Concurrent Session

Current Developments (Consumer)

Ford Elsaesser
Elsaesser, Jarzabek, Anderson, Marks, Elliott & McHugh, Chtd.; Sandpoint, Idaho

Hon. Eileen W. Hollowell
U.S. Bankruptcy Court (D. Ariz.); Tucson

Hon. Christopher M. Klein
U.S. Bankruptcy Court (E.D. Calif.); Sacramento

Randy Nussbaum
Nussbaum & Gillis, PC; Scottsdale, Ariz.

2009 Educational Materials

Schwab v. Reilly
Ruling Below: 534 F.3d 173 (3d Cir.)
Cert. Granted: 4/27/09
Docket #: 08-538

A. Facts/Background:

Reilly filed a Chapter 7 petition with all of the necessary schedules and statements. Reilly listed as personal property on her Schedule B "business equipment" with a value of $10,718. On her Schedule C, Reilly combined two exemptions in order to equal the full $10,718 value of the property, asserting $1,850 under 11 U.S.C. § 522(d)(6) ("tools of trade") and $8,868 under 11 U.S.C. § 522(d)(5) ("wildcard"). Schwab, the trustee, failed to object to the exemption within the 30-day period under Fed. R. Bankr. P. 4003(b). Schwab subsequently discovered that the business equipment had a value of approximately $17,200, and filed a motion to sell the business equipment in order to recoup the difference between the $17,200 and the claimed exemption of $10,718. Reilly asserted that the business equipment had become fully exempt when the period for filing an objection expired. The Bankruptcy Court agreed with Reilly that the property was fully exempt as a result of Schwab's failure to timely object to Reilly's exemption claim.

B. Procedural History:

The 3d. Cir. Court of Appeals affirmed the decision of the U.S. District Court for the Middle Dist. of Penn. (and, in turn, the Bankruptcy Court) in holding that where a debtor lists a value for property and claims an exemption in the same amount, the trustee is on notice of the debtor's valuation; and if the trustee fails to object within Rule 4003(b)'s 30-day period, the property becomes fully exempt from the bankruptcy estate regardless of its ultimate market value.

C. Schwab's Petition for Cert.:

I. Review is warranted to resolve a conflict between a bankruptcy rule of procedure involving exemptions and the duty of a trustee to sell property for the benefit of creditors.

A. The Courts of Appeals are split with regard to which valuations require a trustee to object to claims of exemptions and the duty of a trustee to sell property for the benefit of creditors.

B. The 3d Cir. improperly relied on *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992) – a case that the lower courts have neither uniformly applied, nor followed the Courts of Appeals which have construed it, resulting in a wide and contradictory array of decisions. In *Taylor*, a Chapter 7 debtor claimed as exempt potential proceeds from a pending employment discrimination suit. No objection to the exemption was filed, and the debtor was granted a discharge. On review from the 3d. Cir., the Supreme Court held that a Chapter 7 trustee could not contest the validity of a claimed exemption after the statutory 30-day period for objecting had expired and no extension had been obtained, even though the debtor had no colorable basis for claiming the exemption.

II. Review is warranted because the 3d Circuit's holding will require every trustee to object to countless claims of exemptions in order to protect her duty to sell property which exceeds the value estimated by the debtor. Essentially, the trustee would be forced to object to the valuation of an exemption every time the debtor values the property and the exemption identically. Moreover, this would create gamesmanship among debtors, who would seek to undervalue their assets.

III. Review is warranted because the 3d Cir. has unconstitutionally encroached on Congress's exclusive power to legislate in the field of bankruptcy by: (a) creating new duties for trustees; and (b) enlarging the exemptions available to debtors.

D. Questions Presented to Court:

(1) When a debtor claims an exemption using a specific dollar amount that is equal to the value that the debtor places on the asset, is the exemption limited to the specific amount claimed, or does the fact that the numbers are equal operate to "fully exempt" the asset, regardless of its true value? (2) Taking the situation above, must the trustee who wishes to sell the asset object to the exemption within the 30-day period of Rule 4003(b), even though the amount claimed as exempt and the type of property are within the amount set forth under the exemption statute?

E. Sources:

Schwab's Petition for Cert. dated 10/20/2008 **(2008 WL 4678678)**

Document from Supreme Court granting cert. and narrowing issues dated 04/27/2009 **(129 S.Ct. 2049)**

In re Reilly, 534 F.3d 173 (3d. Cir. 2008)

Taylor v. Freeland & Kronz, 503 U.S. 638 (1992)

Law Week: Proceedings of the Supreme Court, Vol. 77, No. 41, Apr. 28, 2009, at 3591

U.S. v. Milavetz, Gallop, & Milavetz PA
Docket #: 08-1225
&
Milavetz, Gallop, & Milavetz PA v. U.S.
Docket #: 08-1119
[Consolidated for Oral Argument]
Ruling Below: 541 F.3d 785 (8th Cir.)
Cert. Granted: 6/8/09

A. Facts/Background:

Milavetz, a law firm practicing bankruptcy law, along with several clients, brought suit against the U.S. seeking a declaratory judgment that certain provisions of the 2005 BAPCPA (11 U.S.C. §§ 526(a)(4), 528(a)(4) and (b)(2)) do not apply to attorneys and law firms and are unconstitutional as applied to attorneys. The Bankruptcy Code, 11 U.S.C. § 526(a)(4) precludes a debt relief agency (DRA) from advising an assisted person from incurring additional debt in contemplation of bankruptcy. §§ 528(a)(4) and (b)(2) require a DRA to include a disclosure in their bankruptcy-related ads directed to the general public declaring: "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code" (or a statement that is substantially similar).

