NOTES ON

DEBTOR/CREDITOR

RELATIONS

June 1996

Foreclosure Fails to Launder Assets

As a general matter, assets of a business which are purchased at a foreclosure sale are free and clear of the claims of unsecured creditors of the business. But, not always. Under certain circumstances, the entity acquiring the assets may be liable for the debts of the prior owner.

For example, Widget, Inc. cannot pay its debts when due. All of Widget's assets are pledged to Bank as collateral for a loan, which is in default. Both Bank and Widget believe that Widget's business can survive and the loan can be repaid if Widget's other debt to unsecured creditors is eliminated.

To accomplish this goal, Bank forecloses on and acquires all of Widget's assets. One week later, Bank sells all of Widget's assets to New Widget, a corporation owned by the children of Dad, old Widget's sole shareholder. New Widget pays no cash for the assets, but merely assumes old Widget's debt to Bank. Dad becomes president of New Widget and continues to operate the same business.

Presented with this situation, a federal district court in Philadelphia decided that the new corporation was a successor to the old corporation and remained liable to all of the old creditors. The foreclosure did not free the assets from creditors' claims. However, as one of the witnesses quoted by the court noted, the bank and the company could have achieved their goal through a plan of reorganization in bankruptcy.
Fiber-Lite Corp. v. Molded Acoustical Products of Easton, Inc., 186 B.R. 603 (E.D. Pa. 1994).

Payments to Partners Escape Bank

Loans to real estate investors are often secured by a pledge of the investor's partnership interests. Recently, a Massachusetts bankruptcy court made those partnership interests less desirable as collateral.

Allen Mintz borrowed from State Street Bank and pledged as collateral his "right to receive distributions from" a limited partnership interest. After Mintz defaulted in repaying the loan, the bank obtained a $319,127.34 judgment, and Mintz filed a bankruptcy petition. Post-bankruptcy, the partnership made a distribution to limited partners. The bank claimed entitlement to the distribution under its pledge agreement.

The bankruptcy court denied the bank's claim to the distribution, reasoning that Mintz's bankruptcy cut off the bank's right to collect the partnership distributions unless they were "proceeds, product, offspring or profits" of collateral which existed before the bankruptcy. Because the distribution to limited partners did not fit any of those categories (as technically defined by the Uniform Commercial Code), the bank lost its right to the funds.
In re Mintz, 192 B.R. 313 (Bankr. D. Mass. 1996).

This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

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