Commercial Law and Bankruptcy Section Newsletter

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JAMES C. MESERVY
Section Chairperson

RANDAL J. FRENCH
Newsletter Chairperson

Application for Employment Pursuant to 11 U.S.C. § 327

By Patrick J. Geile, Foley Freeman PLLC

The Application for Employment in a Chapter 11 case is one of the most important aspects in the commencement of a Chapter 11 case, but often it is time consuming and frustrating when proper disclosures are not made.

11 U.S.C. § 327 requires that "the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title." 11 U.S.C. 327 (2012)

This is a two prong test: 1) the attorney or other professional does not hold or represent an interest adverse to the estate; and 2) that the attorney or other professional is disinterested. The court and interested parties analyze the aforementioned prongs by reviewing the connections disclosed in the Application and Verified Statement.

"Disinterested person" is a term of art in the Bankruptcy Code and is defined in Section 101(14):

> (14) The term "disinterested person" means a person that –
> (A) is not a creditor, an equity security holder, or an insider;
> (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
> (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

11 U.S.C. 101(14)(2012).

The associated Bankruptcy Rule is 2014: Employment of Professional Persons. Rule 2014 sets forth the information needed in the Application and accompanying Verified Statement. There is also a local bankruptcy rule, 2014.1, which sets forth additional disclosure, timing and notice requirements.

The Application

Rule 2014 sets forth information required in the Application which is "the Application shall state the specific facts showing the necessity of the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and to the best of the applicant's knowledge, all of the person's connections with the debtor, creditor, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the office of the United States Trustee." F.R.B.P. 2014 (2012).

Verified Statement

Rule 2014 requires that "the Application shall be accompanied by a Verified Statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the office of the United States Trustee." F.R.B.P. 2014(a) (2012).

Therefore the information set forth in the Application needs to be repeated in the Verified Statement disclosing any and all connections that both the applicant and professional person are aware.

Disclosures

In Judge Pappas' recent decision In re *Werry*, Case Number 11-01710-JDP the application process is discussed at length. In *Werry*, Judge Pappas went through the appropriate level of disclosures necessary for employment. The Court there set a high bar for disclosures for approval of employment as a professional quoting several Ninth Circuit cases.

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By Randal French

A Word From the Editor

Thanks to R. Wayne Sweney, of Lukins Annis; Alexandra O. Caval, Staff Attorney, Office of Kathleen A. McCallister, Chapter 13 Trustee; and Patrick J. Geile, of Foley Freeman, PLLC, for contributing articles for this Quarterly Newsletter. You will find each article informative and useful in dealing with day-to-day issues in the practice of Commercial Law and Bankruptcy.

If you have ideas for articles that you would like to see, or if you would like to contribute an article to the newsletter, please contact me at rfrench@bauerandfrench.com. We hope to publish additional newsletters in August, October, and January. To do that, we need all of the input and all of contributions we can garner. Your input is important.

Application for Employment Pursuant to 11 U.S.C. § 327

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> To help the Court in determining whether a proposed professional person meets the requirements of § 327(a), Rule 2014(a) mandates that a verified statement of the proposed professional be submitted, setting forth the person's "connections" with the debtor, creditors, and any other party in interest. Id. The proposed professional has a duty to fully disclose all such connections, even if they seem irrelevant or trivial. *See Neben & Starrett, Inc. v. Chartwell Fin. Corp. (In re Park Helena Corp.)*, 63 F.3d 877, 881-82 (9th Cir. 1995); *Mehdipour v. Marcus & Millichap (In re Mehdipour)*, 202 B.R. 474, 480 (9th Cir. BAP 1996). In addition, the disclosure should be full, candid, and complete, and the Court should not have to mine a debtors' schedules or other filings to ferret out potential disinterestedness issues. *See In re Hathaway Ranch P'ship*, 116 B.R. 208, 219 (Bankr. C.D. Cal. 1990) ("The disclosure must be made in the application for order approving employment. 'It is not sufficient that the information might be mined from petitions, schedules, § 341 meeting testimony, or other sources.'" (citations omitted)). Even a negligent or inadvertent omission from the required disclosures is sufficient reason to deny a professional's employment. *See In re Park Helena Corp*., 63 F.3d at 881-82.

In re *Werry*, Case Number 11-01710-JDP, (Bankr. D. Idaho 2011). The *Werry* decision denying applicants' request to employ counsel has been appealed and arguments are slated for June 14th, 2012.

This decision is especially important for debtor's counsel as it reiterates the level of due diligence that must be completed in a very short period of time. Applications for employment should be filed at the commencement of the case, often times on very short notice due to a pending foreclosure or Motion for Summary Judgment hearing and the attorney is basing its verified statement on what the Debtor-in-Possession is providing. Ensuring the information is correct is vital to successfully becoming employed.

