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Upside Down and How to Float Your Boat

By Don Gadda

Your new client has come to you seeking help. He tells you he is upside down on his home. Either by entering into an unwise financing arrangement, just paying way too much for the home, or through sheer bad timing he now owes significantly more to his lender than his home is worth and if he is not in default on his loan he soon will be. What can he do? This question has become so common that you would be hard pressed to find an Idaho lawyer that has not struggled to find an answer to it.

Remember most clients don't really want to know their legal options. They want to know what to do. But you have to start somewhere. It is not difficult to come up with a list of options. A list of good options is another matter. There are some simple questions that will help you and your client face facts. How much did Mr. Jones borrow to purchase his home? What were the terms of the loan (conventional, adjustable rate, 80/20 . . .) How much has your client paid on the loan to date? Is he currently in default? Have foreclosure proceedings begun? And, what kind of income does your client have and what does he expect in the future? Is there a first loan, a second or what? All too often you will discover that Mr. Jones has little or no equity in his home, owes the bank (or banks) far more than the home is worth and cannot rationally expect to continue to make the payments and avoid default. Always remember that home ownership is a very emotional matter. People don't generally purchase homes thinking that they'll just walk away from them someday. You client's house is HOME. It is the center of his family's life and a cold rational discussion of the options a homeowner can face can easily stumble on unspoken needs and desires. So, where do you start?

There five real options available to your client. He can do nothing and stay where he is and keep paying on the mortgage. He can just walk away from his house and mortgage. He can seek a loan modification either through his lender or a government program. He can seek a short sale or deed in lieu of foreclosure. He could file for bankruptcy. At first blush some of these may not seem like options to your client, but after careful analysis of his situation and explanation of the legal consequences of his actions his view is likely to change.

DOING NOTHING

If your client is not currently in default on his loan, can afford the monthly payments and there is reason to believe his economic prospects are such that he honestly believes he will continue to be able to make those payments there is no reason he can't just keep making his payments. Eventually, the loan will be paid off and he will own his home free and clear. The downside here is that even should he be able finally to pay off his loan and own it free and clear it is

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A Word From the Editor

By Katie Dullea

Thanks to attorneys Sheila Schwager, Noah Hillen and Don Gadda for their informative and well-thought-out articles for this newsletter. I would like to publish another in November, so please think about writing one – I'll need drafts by mid-October.

Bob Meek asked that I relate to Newsletter readers that Idaho Legal Aid in Boise has done most of the work for the bankruptcy clinic and all kudos go to them. I would like more feedback from the practitioners who are helping with the clinic for a future newsletter.

Upside Down and How to Float Your Boat

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questionable whether he would ever be able to sell it for a profit and move up to a nicer home. Or, if for some reason he had to relocate he could be stuck with a house that was not salable at a price that will allow him to pay off the loan. All of this is premised on the assumption that the future mortgage payments are predictable (not an ARM) and that his income is not suddenly reduced. Staying in the house under these circumstances is huge roll of the dice for your client and his family. It is important to remember that it is his HOME with all that the word implies. For some people staying put is the only option they can imagine and it will take time and tact for you to convince them that there are other options that should be considered. Always remember that, where possible, this is the only option that does not have negative repercussions for your client's credit.

A related option might be to rent out all or part of the residence. If your client can find a reliable tenant (another roll of the dice) and if the rental income covers his costs of ownership he might be able to rent the home and at the same time find a cheaper place to live thereby turning a small, albeit temporary, profit. Or, he might be able to let a room in his home to help cover his costs. Rental is only a part time solution though and does not change the essential problem and may only stave off default and foreclosure and the nightmare for his family that these words contain.

It is vital that your client understands that should he cease making his payments there is no turning back. At that point he will be in default on his loan and his options become far less palatable.

WALKING AWAY (or telling the bank to 'eat dirt')

Many clients' first question is what happens if I just walk away from the house and debt. Your client could just pack his bags (dogs, kids, furniture and a lifetime of stuff) and leave the house. Just walk away. Let the weeds grow. The internet is riddled with websites claiming that Idaho is a non-recourse state, but it is not true and this not an option that you can recommend. In Idaho a lender can recover a deficiency in a separate action if the transaction was based on a note and deed of trust or as part of the initial action if on a mortgage. Either way your client must be informed that should he just up and leave the house the lender will foreclose upon the home, that it will be sold at a foreclosure sale AND unless his loan expressly states otherwise that the lender can then file an action against him for a deficiency judgment for any difference between sale price (but not less than the fair market value on the date of the sale) and the amount owing on the loan. Considering the nose dive the real estate market has taken in the last few years many home owners have huge exposures. Your client should reconsider. Here he could end up homeless, with a huge judgment hanging over him and without good credit. Worse yet tax consequences can possibly include cancellation of debt income (income taxes) and a reportable gain from the disposition of the property (capital gains taxes.)

