Controlling the Crafty Chapter 13 Creditor

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I. Proofs of Claim for Time-Barred Debt

The Circuits have been split for some time on the issue of whether the filing of a proof of claim for a debt upon which the statute of limitations has expired constitutes a violation of the FDCPA.

In 2010, the Second Circuit held that the filing of such claims do not violate the FDCPA. Its reasoning was that the bankruptcy process and courts sufficiently protect debtors.

In 2014, the Eleventh Circuit found that filing such a proof of claim is misleading. The Eleventh Circuit relied, at least in part, upon a Seventh Circuit case, *Phillips v. Asset Acceptance, LLC*, 736 F.3d 1076 (7th Cir., 2013). *Phillips* did not deal with bankruptcy claims, but with state court lawsuits. In *Phillips,* the Seventh Circuit held that the filing of suit to collect on a time-barred debt was misleading or deceptive, and thus a violation of the FDCPA.

Earlier this summer, the Eighth Circuit weighed in, finding no violation of the FDCPA for the filing of a time-barred proof of claim in bankruptcy. *Nelson v. Midland Credit Mgmt.,* 2016 WL 3672073 (8th Cir. July 11, 2016).

Now the Seventh Circuit has spoken. In three cases decided together, debt collectors in Chapter 13 cases filed proofs of claim for debts upon which the statute of limitations had expired. The proofs properly conformed to Fed. R. Bankr. Pro. 3001, setting forth the origin of the debt, the date of last payment, and the date of the last transaction. In each case, the debtor objected to the claim and the claim was disallowed. Each claim was thereafter discharged.

The debtors then brought suit in federal court, alleging that the filing of the proof of claim was false, deceptive, misleading, unfair, or unconscionable, thus violating §§ 1692e and 1692f of the FDCPA.

The district courts dismissed these suits. At least one of those courts noted that the proof of claim was complete and accurate. The debtors appealed.

The Seventh Circuit began by reviewing the definition of "claim" under the Bankruptcy Code. It noted that a "claim" in bankruptcy is subject to a broader definition than the existence of the right to sue. The court noted that in most jurisdictions the expiration of the statute of limitations period does not extinguish the debt. It specifically noted that this is the law in both Illinois and Indiana.

The court also discussed Fed. R. Bankr. Pro. 3001 and its requirements. It found that those requirements demonstrate that Congress anticipated that proofs of claim would be filed upon time-barred debts. The court held that such a proof of claim is nothing more than a claim which may be disputed in the bankruptcy case. It therefore is not inherently misleading or deceptive. The court did note that if the proof of claim had been filed with inaccurate information, a cause of action under the FDCPA would have accrued.

In discussing the holdings of the other circuits, the Seventh Circuit criticized the decision of the Eleventh Circuit in *Crawford.* The *Crawford* court had utilized the "least sophisticated" consumer standard. The Seventh Circuit distinguished by noting that the "unsophisticated consumer" standard (similar to "least sophisticated", but used only in the Seventh Circuit) was not the correct standard when the communication is made to the debtor's lawyer. See *Evory v. RJM Acquisitions Funding, LLC,* 505 F.3d 769 (7th Cir. 2007). See *Bravo v. Midland Credit Mgmt., Inc.,* 812 F.3d 599 (7th Cir. 2016). Since the debtors in the cases before the Seventh Circuit were all represented by counsel, the standard is whether or not the communications (the proof of claim) would be likely to mislead a competent lawyer.

The Seventh Circuit found it would not. In language which may come back to haunt debtors' counsel someday, the court quoted district court on one of the three cases on appeal: "A competent lawyer would undoubtedly be aware of the statute of limitations defense that is common in most areas of law and permitted by the Bankruptcy Code."

Owens is clearly helpful for creditors in Illinois and Indiana. But what about Wisconsin? Wis. Stat. § 893.05 provides,

> "893.05 Relation of statute of limitations to right and remedy. When the period within which an action may be commenced on a Wisconsin cause of action has expired, the right is extinguished as well as the remedy.
>
> History: 1979 c. 323.
>
> Judicial Council Committee's Note, 1979: This new section is a codification of Wisconsin case law. See Maryland Casualty Company v. Beleznay, 245 Wis. 390, 14 N.W.2d 177 (1944), in which it is stated at page 393: "In Wisconsin the running of the statute of limitations absolutely extinguishes the cause of action for in Wisconsin limitations are not treated as statutes of repose. The limitation of actions is a right as well as a remedy, extinguishing the right on one side and creating a right on the other, which is as of high dignity as regards judicial remedies as any other right and it is a right which enjoys constitutional protection". [Bill 326-A]
>
> The expiration of the limitations period extinguishes the cause of action of the potential plaintiff and it also creates a right enjoyed by the would-be defendant to insist on that statutory bar. A defendant, having acquired a right to assert the statute of limitations bar by operation of law, would suffer plain legal prejudice if a plaintiff's motion for voluntary dismissal were granted. Wojtas v. Capital Guardian Trust Co. 477 F.3d 924 (2007)."

