Fall 2022

Financial newsletter

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THE BASICS OF FIXTURE FILINGS

The distinction between a security interest and a mortgage is easy to understand: a security interest under Article 9 of the UCC is used for personal property, and a mortgage is used for real estate. Rarely is there any confusion between these two. However, there is a third category of collateral which blurs the lines between real estate and personal property, known as fixtures. Fixtures are items of personal property that become so affixed to real estate they become part of the real estate, but still retain their separate character. Identifying fixtures, or identifying what *might* be a fixture, and making the necessary filings ensures that a lender will remain perfected in those items in the event of a default or dispute among creditors.

Understanding what falls into the "fixture" category is best explained by examples. There are certain items of personal property that, once incorporated into the real estate become part of the real estate permanently: lumber, drywall, concrete, and wiring that make up a building almost certainly become part of the real estate and lose their personal property character once incorporated into a building.

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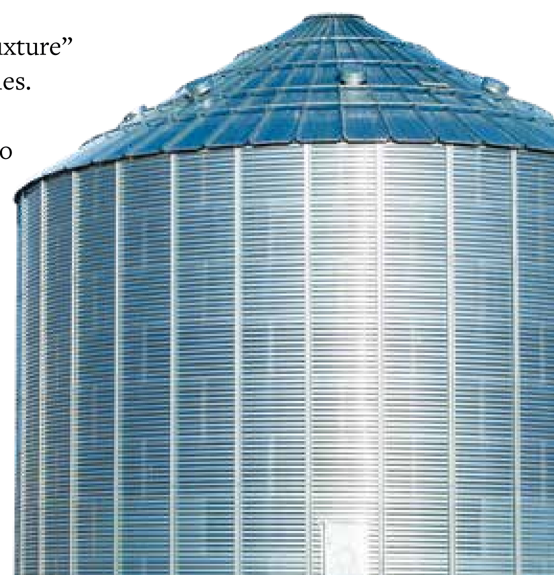

THE BASICS OF FIXTURE FILINGS

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On the other hand, some items are never attached to real estate and there is no real question they remain personal property such as a computer, fridge, furniture, or air compressor. Fixtures fall somewhere between these two, and the lines are blurry at best. A furnace or boiler maybe a fixture; they are hooked directly to the building and are an integral part of the mechanical system, but could also be removed and sold separately. An exhaust hood over a restaurant grill or a walk-in freezer may be similarly affixed to the building but still removable and valuable on their own. These latter examples may be fixtures, depending on the unique facts of the case.

To show just how difficult this distinction is, consider a recent case decided by the Minnesota Court of Appeals, Lighthouse Management Inc., v. Oberg Family Farms. In that case there was a dispute between a creditor with a personal property security interest in all the equipment on a particular piece of real estate, and another creditor who had a mortgage over the same real estate, which included a security interest in fixtures. In dispute was a large grain bin that had been constructed on the property; the mortgage creditor argued the grain bin was a fixture and therefore subject to its mortgage and fixture financing statement. The creditor with a security interest only argued the was personal property and thus subject to its prior security agreement. Interestingly, the bin in question was used—disassembled in Iowa and transported in eleven semi-truck loads to northern Minnesota where it was reconstructed. The bin was 132-feet in diameter and stored over 800,000 bushels of grain. According to one of the parties, 1,000 bolts were required just to affix the bin to the foundation, and construction took over a month to complete with the work of 30 subcontractors and material suppliers.

Despite these impressive facts about the construction of the bin, the Court of Appeals held there was a factual dispute about whether this grain bin became a fixture attached to the real estate or retained its personal property character and determined a judge or jury would have to make that decision at trial. The Court of Appeals offered four factors that could be considered in determining whether personal property would be considered a fixture: (1) whether the property could be removed without leaving the real estate in substantially worse condition than before; (2) whether the property can be removed without breaking it into pieces and damaging it; (3) whether the property has any independent value once removed from the real estate; and (4) the intent of the parties. None of this provides much certainty for lenders trying to determine whether property may be treated a personal property as opposed to a fixture.