It is typically the disclosures associated with explaining connections where applications and statements are deficient. It is, at first blush, not difficult to determine if there is an adverse interest with the Debtor-in-Possession such as:

1) Does the Debtor-in-Possession owe the professional person money on a past bill?

2) Does the professional person represent one of the creditors in the Chapter 11 case? or

3) Does the professional person have some other conflict under Idaho's ethical rules?

The Application becomes more convoluted in disclosing all connections to "any interested party" (F.R.B.P. 2014). Such as if there are any potential preference payments made to the law firm prior to the bankruptcy filing, and the source of the retainer payment to the professional person.

The disclosure of connections should read like a good newspaper article with the who, what, when, where, how and why's of the retainer paid and the representation. Any Application should include the following information in regards to the retainer:

1) how much was paid,

2) who paid the funds,

3) how was the payment characterized, was this a gift, was this a loan if paid from a third party,

4) when were the funds received,

5) has the professional person represented the Debtor before or its agents, officers, etc.,

6) how will the professional person be paid moving forward,

7) why the professional person was paid, and what is the scope of representation.

Much of this information in regards to the payment moving forward and for what services are going to be provided should be set forth in the professional person's retention agreement, which should be attached to the Application.

One of the most common pitfalls is the professional person being paid by a third-party. It is essential that payments for the retainer made by a third party are properly disclosed. It is very common that an officer or agent will make payment for an LLC's bankruptcy. This needs to be disclosed and further whether the payment was a loan to the LLC or whether it was a capital contribution to the LLC. If the payment for the retainer is a loan, and if future payments will also be deemed a loan it will require court approval. See 11 U.S.C. 364(b) Obtaining Credit.

If a third party loaned money for the retainer, there are additional disclosures which need to be made which are set forth in *In re Dye*. In the 9th Circuit decision *Dye v. Brown* 530 F. 3d 832 (9th Circuit 2008), the Court indicated several items to consider when a retainer comes from a third party:

> (1) possession or assertion of an economic interest that would tend to lessen the value of the bankruptcy estate, (2) possession or assertion of an economic interest that would create either an actual or potential dispute in which the estate is a rival claimant, or (3) possession of a predisposition under circumstances that create a bias against the estate.

Id.

While these items are easily discussed and may not prove fatal to an application to employ, failure to discuss them up front in the application may be fatal and employment denied.

The other issue that can commonly arise is whether or not the law firm received a preference payment. Pursuant to 11 U.S.C. § 547, if a non-insider receives payment of more than $600.00 in the ninety days prior to filing bankruptcy it is a potential avoidable preference payment.

More common in the Chapter 11 context is a case where the debts are **not primarily consumer debts**. In that case, the threshold for a preference payment is $5,850.00, that has been paid within ninety days prior to filing and that the payment is for an antecedent debt. A common situation is that the professional person has been rendering services for the Debtor, such as for tax preparation services, and in order to employ that professional, the Debtor must have the person paid in full or the person has agreed to write down those fees; otherwise the person would be a creditor and could not be employed. See 11 U.S.C. 101(14) *supra*.

If the Debtor-in-possession pays more than $5,850.00 to the professional person, that would be a potential preference that the Debtor-in-Possession could demand from the accountant, or, if the case were converted to a Chapter 7, the Chapter 7 trustee will make the demand on the professional person for those funds to be returned to the estate. I have not been involved in a case where the Court approved an Application for Employment where there was such an obvious preference payment. I have been chastised by the Court for submitting an Application for employment of an accountant where there was a potential substantial preference payment (which may be part of the reason for this article).

In disclosing issues related to preference payments and possible fraudulent transfers, it is unnecessary to draft a treatise on bankruptcy law designed to inform all parties of their rights. Analyze the legal issues with the Court and U.S. Trustee's office in mind.

2016 (b) and SOFA 9

The other important aspect of Applications for employment is making sure that your Application and Verified Statement match what is set forth on the Statement of Financial Affairs as well as the attorney's 2016(b) Statement. The Statement of Financial Affairs, paragraph 9, requires the

debtor to "list all payments made or property transferred by or on behalf of the Debtor to any person, including attorneys, for consultation concerning debt consolidation, relief under the bankruptcy law or preparation of the Petition in bankruptcy within one year immediately preceding the commencement of this case." F.R.B.P. 2016(b). Therefore any funds received by the professional person needs to be disclosed. I suggest disclosing the retainer received and also the pre-petition funds which the attorney received in the past year.

Rule 2016(b) requires that within fourteen days of the date of the filing of the Petition, a statement which sets forth the requirements of 11 U.S.C. § 329 is filed. These requirements are "a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation." 11 U.S.C. § 329(a)(2005).