B. Procedural History:

The District Court ruled in favor of Milavetz (and clients) and the U.S. appealed. The 8th Cir. Court of Appeals affirmed in part and reversed in part, holding that: (1) attorneys who provide "bankruptcy assistance" to "assisted persons" are DRAs under the Bankruptcy Code; (2) 11 U.S.C. § 526(a)(4) is unconstitutionally overbroad as applied to these types of attorneys; (3) rational basis review is the proper standard for reviewing the constitutionality of the Bankruptcy Code's advertising disclosure requirements; and (4) the Bankruptcy Code's disclosure requirements (§§ 528(a)(4) and (b)(2)) are reasonably related to the government's interest in protecting consumer debtors from deceptive advertising, and therefore pass constitutional muster.

C. United States' Petition for Cert.:

I. Review is warranted because the 8th Circuit's interpretation of § 526(a)(4) is in conflict with that of the 5th Cir. As the 5th Cir. has recognized, § 526(a)(4) imposes only a modest requirement to refrain from urging a debtor to accumulate eve-of-filing debt that would abuse the bankruptcy system. Here, the 8th Cir. has imposed its own, much more expansive construction, and then struck down the statute (so interpreted) as overbroad. As a result, attorneys in the 8th Cir. who qualify as DRAs are free to urge even the most abusive practices without being subjected to the federal sanctions and client protection measures set forth in § 526(a)(4) and (c).

II. Review is warranted because the 8th Cir. erred in holding § 526(a)(4) unconstitutionally overbroad. The 8th Cir. held that § 526(a)(4) *unambiguously* (emphasis in original) sweeps in other attorney advice, unrelated to abuse of the bankruptcy system, and that the statute is

therefore fatally overbroad. This reasoning is flawed both in its statutory premise and its constitutional conclusion. As the text, structure, and purpose of § 524(a)(4) make clear, Congress forbade only advice to incur new debt for the purpose of abusing the bankruptcy system or defrauding creditors. That prohibition is consistent with the 1st Amendment.

III. Review is warranted because the question presented is an important one. The statute at issue here serves an important function in the administration of the Nation's bankruptcy laws, and the circuit conflict over the validity of that statute warrants Supreme Court review. The central goal of the Bankruptcy Code is to give a fresh start to the honest but unfortunate debtor, and § 524(a)(4), by curbing abuse of the bankruptcy system (including abuse that comes at the suggestion of a bankruptcy professional), is an important part of Congress's effort to further this end. By invalidating this section, the 8th Cir. has frustrated this effort.

D. Questions Presented to Court (United States' Petition):

(1) Does 11 U.S.C. § 526(a)(4) preclude only advice to incur more debt with purpose to abuse bankruptcy system? (2) Does § 526(a)(4), construed with due regard for the principle of constitutional avoidance, violate the 1st Amendment?

E. Milavetz's Petition for Cert.:

I. Review is warranted because the 8th Circuit's ruling is in conflict with other decisions (both in the Supreme Court and the lower courts) regarding whether attorneys are DRAs under 11 U.S.C. § 101(12A). Supreme Court review would clarify this issue, which is of national importance given the number of challenges throughout the U.S. to whether attorneys are DRAs.

II. Review is warranted because the 8th Cir. was incorrect in holding that attorneys are DRAs under § 101(12A).

A. A plain meaning interpretation of the term "DRA" excludes attorneys.

B. A logical interpretation of the term "DRA" excludes attorneys.

C. The legislative history does not support the inclusion of attorneys in the definition of DRAs under § 101(12A).

D. The doctrine of constitutional avoidance requires that the phrase "DRA" be read to exclude attorneys (when there are two reasonable constructions for a statute, yet one raises a constitutional question, the Court should choose the interpretation that avoids the constitutional issue).

III. If attorneys are DRAs, review is warranted because the 8th Cir. is incorrect in holding that § 528 does not unconstitutionally burden attorneys' commercial speech.

A. Regulation of commercial speech is subject to the standard of review of intermediate scrutiny.

B. § 528 does not stand up to intermediate scrutiny because the restriction is not supported by a substantial government interest.

F. Questions Presented to Court (Milavetz's Petition):

(1) Is the 8th Circuit's interpretation of attorneys as DRAs contrary to the plain meaning of 11 U.S.C. § 101(12A)? (2) Does 11 U.S.C. § 528 which, as applied to attorneys, restricts commercial speech by requiring mandatory deceptive disclosures in their ads, violate the 1st Amendment's free speech guarantee? (3) Does 11 U.S.C. § 528 violate 5th Amendment due process by requiring deceptive disclosures in advertisements for consumers and attorneys?

G. Sources

Milavetz's Petition for Cert. dated 03/05/2009 **(2009 WL 598042)**

United States' Petition for Cert. dated 04/03/2009 **(2009 WL 907848)**

Documents from Supreme Court granting cert. and consolidating the case for oral argument dated 06/08/2009 **(2009 WL 602029)** and **(2009 WL 908452)**

Milavetz, Gallop, & Milavetz PA v. U.S., 541 F.3d 785 (8th Cir. 2008)

Law Week: Proceedings of the Supreme Court, Vol. 77, No. 47, June 09, 2009, at 3665

United Student Aid Funds, Inc. v. Espinosa
Ruling Below: 553 F.3d 1193 (9th Cir.)
Cert. Granted: 6/15/09
Docket #: 08-1134

A. Facts/Background:

The Bankruptcy Code (11 U.S.C. § 523(a)(8)) provides that student loans cannot be discharged under a Chapter 13 unless the debtor shows undue hardship. Pursuant to the Bankruptcy Rules (Fed. R. Bankr. P. 7001(6)), this showing must be made in an adversary proceeding. To initiate an adversary proceeding, the debtor must file a complaint (Rule 7003), which is to be served on the student loan creditor along with a summons (Rule 7004). The debtor in this case did not initiate an adversary proceeding, but instead listed the debt in his Chapter 13 plan, which was confirmed by the Bankruptcy Court. The trustee then mailed the student loan creditor a notice stating that the amount of the claim for which the creditor had filed a proof of claim was different from the amount listed for payment in the plan. This notice included a warning that unless the trustee received a written request for different treatment of the claim within 30 days, the claim would be treated as indicated in the plan. The creditor never filed such a written request. The debtor successfully completed the plan, and the Bankruptcy Court granted him a discharge. 3 years later, the student loan creditor began intercepting the debtor's income tax returns to satisfy the unpaid portion of the student loan, and the debtor petitioned the Bankruptcy Court for an order holding the creditor in contempt.