SEEKING LOAN MODIFICATIONS

Sadly, the majority of clients coming to see their lawyer have already attempted a loan modification -- and failed. Not always though. One option has been the government sponsored programs that were to provide for renegotiation of home loans such as the HAMP (Home Affordable Modification Program.) Those residents whose mortgage does not exceed 125% of the market value of property, the debt on the single unit home does not exceed $729,750, monthly payment exceeds 31% of the gross income, and the first mortgage is guaranteed by either Freddie Mac or Fannie Mae are eligible for this program. Clearly, if your client is seriously upside down on an expensive property he will not be eligible for this program. There is also an FHA loan modification program that is worth looking into providing homeowners facing foreclosures with an opportunity to modify or refinance their existing mortgages and make their monthly payments more affordable.

For those who qualify for loan modification programs it sounds good, but the ugly truth is that the banks have not been straight with many homeowners and after months, sometimes years of making their reduced payments they find themselves facing foreclosure and bankruptcy because their initial modification was only temporary and the bank is now pulling the rug out from under them. Sadly, these programs are voluntary and, on the whole have been poorly administered by the banks and the government. Too, often the homeowner who, in good faith, entered into the loan modification program through his lender and was granted a temporary payment reduction finds his position to be as bad as or worse than it was before he entered the modification program. He received a temporary reduction in payments. Time drifted on. Payments were made in a timely fashion. And then, one day, six, eight or twelve months later he gets a letter from the bank telling him that he has been dropped from the program (clearly he was able to save all that money he did not pay thanks to the program). Now foreclosure proceedings begin and no one can satisfactorily explain to him what has happened. He is back at square one and foreclosure looms in his future. This is not to say that these programs never work. They can and do. And, they are programs that the homeowner can participate in without incurring legal expenses that may just add to his problems. But, all too often in the long run, they do not help. In fact, in many cases the homeowner just finds that he has thrown good money after bad and that regardless of his good faith efforts to comply with the plan he is going to lose his home and all of the money he has paid to his lender.

SHORT SALES AND DEEDS IN LIEU

A short sale is where the lender agrees to accept less than is currently owing on the note as generally payment in full on the loan. This will probably relieve your client from any continuing liability on his loan. A deed in lieu of foreclosure is just that. The homeowner offers the bank a deed to his home in exchange for forgiveness from any deficiency on his loan that results. The bank "eats dirt". That is, it takes the property and releases the homeowner from any further liability. A short sale is not that different. Here the bank allows the homeowner to sell his house for less than is owed on the loan and contractually agrees not to hold him liable for any deficiency that results. The result for the homeowner is much the same whether it is short sale or deed in lieu. He is relieved of further liability. He is also without his home, has lost all the money he has invested in his home and faces a potentially serious tax liability. The great advantage to short sales and deeds in lieu is that they do not negatively impact the homeowner's credit as would a foreclosure or bankruptcy. The client must be made aware that the lender can choose to agree to a short sale, but is just as likely to drag its feet and at the last minute either reject the short sale offer or make a counter-offer that is just not financially workable for Mr. Jones. Whether seeking a short sale or deed in lieu is the right course will depend on an analysis of your client's total financial picture. Short sale agreements need to be reviewed carefully. The goal is to escape the debt owing on the house, but sometimes the bank will still require the homeowner to pay part or even all of the difference — the balance due is just converted into an unsecured loan.

Another question you will hear is, "how will a short sale or deed in lieu affect my credit?" In short it will not, but the missed payments on the house prior to the successful completion of the short sale or deed in lieu certainly will.

By the time your client has come to you it is likely that he has attempted a short sale, offered a deed in lieu and tried to modify his mortgage as well. He has not succeeded at any of these. That is why he is in your office. He has found that the much ballyhooed government programs have provided little or no relief. He faces foreclosure proceedings, eviction, and the real possibility of the entry of a deficiency judgment against him. He could lose the home and his good credit and end up with a judgment against him for the difference between the fair market value of his home on the date of the foreclosure sale and the amount left owing on the loan. His wages could be garnished and his property executed upon. Your client's expectations for the future are in big trouble. What else can he do?

