EASTERN WASHINGTON BANKRUPTCY

NOTES

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Ninth Annual Northwest Bankruptcy Institute

The Ninth Annual Northwest Bankruptcy Institute is scheduled for April 19–20, 1996. It will be held at the Benson Hotel in Portland, Oregon. This seminar has been approved for 10 CLE credits for Washington and Oregon attendees.

The seminar will feature nationally acclaimed speakers, including Judge Mary Davies Scott, Judge Keith M. Lundin, Professor Lawrence P. King, Professor Charles Mooney, Susan J. Brandt, and Henry E. Hildebrand III. Two judges' panels, moderated by Bernard Shapiro, will address issues of local import. Joseph Patchan, director of the Executive Office for the U.S. Trustees, will be a special guest keynote speaker at the Friday luncheon.

A variety of topics will be presented at the Institute. They include recent developments in Chapter 13, Article 9, leases, preferences, avoidances, domestic relations, and consumer issues.

Inside...

Thanks from Past Chair

My term as chair of the Bankruptcy Bar Association expired in June of 1995. With help from many members, we had an interesting and productive year.

Many of you deserve recognition for good work done for the Association. First in line for thanks is Matt Anderton, the editor of *Notes*, our Association's newsletter. The newsletter is the "glue" that holds the Association together. Thanks also to the law clerks and other contributors to *Notes*.

The 1995 Bankruptcy Seminar and Retreat at Sun Mountain was a resounding success. Kudos to Frank Kurtz for assembling an outstanding slate of speakers, to Tom Bassett for negotiating food and facilities with Sun Mountain Lodge, to Jean Campbell for assisting with registration, and to Judge Glover, Merrilee MacLean, and Bill Weigand for publicizing this event on the west side of the state. Thanks to Judge Rossmeissl, Judge Klobucher, Judge Perris, Judge Glover, Justice Guy, Professor King, Gayle Bush, Dan Caine, Nancy Isserlis, Dillon Jackson, Ted McGregor, Irv Sandman, Frank Smith, Jake Miller, Gary Farrell, and Dan Brunner for puting forth the time and effort to impart their wisdom to the seminar attendees. Thanks also to Metiner Kimel for handling the transportation logistics for Professor King, and to the firm of Kurtz, Hurley, Lara & Adams for, once again, sponsoring the perpetual hospitality suite.

None of these activities would have been possible without the excellent support from the Association's board members: Terry Nealey, Bill Hames, Nancy Isserlis, Chris Hedine, Tom Bassett, Frank Kurtz, Shaun Cross, and Jim Hurley. My sincere thanks to all of you.

Thanks also to everyone else who may have undertaken a job or task to help with these activities and with our Association.

It was my privilege to serve as chair of the Bankruptcy Bar Association. I enjoyed my term in office, and look forward to continuing my association with all of you.

Ian Ledlin

Don't Forget...
Dues are Due
Look for your
Dues Statement
In This Issue

From the Clerk

Ch. 7 Fee Increased, PAS Imroved

By T.S. McGregor

Chapter 7 Fee Increased October 22

Effective October 22, 1995, a $15 increase in the filing fee for Chapter 7 was imposed by action of the Judicial Conference of the United States. The increase was also effective as to conversions occurring on or after October 22. The increase raised the cost of filing a Chapter 7 from $160 to $175. Fees for all other chapters are unchanged.

Bankruptcy Noticing Center

In the very near future all notices initiated by the court will be actually mailed by the Bankruptcy Noticing Center located in Reston, Virginia. This initiative of the Administrative Office of the United States Courts has proved to be both efficient and cost effective for bankruptcy courts already using the system, particularly as to postage costs. The Noticing Center will receive form notices from the Court, either by mail or electronically, print the notices, post them, and electronically provide proof of mailing to the Court for entry on the docket in the case. The return address of notices sent by the Center will be that of the attorney for the debtor, thus providing the attorney with information as to non-delivery of a notice so that appropriate action can be take. We anticipate that the reverse side of asset notices will include a form proof of claim which will be preprinted with the case name and number, a claim number and the name of the creditor.

Adversary Procedure Changed

By General Order dated October 31, 1994, the bankruptcy judges opted to make F.R. Bank. P. 7026, entitled "General Provisions Governing Discovery," applicable in all adversary proceedings filed after November of 1994. This action necessitated certain procedural changes in adversary proceedings. A party filing an adversary proceeding must present with the complaint and cover sheet a completed form summons for issuance by the clerk. The party initiating the adversary proceeding will receive from the clerk the issued summons for service in accordance with F.R. Bank. P. 7004 as well as a "Notice of Scheduling Conference." The Notice of Scheduling Conference is required to be served in accordance with the instructions contained in the notice itself. Generally, the prcess sets the scheduling conference required by F.R. Bank. P. 7026. Please note that the parties to an adversary proceeding are required to confer prior to the scheduling conference.

Matrix Format Guidelines

A matrix containing the names and addresses of debtors, their attorneys, and all creditors and equity security holders is required by local rule to accompany each petition for relief in bankruptcy. The format of the matrix is important so that the information will be compatible with the scanning equipment used by the Court. A matrix that cannot be scanned will be returned to the presenting party for re-preparation.

The entries on the matrix are to be black on 8x10 white bond or standard paper of good quality, with no letters or numbers touching one another. Font styles 10 pitch Courier, Prestige Elite or Letter Gothic are satisfactory; script or "Old English" are not. Entries are to be positioned in a single centered column, the first and second entry of which are to be those of the debtor and joint debtor, if any, followed by the entry for the attorney for the debtor. The balance of the entries need not be alphabetized as the scanning equipment performs this function. A separate matrix should be prepared and clearly identified for equity security holders.

Each entry is to consist of no more than four (4) single-spaced lines with no more than 40 characters, including spaces, per line. The first line is to be the name of the addressee. In the case of an individual the last name is to be used first, e.g. "Doe, John A. Jr.," or "Jones, Dr. Peter." The reason for this is to accommodate the automatic alphabetizing feature of the scanner. The second and third lines are to be those of the street number, box number, apartment or suite number. The last line is to be that of the city, state, and 5- or 9-digit zip code. The zip code should never be the only entry on a line. The standard two-letter abbreviation without punctuation sign is to be used for the state, e.g. "WA" or "ID." There is to be no less than three spaces between entries.

Examples of proper entries are:

```
Jones, John A. Jr.
1234 Evergreen Drive Apartment 3C
Anywhere WA 99999


Acme Toy Company
Medical Building
455 Toy Tower Building Suite 455
Someplace ID  88888-8888
```

The ability to scan entries on matrices into the Court's database quickly and accurately is of great benefit to the Court and all of its users. Any questions or comments concerning matrices should be addressed to the Clerk.

PAS Innovations Offered

Several enhancements have been made to PAS, the public access system of the Court: the introduction of high-speed 28.8-Kbps modems, an upgrade to PC Anywhere 4.5, and the installation of two 486 Cubix processor boards to the Court's network server. The combination of these changes should significantly increase the speed with which information can be recovered from the Court.

An 800 number is now available for users outside of the local Spokane area: (800) 314-3430. Affected users should add this number to their communications software. The local number for gaining access to PAS remains as 353-3286.

The user fee, as was previously announced, has been decreased to $.75 per minute. The collection of the fee is the function of the PACER Service Center in San Antonio. In order to gai access to PAS it is necessary to register with the service cente, which can be done by calling 800-676-6856.