B. Procedural History:

The Bankruptcy Court ordered the creditor to cease its collection activities. The District Court reversed on appeal. The 9th Cir. Court of Appeals reversed the District Court, holding that the fact that the debtor did not comply with the heightened notice requirements embodied in the Bankruptcy Code and Bankruptcy Rules to discharge student loan debt did not warrant setting aside the debtor's discharge. Moreover, the court held that the creditor's due process rights were not violated because it received actual notice of the debtor's case and proposed plan, despite the fact that it was never served with a complaint and summons because the debtor did not commence an adversary proceeding.

C. United Student Aid Funds' Petition for Cert.:

I. Review is warranted because the 9th Circuit's ruling conflicts with rulings of the 2d, 4th, 6th, 7th, and 10th Circuits.

A. The circuits expressly acknowledge the conflict.

B. The 9th Circuit's decision is intolerable given the necessity of national uniformity in bankruptcy law. In view of the circuit split and the 9th Circuit's refusal to adopt the prevailing view, only the Supreme Court can resolve this recurring issue.

II. Review is warranted because the 9th Circuit's decision conflicts with principles expressly recognized in the Supreme Court's ruling in *Tenn. Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004). In *Hood*, the Supreme Court held that 11 U.S.C. § 523(a)(8) – which provides that student loan debts are not included in a general discharge order unless this would impose an undue hardship on the debtor – is "self-executing." This meant that unless the debtor affirmatively secures a hardship determination, the discharge order will not include a student loan debt.

III. Review is warranted because the 9th Circuit's decision is simply incorrect.

A. Discharging student loan debt by merely including it in a Chapter 13 plan without proving undue hardship via an adversary proceeding violates the Bankruptcy Code and Bankruptcy Rules and is therefore void.

B. Discharging student loan debt in such a manner is also void for lack of sufficient notice to the creditor.

C. An order confirming a plan that provides for discharge of student loan debt without proof of undue hardship via an adversary proceeding, and the subsequent discharge order, has no res judicata effect.

D. If not abolished, this tactic of "discharge by declaration" threatens to spread to other presumptively non-dischargeable debts such as child support, alimony, fines, and taxes.

D. Questions Presented to Court:

(1) Are orders confirming a debtor's Chapter 13 plan and discharging a debtor from repayment of student loans for which a debtor had failed to prove, in an adversary proceeding, that repayment would cause undue hardship, void? (2) Does the procedure by which the debtor merely included the discharge of student loans in his Chapter 13 plan, which he then mailed to the creditor's post office box, meet the rigorous demands of due process and entitle resulting orders to respect under principles of res judicata?

E. Sources

United Student Aid Funds' Petition for Cert. dated 03/10/2009 **(2009 WL 641508)**

Document from Supreme Court granting cert. dated 06/15/2009 **(2009 WL 646192)**

United Student Aid Funds, Inc. v. Espinosa, 553 F.3d 1193 (9th Cir. 2008)

Tenn. Student Assistance Corp. v. Hood, 541 U.S. 440 (2004)

Law Week: Proceedings of the Supreme Court, Vol. 77, No. 48, June 16, 2009, at 3673
Tenn. Student Assistance Corp. v. Hood, 541 U.S. 440 (2004)

Hamilton v. Lanning
Ruling Below: 545 F.3d 1269 (10th Cir.)
*Cert. has not yet been granted.

A. Facts/Background:

Lanning filed bankruptcy and Hamilton was appointed Chapter 13 trustee. In the 6-month period prior to filing her petition, Lanning took a buyout from her employer, which substantially raised her monthly income for two of these months. When Lanning filed her Schedule I, her monthly net income reflected her current earnings at her new job. When this net income was compared against her monthly expenses under Schedule J, Lanning's excess monthly income was very modest. Lanning also completed Form B22C (22C), which requires a debtor to calculate current monthly income under the so-called means test of § 707(b)(2) by averaging monthly income for the 6 months immediately preceding the filing of the petition. As a result of the inflated monthly income from the employer buyout, Lanning's Form 22C showed a much larger disposable monthly income than did her Schedules I and J. Lanning proposed a monthly payment that reflected the modest excess monthly income under her Schedules I and J. Hamilton objected, proposing the higher monthly payment based on the figure under Form 22C.

B. Procedural History:

The Bankruptcy Court denied the trustee's objection, and the 10th Cir. BAP affirmed. Hamilton appealed, and the 10th Cir. Court of Appeals affirmed, holding that, as a matter of first impression, the starting point for calculating a Chapter 13 debtor's projected disposable income is presumed to be the debtor's current monthly income as calculated under the means test, subject to a showing of a substantial change in circumstances.

C. Hamilton's Petition for Cert.:

I. Review is warranted to resolve the conflict between circuits as to the interpretation of 11 U.S.C. § 1325(b)(1)(B).

A. The "forward-looking" approach was adopted by the 10th Cir. in this case. Under this approach, a debtor's "disposable income" calculation on Form 22C is a starting point for determining "projected disposable income," but the final calculation can take into consideration changes that have occurred in the debtor's financial circumstances as well as the debtor's actual income and expenses as reported on Schedules I and J.

