2017 WL 2180399
United States Bankruptcy
Appellate Panel of the First Circuit.

IN RE Auberto NIEVES GUZMÁN and
Annette Nazario Rodríguez, Debtors.
Auberto Nieves Guzmán and Annette
Nazario Rodríguez, Appellants,
v.
Noreen Wiscovitch Rentas,
Chapter 7 Trustee, Appellee.

BAP NO. PR 16–045
|
Bankruptcy Case No.
13
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04232
–BKT
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May 17, 2017

Synopsis

Background: In case converted from Chapter 11 to Chapter 7, Chapter 7 trustee objected to certain exemptions claimed by debtors in funds that had been held in the Chapter 11 debtor-in-possession (DIP) bank accounts. The United States Bankruptcy Court for the District of Puerto Rico, Brian K. Tester, J., sustained objections and subsequently denied debtors' second motion for reconsideration. Debtors appealed.

Holdings: The Bankruptcy Appellate Panel (BAP), Diane Finkle, J., held that:

[1] the BAP's review was confined to the bankruptcy courtorder denying debtors' second reconsideration motion;

[2] the bankruptcy court's decision to sustain trustee'ssecond exemption objection, despite trustee's erroneous notice of a 30-day response period to her objection instead of the actual 14-day response period provided by local bankruptcy rule, was neither a manifest error of law or an abuse of discretion;

[3] the bankruptcy court's adoption of lower court casessupporting trustee's position that her second exemption objection was not time-barred did not constitute a manifest error of law; and

[4] debtors waived their argument that they were permittedto exempt funds in the DIP accounts and that trustee's contrary position was wrong as a matter of law.

Affirmed.

West Headnotes (27)

[1] **Bankruptcy**
Appellate Panel

Bankruptcy Appellate Panel (BAP) is dutybound to determine its jurisdiction before proceeding to the merits, even if not raised by the litigants.

Cases that cite this headnote

[2] **Bankruptcy**
Scope of review in general

Appeal from an order denying reconsideration is generally not considered to be an appeal from the underlying judgment.

Cases that cite this headnote

[3] **Bankruptcy**
Record; a ssignments of error; b riefs
Bankruptcy
Scope of review in general

Bankruptcy Appellate Panel (BAP) may review both an order denying reconsideration and the underlying judgment itself where two conditions have been met: first, both orders may be reviewed when the appeal involves a post-judgment motion filed within 14 days of the judgment, thereby tolling the appeal period for the underlying order, and second, both orders may be reviewed only when it is clear that the appellant intended to appeal both orders, and where both parties brief issues relating to the underlying judgment. Fed. R. Bankr. P. 8002(b)(1).

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Cases that cite this headnote

[4] **Bankruptcy**

Record; a ssignments of error; b riefs

Where appellant's intent to appeal the underlying judgment is clear, appellate courts may treat the appeal as encompassing both the order denying reconsideration and the underlying judgment itself.

Cases that cite this headnote

[5] **Bankruptcy**
Record; a ssignments of error; b riefs

On appeal from the bankruptcy court's denial of Chapter 7 debtors' second reconsideration motion, the Bankruptcy Appellate Panel's (BAP) review was confined to the bankruptcy court order denying debtors' second reconsideration motion, and did not include the underlying judgment; debtors' intent was unequivocal and plainly limited to an appeal from the order denying the second reconsideration motion, as not only was that the sole order identified in their notice of appeal and in their statement of the issues on appeal, they posed each of the stated issues solely in the context of whether the bankruptcy court erred in denying the second reconsideration motion and, at oral argument, debtors' counsel confirmed that the appeal was only from that order.

Cases that cite this headnote

[6] **Bankruptcy**
Finality

Bankruptcy court order denying reconsideration is “final,” for purposes of appeal, if the underlying order is final and, together, the orders end the litigation on the merits. 28 U.S.C.A. § 158(a)(1).

Cases that cite this headnote

[7] **Bankruptcy**
Finality

Bankruptcy court's order sustaining an objection to a debtor's claimed exemption is a final, appealable order. 28 U.S.C.A. § 158(a)(1).

Cases that cite this headnote

[8] **Bankruptcy**
Judgment or Order

Because motions for reconsideration are not recognized by the Federal Rules of Civil Procedure or the Federal Rules of Bankruptcy Procedure, bankruptcy courts usually treat a motion for reconsideration as either a motion to

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Cases that cite this headnote

Bankruptcy
alter or amend a judgment or as a motion for relief from judgment. Fed. R. Civ. P. 59(e), 60(b); Fed. R. Bankr. P. 9023, 9024.

Cases that cite this headnote

[9]

Judgment or Order

Rules governing motions to alter or amend a judgment and motions for relief from judgment are distinct; they serve different purposes and produce different consequences. Fed. R. Civ. P. 59(e), 60(b); Fed. R. Bankr. P. 9023, 9024.

Cases that cite this headnote

[10]

Judgment or Order

Where no rule is designated in a motion for reconsideration, the applicable rule often depends on the time such motion is filed; a motion to alter or amend a judgment must be filed within 14 days of the entry of the judgment or order, and though a motion for relief from judgment may also be filed within 14 days of the entry of the judgment or order, if a motion is filed after the 14-day period and within one year of the entry of the judgment or order, the motion is usually construed under the rule governing motions for relief from judgment. Fed. R. Civ. P. 59(e), 60(b); Fed. R. Bankr. P. 9023, 9024.

[11]

Bankruptcy

Judgment or Order

Even where a movant seeking reconsideration of a bankruptcy court order designates a particular rule, the substance of the motion, not the nomenclature used or labels placed on motions, is controlling in determining whether the motion will be treated as a motion to alter or amend a judgment or as a motion for relief from judgment. Fed. R. Civ. P. 59(e), 60(b); Fed. R. Bankr. P. 9023, 9024.

Cases that cite this headnote

[12]

Bankruptcy

Judgment or Order

Under either the rule governing motions to alter or amend a judgment or the rule governing motions for relief from judgment, the granting of a motion for reconsideration is an extraordinary remedy which should be used sparingly. Fed. R. Civ. P. 59(e), 60(b); Fed. R. Bankr. P. 9023, 9024.

Cases that cite this headnote

[13]

Bankruptcy

Judgment or Order

Courts have "considerable discretion" in deciding whether to grant or deny a motion to alter or amend a judgment.

[15]

[16]

[17]

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Cases that cite this headnote

Bankruptcy
Fed. R. Civ. P. 59(e); Fed. R. Bankr. P. 9023.

Cases that cite this headnote

[14] Bankruptcy
Judgment or Order
To meet the threshold requirements of the rule governing motions to alter or amend a judgment, the motion must demonstrate the reason why the court should reconsider its prior decision and must set forth facts or law of a strongly convincing nature to induce the court to reverse its earlier decision. Fed. R. Civ. P. 59(e); Fed. R. Bankr. P. 9023.

Cases that cite this headnote

Bankruptcy
Judgment or Order
Under the rule governing motions to alter or amend a judgment, movant must either clearly establish a manifest error of law or fact or must present newly discovered evidence that could not have been discovered during the case. Fed. R. Civ. P. 59(e); Fed. R. Bankr. P. 9023.

Cases that cite this headnote

Bankruptcy
Judgment or Order
Motion for reconsideration is not the venue to undo procedural snafus or permit a party to advance arguments it should have developed prior to judgment, nor is it a mechanism to regurgitate old arguments previously considered and rejected. Fed. R. Civ. P. 59(e); Fed. R. Bankr. P. 9023.

Cases that cite this headnote

Bankruptcy
Judgment or Order
Rule governing motions for relief from judgment seeks to balance the importance of finality against the desirability of resolving disputes on the merits. Fed. R. Civ. P. 60(b); Fed. R. Bankr. P. 9024.

[18]

Cases that cite this headnote

Bankruptcy
Judgment or Order
In contrast to the rule governing motions to alter or amend a judgment, the rule governing motions for relief from judgment sets forth the grounds for relief, providing that the bankruptcy court may relieve a party from a final judgment, order, or proceeding if the movant successfully establishes any of the enumerated items. Fed. R. Civ. P. 59(e), 60(b); Fed. R. Bankr. P. 9023, 9024.

[19]
Proceedings
Bankruptcy court's decision to sustain Chapter 7 trustee's second objection to debtors' claim of exemption, despite trustee's erroneous notice of 30-day response period to her objection instead of actual 14day response period provided by local bankruptcy rule, was neither a manifest error of law or an abuse of discretion, such that court properly denied debtors' second reconsideration motion; bankruptcy court denied debtors' motion for reasons stated in trustee's opposition thereto, in which trustee conceded her “inadvertent” error but argued that debtors could not have been misled or confused because of their prior knowledge of the applicable, shorter response period and the clear notice of a 14-day response time on bankruptcy court's docket, case law supported bankruptcy court's adoption of trustee's reasoning, and local rule gave bankruptcy court discretion to deny trustee the relief requested. Fed. R. Civ. P. 59(e); Fed. R. Bankr. P. 9023; U.S.Bankr.Ct.Rules D.P.R., Rules 1001-1(f), 9013-1(c).

Cases that cite this headnote

[20] Bankruptcy

Cases that cite this headnote

Bankruptcy
Creation of estate; t ime
Bankruptcy
Interest of debtor in general

Commencement of a bankruptcy case creates an estate comprised of property in which the debtor holds an interest. 11 U.S.C.A. § 541.

Cases that cite this headnote

[21] Bankruptcy
Exemptions

Debtors may exempt certain property from the bankruptcy estate that would otherwise be available for distribution to creditors. 11 U.S.C.A. §§ 522, 541.

Cases that cite this headnote

[22] Bankruptcy
Effect of State Law

Debtors may choose between the federal bankruptcy exemptions listed in the Bankruptcy Code and the exemptions provided by their state of residence, together with those provided by federal nonbankruptcy law. 11 U.S.C.A. § 522.

Cases that cite this headnote

[23] Bankruptcy
Time
Bankruptcy
Proceedings

Debtor's claimed exemptions are presumed valid in the absence of a timely objection. 11 U.S.C.A. § 522(l).

Cases that cite this headnote

[24] Bankruptcy Time

Strict adherence to the deadline for objecting to a debtor's claim of exemption, unless extended by the bankruptcy court on a request made before expiration of that deadline, is critical; if no timely objection to an unambiguously-described and dulylisted exemption is filed, the property claimed as exempt is deemed exempt, regardless of whether the debtor had a colorable basis for claiming the exemption in the first place. 11 U.S.C.A. § 522(l); Fed. R. Bankr. P. 4003(b).

Cases that cite this headnote

[25] Bankruptcy
Proceedings

In case converted from Chapter 11 to Chapter 7, bankruptcy court's adoption of lower court cases supporting Chapter 7 trustee's position that her second exemption objection was not time-barred did not constitute a manifest

error of law, such that court properly denied debtors' second reconsideration motion; there was no controlling appellate decision on whether debtors' filing of amendments to their list of exemptions reopened the time to object to original objections not affected by the amendments, and because there were lower court cases supporting trustee's position, bankruptcy court's adoption of trustee's position was not a plain and indisputable error that amounted to a complete disregard of controlling law. 11 U.S.C.A. § 522(l); Fed. R. Civ. P. 59(e); Fed. R. Bankr. P. 4003(b)(1), 9023.

Cases that cite this headnote

[26] **Bankruptcy**

Presentation of grounds for review

In case converted from Chapter 11 to Chapter 7, Chapter 7 debtors waived their argument that they were permitted to exempt funds in the Chapter 11 debtor-in-possession (DIP) bank accounts and that trustee's contrary position was wrong as a matter of law where debtors raised the issue for the first time on appeal, having failed to squarely present this argument in their second reconsideration motion. 11 U.S.C.A. § 522(d)(5).

Cases that cite this headnote

[27] **Bankruptcy**

Presentation of grounds for review

Issues not raised below cannot be raised on appeal, and such arguments are deemed waived.

Cases that cite this headnote

Appeal from the United States Bankruptcy Court for the District of Puerto Rico (Hon. Brian K. Tester, U.S. Bankruptcy Judge)

Attorneys and Law Firms

Gerardo Santiago Puig, Esq., on brief for Appellants.

Javier Vilariño Santiago, Esq., on brief for Appellee.

Before Feeney, Finkle, and Fagone, United States Bankruptcy Appellate Panel Judges.

Opinion

Finkle, U.S. Bankruptcy Appellate Panel Judge.

***1** Auberto Nieves Guzmán and Annette Nazario Rodríguez (“Debtors”) appeal from the bankruptcy court's order denying their motion for reconsideration of the court's order sustaining the chapter 7 trustee's (the “Trustee”) objection to certain claimed exemptions. Because we find no abuse of discretion, we **AFFIRM** the bankruptcy court's order.

BACKGROUND

The muddled procedural history of this case results from the Debtors' multiple amendments to their asset and exemptions schedules, the Trustee's objections to such amendments, the Debtors' failure to timely respond to those objections, and delays by the parties.[1]

The Debtors originally filed a voluntary chapter 11 petition in May 2013 and, at their request, the case was converted to chapter 7 a little over two years later. For purposes of this appeal it is sufficient to note that during the chapter 11 case they filed their first amendment to Schedule C–Property Claimed as Exempt (“Schedule C”). Shortly after the case conversion, on July 9, 2015, the Debtors again amended Schedule C (“Second Amended Exemption Schedule”) to add to their claimed exemptions under § 522(d)(5)[2] the funds that had been held in the chapter 11 debtor-in-possession bank accounts (“DIP Accounts”).

Within 30 days of the filing of the Second Amended Exemption Schedule,[3] the Trustee filed an objection to the Debtors' claimed exemptions to the DIP Accounts (“First Exemption Objection”). She asserted that the Debtors were not entitled to claim exemptions for those accounts because they were funds earned or acquired postpetition, and as such, were property of the estate to be administered by the Trustee. The objection contained a notice provision incorrectly advising parties in interest, including the Debtors, of a 30–day period in which to object or otherwise respond, or the objection would be deemed unopposed and

possibly granted by the court without a hearing.[4] Nineteen days later, the bankruptcy court entered an order sustaining the Trustee's objection as unopposed ("First Exemption Order").

***2** Shortly thereafter, the Debtors filed a motion requesting reconsideration of the First Exemption Order and also presenting their opposition to the First Exemption Objection. As grounds for reconsideration, the Debtors asserted that the 30–day response period provided by the Trustee in the objection was misleading and led to their admittedly "erroneous" belief that they had 30 days to respond when, in fact, the appropriate response period was only 14 days. As to the merits of their claimed exemption, they maintained that the First Exemption Objection should not be sustained because the funds in the DIP Accounts were property of the estate in which they can properly claim an exemption under § 522(d)(5). The Trustee did not file any opposition to the reconsideration motion.

On September 9, 2015, before the court acted on this motion, the Debtors filed their third amended Schedule C ("Third Amended Exemption Schedule"). The pertinent change to the schedule updated the balance in the DIP Accounts claimed as exempt. Without conducting a hearing (or referencing the reconsideration motion), by order entered on October 1, 2015, the bankruptcy court vacated the First Exemption Order ("Vacating Order") as "improvidently entered." On that same day, the court also entered a separate order overruling the Trustee's First Exemption Objection ("Order Overruling First Exemption Objection"). No explanation for the court's ruling was given. The Trustee did not appeal either of these orders, but a few days after their entry, she filed a motion requesting a 30–day extension of time to seek reconsideration of the orders. The bankruptcy court did not rule on the extension request for many months and, for unexplained reasons, the Trustee did not file a motion for reconsideration of the orders until almost six months later—March 29, 2016. As grounds she argued that the Order Overruling First Exemption Objection was a manifest error of law. On May 3, 2016, again without explanation, the bankruptcy court denied the Trustee's extension request filed months earlier ("Order Denying Extension"), but it did not acknowledge or rule on the Trustee's motion for reconsideration.

Meanwhile, on April 4, 2016, the Debtors amended Schedule C for the fourth time ("Fourth Amended Exemption Schedule"), to include an exemption for an apartment they owned. The Debtors made no other additions or changes to their other claimed exemptions. Within 30 days of the filing of this amendment, the Trustee filed a "Second Objection to Claimed Exemption and, in the Alternative for Turnover of Property of the Estate" ("Second Exemption Objection"). She maintained that the Vacating Order and the Order Overruling First Exemption Objection only related to the First and Second Amended Exemption Schedules, and the Debtors' subsequent filings of the Third and Fourth Amended Exemption Schedules rendered those prior orders moot. She asserted that this objection was timely because it was filed within the 30–day period for objection to the Fourth Amended Exemption Schedule. As to the merits, the Trustee primarily pressed her position that as a matter of law the Debtors were not entitled to claim an exemption in the DIP Accounts upon conversion of the case to chapter 7.

Adding to the procedural mishmash of this case, the Trustee's Second Exemption Objection contained the same notice error as the First Exemption Objection, stating a 30–day response period. The bankruptcy case docket, however, reflected that the actual response period was 14 days. Once again the bankruptcy court acted on this objection prior to the expiration of the incorrectly stated response period, treating it as "unopposed," and on May 20, 2016, entered an order sustaining the Trustee's objection ("Order Sustaining Second Exemption Objection").

***3** This time the Debtors reacted swiftly and on that same date filed a motion seeking reconsideration of that order and also opposing the Second Exemption Objection

("Debtors' Second Reconsideration Motion").[5] First, they asserted that the Trustee misled them by providing "inadequate and improper notice" of the appropriate response period for the Second Exemption Objection, and, because they filed their opposition within the 30– day period stated in the objection, the court should consider their opposition on the merits. Second, they challenged this objection as "unwarranted as a matter of law" because: (1) the 30–day time frame for objections to the Fourth Amended Exemption Schedule only applied to newly listed exemptions not previously claimed, and thus, did not apply to the DIP Accounts which were not modified by the Fourth Exemption Schedule; and (2) the Trustee could not reassert her objection to the exemption in the DIP Accounts because the bankruptcy court had already overruled the First Exemption Objection which had raised the same objection,

and the court "ended the discussion" when it entered the Order Denying Extension.

The Trustee filed an opposition to the Debtors' Second Reconsideration Motion ("Trustee's Opposition"), contending that: (1) the Debtors knew of the appropriate response date, which was clearly noted in the bankruptcy court's docket as a 14–day response period, and they had previously acknowledged this time frame as the appropriate response period in connection with the First Exemption Objection; (2) the Second Exemption Objection was timely because a new 30–day objection period as to *all* listed exemptions arose upon the filing of the Fourth Amended Exemption Schedule; and (3) the Order Overruling First Exemption Objection and the Order Denying Extension only pertained to the First and Second Amended Exemption Schedules, and the subsequent filings of the Third and Fourth Amended Exemption Schedules rendered those previous orders moot. Finally, the Trustee reasserted her substantive argument that as a matter of law the Debtors could not claim an exemption in the funds in the DIP Accounts.

On July 13, 2016, the bankruptcy court entered an order denying the Debtors' Second Reconsideration Motion ("July 13 Order Denying Reconsideration"), noting only: "for the reasons state[d] in the Chapter 7 Trustee's Opposition." The Debtors then timely filed their notice of appeal of the July 13 Order Denying Reconsideration, and only that order.

JURISDICTION

[1] A bankruptcy appellate panel is "duty-bound" to determine its jurisdiction before proceeding to the merits, even if not raised by the litigants. Rivera Siaca v. DCC Operating, Inc. (In re Olympic Mills Corp.), 333 B.R. 540, 546–47 (1st Cir. B.A.P. 2005) (citing Boylan v. George E. Bumpus, Jr. Constr. Co. (In re George E. Bumpus, Jr. Constr. Co.), 226 B.R. 724, 725–26 (1st Cir. B.A.P. 1998)). In order to assess our jurisdiction, we must first identify the order or orders on appeal.

I. Scope of Appeal

[2] **[3]** In their notice of appeal, the Debtors only identified the July 13 Order Denying Reconsideration. An appeal from an order denying reconsideration is "generally not considered to be an appeal from the underlying judgment." Batiz Chamorro v. Puerto Rican Cars, Inc., 304 F.3d 1, 3 (1st Cir. 2002) (citation omitted). Notwithstanding this general rule, we have, on occasion, reviewed both the order denying reconsideration and the underlying judgment itself where two conditions have been met. First, both orders may be reviewed when the appeal involves a post-judgment motion filed within 14 days of the judgment, thereby tolling the appeal period for the underlying order by operation of Bankruptcy Rule 8002(b)(1). See Ross v. Garcia (In re Garcia), 532 B.R. 173, 180 (1st Cir. B.A.P. 2015) (citing Municipality of Carolina v. Baker González (In re Baker González), 490 B.R. 642, 646 (1st Cir. B.A.P. 2013)); see also Haddock Rivera v. ASUME (In re Haddock Rivera), 486 B.R. 574, 577 n.4 (1st Cir. B.A.P. 2013). Here, the Debtors' Second Reconsideration Motion was filed within 14 days of the entry of the Order Sustaining Second Exemption Objection, and tolled the appeal period. Hence, this timeliness requirement is satisfied.

***4** **[4]** Second, both orders may be reviewed only "when it is clear that the appellant intended to appeal both orders, and where both parties brief issues relating to the underlying judgment." In re Baker González, 490 B.R. at 646 (citing Bellas Pavers, LLC v. Stewart (In re Stewart), No. MB 12-017, 2012 WL 5189048, at *4–5 (1st Cir. B.A.P. Oct. 18, 2012); Vicenty v. San Miguel Sandoval (In re San Miguel Sandoval), 327 B.R. 493, 504 (1st Cir. B.A.P. 2005). "Where the appellant's intent to appeal the underlying judgment is clear, appellate courts in this circuit generally treat the appeal as encompassing both orders." In re Stewart, 2012 WL 5189048, at *4 (citing Marie v. Allied Home Mortgage Corp., 402 F.3d 1, 8 (1st Cir. 2005); Wilson v. Wells Fargo Bank, N.A. (In re Wilson), 402 B.R. 66, 69 (1st Cir. B.A.P. 2009); In re San Miguel Sandoval, 327 B.R. at 504).

[5] Here, the Debtors' intent is unequivocal and plainly limited to an appeal from the July 13 Order Denying Reconsideration. Not only was this the sole order identified in their notice of appeal and in their statement of the issues on appeal, they posed each of the stated issues solely in the context of whether the bankruptcy court erred in denying the Debtors' Second Reconsideration Motion.

Precluding any doubts of their intention, at oral argument the Debtors' counsel confirmed that the appeal is only from the July 13 Order Denying Reconsideration. Our review then is confined to that order, and for reasons elucidated below, this limitation significantly impacts the appeal.

II. Finality

[6] [7] We have jurisdiction to hear appeals from final judgments, orders and decrees of the bankruptcy court. See 28 U.S.C. § 158(a)(1), (b)(1). " '[A]n order denying reconsideration is final if the underlying order is final and together the orders end the litigation on the merits.' " United States v. Monahan (In re Monahan), 497 B.R. 642, 646 (1st Cir. B.A.P. 2013) (quoting Garcia Matos v. Oliveras Rivera (In re Garcia Matos), 478 B.R. 506, 511 (1st Cir. B.A.P. 2012)). A bankruptcy court's order sustaining an objection to a debtor's claimed exemption is a final, appealable order. Massey v. Pappalardo (In re Massey), 465 B.R. 720, 723 (1st Cir. B.A.P. 2012) (citations omitted); Newman v. White (In re Newman), 428 B.R. 257, 261 (1st Cir. B.A.P. 2010) (citations omitted). Accordingly, the July 13 Order Denying Reconsideration is also a final order, and we have jurisdiction to hear this appeal.

STANDARD OF REVIEW

We review a bankruptcy court's findings of fact for clear error and its conclusions of law de novo. Jeffrey P. White & Assocs., P.C. v. Fessenden (In re Wheaton), 547 B.R. 490, 496 (1st Cir. B.A.P. 2016) (citation omitted). If the underlying Order Sustaining Second Exemption Objection were before us, we would conduct a de novo review on the merits of the legal issues raised by that order, including whether a new objection period arises as to all claimed exemptions with any amendment of the exemption schedule and whether the DIP Accounts were subject to exemption under § 522(c)(5). But it is not, so our review of the July 13 Order Denying Reconsideration is limited to the abuse of discretion standard. See Rodriguez v. Banco Popular de Puerto Rico (In re Rodriguez), 516 B.R. 177, 183 (1st Cir. B.A.P. 2014) ("We review a bankruptcy court's order denying a motion for reconsideration of a previous judgment for manifest abuse of discretion."). "The abuse of discretion standard is quite deferential[.]" Berliner v. Pappalardo (In re Sullivan), 674 F.3d 65, 68 (1st Cir. 2012). The First Circuit's explanation of the implications of this type of limited review is instructive:

> ***5** On appeal from a denial of a [reconsideration] motion, the movant faces a further hurdle. The [bankruptcy] court typically has an intimate, first-hand knowledge of the case, and, thus, is best positioned to determine whether the justification proffered in support of a [reconsideration] motion should serve to override the opposing party's rights and the law's institutional interest in finality. Consequently, we defer broadly to the [bankruptcy] court's informed discretion in granting or denying relief from judgment, and we review its ruling solely for abuse of that discretion.

Karak v. Bursaw Oil Corp., 288 F.3d 15, 19 (1st Cir. 2002) (citations omitted).

We may set aside a bankruptcy court's discretionary ruling only if it appears the court " 'relie[d] upon an improper factor, neglect[ed] a factor entitled to substantial weight, or consider[ed] the correct mix of factors but ma[de] a clear error of judgment in weighing them.' " Mercado v. Combined Invs., LLC (In re Mercado), 523 B.R. 755, 761 (1st Cir. B.A.P. 2015) (quoting Bacardí Int'l Ltd. v. V. Suárez & Co., 719 F.3d 1, 9 (1st Cir. 2013)). "Material" errors of law may constitute an abuse of discretion. See Charbono v. Sumski (In re Charbono), 790 F.3d 80, 85 (1st Cir. 2015) (citing In re Sullivan, 674 F.3d at 68). "A manifest error of law is [a]n error that is plain and indisputable, and that amounts to a complete disregard of the controlling law." Venegas–Hernandez v. Sonolux Records, 370 F.3d 183, 195 (1st Cir. 2004) (quoting Black's Law Dictionary 563 (7th ed. 1999)) (internal quotations omitted).

DISCUSSION

I. Legal Framework of Motions for Reconsideration We think it appropriate to discuss at some length the rule-based underpinnings of motions for reconsideration.

There appears to be confusion by many practitioners about such motions, as they frequently omit any reference to their predicate authority. In fact, such motions are a misnomer.

[8] [9] As a starting point, motions for reconsideration are *not* recognized by the Federal Rules of Civil Procedure or the Federal Rules of Bankruptcy Procedure. In re Ortiz Arroyo, 544 B.R. 751, 756 (Bankr. D.P.R. 2015) (citation omitted). Bankruptcy courts usually treat a motion for reconsideration as either a motion to alter or amend a judgment under Rule 59(e),

made applicable in bankruptcy by Bankruptcy Rule 9023, or as a motion for relief from judgment under Rule 60(b), made applicable in bankruptcy by Bankruptcy Rule 9024. See Surita Acosta v. Reparto Saman Inc. (In re Surita Acosta), 497 B.R. 25, 31 (Bankr. D.P.R. 2013) (citations omitted) (noting motion for reconsideration implicates either Rule 59(e) or 60(b)). " 'These two rules are distinct; they serve different purposes and produce different consequences.' " In re Ortiz Arroyo, 544 B.R. at 756 (quoting Lopez Jimenez v. Pabon Rodriguez (In re Pabon Rodriguez), 233 B.R. 212, 219 (Bankr. D.P.R. 1999), aff'd, 17 Fed.Appx. 5 (1st Cir. 2001)).

[10] [11] [12] Where no rule is designated, the applicable rule often depends on the time such motion is filed. See Ramirez Rosado v. Banco Popular de P.R. (In re Ramirez Rosado), 561 B.R. 598, 607 (1st Cir. B.A.P.2017). A motion under Rule 59(e) must be filed within 14 days of the entry of the judgment or order.[6] A Rule 60(b) motion may also be filed within 14 days of the entry of the judgment or order, but if a motion is filed after the 14–day period, and within one year of the entry of the judgment or order, the motion is usually construed under Rule 60(b). Nonetheless, even where the movant designates a particular rule, "[t]he substance of the motion, not the nomenclature used or labels placed on motions, is controlling." In re Lozada Rivera, 470 B.R. 109, 113 (Bankr. D.P.R. 2012). Under either rule, "the granting of a motion for reconsideration is 'an extraordinary remedy which should be used sparingly.' " Palmer v. Champion Mortg., 465 F.3d 24, 30 (1st Cir. 2006) (citations omitted); see also In re Lozada Rivera, 470 B.R. at 112.

***6 [13] [14] [15] [16]** Rule 59(e) does not state the grounds on which relief may be granted, and courts have "considerable discretion" in deciding whether to grant or deny a motion under the rule. ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46, 55 (1st Cir. 2008). It is well settled in the First Circuit that to meet the threshold requirements of Rule 59(e), the motion "must demonstrate the 'reason why the court should reconsider its prior decision' and 'must set forth facts or law of a strongly convincing nature' to induce the court to reverse its earlier decision." In re Arroyo, 544 B.R. at 756–57 (quoting In re Pabon Rodriguez, 233 B.R. at 219). The movant must either clearly establish a manifest error of law or fact or must present newly discovered evidence that could not have been discovered during the case. See Banco Bilbao Vizcaya Argentaria P.R. v. Santiago Vázquez (In re Santiago Vázquez), 471 B.R. 752, 760 (1st Cir. B.A.P. 2012) (citing Aybar v. Crispin–Reyes, 118 F.3d 10, 16 (1st Cir. 1997)); see also Marie, 402 F.3d at 7 n.2 (citations omitted). "A motion for reconsideration is not the venue to undo procedural snafus or permit a party to advance arguments it should have developed prior to judgment, nor is it a mechanism to regurgitate old arguments previously considered and rejected." Biltcliffe v. CitiMortgage, Inc., 772 F.3d 925, 930 (1st Cir. 2014) (citations omitted) (internal quotations omitted). "In practice, [Rule] 59(e) motions are typically denied because of the narrow purposes for which they are intended." In re Arroyo, 544 B.R. at 757 (citation omitted).

[17] [18] Rule 60(b) "seeks to balance the importance of finality against the desirability of resolving disputes on the merits." Farm Credit Bank of Baltimore v. Ferrera– Goitia, 316 F.3d 62, 66 (1st Cir. 2003) (citation omitted). In contrast to Rule 59(e), it sets forth the grounds for relief, providing that the bankruptcy court may relieve a party from a final judgment, order or proceeding if the movant successfully establishes any of the following:

(1) mistake, inadvertence, surprise, or excusable neglect;

(2) newly discovered evidence that, with reasonable diligence, could not have been discovered in time to move for a new trial under Rule 59(b);

(3) fraud (whether previously called intrinsic or extrinsic), misrepresentation, or misconduct by an opposing party;

(4) the judgment is void;

(5) the judgment has been satisfied, released or discharged; it is based on an earlier judgment that has been reversed or vacated; or applying it prospectively is no longer equitable; or

(6) any other reason that justifies relief.

Fed. R. Civ. P. 60(b).

The Debtors' Second Reconsideration Motion did not refer to the underlying authority for the motion, let alone specify under which of the two potentially applicable rules they were proceeding. In the absence of such specification, because the motion was filed within 14 days of the entry of the Order

Sustaining Second Exemption Objection, we deem it a motion under Rule 59(e).[7] To prevail on their motion then, the Debtors needed to either present to the bankruptcy court newly discovered evidence unavailable prior to the entry of the order, or demonstrate that the bankruptcy court made a manifest error of law or fact in sustaining the Trustee's objection.

II. Debtors' Arguments

The Debtors urge the Panel to reverse the bankruptcy court's denial of reconsideration on the following grounds: (1) the 30–day response period in the Second Exemption Objection was misleading, resulting in their failure to file an opposition within the applicable 14–day period and the entry of the order sustaining the Trustee's objection by default; (2) the Trustee's Second Exemption Objection was time-barred and should not have been considered by the court; and (3) the Trustee's objection to their claimed exemption in the DIP Accounts was unwarranted as a matter of law. We consider each in turn.

A. Trustee's Erroneous Notice of Response Period *7 [19]

Puerto Rico Local Bankruptcy Rule ("Local Rule") 9013–1(c) provides, in relevant part:

> **(c) Required Response Time Language Must be Included on All Papers.**
>
> **(1) Usual Papers.** Adequate notice must be given to interested parties of the time to respond to every motion, application, or objection to exemption. Motions with a different response time are set forth in paragraph (2) below.
>
> This notice may be in single or double space, must be in at least 11 point type, and must contain language substantially similar to the following:
>
> **NOTICE**
>
> Within fourteen (14) days after service as evidenced by the certification, and an additional three (3) days pursuant to Fed. R. Bank[r]. P. 9006(f) if you were served by mail, any party against whom this paper has been served, or any other party to the action who objects to the relief sought herein, shall serve and file an objection or other appropriate response to this paper with the clerk's office of the United States Bankruptcy Court for the District of Puerto Rico. If no objection or other response is filed within the time allowed herein, the paper will be deemed unopposed and may be granted unless: (i) the requested relief is forbidden by law; (ii) the requested relief is against public policy; or (iii) in the opinion of the court, the interest of justice requires otherwise. P.R. LBR 9013–1(c)(1).

Subsection (2) of the rule enumerates various motions and applications for which a different response time is applied from the "usual papers" under subsection (1). An opposition to an objection to claimed exemptions is not included among these and the 14–day period is the applicable one here. See P.R. LBR 9013–1(c)(2).

Local Rule 9013–1 "implements [Bankruptcy Rule] 9013 and the 'after notice and a hearing' concept established in [§] 102(1)(A) of the Bankruptcy Code, which affords an opportunity to be heard 'as is appropriate in the particular circumstances.' " In re MJS Las Croabas Props., Inc., 530 B.R. 25, 34 (Bankr. D.P.R. 2015) (quoting 11 U.S.C. § 102(1)(A)), aff'd, Castellanos Grp. Law Firm, L.L.C. v. F.D.I.C. (In re MJS Las Croabas Props., Inc.), 545 B.R. 401 (1st Cir. B.A.P. 2016).

The parties agree that the correct response period for the Debtors' objection to both the First Exemption Objection and the Second Exemption Objection was 14 days, even though the Trustee recited the wrong time period of 30 days. After the Debtors moved for reconsideration of the order sustaining the Trustee's First Exemption Objection on the basis of the Trustee's incorrect and longer response notice by which they complained they were misled, the bankruptcy court vacated the order as "improvidently entered." When the same notice defect occurred with the Trustee's second objection, however, the bankruptcy court denied the Debtors' reconsideration request. They urge the Panel to reverse, because the erroneous notice misled them and, although they did not file their opposition until after the 14–day period, they filed it well within the erroneously stated 30–day response period.

Although the bankruptcy court did not specifically explain its rationale in denying the Debtors' Second Reconsideration Motion as to this contention, it denied the motion "for the reasons stated in the Trustee's Opposition" to the Debtors' Second Reconsideration Motion. Challenging the Debtors' assertion, the Trustee conceded that once again she "inadvertently" provided the wrong response period, but argued that this time around the Debtors could not have been misled or confused where the docket entry for the Second Exemption Objection stated the correct 14–day response

deadline and the Debtors' counsel received such notification through the CM/ECF system. She also emphasized that the Debtors were already on notice of the appropriate shorter deadline by virtue of the earlier proceedings relating to the First Exemption Objection and, in fact, had previously acknowledged the 14–day period as the correct deadline.

***8** It is undisputed that although the Trustee attempted to comply with Local Rule 9013–1(c)'s notice provision, she failed to provide the correct response period. Local Rule 1001–1(f) sets forth the consequences for a party's failure to comply with the Local Rules:

(f) Failure to Comply with Local Rules. The court, *sua sponte* or on the motion of any interested party, *may* impose sanctions for failure to comply with these rules. Sanctions may include but are not limited to: the imposition of monetary sanctions; non-monetary sanctions; dismissal of the case or proceeding; striking of papers filed with the court; or denial of the relief sought, as the court in its discretion deems appropriate. P.R. LBR 1001–1(f) (emphasis added).

While the bankruptcy court had discretion to deny the Trustee the relief requested and alter or vacate the Order Sustaining Second Exemption Objection, it declined to do so "for the reasons set forth in the Trustee's Opposition." One of those reasons was the Debtors' prior knowledge of the applicable, shorter response period and the clear notice of a 14–day response time on the bankruptcy court's docket.[8] The bankruptcy court's adoption of this reasoning is supported by case law. See, e.g., In re Hartman, No. 08-41100-JDP, 2009 WL 4263503 (Bankr. D. Idaho Nov. 24, 2009) (citation omitted) (holding that a debtor's conduct is "culpable" if he has received actual or constructive notice of the trustee's objections to his claimed exemptions, yet failed to respond timely). The Debtors have simply not demonstrated that the bankruptcy court committed a manifest error of law and abused its discretion.

It also bears noting, as discussed earlier, that a motion for reconsideration is not a vehicle by which a party may attempt to overcome its own procedural failures and does not permit the Debtors to advance arguments they could have, or should have, presented to the bankruptcy court prior to the entry of the July 13 Order Denying Reconsideration.[9]

B. Timeliness of Trustee's Second Exemption Objection

***9 [20] [21] [22]** The commencement of a bankruptcy case creates an estate comprised of property in which the debtor holds an interest. See 11 U.S.C. § 541. Section 522 allows debtors to exempt certain property from the bankruptcy estate that would otherwise be available for distribution to creditors; § 522(b) allows debtors to choose between the federal bankruptcy exemptions listed in § 522(d) and the exemptions provided by their state of residence, together with those provided by federal nonbankruptcy law. See 11 U.S.C. § 522. A debtor may amend the list of property claimed as exempt "as a matter of course at any time before the case is closed." Fed. R. Bankr. P. 1009(a).

[23] Under § 522(l), a debtor's claimed exemptions are presumed valid in the absence of a timely objection. Bankruptcy Rule 4003(b)(1) governs the deadline within which a party in interest may object to a claim of exemption:

> [A] party in interest may file an objection to the list of property claimed as exempt within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later. The court may, for cause, extend the time for filing objections if, before the time to object expires, a party in interest files a request for an extension.

Fed. R. Bankr. P. 4003(b)(1). Bankruptcy Rule 1019(2) (B), with some exceptions not applicable here, provides in relevant part that "[a] new time period for filing an objection to a claim of exemptions shall commence under [Bankruptcy] Rule 4003(b) after conversion of a case to chapter 7 [.]" Fed. R. Bankr. P. 1019(2)(B).

[24] "Strict adherence to the deadline, unless extended by the [bankruptcy c]ourt on a request made before expiration of that deadline, is critical. "If no timely objection to an unambiguously-described and duly-listed exemption is filed, the property claimed as exempt is *deemed* exempt, *regardless of whether the debtor had a colorable basis for claiming the exemption in the first place*." In re Vierstra, 490 B.R. 146, 149 (Bankr. D. Mass. 2013) (citing Taylor v. Freeland & Kronz, 503 U.S. 638, 642–44, 112 S.Ct. 1644, 118 L.Ed.2d 280

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(1992); Mercer v. Monzack, 53 F.3d 1, 3 (1st Cir. 1995) (distinguishing Taylor on other grounds)) (emphasis added).

[25] In this case, the bankruptcy court converted the case from chapter 11 to chapter 7 on June 29, 2015 (after the filing of the First Amended Exemption Schedule), and a new time period for filing an objection to the Debtors' claimed exemptions commenced. See Fed. R. Bankr. P. 1019(2)(B). This new deadline was the later of 30 days after the conclusion of the post-conversion meeting of creditors (§ 341 meeting) or any amendments to the schedules. See Fed. R. Bankr. P. 4003(b)(1). The Debtors filed the Second Amended Exemption Schedule on July 9, 2015, and the post-conversion meeting of creditors concluded on September 14, 2015. Consequently, the deadline for objections to these amended exemptions would have been October 14, 2015. The Debtors, however, filed their Third Amended Exemption Schedule on September 9, 2015, and the Fourth Amended Exemption Schedule on April 4, 2016.

In the Trustee's Opposition, she contended that under Bankruptcy Rule 4003(b)(1), each of the Debtors' amendments to their claimed exemptions started a new 30–day objection period for any exemptions listed in such Amended Exemption Schedules, regardless of whether or not a particular claimed exemption was actually added or modified by the amended schedule. Following this line of reasoning, she argued that the Second Exemption Objection filed on May 3, 2016 was timely, having been filed within 30 days of the filing of the Fourth Amended Exemption Schedule. The bankruptcy court adopted the Trustee's position when it denied the Debtors' Second Reconsideration Motion "for the reasons state[d] in the Chapter 7 Trustee's Opposition." The Debtors advanced a narrower approach, arguing that the bankruptcy court abused its discretion because an amendment starts a new objection period only for those specific exemptions that were added or amended. They contended that because the Fourth Amended Exemption Schedule only added a claimed homestead exemption with respect to the apartment and did not alter or affect the other exemptions which were listed in the prior Amended Exemption Schedules, any objection had to be limited to that specific exemption claim and the Trustee's Second Exemption Objection was untimely.

***10** Neither the Supreme Court nor the First Circuit has addressed this precise issue, and courts are not in agreement. The majority of courts that have considered it have concluded that the filing of an amendment to the list of exemptions " 'does not reopen the time to object to original exemptions not affected by the amendment.' " In re Walker, 505 B.R. 217, 219 (Bankr. E.D. Tenn. 2014) (quoting In re Larson, No. 12-30913, 2013 WL 4525214, at *4 (Bankr. D.N.D., Aug. 27, 2013), and citing Bernard v. Coyne (In re Bernard), 40 F.3d 1028, 1032 (9th Cir. 1994); In re Kazi, 985 F.2d 318, 323 (7th Cir. 1993); Grueneich v. Doeling (In re Grueneich), 400 B.R. 680, 684 (8th Cir. B.A.P. 2009); In re Payton, 73 B.R. 31, 33 (Bankr. W.D. Tex. 1987); In re Gullickson, 39 B.R. 922, 923 (Bankr. W.D. Wis. 1984)); see also Alan N. Resnick & Henry J. Sommer, 9 Collier on Bankruptcy ¶ 4003.03[1][a] (16th ed. 2013). The rationale behind this conclusion is primarily the need for prompt action and finality in bankruptcy proceedings. See, e.g., In re Bernard, 40 F.3d at 1032; In re Kazi, 985 F.2d at 323; In re Grueneich, 400 B.R. at 684.

Other courts have adopted a literal reading of Bankruptcy Rule 4003(b)(1) and determined that a party in interest may object to *any* claimed exemption even if the challenged exemption was not itself the subject of an amendment. See, e.g., In re Woerner, 483 B.R. 106, 110 (Bankr. W.D. Tex. 2012); In re Allen, 454 B.R. 894, 896 (Bankr. S.D. Fla. 2011); In re Ronk, No. 05-42552DML-7, 2006 WL 2385240, at *4 (Bankr. N.D. Tex. June 19, 2006). These courts look to the plain language of the Bankruptcy Rule which refers to a 30–day objection deadline to "any amendment to the list or supplemental schedules filed," opining that it is broad and does not limit what exemptions may be objected to after an amendment to Schedule C.

Some of these courts also find support, as the Trustee argued, in "the interdependence of exemption schemes," which they conclude logically opens the door for objections to any claimed exemptions within 30 days following an amendment to the exemption schedule. In re Woerner, 483 B.R. at 110. The rationale is that any exemption amendment may impact the other claimed but unaltered exemptions, and once an exemption scheme has been approved, any modification of the scheme could affect the rest of the exemptions previously claimed, particularly exemptions under claimed under § 522(d)(1) and § 522(d)(5) (the so-called "wild card" exemption).

But we need not, and should not, in this case decide the issue on its merits because of the limited standard of review we must apply to the bankruptcy court's denial of the Debtors' Second Reconsideration Motion. There is no controlling appellate

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decision on this issue, but as indicated above, there are lower court cases supporting the Trustee's position. Consequently, the bankruptcy court's adoption of the Trustee's position was not a "plain and indisputable" error "that amount[ed] to a complete disregard of the controlling law." Venegas–Hernandez, 370 F.3d at 195 (citation omitted) (internal quotations omitted). Simply stated, there was no manifest error of law.

Alternatively, the Debtors maintain that the Trustee's renewed objection to exemption of the DIP Accounts was precluded by the earlier final order of the bankruptcy court overruling the Trustee's First Exemption Objection, which order was not appealed. In the Trustee's Opposition, relying on the cases applying a literal construction of Bankruptcy Rule 4003(b)(1), she countered that this prior ruling applied only to the First Exemption Objection and became moot upon the Debtors' subsequent amendments to Schedule C. Once again, under our limited review standard here, the bankruptcy court's ruling did not constitute a manifest error of law and there was no abuse of discretion in denying reconsideration on this ground.

C. Objection to Exemption of DIP Accounts

***11 [26] [27]** Lastly, the Debtors seek reversal of the bankruptcy court's denial of their Second Reconsideration Motion on the basis that they are permitted to exempt the funds in the DIP Accounts and the Trustee's contrary position is wrong as a matter of law. According to the Debtors, post-petition earnings in the DIP Accounts are property of their chapter 7 estate which they are entitled to claim as exempt under the wild card exemption of § 522(d)(5). They raise this issue for the first time on appeal, having failed to squarely present this argument in Debtors' Second Reconsideration Motion. It is axiomatic that issues not raised below cannot be raised on appeal and such arguments are deemed waived.[10] Benoit v. Deutsche Bank Nat'l Trust Co. (In re Benoit), 564 B.R. 799, 805– 06 (1st Cir. B.A.P. 2017) (stating that failure to raise argument in proceedings below constitutes waiver of the argument on appeal) (citation omitted); see also Above–All Transp., Inc. v. Fraher (In re Fraher), No. MB 16-026, 2017 WL 715059, at *4 (1st Cir. B.A.P. Feb.21, 2017) ("Absent extraordinary circumstances, it is apodictic that legal theories not squarely addressed and litigated below cannot be raised for the first time on appeal.") (citations omitted).

CONCLUSION

In short, the Debtors did not demonstrate that the bankruptcy court abused its discretion in denying Debtors' Second Reconsideration Motion. The July 13 Order Denying Reconsideration is **AFFIRMED**.

All Citations

--- B.R. ----, 2017 WL 2180399

Footnotes

1 Unfortunately, the bankruptcy court did not provide much explanation of its rulings in the orders entered on the various amendments, objections, and related filings. Perhaps if it had, the proceedings might not have been quite as protracted.

2 Unless expressly stated otherwise, all references to "Bankruptcy Code" or to specific statutory sections are to the Bankruptcy Reform Act of 1978, as amended, 11 U.S.C. §§ 101, et seq. All references to "Bankruptcy Rule" are to the Federal Rules of Bankruptcy Procedure, and all references to "Rule" are to the Federal Rules of Civil Procedure.

3 See discussion of Bankruptcy Rule 4003(b)(1) (setting forth 30–day deadline for objecting to claimed exemptions), *infra*.

4 Attempting (but failing) to follow the applicable notice requirements set forth in the local rules of the Puerto Rico Bankruptcy Court, the Trustee in the First Exemption Objection stated:

> Within thirty (30) days after service as evidenced by the certification, and an additional 3 days pursuant to F.R.B.P. 9006(f) if you were served by mail, any party against whom this paper has been served, or any other party to the action who objects to the relief sought herein, shall serve and file an objection or other appropriate response to this paper with the Clerk's office of the U.S. Bankruptcy Court for the District of Puerto Rico. If no objection or other response is filed within the time allowed herein, the objection will be deemed unopposed and may be granted unless: (1) the requested relief is forbidden by law; (2) the requested relief is against public policy; or (3) in the opinion of the court, the interest of justice requires otherwise. If you file a timely response, the court may, in its discretion, schedule a hearing.

5 The order on the Debtors' Second Reconsideration Motion is the subject of this appeal.

6 Bankruptcy Rule 9023 expressly alters the 28–day time frame set forth in Rule 59(e).

7 When questioned at oral argument the Debtors' counsel initially indicated that the reconsideration motion was based on Rule 60(b). However, when asked to identify the particular subsection of Rule 60(b) which justified his request for relief, he stated (erroneously) that neither Rule 60(b) nor Rule 59(e) were applicable.

8 P.R. LBR 9036–1(a)(2) provides, in relevant part:

> Filing users of CM/ECF consent to notice and service by electronic transmission upon registration as filing users. A Notice of Electronic Filing ("NEF") is automatically generated by CM/ECF and sent electronically to filing users. Service of the NEF constitutes notice and service pursuant to the Fed. R. Civ. P., Fed. R. Bankr. P., and these rules for all persons and entities that have consented to electronic service.

P.R. LBR 9036–1(a)(2). Thus, as a CM/ECF user, the Debtors' counsel received notice of the bankruptcy court's docket entry.

9 The Debtors did not argue below, and do not argue on appeal, that their failure to timely respond was a result of "excusable neglect," nor do they address the factors for "excusable neglect" set forth in Pioneer Inv. Servs. Co. v. Brunswick Assocs. L.P., 507 U.S. 380, 395, 113 S.Ct. 1489, 123 L.Ed.2d 74 (1993). See, e.g., In re Becker, 393 B.R. 233, 239 (Bankr. D. Idaho 2008) (determining debtor's failure to respond to creditor's objection to her claimed exemption was the result of excusable neglect under Pioneer). In Pioneer, the Supreme Court held that a determination of excusable neglect is an equitable determination, which takes into account all relevant circumstances surrounding a party's omission, including: (1) danger of prejudice to the non-moving party; (2) the length of the delay; (3) the reason for the delay, including whether it was in the reasonable control of the movant; and (4) whether the movant acted in good faith. 507 U.S. at 395, 113 S.Ct. 1489. Under the circumstances presented here, it is highly unlikely that the Debtors would have prevailed under the excusable neglect test in light of their constructive notice of the appropriate response date and their prior acknowledgement of the correct, shorter response deadline. As the adage goes: "Fool me once, shame on you; fool me twice, shame on me."

10 Although the Debtors asserted this substantive argument in their first motion for reconsideration of the order sustaining the Trustee's First Exemption Objection, they did not raise it as a basis on which the bankruptcy court should reconsider the Order Sustaining Trustee's Second Exemption Objection. Therefore, it was not before the bankruptcy court at the relevant time in the proceedings.

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This case was not selected for
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RULINGS BY SUMMARY ORDER DO NOT HAVE PRECEDENTIAL EFFECT. CITATION TO A SUMMARY ORDER FILED ON OR AFTER JANUARY 1, 2007, IS PERMITTED AND IS GOVERNED BY FEDERAL RULE OF APPELLATE PROCEDURE 32.1 AND THIS COURT'S LOCAL RULE 32.1.1. WHEN CITING A SUMMARY ORDER IN A DOCUMENT FILED WITH THIS COURT, A PARTY MUST CITE EITHER THE FEDERAL APPENDIX OR AN ELECTRONIC DATABASE (WITH THE NOTATION "SUMMARY ORDER"). A PARTY CITING A SUMMARY ORDER MUST SERVE A COPY OF IT ON ANY PARTY NOT REPRESENTED BY COUNSEL.
United States Court of Appeals,
Second Circuit.

Michael H. ARNOLD, as Chapter 11 Trustee, Plaintiff-Appellant,
v.
FIRST CITIZENS NATIONAL BANK, The Community Preservation Corporation, Elmira Savings Bank, Defendants-Appellees.

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May 31, 2017

Appeal from a judgment of the United States District Court for the Western District of New York (Geraci, *C.J.*).

***1 UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED** that the judgment of the district court is **AFFIRMED**.

Attorneys and Law Firms

For Plaintiff-Appellant: GREGORY MASCITTI (Christina L. Shifton, on the brief), LeClairRyan, P.C., Rochester, NY
For Defendant-Appellee First Citizens: ALLAN HILL (Nickolas Karavolas, on the brief), Phillips Lytle LLP, Rochester, NY

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For Defendant-Appellee Elmira Savings: DAVID D. MACKNIGHT, Lacy Katzen LLP, Rochester, NY

Present: John M. Walker, Jr., Debra Ann Livingston, Gerard E. Lynch, Circuit Judges.

SUMMARY ORDER

Plaintiff-appellant Michael H. Arnold, the bankruptcy trustee (the "Trustee") for debtor Cornerstone Homes, Inc. ("Cornerstone"), appeals from the November 11, 2016 judgment of the United States District Court for the Western District of New York (Geraci, *C.J.*) which, in turn, affirmed a grant of summary judgment to defendants-appellees First Citizens National Bank ("First Citizens"), The Community Preservation Corporation ("CPC"), and Elmira Savings Bank ("Elmira", collectively, the "Banks") by the bankruptcy court. We assume the parties' familiarity with the underlying facts, the procedural history of the case, and the issues on appeal.

Over the course of its life as an ongoing concern, Cornerstone developed a large portfolio of residential real estate properties in southern New York, mostly in economically depressed communities in the region. At the time the bankruptcy petition in this case was filed, Cornerstone owned more than seven hundred parcels of residential real estate, which, together, were valued at more than $18,000,000. In order to build its holdings, Cornerstone initially solicited investment from hundreds of individual investors. These individual investors (the "Individual Lenders") lent Cornerstone funds to purchase and renovate properties in the region in exchange for a promissory note (the "Individual Notes"), secured by a mortgage (an "Individual Mortgage") on one of Cornerstone's residential properties. These loans were relatively small—often on the order of $40,000—and the rates relatively high, with interest on the Individual Notes generally accruing at ten percent per year.

In 2006 and 2007, Cornerstone sought to refinance these loans at substantially lower interest rates and, to this end, turned to several banks, First Citizens, CPC, and First Niagara Bank ("First Niagara"), for funding.[1] Each of the Banks entered into separate loan agreements with Cornerstone (the "Bank Loans"). In connection with these

agreements, the Banks lent Cornerstone the specified sum, and, in return, Cornerstone separately granted each Bank a mortgage on certain properties in Cornerstone's portfolio (the "Bank Mortgages"). In an apparent effort to avoid New York's mortgage recordation tax, the parties also asked the Individual Lenders to execute a written agreement assigning his or her Individual Mortgage and the associated note to the Bank lending money against the underlying property. The individual security interests putatively transferred by these assignments were consolidated by agreements between each of the Banks and Cornerstone, each of which separately secured a Bank Loan. Under the assignments, each Individual Lender agreed to convey "unto [the assignee Bank] ... a certain mortgage made by Cornerstone ... together with the bond or obligation described in said mortgage." App'x 946. It remains uncontested on appeal that, as the Bankruptcy Court observed, the Individual Lenders "neither indorsed the underlying promissory notes nor delivered physical possession of their Individual ... Notes to the" Banks. *In re Cornerstone Homes, Inc.*, 544 B.R. 492, 497-98 (Bankr. W.D.N.Y. 2015).

***2** After Cornerstone filed for bankruptcy protection, the Trustee sued the Banks, seeking a declaratory judgment that the Bank Mortgages were unenforceable as a matter of law. It argued that, because the Individual Notes were negotiable notes covered by Article 3 of New York's Uniform Commercial Code (the "UCC"), the Banks had standing under New York law to enforce the Bank Mortgages only if the written assignments executed by the Individual Lenders validly conveyed title to the Individual Notes under Article 3. It further argued that, because Article 3 does not provide for the transfer of title to a negotiable note by written assignment, the assignments at issue only effected the transfer of the Individual Mortgages, not the Individual Notes. Since it is "the note, and not the mortgage, [which] is the dispositive instrument that conveys standing to foreclose under New York law," *Aurora Loan Servs., LLC v. Taylor*, 25 N.Y.3d 355, 361, 12 N.Y.S.3d 612, 34 N.E.3d 363 (2015), the Trustee argues that, because the Banks never gained title to the Individual Notes, the Banks have no standing to foreclose and thus cannot enforce the security interest reflected in the Bank Mortgages against property of the debtor.

In general, Article 3 of the UCC provides for two ways to gain title to a negotiable instrument: transfer and negotiation. *See* N.Y. U.C.C. §§ 3-201 (transfer); 3-202 (negotiation). Negotiation, which confers holder status on the transferee, is accomplished by physical delivery and indorsement (if the instrument is payable to order) or by delivery alone (if it is payable to bearer or is "indorsed in blank"). *Id.* §§ 3-202(1); 1-201(b)(21)(B). The UCC also permits the transfer of a negotiable instrument, which "vests in the transferee such rights as the transferor has therein." N.Y. U.C.C. § 3-201(1). However, New York's version of the UCC does not clearly define the mechanism for a valid "transfer," and the parties join issue on whether a written assignment without physical delivery of the instrument can effect a valid transfer of the instrument under Article 3. Though there are numerous New York decisions that suggest, in passing, that the recipient of a written assignment who has not taken physical delivery has, at the very least, standing to foreclose, *see, e.g.*, *Aurora Loan Servs., LLC v. Weisblum*, 85 A.D.3d 95, 108, 923 N.Y.S.2d 609 (2d Dep't 2011) ("A plaintiff has standing where it is both (1) the holder or assignee of the subject mortgage and (2) the holder or assignee of the underlying note, *either* by physical delivery *or* execution of a written assignment prior to the commencement of the action with the filing of the complaint.") (emphasis added), the parties have not pointed us to New York case law articulating a clear basis for this view or otherwise generally considering the interaction between negotiable instruments law and the law governing the prerequisites for standing to foreclose.[2] We need not address the issue ourselves here, however, as doing so is ultimately unnecessary to our resolution of this case.

As described above, rather than proceeding through purchases of the Individual Notes from the Individual Lenders by the Banks, the Bank Loans were structured as loans from each Bank, respectively, to Cornerstone. This is directly memorialized in the loan agreements between Cornerstone and the Banks, several of which include a clear promise to pay running from Cornerstone to the applicable Bank, and make no mention of the Individual Notes. But it is also the way the Trustee itself characterized the loan transactions before the bankruptcy court on summary judgment. For instance, with respect to First Citizens, the Trustee explained that "[u]pon the closing of the [First Citizens] Loan, First Citizens loaned $1,000,000.00 to [Cornerstone] pursuant to the terms of that certain promissory note issued by [Cornerstone] to First Citizens ... and that certain mortgage issued by [Cornerstone] to First Citizens...." App'x 632.

***3** The fact that the parties also obtained written assignments of the Individual Mortgages, which they subsequently consolidated by agreement, is therefore incidental, in this

case, to the parties' transaction. While these consolidation agreements might have been effective in minimizing the total mortgage recordation tax burden borne by the parties, they do not change the fundamental structure of the Bank Loans, or the fact that Cornerstone granted the Banks a mortgage securing these loans. Because the loans made by the Banks are independently sufficient to support the security interest at issue in this case, the Banks have standing under New York law to foreclose. *Citimortgage, Inc. v. Chow Ming Tung*, 126 A.D.3d 841, 842, 7 N.Y.S.3d 147 (2d Dep't 2015) ("In an action to foreclose a mortgage, the plaintiff has standing where, at the time the action is commenced, it is the holder or assignee of both the subject mortgage and the underlying note."); *see also Bank of N.Y. v. Silverberg*, 86 A.D.3d 274, 280, 926 N.Y.S.2d 532 (2d Dep't 2011) (explaining that "foreclosure of a mortgage can[ ] be pursued by one who has ... [a] demonstrated right to the debt").

* * *

We have considered the Trustee's remaining arguments and find them to be without merit. Accordingly, we **AFFIRM** the judgment of the district court.

All Citations

--- Fed.Appx. ----, 2017 WL 2350235

Footnotes

1 Elmira, the third defendant-appellant here, would later purchase the loan it currently holds from First Niagara.

2 We note, however, that the Banks have pointed us to two Appellate Division decisions which appear to have clearly held that written assignment, even absent physical delivery, is sufficient to confer standing to foreclose. *See Wells Fargo Bank, N.A. v. Walker*, 141 A.D.3d 986, 988, 35 N.Y.S.3d 591 (3d Dep't 2016) (holding that, though, "plaintiff's proof falls short of establishing standing by physical delivery" the assignment of the mortgage "together with the bond or note" was sufficient for standing); *U.S. Bank Nat'l Ass'n v. Akande*, 136 A.D.3d 887, 890, 26 N.Y.S.3d 164 (2d Dep't 2016) (explaining that the written assignment in the case was sufficient to establish standing even absent physical delivery of the note).