BANKRUPTCY

Bankruptcy, while it has historically been stigmatized by society as a badge of failure is becoming a more acceptable option for people in straightened circumstances. For some it is the only way out. Essentially, a homeowner may, if eligible, opt for a chapter 7 bankruptcy where all of his non exempt assets are collected and sold by the Trustee with any money recovered being distributed by the trustee to his creditors. He is then discharged of all his non priority unsecured debt. Since the 2005 amendments to the code every person seeking a chapter 7 must first pass a "means test." For a chapter 7, the debtor must be able to show that for the six months prior to his filing he has made less than the state median income. For many people this is easy. For others it is not and can prevent them from using Chapter 7 bankruptcy as a way out. Most chapter 7 debtors who use Idaho exemptions have little or nothing to lose as the majority of their assets are exempt. The debtor's retirement accounts are generally protected and there are generous exemptions for personal property such as a $7000 exemption for an automobile. With the exception of priority debts such as taxes and child support almost all unsecured debts are dischargeable in a chapter 7. The same is not true for secured debts such as a home or car. Since the amendments to the code of 2005 only two options remain your client's home in a chapter 7. He can either surrender the home to the lender (and thereby avoid any personal liability) or he can enter a reaffirmation agreement with the lender. The first option is painful, but often it is the best course. Where modification, short sale and deed in lieu are no longer options and the homeowner will not be able to prevent default it is often the only way to reach any semblance of financial stability and cut off personal liability on the home debt. If your client enters into a reaffirmation agreement with his lender it is as if there was no bankruptcy as far as the debt on the house is concerned. If he then misses payments on his home and goes into default the bank will not only foreclose but your client will have no protection against personal liability on any deficiency as, under BAPCA, he can only petition for a chapter 7 once every eight years.

Chapter 13 offers individuals a number of advantages over liquidation under chapter 7. Perhaps most significantly, chapter 13 offers individuals an opportunity to save their homes from foreclosure. By filing under this chapter, individuals can stop foreclosure proceedings and may cure delinquent mortgage payments over time. Nevertheless, they must still make all mortgage payments that come due during the chapter 13 plan on time. Another advantage of chapter 13 is that it allows individuals to reschedule secured debts (other than a mortgage for their primary residence) and extend them over the life of the chapter 13 plan. Doing this may lower the payments. Finally, chapter 13 acts like a consolidation loan under which the individual makes the plan payments to a chapter 13 trustee who then distributes payments to creditors. Individuals will have no direct contact with creditors while under chapter 13 protection except for payments made outside the plan. The plan is for a period of 3 to 5 years, and upon making all of the payments required by the plan the debtor will receive a discharge. Debts not discharged in chapter 13 include certain long term obligations (such as a home mortgage), debts for alimony or child support, certain taxes, debts for most government funded or guaranteed educational loans or benefit overpayments, debts arising from death or personal injury caused by driving while intoxicated or under the influence of drugs, and debts for restitution or a criminal fine included in a sentence on the debtor's conviction of a crime. To the extent that they are not fully paid under the chapter 13 plan, the debtor will still be responsible for these debts after the bankruptcy case has concluded. Under Chapter 7 and 13 debts for money or property obtained by false pretenses, debts for fraud or defalcation while acting in a fiduciary capacity, and debts for restitution or damages awarded in a civil case for willful or malicious actions by the debtor that cause personal injury or death to a person will be discharged unless a creditor timely files and prevails in an action to have such debts declared nondischargeable. 11 U.S.C. §§ 1328, 523(c); Fed. R. Bankr. P. 4007(c).

The discharge in a chapter 13 case is somewhat broader than in a chapter 7 case. Debts dischargeable in a chapter 13, but not in chapter 7, include debts for willful and malicious injury to property (as opposed to a person), debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. 11 U.S.C. § 1328(a).

A chapter 13 is often difficult to recommend. While it may serve to save the home, such grace may only be temporary and if your client is in deep financial difficulty it is often the case that a chapter 13 will not be granted. Some clients will fall through the crack between a 7 and a 13. Their income is too great to pass the chapter 7 means test but not great enough for them to be able to successfully put together a chapter 13 plan.

WHAT ABOUT TAXES?

Whether your client enters into a short sale, deed in lieu, or simply lets the property go to foreclosure there will be a cancellation of debt as far as the IRS is concerned. When a debt is cancelled or forgiven the lender is usually required to issue a 1099C reporting the amount of the forgiven debt to the IRS. Such cancellation of debt is not always a taxable event and the following are exceptions:

- Bankruptcy: Debts discharged through bankruptcy are not considered taxable income.
- Insolvency: If your client is was insolvent when the debt was cancelled, some or all of the cancelled debt may not be taxable. You client is insolvent when his total debts are more than the fair market value of his total assets.
- Certain farm debts: If your client incurred the debt directly in operation of a farm, more than half of his income from the prior three years was from farming, and the loan was owed to a person or agency regularly engaged in lending, your cancelled debt is generally not considered taxable income.
- Non-recourse loans: A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue you personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt income. However, it may result in other tax consequences.

When a debt is forgiven, the amount you received as loan proceeds is reportable as income because you no longer have an obligation to repay the lender. The Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA) (Pub.L. No. 110-142, 121 *Stat. 1803.*) generally allows taxpayers the right to exclude debt forgiven as a result of a foreclosure on their primary residence. As a result, in today's declining housing market, the 1099 C issue arises most frequently in the context of investment properties. Borrowers holding a portfolio of underwater investment properties will see their tax bill skyrocket in the event of foreclosure or where they successfully negotiate a short sale or deed in lieu of foreclosure. Any cancelled debt in excess of $600 can result in the dreaded 1099 C and a tax bracket that will likely have no bearing on the borrower's actual income. It must be kept in mind that the MFDRA does not completely insulate the homeowner from taxation. 26 § 108(a)(1)(E) states that "qualified principal residence indebtedness which is discharged before January 1, 2013" is not included in the taxpayer's income. Instead, the basis of the home is reduced by the amount of the debt discharged (but not below zero). The effect of this provision is to defer the income until the home is sold, and to convert what would have been ordinary income to capital gain income, which is taxed at lower rates. Still better than the big income tax hit your client could suffer.

