COMMERCIAL LAW AND BANKRUPTCY SECTION NEWSLETTER

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MERS DEED OF TRUST FORECLOSURES; IDAHO COURTS HAVE SPOKEN - AGAIN

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Last year I submitted an article for the Section Newsletter (Spring 2012) regarding the application of Article 3 of the Uniform Commercial Code to enforcement of assigned negotiable promissory notes by the assignee beneficiaries to nonjudicially foreclose deeds of trust. *Trotting Past Article 3 of the UCC, The Transfer of Negotiable Notes and the ISC Decision in Trotter v. Bank of NY*. While we seem to be getting past the tidal wave of real estate foreclosures, the related legal issues are still being decided by appellate courts and the Idaho Supreme Court has issued another opinion on of the requirements for an Idaho nonjudicial deed of trust foreclosure in the recent decision of *Edwards v. MERS et al.* 2013 WL 1760620, 4/25/13 ("*Edwards*").

As pointed out in the 2012 Article, the right to enforce a negotiable note secured by the deed of trust [or mortgage] must be held by person entitled to enforce the note. Idaho Code § 28-3-301. In the case of a transfer of the obligation for which payment is secured by a mortgage, Idaho Code § 45-911 provides that assignment of a debt, negotiable or nonnegotiable, secured by a mortgage carries with it the security. Idaho Code § 28-9-203 provides that the security interest securing a right to payment, such as a note, also attaches to the security interest securing the right to payment (i.e. the security follows the right to payment). If the note is nonnegotiable then common law contract law, and its related provisions on assignments, applies to its transfer. *Security Finance Co. v. Jensen Auto Co.*, 48 Idaho 376, 282 P. 88 (1929). Under the UCC, rights in a promissory note, ownership and right to enforce, can be separated. Ownership of a note provides the economic benefits of the note while the right to enforce allows the right to sue on the note or foreclose. Idaho Code §§ 28-9-109(a)(3), 28-3-301. The person enforcing the note must have physical possession of the note. Idaho Code § 28-3-301.[1]

A residential loan is primarily evidenced by a negotiable promissory note or credit agreement issued by the borrower and, usually, a deed of trust granted by the borrower to a trustee for the benefit of the lender. Traditionally the loan would be transferred by the lender by recording an assignment of the deed of trust which usually contained an assignment of the underlying payment obligation or note to the buyer. Keeping in mind that the right to foreclose accrues to the person who has the right to enforce the secured note, it should be noted that there is no requirement in the Idaho Code that the <u>transfer of the note</u> itself be recorded. The recording statutes really apply only to the transfer of a mortgage (or deed of trust) as it relates to real property. *Insight LLC v. Gunter*, 2013 WL 1730149, *8 (Idaho, 2013) ("Idaho's race-notice statute provides that "[e]very conveyance of real property is ... void as against any subsequent purchaser or mortgagee of the same property, or any part thereof, in good faith and for valuable consideration, whose conveyance is first duly recorded." I.C. § 55–812"). There

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[1] Subject to the exception for lost notes. Idaho Code § 28-3-309.

has never been a system of publicly tracking the ownership and transfer of the notes that the mortgages (or deeds of trust) secure.

In the 1990s, major financial institutions dealing in loan sales and purchases desired to avoid the burden of recording transfers or assignments of real estate loans in the secondary mortgage market for securitizing home mortgage loans which led to the creation of MERS (Mortgage Electronic Registration Systems). MERS was designed to act as nominal mortgagee for lenders that may then transfer the note or partial interests in the note without regard to the use of any public recording system.[2] Under the MERS system, MERS was designated as the mortgagee, or the designee of the mortgagee on mortgages and as the beneficiary on deeds of trust.[3] *A National Mortgage Registry: Why We Need It, And How to Do It,* Whitman, *UCC Law Journal*, Vol. 45, Issue 1 (April, 2013). The original mortgage or deed of trust was then recorded and all subsequent transactions with regard to the note and mortgage were kept by MERS non-public record system. *Id.* The debt secured by the deed of trust was often securitized and transferred by the original lender to another institution. Designating MERS as a "nominee" in the deeds of trust clashed with the provisions of statutory foreclosure requirements and the provisions of the UCC so the deficiencies in the MERS scheme were exposed in court decisions in actions filed by foreclosure defense lawyers and the bankruptcy bar. *E.g., Law of Distressed Real Estate,* § 24:20; *James v. ReconTrust Co.,* 845 F. Supp. 2d 1145 (D. Or. 2012) (MERS not a beneficiary of trust deed as required under Oregon law); *MERS v. Graham*, (KN.App.2010) 247 P.3d 223; *In re Wilhelm*, (USBCID,2009) 407 BR 392. Considering the legal controversy surrounding MERS it is ironic that MERS was created to create a registry to avoid having to record assignments of deeds of trust and not for the transfer of the underlying secured obligation to pay, which was the source of the right to enforce the obligation or foreclose the security instrument. *Robeson v. Mortgage Electronic Registration Systems, Inc*., 2012 WL 42965 (Tex. App. Fort Worth 2012).

The Idaho Supreme Court addressed nonjudicial foreclosure proceedings involving assigned, securitized, residential loans and MERS in the *Trotter v. Bank of NY Mellon*, 152 Idaho 842, 275 P.3d 857 (2012) ("*Trotter*") and *Edwards* decisions where the borrowers

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[2] It should be noted, as it was in Trotter, that any assignment of the deed of trust must be recorded before the deed of trust can be foreclosed nonjudicially. Idaho Code § 45-1505(1). A judicial foreclosure of an assigned mortgage or deed of trust apparently does not require recordation of the assignment. See, Idaho Code § 6-101. However, the "standing" of the plaintiff in such a case would likely be raised if the complaint does not show that the plaintiff is entitled to assert the claim. Discussion infra.