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RULINGS BY SUMMARY ORDER DO NOT HAVE PRECEDENTIAL EFFECT. CITATION TO A SUMMARY ORDER FILED ON OR AFTER JANUARY 1, 2007, IS PERMITTED AND IS GOVERNED BY FEDERAL RULE OF APPELLATE PROCEDURE 32.1 AND THIS COURT'S LOCAL RULE 32.1.1. WHEN CITING A SUMMARY ORDER IN A DOCUMENT FILED WITH THIS COURT, A PARTY MUST CITE EITHER THE FEDERAL APPENDIX OR AN ELECTRONIC DATABASE (WITH THE NOTATION "SUMMARY ORDER"). A PARTY CITING A SUMMARY ORDER MUST SERVE A COPY OF IT ON ANY PARTY NOT REPRESENTED BY COUNSEL.
United States Court of Appeals,
Second Circuit.

IN RE: AMPAL-AMERICAN ISRAEL CORPORATION, Debtor.
Yosef A. Maiman, Merhav (M.N.F.) Limited, Appellants,
v.
Alex Spizz, Chapter 7 Trustee, Appellee.

No.
16
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2855
-bk
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May 24, 2017

Appeal from a July 19, 2016 judgment of the United States District Court for the Southern District of New York (Failla, *J.*).

UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the judgment of the district court is **AFFIRMED**.

Attorneys and Law Firms

FOR APPELLANTS: Daniel A. Fliman (Michele L. Angell, on the brief), Kasowitz, Benson, Torres & Friedman LLP, New York, NY.

FOR APPELLEE: Arthur Goldstein (Alex Spizz, Jill Makower, on the brief), Tarter, Krinsky & Drogin LLP, New York, NY.

PRESENT: Barrington D. Parker, Richard C. Wesley, Christopher F. Droney, Circuit Judges.

SUMMARY ORDER

***1** This appeal arises from the litigious bankruptcy of Debtor Ampal-American Israel Corporation ("Ampal") encompassing a series of disputes between Ampal's creditors and its controlling shareholders. More specifically, this particular appeal involves a dispute between Appellee Alex Spizz, Ampal's Chapter 7 Trustee, and the aforementioned controlling shareholders, led by Appellants Yosef A. Maiman (Ampal's former chief executive officer, chairman, and president) and an entity under his control, Merhav (M.N.F.) Limited (collectively, "Maiman").

In 2012, Ampal filed a Chapter 11 petition in the Southern District of New York, and after the bankruptcy court converted the proceeding to Chapter 7, Ampal's creditors elected Spizz as Trustee in 2013. Consequently, the Trustee retained his law firm ("Spizz Cohen") as general bankruptcy counsel. Over the next two years, various disputes arose between Maiman and Ampal's creditors. One such creditor, Mishmeret-Trusts Company Ltd. ("Mishmeret"),[1] and Mishmeret's long-time counsel Ofer Shapira, retained the law firm Tarter, Krinsky & Drogin LLP ("TKD") to represent them in at least some of those disputes against Maiman.

In April 2015, Spizz Cohen dissolved, and Spizz joined TKD as a partner. The Trustee (Spizz) subsequently filed an application under 11 U.S.C. § 327(a) to retain TKD as substitute general bankruptcy counsel, disclosing that TKD had previously represented Mishmeret and Shapira but asserting that the firm no longer represented either party. Citing TKD's representation of Mishmeret and Shapira, Maiman objected to the Trustee's application and cross-moved to remove the Trustee for "cause" pursuant to 11 U.S.C. § 324(a). Upon further briefing and an evidentiary hearing, the bankruptcy court issued its findings of fact and conclusions of law (1) granting the Trustee's application to retain TKD, and (2) denying Maiman's cross-motion to remove the Trustee for "cause." *See In re Ampal-Am. Israel Corp.*, 534 B.R. 569 (Bankr. S.D.N.Y. 2015). After Maiman appealed, the district court affirmed the bankruptcy court's order and entered judgment. *See In re Ampal-Am. Israel Corp.*, 554 B.R. 604 (S.D.N.Y. 2016).

Maiman appeals from the district court's final judgment, arguing that the bankruptcy court erroneously granted the Trustee's application to retain TKD because the firm (1) "represent[s] ... interest[s] adverse to the estate" under 11 U.S.C. § 327(a), and (2) has an "actual conflict of interest" under 11 U.S.C. § 327(c). Furthermore, Maiman contends that the bankruptcy court abused its discretion in denying the motion to remove Spizz as Trustee for "cause" pursuant to 11 U.S.C. § 324(a).

Generally, a "district court's order in a bankruptcy case is subject to plenary review," *In re Cacioli*, 463 F.3d 229, 234 (2d Cir. 2006), meaning that "we review the bankruptcy court decision independently, accepting its factual findings unless clearly erroneous but reviewing its conclusions of law *de novo*." *In re AroChem Corp.*, 176 F.3d 610, 620 (2d Cir. 1999). In so doing, we assume the parties' familiarity with the underlying facts, the procedural history of the case, and the issues on appeal, which we reference only as necessary to explain our decision to affirm.

1. <u>The Trustee's Application to Retain TKD</u>

***2** We agree with the district court's conclusion that the bankruptcy court committed no clear factual error nor any legal error in granting the Trustee's application to retain TKD under sections 327(a) and 327(c) of the Bankruptcy Code.

a. Adverse Interest under Section 327(a)

Maiman's factual argument that TKD *presently* represents interests adverse to the Ampal estate (namely, Mishmeret and Shapira) is belied by the record.[2] The co-chair of TKD's bankruptcy group testified that the firm's representation of Mishmeret and Shapira ceased no later than July 2014 (approximately nine months before the Trustee applied to retain TKD), and its engagement letters and billing records corroborate his testimony. Maiman, although not disputing that evidence, contends that TKD still represents Mishmeret and Shapira, even absent an active attorney-client relationship, based on other factors, such as the firm's ongoing "duties and loyalties" to past clients and possession of privileged materials. We conclude that his arguments are unpersuasive for the reasons set forth in the district court's decision. *See Ampal*, 554 B.R. at 621–22. Accordingly, the bankruptcy court's amply supported finding that TKD no longer represents interests adverse to the estate is not clearly erroneous.

Furthermore, Maiman's legal challenge to the bankruptcy court's application of our decision in *AroChem* is "unavailing," as the district court concluded, even subject to *de novo* review. *See id.* at 620. As we held in *AroChem*, "counsel will be disqualified under section 327(a) *only if it presently* holds or represents an interest to the estate, *notwithstanding any interests it may have held or represented in the past*." *AroChem*, 176 F.3d at 623 (emphasis added) (alterations and internal quotation marks omitted). Maiman argues that *AroChem* is "inapposite" and "distinguishable," but he is incorrect. Section 327(a)'s clear present-tense language (*e.g.*, "hold," "represent," and "are disinterested persons") and its juxtaposition with "related portions of the Bankruptcy Code, which draw explicit distinctions between current and past relationships," apply to the situation here. *See id.*

Finally, Maiman conflates two distinct parts of section § 327(a) by arguing that because " 'whether an adverse interests exists is best determined on a case-by-case basis'.... *AroChem* does not support a blanket rule that an adverse interest will not be found whenever another representation in the bankruptcy is ostensibly over." Appellants' Br. 28 (quoting *AroChem*, 176 F.3d at 623) (alteration omitted). Whether an adverse interest "exists," however, is a separate issue from whether TKD *represents* that adverse interest. *See AroChem*, 176 F.3d at 624 ("Because [the attorney] no longer 'represents' [the creditor], [the attorney] does not represent any of [the creditor's] interests, *whether or not any of those interests might be adverse to the estate*." (emphasis added)). Therefore, we conclude, upon *de novo* review, that the bankruptcy court properly construed and applied our decision in *AroChem*.

b. Actual Conflict of Interest under Section 327(c)

***3** Generally, we defer to a bankruptcy court's "findings on conflict of interest questions ... because a bankruptcy judge is on the front line, in the best position to gauge the ongoing interplay of factors and to make the delicate judgment calls which such a decision entails." *Id.* at 628 (internal quotation marks omitted). Although Maiman contends that TKD has a conflict of interest due to its prior representation of Mishmeret and Shapira, he concedes that section 327(c) requires disqualification of professionals possessing only

"actual" conflicts, as opposed to potential conflicts. *See* 11 U.S.C. § 327(c). He also concedes that an actual conflict "involves the *representation* of two presently competing and adverse interests." Appellants' Br. 36 (emphasis added) (internal quotation marks omitted). Those concessions are fatal to Maiman's challenge, as we have already concluded that the bankruptcy court did not commit clear error in finding that TKD no longer represents adverse interests.

We also credit the bankruptcy court's well-supported findings that "there is no failure to disclose [its prior representations] on [TKD's] part, [it] has no ongoing relationship with Shapira or Mishmeret, and it is unlikely that the subject matter of its prior representations will become the subject matter of a dispute between the estate and the former clients." *Ampal*, 534 B.R. at 585. Finally, Maiman's other arguments as to TKD's alleged conflicts—including its purported inability to act adversely to Mishmeret and Shapira, the bankruptcy court's discovery order, and the litigation financing agreement—are unpersuasive, principally for the reasons explained by the district court. *See Ampal*, 554 B.R. at 622–23. Accordingly, we decline to disturb the bankruptcy court's finding that TKD does not have an actual conflict of interest requiring disqualification under section 327(c).

2. Maiman's Cross-Motion to Remove the Trustee

Although we generally review a bankruptcy court's factual findings for clear error and its legal conclusions *de novo*, *see AroChem*, 176 F.3d at 620, we review a bankruptcy court's denial of a motion to remove the Trustee for abuse of discretion. *See In re Eloise Curtis, Inc.*, 326 F.2d 698, 701 (2d Cir. 1964); *accord In re Fletcher Int'l, Ltd.*, 661 Fed.Appx. 124, 125–26 (2d Cir. 2016) (summary order). A bankruptcy court abuses its discretion when its ruling "(1) rests on an error of law ... or a clearly erroneous factual finding, or (2) cannot be located within the range of permissible decisions." *In re Smith*, 507 F.3d 64, 73 (2d Cir. 2007) (alterations and internal quotation marks omitted).

The bankruptcy court did not abuse its discretion in denying Maiman's motion to remove the Trustee for "cause" pursuant to 11 U.S.C. § 324(a). "Grounds for disapproval or removal of a trustee in bankruptcy are not to be found in his formal relationships," and, in assessing whether "cause" for removal exists under § 324(a), "[w]e have traditionally stressed the elements of fraud and actual injury to the debtor interests." *In re Freeport Italian Bakery, Inc.*, 340 F.2d 50, 54 (2d Cir. 1965) (internal quotation marks omitted); *accord In re Soundview Elite Ltd.*, 646 Fed.Appx. 1, 1–2 (2d Cir. 2016) (summary order).

As both the bankruptcy court and district court noted, Maiman does not allege that the Trustee engaged in fraud or caused any actual injury to the estate. *See Ampal*, 534 B.R. at 586; *see also Ampal*, 554 B.R. at 624. Furthermore, Maiman's argument that the Trustee's joining TKD necessitates his removal is unpersuasive in light of our agreement with the bankruptcy court's findings concerning disqualification of TKD under sections 327(a) and 327(c). In sum, the bankruptcy court did not abuse its discretion in denying Maiman's motion to remove the Trustee.

3. Conclusion

We have considered the Appellants' remaining arguments and conclude that they are without merit. Accordingly, we **AFFIRM** the judgment of the district court.

All Citations

--- Fed.Appx. ----, 2017 WL 2274279

Footnotes

1 Specifically, Mishmeret is an indenture trustee for Ampal's Series C debentures. For the sake of simplicity, we refer to Mishmeret and Ampal's other indenture trustees as creditors.

2 Maiman does not argue on appeal that TKD itself "hold[s]" interests adverse to the estate or that the firm is not a "disinterested person[ ]." *See* 11 U.S.C. § 327(a); *see also* 11 U.S.C. § 101(14) (defining "disinterested person").

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United States Court of Appeals,
Second Circuit.

IN RE: FAIRFIELD SENTRY LIMITED, Debtor.
Farnum Place, LLC, Appellant,
v.
Kenneth M. Krys, in his capacity as the duly appointed liquidator and foreign representative of Fairfield Sentry Limited, Appellee.

No.
16
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2127
-bk
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May 22, 2017

Appeal from a judgment of the United States District Court for the Southern District of New York (Alvin K. Hellerstein, *Judge*; Stuart M. Bernstein, *Bankruptcy Judge*).
UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the judgment entered on June 3, 2016, is AFFIRMED.

Attorneys and Law Firms

APPEARING FOR APPELLANT: KATHLEEN M. SULLIVAN (Cleland B. Welton II, Quinn Emanuel Urquhart & Sullivan, LLP, New York, New York; Eric D. Winston, Quinn Emanuel Urquhart & Sullivan, LLP, Los Angeles, California, on the brief), Quinn Emanuel Urquhart & Sullivan, LLP, New York, New York.

APPEARING FOR APPELLEE: JEFFREY A. LAMKEN (David J. Molton, Daniel J. Saval, Brown Rudnick LLP, New York, New York; Lucas M. Walker, MoloLamken LLP, Washington, D.C., on the brief), MoloLamken LLP, Washington, D.C.

PRESENT: REENA RAGGI, SUSAN L. CARNEY,

Circuit Judges, LEWIS A. KAPLAN, District Judge.*

SUMMARY ORDER

***1** This case returns to us following remand. *See Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)* (*Sentry I*), 768 F.3d 239 (2d Cir. 2014) (ordering bankruptcy court to apply 11 U.S.C. § 363(b) to sale ("Sale") of Fairfield Sentry Limited's ("Debtor") claim in liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS") by Kenneth M. Krys, duly appointed liquidator in and recognized foreign representative of Debtor's British Virgin Islands ("BVI") liquidation, to Farnum Place, LLC ("Farnum")). Farnum here appeals from the district court's affirmance of the bankruptcy court's decision to disapprove that transaction pursuant to § 363(b) based on its determination that Krys had provided a "sound business reason" for disapproval. S.P.A. 19. "We review an appeal from a district court's affirmance of a bankruptcy court decision independently, accepting the bankruptcy court's factual findings unless clearly erroneous, and reviewing [its] legal conclusions *de novo*." *Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127, 132 (2d Cir. 2013) (internal quotation marks omitted). In so doing, we assume the parties' familiarity with the facts and record of prior proceedings, *see Sentry I*, 768 F.3d at 241–43, which we reference only as necessary to explain our decision to affirm.

Farnum here makes two principal arguments: (1) that the bankruptcy court erred in disapproving the Sale in 2015 because its issuance of a 2010 order "entrusting the administration or realization of all or part of the debtor's assets within the territorial jurisdiction of the United States to the foreign representative," 11 U.S.C. § 1521(a)(5); *see In re Fairfield Sentry Ltd.*, 440 B.R. 60, 67 (Bankr. S.D.N.Y. 2010), satisfied the notice-and-hearing requirement of § 363(b) imposed upon the sale by operation of 11 U.S.C. § 1520(a)(2) ("Entrustment Argument"); and (2) that the bankruptcy court gave insufficient weight in its § 363(b) analysis to comity values

("Comity Argument"). We hold both arguments foreclosed by *Sentry I*'s mandate, and we decline to reconsider our direction in that decision that the bankruptcy court was obliged to conduct § 363(b) review.

1. Mandate Rule

"The mandate rule compels compliance on remand with the dictates of the superior court and forecloses relitigation of issues expressly or *impliedly* decided by the appellate court." *United States v. Ben Zvi*, 242 F.3d 89, 95 (2d Cir. 2001) (emphasis in original) (internal quotation marks omitted). Beyond deciding issues expressly or impliedly, "[a] mandate may also, by its terms, further limit issues open for consideration on remand." *Statek Corp. v. Dev. Specialists, Inc. (In re Coudert Bros. LLP)*, 809 F.3d 94, 99 (2d Cir. 2015) (alteration and internal quotation marks omitted); *see Puricelli v. Republic of Argentina*, 797 F.3d 213, 218 (2d Cir. 2015) ("[W]here a mandate directs a district court to conduct specific proceedings and decide certain questions, generally the district court must conduct those proceedings and decide those questions."). "To determine whether an issue remains open for reconsideration on remand, the trial court should look to both the specific dictates of the remand order as well as the broader spirit of the mandate." *United States v. Ben Zvi*, 242 F.3d at 95 (internal quotation marks omitted). We review *de novo* a lower court's interpretation of an appellate mandate. *See Puricelli v. Republic of Argentina*, 797 F.3d at 218.

***2** In *Sentry I*, this court considered Krys's appeal from the affirmance of a bankruptcy order concluding that the Sale property at issue was not "within the territorial jurisdiction of the United States" within the meaning of 11 U.S.C. § 1520(a)(2), which otherwise would have required review of the Sale pursuant to 11 U.S.C. § 363 to determine whether there was a "good business reason" to approve it, *Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983). The bankruptcy court had also held, in the alternative, that "comity dictate[d] deference to [the BVI] Court's judgment approving the sale." *Sentry I*, 768 F.3d at 241.

We identified as the "primary question" on that appeal "whether the bankruptcy court was required to consider a review under section 363," an inquiry that we answered in the affirmative because the Sale property was within the territorial jurisdiction of the United States. *Id.* at 243. In a section of the opinion entitled "Section 363 Review," we stated that "[t]he language of [§ 1520(a)(2)] makes it plain that the bankruptcy court was *required* to conduct a section 363 review." *Id.* at 246 (emphasis added). We then provided "some guiding principles" to aid in that task, instructing that "a judge determining a § 363(b) application is required to expressly find from the evidence presented before him at the hearing a good business reason to grant" the sale request, and specifically directing that the bankruptcy court here "must consider as part of its section 363 review the increase in value of [Debtor's claim against BLMIS] between the signing of the [Sale agreement] and approval by the bankruptcy court." *Id.* at 246–47 (alteration and internal quotation marks omitted).

We also rejected the bankruptcy court's alternative holding regarding comity. While acknowledging the centrality of comity to Chapter 15, we observed that § 1520(a)(2)'s requirement of § 363(b) review operated as a "brake or limitation on comity." *Id.* at 245 (internal quotation marks omitted). We noted that § 1520(a) (2) expressly provides that § 363 must apply "to the same extent" as it would to the property of a domestic bankruptcy estate, *id.* at 244, and that "it is not apparent at all that the BVI Court even expects or desires deference in this instance," *id.* at 246, given that, in its order approving the sale, it stated, *inter alia*, that Krys should "bring before the U.S. Bankruptcy Court the question of *approval (or nonapproval)* by that Court" of the Sale and, if the
U.S. bankruptcy court were to "withhold approval of the [Sale], that will bring the [Sale] to an end," *id.* at 246 n.2 (emphasis in original). We concluded by remanding the case to the district court with specific "instructions to [remand] to the bankruptcy court for such [§ 363(b)] review." *Id.* at 247.

On remand, the bankruptcy court conducted a § 363(b) review and disapproved the Sale based upon the postSale increase in value of Debtor's claim against BLMIS. In reaching its conclusion, it suggested that both the Entrustment and Comity Arguments were foreclosed by *Sentry I*'s mandate. This was correct.

a. Entrustment Argument

Upon deciding that the Sale property was within the territorial jurisdiction of the United States within the meaning of § 1520(a)(2), *Sentry I* held that the bankruptcy court was to conduct a § 363(b) review. This is evident in the statement that "the bankruptcy court was *required* to conduct a section 363 review," *id.* at 246 (emphasis added), which would entail "expressly find[ing] from the evidence presented before [it]

at the hearing a good business reason to grant such an application," *id.* (internal quotation marks omitted). Further, *Sentry I* stated that the bankruptcy court was to consider "salient factors pertaining to the proceeding," including "whether the [Sale] asset is increasing or decreasing in value," which, in this case, meant accounting for the increase in value of Debtor's claim against BLMIS after the Sale agreement was executed. *Id.* (internal quotation marks omitted). In so holding, we necessarily concluded that the bankruptcy court's initial § 1521(a)(5) entrustment order—issued when Krys first sought Chapter 15 recognition of the BVI liquidation in 2010—did not satisfy § 363(b), as Farnum now argues, because, otherwise, we would not have instructed the bankruptcy court to consider all relevant § 363(b) factors on remand. Indeed, as Krys contends, the § 1521(a)(5) order predated the Sale agreement and, thus, the post-Sale increase in value of Debtor's claim against BLMIS, so that satisfaction of § 363(b) by virtue of the earlier § 1521(a)(5) order could not coexist with our mandate to consider that increase in value in conducting the § 363(b) review.

***3** Our conclusion that the Entrustment Argument was rejected in *Sentry I* finds support in the fact that Farnum made effectively the same argument in the earlier appeal that it now advances. The *Sentry I* panel was thus presented with the argument that further § 363(b) review was unnecessary but, nonetheless, directed that such review—which our precedent suggests requires a business-judgment analysis—go forward.

Moreover, in petitioning for rehearing of *Sentry I*, Farnum requested that the opinion "be amended so as not to *require* the bankruptcy court to conduct a section 363 review," because the issued opinion "could be read to foreclose the prior consideration on remand of the alternative arguments," including the Entrustment Argument. J.A. 565 (emphasis in original). We ordered Krys to respond to the petition and, in particular, to the argument that the lower courts should be permitted "to consider any issues not already adjudicated that might preclude the need for a section 363 hearing." *Id.* at 569. After Krys responded, we nevertheless denied the petition. Farnum contends that "such a denial is fully consistent with a conclusion that clarification was *unnecessary* because the opinion is not reasonably read to foreclose Farnum's argument." Appellant's Br. 28 (emphasis in original). In light of our explicit request for briefing as to the opinion's effect on Farnum's alternative arguments, we cannot agree. Because *Sentry I* foreclosed the Entrustment Argument, the denial is more reasonably understood to reject the need to modify the opinion to allow Farnum to make the same Entrustment Argument it advances in this appeal.

Sentry I thus both impliedly rejected the Entrustment Argument and limited the lower courts' consideration on remand to a traditional § 363(b) analysis. At the very least, the Entrustment Argument was repudiated by the "broader spirit of the mandate." *Statek Corp. v. Dev. Specialists, Inc.*, 809 F.3d at 99 (internal quotation marks omitted). Accordingly, that mandate bars further consideration of the argument.

b. Comity Argument

Sentry I explicitly rejected the notion that comity values underlying Chapter 15 compelled deference to the BVI court's approval of the Sale to the exclusion of any § 363(b) review. As Krys observes, Farnum has now repackaged this argument to suggest that comity values should instead have weighed as a dispositive factor in that review. Because this is effectively the same argument, it is barred by the mandate.

In *Sentry I*, we concluded that "the bankruptcy court erred when it gave deference to the BVI Court's approval of the [Sale] and failed to conduct a review under section 363." 768 F.3d at 246. In so holding, we highlighted "[t]he express statutory command that, in a Chapter 15 ancillary proceeding, the requirements of section 363 'apply ... *to the same extent*' as in" domestic bankruptcies. *Id.* at 245 (alteration and emphasis in original) (quoting 11 U.S.C. § 1520(a)(2)). These statements evince our holding that, in this statutory context, comity may not play a dispositive role, whether within a § 363(b) review or by displacing that review entirely. Reinforcing that conclusion is the note taken in *Sentry I* of the language in the BVI court's decision, from which "it is not apparent at all that the BVI Court even expects or desires deference in this instance." *Id.* at 246. Farnum's contention that the § 363(b) factors should differ depending on the type of bankruptcy proceeding and that, in a Chapter 15 proceeding, comity should play a significant role, was rebuffed when we instructed the bankruptcy court to conduct a § 363(b) review consistent with the factors identified in *In re Lionel*, a Chapter 11 proceeding. *See id.* Accordingly, *Sentry I* rejected the Comity Argument and explicitly required the lower courts on remand to conduct a § 363(b) review that would *not* give comity controlling weight. Thus, the mandate forecloses this argument as well.

2. Reconsideration of *Sentry I*'s Repudiation of **Farnum's Arguments**

***4** Even if the mandate rule prohibited the lower courts from considering the Entrustment and Comity Arguments, Farnum contends that this court may reconsider its earlier ruling for "cogent or compelling reasons" consistent with the law-of-the-case doctrine. *United States v. Tenzer*, 213 F.3d 34, 39 (2d Cir. 2000) (internal quotation marks omitted). We have identified "the need to correct a clear error or prevent manifest injustice" as a primary reason justifying reconsideration. *Id.* (internal quotation marks omitted); *see also Johnson v. Holder*, 564 F.3d 95, 100 (2d Cir. 2009) (observing that appellate court may reconsider prior ruling only where argument "obviously compel[s] a result contrary to" initial decision). We here identify no clear error and decline to reconsider our earlier decision.[1]

a. Entrustment Argument

Farnum's Entrustment Argument fails to demonstrate clear error in *Sentry I*' s direction to conduct § 363(b) review. As noted earlier, § 1520(a)(2) expressly commands that, in a Chapter 15 ancillary proceeding, the requirements of § 363 apply to the same extent as in Chapter 7 or 11 proceedings. *See* 11 U.S.C. § 1520(a)(2). The plain language of the statute thus seems to require that, pursuant to § 363 and our precedent, any sale of debtor property outside of the ordinary course of business can be approved by the bankruptcy court only after notice, hearing, and a finding of good business reasons to permit the sale. *See* 11 U.S.C. § 363(b); *Committee of Equity Sec. Holders v. Lionel Corp.*, 722 F.2d at 1071.

Farnum argues that § 1521(a)(5) operates as a carveout from § 1520(a)(2) because the grant of entrustment authority satisfies § 363. It submits first that the plain language of § 1521(a)(5) establishes that an entrustment order gives the foreign representative the unfettered ability to convert the debtor's noncash assets into cash, including by selling them, even though the statute does not address the need (or lack thereof) to seek further approval for asset sales.[2] Farnum urges that its reading comports with the structure of Chapter 15 because (1) § 1521(a)'s requirement that entrustment relief be granted only "where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interests of the creditor," 11 U.S.C. § 1521(a), satisfies the demands of § 363(b); and (2) Krys's interpretation requiring § 363(b) review even after a § 1521(a)(5) order would render the latter provision superfluous. Farnum also contends that its reading is supported by the history and purpose of Chapter 15, which is to "rest authority for supervising the foreign representative" in, and to encourage cooperation with, the foreign court. Appellant's Br. 42. Finally, it points to Krys's prior settlement of certain U.S. claims without seeking § 363(b) review to suggest that Krys's conduct supports Farnum's interpretation.[3]

***5** Krys counters that these arguments are defeated by the plain language of § 1520(a)(2), which calls for § 363 to apply "to the same extent" as in a domestic bankruptcy, in which non-ordinary-course sales of a debtor's property are subject to the § 363 review discussed by our court in *In re Lionel Corp.*, 722 F.2d 1063. Section 1521(a)(5) cannot support a different conclusion because a canon of construction dictates that "the specific governs the general." *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 132 S.Ct. 2065, 2071, 182 L.Ed.2d 967 (2012) (internal quotation marks omitted). Thus, the § 1520(a)(2) specific requirement as to non-ordinary-course property sales governs instead of the general conferral-ofauthority language in § 1521(a)(5).

Further, Krys argues that § 1521(a)(5) is neither a nullity nor superfluity because its entrustment authority may reach beyond non-ordinary-course property sales, *e.g.*, obtaining turnover of debtor assets from third parties and collecting on debts. As for Chapter 15's history and purpose, Krys points to language in the *Guide to Enactment* of the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency, on which the U.S. law is based, suggesting that the Model Law recognized that ancillary bankruptcy proceedings might impose procedural requirements on a foreign representative different from those in the foreign main proceeding. Finally, Krys contends that, as a structural matter, § 1521(a)(5) should not be read to satisfy § 363(b) because it fails to provide the same degree of protection to interested parties.

This summary of the parties' arguments is sufficient to demonstrate that Farnum's Entrustment Argument is "not of such a character as to obviously compel a result contrary to the one reached by" *Sentry I*. *Johnson v. Holder*, 564 F.3d at 100. Further, even if we had not previously decided *Sentry I*, we agree that, on its face, § 1520(a)(2) is an "express statutory command that, in a Chapter 15 ancillary proceeding, the requirements of section 363 apply to the same extent as in Chapter 7 or 11 proceedings." *Sentry I*, 768 F.3d at 245

(alteration, emphasis, and internal quotation marks omitted). Accordingly, we decline Farnum's request for reconsideration and a different ruling.

b. Comity Argument

Farnum's Comity Argument also does not warrant reconsideration. Given § 1520(a)(2)'s call for § 363 to apply to certain transfers "to the same extent" that it would in a domestic bankruptcy, we look to *In re Lionel Corp.*'s identification of factors relevant to § 363 review in a domestic bankruptcy:

> [A] bankruptcy judge ... should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. He might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-à -vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value.

722 F.2d at 1071.

Farnum argues that our precedent suggests that the factors most important to a § 363(b) review depend upon the type of bankruptcy proceeding. It urges us to hold, as a conceded matter of first impression, that, in a Chapter 15 proceeding, facilitating transnational cooperation is the most important factor. Farnum contends that, when due weight is given to transnational cooperation, it becomes clear that the Sale satisfies § 363(b). Further, Farnum argues that reversal here would not require us to hold that "U.S. courts conducting Chapter 15 proceedings are *always* obligated to defer to foreign courts in applying section 363" because no such obligation would arise where a foreign court has not asserted jurisdiction over an asset or where its decision is contrary to U.S. public policy.

Appellant's Br. 56 (emphasis in original).[4]

***6** Even assuming that comity can be considered in § 363 review,[5] Farnum has not demonstrated that it obviously compels a result contrary to that reached in *Sentry I*. The post-Sale increase in the value of Debtor's claim against BLMIS still provides a "good business reason" to disapprove the transaction, *In re Lionel Corp.*, 722 F.2d at 1071, that is not clearly outweighed by comity where, as here, the BVI court's statements signal that it did not "expect[ ] or desire[ ] deference" to its approval of the Sale, *Sentry I*, 768 F.3d at 246.

Accordingly, we decline to reconsider Farnum's Comity Argument or to render a different ruling.

3. Conclusion

We have considered Farnum's remaining arguments and conclude that they are without merit. Accordingly, the judgment of the district court is AFFIRMED.

All Citations

--- Fed.Appx. ----, 2017 WL 2258282

Footnotes

* Judge Lewis A. Kaplan, of the United States District Court for the Southern District of New York, sitting by designation.

1 Farnum's argument that it has never had its day in court to present the Entrustment Argument fails because it, in fact, has had several opportunities to make that argument to tribunals in this circuit.

2 Farnum relies on the use of the word "entrust" in (1) N.Y. U.C.C. § 2-403, allowing the entrustee to transfer the entruster's rights to a buyer in an unencumbered fashion, and (2) the Securities Investor Protection Act context, in which the entruster permits the entrustee to do business on the entruster's behalf, including by selling assets. These procedural

contexts are so different from the statutory structure under consideration here as to be irrelevant. The case law Farnum cites is equally unpersuasive in compelling its urged reading.

3 The parties acknowledge that the law as to whether a settlement constitutes a sale requiring § 363(b) review is unsettled. We here take no position on the merits of that issue.

4 In its reply brief, Farnum suggests that a U.S. court also may not need to defer to foreign courts where "other 'salient factors' outweigh the interest in cooperation." Appellant's Reply Br. 8.

5 *See* 8 Alan N. Resnick & Henry J. Sommer, *Collier on Bankruptcy* ¶ 1520.01 at 1520-3 n.11 (16th ed. 2015) ("But applying section 363 to the same extent that it would apply to property of an estate does not rule out the granting of comity to a foreign court's order. ... [N]othing in section 1520 suggests that section 363 should apply to the exclusion of traditional principles of comity or that it cannot be satisfied by a procedurally proper foreign order.").

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855 F.3d 459
United States Court of Appeals, Second Circuit.

IN RE: LEHMAN BROTHERS HOLDINGS INC., Debtor.
Jennifer Adler, Ian Anderson, Jennifer Becker, Craig Benson, Paola Biraschi, Karen Brewer, William Broadbent, David Brooks, Guillemette Callies, Patrick Cremin, Michael Collier, Joseph D'Amadeo, John Dmuchowski, Nestor De Jesus, Steven Engel, Louise Goldberg, Michael Gran, Anshuman Goyal, Adrian Graves, Sandra Hahn–Colbert, Gregg Hawes, Nicholas Howard, Julian Iragorri, Harriet Chan King, Karen Krieger, Tal Lev Ari, Yeruchim Levilev, Sarah Lewis, Patricia Luken, Lawrence McCarthy, Michael McCully, Paul Shotton, Steven Schwab, Colin S.A. Welch, Pierluigi Volini, Ian Neville, Sandy Fleischman Richman, Jeffrey Wecker, Norman Siegel, Thomas O'Sullivan, Peter Ward, Timothy Wilkinson, Milan Veleba, Andrea Sullivan, Hugh McGee, Judith Winchester, Ross Shapiro, Stephen Snelling, Brian Seward, Margaret Smith, Alvaro Santodomingo, Helmut Olivier, (Estate of) Michael Mullen, Jack Rivkin, Barry Porter, Gregg Somma, Christiane Schuster, Michael Petrucelli, Martin Patterson, Fabio Liotti, Mary Langevin, Amit K. Sarkar, Darian J. Cohen, Lars P. Jacobson, Christian E. Stevens, Andrew Wideman, Madelyn Antoncic, Michele Bareggi, Riccardo Banchetti, Timothy A. Burke, Nachiketa Das, Philippe Dufournier, Brian Gross, Peter Hornick, Andrea Jao, Michael Lawsky, Alexandre Catalao Maia, Nikki Marshall, Richard Noble, Anke Parr, Vincent Primiano, Giancarlo Saronne, Johathan Sebiri, Charles Spero, Harshad Shah, Gordon Sweely, Rocco F. Andriola, Morgan Lawrence, Nicole Lawrence, Marvin C. Schwartz, Stephanie Stiefel, Richard J. Glasebrook, II, Judith Ann Kenney, Richard Nackerson, Henry Ramallo, Christian Reynolds, David I. Weiner, Richard Levine, Seth Finkel, Claimants–Appellants, Virgilio Casuple, Donald Boughrum, Brian Monahan, Roger Saks, Claimants,
v.
Lehman Brothers Holdings Inc., Debtor–Appellee.*

Docket Nos.
16
-
1296
-bk, 16-1304-bk, 16-1306-bk, 16-1360-bk, 16-1361-bk, 16-1363-bk, 16-1365-bk, 16-1367-bk
|
August Term, 2016
|
Argued: January 4, 2017
|
Decided: May 4, 2017

Synopsis

Background: Chapter 11 debtor objected to proofs of claim filed by former employees based on restricted stock units (RSUs) granted to them as form of compensation, on ground that these claims were subject to mandatory subordination. The United States Bankruptcy Court for the Southern District of New York, Shelley C. Chapman, J., 519 B.R. 47, entered order sustaining objections, and former employees appealed. The District Court, Richard J. Sullivan, J., 548 B.R. 663, affirmed. Former employees appealed.

Holdings: The Court of Appeals, Sack, Circuit Judge, held that:

[1] proofs of claim that employees filed were notduplicative of any proofs of interest which they might have filed, and could not be disallowed on that basis;

[2] restricted stock units (RSUs) granted to employeesof bankrupt financial services company qualified as "securities," as that term was used in the Bankruptcy Code;

[3] all employees of bankrupt financial services company,even those who became employees as result of merger after having entered into covenants not to compete that limited their ability, for period of three years, to obtain employment with competitors of company, had to be regarded as having "purchased" these RSUs; and

[4] employees' claims were subject to mandatorysubordination as claims for "damages arising from the purchase of a security" of debtor.

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Affirmed.

West Headnotes (21)

[1] **Bankruptcy**

Conclusions of law; d e novo review

Bankruptcy

Clear error

Court of Appeals exercises plenary review over district court's affirmance of bankruptcy court's decision, reviewing de novo the bankruptcy court's conclusion of law, and reviewing its findings of fact for clear error. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[2] **Federal Courts**

Conflicting or undisputed evidence

Federal Courts

Definite and firm conviction of mistake

Finding of fact is clearly erroneous when reviewing court, on the entire evidence, is left with definite and firm conviction that mistake has been made; if there are two permissible views of the evidence, then fact-finder's choice between them cannot be clearly erroneous.

Cases that cite this headnote

[3] **Bankruptcy**

Claims by insiders and by attorneys in excess of value

Regardless of whether restricted stock units (RSUs) held by corporate Chapter 11 debtor's employees qualified as "equity securities" which would have enabled these employees to file proofs of interest, proofs of claim that employees did file for breach of contract, based on their failure to receive value that they anticipated when the RSUs became worthless following debtor's financial collapse, were not duplicative of any such proofs of interest and could not be disallowed on that basis. 11 U.S.C.A. § 101(16); Fed. R. Bankr. P. 3007(d)(7).

Cases that cite this headnote

[4] **Bankruptcy**

Claims by insiders and by attorneys in excess of value

Under some circumstances, an equity security holder may assert both an interest and a claim relating to that interest.

Cases that cite this headnote

[5] **Bankruptcy**

Claims by insiders and by attorneys in excess of value

If equity security holder, out of confusion, files proof of claim instead of a proof of interest, its claim is properly disallowed as duplicative of proof of interest; however, if equity security holder asserts a proof of claim for breach of contract or fraud relating to purchase of security, that claim is not duplicative of equity holder's proof of interest and may therefore be allowed, despite claimant's status as equity security holder.

Cases that cite this headnote

[6] **Bankruptcy**

Security purchase rescission claims

Mandatory claim subordination provision for security purchase rescission claims safeguards the absolute priority rule, a bedrock principle of bankruptcy law, under which creditors are entitled to be paid ahead of shareholders in the distribution of assets of corporate debtor. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[7] **Bankruptcy**

Security purchase rescission claims

Mandatory claim subordination provision for security purchase rescission claims is construed broadly in light of the statute's legislative history. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[8] **Bankruptcy**

Security purchase rescission claims

Contract damages claims asserted by employees of corporate Chapter 11 debtor on account of restricted stock units (RSUs) that they held had to be subordinated pursuant to mandatory subordination provision upon satisfaction of each of the following three conditions: (1) the RSUs qualified as securities, (2) the employees acquired these RSUs in a purchase, and (3) the claims for damages arose from that purchase or the asserted rescission of it. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[9] **Bankruptcy**

Construction and Operation

Restricted stock units (RSUs) granted to employees of bankrupt financial services company, which gave employees a contingent right to receive and/or purchase company's common stock five years after the RSUs were granted as long as certain employment conditions were met, qualified as "securities," as that term was used in the Bankruptcy Code; RSUs bore many of hallmark characteristics of securities, as granting employees that held them limited voting rights and a right to receive declared dividends in form of additional RSUs, and as exposing employees to same risk and benefit expectations as shareholders because value of RSUs was tied to the value of company's common stock. 101 U.S.C. § 101(49)(A)(xiv).

Cases that cite this headnote

[10] **Bankruptcy**

Construction and Operation

Statutory list of "securities" set forth in first paragraph of definitional provision of the Bankruptcy Code, being introduced by the word "including," is not exclusive. 11 U.S.C.A. § 101(49)(A).

Cases that cite this headnote

[11] **Bankruptcy**

Security purchase rescission claims

Restricted stock units (RSUs) awarded to employees of bankrupt financial services company as form of additional compensation were acquired by employees through "purchase" transaction, in exchange for their labor, as required for mandatory subordination of damages claims asserted by these employees pursuant to statutory subordination provision. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[12] **Bankruptcy**

Security purchase rescission claims

Term "purchase," as used in mandatory subordination provision, is to be construed broadly to include circumstances in which claimant has received equity securities in exchange for labor. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[13] **Bankruptcy**

Security purchase rescission claims

All employees of bankrupt financial services company, even those who became employees as result of merger after having entered into covenants not to compete that limited their ability, for period of three years, to obtain employment with competitors of company, had to be regarded as having "purchased" the restricted stock units (RSUs) granted to them

as part of their compensation, thereby triggering possible application of mandatory subordination provision to proofs of claim that they filed for value of these RSUs; three-year restrictive covenants, which were narrowly limited to market where financial services company operated, were not so restrictive as to support claim of economic duress by these employees, i.e., that they were essentially forced to accept RSUs and did not voluntarily "purchase" them by choosing to continue with their employment post-merger. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[14] Contracts

Threats in general

Under New York law, economic duress doctrine is reserved for extreme and extraordinary cases, in which the party asserting economic duress can show (1) threats of an unlawful act by one party that (2) compel performance by the other party of an act that it had legal right to abstain from performing.

1 Cases that cite this headnote

[15] Contracts

Duress

Under New York law, party asserting economic duress must do so promptly.

1 Cases that cite this headnote

[16] Bankruptcy

Security purchase rescission claims

Any economic duress argument by those who became employees of bankrupt financial services company as result of merger, that restrictive covenants which they had signed deprived them of any choice other than to continue with their employment post-merger, and for that reason they had not "purchased" restrictive stock units (RSUs) granted as additional component of their compensation for continuing in their positions, and mandatory subordination provision did not apply, was forfeited by employees' multi-year delay in raising any such economic duress claims. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[17] Bankruptcy

Security purchase rescission claims

Mandatory subordination provision of the Bankruptcy Code, which requires the subordination of claims "arising from" a securities transaction, is to be interpreted broadly. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[18] Bankruptcy

Security purchase rescission claims

Claim, no matter how it is characterized by claimant, "arises from a securities transaction," as those terms are used in mandatory subordination provision, as long as the securities transaction is part of causal link leading to claimant's alleged injury. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[19] Bankruptcy

Security purchase rescission claims

Claims asserted by employees of bankrupt financial services company, each of whom, by their continued employment with company, had "purchased" restricted stock units (RSUs) that gave him or her a contingent right to acquire company stock five years after RSUs were granted, after company's financial collapse deprived employees of the value that they anticipated from these RSUs, were subject to mandatory subordination as claims for "damages arising from the purchase of a security" of debtor; employees, who had no right to alternative performance by payment of their compensation in cash once RSUs were granted, could not evade application of

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mandatory subordination provision by asserting restitution claims, or by asserting that deletion of express subordination language from RSU program documents reflected intent to treat them as general creditors. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[20] Contracts

Grounds of action

Under Delaware law, breach-of-contract claim requires damage to plaintiff resulting from the breach.

Cases that cite this headnote

[21] Bankruptcy

Claims by insiders and by attorneys in excess of value

While employees of bankrupt financial services company were theoretically wronged when, as result of company's financial collapse, they did not receive the company stock that they were promised as result of continuing with their employment and of holding their restricted stock units (RSUs) for requisite five-tear holding period, they did not sustain any damage as result of this wrong, and had no viable breach-of-contract claims against company's Chapter 11 estate, given that these RSUs required them to share in company's fortunes, and that company stock had been rendered worthless due to its financial collapse.

Cases that cite this headnote

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RALPH I. MILLER, Weil, Gotshal & Manges LLP, New York, NY, for Debtor–Appellee Lehman Brothers Holdings Inc.

Before: Jacobs, Sack, and Carney, Circuit Judges.

Opinion

Sack, Circuit Judge:

It is not uncommon for corporate employers to compensate their high–ranking employees not only with cash, but also with equity in the corporation. Such arrangements align the

employees' financial incentives with those of the company: If the company succeeds financially, so too do its stake–holding employees; but if the company falters—even to and beyond the point of bankruptcy—its employees bear some of the loss. Prior to its bankruptcy filing, Lehman Brothers Holdings Inc. ("Lehman Brothers") adopted this approach, compensating many of its employees in part with restricted stock units ("RSUs"), which gave them a contingent right to own Lehman Brothers common stock at the conclusion of a five-year holding period. The holder of an RSU had risk and return expectations similar to those of a shareholder; he or she would ultimately benefit from any increase in the stock price or suffer from any decline.

When Lehman Brothers filed for Chapter 11 bankruptcy on September 15, 2008—the largest bankruptcy filing in United States history[1]—thousands of its employees were holding RSUs that had been awarded over the preceding five years, but that had not yet vested and had therefore apparently been rendered worthless by the bankruptcy filing. Many of these employees filed proofs of claim in the Chapter 11 proceeding seeking cash payments in the amounts of and as substitutes for compensation they had been paid in RSUs. Lehman Brothers filed omnibus objections to the claims, and the United States Bankruptcy Court for the Southern District of New York (James M. Peck, *Judge*) sustained these objections on two alternative grounds. First, it concluded that because the claims arise from the purchase or sale of securities, they must be subordinated to the claims of general creditors pursuant to section 510(b) of the Bankruptcy Code, 11 U.S.C. § 510(b). Second, the court decided that because an RSU is an "equity security," 11 U.S.C. § 101(16), the employees' claims were disallowed ***465** insofar as the claimants, as equity security holders, may assert only proofs of interest, not proofs of claim. The United States District Court for the Southern District of New York (Richard J. Sullivan, *Judge*) affirmed on both grounds.

We note at the outset that we need not determine whether an RSU is an "equity security" pursuant to 11 U.S.C. § 101(16), because, even if it is, RSU holders are not barred from asserting proofs of claim—such as the breachof-contract claims asserted here—inasmuch as at least some of their claims are not duplicative of proofs of interest. We conclude, however, that Lehman Brothers' omnibus objections must nonetheless be sustained on the alternative ground that, pursuant to section 510(b), the claims must be subordinated to the claims of general creditors because, for purpose of this statute, (1) RSUs are securities, (2) the claimants acquired them in a purchase, and (3) the claims for damages arise from those purchases or the asserted rescissions thereof.

BACKGROUND

Lehman Brothers paid many of its employees a portion of their compensation in RSUs,[2] equity awards that gave each of the recipient employees a contingent right to own Lehman Brothers common stock five years after issuance of each RSU so long as certain employmentrelated conditions were met. When Lehman Brothers filed for Chapter 11 bankruptcy on September 15, 2008, many of its employees were holding RSUs that had not yet vested. They filed proofs of claim in the bankruptcy proceedings for cash payments equivalent to the amounts they had received in RSUs.

The Program

The RSUs were awarded in accordance with Lehman Brothers' Equity Award Program (the "Program"), which was administered by Lehman Brothers' Board of Directors' Compensation and Benefits Committee (the "Committee"). The Program's purpose was to give Lehman Brothers' employees (1) a financial stake in the company that aligned their interests with those of the company, and (2) a financial incentive to remain with the company until the RSUs matured.

In accordance with those goals, the Program gave Lehman Brothers discretion to pay some of its employees a portion of their compensation in equity-based awards, including RSUs.[3] "At [Lehman Brothers'] option, a portion of [an employee's] total compensation ... may be payable in the form of conditional equity awards ([RSUs], stock options, or other equity awards) pursuant to the [Program]." Joint App'x ("JA") at 7 ¶ 2. And where Lehman Brothers had employment contracts with its employees, those contracts stated that "[a]t the Firm's discretion, a portion of [the employees'] total ... compensation ... will be [or may be] payable in conditional equity awards ([RSUs] and/or other equity awards) pursuant to the [Program]." *Id*. In practice, RSUs were awarded near the end of each year to some employees. These RSU holders were entitled to Lehman Brothers common stock at the conclusion of a five-year holding period, assuming they met certain employment-related conditions. Employees ***466** whose RSUs vested at

the end of the five-year holding period could dispose of their shares of common stock as they saw fit.

The Program was governed by the terms of various documents, including the Employee Incentive Plan (the "Plan"). Section 8(b) of the Plan provides in pertinent part that Lehman Brothers' RSU obligation is limited to delivery of the stock, and does not include payment of cash:

> With respect to any [RSUs] granted under the Plan, the obligations of the Company or any Subsidiary are limited solely to the delivery of shares of Common Stock on the date when such shares of Common Stock are due to be delivered under each Agreement, and in no event shall the Company or any Subsidiary become obligated to pay cash in respect of such obligation (except that the Company or any Subsidiary may pay to [Plan] Participants amounts in cash in respect of a restricted stock unit equal to cash dividends paid to a holder of shares of Common Stock, for fractional shares or for any amounts payable in cash upon the occurrence of a Change in Control).

Id. at 2890. Section 13(b) further provides that "[t]he grant of an Award shall not be construed as giving a Participant the rights of a stockholder of Common Stock unless and until shares of Common Stock have been issued to Participants pursuant to Awards hereunder." *Id*. Section 16 provides additional information about the rights of Plan participants, and authorizes the creation of trusts to meet Plan obligations:

> With respect to any payments not yet made to a Participant, ... nothing herein contained shall give any Participant any rights that are greater than those of a general creditor of the Company. In its sole discretion, the Committee may authorize the creation of trusts or other arrangements to meet the obligations created under the Plan to deliver Common Stock or payments in lieu thereof....

Id. at 2891.

During the five-year holding period, the common stock was held in a trust, established and governed by a Trust Agreement, which provides that the "assets [,] including [s]hares, that shall be held therein" are "subject to the claims of the Company's general creditors in the event the Company becomes insolvent ... until paid to Participants ... in such manner and at such times as the Company may specify to fulfill [its] obligations under the Plans." *Id.* at 1835. Section 1(e) of the Trust Agreement subjects the trust assets to claims of general creditors:

> The principal of the Trust, and any earnings thereon, ... shall be used exclusively for the uses and purposes of Participants and general creditors as herein set forth. Participants shall have no preferred claim on, or any beneficial ownership interest in, any assets of the Trust. Any rights created under the Plans and this Agreement shall be mere unsecured contractual rights of Participants against the Company. Any assets held by the Trust will be subject to the claims of the Company's general creditors under federal and state law in the event the Company becomes insolvent....

Id. at 1836. Section 3(b) reiterates that, "[a]t all times during the continuance of this Trust, ... the principal and income of the Trust shall be subject to claims of general creditors of the Company under federal and state law" in accordance with the provisions of the Trust Agreement. *Id.* at 1838.

Program documents for the years 2003 and 2004 (but not after) included provisions ("Subordination Provisions") explicitly ***467** stating that, "in the event of bankruptcy," RSU–holder claims would be "deemed ... claims for damages arising from the purchase or sale of [Lehman Brothers c]ommon [s]tock [ ] within the meaning of section 510(b) ... and shall have in such bankruptcy the same priority as, and no greater priority than, common stock interests in [Lehman Brothers]." *Id*. at 52 ¶ 10, 57 ¶ 10. The record on appeal does not appear to disclose why, after 2004, the Program documents no longer included these Subordination Provisions.

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Employees received annual notice of the Program's terms by way of information packets containing a summary of the Program's material terms and a Program brochure.[4] These brochures stated, *inter alia*, that an RSU "represents [a] conditional right to receive one share of Lehman Brothers common stock," which "the firm holds on [an employee's] behalf for five years, which [he or she] will be entitled to receive at that time, provided [the employee] meet[s] certain terms and conditions." *Id*. at 36, 37.

Although common stock was not issued until the completion of a five-year period,[5] RSU holders received benefits similar to those of shareholders. They were paid dividends in the form of additional RSUs during the five-year period, and Program documents indicate that they could direct the trustee's votes on the shares held in the trust in proportion to the number of RSUs each owned. The value of their RSUs, moreover, was directly tied to the value of Lehman Brothers' common stock: If the stock's value increased during the five-year holding period, RSU holders would benefit from that increase; if the stock's value decreased during that same period, they would ultimately bear the loss.

The Dispute

When Lehman Brothers filed for Chapter 11 bankruptcy on September 15, 2008, thousands of Lehman Brothers employees were holding RSUs that had not yet vested, having been granted for services performed between 2003 and 2008. Many RSU holders filed proofs of claim in the bankruptcy proceeding seeking cash payments equivalent to the amounts previously paid to them in RSUs. In response, Lehman Brothers filed fourteen omnibus objections seeking to reclassify over 3,000 RSU–based claims as equity interests and to subordinate them to the claims of general creditors. Most of the claimants did not oppose Lehman Brothers' objections, and accordingly, the United States Bankruptcy Court for the Southern District of New York reclassified their claims as equity.

But 222 of the claimants opposed the objections. The bankruptcy court therefore held a hearing on December 21, 2011, where it indicated that it would follow the reasoning of *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006), which held "that claims for damages that arise from the ownership of employee stock options ... should be subordinated [to the claims of general creditors] pursuant to section 510(b)," *id*. at 144, unless the claimants could establish that their RSUs were meaningfully different from the stock options at issue in *Enron*. The bankruptcy court directed the parties to develop a factual record in this regard. And in April 2014, at the conclusion of more than a year of discovery, the bankruptcy court conducted a three-day evidentiary hearing at which it heard live testimony from six ***468** witnesses. The parties then submitted supplemental briefs.

On November 3, 2014, the bankruptcy court (Shelley C. Chapman, *Judge*)[6] issued a decision sustaining Lehman Brothers' omnibus objections on two alternative grounds. *See In re Lehman Bros. Holdings Inc.*, 519 B.R. 47, 67 (Bankr. S.D.N.Y. 2014), *aff'd*, 548 B.R. 663 (S.D.N.Y. 2016). First, it held that the RSU–based claims, like the claims at issue in *Enron*, must be subordinated pursuant to section 510(b). *See id*. at 59–65. Second, it held that because the RSUs are equity securities under section 101(16) of the Bankruptcy Code, the claimants may assert only proofs of interest—not proofs of claim—against the debtor. *See id*. at 65–67.

Thereafter, some of the claimants appealed the bankruptcy court's decision to the United States District Court for the Southern District of New York. And on March 30, 2016, the district court issued an opinion and order affirming the bankruptcy court's decision on both grounds. *In re Lehman Bros. Holdings Inc.*, 548 B.R. 663, 671, 673 (S.D.N.Y. 2016).

Three sets of claimants, representing a portion of the remaining claimants and each represented by different counsel, appealed from the judgment of the district court: (1) the Adler Claimants,[7] (2) the Antoncic Claimants,[8] and (3) the Neuberger Claimants.[9] The pertinent facts are essentially the same with respect to all three sets, with one exception: The Neuberger Claimants became Lehman Brothers employees (and RSU holders) when Lehman Brothers acquired Neuberger Berman, an investment management firm. As former managing directors of Neuberger Bergman, they are subject to restrictive non–compete covenants. They assert that they had no real choice but to accept RSUs as part of their compensation because the acquisition forced them to become Lehman Brothers employees, and the restrictive non–compete covenants effectively forced them to remain employed at Lehman Brothers.

***469 DISCUSSION**

The bankruptcy and district courts addressed the subordination issue before considering whether the claims at issue here are disallowed because the claimants are equity security holders. We address these two issues in the reverse order because we think it more appropriate to determine whether the asserted claims are disallowed full stop, before considering whether they must be subordinated; an affirmative answer to the first question could preclude the need to answer the second. We conclude, however, that the claims at issue are not categorically disallowed because at least some of the claims are distinct from any equity security interests the claimants may otherwise hold, but that the claims must nonetheless be subordinated pursuant to section 510(b).

I. Standard of Review

[1] [2] "We exercise plenary review over a district court's affirmance of a bankruptcy court's decision, reviewing *de novo* the bankruptcy court's conclusion of law, and reviewing its findings of fact for clear error." *ANZ Sec., Inc. v. Giddens (In re Lehman Bros. Inc.)*, 808 F.3d 942, 946 (2d Cir. 2015) (internal quotation marks omitted).[10] A finding of fact is clearly erroneous when "the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *Anderson v. City of Bessemer*, 470 U.S. 564, 573, 105 S.Ct. 1504, 84 L.Ed.2d 518 (1985) (internal quotation marks omitted). "Where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous." *Id.* at 574, 105 S.Ct. 1504.

II. Permissibility of the Claims

[3] A debtor in bankruptcy may file an "omnibus objection" to purported claims on the ground they are "interests, rather than claims." Fed R. Bankr. P. 3007(d) (7). The Bankruptcy Code defines a "claim" as a "right to payment ... or ... an equitable remedy," 11 U.S.C. § 101(5), whereas an "equity security" is, as relevant here, a "share in a corporation, whether or not transferrable or denominated 'stock,' or similar security," or a "warrant or right, other than a right to convert, to purchase, sell, or subscribe to [such an interest]," *id.* § 101(16)(A), (C). Those with "claims" against a debtor are "creditors," *id.* § 101(10), and those with "equity securities" of the debtor are "equity security holders," *id.* § 101 (17). Thus, an interest in an equity security is distinct from a claim to a right to payment or an equitable remedy. *See In re Pine Lake Vill. Apartment Co.*, 21 B.R. 478, 480 (Bankr. S.D.N.Y. 1982) (distinguishing an interest in an equity security from "a claim against the debtor for which the equity holder may assert a right to payment").

[4] [5] But under some circumstances, an equity security holder may assert both an interest and a claim relating to that interest. *See* 2 COLLIER ON BANKRUPTCY ¶ 101.16 (Alan N. Resnick & Henry J. Sommer eds., 16 ed.) (explaining that "the holder of an equity security may also hold a claim that relates to or arises out of an equity security"). If an equity security holder, "out of confusion," "file[s] [a] proof[ ] of claim"—instead of a proof of interest—the claim is "properly disallowed" as "duplicative" of a proof of interest. ***470** *USA Capital Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund, LLC (In re USA Commercial Mortg. Co.)*, 377 B.R. 608, 615 (B.A.P. 9th Cir. 2007). But where an equity security holder asserts "[a] proof of claim ... for breach of contract [or] fraud relating to the purchase of a security," that claim "is ... not duplicative of the equity holder's proof of interest" and may therefore be allowed, notwithstanding the claimant's status as an equity security holder. *Id.* (distinguishing between equity security holders' proofs of interest and proofs of claim).

Here, the bankruptcy court determined that an RSU constitutes an "equity security" pursuant to section 101(16); on this basis alone, it held that the claimants' proofs of claim must be disallowed. *See Lehman Bros.*, 519 B.R. at 65–67 ("[T]he [claimants] assert an interest based on equity securities, and, accordingly do not assert a 'claim' at all under the Bankruptcy Code."). This reasoning skips a step: Even assuming that RSU holders do have the right to assert proofs of interest insofar as RSUs constitute equity securities, it does not necessarily follow that the proofs of claim asserted by the claimants must be disallowed. They might be allowed if they are not duplicative of an asserted interest in an equity security. *See USA Commercial Mortg.*, 377 B.R. at 615. And in our view, at least some of the breach-of-contract claims at issue here fall into this category.

The claimants assert, for example, that Lehman Brothers breached its contractual obligation to compensate them insofar as it did not pay them the cash value of the RSUs that never vested. This breach-of-contract claim, whatever its

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merits, is analytically distinct from any equity interest the claimants may or may not have in the RSUs. Thus, we need not resolve whether an RSU is an "equity security" pursuant to section 101(16) because, regardless of how we answer that question, the claimants are permitted to bring at least some of the claims at issue here.

III. Subordination of Claims

Although equity security holders may assert claims related to, but distinct from, their equity security interests, such claims are not necessarily on a par with other claims against the debtor. They must be subordinated if they are governed by section 510(b), which provides:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such a security, ... shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

11 U.S.C. § 510(b).

[6] Section 510(b) safeguards the absolute priority rule, a bedrock principle of bankruptcy law, under which creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets. *See Motorola, Inc. v. Official Comm. of Unsecured Creditors and JPMorgan Chase Bank, N.A. (In re Iridium Operating LLC)*, 478 F.3d 452, 463 (2d Cir. 2007) (explaining that, under the absolute priority rule, "any plan of reorganization in which stockholders are preferred before the creditor is invalid" (internal quotation marks and brackets omitted)); Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 793 (1987) (explaining that "[t]he [Bankruptcy] Code provides that the equity owners participate in distributions or maintain ownership interests following reorganization only if the creditors have been paid in full or ... consent to their continued ownership[,]" in accordance with ***471** the "almost axiomatic principle ... that, because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the business's collapse—up to the full amount of the investment").[11] Section 510(b) preserves the absolute priority rule by ensuring that security holders may not gain parity with creditors simply by alleging claims that arise from the purchase of their securities. *See* 4 COLLIER ON BANKRUPTCY ¶ 510.04 ("The clear mandate of section 510(b) is that shareholder claimants will not be permitted to elevate their interests from the level of equity to general claims.").