Therefore, make sure the information set forth on the Application, Verified Statement, Statement of Financial Affairs, paragraph 9, and the 2016(b) Statement are all correct and state the same thing.

Timing and Notice

In any case, it is important to make sure that the Applications and Verified statements are filed and proper service is made in a Chapter 11 case at the time of the bankruptcy filing.

Local Rule 2014.1 sets forth the mechanics of the application process:

> (a) **Applications for approval of employment of professional persons.** In addition to including the information required by Fed. R. Bankr. P. 2014(a), an application for approval of employment of a professional person shall be signed by the trustee, debtor-in-possession or committee, and shall state the following information:
>
> (1) The proposed arrangement for compensation. If there is a retainer, the application shall disclose all pre-petition fees and expenses drawn down against the retainer, and any written retainer agreement shall be attached to the application; and
> (2) To the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, or any other party in interest, their respective attorneys and accountants, the U.S. Trustee, or any person employed in the office of the U.S. Trustee.
>
> **(b) Service and proof of service.**
> (1) Copies of the application for approval of employment, the verified statement, any accompanying documents, and the proposed order approving employment shall be transmitted to the office of the U.S. Trustee in Boise.
> (2) In a non-chapter 11 case, service shall also be made upon the debtor(s), debtor(s)' counsel, the trustee, and trustee's counsel.
> (3) In a chapter 11 case, service shall also be made upon members of any creditors' committee and any attorneys appointed to represent the committee. In the event no committee has been appointed, service shall also be made on the 20 largest unsecured creditors. In a chapter 11 case, service shall also be made on the debtor and the attorney for the debtor if the application is made upon behalf of a party other than the debtor.
> (4) Proof of such service shall be filed with the application.

(c) Entry of an order of approval of employment.

> If neither the U.S. Trustee nor any other party in interest objects to the application for approval of employment of the professional within twenty-one (21) days of the date of service of the application, the court may enter the order approving the employment of the professional without a hearing. If an objection to the application is timely filed, then the applicant shall schedule a hearing on the application and serve notice of the hearing on the U.S. Trustee and all other parties in interest. Proof of such service shall be filed with the notice of hearing. Any order of approval of employment entered by the court will relate back to the date of service of the application, which date shall be set forth in the order.

If the attorney waits to file the Application for Employment, but continues to work on the Debtor's case, there will be the creation of a conflict due to the fact that the Debtor-in-Possession will owe the professional person funds from the commencement of the case to the date of the Application which the attorney will likely have to either write down or request that the Court grant *Nunc Pro Tunc* approval of those fees. "For the professional seeking an order approving employment *nunc pro tunc*, 'exceptional circumstances' exists when the professional (1) satisfactorily explains his failure to receive prior judicial approval; and (2) demonstrates that his services benefitted the bankrupt estate in a significant manner." *In re Ball*, 04.3 I.B.C.R. 87, 87 (Bankr.D.Idaho 2004) (citing *Atkins*, 69 F.3d at 974). Whether to approve an application for employment *nunc pro tunc* is left to the bankruptcy court's discretion. *In re Kroeger Prop. and Dev., Inc.,* 57 B.R. at 822.

In re Melton, 353 B.R. 901, 904 (Bankr. D. Idaho 2006).

The Court may also rule that the potential conflict due to the delay in the Application for Employment may create a situation where the attorney cannot be disinterested under section 327.

Supplementing the Record

Just because the Court entered the Order, doesn't mean that the professional person is free and clear. If the Application or Verified Statement is deficient to begin with and doesn't list information which creates a potential conflict or prevents a professional person from being disinterested, the professional person and attorney has a duty to supplement the Application at which time the US Trustee's Office may, and likely will, object to the Application for Employment.

In re Werry, sets forth important phrases which both our Judges have reminded counsel, which is that the US Trustee's Office and the Court should not have to mine through the Petitions, Schedules, and Monthly Operating Reports filed with the Court to determine whether or not an attorney is disinterested. It is somewhat embarrassing, at the very least, to have the US Trustee's Office bring a potential conflict to your attention, file a Supplement, and then have the US Trustee's Office object pointing out that it was a conflict they discovered when it should have been the professional person which had known and disclosed the potential conflict. A simple word to the wise is the Court does not view these inadvertent non-disclosures lightly as was indicated in the *Werry* decision.

Conclusion

In sum, correct Applications for Employment and Verified Statement with full disclosure are important so the case can move forward smoothly and be focused on successful reorganization rather than the minutia of employing professional persons. Also, reliance on a form Application for Employment is simply not good enough to get an approved Application. A detailed history of prior relationships and connections along with the who, what, when, where, how, and why's, in addition to the requirements of Rules 2014, Local 2014.1, and sections 327 and 329, will allow you to be employed as a professional.