Following is a brief description of the data that is available over PAS. It should be remembered that the information con

Ch. 11 Payments Extended

Congress, in an effort to generate additional income, has determined that Chapter 11 debtors may be a good revenue source. An amendment to 28 U.S.C. §1930(a)(6) became effective January 27, 1996. The amendment provides that the quarterly fees payable to the U.S. Trustee shall continue until the case is closed, converted, or dismissed. Former language in the statute reading "until a plan is confirmed" was stricken. This means that, if a case remains open after it has been confirmed, the debtor now must continue to pay the quarterly fee to the U.S. Trustee.

As of this writing, it is the U.S. Trustee's position that this amendment applies to cases pending on its effective date, as well as cases filed in the future. If a case with a confirmed plan was open on January 27, 1996, the debtor will receive a billing statement from the U.S. Trustee. The billing statement will request a fee based on the debtor's disbursements from January 27, 1996 to the date the case is closed. At this juncture, the U.S. Trustee will not seek payment of the fee in confirmed cases for periods prior to January 27, 1996. The U.S. Trustee has not yet determined whether or not to require additional reporting from debtors with confirmed plans.

Most chapter 11 cases can be closed shortly after a plan is confirmed. The document closing a case is typically titled a "Final Decree." A final decree is entered on application of the debtor once the Clerk determines that the case is fully administered. 11 U.S.C. §350. Questions about the status of a chapter 11 case can be answered by the Clerk.

U.S. Trustee Guidelines for Fee Applications Revised

Revised guidelines for reviewing applications for compensation and reimbursement of expenses filed under 11 U.S.C. 330 were issued on January 30, 1996. Contact the office of the Assistant U.S. Trustee, 920 W. Riverside Ave., Suite 593, Spokane, Washington 99201, (509) 353-2999 for a copy.

Sun Mountain Bankruptcy Seminar and Retreat

The Annual Bankruptcy Seminar and Retreat will be held June 7-8 at Sun Mountain Lodge in Winthrop, Washington. A distinguished faculty will be led by two nationally prominent bankruptcy judges. Judge Robert E. Ginsberg serves on the United States Bankruptcy Court for the Northern District of Illinois. Prior to joining the bench, Judge Ginsberg spent ten years on the faculties of DePaul University College of Law and the University of Illinois College of Law. Before that, Judge Ginsberg was a trial attorney for the Securities and Exchange Commission in Washington, D.C. Recently, Judge Ginsberg was appointed by Chief Justice William Rehnquist to the National Bankruptcy Review Commission. He is a member of the National Bankruptcy Conference and a Fellow of the American College of Bankruptcy. Judge Ginsberg received his LL.M. from Harvard Law School.

Judge Elizabeth L. Perris serves on the United States Bankruptcy Court for the Eastern District of Oregon. Judge Perris also served on the Ninth Circuit Bankruptcy Appellate Panel. Judge Perris is a contributor to *Norton Bankruptcy Law and Practice.* She is a member of the Board of the Federal Judicial Center and the U.S. Trustee's Directors Advisory Board. Judge Perris is a recipient of the Oregon State Bar President's Service Aware for outstanding contributions to Continuing Legal Education. Judge Perris is a Fellow of the American College of Bankruptcy. She received her J.D. Degree from the University of California, Davis.

Other distinguished members of the Sun Mountain seminar faculty include: Justice Richard P. Guy, the Hon. Thomas Glover, the Hon. John M. Klobucher, the Hon. John A. Rossmeissl, Daniel M. Caine, Mary Ellen Gaffney-Brown, Prof. Frank W. Smith, Jr., and Sarah Weaver.

Because rooms at the Sun Mountain Lodge are limited, you should call the Lodge today for a reservation if you plan to attend the seminar: (800) 572-0493.

From the Clerk cont'd

tained on PAS is "live," which means that as soon as information is electronically docketed it is available on PAS.

Description	*Dates*	*Form*
Daily Case Filings	Current	View & Print
General Case & AP Info	86-00001 fwd	View Only
Case Dockets	92-00001 fwd	View & Print
Claims Registers	89-00001 fwd	View & Print
Judges' Calendars	Current	View Only
Master Mailing Lists	92-01600 fwd	Print Only
Ch. 11 Ballot Docket	Current	Print Only
Ch. 11 Rpt. of Balloting	Current	Print Only
52-wk Avg. T-Bill Rate	Dec. 1974 fwd	View Only

Also accessible through PAS are the proposed local rules, an administrative and technical bulleting board, and the general orders concerning fax filing and information concerning F.R. Bank. P. 7026.

The intent of the Court is to provide as much information as possible over PAS. General questions, comments or suggestions regarding PAS should be addressed to the Clerk, and technical inquiries to extension 218.

Computer and Printer Available for Public Use

PAS access is now available to visitors to the Clerk's offices at both Spokane and Yakima by means of a computer and printer located in the viewing areas. This innovation has proved to be very popular and efficient and many visitors find that they can retrieve the information the need without the assistance of Court personnel.

VCIS - New Service for Court Users

VCIS, a system by which information can be retrieved by the use of a touch-tone telephone, has been introduced by the Court. Access to the system is accomplished by calling the basic number of the Clerk's office, 509-353-2404, and pressing "6" when prompted. Information can be accessed by case number, social security number, tax identification number, or by debtor's name. Like similar systems, it is self-guiding and user-friendly. VCIS operates all hours except maintenance periods from midnight until 5 a.m. We anticipate toll-free access to be available in the near future.

Case Notes

The following discusses an en bank decision by the Judges of the Eastern District. Notes *expresses its appreciation to the law clerks for their help in providing case notes, and for this issue especially to Julianne L. Taylor, Law Clerk to Judge Klobucher.*

1. *In re Slater, No. 93-03036-K13, Bank. E.D. Wash., Sept. 5, 1995.*

The Debtor and Maxine Slater dissolved their marriage in 1987. A judgment was entered against the Debtor requiring him to pay $24,508.84 in back child support and spousal maintenance. The Debtor filed for relief under Chapter 13 of the Bankruptcy Code and proposed a plan which would pay the full amount of the child support obligation. Maxine Slater objected to the Debtor's plan because it included her non-dischargeable debt, did not provide interest on her claim, and proposed to avoid a judicial lien for attorney's fees and costs incurred in enforcing the maintenance and support obligation.

In order to determine whether the Debtor's plan was confirmable, pursuant to 11 U.S.C. 1325 the Court, sitting *en banc*, needed to determine whether (1) it has jurisdiction to mandatorily include child support and spousal maintenance arrearages in a Chapter 13 plan; (2) the debtor could separately classify a non-dischargeable unsecured claim without priority; (3) the interest on a non-dischargeable debt must be provided for; and (4) the plan could avoid a lien on the debtor's residence for attorney's fees incurred in enforcing a maintenance and support obligation.

Debtor's counsel argued that the court may include child support arrearages in a Chapter 13 plan as long as the plan does not change or modify the state court order awarding those payments, relying on *Ankenbrandt v. Richards,* 504 U.S. 689, 112 S.Ct. 2206, 119 L.Ed.2d 468 (1992), and *In re Stringer,* 847 F.2d 549 (9th Cir. 1988).

Maxine Slater, represented by University Legal Assistance, argued that child support and alimony debts are insulated from mandatory inclusion in a Chapter 13 plan, are excepted from discharge, and are not subject to the automatic stay, relying on *In re Pacana,* 125 B.R. 19 (9th Cir 1991) and *In re Engel,* 151 B.R. 542 (Bankr. D. Idaho 1993), a post-*Ankenbrandt* decision.

The State of Washington, Department of Social and Health Services, Division of Child Support, asserted child support arrearages may be included in a Chapter 13 plan as long as the court is not issuing a decree of support, alimony or child custody, or interfering with a state court remedy or pending state action. Additionally, the state argued that the bankruptcy court should include provisions for interest in accordance with the state court judgment.