[7] To that end, we construe section 510(b) broadly. *See Rombro v. Dufrayne (In re Med Diversified, Inc.)*, 461 F.3d 251, 255–59 (2d Cir. 2006). We do so in light of the statute's legislative history, specifically the House Report on the 1978 Bankruptcy Reform Act, H. Rep. No. 95–595, Bankruptcy Reform Act of 1978 (1977) ("House Report"), which, in adopting the language contained in the Act, relied on an article by John J. Slain and Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. Rev. 261 (1973) ("Slain and Kripke").[12] *See* House Report at 196 (explaining that "[t]he bill generally adopts [the] Slain[and]Kripke position"); *see also Med Diversified*, 461 F.3d at 255– 56. The House Report reflects Congress's apparent view that claims should be subordinated where, *inter alia*, the claimant "took on the risk and return expectations of a shareholder, rather than a creditor." *Id.* at 256.[13] Thus we held in *Med Diversified* that section 510(b) required subordination of fraud and breach-of-contract claims arising from a debtor's alleged failure to issue common stock in the debtor in exchange for the claimant's shares in another company inasmuch as the claimant had taken on the "risk and return expectations of a shareholder" by "bargain[ing] not for cash but to become a stockholder in the debtor"; we explained that he "became bound by the choice he made to trade the relative safety of cash compensation for the upside potential of shareholder status—the very choice highlighted by Slain and Kripke." *Id.*

In *Med Diversified*, we also cited with approval *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006), a thorough and well-reasoned bankruptcy court decision applying section 510(b) to fraud and ***472** breach-ofcontract "claims by employees for damages they allegedly suffered when, due to the debtor's fraud, they chose not to exercise stock options immediately when they vested but to hold onto the options

with hopes for future higher returns." *Med Diversified*, 461 F.3d at 257 ("Helpful too is the recent and extraordinarily thorough decision in *In re Enron* [.]"). Adopting a broad construction of section 510(b) premised on Slain and Kripke, *Enron*, 341 B.R. at 163–65, the *Enron* court concluded, *inter alia*, that (1) a stock option is a "security" within the meaning of section 510(b) insofar as it meets the definition of that term set forth in 11 U.S.C. § 101(49)(A)(xv) (providing that the term "security" includes a "warrant or right to subscribe to or purchase or sell[ ] a security"), *id.* at 149–50; and (2) the employees "purchase[d]" the stock options within the meaning of section 510(b) inasmuch as they "willingly accepted [them] in return for their labor," even though they "were required to receive [them as] a portion of their compensation," *id.* at 151. The court therefore held that the breach-of-contract claim arising from their stock options must "be subordinated under section 510(b)." *Id.* at 161. In reaching that result, it explained that allowing parties to "recharacterize" equity-based claims as breachof-contract claims of a creditor would undermine the purpose of section 510(b): "to prevent shareholders and other securityholders from bootstrapping their equity interests to a level on [a] par with general creditors and thus sharing equally in the distribution of the bankrupt estate." *Id.*

[8] In light of the analysis set forth in *Med Diversified* and *Enron*, the claims at issue here must be subordinated pursuant to section 510(b) if each of the following three conditions is met: (1) RSUs are securities, (2) the claimants acquired them in a purchase, and (3) the claims for damages arise from that purchase or the asserted rescission of it. We address each in turn, and ultimately conclude that subordination is appropriate.

A. RSUs as Securities

[9] At the threshold lies the question whether an RSU of the sort at issue here constitutes a "security," as that term is defined by the Bankruptcy Code. *See* 11 U.S.C. § 101(49). We conclude that it does.

Section 101(49) contains two subsections. Subsection (A) enumerates fifteen interests "include[d]" in the definition of a "security": Fourteen of these are specific examples, *see id.* § 101(49)(A)(i)–(xiii), (xv);[14] the fifteenth is a residual clause that covers any "other claim or interest commonly known as 'security,' " *id.* § 101(49)(A)(xiv). Subsection (B) enumerates seven items excluded from the definition of a security, *see id.* § 101(49)(B)(i)–(vii);[15] it does not include a residual clause.

[10] ***473** As a practical matter, some interests will not perfectly match any of the specific examples in either list, and it will not immediately be clear whether they are "securities." On these occasions, it should be borne in mind that the interests specifically enumerated in subsection (A) do not exhaust the universe of securities within the meaning of the Bankruptcy Code. This is clear from the text of subsection (A), which provides that "[t]he term 'security' ... *includes*" the items listed, *id.* § 101(49) (A) (emphasis added), where the term " 'includes' ... [is] not [a] limiting" term, *id.* § 102(3). Thus, as other courts have recognized, the statutory list of securities set forth in subsection (A) is "non–exclusive." *O'Donnell v. Tristar Esperanza Props., LLC (In re Tristar Esperanza Props., LLC)*, 488 B.R. 394, 399 (B.A.P. 9th Cir. 2013) (concluding that a membership interest in an LLC is a "security"), *aff'd*, 782 F.3d 492 (9th Cir. 2015); *see also O'Cheskey v. Templeton (In re Am. Hous. Found.)*, No. 09-20232-RLJ-11, 2013 WL 1316723, at *18, 2013
Bankr. LEXIS 1449 (Bankr. N.D. Tex. Mar. 30, 2013) (concluding that the enumerated list in section 101(49) is not exhaustive and that securities are not limited to the items specifically identified), *aff'd in part, rev'd in part on other grounds*, 785 F.3d 143 (5th Cir. 2015). Indeed, the residual clause set forth in subsection (A)(xiv) clearly opens the door to securities not specifically listed. *See* 11 U.S.C. § 101(49)(A)(xiv) (providing that the term "security" includes any "other claim or interest commonly known as [a] 'security' "); *see also SeaQuest Diving, LP v. S&J Diving, Inc. (In the matter of SeaQuest Diving, LP)*, 579 F.3d 411, 418 (5th Cir. 2009) (observing that subsection (A)(xiv) is a "broad residual category").

An argument can be made that an RSU of the sort at issue qualifies as a security pursuant to one of the specific examples enumerated in subsection (A), namely that it is a "certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell, a security." 11 U.S.C. § 101(49)(A)(xv); *see also id.* § 101(49)(A)(ii) (identifying "stock" as a "security"). As the bankruptcy court explained, "a grant of an RSU constitutes a contingent right to participate in, receive [or] purchase [Lehman Brothers] common stock" "once certain employmentrelated conditions have been satisfied."

Lehman Bros., 519 B.R. at 60 (citing various Program documents). But even assuming that the claimants' RSUs do not fall squarely within subsection (A)(xv)[16]—or any of the other enumerated examples in subsection (A)—we think that they nevertheless qualify as securities pursuant to the residual clause. *See* 101 U.S.C. § 101(49)(A)(xiv).

We reach this conclusion on the ground that, in certain important respects, the ***474** claimants' RSUs resemble other securities specifically enumerated in subsection (A), *see* *United States v. Amato*, 540 F.3d 153, 160 (2d Cir. 2008) (explaining that, under the canon of construction *ejusdem generis*, "general terms that follow specific ones are interpreted to embrace only objects of the same kind or class as the specific ones"), *cert denied*, 556 U.S. 1138, 129 S.Ct. 1635, 173 L.Ed.2d 1014 (2009). Indeed, these RSUs bear many of the hallmark characteristics of a security. Like many security holders, the RSU holders had limited voting rights[17] and received any declared dividends in the form of additional RSUs.[18] And of most significance, they had the same risk and benefit expectations as shareholders because the value of their RSUs was tied to the value of Lehman Brothers' common stock. Each RSU holder therefore had "greater financial expectations than [a] creditor" inasmuch as a "creditor can only recoup her investment," whereas an RSU holder "expect[ed] to participate in firm profits." *Med Diversified*, 461 F.3d at 257 (internal quotation marks omitted).[19]

Several courts have similarly defined "security" in section 510(b) in terms of an interest tied to a firm's overall success. *See, e.g.*, *KIT digital, Inc. v. Invigor Grp. Ltd. (In re KIT digital, Inc.)*, 497 B.R. 170, 183 (Bankr. S.D.N.Y. 2013) (treating a debtor's obligation to pay stock to a claimant as a security under section 510(b) because, "by agreeing to accept stock instead of cash[,] ... [the claimant] subjected itself to the greater risk that the price of the stock it would then receive might go down" while ensuring that it "would get the benefits if the price of the stock went up"); *In re Club Ventures Inv. LLC*, No. 11-10891 (ALG), 2012 WL 6139082, at *5, 2012 Bankr. LEXIS 5742 (Bankr. S.D.N.Y. Dec. 11, 2012) (holding that unissued membership units representing a future interest in an LLC after certain conditions were met constituted "securities" subject to section 510(b) because the units "would have given [the claimant] certain rights to share in the [d]ebtor's profits[ ] and ... the risk and reward expectations of an equity holder"); *Aristeia Capital, L.L.C. v. Calpine Corp. (In re Calpine Corp.)*, No. 05-60200 (BRL), 2007 WL 4326738, at *13, 2007 U.S. Dist. LEXIS 86514 (Bankr. S.D.N.Y. Nov. 21, 2007) ("The value of the [convertible notes] var[ies] with the value of the common stock of [the debtor], and therefore resemble[s] an equity interest to which [s]ection 510(b) is applicable.").[20]

***475** We therefore conclude that the claimants' RSUs are securities within the meaning of section 510(b) because they meet the definition of that term set forth in section 101(49)(xiv) insofar as they bear hallmarks of interests commonly known as securities.[21]

B. Purchase of Security

[11] We must next decide whether the claimants received the RSUs through a "purchase or sale." 11 U.S.C. § 510(b). We think they did insofar as Lehman Brothers awarded the claimants the RSUs as compensation for their labor.

[12] The term "purchase" in section 510(b) is properly construed broadly to include circumstances where a claimant has received equity securities in exchange for labor. *See* *Enron*, 341 B.R. at 151 ("While it is true that the [c]laimants did not purchase the stock options on the open market, they nonetheless exchanged value for the options: here, their labor. Such exchange falls under a broad reading of the term 'purchase.' "); *see also* *Med Diversified*, 461 F.3d at 258 (noting that the rationale for mandatory subordination "applies even if there is no actual sale or purchase" of securities (internal quotation marks omitted)); *Liquidating Trust v. Wax (In re U.S. Wireless Corp.)*, 384 B.R. 713, 719 (Bankr. D. Del. 2008) ("[T]he Equity Package [the claimant] received as a portion of his compensation, i.e., in exchange for his labor, constitutes a purchase and sale of a security for the purpose of section 510(b)."); *In re Touch Am. Holdings, Inc.*, 381 B.R. 95, 104 (Bankr. D. Del. 2008) (broadly interpreting "purchase" and noting that "[s]tock given to an employee as compensation nonetheless involves a bargain and exchange of value" (internal quotation marks omitted)).[22]

***476** The claimants "purchased" RSUs within the meaning of section 510(b) by agreeing to receive them, in lieu of cash, in exchange for a portion of their labor. As the bankruptcy court determined, "although the RSU [c]laimants had the option to leave employment at Lehman, they elected voluntarily not to do so primarily because of the high cost associated with leaving—i.e., leaving unvested equity awards 'on the table'

[and] the inability to make as much money anywhere else." *Lehman Bros.*, 519 B.R. at 60–61. By agreeing to work for Lehman Brothers, the claimants voluntarily accepted that Lehman Brothers had the discretion to pay part of their total compensation in RSUs.[23] *Cf. Enron*, 341 B.R. at 151 (concluding that the claimants purchased securities insofar as they "willingly accepted," as "a condition of [their] employment," "a portion of their compensation as [stock] options ... in return for their labor").

In arguing otherwise, the claimants point to *International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America v. Daniel*, 439 U.S. 551, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979), in which the Supreme Court held that participation in a compulsory and noncontributory pension plan does not constitute an investment decision within the meaning of the Securities Act or the Securities Exchange Act, *id*. at 559–60, 99 S.Ct. 790. Other courts, also in the context of federal securities law, have extended *Daniel* to compulsory and involuntary employee stock option plans. *See, e.g.*, *McLaughlin v. Cendant Corp. (In re Cendant Corp. Sec. Litig.)*, 76 F.Supp.2d 539, 545 (D.N.J. 1999) (holding that the "[p]laintiff did not receive her options as part of a bargained–for exchange that required her to make an affirmative investment decision" where her "participation in the option plan was an incident of employment and [her] only [other] choice would have been to [forgo] the receipt of benefits entirely" (internal quotation marks omitted) (second brackets in original)).

Here, however, *Daniel* is a glove that does not fit. It focused on whether employees made an investment decision that could be influenced by fraud or manipulation; the present case poses the distinct question whether equity was purchased through labor for purposes of subordination in bankruptcy. No case has been cited by the parties—nor have we found one—in which a court has applied the *Daniel* principle to section 510(b). And the claimants fail to make a compelling argument why the holding of *Daniel* should be extended beyond the context of federal securities laws so as to contravene the lesson of *Med Diversified* and *Enron*: Section 510(b) should be broadly construed in light of its purpose, *see Med Diversified*, 461 F.3d at 255–59, to include circumstances where a claimant has received a security in exchange for labor, *Enron*, 341 B.R. at 150–51.[24]

[13] ***477** The Neuberger Claimants argue that, whatever can be said of the means by which the other claimants acquired RSUs, they did not voluntarily purchase them. They urge that when Lehman Brothers acquired Neuberger Berman, they had no realistic choice but to continue employment with Lehman Brothers' subsidiary because not doing so would have required them to forfeit their previously earned equity in Neuberger Berman, and to abandon their careers in light of preexisting non-compete covenants imposed by Neuberger Berman. We do not find this argument persuasive. As the bankruptcy court reasoned, "beginning with the merger and every day thereafter, the Neuberger [ ] Claimants," exactly like the other claimants, "had the choice to 'vote with their feet' against the terms of the Program by leaving Lehman [Brothers]." *Lehman Bros.*, 519 B.R. at 62. That they considered this option to be less rewarding than remaining employed by Lehman Brothers does not mean that they had no choice in the matter; it means that they "made an economic decision based on rational selfinterest." *Id.*

[14] **[15]** **[16]** Nor can the Neuberger Claimants successfully argue economic duress under New York law, a doctrine "reserved for extreme and extraordinary cases," *VKK Corp. v. NFL*, 244 F.3d 114, 123 (2d Cir. 2001), where the party asserting economic duress can show "(1) threats of an unlawful act by one party [that] (2) compel[ ] performance by the other party of an act [that] it had a legal right to abstain from performing," *Chase Manhattan Bank v. New York*, 13 A.D.3d 873, 874, 787 N.Y.S.2d 155, 157 (3d Dep't 2004). And even in the unlikely event that they could meet these requirements,[25] the Neuberger Claimants have waived any economic duress argument by failing to seek prompt repudiation of the terms of their 2003 agreement with Lehman Brothers. *See VKK Corp.*, 244 F.3d at 123 (explaining that "it is well established under New York law that a party asserting duress must do so promptly" and that "[d]elays as short as six months have been held to constitute forfeiture of the claim") (internal quotation marks and citation omitted). The Neuberger Claimants' assertion of economic duress many years after entering the agreement is untimely.

Thus, within the meaning of section 510(b), we conclude that all the claimants purchased their RSUs by voluntarily choosing to receive them in exchange for a portion of their labor.

478** ***C. Arising from the Purchase of a Security Finally, we must address whether the claims at issue are claims for damages arising from the purchase of a security pursuant to section 510(b). We conclude that they are.

[17] **[18]** Section 510(b) provides that claims "arising from" a securities transaction must be subordinated. In light of the well-settled principle that this provision is to be interpreted broadly, *see Med Diversified*, 461 F.3d at 257–58, courts have concluded that section 510(b) covers "a wide variety of causes of action arising out of securities transactions." 4 COLLIER ON BANKRUPTCY ¶
510.04 (collecting cases). A claim (no matter how it is characterized by the claimant) arises from a securities transaction so long as the transaction is part of the causal link leading to the alleged injury. *See, e.g.*, *Med Diversified*, 461 F.3d at 257–59 (holding that section 510(b) applies to a claim arising from a failed securities transaction even though the claimant never received shares in the debtor); *Baroda Hill Invs., Ltd. v. Telegroup, Inc. (In re Telegroup, Inc.)*, 281 F.3d 133, 143–44 (3d Cir. 2002) (concluding that section 510(b) applied to a claim arising from the debtor's failure to register shares after the securities transaction had been completed); *In re Worldcom, Inc.*, 329 B.R. 10, 14 (Bankr. S.D.N.Y. 2005) ("So long as the nature of the damage or harm complained of by a shareholder can be said to result as a consequence of his having purchased or sold shares of stock or other securities of the debtor, the claimant falls within the scope of [s]ection 510(b)[.]"); *Queen v. Official Comm. of Unsecured Creditors (In re Response U.S.A., Inc.)*, 288 B.R. 88, 94 (D.N.J. 2003) (concluding that breach-ofcontract claims must be subordinated where "they would not exist but for the [purchase of the security]," despite the claimants' attempt to characterize themselves as "creditors who seek payment based on a contract").

We think section 510(b) applies to all claims asserted here —and characterizations thereof—because they would not have arisen but for the claimants' agreement with Lehman Brothers to receive part of their compensation in the form of RSUs.

[19] The claimants advance a variety of theories in opposition to this conclusion. We find none of them to be persuasive.

1. Alternative Performance

The claimants first assert that they have alternativeperformance claims against Lehman Brothers to be paid in cash in exchange for their labor because the RSUs they received never vested. These claims, they contend, do not arise from the purchase of a security within the meaning of section 510(b), but are instead general-creditor claims for cash owed in exchange for services rendered.

This theory finds no support in the Program documents under the terms of which Lehman Brothers had the discretion to pay a portion of the claimants' compensation with RSUs; those documents also make clear that once Lehman Brothers chose to award RSUs in this manner, it had no further obligation to pay cash for that same portion of compensation.[26] Its ***479** only remaining obligation was to deliver stock to the RSU holders at the conclusion of the five-year period, assuming the specified conditions were met. In this regard, the Plan provides:

> With respect to any [RSUs] granted under the Plan, the obligations of the Company or any Subsidiary are limited solely to the delivery of shares of Common Stock on the date when such shares of Common Stock are due to be delivered under each Agreement, and in no event shall the Company or any Subsidiary become obligated to pay cash in respect of such obligation....[27]

JA at 2890 § 8(b); *see also id*. at 3505 § 8(b) (same). The Trust Agreement further reflects that RSU holders are distinct from general creditors insofar as the assets held in the trust, including the shares held for RSU holders, are "subject to the claims of the Company's general creditors in the event the Company becomes insolvent." *Id*. at 1835, 1838.

The claimants point to the following language of the Plan as evidence that RSU holders are to be treated as general creditors: "With respect to any payments not yet made to a [p]articipant, ... nothing herein contained shall give any [p]articipant any rights that are greater than those of a general creditor...." *Id*. at 2891 § 16. But this provision does not support the claimants' assertion. Its plain language reflects no more than that the participants' rights may not be *greater* than

those of general creditors, not that they may not be *less* than—or subordinate to— the rights of general creditors. The provision, moreover, applies by its own terms only to "any payments not yet made to a [p]articipant," *id*., which, in light of the other Program documents already described, clearly refers to circumstances where Lehman Brothers has not yet paid its employees—either in cash or in RSUs—for services rendered. The provision does not apply where, as here, Lehman Brothers has already made payments to the claimants for all services rendered, either in the form of cash or RSUs.

In sum, we conclude that the claimants cannot assert claims arising from anything other than the purchase of RSUs because they have already been paid the compensation they were due in the form of RSUs and, as a result, have no right to any other mode of performance. Once they received RSUs, their only right vis-à -vis Lehman Brothers was for the delivery of stock at the conclusion of the five-year holding period, assuming the specified employment-related conditions were met. They therefore cannot avoid subordination of their claims under section 510(b).[28]

***480** *2. Restitution*

[20] [21] Nor can the claimants circumvent section 510(b) by asserting restitution claims. In light of the failure of their alternative-performance theory, their strongest argument for restitution appears to be that: (1) Lehman Brothers, by filing for bankruptcy, repudiated its contractual condition to issue stock to RSU holders (who presumably satisfied their own employment-related conditions); and (2) as a result, RSU holders are entitled to recover in restitution for the reasonable value of the services they rendered to Lehman Brothers. Yet, under Delaware law, which governs the construction of the Program documents, *see* JA at 68, a breach-of-contract claim requires "damage to the plaintiff" resulting from the breach, *VLIW Tech., L.L.C. v. Hewlett–Packard Co.*, 840 A.2d 606, 612 (Del. 2003). Although the claimants were theoretically wronged by not receiving the Lehman Brothers shares they were owed, those shares became worthless once Lehman Brothers filed for bankruptcy. They therefore suffered no actual injury because the only thing to which they were contractually entitled—shares of Lehman Brothers common stock—had no value. This defeats their breach-of-contract claim and, thus, their right to restitution.[29]

***481** *3. Subordination Provisions*

Finally, the claimants contend that the deletion of the Subordination Provisions in the Program documents evidences the parties' intention to treat the claimants as general creditors in the event of bankruptcy.

As we have noted, Program documents for 2003 and 2004 included Subordination Provisions explicitly stating that in the event of bankruptcy, claims of RSU holders would be deemed to be claims for damages arising from the purchase or sale of a security pursuant to section 510(b); Program documents for subsequent years, however, did not contain Subordination Provisions. The claimants assert that this history supports a conclusion that (at least after 2004) the parties intended for the claimants to be treated as general creditors. But this assertion rests entirely on speculation. The claimants cite, and we ourselves see, no record evidence establishing the reason for the removal of the Subordination Provisions.[30] There is thus no basis to conclude that the removal of these provisions reflects the parties' intention to treat RSU holders as general creditors in the event of insolvency.

* * *

In sum, we conclude that the claimant's' RSU–based claims—no matter how they are characterized—must be subordinated pursuant to section 510(b) because they arise from the purchase or sale of securities. The claimants "took on the risk and return expectations of ... shareholder[s], rather than ... creditor [s]," *Med Diversified*, 461 F.3d at 256, by agreeing to be paid a portion of their compensation in RSUs. They are thus "bound by the choice [they] made to trade the relative safety of cash compensation for the upside potential of shareholder status," *id*., and the risk of loss—even bankruptcy—that accompanies that status.

CONCLUSION

For the foregoing reasons, we AFFIRM the judgment of the district court.

All Citations

855 F.3d 459, 64 Bankr.Ct.Dec. 21

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Footnotes

* The Clerk of Court is respectfully directed to amend the official caption in this case to conform with the above caption.

1 *See ANZ Sec., Inc. v. Giddens (In re Lehman Bros. Inc.)*, 808 F.3d 942, 944 (2d Cir. 2015) ("On September 15, 2008, Lehman Holdings filed for Chapter 11 bankruptcy protection—the largest bankruptcy filing in U.S. history.").

2 Lehman Brothers awarded RSUs to United States employees and contingent stock awards to overseas employees. These forms of equity, though different in name, were identical in substance.

3 Near the end of each fiscal year, employees received a brochure with a schedule identifying the portion of their compensation they would be paid in RSUs, based on the employee's corporate title and compensation level.

4 Employees were also notified of the Program's terms via face-to-face communications, conference calls, and e–mail.

5 RSU holders did not incur income tax liability on the value of their RSUs until they vested. 6 On February 1, 2014, these cases were transferred to Judge Chapman upon Judge Peck's retirement from the bench.
See Lehman Bros., 519 B.R. at 51 n.4.

7 The Adler Claimants comprise: Jennifer Adler, Ian Anderson, Jennifer Becker, Craig Benson, Paola Biraschi, Karen Brewer, William Broadbent, David Brooks, Guillemette Callies, Patrick Cremin, Michael Collier, Joseph D'Amadeo, John Dmuchowski, Nestor De Jesus, Steven Engel, Louise Goldberg, Michael Gran, Anshuman Goyal, Adrian Graves, Sandra Hahn–Colbert, Gregg Hawes, Nicholas Howard, Julian Iragorri, Harriet Chan King, Karen Krieger, Tal Lev Ari, Yeruchim Levilev, Sarah Lewis, Patricia Luken, Lawrence McCarthy, Michael McCully, Paul Shotton, Steven Schwab, Colin S.A. Welch, Pierluigi Volini, Ian Neville, Sandy Fleischman Richman, Jeffrey Wecker, Norman Siegel, Thomas O'Sullivan, Peter Ward, Timothy Wilkinson, Milan Veleba, Andrea Sullivan, Hugh McGee, Judith Winchester, Ross Shapiro, Stephen Snelling, Brian Seward, Margaret Smith, Alvaro Santodomingo, Helmut Olivier, (Estate of) Michael Mullen, Jack Rivkin, Barry Porter, Gregg Somma, Christiane Schuster, Michael Petrucelli, Martin Patterson, Fabio Liotti, and Mary Langevin.

8 The Antoncic Claimants comprise: Madelyn Antoncic, Michele Bareggi, Riccardo Banchetti, Timothy A. Burke, Nachiketa Das, Philippe Dufournier, Brian Gross, Peter Hornick, Andrea Jao, Michael Lawsky, Alexandre Catalao Maia, Nikki Marshall, Richard Noble, Anke Parr, Vincent Primiano, Giancarlo Saronne, Johathan Sebiri, Charles Spero, Harshad Shah, Gordon Sweely, Rocco F. Andriola, Amit K. Sarkar, Darian J. Cohen, Lars P. Jacobson, Christian E. Stevens, and Andrew Wideman.

9 The Neuberger Claimants comprise: Marvin C. Schwartz, Stephanie Stiefel, Richard J. Glasebrook, II, Judith Ann Kenney, Richard Nackerson, Henry Ramallo, Christian Reynolds, David I. Weiner, Richard Levine, and Seth Finkel.

10 Although *Giddens* also arose out of Lehman Brothers' bankruptcy proceedings and involved the subordination of claims pursuant to section 510(b), the specific legal issues there are not relevant here.

11 Although various Bankruptcy Code provisions reflect the absolute priority rule, it is particularly prominent in 11 U.S.C. § 1129(b)(2)(B), which "provides that a reorganization plan may not give 'property' to the holders of any junior claims or interests 'on account of' those claims or interests, unless all classes of senior claims either receive the full value of their claims or give their consent." *DISH Network Corp. v. DBSD North America, Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 88 (2d Cir. 2011) (quoting 11 U.S.C. § 1129(b)(2)(B)).

12 Slain and Kripke conceptualized the subordination principle ultimately adopted in section 510(b) in terms of the absolute priority rule:

> In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for reallocating that risk.

Slain and Kripke, *supra*, at 286–87.

13 The House Report also suggests that Congress sought to subordinate claims "seek[ing] to recover a contribution to the equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor." *Med Diversified*, 461 F.3d at 256.

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14 The enumerated examples of a "security" are:

> (i) note; (ii) stock; (iii) treasury stock; (iv) bond; (v) debenture; (vi) collateral trust certificate; (vii) pre–organization certificate or subscription; (viii) transferable share; (ix) voting–trust certificate; (x) certificate of deposit; (xi) certificate of deposit for security; (xii) investment contract or certificate of interest or participation in [certain types of] profitsharing agreement[s] or [leases for] oil, gas, or mineral royalt[ies] ...; (xiii) interest of a limited partner in a limited partnership; ... [and] (xv) certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell, a security[.] 11 U.S.C. 101(49)(A).

15 The specific examples expressly excluded from the definition of "security" are:

> (i) currency, check, draft, bill of exchange, or bank letter of credit; (ii) leverage transaction, as defined in section 761 of this title; (iii) commodity futures contract or forward contract; (iv) option, warrant, or right to subscribe to or purchase or sell a commodity futures contract; (v) option to purchase or sell a commodity; (vi) contract or certificate of a kind specified in subparagraph (A)(xii) of this paragraph that is not required to be the subject of a registration statement filed with the Securities and Exchange Commission and is not exempt under section 3(b) of the Securities Act of 1933 from the requirement to file such a statement; or (vii) debt or evidence of indebtedness for goods sold and delivered or services rendered.

11 U.S.C. § 101(49)(B).

16 The claimants contend that subsection (A)(xv) does not cover an RSU because an RSU merely grants its holder a *contingent* or *conditional* right to receive stock upon the occurrence of certain events rather than an absolute right to participate in or subscribe to a stock. We do not find this argument persuasive because subsection (A)(xv) makes no distinction between conditional rights and absolute rights; nor have the claimants made any persuasive showing why we should read such a distinction into the text of the statute.

17 The claimants assert that they did not have voting rights, but fail to cite any record evidence supporting their assertion. The documentary evidence on which the bankruptcy court relied, *see Lehman Bros.*, 519 B.R. at 56, reflects that Lehman Brothers established a trust, funded with shares to be issued upon the conversion of RSUs to common stock, that gave RSU holders the ability to direct voting on those shares based on the proportion of the number RSUs held by the employees. *See, e.g.*, JA at 2616 (2003 Program); *id.* at 2862 (2005 Program).

18 The record reflects that (1) RSU dividends accrued quarterly and were reinvested as additional RSUs; (2) upon the issuance of common stock, the RSU holder received additional common stock in proportion to the dividend equivalents that had accrued during the five-year period; and (3) any additional RSUs awarded for dividend equivalents were not treated as income by Lehman Brothers or accounted for as a compensation expense of Lehman Brothers.

19 The fact that RSUs were not taxed as ordinary income until the end of the five-year holding period, when the vested common stock was taxed according to its market value at the time of vesting, further supports the conclusion that RSUs were equity interests without a fixed valued.

20 The claimants rely on three cases in which claims were not subordinated under section 510(b), but they are inapposite because here, unlike in those cases, the value of RSUs rose and fell with the value of common stock. *See Racusin v. Am. Wagering, Inc. (In re Am. Wagering, Inc.)*, 493 F.3d 1067, 1071 (9th Cir. 2007) (involving a claim arising from a pre-bankruptcy money judgment against the debtor, which resulted from the debtor's failure to fulfill its obligation to pay the claimant cash in the fixed amount of "4% of the final evaluation of the [company's] IPO" (internal quotation marks omitted)); *Raven Media Invs., LLC v. DirecTV Latin America, LLC (In re DirecTV Latin America, LLC)*, No. 03-10805 (PJW), 2004 WL 302303, at *4, 2004 U.S. Dist. LEXIS 2425 (D. Del. Feb. 4, 2004) (involving a claim arising out of a "[p]ut [a]greement" that effectively gave the claimant the benefits of holding stock without "expos[ing] [it] to any risk of loss"); *In re NationsRent, Inc.*, 381 B.R. 83, 86, 91–93 (Bankr D. Del. 2008) (involving claims based on a "[m]ake-[w]hole" agreement to pay cash in the fixed amount of the stock price at a particular date).

21 We pause to emphasize that we should not be understood to conclude that any interest called an "RSU" is necessarily a security within the meaning of section 510(b), let alone any other statute. As our analysis indicates, the requisite inquiry in each case is likely to be fact-intensive, and the result will turn on the substance of the particular "RSU" and the relevant legal definition of "security"—and that definition is likely to vary from statute to statute.

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22 The proposition that a security can be purchased with an employer's labor also accords with the Bankruptcy Code's expansive definition of "purchaser" as a "transferee of a voluntary transfer," 11 U.S.C. § 101(43), where "transfer" is to be construed as "broad[ly] as possible." S. Rep. No. 95–989, at 27 (1978); *see also* 11 U.S.C. § 101(54) (defining "transfer" as, among other things, "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with ... an interest in property"). Similarly, the Uniform Commercial Code, on which section 101(43) is based, broadly defines "purchase" as "taking by sale, discount, negotiation, mortgage, pledge, lien, security interest, issue or re–

issue, gift or *any other voluntary transaction* creating an interest in property." 2 COLLIER ON BANKRUPTCY ¶ 101.43 (emphasis added) (quoting U.C.C. § 1–201(29)).

23 The claimants were on notice that they could be compensated in part with RSUs. The employee handbooks reflect that "[a]t the Firm's option, a portion of [an employee's] total compensation ... may be payable in the form of conditional equity awards ([RSUs], stock options, or other equity awards) pursuant to the [Program]." JA at 7 ¶ 2. And where Lehman Brothers had employment contracts with its employees, those contracts stated that "[a]t the Firm's discretion, a portion of [the employees'] total compensation ... will be payable in conditional equity awards ([RSUs] and/or other equity awards) pursuant to the [Program]." *Id.*

24 Even if we were to apply *Daniel* and *Cendant* here, it is far from clear that those cases would help the claimants. Both involved retirement plans offered to employees who were already compensated for their labor. *See Daniel*, 439 U.S. at 553–54, 99 S.Ct. 790 (explaining that the pension plans were part of a collective bargaining agreement and were separate and independent from the plaintiffs' compensation); *Cendant*, 76 F.Supp.2d at 544 (explaining that the "plaintiff acquired her options when she was already employed by Cendant under a plan that offered the options not to her as an individual, but as a member of an employee group"). By contrast, in *Yoder v. Orthomolecular Nutrition Institute, Inc.*, 751 F.2d 555 (2d Cir. 1985) (Friendly, J.), we held that an employee "purchased" stock options within the meaning of the federal securities laws where she accepted employment in return for a salary of $40,000 plus options to purchase up to 30,000 shares of the employer's stock. *Id.* at 560. The case at bar more closely resembles *Yoder* than it does *Daniel* or *Cendant* because the RSUs at issue here were not mere benefits, but instead were a significant portion of the claimants' bargained-for compensation.

25 Indeed, the Neuberger Claimants have failed to show anything unlawful about their arrangement with Lehman Brothers, including their non-compete agreements, which had limited one- to three-year restriction periods and were applicable only to Lehman Brothers' market. *See Cardwell v. Thermo Fischer Scientific*, No. 09 Civ. 7809 (DAB), 2010 WL 3825711, at *7, 2010 U.S. Dist. LEXIS 108302 (S.D.N.Y. Sept. 23, 2010) (stating that "New York Courts have held restrictions of up to five years to be reasonable depending on the circumstances," and holding that a one-year non-compete covenant was reasonable).

26 As noted above, the employee handbooks provide that "[a]t the Firm's option, a portion of [an employee's] total compensation ... may be payable in the form of conditional equity awards ([RSUs], stock options, or other equity awards) pursuant to the [Program]," JA at 7 ¶ 2; and where Lehman Brothers had employment contracts with its employees, those contracts made clear that "[a]t the Firm's option, a portion of [the employee's] total compensation (combined base salary, bonus and other compensation) may be payable in the form of restricted stock units pursuant to ... the standard terms and provisions of the Program[,]" *id.* at 2596; *see also id.* at 2575–76 ¶ 2 (same).

27 There is a discretionary exception to this limited obligation to deliver stock to RSU holders, but it is not applicable here. *See* JA at 2890 § 8(b) (explaining that, "upon the occurrence of a Change in Control," Lehman Brothers "may pay to Participants amounts in cash in respect of a[n RSU] equal to cash dividends paid to a holder of shares of Common Stock, for fractional shares or for any amounts payable in cash").

28 The alternative-performance theory could also be characterized as an argument that the award of RSUs did not constitute a payment in exchange for the claimants' labor, despite the Program documents. Such an argument, however, is effectively a contention to rescind the contractual arrangement to which the claimants agreed so that they may be paid in cash—and only cash—for the services they rendered. Whatever the merits of this argument, it does not change the outcome here because a claim for rescission—like a claim for damages—is subject to section 510(b). *See* 11 U.S.C. §

510(b) ("[A] claim arising from rescission of a purchase or sale of a security of the debtor ... shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security....").

29 Even if the claimants could allege an actual injury, their restitution claims might nonetheless be subordinated under section 510(b) inasmuch as those claims are functionally equivalent to a claim for rescission or a claim for damages, both of which are expressly covered by section 510(b). "As a remedy for [a] breach [of contract], 'restitution' means either the restoration of a specific thing or the payment in money of the value of a contractual performance by [the claimant]." Henry Mather, *Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller*, 92 YALE L. J. 14, 14 n.1 (1982) (citing Restatement of Contracts § 326(b) (1932)). In the former sense, a "plea for restitution is merely the remedial flip side of [a] rescission claim; rescission will unwind or avoid the transaction, and restitution will put the parties back in their original positions." *Tekinsight.Com, Inc. v. Stylesite Mktg., Inc. (In re Stylesite Mktg., Inc.)*, 253 B.R. 503, 510–11 (Bankr. S.D.N.Y. 2000). A claim for restitution in this sense may well be subject to section 510(b), broadly interpreted, insofar as it is functionally equivalent to a claim for rescission. *See id.* at 511 (explaining that a claim that "depend[s] on [the claimant's] purchase of the [debtor's] stock ... arise[s] from that purchase" regardless of whether the claimant "chooses to call it" rescission or restitution). Similarly, the second sense in which the term "restitution" can be used as a breach-of-contract remedy—payment measured in terms of the defendant's gain rather than the claimant's loss—might sometimes (though not always) be functionally equivalent to a claim for damages. Restitution, of course, provides for a measure of recovery that is analytically distinct from that of damages. *See In re Gartenberg*, 636 F.2d 16, 17 (2d Cir. 1980) ("Restitution is a remedy distinct from damages and requiring different proof."); *see also* Douglas Laycock, *Restoring Restitution to the Canon*, 110 MICH. L. REV. 929, 938 (2012) ("The fundamental question in damages ... is how much a plaintiff lost.... But in restitution, ... [it] is how much [the] defendant was unjustly enriched."). But "[w]hen the restitutionary claim leads to the same recovery as the ... claim [for damages], there is little reason to distinguish between them." Douglas Laycock, *The Scope and Significance of Restitution*, 67 TEX. L. REV. 1277, 1286 (1989). Indeed, "[w]hen the underlying wrong is the same and the remedy is the same, important collateral issues," such as whether to subordinate claims pursuant to section 510(b), "should not be left open to the option of the clever pleader." *Id.* Here, it appears that the claimants' remedy would be the same whether awarded as damages or as restitution. Indeed, in making their restitution argument, the claimants contend that the proper measurement for recovery is the amount of cash that Lehman Brothers could have paid them in lieu of RSUs, the very same amount they seek in damages by means of their alternative-performance theory. *See supra*. In this regard, the restitution theory seems to be merely a new bottle for old vinegar; the two theories appear to be functionally the same. To be clear, though, this is not the basis on which we reject the claimants' restitution argument; we reject it because the claimants are unable to allege an injury.

30 As the bankruptcy court found at the evidentiary hearing, the parties adduced: (1) "no evidence as to why the Subordination Provisions are not contained in the Program Documents after 2004"; (2) "no evidence that the decision to omit [them] arose from any intent by [Lehman Brothers] to declare that [RSU–based claims] would cease to be subject to ... section 510(b) ... if a Chapter 11 proceeding should ever arise"; and (3) "no evidence that the [claimants] relied upon the omissions of the Subordination Provisions when making the choice to continue employment at Lehman [Brothers]." *Lehman Bros.*, 519 B.R. at 64.

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856 F.3d 377
United States Court of Appeals, Fifth Circuit.

Ralph S. JANVEY, In His Capacity as Court–Appointed Receiver for The Stanford International Bank, Limited, et al, Plaintiff–Appellant Cross–Appellee
v.
DILLON GAGE, INCORPORATED OF DALLAS; Dillon Gage, Incorporated, Defendants–Appellees Cross–Appellants

No. 15-11211
|
Consolidated w/16-10212
|
FILED May 5, 2017

Synopsis

Background: Court-appointed receiver for entities owned by operator of Ponzi scheme, including a retail seller of coins, bullion, and metals, brought claims under Texas Uniform Fraudulent Transfer Act (TUFTA) against a wholesale supplier of coins, bullion, and metals, relating to six transfers from seller to supplier. The United States District Court for the Northern District of Texas, David C. Godbey, J., entered judgment on jury's verdict for supplier, and denied supplier's request for attorney fees. Receiver appealed and supplier cross-appealed.

Holdings: The Court of Appeals, Stephen A. Higginson, Circuit Judge, held that:

[1] seller's payment of supplier from money that sellerreceived from a purchaser of gold bars was not per se fraudulent;

[2] fraudulent intent based on direct evidence was issue forjury;

[3] evidence allowed inference that seller was not insolvent,as would constitute a badge of fraud; and

[4] in denying attorney fees, District Court did notimpermissibly place on prevailing defendants a higher burden than prevailing plaintiffs.

Affirmed.

West Headnotes (33)

[1] **Fraudulent Conveyances**
Receiver

Court-appointed federal receiver for entity owned by operator of Ponzi scheme, which entity was a retail seller of coins, bullion, and metals, had statutory standing to bring fraudulent transfer claims under Texas Uniform Fraudulent Transfer Act (TUFTA) against seller's wholesale supplier of coins, bullion, and metals, where claims were brought on behalf of seller as the entity in receivership, in contrast to receiver bringing common-law fraud claims on behalf of a purchaser of gold bars from seller, as a creditor of seller. Tex. Bus. & C. Code § 24.001 et seq.

Cases that cite this headnote

[2] **Federal Courts** Standing

The Court of Appeals reviews questions of statutory standing de novo.

Cases that cite this headnote

[3] **Receivers**
Rights of action by receivers

A federal equity receiver has standing to assert only the claims of the entities in receivership, and not the claims of the entities' investorcreditors.

Cases that cite this headnote

[4] **Federal Civil Procedure**
Conclusions or inferences from evidence
Federal Civil Procedure
Evidence

Judgment as a matter of law (JMOL) is proper only when the facts and inferences point so strongly and overwhelmingly in the movant's favor that jurors

could not reasonably have reached a contrary verdict. Fed. R. Civ. P. 50(a).

Cases that cite this headnote

[5] **Federal Civil Procedure**
Construction of evidence
Federal Civil Procedure
Construction of evidence

In evaluating a motion for judgment as a matter of law (JMOL), the court must consider all of the evidence in the light most favorable to the nonmovant, drawing all factual inferences in favor of the nonmoving party, and leaving credibility determinations, the weighing of evidence, and the drawing of legitimate inferences from the facts to the jury. Fed. R. Civ. P. 50(a).

Cases that cite this headnote

[6] **Federal Civil Procedure**
Notwithstanding Verdict; J udgment as Matter of Law

On a motion for judgment as a matter of law (JMOL) after a jury trial, the standard of review is especially deferential. Fed. R. Civ. P. 50(a).

Cases that cite this headnote

[7] **Fraudulent Conveyances**
Protection of creditors
Fraudulent Conveyances
Pre-Existing Creditors
Fraudulent Conveyances
Subsequent Creditors

The Texas Uniform Fraudulent Transfer Act (TUFTA) pursues one overriding goal, which is to protect creditors from being defrauded or left without recourse due to the actions of unscrupulous debtors, and to that end, a creditor may sue a third party that received a fraudulent transfer from the debtor and recover its losses by voiding that transaction. Tex. Bus. & C. Code § 24.001 et seq.

Cases that cite this headnote

[8] **Fraudulent Conveyances**
Intent of Grantor

Direct evidence of fraudulent intent exists, so that actual intent to hinder, delay, or defraud can be decided as a matter of law in an action under the Texas Uniform Fraudulent Transfer Act (TUFTA), when a debtor admits the fraud. Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[9] **Fraudulent Conveyances**
Intent

Mere fact that debtor, a retail seller of coins, bullion, and metals, used money it received from one creditor, a purchaser of gold bars, to pay its antecedent debt to another creditor, a wholesale supplier of coins, bullion, and metals, was not per se fraudulent as a transfer made with actual intent to hinder, delay, or defraud, in action under Texas Uniform Fraudulent Transfer Act (TUFTA), brought against supplier by debtor's court-appointed federal receiver; debtor would have upheld its end of the bargain with purchaser if it had not been shut down by receiver before it could deliver the gold bars, regardless of which specific money debtor used to complete the deal, since money was fungible, though purchaser might have preferred that debtor segregate its money. Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[10] **Fraudulent Conveyances**
Questions for Jury; Q uestions of Law and Fact

Whether debtor, a retail seller of coins, bullion, and metals, acted with actual intent to hinder, delay, or defraud a purchaser of gold bars, as would constitute a fraudulent transfer under Texas Uniform Fraudulent Transfer Act (TUFTA) based on direct evidence of fraudulent intent, when it used money it received from purchaser to pay its antecedent debt to another creditor, a

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wholesale supplier of coins, bullion, and metals, was an issue for jury; evidence allowed inference that debtor reasonably believed that it had sufficient assets to complete the deal with purchaser without having to resort to the use of new customers' money. Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[11] **Fraudulent Conveyances**

Intent to Defraud Subsequent Creditors

A debtor does not act with fraudulent intent when it incurs a new debt, for purposes of a fraudulent transfer claim under Texas Uniform Fraudulent Transfer Act (TUFTA), so long as it has a reasonable expectation that it can pay that debt off. Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[12] **Fraudulent Conveyances**

Insolvency element of fraud

The question of insolvency, as badge of fraud in an action under the Texas Uniform Fraudulent Transfer Act (TUFTA), is to be determined as of the time of the conveyance. Tex. Bus. & C. Code §§ 24.003(a, b), 24.005(b)(9).

Cases that cite this headnote

[13] **Fraudulent Conveyances**

Inability to pay debts constituting insolvency

Among the factors relevant to determining whether a debtor's nonpayment of its debts shows insolvency, as badge of fraud in an action under the Texas Uniform Fraudulent Transfer Act (TUFTA), are the number and amount of the unpaid debts in relation to the size of debtor's operation, the age and number of unpaid debts, the total amount of indebtedness, and the number of unpaid creditors. Tex. Bus. & C. Code §§ 24.003(a, b), 24.005(b)(9).

Cases that cite this headnote

[14] **Fraudulent Conveyances**

Insolvency

Evidence allowed inference that debtor, a retail seller of coins, bullion, and metals, was generally paying its debts as they came due, so that debtor was not insolvent when it made payments to its supplier, as would constitute a badge of fraud under Texas Uniform Fraudulent Transfer Act (TUFTA); the only bills specifically identified as unpaid bills were bills from supplier, and evidence was presented that debtor paid its bills every Friday and that debtor had no creditors who were not being paid. Tex. Bus. & C. Code §§ 24.003(a, b), 24.005(b)(9).

Cases that cite this headnote

[15] **Fraudulent Conveyances**

Inability to pay debts constituting insolvency

Evidence merely showing a significant debt and occasional late payments does not establish insolvency as a matter of law, as badge of fraud under Texas Uniform Fraudulent Transfer Act (TUFTA). Tex. Bus. & C. Code §§ 24.003(a, b), 24.005(b)(9).

Cases that cite this headnote

[16] **Federal Courts**

Instructions

Jury instructions are reviewed for abuse of discretion.

Cases that cite this headnote

[17] **Federal Courts**

Instructions

Jury instructions that hinge on a question of statutory construction are reviewed de novo.

Cases that cite this headnote

[18] **Federal Civil Procedure**

Construction and Effect of Charge as a Whole

Reversal is appropriate, based on error in jury instructions, when the jury charge as a whole leaves the appellate court with substantial and ineradicable doubt whether the jury was properly guided in its deliberations and the challenged instructions, separately or collectively, affected the outcome of the case.

Cases that cite this headnote

[19] Federal Courts
Failure or refusal to instruct; m odification of request

When an appellate challenge involves the trial court's failure to give a requested jury instruction, the appellate court will find reversible error only if the requested instruction: (1) was a substantially correct statement of law; (2) was not substantially covered in the charge as a whole; and (3) concerned an important point in the trial such that the failure to instruct the jury on the issue seriously impaired the party's ability to present a given claim.

Cases that cite this headnote

[20] Fraudulent Conveyances
Intent of grantor

Definition of the word "intent," for purposes of making a transfer with actual intent to hinder, delay, or defraud any creditor, was not necessary, in action under Texas Uniform Fraudulent Transfer Act (TUFTA). Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[21] Federal Civil Procedure
Form, Requisites, and Sufficiency

As a general matter, terms which are reasonably within the common understanding of juries, and which are not technical or ambiguous, need not be defined in the trial court's jury charge, but when an instruction uses a term of legal significance, its meaning must be explained, especially when there is a request for clarifying instructions.

Cases that cite this headnote

[22] Fraudulent Conveyances
Intent of grantor

Even assuming that definition of the word "intent," for purposes of making a transfer with actual intent to hinder, delay, or defraud any creditor, should have been given in action under Texas Uniform Fraudulent Transfer Act (TUFTA), the plaintiff court-appointed receiver for the debtor was not impaired in presenting his fraudulent transfer claim; jury was instructed that "actual intent" could be determined through consideration of badges of fraud that listed objective measures of debtor's assets, liabilities, and conduct as being probative of intent, and receiver therefore was allowed to argue his "substantial certainty" theory to the jury. Tex. Bus. & C. Code § 24.005(a)(1), (b).

Cases that cite this headnote

[23] Fraudulent Conveyances
Intent of grantor

Instruction that in determining actual intent to hinder, delay, or defraud, consideration "may" be given, "among other factors," to 11 listed badges of fraud, sufficiently informed jury that not all, or most, of the 11 badges of fraud needed to be found in order for fraudulent intent to be established, in action under Texas Uniform Fraudulent Transfer Act (TUFTA); "may" meant jury could, but did not have to, consider any of the badges of fraud, and "among other factors" meant that the badges of fraud were a nonexhaustive list. ex. Bus. & C. Code § 24.005(a)(1), (b). Cases that cite this headnote

[24] Fraudulent Conveyances
Intent to Defraud Pre-Existing Creditors

A debtor's mere intention to prefer one creditor over another does not indicate fraudulent intent to hinder, delay, or defraud, in action under Texas Uniform Fraudulent Transfer Act (TUFTA), provided that the creditor does not receive more than is reasonably

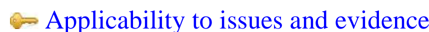
necessary to pay its debts. Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[25]
Fraudulent Conveyances
Intent of grantor

Instruction that mere intention to prefer one creditor over another would not indicate fraudulent intent to hinder, delay, or defraud did not impermissibly suggest that a preferential transfer could never be fraudulent, in action under Texas Uniform Fraudulent Transfer Act (TUFTA); "mere" alerted jury that the instruction referred to preferences standing alone, not preferences in conjunction with other indicators of fraud, and "indicate" told jury that the instruction dealt with evidentiary conclusions that could be drawn from debtor's preference. Tex. Bus. & C. Code § 24.005(a)(1).

Cases that cite this headnote

[26] Federal Courts

Applicability to issues and evidence

Even if jury instructions were erroneous in allegedly failing to exclude, from the counting of debtor's assets, money transferred from the operator of the Ponzi scheme to the debtor, which was one of the operator's entities, the error was harmless to debtor's court-appointed receiver, in action under Texas Uniform Fraudulent Transfer Act (TUFTA); counting of assets was relevant only to determining whether debtor's debts were greater than its assets at fair valuation, which was one of two ways to show insolvency as badge of fraud under TUFTA, and receiver did not attempt to prove insolvency through comparison of debtor's debts and assets. Tex. Bus. & C. Code §§ 24.003(a, d), 24.005(b)(9).

Cases that cite this headnote

[27] Federal Courts

Costs and attorney fees

The Court of Appeals reviews awards or denials of attorney fees for abuse of discretion.

Cases that cite this headnote

[28] Federal Courts

Costs and attorney fees

Factual findings supporting an award of attorney fees are reviewed for clear error.

Cases that cite this headnote

[29] Federal Courts

Costs and attorney fees

Legal conclusions underlying an award of attorney fees are reviewed de novo.

Cases that cite this headnote

[30] Fraudulent Conveyances

Costs and expenses

The Texas Uniform Fraudulent Transfer Act (TUFTA) gives the trial court the sound discretion to award attorney fees based on the evidence the trial court heard. Tex. Bus. & C. Code § 24.013.

Cases that cite this headnote

[31] Fraudulent Conveyances

Costs and expenses

Any attorney fees awarded under the Texas Uniform Fraudulent Transfer Act (TUFTA) must be reasonable and necessary, and must also be equitable and just. Tex. Bus. & C. Code § 24.013.

Cases that cite this headnote

[32] Fraudulent Conveyances

Costs and expenses

Factors relevant to determining whether an attorney fee award is equitable and just under the Texas Uniform Fraudulent Transfer Act (TUFTA) include: (1) whether the case involved egregious conduct; (2) whether an award of fees would accomplish the goals of TUFTA; (3) the evidence heard by the trial court; and (4) evidence of bad faith, vexation, wantonness, oppression, or harassment relating to the filing or the maintenance of the action. Tex. Bus. & C. Code § 24.013.

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Cases that cite this headnote

[33] **Fraudulent Conveyances**
Costs and expenses

District Court's statement when denying transferee's request for attorney fees under Texas Uniform Fraudulent Transfer Act (TUFTA), that the case, like similar claims brought by TUFTA plaintiffs in other cases, represented the best chance for debtor's court-appointed receiver to maximize his recovery, did not impermissibly place on prevailing defendants a higher burden than prevailing plaintiffs; statement did not insist that all prevailing TUFTA plaintiffs had to be awarded attorney fees, and instead the court was saying that the goals of the receivership and other claimants were best served by bringing non-frivolous claims. Tex. Bus. & C. Code § 24.013.

Cases that cite this headnote

***381** Appeals from the United States District Court for the Northern District of Texas, David C. Godbey, U.S. District Judge

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Before WIENER, CLEMENT, and HIGGINSON, Circuit Judges.

Opinion

STEPHEN A. HIGGINSON, Circuit Judge:

This case concerns more fallout from Allen Stanford's Ponzi scheme. Plaintiff–Appellant Ralph Janvey ("Janvey") is the court-appointed receiver tasked with marshalling and distributing the assets of the Stanford entities. This suit relates to Stanford ***382** Coins and Bullion ("SCB"), a coin and bullion company previously owned by Allen Stanford. SCB sold coins and metals to the public. Defendant–Appellee Dillon Gage Inc. of Dallas ("Dillon Gage") is a wholesaler of metals, bullion, and coins and was SCB's largest supplier.

Janvey alleges that six transfers from SCB to Dillon Gage were fraudulent transfers under the Texas Uniform Fraudulent Transfer Act ("TUFTA") and should be returned to the receivership. Following trial, a jury disagreed, finding that the six transfers were not fraudulent. Dillon Gage then sought attorney's fees, which the district court denied. Janvey appealed, challenging the jury verdict and instructions; Dillon Gage cross-appealed, challenging the denial of the fee award. We AFFIRM.

I

For almost two decades, Allen Stanford and his coconspirators perpetrated a multi-billion-dollar Ponzi scheme using a global network of more than 130 entities. The Ponzi scheme sold fraudulent certificates of deposit to investors. Proceeds from investors were used to pay other investors, fund Allen Stanford's lifestyle, and finance other Stanford entities.

One entity related to the scheme was SCB. SCB received capital contributions and loans from other Stanford entities. Indeed, until late 2008, SCB had a line of credit with Stanford International Bank. However, SCB did not sell Stanford certificates of deposit. Instead, SCB operated as an otherwise ordinary coin and bullion business, buying and selling coins and metals. It purchased coins and metals from wholesalers and resold them to retail customers at a markup. SCB ran its business operations through an operating account, that is, when SCB received customers' money, it deposited the funds into SCB's operating account, and the operating account was then used to pay SCB's business expenses. SCB was led by its President Joseph Frisard and its Vice President of Operations Scott Terry. SCB was never profitable, although by 2009 its revenues were rising.

At all relevant times, Dillon Gage was managed by its President of the Metals Division Terry Hanlon and General Manager Ira Fritz. SCB became Dillon Gage's customer in 2004. The relationship grew and by early 2009, Dillon Gage was SCB's largest wholesale supplier. SCB would place orders with Dillon Gage through Dillon Gage's trading desk. Dillon Gage would then either supply the goods to SCB or ship the goods directly to SCB's customers (called "drop-shipping"). SCB would then pay Dillon Gage for the orders, with payment usually due ten days to two weeks after shipment. However, SCB was consistently late in its payments to Dillon Gage.

During this business relationship, Dillon Gage extended SCB a line of credit, which, by 2009, had grown to $2 million. In January 2009, SCB's account balance with Dillon Gage had grown to about $2.3 million. During this time, Hanlon became increasingly concerned with the age and amount of SCB's outstanding invoices, and in response, on January 20, 2009, he traveled to SCB's headquarters to meet with Frisard. At the meeting, Frisard assured Hanlon that SCB had already mailed a payment to Dillon Gage and was anticipating a big order that could be used to pay off the rest of SCB's balance. Frisard also showed Hanlon SCB's offices; Hanlon observed significant inventory and a room full of salespeople taking customers' orders.

As it turned out, the check that Frisard promised was actually only for $250,000. Concerned by the low payment, Hanlon called Scott Terry on January 22, 2009, seeking further payment. Hanlon told Terry ***383** that he was uncomfortable with SCB's slow rate of payment and high balance and asked for an explanation. Terry explained that SCB was suffering from cash flow problems, in part because it had lost its line of credit with Stanford International Bank. Terry further explained that SCB was working on a big deal and that when it received payment, it could use the money to pay Dillon Gage. Terry suggested that if the big deal failed SCB could collect its unpaid accounts receivables, liquidate inventory, or seek additional capital from Stanford. Hanlon responded that Dillon Gage could not keep shipping SCB inventory until it was paid.

The "big deal" referenced by both Frisard and Terry was a deal with the Pre–War Art Gallery (the "Gallery"). The Gallery wanted to purchase 101 gold bars from SCB for approximately $3 million (the "Gallery Deal").

Soon after the January 22 phone call, Dillon Gage stopped shipping orders to SCB and its customers. This was not entirely out of the ordinary; Dillon Gage had halted shipments to SCB before. From January 23 until January 30, SCB made three payments to Dillon Gage, totaling approximately $1.26 million: $501,326.30 (January 23); $394,567.40 (January 27); and $368,491.51 (January 30).

On February 2, 2009, the Gallery placed its order with SCB for 101 gold bars, wiring $3,028,613 to SCB for the order. Frisard then ordered the gold bars from Dillon Gage and provided an upfront payment of approximately $3 million to Dillon Gage. Although the order was placed on February 2, the order did not need to be shipped to the Gallery until March 4.

Following SCB's $3 million payment, Dillon Gage immediately began shipping SCB's backlogged orders, applying the $3 million payment to the oldest invoices first. In total, Dillon Gage shipped $1,947,453.65 in coins and bullion to SCB or its customers in the time between when shipping resumed and when the receivership was imposed.

On February 6 and February 13, SCB made two further payments to Dillon Gage of $366,171.50 and $486,959.86, respectively. Following these payments, SCB had a credit balance with Dillon Gage of $1,069,355. Nonetheless, SCB still owed Dillon Gage more money to complete payment on the Gallery Deal.

On February 17, 2009, SCB was shut down by Janvey, the court-appointed receiver. At the time it was shut down, SCB had over $1 million in cash and $300,000–$400,000 in uncashed checks on hand. SCB's management believed that the company had sufficient cash, or access to capital, to complete the Gallery Deal.

In September 2010, Janvey filed this lawsuit. He alleged that the following payments from SCB to Dillon Gage were fraudulent transfers under TUFTA and therefore should be returned to the receivership:

- January 23, 2009–$501,326.30
- January 27, 2009–$394,567.40
- January 30, 2009–$368,491.51
- February 2, 2009–$3,002,639.10
- February 6, 2009–$366,171.50
- February 13, 2009–$486,959.86

The parties proceeded to trial in July 2015. The jury was asked two questions: (1) were the transfers from SCB to Dillon Gage fraudulent transfers?; and (2) did Dillon Gage accept the transfers from SCB in good faith?

At trial, both parties agreed that Dillon Gage applied the $3 million payment related to the Gallery Deal to its oldest debts with SCB. Both parties also presented significant evidence of SCB's financial condition. Janvey's expert, Karyl Van Tassel, ***384** opined that SCB was insolvent because it was generally not paying its bills as they became due, although she did not distinguish in her analysis between past due bills and general liabilities. Moreover, neither Janvey nor Van Tassel identified any specific debts owed by SCB to anyone other than Dillon Gage. Van Tassel further testified that SCB never generated a profit, had negative equity, and had more liabilities than available cash. However, Van Tassel did not testify that SCB's liabilities were greater than its assets because she never valued SCB's assets.

Dillon Gage introduced testimony concerning SCB's finances from Frisard, Terry, and its industry expert, Michael Fuljenz. Dillon Gage's witnesses testified that SCB had significant non-cash assets including: inventory, uncashed checks, and uncollected accounts receivables. Dillon Gage's witnesses also testified that businesses in the coin and bullion industry typically suffer from cash flow problems in the beginning of the calendar year because, among other reasons, most coin companies buy inventory in the beginning of the year.