This statute codified prior case law. "It is the rule of law in this state that the running of the statute extinguishes the right . . . and that the obligation is thereby extinguished as completely as if it had been paid or otherwise satisfied." *First Nat. Bank of Madison v. Kolbeck*, 247 Wis. 462, 464 (Wis. 1945).

This aspect of Wisconsin law has already been construed in connection with the FDCPA. "When the right is extinguished a creditor may no longer claim the money is owed." *Klewer v. Cavalry Inv., LLC,* No. 01-C-521 (W.D. Wis. Jan. 30, 2002).

At the very least, it would seem that filing a proof of claim upon a time-barred debt in Wisconsin would constitute a *prima facie* case of false representation. See *Anderson v. Riverwalk Holdings Ltd.,* Case No. 15-CV-621-pp (E.D. WI, 2015).

As a result of the split of authority between *Owens* and similar cases in the Fourth and Eighth Circuits and *Crawford* in the Eleventh Circuit, the plaintiffs in *Owens* have petitioned for certiorari in the Supreme Court. Counsel advises that the creditor-respondents will support the petition for certiorari as they would like to see this issue decided definitively.

II. When is Real Property the Debtor's Principal Residence for Purposes of Section 1322(b)(2)?

Modification of a "claim secured only by a security interest in real property that is the debtor's principal residence" is prohibited in Chapter 13. 11 U.S.C. § 1322(b)(2). This statute is easy to apply and interpret when the debtor owns a single family residence. What about situations in which the debtor's principal residence is part of or included in property with other units?

Courts around the country are divided on this issue. The majority of those that have weighed in have held that debtors occupying a multi-unit property may modify the mortgage loan in a Chapter 13 plan. Both the First and Third Circuits have adopted this approach. See *In re Scarborough*, 461 F.3d 406, 411 (3rd Cir. 2006). See *In re Bullard*, 494 B.R. 92, 97 (B.A.P. 1st Cir. 2013). A pre-BAPCPA case had also allowed modification. *Lomas Mortgage, Inc. v. Louis,* 82 F.3d 1 (1st Cir. 1996).

Other courts have ruled that the anti-modification language is much more of an objective bright-line rule and applies to any loan secured only by real property that the debtor uses as a principal residence, even if that real property is used for other purposes as well. See *In Re Macaluso,* 254, B.R. 799, 800 (Bankr. W.D.N.Y. 2000). See *In Re Guilbert,* 176 B.R. 302, 305 (D. R.I. 1995). See *In Re Wages,* 479 B.R. 575, 581 (Bankr. D. Idaho 2012). The third approach, applying a case-by-case analysis, has been adopted by other courts. Some of these look at the predominant intention of the parties.

The Seventh Circuit has not yet ruled on this issue, but a decision from the Northern District of Illinois may provide some guidance. In *In Re Abrego*, 506 B.R. 509 (Bankr. N.D. IL 2014) Judge Hollis considered a Chapter 13 plan in which debtors lived in one of two units in a building. The proposed Chapter 13 plan sought to modify the claim of the mortgage holder, which objected, citing Section 1322(b)(2).

The court analyzed many of the decisions from around the country, ultimately finding that the statute is ambiguous. The Court found that the legislative history indicated that Congress intended the anti-modification provision to protect mortgage holders whose claims were secured by real property consisting solely of the debtor's principal residence. Because this property was not solely the debtor's principal residence, the mortgage could be modified and the plan was confirmed.

The Court also considered the applicable date to use for determining the use of the debtor's property. Some courts had looked at the status of the property on the date the bankruptcy case was filed, while others looked to the date of the granting of the security interest. Judge Hollis adopted the loan transaction date as the relevant date to use, even though this is the minority approach.

Subsequently, Judge Schmetterer considered the question of whether the time to be considered for determining whether a property was a single family residence was either the time the mortgage was granted or the time the petition was filed in *Lopez v. Credit Union One (In re Lopez)* (case 13 B 37072, adv. pro. 13 A 1446, Bankr. N.D. Ill June 16, 2014). While suggesting that the majority approach was the better approach, it was not necessary to decide since the property in question was a two-flat – one of which was rented, at the time of the mortgage.

Based on an evidentiary hearing, Judge Schmetterer held that the actual facts and not the lender's intent was dispositive.

