests of distressed-debt investors (many times hedge funds) who act in tandem through ad hoc committees in reorganization proceedings. In some cases the rule would require disclosure of the date and acquisition price of the economic interest. The rule further clarifies that indenture trustees and administrative agents need not normally disclose the bond holders or syndicated lenders they represent.

***Practice Pointer:*** Lenders need to review their procedures for filing proofs of claim in light of these changes and incorporate any new forms and attachments to comply with the additional requirements. MCM's lawyers have extensive experience in bankruptcy practice and procedure, and can assist in compliance with these and future changes.

## **ARTICLE IN AMERICAN BANKRUPTCY INSTITUTE JOURNAL BY MCM ATTORNEY ON PRIORITY DISPUTES WITH FEDERAL TAX LIENS**

The attached article authored by MCM's Andrew P. Moratzka and published in the American Bankruptcy Institute Journal discusses a recent decision regarding the priority of a bank's security interest in rents over a federal tax lien.

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# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

The Essential Resource for Today's Busy Insolvency Professional

## Security Interests vs. Federal Tax Liens and After-Acquired Property vs. Proceeds

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The U.S. Court of Appeals for the Seventh Circuit recently determined that a bank's security interest in rents from leased real estate subject to a mortgage takes priority over a federal tax lien. This is the first time that this particular issue has been addressed by a circuit court of appeals. Ruling in favor of the bank, the Seventh Circuit distinguished between a secured party's right to after-acquired property and rents.

### Statutory Background



Andrew P. Moratzka

The Internal Revenue Code (IRC) provides that if any person fails to pay taxes, the amount due (plus interest and applicable penalties) shall be a lien in favor of the U.S. upon that person's property and rights to property.<sup>1</sup> Generally, a federal tax lien arises at the time of assessment and continues until the liability for the amount assessed is satisfied,<sup>2</sup> but the lien imposed by § 6321 is not valid against the holder of a security interest until proper notice has been filed.<sup>3</sup> The IRC defines "security interest" to mean:

any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected

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under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.<sup>4</sup>

In the cases below, there is no dispute as to whether the lender parted with money or money's worth. Instead, the focus of the analysis is whether the property is "in existence."

## Lien on Me

### Case Law

Fights regarding priority are generally resolved under the rule "the first in time is the first in right."<sup>5</sup> This rule is qualified by what is often referred to as the "choateness" test: For a security interest to take priority over a subsequently filed federal tax lien, that security interest must be choate.<sup>6</sup> To be "choate," the security interest must be one in which all of the following are established: (1) the identity of the lienor, (2) the property subject to the lien and (3) the amount of the lien.<sup>7</sup> While federal law also determines the priority of competing federal and state liens, it is state law that determines the nature of

the property interest that is subject to the federal tax lien.<sup>8</sup> Courts have struggled in determining how to define rents from real estate when the real estate is subject to a mortgage containing an assignment-of-rents provision. The issues in these cases center around whether the property was in existence at the time of the federal tax lien filing or the amount of the lien was established at the time of the federal tax lien filing.

In *First Nat'l Bank of Ohio v. U.S.*,<sup>9</sup> the district court held that such rents are after-acquired property. The taxpayers executed a note payable to the bank in 1977, which was secured by a mortgage on certain real property. The mortgage was properly recorded under Ohio law and contained a provision specifically providing that "all rents, issues,

profits and income of the real estate" were additional collateral security for payment of the note.<sup>10</sup> The Internal Revenue Service (IRS) filed a notice of federal tax lien on the real property in 1984. Then, in 1986, the taxpayers leased the real property and assigned the rents to the bank. The IRS levied on the rental payments, giving rise to the dispute between the IRS and the bank. The court found in the IRS's favor, holding that the rents were after-acquired property and not "property subject to the lien" under the choateness test.<sup>11</sup> The

<sup>7</sup> *IRS v. McDermott*, 507 U.S. at 449-50 ("[O]ur cases deem a competing state lien to be in existence for the 'first-in-time' purposes only when it has been perfected in the sense that 'the identity of the lienor, the property subject to the lien, and the amount of the lien are established.'" (quoting *U.S. v. City of New Britain*, 347 U.S. at 84); see also *Bank One, West Va., NA v. U.S.*, 1996 WL 303276 at \*2 (1996) (citing *U.S. v. Pioneer American Ins. Co.*, 374 U.S. 84, 88-90 (1963) (citing *U.S. v. City of New Britain*, 347 U.S. at 84)).

