United States Bankruptcy Court
Western District of Wisconsin

Cite as: [Unpublished]

In re Benedict J. and Judith Ann Hofmeister, Debtors
Bankruptcy Case No. 93-30849-7

United States Bankruptcy Court
W.D. Wisconsin

September 27, 1994

James T. Hublou, Madison, WI, for debtor.
Michael E. Kepler, Madison, WI, Trustee.
Roger W. Bracken, U.S. Dept. of Justice, Washington, D.C., for IRS.

Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

On May 28, 1990, the Internal Revenue Service ("IRS") assessed federal income taxes against Benedict and Judith Hofmeister ("the Hofmeisters"). On August 1, 1990, Michael and Judith Linden ("the Lindens") lent the Hofmeisters money to purchase a 1987 Ford pick-up truck ("truck"). The Lindens claimed to have a security interest in the truck by virtue of the loan and placed their names on the truck's certificate of title as lienholders. However, the Hofmeisters never executed a formal security agreement granting the Lindens a security interest in the truck. On March 11, 1991, the IRS filed its tax lien in the Hofmeister's county of residence.

Two years later, the Hofmeisters filed their chapter 7 bankruptcy. The trustee avoided the Linden's lien, preserved the avoided lien under § 551, and moved for turnover of the truck. The Hofmeisters objected, claiming the truck to be exempt. On September 14, 1993, the trustee and the Hofmeisters entered into a settlement agreement under which the Hofmeisters were to give the trustee $1,800 in exchange for "all claims that he might have in their 1987 Ford pickup." All interested parties, including the IRS, were given prior notice of the proposed settlement. No objections were filed.

After the trustee was paid, the IRS demanded the $1,800 as proceeds of the sale of its collateral. The trustee objected to the IRS's claim and argued that the truck was not sold, but rather that the trustee's avoided position was sold, and that the IRS's lien does not burden the trustee's interest.

The initial burden of proof lies with the objecting party, the trustee, to show either that the IRS's lien is inferior to his or that the truck was not sold. The ultimate burden of persuasion placed is on the IRS. *In re Sharon Steel Corp.*, 100 BR 763, 767 (Bankr WD Pa 1989); *In re BRI Corp.*, 88 BR 71, 73 (Bankr ED Pa 1988). To sustain his burden, the trustee advanced a position which may lead to future litigation with the Hofmeisters and the possibility of inconsistent outcomes in disputes arising from a single set of facts. To reach a fair resolution, the Hofmeister's must be joined in this contested matter.[(1)] This

matter will be rescheduled to permit that joinder.

Discussion

The Lindens utilized the only available method of perfecting a security interest in a vehicle in Wisconsin, placing their names on the certificate of title.[(2)] Wis. Stat. § 342.24 (1993); Wis. Stat. § 342.19(2) (1993). While perfection is governed by ch. 342, the creation of a security interest is governed by the Uniform Commercial Code. *Nat. Exchange Bank of Fond du Lac v Mann*, 81 Wis 2d 352, 357 (Wis 1978). "Presumably, then, to perfect a security interest under the vehicle title law, it must be created in accordance with the Commercial Code." *Id*; *see also* Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, § 2.01 (1993); Wis. Stat. § 409.204(1) (1993).

To create an enforceable security interest in a vehicle which the debtor possesses, the debtor must sign a security agreement which describes the collateral. Wis. Stat. § 409.203(1)(b) (1993). Cases outside of Wisconsin have held that the security agreement need not contain formal words of grant. Article 9 only requires that the security agreement contain a reasonable description of the collateral and be signed by the debtor. Clark, supra, § 2.01(c) (1993); *see, e.g. In re Bollinger Corp.*, 614 F2d 924 (3rd Cir 1980) (holding that a promissory note, a financing statement containing a complete list of machinery and equipment as collateral, correspondence between the debtor and the secured party, and a general course of dealing amounted to a security agreement); *In re Hite*, 4 BR 547 (Bankr ND Ohio 1980) (holding that a secured note and a financing statement constituted a valid security agreement); *In re EJM, Inc.*, 1 BR 119 (Bankr ND Ga 1979) (holding that a note and a financing statement executed at the same time qualified as a security agreement).[(3)]

However, in Wisconsin a different rule, announced in *Barth Bros. v Billings*, 68 Wis 2d 80, 88 (1974), requires specific words granting a security interest. In *Barth Bros.*, the court adopted *Shelton v Erwin*, 472 F2d 1118 (8th Cir 1973). In *Shelton*, a buyer and seller of a vehicle intended to create a security interest. A signed bill of sale set out the terms of payment and provided that the buyer should insure the car until fully paid. The parties also filed an application for title showing the seller as holder of a first lien and the buyer as owner. The court held that these documents taken together did not satisfy the requirement of § 9-203(1)(b) and that a security agreement must contain some language actually conveying a security interest. The steps taken to perfect a security interest are insufficient by themselves to create one. Similarly, the notation of the Linden's name on the certificate of title would not qualify as a security agreement in Wisconsin. Presumably, this is the basis on which the Linden's lien was initially avoided by the trustee.