[3] The MERS registration system operates as follows:

> a. When a mortgage loan is registered on the MERS, it receives a mortgage identification number (MIN). The borrower executes a traditional paper mortgage, naming the lender as mortgagee, and the lender executes an assignment of the mortgage to MERS. Both documents are executed according to state law and recorded in the public land records, making MERS the mortgagee of record. From that point on, no additional mortgage assignments will be recorded because will remain the mortgagee of record throughout the life of the loan. In states where deeds of trust are used instead of mortgages, MERS is typically named as beneficiary of the deed of trust.
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> b. The MIN is unique and will not change during the life of the loan.
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> c. As mortgagee of record or beneficiary of the deed of trust, MERS receives service of all legal process related to the property. When notice is physically received by MERS, it is forwarded electronically to the company shown as servicer for that loan on the MERS System.
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> d. "The note is typically endorsed 'in blank' and delivered from the lender to the mortgage loan aggregator and/or securitization trust.
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> Law of Distressed Real Estate, § 24:20.10

objected to the foreclosure proceedings on the grounds the parties prosecuting the foreclosures lacked the apparent authority to do so. Common to both cases is the designation in the deeds of trust of the Mortgage Electronic Recording System (MERS) as nominee of the beneficiaries of the deeds of trust. Neither decision discussed in any detail whether the beneficiaries had the right to enforce the deeds of trust. The *Trotter* Court simply adopted the district judge's determination that MERS was the beneficiary of the original deed of trust and that therefore the successor beneficiary to MERS had the right to direct the trustee to commence foreclosure.

The Supreme Court went a little further in *Edwards* to address MERS's legal capacity under the deed of trust. However, its decision was based on agency law instead of examination of the right to enforce the secured obligation. The pertinent facts cited in the *Edwards* decision are that in 2005, Edwards refinanced the debt secured by her residence by executing a deed of trust conveying her residence to Alliance Title in trust to secure the payment of a promissory note she signed in the sum of $345,000 which was payable to Lehman Brothers Bank, FSB (Lehman Brothers). The deed of trust stated that Lehman Brothers was the lender; that MERS, as nominee for the lender, was the beneficiary; and that Alliance Title was the trustee.

In 2009, MERS, as nominee of Lehman Brothers, appointed Pioneer Lender Trustee Services, LLC (Pioneer), as trustee in the place of Alliance Title. Then Quality Loan, as attorney in fact for Pioneer, recorded a notice of default issued a written notice that it would foreclose the deed of trust by a trustee's sale to be held on April 8, 2010. Just a few days prior to the trustee sale, Edwards filed her action challenging the capacity of the defendant parties to conduct the trustee's sale.

The definitions section of the deed of trust stated: "MERS is a separate corporation that is acting solely as a nominee for Lender and Lender's successors and assigns. **MERS is the beneficiary under this Security Instrument**." (Emphasis added). *Edwards*, p. 5. Another section of the deed of trust provided:

> Borrower understands and agrees that **MERS holds only legal title** to the interests granted by Borrower in this Security Instrument, but, if necessary to comply with law or custom, MERS (as nominee for Lender and Lender's successors and assigns) has the right: to exercise any or all of those interests, including, but not limited to, the right to foreclosure and sell the Property; and to take any action required of Lender, including, but not limited to, releasing and canceling this Security Instrument. (Emphasis added).
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> *Edwards*, p. 5.

The statements in the deed of trust that MERS is the beneficiary and holds the legal title initially raises an issue not addressed by the Court. Under Idaho law the trustee holding legal title under the deed of trust and the beneficiary cannot be the same person. Idaho Code § 45-1502(1).[4] Idaho Code § 45-1502(4) defines "Trustee" as "a person to whom the legal title to real property is conveyed by trust deed, or his successor in interest." Prior to initiating foreclosure, MERS appointed a successor trustee thereby divesting itself of the trusteeship while remaining nominee of the beneficiary, which apparently satisfied the requirement of Idaho Code § 45-1502(1).

The *Edwards* Court's decision holding that the successor trustee may proceed to

[4] Idaho Code § 45-1502(1): "Beneficiary" means the person named or otherwise designated in a trust deed as the person for whose benefit a trust deed is given, or his successor in interest, and who shall not be the trustee.

foreclose the deed of trust because of the borrower's default was based in part on its construction of another provision of the deed of trust that designated MERS as the nominee under the instrument. The Court explained that the deed of trust was not given for the benefit of MERS or to secure the borrower's obligation owing to it. Because the deed of trust designated MERS as the nominee of the lender, the Court held that a "nominee" is "merely a form of agent," so MERS was acting as the agent of the lender-beneficiary. *Edwards*, pp. 4-5. Then the Court pointed out, as it did in *Trotter*, that the trustee is the party that forecloses the deed of trust, not the beneficiary. Idaho Code § 45-1505. Because the successor trustee of the deed of trust was properly appointed by MERS and there was no dispute that the borrower defaulted on the obligation secured by the deed of trust, the Supreme Court affirmed the district judge's rejection of the borrower's challenge to the foreclosure proceeding.

The Idaho Supreme Court decision regarding MERS deeds of trust in *Edwards* can be contrasted to the earlier Washington Supreme Court decision in *Bain v. Metropolitan Mortgage Group, Inc.*,175 Wash.2d 83, 285 P.3d 34 (2012), which involved similar facts and deed of trust provisions. In *Bain*, a US District Judge requested the Washington Supreme Court to answer three certified questions relating to two home foreclosures pending in King County.[5] In addressing the question as to whether MERS as designated beneficiary of the deeds of trust had the power to appoint successor trustees to foreclose the deeds of trust, the *Bain* Court. The Washington Code defines a "beneficiary" of a deed of trust as "the holder of the instrument or document evidencing the obligations secured by the deed of trust, excluding persons holding the same as security for a different obligation." RCW 61.24.005(2). Based on this definition, it was easy for the *Bain* Court to find that MERS was not a beneficiary with power to appoint a successor trustee because it did not hold the instrument evidencing the borrower's obligation.