The jury returned a verdict in favor of Dillon Gage, finding that none of the six transfers was fraudulent. The district court denied Janvey's motion for judgment as a matter of law. Following judgment, Dillon Gage filed a motion seeking attorney's fees under TUFTA. The district court denied the motion. Janvey appeals the denial of his motion for judgment as a matter of law and Dillon Gage cross-appeals the denial of its motion for attorney's fees.

II

Janvey raises two challenges to the jury verdict. First, he argues that a reasonable jury was required to find that SCB's transfers to Dillon Gage were fraudulent. Second, he argues that the jury instructions were erroneous. We reject both challenges.

A

[1] [2] [3] [4] [5] [6] Janvey first argues that, as a matter of law, each of the challenged transfers was fraudulent.[1] We review a district court's denial of a motion for judgment as a matter of law de novo, applying the same standards as the district court. *See, e.g.*, *Ill. Cent. R.R. Co. v. Guy*, 682 F.3d 381, 392–93 (5th Cir. 2012). Judgment as a matter of law is proper only when "a reasonable jury would not have a legally sufficient evidentiary basis to find for the party on that issue." *Abraham v. Alpha Chi Omega*, 708 F.3d 614, 620 (5th Cir. 2013) (quoting Fed. R. Civ. P. 50(a)). "This ***385** will only occur if the facts and inferences point so strongly and overwhelmingly in the movant's favor that jurors could not reasonably have reached a contrary verdict." *Id.* (quoting *Brown v. Sudduth*, 675 F.3d 472, 477 (5th Cir. 2012)). "In evaluating such a motion, the court must consider all of the evidence in the light most favorable to the nonmovant, drawing all factual inferences in favor of the non-moving party, and leaving credibility determinations, the weighing of evidence, and the drawing of legitimate inferences from the facts to the jury." *Price v. Marathon Cheese Corp.*, 119 F.3d 330, 333 (5th Cir. 1997). "After a jury trial, [the] standard of review is especially deferential." *Abraham*, 708 F.3d at 620 (citation omitted, alteration in original).

[7] [8] Janvey brought all of his claims under TUFTA. TUFTA pursues one overriding goal: "to protect creditors from being defrauded or left without recourse due to the actions of unscrupulous debtors." *KCM Fin. LLC v. Bradshaw*, 457 S.W.3d 70, 89 (Tex. 2015). To that end, a creditor may sue a third party that received a fraudulent transfer from the debtor and recover its losses by voiding that transaction. *See In re IFS Fin. Corp.*, 669 F.3d 255, 261–62 (5th Cir. 2012). A transfer is fraudulent under TUFTA if it was made "with actual intent to hinder, delay, or defraud any creditor of the debtor." Tex Bus. & Com. Code § 24.005(a)(1). A fraudulent transfer can be proven in two ways: directly or circumstantially. When direct evidence of fraudulent intent exists, as when a debtor "admits the fraud," then "[i]ntent ... can be decided as a matter of law." *BMG Music v. Martinez*, 74 F.3d 87, 90 (5th Cir. 1996). But "[s]ince [this] intent ... is seldom susceptible of direct proof, courts have relied on badges of fraud," eleven of which are listed in the statute, as circumstantial evidence of fraud. Uniform Fraudulent Transfer Act ("UFTA"), Prefatory Note; *see also* Tex. Bus. & Com. Code § 24.005(b).

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1

[9] Janvey first contends that he provided the jury with irrefutable direct evidence of fraud. He argues that SCB misappropriated the Gallery's $3 million payment in order to pay down SCB's old debts to Dillon Gage. Janvey contends that this misappropriation constitutes direct evidence of fraudulent intent because "a debtor acts with fraudulent intent when it misappropriates funds from one creditor to pay another, and when it disregards the substantial risk that its creditors will be hindered, delayed, or defrauded as a result."[2] That is, Janvey relies on the theory that there is direct evidence of fraud when a debtor uses Creditor A's money to pay off its debts to Creditor B *and* the debtor knows, or must know, that "the natural consequence of its action" is that Creditor A will be hindered, delayed, or defrauded in the collection of its debts. *See In re Sentinel Mgmt. Grp., Inc.*, 728 F.3d 660, 667 (7th Cir. 2013) ("*Sentinel I*").

[10] However, the jury could have concluded that SCB did not disregard a substantial risk that the Gallery would go unpaid (here, not receive its gold bars) ***386** when SCB used the Gallery's money to pay its antecedent debt to Dillon Gage. Specifically, the jury rationally could have concluded that SCB thought that it had sufficient assets to complete the Gallery deal without having to resort to the use of a new customers' money. The jury was told that SCB's revenues were rising—going from about $36 million in 2007 to $60 million in 2008. And, the jury heard evidence from which it could have inferred that this revenue growth would have continued. For example, in early 2009, SCB began a new national advertising campaign. From these facts, the jury could have inferred that, over time, SCB would have generated enough profit to pay down its trade creditor debt without needing to use new customer funds.

[11] But the jury did not need to draw this inference because the jury also heard evidence suggesting that SCB had sufficient saleable inventory in the beginning of 2009 to complete the Gallery transaction, even without growing its business. In order to complete the Gallery Deal, SCB needed to pay Dillon Gage an additional $1.9 million by March 4, 2009. At the time the receivership began, SCB had over $1 million in cash and between $300,000 and $400,000 in uncashed checks on hand. In addition, SCB owned approximately $3 million worth of rare coins and approximately $4.6 to $4.9 million in total inventory. Dillon Gage's industry expert testified that SCB could have easily liquidated its inventory to raise capital because the market for coins and bullion was rising in early 2009. SCB had additional assets that could have been sold to complete the Gallery Deal, such as approximately $1.3 to $1.5 million in unpaid accounts receivables and customer lists that, according to Dillon Gage's industry expert, could be sold. Finally, SCB's employees testified that SCB intended to complete, and could have completed, the Gallery Deal. Based on this evidence, the jury reasonably could have found that SCB could have raised sufficient capital to pay Dillon Gage to complete the Gallery Deal without using new customers' money. Accordingly, the jury could have properly rejected Janvey's direct evidence of fraud theory.[3]

2

Janvey next argues that he provided the jury with significant circumstantial evidence of fraud. At trial, Janvey attempted to prove two badges of fraud: insolvency and incurrence of a substantial debt at the time of the challenged transfers. *See* Tex. Bus. & Com. Code § 24.005(b)(9), (10). Janvey proved one badge—incurrence of substantial debt at the time of the challenged transfers —but failed to prove insolvency as a matter of law.[4]

***387** Under TUFTA, it is a badge of fraud if "the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred." Tex. Bus. & Com. Code § 24.005(b)(9). Insolvency can be proven in two ways: by showing that "the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation," or by showing that the debtor "is generally not paying the debtor's debts as they become due." Tex. Bus. & Comm. Code § 24.003(a), (b). Both parties focus on the second test.[5] TUFTA provides that "[a] debtor who is generally not paying the debtor's debts as they become due is presumed to be insolvent." *See* Tex. Bus. & Com. Code § 24.003(b). Janvey argues that the trial evidence conclusively established that SCB was not generally paying its debts as they came due and was therefore presumptively insolvent under TUFTA.

[12] [13] "The question of insolvency is to be determined as of the time of the conveyance." *United States v. Fritz*, No. SA-12-C-550-FB (HJB), 2014 WL 12540471, at *4 (W.D. Tex. Jan. 7, 2014), *report and recommendation adopted*, 2014 WL 12537176 (W.D. Tex. Feb. 24, 2014), *aff'd*, 608 Fed.Appx. 259 (5th Cir. 2015) (unpublished) (quoting *Jackson Law Office, P.C. v. Chappell*, 37 S.W.3d 15, 25 (Tex. App.—Tyler 2000,

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pet. denied)). "[V]arious factors are relevant to determine whether a debtor's payment of its debts shows insolvency." *Williams v. Hous. Plants & Garden World, Inc.*, 508 B.R. 19, 30–31 (S.D. Tex. 2014) (quoting *In re Arriola Energy Corp.*, 74 B.R. 784, 790 (S.D. Tex. 1987)). "Among them are the number and amount of the unpaid debts in relation to the size of the debtor's operation; the age and number of unpaid debts; the total amount of indebtedness; and the number of unpaid creditors [.]" *Id.* (citing *Arriola Energy Corp.*, 74 B.R. at 790); *accord* Unif. Fraudulent Transfer Act § 2(b) & cmt. 2; *ASARCO LLC v. Ams. Mining Corp.*, 396 B.R. 278, 402 (S.D. Tex. 2008) (looking to the same presumption under Delaware and New Jersey law and noting that "[t]he most commonly used factors are: (1) the number of debts; (2) the amount of delinquency; (3) the materiality of non-payment; and (4) the nature of the debtor's conduct of its financial affairs").

[14] [15] The jury heard evidence from which it could infer that SCB was generally paying its debts as they came due. Other than the bills owed to Dillon Gage, Janvey did not identify any specific bills that were due and that SCB did not pay. And even with regard to the debts owed to Dillon Gage, the jury heard conflicting evidence concerning whether SCB was generally paying Dillon Gage as its debts came due. On the one hand, the jury heard testimony indicating that, from its inception, SCB was "historically late paying [its] bills" to Dillon Gage and was a "slow-pay." ***388** On the other hand, the jury heard that SCB "paid [its] bills every Friday," and had no creditors who were not being paid. Courts interpreting TUFTA have concluded that evidence merely showing a significant debt and occasional late payments does not establish insolvency as a matter of law. *See Williams v. Houston Plants & Garden World, Inc.*, 508 B.R. 11, 18 (S.D.Tex.2014) (rejecting summary judgment on the insolvency badge despite evidence showing that "during the relevant periods, [the transferor] was behind on payments to some of its creditors," and evidence showing that "[the transferor] refinanced some debt that was due and incurred substantial overdraft fees in the year the challenged transfers began"); *Basley v. Adoni Holdings, LLC*, 373 S.W.3d 577, 584 (Tex.App.2012) ("[Creditors] merely proved [Debtor] was failing to pay the debt for which judgment had been taken and was delinquent on another debt. This evidence was insufficient to establish that [Debtor] was generally not paying her debts as they became due."); *In re Iridium Operating LLC*, 373 B.R. 283, 343 (Bkrtcy.S.D.N.Y.2007) ("[T]he failure to make one $90 million interest payment one month prior to its bankruptcy filing does not, by itself, support a finding that Iridium was not paying its debts as they became due."). Accordingly, the jury was not required to find that SCB was insolvent at the time of the transfers.

3

Viewing both the direct and circumstantial evidence of fraud as a whole we conclude that a rational jury could have found that SCB did not act with fraudulent intent. Janvey only established one badge of fraud—incurrence of a substantial debt close in time to the transfers— as a matter of law. Against this single badge of fraud, the jury heard significant evidence from which it could have inferred that SCB did not make the transfers with fraudulent intent. Accordingly, we affirm the jury verdict.

B

Janvey next argues that a new trial is needed because the jury instructions were misleading and erroneous. Janvey raises four challenges to the jury instructions. We conclude that each is without merit.

[16] [17] [18] [19] Jury instructions are reviewed for abuse of discretion. *Jowers v. Lincoln Elec. Co.*, 617 F.3d 346, 352 (5th Cir. 2010). Instructions that hinge on a question of statutory construction are reviewed de novo. *GE Capital*, 754 F.3d at 302. Reversal is appropriate when the "charge as a whole leaves [the court] with substantial and ineradicable doubt whether the jury [was] properly guided in its deliberations" and the challenged instructions, separately or collectively, "affected the outcome of the case." *Jowers*, 617 F.3d at 352 (quoting *Bender v. Brumley*, 1 F.3d 271, 276–77 (5th Cir. 1993)). Similarly, when a challenge involves the trial court's failure to give a requested jury instruction, the court will find reversible error only if the requested instruction "1) was a substantially correct statement of law, 2) was not substantially covered in the charge as a whole, and 3) concerned an important point in the trial such that the failure to instruct the jury on the issue

those creditors. SCB acted with such disregard if, at the time that it made the transfers to Dillon Gage, SCB knew that it could not pay existing creditors.

Janvey argues that "the proposed instruction would have provided a critical clarification" because the legal definition of intent is broader than the common-sense

seriously impaired the [party's] ability to present a given [claim].” *Baisden v. I'm Ready Prods., Inc.*, 693 F.3d 491, 505 (5th Cir. 2012) (citation omitted).

1

[20] Janvey first argues that the jury instructions were erroneous because they failed to define the word “intent.” For the purpose of determining whether SCB's ***389** transfers to Dillon Gage were fraudulent, the district court instructed the jury that “[a] transfer made by SCB is fraudulent if SCB made the transfer with actual intent to hinder, delay, or defraud any creditor of SCB.” Janvey requested this additional instruction:

> [I]f you find that SCB disregarded the substantial certainty that SCB's creditors would be hindered, delayed, or defrauded by the transfers to Dillon Gage, then the transfers were made with actual intent to hinder, delay, or defraud meaning of the term. Specifically, Janvey argues that the legal definition of intent, unlike the colloquial definition, includes cases in which a party “disregarded the substantial risk or certainty that a particular consequence would occur” even if the party did not desire the result.

[21] As a general matter, “[t]erms which are reasonably within the common understanding of juries, and which are not technical or ambiguous, need not be defined in the trial court's charge.” *United States v. Anderton*, 629 F.2d 1044, 1048–49 (5th Cir. 1980). Nonetheless, “[w]hen the instruction uses a term of legal significance, its meaning must be explained, especially when there is a request for clarifying instructions.” *Id.* at 1049.

Texas's model TUFTA jury instructions do not define intent. *See* Texas Pattern Jury Instruction, Business, Consumer, Insurance & Employment § 105.25 (2016). And Texas's approach is consistent with the model jury instructions from other states that have adopted the UFTA. *See, e.g.*, Alabama Pattern Jury Instructions § 18.22 (3d ed. 2015); California Model Jury Instruction § 4200 (2016); North Carolina Civil Pattern Jury Instruction § 814.50 (2015). Moreover, in federal cases when intent is an element, we too have approved jury instructions that have left the term undefined. *See, e.g.*, *United States v. Sanchez–Sotelo*, 8 F.3d 202, 212 (5th Cir. 1993). Accordingly, we conclude that the district court did not err by declining to define intent.

[22] In any event, failure to give Janvey's proposed instruction did not impair his presentation of his claim. Although the jury was instructed to consider whether SCB acted with “actual intent,” the charge went on to instruct the jury that “actual intent” could be determined through consideration of, among other factors, the badges of fraud. And, the badges of fraud list objective measures of the debtor's assets, liabilities, and conduct as being probative of intent. Accordingly, under the instructions as given, the jury was told to consider not just the state of mind of SCB's principals in determining intent but also the objective facts surrounding the challenged transfers. The instructions therefore allowed Janvey to argue his “substantial-certainty” theory to the jury and signaled to the jury that they should take the theory seriously. Thus, the jury charge was not reversible error. *See Baisden*, 693 F.3d at 504–05.

2

[23] Janvey next argues that “[t]he instructions also improperly increased the Receiver's burden of proof because they did not specify that the Receiver did not have to prove most or all of TUFTA's eleven badges of fraud to show SCB's fraudulent intent.” Specifically, Janvey complains that by listing all eleven badges ***390** of fraud in the jury instructions, but not instructing the jury that all eleven need not be found to find fraudulent intent, the jury could have been misled.

Contrary to Janvey's claim, the jury instruction as given communicated to the jury that not all eleven badges needed to be found. The district court instructed the jury that “[i]n determining actual intent, consideration may be given, among other factors, to” the badges of fraud. This instruction closely mirrors the Texas Pattern Instruction. *See* Texas Pattern Jury Instruction, Business, Consumer, Insurance & Employment § 105.25 (2016) (“In determining actual intent, you may consider, among other factors [the badges of fraud].”). The use of the term “may” instructed the jury that they could, but did not have to, consider any of the badges of fraud. Bryan Garner, Black's Law Dictionary 1068 (9th ed. 2009) (defining “may” as “to be permitted to”). Similarly, the use of the phrase “among other factors” instructed the jury that the

badges of fraud were a nonexhaustive list. The charge therefore properly instructed the jury that they could, but were not required to, consider the badges of fraud and that they could also consider any other relevant factor.

3

[24] Janvey next argues that the district court's instruction on debtor preferences was erroneous. The district court instructed the jury that "[a] debtor's mere intention to prefer one creditor over another does not indicate fraudulent intent, provided that the creditor does not receive more than is reasonably necessary to pay its debts." Janvey contends that the district court's instruction was "prejudicial ... because it incorrectly suggested that preferential transfers and fraudulent transfers are mutually exclusive."

The instruction, however, was a correct statement of Texas law. Under Texas law, "a debtor has the right to prefer his obligation to one creditor over an obligation to another creditor." *Englert v. Englert*, 881 S.W.2d 517, 518 (Tex. App.—Amarillo 1994, no writ); *see also Quinn v. Dupree*, 157 Tex. 441, 303 S.W.2d 769, 774 (1957) ("[E]very debtor has the right to pay or secure one or more of his just debts with any property he has, provided that no m[or]e property is transferred than is reasonably necessary to pay or secure the debt. A mere intention to prefer one creditor over the other thus will not vitiate the transaction, and the conveyance or security instrument will not be h[el]d void as to creditors unless it was executed with fraudulent intent or amounts to a fraud in law.") (alterations in original); *Jackson Law Office*, 37 S.W.3d at 25 ("The general rule is that a debtor has the right to prefer his obligation to one creditor over an obligation to another creditor."). Texas's preference law "remain[s] valid notwithstanding the subsequent enactment of the TUFTA...." *Alexander v. Holden Bus. Forms, Inc.*, No. 4:08-CV-614-Y, 2009 WL 2176582, at *7 (N.D. Tex. July 20, 2009). Accordingly, "[a] debtor in Texas has the right to prefer an obligation to one creditor over an obligation to another creditor, as long as the debtor's preference is devoid of fraudulent intent." *Geneva Corp. Fin., Inc. v. Waddell*, 251 F.3d 157, 2001 WL 300795, at *2 (5th Cir. 2001) (unpublished); *see also Janvey v. Golf Channel, Inc.*, 792 F.3d 539, 543 (5th Cir. 2015) (noting that the "right to prefer does not extend to transfers made in fraud of the rights of the other creditors" (citing *Englert*, 881 S.W.2d at 518)).

The district court instructed the jury that a debtor's "mere intention" to prefer one creditor over another creditor "does not indicate fraudulent intent." The use of the word "mere" is critical. "Mere" means ***391** "being nothing more than." Merriam–Webster's Collegiate Dictionary 726 (10th ed. 2002). The instruction thus told the jury that a debtor's intention to prefer a specific creditor, standing alone, is not fraudulent. That is an accurate summary of Texas law. *See Englert*, 881 S.W.2d at 518 (noting that fraudulent intent must be affirmatively shown and that the debtor's mere knowledge that there were other creditors who were not receiving payment was insufficient to show fraudulent intent).

[25] Janvey argues that even if the instruction was a technically correct statement of law, it was misleading "because it suggested that as long as SCB made a transfer with the intent of satisfying one of its creditors —in this case, Dillon Gage—then that transfer could never be avoidable under TUFTA." But the instruction does not suggest that a preferential transfer can never be fraudulent. Instead, it says that a "mere intention" does not "indicate" fraudulent intent. The word "mere" alerted the jury that the instruction referred to preferences standing alone, not preferences in conjunction with other indicators of fraud. Moreover, the word "indicate" told the jury that the instruction dealt with evidentiary conclusions that could be drawn from the debtor's preference. *See* Merriam–Webster's Collegiate Dictionary 590 (10th ed. 2002) (defining "indicate" as "to be a sign, symptom, or index of"). Taken together, the instruction informed the jury that a debtor's intent to prefer one creditor over another was not evidence of fraud. It did not instruct the jury that a debtor's intent to prefer one creditor insulated the debtor from fraud.

4

[26] Finally, Janvey objects to the district court's definition of assets. The parties' dispute over the "assets" instruction centers on Section 24.003 of TUFTA, which defines insolvency. Section 24.003(a) provides that "[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation." Tex. Bus. & Com. Code § 24.003(a). Section 24.003(d) excludes specific kinds of assets from the calculation of assets prescribed by Section 24.003(a): "[a]ssets under this section do not include property that has been transferred, concealed, or removed with intent to

hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable under this chapter." Tex. Bus. & Com. Code § 24.003(d).

The district court instructed the jury:

> A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation.... Assets under this section do not include property that has been transferred, concealed, or removed with intent to hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable.
>
> A transfer made by the Stanford Ponzi scheme to SCB is presumed to be voidable, unless the transfer is taken in good faith and for reasonably equivalent value.

Janvey objects to the second paragraph of the instruction. He argues that the instruction was a misstatement of law because it allowed the jury to count money transferred from the Stanford Ponzi scheme to SCB as SCB's assets.

Even assuming that the district court erred in giving the instruction, which we doubt, the error was harmless. We will remand to correct a flawed jury instruction only if the error "affected the outcome of the case." *Jowers*, 617 F.3d at 352 (quoting *Bender*, 1 F.3d at 276); *see also Rubinstein v. Admins. of Tulane Educ. Fund*, 218 F.3d 392, 404 (5th Cir. 2000) ("Further, ***392** and importantly to this case, review of jury instructions is for harmful error. Even if an instruction erroneously states the applicable law or provides insufficient guidance, this Court will not disturb the judgment unless the error could have affected the outcome of the trial.").

As Janvey himself recognizes, the issue of which of SCB's assets count as "assets" under Section 24.003(d) is only relevant to determining whether SCB's debts were greater than its assets at a fair valuation, which is one of two ways to show insolvency under TUFTA (the other being general failure to pay debts as they become due). *See* Tex. Bus. & Com. Code § 24.003. However, Janvey did not attempt to prove SCB's insolvency through a comparison of SCB's debts and assets. Janvey's expert testified that she did not attempt to value SCB's debts or assets. In fact, Janvey's expert testified that she had not even attempted to determine what SCB's assets were. The district court noted that "[o]n the issue about insolvency and debts greater than all assets at fair valuation, I agree with [Dillon Gage] that no single expert witness testified to that and that plaintiff's expert disclaimed any opinion on the definition of insolvency." Moreover, no witness gave a complete accounting of SCB's debts and assets. And we have held that balance-sheet insolvency cannot be determined when evidence of the debtor's assets is not introduced. *Lamar Haddox*, 40 F.3d at 121–22. Thus, any miscalculation of SCB's assets could not have led to a different outcome on the insolvency badge because no party has argued (even on appeal) that SCB was balance-sheet insolvent or offered evidence showing SCB's full assets and debts at a fair valuation. We conclude that any error with respect to the assets instruction was harmless.

III

We now turn to Dillon Gage's cross-appeal concerning attorney's fees. Following trial, Dillon Gage requested an award of $278,603 in attorney's fees. The district court denied the motion, concluding that Janvey's claims "were not frivolous, unreasonable, or without foundation[,]" that the litigation represented Janvey's "most likely avenue by which he can fulfill his goal of maximizing recovery to make whole the Stanford Ponzi scheme's defrauded investors[,]" and that "an award of attorney's fees for Dillon Gage would not be equitable and just."

[27] [28] [29] This court reviews awards or denials of attorney's fees for abuse of discretion; factual findings supporting a fee award are reviewed for clear error, and legal conclusions underlying a fee award are reviewed de novo. *Dearmore v. City of Garland*, 519 F.3d 517, 520 (5th Cir. 2008). The standard of review is substantially the same under Texas law. *See Shaw v. Cty. of Dallas*, 251 S.W.3d 165, 171 (Tex. App.—Dallas 2008, pet. denied) ("We will reverse a trial court's ruling on a request for attorney's fees under [a discretionary fee statute] only if the court's decision is arbitrary, unreasonable, and without regard to guiding legal principles.").

[30] [31] [32] TUFTA provides that "the court may award costs and reasonable attorney's fees as are equitable and just." Tex. Bus. & Com. Code § 24.013. "This provision of TUFTA gives the trial court the sound discretion to award attorney's fees based on the evidence the trial court heard." *Walker v. Anderson*, 232 S.W.3d

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899, 919 (Tex. App.—Dallas 2007, no pet.). "The Court's exercise of this discretion is subject to the following limitations: any fees awarded must be reasonable and necessary, and must also be equitable and just." *Janvey v. Romero*, No. 3:11-CV-0297-N, 2015 WL 11017950, at *1 (N.D. Tex. Sept. 22, 2015) (citing ***393** *Qui Phuoc Ho v. MacArthur Ranch, LLC*, No. 05-14-00741-CV, 2015 WL 5093273, at *10 (Tex. App.—Dallas Aug. 28, 2015, pet. denied)). A number of factors are relevant to determining whether a fee award is "equitable and just" under TUFTA, including: (1) whether the case involved egregious conduct, *In re Pace*, 456 B.R. 253, 283 (Bankr. W.D. Tex. 2011); (2) whether an award of fees accomplishes the goals of TUFTA, *In re Edwards*, 537 B.R. 797, 806 (Bankr. S.D. Tex. 2015); (3) the evidence heard by the trial court, *Citizens Nat. Bank of Tex. v. NXS Const., Inc.*, 387 S.W.3d 74, 87 (Tex. App.—Houston [14th Dist.] 2012, no pet.); and (4) "evidence of bad faith, vexation, wantonness, oppression, or harassment relating to the filing or the maintenance of this action[,]" *RFAR Grp., LLC v. Epiar, Inc.*, No. 11-CV-3432, 2013 WL 1743880, at *3 (N.D. Tex. Jan. 9, 2013), *report and recommendation adopted*, 3:11–CV–3432–L, 2013 WL 1748619 (N.D. Tex. Apr. 23, 2013).

[33] Dillon Gage does not assert that the district court relied on improper considerations when it denied the fee request; instead, it contends that the district court impermissibly placed a higher burden on prevailing defendants than prevailing plaintiffs by focusing on the frivolousness of Janvey's claim here and by not focusing on the frivolousness of the defenses in other cases in which the receiver prevailed. However, nothing in the district court's order suggests that it treated Dillon Gage differently merely because it was a prevailing defendant. The closest the district court came to signaling a different standard between prevailing plaintiffs and defendants is its statement that this case "and other similar claims" represented the Receiver's best chance at maximizing his recovery. But, even that statement does not insist that all prevailing TUFTA plaintiffs must be awarded fees. Instead, read in context, the district court was saying that the goals of the receivership are best served when the receiver brings claims similar to those brought in this litigation—namely non-frivolous claims. Moreover, Dillon Gage's contention that *Romero*, 2015 WL 11017950, demonstrates unequal treatment is without merit. In *Romero*, the district court awarded fees to a prevailing receiver. *See id.* at *3–4. Dillon Gage argues that in *Romero* "the court held that it would always be 'equitable and just' to award fees to a receiver who prevailed at trial in view of a receivership's 'goals and purposes.' " But that simply is not what *Romero* says. Instead, the district court in *Romero* found that a fee award was "equitable, just, and reasonable based on the evidence" including "the case's outcome and the receivership's goals and purposes." *Id.* at *2–3. Nowhere did the district court say that prevailing receivers must always recover. *Id.* Accordingly, we hold that the district court did not apply the wrong standard in assessing Dillon Gage's fee request.

We AFFIRM the jury verdict. We AFFIRM the district court's order denying attorney's fees.

All Citations

856 F.3d 377

Footnotes

1 As a preliminary matter, Dillon Gage argues that Janvey does not have standing to assert its fraud claim because, Dillon Gage claims, the fraud claim is brought on behalf of the Gallery. "[This Court] review[s] questions of statutory standing de novo." *Janvey v. Brown*, 767 F.3d 430, 437 (5th Cir. 2014). "[A] federal equity receiver has standing to assert only the claims of the entities in receivership, and not the claims of the entities' investor-creditors." *Janvey v. Democratic Senatorial Campaign Comm., Inc.*, 712 F.3d 185, 190 (5th Cir. 2013). Here, Janvey is not bringing a common-law fraud claim on behalf of the Gallery. Instead, he is bringing a statutory TUFTA claim on behalf of SCB—an entity under his receivership. *Id.* at 192–93 (looking to the claims asserted in the complaint to determine what claims were asserted by the receiver). Janvey has standing to bring a TUFTA claim on behalf of a Stanford entity. *Id.* at 192 ("[W]e conclude that the Receiver has standing to assert the claims of [a Stanford entity], and any other Stanford entity in receivership, against the [defendants] to recover the contributions made to them without reasonably equivalent value by the Stanford Ponzi operation."); *see also* *Janvey v. Suarez*, 978 F.Supp.2d 685, 697–98 (N.D. Tex. 2013). Thus, Janvey has standing to bring these TUFTA claims on behalf of SCB.

2 The mere fact that SCB used money from the Gallery to pay its antecedent expenses is not per se fraudulent. SCB would have upheld its end of the bargain with the Gallery if it delivered gold on March 4, regardless of which specific money

SCB used to complete the deal. After all, money is fungible. The fact that the Gallery may have preferred that SCB segregate its money does not indicate fraud. *See* *Quadrant Structured Prods. Co., Ltd. v. Vertin*, No. CV 6990-VCL, 2015 WL 6157759, at *20 (Del. Ch. Oct. 20, 2015), *aff'd*, No. 210,2016, 2016 WL 6438209 (Del. Oct. 31, 2016).

3 Janvey relies primarily on two cases to support its direct evidence of fraud theory: *Sentinel I* and *GE Capital Commercial, Inc. v. Worthington National Bank*, 754 F.3d 297 (5th Cir. 2014). Neither case supports Janvey's argument on this factual record, because a debtor does not act with fraudulent intent when it incurs a new debt so long as it has a reasonable expectation that it can pay that debt off. *See, e.g.*, *Vertin*, 2015 WL 6157759, at *19. That is, because the jury could have found that SCB reasonably believed that it could complete the Gallery deal without churning funds from new customers to pay old debts, the cases Janvey cites are inapposite. In both *Sentinel I* and *GE Capital* the debtor could not have reasonably believed that it could make payment on the debts it incurred. *See* *Sentinel I*, 728 F.3d at 667 (noting that the debtor must have known that the "natural consequence of its actions" was to deny its creditors repayment); *GE Capital*, 754 F.3d at 300 (noting that the alleged fraudster took the creditor's money for his own purposes, outside the scope of the debtor's business).

4 The challenged transfers occurred between January 23 and February 13, 2009. Janvey argues that those transfers occurred shortly before or after an incurrence of substantial debt because SCB increased its trade-creditor debt by over $2 million in early 2009 and SCB incurred an additional approximately $3 million debt on February 2, 2009 when it took payment from the Gallery (because at that point, SCB owed gold to the Gallery). Dillon Gage does not meaningfully contest this analysis.

5 At trial, Janvey did not rely on the first test of insolvency, called "balance-sheet insolvency." Here too, Janvey does not attempt to prove balance-sheet insolvency. In any event, because Janvey did not attempt to value all of SCB's assets, there is no way to conduct a complete analysis of balance-sheet insolvency. *See* *In re Lamar Haddox Contractor, Inc.*, 40 F.3d 118, 121–22 (5th Cir. 1994) (reversing a finding of insolvency because the district court heard no evidence regarding the value of the debtor's assets).

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856 F.3d 393
United States Court of Appeals, Fifth Circuit.

In the MATTER OF Carl J. SELENBERG, Debtor.
Carl J. Selenberg, Appellant,
v.
Dianne Bates, Appellee.

No. 16-30649
|
FILED May 8, 2017

Synopsis

Background: Former client brought adversary proceeding to except debt from discharge in Chapter 7 case of her ex-attorney. The United States Bankruptcy Court for the Eastern District of Louisiana, Jerry A. Brown, J., 2015 WL 5579697, entered judgment in former client's favor, and debtor-attorney appealed. The District Court, Jane Triche Milazzo, 2016 WL 3034165, affirmed. Debtorattorney appealed.

Holdings: The Court of Appeals, Edward C. Prado, Circuit Judge, held that:

[1] when debtor-attorney gave former client a $275,000promissory note in order to induce former client not to immediately file a legal malpractice action against him, he thereby obtained “extension of credit,” as that term was used in fraud-based dischargeability exception;

[2] by failing to advise client on desirability of securingindependent legal representation before effectively settling her malpractice claims, debtor-attorney made “false representation,” within meaning of dischargeability exception;

[3] bankruptcy court did not clearly err in findingthat debtor-attorney had acted with requisite fraudulent intent; and

[4] resulting debt was nondischargeable under fraud-baseddischargeability exception.

Affirmed.

West Headnotes (12)

[1] Bankruptcy
Conclusions of law; d e novo review
Bankruptcy
Clear error

When Court of Appeals reviews decision of district court in its bankruptcy appellate capacity, it applies same standards of review to bankruptcy court's findings of fact and conclusions of law as were applied by the district court and reviews conclusions of law de novo and findings of fact for clear error. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[2] Bankruptcy
Clear error

Under a “clear error” standard of review, the Court of Appeals will reverse only if, on entire evidence, it is left with definite and firm conviction that a mistake has been made. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[3] Bankruptcy
Degree of Proof Required

Standard of proof in nondischargeability proceedings is the ordinary preponderance-ofthe-evidence standard. 11 U.S.C.A. § 523(a).

Cases that cite this headnote

[4] Bankruptcy
Extension of credit

“Extension of credit,” within meaning of fraud-based dischargeability exception, is an indulgence by creditor in granting his debtor further time to pay an existing debt; dischargeability exception protects creditors who are deceived into forbearing collection efforts. 11 U.S.C.A. § 523(a)(2).

Cases that cite this headnote

[5] Bankruptcy

Extension of credit

When Chapter 7 debtor-attorney gave former client a $275,000 promissory note in order to induce former client not to immediately file a legal malpractice action against him prior to expiration of one-year statute of limitations on such claims, attorney thereby obtained "extension of credit," as that term was used in fraud-based dischargeability exception, in the form of longer period of time to make restitution for injury that client sustained when attorney failed to commence cause of action on client's behalf before limitations period expired. 11 U.S.C.A. § 523(a)(2).

Cases that cite this headnote

[6] Bankruptcy

Actual, constructive, or implied fraud

Creditor may prove "actual fraud," within meaning of dischargeability exception, by showing the following: (1) that debtor made representations; (2) that debtor knew at the time these representations were made that they were false; (3) that debtor made the representations with intention and purpose of deceiving creditor; (4) that creditor relied on such representations; and (5) that creditor sustained losses as proximate result of the representations. 11 U.S.C.A. § 523(a)(2)(A).

Cases that cite this headnote

[7] Bankruptcy

Actual, constructive, or implied fraud

While a false representation by debtor is not required to establish "actual fraud," within meaning of dischargeability exception, it can still be proven by showing that the debtor in fact made a false representation. 11 U.S.C.A. § 523(a)(2)(A).

Cases that cite this headnote

[8] Bankruptcy

False pretenses; c onduct, concealment, omission or silence; i mplied representations

Debtor's silence regarding a material fact can constitute a "false representation" actionable under fraud-based dischargeability exception; when debtor has duty to speak, both concealment and silence can constitute fraudulent misrepresentation, and overt act is not required. 11 U.S.C.A. § 523(a)(2)(A).

Cases that cite this headnote

[9] Bankruptcy

False pretenses; c onduct, concealment, omission or silence; i mplied representations

Bankruptcy court did not clearly err in finding that former client's legal malpractice claims against Chapter 7 debtor-attorney were effectively being settled, thereby triggering attorney's obligation under Louisiana Rules of Professional Conduct to advise client of desirability of obtaining independent legal counsel, when attorney, in order to induce client not to file malpractice action against him, had given her a $275,000 promissory note and represented that client would be better off with this note, which she had five years to collect, than with legal malpractice claim; accordingly, by failing to provide such advice on desirability of securing independent legal representation, attorney made "false representation," within meaning of dischargeability exception. 11 U.S.C.A. § 523(a)(2)(A); La. R. Prof. Conduct 1.8(h)(2).

Cases that cite this headnote

[10] Bankruptcy

Intent

Intent to deceive, of kind required by fraudbased dischargeability exception, may be inferred from debtor's reckless disregard for the truth or from falsity of debtor's statement combined with the sheer magnitude of the resultant misrepresentation. 11 U.S.C.A. § 523(a)(2)(A).

Cases that cite this headnote

[11] Bankruptcy

Intent or knowledge

Bankruptcy court did not clearly err in finding that Chapter 7 debtor-attorney, in persuading former client to refrain from filing legal

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malpractice action against him before oneyear statute of limitations on such claims expired in exchange for an unsecured $275,000 promissory note that attorney did not have ability to pay, and which he sought to discharge in bankruptcy immediately after client commenced suit to recover thereon, had acted with intent to deceive, of kind required by fraud-based dischargeability exception. 11 U.S.C.A. § 523(a)(2)(A).

Cases that cite this headnote

[12] Bankruptcy

Cause of loss

Losses that former client sustained when she allowed Chapter 7 debtor-attorney to convince her to accept unsecured $275,000 promissory note for not pursuing her legal malpractice claims against attorney before statute of limitations expired were proximately caused by attorney's false representation, in not advising client of desirability of obtaining independent legal counsel before she effectively settled her malpractice claims, such that resulting debt was nondischargeable under fraud-based dischargeability exception. 11 U.S.C.A. § 523(a)(2)(A).

Cases that cite this headnote

***396** Appeal from the United States District Court for the Eastern District of Louisiana

Attorneys and Law Firms

Thomas E. Schafer, III, Bankruptcy Counsel, Schafer & Schafer, Orleans, LA, for Appellant.

Jacques F. Bezou, Jr., Rachel Thyre Anderson, Bezou Law Firm, Covington, LA, for Appellee.

Before PRADO, HIGGINSON, and COSTA, Circuit Judges.

Opinion

EDWARD C. PRADO, Circuit Judge:

This appeal involves a bankruptcy dispute between Debtor and Appellant Carl J. Selenberg and Appellee Dianne P. Bates. The bankruptcy court held that a promissory note Selenberg gave to Bates was a nondischargeable debt under 11 U.S.C. § 523(a)(2)(A). The district court affirmed. On appeal, Selenberg argues that the bankruptcy court erred in concluding that the requirements for nondischargeability under § 523(a)(2)(A) were met. We AFFIRM.

I. BACKGROUND

In 2008, Bates was seriously injured in an accident. Bates retained an attorney, Robert Faucheux, to represent her in bringing a personal injury lawsuit, but Faucheux failed to file the suit before the prescriptive period had run. Bates then retained another attorney, Selenberg, to represent her in bringing a malpractice claim against Faucheux. But in another unfortunate series of events, Selenberg failed to properly file Bates's malpractice suit against Faucheux before the prescriptive period had run, and the case was ultimately dismissed.

In early December 2011, Selenberg informed Bates that her case had been dismissed, and he told her that he had no malpractice insurance and no money with which to compensate her. On December 15, 2011, Selenberg met with Bates to discuss her potential malpractice claim against him. He only agreed to this meeting after Bates assured him that she did not intend to hire another attorney. Selenberg offered to give Bates a promissory note in the amount of $275,000 plus attorneys' fees of up to 25% of the value of the note. He explained that one of his cases might pay out in the future and that he might be able to compensate Bates for her loss at that point. According to Selenberg, Bates would have five years to file suit to collect on the note, whereas she would only have one year to bring a malpractice claim against him. Selenberg also told Bates that if she filed an attorney disciplinary complaint against him, she would never recover anything from him. Bates accepted the offer, and shortly thereafter, Selenberg sent her the promissory note.

Selenberg never made any payments on the note. On June 19, 2012, Bates filed a disciplinary complaint against Selenberg with the Louisiana Office of Disciplinary Counsel. On November 19, 2013, almost

two years after she received the promissory note from Selenberg, Bates filed suit to collect on the note in Louisiana state court. At that point, the prescription period for her malpractice claim against Selenberg had run. On February 25, 2014, Selenberg filed for Chapter 7 bankruptcy, staying the state court case. Bates then filed this adversary proceeding seeking to have the promissory note declared nondischargeable under 11 U.S.C. § 523(a)(2)(A)–(B). Following a bench trial, the bankruptcy court held that the debt was nondischargeable under § 523(a)(2)(A). The district ***397** court affirmed, and Selenberg timely appealed.

II. STANDARD OF REVIEW

[1] [2] [3] "When a court of appeals reviews the decision of a district court, sitting as an appellate court, it applies the same standards of review to the bankruptcy court's findings of fact and conclusions of law as applied by the district court." *In re Jacobsen*, 609 F.3d 647, 652 (5th Cir. 2010) (quoting *Kennedy v. MindPrint* (*In re ProEducation Int'l, Inc.*), 587 F.3d 296, 299 (5th Cir. 2009)). "Accordingly, we review conclusions of law de novo and findings of fact for clear error." *In re Ritz*, 787 F.3d 312, 315 (5th Cir. 2015), *rev'd and remanded on other grounds sub nom. Husky Int'l Elecs., Inc. v. Ritz*, ––– U.S. ––––, 136 S.Ct. 1581, 194 L.Ed.2d 655 (2016). "Under a clear error standard, this court will reverse only if, on the entire evidence, we are left with the definite and firm conviction that a mistake has been made." *In re Am. Hous. Found.*, 785 F.3d 143, 152 (5th Cir. 2015) (quoting *Morrison v. W. Builders of Amarillo, Inc.* (*In re Morrison*), 555 F.3d 473, 480 (5th Cir. 2009)). In reviewing the bankruptcy court's findings of fact, we must also bear in mind that "the standard of proof for the dischargeability exceptions in 11 U.S.C. § 523(a) is the ordinary preponderance-of-the-evidence standard." *Grogan v. Garner*, 498 U.S. 279, 291, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991).

III. DISCUSSION

Section 523(a)(2)(A) provides that an individual debtor will not be discharged "from any debt ... for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by ... false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition." The bankruptcy court found that when Selenberg gave Bates the promissory note, the parties entered into an "agreement or settlement that bought [Selenberg] almost two years of time without being sued by Mrs. Bates." The court also held that Selenberg had a duty under Louisiana Rule of Professional Responsibility 1.8(h) to inform Bates of the desirability of seeking independent legal counsel before entering into this agreement. According to the bankruptcy court, by failing to disclose this information to Bates, Selenberg engaged in actual fraud within the meaning of § 523(a)(2)(A). Selenberg appears to make two basic contentions on appeal: (1) he did not receive an extension of credit from Bates; and (2) he did not use actual fraud to obtain any such extension of credit.

A. Extension of Credit

[4] Selenberg first argues that he did not receive an extension of credit from Bates. Courts have stated that "[a]n extension, within the meaning of § 523(a)(2), is 'an indulgence by a creditor giving his debtor further time to pay an existing debt.' " *In re Gerlach*, 897 F.2d 1048, 1050 (10th Cir. 1990) (quoting *Takeuchi Mfg. (U.S.), Ltd. v. Fields* (*In re Fields*), 44 B.R. 322, 329 (Bankr. S.D. Fla. 1984)); *accord In re Rollins*, No. 06-10549, 2007 WL 2319778, at *6 (Bankr. E.D. La. Aug. 10, 2007). In other words, the Bankruptcy Code "protects the creditor who is deceived into forbearing collection efforts." *In re Marx*, 138 B.R. 633, 636 (Bankr. M.D. Fla. 1992); *accord In re Gerlach*, 897 F.2d at 1050; *In re Rollins*, 2007 WL 2319778, at *6.

[5] In *Marx*, after a creditor demanded that a delinquent account be brought current, the debtor gave the creditor "a promissory note secured by a mortgage on commercial property" owned by the debtor. ***398** 138 B.R. at 635. In exchange for the note, the creditor "agreed not to take legal action to collect [the debtor's] account and agreed to extend additional credit." *Id.* The district court in that case concluded that the creditor had received an extension of credit within the meaning of § 523(a) when the debtor executed the promissory note. *Id.* at 636–37. Similarly, in *Gerlach*, an owner of a John Deere dealership arranged for various parties to enter sham purchase contracts for equipment. 897 F.2d at 1049. Though the contracts were ultimately rejected by John Deere, the dealership received temporary credit for the sales against the dealership's debts to John Deere. *Id.* The Tenth Circuit held that each contract resulted in an extension of credit under § 523(a) because the "fraudulent contract had its intended effect of giving the dealership more time in which to pay the amount of the ... credit." *Id.* at 1050.

Likewise, in the instant case, the promissory note that Selenberg executed had its intended effect of giving him more time to pay. Selenberg contends that he gave the promissory note to Bates as an "option"—Bates could file a malpractice suit against him within one year, or she could wait up to five years to collect on the promissory note. However, the bankruptcy court found that Selenberg gave Bates the promissory note in order to induce her to forego any attempts to pursue a malpractice claim against him. This was supported by Selenberg's testimony that he gave Bates the promissory note to "facilitate the chance of [his] obtaining some money to pay her by extending the time that she would have to file suit." Accordingly, we hold that Selenberg received an extension of credit from Bates when she agreed to accept the promissory note.

B. Actual Fraud

[6] [7] Selenberg also argues that the bankruptcy and district courts erred in concluding that the extension of credit was obtained by actual fraud. This Court has stated that actual fraud may be proven by showing:

> (1) the debtor made representations;
> (2) at the time they were made the debtor knew they were false; (3) the debtor made the representations with the intention and purpose to deceive the creditor; (4) that the creditor relied on such representations; and (5) that the creditor sustained losses as a proximate result of the representations.

In re Ritz, 787 F.3d at 319 (emphasis removed) (quoting *RecoverEdge L.P. v. Pentecost*, 44 F.3d 1284, 1293 (5th Cir. 1995)).[1] Selenberg contends that (1) he did not make any false representations, (2) he did not intend to deceive Bates, and (3) Bates did not sustain any losses as a proximate result of his representations.[2]

1. False Representation

[8] Selenberg argues that he did not make any false representations to Bates. For one, he notes that he accurately stated ***399** that he had no funds or assets to pay Bates. But the bankruptcy court based its decision on Selenberg's failure to disclose material information, not on overt statements he made. This Court and others "have overwhelmingly held that a debtor's silence regarding a material fact can constitute a false representation actionable under section 523(a)(2)(A)." *In re Van Horne*, 823 F.2d 1285, 1288 (8th Cir. 1987) (collecting cases), *abrogated on other grounds by Grogan*, 498 U.S. at 291, 111 S.Ct. 654; *accord In re Mercer*, 246 F.3d 391, 404 (5th Cir. 2001). "When one has a duty to speak, both concealment and silence can constitute fraudulent misrepresentation; an *overt act* is *not* required." *In re Mercer*, 246 F.3d at 404.

[9] The bankruptcy court found that Selenberg was Bates's attorney, and "as such, he was required to abide by the Louisiana Rules of Professional Conduct." Rule 1.8(h)(2) provides that a lawyer shall not "settle" an actual or potential malpractice claim "with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith." The bankruptcy court found that Selenberg "concocted [an] agreement or settlement that bought him almost two years of time without being sued by Mrs. Bates." Because there was "absolutely no evidence that [Selenberg] ever advised Mrs. Bates, either orally or in writing, to seek independent counsel" prior to entering this agreement, the court held that Selenberg failed to fulfill his duty to disclose under Rule 1.8(h) and thereby made "a false representation for purposes of § 523(a)(2)."

The bankruptcy court's approach is consistent with cases from other circuits. In one case, an attorney received construction services from a client and later gave the client a promissory note for the amount owed. *In re Young*, 91 F.3d 1367, 1370 (10th Cir. 1996). The Tenth Circuit held that the attorney made false representations under § 523(a)(2)(A) by failing to inform the client of "information that the New Mexico Rules of Professional Conduct required him to disclose," including "the potential conflicts of interest involved" in the transaction. *Id.* at 1373–75. In another case, an attorney borrowed money from his client without advising the client of "the adverse nature of their relationship" or the client's "right to seek independent legal advice." *In re Tallant*, 218 B.R. 58, 61, 65 (B.A.P. 9th Cir. 1998). Because this conduct violated California's rules of professional responsibility and the attorney's fiduciary responsibilities to his client, the bankruptcy appellate panel held that the attorney "misrepresented the legal

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protections afforded" to the client and thereby made a "false representation" under § 523(a)(2)(A). *Id.* at 65–66.

Selenberg argues that he did not violate Rule 1.8(h)(2) because he did not settle the malpractice claim with Bates. He contends that the promissory note simply gave Bates an additional means of recovering from him.[3] It is true that both Selenberg ***400** and Bates testified during trial that they never signed a formal settlement agreement. However, evidence in the record supports a finding that Selenberg and Bates effectively settled the malpractice claim. In the letter notifying Bates that her case was dismissed, Selenberg stated, "I am trying to come up with an idea so that I can pay you the value of the case." Bates later testified that during her meeting with Selenberg, they discussed "what went wrong, what happened," and "what was he going to do" to "compensate [her] for [her] lost wages, the pain and suffering, the medication, the hospital bills." Selenberg also advised Bates that it was in her best interest to accept the promissory note and that the promissory note would place her in a better position than a malpractice suit.

After considering these facts, we conclude that the bankruptcy court did not clearly err in finding that the parties effectively settled the malpractice claim. Moreover, the district court was correct in concluding that Selenberg had an ethical duty to advise Bates in writing of the desirability of seeking independent legal counsel before settling the malpractice claim. He did not do so. Thus, we hold that Selenberg violated Rule 1.8(h)(2) and thereby made a false representation under § 523(a)(2)(A).

2. Intent to Deceive

[10] Selenberg next contends that any false representations were not made with the intent and purpose to deceive Bates. "An intent to deceive may be inferred from 'reckless disregard for the truth or falsity of a statement combined with the sheer magnitude of the resultant misrepresentation.' " *In re Acosta*, 406 F.3d 367, 373 (5th Cir. 2005) (quoting *In re Norris*, 70 F.3d 27, 30 n.12 (5th Cir. 1995)), *abrogated on other grounds by Ritz*, 136 S.Ct. at 1581. After weighing the evidence, the bankruptcy court concluded that Selenberg's "main concern was to convince Mrs. Bates that taking the promissory note was her only option" and that his "primary intent was to buy some time and to keep himself out of trouble."

[11] Selenberg argues that he clearly did not have the requisite intent to deceive because he was truthful in telling Bates that he had no assets with which to pay her. We find this argument unpersuasive. Although Selenberg was truthful with Bates about his financial situation at the time, he did not advise her of the desirability of seeking independent counsel. On the contrary, he only agreed to meet with Bates after being assured that she had not hired another attorney. Furthermore, Selenberg suggested that Bates had few options for recovering from him and thereby convinced her not to sue him for malpractice. Yet as the district court noted, other options, such as a consent judgment, "may very well have been available" and likely "would have put her in a much better legal position than the unsecured note." Selenberg also led Bates to believe he might be able to pay her in the future, even though that possibility was remote. These actions all suggest that Selenberg intended to deceive her.

Selenberg also contends that he "could not have made the statements with the intent to deceive since the promissory note provided for Selenberg to pay a 25% attorney fee," "thereby insuring Bates that she would recover the full amount of $275,000.00" even after paying attorneys to assist in collecting on the note. But the fact that the promissory note provided for attorneys' fees was essentially meaningless given that Selenberg knew there was a significant likelihood he would never be able to pay Bates the full $275,000, not to mention the additional attorneys' fees. Accordingly, ***401** we hold that the bankruptcy court did not clearly err in finding that Selenberg acted with intent to deceive Bates.

3. Losses as a Proximate Result of Selenberg's Representation

[12] Finally, Selenberg argues the bankruptcy court erred in concluding that Bates sustained a loss or that any loss suffered was a proximate result of Selenberg's representation. Yet Selenberg does not point to any authority in support of his arguments. The bankruptcy court held that Bates "lost her chance to pursue [Selenberg] on a malpractice action" because Selenberg "persuaded her to take the note and ... convinced her that pursuing a malpractice action against him would be futile." Thus, the court concluded that Bates sustained a loss as a proximate result of Selenberg's false representation.

Selenberg first contends that the monetary value of the promissory note exceeded the value of Bates's malpractice claim against Selenberg because the promissory note included an additional amount for attorneys' fees. In this way, Selenberg seems to suggest that Bates received a benefit (rather than sustaining a loss) when she received the promissory note. But Bates did not receive any benefit at all because Selenberg never obtained the funds to pay her. Moreover, Selenberg subsequently sought to have the debt discharged in bankruptcy and to eliminate any rights bestowed by the promissory note. Next, Selenberg points out that Bates testified that she did not give up anything in accepting the promissory note. However, Bates's opinion on this matter is not dispositive. It seems clear from the record that Bates did not fully appreciate that she was forgoing the opportunity to recover from Selenberg by accepting the promissory note and declining to pursue a malpractice claim against him.

Footnotes

Selenberg also seems to argue that any loss Bates sustained actually occurred as a result of Selenberg's failure to properly litigate the malpractice case against Faucheux, not as a result of Selenberg's false representation. However, case law directly contradicts this assertion. In *Young*, the Tenth Circuit held that the client "sustained a loss, which satisfies the final element under § 523(a) (2)(A)," because the client "never received payment on [the attorney's] promissory note." 91 F.3d at 1375. Like the client in *Young*, Bates never received payment on the promissory note. Furthermore, Bates lost the opportunity to pursue her malpractice claim against Selenberg because she relied on Selenberg's advice that she would be more likely to recover if she bypassed a malpractice suit and sought to collect on the promissory note at a later date. Accordingly, the bankruptcy court correctly concluded that Bates sustained a loss as a proximate result of Selenberg's false representation.

IV. CONCLUSION

For the reasons discussed above, we hold that the bankruptcy court did not err in holding that Selenberg obtained an extension of credit from Bates by actual fraud. Therefore, we AFFIRM the bankruptcy court's conclusion that the debt was nondischargeable under § 523(a).

All Citations

856 F.3d 393, 64 Bankr.Ct.Dec. 22

1 On appeal in *Ritz*, the Supreme Court held that "actual fraud" encompasses "fraudulent conveyance schemes, even when those schemes do not involve a false representation." 136 S.Ct. at 1590. On remand, this Court stated that "[t]o the extent that ... prior Fifth Circuit cases required that a debtor make a representation in order for a debt to be nondischargeable under § 523(a)(2)(A), those cases are effectively overruled by the Supreme Court's decision in this case." *In re Ritz*, 832 F.3d 560, 565 n.3 (5th Cir. 2016). Although a false representation is no longer *required*, actual fraud can still be proven by showing that the debtor in fact made a false representation.

2 Selenberg does not appear to take issue with the bankruptcy court's conclusion that Bates relied on Selenberg's representation.

3 Selenberg does not cite any legal authority in support of his assertion that an attorney and client must actually settle a malpractice claim in order to trigger Rule 1.8(h)(2)'s disclosure obligations. On the contrary, Louisiana law suggests that *attempts* to settle a malpractice claim trigger an attorney's disclosure obligations. *See, e.g.*, *In re Lester*, 26 So.3d 735, 738, 744 (La. 2010); *In re Petal*, 972 So.2d 1138, 1139–42 (La. 2008); *In re Thompson*, 712 So.2d 72, 73–74 (La. 1998); *In re Elbert*, 698 So.2d 949, 949–50 (La. 1997). Nevertheless, because we hold that the district court did not clearly err in finding that the parties effectively settled the claim, we need not reach the issue of whether the parties' negotiations were themselves sufficient to trigger Rule 1.8(h)(2).

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2017 WL 1839156
United States Bankruptcy Court, D. New Mexico.

IN RE: FLYING STAR CAFES, INC., Debtor.
NM Enterprises, Inc. d/b/a NM Bakery Service Company, Plaintiff,
v.
Clyde Harrington and Donna Schmidt, Defendants.

Case No. 15–10182 t11
|
Adv. No. 16–1060–t
|
Signed May 5, 2017

Synopsis
Background: Creditor in Chapter 11 case, after objecting to claimants' amended proofs of claim, brought adversary proceeding seeking subordination of the claims. Claimants filed motion to dismiss proceeding for lack of standing.

Holdings: The Bankruptcy Court, David T. Thuma, J., held that:

[1] individual creditors lack standing to bring claims against other creditors under the mandatory subordination provision of the Bankruptcy Code, and

[2] under the confirmed Chapter 11 plan, only thereorganized debtor had the right to pursue such actions.

Motion granted.

West Headnotes (23)

[1] Bankruptcy
Parties
In the Tenth Circuit, a standing challenge is generally considered an attack on the court's subject matter jurisdiction. Fed. R. Civ. P. 12(b)(1); Fed. R. Bankr. P. 7012(b).

Cases that cite this headnote

[2] Federal Courts
Nature of dispute; c oncreteness
Article III restricts federal court adjudication to actual cases or controversies. U.S. Const. art. 3, § 2, cl. 1.

Cases that cite this headnote

[3] Bankruptcy
Parties
To satisfy Article III's standing requirements, a plaintiff must show an injury in fact, causation, and redressability. U.S. Const. art. 3, § 2, cl. 1.

Cases that cite this headnote

[4] Bankruptcy
Parties
Prudential standing embodies judicially selfimposed limits on the exercise of federal jurisdiction.

Cases that cite this headnote

[5] Bankruptcy
Parties
Prudential standing doctrine encompasses various limitations, including the general prohibition on a litigant's raising another person's legal rights.

Cases that cite this headnote

[6] Bankruptcy
Parties
Pursuant to the prudential standing doctrine, a plaintiff generally must assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties.

Cases that cite this headnote

[7] Bankruptcy
Parties

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Prudential standing is an issue of subject matter jurisdiction.

Cases that cite this headnote

[8] **Bankruptcy**
Parties

When the right to bring a cause of action is conferred by statute, prudential standing concepts, which are judge-made, take a back seat.

Cases that cite this headnote

[9] **Bankruptcy**
Parties

Standing analysis after the Supreme Court's decision in *Lexmark*, 134 S.Ct. 1377, asks: (1) whether there is Article III standing, (2) whether there is a statute that confers or denies standing, and (3) if there is Article III standing and no statute gives guidance one way or another, whether prudential standing concepts should be employed to dismiss the cause of action. U.S. Const. art. 3, § 2, cl. 1.

Cases that cite this headnote

[10] **Bankruptcy**
Parties

Under Article III, statutory, or prudential standing, the requirement that a plaintiff have proper standing is not measured only at the commencement of the case, but is continuous. U.S. Const. art. 3, § 2, cl. 1.

Cases that cite this headnote

[11] **Bankruptcy**
In general; s tanding
Bankruptcy
Determination of priority

Individual creditors lack standing to bring claims against other creditors under the mandatory subordination provision of the Bankruptcy Code; such claims are "general" claims that are owned by the estate, not "personal" claims owned by individual creditors. 11 U.S.C.A. § 510(b). Cases that cite this headnote

[12] **Bankruptcy**
Determination of priority

If a creditor suffered no "particularized injury," that is, harm that differs from injury suffered by creditors generally, it has no standing to seek equitable subordination on behalf of creditors generally. 11 U.S.C.A. § 510(c).

Cases that cite this headnote

[13] **Bankruptcy**
In general; s tanding
Bankruptcy
Determination of priority

Creditors cannot assert "general" equitable subordination claims because such claims belong to the estate. 11 U.S.C.A. § 510(c).

Cases that cite this headnote

[14] **Bankruptcy**
In general; s tanding

In bankruptcy, the right to pursue claims that benefit creditors generally is reserved for the estate representative.

Cases that cite this headnote

[15] **Bankruptcy**
In general; s tanding

Rule that, in bankruptcy, the right to pursue claims that benefit creditors generally is reserved for the estate representative, is intended to promote the orderly and equitable administration of a debtor's estate by preventing individual creditors from pursuing separate actions to the detriment of other creditors and of the estate as a whole.

Cases that cite this headnote

[16] **Bankruptcy**
In general; s tanding

Although the Bankruptcy Code gives any party in interest the right to raise and be heard on any issue in a Chapter 11 case, the right does not extend to asserting estate claims. 11 U.S.C.A. § 1109.

Cases that cite this headnote

[17] **Bankruptcy**
Construction, execution, and performance

Confirmed Chapter 11 plan generally is interpreted according to the rules governing the interpretation of contracts.

Cases that cite this headnote

[18] **Contracts**
Existence of ambiguity

Under New Mexico law, a contract is "ambiguous" when it is reasonably susceptible to multiple interpretations.

Cases that cite this headnote

[19] **Bankruptcy**
Subordination

"Subordination" concerns the distribution priority of allowed claims. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[20] **Evidence**
Grounds for admission of extrinsic evidence

Under New Mexico law, parties may present parol evidence to aid the court in interpreting an ambiguous contract.

Cases that cite this headnote

[21] **Bankruptcy**
Construction, execution, and performance

Ambiguous Chapter 11 plans should be interpreted to comply with the Bankruptcy Code.