The MFDRA (which has been extended to the end of 2012) may protect your client from income tax liability on a short sale, a deed in lieu or a foreclosure on his "qualified principal residence". The MFDRA offers no relief if the property at issue is not a qualified principal residence. For the majority of homeowners the property in question is their principal residence. It is their only residence. Other clients may come to you with issues involving multiple properties, some of which they have lived in for periods of time and others that are clearly investment vehicles. While the Act does not expressly define "principal residence" it appears to refer the reader to 26 USC §121(a) for such a definition. That section (which concerns capital gains taxation) states that, "Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more." 26 USC §121(a). So, is there wiggle room for your client if he has lived in the house for a total of two years out of the previous five? Probably not. It is more likely that the actual definition is not that broad. 26 § 108(h)(5) states that "the term 'principal residence' has the same meaning as when used in section 121." IRC § 121 is the provision that excludes up to $250,000 of gain ($500,000 in the case of married taxpayers filing a joint return) on the sale of a home if the taxpayer both owned the home and lived in it as his principal residence for at least two of the 5 years immediately preceding the date of the sale. Principal residence tells you what you must have owned and lived in for 2 of the last 5 years. It is thus just a part of what it takes to qualify for section 121. What Congress was saying in 26 § 108(h)(5) is that it wants "principal residence" to mean the same thing for that provision that it does for § 121, not that you must qualify for § 121.

So, the issue is, what does "principal residence" mean under § 121? The statute does not actually define the term. What Congress was doing here adopting the definition the IRS had issued in regulations for § 121. Specifically, Treas. Reg. § 1.121-1(b) states:

(b) Residence--(1) In general. Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

(2) Principal residence. In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to--

(i) The taxpayer's place of employment;
(ii) The principal place of abode of the taxpayer's family members;
(iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
(iv) The taxpayer's mailing address for bills and correspondence;
(v) The location of the taxpayer's banks; and
(vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

Treas. Reg. § 1.121-1(b)

That is the definition of "principal residence." The other parts of § 121 about owning the home and living in it for 2 out of the last 5 years are arguably not relevant.

Second homes, vacation homes, investment properties, or rental units generally will not qualify under the MFDRA. The maximum amount your client can treat as qualified principal residence indebtedness is $2 million ($1 million if married filing separately for the tax year), at the time the loan was forgiven.

It is also important to remember that the MFDRA applies only to acquisition debt. The Act applies only to forgiven or cancelled debt used to buy, build or substantially improve your client's principal residence, or to refinance debt incurred for those purposes. In addition, the debt must be secured by the home. Any form of 2nd mortgage or home equity loan is not covered and your client will suffer an income tax hit in regard to any non-acquisition debt that is cancelled.

In a nutshell then, if your client comes to you and he is significantly upside down on his home loan, is in default or appears to be headed that direction there are a series of options you can discuss with him. If he can afford it the best is to stay where he is. You want to establish whether he is qualified for a chapter 7. If all of this is true his best financial outcome will be had with a chapter 7 bankruptcy. Remember though. It is his HOME. Make sure you have surveyed all of his options before recommending bankruptcy. More often than not before the conference has ended your client will reach that conclusion on his own.♦

Remember, Idaho is a "recourse" state. The lender, if the loan is based on a note and deed of trust, has 90 days after the sale of the property within which to file an action for a deficiency. Where the debt is based on a traditional mortgage the lender must seek any deficiency within the bounds of his initial action. Either way the lender can seek and be awarded a deficiency judgment against the borrower for which the debtor will be personally liable. Such a judgment will also be a lien on any real property of the debtor in any county where that judgment is recorded.

(1) Basis reduction.—The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer. 26 USC 108(h)(1).

Summary of The 2011 Idaho Consumer Non-Judicial Foreclosure Reforms

By Sheila R. Schwager & Michelle Gustavson

The foreclosure reforms set forth below will take effect September 1, 2011.

In connection with the increase in the number of Idaho foreclosures between 2008 and 2010, Idaho consumers filed hundreds of complaints with the Idaho Attorney General's Consumer Protection Division. Although the majority of these complaints dealt with alleged fraudulent or misleading activities by businesses offering loan modification or mortgage "rescue" services, the Idaho Office of the Attorney General ("**AG**") received more than 300 consumer complaints alleging issues or problems with borrowers' loan services. In response to the complaints, the AG conducted an in-depth review to determine whether the allegations in the complaints violated laws enforced by the AG, and, if so, whether evidence existed to warrant further action.

