UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:
Larry Allen Kuhlman, Case No. BKY 97-32178

Debtor. Chapter 7 Case

Charles W. Ries, Trustee for
Larry A. Kuhlman,
Plaintiff, ADV 98-30045

vs.

MEMORANDUM

Norman Kuhlman and ORDER
Norma Kuhlman,
Defendants.

INTRODUCTION

This adversary proceeding came on for trial before the Court on August 31, 1998 to determine the parties' respective interests in the $188,458.10 realized from the Defendants' sale of a convenience store and gas station business located in Ruthton, Minnesota, and known as the Ruthton Mini Mart (Mini Mart). Appearances were made by Charles Ries, the Trustee for the above-captioned bankruptcy estate, and William P. Scott, attorney for the Defendants.

The court has jurisdiction over this adversary proceeding pursuant to 11 U.S.C. Section 1334 and Section 157. This is a core proceeding under 28 U.S.C. Section 157 (b)(2)(A),(B),(E) and (F), and is brought pursuant to Bankruptcy Rule 7001 ct.seq., and Local Rule 1070-1. This cause of action arises under 11 U.S.C. Section 547 and Section 550.

The Debtor, Larry Allen Kuhlman, filed for relief under Chapter 7 of the Bankruptcy Code on March 31, 1997. Less than a month before filing his petition for relief on March 1, 1997, the Debtor deeded real estate and transferred personal property representing his entire ownership interest in the Ruthton Mini-Mart to his parents, Norman and Norma Kuhlman. On April 7, 1997, the Defendant parents sold the business and inventory for $188,458.10.

The Trustee seeks to recover the proceeds of this sale as property of the bankruptcy estate, alleging that the transfers were made pursuant to the grant by the Debtor of a preferential mortgage and security interest to the Defendants within one year of the bankruptcy. The Defendants concede they were insiders of the Debtor as defined by 11 U.S.C. 101(45) but dispute that either the October 15, 1996 mortgage, or the March 1, 1997 transfer, were preferential transfers under 11 U.S.C.

Section 547.

Based on the stipulations of the parties, the Court must determine whether the Debtor was solvent when he granted the October 15, 1996 mortgage, and whether the Defendants held a prior equitable mortgage which would prevent the Trustee from recovering the mini-mart sales proceeds.

FACTS

From July 1, 1991 to August 5, 1996, the Defendants (parents of the Debtor) advanced monies to their son for the construction, maintenance, and operation of the mini-mart. No formal promissory note was signed by the Debtor until October 15, 1996. At that time the outstanding loan balance of $165,271.01 was memorialized in the promissory note and accompanying mortgage. This written agreement also called for a 6% interest rate on the loan, although both the Debtor and Defendant father testified that no interest was ever paid on the loan, either before or after the promissory note was signed. Before October 15, 1996, Defendant Norman Kuhlman kept an informal ledger which tracked the cash advances made to his son for the mini-mart. The ledger is signed by both Norman and Larry but does not indicate any rate of interest for the cash advances, nor did it record any accrual of unpaid interest.

Both the father and son testified that they intended to treat the cash advances as a secured mortgage, but they both admitted that no understanding, written or otherwise, was ever reached about how the debt would be repaid. The only other evidence offered at trial of the son's acknowledgment of this debt before the 1996 agreement, was an insurance policy statement for the mini-mart from 1991. The policy lists the father, Norman Kuhlman, as a mortgagee of the mini-mart.

In addition to his ownership of the mini-mart, the Debtor had $500 of personal assets on October 15, 1996. The Debtor owed $165,271.01 to his parents, and had outstanding federal taxes of $50,204 and state taxes of $8,719. He also owed Tri State Petroleum $46,469, other trade creditors $8,390, and had medical bills of $1,531.

The Debtor tried selling his mini-mart in the fall of 1996 but was unsuccessful. He did receive two informal offers, one for $325,000 and another for $270,000 plus inventory. Both of these prospective buyers testified at trial that they did not consider the offers binding until put in writing. Neither offer was pursued nor accepted by the Debtor.

INSOLVENCY

(b) Except as provided in subsection

> (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property--
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made--
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if--
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.
>
> 11 U.S.C. Section 547

A trustee may recover a preferential transfer of property made by a debtor while the debtor was insolvent under 11 U.S.C. Section 547(b). A debtor is presumed to be insolvent on and during the 90 day preference period under 11 U.S.C. Section 547(f), and the transfer here occurred within that period. To rebut the presumption of insolvency the Defendants need to provide evidence of the Debtor's solvency on October 15, 1996, when he signed the promissory note and mortgage giving the Defendants a secured interest in the mini-mart. 11 U.S.C. Section 547(g).