Cases that cite this headnote

[22] **Bankruptcy**
Determination of priority
Bankruptcy
Construction, execution, and performance

Under debtor's confirmed Chapter 11 plan, only reorganized debtor had the right to pursue actions against creditors under the mandatory subordination provision of the Bankruptcy Code; although plan was ambiguous in defining a "Disputed Claim" as one to which an objection had been filed and in then giving Reorganized Debtor the exclusive right to object to claims or to litigate, settle, or withdraw objections to Disputed Claims, a broad interpretation of "objection" as including not just objections to the allowability of a claim, but any dispute over a claim, including mandatory subordination, was more consistent with the Code because subordination claims are "general" claims that are owned, and should be pursued, by the estate, a broad interpretation was consistent with generally prevailing meaning, a broad interpretation harmonized various plan provisions and disclosure statement, and a broad interpretation served fairness and judicial economy by reducing multiplicity of litigation. 11 U.S.C.A. § 510(b).

Cases that cite this headnote

[23] **Contracts**
Language of Instrument

Under New Mexico law, ambiguous contract terms should be construed in a manner consistent with their generally prevailing meaning.

Cases that cite this headnote

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OPINION

Hon. David T. Thuma, United States Bankruptcy Judge

***1** Before the Court is Defendants' joint motion to dismiss this § 510(b)[1] subordination proceeding for lack of standing. The Court concludes that the Plaintiff did not have standing to bring the action in the first instance, and further concludes that the plan confirmed in this case gave the reorganized debtor the sole right to pursue such actions.

I. FACTS

For the purpose of ruling on the motion to dismiss, the Court finds the following:[2]

Debtor filed this chapter 11 case on January 30, 2015. Each Defendant filed a proof of claim on March 30, 2015. Schmidt's claim was for $2,169,849.96 to $2,669,849.96; Harrington's was for $3,633,085.34 to $4,633,085.34.

Debtor objected to both claims on February 10, 2016. Two days later, it filed an adversary proceeding seeking to subordinate Defendants" claims under § 510(b).[3] After substantial litigation, on July 19, 2016 Debtor filed a motion to settle all disputes with Defendants. The proposed settlement involved payments by third parties to Defendants and required Defendants to file amended proofs of claims as follows:

Harrington: $381,909

Schmidt: 229,614.

In return, Debtor agreed to dismiss the adversary proceeding and withdraw its claim objections.

The Court approved the settlement on August 23, 2016. At the request of the parties, the order made clear that third parties were not precluded from objecting to Defendants' amended proofs of claim. Similarly, the adversary proceeding dismissal order was "without prejudice to any other party in interest." Defendants filed amended proofs of claim, as agreed, on August 25, 2016.

About five weeks later Plaintiff objected to Defendants' amended proofs of claim. Soon thereafter Plaintiff commenced this § 510(b) proceeding against Defendants.

Debtor's owners filed a plan of reorganization on November 14, 2016 (the "Plan"), which provides in part:

DEFINITIONS

> **"Disputed Claim"** means a Claim (or portion of a Claim) as to which an objection has been filed and served within the time period set forth herein for doing so, and which objection has not been determined by a Final Order.
>
> ...

PROCEDURE FOR RESOLVING DISPUTED CLAIMS

> 6.1 Power to Object to, Litigate, and Settle Disputed Claims. After the Effective Date, the Reorganized Debtor will have the exclusive authority to (i) file objections to Claims ... and (iii) litigate to final judgment, settle, or withdraw objections to Disputed Claims.

***2** The Plan also has provisions preserving claims and causes of action for the benefit of the reorganized debtor, and requiring Debtor to promptly resolve disputed claims.

The disclosure statement included Defendants' claims in its disclosure of allowed general unsecured claims.

Defendant Schmidt voted in favor of the Plan as a general unsecured creditor. Her vote was counted when determining that the general unsecured class voted for the Plan. The Court confirmed the Plan on December 20, 2016, with an effective date of January 17, 2017.

Defendants filed the motion to dismiss for lack of standing on January 31, 2017. About six weeks later Plaintiff offered to settle the proceeding by, inter alia, taking an assignment of $200,000 of Defendants' claims, and by requiring a token reduction in the claim amount (the "Settlement Offer").

On April 7, 2017, Plaintiff withdrew its claim objections, leaving only the § 510(b) subordination claim.

II. DISCUSSION

A. Standing.

[1] 1. Rule 12(b)(1) or 12(b)(6)? Defendants challenge Plaintiff's standing, but do not say whether they rely on Rule 12(b)(1) or (b)(6). *See, e.g. Nordisk Sys., Inc. v. Sirius Computer Sols., Inc.*, 156 F.Supp.3d 1212, 1215 (D. Or. 2015) (standing challenges may be brought under either Rule 12(b)(1) or (b)(6)). In the Tenth Circuit, a standing challenge is generally considered an attack on the court's subject matter jurisdiction and treated under Rule 12(b)(1). *See Hill v. Vanderbilt Capital Advisors, LLC*, 702 F.3d 1220, 1224–25 (10th Cir. 2012) ("Our court has repeatedly characterized standing as an element of subject matter jurisdiction"); *Connolly v. City of Houston, Texas (In re Western Integrated Networks, LLC)*, 329 B.R. 334, 337 (Bankr. D. Colo. 2005) ("Standing is a fundamental component of the court's subject matter jurisdiction and is appropriately raised in a motion to dismiss under 12(b) (1)").

The Court will proceed under Rule 12(b)(1), so it will not presume the truthfulness of the complaint's factual allegations, and will consider affidavits and other documents to resolve disputed jurisdictional facts. *See Holt v. U.S.*, 46 F.3d 1000, 1003 (10th Cir. 1995).

[2] **[3]** 2. Article III standing. Article III restricts federal court adjudication to actual cases or controversies. *State of Utah v. Babbitt*, 137 F.3d 1193, 1201 (10th Cir. 1998). To satisfy Article III's standing requirements, a plaintiff must show an injury in fact, causation, and redressability. *Friends of the Earth, Inc. v. Laidlaw Envtl. Servs. (TOC), Inc.*, 528 U.S. 167, 180–81, 120 S.Ct. 693, 145 L.Ed.2d 610 (2000), citing *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560–61, 112 S.Ct. 2130, 119 L.Ed.2d 351 (1992).

[4] **[5]** **[6]** **[7]** 3. Prudential Standing. Prudential standing "embodies judicially self-imposed limits on the exercise of federal jurisdiction." *The Wilderness Soc. v. Kane County, Utah*, 632 F.3d 1162, 1168 (10th Cir. 2011). The prudential standing doctrine encompasses various limitations, including "the general prohibition on a litigant's raising another person's legal rights." *Id.,* quoting *Allen v. Wright,* 468 U.S. 737, 751, 104 S.Ct. 3315, 82 L.Ed.2d 556 (1984). "[T]he plaintiff generally must assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties." *Id.,* quoting *Warth v. Seldin,* 422 U.S. 490, 499, 95 S.Ct. 2197, 45 L.Ed.2d 343 (1975). Prudential standing is an issue of subject matter jurisdiction. *Wilderness Soc.,* 632 F.3d at 1168; *Deutsche Bank Nat. Trust Co. v. F.D.I.C.*, 717 F.3d 189, 194 n.4 (D.C. Cir. 2013) (prudential standing is threshold jurisdictional concept).

***3** **[8]** 4. Statutory Standing. Sometimes the right to bring a cause of action is conferred by statute. In those cases, prudential standing concepts, which are judgemade, take a back seat. *See, e.g., Lexmark Intern. Inc. v. Static Control Components, Inc.*, ––– U.S. ––––, 134 S.Ct. 1377, 1387–88, 188 L.Ed.2d 392 (2014)[4] ("we do not ask whether in our judgment Congress *should* have authorized [plaintiff's] suit, but whether Congress in fact did so.") (emphasis in original).

[9] To summarize, the standing analysis after *Lexmark* is:

(1) Is there Article III standing?

(2) Is there a statute that confers or denies standing? and

(3) If there is Article III standing and no statute givesguidance one way or another, should prudential standing concepts be employed to dismiss the cause of action?

[10] 5. The standing requirement is continuous. Plaintiff argues that standing is measured only at the commencement of the case. Not so. Under Article III, statutory, or prudential standing, the requirement that a plaintiff have proper standing is continuous. *See Friends of the Earth,* 528 U.S. at 189–90, 120 S.Ct. 693 (requisite personal interest must exist when the case begins (standing) must continue throughout (mootness)).

B. Plaintiff Never Had Standing to Bring § 510(b) Claims.

[11] Many reported decisions discuss § 510(b) actions, but they were all brought by a trustee, debtor in possession,

or other estate representative. There does not appear to be a case involving a single creditor[5] pursuing a § 510(b) claim against another creditor. The dearth of case law implies that individual creditors lack standing to bring § 510(b) claims.

[12] In contrast, the case law on whether a creditor may bring an equitable subordination claim under § 510(c)[6] is well developed, and provides a useful analogy. The majority rule is that creditors may only bring § 510(c) actions if their goal is to subordinate another creditor's claim to their own. *See Variable–Parameter Fixture Dev't Corp. v. Comerica Bank–California (In re Morpheus Lights, Inc.)*, 228 B.R. 449, 453 (Bankr. N.D. Cal. 1998); *In re Elrod Holdings Corp.*, 392 B.R. 110, 115 (Bankr. D. Del. 2008) (a secured creditor has standing to seek the equitable subordination of another secured creditor's claim to the extent that it seeks relief for a particularized injury, not an injury incurred by all creditors).[7] A particularized injury means harm that differs from injury suffered by creditors generally. *Black Palm Dev. Corp. v. Barlage*, 2011 WL 4858420, at *4 (W.D.N.C.) (quoting *Elrod Holdings,* 392 B.R. at 115). If the creditor suffered no particularized injury, on the other hand, it has no standing to seek equitable subordination on behalf of creditors generally.

***4 [13]** In other words, creditors cannot assert general equitable subordination claims because they belong to the estate. *See In re Morpheus Lights,* 228 B.R. at 453 (general equitable subordination claims are estate property; particularized claims are not). *See also Kalb, Voorhis & Co. v. American Financial Corp.,* 8 F.3d 130 (2d Cir. 1993) (claims that are property of the estate can only be asserted by the trustee or debtor-in-possession); *St. Paul Fire and Marine Ins. Co., Inc. v. PepsiCo., Inc.*, 884 F.2d 688, 700–01 (2d Cir. 1989) (same); *In re Bridge Information Systems, Inc.,* 344 B.R. 587, 594 (E.D. Mo. 2006) (discussing the distinction between "personal" and "general" claims).

[14] [15] The right to pursue claims that benefit creditors generally is reserved for the estate representative. *In re Medomak Canning*, 922 F.2d 895, 902 (1st Cir. 1990) (the trustee is ordinarily the appropriate party to seek equitable subordination on behalf of the estate and unsecured creditors); *Morpheus Lights,* 228 B.R. 449, 454 (Bankr. N. D. Cal. 1998) (trustee, debtor in possession, or creditor committee may bring general equitable subordination action). "This rule is intended to promote the orderly and equitable administration of a bankrupt's estate by preventing individual creditors from pursuing separate actions to the detriment of other creditors and of the estate as a whole." *Solow v. Stone*, 994 F.Supp. 173, 178 (S.D.N.Y. 1998), *aff'd*, 163 F.3d 151 (2d Cir. 1998).[8]

[16] Moreover, in § 510(b) there is no language allowing "any party in interest" to bring the claim. This is in contrast to, for example, § 502(a).[9] Although § 1109 gives any party in interest the right to raise and be heard on any issue in a chapter 11 case, the right does not extend to asserting estate claims. *See, e.g., Hartford Underwriters Co. v. Union Planters Bank, N.A.,* 530 U.S. 1, 7–8, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000) (had Congress meant § 506(c) claims to be widely available, it would have used the phrase "party in interest" such as used in § 502(a)); 7

Collier on Bankruptcy (16th ed.), ¶ 1109.05 ("section 1109 does not vest a party in interest with the right to usurp the trustee's role as representative of the estate with respect to the initiation of certain types of litigation that belong to the estate and that the Code has assigned to the trustee to pursue").

The Court concludes that individual creditors generally may not bring § 510(b) actions against other creditors. Construing §§ 323, 510, 541, 1107, and 1109, the Court concludes that § 510(b) actions are "general" claims that are owned by the estate, not "personal" claims owned by individual creditors. Section 510(b) claims therefore must be asserted by the estate representative. Plaintiff lacked standing to bring this proceeding.[10]

C. Under the Plan, The Reorganized Debtor Was Given Exclusive Authority To Pursue § 510(b) Claims.

***5** Defendants argue the Plan unambiguously grants the Reorganized Debtor the exclusive authority to pursue the § 510(b) subordination claims post-confirmation. The Court concludes that the Plan language is in fact ambiguous. Nevertheless, the Court agrees that the Plan should be construed as Defendant urges.

[17] 1. General construction rules. A confirmed plan generally is interpreted according to the rules governing the interpretation of contracts. *See Miller v. United States,* 363 F.3d 999, 1004 (9th Cir. 2004) (confirmed plan is akin to a contract and "must be interpreted according to the rules governing the interpretation of contracts."); *Connolly v.*

City of Houston (In re Western Integrated Networks, LLC), 322 B.R. 156, 160–61 (Bankr. D. Colo. 2005) (chapter 11 plan is a contract that must be interpreted according to the general rules of contract interpretation); *In re K.D. Co., Inc.*, 254 B.R. 480, 490 (10th Cir. BAP 2000) (confirmed plan has some indicia of a contract).

[18] A contract is ambiguous when it is reasonably susceptible to multiple interpretations. *Mark V, Inc. v. Mellekas,* 114 N.M. 778, 845 P.2d 1232, 1235–36 (1993).

[19] 2. The Plan's use of "object to" and "objection" is ambiguous. The Plan defines a "Disputed Claim" as one to which an objection has been filed, and then gives the Reorganized Debtor the exclusive right to object to claims or litigate, settle, or withdraw objections to Disputed Claims. "Objections" could reasonably be interpreted to mean § 502 claim objections only, but also could be read more broadly to include any dispute over a claim, including § 510(b) subordination.[11] The Court concludes the Plan is ambiguous on its face.

[20] Parties may present parol evidence to aid the Court in interpreting the contract. *Mark V, Inc.*, 845 P.2d at 1235–36. The only such evidence submitted was the Settlement Offer. The Court will resolve the ambiguity by considering the Settlement Offer and "by interpreting the contract using accepted cannons of contract construction and traditional rules of grammar and punctuation." *Id.* at 1235–36.

[21] **[22]** 3. The Plan should be interpreted as consistent with the Code. Ambiguous plans should be interpreted to comply with the Bankruptcy Code. *See In re Forklift LP Corp.*, 363 B.R. 388, 394, 398 (Bankr. D. Del. 2007) (unless a plan clearly takes them away, creditors are entitled to rely on rights granted by the Bankruptcy Code); *In re Jankins*, 184 B.R. 488, 492 (Bankr. E.D. Va. 1995) (as a matter of policy, ambiguous provision should be construed to comport with Bankruptcy Code); *In re Monclova Care Ctr., Inc.,* 254 B.R. 167, 173 (Bankr. N.D. Ohio 2000) (when "multiple interpretations of a plan are possible, courts should favor an interpretation that is consistent with the Bankruptcy Code over one that contravenes it."). A broad interpretation of "objection" is more consistent with the Bankruptcy Code because subordination actions are "general" claims that are owned, and should be pursued, by the estate.

***6** **[23]** 4. A broad interpretation is consistent with generally prevailing meaning. Ambiguous terms should be construed in a manner consistent with their generally prevailing meaning. *See* Restatement (Second) of Contracts § 202(3) (court should interpret language with its "generally prevailing meaning"). The general meaning of object is "an adverse reason raised to oppose a matter or proceeding." *In re Outdoor Sports Headquarters, Inc.*, 168 B.R. 177, 183 (Bankr. S.D. Ohio 1994) (citing *Black's Law Dictionary*). Construing the Plan's use of "object" in that general sense would include subordination claims as well as § 502 claim objections, because both are in opposition to the claim, and both typically result in actual or *de facto* disallowance.

5. The Plan should be interpreted as a whole. "A writing is interpreted as a whole, and all writings that are part of the same transaction are interpreted together." Restatement (Second) of Contracts § 202(2). A number of provisions in the Plan and accompanying Disclosure Statement are harmonized if the term "objection" is interpreted broadly. First, the Plan makes clear that Debtor committed to resolving disputed claims quickly (5.10; 6.4). The Plan preserved all estate claims, of any kind or nature, known or unknown (5.14). The Plan states that the Reorganized Debtor has the right to pursue all estate claims (5.14(b)), and the right to pursue until resolved all disputed claims. Defendants' claims were shown as allowed, general unsecured claims in the Disclosure Statement. Schmidt's vote in favor of the Plan was counted when determined whether general unsecured creditors voted in favor of the Plan. Construing the term "objection" narrowly would be inconsistent with the foregoing Plan provisions and facts; construing the term broadly would harmonize them.

6. Multiplicity of Litigation. If the Plan were construed to allow any creditor to bring § 510(b) subordination actions against any other creditor, targets (like Defendants) could be exposed to multiple actions, possibly in seriatim. Fairness and judicial economy are much better served by a Plan interpretation that gives one party, the estate representative, the sole right to bring § 510(b) claims.

7. Case Law. One case has addressed similar issues and come to the same conclusion. In *In re Worldwide Direct, Inc.*, 280 B.R. 819, 822–23 (Bankr. D. Del. 2002), the court concluded that the following disclosure statement language: "the Debtors and the Committee currently are investigating all of such Claims and, at this time, dispute and object to them in their entirety," was sufficient to reserve § 510(b) claims against a creditor. Is so ruling, the court held that §

510(b) subordination is "an objection based on the proper priority of payment of a claim"). In *In re Outdoor Sports Headquarters, Inc.*, 168 B.R. 177, 183 (Bankr. S.D. Ohio 1994), the court construed "objection" as used in the plan in its general sense and concluded that the term encompassed subordination actions. *See also In re Melon Produce, Inc.*, 162 B.R. 386, 388 (Bankr. D. Mass. 1993) (agreement not to object subsumes that he would not seek to equitably subordinate).[12]

***7** 8. The Settlement Offer. Plaintiff's Settlement Offer shows why a broad reading of "objection" is indicated. Plaintiff may have commenced this proceeding in good faith, and may have proposed to settle it in good faith, but the Settlement Offer clearly shows that Plaintiff was acting in its own interests, not those of creditors generally. Even though a § 510(b) action is a "general" claim that is supposed to benefit all creditors pro rata, Plaintiff sought to use the action exclusively for its own benefit. The inherent conflict of interest illustrates why an estate representative should be the only party with standing to pursue § 510(b) actions.

III. CONCLUSION

Plaintiff did not have standing to bring this § 510(b) subordination proceeding. Confirmation of the Plan made doubly clear that only an estate representative could pursue such claims. Defendants' motion to dismiss therefore will be granted. The Court will enter a separate order.

All Citations

--- B.R. ----, 2017 WL 1839156, 64 Bankr.Ct.Dec. 29

Footnotes

1 Unless otherwise noted, all statutory references refer to 11 U.S.C.

2 The findings are based in part on taking judicial notice of the dockets in the main case and this proceeding.

3 § 510(b) provides: "For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock."

4 Previously, the Tenth Circuit considered statutory standing within prudential standing. *See, e.g., Wilderness Soc.,* 632 F.3d at 1169, citing *Warth*, 422 U.S. at 500, 95 S.Ct. 2197.

5 In *In re SeaQuest*, 579 F.3d 411 (5th Cir. 2009), debtor and two creditors filed a § 510(b) action against another creditor.

6 "(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or (2) order any lien securing such a subordinated claim be transferred to the estate."

7 *See also In re Mayo,* 112 B.R. 607, 651 (Bankr. D. Vt. 1990) (creditor had standing to assert equitable subordination when it sought only to subordinate two other creditors to its own claim); *In re Vitreous Steel Prod. Co.*, 911 F.2d 1223, 1231 (7th Cir. 1990) (creditor had standing to seek equitable subordination because it had interest separate and apart from creditor body as a whole); *In re M. Paolella & Sons, Inc.*, 85 B.R. 965, 973 (Bankr. E.D. Pa. 1988) (creditor had standing where it only sought to subordinate one creditor's claim to its own); *In re Dayton Title Agency, Inc.*, 527 B.R. 289, 298 (Bankr. S.D. Ohio 2015) ("The courts have permitted a single creditor to obtain subordination of a specific claim to its own claim when the requirements of equitable subordination have been met.").

8 Courts have allowed creditors to bring "general" equitable subordination claims if the estate representative has refused to pursue the litigation after demand, the refusal is unjustified, and the claim would benefit the estate. 7 Collier on Bankruptcy, ¶ 1109.05[2][a] (Alan N. Resnick & Henry J. Somme reds., 16th ed.), *citing Scott v. National Century Financial Enterprises, Inc.* (*In re Baltimore Emergency Services II, Corp.*), 432 F.3d 557, 560 (4th Cir. 2005). *See also Black Palm Development Corp. v. Barlage*, 2011 WL 4858420 (W.D.N.C. 2011) (in chapter 7, unsecured creditor may

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assert subordination claim where trustee has refused to do so and court grants an unsecured creditor leave). Here, Debtor brought a subordination action and settled it. The unsecured creditors committee reviewed whether to bring its own claim and decided not to.

Plaintiff did not ask for permission to pursue the claim on behalf of the estate.

9 "A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed unless a party in interest ... objects."

10 Specifically, Plaintiff has Article III standing, but is denied standing by the relevant statute, i.e. the Code. Alternatively, Plaintiff lacks prudential standing.

11 Subordination concerns the distribution priority of allowed claims, while § 502 deals with the allowability of a claim. *See* *In re USA Commercial Mortg. Co.*, 377 B.R. 608, 617 (9th Cir. BAP 2007) (a § 502 objection seeks a ruling that the claim is not allowable by law, while a subordination action presupposes that the claim is allowed); *In re GEX Kentucky, Inc.*, 100 B.R. 887, 891 (Bankr. N.D. Ohio 1988) (subordination deals with distribution and classification, not allowance).

Subordination claims must be brought by adversary proceeding, while claim objections are contested matters. *See* FRBP 7001(8) (a proceeding to subordinate a claim must be brought in an adversary proceeding).

12 Other cases have construed "objection" more narrowly albeit in different circumstances. For example, in *In re Gordon SelWay*, 1996 WL 571652 (E.D. Mich. 1996), the district court held that a plan provision giving the debtor a deadline to object to claims did not bar an equitable subordination action filed after the deadline. 1996 WL 571652, at *2. In *In re County of Orange*, 219 B.R. 543, 559–60 (Bankr. C.D. Cal. 1997), the court held that claim reservation language reserving all "defenses, counterclaims and/or rights of setoff or recoupment" did not reserve § 510(b) subordination claims.

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Only the Westlaw citation is currently available.
United States Bankruptcy Appellate Panel of the
Ninth Circuit.

IN RE: Robert C. KELLER and Finley
Jones Keller, Debtors.
Robert C. Keller; Finley Jones Keller, Appellants,
v.
New Penn Financial, LLC dba Shellpoint
Mortgage Servicing; the Bank of New York Mellon fka
the Bank of New York as Trustee for the
Certificateholders of CWMBS, Inc., CHL Mortgage
Pass–Through Trust 2004–HYB5, Mortgage Pass–
Through Certificates Series 2004–HYB5, Appellees.

BAP No. EC–16–1152–BJuTa
|
Bk. No. 12–22391
|
Argued and Submitted on March
23, 2017, at Sacramento, California
|
Filed May 26, 2017

Synopsis
Background: Chapter 13 debtors filed motion for contempt and sanctions for creditor's alleged violation of the automatic stay and confirmation order. The United States Bankruptcy Court for the Eastern District of California, Christopher D. Jaime, J., 2016 WL 3004488, denied the motion. Debtors appealed.

Holdings: The Bankruptcy Appellate Panel, Brand, J., held that:

[1] in matter of first impression, creditor's postpetitioncredit reporting of overdue or delinquent payments did not constitute a per se violation of the automatic stay, and

[2] creditor's postpetition credit reporting did not violatedebtors' confirmation order.

Affirmed.

West Headnotes (11)

[1] Bankruptcy

Conclusions of law; d e novo review

Bankruptcy

Clear error

Bankruptcy Appellate Panel (BAP) reviews the bankruptcy court's conclusions of law de novo and its findings of fact for clear error.

Cases that cite this headnote

[2] Bankruptcy

Conclusions of law; d e novo review

De novo review of bankruptcy court's decision requires that the Bankruptcy Appellate Panel (BAP) consider a matter anew, as if no decision had been made previously.

Cases that cite this headnote

[3] Bankruptcy

Clear error

Bankruptcy court's factual findings are clearly erroneous if they are illogical, implausible or without support in the record.

Cases that cite this headnote

[4] Bankruptcy

Conclusions of law; d e novo review

Bankruptcy Appellate Panel (BAP) reviews de novo the bankruptcy court's determination as to whether the Bankruptcy Code's automatic stay provisions have been violated. 11 U.S.C.A. § 362.

Cases that cite this headnote

[5] Bankruptcy

Discretion

Bankruptcy Appellate Panel (BAP) reviews the bankruptcy court's decision regarding civil contempt for abuse of discretion.

Cases that cite this headnote

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[6] Bankruptcy

Particular cases and issues

Underlying factual findings made in connection with a bankruptcy court's civil contempt order are reviewed for clear error.

Cases that cite this headnote

[7] Bankruptcy

Proceedings, Acts, or Persons Affected

Creditor's postpetition credit reporting of overdue or delinquent payments, without more, does not constitute a per se violation of the automatic stay. 11 U.S.C.A. § 362(a)(6).

Cases that cite this headnote

[8] Bankruptcy

Right of review and persons entitled; p arties; w aiver or estoppel

On Chapter 13 debtors' appeal from bankruptcy court's decision to deny their motion to hold creditor in contempt for alleged violation of automatic stay, debtors waived their argument that creditor's postpetition reporting of overdue payments to credit reporting agency was inaccurate, although debtors appeared to raise accuracy of the credit reporting as an issue in their contempt motion, where debtors affirmatively abandoned the accuracy issue at oral argument, during which debtors' counsel stated that accuracy of the credit information reported was irrelevant to whether or not negative credit reporting violated the automatic stay. 11 U.S.C.A. § 362(a)(6).

Cases that cite this headnote

[9] Bankruptcy

Effect

Creditor's postpetition credit reporting, stating debtors' account was "past due" or "late," did not violate Chapter 13 debtors' confirmation order, which required postpetition payments made by bankruptcy trustee and received by creditor to be "applied" as if the claim were current and no arrearage existed; the confirmed plan was silent on the issue of credit reporting, and term "applied" in the plan did not necessarily include reporting. 11 U.S.C.A. § 1327(a).

Cases that cite this headnote

[10] Bankruptcy

Carrying out provisions of Code

Bankruptcy

Effect

Violation of Chapter 13 confirmation order is an act of contempt and may be remedied under Bankruptcy Code provision authorizing court to enter "necessary or appropriate" orders. 11 U.S.C.A. §§ 105, 1327(a).

Cases that cite this headnote

[11] Bankruptcy

Contempt

For contempt, the moving party must show by clear and convincing evidence the contemnors violated a specific and definite order of the court.

Cases that cite this headnote

Appeal from the United States Bankruptcy Court for the Eastern District of California, Hon. Christopher D. Jaime, Bankruptcy Judge, Presiding

Attorneys and Law Firms

Scott J. Sagaria of Sagaria Law, P.C. argued for appellants Robert C. Keller and Finley Jones Keller;

B. Ben Mohandesi of Yu Mohandesi LLP argued for appellees New Penn Financial, LLC dba Shellpoint Mortgage Servicing and Bank of New York Mellon fka The Bank of New York as Trustee for the Certificateholders of CWMBS, Inc., CHL Mortgage Pass–Through Trust 2004–HYB5, Mortgage Pass–Through Certificates, Series 2004–HYB5.

Before: BRAND, JURY and TAYLOR, Bankruptcy

Judges.

OPINION

BRAND, Bankruptcy Judge:

***1** Chapter 13[1] debtors Robert and Finley **Keller** ("Debtors") appeal an order denying their motion for contempt and sanctions for violating the automatic stay and confirmation order against **New Penn Financial**, LLC dba Shellpoint Mortgage Servicing ("Shellpoint") and the Bank of **New** York Mellon fka The Bank of **New** York as Trustee for the Certificateholders of CWMBS, Inc., CHL Mortgage Pass–Through Trust 2004–HYB5, Mortgage Pass–Through Certificates, Series 2004–HYB5 (collectively "Defendants"). The issue before the bankruptcy court was whether a creditor's postpetition reporting of overdue or delinquent payments to a credit reporting agency ("CRA"), regardless of the information's accuracy, is a per se violation of § 362(a)(6) and constitutes prohibited collection activity.

This question is an issue of first impression before the Panel. We hold that it is not, and we AFFIRM.

I. FACTUAL BACKGROUND AND PROCEDURAL HISTORY

Debtors filed their chapter 13 bankruptcy case on February 7, 2012. Shellpoint is the servicer of the loan secured by Debtors' residence. Prepetition arrears on the loan were approximately $11,400.

Debtors' fifth amended chapter 13 plan, confirmed by the bankruptcy court, provided for payment of the prepetition arrears; maintenance of ongoing contractual installments due on the loan would be paid by the chapter 13 trustee. Debtors made all payments under the plan. Prepetition arrears were cured by March 31, 2015. At the time of Debtors' contempt motion, the trustee was making the ongoing monthly loan payments under the plan.

In January 2016, Mrs. **Keller** obtained a 3–bureau credit report (Experian, Equifax and Transunion) containing the following information Shellpoint furnished to these three CRAs about the loan:

> Payment History: 120 to 90 days late on all three bureau reports for March 2014 through December 2015.
>
> Payment Status: Account reported as "past due 150 days," "at least 120 days or more then four payments past due" and "120 days past due."
>
> Past Due Balance: All three bureau reports list the account as $9,297.00 past due.
>
> Bankruptcy Status: Shellpoint failed to report that the account was included in or part of a chapter 13 repayment plan.

Mr. **Keller's** 3–bureau credit report contained similar information furnished by Shellpoint:

> Payment History: 120 to 90 days late on all three bureau reports for March 2014 through March 2015.
>
> Past Due Balance: All three bureau reports list the account as $9,297.00 past due.

On January 27, 2016, Mr. **Keller** was denied credit in the purchase of a **new** vehicle. The denial letter indicated that Mr. **Keller** was an "Unacceptable Credit Risk" and that credit was denied "based in whole or in part on information obtained on a report" from Experian.

Debtors moved for contempt and sanctions against Defendants for violating the automatic stay and confirmation order. Debtors argued that by reporting misleading and inaccurate information on their credit reports—i.e., that the account was severely delinquent and with a past due balance—Defendants had willfully acted to collect on a debt that was subject to the automatic stay and confirmation order in violation of §§ 105, 362 and 1327.

***2** In support of their stay violation claim, Debtors argued that reporting of an account which has been included in a chapter 13 bankruptcy as "past due" or "late" is a per se violation of the automatic stay, because reporting late payments or past due balances is classic collection activity under § 362(a)(6). Debtors argued that such reporting did more than acknowledge that the debt still exists; it suggested that Debtors had failed to perform and served no other purpose than to coerce them into paying the debt directly to Shellpoint, despite the trustee's payments.

Debtors also argued that the exception to the automatic stay under § 362(b)(2)(E), added by BAPCPA in 2005, that allows credit reporting of overdue child support obligations, conversely means that negative credit reporting otherwise falls within the coverage of § 362(a) and constitutes prohibited collection activity under § 362(a)(6). Debtors contended legislative history of this added exception supported their argument; the Congressional Record states that § 362(b)(2)(E) was added "[t]o facilitate the domestic support collection efforts by governmental units ...." H.R. Rep. No. 109–31(I), at 17 (2005).

Lastly, Debtors relied on In re Sommersdorf, 139 B.R. 700 (Bankr. S.D. Ohio 1991), a published case supporting their position.

At the hearing, Debtors' counsel clarified that the issue before the bankruptcy court was not the accuracy of what was reported to the CRAs but rather whether reporting that a payment is past due or late violates the automatic stay. The bankruptcy court confirmed that the legal issue to be decided was "whether past-due credit reporting is a per se violation of § 362," and took the matter under submission. Hr'g Tr. (Apr. 5, 2016) 8:25–9:7; 10:19–24.

In a written memorandum, the bankruptcy court denied Debtors' motion for contempt and sanctions for violation of the automatic stay and confirmation order. Debtors timely appealed the ensuing order.

II. JURISDICTION

The bankruptcy court had jurisdiction under 28 U.S.C. §§ 1334 and 157(b)(2)(A) and (L). We have jurisdiction under 28 U.S.C. § 158.

III. ISSUES

1. Did the bankruptcy court err in determining that the actof postpetition credit reporting of overdue or delinquent payments is not a per se violation of § 362(a)(6)?

2. Did the bankruptcy court err in determining that thecredit reporting did not violate the confirmation order under § 1327(a)?

IV. STANDARDS OF REVIEW

[1] [2] [3] We review the bankruptcy court's conclusions of law de novo and its findings of fact for clear error. Hansen v. Moore (In re Hansen), 368 B.R. 868, 874 (9th Cir. BAP 2007). "De novo review requires that we consider a matter anew, as if no decision had been made previously." Francis v. Wallace (In re Francis), 505 B.R. 914, 917 (9th Cir. BAP 2014). Factual findings are clearly erroneous if they are illogical, implausible or without support in the record. Retz v. Samson (In re Retz), 606 F.3d 1189, 1196 (9th Cir. 2010).

[4] We review de novo the bankruptcy court's determination as to whether the automatic stay provisions of § 362 have been violated. Palm v. Klapperman (In re Cady), 266 B.R. 172, 178 (9th Cir. BAP 2001), aff'd, 315 F.3d 1121 (9th Cir. 2003); Advanced Ribbons & Office Prods., Inc. v. U.S. Interstate Distrib., Inc. (In re Advanced Ribbons & Office Prods., Inc.), 125 B.R. 259, 262 (9th Cir. BAP 1991) (the scope of the automatic stay under § 362(a)(6) is "a legal issue which we review **de novo"**).

[5] **[6]** We review the bankruptcy court's decision regarding civil contempt for abuse of discretion. Knupfer v. Lindblade (In re Dyer), 322 F.3d 1178, 1191 (9th Cir. 2003). Underlying factual findings made in connection with a civil contempt order are reviewed for clear error. Id.

V. DISCUSSION

A. The bankruptcy court did not err in determining that the act of postpetition credit reporting of overdue or delinquent payments is not a per se violation of § 362(a) (6).

***3** Section 362(a)(6) stays "any act to collect, assess, or recover a claim against the debtor that arose before" the filing of the petition. This provision generally prohibits creditors from making demand on a debtor to pay a prepetition debt or engaging in communications with the debtor in an effort to collect the debt. Debtors contend that Shellpoint violated § 362(a)(6) by postpetition reporting of overdue or delinquent loan payments, because such credit reporting is a prohibited collection activity.

[7] We hold that postpetition credit reporting of overdue or delinquent payments, without more, does not violate the automatic stay as a matter of law.

Two district court decisions in the Northern District of California have expressly rejected the argument that postpetition credit reporting of overdue or delinquent payments is a per se violation of the automatic stay.[2] See Giovanni v. Bank of Am., N.A., 2012 WL 6599681, at *5 (N.D. Cal. Dec. 18, 2012); Mortimer v. JP Morgan Chase Bank, N.A., 2012 WL 3155563, at *3 (N.D. Cal. Aug. 2, 2012).

In Mortimer, the debtor argued that the automatic stay prohibited the bank's reporting of delinquent payments while the bankruptcy case was pending, contending that such reporting "violated the letter and the spirit of 11 U.S.C. § 362." 2012 WL 3155563, at *3. The district court rejected that argument, holding that:

> Section 362 does not stand for the proposition that an individual is not obliged to make timely payments on his accounts while his petition for bankruptcy is pending. Rather, § 362 limits collection activities in pursuit of claims that arose before the bankruptcy petition. While it might be good policy in light of the goals of bankruptcy protection to bar reporting of late payments while a bankruptcy petition is pending, neither the bankruptcy code nor the [Fair Credit Reporting Act] ("FCRA") does so.

Id.

In Giovanni, the debtor argued that the bank's reporting of late payments once she filed her bankruptcy case was a " 'prohibited creditor shenanigan' " and violated § 362. 2012 WL 6599681, at *5 (quoting In re Sommersdorf, 139 B.R. at 702). Relying on Mortimer, the district court rejected debtor's argument and further noted that the debtor cited no case in which a court found negative postpetition credit reporting alone to be a violation of the automatic stay. Id. at *5–6.

Debtors contend the bankruptcy court erred by relying on Mortimer and its progeny because those cases dealt only with "accuracy under the FCRA and not § 362." While it is true that Mortimer and Giovanni were decided in the context of the FCRA, it is clear that the argument Debtors raise here with respect to § 362 was also raised and rejected in both cases.[3]

We also reject Debtors' argument that the bankruptcy court erred by relying on Mortimer but failing to acknowledge the "split of authority" regarding the issues presented in Mortimer, citing Grantham v. Bank of Am., N.A., 2012 WL 5904729 (N.D. Cal. Nov. 26, 2012) and Venugopal v. Digital Fed. Credit Union, 2013 WL 1283436, at *3 (N.D. Cal. Mar. 27, 2013). The issue in both Grantham and Venugopal was the accuracy of the credit reporting and claims under the FCRA and its California counterparts, not whether the credit reporting violated the automatic stay.

***4** We note the dearth of case law on the precise issue before us. Most courts have addressed this issue in the context of the discharge injunction. The discharge injunction serves as a broad injunction against a wide range of collection activities for discharged debts. See § 524(a)(2). Debtors fault the bankruptcy court for relying on such cases for its ruling, arguing that these cases stand merely for the proposition that reporting certain types of credit information, such as a balance or a mere existence of a debt, is not collection activity that runs afoul of § 362 or § 524. Debtors argue that while such information may have an "adverse" effect on a credit report (the term the bankruptcy court used and Debtors take issue with), it has a different purpose and effect than "overdue" or "delinquent" payment reporting and is distinguishable from the "mere act of credit reporting."

We understand the distinction Debtors attempt to make here but conclude that, because the standard for violations of the automatic stay and the discharge injunction are similar,[4] the discharge injunction cases are relevant and persuasive. These cases stand for the proposition that negative credit reporting, without more, does not violate the discharge injunction. The debtor must show that the credit reporting was done with the purpose of coercing the debtor to pay the reported debt.

In Mahoney v. Washington Mutual, Inc. (In re Mahoney), 368 B.R. 579 (Bankr. W.D. Tex. 2007), the issue before the bankruptcy court was whether reporting a discharged debt constitutes an "act" to collect the debt in violation of the

discharge injunction. The court held that the mere reporting of credit information about a debtor is not an act to collect a discharged debt within the meaning of the statute, unless the evidence shows there is a linkage between the act of reporting and the collection or recovery of the discharged debt. Id. at 584.[5] The following courts are in agreement. See Montano v. First Light Fed. Credit Union (In re Montano), 488 B.R. 695, 710 (Bankr. D.N.M. 2013) (reporting discharged debt as "past due" is facially permissible and does not constitute a per se violation of the discharge injunction, but such act could be found to violate the discharge injunction if its objective effect was to pressure debtor into paying the discharged debt); Russell v. Chase Bank USA (In re Russell), 378 B.R. 735, 742 (Bankr. E.D.N.Y. 2007) (reporting a discharged debt can violate the discharge injunction if done for the specific purpose of coercing payment); Lohmeyer v. Alvin's Jewelers (In re Lohmeyer), 365 B.R. 746, 750 (Bankr. N.D. Ohio 2007) (same); Smith v. Am. Gen. Fin. Inc. (In re Smith), 2005 WL 3447645, at *3 (Bankr. N.D. Iowa Dec. 12, 2005) ("past due" credit report notation can be a violation of the discharge injunction if made with the intent to collect a debt); Helmes v. Wachovia Bank, N.A. (In re Helmes), 336 B.R. 105, 109 (Bankr. E.D. Va. 2005) (bank that mistakenly reported debt as "past due" rather than discharged, absent any other evidence that it did so with intent to collect the debt, did not violate the discharge injunction); Irby v. Fashion Bug (In re Irby), 337 B.R. 293, 296 (Bankr. N.D. Ohio 2005) (reporting of discharged debt does not run afoul of the discharge injunction unless it is also coupled with other actions undertaken by the creditor to collect or recover on the debt); In re Goodfellow, 298 B.R. 358, 362 (Bankr. N.D. Iowa 2003) (finding a violation of the automatic stay and discharge injunction based on creditor's reporting of the debtor's debt as "past due" in addition to its collection letters and threatening phone calls to debtor attempting to collect the debt); Vogt v. Dynamic Recovery Servs. (In re Vogt), 257 B.R. 65, 71 (Bankr. D. Colo. 2000) (false credit reporting, if not done to extract payment of the debt, is not an act proscribed by the Code).

***5** The other line of cases addressing the issue of negative postpetition credit reporting involve alleged violations of the codebtor stay under § 1301. Debtors contend the bankruptcy court erred by relying on these cases, because they largely stand for the proposition that the codebtor stay exists to protect the debtor rather than the codebtor, and suggest that a codebtor's recourse for standing purposes may lie with the FCRA rather than the Code.

While the purpose of the codebtor stay and standing may have been at issue in these cases, they too hold that negative credit reporting, without more, does not violate the codebtor stay. See In re Burkey, 2012 WL 5959991, at *4 (Bankr. N.D.N.Y. Nov. 28, 2012) ("Though there is little case law addressing whether reporting negative information to a credit reporting agency constitutes an act to collect a debt, the court is persuaded by those courts that hold the credit reporting must be part of a broader effort to collect the debt to be a violation of the codebtor stay[.]"); In re Juliao, 2011 WL 6812542, at *4 (Bankr. E.D. Mich. Nov. 29, 2011) (bank's reporting of codebtor's past due payments to CRAs was not an act to collect the debt and therefore did not violate § 1301); Singley v. Am. Gen. Fin. (In re Singley), 233 B.R. 170, 173 (Bankr. S.D. Ga. 1999) (for a violation of the automatic stay under § 362 or the codebtor stay under § 1301 there needs to be a showing that an adverse report to a credit bureau was made with the intent to harass or coerce the debtor and/or the codebtor into paying the prepetition debt).

[8] Finally, the few cases addressing the issue of negative credit reporting in the context of § 362, in addition to Mortimer and Giovanni, hold that postpetition negative credit reporting alone is not an act to collect a debt in violation of the stay; such reporting must have been done with the intent to harass or coerce the debtor to pay the reported debt. See In re Haley, Case No. 15–10712 (Bankr. D. Nev. Sept. 8, 2016) (inaccurate credit reporting, without evidence of creditor's intent to coerce debtor into paying the reported debt, does not violate the automatic stay as a matter of law); Weinhoeft v. Union Planters Bank, N.A. (In re Weinhoeft), 2000 WL 33963628, at *2 (Bankr. C.D. Ill. Aug. 1, 2000) ("Even if it is shown that the Bank's reports to the credit-reporting agencies contain truthful information [about debtors' delinquent mortgage payments], such a report, if made with the intent to harass or coerce a debtor into paying a pre-petition debt, could be deemed a violation of the automatic stay."); Smith v. United Student Aid Funds, Inc. (In re Smith), 2000 WL 33710884, at *4 (Bankr. D.S.C. Feb. 3, 2000) (rejecting debtor's argument that postpetition negative credit reporting violated § 362(a)(6) and concluding that reporting was not an act to collect because it did not extract payment even if it promoted it). See also Hickson v. Home Fed. of Atlanta, 805 F.Supp. 1567, 1573 (N.D. Ga. 1992), aff'd, 14 F.3d 59 (11th Cir. 1994) ("Section 362 contains no language prohibiting creditors or any other party from making legitimate reports [of delinquent

mortgage payments] to credit agencies regarding parties that have filed for bankruptcy.").[6]

***6** Notably, none of the cases cited above held that negative credit reporting, as a matter of law, is a collection activity that violates § 362, § 524 or § 1301. The only case supporting Debtors' argument is Sommersdorf. There, the bankruptcy court held that the codebtor stay under § 1301 was violated when the creditor bank had reported an auto loan debt as "written off" when in fact the loan was paid in full under the debtor's chapter 13 plan. As a result of a negative credit report, the codebtor was unable to obtain a home loan. 139 B.R. at 701. The bank argued that federal banking audit requirements required it to charge off any amount that was more than four months in arrears. Id. Rejecting this argument, the court held:

> [T]here is a distinction between an internal bank accounting procedure and the placing of a notation on an obligor's credit report. We find that the latter most certainly must be done in an effort to effect collection of the account. See, In re Spaulding, 116 B.R. 567, 570 (Bankr. S.D. Ohio 1990) .... Such a notation on a credit report is, in fact, just the type of creditor shenanigans intended to be prohibited by the automatic stay. H.R. Rep. No. 95–595, 95th Cong.
> 1st Sess. 342 (1977) reprinted in 1978 U.S. Cong. & Admin. News 5787, 6298 (omitted).

Id. Cf. Bruno v. First USA Bank (In re Bruno), 356 B.R. 89, 91 (Bankr. W.D.N.Y. 2006) (credit reporting could constitute an act to collect a debt, but because creditor's reporting of the debt occurred prepetition the court declined to extend the discharge injunction to cause the creditor, post-discharge, to update its reporting of discharged debt).

We respectfully do not find Sommersdorf persuasive. First, the Sommersdorf court provided little analysis to support its holding, and what authority it did rely upon does not support it. It cited the Congressional Record, which is silent on credit reporting but speaks only of debtors feeling pressured to pay prepetition debts when contacted by creditors on the telephone. 139 B.R. at 701. Its reliance on Spaulding is also misplaced. Spaulding did not involve credit reporting but rather letters sent directly to the debtor from her bank about closing her account due to the bankruptcy filing, the closing of the debtor's account and the bank's withholding of some of the account funds. 116 B.R. at 570. The debtor contended that the creditor's actions violated the automatic stay. Id. Because of the absence of any evidence that the bank intentionally attempted to collect or recover a debt, the court granted the bank summary judgment. Id. at 570–71. Thus, Spaulding does not stand for the proposition that negative credit reporting is an act to collect a debt in violation of § 362(a)(6). As the bankruptcy court so eloquently put it in Mahoney: "The rhetoric in Sommersdorf writes checks that the authorities cannot cash." 368 B.R. at 586.

Second, as the bankruptcy court recognized and as we have pointed out with the above cases, Sommersdorf's per se analysis has been rejected or largely not followed. In addition, there were other affirmative acts and facts on which the court could have concluded that the creditor's negative credit reporting was done for the purpose of attempting to collect the debt. Prior to filing the motion alleging the stay violation, the debtor requested the creditor to remove the charge-off notation but the creditor refused. Also, the creditor was receiving a 100% payment of its claim and could not have prevailed on a motion for relief from stay. Lastly, Sommersdorf is inconsistent with Ninth Circuit law, which requires evidence indicating harassment or coercion to establish a violation under § 362(a).

In Morgan Guar. Tr. Co. of N.Y. v. Am. Sav. & Loan Ass'n, 804 F.2d 1487, 1491 (9th Cir. 1986), the issue was whether presentment of the debtor's bearer notes to a third party bank postpetition violated the automatic stay under § 362(a)(6). The Ninth Circuit Court of Appeals held that "the language and purposes of section 362(a) do not bar mere requests for payment unless some element of coercion or harassment is involved."[7] Likewise, an act does not violate the stay unless it immediately or potentially threatens the debtor's possession of his or her property, such that the debtor is required to take affirmative acts to protect his or her interest. Id. We fail to see how negative credit reporting, standing alone, could be a violative act.

***7** In Zotow v. Johnson (In re Zotow), 432 B.R. 252, 259 (9th Cir. BAP 2010), the Panel held in the context of a motion alleging a creditor's violation of the automatic stay under § 362(a)(6), that "one distinguishing factor between

permissible and prohibited communications is evidence indicating harassment or coercion." Thus, in this circuit, negative credit reporting, standing alone, is insufficient to show a violation of the automatic stay under § 362(a)(6).[8]

Debtors want us to hold that the act of reporting overdue or delinquent payments during the pendency of a chapter 13 bankruptcy is collection activity that violates the automatic stay because its sole purpose is to coerce a debtor into paying the debt. We reject this argument because it presumes that no other reasons explain why a creditor would furnish negative credit information to CRAs. We believe the bankruptcy court in Helmes stated it best in rejecting this same argument:

> The debtor asserts that the only reason for a creditor to submit such a derogatory report is to collect the debt. The debtor is certainly correct that such a derogatory notation on a credit report may have the effect of causing some debtors to pay the discharged debt, but that does not prove that it was submitted with that intention. The argument assumes that there is no other reason why such a derogatory report would be submitted and, concludes that it must have been submitted with the proscribed intent. The debtor's argument fails if there is another reason why the derogatory report was made.

336 B.R. at 109. In Helmes, another reason for the negative credit reporting was mistake.

Another reason for reporting a delinquent debt that does not have a direct purpose of collecting the debt is to share information relevant to credit granting decisions:

> [A] distinction must be made between acts which have as their direct and natural purpose the collection of debts and acts which have some other lawful purpose but could also be used (or, more accurately, misused) to coerce payment of a debt. The reporting of a delinquent debt to a credit reporting agency is not inherently an act to collect a debt but rather to share information relevant to credit granting decisions. A creditor reports both performing and delinquent accounts in the expectation that other credit grantors will do the same, enhancing each creditor's ability to evaluate proposed credit transactions and to avoid extending credit or making loans to poor credit risks.

***8** In re Jones, 367 B.R. 564, 569 (Bankr. E.D. Va. 2007).[9]

We are also not persuaded by Debtors' argument with respect to § 362(b)(2)(E). That provision, added by BAPCPA in 2005, excepts from the automatic stay "the reporting of overdue support owed by a parent to any consumer reporting agency as specified in section 466(a) (7) of the Social Security Act." Debtors contend that since the act of reporting overdue domestic support obligations has been listed as an exception to the automatic stay in § 362(b), then all other instances of overdue credit reporting must be prohibited by § 362(a).

Prior to BAPCPA, the automatic stay did not bar commencement of an action or proceeding to establish paternity, to establish or modify an order for alimony, maintenance or support, or to collect such debts from property that was not property of the estate. However, BAPCPA revamped the way the automatic stay applies to domestic matters. Under the **new** § 362(b), it is now easier for a spouse to bring or to continue actions against the debtor regarding child custody, visitation matters, domestic violence issues, or pursuit of state remedies for nonpayment of domestic support obligations such as the suspension of a driver's, occupational or professional license, and to report overdue support debts to credit agencies. See 17 J. Bankr. L. & Prac. 3 Art. 1, Edward W. Vopat, Domestic Support Obligations Under the Revised Bankruptcy Code (2008).

Thus, BAPCPA's expansion with respect to domestic relation proceedings in § 362(b) clearly evidenced congressional intent to expand and clarify which domestic relation proceedings are not covered by the automatic stay. Therefore, we disagree with Debtors that the addition of § 362(b)(2)(E) necessarily implies that all other instances of negative credit reporting are barred by the automatic stay.

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Furthermore, to read § 362(b)(2)(E) as Debtors suggest —that it creates a singular and exclusive exception to § 362(a) for credit reporting—flies in the face of § 1681c(a)

(1)[10] of the FCRA, which permits the credit reporting of bankruptcies for a period of up to ten years, and would require the court to conclude that Congress intended to invalidate that FCRA provision through an amendment of § 362(b)(2)(E). Debtors' interpretation of § 362(b)(2) (E) would be at odds with what Congress has intended in § 1681c(a)(1) of the FCRA. See Morton v. Mancari, 417 U.S. 535, 551, 94 S.Ct. 2474, 41 L.Ed.2d 290 (1974) ("[C]ourts are not at liberty to pick and choose among congressional enactments, and when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intent to the contrary, to regard each as effective."); Posadas v. Nat'l City Bank of N.Y., 296 U.S. 497, 503, 56 S.Ct. 349, 80 L.Ed. 351 (1936) (when Congress passes two statutes that may touch on the same subject, we give effect to both unless doing so would be impossible).

***9** Accordingly, we hold that the act of postpetition credit reporting of overdue or delinquent payments while a bankruptcy case is pending is not a per se violation of § 362(a)(6).

B. The bankruptcy court did not err in determining that the credit reporting did not violate the confirmation order under § 1327(a).

[9] [10] [11] A violation of the confirmation order under § 1327(a) is an act of contempt and may be remedied under § 105. In re Dendy, 396 B.R. 171, 179–80 (Bankr. D.S.C. 2008). For contempt, the moving party must show by clear and convincing evidence the contemnors violated a specific and definite order of the court. Renwick v.

Bennett (In re Bennett), 298 F.3d 1059, 1069 (9th Cir. 2002).

Debtors argued that Shellpoint's reporting of past due balances on Debtors' credit reports violated the confirmation order. First, Debtors argued Shellpoint was bound by the chapter 13 plan, and its actions of reporting past due payments to CRAs failed to conform to the plan's terms.

Second, § 2.08(b)(5) of the plan required that "[p]ostpetition payments made by Trustee and received by the holder of Class 1 claims shall be applied as if the claim were current and no arrearage existed on the date the case was filed." Thus, argued Debtors, the plan required Shellpoint "to report all timely made postpetition payments as being current as though no default existed," and Shellpoint had failed to comport its reporting of the account with this requirement. Defendants countered that Debtors' plan was silent about credit reporting, and § 2.08(b)(5) of the plan did not refer to credit reporting as Debtors had argued; it only governed the manner in which payments of the arrearage would be applied to the claim.

The bankruptcy court found that the confirmation order did not require Defendants to report—or not report — anything regarding Debtors' credit information. The confirmation order neither directed nor prohibited credit reporting. Debtors were reading too much into § 2.08(b)(5), attempting to make the word "applied" synonymous with "report." The court reasoned that in order to reach the conclusion Debtors suggested, it would have to infer a nexus between the application and reporting of payments. In other words, the court would have to read into the plan what the plan did not expressly state. Hence, this meant—at least with respect to credit reporting—Debtors' confirmed plan was not definite and specific. Accordingly, Defendants could not be found in contempt.

We perceive no error in the bankruptcy court's ruling. The confirmed plan is entirely silent on the issue of credit reporting. Debtors contend that "applied" necessarily includes "reporting" but fail to cite any authority for this contention. To the extent Debtors contend the postpetition credit reporting is erroneous and does not match Defendants' application of Debtors' loan payments under the confirmed plan, as the bankruptcy court noted, the remedy for that is not in the Code but perhaps in the FCRA.

VI. CONCLUSION

For the reasons stated above, we AFFIRM.

All Citations

--- B.R. ----, 2017 WL 2312849

Footnotes

1 Unless specified otherwise, all chapter, code and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532, and the Federal Rules of Bankruptcy Procedure, Rules 1001–9037.

2 Debtors' counsel in this case also represented the plaintiffs in Giovanni and Mortimer.

3 In another case, Debtors' attorneys attempted to distinguish Mortimer, arguing that the case "focused on the automatic stay." Mestayer v. Experian Info. Sols., Inc., 2016 WL 631980, at *3 (N.D. Cal. Feb. 17, 2016).

4 See ZiLOG, Inc. v. Corning (In re ZiLOG), 450 F.3d 996, 1008 n.12 (9th Cir. 2006).

5 The Mahoney court also aptly notes that unauthenticated copies of credit reports or conclusory allegations that furnishing credit information is done with intent to collect a debt will not serve as competent evidence of a creditor's attempt to collect a debt. 368 B.R. at 592–94.

6 Debtors contend the bankruptcy court found that the information Shellpoint furnished was inaccurate. Debtors fail to cite to the record where that finding was made, and we do not see where the court made any such finding. Debtors continue that the bankruptcy court erred by not considering the accuracy of the credit report; it could have found a per se violation of the reporting of overdue payments when such a report was inaccurate.

As the bankruptcy court noted, although Debtors appeared to raise accuracy of the report as an issue in their motion, counsel at oral argument stated that accuracy of the credit information reported was irrelevant to whether or not negative credit reporting violated the automatic stay. Accordingly, the court addressed the issue without considering accuracy. Because Debtors affirmatively abandoned the accuracy issue at oral argument they have waived it on appeal. See Reynoso v. Giurbino, 462 F.3d 1099, 1110 (9th Cir. 2006) (citing Russell v. Rolfs, 893 F.2d 1033, 1038–39 (9th Cir. 1990)); Sheehan v. Marr, 207 F.3d 35, 42 (1st Cir. 2000) (appellate court need not consider issue so explicitly abandoned below).

7 Congress amended § 362 in 1985 to provide that presentment of a negotiable instrument is not a violation of § 362(a), as now codified in § 362(b)(11). However, we believe the Ninth Circuit's holding that mere requests for payment do not constitute a stay violation absent coercion or harassment relevant and is still good law.

8 We also note Bell v. Clinic Labs. of Haw. (In re Bell), 2008 WL 8444796 (9th Cir. BAP Feb. 11, 2008). In that case, a chapter 13 bankruptcy petition was filed in October 2005 and the plan paid off early, resulting in a discharge on March 13, 2007. Despite receiving notice of the bankruptcy, the creditor continued to send debtor over seventeen demand letters between 2006 and 2007. The creditor also retained a collection agency to pursue the prepetition debt, and thereafter the collection agency reported the discharged debt to the CRAs.

The only issue before the Panel was whether the bankruptcy court abused its discretion in denying debtor's request for attorney's fees once the creditor was found to have willfully violated the automatic stay. Id. at *2. While the negative credit reporting was one factor supporting debtor's claim for damages, the Panel did not conclude that the creditor's negative reporting, standing alone, violated the automatic stay. Rather, this fact combined with the creditor's other overt collection acts—sending seventeen collection letters during the postpetition period—is what violated the stay because the creditor was clearly "attempt[ing] to collect a prepetition debt." Id. at *3.

In other words, the Panel in Bell concluded that the debtor had met his burden of proving that the creditor's cumulative communications were coercive and harassing. This is consistent with the law of this circuit.

9 Debtors cite In re Thistle, 1998 WL 35412015 (Bankr. E.D. Va. July 17, 1998), which they claim held "reporting the debt to the credit bureau as 'bad debt' with a past due balance could hardly have any purpose except to coerce the debtors into paying the debt." They also accuse the bankruptcy court for having cited Thistle improperly. We could not locate Debtors' quoted passage anywhere in Thistle.

10 See 15 U.S.C. § 1681c(a)(1). See also In re Kuehn, 563 F.3d 289, 291 (7th Cir. 2009) (reviewing § 1681c and noting that within ten years from the date of discharge a prospective creditor may consider discharged debts (minus a few exceptions under the Code) in determining creditworthiness and reasoning that "yesterday's failure to pay is a proper basis for tomorrow's refusal to extend credit.").

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WESTLAW

2017 WL 2294746
United States Court of Appeals,
Ninth Circuit.

IN RE SUNNYSLOPE HOUSING LIMITED PARTNERSHIP, Debtor.
First Southern National Bank, Plaintiff-Appellant,
v.
Sunnyslope Housing Limited Partnership, Defendant-Appellee.
In re Sunnyslope Housing Limited Partnership, Debtor.
Sunnyslope Housing Limited Partnership, Plaintiff-Appellant,
v.
First Southern National Bank, Defendant-Appellee.
In re Sunnyslope Housing Limited Partnership, Debtor.
First Southern National Bank, Plaintiff-Appellant,
v.
Sunnyslope Housing LP, Defendant-Appellee.
In re Sunnyslope Housing Limited Partnership, Debtor.
Sunnyslope Housing LP, Plaintiff-Appellant,
v.
First Southern National Bank, Defendant-Appellee.