B. The correct approach is the "mechanical approach," which was adopted by the 9th Cir. in *Marey v. Kagenveama (In re Kagenveama)*, 541 F.3d 868 (9th Cir. 2008). This approach equates a debtor's "projected disposable income" with statutorily defined "disposable income" and then projects the amount over the commitment period without permitting adjustment to "projected disposable income" to account for special or changed circumstances at the time of confirmation of the plan.

C. The lack of uniformity in interpretation of 11 U.S.C. § 1325(b)(1)(B) has resulted in a wide array of approaches at the bankruptcy court and BAP levels. For example, in *In re Hanks*, 362 B.R. 494 (Bankr. D. Utah 2007) and *In re Jass*, 340 B.R. 411 (Bankr. D. Utah 2006), courts sitting in the same city and reading the same statute came to completely opposite conclusions, all the while each claiming its view was the "plain reading" view of the statute.

II. Review is warranted because the 10th Circuit's interpretation of 11 U.S.C. § 1325(b) disregards the plain meaning of the statute.

A. § 707(b)(2) provides a precise and unambiguous method for determining how a debtor's monthly "disposable income" is to be calculated. Although the Bankruptcy Code defines "disposable income," it does not provide a specific definition of "projected disposable income." The proper interpretation of "projected disposable income" requires the court to take the debtor's "disposable income" as determined under the means test, and project it over the applicable commitment period. To assume otherwise is to presume that the word "projected" requires the court to consider the debtor's *actual* (emphasis in original) future income and expenses. This distinction is unwarranted and not imposed by the bankruptcy code. The court can give meaning to the word "projected" by "projecting forward" the means test calculations. This can be accomplished simply by multiplying the net "disposable income" figure from Form 22C and multiplying it by the applicable commitment period.

B. Bankruptcy courts have overextended the "absurd results" language from *Lamie v. U.S. Trustee*, 540 U.S. 526, 533 (2004) in order to stray from the plain language of 11 U.S.C. § 1325(b). In *Lamie*, the Court asserted that when a statute's language is plain, the sole function of the court is to enforce it according to its terms, except where doing so would lead to "absurd results." Many courts, including the Bankruptcy Court in this case, have determined that the results under the mechanical approach are "absurd," and therefore have deviated from the congressional mandate, which requires a debtor to pay her unsecured creditors her projected disposable income, without reference to exceptions if the debtor feels this calculation does not accurately reflect her income.

C. What little legislative history exists supports the mechanical approach. The congressional record is almost nonexistent. Congress was perfectly aware that prior to BAPCPA, courts had discretion to perform a case-by-case analysis, yet it chose to implement a standardized formula with the amendment. This standardized formula simply does not allow for a case-by-case examination of the facts and circumstances of a particular debtor's financial affairs beyond that reflected by the means test.

D. Questions Presented to Court:

Did the 2005 BAPCPA eliminate judicial discretion by requiring an above-median income debtor to pay unsecured creditors the net result reported on Official Form 22C?

E. Sources

Hamilton's Petition for Cert. dated 02/03/2009

Hamilton v. Lanning, 545 F.3d 1269 (10th Cir. 2008)

Lamie v. U.S. Trustee, 540 U.S. 526 (2004)

Law Week: Proceedings of the Supreme Court, Vol. 77, No. 33, March 3, 2009, at 3489

Standing and Real Party in Interest Requirements for Lenders Seeking to Foreclose

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This material summarizes the holdings of *In re Hwang*, *In re Jacobson*, *In re Sheridan*, *In re Mitchell*, and *In re Wilhelm*, five recent decisions by bankruptcy courts faced with deciding whether to grant automatic stay relief for purported lenders or their agents to foreclose on property. These cases address the constitutional standing of parties to foreclose where they cannot show they hold the past due note or that they are entitled to enforce it.

INTRODUCTION

In the past decade, electronic information and data transmission have increased the speed at which we do business. These seemingly efficient tools have made it easier for banks to transfer funds and buy and sell notes without leaving a paper trail. However, now that the real estate bubble has burst, courts are demanding to see the paper trail for promissory notes before allowing lenders to foreclose on real property. As required by the constitution, courts must confirm that a lender actually has standing and will benefit from the court granting relief from an automatic stay before the court can do so. Below is a brief description of the concepts related to standing and real parties in interest, followed by a summary of several different cases addressing these issues.

DISCUSSION

In the cases below, the courts discuss whether the party seeking relief from the automatic stay have standing to bring the motion and/or are the real party in interest. Many courts use the terms of standing and real party in interest interchangeably because the two concepts are closely related, but they do have distinct requirements. Standing has both

constitutional and prudential (i.e. self-imposed) requirements. As pointed out by the *Hwang* court, the real party in interest question is really the prudential component of the overall standing analysis, while injury-in-fact is a constitutional requirement, and both requirements must be met before a court can grant relief from the automatic stay. In addition, a party also has standing to seek relief if it has the authority to act on behalf of an entity that has standing. Therefore, a nominee or agent will have to prove both 1) it is an agent with the authority to act on behalf of the principal and 2) the principal has both constitutional standing and prudential standing. However, even if a party has standing, the agent must prosecute the action in the name of the real party in interest and not in its own name.

The standing requirement is "an essential and unchanging part of the case-or-controversy requirement of Article III." *Lujan v. Defenders of Wildlife*, 502 US 555, 560 (1992). This constitutional doctrine requires that a claimant must present an actual or imminent injury that is fairly traceable to the defendant's conduct and redressable by a favorable ruling. *Davis v. Fed. Election Comm'n*, 128 S.Ct. 2759 (2008). The standing question is a threshold issue, required before a court may entertain a suit. *Warth v. Seldin*, 422 U.S. 490, 495 (1975). Thus, if a lender cannot prove standing, the court has no authority to hear its motion for relief from stay and it must dismiss the motion.

