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New Interpretation of Law Regarding Stripping Liens Secured by Debtor's Homestead

In In re Fisette, No. 11-6012, the 8th Circuit B.A.P. (July 27, 2011) reversed the Minnesota Bankruptcy Court and held that a debtor can "strip off" wholly unsecured junior mortgages on a homestead even if the debtor is ineligible to receive a Chapter 13 discharge.

In Fisette, less than one year before filing this Chapter 13 bankruptcy case, the debtor received a Chapter 7 discharge. Based on this prior discharge, the debtor was not eligible to receive a discharge in his Chapter 13 bankruptcy case. The dispute in the current case surrounds liens on the debtor's homestead. The first mortgage on the debtor's homestead is greater than the debtor's scheduled appraised value of the property, but there are also second and third liens on the property which, based on the value of the property, are actually unsecured liens. In the proposed Chapter 13 plan, the debtor planned on avoiding the 1st secured lien and paying all the unsecured creditors except the second and third priority lien holders of the property. The Minnesota Bankruptcy Court denied the confirmation of the debtor's plan stating the law in Minnesota prohibits a debtor from stripping second or third mortgages secured only by a homestead.

On review, the 8th Circuit B.A.P. reviewed the Minnesota Bankruptcy Court's interpretation of 11 U.S.C. § 1322 and the ruling in Nobleman v. Am. Sav. Bank, 508 U.S. 324 (1993). In Nobleman, the Supreme Court held that the antimodification clause in §1322 prohibited the debtor from "stripping down" the unsecured portion of the creditor's undersecured claim on a debtor's homestead. Before and after the Nobleman case, Minnesota courts have held that under §1322 a debtor could not strip off a wholly unsecured lien on a homestead. However, the B.A.P. noted that appellate courts in all other circuits disagree with Minnesota's interpretation, and hold that §1322 "bars Chapter 13 debtors from stripping down a debtor's claim *when any portion of that claim is secured by the debtor's home*." Griffey v. U.S. Bank (In re Griffey), 335 B.R. 166, 168-69 (B.A.P. 10th Cir. 2005) (emphasis added). In this case, the B.A.P. agrees with the other circuit courts and their interpretations of §1322 and Nobleman and effectively changes the law in Minnesota. In this case, the B.A.P. first looked to see if the second and third lien holders had secured claims. Unlike the facts of Nobleman where the lien holder was *partially* secured, the first mortgage in this case was undersecured, which left no value in the property to secure the second and third liens. The court noted that the plain language of §1322 states that a debtor may modify the rights of holders of unsecured claims, and therefore since the second and third lien holders are *wholly* unsecured, the rights of the second and third lien holders may be modified and are not protected by §1322.

Next, the B.A.P. looked at whether the debtor could effectively "strip" the second and third liens on his homestead even though he was not eligible for discharge. Although there is a disagreement in the courts on this question, the B.A.P. held that stripping of a wholly unsecured lien on a homestead becomes effective upon completion of a debtor's obligation under her plan and is not contingent on

receiving a Chapter 13 discharge because the conditions to confirmation of a Chapter 13 plan does not include eligibility for a discharge. Thus, the debtor is allowed to avoid the second and third liens.

While the B.A.P reversed the Minnesota Bankruptcy Court's decision not to confirm the debtor's Chapter 13 plan because it objected to the stripping of the second and third liens on the debtor's homestead, the B.A.P. did not conclude that the debtor's plan, as proposed, should be confirmed. They noted that because the second and third lien holders on the debtor's homestead are unsecured creditors, they should be treated like all other unsecured non-priority claims.

Creditor's Improved Position Test Defense to §547 Lien Avoidance

In Lange v. Inova Capital Funding, LLC (In re Qualia Clinical Service, Inc.), No. 11-1201 (June 14, 2011), the 8th Court of Appeals affirmed the Nebraska Bankruptcy Court and 8th Circuit B.A.P.'s finding that a trustee could avoid a security interest that was perfected just one month prior to the debtor's bankruptcy filing as a preferential transfer under 11 U.S.C. § 547.

In this case, the appellant had an agreement with the debtor in which it would buy some of the debtor's outstanding account receivables invoices. Under this agreement, if the appellant could not collect the full amount of the invoice, it could collect the remaining amount due from the debtor. As security for the amount owed by debtor to appellant, the appellant took a security interest in the debtor's property, including its accounts receivable. However, the appellant failed to properly file its UCC Financing Statement against debtor's accounts receivable until eighteen months after it made the agreement with the debtor, which was just one month before the debtor filed for bankruptcy protection. After the bankruptcy filing, the bankruptcy trustee filed this adversary proceeding to avoid the appellant's lien on the debtor's accounts receivable arguing that the perfection of the appellant's security interest happened within the 90 days prior to filing the bankruptcy petition. Both the Nebraska Bankruptcy Court and 8th Circuit B.A.P. held that the appellant's lien was an avoidable preference under §547.

The Court of Appeal's analysis centers around §547(c)(5)'s preference defense that provides a creditor protection from a trustee's lien avoidance if the creditor's position is not improved in a certain amount of time prior to when the debtor files for bankruptcy. Under §547(c)(5)(A), a court must compare a creditor's position at the time the debtor files for bankruptcy and its position 90 days prior to such filing. The first step is to calculate the difference between the amount of debt owed the creditor and the value of the property securing the debt 90 days prior to the debtor's bankruptcy filing. Next, the same calculation is made based on the amount of debt and value of the property at the time the debtor files for bankruptcy. Finally, the two calculations are compared and if there is a reduction in the amount by which the debt exceeded the value of the security then the creditor has an improved position and is not protected by §547(c)(5).

In this case, the appellant argued that it was oversecured when the debtor filed for bankruptcy and for the 90 days prior to this filing, and therefore its position could not have been improved. However, the courts rejected this argument because 90 days prior to the debtor's bankruptcy filing the appellant's security interest was unperfected, but was perfected by the time the debtor filed. The Court of Appeals held that under §547(c)(5) when a creditor's security interest is unperfected, the value of its interest is zero. So the appellant's position was greatly improved during the 90 days prior to the debtor's bankruptcy filing, because upon perfection the appellant's lien, and thereby its interest, went from undersecured to oversecured. The court noted that the legislative purpose of §547(c)(5) is to limit the right of creditors with floating liens over receivables or inventory, and not to improve the rights of an unsecured creditor with respect to other unsecured creditors that are unaware of such a creditor. The court does not believe §547(c)(5) should protect unsecured creditors that have "secret" liens that are perfected only upon the eve of a bankruptcy petition, and therefore appellant's perfected lien in debtor's accounts receivable can be avoided under §547.