As for getting paid? That's a whole other article.

910 Claims and the Doctrine of Implied Acceptance

By Alexandra O. Caval, Staff Attorney, Office of Kathleen A. McCallister, Chapter 13 Trustee

In bankruptcy, a Chapter 13 debtor has three options in dealing with the allowed secured claims of creditors. First, the debtor may obtain the creditor's acceptance of the plan. Second, the debtor may retain the collateral but make full payment of the creditor's allowed secured claim. Lastly, the debtor has the option of surrendering the collateral to the creditor.[1]

Prior to the passage of BAPCPA in 2005, a debtor had the fourth option – to retain the collateral yet pay only its present value to the creditor, over the term of the plan.[2] Under this fourth option, the creditor had an allowed secured claim for the present value of the collateral and the balance of the debt was a general unsecured claim. This option, known as the "cram down," could be done over the objection of the creditor.[3] A debtor could "cram down" because 11 U.S.C. §1325(a)(5)(B) allows a debtor to retain the collateral so long as the creditor receives "not less than the allowed amount of such [allowed secured] claim."[4]

Mechanically, a "cram down" of an allowed secured claim is determined by §506(a) which bifurcates claims into a secured claim for the value of the collateral and an unsecured claim for the remainder.[5] Specifically, §506(a)(1) provides that, "[an] allowed claim of a creditor secured by a lien on property in which the estate has an interest…is a secured claim to the extent of the value of such creditor's interest in in the estate's interest in such property." Thus, a creditor will have a secured claim in the amount that is equal to the value of the collateral and an unsecured claim for the remainder.

In 2005, BAPCPA eliminated the "cram down" option for vehicles purchased less than 910 days before the Chapter 13 bankruptcy petition is filed.[6] More specifically, the hanging paragraph at the end of §1325(a)(9) states:

> For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day period preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

Thus, a creditor holds a 910-claim if it has (1) a purchase money security interest securing the debt that is the subject of the claim; (2) if the debt was incurred within 910-days before the petition date, (3) if the collateral is a vehicle, and (4) if the vehicle was acquired for the personal use of the debtor. It's important to note that if the collateral is something other than a vehicle, then the debt must be incurred within 1 year before the filing date.

Therefore, post-BAPCPA, the hanging paragraph of §1325(a) prohibits the application of §506(a) to 910-claims.[7] Consequently, debtor may no longer "cram down" a 910-claim and, instead, must pay the entire amount owed to the creditor in order to retain the collateral. The question arises whether the holder of a 910-claim may be deemed to have accepted a plan that nonetheless "crams down" its claim if the creditor fails to object to the plan.

Model Chapter 13 plans generally contain language in the plan that a creditor's failure to timely file a written objection to this plan prior to confirmation constitutes acceptance of both the plan and the treatment provided in the plan. In fact, the model Chapter 13 plan for the District of Idaho states:

> …[the plan] contains matters, which if not objected to, may be accepted by the court as true…[a]bsent any ... objection[s], the court may confirm this plan, accept the valuations and allegations herein, and grant the motions without further notice or hearing."

The rationale for this language is rooted in 11 U.S.C. 1325(a)(5)(A) which allows a court to confirm a chapter 13 plan if the holder of each allowed secured claim accepts the plan but it is also rooted in the doctrine of implied acceptance.

Chapter 13 is an interesting statutory creature because unlike Chapter 11, there is no balloting mechanism for a creditor to evidence acceptance of a plan.[8] Rather, it is the negative – the filing of an objection – that evidences the lack of acceptance. Generally, when a creditor simply does nothing the judicial doctrine of implied acceptance operates as a gap filler. [9] Under the doctrine of implied acceptance, if a plan is properly noticed and otherwise meets the requirements of §1325(a) then the court may deem a secured creditor's silence to constitute acceptance of a plan and the plan may be confirmed.[10] Thus, the failure to object to a plan that otherwise meets the requirements for confirmation results in the creditor's acceptance of the treatment provided for in the debtor's plan.