MERS, as the designated beneficiary and nominee for the lender beneficiaries of the deeds of trust, was informed by the loan servicers that the homeowners were delinquent on their mortgages. MERS then appointed trustees who initiated foreclosure proceedings. The primary issue before the Washington court was whether MERS could be a lawful beneficiary with the power to appoint trustees within the Washington deed of trust act if it did not hold the promissory notes secured by the deeds of trust. The definition of "beneficiary" in the Washington Code required that only the actual holder of the promissory note or other instrument evidencing the obligation may be a "beneficiary" with the power to appoint a trustee to proceed with a nonjudicial foreclosure on real property. Because MERS did not hold the note, it could not be a beneficiary. *Bain*, 285 P.3d at 36-37. MERS also argued to the *Bain* court that the text of the deed of trust, as with the deed of trust in *Edwards*, was sufficient to authorize it to act as

[5] The certified questions and answers were:

1. Is Mortgage Electronic Registration Systems, Inc., a lawful "beneficiary" within the terms of Washington's Deed of Trust Act, Revised Code of Washington section 61.24.005(2), if it never held the promissory note secured by the deed of trust? [Short answer: No.]

2. If so, what is the legal effect of Mortgage Electronic Registration Systems, Inc., acting as an unlawful beneficiary under the terms of Washington's Deed of Trust Act? [Short answer: We decline to answer based upon what is before us.]

3. Does a homeowner possess a cause of action under Washington's Consumer Protection Act against Mortgage Electronic Registration Systems, Inc., if MERS acts as an unlawful beneficiary under the terms of Washington's Deed of Trust Act? [Short answer: The homeowners may have a CPA action but each homeowner will have to establish the elements based upon the facts of that homeowner's case.] Bain, 285 P.3d at 37-38

agent for the true beneficiary-lender. The Washington court rejected this argument:

> Similarly, MERS argues that lenders and their assigns are entitled to name it as their agent. [Citation omitted] …
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> But Moss [*Moss v. Vadman*, 77 Wash.2d 396, 402–03, 463 P.2d 159 (1970)] also observed that "[w]e have repeatedly held that a prerequisite of an agency is *control* of the agent by the principal." Id. at 402, 463 P.2d 159 (emphasis added) (Citation omitted). While we have no reason to doubt that the lenders and their assigns control MERS, agency requires a specific principal that is accountable for the acts of its agent. If MERS is an agent, its principals in the two cases before us remain unidentified. [Footnote omitted]. MERS attempts to sidestep this portion of traditional agency law by pointing to the language in the deeds of trust that describe MERS as "acting solely as a nominee for Lender and Lender's successors and assigns." [Citation omitted]. But MERS offers no authority for the implicit proposition that the lender's nomination of MERS as a nominee rises to an agency relationship with *successor* noteholders. [Footnote omitted]. MERS fails to identify the entities that control and are accountable for its actions. It has not established that it is an agent for a lawful principal. (Emphasis added).
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> *Bain*, 285 P.3d at pp. 45-46.

So the decisions in *Edwards* and *Bain* regarding the authority of MERS as a designated "nominee" of the beneficiary-lender of the deed of trust turned on the definition of "beneficiary" under the respective state deed of trust acts and application of the law of agency. The Washington definition expressly defines "beneficiary" as the holder of the obligation secured by the deed of trust and with the right to enforce it. This definition is consistent with the UCC analysis presented in my earlier article on the *Trotter* decision. The Idaho deed of trust act does not expressly tie the obligation secured by the deed of trust to the beneficiary in the definitions of Idaho Code § 45-1502 as the Washington Code does. Idaho Code § 45-1502(3) defines "trust deed" as a "deed executed in conformity with [the] act and conveying real property to a trustee in trust to secure the performance of *an obligation of the grantor … to a beneficiary.*" Idaho Code § 45-1503(1) provides that transfers of real property in trust may be made to "secure the performance of an obligation of the grantor or any other person named in the deed to a beneficiary." This statute infers that the because the obligation is to be performed to a beneficiary that the designated beneficiary has the right to enforce it. The Supreme Court in *Edwards* construed these provisions to require that "the deed of trust must have been given to secure an obligation to the beneficiary and for the benefit of the beneficiary." *Edwards,* p. 6. The *Edwards* Court accepted MERS's agency argument that was rejected in *Bain* because it was not shown that the beneficiary had control over MERS. The Idaho Supreme Court has recognized "control" by the principal as a requirement of the agency relationship. Gorton v. Doty 57 Idaho 792, 69 P.2d 139 (1937). However, there were successor note-holders to the original lenders in *Bain* and not in *Edwards* so the Idaho Supreme Court did not have the same basis for rejecting the agency argument as in the Washington decision in *Bain*.

The *Bain* decision was cited to US District Judge Lodge in *Mortenson v. MERS, Inc.*, 2012 WL 4482370 (USDC Idaho), which was a removed action to enjoin a deed of trust foreclosure involving a MERS deed of trust. In *Mortenson,* Mortenson defaulted on the obligation secured by the deed of trust.

Subsequently, MERS, as the deed of trust beneficiary and the lender's nominee, appointed a successor trustee which appointment was recorded as was an assignment of the deed of trust in which MERS as beneficiary under the deed of trust granted all its beneficial interest, together with the note or notes described in the deed of trust to HSBC Bank USA (“HSBC”). Mortenson filed for bankruptcy relief and HSBC obtained stay relief to foreclosure. The successor trustee conducted the trustee’s sale but instead of vacating the premises, Mortenson challenged the propriety of the foreclosure proceeding naming MERS, the servicer of the secured note, and the deed of trust trustee as defendants. The defendants filed a motion to dismiss, the federal magistrate assigned to the case recommended that the action be dismissed, and the plaintiff objected on the basis of the Washington *Bain* decision that MERS was an “invalid” beneficiary. Judge Lodge rejected Mortenson’s objection to the magistrate’s report, stating:

> First, the *Bain* decision by the Washington state Supreme Court is not binding precedent on this Court. Second, the *Bain* court acknowledged in its opinion that Idaho law (Idaho's Deed of Trust Act) did not define “beneficiary” similar to Washington law. *Id.* * 13. *Idaho law does not require that a “beneficiary” be “the holder of the instrument” like Washington law*. Third, this Court must apply Idaho law and the Idaho Supreme Court has determined MERS can execute the rights of a beneficiary. *Trotter v. Bank of N.Y. Mellon*, 275 P.3d 857 (Idaho 2012). *Fourth, all of the assignments necessary to validate the non-judicial foreclosure of the property at issue were properly recorded in this case*. Fifth, the foreclosure has already been upheld by the Idaho state court and Mortensen failed to appeal the state court judgment in favor of HSBC. Sixth, the Ninth Circuit has held even if MERS is a sham beneficiary and the note is split from the deed, this does not result in no party having the power to foreclose. *Cervantes, v. Countrywide Home Loans, Inc.*, 656 F.3d 1034, 1044 (D.Ariz.2011). (Emphasis added).
> *Mortenson*, 2012 WL 4482370, p. 3.

Judge Lodge dismissed the borrower’s complaint. Judge Lodge is correct that the Idaho Code does not expressly require that the beneficiary be “the holder of the instrument [secured by the deed of trust]” but as pointed out, Idaho Code §§ 45-1502(3) and 45-1503(1) at least infer that performance of the secured obligation be owed to the beneficiary. Further, if “all of the assignment necessary to validate the non-judicial foreclosure” were recorded as was noted in the *Trotter* decision, then it may be inferred that they document the transfer of the secured obligation from the original lender/beneficiary or MERS to HSBC.

In summary, while the designation of MERS as a nominee in a deed of trust encumbering real property in Idaho may not impair nonjudicial foreclosure of the deed of trust in Idaho, some legal concerns remain. The *Trotter, Edwards,* and *Mortenson* decisions never addressed whether the beneficiaries of the deeds of trust in those cases were parties entitled to enforce the obligations secured by the deeds of trust. The *Mortenson* decision simply noted that the “assignments necessary to validate the non-judicial foreclosure of the property at issue were properly recorded.” However, Idaho Code § 45-1505(1) requires the recording of the trust deed (and any assignment thereof), *not the obligation secured by the deed of trust* which is the basis for enforcement. In other words, as the *Trotter* decision noted, there is no requirement in the Idaho deed of trust act that the beneficiary produce the note secured by the deed of trust to initiate foreclosure.

Mortgages and deeds of trust may be foreclosed judicially in Idaho. Idaho Code §§ 6-101, 45-1503. A requirement for pleading a claim in Rule 8(a)(1), IRCP, is that the pleader is entitled to relief. This provision would require the plaintiff to show that it is a party entitled to enforce the obligation secured by the mortgage or deed of trust in foreclosure. A power of sale foreclosure of a deed of trust is outside the judicial process as pointed out by the *Trotter* decision. Absence compliance with the statutory procedure for conducting a power of sale foreclosure of a "MERS deed of trust," Idaho courts are unlikely to intervene for the borrower as a result of the *Trotter* and *Edwards* decisions. However, there may be an opening to challenge MERS's agency argument if there has been a transfer of the obligation secured by the deed of trust.

As to whether the beneficiary of the deed of trust is **the** person entitled to enforce the secured note, Idaho Code § 28-3-602 provides that a negotiable note is paid to the extent payment is made to a person entitled to enforce the note.[6] In neither *Trotter* nor *Edwards* did the plaintiff-borrower tender a cure of the default or assert that he or she did not know who was entitled to enforce the note. Idaho Code § 28-3-602(b) provides that a note is paid to the extent payment is made to a person *formerly* entitled to enforce the note only if at the time of payment the party obliged to pay has not received adequate notification that the note was transferred and that payment was to be made to the transferee.

[6] Trotter argued that his note was paid by insurance but produced no evidence of such payment. Trotter, 152 Idaho at 849, 275 P.3d at 864.

A Penny for Your Thoughts: How Much for a Debtor's Life Story?

Brent R. Wilson, Esq.[1]

For a period of time in the summer of 2011 you could not turn on the television or log on to the internet without hearing about Casey Anthony and the tragic death of her two year-old daughter, Caylee Anthony. The world was transfixed. What happened? Who's responsible? Is Ms. Anthony evil personified?

Ms. Anthony was charged with murder of her daughter, Caylee. At a trial that lasted six weeks, the prosecution sought the death penalty. Ms. Anthony's defense was Caylee accidentally drowned in the pool. The jury ultimately found Ms. Anthony not guilty on July 5, 2011. Largely, the verdict was met with public outrage. The media coverage and the public trial, of sorts, that occurred on social media allowed many to decide for themselves whether Ms. Anthony was responsible.[2]

Not surprisingly, what comes with a six week trial, which has the attention of the world, is staggering legal fees. And for an individual who is unemployed, the likelihood of being able to pay these fees is slim. The writing was on the wall for Ms. Anthony's next legal step: bankruptcy. Ms. Anthony filed her chapter 7 petition on January 25, 2013, in the Bankruptcy Court for the Middle District of Florida.[3] Due to her infamy, the bankruptcy has attracted some attention. But what makes this case interesting, from a bankruptcy perspective, is the approach taken by the chapter 7 trustee assigned the case, Stephen L. Meininger. On March 15, 2013, the trustee filed a motion requesting bankruptcy court approval to sell the "life story" of Ms. Anthony as "property of the estate." Of course, this motion is opposed by Ms. Anthony's bankruptcy counsel, David L. Schrader. During the writing of this article, the matter was under advisement with a decision to be issued by Judge K. Rodney May in the near future. However, on May 7, 2013, for reasons unclear from the record, the trustee withdrew his motion to sell Ms. Anthony's life story.[4] Nevertheless, this article will examine the interesting issues raised by the trustee's motion.

