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FINANCIAL newsletter

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INSIDE THIS ISSUE

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MARSHALING OF ASSETS: OLD DOCTRINE LEARNS NEW TRICKS

As the economy enters into a recession and debtors' assets are losing value, dwindling or disappearing, the doctrine of marshaling assets is appearing in more and more collection actions and appellate decisions. The increased use of marshaling assets is also the result of land prices remaining high while other property values, such as equipment and inventory, are decreasing substantially. Creditors should know how to use the doctrine both offensively – if they choose to use it against another creditor – and defensively – if another creditor tries to use it against them. Marshaling of assets is another tool in the kit available to creditors. Being aware of this doctrine and how it can be applied helps prepare creditors when reviewing loan agreements, provides information about potential outcomes at trial, and protects a creditor's ability to collect.

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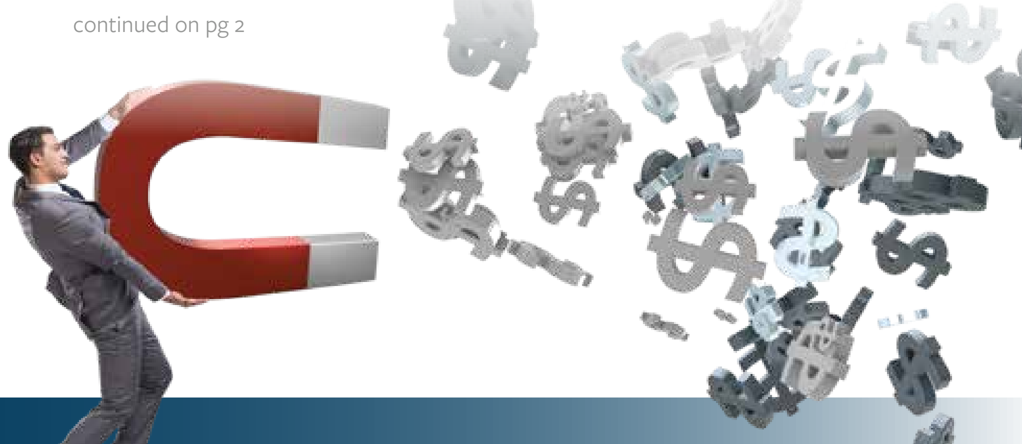

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MARSHALING OF ASSETS: OLD DOCTRINE LEARNS NEW TRICKS

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I. What is the marshaling of assets doctrine?

A creditor who invokes the marshaling doctrine (sometimes spelled "marshalling" and also known as the "two funds" doctrine) asks a court to force a superior creditor to satisfy their debt out of the security interest which the invoking creditor does not have a lien against.

The doctrine can be applied when:

1. There are two creditors who have a common debtor;
2. The common debtor has two funds or assets; and
3. The first creditor has legal claims to both funds or assets while the second creditor has legal claim to only one.

The second creditor may ask the court to force the first creditor to access the non-common source of funds first to protect the common source and make it available to the second creditor. Most frequently, the two funds are real estate and equipment/inventory. For example, Creditor A has a lien against the debtor's equipment and inventory while Creditor B has a lien against the debtor's equipment and inventory and real estate. Creditor A will ask the court to force Creditor B to liquidate the real estate for payment before liquidating the equipment or inventory. If the court agrees, then the funds left from the liquidation of the equipment or inventory can be used to pay off Creditor A. The purpose of the doctrine is to prevent a senior lienholder from arbitrarily destroying the rights of a junior lienholder.

II. Does the court have to marshal assets if a subsequent creditor asks them to?

The doctrine of marshaling assets is not an absolute right. It is an equitable remedy, meaning the court controls it for the "promotion of justice" in a case-by-case basis. Because it is equitable, the court takes into consideration all parties, including other non-invoking creditors and the debtor. The doctrine cannot be invoked to create an unjust result or to substantially injure any party with an interest (including the debtor). In other words, the court considers all evidence before it and makes its decision based on what it feels is "fair" to everyone. It is up to the party requesting the marshaling to show it would not impose undue hardship on senior lienholders.