No. 12-17241, No. 12-17327,
No. 13-16164, No. 13-16180
|
Argued and Submitted En Banc January 17, 2017 San Francisco, California
|
Filed May 26, 2017

Appeals from the United States District Court for the District of Arizona, H. Russel Holland, District Judge, Presiding, D.C. No. 2:11-cv-02579-HRH, D.C. No. 2:11cv-02579-HRH, D.C. No. 2:12-cv-02700-HRH, D.C. No. 2:12-cv-02700-HRH

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Before: Sidney R. Thomas, Chief Judge, and Alex Kozinski, Diarmuid F. O'Scannlain, Susan P. Graber, Ronald M. Gould, Richard C. Tallman, Carlos T. Bea, Jacqueline H. Nguyen, Andrew D. Hurwitz, John B. Owens, and Michelle T. Friedland, Circuit Judges.

Dissent by Judge Kozinski

OPINION

HURWITZ, Circuit Judge:

When a debtor, over a secured creditor's objection, seeks to retain and use the creditor's collateral in a Chapter 11 plan of reorganization through a "cram down," the Bankruptcy Code treats the creditor's claim as secured "to the extent of the value of such creditor's interest." 11 U.S.C § 506(a)(1). That value is to "be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." *Id.*

In *Associates Commercial Corp. v. Rash*, the Supreme Court adopted a "replacement-value standard" for § 506(a)(1) cram-down valuations. 520 U.S. 953, 956 (1997). The Court held that replacement value, "rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's 'disposition or use.' " *Id.* at 963 (quoting *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 75 (1st Cir. 1995)).

***2** In rejecting a "foreclosure-value standard," the Court also noted that foreclosure value was "typically lower" than replacement value. *Id.* at 960. Today, however, we confront the atypical case. Because foreclosure would vitiate covenants requiring that the secured property— an apartment complex—be used for low-income housing, foreclosure value in this case exceeds replacement value, which is tied to the debtor's "actual use" of the property in the proposed reorganization. *Id.* at 963. But we take the Supreme Court at

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its word and hold, as *Rash* teaches, that § 506(a)(1) requires the use of replacement value rather than a hypothetical value derived from the very foreclosure that the reorganization is designed to avoid. Thus, the bankruptcy court did not err in this case in approving Sunnyslope's plan of reorganization and valuing the collateral assuming its continued use after reorganization as low-income housing.

BACKGROUND

I. The Sunnyslope Project

Sunnyslope Housing Limited Partnership ("Sunnyslope") owns an apartment complex in Phoenix, Arizona. Construction funding came from three loans. Capstone Realty Advisors, LLC, provided the bulk of the funding through an $8.5 million loan with an interest rate of 5.35%, secured by a first-priority deed of trust. The Capstone loan was guaranteed by the United States Department of Housing and Urban Development ("HUD"), and funded through bonds issued by the Phoenix Industrial Development Authority. The City of Phoenix and the State of Arizona provided the balance of the funding. The City loan was secured by a second-position deed of trust, and the State loan by a third-position deed of trust.

A. The Covenants

To secure financing and tax benefits, Sunnyslope entered into five agreements:

1. To obtain the HUD guarantee, Sunnyslope signed aRegulatory Agreement requiring that the apartment complex be used for affordable housing.

2. Sunnyslope also entered into a RegulatoryAgreement with the Phoenix Industrial Development Authority, requiring Sunnyslope to "preserve the tax-exempt status" of the project, and use 40% of the units for low-income housing. The agreement provided that its covenants "shall run with the land and shall bind the Owner, and its successors and assigns and all subsequent owners or operators of the Project or any interest therein." The restrictions, however, terminated on "foreclosure of the lien of the

   Mortgage or delivery of a deed in lieu of foreclosure."

3. The City of Phoenix required Sunnyslope to signa Declaration of Affirmative Land Use Restrictive Covenants, mandating that 23 units be set aside for low-income families. The restriction ran with the land and bound "all future owners and operators" but, similarly, would be vitiated by foreclosure.

4. The Arizona Department of Housing requiredSunnyslope to enter into a Declaration of Covenants, Conditions, and Restrictions. That 40year agreement set aside five units for low-income residents. The agreement ran with the land and bound future owners, terminated upon foreclosure, and was expressly subordinate to the HUD Regulatory Agreement.

5. Finally, in order to receive federal tax credits,Sunnyslope agreed with the Arizona Department of Housing to use the entire complex as low-income housing. The tax credits, and restriction on use, would terminate on foreclosure.

B. The Default and its Aftermath

In 2009, Sunnyslope defaulted on the Capstone loan. As guarantor, HUD took over the loan and sold it to First Southern National Bank ("First Southern") for $5.05 million. In connection with the sale, HUD released its Regulatory Agreement. The Loan Sale Agreement confirmed, however, that the property remained subject to the other "covenants, conditions and restrictions."

First Southern began foreclosure proceedings, and an Arizona state court appointed a receiver. In December 2010, the receiver agreed to sell the complex to a third party for $7.65 million.

II. The Bankruptcy Proceedings

***3** Before the sale could close, Sunnyslope filed a Chapter 11 petition. Over First Southern's objection, Sunnyslope sought to retain the complex in its proposed plan of reorganization, exercising the "cram-down" option in 11 U.S.C. § 1325(a)(5)(B). A successful cram down allows the reorganized debtor to retain collateral over a secured creditor's objection, subject to the requirement in § 506(a)(1) that the debt be treated as secured "to the extent of the value of such creditor's interest" in the collateral.

The central issue in the reorganization proceedings was the valuation of First Southern's collateral, the apartment complex. Sunnyslope asserted that the complex should be valued as low-income housing, while First Southern contended that the complex should instead be valued without regard to Sunnyslope's contractual obligations to use it as low-income housing, which would terminate upon foreclosure.

In that regard, First Southern's expert valued the complex at $7.74 million, making the "extraordinary assumption" that a foreclosure would remove any lowincome housing requirements. First Southern's expert also opined, however, that the value of the property was only $4,885,000 if those requirements remained in place. Sunnyslope's expert valued the property at $2.6 million with the low-income housing restrictions in place, and at $7 million without.

During its original proceeding, the bankruptcy court held that, under § 506(a)(1), the value of the property was $2.6 million because Sunnyslope's plan of reorganization called for continued use of the complex as low-income housing. The court also declined to include in the valuation of the complex the tax credits available to Sunnyslope. First Southern then elected to treat its claim as fully secured under 11 U.S.C. § 1111(b).

The bankruptcy court subsequently confirmed the plan of reorganization, which provided for payment in full of the First Southern claim over 40 years, at an interest rate of 4.4%, with a balloon payment at the end without interest. The reorganization plan required the City and State to relinquish their liens, but provided for payment of their unsecured claims in full, albeit without interest, at the end of the 40 years.

The bankruptcy court found the plan fair and equitable under 11 U.S.C. § 1129(b)(1) because First Southern retained its lien, would receive an interest rate equivalent to the prevailing market rate, and could foreclose (and, therefore, obtain the property without the restrictive covenants) should Sunnyslope default. The court also found the plan feasible under 11 U.S.C. § 1129(a)(11), citing Sunnyslope's financial projections, and noting that "the Creditor has come in with no evidence of a lack of feasibility." The court concluded that it was more likely than not that Sunnyslope could make plan payments based on the history of comparable properties. The court also noted that, when the balloon payment came due, the property would be free of the low-income housing restrictions, making the collateral an even more valuable asset.

After confirmation, Cornerstone at Camelback LLC invested $1.2 million in the complex. First Southern then obtained a stay of the plan of reorganization from the district court pending appeal. The district court affirmed the bankruptcy court's valuation of the complex with the low-income housing restrictions in place, but held that the tax credits should also have been considered. Both parties appealed.

After First Southern unsuccessfully sought a writ from this court prohibiting the bankruptcy court from considering the district court's remand pending resolution of the appeals, the bankruptcy court valued the tax credits at $1.3 million, added that amount to its previous valuation, and re-confirmed the plan of reorganization. First Southern attempted to withdraw its § 1111(b) election, but the bankruptcy court denied the request.

***4** First Southern again appealed. The district court denied First Southern's request for a stay and affirmed the reorganization plan as modified. First Southern timely appealed to this court, and Sunnyslope cross-appealed.

III. Panel Opinion

After the various appeals were consolidated, a divided panel of this court reversed the bankruptcy court's order approving the plan of reorganization, holding that the court should have valued the apartment complex without regard to the affordable housing requirements. *In re Sunnyslope Hous. Ltd. P'ship*, 818 F.3d 937, 940 (9th Cir. 2016). The majority held that, under § 506(a)(1), replacement cost "is a measure of what it would cost to produce or acquire an equivalent piece of property" and that "the replacement value of a 150-unit apartment complex does not take into account the fact that there is a restriction on the use of the complex." *Id.* at 948 n.5. The dissenting opinion, in contrast, argued that "a straightforward application" of *Rash* "compels valuing First Southern's collateral ... in light of Sunnyslope's proposed use of the property in its plan of reorganization as affordable housing." *Id.* at 950 (Paez, J., dissenting).[1]

A majority of the active judges of this court voted to grant Sunnyslope's petition for rehearing en banc, and the panel opinion was vacated. *In re Sunnyslope Hous. Ltd. P'ship*, 838 F.3d 975 (9th Cir. 2016); *see* Fed. R. App. P. 35.

DISCUSSION

The critical issue for decision is whether the bankruptcy court erred by valuing the apartment complex assuming its continued use after reorganization as low-income housing. In addition, First Southern contends that the plan of reorganization is neither fair and equitable nor feasible, and that the district court erred in not allowing it to withdraw its § 1111(b) election.

I. Valuation

When a Chapter 11 debtor opts for a cram down, a creditor's claim is secured "to the extent of the value of such creditor's interest in the estate's interest in [the secured] property." 11 U.S.C. § 506(a)(1). The value of that claim is "determined in light of the purpose of the valuation and of the proposed disposition or use of such property." *Id.* We established long ago that, "[w]hen a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral." *In re Taffi*, 96 F.3d 1190, 1192 (9th Cir. 1996) (en banc). The debtor is "in, not outside of, bankruptcy," so "[t]he foreclosure value is not relevant" because the creditor "is not foreclosing." *Id.*

In *Taffi*, we noted that our decision was consistent with the approach of all but one circuit—the Fifth—which had adopted a foreclosure-value standard in *In re Rash*, 90 F.3d 1036 (5th Cir. 1996) (en banc). *See* 96 F.3d at 1193. There, the Rashes owed $41,171 on a freight-hauler truck loan when they filed a Chapter 13 petition. *Rash*, 520 U.S. at 956. They sought to retain the truck through a cram down, proposing a reorganization plan paying the creditor for the foreclosure value of the truck, which they contended was $28,500. *Id.* at 957. In contrast, the creditor argued the truck should be valued at "the price the Rashes would have to pay to purchase a like vehicle," estimated at $41,000. *Id.* But the Fifth Circuit disagreed and held that § 506(a)(1) required the use of foreclosure value. *Rash*, 90 F.3d at 1060–61.

***5** One year after we decided *Taffi*, the Supreme Court reversed the Fifth Circuit. The Court held, consistent with *Taffi*, that "§ 506(a) directs application of the replacementvalue standard," rather than foreclosure value. *Rash*, 520 U.S. at 956.[2] The Court stated that the value of collateral under § 506(a)(1) is "the cost the debtor would incur to obtain a like asset for the same 'proposed ... use.' " *Id.* at 965 (alteration in original).

Rash stressed the instruction in § 506(a)(1) to value the collateral based on its "proposed disposition or use" in the plan of reorganization. *Id.* at 962. The Court emphasized that, in a reorganization involving a cram down, the debtor will continue to use the collateral, and valuation must therefore occur "in light of the proposed repayment plan reality: no foreclosure sale." *Id.* at 963 (alteration omitted) (quoting *Winthrop Old Farm Nurseries*, 50 F.3d at 75). The "actual use," the Court held, "is the proper guide," *id.*, and replacement value is therefore "the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller," *id.* at 960.

Rash also teaches that the determination of replacement value by the bankruptcy court is a factual finding. *Id.* at 965 n.6. We therefore review the valuation determination in this case for clear error. *In re JTS Corp.*, 617 F.3d 1102, 1109 (9th Cir. 2010). We find none.

The essential inquiry under *Rash* is to determine the price that a debtor in Sunnyslope's position would pay to obtain an asset like the collateral for the particular use proposed in the plan of reorganization. 520 U.S. at 965. First Southern does not dispute that there was substantial evidence before the bankruptcy court that it would cost Sunnyslope $3.9 million to acquire a property like the apartment complex (including the tax-credits) with similar restrictive covenants requiring that it be devoted to lowincome housing.

Despite this, First Southern argues that the property should instead be valued at its "highest and best use"— housing without any low-income restrictions. But § 506(a)(1) speaks expressly of the reorganization plan's "proposed disposition or use." Absent foreclosure, the very event that the Chapter 11 plan sought to avoid, Sunnyslope cannot use the property except as affordable housing, nor could anyone else. *Rash* expressly instructs that a § 506(a)(1) valuation cannot consider what would happen after a hypothetical foreclosure—the valuation must instead reflect the property's "actual use." 520 U.S. at 963.

First Southern attempts to distinguish *Rash* by noting that foreclosure value is greater than replacement value in this case. But *Rash* implicitly acknowledged that this outcome

might occasionally be the case, and nonetheless adopted a replacement-value standard. *See* 520 U.S. at 960. We cannot depart from that standard without doing precisely what *Rash* instructed bankruptcy courts to avoid —assuming a foreclosure that the Chapter 11 petition prevented. *See id.* at 963.

To be sure, a creditor is better off whenever the highest possible value for its collateral is chosen, and *Rash* did in fact recognize that when "a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use." *Id.* at 962. But *Rash* did not adopt a rule requiring that the bankruptcy court value the collateral at the higher of its foreclosure value or replacement value. Rather, it expressly rejected the use of foreclosure value, and instead stressed the requirement in § 506(a)(1) that the property be valued in light of its "proposed disposition or use." 520 U.S. at 960, 962. Here, the proposed disposition and use is for low-income housing; indeed, no other use is possible without foreclosure. First Southern may be exposed to an increased risk under the cram down, but that does not allow us to ignore the command of *Rash*.

***6** First Southern also argues that the low-income housing requirements do not apply to its security because HUD released its Regulatory Agreement, and all other covenants are junior to its lien. Although the State and City liens may be subordinate to First Southern's, it is undisputed the restrictions they impose continue to run with the land absent foreclosure. Thus, they were properly considered in determining the value of the collateral.

Finally, First Southern's amici argue that valuing the collateral with the low-income restrictions in place would discourage future lending on like projects. We disagree. "[W]hile the protection of creditors' interests is an important purpose under Chapter 11, the Supreme Court has made clear that successful debtor reorganization and maximization of the value of the estate are the primary purposes." *In re Bonner Mall P'ship*, 2 F.3d 899, 916 (9th Cir. 1993) (footnote omitted), *abrogated on other grounds by Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (2015). Allowing the debtor to "rehabilitate the business" generally maximizes the value of the estate. *Id.* And, in this case, First Southern bought the Sunnyslope loan at a substantial discount, knowing of the risk that the property would remain subject to the low-income housing requirements. Valuing First Southern's collateral with those restrictions in mind subjects the lender to no more risk than it consciously undertook. *See Rash*, 520 U.S. at 962–63.

Accordingly, we hold that the bankruptcy court did not err in valuing First Southern's collateral in the plan of reorganization assuming its continued use as affordable housing.[3]

II. Plan Fairness

The cram-down provision in 11 U.S.C. § 1129(b) requires that the reorganization plan be "fair and equitable." The secured creditor must retain its lien, § 1129(b)(2)(A)(i)(I), and receive payments over time equaling the present value of the secured claim, § 1129(b)(2)(A)(i)(II). Whether a plan is fair and equitable is a factual determination reviewed for clear error. *In re Acequia, Inc.*, 787 F.2d 1352, 1358 (9th Cir. 1986).

The bankruptcy court found the Sunnyslope plan fair and equitable because First Southern retained its lien and received the present value of its allowed claim over the term of the plan. There is no dispute that First Southern retained its lien, and our discussion above disposes of any contention that its secured claim was undervalued. Thus, the only remaining question is whether the bankruptcy court erred in concluding that the plan provides for payments equal to the present value of the secured claim.

The interest rate chosen must ensure that the creditor receives the present value of its secured claim through the payments contemplated by the plan of reorganization. *Till v. SCS Credit Corp.*, 541 U.S. 465, 469 (2004). In *Till*, a plurality endorsed the "formula approach" for calculating the appropriate interest rate, which begins with the national prime rate and adjusts up or down according to the risk of the plan's success. *Id.* at 478–79. The creditor bears the burden of showing that the prime rate does not adequately account for the riskiness of the debtor. *Id.*

***7** First Southern argues that it is not receiving the present value of its secured claim because the interest rate adopted in the plan, 4.4%, is lower than the original rate on its loan. But we find no clear error in the bankruptcy court's determination. The bankruptcy court conducted a hearing at which it heard expert testimony, applied the *Till* test, and found that the 4.4% interest rate on the plan payments would result in First Southern's receiving the present value of its $3.9 million

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security over the term of the reorganization plan. The relevant national prime rate was 3.25%, and the bankruptcy court adjusted that rate upward to account for the risk of non-payment. The court also heard testimony that the market loan rate for similar properties was 4.18%. In setting the 4.4% rate, the bankruptcy court carefully explained its reasoning, noting that interest rates had decreased significantly since the Capstone loan was made. The bankruptcy court also noted that the risk to the lender had similarly decreased since then because, when the loan was made, the apartment complex had not yet been built.[4]

The bankruptcy court did not clearly err, and we affirm its determination.

III. Plan Feasibility

Plan confirmation also requires a finding that the debtor will not require further reorganization. 11 U.S.C. § 1129(a) (11). It therefore requires the debtor to demonstrate that the plan "has a reasonable probability of success." *Acequia*, 787 F.2d at 1364. A bankruptcy court's finding of feasibility is reviewed for abuse of discretion. *Id.* at 1365.

The bankruptcy court did not abuse its discretion in finding the Sunnyslope plan feasible. A projection showed that Sunnyslope would be able to make plan payments, and expert testimony confirmed that the collateral would remain useful for 40 years (the term of the plan). The court also found the balloon payment feasible because it was secured by property whose value exceeded the value of the remaining First Southern claim. And the court noted that First Southern had "come in with no evidence of a lack of feasibility." It was therefore well within the bankruptcy court's discretion to find that the plan of reorganization was feasible.

IV. The § 1111(b) Election

Finally, § 1111(b) of the Bankruptcy Code allows a secured creditor to elect to have its claim treated as either fully or partially secured. An election affects the treatment of the unsecured portion of the claim under the plan and the procedural protections afforded to the creditor. *See, e.g.*, 11 U.S.C. § 1129(a)(7)(B). In the absence of a contrary order by the bankruptcy court, the creditor must make this election before the end of the disclosure statement hearing. Fed. R. Bankr. P. 3014.

In this case, the bankruptcy court ordered that First Southern make its § 1111(b) election "7 calendar days after the court issues a ruling on valuation." First Southern timely did so, choosing to treat its entire claim as secured.

First Southern now argues that the bankruptcy court erred in not allowing it to make a second election after the district court remanded and required the tax credits be added to the valuation. In effect, First Southern contends that the bankruptcy court erred by not amending its scheduling order to allow the creditor a second bite at the apple. A bankruptcy court may modify a scheduling order "for cause," Fed. R. Bankr. P. 9006(b)(1), and we review its decision whether to do so for abuse of discretion, *see In re Zilog, Inc.*, 450 F.3d 996, 1006–07 (9th Cir. 2006). We assume without deciding that a court should modify a scheduling order to allow a creditor to change its § 1111(b) election after a material alteration to the original plan. *See In re Scarsdale Realty Partners, L.P.*, 232 B.R. 300, 300 (Bankr. S.D.N.Y. 1999); *see also In re Keller*, 47 B.R. 725, 730 (Bankr. N.D. Iowa 1985). But, in this case, we agree with the district court that the only alteration in the plan— the increased valuation of the collateral—was not material to the election decision.

***8** When First Southern made its election, the plan provided for 40 years of payments of principal and interest providing the creditor with the present value of its $2.6 million secured claim, with a final balloon payment covering the remainder of the debt. After remand, as the district court noted, "First Southern's treatment under the plan as modified remains the same; the only difference is that its annual payments will be more and the balloon payment at the end of the 40 years will be less." Significantly, the amended plan of reorganization did not alter the treatment of unsecured claims, which are to be paid without interest in 40 years, or immediately at five cents on the dollar. Thus, First Southern knew at the time of the initial election "the prospects of its treatment under the plan," *Keller*, 47 B.R. at 729 (quoting Fed. R. Bankr. P. 3014 advisory committee note), yet it opted to treat its entire claim as secured.

Allowing a second election would give First Southern a second chance to object to the plan, this time both as a secured and unsecured creditor and, given the potential size of the unsecured claim, the ability to prevent approval of the reorganization plan. *See* 11 U.S.C. § 1129(a)(7)(A)(ii). But this is precisely the option First Southern had at the time of its first election, when it chose to forgo having any portion of its claim treated as unsecured, instead seeking to increase the

valuation of its secured claim through appeal. That gambit failed, and the bankruptcy court did not err when it rejected First Southern's attempt to turn back the clock and torpedo the plan of reorganization.

CONCLUSION

We **AFFIRM** the judgment of the district court.[5]

KOZINSKI, Circuit Judge, with whom Circuit Judges O'SCANNLAIN and FRIEDLAND join, dissenting: Today's opinion claims to "take the Supreme Court at its word," but it fetishizes a selection of the Court's words at the expense of its logic. This cramped formalism produces a strange result: Even though the Court has told us that cramdown valuations are supposed to limit a secured creditor's risk, we've adopted a new valuation standard that turns entirely on the debtor's desires— creditors be damned. Instead of holding the valuation hostage to the debtor's "particular use," I would hold that the appropriate value is the market price of the building without restrictive covenants.[1]

The majority purports to rely on *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), but *Rash* never adopted today's strict "particular use" interpretation of replacement value. The Court was more flexible: "Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property." *Id.* at 965 n.6. After all, the bare notion of "replacement value" isn't self-interpreting. A conservation-minded owner may prefer to see his lands stay wild. He may adopt an easement to keep them that way, and may not care that this drastically reduces the commercial value of the property. But the owner's preferences don't shape the market value of an undeveloped acre—which is what the owner who actually *did* buy new replacement property would have to pay.

***9** What interpretation of "replacement value" should we use? Unhelpfully, *Rash* offers few specifics on how the nature of the property and the debtor should affect valuation.[2] But *Rash* expressly notes that replacement value shouldn't include certain warranties and modifications that drive a wedge between private value and market value. *See id.* And *Rash* was unambiguously motivated by a desire to reduce what it saw as the "double risks" that cramdowns pose for creditors: "The debtor may again default and the property may deteriorate from extended use." *Id.* at 962. With these risks in mind, the *Rash* Court adopted a broad standard—the typically higher replacement value over the typically lower foreclosure value—that would give secured creditors their due protection. *See also Till* v. *SCS Credit Corp.*, 541 U.S. 465, 489 (2004) (Thomas, J., concurring) (noting that creditors are "compensated in part for the risk of nonpayment through the valuation of the secured claim" because *Rash* used a "securedcreditor-friendly replacement-value standard rather than the lower foreclosure-value standard"). A moment's reflection reveals why today's holding is at odds with these motivations: The majority's valuation falls well below what the secured creditor would obtain from an immediate sale.[3]

In short, the majority has adopted a test that is not dictated by the letter of *Rash* and is contradicted by its reasoning. For these reasons, and those offered by Judge Clifton in his panel opinion, *In re Sunnyslope Hous. Ltd. P'ship*, 818 F.3d 937 (9th Cir. 2016), I dissent.

All Citations

--- F.3d ----, 2017 WL 2294746, 64 Bankr.Ct.Dec. 51, 17 Cal. Daily Op. Serv. 4889

Footnotes

1 The panel unanimously rejected Sunnyslope's contention that the appeal was equitably moot because the plan of reorganization had gone into effect during the appeal. *Sunnyslope*, 818 F.3d at 945 (majority); *id.* at 950 n.1 (dissent). And, because the panel reversed the order approving the reorganization plan on the valuation issue, it pretermitted the other issues raised by the parties. *See id.* at 949 n.6 (majority).

2 *Rash* used the term "replacement" value, but noted that the term is consistent with the "fair-market" valuation nomenclature that we used in *Taffi*. *Rash*, 520 U.S. at 959 n.2.

3 The dissent correctly notes the statement in *Rash* that "[w]hether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property." 520 U.S. at 965 n.6. But the very footnote in which that language appears stresses "that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases." *Id.* Given the Court's plain injunction that "actual use, not a

foreclosure sale that will not take place, is the proper guide" to determining replacement value, *id.* at 963, a bankruptcy court surely cannot premise a § 506(a) valuation on a hypothetical foreclosure. And, First Southern had no ability to sell the property free and clear of the low-income restrictions absent such a foreclosure.

4 First Southern contends that the bankruptcy court erred by considering the chance of a second default as a credit enhancement. But if Sunnyslope defaults a second time, First Southern can foreclose and obtain a property worth more than the court's § 506(a)(1) valuation. *See Till*, 541 U.S. at 479 (noting that risk can be evaluated in light of "the nature of the security").

5 Sunnyslope's cross-appeal argues that the tax credits should not have been included in the valuation of the security. At oral argument, counsel for Sunnyslope stated that this argument would be withdrawn if the bankruptcy court's valuation were otherwise affirmed. Given our conclusions above, we do not address the tax credit issue. In the exercise of our discretion, we also decline to address Sunnyslope's argument that the appeal is equitably moot. *See In re Transwest Resort Props., Inc.*, 801 F.3d 1161, 1167 (9th Cir. 2015) (noting that "[e]quitable mootness is a prudential doctrine").

1 In this case, the price a buyer would have to pay on the market for like property may be closely approximated by "foreclosure value." That coincidence drives the majority's analysis, but it does nothing to answer the real question presented by this case: Whether the market valuation commanded by *Rash* turns on a debtor's idiosyncratic use of the particular property. It does not.

2 The fact that *Rash* does not adopt a strict definition of "replacement value" and offers little guidance on how to apply it has been widely appreciated by other courts and commentators. *See, e.g.*, Charles Jordan Tabb, *Law of Bankruptcy* 741 (4th ed. 2016) (describing footnote 6 of *Rash* as a "substantial opening" that has allowed a wide variety of valuation standards to flourish). I make no effort to defend *Rash*, which has been subject to abundant criticism along these lines. But I also see no reason to step beyond it, as today's majority does.

3 In my view, much of this risk will be passed on to borrowers in the form of higher interest rates—in which case, the joke's on future Sunnyslopes. Regardless, the Supreme Court expressly held that "[a]djustments in the interest rate and secured creditor demands for more 'adequate protection' do not fully offset" the risks of cramdowns. 520 U.S. at 962–63 (quoting 11 U.S.C. § 361). Of course, one reason for ex-post credit risk might be *Rash* itself: It's hard for parties to bargain in the shadow of an unclear rule.

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2017 WL 2345708
United States Bankruptcy Appellate Panel
of the Ninth Circuit.

IN RE: Ahmad J. TUKHI, Debtor.
Abdul Habib Olomi, Appellant,
v.
Ahmad J. Tukhi, Appellee.

BAP No. CC–16–1318–KuFL
|
Bk. No. 8:15–bk–14015–MW
|
Adv. No. 8:15–ap–01449–MW
|
Argued and Submitted on March 23, 2017 at Pasadena, California
|
Filed—May 30, 2017

Synopsis

Background: Creditor filed adversary complaint against Chapter 7 debtor, seeking determination that debt arising out of motor vehicle collision should be excepted from discharge as one for debtor's willful and malicious injury. The United States Bankruptcy Court for the Central District of California subsequently dismissed complaint as sanction for creditor's failure to comply with local bankruptcy rule relating to pretrial conferences. Following denial of creditor's motion for reconsideration, 560 B.R. 326, creditor appealed.

Holdings: The Bankruptcy Appellate Panel, Kurtz, J., held that:

[1] bankruptcy court abused its discretion in dismissingcreditor's nondischargeability complaint as sanction for creditor's violation of local rule, and

[2] bankruptcy court abused its discretion in dismissingcreditor's nondischargeability complaint, to extent that dismissal order was based on lack of prosecution.

Vacated and remanded.

West Headnotes (15)

[1] Bankruptcy

Notice of Appeal; T ime

On appeal from bankruptcy court order dismissing creditor's nondischargeability complaint, the Bankruptcy Appellate Panel did not have jurisdiction to review bankruptcy court's denial of postjudgment motion to alter or amend dismissal order, from which no notice of appeal was ever filed. 11 U.S.C.A. § 523(a); Fed. R. Bankr. P. 8002(b)(3).

Cases that cite this headnote

[2] Bankruptcy

Particular cases and issues

In reviewing bankruptcy court's judgment of dismissal, Bankruptcy Appellate Panel had jurisdiction, and duty, to review any enhanced findings or new factual determinations that bankruptcy court made in support of its original ruling, even if those enhanced findings were part of the court's ruling on motion to alter or amend judgment that never was appealed, and even if the court, in denying motion to alter or amend, considered and relied on evidence that was not presented until after bankruptcy court made its original ruling.

Cases that cite this headnote

[3] Bankruptcy

Discretion

Bankruptcy Appellate Panel reviews for abuse of discretion a bankruptcy court's dismissal of cause of action for failure to comply with local rule.

Cases that cite this headnote

[4] Bankruptcy

Discretion

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Bankruptcy Appellate Panel reviews for abuse of discretion a bankruptcy court's dismissal for lack of prosecution.

Cases that cite this headnote

[5] Bankruptcy

Conclusions of law; d e novo review

Bankruptcy

Discretion

Bankruptcy

Clear error

Bankruptcy Appellate Panel employs twopart test to determine whether bankruptcy court abused its discretion, under which it first reviews de novo whether bankruptcy court identified and applied the correct legal rule, and then examines bankruptcy court's factual findings under "clear error" standard.

Cases that cite this headnote

[6] Bankruptcy

Findings of Fact

Bankruptcy Appellate Panel must uphold bankruptcy court's factual findings unless they were (1) illogical, (2) implausible, or (3) without support in inferences that may be drawn from facts in the record. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[7] Bankruptcy

Pleading; d ismissal

Dismissal sanctions based on local rule violations must be supported by finding of degree of culpability higher than mere negligence or fault, such as willfulness, bad faith, recklessness, or gross negligence or repeated disregard of court rules.

Cases that cite this headnote

[8] Bankruptcy

Frivolity or bad faith; s anctions

Any sanctions order based on a local rule violation must be proportionate to the offense and commensurate with principles of restraint and dignity inherent in judicial power.

Cases that cite this headnote

[9] Bankruptcy

Pleading; d ismissal

Prior to dismissing a proceeding as sanction for a local rules violation, bankruptcy court must consider (1) the public's interest in expeditious resolution of litigation, (2) the court's need to manage its docket, (3) the risk of prejudice to defendants, (4) the public policy favoring disposition of cases on their merits, and (5) the availability of less drastic sanctions.

Cases that cite this headnote

[10] Bankruptcy

Hearing and Determination; D efault

Bankruptcy court abused its discretion in dismissing creditor's nondischargeability complaint as sanction for creditor's violation of local rule in not timely filing a required joint pretrial stipulation, where creditor did not have history of noncompliance or disobedience of local rules, and where only evidence in record was that creditor's faIlure to file this joint pretrial stipulation was result of simple misreading of local rules by creditor's attorney. U.S.Bankr..Ct.Rules C.D.Cal., Rule 7016-1(f).

Cases that cite this headnote

[11] Bankruptcy

Pleading; d ismissal

Dismissal for failure to prosecute must be supported by a showing of unreasonable delay and by consideration of the five *Henderson* factors: (1) the public's interest in

expeditious resolution of litigation; (2) the court's need to manage its docket; (3) the risk of prejudice to defendants; (4) the public policy favoring disposition of cases on their merits; and (5) the availability of less drastic sanctions.

Cases that cite this headnote

[12] Bankruptcy

Pleading; d ismissal

While no showing of heightened culpability is required in order to dismiss for lack of prosecution, the delaying party's mental state is generally relevant, and bankruptcy court should consider any excuse offered by the delaying party in the process of determining whether the delay was unreasonable and whether there is risk of prejudice to adverse party.

Cases that cite this headnote

[13] Bankruptcy

Hearing and Determination; D efault

Bankruptcy court abused its discretion in dismissing creditor's nondischargeability complaint, to extent that dismissal order was based on lack of prosecution, where debtor had requested an even longer delay in resolution of nondischargeability claim than that necessitated by creditor's delay, and thus was not at risk of being prejudiced by this lack of prosecution, where creditor had no history of impeding progress of proceeding, of kind sufficient to undercut the public interest in deciding proceedings on their merits, and where bankruptcy court failed to adequately consider potential of alternative lesser sanctions to secure future compliance from creditor. 11 U.S.C.A. § 523(a).

Cases that cite this headnote

[14] Bankruptcy

Particular cases and issues

On appeal from bankruptcy court order dismissing a proceeding for lack of prosecution, bankruptcy appellate court must give significant deference to bankruptcy court's assessment of whether plaintiff's delay implicated the public interest, because bankruptcy court is in best position to determine what amount of delay reasonably can be endured.

Cases that cite this headnote

[15] Bankruptcy

Discretion

Bankruptcy appellate courts generally should defer to bankruptcy court's assessment of what action is needed to facilitate the court's management of its own docket.

Cases that cite this headnote

Appeal from the United States Bankruptcy Court for the Central District of California, Honorable Mark S. Wallace, Bankruptcy Judge, Presiding

Attorneys and Law Firms

Nikolaus W. Reed argued for appellant;

Randal Paul Mroczynski of Cooksey, Toolen, Gage, Duffy & Woog argued for appellee.

Before: KURTZ, FARIS and LAFFERTY, Bankruptcy Judges.

OPINION

KURTZ, Bankruptcy Judge:

INTRODUCTION

***1** Abdul Habib **Olomi** appeals from a judgment dismissing his nondischargeability action against chapter 7[1] debtor Ahmad J. **Tukhi**. The bankruptcy court dismissed the action because **Olomi** appeared for a pretrial conference without having filed or served a pretrial stipulation as required by the bankruptcy court's Local Rule 7016–1(b) and (c). According to the bankruptcy court, **Olomi's** noncompliance was the result of the "fault" of his counsel but was neither willful nor done in bad faith.

Even though this one-time act of noncompliance would have resulted merely in several weeks of delay in the pretrial proceedings, the bankruptcy court held that dismissal was appropriate either under its Local Rule 7016–1(f) sanctioning authority or as a failure to prosecute under Civil Rule 41(b) (made applicable in adversary proceedings by Rule 7041). The bankruptcy court's dismissal order was an abuse of discretion. The bankruptcy court did not apply the correct legal standard before imposing the sanction of dismissal based on a Local Rule violation. Furthermore, the facts in the record do not support dismissal either based on the Local Rule violation or based on a failure to prosecute.

Accordingly, the bankruptcy court's judgment of dismissal is VACATED, and this matter is REMANDED for completion of pretrial proceedings and the setting of a trial date.

FACTS

Tukhi commenced his bankruptcy case in August 2015, and **Olomi** timely filed a nondischargeability complaint against **Tukhi** in November 2015. **Olomi** stated a single claim for relief under § 523(a)(6) for a debt allegedly arising from a willful and malicious injury. According to **Olomi**, **Tukhi** intentionally struck him with an automobile.

The nondischargeability action proceeded without incident – even smoothly – up until the time the parties' joint pretrial stipulation was due. In the bankruptcy court's scheduling order entered March 7, 2016, the bankruptcy court set a pretrial conference date of September 28, 2016. The scheduling order contained the following warning:

> **The parties are placed on notice that it is the Court's policy to strictly enforce the Local Bankruptcy Rules relating to pre-trial conferences and this Court's procedures supplement to those rules, which are published on the court's website. Failure to comply with the provisions of this order may subject the responsible party to sanctions, including judgment of dismissal or the entry of a default and a striking of the answer.**

Scheduling Order (Mar. 7, 2016) at pp. 2–3 (emphasis in original).

The bankruptcy court obviously considered it extremely important to obtain the litigants' compliance with its pretrial procedures. The scheduling order admonition was the fourth of four advance warnings regarding the importance of adhering to required pretrial procedures. At the initial status conference held immediately before the scheduling order was issued, the bankruptcy court stated as follows:

> ***2** THE COURT: And the Court wishes to advise the parties that the Court applies the Local Bankruptcy Rules relating to pretrial conferences very strictly. The Court views the pretrial conference as an indispensable part of the resolution of this matter and probably the second most important proceeding after the trial itself.
>
> And for that reason, it's the Court's practice that if there is a material default by the plaintiff in compliance with the Local Bankruptcy Rules relating to pretrial conferences, the most likely outcome is that the Court will grant judgment of dismissal in favor of the defendant and, on the other hand, if there's a material default by the defendant, the Court's most likely outcome is that the Court would strike the answer and enter a default.
>
> These consequences are in the nature of terminating sanctions. The Court believes that those types of—that that type of sanction is appropriate in connection with pretrial conferences because to allow a material breach of those rules and to simply impose a monetary sanctions it could be viewed as setting up a situation where there's simply a toll charge for violating the Local Bankruptcy Rules and I don't think that's appropriate. So the parties are on notice of the Court's intentions in this regard and the Court will certainly be looking to the parties to fully comply with those Local Bankruptcy Rules.

Hr'g Tr. (Mar. 2, 2016) at 4:14–5:15.[2]

There were similar warnings about the importance of the pretrial procedures in form instructions accompanying the summons and in the presiding judge's supplemental procedures set forth on the court's website. Indeed, the form instructions accompanying the summons stated:

> **11. Joint Pre–Trial Order. Failure to timely file a Joint Pre–Trial order may subject the responsible party and/ or counsel to sanctions, which may include dismissal of the adversary proceeding. The failure of either party to cooperate in the**

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> **preparation of timely filing of a Joint Pre–Trial Conference [sic] or appear at the Joint Pre– Trial Conference may result in the imposition of sanctions under LBR 7016–1(f) or (g).**

Early meeting of Counsel and Status Conference Instructions (Nov. 19, 2015) at ¶ 11 (emphasis in original).

Notwithstanding all of these warnings, and the unequivocal requirement set forth in Local Rule 7016– 1(b) and (c) for the preparation, service and filing of a joint pretrial stipulation in advance of the pretrial conference, **Olomi** attended the pretrial conference without having first served or filed the requisite pretrial stipulation. When the court asked **Olomi's** counsel where his pretrial stipulation was, counsel explained that he had mistakenly prepared and filed instead a joint status report because he was inexperienced in practicing before the bankruptcy court and had misread what the "statute" required. The bankruptcy court seemed to credit counsel's explanation for his noncompliance but nonetheless concluded that dismissal was appropriate under Local Rule 7016–1(f)(4). The court reasoned that dismissal was justified because: (1) the pretrial conference and the pretrial procedures were very important; (2) **Olomi** had been warned of that importance and of the consequences for failure to comply; and (3) lesser sanctions in the form of monetary sanctions would amount to nothing more than a "toll charge" for violating the very important pretrial procedures. The bankruptcy court reiterated the same reasoning in its written order of dismissal.

***3** Within a few days of the bankruptcy court's dismissal ruling, **Olomi** simultaneously filed both a notice of appeal and a motion for reconsideration. **Olomi** explicitly based his reconsideration motion on Civil Rule 60(b)(1), as made applicable in bankruptcy cases pursuant to Rule 9024. **Olomi** maintained that the court should grant him relief from his excusable neglect under the factors set forth in Pioneer Investment Services v. Brunswick Assocs., 507 U.S. 380, 395, 113 S.Ct. 1489, 123 L.Ed.2d 74 (1993).

Olomi's counsel filed a declaration in support of the reconsideration motion in which he elaborated on his efforts to comply with the court's pretrial procedures. As **Olomi's** counsel put it, he and his paralegal "discussed and reviewed" the Local Rules in July 2016 and prepared a draft joint pretrial stipulation as well as a draft joint status report at the time. However, in September 2016, when it came time to submit these documents, he asserts that he only found the draft joint status report on his computer, and he did not recall the Local Rule requirement to file and serve the draft joint pretrial stipulation. According to **Olomi's** counsel, he carefully reviewed the March 2016 scheduling order and also reviewed the docket, and neither mentioned any deadline for filing or serving a joint pretrial stipulation, so he (erroneously) thought that filing and serving the joint status report would comply with the relevant pretrial procedures.

After full briefing and a hearing, the bankruptcy court took the matter under submission and ultimately issued a nine-page memorandum decision and order denying the reconsideration motion. Even though **Olomi** specifically asked for relief under Rule 9024 and Civil Rule 60(b), the bankruptcy court treated **Olomi's** motion as a motion to alter or amend the judgment under Rule 9023 and Civil Rule 59(e). In relevant part, the bankruptcy court ruled that it did not commit any manifest error of law when it dismissed **Olomi's** adversary proceeding. Interestingly, in making this ruling, the court analyzed the dismissal as if it were based on a failure to prosecute under Rule 7041 and Civil Rule 41(b); in contrast, at the time of the pretrial conference, the court had based the dismissal on violation of Local Rule 7016–1(c) and (e) –sanctionable pursuant to Local Rule 7016–1(f).

In any event, after considering the additional evidence submitted in support of the postjudgment motion, identifying the five-part test for dismissals for failure to prosecute and enhancing its findings in support of its dismissal ruling, the bankruptcy court concluded that the dismissal did not constitute a manifest injustice and that the postjudgment motion should be denied.

Olomi timely appealed the judgment of dismissal, but he did not file a new or amended notice of appeal from the order denying his postjudgment motion.

JURISDICTION

The bankruptcy court had jurisdiction pursuant to 28 U.S.C. §§ 1334 and 157(b)(2)(I), and we have jurisdiction under 28 U.S.C. § 158 to review the bankruptcy court's judgment of dismissal.

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[1] We do not have jurisdiction to review the bankruptcy court's order denying **Olomi's** postjudgment motion. As the governing Rule specifies:

> If a party intends to challenge an order disposing of any motion listed in subdivision (b)(1) ... the party must file a notice of appeal or an amended notice of appeal. The notice or amended notice must ... be filed within the time prescribed by this rule, measured from the entry of the order disposing of the last such remaining motion.

***4** Rule 8002(b)(3). An appellant's failure to comply with the appeal filing deadlines set forth in Rule 8002 typically deprives us of jurisdiction. See Slimick v. Silva (In re Slimick), 928 F.2d 304, 306 (9th Cir. 1990).

[2] That being said, in reviewing the bankruptcy court's judgment of dismissal, we have jurisdiction (and a duty) to review any enhanced findings or "new factual determinations" the bankruptcy court made in support of its original ruling – even if those enhanced findings were part of the court's ruling on a postjudgment motion that never was appealed and even if the court considered and relied upon evidence that was not presented until after the bankruptcy court made its original ruling. Moldo v. Ash (In re Thomas), 428 F.3d 1266, 1268–69 (9th Cir. 2005) ("The BAP erred in concluding that it lacked jurisdiction to review the bankruptcy court's amended findings"); see also Ash v. Moldo (In re Thomas), 2006 WL 6811032 at *4–7 (9th Cir. BAP 2006) (on remand from Circuit, holding that bankruptcy court's amended findings were clearly erroneous based on evidence submitted to the court as part of postjudgment proceedings).

ISSUE

Did the bankruptcy court abuse its discretion when it dismissed **Olomi's** nondischargeability action?

STANDARDS OF REVIEW

[3] [4] We review a bankruptcy court's local-rules based dismissal for an abuse of discretion. Lee v. Roessler– Lobert (In re Roessler–Lobert), 567 B.R. 560, ––––, 2017 WL 2189520, *4 (9th Cir. BAP May 15, 2017). We similarly review a bankruptcy court's dismissal for lack of prosecution. Omstead v. Dell, Inc., 594 F.3d 1081, 1084 (9th Cir. 2010); Moneymaker v. CoBen (In re Eisen), 31 F.3d 1447, 1451 (9th Cir. 1994).

[5] [6] We employ a two-part test to determine whether the bankruptcy court abused its discretion. United States v. Hinkson, 585 F.3d 1247, 1261–62 (9th Cir. 2009) (en banc). First, we review de novo whether the bankruptcy court identified and applied the correct legal rule. Id. Second, we examine the bankruptcy court's factual findings under the clearly erroneous standard. Id. at 1262 & n.20. We must affirm the bankruptcy court's factual findings unless they were "(1) illogical, (2) implausible, or (3) without support in inferences that may be drawn from the facts in the record." Id. (internal citations omitted).

DISCUSSION

A. Dismissal Based On Local Rule Violation In its original dismissal ruling, the bankruptcy court relied on one of the sanctions provisions in its Local Rules — Local Rule 7016–1(f)(4). On its face, that Local Rule authorized the bankruptcy court to dismiss **Olomi's** action based on his violation of Local Rule 7016–1(b) and (c), which imposed a duty on **Olomi** as the plaintiff to prepare, sign and serve a draft pretrial stipulation.

[7] This Panel has held that dismissal sanctions based on local rule violations must be supported by a finding of a degree of culpability higher than mere negligence or fault, such as "willfulness, bad faith, recklessness, or gross negligence" or a "repeated disregard of court rules." In re Roessler–Lobert, 567 B.R. at ––––, 2017 WL 2189520, *10; see also Kostecki v. Sutton (In re Sutton), 2015 WL 7776658, at *8 (Mem. Dec.) (9th Cir. BAP Dec. 3, 2015); Taylor v. Singh (In re Singh), 2016 WL 770195, at *4–5 (Mem. Dec.) (9th Cir. BAP Feb. 26, 2016).

***5 [8] [9]** In so holding, In re Roessler–Lobert relied on Zambrano v. City of Tustin, 885 F.2d 1473, 1480 (9th Cir. 1989). In addition to requiring the abovereferenced finding assessing the culpability and/or state of mind of the rule violator, Zambrano indicated that any sanctions order based on a local rule violation needed to be "proportionate to the offense and commensurate with principles of restraint and dignity inherent in judicial power." Zambrano, 885 F.2d at 1480. The bankruptcy court also needed to consider: "(1)

the public's interest in expeditious resolution of litigation; (2) the court's need to manage its docket; (3) the risk of prejudice to the defendants; (4) the public policy favoring disposition of cases on their merits[;] and (5) the availability of less drastic sanctions." In re Roessler–Lobert, 567 B.R. at ––––, ––––, 2017 WL 2189520, *5, 10 (citing Henderson v. Duncan, 779 F.2d 1421, 1423 (9th Cir. 1986)).

[10] The bankruptcy court, here, did not consider the three-part Zambrano test. Prejudgment, the court did not consider the culpability or state of mind of **Olomi** or his counsel, nor did the court apply the traditional five-factor dismissal sanctions standard originating from Henderson. In addition, nothing in the court's comments indicated that it ever considered, pre- or postjudgment, whether the dismissal sanction was proportionate to the offense.

Zambrano and In re Roessler–Lobert indicate that we may review the record ourselves and independently determine whether the record supported the bankruptcy court's sanctions ruling. Zambrano, 885 F.2d at 1484 & n.32; In re Roessler–Lobert, 567 B.R. at ––––, 2017 WL 2189520, *5. But the prejudgment record is inadequate to support dismissal under Zambrano and In re Roessler– Lobert. At the time of the pretrial conference, there was no prior history in the adversary proceeding of any delay or noncompliance, and **Olomi's** counsel only stated that he had not filed the required pretrial stipulation because he had misread the rules and had thought a joint status report would be sufficient. Thus, absent a finding that **Olomi's** counsel's explanation was not credible, the record as it existed at that time essentially precluded a finding of culpability sufficient to support dismissal under Zambrano and In re Roessler-Lobert. The same record limitations effectively would have made it impossible to find that dismissal was proportionate to the offense or commensurate with judicial restraint.

Postjudgment, in the process of denying **Olomi's** reconsideration motion, the bankruptcy court specifically considered whether **Olomi's** noncompliance was the result of willfulness, bad faith or fault, and the court explicitly determined that "Plaintiff's failure [was] due to fault." Mem. Dec. (Nov. 10, 2106) at 6:25. As stated above, mere "fault" is insufficient under Zambrano and In re Roessler– Lobert to justify sanctions for violation of a Local Rule.

Nor does the additional evidence in the record regarding **Olomi's** attempts to comply with pretrial procedures persuade us that the record could have supported a gross negligence, recklessness or willfulness finding.

In short, the prejudgment record was insufficient under Zambrano and In re Roessler–Lobert to support the bankruptcy court's dismissal sanction based on a local rule violation, and none of the additional evidence presented or enhanced findings made postjudgment cured that insufficiency.

B. Dismissal Based On A Delay In Prosecution

[11] [12] As stated in the facts section, supra, the bankruptcy court offered a different legal basis for its dismissal sanction when it ruled on **Olomi's** reconsideration motion. According to the court's ruling denying the reconsideration motion, dismissal was appropriate under Civil Rule 41(b) as made applicable in adversary proceedings by Rule 7041. The elements for a Civil Rule 41(b) dismissal for failure to prosecute are different than those set forth above for a dismissal for violation of local court rules. See In re Roessler– Lobert, 567 B.R. at ––––, ––––, 2017 WL 2189520, *5, 10. Dismissal for failure to prosecute must be supported by a showing of unreasonable delay and by consideration of the five Henderson factors. Id. While no showing of heightened culpability is required, the delaying party's mental state typically is relevant, and the bankruptcy court should consider any excuse offered by the delaying party in the process of determining whether the delay was unreasonable and whether there is a risk of prejudice to the adverse party. Id. at –––– & n.8, at *5 & n.8.

***6 [13]** Even though **Olomi** did not appeal the bankruptcy court's order denying his reconsideration motion, we will look at the bankruptcy court's postjudgment findings on each of the five Henderson factors, and we will consider all of the evidence before the court at the time those findings were made. See In re Thomas, 428 F.3d at 1268–69.

1. The Public's Interest In Expeditious Resolution of Litigation

The bankruptcy court found that the public's interest in the expeditious resolution of litigation lightly militated in favor of dismissal. The bankruptcy court acknowledged that the expeditious resolution of litigation was implicated by **Olomi's** noncompliance

only to the extent that the noncompliance resulted in a delay in the resolution of the litigation. As the bankruptcy court explained, the pretrial conference would have been delayed by roughly four to six weeks, so the bankruptcy court determined that this amount of delay implicated the public's interest in expeditious litigation resolution only in a minor way.

[14] While we admit to having some doubt that the noncompliant conduct at issue herein would have had any impact on the timing of the ultimate resolution of **Olomi's** action, the Ninth Circuit requires us to give significant deference to the bankruptcy court's assessment of whether the delay implicated the public interest because the bankruptcy court is in the best position to determine what amount of delay reasonably can be endured. In re Eisen, 31 F.3d at 1451; Tenorio v. Osinga (In re Osinga), 91 B.R. 893, 895 (9th Cir. BAP 1988).

Based on this deference, and on the undisputed fact that **Olomi's** failure to file and serve the pretrial stipulation would have delayed the pretrial conference by several weeks, we hold that the bankruptcy court's finding on the first Henderson factor was not clearly erroneous.

2. The Court's Need To Manage Its Docket The bankruptcy court found that its need to manage its docket militated strongly in favor of dismissal. The court noted that material noncompliance with Local Rule 7016–1 was fairly common notwithstanding the routine warnings the court gave at status conferences and in scheduling orders regarding the importance of the pretrial procedures. In essence, the court reasoned that not issuing terminating sanctions when the litigant completely failed to file or serve a pretrial stipulation would encourage a relaxed and cavalier attitude towards the pretrial stipulation requirement, which in turn would materially contribute to additional congestion on the court's already busy docket.

[15] Again, the Ninth Circuit has counseled that appellate courts generally should defer to the bankruptcy court's assessment of what action is needed to facilitate the court's management of its own docket. In re Eisen, 31 F.3d at 1452; see also Yourish v. Cal. Amplifier, 191 F.3d 983, 991 (9th Cir. 1999) ("Because the district judge was in a superior position to evaluate the effects of delay on her docket, ... we find that this factor strongly favors dismissal."). Based on this deference and on the indisputable delay in the pretrial proceedings, we hold that the bankruptcy court's finding on the second Henderson factor was not clearly erroneous.

3. The Risk Of Prejudice To The Defendant The bankruptcy court found that the four- to sixweek delay in the pretrial proceedings constituted a risk of prejudice to **Tukhi** because the delay in pretrial proceedings might impede **Tukhi's** enjoyment of his fresh start. The court essentially determined that the unreasonable delay caused by **Olomi's** failure to file and serve the pretrial stipulation created a risk of interference with **Tukhi's** ability quickly to go to trial and thereafter enjoy the full benefit of his chapter 7 discharge. Because the length of the delay was relatively minor, the bankruptcy court concluded that this factor only lightly militated in favor of dismissal.

***7** We agree with the bankruptcy court to a point. We agree that a significant delay in resolution of litigation caused by a litigant's unreasonable conduct can cause prejudice to the adverse party under certain circumstances. See Malone v. United States Postal Serv., 833 F.2d 128, 131 (9th Cir. 1987). This is particularly true in bankruptcy cases, when the litigation involves an exception to discharge claim, which clouds the debtor's fresh start by its mere existence. In re Osinga, 91 B.R. at 895; see also Tong v. Sandwell (In re Sandwell), 2005 WL 6960219, at *5 (Mem. Dec.) (9th Cir. BAP June 13, 2005).

However, the record here does not support the bankruptcy court's risk of prejudice finding. The contents of the joint status report presented to the court at the time of the pretrial hearing – and resubmitted to the court as part of **Olomi's** papers in support of his reconsideration motion – reflect that **Tukhi** was advocating for a continuance of the pretrial conference until at least January 2017 and for trial not to be set before February 2017. The status report further indicates that **Tukhi's** scheduling issues were being driven by the congestion of his counsel's trial calendar. When, as here, the debtor **Tukhi** was advocating for even greater delay in the resolution of the nondischargeability action, it is illogical to conclude that **Tukhi** was at risk of being prejudiced by a brief delay resulting from the plaintiff **Olomi's** isolated incident of noncompliance with pretrial procedures.[3]

We therefore hold that the bankruptcy court's finding on the third Henderson factor was clearly erroneous.

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4. The Public Policy Favoring Disposition Of Cases OnTheir Merits

The bankruptcy court conceded that this factor militated against dismissal, but the court posited that the force of this factor was attenuated because Olomi's conduct was impeding the progress of the case towards a merits resolution. The two decisions on which the bankruptcy court relied for this point involved severe obstacles to merits determinations caused by the plaintiff's noncompliant conduct over an extended period of time. Allen v. Bayer Corp. (In re Phenylpropanolamine (PPA) Prod. Liab. Litig.), 460 F.3d 1217, 1237 (9th Cir. 2006) ("failure to comply with [case management order] obligations brought these MDL actions to a standstill"); Alonzo v. City of L.A., No. CV 14–05636–RGK (Minute Order) (C.D. Cal. July 24, 2015) ("Plaintiff failed to produce documents which are necessary for Defendant to adequately litigate this case."). Here, in contrast, Olomi's one-time act of neglect in failing to file and serve a pretrial stipulation did not present anything close to the type of severe impediment to litigation on the merits that was at issue in Allen and Alonzo. Simply put, there was nothing in the record to differentiate the case at bar from the majority of cases in which this factor militates decidedly against dismissal. See, e.g. Yourish, 191 F.3d at 992; Hernandez v. City of El Monte, 138 F.3d 393, 399 (9th Cir. 1998); Malone, 833 F.2d at 133 n.2; see also Gonzalez v. Kitay (In re Kitay), 2015 WL 8550637 at *9 (Mem. Dec.) (9th Cir. BAP Dec. 10, 2015) ("The fourth factor, whether public policy favors disposition of the case on the merits, normally weighs strongly against dismissal.").

***8** Thus, the bankruptcy court's finding on the fourth Henderson factor was clearly erroneous. The policy in favor of litigation on the merits strongly militated against dismissal of Olomi's nondischargeability action, and the bankruptcy court's finding that this factor only weakly militated against dismissal was illogical and not supported by the record.

5. Availability Of Less Drastic Sanctions

In its memorandum decision denying Olomi's reconsideration motion, the bankruptcy court elaborated on its reasoning why alternative lesser sanctions were "unavailable." The court admitted that alternatives "are always available," but it considered such alternatives unwise, inappropriate and improper. The bankruptcy court engaged in a slippery-slope type of analysis in which it concluded that, if it imposed lesser, monetary sanctions against Olomi, pretty soon all litigants would be free to ignore the pretrial stipulation requirement, "knowing that the worst that would happen to them is that they would be required to pay a toll charge in the form of a monetary sanction for this privilege." Mem. Dec. (Nov. 10, 2016) at 8:13–15.

Aside from the logical fallacy evident in the court's reasoning, the court's analysis incorrectly emphasized the perceived systemic impact of a more lenient approach to sanctions, instead of focusing on the potential of alternative lesser sanctions to secure future compliance from Olomi. See In re Singh, 2016 WL 770195 at *9– 10 (rejecting a similar alternative lesser sanctions analysis that emphasized systemic concerns over what was needed on a case-specific basis to secure litigant compliance).

Here, Olomi had no prior history of noncompliance. While his efforts to ascertain and follow the court's pretrial procedures were clearly inadequate, there is nothing in the record to indicate that a monetary/compensatory sanction would have been insufficient to obtain his future compliance. Consequently, the bankruptcy court's finding on the fifth Henderson factor was clearly erroneous.[4]

Additionally, the bankruptcy court's emphasis on the perceived systemic effect of a more lenient approach to sanctions rendered its dismissal sanction wholly disproportionate to Olomi's one-time act of noncompliance. A dismissal sanction cannot ever really satisfy the fifth Henderson factor without some thought given to the proportionality of the sanction to the misconduct. See In re Roessler–Lobert, 567 B.R. at –––– & n.13, 2017 WL 2189520, *10 & n.13 (noting that concept of proportionality is largely subsumed within the fifth Henderson factor).

6. Results From Application Of The Henderson Factors Only the first two of the five Henderson factors militated in favor of dismissal. There was no demonstration of a genuine risk of prejudice to Tukhi, nor were effective alternative lesser sanctions shown to be unavailable. Furthermore, the policy favoring decisions on the merits strongly militated against dismissal.

***9** At bottom, the bankruptcy court appears to have given inordinate weight to its concern over its overcrowded docket and the systemic effect a more lenient sanctions policy might have on its ability quickly and efficiently to

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move cases on its docket towards resolution. We sympathize with the bankruptcy court's palpable frustration with litigants who do not pay adequate attention to court procedures and the very real impact their inattention has on the court's ability expeditiously to administer justice. Even so, that sympathy does not permit us to gloss over the established legal standards for imposing terminating sanctions on plaintiffs.

In sum, the bankruptcy court abused its discretion in dismissing **Olomi's** nondischargeability action based

Footnotes

either on his violation of Local Rule 7016–1(b) and (c) or on his delay in prosecution of the adversary proceeding.

CONCLUSION

For the reasons set forth above, the bankruptcy court's judgment dismissing **Olomi's** adversary proceeding is VACATED, and this matter is REMANDED for completion of pretrial proceedings and the setting of a trial date.

All Citations

--- B.R. ----, 2017 WL 2345708, 64 Bankr.Ct.Dec. 45

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. All "Civil Rule" references are to the Federal Rules of Civil Procedure, and all "Local Rule" references are to the Local Rules of the United States Bankruptcy Court for the Central District of California.

2 Neither party included in their excerpts of record a copy of the transcript from the March 2, 2016 status conference. Nonetheless, we can consider the contents of this transcript, which we obtained by accessing the bankruptcy court's electronic docket. See Franklin High Yield Tax–Free Income Fund v. City of Stockton, Cal. (In re City of Stockton, Cal.), 542 B.R. 261, 265 n.2 (9th Cir. BAP 2015).

3 For purposes of prejudice, it also is worth noting that Local Rule 7016–1(e)(2) prescribes procedures parties other than plaintiff must take when the plaintiff fails to comply with the pretrial stipulation requirement. It is undisputed here that **Tukhi** did not follow these procedures. If **Tukhi** had been concerned about potential prejudice arising from the delay caused by **Olomi's** failure to file and serve the pretrial stipulation, **Tukhi** could have helped to keep the matter on track by filing and serving the declaration prescribed in Local Rule 7016–1(e)(2).