The Chapter 13 trustee submitted that since section 1306(a) includes all post-petition earnings as property of the estate, and the debtor's plan provides for postponing the vesting of property in the debtor until discharge or dismissal, the section 362(b)(2) exception which permits collection of alimony and support from property that is not property of the estate does not apply. The trustee argued, based on *Stringer,* that the court should overrule Maxine Slater's objection insofar as she claims the debt owed to her is outside the scope of a Chapter 13 plan. The Chapter 13 Trustee cited *In re Gonzales,* 172 B.R. 320 (DC E.D. Wash. 1994) for the proposition that *Pacana*is not binding authority in this district.

I. To what extent do federal courts have jurisdiction over domestic relations cases and issues?

The Supreme Court, in *Ankenbrandt v. Richards,* 504 U.S. 689 (1992), held the Constitution does not exclude all domestic relations matters from the jurisdiction otherwise granted by statute to the federal courts. The *Ankenbrandt* court limited federal jurisdiction to the enforcement of a state court decree, precluding authority to either grant or modify a divorce or alimony decree.

Since *Slater* was argued before this Court, the Bankruptcy Reform Act of 1994 was enacted. Although the new Act applies to cases filed after October 1994, the court found it instructive as to Congress' intent on the issue of bankruptcy court jurisdiction in domestic relations matters. Various sections of the code were amended to increase the protection the Code offers for alimony and child support. Significantly, the automatic stay will not apply to the establishment or modification of child support orders or to the collection of such payments from non-estate property.

II. Can a debtor separately classify a non-dischargeable unsecured claim without priority?

Again, the Bankruptcy Reform Act of 1994, even though inapplicable to this case, resolved this issue and provides that child support debt is given seventh priority under Section 507(a). Additionally, Chief District Judge Quackenbush decided *Gonzales, supra,* which addressed the issue of whether separate classification of child support debt constitutes unfair discrimination. After considering *Pacana,* the Court noted that "No previously-mentioned case discussing the inclusion of child support in a Chapter 13 plan directly binds this court," and ruled that separate classification for child support is not unfair in light of the non-dischargeability of child support, society's strong interest in having child support paid in full, and the debtor's need to start fresh upon completion of the plan.

Based on the foregoing, the Court concluded that it has the authority to include child support arrearages in a Chapter 13 plan, and adopted the rationale for including the support payments as set forth in *Gonzales.* Additionally, the court concluded that the inclusion of the child support arrearages complies with the requirements of 11 U.S.C. § 1325.

III. Is post-petition interest required to be paid in a Chapter 13 plan on an unsecured, non-dischargeable debt?

As the court had already noted, *Ankenbrandt* held that federal courts do not have jurisdiction to modify divorce, alimony or custody decrees.

The Findings of Fact and Conclusions of Law and Order issued from the superior court in this case indicated that the principal judgment and attorney's fees, costs, and other recovery amounts will bear interest at 12 percent per annum. RCW 4.56.110(2) stats that all judgments for unpaid child support that have accrued under a superior court order shall bear interest at the rate of twelve percent. And, in *Marriage of Glass,* 67 Wn.App. 378 (1992), the court held a court has no power to decline to award the full amount of statutory interest due on a judgment for overdue child support and/or maintenance. Clearly Washington law anticipates child support and maintenance will include interest.

Under the Bankruptcy Code, unsecured creditors are not ordinarily entitled to include unmatured post-petition interest as part of their claims. 11 U.S.C. 502(b)(2). However, the Supreme Court, in *Brunning v. United States,* 376 U.S. 358, 84 S.Ct.906, 11 L.Ed.2d 772 (1962), distinguished between the concepts of the denial of post-petition interest against the estate and the accrual of interest on a non-dischargeable debt during the pendency of a bankruptcy collectable after the conclusion of the bankruptcy proceeding. The Supreme Court held in *Brunning* that for varying policy reasons, if a debt was non-dischargeable, post-petition interest on that debt would also be non-dischargeable. Although *Brunning* is a pre-Code case, its authority on this issue has been applied by other appellate courts to cases arising under the Code. *See Leeper v. Pennsylvania Higher Education Assistance Agency,* 39 F.3d 98 (3d Cir. 1995).

The *Brunning* decision allowing post-petition interest to accrue against the debtor has also been followed in the context of a Chapter 13 proceeding. *Leeper, supra.* In *Leeper,* the Third Circuit Court of Appeals ruled that even though the accrual of interest may result in a Chapter 13 debtor emerging from bankruptcy owing more than at the time of filing his petition, post-petition interest may accrue as to the debtor personally while a bankruptcy is pending.

The court concluded therefore, that even though the debtor's plan does not provide for interest on the non-dischargeable child support debt, the plan is confirmable because the interest may continue to accrue against the debtor to be recovered from the debtor personally at the conclusion of the case. Furthermore, prior to the Reform Act there was no requirement that the non-dischargeable debt — with or without interest — be paid in full during the pendency of the case.

IV. Are attorney's fees awarded to Ms. Slatler to be paid to University Legal Assistance as the attorney for the judgment creditor non-dischargeable?

RCW 26.09.160(1) mandates an award of reasonable attorney's fees to the aggrieved party enforcing a decree of dissolution. The United States Bankruptcy Appellate Panel in *Matter of Gwinn,* 20 B.R. 233 (9th Cir. BAP 1982) chose to follow the line of cases that held a claim for attorney's fees awarded to the debtor's wife's attorney in a divorce action is non-dischargeable pursuant to 11 U.S.C. § 523(a)(5) even though the debt was payable directly to the attorney. However, in *In re Gibson,* 103 B.R. 218 (9th Cir. BAP 1989), the Court held that for dischargeability purposes, the Bankruptcy Court must look at the intent of the parties and the substance of the obligation as well as other factors such as the need of the recipient spouse and the relative incomes of the parties to determine whether or not the obligation is in the nature of alimony, maintenance or support, and thus dischargeable. Similarly, Judge Quackenbush, in *Dahlin v. Nagy,* U.S. District Court, E.D. Wash., No. CS-94-077-JLQ, held guardian ad litem fees are non-dischargeable as they too are in the nature of support.

Applying the law to mthe facts at hand, the court noted that Ms. Slater's need for support was evidenced by the fact that she could not afford an attorney but rather needed the assistance of University Legal Services. As noted above, the payment of the fees to a third party is not in and of itself sufficient to exclude the payment from the 523(a)(5) exception to dischargeability. The court therefore found the attorney's fees to be in e nature of support and non-dischargeable.

V. Does the dischargeability status of a debt secured by a lien affect the debtor's right to avoid the lien?

The debtor applied to avoid the judicial lien of University Legal Assistance on his residence. Ms. Slater objected to the debtor's notice asserting the award of attorney's fees was for costs and representation for the enforcement of support moneys owed by the debtor and are therefore not dischargeable. The issue addressed was whether the dischargeability status of a debt secured by a lien affects the debtor's right to avoid the lien.

11 U.S.C. 522(f)(1) states the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent the lien impairs an exemption to which the debtor would have been entitled if the lien is a judicial lien. Here it is undisputed University Legal Assistance holds a valid judicial lien. The inquiry, then, was whether University Legal Assistance's lien impaired an exemption to which the debtor would have been entitled.

Section 522(b) states that an individual debtor may exempt property listed in either paragraph (1) or (2) of that subsection. Property exempted is not liable during or after the case for any debtor of the debtor *except* a debt of the kind specified in section 523(a)(1) (taxes), or section 523(a)(5) (alimony, child support or maintenance). 11 U.S.C. 522(c).