The courts often play a balancing game of fairness to all parties. In a bankruptcy case applying Ohio law, the court found that even if the second creditor's interests were unperfected, the unperfected interests would still be entitled to secured status under the facts of the case. The first creditor had a large claim of roughly $31.7 million. It was secured both by real property and collateral shared with the second creditor. The court found the value of the real property to be $32.5 million. As such, the court found it would be inequitable to allow the first creditor to pursue the shared collateral as its interests were wholly satisfied by the value in the real property.

A bankruptcy case applying Nebraska law came to the opposite conclusion when a junior creditor requested the marshaling of assets related to pharmaceutical goods. Such marshaling would have delayed the sale of the assets substantially, resulting in a significantly lowered payment to the senior creditors. The court refused to marshal assets, citing that the remedy of marshaling assets proposed by the junior creditor would be inequitable to the senior creditors whose debt would not be satisfied by sale of the pharmaceuticals alone regardless of price.

III. When does the doctrine of marshaling assets work and when does it not work?

Whether the request to marshal assets will or will not be successful depends on the specific facts of the claim and the court (and state) in which the claim is being brought. Contributing factors include the size of the claims, a particular state's laws regarding the marshaling of assets (such as that state's homestead exemption rules), and that state's court interpretations of marshaling assets doctrine.

For example, some courts do not allow a mortgagor to make an argument for marshaling of assets but instead reserved the right to marshal assets for secured creditors only. In Minnesota, marshaling may not be applied to defeat statutory rights, such as properly perfected crop production input liens or other rights found under the U.C.C. The United States Supreme Court has specifically recognized the inapplicability of the doctrine where certain funds at issue are exempted from collection under state law, such as when state statute exempts insurance benefits of a widow from claims of creditors of her husband's estate. Some courts of equity (i.e. bankruptcy court) have found that marshaling of assets can be invoked during trial, even if it was not raised in the pleadings.

While the elements of marshaling assets are consistent, the interpretations from court to court vary significantly. For example, a bankruptcy court using Minnesota Law allowed the doctrine to be used on the homestead of a non-debtor spouse. Debtor had transferred his interest in the homestead (as well as other real property) to non-debtor spouse and as a result, there was no common debtor for the two funds. Despite the transfer to a non-debtor, the court ordered the marshaling of assets to protect the interests of creditors as their interests were created before the debtor had transferred the property to his wife. The Eighth Circuit allowed this finding as it has an expansive view of marshaling assets, allowing the court to fashion broad equitable remedies. Directly counter to the Eighth Circuit, the Tenth Circuit Court of Appeals using Colorado law did not allow the doctrine to be used against the non-debtor non-filing spouse. In the Tenth Circuit Case, the debtor and spouse "sometimes owned and always controlled" a residence. The debtor filed a Chapter 13 bankruptcy, which was converted to a Chapter 7. At some point, the residence was sold, with half the proceeds going to pay off a home equity line of credit and half the proceeds going to the non-debtor spouse. The court directly cited to the Minnesota case and stated it did not apply in Colorado. The Colorado court did not allow the marshaling of assets because the elements of the doctrine were not strictly met.

Like other creditors, the doctrine of marshaling assets applies to the government. Although not always in favor of the other creditors, taxing entities (including state taxing offices and the IRS) are subject to the marshaling of assets. For example, a bankruptcy court applying Massachusetts law specifically found the United States (and its various governmental entities) is not wholly exempt from the doctrine. In this specific case, the court found the IRS had properly been compelled by the lower court to marshal assets it had tax liens against to preserve funds for a bankruptcy estate and its unsecured creditors. The IRS was required to look at the equity in the homestead or execute on nonexempt assets for payment. However, in Kansas, when a Chapter 7 trustee requested the IRS refund be turned over to be included in the bankruptcy estate, the court found that the refund was used as a setoff and was never in the debtor's control such that it was not subject to marshaling.