This article will proceed with a review of Ms. Anthony's bankruptcy petition. Next the article will discuss the arguments of the trustee as to this issue, followed by an analysis of the response by Ms. Anthony's bankruptcy counsel. Finally, this article will review prior cases on this issue.

The Bankruptcy Petition

Ms. Anthony's petition listed $1,084 in assets with $792,119.23 in liabilities. Amongst her few assets listed, Schedule B had no mention of Ms. Anthony's life story as an asset of the estate. As for Ms. Anthony's liabilities, many court costs and fees incurred were listed as "unknown," however, Schedule F stated she owed her primary criminal defense counsel, Jose Baez, attorney's fees in the amount of $500,000. Ms. Anthony's Schedule I listed no monthly income and the fact that she was unemployed and had been so for four years. Apparently, according to the Statement of Financial Affairs (SOFA), Ms. Anthony was living off of "gifts and gift cards from various unrelated third parties" from 2011 through

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[2] *See* John Cloud, *How the Casey Anthony Murder Case Became the Social-Media Trial of the Century*, TIME (June 16, 2011), http://www.time.com/time/nation/article/0,8599,2077969,00.html.

[3] *See In re Casey Marie Anthony*, (Case No. 13-00922), United States Bankruptcy Court, Middle District of Florida.

[4] *Id.* at Dkt. No. 88.

2013. The SOFA also lists five pending state court lawsuits against Ms. Anthony pending or already to judgment. Notably, the SOFA further listed under "Other transfers," "Debtor may have reliquished [sic] rights to photographs of Debtor. Value unknown."

Trustee's Arguments

In his motion to "sell property of the estate and approve auction procedures," the chapter 7 trustee, Mr. Meininger, set forth his intentions when it comes to the "life story" of Ms. Anthony. The trustee stated,

[a]mong the assets of the Estate are the exclusive worldwide rights in perpetuity to the commercialization of Anthony's life story including her version of the facts, her thoughts and impressions of whatever nature . . . [regarding the] death of her daughter, Caylee Anthony, her subsequent arrest, incarceration, trial, acquittal and withdraw from society, including the rights to motion pictures, documentaries, live stage performances and any other form of performance art . . . whether presently existing or hereafter developed . . . .[5]

The trustee went on to describe an offer already on the table from an individual named James M. Schober in the amount of $10,000. Apparently, Mr. Schober's intention is to purchase the rights to Ms. Anthony's life story to ensure she is never able to tell it.[6] The trustee then indicated he expects others would be interested in purchasing the life story "[d]ue to the intense public interest in [Ms. Anthony] and the Property."[7]

In the motion, nary a Bankruptcy Code section, nor other authority, is cited to for the proposition that Ms. Anthony's life story is property of the estate. Of course, the starting point to determine property of the estate is 11 U.S.C. § 541. In section 541(a) "property of the estate" is defined as all of a debtor's legal or equitable interest in property as of the filing of the bankruptcy petition. That section goes on to list nine non-exhaustive categories of property in the bankruptcy estate. 11 U.S.C. §§ 541(a)(1) - (a)(9). And, as pointed out by the Ninth Circuit Court of Appeals recently, "nothing in § 541 limits property of the estate to property scheduled by a debtor . . . [p]roperty of the estate, therefore, includes property not identified or listed on the bankruptcy schedules."[8] Based upon this broad net cast by section 541, the trustee's argument is likely that Ms. Anthony's life story is clearly ensnared and subject to his administration in the bankruptcy case for the benefit of her creditors.

Ms. Anthony's Response

Bankruptcy counsel for Ms. Anthony, David L. Schrader, of course, begged to differ with the conclusion reached by the trustee.[9] He argued "[t]he relief sought by the Trustee is both absurd and frightening,"[10] and that it has no basis in law. Counsel reached this conclusion by discussing various areas of the law that are not often in play in the bankruptcy courts. Namely, counsel invoked the First, the Fifth, the Thirteenth, and the Fourteenth Amendment to the United States Constitution.

However, counsel began his analysis with an issue that is a part of every bankruptcy case: what is property of the estate? Counsel

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[5] Case No. 13-00922, Dkt. No. 34 at ¶ 3.

[6] *See id.* at ¶ 4 (advising the court of the offer amount and intentions of the proposed buyer, "Mr. Schober's stated intention is to acquire the Property in order to prevent Ms. Anthony or others from publishing or profiting from her story in the future . . . .").

[7] *Id.* at ¶ 5.

[8] *Samson v. W. Capital Partners, LLC (In re Blixseth)*, 684 F.3d 865, 871 (9th Cir. 2012).

[9] *See* Debtor's Response to Trustee's Motion to Sell Property, Case No. 13-00922, Dkt. No. 51.

[10] *Id.* at 17.

argued that there is no deal in the works, no contract signed, copyright, or trademark existing at the time of the bankruptcy filing that could be property of the estate. Rather, counsel stated, it is Ms. Anthony's "mind and memory" the trustee seeks to bring into the estate, and there is no right under section 541 for the trustee to do so.[11] Further, counsel pointed out that section 541(a)(6) excludes a debtor's future "earnings from services performed by an individual after commencement of the case."[12] That section, counsel argued, should apply here because any deal for Ms. Anthony's life story would include her time and effort to make the story marketable and thus this effort should be deemed to be excluded from the estate under section 541(a)(6).[13] To drive home this point, counsel stated, "the Order sought by the Trustee would result in the judicial invasion and taking of thoughts and memories that have not been memorialized but are contained solely within the debtor's mind."[14]