The Bankruptcy Code defines insolvent as "a financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors and property that may be exempted from property of the estate under 11 U.S.C. Section 522 of the Code." 11 U.S.C. Section 101(32).

> The determination of solvency or insolvency for purposes of the preference test . . . is not a strictly "balance sheet" calculation, although one has to determine the value of the assets and the value of the liabilities. A true balance sheet does not reflect "fair valuation"

> of either assets or liabilities. In re F & S Cent. Mfg. Corp., 53 B.R. 842, 849 (Bankr. E.D.N.Y.1985). Fair value is determined by estimating what the debtor's assets would realize if sold in a prudent manner in current market conditions.
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> Plihal v. First National Bank of Wahoo, 97 B.R. 554, 558-559 (Bankr. D.Neb. 1989).

On October 15, 1996 the Debtor had liabilities of $280,584 and assets of $500 plus the value of the mini-mart. Unless the Defendants can present evidence that the mini-mart was worth over $280,034, the Debtor was insolvent.

The Defendants did provide testimony from two people who made oral offers for the business in September and November of 1996. The September oral offer of $325,000 was withdrawn only weeks after it was made. The November oral offer of $270,000, plus inventory, was rejected by the Debtor. A firm commitment to buy at a certain price has considerable probative value, (In re Energy CO-OP., Inc., 109 B.R. 822 (N.D.Ill. 1989), but neither bidder reviewed any financial statements regarding the business; no terms of payment, or financing, were discussed with the Debtor; no bank was consulted or committed; and no attorney was consulted by any party. No written offer to purchase the business was ever presented and both individuals testified that they believed their oral offers were unenforceable.

On April 7, 1997, six months after signing the mortgage note, one month after taking the store from their son, and only a week after Larry Kuhlman filed for bankruptcy protection, the Defendants sold the mini-mart for $188,458.10 ($175,000 plus inventory of $13,458.10(1)).

The most reliable evidence presented at trial supports a October 15, 1996 valuation of $188,458.10 for the mini-mart.(2) When the Debtor signed the promissory note and mortgage on October 15, 1996, he was insolvent because his liabilities exceeded his assets by $91,575.

EQUITABLE MORTGAGE

The Defendants argue that regardless of the solvency of the Debtor on October 15, 1996, the Defendants held a valid prior security interest in all of the Debtor's real and personal property in the mini-mart by virtue of an equitable mortgage which dated to the first cash advances in 1991.

The creation and determination of property interests is determined in bankruptcy cases by the applicable non-bankruptcy law. Butner v. United States, 440 U.S. 48, (1979). In Minnesota a transaction involving some conveyance, or transfer, of some interest in land must be contained in a "writing" to satisfy the Statute of

Frauds. Minn. Stat. Section 513.04. A mortgage on real property constitutes an "interest" in land and must be in writing to be valid. Hatlestad v. Mutual Trust Life Insurance Co., 268 N.W. 665 (Minn.1936).

Additionally, every conveyance of real estate must be recorded in the office of the county recorder of the county where such real estate is situated. See Minn. Stat. Section 507.34. The purpose of the Minnesota Recording Act is to protect good faith third party purchasers against unrecorded claims to real property. Thomson v. U.S.,, 867 F.Supp. 1420 (D.Minn.1994), reversed 66 F.3rd 160.(3) There was no recording of any interest in real property in the county recorder's office by either the Debtor or the Defendants prior to October 15, 1996. The required recording of a conveyance of an interest in real property was not satisfied by the Debtor or the Defendants.

An equitable mortgage exists when at the time of the conveyance of an interest in property both parties intention was to enter into a mortgage relationship, despite the formalities of the documents of the underlying transaction. See, Miller v. Anderson, 394 N.W.2d 279, (Minn. Ct. App. 1986); The Ministers of Life and Casualty Union v. Franklin Park Tower Corp., 239 N.W.2d 207, (Minn. 1976).

An equitable mortgage may be created when all of the documents, facts, and surrounding circumstances indicate that the real nature of the transaction is that of a loan advanced on security of realty, See Gagne v. Hoban, 159 N.W.2d 896 (Minn. 1968); Albright v. Henry, 174 N.W.2d 106 (Minn. 1970); Proulx v. Hirsch Brothers, Inc., 155 N.W.2d 907 (Minn. 1968).

For a court to find an equitable mortgage it must be found that both parties so intended, not just one party to the transaction. Nitkey v. Ward, 271 N.W. 873 (Minn. 1937). Intent, by itself, is insufficient to create an equitable mortgage in the absence of some form of written conveyance. In re Deppe., 215 B.R.743 (D.Minn. 1997).