Obtaining a lien in a fixture is fairly straightforward. The debtor needs to execute a security agreement which grants a lien in the property that is a fixture or may become a fixture. The security agreement for fixtures may be part of a mortgage. To perfect a security interest in fixtures, a fixture financing statement must be recorded with the county recorder's office and include a description of the real property where the fixture will be located. A mortgage which grants a security interest in fixtures that is recorded will be sufficient to grant a security interest in the fixtures so long as the rest of the normal requirements for a financing statement are contained in the mortgage, such as including the name of the debtor, name of the secured party, and a sufficient description of the collateral.

Because of the ambiguity over whether property is or will become a fixture, the best practice will be to obtain a security interest in both fixtures and personal property. Most commercial mortgages include a grant of a security interest in personal property and in fixtures located on the real estate. While recording the mortgage in the county land records perfects the security interest in fixtures, a lender must also record a separate UCC-1 financing statement with the secretary of state in order to perfect a security interest in anything deemed personal property. Of course, security interests in property that may be fixtures are subject to the same priority rules that apply for other security interests, generally granting priority to the first party to file or record. Thus, it is important to check out any prior liens, and potentially enter into subordination agreements to determine priority.

Fixtures are items of personal property that have become affixed to and part of the real estate. Because the line between personal property and fixtures is blurry and unclear, using best practices to obtain a security interest in both fixtures and personal property is important to protect the value of collateral.

Please join us

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AGRICULTURAL LENDING CONFERENCE | 2022

THURSDAY, SEPTEMBER 8, 2022

Royal Oak Event Center (Formerly New Ulm Event Center)
301 20TH S ST, NEW ULM, MN 56073
9:30am-4:30pm

TOPICS INCLUDE:

SESSION 1 | 9:30-11:45am

- Loan Monitoring and Related Issues
- Top Issues Impacting Lenders
- Collateralizing Carbon Credits

BREAK FOR LUNCH | 11:45am-1:00pm

SESSION 2 | 1:00-4:30pm

- Security Interests and Ag Lien Priority Issues
- Farm Succession Planning
- Case Law & Legislative Update

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SECOND CIRCUIT DECISION SHOWS THE IMPORTANCE OF SEEKING RELIEF FROM THE AUTOMATIC STAY IN BANKRUPTCY COURT

Though not binding in Minnesota yet, the U.S. Court of Appeals for the Second Circuit's recent decision relating to the automatic stay in bankruptcy is causing some angst across the nation. A creditor loan servicer in New York received something of a shock in July 2022, when the U.S. Court of Appeals for the Second Circuit ruled that its 2018 foreclosure sale of an LLC's defaulted property violated the automatic stay provisions of 11 U.S.C. § 362 simply because the person living on the property had filed for bankruptcy. The Second Circuit held, in *in re Fogarty*, that when a party is in bankruptcy, no actions in which "the debtor is a named party" can proceed, even if, as in *Fogarty*, the debtor herself is not the party being foreclosed upon. The court wrote, "any action or proceeding 'against the debtor' is stayed, regardless of whether the debtor was purportedly named as merely an interested or nominal party or as some other kind of defendant."

Creditors are no doubt familiar with the automatic stay provisions of U.S.C. § 362. After a debtor files for bankruptcy, creditors are stayed from pursuing actions against the debtor, such as foreclosures or evictions. The scope of the protection is broad. Creditors cannot commence a new action, nor can they continue an existing action against the debtor or recover upon a claim that arose before the debtor filed for bankruptcy. 11 U.S.C. § 362(a)(1). Creditors are also prevented from enforcing any existing judgment against the debtor or any property contained in the bankruptcy estate. 11 U.S.C. § 362(a)(2).

In *Fogarty*, Bayview Loan Servicing held a mortgage on a property owned by an LLC. Eileen Fogarty held a 99 percent interest in the LLC, and also lived on the property. When the LLC defaulted on the mortgage, Bayview brought a foreclosure action and was granted a judgment permitting it to dispose of the property in a foreclosure sale. Four days before the sale was to occur, Fogarty personally filed for bankruptcy, triggering an automatic stay upon actions or judgments against her. The LLC never applied for bankruptcy and was never explicitly protected by an automatic stay, so Bayview's belief was that, since the property was in the LLC's name, the sale was not covered by any stay and the foreclosure sale could proceed.