Several courts have held a debtor's avoidance powers are not conditioned upon whether the underlying debt is non-dischargeable. *In re Ash,* et al., 166 B.R. 202 (Bkrtcy. D.Conn. 1994). A few courts have found that §522(f) can be used to avoid liens on exempt property secured by non-dischargeable debts not specifically protected by §522(c). *In re Evaul,* 152 B.R. 31 (Bankr. W.D. N.Y. 1993). Other courts have found a conflict between the provisions of section 522(f) and 522(c), and have allowed judicial liens to be avoided under 522(f) even where the underlying debt was found to be non-dischargeable pursuant to section 523(a)(5). Henry J. Sommer & Margaret Dee McGarity, *Collier Family Law and the Bankruptcy Code,* section 7.03(5) and 7.04 et. al. (Lawrence P. King, ed., 1993).

This Court was cognizant of RCW 6.13.080 which states that the homestead exemption is not available against execution or forced sale in satisfaction of judgments obtained on debts arising from a lawful court order or decree or administrative order establishing a child support obligation or obligation to pay spousal maintenance. RCW 6.13.080(4). Applying state law, the Court noted one could arguably conclude that the lien of University Legal Assistance does not impair an exemption to which the debtor would have been entitled.

However, in *Owen v. Owen,* 500 U.S. 305, 111 S.Ct. 1833, 114 L.Ed.2d 350 (1990), Justice Scalia held a judicial lien could be avoided under the bankruptcy statute as impairing the debtor's state law exemptions, even though the state had defined exempt property in such a way as to specifically exclude property encumbered by the lien. The import of *Owen* was that to avoid liens in bankruptcy, one looks to federal law for the exempt status of the property.

The Court found most persuasive the argument made in *In re DeCosmo,* 163 B.R. 227 (Bkrtcy. W.D. N.Y. 1994) that because 11 U.S.C. 522(c) specifically enumerates certain non-dischargeable pre-petition debts for which exempt property is liable, Congress clearly intended the avoidance powers of 522(f) to be used to avoid judicial liens on exempt property secured by non-dischargeable debts *not* specifically protected by section 522(c). This analysis accommodates the Supreme Court ruling in *Owen* that federal law applies to determine the exemption status of property of the estate, and it conforms to the policy inherent in the Washington homestead exemption statute of excepting otherwise exempt property from judicial liens for child support, maintenance and alimony.

Therefore, the Court concluded that the judicial lien of University Legal Assistance was for a non-dischargeable debt pursuant to 522(a)(5) and did not impair an exemption pursuant to 522(c). The application to avoid the lien was denied.

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To join the Bankruptcy Section send $25 annual dues and your name and address to:
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Notes Has New Editor

Please welcome the new Editor of *Eastern Washington Bankruptcy NOTES.* He is **Gary Farrell** of the Office of the Assistant U.S. Trustee in Spokane. Please lend him your support by submitting articles and information, and by offering your suggestions for ways *Notes* can be more helpful to you in your practice. Of course, not all suggestions can be implemented, but many are possible. Our goal is to be as helpful to you as we can. You will find Gary's address and phone numbers in the roster of board members to the left.

Thanks to "retiring" editor. We express our heartfelt appreciation to **Matt Anderton** of the Velikanje firm in Yakima for the tremendous effort he has put into editing *Notes. Thanks, Matt!*

Help the Section grow

Invite a new member

Your contributions are welcome

Have you had a particularly interesting case? Perhaps it's a trend-setter. Perhaps it even makes new law. Or maybe you've accidentally fallen into a trap that you can help other practitioners avoid.

We encourage submissions for the edification of the bankruptcy bar. If you are considering writing an article for *Notes,* contact Editor Gary Farrell, Office of the Assistant U.S. Trustee, 920 W. Riverside #593, Spokane, WA 99201, (509) 353-2999.

Foreclosure and Realizing on Collateral: The Seven Deadly Sins

By Cassondra E. Joseph, Esq., Bellevue, Washington

Of all the areas that generate litigation under the Uniform Commercial Code ("UCC" or "Code"), the most active is for alleged violations by secured creditors of Part 5 of UCC Article 9 ("Part 5"), the rules that govern defaults under security interests. This article discusses how to help your creditor client avoid - or at least minimize - judicial review of his/her actions when realizing and foreclosing on collateral or, concomitantly, help your debtor client obtain judicial relief from such conduct. Part 5 is designed to deter creditor misbehavior. By clearly understanding Part 5 requirements, your client can structure transactions, and enforce rights under those transactions, to avoid what I characterize as "The Seven Deadly Sins."

The Seven Deadly Sins permeate all secured transactions. Committing any one of these sins will likely subject your creditor client - or entitle your debtor client - to a damage claim for violations of the Part 5 rules. The use of "living" collateral to finance agricultural transactions makes Part 5 compliance more complicated. When negotiating a workout involving, or foreclosing on, agricultural collateral, awareness of The Seven Deadly Sins prevents liability. These Sins are:

#1: Defining Default - Know Your Collateral
#2: Review Your Documentation Before Declaring a Default
#3: Know Your Competition: UCC and Other Lien Searches, Due Diligence and Appraisals Post-Default
#4: Breach of the Peace
#5: Notice
#6: Commercial Reasonableness Factors
#7: Sureties (Guarantors and Accommodation Parties)

Planning Stage: Due Diligence Prior to Closing

Sin #1: Defining Default - Know Your Collateral

Avoiding trouble starts at the documentation stage, by undertaking appropriate due diligence and drafting your documents with a view to avoiding The Seven Deadly Sins. In agricultural financing, as with all lending, the secured creditor must know his/her debtor and the nature of the collateral securing the debt at the planning stage. Corporate due diligence should be undertaken. *See, e.g., McCall Stock Farms, Inc. v. United States,* 14 F3d 1562 (Fed. Cir. 1993) (summary judgment granted to SBA using common law alter ego theory to reverse-pierce the corporate veil upheld on appeal; corporate farm debtor held liable for debts of its shareholders).

It is important to know, with specificity, how the debtor markets the collateral subject to the security interest and impose appropriate monitoring controls. This is also the time to identify any special requirements, *e.g.*, feeding livestock, pregnant animals, growing crops, flood and hail damage insurance. The security agreement can authorize the secured creditor to operate the business in default, but doing so exposes the creditor to liability to trade creditors or a tort action for malicious interference with business relationships. It may be the only viable option, however, if the default occurs during the growing season and the crops must be harvested to preserve the value of the collateral.

As we all know, the Code does not define "default," allowing the parties to define that term in their security agreement to suit their particular transaction and/or reflect their bargaining power. *Foster v. Knutson,* 84 Wash. 2d 538, 527 P2d 1108, 15 UCC Rep Serv 1127 (1974). In addition to defining default, it is also important for secured creditors to take advantage of two other options available if, and only if, provided for in the security agreement. Upon default, under §9-503, the debtor can be required to assemble the collateral at a mutually convenient place. Attorneys' fees incurred by the secured creditor when disposing of repossessed collateral can be charged to the debtor, both as a first priority to the sale proceeds, and if the debtor chooses to redeem the collateral prior to its disposition (§§9-504(1)(a) and 9-506). If the potential default is large enough, the security agreement should also authorize the secured creditor to engage specialists, for which the borrower pays, to monitor the borrower's financial and operational status. At the very least, the security agreement should provide for increased monitoring requirements when the loan hits problem status.

The security agreement should define "default" broadly. Events of default can include both payment and performance breaches. Payment breach can be defined to occur upon the failure to pay principal or interest, other obligations, whether or not cross-collateralized, including overdrafts, insurance and taxes. Performance obligations can include maintaining the collateral, cultivating and tending crops and feeding animals, including the right to hire others to perform such services if the debtor fails to do so, the death, dissolution or insolvency of the debtor and the violation of a negative pledge clause. An insurance obligation clause should require the debtor to name the secured creditor as a loss payee. The secured creditor should also have the right to pay the debtor's delinquent insurance and tax premiums, and hire others to maintain the collateral, if appropriate, and charge these expenses to the unpaid debt.