Mix of Exempt and Non-Exempt Property Does Not Destroy Exemption

In In re Danduran, No. 10-3813 (June 14, 2011), the 8th Circuit Court of Appeals reversed the North Dakota Bankruptcy Court and 8th Circuit B.A.P.'s rulings not allowing a debtor's homestead exemption. In its reversal, the Court of Appeals held that the trustee did not provide any evidence to support its objection of the debtor's homestead exemption and there were insufficient findings supporting the trustee's allegation that exempt property was converted to non-exempt property.

Prior to filing his bankruptcy petition, the debtor in Danduran sold his primary residence. Included in the sale of his home were fixtures and a number of personal property items including a hot tub, furniture, rugs, decorations and audio-visual equipment. Some of the proceeds from the sale were used to fully pay off the mortgage on the property. The remaining proceeds were deposited in a savings account. In his bankruptcy case, the debtor claimed the homestead exemption for the amounts held in the savings account. The bankruptcy trustee objected to this exemption, and the North Dakota Bankruptcy Court found that a "significant portion" of the account was proceeds from the sale of non-exempt personal property. Based on this finding, the bankruptcy court held that the debtor's actions were "sufficient indicia" of his intent of converting his non-exempt property to exempt, homestead property, and therefore the debtor's homestead exemption was not allowed. The 8th Circuit B.A.P. affirmed the bankruptcy court's holding.

The Court of Appeals disagreed with the lower courts and stated that "sufficient indicia" of intent to convert non-exempt property to exempt property is insufficient to disallow an exemption. Instead, there must be intent to covert non-exempt property *plus* actual conversion of that property. Simply depositing proceeds of the sale of personal property into an account that holds proceeds of the sale of exempt

property does not convert the non-exempt property. Instead, to prove conversion, the proceeds of the non-exempt property would have to be used to pay a lien holder in order to increase the value of the exempt property. While the Court of Appeals found that the bankruptcy court properly ruled on the amount of proceeds for the personal property, it also noted that the bankruptcy trustee did not provide any evidence that the proceeds of the sale of the house, both exempt and non-exempt property, was ever segregated and eventually improperly combined to get an exemption for non-exempt property.

Avoidance Actions Should Generally Remain in the Bankruptcy Court until Trial-Ready

In Kelley v. JP Morgan Chase & Co., the district court denied a motion to withdraw reference of four separate trustee avoidance actions pending in the bankruptcy court as adversary proceedings, which were nearly identical to a fraudulent transfer action pending in the district court brought by the same plaintiff, but in his capacity as a federal receiver. The avoidance actions included fraudulent transfer and preference actions to recover moneys paid by Tom Petters and his affiliated companies to JP Morgan Chase as part of JP Morgan's sale of Polaroid and subsequent loans to Petters' companies. Douglas Kelley served as receiver for Petters and bankruptcy trustee for two Petters-related companies, Petters Company, Inc., and Petters Group Worldwide, LLC. Kelley and two other trustees for the bankruptcy Polaroid entities and Petters Capital, LLC commenced similar adversary proceedings in the bankruptcy cases to avoid payments made by the companies pursuant to the alleged Petters Ponzi scheme. Kelley in his capacity as receiver also commenced a lawsuit in the district court to similarly recover payments made by Petters individually. JP Morgan sought to withdraw reference of the adversary proceedings to the district court so that all matters would be pending before the district court.

The district court denied the motion to withdraw reference. It found that the bankruptcy court generally should retain a case until trial except in extraordinary circumstances. This is particularly true where the case involves core claims, and the district court found that the fraudulent transfer, preference and turnover claims were core. The district court found that Stern v. Marshall did not require transfer, and found that Stern applied narrowly only to the state-law counterclaims at issue in that case. Even though state law counterclaims against the debtor are also core as defined under the statute, the claim in Stern was "'in no way derived from or dependant on bankruptcy law,' but rather was 'a state tort action that exists without regard to any bankruptcy proceeding.'" The district court further held Stern did not direct the court to transfer a case early in the proceedings.

Defendant argued that because one case was already pending before the district court, it would promote judicial efficiency to withdraw the remainder. The district court distinguished the adversary proceedings from other adversary proceedings which were related to large multi-district litigation taking place already. The district court found here the converse was true. The adversary proceedings filed in Petters were part of over 200 similar adversary

proceedings already pending in the bankruptcy court which were brought to recover payments made from the Petters Ponzi scheme. The bankruptcy court had already established procedures to consolidate issues on a number of fronts and withdrawing a small grouping of cases from that process would not serve judicial economy. The district court stated that JP Morgan could renew the motion once the case was ready for trial.

BAP Reverses Bankruptcy Court Regarding Avoidance Action on Hecker's Medina Property

The Eighth Circuit Bankruptcy Appellate Panel found that the Chapter 7 trustee for Dennis Hecker could maintain an avoidance claim based on a judgment creditor's post-petition registration of judgment against Hecker's already fully-encumbered real property located in Medina, and reversed the bankruptcy court's dismissal of such claims and remanded for further findings.

Three creditors obtained judgments against Hecker shortly before Hecker filed for bankruptcy. The judgments did not initially attach to the Medina property, which was Torrens property and as such, required registration of the judgments to create a lien. The judgments were not registered as of the petition date.

After Hecker filed, US Bank sought relief from stay to foreclose its first-position lien. The property had an assessed value of $1,617,000, but encumbrances totaling approximately $3,700,000 consisting of three existing mortgages, two tax liens, and a mechanic's lien. The trustee did not oppose the lift stay and let the foreclosure sale proceed pursuant to which US Bank purchased the property for $213,263.