A Chapter 13 plan that proposes to "cram down" a 910-claim may not be confirmed even in the absence of an objection by the creditor.[11] In *Montoya*, both the debtor and the Trustee argued that the 910-creditor's failure to object to the "cram down" constituted acceptance under 11 U.S.C. 1325(a)(5)(A).[12] The court held that the doctrine of implied acceptance was appropriate for cases that had plans that complied with the Code but that it could not be used to essentially spring a trap on a somnolent creditor.[13] Creditors, the court pointed out, "were entitled to rely on the few unambiguous provisions of the BAPCPA for their treatment."[14] The court held that it had an affirmatively duty to review and ensure that a plan complies with the Code even if creditors fail to object to confirmation.[15] The court found that the "offending provision presents no less a bar to confirmation than failing to pay priority claims in full, proposing a plan in bad faith, or proposing a plan that is not feasible."[16]

The importance of ensuring that plans comply with the requirements of the Bankruptcy Code cannot be overstated. A confirmation order is binding even if it contains a provision that violates provisions of the Bankruptcy as the Supreme Court held in *Espinosa*.[17] In *Espinosa* the court confirmed a Chapter 13 plan that discharged the unpaid interest on the debtor's student loans without an undue hardship finding by the bankruptcy court.[18] After the debtor received his discharge the creditor attempted to collect the unpaid interest on the student loans and the debtor filed a motion to enforce the discharge.[19] The creditor argued that the confirmation order was void because the order violated the Code's requirement that requires a court to find undue hardship before discharging student loan debt.[20]

The Supreme Court rejected this argument holding that a judgment is not void simply because it is erroneous – there must be a jurisdictional defect for it to be void.[21] In its decision the Supreme Court noted that §1325(a) instructs courts to confirm a plan only if the court finds, inter alia, that the plan complies with the "applicable provisions" of the Code.[22] Additionally, under §105(a), bankruptcy courts have the authority to issue "any order, process or judgment that is necessary or appropriate to carry out" the Code's provisions.[23] Thus, courts have the authority and obligation to direct debtors to conform their plans to the requirements of the Bankruptcy Code.[24]

With respect to 910-claims, the 9th Circuit B.A.P., like the majority of courts that have addressed the issue, held in *Trejos* that that the hanging paragraph of 1325(a) prohibits a debtor from "cramming down" a 910-claim.[25] It essentially requires a debtor to pay the whole claim amount as an allowed secured claim. This hanging paragraph is clearly one of the requirements for confirmation that a court must evaluate in determining whether the Chapter 13 plan may be confirmed. The doctrine of implied acceptance cannot be used to confirm a plan that "crams down" a 910-claim because the doctrine of implied acceptance is conditioned upon compliance with the provisions of Bankruptcy Code.[26]

The hanging paragraph of §1325(a) does not prevent a debtor from proposing a plan that pays the full principal amount of the secured claim but modifies the contractual rate of interest on a 910 claim.[27] In *Velez*, the bankruptcy court held that the hanging paragraph expressly prohibits "cramming down" under §506(a) but that it was silent with respect to modifying any other applicable terms. The court noted that before and after BAPCPA, courts permitted modification of repayment terms so long as the confirmation standards set forth in §1325 were met.[28] The only exception to this general rule were claims that were secured by the debtor's primary residence which could not be modified under §1322(b)(2).[29] The *Velez* court held that because the hanging paragraph references §506(a) rather than §1322(b)(2), the hanging paragraph prohibits bifurcation, or cramming down, but that it does not prohibit modification of other contractual rights of a secured creditor, including interest rate. Had Congress intended that 910-claims be excluded from all modification in bankruptcy it could have done so explicitly, just like they did with home mortgages.

In summary, the hanging paragraph of §1325 is a requirement that must be satisfied before a Chapter 13 plan can be confirmed. Additionally, a plan that proposes to "cram down" a 910-claim cannot be confirmed even if the creditor fails to object to such treatment. To fall within the parameters of implied acceptance the plan must comply with the confirmation requirements and a plan cannot do so if it expressly violates the hanging paragraph. However, it's important to note that the hanging paragraph is narrow – it only prohibits a debtor from paying less than the full principal amount of the secured claim. The hanging paragraph does not prohibit a debtor from proposing a plan that alters other terms of the contract. If a 910-creditor fails to object to the modification of any of the other terms of the contract (interest rate, repayment terms, etc.) then the creditor's silence may be deemed acceptance of the plan under §1325(a)(5)(A) and the court may confirm the plan because the modification is not prohibited by any provision of the Bankruptcy Code.

ENDNOTES

1 11 U.S.C. §1325(a)(5).

2 *Capital One Auto Fin. v. Osborn (In re Osborn)*, 515 F.3d 817, 820 (8th Cir.2008).

3 *Id. citing Till v. SCS Credit Corp.*, 541 U.S. 465, 468-69 (2004).

4 11 U.S.C. §1325(a)(5)(B).

5 11 U.S.C. §506(a).

6 11 U.S.C. §1325(a)(hanging paragraph).

7 *In re Penrod*, 611 F.3d 1158, 1161 (9th Cir. 2010); see also *In re Quick*, 371 B.R. 459, 462 (B.A.P. 10th Cir.2008).

8 *See In re Montoya*, 341 B.R. 41, 45 (Bankr.D.Utah 2006).

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.* at 44-45.

13 *Id.* at 45.

