

UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF )

WILBERT A. SARGENT and )  
THERESA B. SARGENT, )

CASE NO. BK80-1083

DEBTORS )

A80-498

WILBERT A. SARGENT and )  
THERESA B. SARGENT, )

Plaintiffs )

vs. )

BANK OF VALLEY, and SMALL )  
BUSINESS ADMINISTRATION, )

Defendants )

MEMORANDUM

The Court has been asked by petitioners in this adversary matter to determine the value of the security interest held by the Bank of Valley (Bank) due to the subordination of its mortgage to that held by the Small Business Administration (SBA). The facts reveal that Wilbur and Theresa Sargent received the deed for their personal residence, the subject matter of this litigation, on May 16, 1977. The parties have agreed in their order on pretrial conference that the value of that real estate on May 22, 1980, the date of the Chapter 7 petition, was \$35,000. On September 28, 1977, the debtors executed a promissory note and mortgage on behalf of the Bank of Valley in the amount of \$62,401.59. Flood damage occurred to the property during the first quarter of 1978, and the debtors made application to the SBA for flood relief assistance. When their application had been provisionally approved, the debtors executed a promissory note and real estate mortgage dated May 17, 1978, to the SBA in the amount of \$44,900. On July 25th, the Bank, through its president Robert Pease, executed and delivered to the SBA a subordination agreement. The SBA made disbursements to the debtors both before and after receipt of the subordination agreement in the following manner: \$5,000 on May 17, 1978; \$15,000 on May 23, 1978; \$9,900 on June 7, 1978, and \$15,000 on August 2, 1978.

It is the contention of the Sargents that the value of the real estate does not exceed the value of the mortgage held by the SBA and that due to the subordination agreement, the Bank's mortgage debt is unsecured and thereby discharged by order of this Court on October 8, 1980.

The subordination agreement, the heart of this litigation, in part reads, "In consideration of the loan made by the Small Business Administration. . .to Wilbur A. and Theresa B. Sargent. . .dated April 24, 1978, in the amount of \$44,900 and secured by a note, security interest and mortgage all dated May 17, 1978. . .the Bank of Valley hereby subordinates in favor of the SBA any mortgage which it now has on the above-described property, to the extent of \$44,900." The agreement further reserves to the Bank a mortgage interest in the amount of \$7,100 which the parties agree represents a first mortgage in favor of the Bank to the extent of that amount only.

The sole issue in this case is whether the Bank of valley received consideration for entering into the subordination agreement. In its document captioned "Authorization and Loan Agreement (Direct Loans)", the SBA specifically states that the loan is approved subject to representations made in the loan application, including the supporting documents. The Loan Agreement provided that the SBA would have a second mortgage on the property subject only to the Bank's first mortgage of \$7,100. Testimony shows that it is SBA procedure that partial disbursements up to \$5,000 unsecured could be made to the applicant prior to final loan approval if a note were given. In this instance, the mortgage had been signed at the time of the note allowing the SBA to proceed with disbursements in excess of \$5,000. When the SBA received the July 1978 abstract of title on the property in question, it discovered the Bank's existing first mortgage was in excess of \$62,000 rather than \$7,000 as Sargent had stated on his loan application. SBA loan officers were consulted. It was their opinion that the SBA could not continue disbursing funds to the Sargents because as a matter of record, the SBA mortgage was second to the entire Bank loan. Only after the subordination agreement was executed and received by SBA, that is, when the mortgages were conformed to the documents in the application and authorization for the disaster relief loan, did SBA resume and complete distribution of the remaining balance of the loan to the debtors.

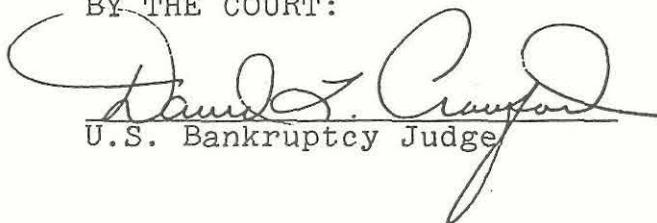
The Bank of Valley raises the argument that the SBA was, by the time of discovery of the full amount of the Bank's mortgage, legally obligated to disburse the remainder of the funds for which the debtors had applied and that no valid consideration could be given because the SBA was under a pre-existing legal duty to perform. The facts, however, lead me to a different conclusion. The note which the debtors signed for their disaster relief contains an acceleration clause effective upon the happening of any of certain events, two of which are failure of the debtor to comply with any condition imposed in the loan and the holder's discovery of the debtor's failure in any application to the SBA to disclose any facts deemed by the holder to be material or making any statement within the agreements submitted in connection with the application of any misrepresentation for the benefit of the applicant. Based upon that language and based upon the debtors' application and the paperwork signed in procuring the loan, I find that the discovery

of the existence of the Bank's \$62,000 first mortgage did constitute a material breach sufficient to justify rescission of the loan agreement. Upon making that discovery, the SBA was no longer legally obligated to disburse the funds and defendant Bank of Valley must fail in its argument that no consideration could be given. I find the language of the subordination agreement to be on its face correct, that in consideration of the loan made by the SBA, the Bank subordinated its mortgage to the extent of all but \$7,100. The actual making of the loan after that discovery was the detriment to the SBA sufficient to validate consideration for the subordination agreement. A first mortgage on un-rebuilt flood-damaged property would be, in essence, worthless to the Bank. The only way that it could hope to realize any value from its security was to subordinate its first mortgage in favor of the necessary loan to restore the property to its previous condition.

A separate judgment is entered in accordance with the foregoing.

DATED: August 11, 1982.

BY THE COURT:

  
U.S. Bankruptcy Judge

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