Often overlooked is the need for insecurity and acceleration clauses in both the note and security agreement. An insecurity clause allows the secured creditor to declare a default upon his/her good faith belief that the prospect of payment, performance and/or realization of collateral under the security agreement is impaired (§1-208). Two requirements bolster the advantages conferred by an insecurity clause: the burden of establishing the lack of good faith is on the debtor and good faith in this context is measured by the subjective standard set forth in Article 1 (§1-201(19)). Since courts generally construe both insecurity and acceleration clauses strictly, well-drafted insecurity clauses should cover both the debt and the collateral, triggering the right to accelerate.

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Foreclosure and Realizing on Collateral *cont'd*

Section 1-208 does not apply to a demand note, allowing a secured creditor to avoid insecurity and acceleration issues. However, the creditor may be estopped if, when the demand note is executed or thereafter, he/she has promised that demand will not be made other than upon the failure to make a payment or other default.

Acceleration rights are not automatic. *See, e.g., Badgett v. Security State Bank,* 116 Wash. 2d 563 (1991); *Seattle First National Bank v. Westwood Lumber, Inc.,* 65 Wash. App. 811 (1992); Redding v. Rowe, 36 Wash. App. 822, 678 P2d 337 (1984); *Producers Livestock Production Credit Ass'n of Chippewa Falls v. Equity Coop. Livestock Sales Ass'n,* 82 Wis. 2d 5, 261 NW2d 127, 23 UCC Rep Serv 520 (1978). A secured creditor has the right to repossess collateral without first accelerating and the right to accelerate can be exercised after repossession. Thus, the definition of default should be linked to the acceleration clause. Debtors often attempt to reverse an acceleration by asserting an estoppel or waiver defense. Note that an anti-waiver clause in the security agreement can itself be waived by course of performance (*see* Sin #2, *infra*).

Care should be taken not to draft clauses that impair what the Code characterizes as non-waivable debtor default protections, although the security agreement may specify the standards that govern the creditor's compliance with such debtor rights. These rights are an accounting for surplus foreclosure sale proceeds; notice; compliance with commercial reasonableness factors; strict foreclosure; redemption of repossessed collateral; and remedies for violations of the above (§9-501(3)). *See, e.g., Boatmen's Bank of Nevada v. Dahmer,* 716 SW2d 876, 2 UCC Rep Serv 2d 754 (Mo. App. 1986); *In re Jones,* 107 BR 888, 10 UCC Rep Serv 2d 1043 (Bankr. N.D. Miss. 1989).

Problem Loan Stage: Getting Ready to Declare a Default

Sin #2: Review Your Documentation Before Declaring a Default

Before attempting to negotiate a workout or declare a default, creditors should review all of their loan documentation, including guarantees, and the Part 5 rules. A complete legal audit of the file is warranted, with emphasis on documentation problems.

Your security agreement should contain default provisions that support the early warning system you have developed to track problem credits. Clues that problems may be brewing include missed payments; breach of major loans covenants; attachments against the borrower's assets; the appointment of a receiver, a partial assignment for the benefit of creditors, bankruptcy or other insolvency; filing of tax and other liens; lawsuits; sales of assets out of the ordinary course of business; favorable pricing changes by borrower indicating a desperate need to raise cash; increased price competition; overdraft and temporary overdraft activity; changes in borrowing patterns; changes in payment patterns, transfers of accounts to other banks; late delivery of financial statements; accounts payable agings indicate deterioration; unfavorable changes in key financial indicators; departures of key personnel; unreasonable denial of information by the borrower; excessive lifestyle; adverse regulatory developments; unexpected losses; and adverse changes in the borrower's business cycle. You probably have a more extensive list.

A recurring problem is conduct by the secured creditor that may be deemed a waiver of his/her contractual rights. Waiver of rights is often held to have occurred if the secured creditor ignores rights, remedies and procedures contained in the security agreement. Prior to accelerating, a secured creditor should review both the loan documents and his/her business records to determine if waiver arguments can be plausibly asserted. *See, e.g., Ottumwa Production Credit Ass'n v. Keoco Auction Co.,* 347 NW2d 393, 38 UCC Rep Serv 624 (Iowa Sup. Ct. 1984). If so, place debtor on notice of "strict compliance" in writing. *See, e.g., First State Bank v. Shirley AG Service, Inc.,* 417 NW2d 448, 5 UCC Rep Serv 2d 172 (Iowa 1987).

Part 5 provides additional protections, which some secured creditors also draft into their security agreements. Default rights and remedies are cumulative, *see, e.g., Butte County Bank v. Hobley,* 109 Idaho 402, 707 P2d 513, 42 UCC Rep Serv 762 (Idaho App. 1985), although courts are split on whether alternative remedies can be pursued concurrently. *Compare Glamorgan Coal Corp. v. Bowen,* 742 F. Supp. 308, 13 UCC Rep Serv 2d 596 (W.D. Va. 1990) (applying Ariz. law); *Bank One Akron, N.A. v. Nobil,* 80 Ohio App. 3d 638, 610 NE2d 538, 20 UCC Rep Serv 2d 1318 (1992) (following *Bowen,* while recognizing that case law in other states is split as to what extent a creditor may pursue more than one remedy simultaneously) with *Production Credit Ass'n of Mandan v. Obrigewitch,* 443 NW2d 923, 10 UCC Rep Serv 2d 253 (N. Dak. 1989) (only one remedy at a time).

The secured creditor can institute either a foreclosure or judicial procedure (§9-501(1) and (2)). Although time consuming and expensive, there are certain advantages to obtaining a foreclosure judgment by bringing an *in personam* action on the underlying debt. This is the option to consider when the secured creditor is undersecured and/or the debtor has other unencumbered and non-exempt assets. It avoids issues of breach of the peace (*see,* Sin #4, *infra*). The judgment relates back to date the security interest was perfected and the secured creditor may purchase the collateral at such a sale without further compliance with Article 9 (§9-501(5)). A disposition approved by judicial proceeding or bona fide creditors' committee is conclusively deemed commercially reasonable, but such approval does not have to be obtained nor is there any implication from a failure to obtain such approval (§9-507(2), last sentence). There is, however, a downside to judicial foreclosure because it is, after all, a plenary proceeding: due process requires a hearing prior to awarding a judgment. At the hearing, the debtor may raise defenses or claims, including breach of warranty, unless the creditor takes free from those defenses or claims as a holder in due course. The debtor may further assert counterclaims and setoff any recovery by the secured creditor against a judgment on those counterclaims.

A repossessing creditor must exercise due care while the collateral remains in its possession in accordance with §9-207 (§9-501(2)). When the security agreement covers both real and personal property, the secured creditor can choose the foreclosure rules of either (§9-501(4)). *Foster v. Knutson, supra,* 84 Wash. 2d 538, 527 P2d 1108, 15 UCC Rep Serv 1127 (1974). Section 9-502 provides collection rights to the secured creditor by notification to the borrower's account debtors. *Wagner v. Glasgow Livestock Sales Co.,* 222 Mont. 385, 722 P2d 1165, 5 UCC Rep Serv 2d 1225 (1986). Generally, such a clause is also included in the security agreement.