4 Sometimes, a prior warning that noncompliance will result in dismissal can serve as a substitute to consideration of alternative lesser sanctions. Yourish, 191 F.3d at 992; see also Pagtalunan v. Galaza, 291 F.3d 639, 643 (9th Cir. 2002). This substitution theory apparently is based on the notion that the threat of dismissal is, itself, a form of alternative lesser sanction, and if that does not secure compliance, the trial court has discharged its duty to consider alternative lesser sanctions. Pagtalunan, 291 F.3d at 643. But this substitute to considering alternative lesser sanctions typically applies only when the dismissal warnings were made in response to prior noncompliance. Id.; Yourish, 191 F.3d at 992.

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See also U.S. Ct. of App. 11th Cir. Rule 36-
2. United States Court of Appeals, Eleventh
Circuit.

Gayle HELMAN, an individual, Plaintiff-Appellant,
v.
BANK OF AMERICA, successor by merger to BAC Home Loan Servicing, LP, f.k.a. Countrywide Home Loan Servicing, LP, Defendant-Appellee.

No. 15-13672
|
(April 12, 2017)

Appeal from the United States District Court for the Southern District of Florida, D.C. No. 9:12-cv-80808-KLR

Attorneys and Law Firms

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Before MARCUS, ANDERSON, and GINSBURG,[*] Circuit Judges.

Opinion

PER CURIAM:

***1** Plaintiff-appellant Gayle Helman ("Helman") challenges the dismissal, with prejudice, of her action against defendant-appellee Bank of America, N.A. ("BANA" or "the Bank") for allegedly wrongful practices in connection with the home mortgage loan and home equity line of credit secured by her residence. We have carefully reviewed the briefs of the parties, along with the relevant portions of the record, and we have had the benefit of a vigorous oral argument. For the reasons fully explored at oral argument, and set forth briefly below, we conclude that the judgment of the district court should be affirmed.

I. Background

In 2004, Helman obtained a home mortgage loan and a home equity line of credit from BANA, both of which were secured by her primary residence. In 2009, she filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code in the Bankruptcy Court for the Southern District of Florida. She subsequently received a discharge pursuant to § 727 of the Bankruptcy Code, after which the bankruptcy court issued a final decree and closed the case.

Following Helman's discharge from bankruptcy, BANA continued to send her monthly statements regarding the status of both loans. She responded by filing a putative class action in the Southern District of Florida, alleging violations of both federal and Florida law. Her amended complaint asserted a federal claim under the Fair Debt Collection Practices Act ("FDCPA"), 15 U.S.C. § 1692 et seq., and several Florida state law claims (collectively, "the State Law Claims") for: (1) a violation of the Florida Consumer Collection Practices Act ("FCCPA"), Fla. Stat. § 559.72 et seq.; (2) a violation of the Florida Unfair and Deceptive Trade Practices Act, Fla. Stat. § 501.201 et seq.; (3) common law conversion; (4) fraudulent inducement; and (5) negligent misrepresentation.

BANA filed two motions in response—a motion to dismiss and a motion to refer the case to bankruptcy court. The first argued that the FDCPA claim should be dismissed because BANA was not a "debt collector" as statutorily defined and that Helman failed to state a claim under state law. The second argued that all of the claims were premised on an underlying violation of the bankruptcy injunction that issued upon Helman's discharge from bankruptcy and that the Bankruptcy Code preempted the State Law Claims. The district court agreed and entered an order dismissing the FDCPA claim, finding the State Law Claims preempted, and referring the matter of the alleged injunction violation to the bankruptcy court. Helman filed an appeal to this Court, which we dismissed because it was appealable neither as a final order nor as an interlocutory appeal.

After the parties represented to the bankruptcy court that neither of them was arguing that a violation of the bankruptcy injunction had occurred, the case returned to district court on

motion from Helman. As relevant here, the court declined to reconsider its earlier ruling that BANA was not a debt collector with respect to Helman under the FDCPA and—notwithstanding its earlier ruling on preemption—dismissed the State Law Claims with prejudice for failure to state a claim. This appeal followed.

II. Discussion

***2** We examine first Helman's challenge to the dismissal of her FDCPA claim before turning to the dismissal of her State Law Claims. We review "de novo a district court's dismissal of a complaint, under Federal Rule of Civil Procedure 12(b)(6), for failure to state a claim for relief after accepting the factual allegations of the complaint as true and considering them in the light most favorable to the plaintiff." Starship Enters. of Atlanta, Inc. v. Coweta County, 708 F.3d 1243, 1252 (11th Cir. 2013).

A. Helman's FDCPA Claim

The FDCPA was enacted "to eliminate abusive debt collection practices by debt collectors." 15 U.S.C. § 1692(e). To state a claim under the FDCPA, the complaint must allege that "(1) the plaintiff has been the object of collection activity arising from a consumer debt; (2) the defendant is a debt collector as defined by the statute; and (3) the defendant has engaged in an act or omission prohibited by the FDCPA." Eke v. FirstBank Fla., 779 F.Supp.2d 1354, 1357 (S.D. Fla. 2011). As step two of that three-part test makes clear, "the FDCPA does not apply to all creditors; it applies only to professional debt-collectors." Crawford v. LVNV Funding, LLC, 758 F.3d 1254, 1258 n.3 (11th Cir. 2014). Accordingly, it specifically exempts from its reach "any person collecting or attempting to collect any debt ... to the extent such activity ... concerns a debt which was originated by such person [or] which was not in default at the time it was obtained by such person." 15 U.S.C. § 1692a(6)(F).

We have no trouble concluding that BANA is not a debt collector as that term is defined by the FDCPA. Helman's amended complaint makes clear that she obtained both her home loan and her home equity line of credit from BANA. As the originator of those loans, the Bank is plainly not subject to the provisions of the FDCPA. There is simply no indication that the terms of the statute were meant to apply where, as here, the Bank originated the loans in question and then sought to collect on them.

In addition to falling squarely outside the definition of a debt collector for FDCPA purposes, the Bank also falls squarely inside the definition of a creditor under the same statute. Helman attempts to argue that BANA is not a creditor because, following her bankruptcy discharge, it is no longer someone "to whom a debt is owed." 15 U.S.C. § 1692a(4). However, the FDCPA actually defines a creditor to include "any person who offers or extends credit creating a debt or to whom a debt is owed." Id. (emphasis added). Therefore, regardless of whether

Helman's debt is, in fact, still owed,[1] it is clear to us that BANA extended the credit creating the debt and is, accordingly, a creditor under the FDCPA.

Accordingly, where BANA both clearly is a creditor and clearly is not a debt collector under the terms of the statute, we have no difficulty concluding that the district court's decision to dismiss Helman's FDCPA claim was correct and is due to be affirmed.[2]

B. Helman's State Law Claims

***3** After this matter returned from the bankruptcy court, the district court dismissed each of the State Law Claims for failing to state a claim for relief. On appeal, Helman challenges only the dismissal of her FCCPA, fraudulent inducement, and negligent misrepresentation claims. We discuss first the FCCPA claim before turning to the fraudulent inducement and negligent misrepresentation claims.

Although her amended complaint did not specify under which provision of the FCCPA she was proceeding, the district court treated the action as arising under Fla. Stat. § 559.72(9), which provides:

> In collecting consumer debts, no person shall ... [c]laim, attempt, or threaten to enforce a debt when such person knows that the debt is not legitimate, or assert the existence of some other legal right when such person knows that the right does not exist.

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The FCCPA applies to anyone who attempts to collect a consumer debt which, unlike the FDCPA, brings BANA within its ambit. Therefore, the Bank would be in violation of the FCCPA if it knew that the debt was not "legitimate" or asserted a legal right that did not exist—such as the right to proceed against Helman personally despite the discharge of her personal liability in bankruptcy.

This assertion of a right to proceed personally need not have been explicit; this Court has recognized that violations can occur through implied threats and statements in a communication with a debtor. See, e.g., Caceres v. McCalla Raymer, LLC, 755 F.3d 1299, 1303 & n.2 (11th Cir. 2014). Whether a communication contains an implied assertion of the right to proceed personally is a question we approach from the perspective of the least sophisticated consumer. See LeBlanc v. Unifund CCR

Partners, 601 F.3d 1185, 1193–94 (11th Cir. 2010).[3] While this standard does not impose on consumers a duty " 'to suspect the honesty of those with whom [they] transact[ ] business,' " id. at 1194 (quoting Fed. Trade Comm'n v. Standard Educ. Soc'y, 302 U.S. 112, 116, 58 S.Ct. 113, 115, 82 L.Ed. 141 (1937)), it does presume that they " 'possess a rudimentary amount of information about the world and a willingness to read a collection notice with some care,' " id. (quoting Clomon v. Jackson, 988 F.2d 1314, 1319 (2d Cir. 1993)). Thus, the test strikes a balance between "protecting naïve consumers" and "prevent[ing] liability for bizarre or idiosyncratic interpretations of collection notices." Id. (quoting United States v. Nat'l Fin. Servs., Inc., 98 F.3d 131, 136 (4th Cir. 1996)).

The crux of Helman's claim under the FCCPA, and indeed the basis of each of Helman's claims, is her assertion that the monthly statements[4] sent to her after her bankruptcy discharge were implied assertions of a right to collect against her personally, that BANA knew it had no such right because of her discharge, and that BANA was thus in violation of the FCCPA. BANA, of course, defends that its monthly statements were sent pursuant to its right under 11 U.S.C. § 524(j) to seek "periodic payments associated with a valid security interest in lieu of pursuit of in rem relief to enforce the lien." § 524(j)(3). BANA argues that even a least sophisticated consumer in Helman's shoes would not have been misled by its monthly statements.

***4** We are confident that no consumer—even the least sophisticated one—could have been misled into thinking that BANA was seeking to collect against her personally on the basis of the monthly statements Helman received. As an initial matter, Helman's bankruptcy discharge informed her that it "prohibit [ed] any attempt to collect ... a debt that has been discharged" but that "a creditor may have the right to enforce a valid lien, such as a mortgage or security interest, ... after the bankruptcy, if that lien was not avoided or eliminated." This is consistent with BANA's right to seek payment under 11 U.S.C. § 524.

More significantly, BANA's monthly statements themselves—and in particular, the statements covering the home mortgage—informed even a least sophisticated consumer that BANA recognized Helman was not personally liable, but that the security agreement allows foreclosure if the monthly payments are not made. We recognize that both monthly statements contain terms that courts, including this one, have previously suggested might—in other circumstances—indicate an attempt to collect personally against a debtor. See, e.g., Caceres, 755 F.3d at 1303 n.2. But in the circumstances of this case the express language of the home mortgage monthly statement could not be clearer:

> FORINFORMATIONPURPOSES
>
> ...
>
> **The Impact of the Bankruptcy:** Our records indicate that in the past you received a discharge of this debt in a bankruptcy case. Section 524 of the Bankruptcy Code tells us the discharge of this debt means you have no personal obligation to repay it. The discharge also protects you from any efforts by anyone to collect this discharged debt as a personal liability of the debtor. You cannot be pressured to repay this debt. On the other hand, the security agreement allows foreclosure if the requirements under the loan documents are not met.

A least sophisticated consumer—reading that notice with some care—would be informed that she (1) has no personal obligation to repay the debt; (2) is not personally liable for the debt; and (3) cannot be pressured to repay the debt. We are simply unable to conclude that a debtor, having been so informed, could have been misled into believing that the Bank was implying a right to proceed against her personally.

Similar to the home mortgage statement, the home equity line of credit statement provided that it was:

> being furnished for informational purposes only and should not be construed as an attempt to collect against you personally. While your obligation to Bank of America, N.A. may be discharged, by operation of law, Bank of America, N.A. has retained the ability to enforce its rights against the property securing the loan should there be a default.

Unlike the home mortgage statement however, the language in the home equity statement is preceded by the heading: "If You Are Currently a Debtor in a Bankruptcy." If we were to strain and excuse a consumer who declines altogether to read the message under the heading because she had already been discharged and thus is no longer currently in bankruptcy—and if this monthly statement had to be evaluated in isolation—this home equity monthly statement might have given us some pause about the extent to which a least sophisticated consumer could have been misled.

However, we need not make that determination here because, as we have previously discussed, the home equity statement was far from the only available source of information. The least sophisticated consumer in Helman's position necessarily would have had at least the following knowledge: that she had been through the bankruptcy process and received a discharge; that she had no personal liability on the home mortgage; and that the debt had been discharged but that the bank could still enforce its mortgage. Helman was receiving this information every month in the form of the home mortgage statement. Thus, in order to believe that she was personally liable for these debts, Helman would have had to conclude not only that the language of the home equity statement did not apply to her since she was no longer "currently a debtor in bankruptcy," but that everything else she had been told no longer applied to her either. Such a conclusion—that a single potentially ambiguous communication would override a series of clear and unambiguous communications to the contrary—is exactly the type of "bizarre or idiosyncratic interpretation of collection notices" to which we have refused to give protection even under the least sophisticated consumer standard. We likewise decline to do so here.

***5** Having decided that a least sophisticated consumer could not have been misled by these notices, we have no trouble concluding that Helman's negligent misrepresentation and fraudulent inducement claims were also correctly dismissed. Both of these actions require —as one of their elements—reliance on the part of the plaintiff. See, e.g., Gilchrist Timber Co. v. ITT Rayonier, Inc., 127 F.3d 1390, 1393 (11th Cir. 1997) (negligent misrepresentation); Butler v. Yusem, 44 So.3d 102, 105 (Fla. 2010) (fraudulent inducement).[5] Under Florida law, "a recipient may rely on the truth of a representation ... unless he knows the representation to be false or its falsity is obvious to him." Butler, 44 So.3d at 105. As we have already detailed, Helman knew that her personal liability had been discharged and even the least sophisticated consumer would not have been misled by BANA's actions. Having been so informed, Helman would have known any representations of personal liability to be obviously false and would not have been entitled to rely on them. Accordingly, the district court correctly dismissed these two claims.

III. Conclusion

Given that BANA is not a debt collector as that term is defined by the FDCPA, that a least sophisticated consumer would not have been misled by the monthly statements, and that Helman cannot state a valid claim for fraudulent inducement or negligent misrepresentation, the district court was correct to dismiss all of the claims with prejudice.[6] Accordingly, the decision is due to be

AFFIRMED.

All Citations

--- Fed.Appx. ----, 2017 WL 1350728

Footnotes

* Honorable Douglas H. Ginsburg, United States Circuit Judge for the District of Columbia Circuit, sitting by designation.

1 We need not, and expressly do not, decide whether BANA satisfies the criteria of a creditor for the alternative reason that they are someone "to whom a debt is owed."

2 We also find no merit in Helman's argument that, simply because BANA sought to collect on a debt that it was owed, the Bank somehow transformed itself from a creditor to a debt collector. Such an approach would prevent an FDCPA creditor from ever seeking payment on a loan without subjecting itself to the provisions of the statute.

3 Although LeBlanc, among others, applied the least sophisticated consumer standard to the FDCPA, it is applicable in the FCCPA context as well, given the Florida statute's instruction that "[i]n applying and construing [the FCCPA], due consideration and great weight shall be given to the interpretations of the ... federal courts relating to the federal [FDCPA]." Fla. Stat. § 559.77(5).

4 Helman's complaint and briefs on appeal point only to the monthly statements sent to her as potentially violating the law.

5 In the context of negligent misrepresentation, the plaintiff's reliance must also have been justifiable. See Gilchrist Timber, 127 F.3d at 1393. Helman correctly notes that mere reliance—not justifiable reliance—is sufficient to state a claim for fraudulent inducement under Florida law. See Butler, 44 So.3d at 105.

6 Having affirmed the dismissal of each of the claims on alternative grounds, we need not consider whether the claims are also preempted by the Bankruptcy Code. Additionally, we summarily reject, without the need for further elaboration, any arguments regarding the decision to refer this case to the bankruptcy court. Lastly, Helman clearly failed to put her motion to amend properly in front of the district court, see, e.g., Posner v. Essex Ins. Co., 178 F.3d 1209, 1222 (11th Cir. 1999) ("Where a request for leave to file an amended complaint simply is imbedded within an opposition memorandum, the issue has not been raised properly."), and "also failed to comply with Federal Rule of Civil Procedure 7(b) when [she] failed to attach a copy of [her] proposed amendment or to describe the substance of [her] proposed amendment," Rosenberg v. Gould, 554 F.3d 962, 967 (11th Cir. 2009). Any other challenges on appeal are rejected without the need for further discussion.

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This case was not selected for
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See Fed. Rule of Appellate Procedure 32.1
generally governing citation of judicial
decisions issued on or after Jan. 1, 2007.
See also U.S. Ct. of App. 11th Cir. Rule 36-2.
United States Court of Appeals, Eleventh
Circuit.

IN RE: Alexandra Elizabeth
ACOSTA-CONNIFF, Debtor.
ECMC, a.k.a. Educational Credit
Management Corporation, Plaintiff-Appellee,
v.
Alexandra Elizabeth Acosta-
Conniff, Defendant-Appellant.

No. 16-12884
|
(April 19, 2017)

Synopsis
Background: Chapter 7 debtor, a 44-year-old single mother with two sons, who worked as public school teacher, sought determination that she was entitled to "undue hardship" discharge of her $112,000 in student loan debt. The United States Bankruptcy Court for the Middle District of Alabama, William R. Sawyer, J., 536 B.R. 326, entered judgment in favor of debtor, and student loan creditor appealed The District Court, W. Keith Watkins, Chief Judge, 550 B.R. 557, reversed and remanded. Debtor appealed.

[Holding:] The Court of Appeals held that bankruptcy court's findings as to each of the three prongs of the *Brunner* test for whether debtor was entitled to "undue hardship" discharge of her student loan debt were factual findings, that district court should have reviewed only for clear error.

Vacated and remanded.

West Headnotes (2)

[1] **Bankruptcy**
Particular cases and issues

Bankruptcy court's findings as to each of the three prongs of the *Brunner* test for whether debtor was entitled to "undue hardship" discharge of her student loan debt were factual findings, that district court should have reviewed only for clear error, and not under a de novo standard. 11 U.S.C.A. § 523(a)(8).

Cases that cite this headnote

[2] **Bankruptcy**
Hardship

Chapter 7 debtor's past conduct, in choosing to pursue advanced degree in education despite evidence that it was unlikely to result in significant increase in her earnings, was not factor that court could consider under the second, or "additional circumstances," prong of *Brunner* test for whether debtor was entitled to "undue hardship" discharge of her student loan debt; second prong of test was forward-looking, and was directed at whether additional circumstances demonstrated that debtor's present inability to repay her student loan debt was likely to persist. 11 U.S.C.A. § 523(a)(8).

Cases that cite this headnote

Appeal from the United States District Court for the Middle District of Alabama, D.C. Docket Nos. 2:15cv-00220-WKW, 2:12-bkc-31448-WRS

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Before ROSENBAUM and JULIE CARNES, Circuit Judges, and SCHLESINGER,[*] District Judge.

Opinion

PER CURIAM:

***1** Appellant Alexandra Elizabeth Acosta Conniff ("Conniff") recently emerged from Chapter 7 bankruptcy and was granted a discharge on her outstanding debts. Because the Bankruptcy Code does not, as a general matter, permit student loans to be discharged via bankruptcy, *see* 11 U.S.C. § 523(a)(8), Conniff's student debt totaling $112,000 was excluded from this discharge. There is, however, a narrow exception to this exclusion for a debtor who can show that repayment of her student debt would cause "undue hardship." *Id.*

Conniff argued that she would suffer undue hardship if required to repay the balance of her student debt. Following briefing and a trial, the bankruptcy court concluded that Conniff met her burden of demonstrating undue hardship, and it granted her a complete discharge of her student debt. Conniff's student-loan creditor, Educational Credit Management Corp. ("ECMC"), appealed this decision to the district court, which concluded that Conniff had failed to show undue hardship and accordingly reversed the bankruptcy court's order finding the student debt was dischargeable. Conniff appeals the district court's reversal.

After careful consideration of the record before us, and with the benefit of oral argument, we VACATE the district court's judgment and REMAND for further consideration consistent with this opinion.

STANDARD OF REVIEW

This Court reviews a district court's legal conclusions *de novo*. *See In re Fin. Federated Title & Trust, Inc.*, 309 F.3d 1325, 1328–29 (11th Cir. 2002) (citing *Capital Factors, Inc. v. Empire for Him, Inc. (In re Empire for Him, Inc.)*, 1 F.3d 1156, 1159 (11th Cir. 1993)). Whether a district court has applied the correct standard of review to a bankruptcy court's decision is a legal question that this Court also reviews *de novo*. *See, e.g.*, *Rush v. JLJ Inc. (In re JLJ Inc.)*, 988 F.2d 1112, 1116–17 (11th Cir. 1993).

DISCUSSION

An individual debtor like Conniff may not discharge her student loans through bankruptcy unless she can show that repayment would cause her "undue hardship." 11 U.S.C. § 523(a)(8). The term "undue hardship" is not defined in the Bankruptcy Code. To guide courts' analysis, this circuit has adopted the test set out in *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987) (the "*Brunner* test"). *See Hemar Ins. Corp. v. Cox (In re Cox)*, 338 F.3d 1238, 1241–42 (11th Cir. 2003). Under the *Brunner* test, a debtor is entitled to discharge of her student debts if she proves all of the following:

(1) That the debtor cannot maintain, based on currentincome and living expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans;

(2) That additional circumstances exist indicating thatthis state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and

(3) That the debtor has made good faith efforts to repaythe loans.

Brunner, 831 F.2d at 396.

This three-prong test looks at three different time periods. The first prong focuses on the present ability of the debtor to repay the debt. The second prong looks to the future to determine the unlikelihood that the debtor could become able to repay the loan. The third prong looks to the debtor's past conduct to determine whether her actions in the past have manifested a good faith effort to repay that which she owes. The debtor bears the burden of proving each prong of the *Brunner* test by a preponderance of the evidence. *Educ. Credit Mgmt. Corp. v. Mosley (In re Mosley)*, 494 F.3d 1320, 1324 (11th Cir. 2007).

***2** Following a trial, the bankruptcy court concluded that Conniff met her burden under all three prongs of the *Brunner* test and thus was entitled to discharge. The legal standard applicable to the second prong, which looks to the likelihood that the debtor will continue to be unable to repay the loans, is whether "there is a 'certainty of hopelessness' that the debtor will be able to repay the loans within the repayment period." *Mosley*, 494 F.3d 1320. Addressing this second

prong, the district court disagreed with the bankruptcy court's conclusion that Conniff had met her burden under this prong of the *Brunner* test, and it reversed on that basis. Because Conniff had to prove all three prongs of the test, the district court indicated that Conniff's failure to meet her burden on the second prong meant that it was unnecessary for the court to decide whether she had met the first or third prong.

Conniff argues on appeal that instead of reviewing the bankruptcy court's ruling under a clearly erroneous standard, the district court actually applied a *de novo* standard, substituting its own judgment of the facts for the bankruptcy court's. On appeal from a bankruptcycourt order, a district court reviews findings of fact for clear error and conclusions of law *de novo*. *See In re Fin. Federated Title & Trust, Inc.*, 309 F.3d 1325, 1328–29 (11th Cir. 2002). Because application of the *Brunner* test involves mixed questions of fact and law, *In re Mosley*, 494 F.3d at 1324, it is important that a reviewing court identify the standard of review it is applying in considering the various factual findings and legal conclusions reached by the bankruptcy court.

[1] A bankruptcy court's findings as to each of the three prongs of the *Brunner* test are factual findings that should be reviewed by the district court for clear error; not under a *de novo* standard of review. *Cf. In re Mosley*, 494 F.3d at 1326–27 (indicating that the evidence at trial supported the bankruptcy court's finding that the debtor would be highly unlikely to become able to repay his student loans and that he had made good faith efforts to obtain work to enable him to repay those loans). By contrast, a bankruptcy court's interpretation of any legal question pertinent to its fact finding, including whether or not a debtor is entitled to discharge based on its findings as to the three *Brunner* prongs, is a legal conclusion subject to *de novo* review. *See Hedlund v. Educ. Res. Inst. Inc.*, 718 F.3d 848, 849, 854 n. 10 (9th Cir. 2013) ("In a § 523(a)(8) proceeding, the bankruptcy court's good faith finding" under the third prong of the *Brunner* test "should be reviewed for clear error," but "we review the application of *Brunner de novo*, *i.e.*, whether the bankruptcy court properly applied the three-prong test" in deciding whether a debtor is entitled to discharge based on the *Brunner* findings).

The district court did not, however, indicate whether it was applying a clear error or a *de novo* standard of review when it considered the bankruptcy court's finding as to the second prong of the *Brunner* test, which is the only prong the district court examined. From our review of the district court order, we cannot confidently conclude that the court was applying a clear error standard.

Given this uncertainty, we remand the case to the district court with instructions to apply clear-error review to the bankruptcy court's factual findings as to <u>each</u> prong of the *Brunner* test and *de novo* review to any of the bankruptcy court's legal conclusions. If the district court concludes that it lacks sufficient factual findings to review the bankruptcy court's decision as to any of the three prongs,[1] the district court may remand the matter to the bankruptcy court for further factual findings as it deems necessary.

***3 [2]** Finally, in expressing its disagreement with the bankruptcy court's decision, the district court offers several grounds in support of its reasoning. One of those grounds, however, merits mention. Specifically, in reaching its conclusion that Conniff had not proven the second prong, the district court opined that Conniff has only herself to blame for incurring student debt in the pursuit of multiple degrees that she should have known would not lead to an increase in income sufficient to cover the debt:

> Although she is not satisfied with the pay the advanced degrees ultimately have yielded, Conniff chose to earn four degrees, funded primarily by student loans, in her preferred career path of education with a general understanding of the benefits she would obtain from the degrees versus the costs. She admits specifically that she decided to obtain another student loan to earn her pinnacle Ph.D in special education and agreed to repay it, knowing how the cost of the Ph.D compared with the increase in pay it would provide. (Doc. #2-11, at 31.) Conniff finds herself in circumstances largely of her own informed decision-making, which although not dispositive, is a consideration. *See In Re Brightful*, 267 F.3d 324, 328 (3d Cir. 2001).

From this, the district court concluded, among other things, that "[a]lthough Conniff admittedly finds herself in

undesirable financial difficulties, she ultimately must bear the consequences of her decision to obtain loans in order to pursue her multiple educational goals."

As noted, the second prong is a forward-looking test that focuses on whether a debtor has shown her inability to repay the loan during a significant portion of the repayment period. It does not look backward to assess blame for the student debtor's financial circumstances. Thus, even if the court concludes that a debtor has acted recklessly or foolishly in accumulating her student debt, that does not play into an analysis under the second prong. Nor should it be considered on remand in analysis of that prong.[2]

CONCLUSION

The district court's decision reversing the bankruptcy court's discharge order is VACATED and the matter is REMANDED to the district court for further review consistent with this opinion.

All Citations

--- Fed.Appx. ----, 2017 WL 1396164

Footnotes

* The Honorable Harvey E. Schlesinger, United States District Judge for the Middle District of Florida, sitting by designation.

1 Expressing its uncertainty whether the bankruptcy court's conclusion constituted an effort "to provide an equitable escape from a perceived 'life sentence' of debt," the district court indicated the need for more detailed factual findings by the bankruptcy court as to the reasonableness and necessity of Conniff's expenses and the extent to which she could reduce those expenses. The court further indicated that the bankruptcy court had not spelled out its thinking as to why it had chosen $915 as the benchmark for Conniff's monthly repayment obligations, nor made factual findings regarding her eligibility for a repayment plan that would substantially reduce her monthly payments. Finally, as to Conniff's failure to take advantage of a loan forgiveness program that would have wiped out $17,500 of her debt for every five years she taught special education in a rural district, the district court found the record lacking in explaining why Conniff was unsuccessful in participating in this program and what steps she could have taken to achieve a different result.

2 We neither foreclose nor endorse a possible argument that the third prong, which looks to a debtor's good faith, might be implicated in an extreme case by a debtor who unnecessarily and unreasonably amasses substantial additional debt at a time when she is obligated to pay a student loan, and who then argues that, because she now has so many other bills to pay, she should receive an undue hardship exemption as to her student debt. We merely note that our holding regarding the need to look only to the debtor's future ability to pay applies solely to the second prong.

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2017 WL 2039159
Supreme Court of the United States

MIDLAND FUNDING, LLC, Petitioner
v.
Aleida JOHNSON.

No. 16–348.
|
Argued Jan. 17, 2017.
|
Decided May 15, 2017.

Synopsis

Background: Two Chapter 13 debtors brought separate actions against creditors, alleging that, by filing a proof of claim that disclosed on its face that the claim was barred by the statute of limitations, creditor violated the Fair Debt Collection Practices Act (FDCPA). The United States District Court for the Southern District of Alabama, No. 1:14–CV–00322–WS–C, William H. Steele, J., 528 B.R. 462, dismissed one action, and 1:14–CV–00324–WS–M, granted creditor's motion for judgment on the pleadings in the other action. Debtors appealed, and the actions were consolidated on appeal. The Court of Appeals for the Eleventh Circuit, Martin, Circuit Judge, 823 F.3d 1334, reversed and remanded. Certiorari was granted.

Holdings: The Supreme Court, Justice Breyer, held that:

[1] creditor's proof of claim was not “false, deceptive, ormisleading” within meaning of the FDCPA, and

[2] creditor's proof of claim was not “unfair” or“unconscionable” under the FDCPA.

Reversed.

Justice Sotomayor filed a dissenting opinion in which Justices Ginsburg and Kagan joined.

Justice Gorsuch took no part in the consideration or decision of the case.

West Headnotes (16)

[1] **Antitrust and Trade Regulation**
Practices Prohibited or Required in General
Bankruptcy
Time for Filing

Creditor's filing of proof of claim that on its face indicated that the limitations period on the underlying debt had run was not “false, deceptive, or misleading” within meaning of the Fair Debt Collection Practices Act (FDCPA). 11 U.S.C.A. § 101(5)(A); Fair Debt Collection Practices Act, § 807, 15 U.S.C.A. § 1692e.

Cases that cite this headnote

[2] **Bankruptcy**
Claims Allowable; W hat Constitutes “Claim.”

Under the Bankruptcy Code, a “claim” is a right to payment. 11 U.S.C.A. § 101(5)(A).

Cases that cite this headnote

[3] **Bankruptcy**
Effect of State Law, in General

State law usually determines whether a person has a right to payment and hence a “claim” within meaning of the Bankruptcy Code. 11 U.S.C.A. § 101(5)(A).

Cases that cite this headnote

[4] **Limitation of Actions**
Operation as to Rights or Remedies in General

Under Alabama law, a creditor has the right to payment of a debt even after the limitations period has expired.

Cases that cite this headnote

[5] **Bankruptcy**
Claims Allowable; W hat Constitutes “Claim.”

Congress intended to adopt the broadest available definition of “claim” in the Bankruptcy Code. 11 U.S.C.A. § 101(5)(A).

Cases that cite this headnote

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[6] **Bankruptcy**
Claims Allowable; W hat Constitutes "Claim."

Under the Bankruptcy Code, if a contingency does not arise, or if a claimant loses a dispute, then the claim is unenforceable, but the unenforceable claim is nonetheless a "right to payment" and hence a "claim." 11 U.S.C.A. §§ 101(5)(A), 502(b)(1).

Cases that cite this headnote

[7] **Bankruptcy**
Time for Filing

Under the Bankruptcy Code, the running of a limitations period constitutes an affirmative defense, a defense that the debtor is to assert after a creditor makes a "claim." 11 U.S.C.A. §§ 502, 558.

Cases that cite this headnote

[8] **Federal Civil Procedure**
Limitations and Laches

The law has long treated unenforceability of a claim, due to expiration of the limitations period, as an affirmative defense. Fed.Rules Civ.Proc.Rule 8(c)(1), 28 U.S.C.A.

Cases that cite this headnote

[9] **Antitrust and Trade Regulation**
Communications, Representations, and Notices; D ebtor's Response

To determine whether a statement is "misleading" within meaning of the Fair Debt Collection Practices Act (FDCPA) normally requires consideration of the legal sophistication of its audience. Fair Debt Collection Practices Act, § 807, 15 U.S.C.A. § 1692e.

Cases that cite this headnote

[10] **Bankruptcy**
Time for Filing
Bankruptcy
Objections Generally; T ime, Form, and Sufficiency; P leading

Chapter 13 trustee must examine proofs of claim and, where appropriate, pose an objection, including any timeliness objection. 11 U.S.C.A. §§ 502(b)(1), 558, 704(a)(5), 1302(a), (b)(1).

Cases that cite this headnote

[11] **Antitrust and Trade Regulation**
Practices Prohibited or Required in General
Bankruptcy
Time for Filing

Creditor's filing of proof of claim that on its face indicated that the limitations period on the underlying debt had run was not "unfair" or "unconscionable" within meaning of the Fair Debt Collection Practices Act (FDCPA). 11 U.S.C.A. § 101(5)(A); Consumer Credit Protection Act, § 808, 15 U.S.C.A. § 1692f.

Cases that cite this headnote

[12] **Bankruptcy**
Time for Filing

Chapter 13 trustee normally bears the burden of investigating claims and pointing out that a claim is stale. 11 U.S.C.A. §§ 1302(a), (b)(1), 502(b)(1), 558, 704(a)(5).

Cases that cite this headnote

[13] **Bankruptcy**
Debts Dischargeable

Filing and disallowance of even a stale claim in a Chapter 13 proceeding discharges the debt. 11 U.S.C.A. § 1328(a).

Cases that cite this headnote

[14] **Bankruptcy**
Discharge

Discharge of a debt in a Chapter 13 proceeding means that the debt, even if unenforceable, will not remain on a credit report potentially affecting an individual's ability to borrow money, buy a home, and perhaps secure

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employment. 11 U.S.C.A. § 1328(a); Fair and Accurate Credit Transactions Act of 2003, 15 U.S.C.A. § 1681c(a)(4).

Cases that cite this headnote

[15] Antitrust and Trade Regulation

Debt Collection

Fair Debt Collection Practices Act (FDCPA) seeks to help consumers by preventing consumer bankruptcies in the first place. Fair Debt Collection Practices Act, § 807(a, b, e), 15 U.S.C.A. § 1692e.

Cases that cite this headnote

[16] Bankruptcy

Construction and Operation

Bankruptcy Code creates and maintains the "delicate balance" of a debtor's protections and obligations.

Cases that cite this headnote

Syllabus [*]

***1** Petitioner Midland Funding filed a proof of claim in respondent Johnson's Chapter 13 bankruptcy case, asserting that Johnson owed Midland credit-card debt and noting that the last time any charge appeared on Johnson's account was more than 10 years ago. The relevant statute of limitations under Alabama law is six years. Johnson objected to the claim, and the Bankruptcy Court disallowed it. Johnson then sued Midland, claiming that its filing a proof of claim on an obviously time-barred debt was "false," "deceptive," "misleading," "unconscionable," and "unfair" within the meaning of the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692e, 1692f. The District Court held that the Act did not apply and dismissed the suit. The Eleventh Circuit reversed.

Held : The filing of a proof of claim that is obviously time barred is not a false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the Fair Debt Collection Practices Act. Pp. —— – ——.

(a) Midland's proof of claim was not "false, deceptive, or misleading." The Bankruptcy Code defines the term "claim" as a "right to payment," 11 U.S.C. § 101(5) (A), and state law usually determines whether a person has such a right, see *Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co.,* 549 U.S. 443, 450–451, 127 S.Ct. 1199, 167 L.Ed.2d 178. The relevant Alabama law provides that a creditor has the right to payment of a debt even after the limitations period has expired.

Johnson argues that the word "claim" means "enforceable claim." But the word "enforceable" does not appear in the Code's definition, and Johnson's interpretation is difficult to square with Congress's intent "to adopt the broadest available definition of 'claim,' " *Johnson v. Home State Bank,* 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66. Other Code provisions are still more difficult to square with Johnson's interpretation. For example, § 502(b)(1) says that if a "claim" is "unenforceable" it will be disallowed, not that it is not a "claim." Other provisions make clear that the running of a limitations period constitutes an affirmative defense that a debtor is to assert after the creditor makes a "claim." §§ 502, 558. The law has long treated unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense, and there is nothing misleading or deceptive in the filing of a proof of claim that follows the Code's similar system.

Indeed, to determine whether a statement is misleading normally "requires consideration of the legal sophistication of its audience," *Bates v. State Bar of Ariz.,* 433 U.S. 350, 383, n. 37, 97 S.Ct. 2691, 53 L.Ed.2d 810, which in a Chapter 13 bankruptcy includes a trustee who is likely to understand that a proof of claim is a statement by the creditor that he or she has a right to payment that is subject to disallowance, including disallowance based on untimeliness. Pp. —— – ——.

***2** (b) Several circumstances, taken together, lead to the conclusion that Midland's proof of claim was not "unfair" or "unconscionable" within the terms of the Fair Debt Collection Practices Act.

Johnson points out that several lower courts have found or indicated that, in the context of an ordinary civil action to collect a debt, a debt collector's assertion of a claim known to be time barred is "unfair." But those courts rested their conclusions upon their concern that a consumer might

unwittingly repay a time-barred debt. Such considerations have significantly diminished force in a Chapter 13 bankruptcy, where the consumer initiates the proceeding, see §§ 301, 303(a); where a knowledgeable trustee is available, see § 1302(a); where procedural rules more directly guide the evaluation of claims, see Fed. Rule Bkrtcy. Proc. 3001(c)(3)(A); and where the claims resolution process is "generally a more streamlined and less unnerving prospect for a debtor than facing a collection lawsuit," *In re Gatewood,* 533 B.R. 905, 909.

Also unpersuasive is Johnson's argument that there is no legitimate reason for allowing a practice like this one that risks harm to the debtor. The bankruptcy system treats untimeliness as an affirmative defense and normally gives the trustee the burden of investigating claims to see if one is stale. And, at least on occasion, the assertion of even a stale claim can benefit the debtor.

More importantly, a change in the simple affirmativedefense approach, carving out an exception, would require defining the exception's boundaries. Does it apply only where a claim's staleness appears on the face of the proof of claim? Does it apply to other affirmative defenses or only to the running of the limitations period? Neither the Fair Debt Collection Practices Act nor the Bankruptcy Code indicates that Congress intended an ordinary civil court applying the Act to determine answers to such bankruptcy-related questions. The Act and the Code have different purposes and structural features. The Act seeks to help consumers by preventing consumer bankruptcies in the first place, while the Code creates and maintains the "delicate balance of a debtor's protections and obligations," *Kokoszka v. Belford,* 417 U.S. 642, 651, 94 S.Ct. 2431, 41 L.Ed.2d 374. Applying the Act in this context would upset that "delicate balance."

Contrary to the argument of the United States, the promulgation of Bankruptcy Rule 9011 did not resolve this issue. Pp. —— – ——.

823 F.3d 1334, reversed.

BREYER, J., delivered the opinion of the Court, in which ROBERTS, C.J., and KENNEDY, THOMAS, and ALITO, JJ., joined. SOTOMAYOR, J., filed a dissenting opinion, in which GINSBURG and KAGAN, JJ., joined. GORSUCH, J., took no part in the consideration or decision of the case.

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Opinion

Justice BREYER delivered the opinion of the Court.

***3** The Fair Debt Collection Practices Act, 91 Stat. 874, 15 U.S.C. § 1692 *et seq.,* prohibits a debt collector from asserting any "false, deceptive, or misleading representation," or using any "unfair or unconscionable means" to collect, or attempt to collect, a debt, §§ 1692e, 1692f. In this case, a debt collector filed a written statement in a Chapter 13 bankruptcy proceeding claiming that the debtor owed the debt collector money.

The statement made clear, however, that the 6–year statute of limitations governing collection of the claimed debt had long since run. The question before us is whether the debt collector's filing of that statement falls within the scope of the aforementioned provisions of the Fair Debt Collection Practices Act. We conclude that it does not.

I

In March 2014, Aleida Johnson, the respondent, filed for personal bankruptcy under Chapter 13 of the Bankruptcy Code (or Code), 11 U.S.C. § 1301 *et seq.,* in the Federal District Court for the Southern District of Alabama. Two

months later, Midland Funding, LLC, the petitioner, filed a "proof of claim," a written statement asserting that Johnson owed Midland a credit-card debt of $1,879.71. The statement added that the last time any charge appeared on Johnson's account was in May 2003, more than 10 years before Johnson filed for bankruptcy. The relevant statute of limitations is six years. See Ala. Code § 6–2–34 (2014). Johnson, represented by counsel, objected to the claim; Midland did not respond to the objection; and the Bankruptcy Court disallowed the claim.

Subsequently, Johnson brought this lawsuit against Midland seeking actual damages, statutory damages, attorney's fees, and costs for a violation of the Fair Debt Collection Practices Act. See 15 U.S.C. § 1692k. The District Court decided that the Act did not apply and therefore dismissed the action. The Court of Appeals for the Eleventh Circuit disagreed and reversed the District Court. 823 F.3d 1334 (2016). Midland filed a petition for certiorari, noting a division of opinion among the Courts of Appeals on the question whether the conduct at issue here is "false," "deceptive," "misleading," "unconscionable," or "unfair" within the meaning of the Act. Compare *ibid.* (finding the Fair Debt Collection Practices Act applicable) with *In re Dubois,* 834 F.3d 522 (C.A.4 2016) (finding the Act inapplicable); *Owens v. LVNV Funding, LLC,* 832 F.3d 726 (C.A.7 2016) (same); and *Nelson v. Midland Credit Management, Inc.,* 828 F.3d 749 (C.A.8 2016) (same). We granted the petition. We now reverse the Court of Appeals.

II

***4 [1] [2] [3] [4]** Like the majority of Courts of Appeals that have considered the matter, we conclude that Midland's filing of a proof of claim that on its face indicates that the limitations period has run does not fall within the scope of any of the five relevant words of the Fair Debt Collection Practices Act. We believe it reasonably clear that Midland's proof of claim was not "false, deceptive, or misleading." Midland's proof of claim falls within the Bankruptcy Code's definition of the term "claim." A "claim" is a "right to payment." 11 U.S.C. § 101(5)(A). State law usually determines whether a person has such a right. See *Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co.,* 549 U.S. 443, 450– 451, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007). The relevant state law is the law of Alabama. And Alabama's law, like the law of many States, provides that a creditor has the right to payment of a debt even after the limitations period has expired. See *Ex parte HealthSouth Corp.,* 974 So.2d 288, 296 (Ala.2007) (passage of time extinguishes remedy but the right remains); see also, *e.g., Sallaz v. Rice,* 161 Idaho 223, ––––, 384 P.3d 987, 992–993 (2016) (similar); *Notte v. Merchants Mut. Ins. Co.,* 185 N.J. 490, 499–500, 888 A.2d 464, 469 (2006) (similar); *Potterton v. Ryland Group, Inc.,* 289 Md. 371, 375–376, 424 A.2d 761, 764 (1981) (similar); *Summers v. Connolly,* 159 Ohio St. 396, 400–402, 112 N.E.2d 391, 394 (1953) (similar); *De Vries v. Secretary of State,* 329 Mich. 68, 75, 44 N.W.2d 872, 876 (1950) (similar); *Fleming v. Yeazel,* 379 Ill. 343, 344– 346, 40 N.E.2d 507, 508 (1942) (similar); *Fidelity & Cas. Co. of N.Y. v. Lackland,* 175 Va. 178, 185–187, 8 S.E.2d 306, 309 (1940) (similar); *Insurance Co. v. Dunscomb,* 108 Tenn. 724, 728–731, 69 S.W. 345, 346 (1902) (similar); but see, *e.g.,* Miss. Code Ann. § 15–1–3(1) (2012) (expiration of the limitations period extinguishes the remedy and the right); Wis. Stat. § 893.05 (2011–2012) (same).

Johnson argues that the Code's word "claim" means "enforceable claim." She notes that this Court once referred to a bankruptcy "claim" as "an enforceable obligation." *Pennsylvania Dept. of Public Welfare v. Davenport,* 495 U.S. 552, 559, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990). And, she concludes, Midland's "proof of claim" was false (or deceptive or misleading) because its "claim" was not enforceable. Brief for Respondent 22; Brief for United States as *Amicus Curiae* 18–20 (making a similar argument).

***5 [5]** But we do not find this argument convincing. The word "enforceable" does not appear in the Code's definition of "claim." See 11 U.S.C. § 101(5). The Court in *Davenport* likely used the word "enforceable" descriptively, for that case involved an enforceable debt. 495 U.S., at 559, 110 S.Ct. 2126. And it is difficult to square Johnson's interpretation with our later statement that "Congress intended ... to adopt the broadest available definition of 'claim.' " *Johnson v. Home State Bank,* 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991).

[6] It is still more difficult to square Johnson'sinterpretation with other provisions of the Bankruptcy Code. Section 502(b)(1) of the Code, for example, says that, if a "claim" is "unenforceable," it will be disallowed. It does not say that an "unenforceable" claim is not a "claim." Similarly, § 101(5)(A) says that a "claim" is a "right to payment," "whether or not such right is ... fixed, *contingent,* ... [or] *disputed.*" If a contingency does not arise, or if a claimant loses a dispute, then the claim is unenforceable. Yet this section makes clear that the

unenforceable claim is nonetheless a "right to payment," hence a "claim," as the Code uses those terms.

[7] **[8]** Johnson looks for support to other provisions that govern bankruptcy proceedings, including § 502(a) of the Bankruptcy Code, which states that a claim will be allowed in the absence of an objection, and Rule 3001(f) of the Federal Rules of Bankruptcy Procedure, which states that a properly filed "proof of claim ... shall constitute prima facie evidence of the validity and amount of the claim." But these provisions do not discuss the scope of the term "claim." Rather, they restate the Bankruptcy Code's system for determining whether a claim will be allowed. Other provisions make clear that the running of a limitations period constitutes an affirmative defense, a defense that the debtor is to assert after a creditor makes a "claim." §§ 502, 558. The law has long treated unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense. See, *e.g.,* Fed. Rule Civ. Proc. 8(c)(1); 13 Encyclopaedia of Pleading and Practice 200 (W. McKinney ed. 1898). And we see nothing misleading or deceptive in the filing of a proof of claim that, in effect, follows the Code's similar system.

***6** **[9]** **[10]** Indeed, to determine whether a statement is misleading normally "requires consideration of the legal sophistication of its audience." *Bates v. State Bar of Ariz.,* 433 U.S. 350, 383, n. 37, 97 S.Ct. 2691, 53 L.Ed.2d 810 (1977). The audience in Chapter 13 bankruptcy cases includes a trustee, 11 U.S.C. § 1302(a), who must examine proofs of claim and, where appropriate, pose an objection, §§ 704(a)(5), 1302(b)(1) (including any timeliness objection, §§ 502(b)(1), 558). And that trustee is likely to understand that, as the Code says, a proof of claim is a statement by the creditor that he or she has a right to payment subject to disallowance (including disallowance based upon, and following, the trustee's objection for untimeliness). §§ 101(5)(A), 502(b), 704(a) (5), 1302(b)(1). (We do not address the appropriate standard in ordinary civil litigation.)

III

[11] Whether Midland's assertion of an obviously timebarred claim is "unfair" or "unconscionable" (within the terms of the Fair Debt Collection Practices Act) presents a closer question. First, Johnson points out that several lower courts have found or indicated that, in the context of an ordinary civil action to collect a debt, a debt collector's assertion of a claim known to be time barred is "unfair." See, *e.g., Phillips v. Asset Acceptance, LLC,* 736 F.3d 1076, 1079 (C.A.7 2013) (holding as much); *Kimber v. Federal Financial Corp.,* 668 F.Supp. 1480, 1487 (M.D.Ala.1987) (same); *Huertas v. Galaxy Asset Management,* 641 F.3d 28, 32–33 (C.A.3 2011) (indicating as much); *Castro v. Collecto, Inc.,* 634 F.3d 779, 783 (C.A.5 2011) (same); *Freyermuth v. Credit Bureau Servs., Inc.,* 248 F.3d 767, 771 (C.A.8 2001) (same).

We are not convinced, however, by this precedent. It considers a debt collector's assertion *in a civil suit* of a claim known to be stale. We assume, for argument's sake, that the precedent is correct in that context (a matter this Court itself has not decided and does not now decide). But the context of a civil suit differs significantly from the present context, that of a Chapter 13 bankruptcy proceeding. The lower courts rested their conclusions upon their concern that a consumer might unwittingly repay a time-barred debt. Thus the Seventh Circuit pointed out that " 'few unsophisticated consumers would be aware that a statute of limitations could be used to defend against lawsuits based on stale debts.' " *Phillips, supra,* at 1079 (quoting *Kimber, supra,* at 1487). The " 'passage of time,' " the Circuit wrote, " 'dulls the consumer's memory of the circumstances and validity of the debt' " and the consumer may no longer have " 'personal records.' " 736 F.3d, at 1079 (quoting *Kimber, supra,* at 1487). Moreover, a consumer might pay a stale debt simply to avoid the cost and embarrassment of suit. 736 F.3d, at 1079.

***7** These considerations have significantly diminished force in the context of a Chapter 13 bankruptcy. The consumer initiates such a proceeding, see 11 U.S.C. §§ 301, 303(a), and consequently the consumer is not likely to pay a stale claim just to avoid going to court. A knowledgeable trustee is available. See § 1302(a). Procedural bankruptcy rules more directly guide the evaluation of claims. See Fed. Rule Bkrtcy. Proc. 3001(c)(3)(A); Advisory Committee's Notes on Rule 3001–2011 Amdt., 11 U.S.C. App., p. 678. And, as the Eighth Circuit Bankruptcy Appellate Panel put it, the claims resolution process is "generally a more streamlined and less unnerving prospect for a debtor than facing a collection lawsuit." *In re Gatewood,* 533 B.R. 905, 909 (2015); see also, *e.g.,* 11 U.S.C. § 502 (outlining generally the claims resolution process). These features of a Chapter 13 bankruptcy proceeding make it considerably more likely that an effort to collect

upon a stale claim in bankruptcy will be met with resistance, objection, and disallowance.

Second, Johnson argues that the practice at least risks harm to the debtor and that there is not "a single legitimate reason" for allowing this kind of behavior. Brief for Respondent 32. Would it not be obviously "unfair," she asks, for a debt collector to adopt a practice of buying up stale claims cheaply and asserting them in bankruptcy knowing they are stale and hoping for careless trustees? The United States, supporting Johnson, adds its view that the Federal Rules of Bankruptcy Procedure make the practice open to sanction, and argues that sanctionable conduct is unfair conduct. Brief for United States as *Amicus Curiae* 20. See Fed. Rule Bkrtcy. Proc. 9011(b) (2) (sanction possible if party violates the Rule that by "presenting to the [bankruptcy] court" any "paper," a "party is certifying that to the best of" his or her "knowledge, ... the claims ... therein are warranted by existing law").

[12] [13] [14] We are ultimately not persuaded by these arguments. The bankruptcy system, as we have already noted, treats untimeliness as an affirmative defense. The trustee normally bears the burden of investigating claims and pointing out that a claim is stale. See *supra,* at –––– – ––––. Moreover, protections available in a Chapter 13 bankruptcy proceeding minimize the risk to the debtor. See *supra,* at ––––. And, at least on occasion, the assertion

of even a stale claim can benefit a debtor. Its filing and disallowance "discharge[s]" the debt. 11 U.S.C. § 1328(a). And that discharge means that the debt (even if unenforceable) will not remain on a credit report potentially affecting an individual's ability to borrow money, buy a home, and perhaps secure employment. See 15 U.S.C. § 1681c(a)(4) (debt may remain on a credit report for seven years); cf. Ala. Code § 6–2–34 (6–year statute of limitations); Md. Cts. & Jud. Proc. Code Ann. § 5–101 (2013) (3–year statute of limitations); cf. 16 C.F.R. pt. 600, App. § 607, ¶ 6 (1991) (a credit report may include discharged debt only if "the debt [is reported] as having a zero balance due to reflect the fact that the consumer is no longer liable for the discharged debt"); FTC, 40 Years of Experience with the Fair Credit Reporting Act: An FTC Staff Report with Summary of Interpretations 66 (2011) (similar).

***8** More importantly, a change in the simple affirmativedefense approach, carving out an exception, itself would require defining the boundaries of the exception. Does it apply only where (as Johnson alleged in the complaint) a claim's staleness appears "on [the] face" of the proof of claim? Does it apply to other affirmative defenses or only to the running of a limitations period?

[15] [16] At the same time, we do not find in either the Fair Debt Collection Practices Act or the Bankruptcy Code good reason to believe that Congress intended an ordinary civil court applying the Act to determine answers to these bankruptcy-related questions. The Act and the Code have different purposes and structural features. The Act seeks to help consumers, not necessarily by closing what Johnson and the United States characterize as a loophole in the Bankruptcy Code, but by preventing consumer bankruptcies in the first place. See, *e.g.,* 15 U.S.C. § 1692(a) (recognizing the "abundant evidence of the use of abusive, deceptive, and unfair debt collection practices [which] contribute to the number of personal bankruptcies"); see also § 1692(b) ("Existing laws and procedures ... are inadequate to protect consumers"); § 1692(e) (statute seeks to "eliminate abusive debt collection practices"). The Bankruptcy Code, by way of contrast, creates and maintains what we have called the "delicate balance of a debtor's protections and obligations." *Kokoszka v. Belford,* 417 U.S. 642, 651, 94 S.Ct. 2431, 41 L.Ed.2d 374 (1974).

To find the Fair Debt Collection Practices Act applicable here would upset that "delicate balance." From a substantive perspective it would authorize a new significant bankruptcy-related remedy in the absence of language in the Code providing for it. Administratively, it would permit postbankruptcy litigation in an ordinary civil court concerning a creditor's state of mind— a matter often hard to determine. See 15 U.S.C. § 1692k(c) (safe harbor for any debt collector who "shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error"). Procedurally, it would require creditors (who assert a claim) to investigate the merits of an affirmative defense (typically the debtor's job to assert and prove) lest the creditor later be found to have known the claim was untimely. The upshot could well be added complexity, changes in settlement incentives, and a shift from the debtor to the creditor the obligation to investigate the staleness of a claim.

Unlike the United States, we do not believe that the Advisory Committee on Rules of Bankruptcy Procedure settled the issue when it promulgated Bankruptcy Rule 9011. The

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Committee, in considering amendments to the Federal Rules of Bankruptcy Procedure in 2009, specifically rejected a proposal that would have required a creditor to certify that there is no valid statute of limitations defense. See Agenda Book for Meeting 86–87 (Mar. 26–27, 2009). It did so in part because the working group did not want to impose an affirmative obligation on a creditor to make a prefiling investigation of a potential time-bar defense. *Ibid.* In rejecting that proposal, the Committee did note that Rule 9011 imposes a general "obligation on a claimant to undertake an inquiry reasonable under the circumstances to determine ... that a claim is warranted by existing law and that factual contentions have evidentiary support," and to certify as much on the proof of claim. *Id.,* at 87. The Committee also acknowledged, however, that this requirement would "not addres [s] the statute of limitation issue," but would only ensure "the accuracy of the information provided." *Ibid.*

***9** We recognize that one Bankruptcy Court has held that filing a time-barred claim without a prefiling investigation of a potential time-bar defense merits sanctions under Rule 9011. *In re Sekema,* 523 B.R. 651, 654 (Bkrtcy.Ct.N.D.Ind.2015). But others have held to the contrary. See, *e.g., In re Freeman,* 540 B.R. 129, 143–144 (Bkrtcy.Ct.E.D.Pa.2015); *In re Jenkins,* 538 B.R. 129, 134–136 (Bkrtcy.Ct.N.D.Ala.2015); *In re Keeler,* 440 B.R. 354, 366–369 (Bkrtcy.Ct.E.D.Pa.2009); see also *In re Andrews,* 394 B.R. 384, 387–388 (Bkrtcy.Ct.E.D.N.C.2008) (recognizing that "[m]any courts have ... found that sanctions [under Rule 9011] were not warranted for filing stale claims").

These circumstances, taken together, convince us that we cannot find the practice at issue here "unfair" or "unconscionable" within the terms of the Fair Debt Collection Practices Act.

IV

For these reasons, we conclude that filing (in a Chapter 13 bankruptcy proceeding) a proof of claim that is obviously time barred is not a false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the Fair Debt Collection Practices Act. The judgment of the Eleventh Circuit is reversed.

It is so ordered.

Justice GORSUCH took no part in the consideration or decision of this case.

Justice SOTOMAYOR, with whom Justice GINSBURG and Justice KAGAN join, dissenting.

***9** The Fair Debt Collection Practices Act (FDCPA or Act) prohibits professional debt collectors from using "false, deceptive, or misleading representation[s] or means in connection with the collection of any debt" and from "us[ing] unfair or unconscionable means to collect" a debt. 15 U.S.C. §§ 1692e, 1692f. The Court today wrongfully holds that a debt collector that knowingly attempts to collect a time-barred debt in bankruptcy proceedings has violated neither of these prohibitions.

Professional debt collectors have built a business out of buying stale debt, filing claims in bankruptcy proceedings to collect it, and hoping that no one notices that the debt is too old to be enforced by the courts. This practice is both "unfair" and "unconscionable." I respectfully dissent from the Court's conclusion to the contrary.[1]

I

Americans owe trillions of dollars in consumer debt to creditors—credit card companies, schools, and car dealers, among others. See Fed. Reserve Bank of N.Y., Quarterly Report on Household Debt and Credit 3 (2017). Most people will repay their debts, but some cannot do so. The debts they do not pay are increasingly likely to end up in the hands of professional debt collectors—companies whose business it is to collect debts that are owed to other companies. See Consumer Financial Protection Bur., Fair Debt Collection Practices Act: Annual Report 2016, p. 8 (CFPB Report). Debt collection is a lucrative and growing industry. Last year, the Nation's 6,000 debt collection agencies earned over $13 billion in revenue. *Ibid.*

***10** Although many debt collectors are hired by creditors to work on a third-party basis, more and more collectors also operate as "debt buyers"—purchasing debts from creditors outright and attempting to collect what they can, with the profits going to their own accounts.[2] See FTC, The Structure and Practices of the Debt Buying Industry 11–12 (2013) (FTC Report); CFPB Report 10. Debt buyers now hold hundreds of billions of dollars in consumer debt; indeed, a study conducted by the Federal Trade Commission (FTC) in 2009 found that nine of the leading debt buyers had purchased over $140 billion in debt just in the previous three years. FTC Report, at i-ii, T–3 (Table 3).

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Because creditors themselves have given up trying to collect the debts they sell to debt buyers, they sell those debts for pennies on the dollar. *Id.,* at 23. The older the debt, the greater the discount: While debt buyers pay close to eight cents per dollar for debts under three years old, they pay as little as two cents per dollar for debts greater than six years old, and "effectively nothing" for debts greater than 15 years old. *Id.,* at 23–24. These prices reflect the basic fact that older debts are harder to collect. As time passes, consumers move or forget that they owe the debts; creditors have more trouble documenting the debts and proving their validity; and debts begin to fall within state statutes of limitations—time limits that "operate to bar a plaintiff's suit" once passed. *CTS Corp. v. Waldburger,* 573 U.S. ––––, ––––, 134 S.Ct. 2175, 2182, 189 L.Ed.2d 62 (2014). Because a creditor (or a debt collector) cannot enforce a time-barred debt in court, the debt is inherently worth very little indeed.

But statutes of limitations have not deterred debt buyers. For years, they have filed suit in state courts—often in small-claims courts, where formal rules of evidence do not apply—to collect even debts too old to be enforced by those courts.[3] See Holland, The One Hundred Billion Dollar Problem in Small–Claims Court, 6 J. Bus. & Tech. L. 259, 261 (2011). Importantly, the debt buyers' only hope in these cases is that consumers will fail either to invoke the statute of limitations or to respond at all: In most States the statute of limitations is an affirmative defense, meaning that a consumer must appear in court and raise it in order to dismiss the suit. See *ante,* at –––– – –––– (majority opinion). But consumers do fail to defend themselves in court—in fact, according to the FTC, over 90% fail to appear at all. FTC Report 45. The result is that debt buyers have won "billions of dollars in default judgments" simply by filing suit and betting that consumers will lack the resources to respond. Holland, *supra,* at 263.

***11** The FDCPA's prohibitions on "misleading" and "unfair" conduct have largely beaten back this particular practice. Every court to have considered the question has held that a debt collector that knowingly files suit in court to collect a time-barred debt violates the FDCPA. See *Phillips v. Asset Acceptance, LLC,* 736 F.3d 1076, 1079 (C.A.7 2013); *Kimber v. Federal Financial Corp.,* 668 F.Supp. 1480, 1487 (M.D.Ala.1987); see also *ante,* at –––– – –––– (majority opinion) (citing other cases). In 2015, petitioner and its parent company entered into a consent decree with the Government prohibiting them from filing suit to collect time-barred debts and ordering them to pay $34 million in restitution. See Consent Order in *In re Encore Capital Group, Inc.,* No. 2015–CFPB–0022 (Sept. 9, 2015), pp. 38, 46. And the leading trade association has now adopted a resolution barring the practice. See Brief for DBA International, Inc., as *Amicus Curiae* 2–3.