<sup>8</sup> *Bank One, West Va., NA v. U.S.*, 1996 WL 303276 at \*3.

<sup>9</sup> 1994 WL 481357.

<sup>10</sup> 1994 WL 481357 at \*2.

<sup>1</sup> 26 U.S.C. § 6321.

<sup>2</sup> 26 U.S.C. § 6322.

<sup>3</sup> 26 U.S.C. § 6323(a).

<sup>4</sup> 26 U.S.C. § 6323(h)(1) (emphasis added).

<sup>5</sup> *IRS v. McDermott*, 507 U.S. 447, 449 (1993) (quoting *United States v. City of New Britain*, 347 U.S. 81, 85 (1954)).

<sup>6</sup> For a short, but entertaining, summary of the origins of the term "choate," see *Bloomfield State Bank v. United States*, -- F.3d --, 2011 WL 1773953 at \*2 (7th Cir. App. 2011).

court noted that the “bank’s security interest in the rental payments did not attach thereto until the taxpayers began receiving the payments, which did not occur until 1986 (when the rental payments began), well after the filing of the federal tax lien.”<sup>12</sup>

In *Bank One, West Va., NA v. U.S.*,<sup>13</sup> the court reached the opposite conclusion under similar facts. The taxpayers borrowed money from the bank under a series of notes in 1986 and 1989, secured by various documents including a deed of trust, collateral assignment of leases and rentals, and security agreement.<sup>14</sup> At the time these security documents were executed on the parcel of real estate owned by the taxpayer, it was sublet, which sublease was subsequently vacated in December 1989.<sup>15</sup> In 1991 and 1992, the IRS filed various tax liens against the taxpayers.<sup>16</sup> In March 1992, the taxpayers relet the facility that was vacated in December 1989. The IRS levied on that stream of rental payments. The bank then commenced an action against the IRS claiming that the IRS wrongfully levied against real property in which the bank claimed an interest. In its application of the law to these facts, the court relied on Justice Benjamin Cardozo’s description of property rights as a bundle of sticks.<sup>17</sup> The court then concluded that “[t]he sublease granted to the State of West Virginia did not alter the essential character of the property subject to the Bank’s security interest. The sublease is a lesser included interest in the leasehold estate... [The property subject to the Bank’s security interest] was established before the sublease was signed and before the Government filed its tax liens.”<sup>18</sup>

### **Bloomfield State Bank v. U.S.**

The U.S. Court of Appeals for the Seventh Circuit was the first circuit court to address a priority dispute between the IRS and a creditor under similar facts. In 2004, Bloomfield State Bank (BSB) made a mortgage loan secured by, *inter alia*, the borrower’s real estate and “all rents... derived or owned by the Mortgagor directly or indirectly from the Real Estate or the Improvements.”<sup>19</sup> The taxpayer default-

ed in 2007,<sup>20</sup> and at BSB’s request, a state court appointed a receiver to administer the real estate, who subsequently rented the real estate, collecting in excess of \$80,000.<sup>21</sup> During the rental period, the IRS filed a tax lien against the real estate. The IRS conceded that rentals received prior to the filing of the tax lien were BSB’s, but any rents received after the filing of the tax lien were junior to the IRS.<sup>22</sup>

The Seventh Circuit disagreed. To succeed, the creditor must establish: (1) the lienor’s identity, (2) the property subject to the lien and (3) the amount of the lien. As with the cases above, the first factor is easy to prove. With respect to the third factor, the court refused to accept the government’s argument that the IRC’s requirement that the amount of the lien must be established means the amount of money that enforcement of a lien will yield must be known. The court stated that “[t]he mortgage agreement in this case established a lien on the real estate and all the rents it might yield, up to the amount of the loan, which of course is stated in the agreement.”<sup>23</sup>