By preserving the avoided lien, the trustee acquired no greater rights than those held by the Lindens. *See In re Coal-X Ltd.*, "76", 103 BR 276, 280 (D Utah 1986); *In re Appalachian Energy Industries, Inc.*, 25 BR 515, 517 (Bankr MD Tenn 1982). The trustee takes the avoided lien with its defects. *See Matter of Woodworks Contemporary Furniture, Inc.*, 44 BR 971, 973 (Bankr WD Wis 1984). "[I]f the avoided lien will sink below other liens against the estate, the trustee who stands in the shoes of the inferior avoided lien will likewise sink while in those shoes . . . ." *Matter of DeLancey*, 94 BR 311, 313 (Bankr SDNY 1988).

The IRS's lien against the Hofmeister's property was created as of the date of the tax assessment on May 28, 1990 and reached all property owned by the debtor. 26 U.S.C. § 6321 (1993); 26 U.S.C. § 6322 (1993); *United States v National Bank of Commerce*, 472 US 713, 719-20 (1985). However, the IRS lien was not recorded until March 11, 1991. Prior to the recording of a tax lien, holders of security interests are provided

protection. Section 6323(a) provides:

The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgement lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

26 U.S.C. § 6323(a) (1993). Section 6323(h)(1) defines a security interest as used in § 6323(a):

The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgement lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

26 U.S.C. § 6323(h) (1993). To meet the test, the Linden's security interest would have to have been enforceable against third parties and entitled to priority under Wisconsin law. As discussed previously, it was not. Therefore, the IRS lien primed any interest that the Lindens and the trustee had.

While the IRS may retain a position in the truck superior to the trustee, it must still be determined whether the truck was sold. If it was sold, the IRS has a right to the proceeds from the sale. "[A] lien created in favor of the United States by virtue of 26 U.S.C. § 6321 attaches to the sale of that property." *In re Nevada Environmental Landfill*, 81 BR 55, 56 (Bankr D Nev 1987); *see also Phelps v United States*, 421 US 330, 334. It makes no difference whether the debtor or the trustee sold the truck. In either event, the IRS's lien would still attach. *See Phelps v United States*, 421 US at 330-31; and *In re Nevada Environmental Landfill*, 81 BR at 56.

The trustee seeks to meet his burden by arguing that the truck wasn't sold, but rather that the avoided position was sold.[(4)] The avoided position does not belong to the debtor, but to the debtor's estate. *In re Groves*, 120 BR 956, 964 (Bankr ND Ill 1990). The IRS does not have a lien on property acquired by the estate, unless the lien existed prior to the bankruptcy against the property when held by the debtor. Since the trustee's interest came into being after bankruptcy the lien does not attach to it. 11 U.S.C. § 552(a) (1994); *see In re Strangis*, 67 BR 243, 246 (Bankr D Minn 1986).

If the trustee is correct, what he sold to the Hofmeisters was a junior interest (if an interest at all) in a truck on which the IRS lien remained paramount. While this might defeat the IRS's claim to proceeds of a sale, it leaves the Hofmeisters holding a truck for which they apparently believe they paid $1,800 that is still subject to an IRS lien for the full amount of its value (presumably about $1,800).[(5)] At least, the Hofmeisters paid $1,800 more than the trustee's interest was worth. At worst, they were duped by the trustee into believing that they were purchasing a truck free and clear of all liens. In any event, it is likely that the Hofmeisters will seek court protection against the trustee and/or the IRS.[(6)]

If the trustee is wrong about what he sold, and indeed it was the truck, then the $1,800 received would be proceeds of the sale and subject to the IRS lien.[(7)] However, sales of property require notice and a motion under § 363(b).[(8)] To be adequate, the notice of such a sale would presumably require that the truck be identified, and if the sale were to be free and clear of liens that the requirements of § 363(f) would be met.[(9)] Were the notice inadequate, and on an initial view of the stipulated facts it seems to be, it is possible that the IRS might continue to pursue the truck as well as its proceeds.

Whether the trustee is right or wrong, the interest of the Hofmeisters will be directly and significantly affected by a determination in this dispute. A resolution requires all parties to be in a single forum. Under Federal Bankruptcy Rule 7019(a)(2)(ii) the Hofmeisters must be joined as parties. The rule provides:

(a) Persons To Be Joined if Feasible. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if . . . (2) the person claims an interest relating to the subject of the action and is so situated that the disposition of the action in the persons absence may . . . (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of the claimed interest. If the person has not been joined, the court shall order that the party be made a party. If the person should join as plaintiff but refuses to do so, the person shall be made a defendant, or in a proper case, an involuntary plaintiff. If the joined party objects to the venue and joinder of that party would render the venue of the action improper, that party shall be dismissed from the action.