Sin #3: Know Your Competition: UCC and Other Lien Searches, Due Diligence and Appraisals Post-Default

Before foreclosing, a secured creditor should ascertain its competition for the debtor's assets. This is the time to update your

Foreclosure and Realizing on Collateral *cont'd*

UCC and other lien searches, undertake due diligence to find out what has happened since the loan was made and order an appraisal of the collateral. Prepare a viability and liquidation analysis of the borrower. Insist on the early development of a detailed business plan by the borrower that includes a real estate workout and options available to solve the debtor's short-term problems, especially immediate cash needs. This is the time to cure documentation problems and obtain new collateral, guarantees and a current list of collateral. Obtain a marketing analysis to identify potential buyers and markets for the debtor's products. All of these will permit the secured creditor to assess the debtor's ability to get additional financing, including equity or subordinated debt, restructure the debt, whether subordinated and unsubordinated, long-term and short-term, secured and unsecured, or whether special inducements to trade creditors will allow the debtor to complete his/her production cycle. Rather than foreclosing on all of the debtor's assets, sometimes a selective sale of assets, including entire divisions of the business, may be sufficient.

By determining priorities to the collateral (or its proceeds) prior to initiating foreclosure procedures, a secured creditor can minimize the risk of Part 5 violations by notifying a competing creditor with a paramount interest of the default and permitting that creditor to conduct the disposition. *Raasch v. Tri-County Trust Co.,* 712 SW2d 5, 2 UCC Rep Serv 2d 294 (Mo. App. 1986); *Glamorgan Coal Corp. v. Bowen, supra,* 742 F. Supp. 308, 13 UCC Rep Serv 2d 596 (W.D. Va. 1990) (applying Ariz. law); *AgriStor Credit Corp. v. Unruh,* 571 P2d 1220, 23 UCC Rep Serv 241 (Okla. 1977) (prior perfected security interest took priority over subsequently created agisters' liens (for feed)); *Bank of Stockton v. Diamond Walnut Growers, Inc.,* 199 Cal. App. 3d 144, 244 Cal. Rptr. 744, 5 UCC Rep Serv 2d 1147 (1988) (defendant marketing association had priority over the plaintiff bank as the first to file). Knowing your competition allows a secured creditor to comply with the protections Part 5 provides to competing security interest holders. Most important is the right of any of the debtor's other secured creditors to notice of the disposition of the collateral by the repossessing creditor. This is done by simply notifying the repossessing creditor in writing of the competing interest before the repossessing creditor has notified the debtor of its intended disposition or before the debtor purportedly renounces his/her rights to such notice (*see* Sin #5, *infra*). This rule applies to both foreclosure sales and strict foreclosures. Failure of the repossessing creditor to comply with this notice requirement will subject the repossessing creditor to damages (§§9-504(3), 9-505(2) and 9-507(1)). A subordinate security interest holder also becomes entitled to undistributed disposition proceeds by notifying the secured creditor conducting the disposition of its interest in writing before the distribution of proceeds is completed (§9-504(1)(c)).

An appraisal can be made either prior to or immediately after repossession. Many secured creditors resist incurring these expenses on the premise of not throwing good money after bad. But when your attempt to obtain a deficiency judgment in court is challenged by the debtor, appraisal evidence goes a long way to establishing compliance with the commercial reasonableness rules, both as to foreclosure price and procedures. *Bankers Trust Co. v. Dowler & Co.,* 47 NY2d 128, 417 NYS2d 47 (1979) (commercial reasonableness turns on both the actual procedures employed and optimizing the resale price).

Foreclosure Issues

Sin #4: Breach of the Peace

A secured party's right to repossession accrues immediately upon default under the security agreement. This triggers the creditor's right to take possession of the collateral without breach of the peace (§9-503). Prior notice to the debtor of the impending seizure is neither required nor advisable. Upon repossession, the creditor must exercise due care in the storage and handling of the collateral under §9-207, which, unless otherwise provided in the security agreement, includes the payment of taxes and insurance coverage. *(See also,* Sins #1 and #2, *supra.*) To buttress its position that it acted in a commercially reasonable manner and meet its due care duties, the secured creditor should take an inventory of the repossessed collateral as soon after repossession as feasible. Note that a debtor's breach of warranty claim is not a defense to repossession.

Self-help repossession should not be attempted where the debtor's prior conduct indicates that a likelihood of violence exists. Section 9-503 assumes that self-help repossessions will occur without the debtor's consent. In determining when a creditor's trespass constitutes a breach of the peace, courts rely principally on two factors: (1) the potential for immediate violence; and (2) the nature of the premises where the intrusion occurs. *Cottam v. Heppner,* 777 P2d 468, 9 UCC Rep Serv 2d 805 (Utah 1989); *Massey Ferguson Credit Corp. v. Peterson,* 102 Idaho 111, 626 P2d 767, 31 UCC Rep Serv 747 (1980) (no breach of the peace by repossessing creditor who cut a padlock belonging to the third party where combine was stored when there was no protest by the third party); *Madden v. Deere Credit Services, Inc.,* ___So.2d ___, 16 UCC Rep Serv 2d 903, *substituted op. on other issues,* 598 So.2d 860, 18 UCC Rep Serv 2d 973 (Ala. 1992) (jury should determine whether breaking a padlock on a gate to repossess timber-cutting equipment was a breach of the peace).

Third parties can be hired by the secured creditor to repossess the collateral, but the creditor generally remains liable for their conduct under agency principles. Unless executing a judgment, however, the secured creditor should not retain law enforcement officials in uniform to conduct the repossession. In the by-now notorious case of *Stone Machinery Co. v. Kessler,* 1 Wash. App. 750, 463 P2d 651, 7 UCC Rep Serv 135 (1970), the secured creditor was accompanied by the sheriff of the county where the tractor was located when repossession occurred. Although not actively participating in seizing the collateral, the sheriff was in uniform and wearing his badge and sidearms. The court held that the debtor had a right to obstruct, by all lawful and reasonable means, any attempt to repossess the tractor forcibly. The sheriff's presence prevented the debtor from acting to protect his interests and amounted to constructive force, intimidation and oppression. As a result, the secured creditor was held to have committed a breach of the peace and the debtor was awarded damages for conversion. *See also, Hilliman v. Cobado,* 131 Misc. 2d 206, 499 NYS2d 610, 1 UCC Rep Serv 2d 327 (Sup. Ct. 1986). Deceit or trickery by the secured creditor is not unlawful. *Pleasant v. Warrick,* 590 So. 2d 214, 17 UCC Rep Serv 2d 1343 (Ala. 1991).

Recognizing the cost effectiveness of self-help, one court held that a failed attempt by the secured creditor to foreclose did not constitute a waiver of the creditor's rights to repossess the collateral. *Farmers Production Credit Ass'n v. Arena,* 145 Vt. 20, 481 A2d 1064, 39 UCC Rep Serv 245 (1984). Another court held that the *debtor* was liable in conversion when the debtor, after default, refused to surrender the collateral, regardless of whether defendant's original taking was wrongful. *Production Credit Ass'n of Madison v. Nowatzski,* 90 Wis. 2d 344, 280 NW2d 118, 26 UCC Rep Serv 1338 (1979).

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Foreclosure and Realizing on Collateral *cont'd*

Sin #5: Notice

A debtor has a non-waivable right to notice under the Code in several situations. Notification to the debtor (and other creditors) is required when the secured creditor either seeks to sell the repossessed collateral (§9-504(3)) or proposes to retain collateral in full satisfaction of the debt, *i.e.*, "strict foreclosure" (§9-505(2)). Interestingly, Article 9 does not expressly require notice to the debtor to protect redemption rights. Despite Article 9 authorization to obtain a post-default written waiver of notice from a debtor, it is questionable whether any secured creditor should rely on that waiver meeting the common law requirements that it be given "knowingly, willingly and intelligently." *Cf.* §1-103.