In February of 2011, the AG released "The Attorney General's Report on the Idaho Housing Crisis and How Stakeholders Can Facilitate Cooperative Solutions," which details the AG's review and analysis of the complaints. Shortly thereafter, the Idaho Bankers Association ("**IBA**") contacted the AG and offered to work with the AG to draft legislation. House Bill 331, which was signed by Governor Butch Otter on April 13, 2011, is the result of the collaboration between the AG and the IBA, and results in certain changes to the non-judicial foreclosure statute Idaho Code § 45-1506 and the Idaho Consumer Protection Act.

The changes to the foreclosure statute by HB 331 are broken into three distinct parts. First, Idaho Code § 45-1506(8) is amended by requiring a trustee, that is pursing foreclosure on a deed of trust on behalf of a federal or state regulated beneficiary, which encumbers a borrowers' primary residence, to mail written notice of a rescheduled foreclosure sale to certain parties. Second, Idaho Code § 45-1506C, is a new section which requires state or federally regulated lenders to provide a supplemental written notice to grantors for noncommercial loans secured by the borrower's primary residence that 1) details the ramifications of foreclosure; 2) provides grantors the opportunity to seek loan modification assistance and 3) provides grantors the right to meet with the lender, upon additional written request. Idaho Code § 45-1506C also requires the trustee to file an affidavit of lender or lender's agent with the officer of the county recorder where the trust property is located establishing the lender's compliance with the statute. Third, Idaho Code § 48-603F, is added, which makes it a violation of the Idaho Consumer Protection Act to share or receive a fee in connection with a mortgage loan modification unless licensed, or exempt from licensing, under Parts 2 and 4 of the Idaho Residential Practices Act, Idaho Code § 26-31-101 *et seq*. The details of these foreclosure reforms are detailed below.

A. Trustee's Notice of Rescheduled Foreclosure Sale.

Pursuant to the amended Idaho Code § 45-1506(8), a trustee pursing a foreclosure sale on a deed of trust, on behalf of a federal or state regulated beneficiary, which encumbers the borrower's primary residence, <u>that is postponed or continued</u>, is now required to mail written notice of the rescheduled foreclosure sale to certain parties at least 14 days prior to conducting the sale. Prior to the amendment, once a foreclosure sale was postponed, the trustee could undertake a subsequent sale without written notice. Idaho Code § 45-1506(8) now states in pertinent part as follows:

> For any loan made by a state or federally regulated beneficiary, which loan is secured by a deed of trust encumbering the borrower's primary residence, as determined pursuant to section 45-1506C(1), Idaho Code, the trustee, prior to conducting any trustee's sale previously postponed pursuant to this section, shall mail notice of such trustee sale at least fourteen (14) days prior to conducting such sale by the same means and to the same persons as provided in subsection (2) of this section. The trustee or beneficiary shall, prior to conducting the trustee's sale, record an affidavit of mailing confirming that such notice has been mailed as required by this section. The filing of such affidavit of mailing is conclusive evidence of compliance with this section as to any party relying on said affidavit of mailing.

To determine whether the deed of trust encumbers the "borrower's primary residence," the lender, as beneficiary, or its agent must "search[ ] the county assessor's tax rolls prior to recording a notice of default to confirm whether such real property has been granted a homeowner's property tax exemption pursuant to [Idaho Code § 63-602G]." Idaho Code § 45-1506C(1). "Any property for which a homeowner's property tax exemption has been granted for the year in which the notice of default is recorded shall be deemed to be a borrower's primary residential dwelling." Id. "If no homeowner's property tax exemption has been granted for the year in which the notice of default is recorded, the provisions of this section shall not apply." *Id*.

The notice of the rescheduled sale must be provided to the following persons or their legal representatives, if any: (1) "[t]he grantor in the trust deed and any person requesting notice of record as provided in [Idaho Code § 45-1511]," (2) "[a]ny successor in interest of the grantor including, but not limited to, a grantee, transferee or lessee, whose interest appears of record prior to the recording of the notice of default, or where the trustee or the beneficiary has actual notice of such interest," and (3) "[a]ny person having a lien or interest subsequent to the interest of the trustee in the trust deed where such lien or interest appears of record prior to the recording of the notice of default, or where the trustee or beneficiary has actual notice of such lien or interest." Idaho Code § 45-1506(2) (as amended). Further, as required by the amended Idaho Code § 45-1506(8), the trustee or lender, as beneficiary, prior to conducting the trustee's sale, must record an affidavit of mailing with the county recorder where the property is located confirming that such notice has been mailed as required by subsection 8. The statute only requires the notice of rescheduled sale to be recorded "prior to conducting the trustee's sale," whereas the initial notice of the trustee's sale must be recorded at least 20 days prior to the sale. Cf Idaho Code § 45-1506(7). The filing of the affidavit of mailing of notice of the rescheduled sale is conclusive evidence of compliance with Idaho Code § 45-1506(8) as to any party relying on the affidavit.