These cases – and many more uncited here – show the doctrine of marshaling assets is complex, can be unpredictable, and is evolving during this uncertain time. Creditors should be aware of the doctrine and how it might apply in each of their cases. Creditors may also want to keep the doctrine in mind when analyzing loans for renewal. Proactive thinking will aid in protecting a creditor's interests.

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DESPERATE MEASURES CALL FOR AN EXTRAORDINARY RESPONSE: EMERGENCY COLLECTION ACTIONS

A seriously dishonest or desperate borrower, even if relatively rare, can be the cause of the biggest losses a lender may face. Many loans are extended on the assumption that the bank has sufficient collateral—whether real estate, equipment, receivables, or other property—to repay the loan in the event the borrower cannot make his regular payments. If a lender goes to collect and finds that the collateral no longer exists, recovering the potential losses becomes that much more difficult and ultimately unlikely.

A desperate borrower facing a cash crunch or dwindling revenues and unable to make his payments might take drastic measures to avoid the day of reckoning such as selling collateral without the lender's knowledge or approval in order to continue making payments. Even worse, a borrower who believes he has been wronged by the lender might feel justified in hiding, transferring, or giving away collateral, simply to keep the lender from liquidating it at all.

In any of these scenarios, the risk of loss for the lender is considerable, but a lender is not without recourse if it discovers this type of wrongdoing, particularly if it catches it early. There are several emergency legal procedures that can be taken to restrict the debtor and protect collateral, including replevin, temporary restraining orders, and preliminary attachment motions. Prompt court involvement is key to limiting losses.

Ex Parte Replevin Motion

A replevin motion is brought at the beginning of a collection lawsuit to get court permission to seize personal property collateral so that it can be liquidated and applied to the loan. Typically, the debtor must be given advanced notice (around twenty-one days) of the request and is entitled to appear at a hearing and argue that the lender should not be granted immediate possession of the personal property.

Naturally a bank may be concerned that the borrower could dissipate significant assets before the hearing is held or might ramp up their fraudulent activity while the hearing is pending. In limited circumstances, Minnesota law allows a lender to obtain a replevin order "ex parte," meaning without notice to the other side and without a hearing. A court can grant a replevin order if, in addition to demonstrating that the lender is entitled to immediate possession because of a default under a security agreement or otherwise, the lender also shows: (1) that informing the borrower of the hearing would pose a risk to the collateral, (2) that the lender is likely to succeed, (3) that the collateral is at serious risk of being sold, hidden, or destroyed, or the lender will otherwise suffer irreparable harm, and (4) the only way to protect the lender is to grant immediate possession.

If a court determines that these requirements are met, it can grant the replevin order and direct the sheriff to assist the lender in recovering the property immediately and without first notifying the borrower. Typically, such an order will also restrict the debtor from taking any action to hide or transfer more collateral in the meantime until the sheriff collects it, thus hopefully stemming additional losses. A borrower who disobeys that order could be fined or even jailed for contempt of court. As a condition of granting the order, the statute requires the lender post a bond or other security with the court equal to 150% of the value of the security.

After the initial order, the court must hold a hearing allowing the debtor to explain their side of the case. However, so long as the lender has a valid security interest and can show a default, the court is unlikely to reverse the order.

Temporary Restraining Order and Preliminary Injunction

Similar to an ex parte replevin order, the court can also issue an ex parte temporary restraining order. A restraining order is simply an order from the court directing a person to refrain from doing something, or in some cases requiring a person to act. A court has wide discretion in whether to issue a restraining order, and will look at factors including the relationship between the parties, the harm either party will suffer if the restraining order is granted or denied, the likelihood the party seeking the order will ultimately prevail at trial, and other public policy considerations. Most importantly, however, the party seeking the order must show they will suffer "irreparable harm" if the order is not granted.