After the foreclosure sale, Fogarty sued Bayview in bankruptcy court, but the judge agreed with Bayview's interpretation of the automatic stay rule. Fogarty appealed to the district court for the Eastern District of New York, which ruled in Fogarty's favor. Bayview appealed to the Second Circuit, which also held for Fogarty and gave its "bright-line rule" the precedential power in the states of the Second Circuit, which includes New York, Connecticut and Vermont. The court did not state that the property was protected because a bankrupt debtor lived on it, but rather, quite simply, that because Fogarty was a named party in the foreclosure action, alongside the LLC, the foreclosure

sale should have been stayed because one of the defendants, Fogarty, was protected by the automatic stay in bankruptcy. Unless an appeal to the U.S. Supreme Court follows, Bayview will have to pay damages to Fogarty for violating the automatic stay, even though Bayview—and probably most creditors—would have expected its foreclosure action to be allowable on the basis that it was foreclosing on a non-bankrupt party, the LLC, and was not evicting the bankruptcy debtor.

Precedent on the automatic stay in Minnesota is largely guided by *Bernick v. Caboose Enterprises, Inc.* (1986), which interpreted the automatic stay as providing "a focal point for all legal actions and claims against the **debtor's property**—the bankruptcy court." The *Bernick* ruling interpreted the automatic stay as temporarily removing all power over the debtor from the district courts and placing the debtor solely under the jurisdiction of the bankruptcy court until the bankruptcy proceedings are complete. Any judgment rendered by any other court in the meantime will be voided. However, the court described the bankruptcy court's jurisdiction as being "over the [bankruptcy] estate of the debtor," which is not as broad as the Second Circuit's interpretation that the bankruptcy court has sole jurisdiction over any action connected with the debtor. The wording of the *Bernick* decision would appear to support Bayview's argument against Fogarty, had that case been before a Minnesota court.

To be on the safe side, creditors should take advantage of the option of seeking a bankruptcy court's permission to proceed against a defendant in district court. In *Zahn Law Firm, P.A. v. Baker* (2019), the Minnesota Court of Appeals affirmed a district court's enforcement of a settlement agreement against a debtor in bankruptcy. The creditor had moved the bankruptcy court for permission to proceed with its non-bankruptcy claim in district court, also known as relief from the automatic stay, and the bankruptcy court granted permission. The court held that if a bankruptcy court explicitly permits a creditor to pursue a non-bankruptcy against a bankrupt debtor, the automatic stay is not violated: in effect, the bankruptcy court's jurisdiction over bankrupt debtors includes the discretion to decide whether a non-bankruptcy action is or is not covered by the automatic stay, and the bankruptcy court may permit actions that it deems not to be covered.

The automatic stay provision derives from a federal statute, so debtors in all states are protected by it, and creditors in all states must abide by it. Different courts interpret the breadth of the automatic stay provision differently, however, as the Second Court decision shows. The Second Circuit's particular interpretation of the federal statute is not binding on Minnesota state courts or the federal District of Minnesota, but courts often look to decisions in other jurisdictions to guide their own interpretations of the law, so Minnesota creditors should be aware of the Second Circuit's new "bright-line rule" and keep abreast of any subsequent decisions by which the Second Circuit's interpretation may spread to other jurisdictions. Certainly, a Minnesota creditor should not be surprised if a similarly-situated debtor cites *Fogarty* and attempts to persuade the state or District of Minnesota court to adopt the Second Circuit's interpretation.

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SMALL-BUSINESS DEBTORS AND A PRIMER ON THE SMALL BUSINESS REORGANIZATION ACT

The American Bankruptcy Institute once observed that “[a] robust, effective, and efficient bankruptcy system rebuilds companies, preserves jobs, and facilitates economic growth with dynamic financial markets and lower costs of capital.” These ideals have not been the reality for many small-business debtors in financial distress, who have historically been forced to reorganize under Chapter 11, Chapter 7, or Chapter 12 (if the debtor was also a family farmer).