In reaching its conclusions on the second factor, the Seventh Circuit addressed the concern behind the “existence” requirement. It found the requirement that the property must be in existence for a creditor’s lien to take priority over a federal tax lien to be a source of value for repaying the loan in the event of default, not the money the lender realizes by enforcing the security interest.<sup>24</sup> The Seventh Circuit refused to distinguish between the proceeds received from sale income and rental income. It stated that “[t]o say that a parcel of land is ‘sold’ rather than ‘rented’ just means that the owner sells the use of the land forever rather than for a limited period. Sale income and rental income are just two forms of proceeds from land (or from improvements on it).”<sup>25</sup>

The Seventh Circuit opined that the theory behind the “existence” requirement was based on concerns about after-acquired property liens to trump a federal tax lien. This was

not a concern here because “[t]he real estate that generated the rental income at issue in this case existed when the mortgage was issued and thus before the tax lien attached; the rental income was proceeds of that property, which preexisted the lien.”<sup>26</sup> The Seventh Circuit seemed to acknowledge that its conclusion would be different if the mortgage had also created a lien in any property of any kind that the mortgagor might ever acquire. The distinction between after-acquired property and rents from specific property is clearly delineated in the final paragraph of the Seventh Circuit’s opinion. The Court stated:

By virtue of the rental-income provision in the mortgage, the bank had a separate lien on the rents, but that is not the lien on which it is relying to trump the tax lien. The lien on which it is relying is the lien on the real estate. If an asset that secures a loan is sold and a receivable generated, the receivable becomes the security, substituting for the original asset. The sort of receivable to which the statute denies priority over a federal tax lien is one that does not match an existing asset; a month’s rent is a receivable that matches the value of the real property for that month.<sup>27</sup>

### **Conclusion**

The Seventh Circuit’s decision is a far more reasoned approach, both analytically and conceptually, than the court’s decision in *First Nat’l Bank of Ohio v. U.S.*<sup>28</sup> Rents are not after-acquired property. To the contrary, rents are proceeds of property. Another way to look at rents substituting for the original asset (as stated by the Seventh Circuit) is to state that rents would not exist but for the original asset. After-acquired property, on the other hand, is not necessarily related to—or a substitute of—a specific asset. Consider the legal definition of the two terms. “After-acquired property” is defined as a “debtor’s property that is acquired after a security transaction and becomes additional security for payment of the debt.”<sup>29</sup> “Proceeds,” on the other hand, are defined as “[s]omething received upon selling, exchanging, collecting

<sup>11</sup> 1994 WL 481357 at \*3 (stating that “[t]he property at issue here... constitutes after-acquired property”).

<sup>12</sup> *Id.*

<sup>13</sup> 1996 WL 303276.

<sup>14</sup> *Id.* at \*6-7.

<sup>15</sup> *Id.* at \*7.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at \*3-4.

<sup>18</sup> *Id.* at \*4.

<sup>19</sup> The Seventh Circuit was not faced with a situation involving an absolute assignment of rents, but given its holding, it would appear that such a provision (if upheld) would further protect the creditor from the IRS. *Bloomfield State Bank v. United States*, -- F.3d --, 2011 WL 1773953 at \*1 (7th Cir. App. 2011).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at \*2.

<sup>24</sup> *Id.* at \*3.

<sup>25</sup> *Id.* at \*3.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at \*4.

<sup>28</sup> 1994 WL 481357.

<sup>29</sup> *Black’s Law Dictionary*, 7th ed., page 61; see also U.C.C. § 9-204.

or otherwise disposing of collateral.”<sup>30</sup>  
The court’s result in *First Nat’l Bank of Ohio* is not surprising given that it defined the rents as after-acquired property, which is independent of an asset that can be pledged with certainty in a security interest or mortgage and therefore fails to meet the “in existence” test of the IRC. Therefore, practitioners should be alert to this issue and clearly define the terms at issue for the court to apply in any dispute involving a federal tax lien. ■

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<sup>30</sup> *Black’s Law Dictionary*, 7th ed., page 1222; see also U.C.C. § 9-102(64).