Sale or Other Disposition

Section 9-504(3)'s notice requirements are designed to give a debtor an opportunity to protect its interests at a foreclosure sale or other disposition. The failure to give notice constitutes conversion. *Davis v. Huntsville Production Credit Ass'n*, 481 So. 2d 1103, 42 UCC Rep Serv 1863 (Ala. 1985). A defective notice raises the claim that the sale was not commercially reasonable (*see* Sin #6, *infra*). Notice only has to be sent: the debtor does not have to receive it. *Swanson v. May*, 40 Wash. App. 148, 697 P2d 1013, 41 UCC Rep Serv 274 (1985); *Altman Tractor & Equipment Co. v. Weaver*, 288 S. Car. 449, 343 SE2d 444, 1 UCC Rep Serv 2d 599 (1986) (notice requirements satisfied when notice sent by registered mail, with return receipt signed by a third party, even though debtor never actually received the notice). *Compare, Bailey v. Navistar Financial Corp., supra*, 709 SW2d 841, 1 UCC Rep Serv 2d 1404 (Ky. App. 1986) (summary judgment denied because secured party did not meet its burden under §9-504(3) that notice of public sale sent by ordinary mail was commercially reasonable).

Notice is required of the time and place of any public sale and the time after which any private sale is to be made. The Code does not state the number of days by which the notice must precede the sale, and the parties are free to establish what constitutes a reasonable time period in the security agreement (*see* Sin #1, *supra*). Generally, a 10-day period is safe. Shorter periods are acceptable so long as those entitled to notice have sufficient time to take appropriate steps to protect their interests by taking part in the sale or other disposition; this includes finding potential buyers. Remember that notice must also be sent to other secured parties from whom the secured creditor has received written notice of a claim to the collateral, as discussed under Sin #3, *supra*. Although actual or constructive notice may be sufficient under certain circumstances, generally oral notice leads to litigation. Delays in conducting the sale on the notice day may lead a court to hold that the notice was defective or had become stale.

The Code recognizes four exceptions to the notice requirement:

[a] collateral is perishable;

[b] collateral threatens to decline speedily in value;

[c] collateral is customarily sold on a recognized market; or

[d] debtor has waived or modified the right to notice in writing after default (discussed unfavorably above).

Reliance on any of these exceptions is risky, especially for agricultural collateral, because courts don't like situations where the debtor is deprived of notice. The notice rules were intended to allow the debtor to monitor and participate in the foreclosure disposition to minimize the deficiency, ensure that the sale is conducted in a commercially reasonable manner and, perhaps, find a fair market buyer. At the very least, a secured creditor seeking to rely on these exceptions should research the current state of the law in his/her respective jurisdiction to determine how local courts have characterized particular types of collateral.

Even though much agricultural collateral is alive, most courts have held that it is not perishable for notice of foreclosure sale purposes. Cattle has been held not to be perishable because its value would not be materially affected by the delay resulting from proper written notification to the debtor. *See, e.g., Boatmen's Bank of Nevada v. Dahmer, supra*, 716 SW2d 876, 2 UCC Rep Serv 2d 754 (Mo. App. 1986) (secured creditor's failure to fatten the repossessed cattle for market as expected did not cause the cattle to become perishable collateral); *United States v. Mid-States Sales Co. Inc.*, 336 F. Supp. 1099, 10 UCC Rep Serv 703 (D. Neb. 1971) (two week time between repossession and auction was sufficient in which to notify junior lienholder of impending sale); *City Bank & Trust Co. v. Van Andel*, 220 Neb. 152, 368 NW2d 789, 41 UCC Rep Serv 282 (1985) (whether condition of cattle caused them to be "perishable" is a question of fact); *State Bank of Towner v. Hansen, infra*, 302 NW2d 760, 30 UCC Rep Serv 1493 (N. Dak. 1981) (notice should have been sent to the debtor during the 18 to 20 days in which cattle were repossessed by secured party prior to auction).

The "recognized market" exception is premised on the notion that a price in a recognized market represents the fair market value, making notice to the debtor unnecessary to protect him/her from an inadequate sale price. The courts are split on whether cattle is "customarily sold on a recognized market." *Compare First Nat. Bank of Minneapolis v. Kehn Ranch, Inc.*, 394 NW2d 709, 2 UCC Rep Serv 2d 399 (S. Dak. 1986) (majority relied on prices quoted on the commodity futures market; dissent argued that a livestock auction involved competitive bidding and cannot qualify as a "recognized market"); *Cottam v. Heppner, supra*, 777 P2d 468, 9 UCC Rep Serv 2d 805 (Utah 1989) (jury could find that the livestock auction where the cattle was sold constituted a "recognized market"); *Arcoren v. Peters*, 627 F. Supp. 1513, 42 UCC Rep Serv 1531 (D. S. Dak. 1986), *vacated on other grounds*, 829 F2d 671, 4 UCC Rep Serv 2d 956 (8th Cir. 1987) (*en banc*), *cert. den.*, 485 US 987, 99 L. Ed.2d 500, 108 S. Ct. 1290 (1988) (relying on *Kehn Ranch*, FmHA retained its qualified immunity despite its failure to notify debtor of sale because it has not been "clearly established" that cattle are not collateral of a type customarily sold on a recognized market, while acknowledging that South Dakota Supreme Court has held that commercial cattle raised for sale at public livestock markets are "collateral of a type customarily sold on a recognized market" under §9-504(3)) *with Wippert v. Blackfeet Tribe of Blackfeet Indian Reservation*, 215 Mont. 85, 695 P2d 461, 40 UCC Rep Serv 1589 (1985) (cattle not sold on a recognized market; reasonable notice of sale means at least 5 days' notice); *State Bank of Towner v. Hansen, supra*, 302 NW2d 760, 30 UCC Rep Serv 1493 (N. Dak. 1981). Nor is farm equipment collateral sold on a recognized market; *Walter Implement, Inc. v. Focht*, 42 Wash. App. 104, 709 P2d 1215, 42 UCC Rep Serv 356 (1985), *rev'd in part on other grounds*, 107 Wash. 2d 553, 730 P2d 1340 (1987).

If faced with a volatile grain market at the time of foreclosure, which may have precipitated the default, a secured creditor should be prepared to document those market conditions. In *Moutray v. Perry State Bank*, 748 SW2d 749, 7 UCC Rep Serv 2d 1340 (Mo. App. 1988), the appellate court held that the evidence supported the trial court's determination that the market value of the collateral, milo, a grain used primarily as feed for livestock, was likely to decline rapidly.

Strict Foreclosure

Notice is also required when a secured creditor wants to retain the collateral in full satisfaction of the debt, without the right to seek a deficiency judgment (§9-505(2)). Strict foreclosure of collateral is the statutory analogue to the common law rule of accord and satisfaction. Since the secured creditor is not seeking a deficiency, eliminating price as an issue, courts reviewing a strict foreclosure place heavy emphasis on procedural compliance.

Implementation of this option requires the secured creditor to provide written notice to the debtor, and others claiming an interest in the collateral, of such intent. As discussed above, in theory, the debtor can waive or modify his/her right to notice in writing after default. The debtor and the other claimants then have 21 days within which to object in writing to the strict foreclosure proposal. If proper objection is received, the secured creditor must dispose of the collateral under §9-504.

Courts have taken three approaches in determining whether a secured creditor who has held repossessed collateral for a period of time should, absent notice to the debtor of that intention, be deemed to have elected strict foreclosure:

[a] election can not be implied, since the Code requires notice;

[b] election can be implied if retention is for an "unreasonably" long period, as determined by a jury; or

[c] proof of a manifest intent to elect is required.

Note that some courts have deemed strict foreclosure to occur when there has been a conversion of the collateral by the repossessing creditor.