Prudential requirements also require that a party bringing a motion be the real party in interest. Rule 17 of the Federal Rules of Civil Procedure ("FRCP") requires "[a]n action must be prosecuted in the name of the real party in interest." Fed. R. Civ. P. 17. The purpose is to ensure the party bringing forth the action is the party who "possesses the substantive right being asserted under the applicable law." Wright, Miller & Kane, *Federal Practice and Procedure* vol. 6A, § 1541 (available at 6A FPP § 1541) (Westlaw current through 2009

update). This reflects the fact that the federal judiciary also adheres to certain prudential principles concerning standing. *Bennett v. Spear*, 520 U.S. 154, 162 (1997). The real party in interest inquiry is one of the prudential considerations the judiciary self-imposes to limit the role of courts in democratic society. *See*, *e.g.*, *In re Village Rathskeller*, 147 B.R. 665, 668 (Bankr. S.D.N.Y. 1992). Because Rule 17 applies in adversarial bankruptcy proceedings, parties must adhere to Rule 17 in order to seek relief from automatic stay. *In re Hwang*, 396 B.R. 757, 766 (Bankr. C.D. Cal. 2008).

The cases in this discussion illustrate potential standing and real party in interest issues arising in bankruptcy proceedings. While the Mortgage Electronic Registration Systems ("MERS") promised to streamline mortgage transactions and cut costs, this service often results in a series of unrecorded transfers or transfers to parties outside the servicer's system that can complicate knowing how a note traveled through the system and whether a party really has standing to seek foreclosure. The cases below demonstrate how some creditors and servicers failed to show they had standing or were, or were acting on behalf of, the real party in interest.

In re Hwang

The Bankruptcy Court for the Central District of California reconsidered its denial of IndyMac Federal Bank's ("IndyMac Bank") motion for relief from automatic stay. *Hwang*, 396 B.R. at 760. In this case, IndyMac transferred ownership of the note to an unknown party, but never transferred possession of the note. *Id.* The court found that despite IndyMac Bank being entitled to enforce the note against the debtors, it was not the real party in interest because it was not ultimately entitled to the payments made on the note, so the court affirmed its denial of IndyMac Bank's motion for relief from automatic stay. *Id.* at 766-67.

The original payee and beneficiary of the deed was Mortgageit, Inc. ("Mortgageit"). *Id.* However, Mortgageit later transferred it to IndyMac Bank. *Id.* at 761. Mortgageit was a MERS member, but MERS lost its rights when the deed passed to IndyMac Bank. *Id.* IndyMac Bank later sold the note to "unidentified 'investors' through Freddie Mac" while retaining physical possession of the note. *Id.* IndyMac Bank argued it was the authorized servicing agent for the new owner. *Id.* at 761-62. However, the court rejected this argument since IndyMac Bank admitted it did not know who the owner was and submitted no evidence of any such agreement. *Id.* However, the court found that IndyMac Bank was entitled to enforce the promissory note since it is a negotiable instrument, and under California law, the holder of a negotiable instrument has the right to enforce it. *Id.* at 762-63. For any instrument payable to a particular person, the holder is required to both 1) be in possession of the instrument and 2) the instrument must be payable to that person. *Id.* Here, IndyMac Bank can enforce the note because it has possession of the note which is payable to IndyMac Bank. *Id.* Since IndyMac Bank never delivered the note to the new owner, the right to enforce the note never passed and IndyMac Bank remains the holder of the note, retaining the right to enforce it. *Id.* at 763-65.

However, to prosecute the action in its own name, IndyMac Bank must also be the real party in interest. *Id.* at 766. The court found that a party may have constitutional standing, but still not be the real party in interest (i.e. have prudential standing) if the substantive right belongs to someone else. *Id.* at 767-68. Here, even though IndyMac Bank was entitled to demand and receive payment from debtors, the payments actually belonged to the new owner, not IndyMac Bank. *Id.* at 764-65. Even if IndyMac Bank proved it was the servicing agent for the owner of the note, it must bring the action in the real party in interest's name rather than

its own name, or join that party to the action to satisfy FRCP 19. *Id.* at 770-71. The purpose of FRCP 19 is to join "all persons whose joinder would be desirable for a just adjudication of the matter." *Id.* In this case, joinder is required because "as a practical matter [failure to join will] impair . . . the person's ability to protect the interest." *Id.* at 771. Here, adjudicating the motion without joining the owner jeopardizes the owner's ability to protect its interest. *Id.* Since the court gave IndyMac Bank more than two months to join the new owner, but IndyMac failed to do so, the court denied the motion for relief from automatic stay. *Id.* at 772.

In re Jacobson

In this case, the Bankruptcy Court for the Western District of Washington denied the motion for relief from automatic stay because the moving party, UBS AG, could not show it had standing, nor that it had authority to act for anyone that did have standing. *In re Jacobson*, 402 B.R. 359, 369 (Bankr. W.D. Wash. 2009). UBS AG purported to represent ACT as servicer of the note. *Id.* The court cited *Hwang*, noting that even if the moving party is the noteholder's agent, it does not make the agent a real party in interest. *Id.* at 366. To have standing to prosecute the motion in the name of the real party in interest, the court required UBS AG to show it had authority to act on the noteholder's behalf. *Id*. at 367. Since UBS AG made no such showing, and it was not the real party in interest, the court denied the motion. *Id.* at 770.

Execution of the original note was on behalf of Castle Point Mortgage ("Castle Point") and listed MERS as a beneficiary "solely as nominee for lender and lender's successors and assigns." *Id.* at 362. Castle Point later sold the note to ACT Properties, LLC ("ACT") in an unrecorded transaction. *Id.* However, UBS AG admitted that Wells Fargo held the note. *Id.* at 363. The court questioned, as the court in *Hwang* did, whether ACT itself would even qualify

as the holder given that someone endorsed it in blank and another had possession of the note. *Id.* at 369.