Since the Defendants wish to enforce a prior mortgage against the Debtor, they must produce a sufficient writing signed by the Debtor which satisfies Minn. Stat. Section 513.04. None was offered at this trial.

The Debtor's insurance policy for the business in 1991 references the Defendant Norman Kuhlman as a mortgagee of the property. The policy statement produced at trial is a printed document from the insurance company, not a writing of the Debtor.

Nor does the informal ledger kept by the Defendants evidence any intention to create a mortgage (or any other right in real property). This document was hand written by the Defendant, and used to track the dates of the advances of monies, any repayments, and a running total amount

owed. At the top of this informal ledger is the date of July 1, 1991, and the statement: "Agreement between Larry Kuhlman and Norman Kuhlman Money Loaned to Larry Kuhlman for construction, equipment, and etc. for Ruthton Mini Mart."

While this document is signed by the Debtor, the wording only makes reference to a loan. This ledger does not include reference to a security interest of any kind, terms of repayment, rate of interest, nor does it record any accrued interest on the loan.

The intention of both the Debtor and Defendants is unclear as to the nature of this transaction. The ledger makes no reference to any interest in property. This transaction has the general characteristics of a loan, and not that of an equitable mortgage. In re Sprint Mortgage Bankers, 164 B.R. 224 (E.D.N.Y. 1994). From the face of the document and the testimony at trial, no property interest in the mini-mart was created, assigned, transferred, or held by the Defendants prior to 1996.

None of the cases cited which examine the doctrine of equitable mortgage extend this concept to situations where the underlying document fails to satisfy the Statute of Frauds.(4) No mortgage relationship can exist without some transfer of interests in property between the parties. Kurz v. Gramhill, 269 N.W.2d 68 (Minn. 1979). With no conveyance of an interest in property between the parties, no mortgage relationship can exist between the Defendants and the Debtor. The Defendants should be treated as unsecured creditors in the bankruptcy estate of the Debtor.

Even if the Defendants could establish the existence of an equitable mortgage, the doctrine of equitable mortgage is used to protect the interests of the mortgagor, the borrower, in a given transaction, rather than the mortgagee, or lender. Blanchard v. Hoffman, 192 N.W. 352 (Minn. 1923). In all of the cases that the Defendants and Plaintiff presented in their trial memoranda, the doctrine of equitable mortgage was found and used to protect the interests of a mortgagor, not that of a mortgagee, within the equitable mortgage context.(5)

DISPOSITION

Based on the foregoing, the Debtor's mortgage of October 15, 1996, and the transfer of real estate and personal property of March 1, 1997 to the Defendants were preferential transfers pursuant to 11 U. S. C. Section 547. The value of these transfers was $188,458.10.

It is hereby ORDERED: The Trustee is awarded judgment against the Defendants in the amount of $42,442.82, representing the cash paid to Defendants for sale of the Ruthton Mini-Mart. The

Trustee is awarded all proceeds currently held in a trust account of William Scott for payment received from Buffalo Ridge Express pursuant to the agreement for the sale of the business dated April 7, 1997, and all future payment to be made pursuant to the contract.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: December 1, 1998 By the Court:

_____
Dennis D. O'Brien
Chief U.S.
Bankruptcy Judge

(1) Trial testimony suggested that the value of inventory on October 15, 1996 might have been more than the $13,458.10 on hand in April of 1997 since the debtor, and then the Defendants, allowed the inventory to be sold down in anticipation of the sale of the business. But, even assuming the inventory had a value of $25,000, the additional $11,541.90 of value is insufficient to move the Debtor's financial position out of insolvency.

(2) The Trustee presented expert testimony that independently valued the business on this date at $175,000 plus inventory.

(3) A trustee in bankruptcy has the rights of a good faith purchaser under 11 U.S.C. Section 544. Because the Court finds that the Defendants have not otherwise proven the existence of an equitable mortgage, the Court does not reach the issue whether an equitable mortgage can be used to defeat the rights of a trustee exercising authority under 11 U.S.C. Section 544.

(4) The following cases on equitable mortgages were cited in Defendant's Trial Memoranda: Miller v. Anderson, 394 N.W.2d 279, (Minn. Ct. App. 1986); Port Authority of St. Paul v. Harstad, 531 N.W.2d 496 (Minn. Ct. App.1995); Guilland v. Port Authority of St. Paul, 270 N.W.2d 743 (Minn. 1978); Gagne v. Hoban, 159 N.W.2d 896, (Minn. 1968); Kurz v. Gramhill, 269 N.W.2d 68, (Minn. 1978); Trondson v. Janikula, 458 N.W.2d 679 (Minn. 1990).

(5) See footnote 4.