Stymied in state courts, the debt buyers have now turned to a new forum: bankruptcy courts. The same debt buyers that for years filed thousands of lawsuits in state courts across the country have begun to do the same thing in bankruptcy courts—specifically, in cases governed by Chapter 13 of the Bankruptcy Code, which allows consumers earning regular incomes to restructure their debts and repay as many as they can over a period of several years. See 8 Collier on Bankruptcy ¶ 1300.01 (A. Resnick & H. Sommer eds., 16th ed. 2016). As in ordinary civil cases, a debtor in a Chapter 13 bankruptcy proceeding is entitled to have dismissed any claim filed against his estate that is barred by a statute of limitations. See 11 U.S.C. § 558. As in ordinary civil cases, the statute of limitations is an affirmative defense, one that must be raised by either the debtor or the trustee of his estate before it is honored. §§ 502, 558. And so—just as in ordinary civil cases—debt collectors may file claims in bankruptcy proceedings for stale debts and hope that no one notices that they are too old to be enforced.

And that is exactly what the debt buyers have done. As a wide variety of courts and commentators have observed, debt buyers have "deluge[d]" the bankruptcy courts with claims "on debts deemed unenforceable under state statutes of limitations." *Crawford v. LVNV Funding, LLC,* 758 F.3d 1254, 1256 (C.A.11 2014); see also *In re Jenkins,* 456 B.R. 236, 239, n. 2 (Bkrtcy.Ct.E.D.N.C.2011) (noting a "plague of stale claims"); Brief for National Association of Consumer Bankruptcy Attorneys et al. as *Amici Curiae* 9 (noting study describing "hundreds of thousands of proofs of claim asserting hundreds of millions of dollars of consumer indebtedness, all in a single year"). This practice has become so widespread that the Government sued one debt buyer last year "to address [its] systemic abuse of the bankruptcy process"—including a "business model" of "knowingly and strategically" filing thousands of claims for time-barred debt. Complaint in *In re Freeman–Clay v. Resurgent Capital Servs., L.P.,* No. 14–41871 (Bkrtcy. Ct. WD Mo.), ¶¶ 1, 35 (*Resurgent* Complaint). This practice, the Government explained,

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"manipulates the bankruptcy process by systematically shifting the burden" to trustees and debtors to object even to "frivolous claims"—especially given that filing an objection is costly, time consuming, and easy to overlook. *Id.,* at ¶¶ 35, 43–44.

II

***12** The FDCPA prohibits professional debt collectors from engaging in "unfair" and "unconscionable" practices. 15 U.S.C. § 1692f.[4] Filing a claim in bankruptcy court for debt that a collector knows to be time barred— like filing a lawsuit in a court to collect such a debt—is just such a practice.

A

Begin where the debt collectors themselves began: with their practice of filing suit in ordinary civil courts to collect debts that they know are time barred. Every court to have considered this practice holds that it violates the FDCPA. There is no sound reason to depart from this conclusion.

Statutes of limitations "are not simply technicalities." *Board of Regents of Univ. of State of N.Y. v. Tomanio,* 446 U.S. 478, 487, 100 S.Ct. 1790, 64 L.Ed.2d 440 (1980). They reflect strong public-policy determinations that "it is unjust to fail to put [an] adversary on notice to defend within a specified period of time." *United States v. Kubrick,* 444 U.S. 111, 117, 100 S.Ct. 352, 62 L.Ed.2d 259 (1979). And they "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared." *Railroad Telegraphers v. Railway Express Agency, Inc.,* 321 U.S. 342, 348–349, 64 S.Ct. 582, 88 L.Ed. 788 (1944). Such concerns carry particular weight in the context of small-dollar consumer debt collection. As one thoughtful opinion explains:

> "Because few unsophisticated consumers would be aware that a statute of limitations could be used to defend against lawsuits based on stale debts, such consumers would unwittingly acquiesce to such lawsuits. And, even if the consumer realizes that she can use time as a defense, she will more than likely still give in rather than fight the lawsuit because she must still expend energy and resources and subject herself to the embarrassment of going into court to present the defense...." *Kimber,* 668 F.Supp., at 1487.

Debt buyers' efforts to pursue stale debt in ordinary civil litigation may also entrap debtors into forfeiting their time defenses altogether. When a debt collector sues or threatens to sue to collect a debt, many consumers respond by offering a small partial payment to forestall suit. In many States, a consumer who makes an offer like this has —unbeknownst to him—forever given up his ability to claim the debt is unenforceable. That is because in most States a consumer's partial payment on a time-barred debt —or his promise to resume payments on such a debt—will restart the statute of limitations. FTC Report 47; see, *e.g., Young v. Sorenson,* 47 Cal.App.3d 911, 914, 121 Cal.Rptr. 236, 237 (1975) (" 'The theory on which this is based is that the payment is an acknowledgement on the existence of the indebtedness which raises an implied promise to continue the obligation and to pay the balance' "). Debt collectors' efforts to entrap consumers in this way have no place in honest business practice.

B

***13** The same dynamics are present in bankruptcy proceedings. A proof of claim filed in bankruptcy court represents the debt collector's belief that it is entitled to payment, even though the debt should not be enforced as a matter of public policy. The debtor's claim will be allowed, and will be incorporated in a debtor's payment plan, unless the debtor or his trustee objects. But such objections require ordinary and unsophisticated people (and their overworked trustees) to be on guard not only against mistaken claims but also against claims that debt collectors know will fail under law if an objection is raised. Debt collectors do not file these claims in good faith; they file them hoping and expecting that the bankruptcy system will fail. Such a practice is "unfair" and "unconscionable" in violation of the FDCPA.

The Court disagrees. But it does so on narrow grounds. To begin with, the Court does not hold that the Bankruptcy Code altogether displaces the FDCPA, leaving it with no role to play in bankruptcy proceedings. Such a conclusion would be wrong. Although the Code and the FDCPA "have different purposes and structural features," *ante,* at ––––, the Court has held that Congress, in passing the FDCPA's predecessor, did so on the understanding that "the provisions and the purposes" of the two statutes were intended to "coexist." *Kokoszka v. Belford,* 417 U.S. 642, 650, 94 S.Ct.

2431, 41 L.Ed.2d 374 (1974). Although petitioner suggests that the FDCPA is best read "to have no application to [a] debt collector's conduct" in a bankruptcy proceeding, Brief for Petitioner 41, the majority declines its invitation to adopt such a sweeping rule.[5]

Nor does the majority take a position on whether a debt collector violates the FDCPA by filing suit in an ordinary court to collect a debt it knows is time barred. *Ante,* at ––––. Instead, the majority concludes, even assuming that such a practice would violate the FDCPA, a debt collector does not violate the Act by doing the same thing in bankruptcy proceedings. Bankruptcy, the majority argues, is different. True enough. But none of the distinctions that the majority identifies bears the weight placed on it.

First, the majority contends, structural features of the bankruptcy process reduce the risk that a stale debt will go unnoticed and thus be allowed. *Ante,* at –––– – ––––. But there is virtually no evidence that the majority's theory holds true in practice. The majority relies heavily on the presence of a bankruptcy trustee, appointed to act on the debtor's behalf and empowered to (among other things) object to claims that he believes lack merit. See 11 U.S.C. §§ 704(a)(5), 1302(b). In the majority's view, the trustee's gatekeeping role makes it "considerably more likely that an effort to collect upon a stale claim in bankruptcy will be met with resistance, objection, and disallowance." *Ante,* at ––––. The problem with the majority's *ipse dixit* is that everyone with actual experience in the matter insists that it is false. The Government, which oversees bankruptcy trustees, tells us that trustees "cannot realistically be expected to identify every time-barred ... claim filed in every bankruptcy." Brief for United States as *Amicus Curiae* 25–26; see also *Resurgent* Complaint ¶ 43 ("Filing objections to all of [one collector]'s unenforceable claims would clog the docket of this Court and other courts with objections to frivolous claims"). The trustees themselves (appearing here as *amici curiae*) agree, describing the practice as "wasteful" and "exploit [ative]." Brief for National Association of Chapter Thirteen Trustees as *Amicus Curiae* 12. And courts across the country recognize that Chapter 13 trustees are struggling under a "deluge" of stale debt. *Crawford,* 758 F.3d, at 1256.

***14** Second, the other features of the bankruptcy process that the majority believes will serve as a backstop against frivolous claims are even less likely to do so in practice. The majority implies that a person who files for bankruptcy is more sophisticated than the average consumer debtor because the initiation of bankruptcy is a choice made by a debtor. *Ante,* at ––––. But a person who has filed for bankruptcy will rarely be in such a superior position; he has, after all, just declared that he is unable to meet his financial obligations and in need of the assistance of the courts. It is odd to speculate that such a person is better situated to monitor court filings and lodge objections than an ordinary consumer. The majority also suggests that the rules of bankruptcy help "guide the evaluation of claims." *Ibid.* But the rules of bankruptcy in fact facilitate the *allowance* of claims: Claims are automatically allowed and made part of a plan unless an objection is made. See 11 U.S.C. § 502(a). A debtor is arguably more vulnerable in bankruptcy—not less—to the oversights that the debt buyers know will occur.

Finally, the majority suggests, in some cases a consumer will actually *benefit* if a claim for an untimely debt is filed. *Ante,* at –––– – ––––. If such a claim is filed but disallowed, the majority explains, the debt will eventually be discharged, and the creditor will be barred from collecting it. See § 1328(a). Here, too, practice refutes the majority's rosy portrait of these proceedings. A debtor whose trustee does not spot and object to a stale debt will find no comfort in the knowledge that *other* consumers with more attentive trustees may have their debts disallowed and discharged. Moreover, given the high rate at which debtors are unable to fully pay off their debts in Chapter 13 proceedings, see Porter, The Pretend Solution: An Empirical Study of Bankruptcy Outcomes, 90 Texas L. Rev. 103, 111–112 (2011), most debtors who fail to object to a stale claim will end up worse off than had they never entered bankruptcy at all: They will make payments on the stale debts, thereby resuscitating them,

Footnotes

see *supra,* at –––– – ––––, and may thus walk out of bankruptcy court owing more to their creditors than they did when they entered it. There is no benefit to anyone in such a proceeding—except the debt collectors.

3

It does not take a sophisticated attorney to understand why the practice I have described in this opinion is unfair. It takes only the common sense to conclude that one should not be able to profit on the inadvertent inattention of others. It is said that the law should not

be a trap for the unwary. Today's decision sets just such a trap.

I take comfort only in the knowledge that the Court's decision today need not be the last word on the matter. If Congress wants to amend the FDCPA to make explicit what in my view is already implicit in the law, it need only say so.

***15** I respectfully dissent.

All Citations

--- S.Ct. ----, 2017 WL 2039159, 64 Bankr.Ct.Dec. 31, 17 Cal. Daily Op. Serv. 4429

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

1 Because I believe the practice at issue here is "unfair" and "unconscionable," and thus violates 15 U.S.C. § 1692f, I do not address the Court's conclusion that the practice is not "false, deceptive, or misleading" in violation of § 1692e.

2 A case pending before this Court, *Henson v. Santander Consumer USA Inc.,* No. 16–349, asks whether a certain kind of debt buyer is a "debt collector" under the FDCPA. Midland does not dispute that it is a debt collector under the Act.

3 Petitioner's parent alone filed 245,000 lawsuits in 2009. See Silver–Greenberg, Boom in Debt Buying Fuels Another Boom—in Lawsuits, Wall Street Journal, Nov. 29, 2010, pp. A1, A16. Petitioner itself filed 110 lawsuits on just one date in a single state court. *Id.,* at A1.

4 This Court has not had occasion to construe the terms "unfair" and "unconscionable" in § 1692f. The FDCPA's legislative history suggests that Congress intended these terms as a backstop that would enable "courts, where appropriate, to proscribe other improper conduct ... not specifically addressed" by the statute. S.Rep. No. 95–382, p. 4 (1977). Courts have construed these terms, consistent with other federal and state statutes that employ them, to borrow from equitable and common-law traditions. See, *e.g., LeBlanc v. Unifund CCR Partners,* 601 F.3d 1185, 1200–1201 (C.A.11 2010) (*per curiam*); *Beler v. Blatt, Hasenmiller, Leibsker & Moore, LLC,* 480 F.3d 470, 473–474 (C.A.7 2007).

5 The majority does lean heavily on its fear that, were we to conclude that the FDCPA bars the practice at issue, we would be licensing "postbankruptcy litigation in an ordinary civil court" concerning matters best left to bankruptcy courts. *Ante,* at ––––. But to do so would not, as the majority suggests, "upset [the] 'delicate balance' " struck by the Code. *Ibid.* (quoting *Kokoszka v. Belford,* 417 U.S., at 651, 94 S.Ct. 2431). For one, nothing requires a debtor to engage in satellite litigation in order to sue a debt collector under the FDCPA; a debtor can easily file an adversary proceeding asserting an FDCPA claim with the bankruptcy court itself, and in many cases will be better served by doing so. See, *e.g., Simon v. FIA Card Servs., N. A.,* 732 F.3d 259, 263 (C.A.3 2013). Nor is there any risk that finding the FDCPA applicable here will authorize bankruptcy courts (or, for that matter, civil courts) to engage in novel and unfettered inquiries into "a creditor's state of mind." *Ante,* at ––––. Both Fed. Rule Civ. Proc. 11 and its bankruptcy counterpart, Fed. Rule Bkrtcy. Proc. 9011, authorize a court to impose sanctions on parties who willfully file meritless claims (a category that includes the debt buyers here, see *In re Sekema,* 523 B.R. 651, 654–655 (Bkrtcy.Ct.N.D.Ind.2015)). So there is nothing new about the inquiry that courts would be required to undertake; it is no different than analyses they conduct every day.

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2017 WL 2039159
Supreme Court of the United States

MIDLAND FUNDING, LLC, Petitioner
v.
Aleida JOHNSON.

No. 16–348.
|
Argued Jan. 17, 2017.
|
Decided May 15, 2017.

Synopsis

Background: Two Chapter 13 debtors brought separate actions against creditors, alleging that, by filing a proof of claim that disclosed on its face that the claim was barred by the statute of limitations, creditor violated the Fair Debt Collection Practices Act (FDCPA). The United States District Court for the Southern District of Alabama, No. 1:14–CV–00322–WS–C, William H. Steele, J., 528 B.R. 462, dismissed one action, and 1:14–CV–00324–WS–M, granted creditor's motion for judgment on the pleadings in the other action. Debtors appealed, and the actions were consolidated on appeal. The Court of Appeals for the Eleventh Circuit, Martin, Circuit Judge, 823 F.3d 1334, reversed and remanded. Certiorari was granted.

Holdings: The Supreme Court, Justice Breyer, held that:

[1] creditor's proof of claim was not "false, deceptive, ormisleading" within meaning of the FDCPA, and

[2] creditor's proof of claim was not "unfair" or"unconscionable" under the FDCPA.

Reversed.

Justice Sotomayor filed a dissenting opinion in which Justices Ginsburg and Kagan joined.

Justice Gorsuch took no part in the consideration or decision of the case.

West Headnotes (16)

[1] Antitrust and Trade Regulation
Practices Prohibited or Required in General

Bankruptcy
Time for Filing

Creditor's filing of proof of claim that on its face indicated that the limitations period on the underlying debt had run was not "false, deceptive, or misleading" within meaning of the Fair Debt Collection Practices Act (FDCPA). 11 U.S.C.A. § 101(5)(A); Fair Debt Collection Practices Act, § 807, 15 U.S.C.A. § 1692e.

Cases that cite this headnote

[2] Bankruptcy
Claims Allowable; W hat Constitutes "Claim."

Under the Bankruptcy Code, a "claim" is a right to payment. 11 U.S.C.A. § 101(5)(A).

Cases that cite this headnote

[3] Bankruptcy
Effect of State Law, in General

State law usually determines whether a person has a right to payment and hence a "claim" within meaning of the Bankruptcy Code. 11 U.S.C.A. § 101(5)(A).

Cases that cite this headnote

[4] Limitation of Actions
Operation as to Rights or Remedies in General

Under Alabama law, a creditor has the right to payment of a debt even after the limitations period has expired.

Cases that cite this headnote

[5] Bankruptcy
Claims Allowable; W hat Constitutes "Claim."

Congress intended to adopt the broadest available definition of "claim" in the Bankruptcy Code. 11 U.S.C.A. § 101(5)(A).

Cases that cite this headnote

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[6] **Bankruptcy**
Claims Allowable; W hat Constitutes "Claim."

Under the Bankruptcy Code, if a contingency does not arise, or if a claimant loses a dispute, then the claim is unenforceable, but the unenforceable claim is nonetheless a "right to payment" and hence a "claim." 11 U.S.C.A. §§ 101(5)(A), 502(b)(1).

Cases that cite this headnote

[7] **Bankruptcy**
Time for Filing

Under the Bankruptcy Code, the running of a limitations period constitutes an affirmative defense, a defense that the debtor is to assert after a creditor makes a "claim." 11 U.S.C.A. §§ 502, 558.

Cases that cite this headnote

[8] **Federal Civil Procedure**
Limitations and Laches

The law has long treated unenforceability of a claim, due to expiration of the limitations period, as an affirmative defense. Fed.Rules Civ.Proc.Rule 8(c)(1), 28 U.S.C.A.

Cases that cite this headnote

[9] **Antitrust and Trade Regulation**
Communications, Representations, and Notices; D ebtor's Response

To determine whether a statement is "misleading" within meaning of the Fair Debt Collection Practices Act (FDCPA) normally requires consideration of the legal sophistication of its audience. Fair Debt Collection Practices Act, § 807, 15 U.S.C.A. § 1692e.

Cases that cite this headnote

[10] **Bankruptcy**
Time for Filing
Bankruptcy
Objections Generally; T ime, Form, and Sufficiency; P leading

Chapter 13 trustee must examine proofs of claim and, where appropriate, pose an objection, including any timeliness objection. 11 U.S.C.A. §§ 502(b)(1), 558, 704(a)(5), 1302(a), (b)(1).

Cases that cite this headnote

[11] **Antitrust and Trade Regulation**
Practices Prohibited or Required in General
Bankruptcy
Time for Filing

Creditor's filing of proof of claim that on its face indicated that the limitations period on the underlying debt had run was not "unfair" or "unconscionable" within meaning of the Fair Debt Collection Practices Act (FDCPA). 11 U.S.C.A. § 101(5)(A); Consumer Credit Protection Act, § 808, 15 U.S.C.A. § 1692f.

Cases that cite this headnote

[12] **Bankruptcy**
Time for Filing

Chapter 13 trustee normally bears the burden of investigating claims and pointing out that a claim is stale. 11 U.S.C.A. §§ 1302(a), (b)(1), 502(b)(1), 558, 704(a)(5).

Cases that cite this headnote

[13] **Bankruptcy**
Debts Dischargeable

Filing and disallowance of even a stale claim in a Chapter 13 proceeding discharges the debt. 11 U.S.C.A. § 1328(a).

Cases that cite this headnote

[14] **Bankruptcy**
Discharge

Discharge of a debt in a Chapter 13 proceeding means that the debt, even if unenforceable, will not remain on a credit report potentially affecting an individual's ability to borrow money, buy a home, and perhaps secure

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employment. 11 U.S.C.A. § 1328(a); Fair and Accurate Credit Transactions Act of 2003, 15 U.S.C.A. § 1681c(a)(4).

Cases that cite this headnote

[15]
Antitrust and Trade Regulation
Debt Collection

Fair Debt Collection Practices Act (FDCPA) seeks to help consumers by preventing consumer bankruptcies in the first place. Fair Debt Collection Practices Act, § 807(a, b, e), 15 U.S.C.A. § 1692e.

Cases that cite this headnote

[16] **Bankruptcy**

Construction and Operation

Bankruptcy Code creates and maintains the "delicate balance" of a debtor's protections and obligations.

Cases that cite this headnote

Syllabus [*]

***1** Petitioner Midland Funding filed a proof of claim in respondent Johnson's Chapter 13 bankruptcy case, asserting that Johnson owed Midland credit-card debt and noting that the last time any charge appeared on Johnson's account was more than 10 years ago. The relevant statute of limitations under Alabama law is six years. Johnson objected to the claim, and the Bankruptcy Court disallowed it. Johnson then sued Midland, claiming that its filing a proof of claim on an obviously time-barred debt was "false," "deceptive," "misleading," "unconscionable," and "unfair" within the meaning of the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692e, 1692f. The District Court held that the Act did not apply and dismissed the suit. The Eleventh Circuit reversed.

Held : The filing of a proof of claim that is obviously time barred is not a false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the Fair Debt Collection Practices Act. Pp. —— – ——.

(a) Midland's proof of claim was not "false, deceptive, or misleading." The Bankruptcy Code defines the term "claim" as a "right to payment," 11 U.S.C. § 101(5) (A), and state law usually determines whether a person has such a right, see *Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co.,* 549 U.S. 443, 450–451, 127 S.Ct. 1199, 167 L.Ed.2d 178. The relevant Alabama law provides that a creditor has the right to payment of a debt even after the limitations period has expired.

Johnson argues that the word "claim" means "enforceable claim." But the word "enforceable" does not appear in the Code's definition, and Johnson's interpretation is difficult to square with Congress's intent "to adopt the broadest available definition of 'claim,' " *Johnson v. Home State Bank,* 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66. Other Code provisions are still more difficult to square with Johnson's interpretation. For example, § 502(b)(1) says that if a "claim" is "unenforceable" it will be disallowed, not that it is not a "claim." Other provisions make clear that the running of a limitations period constitutes an affirmative defense that a debtor is to assert after the creditor makes a "claim." §§ 502, 558. The law has long treated unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense, and there is nothing misleading or deceptive in the filing of a proof of claim that follows the Code's similar system.

Indeed, to determine whether a statement is misleading normally "requires consideration of the legal sophistication of its audience," *Bates v. State Bar of Ariz.,* 433 U.S. 350, 383, n. 37, 97 S.Ct. 2691, 53 L.Ed.2d 810, which in a Chapter 13 bankruptcy includes a trustee who is likely to understand that a proof of claim is a statement by the creditor that he or she has a right to payment that is subject to disallowance, including disallowance based on untimeliness. Pp. —— – ——.

***2** (b) Several circumstances, taken together, lead to the conclusion that Midland's proof of claim was not "unfair" or "unconscionable" within the terms of the Fair Debt Collection Practices Act.

Johnson points out that several lower courts have found or indicated that, in the context of an ordinary civil action to collect a debt, a debt collector's assertion of a claim known to be time barred is "unfair." But those courts rested their conclusions upon their concern that a consumer might

unwittingly repay a time-barred debt. Such considerations have significantly diminished force in a Chapter 13 bankruptcy, where the consumer initiates the proceeding, see §§ 301, 303(a); where a knowledgeable trustee is available, see § 1302(a); where procedural rules more directly guide the evaluation of claims, see Fed. Rule Bkrtcy. Proc. 3001(c)(3)(A); and where the claims resolution process is "generally a more streamlined and less unnerving prospect for a debtor than facing a collection lawsuit," *In re Gatewood,* 533 B.R. 905, 909.

Also unpersuasive is Johnson's argument that there is no legitimate reason for allowing a practice like this one that risks harm to the debtor. The bankruptcy system treats untimeliness as an affirmative defense and normally gives the trustee the burden of investigating claims to see if one is stale. And, at least on occasion, the assertion of even a stale claim can benefit the debtor.

More importantly, a change in the simple affirmativedefense approach, carving out an exception, would require defining the exception's boundaries. Does it apply only where a claim's staleness appears on the face of the proof of claim? Does it apply to other affirmative defenses or only to the running of the limitations period? Neither the Fair Debt Collection Practices Act nor the Bankruptcy Code indicates that Congress intended an ordinary civil court applying the Act to determine answers to such bankruptcy-related questions. The Act and the Code have different purposes and structural features. The Act seeks to help consumers by preventing consumer bankruptcies in the first place, while the Code creates and maintains the "delicate balance of a debtor's protections and obligations," *Kokoszka v. Belford,* 417 U.S. 642, 651, 94 S.Ct. 2431, 41 L.Ed.2d 374. Applying the Act in this context would upset that "delicate balance."

Contrary to the argument of the United States, the promulgation of Bankruptcy Rule 9011 did not resolve this issue. Pp. —— – ——.

823 F.3d 1334, reversed.

BREYER, J., delivered the opinion of the Court, in which ROBERTS, C.J., and KENNEDY, THOMAS, and ALITO, JJ., joined. SOTOMAYOR, J., filed a dissenting opinion, in which GINSBURG and KAGAN, JJ., joined. GORSUCH, J., took no part in the consideration or decision of the case.

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Opinion

Justice BREYER delivered the opinion of the Court.

***3** The Fair Debt Collection Practices Act, 91 Stat. 874, 15 U.S.C. § 1692 *et seq.,* prohibits a debt collector from asserting any "false, deceptive, or misleading representation," or using any "unfair or unconscionable means" to collect, or attempt to collect, a debt, §§ 1692e, 1692f. In this case, a debt collector filed a written statement in a Chapter 13 bankruptcy proceeding claiming that the debtor owed the debt collector money.

The statement made clear, however, that the 6–year statute of limitations governing collection of the claimed debt had long since run. The question before us is whether the debt collector's filing of that statement falls within the scope of the aforementioned provisions of the Fair Debt Collection Practices Act. We conclude that it does not.

I

In March 2014, Aleida Johnson, the respondent, filed for personal bankruptcy under Chapter 13 of the Bankruptcy Code (or Code), 11 U.S.C. § 1301 *et seq.,* in the Federal District Court for the Southern District of Alabama. Two

months later, Midland Funding, LLC, the petitioner, filed a "proof of claim," a written statement asserting that Johnson owed Midland a credit-card debt of $1,879.71. The statement added that the last time any charge appeared on Johnson's account was in May 2003, more than 10 years before Johnson filed for bankruptcy. The relevant statute of limitations is six years. See Ala. Code § 6–2–34 (2014). Johnson, represented by counsel, objected to the claim; Midland did not respond to the objection; and the Bankruptcy Court disallowed the claim.

Subsequently, Johnson brought this lawsuit against Midland seeking actual damages, statutory damages, attorney's fees, and costs for a violation of the Fair Debt Collection Practices Act. See 15 U.S.C. § 1692k. The District Court decided that the Act did not apply and therefore dismissed the action. The Court of Appeals for the Eleventh Circuit disagreed and reversed the District Court. 823 F.3d 1334 (2016). Midland filed a petition for certiorari, noting a division of opinion among the Courts of Appeals on the question whether the conduct at issue here is "false," "deceptive," "misleading," "unconscionable," or "unfair" within the meaning of the Act. Compare *ibid.* (finding the Fair Debt Collection Practices Act applicable) with *In re Dubois,* 834 F.3d 522 (C.A.4 2016) (finding the Act inapplicable); *Owens v. LVNV Funding, LLC,* 832 F.3d 726 (C.A.7 2016) (same); and *Nelson v. Midland Credit Management, Inc.,* 828 F.3d 749 (C.A.8 2016) (same). We granted the petition. We now reverse the Court of Appeals.

II

***4 [1] [2] [3] [4]** Like the majority of Courts of Appeals that have considered the matter, we conclude that Midland's filing of a proof of claim that on its face indicates that the limitations period has run does not fall within the scope of any of the five relevant words of the Fair Debt Collection Practices Act. We believe it reasonably clear that Midland's proof of claim was not "false, deceptive, or misleading." Midland's proof of claim falls within the Bankruptcy Code's definition of the term "claim." A "claim" is a "right to payment." 11 U.S.C. § 101(5)(A). State law usually determines whether a person has such a right. See *Travelers Casualty & Surety Co. of America v. Pacific Gas & Elec. Co.,* 549 U.S. 443, 450– 451, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007). The relevant state law is the law of Alabama. And Alabama's law, like the law of many States, provides that a creditor has the right to payment of a debt even after the limitations period has expired. See *Ex parte HealthSouth Corp.,* 974 So.2d 288, 296 (Ala.2007) (passage of time extinguishes remedy but the right remains); see also, *e.g., Sallaz v. Rice,* 161 Idaho 223, ––––, 384 P.3d 987, 992–993 (2016) (similar); *Notte v. Merchants Mut. Ins. Co.,* 185 N.J. 490, 499–500, 888 A.2d 464, 469 (2006) (similar); *Potterton v. Ryland Group, Inc.,* 289 Md. 371, 375–376, 424 A.2d 761, 764 (1981) (similar); *Summers v. Connolly,* 159 Ohio St. 396, 400–402, 112 N.E.2d 391, 394 (1953) (similar); *De Vries v. Secretary of State,* 329 Mich. 68, 75, 44 N.W.2d 872, 876 (1950) (similar); *Fleming v. Yeazel,* 379 Ill. 343, 344– 346, 40 N.E.2d 507, 508 (1942) (similar); *Fidelity & Cas. Co. of N.Y. v. Lackland,* 175 Va. 178, 185–187, 8 S.E.2d 306, 309 (1940) (similar); *Insurance Co. v. Dunscomb,* 108 Tenn. 724, 728–731, 69 S.W. 345, 346 (1902) (similar); but see, *e.g.,* Miss. Code Ann. § 15–1–3(1) (2012) (expiration of the limitations period extinguishes the remedy and the right); Wis. Stat. § 893.05 (2011–2012) (same).

Johnson argues that the Code's word "claim" means "enforceable claim." She notes that this Court once referred to a bankruptcy "claim" as "an enforceable obligation." *Pennsylvania Dept. of Public Welfare v. Davenport,* 495 U.S. 552, 559, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990). And, she concludes, Midland's "proof of claim" was false (or deceptive or misleading) because its "claim" was not enforceable. Brief for Respondent 22; Brief for United States as *Amicus Curiae* 18–20 (making a similar argument).

***5 [5]** But we do not find this argument convincing. The word "enforceable" does not appear in the Code's definition of "claim." See 11 U.S.C. § 101(5). The Court in *Davenport* likely used the word "enforceable" descriptively, for that case involved an enforceable debt. 495 U.S., at 559, 110 S.Ct. 2126. And it is difficult to square Johnson's interpretation with our later statement that "Congress intended ... to adopt the broadest available definition of 'claim.' " *Johnson v. Home State Bank,* 501 U.S. 78, 83, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991).

[6] It is still more difficult to square Johnson'sinterpretation with other provisions of the Bankruptcy Code. Section 502(b)(1) of the Code, for example, says that, if a "claim" is "unenforceable," it will be disallowed. It does not say that an "unenforceable" claim is not a "claim." Similarly, § 101(5)(A) says that a "claim" is a "right to payment," "whether or not such right is ... fixed, *contingent,* ... [or] *disputed.*" If a contingency does not arise, or if a claimant loses a dispute, then the claim is unenforceable. Yet this section makes clear that the

unenforceable claim is nonetheless a "right to payment," hence a "claim," as the Code uses those terms.

[7] **[8]** Johnson looks for support to other provisions that govern bankruptcy proceedings, including § 502(a) of the Bankruptcy Code, which states that a claim will be allowed in the absence of an objection, and Rule 3001(f) of the Federal Rules of Bankruptcy Procedure, which states that a properly filed "proof of claim ... shall constitute prima facie evidence of the validity and amount of the claim." But these provisions do not discuss the scope of the term "claim." Rather, they restate the Bankruptcy Code's system for determining whether a claim will be allowed. Other provisions make clear that the running of a limitations period constitutes an affirmative defense, a defense that the debtor is to assert after a creditor makes a "claim." §§ 502, 558. The law has long treated unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense. See, *e.g.,* Fed. Rule Civ. Proc. 8(c)(1); 13 Encyclopaedia of Pleading and Practice 200 (W. McKinney ed. 1898). And we see nothing misleading or deceptive in the filing of a proof of claim that, in effect, follows the Code's similar system.

***6** **[9]** **[10]** Indeed, to determine whether a statement is misleading normally "requires consideration of the legal sophistication of its audience." *Bates v. State Bar of Ariz.,* 433 U.S. 350, 383, n. 37, 97 S.Ct. 2691, 53 L.Ed.2d 810 (1977). The audience in Chapter 13 bankruptcy cases includes a trustee, 11 U.S.C. § 1302(a), who must examine proofs of claim and, where appropriate, pose an objection, §§ 704(a)(5), 1302(b)(1) (including any timeliness objection, §§ 502(b)(1), 558). And that trustee is likely to understand that, as the Code says, a proof of claim is a statement by the creditor that he or she has a right to payment subject to disallowance (including disallowance based upon, and following, the trustee's objection for untimeliness). §§ 101(5)(A), 502(b), 704(a) (5), 1302(b)(1). (We do not address the appropriate standard in ordinary civil litigation.)

III

[11] Whether Midland's assertion of an obviously timebarred claim is "unfair" or "unconscionable" (within the terms of the Fair Debt Collection Practices Act) presents a closer question. First, Johnson points out that several lower courts have found or indicated that, in the context of an ordinary civil action to collect a debt, a debt collector's assertion of a claim known to be time barred is "unfair." See, *e.g., Phillips v. Asset Acceptance, LLC,* 736 F.3d 1076, 1079 (C.A.7 2013) (holding as much); *Kimber v. Federal Financial Corp.,* 668 F.Supp. 1480, 1487 (M.D.Ala.1987) (same); *Huertas v. Galaxy Asset Management,* 641 F.3d 28, 32–33 (C.A.3 2011) (indicating as much); *Castro v. Collecto, Inc.,* 634 F.3d 779, 783 (C.A.5 2011) (same); *Freyermuth v. Credit Bureau Servs., Inc.,* 248 F.3d 767, 771 (C.A.8 2001) (same).

We are not convinced, however, by this precedent. It considers a debt collector's assertion *in a civil suit* of a claim known to be stale. We assume, for argument's sake, that the precedent is correct in that context (a matter this Court itself has not decided and does not now decide). But the context of a civil suit differs significantly from the present context, that of a Chapter 13 bankruptcy proceeding. The lower courts rested their conclusions upon their concern that a consumer might unwittingly repay a time-barred debt. Thus the Seventh Circuit pointed out that " 'few unsophisticated consumers would be aware that a statute of limitations could be used to defend against lawsuits based on stale debts.' " *Phillips, supra,* at 1079 (quoting *Kimber, supra,* at 1487). The " 'passage of time,' " the Circuit wrote, " 'dulls the consumer's memory of the circumstances and validity of the debt' " and the consumer may no longer have " 'personal records.' " 736 F.3d, at 1079 (quoting *Kimber, supra,* at 1487). Moreover, a consumer might pay a stale debt simply to avoid the cost and embarrassment of suit. 736 F.3d, at 1079.

***7** These considerations have significantly diminished force in the context of a Chapter 13 bankruptcy. The consumer initiates such a proceeding, see 11 U.S.C. §§ 301, 303(a), and consequently the consumer is not likely to pay a stale claim just to avoid going to court. A knowledgeable trustee is available. See § 1302(a). Procedural bankruptcy rules more directly guide the evaluation of claims. See Fed. Rule Bkrtcy. Proc. 3001(c)(3)(A); Advisory Committee's Notes on Rule 3001–2011 Amdt., 11 U.S.C. App., p. 678. And, as the Eighth Circuit Bankruptcy Appellate Panel put it, the claims resolution process is "generally a more streamlined and less unnerving prospect for a debtor than facing a collection lawsuit." *In re Gatewood,* 533 B.R. 905, 909 (2015); see also, *e.g.,* 11 U.S.C. § 502 (outlining generally the claims resolution process). These features of a Chapter 13 bankruptcy proceeding make it considerably more likely that an effort to collect

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upon a stale claim in bankruptcy will be met with resistance, objection, and disallowance.

Second, Johnson argues that the practice at least risks harm to the debtor and that there is not "a single legitimate reason" for allowing this kind of behavior. Brief for Respondent 32. Would it not be obviously "unfair," she asks, for a debt collector to adopt a practice of buying up stale claims cheaply and asserting them in bankruptcy knowing they are stale and hoping for careless trustees? The United States, supporting Johnson, adds its view that the Federal Rules of Bankruptcy Procedure make the practice open to sanction, and argues that sanctionable conduct is unfair conduct. Brief for United States as *Amicus Curiae* 20. See Fed. Rule Bkrtcy. Proc. 9011(b) (2) (sanction possible if party violates the Rule that by "presenting to the [bankruptcy] court" any "paper," a "party is certifying that to the best of" his or her "knowledge, ... the claims ... therein are warranted by existing law").

[12] [13] [14] We are ultimately not persuaded by these arguments. The bankruptcy system, as we have already noted, treats untimeliness as an affirmative defense. The trustee normally bears the burden of investigating claims and pointing out that a claim is stale. See *supra,* at ––– – –––. Moreover, protections available in a Chapter 13 bankruptcy proceeding minimize the risk to the debtor. See *supra,* at –––. And, at least on occasion, the assertion

of even a stale claim can benefit a debtor. Its filing and disallowance "discharge[s]" the debt. 11 U.S.C. § 1328(a). And that discharge means that the debt (even if unenforceable) will not remain on a credit report potentially affecting an individual's ability to borrow money, buy a home, and perhaps secure employment. See 15 U.S.C. § 1681c(a)(4) (debt may remain on a credit report for seven years); cf. Ala. Code § 6–2–34 (6–year statute of limitations); Md. Cts. & Jud. Proc. Code Ann. § 5–101 (2013) (3–year statute of limitations); cf. 16 C.F.R. pt. 600, App. § 607, ¶ 6 (1991) (a credit report may include discharged debt only if "the debt [is reported] as having a zero balance due to reflect the fact that the consumer is no longer liable for the discharged debt"); FTC, 40 Years of Experience with the Fair Credit Reporting Act: An FTC Staff Report with Summary of Interpretations 66 (2011) (similar).

***8** More importantly, a change in the simple affirmativedefense approach, carving out an exception, itself would require defining the boundaries of the exception. Does it apply only where (as Johnson alleged in the complaint) a claim's staleness appears "on [the] face" of the proof of claim? Does it apply to other affirmative defenses or only to the running of a limitations period?

[15] [16] At the same time, we do not find in either the Fair Debt Collection Practices Act or the Bankruptcy Code good reason to believe that Congress intended an ordinary civil court applying the Act to determine answers to these bankruptcy-related questions. The Act and the Code have different purposes and structural features. The Act seeks to help consumers, not necessarily by closing what Johnson and the United States characterize as a loophole in the Bankruptcy Code, but by preventing consumer bankruptcies in the first place. See, *e.g.,* 15 U.S.C. § 1692(a) (recognizing the "abundant evidence of the use of abusive, deceptive, and unfair debt collection practices [which] contribute to the number of personal bankruptcies"); see also § 1692(b) ("Existing laws and procedures ... are inadequate to protect consumers"); § 1692(e) (statute seeks to "eliminate abusive debt collection practices"). The Bankruptcy Code, by way of contrast, creates and maintains what we have called the "delicate balance of a debtor's protections and obligations." *Kokoszka v. Belford,* 417 U.S. 642, 651, 94 S.Ct. 2431, 41 L.Ed.2d 374 (1974).

To find the Fair Debt Collection Practices Act applicable here would upset that "delicate balance." From a substantive perspective it would authorize a new significant bankruptcy-related remedy in the absence of language in the Code providing for it. Administratively, it would permit postbankruptcy litigation in an ordinary civil court concerning a creditor's state of mind— a matter often hard to determine. See 15 U.S.C. § 1692k(c) (safe harbor for any debt collector who "shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error"). Procedurally, it would require creditors (who assert a claim) to investigate the merits of an affirmative defense (typically the debtor's job to assert and prove) lest the creditor later be found to have known the claim was untimely. The upshot could well be added complexity, changes in settlement incentives, and a shift from the debtor to the creditor the obligation to investigate the staleness of a claim.

Unlike the United States, we do not believe that the Advisory Committee on Rules of Bankruptcy Procedure settled the issue when it promulgated Bankruptcy Rule 9011. The

Committee, in considering amendments to the Federal Rules of Bankruptcy Procedure in 2009, specifically rejected a proposal that would have required a creditor to certify that there is no valid statute of limitations defense. See Agenda Book for Meeting 86–87 (Mar. 26–27, 2009). It did so in part because the working group did not want to impose an affirmative obligation on a creditor to make a prefiling investigation of a potential time-bar defense. *Ibid.* In rejecting that proposal, the Committee did note that Rule 9011 imposes a general "obligation on a claimant to undertake an inquiry reasonable under the circumstances to determine ... that a claim is warranted by existing law and that factual contentions have evidentiary support," and to certify as much on the proof of claim. *Id.,* at 87. The Committee also acknowledged, however, that this requirement would "not addres [s] the statute of limitation issue," but would only ensure "the accuracy of the information provided." *Ibid.*

***9** We recognize that one Bankruptcy Court has held that filing a time-barred claim without a prefiling investigation of a potential time-bar defense merits sanctions under Rule 9011. *In re Sekema,* 523 B.R. 651, 654 (Bkrtcy.Ct.N.D.Ind.2015). But others have held to the contrary. See, *e.g., In re Freeman,* 540 B.R. 129, 143–144 (Bkrtcy.Ct.E.D.Pa.2015); *In re Jenkins,* 538 B.R. 129, 134–136 (Bkrtcy.Ct.N.D.Ala.2015); *In re Keeler,* 440 B.R. 354, 366–369 (Bkrtcy.Ct.E.D.Pa.2009); see also *In re Andrews,* 394 B.R. 384, 387–388 (Bkrtcy.Ct.E.D.N.C.2008) (recognizing that "[m]any courts have ... found that sanctions [under Rule 9011] were not warranted for filing stale claims").

These circumstances, taken together, convince us that we cannot find the practice at issue here "unfair" or "unconscionable" within the terms of the Fair Debt Collection Practices Act.

IV

For these reasons, we conclude that filing (in a Chapter 13 bankruptcy proceeding) a proof of claim that is obviously time barred is not a false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the Fair Debt Collection Practices Act. The judgment of the Eleventh Circuit is reversed.

It is so ordered.

Justice GORSUCH took no part in the consideration or decision of this case.

Justice SOTOMAYOR, with whom Justice GINSBURG and Justice KAGAN join, dissenting.

***9** The Fair Debt Collection Practices Act (FDCPA or Act) prohibits professional debt collectors from using "false, deceptive, or misleading representation[s] or means in connection with the collection of any debt" and from "us[ing] unfair or unconscionable means to collect" a debt. 15 U.S.C. §§ 1692e, 1692f. The Court today wrongfully holds that a debt collector that knowingly attempts to collect a time-barred debt in bankruptcy proceedings has violated neither of these prohibitions.

Professional debt collectors have built a business out of buying stale debt, filing claims in bankruptcy proceedings to collect it, and hoping that no one notices that the debt is too old to be enforced by the courts. This practice is both "unfair" and "unconscionable." I respectfully dissent from the Court's conclusion to the contrary.[1]

I

Americans owe trillions of dollars in consumer debt to creditors—credit card companies, schools, and car dealers, among others. See Fed. Reserve Bank of N.Y., Quarterly Report on Household Debt and Credit 3 (2017). Most people will repay their debts, but some cannot do so. The debts they do not pay are increasingly likely to end up in the hands of professional debt collectors—companies whose business it is to collect debts that are owed to other companies. See Consumer Financial Protection Bur., Fair Debt Collection Practices Act: Annual Report 2016, p. 8 (CFPB Report). Debt collection is a lucrative and growing industry. Last year, the Nation's 6,000 debt collection agencies earned over $13 billion in revenue. *Ibid.*

***10** Although many debt collectors are hired by creditors to work on a third-party basis, more and more collectors also operate as "debt buyers"—purchasing debts from creditors outright and attempting to collect what they can, with the profits going to their own accounts.[2] See FTC, The Structure and Practices of the Debt Buying Industry 11–12 (2013) (FTC Report); CFPB Report 10. Debt buyers now hold hundreds of billions of dollars in consumer debt; indeed, a study conducted by the Federal Trade Commission (FTC) in 2009 found that nine of the leading debt buyers had purchased over $140 billion in debt just in the previous three years. FTC Report, at i-ii, T–3 (Table 3).

Because creditors themselves have given up trying to collect the debts they sell to debt buyers, they sell those debts for pennies on the dollar. *Id.,* at 23. The older the debt, the greater the discount: While debt buyers pay close to eight cents per dollar for debts under three years old, they pay as little as two cents per dollar for debts greater than six years old, and "effectively nothing" for debts greater than 15 years old. *Id.,* at 23–24. These prices reflect the basic fact that older debts are harder to collect. As time passes, consumers move or forget that they owe the debts; creditors have more trouble documenting the debts and proving their validity; and debts begin to fall within state statutes of limitations—time limits that "operate to bar a plaintiff's suit" once passed. *CTS Corp. v. Waldburger,* 573 U.S. ––––, ––––, 134 S.Ct. 2175, 2182, 189 L.Ed.2d 62 (2014). Because a creditor (or a debt collector) cannot enforce a time-barred debt in court, the debt is inherently worth very little indeed.

But statutes of limitations have not deterred debt buyers. For years, they have filed suit in state courts—often in small-claims courts, where formal rules of evidence do not apply—to collect even debts too old to be enforced by those courts.[3] See Holland, The One Hundred Billion Dollar Problem in Small–Claims Court, 6 J. Bus. & Tech. L. 259, 261 (2011). Importantly, the debt buyers' only hope in these cases is that consumers will fail either to invoke the statute of limitations or to respond at all: In most States the statute of limitations is an affirmative defense, meaning that a consumer must appear in court and raise it in order to dismiss the suit. See *ante,* at –––– – –––– (majority opinion). But consumers do fail to defend themselves in court—in fact, according to the FTC, over 90% fail to appear at all. FTC Report 45. The result is that debt buyers have won "billions of dollars in default judgments" simply by filing suit and betting that consumers will lack the resources to respond. Holland, *supra,* at 263.

***11** The FDCPA's prohibitions on "misleading" and "unfair" conduct have largely beaten back this particular practice. Every court to have considered the question has held that a debt collector that knowingly files suit in court to collect a time-barred debt violates the FDCPA. See *Phillips v. Asset Acceptance, LLC,* 736 F.3d 1076, 1079 (C.A.7 2013); *Kimber v. Federal Financial Corp.,* 668 F.Supp. 1480, 1487 (M.D.Ala.1987); see also *ante,* at –––– – –––– (majority opinion) (citing other cases). In 2015, petitioner and its parent company entered into a consent decree with the Government prohibiting them from filing suit to collect time-barred debts and ordering them to pay $34 million in restitution. See Consent Order in *In re Encore Capital Group, Inc.,* No. 2015–CFPB–0022 (Sept. 9, 2015), pp. 38, 46. And the leading trade association has now adopted a resolution barring the practice. See Brief for DBA International, Inc., as *Amicus Curiae* 2–3.

Stymied in state courts, the debt buyers have now turned to a new forum: bankruptcy courts. The same debt buyers that for years filed thousands of lawsuits in state courts across the country have begun to do the same thing in bankruptcy courts—specifically, in cases governed by Chapter 13 of the Bankruptcy Code, which allows consumers earning regular incomes to restructure their debts and repay as many as they can over a period of several years. See 8 Collier on Bankruptcy ¶ 1300.01 (A. Resnick & H. Sommer eds., 16th ed. 2016). As in ordinary civil cases, a debtor in a Chapter 13 bankruptcy proceeding is entitled to have dismissed any claim filed against his estate that is barred by a statute of limitations. See 11 U.S.C. § 558. As in ordinary civil cases, the statute of limitations is an affirmative defense, one that must be raised by either the debtor or the trustee of his estate before it is honored. §§ 502, 558. And so—just as in ordinary civil cases—debt collectors may file claims in bankruptcy proceedings for stale debts and hope that no one notices that they are too old to be enforced.

And that is exactly what the debt buyers have done. As a wide variety of courts and commentators have observed, debt buyers have "deluge[d]" the bankruptcy courts with claims "on debts deemed unenforceable under state statutes of limitations." *Crawford v. LVNV Funding, LLC,* 758 F.3d 1254, 1256 (C.A.11 2014); see also *In re Jenkins,* 456 B.R. 236, 239, n. 2 (Bkrtcy.Ct.E.D.N.C.2011) (noting a "plague of stale claims"); Brief for National Association of Consumer Bankruptcy Attorneys et al. as *Amici Curiae* 9 (noting study describing "hundreds of thousands of proofs of claim asserting hundreds of millions of dollars of consumer indebtedness, all in a single year"). This practice has become so widespread that the Government sued one debt buyer last year "to address [its] systemic abuse of the bankruptcy process"—including a "business model" of "knowingly and strategically" filing thousands of claims for time-barred debt. Complaint in *In re Freeman–Clay v. Resurgent Capital Servs., L.P.,* No. 14–41871 (Bkrtcy. Ct. WD Mo.), ¶¶ 1, 35 (*Resurgent* Complaint). This practice, the Government explained,

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"manipulates the bankruptcy process by systematically shifting the burden" to trustees and debtors to object even to "frivolous claims"—especially given that filing an objection is costly, time consuming, and easy to overlook. *Id.,* at ¶¶ 35, 43–44.

II

***12** The FDCPA prohibits professional debt collectors from engaging in "unfair" and "unconscionable" practices. 15 U.S.C. § 1692f.[4] Filing a claim in bankruptcy court for debt that a collector knows to be time barred— like filing a lawsuit in a court to collect such a debt—is just such a practice.

A

Begin where the debt collectors themselves began: with their practice of filing suit in ordinary civil courts to collect debts that they know are time barred. Every court to have considered this practice holds that it violates the FDCPA. There is no sound reason to depart from this conclusion.

Statutes of limitations "are not simply technicalities." *Board of Regents of Univ. of State of N.Y. v. Tomanio,* 446 U.S. 478, 487, 100 S.Ct. 1790, 64 L.Ed.2d 440 (1980). They reflect strong public-policy determinations that "it is unjust to fail to put [an] adversary on notice to defend within a specified period of time." *United States v. Kubrick,* 444 U.S. 111, 117, 100 S.Ct. 352, 62 L.Ed.2d 259 (1979). And they "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared." *Railroad Telegraphers v. Railway Express Agency, Inc.,* 321 U.S. 342, 348–349, 64 S.Ct. 582, 88 L.Ed. 788 (1944). Such concerns carry particular weight in the context of small-dollar consumer debt collection. As one thoughtful opinion explains:

> "Because few unsophisticated consumers would be aware that a statute of limitations could be used to defend against lawsuits based on stale debts, such consumers would unwittingly acquiesce to such lawsuits. And, even if the consumer realizes that she can use time as a defense, she will more than likely still give in rather than fight the lawsuit because she must still expend energy and resources and subject herself to the embarrassment of going into court to present the defense...." *Kimber,* 668 F.Supp., at 1487.

Debt buyers' efforts to pursue stale debt in ordinary civil litigation may also entrap debtors into forfeiting their time defenses altogether. When a debt collector sues or threatens to sue to collect a debt, many consumers respond by offering a small partial payment to forestall suit. In many States, a consumer who makes an offer like this has —unbeknownst to him—forever given up his ability to claim the debt is unenforceable. That is because in most States a consumer's partial payment on a time-barred debt —or his promise to resume payments on such a debt—will restart the statute of limitations. FTC Report 47; see, *e.g., Young v. Sorenson,* 47 Cal.App.3d 911, 914, 121 Cal.Rptr. 236, 237 (1975) (" 'The theory on which this is based is that the payment is an acknowledgement on the existence of the indebtedness which raises an implied promise to continue the obligation and to pay the balance' "). Debt collectors' efforts to entrap consumers in this way have no place in honest business practice.

B

***13** The same dynamics are present in bankruptcy proceedings. A proof of claim filed in bankruptcy court represents the debt collector's belief that it is entitled to payment, even though the debt should not be enforced as a matter of public policy. The debtor's claim will be allowed, and will be incorporated in a debtor's payment plan, unless the debtor or his trustee objects. But such objections require ordinary and unsophisticated people (and their overworked trustees) to be on guard not only against mistaken claims but also against claims that debt collectors know will fail under law if an objection is raised. Debt collectors do not file these claims in good faith; they file them hoping and expecting that the bankruptcy system will fail. Such a practice is "unfair" and "unconscionable" in violation of the FDCPA.

The Court disagrees. But it does so on narrow grounds. To begin with, the Court does not hold that the Bankruptcy Code altogether displaces the FDCPA, leaving it with no role to play in bankruptcy proceedings. Such a conclusion would be wrong. Although the Code and the FDCPA "have different purposes and structural features," *ante,* at ——, the Court has held that Congress, in passing the FDCPA's predecessor, did so on the understanding that "the provisions and the purposes" of the two statutes were intended to "coexist." *Kokoszka v. Belford,* 417 U.S. 642, 650, 94 S.Ct.

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2431, 41 L.Ed.2d 374 (1974). Although petitioner suggests that the FDCPA is best read "to have no application to [a] debt collector's conduct" in a bankruptcy proceeding, Brief for Petitioner 41, the majority declines its invitation to adopt such a sweeping rule.[5]

Nor does the majority take a position on whether a debt collector violates the FDCPA by filing suit in an ordinary court to collect a debt it knows is time barred. *Ante,* at ——. Instead, the majority concludes, even assuming that such a practice would violate the FDCPA, a debt collector does not violate the Act by doing the same thing in bankruptcy proceedings. Bankruptcy, the majority argues, is different. True enough. But none of the distinctions that the majority identifies bears the weight placed on it.

First, the majority contends, structural features of the bankruptcy process reduce the risk that a stale debt will go unnoticed and thus be allowed. *Ante,* at —— – ——. But there is virtually no evidence that the majority's theory holds true in practice. The majority relies heavily on the presence of a bankruptcy trustee, appointed to act on the debtor's behalf and empowered to (among other things) object to claims that he believes lack merit. See 11 U.S.C. §§ 704(a)(5), 1302(b). In the majority's view, the trustee's gatekeeping role makes it "considerably more likely that an effort to collect upon a stale claim in bankruptcy will be met with resistance, objection, and disallowance." *Ante,* at ——. The problem with the majority's *ipse dixit* is that everyone with actual experience in the matter insists that it is false. The Government, which oversees bankruptcy trustees, tells us that trustees "cannot realistically be expected to identify every time-barred ... claim filed in every bankruptcy." Brief for United States as *Amicus Curiae* 25–26; see also *Resurgent* Complaint ¶ 43 ("Filing objections to all of [one collector]'s unenforceable claims would clog the docket of this Court and other courts with objections to frivolous claims"). The trustees themselves (appearing here as *amici curiae*) agree, describing the practice as "wasteful" and "exploit [ative]." Brief for National Association of Chapter Thirteen Trustees as *Amicus Curiae* 12. And courts across the country recognize that Chapter 13 trustees are struggling under a "deluge" of stale debt. *Crawford,* 758 F.3d, at 1256.

***14** Second, the other features of the bankruptcy process that the majority believes will serve as a backstop against frivolous claims are even less likely to do so in practice. The majority implies that a person who files for bankruptcy is more sophisticated than the average consumer debtor because the initiation of bankruptcy is a choice made by a debtor. *Ante,* at ——. But a person who has filed for bankruptcy will rarely be in such a superior position; he has, after all, just declared that he is unable to meet his financial obligations and in need of the assistance of the courts. It is odd to speculate that such a person is better situated to monitor court filings and lodge objections than an ordinary consumer. The majority also suggests that the rules of bankruptcy help "guide the evaluation of claims." *Ibid.* But the rules of bankruptcy in fact facilitate the *allowance* of claims: Claims are automatically allowed and made part of a plan unless an objection is made. See 11 U.S.C. § 502(a). A debtor is arguably more vulnerable in bankruptcy—not less—to the oversights that the debt buyers know will occur.

Finally, the majority suggests, in some cases a consumer will actually *benefit* if a claim for an untimely debt is filed. *Ante,* at —— – ——. If such a claim is filed but disallowed, the majority explains, the debt will eventually be discharged, and the creditor will be barred from collecting it. See § 1328(a). Here, too, practice refutes the majority's rosy portrait of these proceedings. A debtor whose trustee does not spot and object to a stale debt will find no comfort in the knowledge that *other* consumers with more attentive trustees may have their debts disallowed and discharged. Moreover, given the high rate at which debtors are unable to fully pay off their debts in Chapter 13 proceedings, see Porter, The Pretend Solution: An Empirical Study of Bankruptcy Outcomes, 90 Texas L. Rev. 103, 111–112 (2011), most debtors who fail to object to a stale claim will end up worse off than had they never entered bankruptcy at all: They will make payments on the stale debts, thereby resuscitating them,

Footnotes

see *supra,* at —— – ——, and may thus walk out of bankruptcy court owing more to their creditors than they did when they entered it. There is no benefit to anyone in such a proceeding—except the debt collectors.

3

It does not take a sophisticated attorney to understand why the practice I have described in this opinion is unfair. It takes only the common sense to conclude that one should not be able to profit on the inadvertent inattention of others. It is said that the law should not

be a trap for the unwary. Today's decision sets just such a trap.

I take comfort only in the knowledge that the Court's decision today need not be the last word on the matter. If Congress wants to amend the FDCPA to make explicit what in my view is already implicit in the law, it need only say so.

***15** I respectfully dissent.

All Citations

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* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

1 Because I believe the practice at issue here is “unfair” and “unconscionable,” and thus violates 15 U.S.C. § 1692f, I do not address the Court's conclusion that the practice is not “false, deceptive, or misleading” in violation of § 1692e.

2 A case pending before this Court, *Henson v. Santander Consumer USA Inc.,* No. 16–349, asks whether a certain kind of debt buyer is a “debt collector” under the FDCPA. Midland does not dispute that it is a debt collector under the Act.

3 Petitioner's parent alone filed 245,000 lawsuits in 2009. See Silver–Greenberg, Boom in Debt Buying Fuels Another Boom—in Lawsuits, Wall Street Journal, Nov. 29, 2010, pp. A1, A16. Petitioner itself filed 110 lawsuits on just one date in a single state court. *Id.,* at A1.

4 This Court has not had occasion to construe the terms “unfair” and “unconscionable” in § 1692f. The FDCPA's legislative history suggests that Congress intended these terms as a backstop that would enable “courts, where appropriate, to proscribe other improper conduct ... not specifically addressed” by the statute. S.Rep. No. 95–382, p. 4 (1977). Courts have construed these terms, consistent with other federal and state statutes that employ them, to borrow from equitable and common-law traditions. See, *e.g., LeBlanc v. Unifund CCR Partners,* 601 F.3d 1185, 1200–1201 (C.A.11 2010) (*per curiam*); *Beler v. Blatt, Hasenmiller, Leibsker & Moore, LLC,* 480 F.3d 470, 473–474 (C.A.7 2007).

5 The majority does lean heavily on its fear that, were we to conclude that the FDCPA bars the practice at issue, we would be licensing “postbankruptcy litigation in an ordinary civil court” concerning matters best left to bankruptcy courts. *Ante,* at ––––. But to do so would not, as the majority suggests, “upset [the] ‘delicate balance’ ” struck by the Code. *Ibid.* (quoting *Kokoszka v. Belford,* 417 U.S., at 651, 94 S.Ct. 2431). For one, nothing requires a debtor to engage in satellite litigation in order to sue a debt collector under the FDCPA; a debtor can easily file an adversary proceeding asserting an FDCPA claim with the bankruptcy court itself, and in many cases will be better served by doing so. See, *e.g., Simon v. FIA Card Servs., N. A.,* 732 F.3d 259, 263 (C.A.3 2013). Nor is there any risk that finding the FDCPA applicable here will authorize bankruptcy courts (or, for that matter, civil courts) to engage in novel and unfettered inquiries into “a creditor's state of mind.” *Ante,* at ––––. Both Fed. Rule Civ. Proc. 11 and its bankruptcy counterpart, Fed. Rule Bkrtcy. Proc. 9011, authorize a court to impose sanctions on parties who willfully file meritless claims (a category that includes the debt buyers here, see *In re Sekema,* 523 B.R. 651, 654–655 (Bkrtcy.Ct.N.D.Ind.2015)). So there is nothing new about the inquiry that courts would be required to undertake; it is no different than analyses they conduct every day.

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