<u>Nothing New Under the Sun: Other Cases Addressing Publicity as an Asset</u>

The issue that was before the Bankruptcy Court for the Middle District of Florida is novel. However, courts have addressed similar issues pertaining to the assignability of a person's publicity, often in the context of a discussion of intellectual property. Perhaps the most similar considering the fervor surrounding the murder trial, although not in a bankruptcy context, is the case of O.J. Simpson. Of course, Mr. Simpson is a former NFL star who was accused and acquitted of the murder of his wife, Nicole Brown Simpson, and her friend, Ronald Goldman. Mr. Simpson was found liable, however, in a civil suit by the families of the deceased for wrongful death. The judgment was in the amount of $33.5 million, which was not paid. Mr. Simpson then wrote and published a book entitled *If I Did It*. The families moved, and the state court granted, the copyright to the book to the families, but the court would not go as far as to grant the families the right to Mr. Simpson's publicity in general.[15]

In the bankruptcy context, the copyrighted materials of a debtor are clearly part of the bankruptcy estate.[16] But a debtor's general right of publicity going forward has never been held as an asset of the bankruptcy estate.[17] However, perhaps tangentially related, in *Mullen v. Jones (In re Jones)*, 445 B.R. 677, 726 (Bankr. N.D. Tex. 2011), the bankruptcy court, in the context of a denial of discharge action, stated that the failure of a the debtor to disclose in his schedules the right of publicity that the debtor previously agreed to assign to a creditor, was one reason why the court would deny the debtor a discharge.

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[11] *Id.* at 8.

[12] *Id.* at 10.

[13] *Id.*

[14] *Id.* at 2.

[15] *See Goldman v. Simpson*, No. SC03-6340, slip op. at 12-13 (Cal. Super Ct. Oct. 31, 2006) (labeling the transfer the publicity of Mr. Simpson as basically "involuntary servitude"). Note that the "involuntary servitude" argument was advanced by Ms. Anthony's counsel in his reply to the trustee's motion by citing the bankruptcy court to the Thirteenth Amendment to the U.S. Constitution. *See also* Jennifer E. Rothman, *The Inalienable Right of Publicity*, 101 GEO. L.J. 185, 189 (2012) (discussing the Simpson case and others involving the right of publicity and arguing that the right of publicity is not attachable by a debtor's creditors).

[16] *See Cusano v. Klein*, 264 F.3d 936, 946-47 (9th Cir. 2001).

[17] *See* Rothman, *supra* note 15 at 189; *but see* Melissa B. Jacoby & Diane Leenheer Zimmerman, *Foreclosing on Fame: Exploring the Uncharted Boundaries of the Right of Publicity*, 77 N.Y.U. L. REV. 1322 (2002) (arguing that a debtor's right of publicity should be held to be property of the estate subject to distribution to a debtor's creditors).

Conclusion

The issue that was pending before the Bankruptcy Court for the Middle District of Florida of whether a debtor's publicity is property of the estate subject to administration by the chapter 7 trustee is a thorny one with wide ranging implications. A broad grant of publicity, without regard to whether the debtor's publicity had already been leveraged into a book or movie, as property of the bankruptcy estate, could divert the famous and infamous alike from the bankruptcy system, and perhaps bring into play some constitutional concerns. But is it fair to leave a famous debtor's creditors holding an unenforceable claim against the debtor who eventually sells her story for millions? Unfortunately, it appears we will not get Judge May's thoughts on this interesting issue, but it is an issue that is likely to reappear.

"But they can't take my social security, can they?"

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For most creditors we all know the answer is a resounding "No, they can't touch social security benefits," because Section 207 of the Social Security Act, (42 USC §407) prohibits transfers or assignments of Social Security benefits, and prohibits execution, levy , attachment, garnishment, or other legal process on benefits, and makes payments not subject to the operation of bankruptcy law.

Of course there are exceptions. This memo will not attempt to cover all creditors attempts to get at benefits but everyone should know that despite a bankruptcy Social Security benefits may be at risk.

The Social Security administration can recoup overpayments, 42 USC § 404. There is some case law which prohibits recoupment from Social Security benefits after filing bankruptcy, *French v. U. S. Social Security Administration*, 20 B.R. 155 (Bankr. D. Or., 1982).

In re Contra , 386 B.R. 607 (Bankr.W.D. Va. 2008) allowed the IRS to take a "overpayments" of taxes claimed by the debtor as a refund to offset an overpayment of Social Security benefits. Part of the reasoning was that the right to a refund did not occur until after the overpayment of taxes was reduced by sums owed.

For debts which are exempted from discharge such as alimony, child support and student loans it is clear. Former spouses can attach Social Security for alimony or child support, based upon 42 U.S.C. §659. Paragraph (a) states United States itself, "shall be subject, in a like manner and to the same extent as if the United States . . . were a private person, to withholding in accordance with state law . . . to enforce the legal obligation of the individual to provide child support or alimony." The statute requires the entitlement to be one which is "based upon remuneration for employment." 42 U.S.C. §659(h) (1)(A)(ii)(I) shows that monies payable to an individual which are considered to be based upon remuneration for employment includes periodic benefits under the insurance system established by subchapter 2 of this chapter. The reference to "this Chapter" is a reference to Chapter 7 of the United States Code, Title 42, "The Public Health and Welfare," Chapter 7 "Social Security." Subchapter II is titled: "Federal Old-Age, Survivors, and Disability Insurance Benefits."

Alimony is defined, under 42 USC §659(h)(3), as ". . . periodic payments of funds for the support and maintenance of the spouse or former spouse of the individual including separate maintenance, alimony *pendente lite*, maintenance and spousal support and includes attorney's fees, interest and court costs when, and to the extent, that the same are expressly made recoverable as such pursuant to a decree, order or judgment issued.. . ."

Executive Order No. 12105, December 19, 1978, 43 FR 59465, as amended by Executive Order No. 12107, December 28, 1978, 44 FR 1055, designated the Office of Personnel Management to promulgate regulations for the uniform implementation of this section (42 U.S.C. 659). 5 CFR §581.501, Appendix A, states, "For the garnishment of benefits under Title II of the Social Security Act, legal process may be served on the office manager at any Social Security District or Branch Office." This author has been successful using these authorities to garnish social security benefits to collect alimony.