As both an admonition and suggestion to MERS, the court instructed that it is possible to prove the identity of the various holders and servicers by putting forth evidence and stated that some courts require such evidence to be admissible before considering it. *Id.* at 367. The evidence put forth by UBS AG did not meet any standards of admissibility, and the court further commented on its ineffectiveness. *Id.* UBS AG submitted a conclusory declaration by a "bankruptcy specialist" stating he was a custodian of the records, knew them to be a true copy of the originals made at the time of the events in the ordinary course of business. *Id.* at 368. Although no business records were submitted, the court opined that the "bare assertion that one works for the company and is familiar with its recordkeeping procedures is not sufficient . . . to establish the person is sufficiently knowledgeable about the subject of the testimony." *Id.* The testimony needs to express information warranting the conclusion that the records presented are what they purport to be. *Id.*

Unlike *Hwang*, the movant here asserted that it was the servicer of the note and acting on behalf of the holder. In addition, neither UBS AG nor ACT had actual possession of the note and thus neither appeared to have any right to enforce it. *Id.* at 370. While establishing that UBS AG is the agent rather than the noteholder seems like it might be an easier standard to meet, it must still show it is the agent of ACT. *Id.* Even if it could, it must also show ACT is the real party in interest and join ACT as a party or litigate in its name instead of its own name. *Id.* Because UBS AG was not the real party in interest nor could it show it was acting on behalf of the real party in interest, the court denied the motion for relief from stay. *Id.*

In re Sheridan

In this case, the Bankruptcy Court for the District of Idaho considered a stay relief motion brought by MERS as nominee for HSBC Bank USA ("HSBC"). *In re Sheridan*, 2009 WL 631355 (Bankr. D. Idaho 2009). MERS not only asserted it was nominee, but also characterized itself as a "secured creditor and Claimant." *Id.* MERS was designated a beneficiary on the Deed of Trust and as nominee for the noteholder at the time of execution. *Id.* at 6 The court still found this insufficient, as there was no showing made as to who the current noteholder was. The court also held MERS was not an actual beneficiary, despite the Deed naming it one, since no actual economic benefit accrued to it. *Id.* at 4.

The Promissory Note and Deed of Trust identified the lender as Fieldstone Mortgage Company ("Fieldstone"), and the Deed also identified MERS as nominee and beneficiary for the noteholder and all its successors and assigns. *Id.* at 4. The Promissory Note also stated, "anyone who takes this Note by transfer and who is entitled to receive payments . . . is called the Note Holder." *Id.* at 1. MERS argued that it had authority to act for the current noteholder, whoever that was, since it was named as a beneficiary and nominee for all successors and assigns. *Id.* at 4. Even if the court agreed, there is still the issue of the Note not indicating any transfer to other parties. *Id.* at 5. Therefore, Fieldstone appeared to be the current noteholder, and MERS did not purport to represent Fieldstone at any time. *Id.* at 4. The court denied the motion for relief from stay for two reasons: 1) it found the "titular designation" of MERS as "beneficiary" on the Deed insufficient to establish it as such and 2) there was no evidence or explanation presented showing whether HSBC had any current interest in the note. *Id.*

Merely naming a party as a beneficiary of an instrument is not sufficient to make it one. *Id.* The court looked to Idaho Code § 45-1502(1) which defines a beneficiary for

purposes of the trust deed statute as "the person for whose benefit a trust deed is given." *Id.* Therefore, MERS was not a beneficiary under Idaho Code because the trust deed benefits the noteholder, which appeared to be Fieldstone in this case. *Id.* In addition, the language used in the Deed of Trust was confusing as it also stated that MERS will act "solely as nominee for Lender and Lender's successors and assigns." *Id.* Because MERS was not a beneficiary under Idaho Code and the language of the Deed was ambiguous, the court held that MERS was not a real party in interest and could not bring the motion in its own name. *Id.*

Even if MERS was properly acting as the agent of the real party in interest there was no showing that HSBC, or even Fieldstone, had any current interest in the note. *Id.* If there had been, the action must still be brought in the real party in interest's own name, not its agent's. *Id.* Later MERS submitted a "supplemental affidavit" stating that it had obtained an original copy of the Note, which now indicated an endorsement. *Id.* at 5. The court found the affidavit improper for several reasons, but, even had the court been able to consider it, the affidavit would not have assisted MERS since there was neither a date nor any indication of who the transferor or the transferee was. *Id.* at 6. Even if Fieldstone had endorsed the note in blank it would not have established HSBC or Fieldstone as the noteholder since Idaho Code provides it "may be negotiated by transfer of possession alone until specially indorsed." *Id.* The court held, "the only entity that MERS could conceivably represent as agent/nominee would be [Fieldstone]. But MERS does not represent [Fieldstone] . . . and, in fact, . . . conten[ds] that [Fieldstone] is no longer a party in interest." *Id.* at 6. Because MERS was unable to establish that it was a real party in interest with standing, or even that it represented such, the court denied the motion for relief from stay. *Id.*

In re Mitchell

Mitchell is the lead case for a number of motions to lift stay filed in MERS' own name or filed in the name of MERS as nominee for another. *In re Mitchell*, 2009 WL 1044368 (Bankr. D. Nev. 2009). The Bankruptcy Court for the District of Nevada handled the motions in a joint hearing because each of the cases had substantially similar issues regarding MERS' standing. *Id.* at 1. MERS withdrew the motions to lift stay in all but four of the cases, and the court issued orders in two of the cases in this opinion. *Id.* Like *Sheridan*, this court denied the motions in both cases because MERS was not the noteholder nor did it show the authority to act on behalf of one who was the noteholder. *Id.* at 4.