B. Notice Regarding Effect of Foreclosure and Modification Assistance.

The new Idaho Code Section 45-1506C, requires the lender (that is regulated by the state or federal government), as beneficiary, to send a supplemental notice for noncommercial loans secured by the borrower's primary residence that details the ramifications of foreclosure and provides the grantor an opportunity to seek loan modification assistance. The procedure for determining whether the trust deed covers the grantor's primary residence is set forth in Section 2 of this Memorandum. This supplemental notice must accompany the notice of default provided to the grantor. Idaho Code § 45-1506C(1). The notice must be printed in at least 14-point type and substantially conform to the form notice found in Idaho Code § 45-1506C(1) ("**Form Notice**").

In essence, the Form Notice does three things. First, it clearly explains to the grantor that he is in danger of losing his property if he does not take action immediately. *Id*. Second, it provides grantor with the opportunity to apply for a loan modification by submitting the separate loan modification request form ("**Modification Request Form**"), <u>which needs to be attached to the Form Notice</u>, and to meet with the lender, upon separate written request in accordance with the Modification Request Form, to discuss options for modifying the loan. *Id*. Third, it warns the grantor of the dangers of paying someone to help them obtain a loan modification. *Id*.

<u>The lender must attach a Modification Request Form</u> to the Form Notice. Idaho Code § 45-1506C(2). Grantor has 30 days after the date on the Form Notice to submit the Modification Request Form to the lender. *Id*. The Modification Request Form must contain the date by which the Modification Request Form is due, and the address to which the grantor must send the same. *Id*. The Modification Request Form may state that the grantor must disclose current information about his income and expenses, the grantor's address, phone number and e-mail address, and other facts that may affect the grantor's eligibility for a loan modification. *Id*. If the deed of trust or any assignment of the deed of trust is in Spanish, the Form Notice and Modification Request Form must also be in Spanish. *Id*.

If the grantor timely returns the Modification Request Form to lender, the lender or its agent is required to review the information provided by grantor and evaluate the grantor's request. Idaho Code § 45-1506C(3). The lender or its agent shall then notify the grantor in writing whether the lender approves or denies the request or requires additional information as soon as reasonably practicable, but in no event later than forty-five (45) days after receiving the completed Modification Request Form. *Id*. A trustee's sale for the subject property may not occur until after the lender or its agent timely responds to the grantor's timely Modification Request Form. *Id*.

As set forth in the separate written request on the Modification Request Form, the grantor may ask to meet with the lender to discuss options for modifying the loan. Idaho Code § 45-1506C(4)(a). If such a request is made, the lender or its agent is required to contact the grantor to schedule a meeting in person or speak to the grantor by telephone before the lender or its agent responds to the grantor's timely request to modify the loan. *Id*. The lender or its agent shall schedule the meeting by contacting the grantor at his last know address or telephone number or the grantor's e-mail address, if he indicates on the Modification Request Form that lender may contact him via e-mail. *Id*. The lender or its agent that meets with the grantor shall have or be able to obtain authority to modify the loan. Idaho Code § 45-1506C(4)(c). The lender or its agent is deemed to comply with grantor's request even if the lender or its agent does not speak with the grantor if, within 7 business days after the lender or its agent attempts to contact the grantor, the grantor does not schedule a meeting, or fails to attend a scheduled meeting or telephone call. Idaho Code § 45-1506C(4)(b).

Once the lender has complied with the requirements of Idaho Code § 45-1506C, the trustee shall file an affidavit of compliance by lender or its agent in the office of the recorder in each county wherein the trust property, or some part or parcel, is situated, which must substantially comply with the form affidavit found in Idaho Code Section 45-1506C(5) ("**Form Affidavit**"). Idaho Code § 45-1506C(5). The Affidavit must be recorded at least twenty days prior to the date of the sale. *Id*.

Whenever the AG has reason to believe that a lender has failed to follow the requirements of Idaho Code § 45-1506C and that proceedings would be in the public interest, the AG may bring an action in the name of the state against the person for enforcement of the provisions of Idaho Code § 45-1506C with the same procedure and the same manner as afforded by certain provisions under the Idaho Consumer Protection Act. Idaho Code § 45-1506C(6). Any penalties, costs and fees received or recovered by the AG will be remitted to the consumer protection account and expended by legislative appropriation in furtherance of the AG's duties. Idaho Code § 45-1506C(7).

C.Mortgage Loan Modification Fees.