At around the same time, the trustee had an ongoing dispute with Hecker, Ralph Thomas, and another individual, which the trustee settled by selling whatever remaining interest he had in the property to Thomas for $75,000. The trustee delivered a quit claim deed in exchange for the $75,000 payment, but Thomas never recorded the quit claim deed. The trustee subsequently learned that Hecker had provided the $75,000 to Thomas by raiding his children's and grandchildren's trust accounts, and the trustee advised the court of this fact on March 18, 2010. Nonetheless, the trustee retained the $75,000, although at some point Thomas returned the deed to the trustee.

On April 20 and 22, 2010, the judgment creditors registered their judgments against the Medina property. The redemption period on the US Bank foreclosure expired in June, and at that time neither the debtor, nor the junior lienholders had filed notices of intent to redeem. This left the judgment holders with the last opportunity to redeem, and one of the holders, New Buffalo Auto Sales, LLC, did redeem for payment of the amount owed to US Bank. New Buffalo then sold the property to Palladium Holdings, LLC, an assignee of one of the other judgment holders who registered post-petition, for $80,000 cash and a mortgage lien against the property in the amount of $320,000. Palladium then filed a certificate of redemption.

Although the trustee did not take the position that the actions by the judgment holders violated the automatic stay, the trustee subsequently sued the judgment holders, including New Buffalo and Palladium, for avoidance of the judgments as either preferential or post-petition transfers.

The bankruptcy court dismissed the trustee's complaint because: (1) there was no pre-petition transfer to support a preference claim; (2) even if there was a post-petition transfer, it was not avoidable because there was no equity or value in the property above the already existing encumbrances; and, (3) there also did not appear to be an avoidable post-petition transfer because the bankruptcy court's approval of the settlement agreement whereby the trustee deeded the property to Thomas "authorized" the subsequent transfer by the judgment holders. Moreover, the bankruptcy court found that Thomas did not have to record the deed to complete the transfer of title to the property.

The BAP reversed on several points, although it did find that there was no basis to deem the pre-petition entry of judgment as preferential because on the petition date there was no equity in the property. The BAP, however, did find that there were grounds to further litigate whether or not the subsequent registration of the judgment against the property constituted an avoidable post-petition transfer under 11 U.S.C. § 549. First, the BAP concluded that in fact it appeared that there was a transfer of property of the estate. In these circumstances, Minnesota law required Thomas to register the deed in order to transfer title. Thus, without registration, the property remained part of the estate on the date the judgment holders registered their interests. Second, the BAP found that the bankruptcy court's orders lifting the stay for US Bank to proceed with foreclosure, and approving the settlement agreement did not cause the trustee to abandon the property or otherwise authorize the registration of the judgments. The BAP stated that on remand the bankruptcy court may consider equitable issues in its analysis such as the trustee's decisions not to attempt to vacate the order approving the settlement agreement, not to redeem the property, and not to promptly challenge the post-petition actions as violating the automatic stay.

The BAP next addressed the trustee's potential remedies under Section 550 of the bankruptcy code, but noted that issues such as the transferee's good faith had not been previously addressed in the litigation. The BAP noted that "those judgment liens allowed New Buffalo to redeem at foreclosure, capture the increase in equity, and then sell the property to Palladium, transforming New Buffalo's unsecured pre-petition claim into an equity position." The BAP further found that if the transferee did not act in good faith, the transferred property could be recovered along with any appreciation in its value. The BAP instructed the bankruptcy court to reconsider whether a money judgment would be necessary "to restore the bankruptcy estate to its prior financial condition" before the registration of the judgments.

Aggressive Litigation by Chapter 7 Trustee in Land Development

Contract Dispute Realizes No Gain for Bankruptcy Estate.

The Chapter 7 trustee failed to prove the defendants breached a contract with the debtor or were unjustly enriched as the result of certain development services performed by the debtor on real estate development projects managed by the defendants, according to the bankruptcy court in Bucher v. Scott Unke et al. (In re: Gerald E. DeLoss and Joanne D. DeLoss), Adv. 09-3216 (Bankr. D. Minn., Aug. 22, 2011).

Debtor had worked in the real estate development business for many years. The essence of her work involved creating, soliciting and coordinating complete projects, more in the nature of design and planning. On October 6, 2008, debtor and defendants entered into a development agreement for debtor's services on a specific project, the Marina Lodge Project.

The idea for the project was to develop vacant land for a three-story mixed-use commercial and residential facility. Debtor's role under the contract was as a traditional developer to "create value" by using her expertise to improve design plans and by minimizing time, risk and costs. Debtor performed her work pursuant to the contract and received $6,000 plus expenses as compensation.

Debtor was also required, pursuant to the contract, to assist with document preparation, financing and permits. However, debtor and defendants were unable to sell the project as a going development, so it never made it off the ground and the need for performance of those duties never arose. Although defendants purchased the land for the project and procured architectural drawings, the project was never funded and no physical building was ever constructed on the Marina Lodge site. The site remains a shovel ready mixed-use project with a total price tag of approximately $5,000,000.

On November 27, 2006, debtor and defendants entered into an Independent Contractor Agreement, pursuant to which defendants agreed to pay debtor a percentage of fees collected as developer fees for particular projects. Debtor's share of the developer fees, if any, for each project would be between 20 and 80 percent of the total developer fees paid for each contracted project. Debtor also had the opportunity to realize certain bonuses depending on the amount of profit, if any, obtained.

The Independent Contractor Agreement anticipated a separate project agreement for each such project wherein the parties would determine debtor's portion of the fees and potential bonus compensation on a case by case basis. A generic form project agreement was drafted and ready to use in the event of their acquisition of an actual development project. The generic form contained blanks to describe the potential project and the compensation terms. The parties agree they never entered into any project agreements.

The term of the Independent Contractor Agreement ran until November 1, 2008. It automatically renewed for successive one-year terms unless either party terminated it, which termination did not need to be in writing. The contract also included a mutual exclusivity provision.

Debtor filed for bankruptcy on May 2, 2007. Listed as an asset on debtor's schedules were estimated and anticipated

fees from land development contracts with defendants valued at $25,000.

On May 11, 2007, defendants purchased an option to buy several acres of undeveloped land known as the Center Creek property for $785,000, intending to sell it in lots which would be developed, presumably by them and debtor.