In this case, similar to *Sheridan*, MERS argued it had standing because the deeds of trust either named it as a beneficiary or as the nominee of the beneficiary. *Id.* The court noted that merely naming MERS a beneficiary does not give it any rights to enforce the note. *Id.* at 3. The court found that since MERS had no rights to any payments, servicing rights, or any rights to secured properties it was not a beneficiary. *Id.* The court also found similar ambiguities in the language of the deeds of trust and in MERS' brief regarding whether MERS argued it had standing in its own right, or as the nominee, or both. *Id.* Even if MERS was a beneficiary of the note, that alone would be insufficient to confer standing. *Id.* For MERS to foreclose, it must show that it had possession of the note and the deed of trust or it had authority to act as agent for the entity that did. *Id.* at 4. Because MERS was not the beneficiary or the holder of the deed of trust, nor was there evidence that the principal it purported to act on behalf of were either of these, the court denied the motions for relief from stay. *Id.* at 6.

In re Wilhelm

In a recent decision, the Bankruptcy Court for the District of Idaho further expounded on the requirements for lenders to show standing when seeking relief from the automatic stay. (Westlaw citation not currently available). In his decision issued July 7, 2009, Judge Myers held that the movants in five different actions for relief from stay lacked standing to bring such motions because the movants were not named on the notes at issue, the notes were not indorsed in blank or to any specific person or entity (such as the movants), the movants failed to prove that they held the notes, and the movants were not proper assignees of the notes where they argued that MERS assigned the notes to them because the notes named MERS as beneficiary acting solely as nominee with no right to assign the notes. The court found that "there are two threshold questions in each of these motions: (1) Have Movants established an interest in the notes? (2) Are Movants entitled to enforce the notes?" *Id*. at 17. The court held that the Movants failed to provide any admissible proof to answer either question in their favor, and in fact, the notes attached to several declarations contradicted the information contained in the declarations. In reaching its decision, the court did add one important admonition to counsel, "[i]n general, counsel should gather the appropriate documents and factual data *before* filing the motions (as required by Rule 9011 in any event), rather than attempting to cure patently defective motions with serial supplemental filings." *Id*. at 22.

CONCLUSION

The cases discussed above highlight the failure of several lenders to keep adequate records of transfers of underlying notes. Without the paper trail, lenders cannot show that they have standing or are the real parties in interest entitled to bring a motion for relief from the automatic stay. In addition, attorneys should take note of how courts will regard conclusory affidavits in support of these motions as well as the potential for Rule 11 land

mines when taking a client's averments regarding the ownership of a note or deed at face value without making a reasonable and independent inquiry before submitting such statements to a court.

AMERICAN BANKRUPTCY INSTITUTE

17TH ANNUAL SOUTHWEST BANKRUPTCY CONFERENCE

HYATT REGENCY
LAKE TAHOE

September 10 – 12, 2009

PRE-BANKRUPTCY PLANNING

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PRE-BANKRUPTCY PLANNING

For over ten years, bankruptcy clients have received, as part of their initial cover letters, an in-depth discussion of pre-bankruptcy planning similar to the sample which follows this introduction. Though the verbiage has obviously been modified after the enactment of the 2005 amendments, the basic wording has remained the same.

This discussion is included in almost 100% of my cover letters, because almost every client has reason to at least consider this issue. That is because the majority of my clients are middle-class or upper-middle-class and, consequently, have acquired at least some non-exempt property.

There are two distinct reasons why I include this explanation. First of all, as a bankruptcy practitioner, I am concerned about potential liability both to my client and to the Chapter 7 Trustee. As importantly, it is crucial that a client not only be advised verbally about the potential risks and benefits of pre-bankruptcy planning, but that such is reduced to a clear and precise writing.

By providing this provision, I am inviting a dialog from audience members as to whether this language properly addresses the issue or may still run awry of current statutory and judicial standards on this matter.

PRE-BANKRUPTCY PLANNING

Pre-bankruptcy planning is the converting of non-exempt assets into exempt assets. This practice is not illegal or improper; Bankruptcy Code legislative notes specifically permit this type of activity. This is not to say that this procedure is without risk.

In July of 1996, In re Elia became the first Arizona published opinion on pre-bankruptcy planning. The judge found nothing inappropriate with buying a house right before bankruptcy and other similar strategies. However, that case is persuasive but not binding on the other judges. In other courts throughout the country, this issue has been addressed and in certain instances, the pre-bankruptcy planning vilified by the bankruptcy judges. Though no single test has been universally accepted by the courts in determining whether or not to tolerate pre-bankruptcy planning, a number of criteria continuously surface in case after case:

1. What is the amount of the transfer to exempt property?

2. What is the proximity to the bankruptcy filing?

3. Did the conversion to exempt property involve newly acquired funds or previously secured property?

4. Did the conversion benefit insiders of the debtor?

5. Did the debtor mislead creditors during the conversion?

Other courts have considered additional circumstances in determining whether or not the pre-bankruptcy planning is reproachable, but the best way to summarize whether or not pre-bankruptcy planning will succeed is to consider the old maxim, "pigs get fat, and hogs get slaughtered."

Your attorney would also be incurring some risk if the planning progresses to a stage where it could be interpreted as a fraud upon creditors. Though normally the bankruptcy courts do not condemn the attorneys for the planning, but rather punish the debtors, in past non-bankruptcy settings, the Arizona courts have sanctioned attorneys for overly zealous asset protection tactics.

Debtors whose pre-bankruptcy planning has been successfully challenged face a number and variety of repercussions. Oftentimes, the courts order that transfers be set aside and/or reversed. For example, if a debtor has utilized cash to increase his homestead by $50,000 in advance of bankruptcy, an intolerant court can either require that the debtor find the means to replace the $50,000, or, in extreme circumstances, compel the debtor to sell the exempt property and remit $50,000 to the estate. In certain instances, reversing what has occurred is simple while at other times creates a new set of problems for the debtor.