14 *Id.*

15 *Id.* at 46.

16 *Id.*

17 *United Student Aid Funds, Inc. v. Espinosa*, 130 S.Ct. 1367, 1380 (2010).

18 *Id.* at 1374.

19 *Id.*

20 *Id. citing* 11 U.S.C. §§523(a)(8) and §1328(a). The creditor also raised a due process argument that the Court address but ultimately rejected.

21 *Id.* at 1377.

22 *Id.* at 1381.

23 *Id.*

24 *Id.*

25 *In re Trejos*, 374 B.R. 210,219 (9th Cir. BAP.2007)

26 *See Generally In re Montoya*, 341 B.R. 41, 45 (Bankr.D.Utah 2006).

27 *In re Velez*, 431 B.R. 567 (Bankr.S.D.N.Y.2010); *In re Johnson*, 337 B.R. 269, 271 (Bankr.M.D.N.C.2006). Of interest in *Velez* is the fact that the creditor did not object to the debtor's motion to reduce the interest rate. The Court nonetheless analyzed whether the hanging paragraph prohibited such treatment.

28 *Id.* at 570.

29 *Id.*

Do you have something to submit?

The Commercial Law and Bankruptcy Section Newsletter is produced quarterly.
If you would like to include an item in the upcoming newsletter,
please contact Randal French at rfrench@bauerandfrench.com.

Trotting Past Article 3 of the UCC, The Transfer of Negotiable Promissory Notes, and The ISC Decision in *Trotter v. Bank of New York*

By R. Wayne Sweney, Lukins & Annis PS

The Permanent Editorial Board for the Uniform Commercial Code issued a report on November 14, 2011, entitled "Application of the Uniform Commercial Code to Selected Issues Relating to Mortgage Notes." The report is available at www.ali.org. The PEB Report addresses how the UCC governs the following matters:

- Who is the person entitled to enforce a mortgage note?
- How is the transfer of a property interest (ownership or a security interest to secure an obligation) in a mortgage note accomplished?
- What effect does the transfer of a mortgage note have on the related mortgage?
- How can a person enforce a mortgage note by foreclosing non-judicially if the person does not have a recordable assignment of the mortgage?

Article 3 of the UCC applies to "negotiable instruments." Idaho Code § 28-3-102. A negotiable instrument is an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges if it is payable to bearer or to order at the time it is issued or first comes into possession of a holder; is payable on demand or at a definite time; and does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money. Idaho Code § 28-3-102. An instrument is a "note" if it is a promise. Idaho Code § 28-3-104(e).

> Idaho Code § 28-3-203 addresses the transfer of negotiable notes:
>
> (1) An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.
>
> (2) Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument.
>
> (3) Unless otherwise agreed, if an instrument is transferred for value and the transferee does not become a holder because of lack of indorsement by the transferor, the transferee has a specifically enforceable right to the unqualified indorsement of the transferor, but negotiation of the instrument does not occur until the indorsement is made.
>
> (4) If a transferor purports to transfer less than the entire instrument, negotiation of the instrument does not occur. The transferee obtains no rights under this chapter and has only the rights of a partial assignee.

The question that arises is when the instrument is transferred who can enforce it and what evidence of the rights party seeking to enforce the instrument should be required? Identification of the person entitled to enforce the instrument is also important because payment must be made to that person for the obligor of the note to be discharged. Idaho Code §§ 28-3-412, 3-601(a).

> "Negotiation" means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes a holder of the instrument.[1] Except for negotiation by a remitter, if an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its indorsement by the holder.[2]

A person is entitled to enforce a note if that person is the <u>holder</u> of the note, (ii) a person in possession of the note who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument because the note was lost or destroyed. *A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument. (*Emphasis added). Idaho Code § 28-3-301. To be a holder of the note the person must have possession of the note and the note is either payable or indorsed to that person or in blank.

Article Nine of the UCC governs sales of promissory notes. Idaho Code § 28-9-109(a)(3). Idaho Code § 45-911 provides that assignment of a debt secured by a mortgage carries with it the security. Idaho Code § 28-9-203(g) provides that attachment of a security interest in a right to payment, a note, also attaches to the security interest or mortgage securing payment of that obligation. *See Comment 9, Idaho Code § 28-9-203*.