Shortly thereafter, debtor's husband accepted a job approximately 150 miles away. Debtor informed defendants of this complication, noting that it was an unreasonable commuting distance away and that this was the end of their business relationship. The parties never communicated again and debtor took no further actions on behalf of defendants or any of the potential projects they had explored. Debtor moved away in October 2007.

On October 31, 2007, defendants executed an option to purchase real estate known as the Center Creek property. Defendants platted the property and, over the next two years, sold four lots that were developed for several commercial enterprises. Defendants were not selected as the developer of any of the parcels and they were not retained to perform any aspect of the property development. Instead, defendants were merely sellers.

The trustee argued the debtor's estate was entitled to $30,000 from the Marina Lodge project and $18,810 from the Center Creek property and he commenced an adversary proceeding against defendants for breach of contract and unjust enrichment.

The court ruled in favor of defendants, determining there was no breach of the Marina Lodge contract as both parties performed all duties essentially required by the agreement and no developer fees or bonus compensation was contemplated by that agreement, or, as a practical matter, collected. The court further determined that the Independent Contractor Agreement did not apply to the Marina Lodge project, as it was entered into after the execution of the agreement for that project, and because that project agreement contained a standard "entire agreement" clause.

With respect to the trustee's breach of contract claim concerning the Center Creek project, the court determined that the Independent Contractor Agreement terminated when debtor moved away, and even if it were still in effect, there was no separate project agreement drafted, and no development services performed by defendants. Instead, defendants were simply sellers of real estate.

Additionally, the court dismissed the trustee's unjust enrichment claim as a consequence of finding no enrichment whatsoever by the defendants at the debtor's expense.

Debtor's Failure to Properly Schedule All Creditor Claims in Time to Allow Creditor to Actively Participate Resulted in Exception to Discharge

In Croix Oil Co. v. Moua (In re: Mai Yer Moua), Adv. 10-3226 (Bankr. D. Minn., Oct. 14, 2011), the debtor executed a personal guaranty in 2007 as to an agreement between creditor and a third party for the purchase of BP-branded gasoline for sale at retail. On October 8, 2009, creditor commenced suit against debtor and others for breach of contract.

The action was venued in Washington County, Minnesota, District Court.

Debtor filed for Chapter 7 bankruptcy on November 24, 2009. Debtor's schedules did not include an entry for creditor's claim and creditor was not listed on the matrix of creditors that debtor's counsel included in the initial filing.

On February 11, 2010, the trustee filed a notice that assets would be administered for the payment of the claims of debtor's creditors. Notice was sent to all matrix-identified creditors identifying a May 17, 2010, deadline for filing proofs of claim. Meanwhile, the Washington County District Court ordered entry of a default judgment in favor of creditor and against debtor and others on May 28, 2010. The amount of the judgment entered in creditor's favor was $194,343.72.

On July 8, 2010, debtor's counsel filed amended schedules, adding an entry for creditor as a secured creditor. The collateral described was the commercial property on which the supplied gas station had been operated. However, creditor never filed a proof of claim and debtor's counsel never filed one on creditor's behalf.

Creditor learned of debtor's bankruptcy on July 8, 2010, when it was notified of the amended schedules and that the deadline for filing a proof of claim had expired. Creditor filed an adversary proceeding on October 29, 2010, seeking to except its judgment from debtor's discharge.

The trustee filed her final report on December 21, 2010, proposing a distribution that did not include any distribution to creditor. The notice sent with the proposed distribution identified a deadline of January 18, 2011, for filing objections. No party filed an objection to the trustee's proposed distribution.

Instead, creditor moved for summary judgment in the adversary proceeding to have its entire claim be determined nondischargeable pursuant to 11 U.S.C. § 523(a)(3)(A), which sets forth an exception to a debtor's discharge where the claim was neither listed nor scheduled in time to permit a timely filing of a proof of claim, unless the creditor had notice or actual knowledge of the case in time for a timely filing.

The court granted creditor's motion, reasoning that it was uncontroverted that creditor's claim was not scheduled or listed by debtor, and that creditor had no notice or actual knowledge of debtor's bankruptcy filing in time to timely file a proof of claim. Because creditor lost the right to participate in the estate in the status of a creditor, the court determined that debtor's entire debt to creditor was exempted from discharge.

In so ruling, the court rejected debtor's argument to interpret the distribution provisions of the Bankruptcy Code pursuant to a "holistic approach" of statutory construction, under which provisions of a comprehensive statute that are extraneous to the one that specifically governs the subject matter in suit are considered in order to determine the meaning of words in the governing provision. The court determined that this approach ignored the plain meaning of the statutory language and would be impractical in light of the actual legalities, mechanics, and function of estate administration.

Additionally, the court held that debtor's interpretation would improperly shift the

burden of claim management from the debtor to creditors, which would be inconsistent with the Bankruptcy Code in light of several Code provisions that explicitly and implicitly require the debtor to file accurate schedules of creditors' claim in the first instance.

The court also rejected debtor's plea at oral argument to limit the discharge to what creditor would have received had a proof of claim been timely filed, holding there was no basis in 11 U.S.C. § 523(a)(3)(A) to do that.

BAP Affirms that Failure to Turn Over Construction Proceeds to Subcontractor Does Not Result in Nondischargeabilty of Amount Owed.

In Reshetar Systems, Inc. v. Thompson (In re: Scott Alfred Thompson and Kirsten Marie Thompson), No. 11-6008 (BAP 8th Cir., October 4, 2011), debtor was the sole owner and president of a construction company that served as the general contractor hired to construct an Applebee's restaurant. Creditor was a subcontractor that agreed to provide the labor, materials, skills, and equipment necessary to perform carpentry and drywall work for the project.

Creditor performed its end of the bargain in full, completing its work in January 2004. Despite being paid most of what it claimed it was owed from Applebee's, debtor's company failed to pay creditor $48,293.81 of the total it was owed. Creditor filed a lawsuit against debtor and debtor's company, and in June 2009 debtor confessed judgment in the amount of $78,000.

Debtor filed a Chapter 7 bankruptcy petition in December 2009. Creditor commenced an adversary proceeding pursuant to 11 U.S.C. § 523(a)(2)(A), (4) and (6) to determine the dischargeability of the $78,000 owed by debtor. The matter was tried, and on January 20, 2011, the bankruptcy court entered judgment in favor of debtor. Creditor appealed, although it abandoned its claim pursuant to 11 U.S.C. § 523(a)(2)(A).