In some situations, courts have found the pre-bankruptcy planning to be so egregious as to justify the denial of a discharge. Though this result is rare, being deprived of a discharge defeats the entire reason behind bankruptcy and is disastrous for the debtor. **This risk is now even more pertinent because of the following change in the law.**

One of the changes in the bankruptcy law which went into effect on April 20, 2005, specifically provides that the Court has the power to reduce a state law homestead exemption by any transfers of nonexempt property made to increase that exemption for an extended period of time (10 years) prior to bankruptcy filing if such transfers were done in fraud of creditors. Though this has always been the case law, this change now incorporates the case law into the Bankruptcy Code itself and no one knows how strictly this new section will be interpreted by the courts. Unfortunately for you, it may increase the chances that your pre-bankruptcy planning could be successfully challenged, though you may still need to engage in the planning nevertheless.

The BAPCPA was specifically designed to discourage debtors from engaging in pre-bankruptcy planning and in particular to stop the practice of Chapter 7 debtors paying down their mortgages in advance of bankruptcy. Some experts have even gone so far as to recommend that pre-bankruptcy planning is no longer a viable option.

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September 10 – 12, 2009

CHAPTER 11 VS. CHAPTER 13

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CHAPTER 11 VS. CHAPTER 13

Because of certain discreet differences between Chapter 11 and Chapter 13 which may benefit certain individual debtors, I now include in my cover letters to clients a discussion regarding those differences. Following this introduction is a copy of that verbiage which is incorporated into those letters.

Since I began including this language, I have discovered that most higher-income individuals have either considered proceeding in Chapter 11 if reorganization is necessary, or in other instances, have actually selected that option over Chapter 13 even when eligible for Chapter 13.

Nevertheless, because not enough time has passed since I began commonly offering these alternatives on a regular basis, it is still unclear as to the ultimate benefits which will inure to debtors selecting Chapter 11 over Chapter 13. It is important to remember that, prior to the massive overhaul of the Bankruptcy Code in 2005, many high-income individuals could still proceed in Chapter 7, since stringent eligibility requirements for Chapter 7 had not yet been enacted.

CHAPTER 11 VS. CHAPTER 13

Clients who are facing serious financial difficulties but may not be eligible for Chapter 7 need to consider from the onset whether they are willing to proceed under Chapter 11 or 13 of the Bankruptcy Code. In determining whether to choose either of those options, clients need to understand the ramifications of each because if for whatever reason reorganization is not acceptable to them, then they are left with having to settle with their creditors. Settlement may not be a horrible alternative, though that option requires clients to come up with money to settle and to also have to address potential tax ramifications since debt forgiveness can trigger taxable income at ordinary income rates.

Traditionally, individuals seeking reorganization would proceed under Chapter 13 as long as they were eligible. To be eligible, a potential debtor would need to have ordinary income and total secured debt of just over one million dollars and unsecured debt of approximately $337,000. If those criteria were met, then Chapter 13 would often be a viable alternative.

Unfortunately, there are a number of problems with Chapter 13 as currently enacted. In almost all cases, a client proceeding under Chapter 13 will have to make monthly payments to a Trustee for five (5) years. That payment would consist of the difference between that client's income and allowed monthly expenses, which are regulated to ensure that a Chapter 13 debtor can maintain a decent lifestyle, but nothing too extravagant. Even more importantly, the number is an adjustable one, which means if a client's disposable income increases either because that client's income goes up or expenses are reduced, then the monthly payment can be adjusted, though normally it is adjusted upwards. Finally, Chapter 13 clients have to remain in Chapter 13 for five years even if a third party is willing to lend them the money so they can pay off the Plan early or even if the client has non-exempt assets that that client could access to pay off the Plan. This effectively places a Chapter 13 client in a situation in which he is handcuffed for that period of time because of the restrictions imposed on that client by bankruptcy law.

Chapter 11 is another form of reorganization which is really designed for companies and bigger cases, but can be utilized by individuals. This of course raises the question of why would an individual consider a Chapter 11 since it is more expensive, far more burdensome than a Chapter 13, requires more extensive paperwork to be filed, not just initially but throughout the case, and requires a far more complicated procedure for approval of a Plan of Reorganization. The answer is based upon certain aspects of Chapter 11 which can actually make it far more attractive than Chapter 13 for certain individuals.

An individual Chapter 11 can easily cost $15,000 to $20,000, which is three to four times more than many Chapter 13s. Nevertheless, Chapter 11 may be far more beneficial than a Chapter 13 for the following reasons:

1. A Chapter 11 debtor may be able to deduct certain expenses on a monthly basis that may not be allowed in a Chapter 13. Even if that difference is only $500 a month over the course of a 60-month Plan, this translates to $30,000 of additional money available to a debtor.

2. Whereas in a Chapter 13 the statute specifically provides for a procedure for annual adjustments of the monthly Plan payment, in a Chapter 11, a creditor has to take affirmative action to compel the debtor to increase his monthly payments once the initial Plan is approved. This substantially reduces the chances that the Plan payment would be adjusted once the Plan is confirmed.

3. Probably most importantly, there does not appear to be any prohibition in permitting a Chapter 11 debtor to pay off a Plan early as long as the money comes from a third party or from exempt funds. This option could allow a Chapter 11 debtor to extricate himself from bankruptcy much earlier if that individual can raise the money to pay off the Plan early.

4. The debtor's plan payment does not commence until confirmation of the plan, which may not be for many months from the original filing date.

5. A Chapter 11 does not require the appointment of a Chapter 13 Trustee, which eliminates that individual's statutory percentage which can be as high as 10% of payments disbursed.

An individual should therefore consider these differences and decide whether Chapter 11 is an option he may want to consider.