> ***"...a lender is not without recourse if it discovers this type of wrongdoing, particularly if it catches it early."***

In many cases, the same facts that would support a request for an ex parte replevin order will also support a claim for a temporary restraining order, but occasionally the situation will call for one as opposed to the other. For example, if a borrower has hidden collateral so that the bank might not be able to repossess it even if it does obtain a replevin order, a restraining order could be used to restrict the borrower from disposing of it and to require the borrower to turn it over. If a borrower has transferred assets to a third party, a temporary restraining order could be issued against the third party, imposing similar restrictions.

Also similar to the replevin order, if the court issues a restraining order ex parte, the court rules require that a hearing be held to determine whether the restraining order should be converted into a "preliminary injunction" that will remain in force for the remainder of the case. At this hearing, the borrower can present his or her own evidence and arguments against the continued restrictions.

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DESPERATE MEASURES

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Prejudgment Attachment

The two prior remedies often apply in cases where specific collateral subject to a lender's security interest is at risk due to the borrower's actions. In situations where the lender does not have a security interest in property, the lender typically must file a lawsuit and obtain a judgment for the outstanding debt, and then execute that judgment by having the sheriff seize that property and sell it. But completing a lawsuit and obtaining a final judgment can take a year or longer, leaving the borrower ample time to dissipate assets in the meantime.

However, a lender can seek prejudgment attachment of nonexempt property. Prejudgment attachment in effect freezes the assets while the case is pending, ensuring it remains available to satisfy an eventual judgment against the debtor. Prejudgment attachment may only be ordered in limited circumstances where there is a risk the debtor is hiding or disposing of assets to defraud creditors, is removing property from the state, has committed fraud or committed a felony relating to the claim, or where the debtor has converted property into money in an attempt to place it outside the reach of creditors. If the court finds one of these situations exist and determines the plaintiff is likely to succeed in the lawsuit itself, it can issue an attachment order directing the freeze and seizure of property, both real and personal.

Petition to Avoid Farmer-Lender Mediation

As all agricultural lenders know, before pursuing actions to enforce a debt against agricultural property, the lender must offer farmer-lender mediation, a process that can last months and significantly delay collection efforts. Even if the debtor does not take advantage of mediation, a delay of even a few weeks to send the offer may allow additional collateral to be lost. The farmer-lender mediation statute does allow a court to proceed with a collection action without offering mediation in limited circumstances.

Under the statute, if a debtor has fraudulently concealed, removed, or transferred agricultural property subject to a security interest, a lender may petition the court to excuse mediation. Upon filing a petition, the court must hold a hearing within seven to fourteen days and issue an order within ten days after. If the court determines the borrower has mishandled or converted collateral, it can waive the mediation requirement and allow the lender to immediately pursue its collection efforts.

Conclusion

If a lender discovers that their borrower has sold collateral without permission or has hidden or dissipated assets, the lender should act quickly to protect the remaining collateral to ensure a full recovery to the extent possible. Taking advantage of some of these emergency procedures can limit any losses and protect the lender's position.

Save the Date!

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STATE COURT RECEIVERSHIP: A POWERFUL CREDITOR'S TOOL

A receivership is often labeled as the state court's version of bankruptcy, though there are many differences between the two. The device of receivership is primarily a creditor's remedy and is typically invoked in various circumstances including the collection of a money judgment, liquidation, and managing assets. A creditor is typically the party requesting the court for appointment of a receiver and the lender is the respondent in the case and whose property is being subjected to a receivership. Because of the fundamental nature of a receivership, the imposition of a receiver is more prevalent during periods of economic recession and depression including the Great Recession of 2008. Not surprisingly, and seemingly in response to the Great Recession, Minnesota revised and enacted an updated receivership statute in 2012 which can be found at Minnesota Statutes sections 576.21-576.53.

The Life of the Receivership

The inception of a receivership begins when a party in a suit, typically a creditor, brings a motion to appoint a receiver. Thereafter, the receivership is established when the court grants the motion. It is generally within the discretion of the court whether a receiver is appointed—but where a creditor is seeking a mortgage foreclosure—the court must appoint a receiver after the creditor moves for one. A receiver may be appointed to enforce a prior judgment, preserve property pending an appeal, as a creditor's remedy, or in all other cases, under the general equity powers of the court. The party seeking the receivership will recommend a receiver, and a court will generally appoint the recommended receiver if the recommended person or entity is qualified and independent. Accordingly, the court will examine whether the recommended receiver is independent from the parties in the underlying litigation and has the sufficient experience and knowledge to adequately manage and control the receivership property in question.