Judge Myers held in *In re Wilhelm*, 407 BR 392, 398 (2009) that a party seeking stay relief must have standing and be a real party in interest. A moving party for stay relief then must show it has an interest in the debtor's obligation secured by the collateral at issue. If the obligation is evidenced by a negotiable note, then Article 3 of the UCC will apply to determine whether the moving party has the right to enforce the note. *Wilhelm*, 407 BR at 401. If the moving party is the holder in possession of the note, the movant must show that the note is either payable to bearer or the movant or indorsed to movant or in blank. *Id.* If the movant is a nonholder in possession, then the nonholder must prove the transaction by which it acquired the note as explained in Comment 2 to Idaho Code § 28-3-203:

> Because the transferee's rights are derivative of the transferor's rights, those rights must be proved. Because the transferee is not a holder, there is no presumption under Section 3–308 that the transferee, by producing the instrument, is entitled to payment. The instrument, by its terms, is not payable to the transferee and the transferee must account for possession of the unindorsed instrument by proving the transaction through which the transferee acquired it.

In *Wilhelm*, the moving parties did not demonstrate possession or the means by which they acquired ownership of the notes so stay relief was denied. In June 2011 in *In re Veal*, 450 B.R. 897 (9th BAP, 2011), the Ninth Circuit Appeals Panel reversed a stay relief order issued by an Arizona bankruptcy judge on the grounds that the assignee of the mortgage whose evidence for stay relief consisted of an assignment of the mortgage, not the note, did not have standing to move for stay relief. The BAP applied the same Article 3 analysis in *Veal* that Judge Myers did in *Wilhelm* to vacate the stay relief order.

In *U.S. Bank v. Ibanez*, 458 Mass. 637, 941 N.E.2d 40 (2011), the Massachusetts Supreme Court held that under that state's common law the transfer of a note secured by a mortgage *does not include the mortgage* without a separate assignment of the mortgage. The *Ibanez* Court did not address the application of Article 3 or Section 9-203(g) of the UCC to the issue.[3] The *Ibanez* decision was subsequently cited by the U.S. District Court in Massachusetts in *Wenzel v. Sand Canyon Corp*. 2012 WL 219371, 15 (D.Mass.,2012) for the proposition that: "In Massachusetts, the foreclosing entity must hold the mortgage only, not both the mortgage and the note." These Massachusetts decisions appear contrary to the result required by Articles 3 and 9 of the UCC.

The Trotter Decision

On On March 23, 2012 the Idaho Supreme Court issued its second decision in *Trotter v. Bank of New York Mellon*, 2012 Opinion No. 22, 2012 WL 975493.[4] Vermont Trotter was a homeowner in default on his home loan. ReconTrust, the trustee appointed by the beneficiary of the deed of trust, notified Trotter of the default and initiated a nonjudicial foreclosure on the deed of trust pursuant to I.C. § 45–1505. Upon receiving notice of the trustee's sale, Trotter sued ReconTrust, Mortgage Electronic Registration Systems, Inc. (MERS), and Bank of New York Mellon. Trotter's complaint alleged that none of the defendants had standing to initiate a foreclosure under I.C. § 45–1505. Bank of New York filed a motion to dismiss for failure to state a claim pursuant IRCP 12[b][6] to on the grounds that it had complied with all statutory requirements to foreclose and that standing is not a requirement of nonjudicial foreclosures under I.C. § 45–1505. The district court granted the motion to dismiss. On appeal, Trotter argued that before any party may initiate a nonjudicial foreclosure under I.C. § 45–1505, it must affirmatively demonstrate its standing to foreclose by proving it has an interest in both the deed of trust and the promissory note it secures. Additionally, Trotter asserted that MERS was never the true beneficiary of the deed of trust and therefore lacked the authority to assign it to Bank of New York. Therefore he argued, Bank of New York's appointment of ReconTrust as successor trustee was invalid so neither ReconTrust nor Bank of New York had standing to foreclose. The Supreme Court affirmed the dismissal.

The Supreme Court's recitation of the facts found by the district judge from the record on the motion to dismiss included the judge's determination that MERS was the beneficiary under the deed of trust and that MERS had properly *assigned its rights as beneficiary* to Bank of New York pursuant to I.C. § 45–1502(1). Therefore Bank of New York's appointment of ReconTrust as successor trustee was valid under I.C. § 45–1504(2) so, as a matter of law, ReconTrust was vested with the powers of the original trustee.

The Supreme Court held that, pursuant to Idaho Code § 45–1505, a *trustee* may initiate nonjudicial foreclosure proceedings on a deed of trust *without* first proving ownership of the underlying note or demonstrating that the deed of trust beneficiary has requested or authorized the trustee to initiate those proceedings. *Trotter*, 2012 WL 975493, 4. The Court pointed out that a nonjudicial deed of trust foreclosure does not require "standing" because it is a nonjudicial process. The *Trotter* decision does not specifically state whether Trotter's note was negotiable and therefore subject to the foregoing Article 3 analysis or even if the note itself was assigned to the Bank of New York. Idaho Code § 45-911 is not mentioned in the decision. The Supreme Court's focus in *Trotter* is expressly limited to the trustee's power to foreclose a deed of trust under The Deed of Trust Act instead of transfer of rights in Trotter's promissory note.