The BAP affirmed, holding that creditor could not prevail pursuant to 11 U.S.C. § 523(a)(4) because it could not prove the existence of a fiduciary relationship arising from an express or technical trust. Creditor alleged that Minn. Stat. § 514.02, subd. 1 created the requisite fiduciary relationship as it mandated that debtor's company hold the payments it received from Applebee's in trust for those who furnished labor, skill, or machinery contributing to the improvement of the real property.

However, the BAP held that the statutory language immediately following the provision on which creditor was relying provided for no fiduciary or tort liability for statutory violations and therefore compelled a finding of no fiduciary relationship. The BAP also rejected creditor's alternative argument that because debtor's company was insolvent when it received final payment from Applebee's that a common law fiduciary relationship was created because there was no evidence that debtor preferred himself over his company's other creditors.

Likewise, the BAP ruled against creditor on its claim under 11 U.S.C. § 523(a)(4) because creditor could not show any evidence that the statute, the contract, or

the subcontract gave creditor a specific property right in the payments debtor's company received from Applebee's and because debtor's company was contractually entitled to such payments.

The BAP also held that the bankruptcy court's ruling against creditor on its 11 U.S.C. § 523(a)(6) claim was not clearly erroneous as debtor's failure to pay creditor its portion of the proceeds obtained from Applebee's was not a willful and malicious failure to turn over creditor's property as it was, in fact, the property of debtor's company. Because debtor's company lawfully possessed the proceeds, no claim under 11 U.S.C. § 523(a)(6) could exist according to the BAP.

Mortgage Creditor Must Produce Original Promissory Note to Prove Standing as Mortgagee when Note is Endorsed "in blank."

In Banks v. Kondaur Capital Corporation (In re Banks), 457 B.R. 9 (B.A.P. 8th Cir. 2011) the debtors filed an adversary proceeding challenging the standing of Kondaur Capital Corp. as the holder of the promissory note and owner of the mortgage. The debtors alleged several breaks in the chain of assignment of the mortgage as support for their claims. Kondaur's proof of claim included a promissory note not specifically endorsed to Kondaur; rather, it was endorsed "in blank." Kondaur moved to dismiss the adversary proceeding. The bankruptcy court converted the motion to one for summary judgment and granted the motion.

The BAP reversed the bankruptcy court. The BAP found that, because the promissory note was endorsed in blank, the note was a "bearer" note, which requires actual possession of the note to enforce it under Minnesota's Uniform Commercial Code, Minn. Stat. § 336.3-205(b). Nothing in the record evidenced the location of the note. The BAP held that summary judgment was improper because there was a material issue of fact regarding whether Kondaur had possession of the original promissory note. Kondaur's failure to produce the note at or before its motion precluded a determination that Kondaur has the right, as a matter of law, to enforce the promissory note.

Debtor is Not Required to Turnover Property to the Bankruptcy Estate Under 11 U.S.C. § 542 Based on Trustee's Unjust Enrichment Theory.

In Lovald v. Falzerano, (In re Falzerano), 454 B.R. 81, (B.A.P. 8th Cir. 2011) a South Dakota debtor was deeded a life estate in certain ranch land. As part of a settlement from a will dispute, the debtor was permitted to manage a herd of cattle that were property of the probate estate and use profits from the land and cattle for the debtor's living expenses. Prior to filing Chapter 7 bankruptcy, the Debtor was sued in state court for $10,000 owed on a purchase of hay. The state court entered judgment against the debtor.

The Chapter 7 trustee filed a complaint under 11 U.S.C. § 542 against the debtor, the probate estate, and the debtor's fellow heirs. The trustee sued to recover rent for the pasture and the value of the hay provided to the probate estate's cattle. The trustee argued that the defendants were liable to the bankruptcy estate under an unjust enrichment theory.

The bankruptcy court entered judgment in favor of the Defendants and the BAP affirmed.

The BAP held that the relief sought by the Trustee was beyond the scope of 11 U.S.C. § 542. According to the BAP, actions to collect a debt owed to an estate are governed by § 542(b). And § 542(b) applies only to debts that are "matured, payable on demand, or payable on order." An action to collect a disputed debt based on an unjust enrichment theory does not meet this standard. Under South Dakota law, unjust enrichment merely implies the existence of a contract when a party confers a benefit upon another party and it is inequitable to for that party to receive the benefit without paying.

Additionally, the BAP found no basis to collect a debt under § 542(a). 542(a) permits a trustee to compel turnover only from entities which have control of property of the estate or its proceeds at the time of the turnover demand. At the time of the trustee's demand in the case, the defendants did not have possession of any proceeds of the estate and therefore nothing to turnover to the trustee.

Evidence of Debtor's Fraud, Mismanagement, Squandering of Estate Assets, Self-Dealing, and Sabotage Provide Cause for the Court's Appointment of a Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104(A)(1) and (A)(2)

In Keeley and Grabanski Land Partnership v. Keeley, Keeley, and Choice Financial Group (In re Keeley and Grabanski Land Partnership), No. 11-6020 (8th Cir. BAP, Sept. 6, 2011), the BAP affirms the bankruptcy court's order appointing a chapter 11 trustee.

The Grabanskis and the Keeleys, North Dakota farmers and agricultural business owners, became business partners when they formed the Keeley and Grabanski Land Partnership. The partnership owned several parcels of land, including two parcels in Texas, and was managed by Mr. Keeley and Mr. Grabanski. Later, the Grabanskis and Keeleys formed another partnership, G&K Farms, which rented farm land owned by KGLP. The rents paid to KGLP were used to pay the KGLP note obligations. To fund the farming operations, G&K Farms obtained financing from several lenders, including one lender that required a blanket lien on all of G&K Farms' property.