Other exceptions are found in 31 USC §

3716 which permits the Feds to collect debts by administrative offset after giving the debtor notice of the type and amount of the claim, the right to copy and inspect the records, an opportunity for a review within the agency the decision to collect the claim and an opportunity to enter into a written agreement to repay the claim. §3716(a). Before collecting the agency must have adopted its own regulations or regulations promulgated by Treasury Department, Justice Department or the GAO. §3716(b). Setoff can be made against payments due under the Social Security Act. §3716 (c)(3)(A). The first $9,000 is exempt. The Federal Regulations governing setoff of Social Security amounts are found in 31 CFR 285.4. It is not clear which agencies have adopted this rule. With respect to monthly benefit amounts the government can setoff an amount equal to 15% of the monthly covered benefit payment or the amount by which the monthly covered benefit payment exceeds $750 ($9,000/year).

In *Lockhart v. US*, 126, S. Ct. 699 (2005), the Court allowed administrative offset of a past due student loan from Lockhart's Social Security benefits, even though the student loan debt was more that ten years old. The statute of limitations on collection of debts was effectively abrogated by 20U.S.C. §1091a.

Most of the above cases mentioned are non-bankruptcy cases, but setoff is not necessarily barred by a bankruptcy filing. The concept of setoff is explained in *IRS v. Luongo*, 259 F.3d 323 (5th Cir 2001). The debtor received a bankruptcy discharge for pre-petition tax liabilities. The IRS sought to setoff debtor's income tax refund. The court allowed the IRS to offset under the authority of §553 of the Bankruptcy Code.

> "We agree with the vast majority of courts considering the relationship between § 524(a) and § 553 that a debtor's discharge in bankruptcy does not bar a creditor from asserting its right to setoff. *See In re Davidovich*, 901 F.2d 1533 (10th Cir.1990); *In re Buckenmaier*, 127 B.R. 233 (9th Cir. B.A.P.1991); *Posey v. Dept. of Treasury*, 156 B.R. 910 (W.D.N.Y.1993); *Reich v. Davidson Lumber Sales Emp. Ret. Plan*, 154 B.R. 324 (D.Utah 1993); In re Thompson, 182 B.R. 140 (Bankr.E.D.Va.1995); *In re Runnels,* 134 B.R. 562 (Bankr.E.D.Tex.1991); *In re Morgan*, 77 B.R. 81 (Bankr.S.D.Miss.1987); *In re Conti*, 50 B.R. 142 (Bankr.E.D.Va.1985); *In re Ford*, 35 B.R. 277 (Bankr.N.D.Ga.1983); *In re Slaw Constr. Corp.*, 17 B.R. 744 (Bankr.E.D.Pa.1982); *Krajci v. Mt. Vernon Consumer Discount Co.*, 16 B.R. 464 (Bankr.E.D.Pa.1981). *But see In re Dezarn*, 96 B.R. 93, 95 (Bankr.E.D.Ky.1988); *In re Johnson*, 13 B.R. 185, 189 (Bankr.M.D.Tenn.1981). It is impossible for us to ignore the clear statement of § 553 that "this title [the Bankruptcy Code] does not affect any right of a creditor to offset...." We interpret this statement to allow a discharged debt to be setoff upon compliance with the terms and conditions provided in § 553, notwithstanding § 524(a)'s post-discharge bar. This interpretation avoids the "possible injustice in requiring a creditor to file its claim for satisfaction in the bankruptcy court, while at the same time compelling the same creditor to pay in full its debt to the bankruptcy estate." *In re Davis*, 889 F.2d at 661 (quoting *In re Southern Indus. Banking Corp*., 809 F.2d 329, 332 (6th Cir.1987)). Our interpretation also creates an equitable balance by preventing affirmative action to collect the discharged debt, while preserving

> the creditor's right to raise a discharged debt as a defense to a recovery action brought by the debtor. "In these circumstances, where the creditor's use of § 553 is defensive, the spirit of § 524(a)(2), 'to eliminate any doubt concerning the effect of the discharge as a total prohibition on debt collection efforts' is not violated." *In re Ford*, 35 B.R. at 280 (quoting S.Rep. No. 598, 95th Cong., 2d Sess. 80 (1978), U.S.C.C.A.N.1978, 5866)."*In re Luongo*, 259 F.3d 323, 333-34 (5th Cir. 2001).

So the question remains whether, after discharge, can the government use the administrative offset provisions to collect from a debtor's Social Security benefit for a a pre-petition debt owed by the debtor, such as a Rural Housing Development loan, a USDA overpayment or an SBA loan? For student loans the question has been answered. For other debts owed to governmental agencies the statutory framework is in place, but the adoption of regulations by the agencies to allow setoff against Social Security benefits requires further inquiry. See 13 CFR §140.11(SBA procedures) and 7 CFR §1951Subpart S(USDA procedures).

In re Porretto: Section 542(b) Turnover Actions and Indemnification Agreements

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In re Porretto, a relatively recent bankruptcy decision out of the Southern District of Texas illustrates just "how far-reaching § 542(b) of the Bankruptcy Code really is . . ." 09-35324, 2012 WL 5177977 (Bankr. S.D. Tex. Oct. 18, 2012). Family law attorneys are familiar with "hold harmless" provisions that are often placed in property settlement agreements or divorce decrees. Typically, one party is assigned the obligation to pay a particular community debt and agrees to "indemnify, defend, and hold harmless" the other spouse from the debt. These indemnification obligations are non-dischargeable as debts owed to a spouse and "incurred by the debtor . . . in connection with a . . . divorce decree or other order of a court . . . ." 11 U.S.C. § 523(a) (15).