III. Claim Valuation

Crafty creditors often file claims alleging that the value of the collateral is substantially higher than it may actually be. The standard for valuation in Chapter 13 was set by the U.S. Supreme Court in *Associates Commercial Corporation v. Rash*, 520 U.S. 953 (1997). There the court held that the value of collateral in a Chapter 13 case would be determined by the replacement value. Because the debtor was choosing to retain the truck which served as collateral, the value had to provide for something more than foreclosure value. Replacement value, the court reasoned, would compensate the creditor for additional risk which arises while the debtor retains the collateral.

That sounds good, but how should we determine replacement value? The answer often lies in the form of the collateral. The Supreme Court noted, in the now-famous *Footnote 6*, that replacement value may vary depending upon the type of debtor and the type of collateral. Often replacement value will not include some items which the debtor may have contracted for. The examples used by the court with respect to a vehicle were warranties, inventory storage, and

reconditioning. The court also mentioned that accessories added to the vehicle might not add to the creditor's secured value.

Another factor could be the timing of the purchase. Some courts have held that replacement value for items purchased on the eve of bankruptcy, may in fact be the purchase price paid by the debtor. In *In re Spraggins*, 316 B.R. 317 (Bankr. E.D. Wis 2004), the bankruptcy court adopted reasoning that replacement value of household goods purchased within 90 days of the bankruptcy filing should be the purchase price of those goods. It found that for vehicles, an eve of bankruptcy purchase price would constitute presumptive value. The debtor would then have to produce evidence of a market to replace the vehicle for less.

IV. Interest Rates

Interest rates are another means by which crafty creditors seek to recover more than they perhaps should be allowed. The Supreme Court again has provided guidance, in *In re Till*, 541 U.S. 465 (2004). Till involved a used truck purchased by the debtors who later filed Chapter 13. The plan proposed interest at 9.5%, rather than the 21% contract rate. The 9.5% was determined by using the then-prime rate of 8% and adding 1.5% to account for risk of non-payment.

The court considered various theories, but adopted the "formula" approach based upon the prime rate, which is then adjusted upward for risk. The court did not decide the amount of that adjustment, although it noted that the bankruptcy court had approved a risk add-on factor of 1.5% and that various other courts have generally approved add-ons of 1% to 3%.

Since *Till*, local practices have evolved and most experienced bankruptcy lawyers have a fairly good idea of the rates their local judges will apply. In a decision from the Eastern District of Wisconsin, the bankruptcy court noted the Supreme Court's suggestion in *Till* that the prime rate is the starting point. The court took evidence, but that evidence failed to establish the amount

of adjustment which should have been made. The court looked at the debtor's age, health, employment, and income history, as well as the makeup of the Chapter 13 plan, and found that no risk adjustment was warranted. The plan could therefore be confirmed by paying the secured creditor's claim in full with interest at the prime rate.

Both debtors and creditors are entitled to present evidence of the appropriate risk adjustment. The burden of proof is on the creditor.

This may give an advantage to debtors, at least those who can be good witnesses and present credible testimony about their ability to make the plan payments.

V. Debts Arising from a Divorce (Dealing with Creditors?)

Debts arising from a divorce are generally not dischargeable in bankruptcy. Such debts fall into two categories under 11 U.S.C. §523; 11 U.S.C. §523(a)(5) and §523(a)(15). An exception exists in Chapter 13, however, where debts under §523(a)(15) are dischargeable. See 11 U.S.C. §1328(a)(2).

For this reason divorced debtors often look to Chapter 13 as the optimal form of debt relief. DSOs, of course, remain non-dischargeable and must be paid in full. See §1325(a)(8) and §1328(a).

The divorce party creditor therefore has an incentive to have the obligation treated as a DSO. The crafty Chapter 13 creditor may file a proof of claim asserting that the claim is entitled to priority under 11 U.S.C. §507(a)(1)(A) or (a)(1)(B).

Defending against these claims requires a careful review of the divorce judgment and any findings of fact and conclusions of law, as well as any marital settlement agreement. It also requires an understanding of the factual details involved in the case and how the terms were negotiated.

In *In re Miller*, (13-31039-gmh Bankr. E.D. Wis. July 3, 2014), the debtor's ex-wife filed a claim for over $20,000, listing the entire amount as being entitled to priority as a domestic support obligation. The basis of the claim was a payment made by the ex-wife to a student loan creditor to pay off a student loan on behalf of the parties' daughter.

Although the ex-wife creditor argued that the divorce decree obligated the debtor to pay the student loan debt for the daughter, the divorce judgment was ambiguous about obligations.

The bankruptcy court found that the ex-wife creditor appeared to have paid the debt voluntarily, as there was no evidence of attempts to collect from her.