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STATE COURT RECEIVERSHIP: A POWERFUL CREDITOR'S TOOL

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Once appointed, the receiver takes control of the receivership property, which may include real estate and other assets of the respondent, but it is the court that has ultimate and exclusive authority over the receivership property. During the course of the receivership, the receiver is required to make interim reports to the court providing an update of the receivership and receivership property. Similar to bankruptcy, once the receivership is ordered, an immediate stay puts a halt to anyone from interfering with, taking possession of, or exercising control over the receivership property. The stay expires 30 days form the time of the appointment of the receiver unless the court orders otherwise, and the stay may be extended if the receiver or another party brings a motion seeking an extension. However, the commencement of a bankruptcy proceeding falls outside the receivership stay, and as such, when a receivership is ordered, the respondent may still file for bankruptcy which would halt the state court receivership proceedings. Finally, the receivership ends once the receivership's goals are achieved or by court order, operation of law, or by resignation by the receiver.

Limited Versus General Receiver and Their Respective Powers

One of the key distinctions the Minnesota receivership statutes make is between a limited and a general receiver. When a receiver is appointed and has control over an entity or all of the assets of the respondent, the receiver is a general receiver. In contrast, and in the usual circumstance, when a receiver is appointed over a particular asset of the respondent, the receiver is a limited receiver. The general receiver has the same powers as the limited receiver plus some powers that the limited receiver does not enjoy.

A. Both Receiver's Powers

The powers provided to both types of receivers include, in part, the power to: incur and pay expenses in connection with the receivership; control, manage, and conserve the receivership property, including leasing real estate; and assert rights, claims, and defenses relating to the receivership property. Further, the receiver has the power to sue and be sued, though the receiver is immune to claims against it relating to its duties as receiver. The receiver may demand that persons possessing control over the receivership property turn it over to the receiver and may obtain necessary credit for the benefit of the receivership. These powers are not exclusive, and the court may provide a receiver with a power beyond what is specified in the Minnesota receivership statutes.

B. The Power to Sell Free and Clear of Liens

Among other things, a general receiver has the power to sell receivership property free and clear of liens after prior approval provided by the court. A receivership sale is not a foreclosure and consequently, the receiver may sell the receivership property free from statutory redemption rights. Though, a general receiver's power to sell may not be used to exclusively avoid redemption rights. The receiver may also sell the receivership property free and clear of liens, with some exceptions including liens for unpaid real estate taxes. But a receiver may not sell receivership property free and clear if the real property to be sold is agricultural or is a homestead, unless all owners of the property consent to the sale. Lastly, if an owner or holder of a lien on the property objects to the sale, and the court determines that the amount to be likely realized from the sale is less than the objecting person would realize without the sale, the court will deny the receiver's power to sell the property.

In conclusion, a receivership is different than bankruptcy in many respects. However, a receivership is a powerful tool afforded to a creditor, especially when management over collateral would be beneficial during the pendency of an action relating to debt collection or foreclosure.

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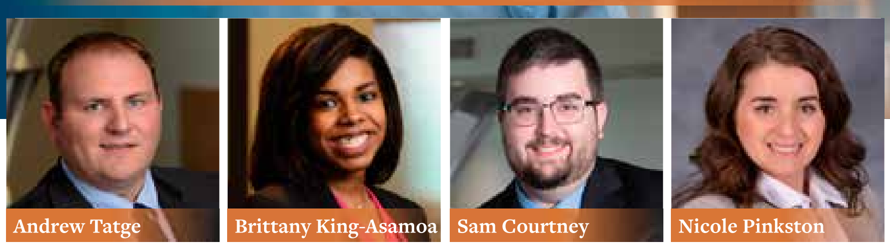

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