Besides the obligation being non-dischargeable by the indemnitor, the right to receive indemnification can also be considered property of the bankruptcy estate of the indemnitee—the spouse to whom indemnification is owed. As *Porretto* illustrates, in a perfect storm the indemnitor can be caught owing his or her former spouse's bankruptcy estate the full amount of the covered debts, pursuant to § 542(b). The indemnitor lacks the option of discharging the indemnification obligation in his or her own Chapter 7 bankruptcy and could remain liable for any unsatisfied portion of the debts even after paying the bankruptcy estate in full pursuant to the indemnification agreement. The indemnitor could potentially end up paying far in excess of what was initially owed on the covered debts.

Porretto involved an adversary proceeding between a Chapter 7 trustee and the former spouse of the Debtor, Mr. Nelson. The Debtor and Nelson divorced in 2008 and in the final decree Nelson was order to pay three community debts. The state court ordered Nelson to "indemnify and hold the wife harmless" from any failure on his part to pay the debts. Nelson then promptly failed to pay the debts. In 2009, the Debtor filed a Chapter 11. All three creditors sued both the Debtor and Nelson. Eventually, the creditors obtained default judgments against Nelson. The Debtor, while in Chapter 11, defended the lawsuits and eventually reached settlements whereby each creditor was allowed claims in the bankruptcy. The Debtor's Chapter 11 was later converted to a Chapter 7.

The Chapter 7 trustee substituted in as plaintiff in an adversary proceeding against Nelson seeking a judgment ordering Nelson to turnover funds sufficient to pay in full the allowed claims of the three creditors, as well as to cover the attorney fees incurred by the Debtor in defending the three lawsuits while in Chapter 11. The trustee's legal basis was § 542(b), which requires that "an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of the trustee." The two elements required for turnover are: "First, the debt must be property of the estate. Second, it must be matured and payable on demand or on order." *Porretto*, 2012 WL 5177977, at *4.

Nelson objected. Apart from equitable defenses, his principal argument was that the indemnification obligations were not mature and payable on demand or order because "the estate has not made any distributions for which the Trustee may seek indemnification." *Id*. at *5. The *Porretto* court rejected this argument. First, *Porretto* discussed how the Debtor's interest in indemnification became property of the estate under § 541(a)(1), a simple question given the expansive scope of the bankruptcy estate, which includes "all legal or equitable interests of the debtor in property as of the commencement of the case." At the time of filing, Debtor had a "legal interest in indemnification pursuant to the Agreed Divorce Decree," which interest became property of the estate. *Id.* at *4.

Second, the indemnification obligations owed by Nelson were also mature and payable on demand or order, meeting the second element of § 542(b). To this point Nelson argued his obligations were not yet triggered because the estate had not yet made any payments. The court responded by pointing out that the Divorce Decree had two separate obligations: a duty to indemnify created by the words "defend, indemnify, and hold harmless" and a duty to reimburse, separately set forth in another place in the Decree. As a matter of contract interpretation, the court found the "two duties separate and distinct." *Id*. at *5. More importantly, the court interpreted the indemnification portion of the Divorce Decree as creating a duty to indemnify against *liability* as opposed to a duty to indemnify against *damages*. As such, the duty to indemnify and the concomitant right to recover from the indemnitor, arise when the liability "becomes fixed and certain, as by rendition of a judgment, whether or not the indemnitee has yet suffered actual damages, as by payment of a judgment." *Id.* at *6 (quoting *Ingersoll–Rand Co. v. Valero Energy Corp., 997 S.W.2d. 203, 207 (Tex. 1999)). Since* the liability against the Debtor had become fixed, the fact that the estate had made no payments was of no consequence. Because each of the three creditors had entered into settlement agreements and been granted allowed claims, "Nelson's obligation to indemnify the estate for the Debts is mature and payable on order." *Id*.

Although the court was interpreting Texas law with regard to how a duty to indemnify against liability is created, its analysis is consistent with courts across the country. *See, e.g., Gardner v. Gardner,* 294 P.3d 600 (Utah Ct. App. 2012) (holding indemnification agreement with hold harmless provision created a duty on the husband's part to indemnify against liability that arose before wife incurred any losses); *Long v. McAllister–Long,* 221 S.W.3d 1 (Tenn. Ct. App. 2006) (focusing on the words "hold harmless" and finding that the obligation to indemnify arose before the creditors required the indemnitee to pay on the debts); *Eaton v. Grau,* 845 A.2d 707 (N.J. Super. Ct. App. Div. 2004) (decree requiring husband to indemnify and hold wife harmless created an obligation to protect against wife's liability to third party as well as any losses suffered by her).

Correctly perceiving the potential injustice of this result, Nelson argued it would be inequitable to make him turnover funds in the full amount of the debts. He argued that given the priority rules of 11 U.S.C. § 726(a), the creditors would likely not be paid in full. Administrative claims and priority unsecured claims would receive payment first, meaning the three creditors would "inevitably not receive 100% payment on their unsecured claims." *Id*. at *6. Nelson argued he would ultimately "have to pay more than what is owed on the Debts." *Id*. Although it was no consolation to Nelson, the Court agreed that he had a point. Nonetheless, the court found Nelson could have avoided the whole thing by paying the debts in a timely manner pursuant to the state court Decree, well before the bankruptcy filing complicated matters. Consequently, he had unclean hands and could not seek equity.

One lesson of *Porretto* is that the agreement of a party to indemnify and hold harmless another party on a debt can have consequences beyond the simple payment of the debt. If the indemnitor fails to fulfill his or her indemnification obligation, a bankruptcy filing by the indemnitee could increase the ultimate exposure the indemnitor has on the debts. In the divorce arena, the circumstances that could create this harsh result are not altogether rare. The party who has assumed or been assigned significant debt in a divorce often has more assets or is awarded more assets. The less financially well-off spouse is a prime candidate for a post-divorce bankruptcy. The question is whether a creditor's collection action on a debt has triggered the duty to indemnify. If so, a Chapter 7 trustee may capitalize on the indemnitor's failure to fulfill his or her indemnification obligations. *Porretto* also highlights the need for Debtors' attorneys to be aware of indemnification agreements as possible assets required to be disclosed on the schedules.