Eventually, G&K Farms suffered significant operating losses and sold all properties except for the two Texas parcels. In response to those losses, Mr. Grabanski obtained millions of dollars of additional financing on behalf of G&K, without obtaining the requisite approval from Mr. Keeley. Ultimately, G&K Farms discontinued operations and Mr. Grabanski convinced the Keeley's to assign their partnership interests in both G&K Farms and KGLP to the Grabanskis in exchange for his promise that he would satisfy all of both partnerships' debts, expenses, and liabilities. Despite this agreement, the Grabanskis failed to satisfy the debts of the partnerships, the partnerships fell into default under their loan obligations, and the lenders commenced various state court actions against the partnerships, the Grabanskis, and the Keeleys to recover their collateral and obtain deficiency judgments, including foreclosure of the Texas parcels.

Following this slew of lawsuits, the Grabanskis filed for chapter 11 bankruptcy and the creditors then filed adversary proceedings in the Grabanskis' bankruptcy case. These lawsuits alleged that Mr. Grabanski fraudulently transferred partnership assets, crop proceeds, and crop insurance to benefit his other farming operations and himself and misrepresented the financial situation of both partnerships. Throughout the Grabanskis' bankruptcy case, they repeatedly requested extensions to meet case deadlines and missed numerous other case deadlines.

Shortly thereafter, in order to stave off the foreclosure of the Texas parcels, the Keeley's filed an involuntary bankruptcy petition against KGLP and requested the appointment of an operating trustee. Although the bankruptcy court denied the Keeley's initial motion requesting the appointment of a trustee, the bankruptcy court ordered that the Keeley's could renew the motion at a later time. Just one month later, the Keeley's filed a second motion seeking a trustee. This time, the Keeley's again asserted that cause existed for the appointment of a trustee because of the allegations of fraud and misconduct by Mr. Grabanski, but also added information regarding Mr. Grabanski's failure to consider a reasonable offer by a reputable buyer to purchase the Texas parcels. The bankruptcy court granted the motion to appoint a trustee and the debtor appealed.

The BAP affirmed, holding that the record of the bankruptcy court proceeding supports a finding of cause under 11 U.S.C. § 1104(a)(1) and the appointment of a trustee is in the interests of creditors and the estate under 11 U.S.C. § 1104(a)(2) and is therefore mandatory. In doing so, the BAP articulated that the movant bears the burden of proof that cause exists to appoint a trustee and that burden must be met with the preponderance of the evidence. Furthermore, the BAP set forth the factors a court may consider when examining whether or not cause exists for the appointment of a trustee under 11 U.S.C. § 1104(a)(1): (i) the materiality of any misconduct; (ii) the debtor's evenhandedness or lack thereof in dealings with insiders and affiliated entities in relation to other creditors; (iii) the existence of pre-petition voidable preferences or fraudulent conveyances; (iv) whether or not conflicts of interest on the debtor's part are interfering with the debtor's ability to fulfill the debtor's fiduciary duties; and (v) whether there has been self-dealing or squandering of estate assets. In the present case, the BAP concludes that the Keeleys, the U.S. Trustee, and other creditors asserted numerous grounds for the appointment of a trustee including: the various fraud allegations against Mr. Grabanski; the failure of Mr. Grabanski or his entities to pay rent for farming the KGLP land or to service any of the KGLP debt; Mr. Grabanski's self-dealing and sabotage efforts in his failure to accept the reasonable sale proposal for the Texas parcels; the absence of any motivation by Mr. Grabanski or the debtor to move forward their bankruptcy cases; and the mismanagement of KGLP as illustrated by the existence of significant and unexplained operating losses of G&K Farms, which was supposed to fund KGLP's loan payments.

Finally, the BAP examined additional factors in the present case and determined that the circumstances also warrant the appointment of a trustee under 11 U.S.C. § 1104(a)(2).

Specifically, the BAP concluded that the movants provided sufficient evidence of the following factors: (i) the trustworthiness of the debtor; (ii) the debtor's past and present performance and prospects for the debtor's reorganization; (iii) the confidence, or lack thereof, of the business community and creditors in the present management; and (iv) the benefits derived from the appointment of a trustee as balanced against the costs of such appointment.

Even When a Claim Arises From the Debtor's Embezzlement and Larceny Related to the Misappropriation of Company Funds, a Member of the Company Does Not Have Standing to Pursue a Nondischargeability Claim Against that Debtor

In Lasica v. Francis (In re Dale Lee Francis, a/s/f Enviro Source and Logic, LLC), Adv. No. 11-3065 (Bankr. D. Minn. Sept. 1, 2011) Judge O'Brien held that the plaintiff's complaint under 11 U.S.C. § 523(a)(4) for the nondischargeability of a debt allegedly owed to him by the defendant as the result of embezzlement and larceny related to the defendant's misappropriation of funds in a limited liability company in which the plaintiff is a member must be dismissed with prejudice because that cause of action belongs to the limited liability company, not to the plaintiff individually.

The defendant, plaintiff, and a third party were equal members of a limited liability company that owned and managed residential properties. The plaintiff invested in the company and provided the company with a loan. The defendant and a third party also owned and managed other entities and engaged in unauthorized transactions with the company and the defendant and entities in which the defendant possessed an interest. Specifically, the transactions included the unauthorized reimbursements for unauthorized or undocumented expenses that were de facto distributions and distributions declared by the defendant and the third party and made to the defendant or his related entities. Despite being an equal member of the company, the plaintiff was neither aware of, nor gave written approval for, these transactions.

Based upon the return of partnership income for 2007 and 2008, the plaintiff should have received a membership distribution of $47,485 in 2007, and $32,811.33 in 2008. The plaintiff, however, only received a distribution of $2,756.13 from the company in 2007. In contrast, the defendant and the third party withdrew and paid themselves or could not account for payments of $378,969.55.

The defendant filed a motion to dismiss the case under Rule 12(b)(6) alleging that the relief sought by the plaintiff is not plausible on its face because the plaintiff has not pleaded a cognizable interest in the property he claims was misappropriated by the defendant. The funds allegedly misappropriated by the defendant were corporate funds and pursuant to Minn. Stat. 322B.55, Minnesota law recognizes corporate ownership of wrongful distributions. An individual shareholder may not directly assert a cause of action that belongs to the company. Because the injury is to the company and only indirectly harms the shareholder, the claim must be pursued as a derivative claim. As a result, the plaintiff did not have standing to pursue the claim. The bankruptcy

court granted the defendant's motion and dismissed the complaint with prejudice.