In order for the rule to be applicable under (a)(2)(ii), there must be a substantial risk of double liability. *Morgan Guaranty Trust Company of New York v Martin*, 466 F2d 593, 598 (7th Cir 1972). To date, the Hofmeisters have not disclaimed their interest in the truck. To the contrary, they have demonstrated a desire to retain possession of the vehicle. The IRS has received nothing as yet and will pursue its lien until payment is received or its lien foreclosed. The Hofmeisters have paid once and face the possibility of having to pay again to keep the truck. The trustee has obtained $1,800. If allowed to keep it, the debtor may pay twice or the IRS may lose twice. It would seem likely that the Hofmeisters would seek court assistance to avoid paying twice. Therefore, before any determination is made between the trustee and the IRS, the Hofmeisters should be made parties.

This matter will be adjourned for 60 days with notice of the adjournment to both parties and the automatic stay modified to permit appropriate pleadings to be filed to permit joinder of the Hofmeisters. If no such pleadings are filed within that time or such extensions as the court may grant, the matter will be reconsidered on the state of the record as it then may exist. It is so ordered.

END NOTES:

1. The objection to claim initiates a contested matter which is governed by FRBP 9014. That rule provides for the application of Part VII of the FRBP. Among the Part VII rules is FRBP 7019(a)(2)(ii) which requires the joinder of necessary parties in the manner of FRCP 19. Accordingly, the standards for joinder under Rule 19 provide the basis for analysis of the procedure in this matter.

2. "'Perfection' . . . means that the security interest which has achieved that state cannot be defeated by lien creditors of the debtor, or, a fortiori, by non-lien creditors." Grant Gilmore, *Security Interest in Personal Property 436* (1965). The term perfection is originally derived from § 60 of the Federal Bankruptcy Act. As used in the Act, the term referred to a point when "no creditor of the debtor could thereafter acquire a judicial lien on the collateral which would be superior to the interest of the secured party." *Id.* at 435.

3. These cases have relied on what has become known as the "collage doctrine." The doctrine provides, "as long as the document as a whole fairly reflects a meeting of the debtor's and creditor's minds on the matter, magic words [of grant] should not enter the picture." Clark, *supra*.

4. While not explicit, the trustee suggests that the IRS may be estopped from gaining possession of the $1,800 because it did not object to the settlement. Cases have held, however, that the IRS has no duty to object at any proceeding prior to the proposed distribution of the proceeds. *In re Stone*, 6 F3d 581, 585 (9th Cir 1993); *In re Kimura*, 969 F2d 806, 814 (9th Cir 1992).

5. It would appear that the Hofmeisters were attempting to redeem the vehicle.

6. The settlement agreement between the Hofmeisters and the trustee is a contract. *See US v Etwick Wood Products, Inc.*, 916 F2d 1211, 1219 (7th Cir 1990); *Leming v Thresermen's Mutual Insurance Co.*, 131 Wis 2d 123, 132 (1986). Among the contract claims the Hofmeisters may make is that the agreement is unconscionable and/or a mistake. Either way, while damages may not be appropriate, restitution is available. James J. White & Robert S. Summers, *Uniform Commercial Code* § 4-9; Restatement (Second) of Contracts § 158 (1981). In order for a contract to be unconscionable in Wisconsin, a certain amount of procedural and substantive unconscionability must be present. *Discount Fabric House v Wisconsin Telephone Co.*, 117 Wis 2d 587, 602 (1984). Procedural inequality may exist in the lack of bargaining power between the trustee and the Hofmeisters. *See, e.g. Matter of Rick Michaels Ford, Inc.*, 7 BR 763, 769 (Bankr ND Ill 1980). Substantive unconscionability may exist in the excessive "price" the Hofmeisters paid. *See Carbani v Arrospide*, 2 Cal Rptr 2d 845 (1991); *Sho-Pro of Indiana, Inc. v Brown*, 585 NE2d 1357 (Ind App 1992); *Vom Lehn v Astor Art Galleries, Ltd.*, 380 NYS2d 532 (NY Sup Ct 1976). No matter if the truck or the avoided position was sold, the Hofmeisters paid $1,800 too much.

In addition to unconscionability, the Hofmeisters may allege mistake in order to void the agreement. Under Restatement (Second) of Contracts § 153 (1981), the Hofmeisters may void the agreement if the trustee either knew of their misunderstanding or if enforcement of the agreement would be unconscionable and the mistake was made to the basic assumption of the agreement.

7. In such an event, the trustee may have breached his warranty of title found at Wis. Stat. § 402.312(1).

8. Section 363(b)(1) provides:

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

9. Section 363(f) provides:

(f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of any entity other than the estate, only if-

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute;

(5) such entity could be compelled, in a legal or equitable proceeding to accept a money satisfaction of such interest.