Chapter 11 appears to be a viable option for small-business debtors because it provides debtors the opportunity to continue operating their businesses while reorganizing their financial affairs. Therefore, Chapter 11 theoretically allows debtors to rebuild their business, maintain staff, and regain financial strength. However, a traditional Chapter 11 proceeding can prove cumbersome and expensive for small-business debtors. Realizing the shortcomings of Chapter 11 and the bankruptcy system generally as-applied to small-business debtors, Congress enacted the Small Business Reorganization Act (SBRA).

Advantages under the Small Business Reorganization Act

The SBRA was enacted on August 23, 2019 and became effective on February 19, 2020. Through its enactment, the SBRA added Subchapter V to Chapter 11 of the Bankruptcy Code with the intent to make bankruptcy proceedings faster, simpler, and more affordable for small businesses while retaining the Chapter 11 tenet that the debtor may continue operating its business.

As an example, Subchapter V cases do not require a quarterly fee to be paid to the U.S. trustee, which is otherwise required in Chapter 11 proceedings. 28 U.S.C. § 1930(a)(6). Moreover, although the U.S. trustee will appoint a Subchapter V trustee to oversee and monitor the case, ensure that the debtor makes timely payments, and facilitate the development of a consensual plan, the Subchapter V trustee does not take possession of the debtor’s assets and does not have the power to sell the assets. 11 U.S.C. §§ 1183, 1184, 1186.

The SBRA also eliminates the “absolute priority rule.” This rule may be summarized as requiring “that a dissenting class of unsecured creditors (...) be provided for in full before any junior class can receive or retain any property [under a reorganization] plan.” *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 202 (1988) (quotation omitted). Practically, the absolute priority rule made it difficult for small-business debtors to get reorganization plans confirmed because it would require unsecured creditors to be paid in full or consent to receive less than full payment. The elimination of the absolute priority rule effectively allows courts in Subchapter V proceedings to confirm plans over the objection of unsecured creditors if all projected disposable income of the debtor will be applied to the plan and the additional statutory conditions are met. 11 U.S.C. § 1191(c). The elimination of the rule also provides greater opportunity for existing owners of the business to retain their ownership interests.

Relatedly, a reorganization plan is typically preceded by a disclosure statement. A disclosure statement contains information for the holder of a claim or interest pertaining to the debtor’s finances. Disclosure statements are not required in

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[1] *American Bankruptcy Institute Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations,* 23 Am. Bankr. Inst. L. Rev. 1, 4 (2015).

Subchapter V cases unless otherwise ordered by the court for cause. 11 U.S.C. § 1181(b). The elimination of this requirement also helps streamline the bankruptcy process for small-business debtors.

Eligibility under the Small Business Reorganization Act

In order to be a "debtor" under Subchapter V, and therefore be eligible to reorganize under Subchapter V, there are four primary requirements:

(1) the debtor must meet the definition of a "person" under the Bankruptcy Code;
(2) the debtor must be "engaged in commercial or business activities";
(3) the debtor's aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief must not exceed $7,500,000.00 (excluding debts owed to 1 or more affiliates or insiders); and
(4) at least 50 percent of the debtor's debts must have arisen from its commercial or business activities. 11 U.S.C. § 1182(1)(A).

Note that the term "person" includes individuals, partnerships, and corporations (but not governmental units unless additional criteria are met). 11 U.S.C. § 101(41).

It should also be clarified that the original debt limit under Subchapter V was $2,725,625.00, but on March 27, 2020, the federal CARES Act increased the debt limit to $7,500,000.00 for a period of one year. The increase was later extended through March 27, 2022 by the COVID–19 Bankruptcy Relief Extension Act of 2021. Since then, the increased debt amount reverted to $2,725,625.00, or $3,024,725.00 to adjust for inflation, until ultimately increasing *again* to $7,500,000.00 with the passage of the Bankruptcy Threshold Adjustment and Technical Corrections Act on June 21, 2022. The latest increase of the debt limit sunsets on June 21, 2024, which significantly expands the opportunity for debtors to utilize Subchapter V.

To summarize, the SBRA addressed several of the Bankruptcy Code's shortcomings with respect to small-business debtors. This article has articulated some key advantages of Subchapter V and the primary eligibility factors. Assuming the debtor qualifies, Subchapter V of Chapter 11 could provide an efficient and cost-effective mechanism for reorganization.

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