

# Newsletter

Volume XXII, Number 1 Debtor-Creditor Section, Oregon State Bar Spring 2003

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By Gary Scharff

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Gary Scharff

Many thanks, members, for inviting me to serve as your chair this year. I look forward to working with you, and encourage you to contact me (telephone 503-493-4353; email [gs@scharfflaw.com](mailto:gs@scharfflaw.com)) with any thoughts you may have over the course of the year for improving the Section's services to you, the public, or our small corner of the legal world.

Let me begin with the tradition falling to the Section chair each January: I invite all members, especially new practitioners in the field, to look through the Section's eight standing committees, listed at the end of this column with their respective chairs for this year, and consider joining your colleagues for a year of service in one or more of those groups. Working with these committees affords opportunities to learn, to network with other attorneys and judges, to help develop our profession here in Oregon and to improve the quality of our services to our clients and the public.

The sight of an undertaker beaming when business is good does not warm the hearts of most people; we debtor/creditor lawyers are careful as we continue to move through "our" phase of the business cycle in Oregon. Calendar 2003 opens with somber economic news. According to US Bank

economist John Mitchell, as of the first of the year there has been no relenting in the state's high unemployment rate after six consecutive quarters of decline in business investment in Oregon. For three straight years our citizens' average net worth has declined. Perhaps most troubling, political and ideological divisions continue to compromise or paralyze our collective response to severe fiscal challenges - to public schools as well as state and local governments, including our state courts. Nor does it help to consider, as I write this column, that our nation is on the brink of war.

We lawyers awake each day to our immediate responsibilities of assisting clients and more generally promoting the just and efficient resolution of debtor/creditor issues and disputes. We seek competent, cooperative, professional work in the courts and in our out-of-court dealings with one another.

Beyond our workplace, I believe the circumstances of urgent need and brokenness in our public life suggest an extra role for us - that of informed and analytical citizen and neighbor.

DeTocqueville called lawyers America's "ruling class." We certainly have a broad range of opinions, with government spending viewed as inadequate or excessive, the balance between public safety and order, on the one hand, and privacy and personal liberty on the other, as tipping this way or that. We may see the environment as under more or less of a significant threat, or view the funding and

conduct of elections of our political leaders as shrewd or insane.

Whatever our views, as lawyers we have a unique appreciation of how these policy choices, once enacted into law, shape the lives of ourselves, our children, and our neighbors. We recognize that the law in a representative democracy is a web of choices we as a people have made collectively. That web of law reflects constantly shifting values, supporting on the one hand ways of expanding opportunity, and on the other rules for constraining abuses that arise from the very opportunities we promote.

In a time of proud and no-holds-barred terrorism, and one-party control of at least two of the three branches of our federal government, the challenge is especially pressing to “give back” by being active and thoughtful citizens. As stewards of the law we are trained to be attentive to the views of one another and to what happens concretely in the real world. We are trained to be intellectually disciplined, responsible with our allegations of fact, and fair – even sympathetic – in considering the causes and results of the people’s collective policy choices enacted into law.

I believe we can be especially helpful now, at a time when thoughtful dialogue is needed to counter the shrill and polarizing rhetoric that seems often to disable meaningful debate and discussion. Whatever our differences on the merits, let’s talk with each other and with our neighbors and our children, responsibly and often, about responsible policies for our state and country—policies and laws that will strengthen us as a people.

**NOTE:**

The final tally of the vote on whether to make a \$2,500 donation to the Campaign for Equal Justice from the Section’s 2002 fund surplus was 51 ayes and 20 nays. The donation was made in late December.

## SECTION COMMITTEES AND CHAIRS:

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503-227-1111

**Consumer Bankruptcy**

Gerry Pederson  
503-253-7777

**Continuing Legal Education**

Chair to be determined

**Legislative Action**

Gary Blackledge  
503-295-2668

**Moot Court Competition**

Judge Randall Dunn  
503-326-4175

**Newsletter**

Deborah Guyol  
503-281-2446

**Pro Bono Activities**

Valerie Auerbach  
503-228-6044

**Saturday Session**

Doug Schultz  
541-686-8833

## Debtor-Creditor Newsletter

The Debtor-Creditor Newsletter is published three times a year by the Debtor-Creditor Section, Oregon State Bar, P.O. Box 1689, Lake Oswego, OR 97035.

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The purpose of this publication is to provide information on current developments in the law. Attorneys using information in this publication for dealing with legal matters should also research original sources and other authorities.

## APPROACHING WATER RIGHTS AS COLLATERAL

By Steven Shropshire  
Jordan Schrader PC

### INTRODUCTION

Water is scarce in the West, making it a valuable commodity and an important component of rural land ownership. This was clearly demonstrated in the Klamath River Basin where, during summer 2001, the average price of irrigated farmland dropped from \$2,200 - 2,800 per acre to \$150 - \$250 per acre after federal reclamation project water was redirected from agriculture to endangered species. As Oregon's population grows, the potential for similar conflicts in other parts of the state is very real. Attorneys advising financial institutions, debtors, and creditors must understand the role water plays in the value of rural properties.

This article addresses that role. It begins with a review of the legal framework governing the acquisition and use of water in Oregon. It identifies issues and risks associated with the use of water under this system. It addresses valuation considerations, and concludes with recommendations for successfully creating a security interest in water rights and protecting that interest.

### I. OREGON WATER LAW

The prior appropriation doctrine is used by all western states, including Oregon. Under this system, a property owner who does not receive water from a community water supply system must have a state-granted legal right to divert and use water. A limited number of statutory exceptions to this requirement are discussed below.

The prior appropriation doctrine is often described as "first in time is first in right." It differs from the riparian doctrine used in eastern states, which mandates shared reasonable use of the resource. A prior appropriator has the right to satisfy a water right by diverting the full entitlement under that right regardless of stream or aquifer conditions. All later rights, *i.e.*, "junior" priorities, may begin to divert water only after the senior right is fully satisfied.

To mitigate the harsh results of a pure priority system, the prior appropriation doctrine contains significant limitations on an appropriator's rights. The first limit is the concept of beneficial use. An appropriator is entitled to divert only the amount of water actually needed to accomplish the beneficial use for which the water is diverted; any additional diversion is considered waste. A diversion can be limited with respect to the rate, volume, or timing.

Any water placed to beneficial use on an appropriator's property becomes appurtenant to that property. This means the landowner cannot transfer the water right to other lands or convey the right separately from the underlying land without taking affirmative legal action. Finally, a water right is subject to abandonment or forfeiture for nonuse. In Oregon, nonuse over the five-year statutory period creates a presumption that the right has been forfeited. Abandonment requires nonuse together with evidence of intent to permanently relinquish a water right.

### II. ISSUES AND RISKS UNDER THE PRIOR APPROPRIATION SYSTEM

During the 1990s, the West was the fastest-growing region in the United States. By the year 2000, it was home to fifteen of the top twenty fastest-growing counties, and all five of the fastest-growing states. This rapid increase in the number of thirsty mouths and lawns placed unprecedented pressure on the region's already scarce water resources. In addition, during the late 1990s many of the West's streams and rivers were designated as habitat for endangered fish, further constraining the availability of water for all uses other than instream flows.

This increasing scarcity affects both the value and the reliability of water rights used by rural property owners. If the water supply is reliable, the value of the right will climb. If the supply is subject to interruption due to drought, competing demands, or government regulation, the value will reflect that decreased reliability. Thus, the risk analysis is subsumed within the valuation analysis.

Water right risk analysis hinges on availability and reliability. If the water right is not legally or physically available when there is a demand, the utility and value of the rural property is diminished. For agricultural properties, this risk is multiplied if the water shortage occurs at crucial times in the growing or processing season.

Many factors affect the availability or reliability of a water right. The weight accorded to these factors depends on the circumstances of the property. Although the factors vary from case to case, the following should always be considered.

**A. Title.** Title companies do not insure water rights in Oregon. This reflects the inconsistent treatment of water rights in most real estate transactions. Although the Oregon Water Resources Department maintains ownership records, water rights are often ignored or mentioned as an appurtenance to the real property in the transactional documents. A traditional title search is thus difficult, but it is prudent to search county and state records for any recorded title defects related to water rights, such as options, rights of first refusal, licenses, covenants, and prohibitions against sale or transfer. A title search may also uncover liens or encumbrances against the water rights.

**B. Status of Water Rights.** The right to divert water and place it to beneficial use can take a number of forms, each with related risks. These rights fall into the following categories:

1) *Vested Rights.* These are traditional water rights known as perfected or certificated rights. They are the equivalent of a real property interest.

2) *Inchoate Rights.* Inchoate rights are known as permit rights. They represent a right to begin withdrawing water and placing it to beneficial use, but are not vested property rights. These rights should be assigned rather than conveyed by deed, and must be perfected through beneficial use within a certain amount of time. Oregon also recognizes water right claims, which are rights initiated before the state water code was adopted in 1909. A claim remains an inchoate right until confirmed by a court in a basin-wide adjudication. Such an adjudication is now underway in the Klamath Basin.

3) *Contract Rights.* These rights arise out of contracts with the United States Bureau of Reclamation or private suppliers. They are usually subject to curtailment or pro-rata reduction during times of shortage or due to government regulation, often without recourse against the supplier. Such contracts are for fixed terms, so they carry a risk of nonrenewal upon expiration.

4) *Exempt Uses.* Oregon law permits certain uses of water in limited amounts for limited purposes without a water right. These so-called "exempt" uses include small domestic wells, livestock water, firefighting use, and small commercial uses. The exemptions are different for surface water use and ground water use.

**C. Physical Constraints.** It is important to examine the hydrologic, geographic, geologic, and climatologic factors that influence the water source, as well as artificial influences such as dams operations. These factors produce physical constraints affecting water availability - including water quality, seasonal fluctuations in water levels, susceptibility to drought conditions, ground water mining (i.e., when extraction exceeds recharge), hydrologic connection between surface and ground water, and the availability of storage supplies.

**D. Legal Constraints.** Water that is physically available from a particular source may not be legally available to a landowner. Legal constraints on water use include the terms of the water right (priority, date rate and volume limits, place of use, point of diversion, season of use, etc.), contractual terms, water conservation or management regulations, instream flow requirements, and land use restrictions.

**E. Historic Use Concerns.** The doctrines of forfeiture and abandonment can extinguish an otherwise valid water right following an extended period of nonuse. Oregon law dictates partial forfeiture if some portion of the water right has remained unused for the statutory period. A historic use analysis requires comparing the paper right with the actual use of water on the ground. A careful analysis may also uncover evidence of water spreading, which is the use of water on more acres than permitted under the water right.

The scope of the historic use analysis will depend on the value of the obligation to be secured. A minimum analysis should include an evaluation of all readily available evidence of water use, such as ground photos, aerial photos, diversion records, and pump logs. A more detailed analysis would include interviews of neighboring landowners, soil composition analyses, review of production records, electrical records for irrigation pumps, and similar anecdotal evidence of water use. It is also advisable to obtain a declaration or affidavit from the water right holder that the water has not gone unused for the statutory forfeiture or abandonment period. For most properties, the information will be hard to obtain and may be incomplete. A certified water rights examiner or water rights lawyer should be able to estimate from the outset how difficult and expensive a search will be.

**F. Latent Problems.** There is a long list of potential outside influences that may affect water availability. Most are unique to a given context and are difficult to identify in the abstract. It is therefore important to work with state water officials to identify concerns relevant to the specific property in question. These concerns may include the following:

- Potential for ongoing litigation over the source stream or aquifer.
- Unexercised municipal rights or undeveloped inchoate rights.
- Unadjudicated rights.
- Unquantified federal reserved rights and tribal rights.
- Endangered Species Act flow or temperature requirements.
- Water quality requirements.
- Dredge and fill permit requirements (pump platforms and other structures in jurisdictional wetlands).
- Hydrologic connectivity determinations between surface and ground water.
- Cost of electricity to operate irrigation pumps.
- Well deepening requirements.
- Changes in state law, regulations, or policy affecting water rights.

### III. VALUATION OF IRRIGATED LAND AND WATER RIGHTS

Water rights are a fundamental component of any appraisal of irrigated property. Water rights add value to real estate, and are crucial to the revenue stream in agricultural enterprises. They may also have independent value apart from their use on the rural land.

The first step in the valuation analysis is an appraisal of the availability and reliability of the water right for the intended use of the property. This produces a risk factor that can be used to discount the underlying property value to reflect concern about the future availability of water.

An appraiser should also consider whether the water is available for transfer to purposes such as municipal and industrial uses. This analysis should take into account whether the right is subject to transfer and how much water would be available to transfer. It should also include a study of the financial and engineering feasibility of conveying water from the source to new locations.

The best appraisal method will depend on the circumstances. Traditional appraisal methods used for real property may produce inaccurate results, especially where an appraiser is attempting to value the water rights apart from the land. This difficulty is magnified by the typical lack of market information for water rights. To compensate for such difficulties, water right appraisers and scholars have developed at least five different methods for appraising water rights and irrigated land: (1) market value analysis, (2) sales comparison approach, (3) income capitalization approach, (4) analysis of land value differentials, and (5) the development-cost approach. A comparison of the relative merits of these valuation methods is beyond the scope of this article, but the best value estimate may result from applying multiple methods.

### IV. CREATING AND PROTECTING SECURITY INTERESTS IN WATER RIGHTS

In Oregon, security interests in water rights are created and perfected in the same manner as mortgages on land. This treatment has been extended to include an after-acquired property interest in the form of contractual rights to irrigation water. *See, eg. Wayt v. Buerkel, 128 Or App 222, 975 P2d 499 (1994)*. The law presumes that water rights pass with the title to the underlying real estate in any conveyance. However, a seller can sever water rights from the underlying property by express reservation, assignment or conveyance to a third party. This same principle of divisibility would permit a lender to encumber land and water rights separately. Thus, borrowers and lenders seeking flexibility may collateralize a small loan with something less than the lender's entire land holdings. For example, a lender could accept one or two water rights from the borrower's portfolio as collateral for the loan.

As pressures on Oregon's water resources mount, and as the value of water rights increases, this type of transaction is more likely to take place. It is risky, however, because Oregon's law on this topic is undeveloped compared to that of other western states. For example, some states treat certain water rights as personal property or even certificated securities in the case of mutual ditch company shares (of which there are a few in Oregon). Oregon appellate courts have not yet addressed any cases in which such an argument was raised.

One unresolved issue involves water right ownership on property within irrigation districts and other special districts with statutory authority to provide irrigation water to rural properties (collectively referred to as "irrigation districts"). The water rights for all lands within the boundaries of an irrigation district are often held in the name of the district. However, Oregon law generally considers a water right to be appurtenant to the land on which it is applied. Thus, the question is whether the district or the landowner owns the water right and can pledge it (or convey it) as collateral for a loan. Likewise, when a creditor initiates foreclosure proceedings against a landowner, a question is whether the irrigation district must also be named as a party to the action. Until issues such as these are resolved, lenders may be rightly hesitant to accept individual water rights as collateral.

Regardless of whether the collateral consists of land and water rights or water rights alone, a lender or creditor can take steps to minimize the risks discussed above. Some of the most effective steps include the following:

1) *Hire or train the necessary experts.* A lender or creditor should have in-house or external personnel who understand state water law, environmental laws, and current legislative and public policy developments likely to affect water rights, and who can evaluate the risks associated with these issues.

2) *Review All Available Water Rights Information.* Information about the rural property and its water rights is available in a number of forms. The Oregon Water Resources Department and possibly the county clerk's office will have records on individual water rights. Both the State Watermaster for the area and surrounding landowners are a valuable source of background information.

- Compare this information to the loan application for consistency; it may be that a prospective borrower holds water rights for only half of the irrigated acreage being pledged as collateral.
- Determine whether other water rights in the area may affect the borrower's ability to access water. Nearby wells, senior water rights, and undeveloped inchoate rights can all affect water availability. For example, in eastern Oregon, it is not uncommon for a water right with an 1880 priority date to be curtailed in mid-summer during a dry year.

3) *Take Steps to Protect the Collateral.* Where irrigated property secures an obligation, affirmative steps should be taken to protect the collateral.

- Lenders should require the borrower to provide evidence that the water rights are being put to full use at least once every five years in order to avoid forfeiture. Such evidence could include photographs, irrigation records, or affidavits of a certified water rights examiner.
- If the property lies within the boundaries of an irrigation district, the secured party should put the district on notice that it holds a security interest in the water right. This notice should ensure that the security holder is notified if the landowner or district takes any action inconsistent with the maintenance of the right.
- A creditor foreclosing on property with appurtenant water rights steps into the shoes of the landowner, subjecting the creditor to any deadlines with regard to water rights on the property. These deadlines include the period allowed for perfection of an inchoate right or transferred right, as well as the statutory forfeiture period for nonuse. In either situation, the creditor must take affirmative steps to protect the water rights.

4) *Understand the Potential for Unanticipated Costs and Delays.* Transfers, adjudications, and water rights litigation are expensive and time-consuming. A simple dispute can escalate into complex, multi-party litigation. Frequently, water rights disputes are based more on principle than sound business judgment, resulting in expenses that bear little relation to the underlying property value. Mark Twain understood this when he wrote, "Whisky is for drinkin'; water is for fightin'."

### CONCLUSION

While water rights issues are complex, the associated risks are manageable. A lender or creditor that understands water law and remains informed on current developments in related legislation, policy, and court decisions is well positioned to protect itself. Even with this minimal knowledge, lenders and creditors can identify issues of concern, and initiate a more detailed risk analysis by their in-house experts or outside consultants.

**Note:** This article is intended to inform the reader of general legal principles applicable to the subject area, not to provide legal advice regarding specific problems or circumstances. Readers should consult competent counsel for advice about specific situations.

## WHAT BANKRUPTCY LAWYERS NEED TO KNOW ABOUT THE SARBANES-OXLEY ACT OF 2002 AND THE CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY ACT OF 2002

Teresa H. Pearson  
Miller Nash LLP

On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley Act of 2002, which contained as one of its component parts the Corporate and Criminal Fraud Accountability Act of 2002 (collectively, the "Sarbanes-Oxley Act"). Pub. L. No. 107-204, 116 Stat. 745. Congress passed the Sarbanes-Oxley Act in response to concerns of the public and Wall Street about accounting irregularities that led to the spectacular failures of several of this country's largest companies. Many provisions in the Sarbanes-Oxley Act are intended to restore investor confidence in the accounting profession and encourage responsible corporate leadership. However, despite its "big business" origins, the Sarbanes-Oxley Act contains two changes that could have far-reaching effects on many Oregon bankruptcy cases, including cases involving small businesses and individuals.

### I. NEW DISCHARGEABILITY PROVISIONS

Section 803 of the Sarbanes-Oxley Act amends 11 USC §523(a) to add an exception to discharge for liabilities arising from conduct that violates state or federal securities laws. The new provision states:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt— . . .

(19) that—

(A) is for—(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or (ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security, and (B) results from—(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding; (ii) any settlement agreement entered into by the debtor; or (iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

This new exception to discharge encompasses all violations of securities laws – technical breaches as well as violations arising from morally culpable or dishonest conduct. For example, a liability for sale of an unregistered, nonexempt security in breach of ORS 59.055 would be nondischargeable. Liability arising from the debtor's fraudulent conduct or use of untrue statements of material fact in the sale of a security in violation of ORS 59.135 would also be nondischargeable. Because new §523(a)(19) applies to technical breaches of securities laws, it is broader than both the exception to discharge for liabilities arising when the debtor obtains money, property, services, or credit using false pretenses, false representations, or actual fraud (§523(a)(2)), and the exception to discharge for fraud or defalcation while acting in a fiduciary capacity (§523(a)(4)).

In addition to liability arising from judgments in private civil actions for securities fraud, this new exception to discharge applies to liability arising from governmental enforcement actions and administrative proceedings. It also applies to settlement agreements—apparently, without regard to whether the debtor admits liability.

One of the most important features of this new exception is that Congress did not limit its application to violations or fraud involving the securities of publicly traded companies. Liabilities arising from securities law violations or securities fraud in the sale of stock of small privately held “mom and pop” businesses are also nondischargeable under the Sarbanes-Oxley Act.

When Congress added the new exception to dischargeability to 11 USC §523(a), it did not amend 11 USC §523(c). Section 523(c) puts the burden on creditors who are owed debts of the types described in §523(a)(2), (4), (6), or (15) to file a complaint to determine the nondischargeability of the debt owed them. New §523(a)(19) was not added to this list. Before enactment of the Sarbanes-Oxley Act, a creditor whose claim arose from the debtor's participation in securities fraud would have had to file a complaint to determine the dischargeability of the debt pursuant to 11 USC §523(a)(2) or (a)(4). Bankruptcy Rule 4007 sets very short time deadlines for filing such complaints. Now, the creditor may rely upon §523(a)(19) and avoid the expense of litigation over nondischargeability.

Congress also did not amend 11 USC §1328 when it enacted the Sarbanes-Oxley Act. Section 1328, the chapter 13 “super-discharge” provision, discharges a debtor from liability for all debts except those arising from family support obligations, student loans, and injuries or deaths caused by the debtor's operation of a motor vehicle while intoxicated. Thus a debtor who qualifies for chapter 13 can still discharge debts arising from securities fraud and other violations of the securities laws, even after enactment of the Sarbanes-Oxley Act.

Consider the following scenario. John Smith owns and operates a small company making widgets. His best customer, BigCo, purchases ninety percent of his output. John wants to expand his company, but needs to purchase more widget-making equipment to do so. Because he cannot afford the equipment, he asks his Aunt Mary to invest. Aunt Mary introduces John to her friends, who also might want to invest. John tells Aunt Mary and her friends about his plans and his need for funds to purchase equipment. He further tells them that BigCo would really like to buy more products from him, and offers Aunt Mary and her friends stock in John's company in exchange for their investment. John knows, but does not tell Aunt Mary and her friends, that BigCo is having financial problems, because John hopes that BigCo will get past its difficult times and continue purchasing his widgets. Aunt Mary and her friends invest in stock of John's company, and John buys the equipment. John, who does not know anything about securities law, does not register the sale of the stock to Aunt Mary and her friends and is unaware that the sale does not qualify for an exemption under the federal or state securities laws.

Six months later, the inevitable occurs. BigCo goes out of business, and John loses most of his customer base. He cannot find anyone else to buy his widgets. Aunt Mary's friends sue John, alleging that he sold them unregistered securities and omitted to disclose material facts when he solicited their investment in his company. They also allege claims for breach of contract. John settles the lawsuit for \$100,000, with no admission of liability. John makes payments toward the settlement for several years, but ultimately files for chapter 7 bankruptcy.

Before the Sarbanes-Oxley Act, Aunt Mary's friends would have to file an action for determination of nondischargeability pursuant to 11 USC §523(a)(2) or (4) within 60 days after the first date set for the meeting of creditors in John's bankruptcy case. They would have to prove that John obtained money from them by false pretenses, a false representation, or actual fraud, or that he engaged in fraud while acting in a fiduciary capacity. John might defend such an action and prove the debt is dischargeable by showing that he had no intent to deceive Aunt Mary's friends and that he owed them no fiduciary duties.

The Sarbanes-Oxley Act makes John's debt to Aunt Mary's friends nondischargeable in his chapter 7 case. John violated the securities laws when he sold them unregistered securities without exemption. Under the securities laws, John can be liable for failing to disclose a material fact, even if he had no intent to deceive Aunt Mary's friends. Aunt Mary's friends do not have to sue to determine the dischargeability of John's debts to them. It is irrelevant that John settled the claims filed by Aunt Mary's friends without admitting liability. John's only option to discharge the debt, if he qualifies, is to convert his bankruptcy case to a chapter 13.

## II. NEW CRIMINAL PENALTIES

In addition to adding a new exception to discharge in bankruptcy, the Sarbanes-Oxley Act amends the criminal code to add a new bankruptcy crime. Section 802 of the Sarbanes-Oxley Act adds the following felony to title 18:

§1519. Destruction, alteration, or falsification of records in Federal investigations and bankruptcy. Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

This statute is in addition to (not a replacement of) the existing bankruptcy crimes set forth in 18 USC §§ 152 and 157. As a result, prosecutors now have the ability to charge dishonest debtors with multiple bankruptcy crimes for the same conduct.

The new criminal provision in §1519 expands prior law on bankruptcy crimes in three ways. First, it expands the type of conduct that is subject to criminal prosecution. Under 18 USC §152, it is a crime to “knowingly and fraudulently” engage in certain specified acts, such as concealing property, destroying or altering documents, and making a false oath. Under 18 USC §157, it is a crime to file, or take certain actions in, a bankruptcy case as part of a “scheme or artifice to defraud.” Section 1519 makes many of the same acts illegal, but fraud is no longer required. It is now a crime merely to “knowingly” take certain actions “with the intent to impede, obstruct, or influence” a bankruptcy case.

Second, the new criminal provision applies to actions taken “in contemplation” of a bankruptcy case. Previously, only subsections (7) and (8) of 18 USC §152 specifically applied to actions taken “in contemplation” of a bankruptcy case. Moreover, the Ninth Circuit Court of Appeals had held that the existence of bankruptcy proceedings was a necessary element to support a conviction for bankruptcy fraud under 18 USC § 152. *United States v. McCormick*, 72 F3d 1404, 1406 (9<sup>th</sup> Cir 1995). Now, it appears that a conviction under new §1519 could be sustained even if the contemplated bankruptcy case was never filed.

Third, and most significantly, the new bankruptcy crime is punishable by a much steeper penalty than the pre-existing bankruptcy crimes. A person convicted of a bankruptcy crime under 18 USC §§152 and 157 can be punished by a fine, up to five years in prison, or both. A person convicted of a bankruptcy crime under new §1519 can be punished by a fine, up to **twenty** years in prison, or both. The penalty has been quadrupled.

Like the new exception to discharge, the new bankruptcy crime is not limited to actions taken with respect to large, publicly traded companies. Under new §1519, a consumer who knowingly puts the title to his car in the name of a family member to avoid disclosing it as an asset on his bankruptcy schedules, or who knowingly fails to list a creditor’s claim, can be imprisoned for up to twenty years. Likewise, a creditor who files an inflated claim may be subject to similar penalties.

## III. REPRESENTING CLIENTS AFTER THE SARBANES-OXLEY ACT

Bankruptcy attorneys representing debtors should question their clients about potential securities law violations, particularly if the debtor operated a business prior to bankruptcy. Debtor’s counsel should carefully review the complaints underlying any settlement agreements to learn whether the case involved claims for violation of the securities laws. By taking these steps, a debtor’s attorney can determine if a chapter 7 case will accomplish the client’s goals of discharging his debt, and can advise the client accordingly.

Bankruptcy attorneys representing creditors can now advise their clients about the exceptions to discharge available for claims relating to violations of the securities laws. These clients may be able to pursue their claims more easily, and without the need for expensive litigation over dischargeability.

Finally, all lawyers should be mindful of the new standards for criminal liability, and should continue to encourage their clients to be as forthcoming and honest as possible in connection with their bankruptcy cases. The risks of doing otherwise are now much, much higher.

## NINTH CIRCUIT CASE NOTES

By Karl E. Hausafus  
Preston Gates & Ellis, LLP

THE DEBTOR'S ATTORNEY SHOULD  
CALL THE PLF

*In re Castillo*, 297 F3d 940 (9<sup>th</sup> Cir 2002)

**D**ue to clerical error in the office of the Chapter 13 Trustee, debtor's confirmation hearing was set one day early and the debtor did not get notice of this date. The court dismissed the case after the debtor failed to appear at the hearing, and the lender foreclosed on the debtor's home before she successfully vacated the dismissal. Upon reinstatement, the bankruptcy court refused to set aside the foreclosure sale and the debtor sought leave to sue the trustee and her staff attorney. (The debtor also sued her attorney, who learned of the dismissal but did not act in time to stop the foreclosure.) The court rejected the trustee's assertion of quasi-judicial immunity, and the trustee appealed. The BAP ruled the trustee had immunity for damages relating to the miscalendarings of the confirmation hearing, but not for damages from the failure to give notice of the hearing. The trustee again appealed.

After reviewing the history of judicial and quasi-judicial immunity, the Ninth Circuit found that quasi-judicial immunity extends to nonjudicial officers only when the exercise of their discretionary judgment is vital to the judiciary and might be impaired by exposure to potential for liability damages. The court held that both scheduling and giving notice of hearings are part of the judicial function of managing the bankruptcy court's docket in the resolution of disputes - a discretionary function. The trustee was therefore immune from damages for both the miscalendarings and the failure to give notice.

BUT YOUR HONOR, IT'S NOT REALLY  
REAFFIRMATION OF A DISCHARGED DEBT

*In re Bennett*, 298 F3d 1059 (9<sup>th</sup> Cir 2002)

**T**he Ninth Circuit held the debtor's postpetition agreement to pay a discharged debt was unenforceable under §524(a) and remanded to the bankruptcy court to determine whether sanctions against the lender under §105(a) were justified.

The lender argued that the requirements of §524(c) were inapplicable because the settlement agreement containing the promise to pay was separate from the discharged debt and because new consideration had been provided for debtor's promise. The Ninth Circuit held that agreements with a debtor for which consideration is based, in whole or in part, on a dischargeable debt must comply with the reaffirmation requirements of §524(c). The fact that the lender

or another party provided additional consideration for the debtor's promise to pay was immaterial - the question was whether the debtor offered new consideration. The court found that in this case he had not, and that the agreement and collection efforts violated §524(a). The court further held that sanctions may be justified under the court's §105(a) contempt power if the creditor knew the discharge injunction was applicable and intended the actions that violated the injunction.

"BECAUSE I SAID IT"

*In re Canter*, 299 F3d 1150 (9<sup>th</sup> Cir 2002)

Parents purchased second home for investment purposes and rented it to their son and his wife. Son and wife divorced, son moved out and ex-wife stopped paying rent. Parents filed an FED action and ex-wife filed chapter 13 (her fourth bankruptcy filing in seven years). The bankruptcy court granted parents relief from stay, and ex-wife and parents entered into stipulated judgment returning possession. Now things get interesting. The district court *sua sponte* withdrew the reference from the bankruptcy court and twice denied parents' motion for relief. When parents asked the district court why the stay was reinstated, the court's only explanation was, "because I said it."

Parents appealed the *sua sponte* withdrawal of reference and denial of motions to lift stay. Although the Ninth Circuit held that the withdrawal of reference was an interlocutory and unreviewable order, it granted parents' request to treat the appeal as a petition for writ of mandamus. The court then granted the writ after finding that all five factors of *Bauman v United States Dist Ct*, 557 F2d 650 (9<sup>th</sup> Cir 1977), weighed in parents' favor. At the time of the court's decision, the ex-wife had occupied the home for nearly three years rent free - two of those due to the district court's decision. No reason was ever given for the district court's withdrawal of reference.

STIPULATION? WHAT STIPULATION?

*In re Allen*, 300 F3d 1055 (9<sup>th</sup> Cir 2002)

**D**ebtor kiwi farmer filed chapter 11 and entered into a stipulation with creditors that provided for staggered dates for relief from stay on various parcels of real property. The stipulation was approved by the bankruptcy court. Four months later, when creditors had not completed their foreclosures, debtor filed a plan of reorganization that restructured creditors' debt and stayed the foreclosures. The bankruptcy court confirmed the plan over creditors' objections; creditors appealed and the district court affirmed.

At the Ninth Circuit, the creditors argued the bankruptcy court could not confirm a plan that did not incorporate the terms of the stipulation without first finding that "special

circumstances" justified doing so. This argument was based upon *In re Lenox*, 902 F2d 737 (9<sup>th</sup> Cir 1990), which held that stipulations are not lightly set aside. The Ninth Circuit distinguished *Lenox* because the stipulation there specifically provided it would bind debtors in any plan of reorganization. Because this stipulation did not contain such a provision, *Lenox* did not apply and the stipulation governed only until confirmation of the plan.

### LESSONS IN UCC ARTICLE 3 *In re Cohen*, 300 F3d 1097 (9<sup>th</sup> Cir 2002)

**H**usband purchased mobile home and later sold it and failed to pay secured creditor. Husband filed a chapter 7 case and negotiated an agreement with creditor to pay \$21,000 in full settlement. Unbeknownst to creditor, the \$21,000 cashier's check it received from husband was purchased by wife with her own funds, although she designated husband on its face as purchaser. At the time of purchase wife was insolvent, and she later filed her own chapter 7 case. The trustee sought to avoid the payment to creditor as a fraudulent transfer under §548(a)(1); the creditor asserted the husband was the initial transferee and creditor was a subsequent "good faith" transferee under §550(b). The bankruptcy court eventually decided that creditor was not the initial transferee and that §550(b) provided a safe harbor. The district court affirmed and the trustee appealed.

After a lengthy analysis of UCC Article 3, the Ninth Circuit held that husband could not be a transferee because he never had legal dominion and control over the funds. Therefore the husband was merely a courier, delivery of the check to creditor qualified as a negotiation and creditor was entitled to enforce the check as its holder. Because creditor was the first entity to exercise dominion of the instrument, it was the initial transferee, strictly liable to the trustee under §§548 and 550.

### WHEN A LANDLORD'S CHAPTER 11 PRIORITY CLAIM IS NOT *In re LPM Corporation*, 300 F3d 1134 (9<sup>th</sup> Cir 2002)

**I**n chapter 11 case, landlord moved for an order compelling debtor to pay the rent and surrender the property under §365(d)(3). The bankruptcy court granted the motion and entered an order requiring the debtor to pay all postpetition rent within two weeks. After debtor paid only one quarter of the rent, landlord had the bankruptcy clerk issue a writ of execution and levied on the debtor's bank. The case converted to chapter 7, the bank refused to release funds, and the landlord moved for an order directing the bank to release funds. The bankruptcy court held that the levy violated the automatic stay and that landlord's chapter 11 priority administrative claim did not have super-priority over chapter 7 administrative expenses. The BAP affirmed.

The Ninth Circuit held that §362(a)(3) requires a creditor to obtain explicit relief from the automatic stay before starting collection proceedings. The bankruptcy court's payment order did not lift the stay for landlord, and therefore landlord violated the stay. The court noted that if this were not the case, a court could lose control as a commercial debtor's multiple landlords are turned loose with writs of execution to collect their postpetition rent. The court also held that §726(b) trumps §365(d)(3), and that while a landlord's claim for post-petition rent has administrative priority in chapter 11, upon conversion such claims are subordinated to chapter 7 administrative claims.

### CAN'T ATTACH PROCEEDS OF TORT CLAIM UNDER OLD ARTICLE 9 *In re Pacific/West Communications Group, Inc.*, 301 F3d 1150 (9<sup>th</sup> Cir 2002)

**T**he Ninth Circuit held that under California's Commercial Code (prior to the July 2001 enactment of Revised Article 9), a creditor's security interest could not attach to proceeds of a debtor's tort claim. Although California's CCC §9306 (UCC 9-306) definitions of "proceeds" and a "secured party's rights on disposition of collateral" were to be interpreted broadly, they were limited by CCC §9104 (UCC 9-104), which excluded a "transfer in whole or in part of any claim arising out of tort" from the type of collateral that may be granted as security. The court noted that Revised Article 9 supports this conclusion. Its amendments specifically allow a security interest to attach to the proceeds of a tort claim, and the legislative history notes that this amendment represents a change in existing law.

### OF COPYRIGHTS AND TULIPS *In re World Auxiliary Power Co.*, 303 F3d 1120 (9<sup>th</sup> Cir. 2002)

**B**ank secured its loan to debtor with a broad security interest including all copyright rights and applications, and perfected its security interest pursuant to UCC Article 9 by filing UCC-1 financing statement with the California Secretary of State. Debtor's copyrights were not registered with the US Copyright Office ("USCO") and the bank did not record any notice of its security interest with that office. The debtor thereafter filed bankruptcy and the trustee sold debtor's copyrights along with any avoidance action it might possess. Buyer then sued the bank, asserting the bank did not properly perfect its security interest by filing notice with the USCO. The bankruptcy court granted bank's motion for summary judgment and the district court affirmed.

The Ninth Circuit affirmed. It adopted the reasoning of the district court in *In re Peregrine Entertainment, Ltd.*, 116 BR 194 (Bankr CD Cal 1990), and held that the

Copyright Act of 1976 preempts state law and the proper place to perfect a security interest in **registered** copyrights is with the USCO. However, because the Copyright Act does not require registration of copyrights in all instances, the Act does **not** govern the perfection of security interests in **unregistered** copyrights. In so holding, the court rejected decisions by the Ninth Circuit BAP and Arizona District Court that applied *Peregrine* to unregistered copyrights. The proper place to perfect a security interest in an **unregistered** copyright is with the Secretary of State as provided in the UCC. Note that under this decision, nothing prevents a debtor from obtaining a loan using unregistered copyrights as collateral, and then registering those copyrights with the USCO and obtaining another loan from a different bank using the registered copyrights.

The court compared equity financing in the 1990s to that of tulips in 17th-century Holland, supported by a footnote to a book called *Tulipomania: The Story of the World's Most Coveted Flower & the Extraordinary Passions It Aroused*.

#### I MEANT TO AVOID THAT LIEN, HONEST *In re Chiu*, 304 F3d 905 (9<sup>th</sup> Cir 2002)

Chapter 7 debtors scheduled their interest in residential real property that was subject to a judicial lien and also claimed a homestead exemption in that property. Debtors did not take action to avoid the lien under §522(f)(1). Years later they sold their home and creditor demanded payment of the lien. The sale closed with the title company holding funds in escrow. Debtors reopened their bankruptcy case and sought to avoid the lien. The creditor argued that the debtors could not avoid the lien under §522(f)(1) because they no longer had an interest in the property. The bankruptcy court granted the motion to avoid the lien and the BAP affirmed.

The Ninth Circuit affirmed and held that a debtor need only have an interest in the property at the time that the lien attached, and not at the time the debtor moves to avoid the lien.

#### LACHES, WE DON'T NEED NO STINKIN' LACHES *In re Beaty*, 306 F3d 914 (9<sup>th</sup> Cir 2002)

In a matter of first impression, the Ninth Circuit held that laches is an available defense to a §523(a)(3)(B) nondischargeability complaint.

Creditor filed a state court fraud action against a named defendant and 50 John Does. Debtor later filed chapter 7 and obtained a discharge without listing creditor on his schedules or notifying creditor of the filing. By the time creditor learned of debtor's participation in the fraud scheme, substituted him for a John Doe defendant and

obtained a default judgment, debtor had obtained a discharge. Debtor then notified creditor of his bankruptcy. Creditor attempted to revoke the debtor's discharge under §727 but was unsuccessful. Nearly five years later, after the Supreme Court ruled that punitive damages are not dischargeable in bankruptcy, the creditor filed a §523(a)(3)(B) complaint. The debtor raised laches as a defense, and the bankruptcy court granted summary judgment in debtor's favor. The BAP held that laches could never apply to a §523(a)(3)(B) action, based upon language in Rule 4007(b) providing that a §523(a)(3)(B) complaint may be filed "at any time."

The Ninth Circuit held that laches **can be** a defense in a §523(a)(3)(B) action, but that the facts in this case did not support such a defense.

#### LACHES, PART 2 *In re Staffer*, 306 F3d 967 (9<sup>th</sup> Cir 2002)

Six years after debtor's discharge, an unsecured creditor moved to reopen the chapter 7 case so he could file a nondischargeability complaint. The bankruptcy court denied the motion as barred by laches. The BAP reversed, holding that Rule 4007(b) governs, the complaint may be filed "at any time," and the issue of laches was not before the court at the motion-to-reopen stage.

The Ninth Circuit affirmed, holding that, under *In re Beaty* (above), laches could properly be considered once the nondischargeability complaint was filed. The court further clarified that a separate motion to reopen is merely an administrative convenience, and is not necessary when commencing an action for nondischargeability.

#### TAX LIEN SUBORDINATION *In re Bankruptcy Estate of Markair, Inc.*, 308 F3d 1038 (9<sup>th</sup> Cir 2002) and 308 F3d 1057 (9<sup>th</sup> Cir 2002)

In these two related cases, the Ninth Circuit addressed the subordination of IRS tax liens under §724(b) of the Bankruptcy Code. Section 724(b) provides for partial subordination of tax liens to the claims of some other parties, including priority unsecured claimants.

In the first case, the Ninth Circuit held that "tax lien" in §724 refers to statutory liens only; and that a judicial lien acquired by the IRS, in settlement of a claim in which it was not entitled to a statutory lien, could not be subordinated. In the second case, the Ninth Circuit held that §724(b) subordinates the interests of tax lienholders to that of priority unsecured creditors, but only up to the total amount of the tax lien. Any remaining proceeds are distributed first to junior lien claimants, then to the tax lienholders, and finally to the estate.

## CREDITORS HAVE AFFIRMATIVE DUTY TO DISCONTINUE COLLECTION ACTIONS

*Eskanos & Adler, PC v Leetien*,  
309 F3d 1210 (9<sup>th</sup> Cir 2002)

Creditor referred debtor's account to attorney for collection. Debtor then filed chapter 7 and listed creditor on its schedules. Creditor failed to notify attorney, who filed a state court action and served debtor. Debtor's counsel tried several times to contact attorney, but without success. Attorney dismissed the state court action nine days after a deadline set in a letter from debtor's counsel, and 23 days after he had notice of the bankruptcy. The bankruptcy court ruled that creditor and attorney violated the stay and awarded punitive damages. The district court affirmed.

On appeal the attorney argued that §362(a)(1) should be interpreted narrowly to prohibit conduct beyond merely maintaining an active claim. The Ninth Circuit disagreed, noting that an active filing is more than a placeholder. A debtor must retain counsel to defend against default, and the action itself may be used as leverage in negotiating collection. Section 362(a)(1) imposes an affirmative duty to discontinue postpetition collection actions. A creditor delays at his own risk.

### DID I MENTION YOU'RE FIRED?

*In re Majewski*, 310 F3d 653 (9<sup>th</sup> Cir 2002)

Debtor incurred substantial medical expenses at the hospital where he worked and failed to pay them. After repayment negotiations failed, debtor told the hospital that he intended to file chapter 7. Hospital fired the debtor before he could file his petition, and the trustee later brought an action against the hospital for violating §525(b)'s prohibition against firing a debtor "solely because" he is or has been in bankruptcy. The bankruptcy court dismissed the trustee's claim, holding that the statute does not protect people who have not yet filed for bankruptcy. The district court affirmed.

The Ninth Circuit also affirmed. The trustee compared §525(b) to the anti-retaliation provisions of the Civil Rights Act and the Fair Labor Standards Act, which protect people who report illegal conduct to the government before instituting formal proceedings.

The court rejected this comparison, noting that the context of a bankruptcy case is different. While the court encourages reporting of statutory violations, it does not want to encourage people to file for bankruptcy or to threaten such filing. Bankruptcy's fresh start comes at the cost of turning one's assets over to the court and repaying debts that can be paid. A debtor is not entitled to the Code's protections before filing a petition and being bound by its other consequences. Because the debtor had not filed at the time of his termination, he was not protected by §525(b).

## 9TH CIRCUIT BAP CASE NOTES

By Matthew Arbaugh  
Farleigh, Wada & Witt, PC

### ORDERS EXTENDING EXCLUSIVITY REVIEWED DE NOVO ON APPEAL *In re Henry Mayo Newhall Memorial Hospital*, 282 BR 444 (9<sup>th</sup> Cir BAP 2002)

The debtor hospital sought to reorganize under chapter 11. The debtor was unable to create a plan of reorganization within the exclusivity period and moved to extend the exclusivity period. The creditors' committee opposed the motion. The court granted the debtor's motion, finding cause to extend the exclusivity period, and the committee appealed.

The BAP noted that orders affecting the length of an exclusivity period are, "the sole category of interlocutory orders that may be appealed as of right." These orders can be mooted easily by the passage of time and they should be reviewed within a very short time after the appeal is filed. The court went on to hold that the appeal was not mooted when subsequent extensions were granted to the debtor during the pendency of the appeal.

Most important, this decision establishes a standard of review for appeals of exclusivity orders. The BAP stated that the review requires a more in-depth inquiry than occurs under an abuse of discretion standard and held that the issue of "cause" for granting an exclusivity extension should be reviewed de novo as a mixed question of law and fact. The court went on to review the specifics of this case for cause and concluded the bankruptcy court did not err in granting the extension. Judge Marlar concurred in the result, but argued that abuse of discretion is the proper standard of review for these appeals.

### JUDGMENT RETAINS CLAIM PRECLUSION EFFECT UNLESS VACATED BY AN AFFIRMATIVE ACT

*In re Arneson*, 282 BR 883 (9<sup>th</sup> Cir BAP 2002)

The debtor injured another person while driving drunk and the debtor's insurance company obtained a judgment against him. After the debtor filed a chapter 13 bankruptcy, the judgment was determined to be nondischargeable under §523(a)(9). While the ruling was on appeal, the debtor's case was dismissed for failure to make plan payments. The appeal was also later dismissed. In a subsequent chapter 7 bankruptcy filing by the debtor, the insurance company sought relief from the stay to enforce the money judgment previously held to be nondischargeable. The debtor claimed there had been no resolution of the claim due to the dismissal of the earlier case and appeal and

therefore his right to due process would be violated if the judgment were enforced. The bankruptcy court granted relief and the debtor appealed to the BAP.

The BAP found that once the judgment was determined to be nondischargeable it had the same preclusive effect granted to any other judgment of a federal court. The court held that the debtor's appeal did not alter the preclusive effect of the judgment. The debtor argued that vacatur of the nondischargeability finding should have been automatic on the dismissal of the case. The Supreme Court has held that vacatur is to be governed by equitable principles. The BAP held that if the appellate court does not order vacatur independently, then it is up to the parties to make the appropriate motion or the judgment of the lower court will remain in effect. The BAP refused to allow vacatur to be accomplished through a collateral attack. The BAP also held that a new automatic stay arose in the second case and it was necessary for the insurance company to seek relief from the automatic stay to enforce its money judgment.

#### EVERY DOLLAR COUNTS IN AWARDING DAMAGES FOR VIOLATION OF STAY *In re Roman*, 283 BR 1 (9<sup>th</sup> Cir BAP 2002)

The bank's attorneys filed a state court collection action against the debtor on the same day the debtor signed a partial reaffirmation agreement with the bank. The bank dismissed its lawsuit but did not notify the debtor or her attorney until debtor's attorney drafted a complaint against the bank for violating the stay and wrote demand letters to the bank. The bankruptcy court found the bank's lawsuit to be a willful violation of the automatic stay, awarded \$5.00 in actual damages, plus attorney fees and sanctions.

The BAP affirmed in part and reversed in part the lower court's award. The court found that §362(h) mandates an award of damages, costs and attorneys fees upon a finding of a willful violation of the automatic stay. A violation is "willful" if the creditor knew of the stay and the creditor's actions were intentional. The BAP upheld the award of \$5.00 in actual damages the debtor suffered in the form of traveling to meet with her attorney. The bank argued that the debtor's travel should have been replaced by a phone call. The BAP held the decision was reasonable and that the bank could not second guess the debtor's decision.

In determining the appropriateness of the attorney fees, the court used a reasonableness analysis and endorsed the use of principles in §330 for guidance. The BAP held the award granted by the lower court was reasonable in light of the facts of the case. The BAP did, however, state that the court should not have used its power under §105 to impose sanctions, because fees and damages were statutorily allowed by §362(h).

#### THAT'S MY TAX REFUND CHECK! *In re Lambert*, 283 BR 16 (9<sup>th</sup> Cir BAP 2002)

The debtors received a \$600 tax refund check pursuant to the Economic Growth and Tax Reconciliation Act of 2001 (the "Act") after their chapter 7 petition was filed. The trustee asserted the check was a refund for prepetition taxes and therefore property of the estate. The bankruptcy court (Judge Alley) held that the funds were at least partly attributable to postpetition tax liability and instructed the debtors to pay the trustee any amount attributable to the prepetition period. The trustee appealed that finding.

The BAP examined the legislative history of the Act to determine how the funds should be attributed, and found the funds were intended to be a credit against taxes due for 2001. The BAP agreed with the bankruptcy court that the year 2000 tax liability was only a template for determining the individual's entitlement to the early refund. The BAP held the funds were to be considered payment based on the debtors' anticipated refund for 2001 and not a refund of tax liability for 2000. The BAP also affirmed the lower court's holding that the portion of the payment attributable to the prepetition part of 2001 should be turned over to the trustee as property of the estate, while the rest of the payment remained the debtors' property.

#### INTENTIONAL CONCEALMENT OF ASSETS NOT ENOUGH TO PREVENT COURT FROM REOPENING CASE *In re Lopez*, 283 BR 22 (9<sup>th</sup> Cir BAP 2002)

In their chapter 7 case, debtors intentionally failed to list among their assets a claim against a former employer for sexual harassment. Approximately eighteen months after receiving their discharge, the debtors sought to reopen the chapter 7 case to schedule the sexual harassment claim as an asset. This action was an apparent attempt by the debtors to better their position in the litigation. The bankruptcy court denied the debtor's motion to reopen.

The BAP reversed. It analyzed the factors for allowing the reopening of a case and noted that a case must be reopened if there is prima facie evidence that the case was not fully administered. The court stated that the debtors' claim became property of the estate despite not being scheduled or administered and remained property of the estate even after the case was closed. The claim was not barred by any applicable statute of limitations and it had not been previously investigated by the trustee. It was not proper to deny reopening of a case because of the debtor's intentional concealment of an asset if there was prima facie evidence which would allow a trustee to determine whether or not the undisclosed asset would benefit creditors. To deny reopening the case could harm creditors for the sake of punish-

ing a debtor for prior bad acts. The BAP acknowledged that in some cases facts, in addition to intentional concealment of assets, may exist which require a court to deny reopening a case, but did not find any in this case.

RES JUDICATA EFFECT OF  
NONDISCHARGEABILITY FINDING  
*In re Paine*, 283 BR 33 (9<sup>th</sup> Cir BAP 2002)

The debtors intentionally omitted from their bankruptcy schedules several high value assets and very large debts secured by notes and deeds of trust. The beneficiaries on those notes did not know of the bankruptcy and pursued state court actions against the debtors. After obtaining judgments in those cases, the creditors successfully petitioned the court to reopen the chapter 7 bankruptcy. The bankruptcy court found no fraud but did find that the debt was nondischargeable on due process grounds. The debtors did not appeal, but rather filed a new chapter 7 case in which they sought to discharge the debts ruled nondischargeable in the earlier bankruptcy. The bankruptcy court found the debts remained nondischargeable pursuant to §523(a)(10).

The BAP affirmed, but analyzed the case in terms of res judicata. It held that res judicata applies and the debts remain nondischargeable in subsequent chapter 7 proceedings. The BAP applied the requirements for issue and claim preclusion and found that the grounds for nondischargeability in the first chapter 7 (due process violation) are not an exception under §523(b) and therefore the debts remained nondischargeable. The same is true regardless of whether the lower court's ruling was in error because the debtors never appealed the ruling and it became a final judgment.

EFFECT OF CONFIRMED CHAPTER 11 PLAN  
ON DISBURSING AGENT'S ACTIONS  
*In re Associated Vintage Group, Inc.*,  
283 BR 549 (9<sup>th</sup> Cir BAP 2002)

The confirmed chapter 11 plan called for a disbursing agent with the powers of a chapter 11 trustee to conduct an orderly liquidation. Only "allowed claims" as defined in the Bankruptcy Code were to be paid. The plan reserved all powers of the debtor to object to claims and avoid transfers. A creditor, Alary, had filed a proof of claim asserting a secured claim. The disbursing agent objected to the claim on the grounds that it was based on an avoidable preference. Alary conceded this fact but argued the disbursing agent did not possess the power to object to the claim. The lower court agreed with the disbursing agent and disallowed the claim.

The BAP affirmed. It reviewed the effects of claim preclusion on the claim objection and the effect of judicial or equitable estoppel on the disbursing agent's actions, and concluded that neither barred the disbursing agent from objecting to Alary's claim. The BAP noted that a "claim" in claim preclusion is different than a "claim" under §101(5). After applying the various tests for claim preclusion, the BAP held that the disbursing agent's preference claim was not part of the same "transactional nucleus" as the plan and was not barred. A disclosure statement and plan do not have to list every possible defendant or theory of recovery and can deal with those categories in a general manner. On the estoppel issue, the BAP held that Alary could not show any inconsistencies justifying the use of judicial or equitable estoppel.

NO ADMINISTRATIVE CLAIM UNTIL  
AFTER YOU HAVE RETURNED YOUR  
AVOIDABLE TRANSFERS  
*In re Microage, Inc.*, 284 BR 914 (9<sup>th</sup> Cir BAP 2002)

In this chapter 11 case the debtor negotiated an agreement for dismissal of the creditor's adversary proceeding; in return the creditor was to receive "an allowed reclamation administrative priority claim." The debtor did not pay the claim and the creditor moved to compel payment. The debtor filed an adversary proceeding against the same creditor for avoidance of a preferential transfer and a ruling that payment of the administrative claim was improper pursuant to §502(d). The bankruptcy court decided that Code section did not apply and the debtor was obligated to pay the administrative priority claim.

The BAP examined the legislative history of and the policy behind §502(d) and decided that the purpose of the section would be frustrated if it were not applied in this situation. It held that allowing a recipient of an avoidable transfer to receive payment on an administrative claim without first returning the avoidable funds would disrupt the equality of distribution envisioned by the Code. Therefore, an administrative claimant in a bankruptcy case who is also the recipient of an avoidable transfer may not receive payment on the administrative claim until the funds attributable to the avoidable transfer have been returned to the bankruptcy estate. The BAP did find in this case, however, that the debtor had to pay the claim because it would be inequitable to allow the debtor to reach a stipulated agreement allowing the claim and then challenge it on other grounds. The BAP reasoned that if the debtor wanted to preserve its rights under §502(d) it should have done so in its settlement agreement.

DOES A DEBT FROM CONVERSION SATISFY THE REQUIREMENTS OF 11 USC §523(A)(6) TO BE EXCEPTED FROM DISCHARGE?

*In re Thiara*, 285 BR 420 (9<sup>th</sup> Cir. BAP 2002)

A creditor initiated an adversary proceeding to except a debt from discharge. The creditor asserted the debt arose from willful and malicious injury because it resulted from the debtor's conversion of a crop loss insurance check in which the creditor asserted an interest. The bankruptcy court found that the debtor converted the insurance proceeds and excepted the debt from discharge under §523(a)(6).

The BAP reversed. It noted that willfulness and maliciousness are two separate requirements and that both must be present to justify exception from discharge under §523(a)(6). The BAP held that the elements of conversion do not in themselves satisfy the requirement of a subjective intent to injure. It remanded for entry of appropriate findings by the Bankruptcy Court.

DISTRICT OF OREGON CASE NOTE

By Matthew Arbaugh  
Farleigh, Wada & Witt, PC

ATTORNEY FEES NOT ALLOWED IN ACTION UNDER 11 USC § 525(b)

*Pratt v. Phoenix Home Life Mutual Ins. Co.*,  
285 BR 3 (D Or 2001)

A former debtor sued a potential employer for withdrawing a job offer after learning of the plaintiff's earlier bankruptcy. The action was based on 11 USC §525(b), which prohibits employers from discriminating against or terminating an employee who filed for bankruptcy protection.

The defendant moved to strike the portion of the complaint seeking attorney's fees pursuant to 11 USC §525(b). The district court granted the motion, holding that neither the language of the statute nor any case law supports an award of attorney fees to the prevailing party in an action under §525(b).

STATE COURT CASE NOTES

By Heather Harriman  
Greene & Markley, PC

ETHICAL CONSIDERATIONS: LAWYER AS CO-SIGNOR ON CLIENT'S BANK ACCOUNTS

*In re Dugger*, 334 Or 602, 54 P3d 595 (2002)

In this disciplinary proceeding, the court explored whether the accused violated various ethical rules by becoming a cosigner on a client's bank accounts. The case presents complicated facts and several disciplinary rules for consideration. The court concluded, however, that the accused attorney had not violated any ethical rules because (1) his legal representation had no connection with the bank accounts such that the lawyer's financial interest would interfere with the representation, and (2) the client had brought the forms for cosigning on the accounts to the accused, so the accused did not "prepare" any documents giving the accused a gift in violation of the disciplinary rules.

The court also considered ethical issues involving misrepresentations to the court.

ATTORNEY FEES RECOVERABLE, BUT CAPPED AT TEN PERCENT. PERIOD.

*Williams v. Cabinet Masters, Inc.*  
335 Or 49, 57 P3d 145 (2002)

Plaintiff sued defendants on a wage claim and the parties went to court-mandated arbitration. Plaintiff prevailed at arbitration but requested a trial *de novo* seeking higher damages. Plaintiff did not improve his position in the trial *de novo* and the court entered judgment. Defendants sought recovery of their attorney fees from the trial *de novo* under ORS 36.425(4)(b) and (5)(b), which authorize an attorney fee award for defendants where plaintiffs failed to improve their position, but limit the amount of recoverable fees to 10% of the amount claimed in the complaint. The trial court awarded defendants 10% of the amount sought in the complaint.

Plaintiff appealed to Court of Appeals and, again, did not improve his position. Defendants sought another award of attorney fees. Plaintiff then filed petitions for review in the Supreme Court and defendants sought additional attorney fees when plaintiff's petitions were denied. Defendants argued that ORS 36.425 and ORS 19.440, read together, allow defendants to recover attorney fees (capped at 10%) for each stage of litigation. The Supreme Court disagreed. It held that recoverable fees are limited to 10% of the amount sought in the complaint, regardless of the number of unsuccessful appeals brought by the plaintiff.

## CONSPICUOUSNESS OF CONTRACT PROVISIONS

*Young v. Continental Crane & Rigging Co.*  
183 Or App 563, 53 P3d 465 (2002)

An indemnity provision of a contract is enforceable only if one of the following is true: (1) the parties specifically bargained for the provision, (2) the party who drafted the contract brought the provision to the other party's attention, or (3) the provision is conspicuous. Here, the defendant did not argue that (1) or (2) was the case, so the issue was whether the indemnity provision was conspicuous. Applying ORS 71.2020(10) and many Oregon decisions on the conspicuousness of various contract provisions, the court considered different types of signals and markers used to distinguish and set off contract provisions (*e.g.*, boldface type, italics, all capitals, etc.). It concluded that an indemnity provision printed on the back side of pink paper in light ink is not conspicuous. The case is mentioned here because of the court's detailed survey of the law.

CONSTRUCTION LIENS: RECOVERING  
ATTORNEY FEES AND OBTAINING PRIORITY  
OVER MORTGAGEE

*Safeport, Inc. v. Equipment Roundup & Mfg.*  
184 Or App 690, 60 P3d 1076 (2002)

Defendant foreclosed its construction lien and sought attorney fees under ORS 87.060(5), which requires compliance with ORS 87.057 (a lien claimant must plead and prove the requirements for notice to the property owner). Defendant failed to **plead** compliance with the notice requirements, but offered evidence sufficient to **prove** compliance in connection with cross-motions for summary judgment. In fact, plaintiff offered the same evidence as defendant, which proved defendant's compliance with the notice to the property owner.

The trial court denied defendant's motion to amend its pleadings to conform to the evidence. After exploring the factors relevant to the allowance of an amendment of the pleadings, the Court of Appeals held that defendant should have been allowed to amend its pleadings to conform with defendant's pleading omission because the plaintiff had in fact offered the same evidence as defendant during the cross-motions for summary judgment, meaning there was no unfairness or surprise in allowing the amendment.

The court also considered the priority of defendant's construction lien as to a mortgagee. The statute requires a lien claimant to provide a mortgagee with notice of materials provided. Here, defendants did not provide the mortgagee bank with the appropriate notice. The court held that where a construction lien lumps together labor and materials, and the claimant fails to provide notice to a prior mortgagee of the materials furnished, the lien claimant may obtain priority over the mortgagee's interest only for the amount of labor, since labor charges don't require notice.

CONSUMER BANKRUPTCY  
COMMITTEE

By Michelle Bertolino  
Farleigh, Wada & Witt, P.C.

The Consumer Bankruptcy Subcommittee of the Debtor-Creditor Section met September 19, 2002, November 21, 2002, and January 16, 2003.

SEPTEMBER 19 MEETING

**1. The office of the Chapter 13 Trustee in Portland discussed the following issues:**

**A. Feasibility Program.** The Feasibility Program will soon be installed on the Trustee's website. Debtor's attorneys can run the program directly from the site and will not need to download the program.

**B. Debtor ID Program.** Rick Yarnall stressed the need for debtors to come to the 341 meeting of creditors with photo ID and proper verification of their Social Security numbers. The 341 meeting will be reset if a debtor appears without the required documentation. Mr. Yarnall suggested that the debtor's attorney make sure that debtor has the appropriate documents available at the intake stage so that if debtor needs to get a Social Security card, they can do so before the meeting. Mr. Yarnall provided attendees with information on how to obtain a replacement or new social security card or verification of social security number.

**C. Electronic Case Files (ECF).** The Trustee's office is planning for implementation of the electronic case filing system, which is currently projected for May 2003. The system for the District of Oregon will be phased in, as opposed to a complete and immediate switch.

**D. Office Staff.** There is some new staff at the Chapter 13 Trustee's office. Please be patient while people become acquainted with their new positions.

**2. Self-Employment and Sole Proprietorships in Chapter 7.** Chapter 7 Trustee Michael Grassmueck was present to discuss issues related to chapter 7 debtors who are self-employed.

Mr. Grassmueck stressed that chapter 7 is a liquidation proceeding and while the trustee may elect to operate a business, there is no provision in the Bankruptcy Code for the continued operation of the business by the debtor. As of the filing date, the Trustee and the bankruptcy estate are liable for business operations and the assets become a part of the bankruptcy estate, subject to claims of exemption. Business assets can include anything from equipment,

inventory and accounts receivable to phone numbers, internet domain names and good will.

Mr. Grassmueck suggested that if self-employed debtors want to protect their businesses, they should either file a chapter 13 or 11 case or establish a new business. A debtor can establish a new business, they may do so by assuming a new business name, opening a new bank account, and obtaining a new tax ID number and new liability and other types of insurance. Mr. Grassmueck warned that continued use of assets of the prior business is only advisable if the assets are clearly within the applicable exemptions. Improper conversion of assets of the estate to a new business could lead to serious problems with the trustee, including claims for money or denial of discharge. An option of last resort is to seek abandonment of the business assets by the trustee. Before abandoning the business, however, the trustee will need to verify the value of the business assets, which may include putting the business on the market.

**3. News From the IRS.** Jeff Werstler of Special Procedures addressed the following issues:

**A. Unfiled returns and objections to confirmation.**

Mr. Werstler stressed the need for debtors to give the IRS time to receive and review tax returns prior to a withdrawal of objection to confirmation of the Plan for unfiled returns. If the debtors file their returns at the last minute, the IRS may not have enough time to review the returns and withdraw objections. Thus, debtors who have a confirmation hearing coming up and are filing returns at the last minute should drop their returns off in person or call the IRS to advise them of the urgency of review.

**B. §1305 Claims.** The IRS will typically entertain a §1305 claim if the claim is for the same year as the year of the bankruptcy filing. For example, the IRS is more likely to allow a §1305 claim for 2002 if the case is filed in October 2002 as opposed to January 2003. Also, if there are prepetition tax debts to be paid through the plan, the IRS is more likely to allow the §1305 claim.

**C. IRS Lien.** Ann Chapman discussed the potential for IRS liens to take precedence over other security interests, particularly where a lender does not timely perfect a lien. The example given was an automobile. When this issue arises in a Chapter 13 case, questions of state title laws and the Federal Tax Code must be resolved between the secured lender and the IRS, ultimately affecting payment of claims through the Plan.

**4. Legal Representation and Discharge to Chapter 7 Cases.** Many attorneys representing discharged debtors in chapter 7 cases discussed concerns that chapter 7 trustees, in connection with asset cases and adversary proceedings, may be communicating directly with debtors and not providing debtors' attorneys with copies of correspondence indicating the status of the case. Thomas Renn and Michael Grassmueck said they are careful not to communicate directly with debtors unless the attorney has authorized them to do so. However, debtors frequently tell the Trustee that they are no longer represented or cannot afford further representation once the case is discharged. It was stressed that the discharge itself does not terminate the attorney-client relationship. For adversary proceedings, Judge Dunn will set a hearing on any case in which an attorney moves to withdraw, in order to ensure that the debtor has been advised of the implications of the proceeding and of the option to obtain new counsel. Judge Dunn also stressed that the inability of the debtor to pay legal fees is not sufficient for an attorney to withdraw.

NOVEMBER 21 MEETING

**1. Announcements.**

**A.** Rich Parker announced that Dagmar Butte will start with Parker, Bush & Lane in January 2003.

**B.** Matt Armory from the IRS announced that their case load is being split. Eugene cases will be handled by the Sacramento office of the IRS, and Portland cases will be handled out of Portland.

**C.** Wayne Godare from Rick Yarnall's office corrected an error in his announcements at the last meeting. Jack Fisher at the trustee's office still does pre-confirmation work and Wayne does post-confirmation work.

**D.** Rick Yarnall announced that Congress has passed an extension of chapter 12 bankruptcy filings. He believes it's a six month extension. Anyone who has a chapter 12 in the pipeline should go ahead and complete it.

**E.** Chapter 7 Trustee Michael Grassmueck reminded us that clients bringing documents to the 341 meeting should remove the documents from their envelopes and unfold them so he can access them quickly. This will speed up the process for all parties.

**2. Fast Track Confirmation Process.** Judge Alley reported that the Fast Track Confirmation Process will continue in Eugene. Confirmation hearings are no longer necessary unless requested by a party in interest. The Fast Track Confirmation Process is an attempt to clear the backlog of cases. It also allows plan disbursements to be made sooner. All cases filed after July 15, if assigned to Judge Alley, will be Fast Track.

Several people voiced concern that the Fast Track Process may prevent all confirmation issues from being resolved before the hearing, especially in complex cases such as divorce cases, child support arrearage cases, and cases where public agencies have secured claims and have not had time to analyze the files. Judge Alley said that the parties should notify the court of any such complexities, and the court can craft special scheduling orders.

## JANUARY 16 MEETING

### 1. Automobile Financing Bankruptcy.

James Penny of Royal Moore Auto Center in Hillsboro was present at the meeting to discuss financing options for debtors in chapter 7 and chapter 13 cases. Mr. Penny is experienced in financing debtors in bankruptcy and has worked with law offices and the Chapter 13 Trustee. Mr. Penny discussed the approval process for debtors in bankruptcy and the \$10,000 limit on auto financing in chapter 13 cases. Practitioners think the \$10,000 limit is too low given market values of reliable vehicles. Any suggestions for changing the approval process and dollar limits may be addressed to the bankruptcy judges or Rick Yarnall's office.

### 2. Chapter 13. Rick Yarnall discussed the following issues:

**A. Secured Claims.** A secured creditor filing a proof of claim must attach security documents to the claim or the trustee will object to the claim. Rick Yarnall suggested changing the procedure to require that all proofs of claim be filed under penalty of perjury so it is not necessary to attach the security documents, which can be lengthy. The only exception to the requirement of security documents is where a debtor files a claim on behalf of a secured creditor. A debtor may file a claim on behalf of creditor within 30 days from the bar date. If the creditor files a secured claim, and the claim is not provided for in the plan, the court will set a hearing because the claim is deemed to control.

**B. Section 1305 Claims.** The current standard language for chapter 13 plans in Section 1305 Tax Claims includes a statement that the tax liability "will not exceed \$\_\_\_\_ dollars" (a cap, required in all cases), and a statement that the "payment of this claim will not diminish distribution to general unsecureds" (required post-confirmation or any time before notice has been given).

i) The dollar cap is essential to determine a plan's feasibility. IRS and ODR have difficulty when combined state and federal tax liability exceeds the cap. The Trustee will pay the competing tax claims on a pro rata basis, as opposed to a "first to file" basis.

ii) The provision stating that section 1305 claims will not diminish distribution to general unsecured creditors may be incorrect; as a practical matter there will be an impact on unsecured creditors whether the claim is paid through the plan or outside the plan as a Schedule J expense. If the section 1305 claim is post-confirmation, the impact on unsecured creditors will be more strictly examined.

**C. Trustee Website.** Anyone having problems with the Trustee's website, including the new feasibility and liquidation programs, should notify the Trustee's office of the precise problem so it can be addressed.

### 3. Announcements

**A.** Diane Tebelius, former Assistant US Attorney in Seattle, was recently named the new US Trustee for the Region.

**B.** Vince Cameron, currently staff attorney for Karla Forsythe, has accepted a position as the Chapter 13 Trustee in Salt Lake City, Utah.

**C.** Michael S. Scott of M. Carolyn Cantrell and Associates is the new Chair of the Consumer Bankruptcy Subcommittee of the Debtor Creditor Section. The subcommittee still needs a secretary. Anyone interested should call Mike Scott at 503/236-9211.

The Consumer Bankruptcy Subcommittee usually meets every other month on the third Thursday of the month at 4:30 p.m. in the 8th floor conference room at the United States Bankruptcy Court in Portland. The next meeting will be March 20, 2003. All bankruptcy practitioners are encouraged to attend. Please contact Gerald Pederson to add topics to the agenda or for further information.

*Thanks to Mike Scott for providing minutes of the meetings from which all or part of this article were derived.*



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## SEMINAR CALENDARS AND REGISTRATION INFORMATION

## MARCH, 2003

**7**

Finance: The Basics (Learn to Read and Understand Balance Sheets, Income and Cash Flow Statements): Portland, OR; LES

**8-11**

Turnaround Management Association 2003 Spring Conference; Lake Buena Vista, FL; TMA

**13-15**

The 36th Annual Uniform Commercial Code Institute:

\*Comprehensive Review of Revised Article 9,

\*Electronic Contracts,

\*Update on Sales (Article 2); San Francisco, CA; UCCI

**27-30**

Norton Bankruptcy Litigation Institute II; Las Vegas, NV; NIBL

**27-28**

Advanced Commercial Loan Workout Techniques: Learn Workout and Restructuring Strategies Used by Experienced Pros!; New York, NY; FRA

**28**

2003 Induction Ceremony, American College of Bankruptcy; Washington, D.C.; ACB

## APRIL, 2003

**1**

Fair Debt Collection Practices Act Compliance for the Oregon Practitioner; Portland, OR; NBI

**3-6**

ABA Section of Business Law Spring Meeting; Los Angeles, CA; ABA

**7-8**

25th Annual Current Developments in Bankruptcy & Reorganization; New York, NY; PLI

**10-13**

ABI 2003 Annual Spring Meeting; Washington, D.C.; ABI

**21**

Bankruptcy Update; Portland, OR; MBA

**21-22**

25th Annual Current Developments in Bankruptcy & Reorganization; San Francisco, CA; PLI

**25-26**

Northwest Bankruptcy Institute; Seattle, WA; OSB

## MAY, 2003

**1-3**

The 36th Annual Uniform Commercial Code Institute:

\*Comprehensive Review of Revised Article 9,

\*Electronic Contracts,

\*Update on Sales (Article 2); Chicago, IL; UCCI

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