The new Idaho Code § 48-603F, governs mortgage loan modification fees. "Loan modification activities" means "for compensation or gain, or in the expectation of compensation or gain, engaging in or offering to engage in effecting loan modifications in this state." Idaho Code § 26-31-201(3). Pursuant to Idaho Code § 48-603F, charging or collecting any fee in connection with mortgage loan modification activities is a violation of the Idaho Consumer Protection Act, unless the person charging or collecting such fees is licensed under Title 54, Chapter 20 of the Idaho Code, governing real estate licenses, or is exempt or excluded from licensing pursuant to Part 2 or 3 of the Idaho Residential Mortgage Practices Act. Such exemptions include "[a]ny person licensed or chartered under the laws of any state or of the United States as a bank, savings and loan association, credit union or industrial loan company." 26-31-202(6).♦

AFFIDAVIT OF COMPLIANCE WITH IDAHO CODE SECTION 45-1506C

COMES NOW __________________, being first duly sworn, deposes and says:

1. I am the (title -- officer or agent) of (name of beneficiary), the beneficiary of the Deed of Trust recorded as instrument number (recorder's instrument number), County of (County) , Idaho, the "**Deed of Trust**."

2. Beneficiary or Beneficiary's agent has complied with section 45-1506C, Idaho Code, in by: (a) providing the notice required in section 1506C(1), Idaho Code; (b) providing the loan modification request form required in section 45-1506C(2), Idaho Code; (c) evaluating the request for modification and providing a written response to the request as required in section 45-1506C(3), Idaho Code; and (d) scheduling, and if attended by the grantor of the Deed of Trust, attending, in person or by telephone, the meeting required in section 45-1506C (4) , Idaho Code.

____
SIGNATURE

(INSERT NOTARY SUBSCRIPTION FOR STATE IN WHICH AFFIDAVIT IS EXECUTED;
IDAHO FORM OF SUBSCRIPTION IS SET OUT BELOW)

STATE OF IDAHO)
) ss.
County of Ada)

On this _____ day of (month), 2011, before me, ____________________, a Notary Public in and for said state, personally appeared _______________, known or identified to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that such officer or agent executed the same.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

____
Name: _________________________
Notary Public for Idaho
Residing at _____________________
My commission expires ____________

IMPORTANT NOTICE:
YOU ARE IN DANGER OF LOSING YOUR PROPERTY
IF YOU DO NOT TAKE ACTION IMMEDIATELY

This notice concerns the mortgage loan for your property at (enter the complete address).

You have not fulfilled your contractual obligations under the terms of your mortgage loan. Under Idaho law, the holder of your loan, "the beneficiary," can sell your property to satisfy your obligation.
As of (enter the date), you needed to pay $ (enter the amount owed) to bring your mortgage loan current. That amount may have increased since that date and may include additional costs and fees described in the loan documents.

The beneficiary can provide you with the exact amount that you owe, but you have to ask. Call (enter the toll-free telephone number) to find out the exact amount you must pay to bring your mortgage loan current and to obtain other details about your loan. You also can send a written request for this information by certified mail to: (enter the complete address)

LOAN MODIFICATION ASSISTANCE

If you want to save your home from foreclosure but you cannot afford your current loan payments, you need to contact the beneficiary immediately to ask about any available loss mitigation programs. You may or may not qualify for a loan modification or other alternative to foreclosure.

You may request to meet with the beneficiary to discuss options for modifying your loan.

IF YOU WANT TO APPLY FOR A MODIFICATION OF YOUR LOAN, YOU MUST COMPLETE AND RETURN THE ENCLOSED "MODIFICATION REQUEST FORM" BY CERTIFIED MAIL, RETURN RECEIPT REQUESTED. THE BENEFICIARY MUST RECEIVE THE FORM ON OR BEFORE (enter the date), WHICH IS THIRTY (30) DAYS AFTER THE DATE BELOW.

WARNING: You may get offers from people who tell you they can help you keep your property. Never pay someone to help you obtain a loan modification. Help is available for free from housing counselors who are certified through the department of housing and urban development. Visit www.hud.gov for a current list of certified housing counselors in Idaho.

DATED: (enter the date)
Beneficiary name: (print name)
Beneficiary or beneficiary's agent's signature: (sign name)
Beneficiary's telephone number: (enter the toll-free telephone number)

Stern Implications: Examining the Effect of Stern v. Marshall on Bankruptcy Litigation

By Noah Hillen

Last month, the United States Supreme Court issued its decision in *Stern v. Marshall*, holding by a five to four majority that the United States Constitution prohibits bankruptcy judges from entering a final judgment on a state law compulsory counterclaim asserted by a debtor where the counterclaim is not resolved in the process of ruling on a creditor's proof of claim. Writing for the majority, Chief Justice Roberts noted, the Constitution requires that an Article III judge enter such a final judgment. In doing so, the Court reawakened questions regarding bankruptcy court jurisdiction that were seemingly addressed by the 1984 amendments to the bankruptcy jurisdiction statutes, which were enacted in response to the Court's 1982 decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

Despite the Court's attempt to portray the effect of its decision as narrow, the case raises numerous questions regarding a bankruptcy court's jurisdiction and how parties should assert certain counterclaims.