Actions Outside the Scope of a Power of Attorney May be Authorized if Accomplished at the Grantor's Request

In Hoglo v. Noreen (*In re Noreen)*, 10-51280 (Bankr. D. Minn. Oct. 18, 2011) (O'Brien, J.), Cindy Hoglo, in her capacity as Personal Representative of the Estate of Florence J. Faiman (the "Plaintiff") and Sharon L. Noreen (the "Debtor") filed cross-motions for summary judgment with respect the Plaintiff's claim for nondischargeability under 11 U.S.C. § 523(a)(4).

The Debtor held a power of attorney from Florence J. Faiman prior to Ms. Faiman's death. The power of attorney granted the Debtor authority to manage Ms. Faiman's affairs, but it did not grant the Debtor authority to make gifts.

In support of her claim under 11 U.S.C. § 523(a)(4), the Plaintiff alleged that the Debtor made several unauthorized gifts to herself and to third parties in violation of her fiduciary duties. In support of her motion for summary judgment, the Plaintiff argued that the Debtor defalcated under her power of attorney *as a matter of law* when she acquired cashier's checks with funds from the Debtor's accounts, and signed and distributed such cashier's checks herself, because such acts were outside the scope of the Debtor's power of attorney.

The Debtor argued in response that all such distributions were made at Ms. Faiman's direction and that, therefore, such distributions did not constitute a misappropriation of funds.

The U.S. Bankruptcy Court for the District of Minnesota agreed with the Debtor and held that, under the circumstances, it remained disputed and "far from clear" whether the Debtor or Ms. Faiman made the gifts at issue.

Summary Judgment is Not Proper in Nondischargeability Cases in Instances Where Material Facts Remain in Dispute

In Heide v. Juve (*In re Juve)*, 455 B.R. 890 (8th Cir. B.A.P. 2011) (J. Schermer, J. Federman, and J. Nail), a debtor (the "Debtor") appealed an order granting summary judgment to one of his creditors (the "Creditors") in a nondischargeability action filed under, among other things, 11 U.S.C. § 523(a)(2)(A). Over a period of years, the Creditors loaned funds with which the Debtor purchased inventory for Imports Plus, Inc. – a corporation owned by the Debtor. By the end of 2004, the Creditors had loaned approximately $300,000 to fund such purchases of vehicles. The checks from the Creditors were, in all instances, made payable to Imports Plus, Inc., and the Debtor and Creditors did not execute any written agreement in connection with the loans.

The Debtor filed a voluntary petition for relief under Chapter 7 jointly with his wife on August 28, 2009, and a few months later, the Creditors filed a complaint to determine dischargeability of the Debtor's debts based on multiple subsections of 11 U.S.C. § 523(a) and 11 U.S.C. § 727(a).

Among other things, the Creditors alleged that the Debtor made false representations that induced them to extend the loans at issue. The U.S.

Bankruptcy Court for the District of Minnesota granted summary judgment with respect to one of the Creditors' claims for nondischargeability pursuant to 11 U.S.C. § 523(a)(2)(A), and the Debtor appealed.

On appeal, the Eighth Circuit's Bankruptcy Appellate Panel determined that summary judgment was improper for two reasons. First, the Bankruptcy Appellate Panel found that a factual issue existed with respect to whether the financing relationship at issue was between the Debtor and the Creditor, or between the Creditor and Imports Plus, Inc. In support of this finding, the Panel noted that (i) all checks relating to the loans were made payable to Imports Plus, Inc. as opposed to the Debtor personally, (ii) there were no written agreements identifying the specific parties to the loans, and (iii) the Bankruptcy Court did not cite to other undisputed facts sufficient to support summary judgment.

Second, the Bankruptcy Appellate Panel determined that a factual issue existed with respect to whether the Debtor had obtained the majority of the funds at issue at the time the alleged false representations were made. In fact, the Panel determined that, based on the limited factual record available, any allegedly false representations appeared to have been made *after* the vast majority of the loans at issue had already been extended. Given its conclusions, the Bankruptcy Appellate Panel reversed the Bankruptcy Court's Order granting partial summary judgment, and remanded the case for further proceedings consistent with the Panel's opinion.

Bankruptcy Court Holds Damage to Residential Real Property Was Not the Consequence of Willful or Malicious Conduct by the Debtor-Lessee as is Required by 11 U.S.C. 523(a)(6)

In the case of Tompkins v. Rogowski, Case No. 10-3122 (Bankr. D. Minn. Aug. 19, 2011) (J. O'Brien), the Bankruptcy Court for the District of Minnesota was tasked with determining the dischargeability of a debt arising from damage sustained by a lessor of real property.

In June 2008, the Debtor-Defendants ("Debtors") entered into a two-year residential lease with the Plaintiff. As part of the lease term, the Plaintiff collected $1,400 as a standard security deposit, as well as $250 pet deposit due to the presence of a dog on the real property. In October 2008, the Plaintiff made an inspection of the home, finding it to be in normal condition.

In July 2009, the Debtors vacated the property without giving the Plaintiff advance notice. A neighbor subsequently informed the Plaintiff that the Debtors had abandoned the property prompting the Plaintiff to immediately enter the home and inspect for damages. During the inspection of the home, the Plaintiff found extensive damage, to include "various stains and traffic degradation on the flooring, marks and scuffs on walls and trim, small holes in the walls as well as possibly disconnected fixtures and various appliance and mechanical issues." Additionally, there was evidence that the Debtors, dog was either poorly house-trained or otherwise neglected resulting

in various damage to carpeted areas of the house.

The Plaintiff commenced suit in September 2009 against the Debtors in the Dakota County District Court, obtaining a default judgment in the amount of $27,092.40 for unpaid rent and property damage. In March 2009, the Debtors filed for Chapter 7 protection and in June 2009, the Plaintiff commenced an adversary proceeding challenging the dischargeability of the property damage portion of the Dakota County default judgment, which amounted to $8,324.40. The Plaintiff challenged dischargeability of the debt under 11 U.S.C. 523(a)(6), which excepts from discharge debts arising from "willful or malicious injury by the debtor . . . to the property of another entity."