The information in the record in the *Trotter* case is sketchy. The Supreme Court adopted the district judge's determination that MERS was the beneficiary "named in the deed of trust" and the successor beneficiary had the rights of a "beneficiary." *Trotter,* 4-5. If Trotter's note was a negotiable instrument subject to Article 3 of the UCC, the *Trotter* decision should not have neglected the application of the Article and Idaho Code § 45-911. While "beneficiary" is defined under Idaho Code § 45-1502(1) as "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," the beneficiary is also the "person" to whom the grantor's deed of trust secured obligation is owed. Idaho Code § 45-1503(1). Therefore, the "beneficiary" in a nonjudicial deed of trust foreclosure must be the person entitled to enforce the obligation secured by the deed of trust. If the Bank of New York was assigned the "rights of a beneficiary" then it may be *inferred* that it also had the right to enforce Trotter's note.

Given the limited record and holding in *Trotter*, its basic holding is correct. The trustee foreclosing the deed of trust cannot be the beneficiary under Idaho Code § 45-1502(1) and therefore would not have the rights of a holder of a promissory note secured by the deed of trust or be entitled to enforce it. The beneficiary has to have the right to enforce the note and therefore to direct the foreclosure of the deed of trust by the trustee.

CONCLUSION

Any litigation over whether the beneficiary has the right to foreclose a deed of trust that secures payment of a promissory note should focus on whether the beneficiary has the right to enforce the note. In the case of negotiable promissory notes the issue is governed by Articles 3 and 9 of the Uniform Commercial Code.

ENDNOTES

1 UCC 3-201(a).

2 UCC 3-201(b).

3 The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage or other lien. Official Comment 9 to this provision states: "**Collateral Follows Right to Payment or Performance.** Subsection (g) codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien. See Restatement (3d), Property (Mortgages) § 5.4(a) (1997). See also Section 9-308(e) (analogous rule for perfection)."

4 The original decision issued January 25, 2012 was withdrawn. 2012 WL 206004.

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Commercial Law & Bankruptcy Section Officers

Chairperson
James Chris Meservy
Williams, Meservy & Lothspeich, LLP
PO Box 168
Jerome, ID 83338
Phone: (208) 324-2303
jcmeservy@cableone.net

Vice Chairperson
Janine Patrice Reynard
United States Chapter 7 Trustee
410 S. Orchard Street, Suite 172
Boise, ID 83705
Phone: (208) 383-4113
reynardtrustee@gmail.com

Secretary/Treasurer
Catherine Louise Dullea
Catherine L. Dullea, Chtd.
101 N. 4th Avenue, Ste. 204
Sandpoint, ID 83864
Phone: (208) 265-2276
katied@nctv.com

Past Chairperson
Kimbell David Gourley
Trout Jones Gledhill Fuhrman, PA
PO Box 1097
Boise, ID 83701
Phone: (208) 331-1170
kgourley@idalaw.com

CLE Chairperson
Janine Patrice Reynard
United States Chapter 7 Trustee
410 S. Orchard Street, Suite 172
Boise, ID 83705
Phone: (208) 383-4113
reynardtrustee@gmail.com

Newsletter Chairperson
Randal Jay French
Bauer & French
PO Box 2730
Boise, ID 83701
Phone: (208) 383-0030
rfrench@bauerandfrench.com

At Large Council Members
Robert John Maynes
Maynes Taggart, PLLC
PO Box 3005
Idaho Falls, ID 83403
Phone: (208) 552-6442
mayneslaw@hotmail.com

Megan Laurisa Johnson
Berg & McLaughlin, Chtd.
414 Church Street, Ste. 203
Sandpoint, ID 83864
Phone: (208) 263-4748
megan@sandpointlaw.com

ISB
IDAHO STATE BAR
PO Box 895
Boise, ID 83701
Phone: (208) 334-4500
Fax: (208) 334-4515
isb.idaho.gov

Luncheon with the Ninth Circuit Bankruptcy Appellate Panel

Thursday, June 14, 2012 * 12:00 p.m. - 1:30 p.m. (MDT)
The Rose Room, 718 W. Idaho Street, Boise
0.5 Credits (Pending)
RSVP: ked@dukescanlan.com

The Ninth Circuit Bankruptcy Appellate Panel (BAP) will be conducting oral arguments in Boise on Thursday, June 14, 2012. The 3-judge panel of BAP members will hear about 10 appeals in cases originating in Idaho, Montana, and Oregon. Arguments will be scheduled for 9:00 a.m. and 2:00 p.m. Please join the Idaho Chapter of Federal Bar and the Idaho State Bar Commercial Law & Bankruptcy Section in welcoming them to Boise.