

UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter of

ROBERT V. BROWN and
SUE A. BROWN,

Chapter 7

Debtors.

Case No. 82-1857-C

DONALD F. NEIMAN, Trustee,

Plaintiff,

Adversary Proceeding
No. 87-0104

vs.

NORWEST FINANCIAL IOWA,
INC.,

Defendant.

ORDER ON MOTION TO DISMISS

On December 21, 1987, the motion to dismiss filed by defendant Norwest Financial Iowa, Inc. (hereinafter "Norwest") on July 17, 1987, and the resistance thereto filed by plaintiff Trustee Donald F. Neiman (hereinafter "Trustee") on December 21, 1987, came on for a hearing before this court in Des Moines, Iowa. August B. Landis appeared on behalf of Trustee and Robert D. Taha appeared on behalf of Norwest.

On December 23, 1987, Trustee filed a of his resistance to the motion to dismiss. 1987, Norwest filed a brief in support of court considers the matter fully submitted.

FACTUAL BACKGROUND

On December 27, 1982, debtors filed a joint petition for relief under Chapter 13 of the Bankruptcy Code, and on November 18, 1986, the proceedings were converted to Chapter 7. On July 24, 1984, while still in Chapter 13, debtors executed a \$40,000 plus interest promissory note to Norwest. In consideration of the note, debtors granted Norwest a mortgage and assignment of rents on certain real estate owned by debtors. This security interest was granted without any prior notice to debtors' creditors. No hearing was held to determine the propriety of debtors' incurrence of secured debt before debtors completed their transaction with Norwest. Nor was any court order entered allowing debtors to incur secured debt. On July 19, 1984, J. W. Warford, Chapter 13 Trustee, did send a letter to Norwest granting them permission to make the above loan. However, during the course of debtors' Chapter 13 proceedings, the existence of Norwest's mortgage and related note was not revealed in debtors' monthly reports.

On June 2, 1987, Trustee, in his interim Chapter 7 trustee capacity, filed this adversary proceeding complaint to determine nature and validity of interest in real estate and requested the court to (1) determine the nature and validity of Norwest's mortgage under 11 U.S.C. §364; and (2) avoid the post-petition transaction pursuant to 11 U.S.C. §549.

On July 17, 1987, Norwest filed its motion to dismiss and stated that pursuant to 11 U.S.C. §549(d), the two-year statute of limitations for Trustee to avoid the post-petition transaction had run. On December 21, 1987, Trustee filed his resistance to said motion and stated that even if Norwest's section 549(d) statute of limitations argument was correct, the court must still determine the validity of Norwest's mortgage under section 364.

DISCUSSION

The issue in this case is whether debtors' incurring of secured debt without notice and hearing is void ab initio or merely voidable.

Bankruptcy Code section 364 governs the incurrence of secured debt during any bankruptcy proceeding. That section in pertinent part reads as follows:

§364 Obtaining credit

- (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt-
 - (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title; [or]
 - (2) secured by a lien on property of the state that is not otherwise subject to a lien; or

....

- (d) (1) The court, after notice and a hearing. may authorize the obtaining of credit or the incurring of the debt secured by a senior or equal lien on property of the state that is subject to a lien only if--
- (A) the trustee is unable to obtain such credit otherwise; and
 - (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
- (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

11 U.S.C. §364 (emphasis added). Thus, before secured debt can be incurred during the pendency of a bankruptcy case, notice of intent to incur the secured debt must be given to all creditors, and a hearing thereon must be held by the court. In re Adamson Co.. Inc., 29 B.R. 937, 939 (Bankr. E.D. Va. 1983). However, while some exceptions exist for not having a hearing, there is no exception for an action to be taken without notice if "notice and a hearing" are required. In re Blumer, 66 B.R. 109, 113 (Bankr. 9th Cir. 1986)

In addition to being a statutory requirement, section 364 notice is also a constitutional requirement. Id. Unsecured creditors are entitled to procedural due process which requires individual notice to creditors before rights can be affected. Id.; see In re Center Wholesale. Inc., 759 F.2d 1440, 1449 (9th Cir. 1985).

In the case at bar, not one single creditor had notice before Norwest made the post-petition \$40,000 loan to debtors, the effect of which was to give Norwest a secured claim to \$40,000 of property of the estate that would otherwise have been distributed to unsecured creditors. Neither debtors, Norwest, nor the Chapter 13 Trustee sought a court order authorizing debtors to incur secured debt. The letter to Norwest from the Chapter 13 trustee granting permission to make the loan cannot substitute for the section 364 requirements of "notice and a hearing." Furthermore, during the course of debtors' Chapter 13 proceedings, the existence of Norwest's mortgage and related note was not revealed in debtors' monthly reports. Therefore, the court holds that debtors' mortgage transaction with Norwest is void ab initio as a violation of section 364 and the due process rights of the unsecured creditors.

Since debtors' mortgage is void and without effect, the issue of post-petition transaction avoidance by Trustee pursuant to section 549(d) is rendered moot.

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing analysis, the court concludes debtors' mortgage with Norwest is void ab initio because it was obtained in violation of both 11 U.S.C. §364 and the due process rights of the unsecured creditors.

THEREFORE, Norwest's motion to dismiss is hereby denied.

DATED this 19th day of February, 1988.

RUSSELL J. HILL
UNITED STATE BANKRUPTCY COURT