The bankruptcy court noted that "willful and malicious" are distinct requirements of a claim under Section 523(a)(6) that must be proved by a preponderance of the evidence, and recklessly or negligently inflicted injuries are insufficient to hold the debts non-dischargeable. There must be a deliberate or intentional injury rather than deliberate or intentional acts leading to injury. Finally, the Debtors need not have actually intended that the injury occur, provided that the nature of the injury was such that the Debtors knew that the consequences or certain, or substantially certain, to be the result of their injurious conduct.

The court noted that the controversy was about "differing standards between reasonably average people, and different expectations," and found that the Debtors conduct did not rise to the level of "willful or malicious." The Plaintiff was aware of the presence of a dog on the property, and collected an additional deposit as a result of the presumable damage that such a pet can exact on real property. Additionally, although the Plaintiff found the property in normal condition upon her initial visit, it is reasonable to assume that such was case because the Plaintiff visited the property early in the lease period and the Debtors' occupied the property for an additional nine months. Although the Plaintiff's frustrations were to be expected, there was no evidence that the lack of care exhibited by the Debtors exceeded mere recklessness or negligence. Therefore, the requirements of Section 523(a)(6), and the property damage portion of the default judgment would not be excepted from discharge.

Excepting the Student Loans of a Mother of Five Would Impose an Undue Hardship

Michele D. Walker v. Sallie Mae Servicing Corp.; SLM Education Credit Finance Corporation; et al, No. 10-2032 (8th Cir. August 18, 2011).

The plaintiff accumulated student loan debt to fund certain portions of her education. In 2007, the plaintiff filed an adversary proceeding seeking to receive undue hardship determination pursuant to 11 U.S.C. § 523(a)(8) and discharge roughly $300,000 of student loan debt. At the time of her chapter 7 petition in 2004, the plaintiff was married and with five children, including two sets of twins. Although at one time the plaintiff was employed as a school psychologist, from 2004 and on, the plaintiff did not work outside of the home after two of the plaintiff's children were diagnosed with autism. The bankruptcy court

discharged the student loan debt, and the Bankruptcy Appellate Panel affirmed.

The defendant raised three claims on appeal. First, the defendant contended that the bankruptcy court erred in considering plaintiff's financial circumstances at the time of the undue hardship proceeding, rather than at the time of the plaintiff's discharge in 2004. The court concluded that the operative rule cited by the defendant did not apply. According to the court, failing to assess the plaintiff's financial activity from the preceding four years "would be inconsistent with the first prong of the totality-of-the-circumstances test, which instructs a fact-finding court to consider 'the debtor's past, present, and reasonably reliable future circumstances.'"

Second, the defendant claimed that the plaintiff failed to meet the burden to prove undue hardship, the bankruptcy court overcame gaps in the record by making impermissible inferences about the plaintiff's financial resources, and the bankruptcy court miscalculated the plaintiff's net income. The court rejected this argument on the basis that the parties stipulated regarding the plaintiff and her husband's 2007 adjusted gross income and the defendant failed to challenge certain pieces of the plaintiff's evidence at trial or before the BAP. Moreover, according to the court, even if all disputed pieces of evidence were excluded, the expenses of the plaintiff were still greater than her available resources.

Finally, the defendant claimed that the bankruptcy court erred in finding the plaintiff's household expenses "modest and commensurate" with a minimal standard of living. The defendant specifically challenged that (i) a monthly car payment of $850 for a Suburban and (ii) a monthly payment of $373.52 on the $48,000 second mortgage used to fund the construction of a porch were unreasonable as a matter of law and should preclude an undue hardship determination. Although the court questioned the wisdom of those purchases, the court recognized that the minimal standard of living the plaintiff must account for the size of her family and the special needs of her two autistic children. The court held that in light of the overall circumstances of the case, excepting the plaintiff's student loan debt from discharge would impose an undue hardship on her and affirmed the decisions of the bankruptcy court and the BAP.

<u>The Record Supported Conversion of the Debtor's Fifth Attempt at a Chapter 11 Petition</u>

Yehud-Monosson USA, Inc. v Habbo Fokkena (In re Yehud-Monosson USA, Inc.), No. 11-6040 (B.A.P. 8th Cir. October 5, 2011).

The debtor appealed an order from the bankruptcy court converting its Chapter 11 bankruptcy case to one under Chapter 7. The Bankruptcy Appellate Panel affirmed. The debtor's 100% shareholder and president filed five Chapter 11 petitions in three different states during a two-year time period involving essentially the same assets and liabilities but two different legal entities. The first four of these cases were dismissed by bankruptcy courts' in Delaware and Minnesota for reasons including abuse of process, bad faith and manipulation of the system. Upon dismissing the fourth case, the bankruptcy court in Minnesota ordered

that the entity be barred from filing another case for at least one year.

The debtor in the case at hand was formed in New York, and sometime after the dismissal of fourth bankruptcy case, allegedly merged with the debtor of the dismissed cases. On March 23, 2011, the debtor filed a Chapter 11 petition in the Southern District of New York, which was subsequently transferred to the District of Minnesota. The defendant, the United States Trustee for Region 12, moved to convert debtor's case because the debtor had filed the New York case in bad faith to circumvent the Minnesota filing bar and in an effort to frustrate its creditors. The bankruptcy court ordered the conversion of the case.

The debtor appealed and argued (1) conversion of its case was an abuse of discretion, (2) 11 U.S.C. § 1112(c) prevented conversion of its case because it is not a moneyed business, and (3) it was entitled to an evidentiary hearing.

The BAP affirmed the order for conversion. First, based on a comparison of schedules and statement of financial affairs, the BAP concluded that the bankruptcy court's implicit finding that the debtor of the present case and the debtor of the prior cases were substantially the same entity and that they had their day in court four times already was not clearly erroneous. Second, although 11 U.S.C. § 1112(c) prevents conversion of a corporation this is not a moneyed, business, or commercial corporation absent consent of the debtor, the BAP agreed with the bankruptcy court that the debtor was a moneyed business. The debtor's certificate of incorporation did not restrict its activities, and the debtor admittedly was primarily in the business of owning and operating convenience stores. Finally, the BAP concluded that an evidentiary hearing was not required because the debtor failed to identify any evidence it would have produced at such evidentiary hearing. The BAP ultimately concluded that the record was supported by sufficient facts to allow the bankruptcy court to convert the case.