Because the debt was not owed from the debtor to the ex-wife or to the child, or to a state DSO agency, the bankruptcy court found insufficient evidence to establish DSO status under either 11 U.S.C. §507(a)(1)(A) or (a)(1)(B).

The second line of defense involves the underlying facts and circumstances. In a case from the Western District of Wisconsin, a debtor faced a proof of claim filed by her ex-husband, asserting priority status as a DSO. The divorce documents stated that the debt was non-dischargeable under both §523(a)(5) and 523(a)(15). An investigation of the facts showed that at the time of the divorce, the parties had disparate earning power and that the amount awarded as a series of payments did not seem to reflect an equal division of the assets. Further investigation led to a review of the correspondence and e-mails between the parties and their counsel. Those showed clearly that the debtor was waiving maintenance in return for a lump sum payment. It was then successfully argued that the lump sum payment was in fact not an equalization of assets and liabilities, but a support obligation which qualified as a DSO.

In this instance the debtor lost, but this same methodology could be applied in reverse to protect debtors.

This is not to say that the language of the divorce decree will not determine the outcome of most cases. It will. In fact, it may well be that the language in the divorce documents is so clear that there is no room for interpretation other than as stated.

This was the outcome of *In re Weaver*, 316 B.R. 705 (Bankr. W.D. Wis. Sept. 29, 2004). In *Weaver,* the court found the following language to be so clear as to require no investigation into the parties' intent.

> "With respect to each party's responsibility for the payment of certain debts and obligations, and the obligation to hold the other harmless for the payment of those debts and obligations, the parties understand and agree that their obligations are non-dischargeable debts under §523(a)(5) of the Bankruptcy Act, these obligations being part of the final financial support settlement for both parties. These financial obligations on the part of both parties are not part of the property settlement.
>
> It is also understood that while these obligations are related to the support of both parties, they in no way affect any other portion of this Marital Settlement Agreement which specifically denies maintenance to both parties, and are not intended to confer additional subject matter jurisdiction in the Courts with respect to any maintenance obligation. This understanding and agreement is set forth in detail so as to clarify the intention of the parties with respect to the payment and legal responsibilities for the payment of certain debts and obligations, with the hold harmless provision."

Things to Remember:

- A creditor's proof of claim constitutes prima facie evidence of the validity and amount of the claim. *In re Spraggins*, 03-26987-svk (Bankr. E.D. Wis. Oct. 8, 2004), citing FRBP 3001(f).
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- If the debtor rebuts the presumption with sufficient evidence, the claimant bears the burden of persuasion as to validity and amount. *In re Spraggins*, citing *In re Roberts*, 210 B.R. 325, 328 (Bankr. N.D. Iowa 1997).
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- Critical issue is intent of parties

- Factors:

    a. The language and substance of the agreement
    b. The relative financial position of the parties when they entered the agreement
    c. The function of the obligation within the agreement
    d. Evidence of overbearing at the time of the agreement.

In re Ludwig, 12-51167 (Bankr. W.D. Va. Feb. 25, 2013)

In conclusion: divorce language is not always what it seems upon its face to be. Look beneath the surface.

VI. Late Filed Claims

The creditor must file a proof of claim in order to receive plan distributions. Fed. R. Bankr. Pro. 3021.

A creditor must file a proof of claim for the claim to be allowed. Fed. R. Bankr. Pro. 3002(a). The proof of claim (other than for governmental creditors) must be filed within 90 days after the first date set for the meeting of creditors. Fed. R. Bankr. Pro. 3002(c).

Different courts have been split on how to handle claims which are filed late. In Wisconsin, late filed claims for secured creditors were accepted at any time. Accordingly, prudent debtor's counsel would check for claims shortly after the due date to make sure that the debtor would not complete the plan only to still have to deal with liens upon collateral the debtor was retaining. If such a claim was missed, it could be filed later so that the secured claim would still be satisfied through the plan.

Last year, though, the Seventh Circuit held that the Fed. R. Bankr. Pro. 3002(c) deadline for filing proofs of claim applied to *all* creditors, both unsecured and secured.

In *Pajian*, 785 F.3d 1161 (7th Cir. 2015), the debtor owned commercial property. The claim was partially secured. The bank filed its proof of claim after the 90 day deadline, and the debtor objected. The bank raised several arguments, most predominantly that Fed. R. Bankr. Pro.3002(c) does not apply to secured claims. The bankruptcy court agreed.

The Seventh Circuit did not, noting that judicial administration goals of certainty and finality support extending Fed. R. Bankr. Pro. 3002(c) to *all* creditors, both secured and unsecured.

An under-secured creditor may take advantage of this by not filing a claim at all. The debtor would emerge from bankruptcy and the creditor could still enforce its lien. See *In re Penrod,* 50 F.3d 459 (7th Cir. 1995). