NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE NINTH CIRCUIT

In re:	BAP No. WW-10-1142-MkHJu
MICHAEL R. MASTRO,	Bk. No. 09-16841-SJS
Debtors.	
JAMES F. RIGBY, JR., Chapter 7 Trustee,	
Appellant,	
v.	**MEMORANDUM**[*]
ITALIAN COMMUNITY HALL, INC.,	
Appellee.	

Submitted Without Oral Argument
on January 21, 2011[**]

Filed - May 10, 2011

Appeal from the United States Bankruptcy Court
for the Western District of Washington

Honorable Samuel J. Steiner, Bankruptcy Judge, Presiding

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[*]This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have (see Fed. R. App. P. 32.1), it has no precedential value. See 9th Cir. BAP Rule 8013-1.

[**]This matter was set for oral argument on the Panel's January 21, 2011, calendar in Seattle, Washington. Although he had previously indicated he would appear and argue, Jerome Shulkin of Shulkin Hutton, Inc., P.S., counsel for Appellee Italian Community Hall, did not appear at the time set for argument. Christine Tobin of Bush, Strout & Kornfeld, counsel for Appellant James Rigby, chapter 7 trustee, appeared but consented to submission of the matter without argument.

Appearances: Christine M. Tobin-Presser of Bush, Strout & Kornfeld on brief for Appellant James F. Rigby, Chapter 7 Trustee
Jerome Shulkin of Shulkin Hutton, Inc., P.S. on brief for Appellee Italian Community Hall, Inc.

Before: MARKELL, HOLLOWELL and JURY, Bankruptcy Judges.

INTRODUCTION

James F. Rigby, Jr., chapter 7[1] trustee ("Trustee"), appeals the bankruptcy court's order granting the motion of Italian Community Hall, Inc. ("ICH") for relief from the automatic stay and also denying the Trustee's motion for authority to sell certain real property (the "Property") that had been owned by debtor Michael R. Mastro ("Mastro"). We REVERSE the order granting relief from stay, and we VACATE the order denying the Trustee's sale motion. We thus REMAND for further proceedings.

FACTS

On July 10, 2009, three of Mastro's secured creditors filed an involuntary chapter 7 petition against him. Mastro consented to the petition on August 20, 2009. The court entered an "Order for Relief and Judgment Granting Petition for Involuntary Chapter 7" on August 21, 2009, and the Trustee was appointed that same day.

On December 31, 2009, ICH filed its motion for relief from stay ("ICH Motion"). ICH sought relief from the automatic stay so that it could pursue its rights against the Property. Those rights derived from a deed of trust dated February 8, 2006.

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[1]Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all Rule references are to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.

ICH's Motion was skeletal and was not accompanied by any declarations or documentary evidence. Rather, the ICH Motion referred to a proof of claim that ICH filed on October 8, 2009, asserting a secured claim in the amount of $647,467.91. Attached to the proof of claim was a copy of the February 8, 2006 deed of trust, and a one-page document entitled "Exhibit A to Promissory Note." The proof of claim stated that the basis of the claim was a "Promissory Note," but no note was attached to the proof of claim.

In subsequent papers filed in support of its motion, ICH provided a copy of a note dated May 9, 2003, in the original principal amount of $400,000, made by Mastro and payable to ICH. ICH contended that the 2006 deed of trust secured the 2003 note.

On January 22, 2010, the Trustee filed an objection to the ICH Motion. In essence, the Trustee argued that ICH's 2006 deed of trust did not validly encumber the Property because it lacked an essential element of any security device: it did not contain a statement of an intention to secure a debt capable of enforcement.

The Trustee's argument is based upon the following language in the 2006 deed of trust:

> This deed is for the purpose of securing performance of each agreement of grantor [identified therein as Mastro] herein contained, and payment of the sum of ($400,000) FOUR HUNDRED THOUSAND DOLLARS and NO/CENTS with interest, in accordance with the terms of a promissory note *of even date herewith*, payable to Beneficiary [identified therein as ICH] or order, and made by Grantor, and all renewalls, modifications and extensions thereof, and also such further sums as may be advanced or loaned by Beneficiary to Grantor, or any of their successors or assigns, together with interest thereon at such rate as shall be agreed upon[.]

2006 Deed of Trust at p. 1 (emphasis supplied).

As the Trustee explained in its subsequent filings in support of its opposition, the words in the 2006 deed of trust unambiguously expressed an intent that the 2006 deed of trust secured a debt evidenced by a note "of even date" with the deed of trust – that is, February 8, 2006 – and ICH produced no evidence that such an indebtedness existed.[2] Further, the Trustee asserted that parol evidence was not admissible to rewrite the unambiguous terms of the deed of trust, as it would constitute an impermissible attempt by ICH to reform the 2006 deed of trust, an action that would require a separate adversary proceeding. The Trustee reiterated its assertion that an adversary proceeding was necessary at the final hearing on the ICH Motion.[3]

Both sides offered extrinsic evidence in support of their positions. ICH offered the declaration testimony of William Buchholz and Anthony Petrarca, two gentlemen affiliated with ICH. They generally testified that, to their knowledge, the 2003 note evidenced the only debt that Mastro owed to ICH, that it was originally secured, and that the parties would from time to time substitute collateral that secured this debt. According to Buchholz and Petrarca, the last collateral that Mastro provided to secure the debt was the Property. The Buchholz and Petrarca

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[2]Indeed, ICH stated that there was no note other than the 2003 note.

[3]The Trustee also argued, both in the bankruptcy court and on appeal, that the evidence presented was insufficient to support a claim for reformation.

declarations were accompanied by a handful of documents, which ICH claimed corroborated their account of the parties' mutual intent. In part, these documents included correspondence between Mastro's office and ICH generally concerning the substitution of collateral and an appraisal report for the Property.

Meanwhile, the Trustee offered transcript excerpts from a Rule 2004 examination of Mastro. Mastro testified that he had signed the 2003 note. He also testified that the parties generally had a practice of substituting collateral with respect to existing notes, and that when collateral was substituted he typically "issued a new note and voided the old one." 2004 Exam Transcript (Feb. 18, 2010) at 70:18-71:19. Mastro further testified that he signed the 2006 deed of trust, and that the parties several times substituted the collateral securing the 2003 Note. Finally, Mastro testified that he did not know whether he ever signed a note dated February 8, 2006, as referenced in the 2006 deed of trust, and that he was unaware of any mistakes in the 2006 deed of trust.

On January 27, 2010, the Trustee file a motion for authority to sell the Property free and clear of liens, claims and encumbrances pursuant to § 363(f) (the "Sale Motion"). The proposed sale price was $160,000. The Trustee acknowledged that the title report for the Property reflected a lien in favor of ICH, but the Trustee asserted his belief that the ICH lien was void, referring to his objection to the ICH Motion and related papers.

ICH objected to the Trustee's Sale Motion, and both parties filed additional papers in support of their respective positions.

Their assertions regarding the Sale Motion largely mirror their assertions regarding the ICH Motion.

The bankruptcy court held a preliminary hearing on the ICH Motion on January 29, 2010. The court continued the matter in order to give the parties the opportunity to marshal their evidence and provide further briefing. According to the court, the principal issue was "whether or not [the 2006] deed of trust was intended to secure the 2003 note." Transcript (Jan. 29, 2010) at 38:13-14.

The bankruptcy court held a joint final hearing on the ICH Motion and the Sale Motion. The final hearing consisted solely of the oral argument of the Trustee's counsel, and the court's comments and ruling on the two motions. No live testimony was taken, no formal evidentiary objections were made to any of the evidence that the parties submitted in their papers, and the court did not formally admit into evidence any of the parties' written submissions.

At the conclusion of the hearing, the court granted the ICH Motion and denied the Sale Motion. At the time of its ruling, the court made the following findings: (1) that Mastro was indebted to ICH; (2) that this debt was a liquidated debt and not subject to any dispute; and (3) the 2006 deed of trust was intended to secure this debt, even though there was no note of even date as referenced in the 2006 deed of trust.

Reading the hearing transcript as a whole, the court's ruling primarily hinged on its legal determination that a debt may be secured by an encumbrance on real property even if the debt is not evidenced by a note. It is unclear whether the court

relied on extrinsic evidence in support of its ruling. The court might have credited the extrinsic evidence tending to show that, from time to time, the parties would substitute the collateral securing the debt evidenced by the 2003 note.

The court acknowledged the Trustee's argument that the 2006 deed of trust expressed an intent for the Property to secure a debt evidenced by a note of even date, but the court apparently rejected this argument. A fair reading of the entire transcript suggests three possible grounds behind the court's ruling: (1) the extrinsic evidence regarding substitution of collateral reflected a different intent, (2) the reference to a note of even date was merely "boilerplate language you find in every form deed of trust" and (3) ICH, a private charitable organization, could not be held to the same degree of skill as a bank in documenting its loan transactions.

On April 14, 2010, the court entered its order granting the ICH Motion and denying the Sale Motion. The Trustee timely appealed.

JURISDICTION

The bankruptcy court had jurisdiction pursuant to 28 U.S.C. §§ 1334 and 157(b)(1). We have jurisdiction under 28 U.S.C. § 158(a)(1).

ISSUE

Did the bankruptcy court abuse its discretion in granting the ICH Motion and denying the Sale Motion?

STANDARDS OF REVIEW

We review orders granting relief from the automatic stay for abuse of discretion. Kronemyer v. American Contractors

Indem. Co. (In re Kronemyer), 405 B.R. 915, 919 (9th Cir. BAP 2009). We also review orders on motions to sell pursuant to § 363 for abuse of discretion. Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25, 32 (9th Cir. BAP 2008).

Under the abuse of discretion standard of review, we first "determine de novo whether the [bankruptcy] court identified the correct legal rule to apply to the relief requested." United States v. Hinkson, 585 F.3d 1247, 1262 (9th Cir. 2009) (en banc). And if the bankruptcy court identified the correct legal rule, we then determine under the clearly erroneous standard whether its factual findings and its application of the facts to the relevant law were: "(1) illogical, (2) implausible, or (3) without support in inferences that may be drawn from the facts in the record." Id. (internal quotation marks omitted).

We generally review de novo the bankruptcy court's interpretation of contract terms. See United States v. 1,377 Acres of Land, 352 F.3d 1259, 1264 (9th Cir. 2003); Kittitas Reclamation Dist. v. Sunnyside Valley Irrigation Dist., 626 F.2d 95, 98 (9th Cir. 1980). In interpreting contracts, findings regarding surrounding circumstances are reviewed under the clearly erroneous standard, but the application of rules of contract construction is a matter of law subject to de novo review. Id.

DISCUSSION

1. Validity and Interpretation of 2006 Deed of Trust

Under Washington law, encumbrances of real property must be created by deed, and deeds must be in writing. Revised Code of Washington ("RCW") §§ 64.04.010, 64.04.020. An essential term of

any encumbrance is a reference to the obligation secured. In other words, to create a valid encumbrance, the parties must have intended to secure a debt that is capable of enforcement. See Tesdahl v. Collins, 97 P.2d 649, 652 (Wash. 1939); John R. O'Reilly, Inc. v. Tillman, 191 P. 866, 868 (Wash. 1920); Reed v. Parker, 74 P. 61, 64 (Wash. 1903); Parker v. Speedy Re-Finance, Ltd., 596 P.2d 1061, 1067 (Wash. Ct. App. 1979).

Here, the 2006 deed of trust expressly and explicitly identifies the obligation secured as a debt evidenced by a note "of even date," but it is undisputed that no such note exists, or at least that no such note was produced or proved. Consequently, given that the 2006 deed of trust does not refer to an enforceable obligation, the deed of trust appears to be invalid on its face.

ICH argues, however, that the 2006 deed of trust was meant to secure the debt evidenced by the 2003 note. ICH points to documents and statements of parties to demonstrate that there was an intent for the 2006 deed of trust to secure the 2003 note. We look to Washington law to determine whether this extrinsic material may be considered.

As a general rule, Washington law provides that when a writing is required, "parol evidence is not admissible or permissible to establish an essential provision of the alleged agreement nor to supply deficiencies in the writing." Smith v. Twohy, 425 P.2d 12, 15 (Wash. 1967). As applied here, Smith suggests that, given the explicit description contained in the 2006 deed of trust, ICH cannot look to extrinsic evidence in an attempt to vary the 2006 deed of trust's description of what it

was meant to secure. Recent Washington case law emphasizes that Washington follows the "objective manifestation theory" of contract interpretation. See Hearst Commc'ns, Inc. v. Seattle Times Co., 115 P.3d 262, 267 (Wash. 2005) (citing cases). In other words, Washington courts "[focus] on the objective manifestations of the agreement, rather than on the unexpressed subjective intent of the parties." Id. Washington courts thus "impute an intention corresponding to the reasonable meaning of the words used." Id. They "do not interpret what was intended to be written but what was written." Id.

This objective manifestation rule coexists with Washington's "context rule," which allows extrinsic evidence to help determine the meaning of specific words and terms used. See Berg v. Hudesman, 801 P.2d 222, 229 (1990). But no context can show that words having only one reasonable meaning – here, a specific date – can mean something completely different – here, a totally different date. The context rule simply does not allow a party to offer extrinsic evidence to demonstrate that party's unilateral or subjective intent, or to show an intention separate and apart from the written instrument. In short, the context rule cannot be used to "vary, contradict or modify the written word." Hollis v. Garwall, Inc., 974 P.2d 836, 843 (Wash. 1999); see also Hearst Commc'ns, 115 P.3d at 267.

Most importantly, as set forth above, the context rule is not so broad as to allow the admission of extrinsic evidence to interpret the meaning of a contract term when the plain language of that term is "subject to only one reasonable interpretation." Hearst Commc'ns, 115 P.3d at 270 & n.14. In Hearst Commc'ns, the

court rejected the extrinsic evidence offered by Hearst because the contract language in question was not reasonably susceptible to the meaning that Hearst was attempting to attribute to it. Id.[4]

ICH here sought to offer extrinsic evidence to contradict the plain meaning of the 2006 deed of trust, which stated on its face that it secured a debt evidenced by a "note of even date." It might have been ICH's subjective, unilateral intent to secure the 2003 note, but that intent is not expressed in the writing, nor is the writing reasonably subject to that interpretation. It also is conceivable that the parties mistakenly referenced "a note of even date" rather than referencing the 2003 note, but proving that the parties' writing does not accurately reflect the parties' intent is not a matter of contract interpretation, but rather must be addressed, if at all, as a matter of reformation.[5]

In sum, Hearst Commc'ns and Hollis require us to hold that the 2006 deed of trust on its face secures an obligation that ICH could not establish. Perhaps it exists, but it does not on this record. Consequently, the 2006 deed of trust, for purposes of

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[4]The court rejected the contentions that the parties had intended that costs associated with a labor strike were costs to be allocated under either a five-page definition of costs or were to be treated under a general force majeure clause. As the court stated, the parties had "failed to reduce such an intention to writing. Instead, they defined the specific elements of calculating gains and losses once, in lengthy detail, and embedded these terms without qualification in the loss operations clause. Hearst essentially asks us to rewrite the JOA by revising the loss operations clause, something we are not at liberty to do".

[5]We discuss contract reformation immediately below.

the matters on appeal, is invalid unless reformation is available.[6]

2. Availability of Reformation

Reformation is an equitable remedy that conforms a writing to the parties' identical mutual intent when the writing materially differs from that intent. See St. Regis Paper Co. v. Wicklund, 610 P.2d 903, 905 (Wash. 1980); Akers v. Sinclair,

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[6]A bankruptcy court generally may not finally adjudicate the validity of a lien in either a relief from stay proceeding under § 362(d) or in a motion to sell under § 363(f). Both of those types of proceedings are contested matters, adjudicated by motion, Rule 9014, whereas lien validity determinations require an adversary proceeding. See Rules 4001(a)(1), 6004(c), 7001(2). However, when exercising its discretion to grant or deny relief under sections 362(d) or 363(f), a bankruptcy court should take into account an apparent issue that calls into question the validity of the creditor's interest. The prospective invalidity of that interest may justify denying relief from stay and/or granting the sale motion. See First Fed. Bank of Cal. v. Robbins (In re Robbins), 310 B.R. 626, 630 (9th Cir. BAP 2004); see generally Moldo v. Clark (In re Clark), 266 B.R. 163, 171-72 (9th Cir. BAP 2001) (explaining when relief under § 363(f) is appropriate). In short, even though the bankruptcy court may not finally determine the validity of the creditor's interest in estate property in these types of proceedings, the validity issue nonetheless can be relevant and should be considered before granting or denying relief.

Because of the relevance of the note validity and reformation issues here, we must address them both. Furthermore, the procedural limitations on bankruptcy courts in resolving contested matters do not apply to us when we are duly presented on appeal with the issue of the underlying merits of the creditor's substantive rights and interests. See, e.g., Biggs v. Stoven (In re Luz Int'l, LTD.), 219 B.R. 837, 843-48 (9th Cir. BAP 1998). Our examination of the validity and reformation issues also is consistent with the well-established rule that we may consider for the first time on appeal issues of law when the relevant facts are undisputed and/or the factual record has been fully developed. See Vasquez v. Holder, 602 F.3d 1003, 1010 n.6 (9th Cir. 2010) (quoting United States v. Berger, 473 F.3d 1080, 1100 n.5 (9th Cir. 2007)).

226 P.2d 225, 230 (Wash. 1950); Restatement (Second) of Contracts § 155, cmt. a (1981).

In Washington, "reformation is justified only if the parties' intentions were identical at the time of the transaction." Seattle Prof'l Eng'g Employees Ass'n v. Boeing Co., 991 P.2d 1126, 1130-1131 (Wash. 2000). The party seeking reformation must prove the facts supporting it by clear, cogent and convincing evidence, Akers, 226 P.2d at 231, and must establish: (1) that the parties made a mutual mistake, or (2) that one of them made a mistake and the other engaged in inequitable conduct. Wash. Mut. Sav. Bank v. Hedreen, 886 P.2d 1121, 1123 (Wash. 1994). Furthermore, reformation is not available if the intervening rights of third parties would be unduly affected. Id. at 230 (citing Restatement (First) of Contracts § 504).

In this case, the Trustee argued both before the bankruptcy court and on appeal that ICH was not entitled to reformation. We agree. The bankruptcy court never expressly invoked the remedy of reformation, but in light of our holding that ICH failed to establish that the 2006 deed of trust secured the debt evidenced by the 2003 note, the bankruptcy court could only have reached the opposite conclusion by reforming the contract.

Reformation of the 2006 deed of trust, however, would have been improper for three separate and independent reasons. First, because reformation is an equitable remedy, the court could not properly grant such relief outside of an adversary proceeding. See Rule 7001(7). Neither relief from stay proceedings nor bankruptcy sale proceedings are appropriate substitutes when an

adversary proceeding is required. See In re Robbins, 310 B.R. at 630-31; GMAC Mortgage Corp. Salisbury (In re Loloee), 241 B.R. 655, 661-62 (9th Cir. BAP 1999).

Second, even if it had been procedurally appropriate for the bankruptcy court to reform the 2006 deed of trust in the context of a relief from stay motion or a sale motion, the evidence in the record was insufficient to establish the grounds necessary for such relief. We have found no evidence in the record of mutual mistake on the parts of both Mastro and ICH – especially given Mastro's testimony at his 2004 examination – nor was there any evidence of inequitable conduct by either one of the parties.

Third and finally, the Trustee holds title to the Property as if he were a bona fide purchaser as of the commencement of Mastro's bankruptcy case for value and without notice of unrecorded competing claims or interests. See 11 U.S.C. § 544(a)(3). The Trustee's assertion of his intervening bona fide purchaser status under § 544(a)(3) would have precluded the bankruptcy court from reforming the 2006 deed of trust in any event. See Wolters v. Flagstar Bank, 429 B.R. 587, 597-98 (W.D. Mich. 2010).

Accordingly, reformation was not available to correct any alleged mistake in the 2006 deed of trust. We next examine the impact of our validity and reformation holdings on the bankruptcy court's rulings.

3. Abuse of Discretion in Granting the ICH Motion for Relief From Stay

Relief from stay motions are summary proceedings. They are, for example, meant to focus on limited issues like adequate

protection of the moving creditor, whether debtor has any equity in the property, and whether debtor needs the property to effectuate a plan of reorganization. So long as the moving creditor has submitted evidence sufficient to support a colorable claim of entitlement to estate property, the relief from stay proceeding should not be used to fully adjudicate the merits of the parties' underlying rights. See In re Robbins, 310 B.R. at 630-31 (citing Johnson v. Righetti (In re Johnson), 756 F.2d 738, 740 (9th Cir. 1985)), partially overruled on other grounds, Travelers Cas. & Sur. Co. v. Pac. Gas & Elec. Co., 549 U.S. 443 (2007); In re Luz Int'l, 219 B.R. at 841-43 (9th Cir. BAP 1998) (also citing Johnson).

However, when the parties' submissions in a relief from stay proceeding demonstrate that the movant has not established a colorable claim to holding an interest in property of the estate, the court should deny the relief from stay motion. See, e.g., In re Hubbel, 427 B.R. 789, 796-98 (N.D. Cal. 2010) (holding that bankruptcy court did not abuse its discretion in denying stay relief because debtor's TILA rescission argument cast serious doubt on the validity of creditor's security interest); Luz, 219 B.R. at 848 (holding that bankruptcy court abused its discretion in granting relief from stay in part because the record established that creditor did not have a valid setoff entitlement).

Here, the bankruptcy court granted ICH's relief from stay motion because it construed the 2006 deed of trust as securing the debt evidenced by the 2003 note. As we explained above, however, the plain language of the 2006 deed of trust is not

reasonably susceptible to this construction. ICH thus did not establish that the 2006 deed of trust secured any obligation in the record, and therefore for purposes of the relief from stay motion it held no security interest in estate property. Under these circumstances, ICH did not establish that it had a colorable interest in the Property, and accordingly the court abused its discretion in granting ICH relief from the stay.

4. Abuse of Discretion in Denying the Trustee's Sale Motion

Under the Bankruptcy Code, a trustee who seeks to sell estate property free and clear of the interests of others in such property must establish one of the following grounds:

> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
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> (2) such entity consents;
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> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
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> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f).

While the Trustee primarily relied on § 363(f)(5) in support of the Sale Motion, we note that § 363(f)(4) expressly permits a sale free and clear of an interest in estate property when "such interest is in bona fide dispute." See Moldo v. Clark (In re Clark), 266 B.R. 163, 171 (9th Cir. BAP 2001). Here, the undisputed facts in the record and our holding that the 2006 deed of trust secures an obligation that ICH could not establish would support a determination that § 363(f)(4) applies. However, we

decline to determine whether this clause applies or whether any of the four other clauses under § 363(f) apply. It suffices for us to say that, in the process of denying the sale motion based on its erroneous construction of the 2006 deed of trust, the bankruptcy court neglected to determine whether authority to sell existed or could have been granted under § 363(b)(1) and § 363(f). Under Hinkson, 585 F.3d at 1262, this constituted an abuse of the court's discretion.

CONCLUSION

Based on the analysis set forth above, the bankruptcy court's order granting the ICH Motion is REVERSED, its order denying the Sale Motion is VACATED, and this matter shall be REMANDED for further proceedings.