Sin #6: Commercial Reasonableness Factors

Upon default, a secured creditor may dispose of the collateral, including by sale or lease, in its then condition or following any commercially reasonable preparation (including assembly by the debtor, if the security agreement so provides; *see* Sin #1, *supra*). *Grant County Tractor Co., Inc. v. Nuss,* 6 Wash. App. 866, 496 P2d 966, 10 UCC Rep Serv 1104 (1972). After the foreclosure sale or other disposition, the secured creditor must account to the debtor for any surplus, but more likely, the debtor remains liable for any deficiency. The disposition may be public or private, by one or more contracts and as a unit or in parcels. The secured creditor may buy-in the collateral at a public foreclosure sale or at a private sale if the collateral is either customarily sold on a recognized market or the subject of widely distributed standard price quotations. A purchaser at a foreclosure sale obtains title as a good faith purchaser for value, cutting off the debtor's rights and discharging the security interest (§9-504(4)).

What is critical is that every aspect of the disposition be commercially reasonable as to method, manner, time, place and terms. To establish compliance with these requirements, a secured creditor should keep detailed records of all efforts to arrange the sale or other disposition, find interested buyers, assess market conditions, arrange redemption, etc., including phone logs. Commercial reasonableness requires a secured creditor to prove that the procedures used met the five factors (§9-504(3)) and that reasonable efforts were made to optimize the resale price (§9-507(2)). Under the current proposed version of Revised UCC Article 9, a guarantor who does not provide collateral may waive the right to a commercially reasonable sale.

According to §9-507(2), a sale or other disposition is commercially reasonable when the collateral is sold:

[a] in the usual manner on a recognized market;

[b] at price current in such market; and

[c] in conformity with reasonable commercial practices among dealers for that type of property.

The fact that a better price could have been obtained using a different resale time or method does not of itself establish that the sale was commercially unreasonable. A secured creditor does not have to accept a credit transaction at foreclosure over cash, even if the credit price is higher, for the sale to be commercially reasonable. As stated above, although a disposition approved by a judicial proceeding or a bona fide creditors' committee is conclusively deemed commercially reasonable, such approval does not have to be obtained nor is there any implication from the failure to obtain such approval.

Redemption Rights

The debtor also has the right to redeem the collateral prior to its disposition. Debtor's redemption rights under §9-506 are protected by certain procedural requirements, which are less stringent than the §9-504(3) commercial reasonableness criteria. To redeem, the debtor must tender full payment of the underlying obligation and the reasonable expenses incurred by the secured creditor in repossessing the collateral and preparing for its sale. Creditors should cooperate with debtors attempting to redeem and provide them with currently available information. *United States Nat. Bank of Oregon v. Boge,* 102 Or. App. 262, 794 P2d 801, 12 UCC Rep Serv 2d 16 (1990), *aff'd in part and remanded,* 311 Or. 550, 814 P2d 1082, 15 UCC Rep Serv 2d 24 (1991). Reasonable attorneys' fees are permissible to the extent provided in the security agreement and not prohibited by law.

Sin #7: Sureties (Guarantors and Accommodation Parties)

Most courts now define a guarantor as a "debtor" because he/she "...owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral,..." (§9-105(1)(d)). *See, e.g., McChord Credit Union v. Parrish,* 61 Wash. App. 8 (1991). The simplest way to avoid problems is to treat all sureties as though they were debtors. Anything discussed above applies with equal force to any sureties. Given the special treatment of farms and farmers under the law, courts often require greater adherence to formalities to protect farmers who act as sureties for their business loans. Notice should be sent to both the business and each guarantor, even if they are married and even if they are all to be found at the same address. At a minimum, all notices to a guarantor must mention the guarantee and also state that the guarantor will remain liable for any deficiency remaining after the sale. *Deutsche Credit Corp. v. Hi-Bo Farms, Inc.,* 224 Neb. 463, 398 NW2d 693, 2 UCC Rep Serv 2d 1479 (1987). Note that the Code provides subrogation rights to guarantors and others to whom collateral is transferred by the secured party (§9-504(5)).

* * * * *

When a secured creditor commits any of The Seven Deadly Sins, he/she risks liability for non-compliance with Part 5. Damages are based on two theories: conversion or breach of contract under §9-507(1) for "any loss" resulting from improper repossession and foreclosure. Conversion is a tort and is subject to a 3 year statute of limitations. *See, e.g., Sherwood v. Bellevue Dodge Inc.,* 35 Wash. App. 741, 669 P2d 1258 (1983). The measure of damages for conversion is the value of the debtor's interest in the property. *Borg-Warner Acceptance Corp. v. Scott,* 86 Wash. 2d 276, 543 P2d 638, 18 UCC Rep Serv 827 (1975).

A breach of contract claim is generally subject to a 6 year statute of limitations. Courts have articulated three competing rules for what constitutes the appropriate sanction when a secured creditor breaches his Part 5 duties. California, Montana and Wyoming apply the "absolute bar" rule, which denies the creditor a deficiency judgment no matter what the reason for the violation, or how minimal it may be. A second approach allows the debtor to set-off the losses caused by an improper foreclosure against the deficiency judgment. The emerging approach, and the one currently recommended in the latest draft of Revised Article 9, is applied by the courts of Washington, Idaho and Oregon. Known as the "rebuttable presumption rule," it presumes that the fair market value at time of repossession equals the outstanding debt. This can be rebutted by the secured creditor, which is why obtaining an appraisal after default is a worthwhile investment (*see* Sin #3, *supra*).

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Incorporating the lessons of The Seven Deadly Sins into your lending practices will minimize conduct that courts could characterize as creditor misbehavior. Although this will not prevent debtor challenges to your foreclosure actions, it will limit your exposure to sanctions for violations of Part 5. The goal is to implement the traditional pillars of lending by protecting the "bargain" of a secured loan: Character, Capacity *and* Collateral.

Position Vacancy

Temporary Law Clerk/Secretary

The United States Bankruptcy Court for the Eastern District of Washington is seeking applications for the position of Temporary Law Clerk/Secretary to the Honorable John M. Klobucher. This position is located at 302 U.S. Post Office Bldg., West 904 Riverside Avenue, Spokane, Washington. The term of this position runs from June 1, 1996 through July 1, 1997. This position is an "At Will" appointment and failure to perform at a satisfactory level may result in an appointee's removal from this position.

Position Overview. Applicants will be asked to provide legal advice and assistance to the court in connection with reviewing pleadings for hearings and in researching issues of federal and state law. Responsibilities will include working up files prior to hearing, processing ex parte orders, and assisting with the flow of work in chambers. The applicant's responsibilities will be coordinated by the senior law clerk.

Applicants will also serve as the judge's personal secretary and must have excellent typing and computer skills. Secretarial duties include making the judge's travel arrangements, compiling administrative reports, managing files, updating library materials, and contributing to efficient office management. The ability to work with the Bar and the public in an effective manner is essential.

Qualifications. Applicants should be law school graduates. Bar membership is not required. Additional legal work experience and/or education in the area of federal law or bankruptcy is not required.

Grade/Salary. JSP-9 to 11 ($29,405 to $35,578) depending on prior work experience. Forward detailed resumé to:

Julianne L. Taylor, Law Clerk
United States Bankruptcy Court
Eastern District of Washington
P.O. Box 2164
Spokane, WA 99210-2164

Closing Date for Receipt of Application: April 30, 1996

Applicants selected for interviews will be scheduled individually, but please contact Ms. Taylor if you will be in the Spokane area prior to May 1, 1996.

Bankruptcy Bar Association
Eastern District of Washington
P. O. Box 1219
Spokane, WA 99210-1219

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