Facts and Procedural History

The Stern case arose from an inheritance dispute concerning the very wealthy J. Howard Marshall II ("Howard"), Howard's wife Vickie Lynn Marshall (better known as Anna Nicole Smith and hereafter "Smith"), and Howard's son E. Pierce Marshall ("Pierce"). Shortly before Howard's death, Smith filed suit against Pierce in Texas state court, claiming that Howard meant to provide for Smith after his death through a trust and Pierce tortiously interfered with that gift, causing Howard to cut Smith out of his estate. After Howard's death, Smith filed a Chapter 11 bankruptcy in California. Pierce filed a proof of claim in Smith's bankruptcy case alleging that Smith had defamed Pierce when, shortly after Howard's death, Smith's lawyers told the press that Pierce had engaged in forgery, fraud, and overreaching to gain control of Howard's assets. Pierce also initiated an adversary proceeding seeking to except his defamation claim from discharge. Smith counterclaimed, alleging, among other claims, tortious interference with the expected trust gift. The Supreme Court noted this was a compulsory counterclaim under Federal Rule of Bankruptcy Procedure 7013 and Federal Rule of Civil Procedure 13(a).

The bankruptcy court ruled against Pierce, and awarded Smith more than $425 million in damages. While the matter was pending on appeal, the Texas state court issued a conflicting judgment in favor of Pierce. After further appeals and one prior decision by the U.S. Supreme Court, the Ninth Circuit, on remand, held that Smith's counterclaim was not a "core" proceeding under 28 U.S.C. § 157(b)(2)(C) because resolution of her claim was not necessary to resolve the claims asserted against her by Pierce. The U.S. Supreme Court granted certiorari.

The Court's Analysis

The Court agreed with Smith that the bankruptcy court had the statutory authority to enter a judgment on her counterclaim under 28 U.S.C. § 157, but it held that the United States Constitution required that an Article III judge resolve Smith's common law counterclaim. Article III of the Constitution defines the judicial power of the United States and provides federal judges with important salary and tenure protections designed to prevent the political branches from encroaching on the power of the judicial branch. U.S. CONST. ART. III, § 1. Bankruptcy judges, however, are appointed pursuant to Article I of the Constitution, which confers Congress the power to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. ART. I, § 8. Therefore, bankruptcy judges lack the constitutionally imposed salary and tenure protections held by their Article III colleagues.

Relying on *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How. 272, 284 (1856), the Court held that Congress violated Article III of the Constitution when it provided a bankruptcy judge with the authority to resolve Smith's state law counterclaim. In other words, only an Article III judge could enter final judgment on Smith's common law counterclaim. The Court concluded such a result was consistent with its plurality decision in *Marathon*, in which the Court held a statute's grant of jurisdiction to bankruptcy judges to issue final decisions on state law contract claims violated Article III of the Constitution.

Effects of Decision

The primary implication of the Court's decision, which Justice Bryer highlighted in his dissent, is that litigants in the bankruptcy courts could be faced with substantial additional costs and delay. While bankruptcy courts can rule on disputes concerning a proof of claim, bankruptcy courts lack jurisdiction to enter a final judgment on certain compulsory counterclaims. Accordingly, those counterclaims must be referred to an Article III judge. Reviewing the caseload statistics from the District of Idaho, from July 2010 through June 2010, parties initiated 267 adversary proceedings in bankruptcy court. During that same time period, 899 cases were filed in the district court (635 civil cases and 264 criminal cases). The Court's decision in *Stern* will necessarily have the effect of increasing the district court's caseload, forcing certain bankruptcy adversary proceedings to compete with the district court's civil and criminal cases. The *Stern* Court attempted to downplay this potential effect of its decision stating: "We do not think the removal of counterclaims such as [Smith's] from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute [28 U.S.C. § 157]; we agree . . . that the question presented here is a 'narrow' one."

Despite the Court's attempt to portray the effect of its decision as narrow, the case raises numerous questions regarding a bankruptcy court's jurisdiction and how parties should assert certain counterclaims. It is unclear if the *Stern* decision applies to counterclaims asserted by litigants based upon federal law, for example, compulsory counterclaims based upon a failure to comply with the Truth in Lending Act, Fair Credit Reporting Act, CARD Act, Home Affordable Modification Program, and other federal statutes and regulations aimed at protecting consumers. This issue is especially pertinent given the litigation resulting from the recent housing and mortgage crisis. Further, the procedures for referring these cases to a district court are unclear and will need to be developed by both bankruptcy and district courts. It is equally unclear how cases pending before bankruptcy courts involving state law counterclaims should be treated, and how these cases should be referred to an Article III court. Jurisdictional issues that prevent a bankruptcy court from rendering a final judgment may also be difficult to determine at the outset of a case. There may be instances when a bankruptcy court determines that it lacks jurisdiction over a claim only after substantial litigation by the parties. The *Stern* decision raises many questions regarding bankruptcy court jurisdiction, and it will be some time before bankruptcy courts and Article III courts grapple with these issues.♦

The Commercial Law & Bankruptcy Section produces this quarterly newsletter. If you would like to include an item in an upcoming newsletter, please contact Katie at katie@nctv.com.

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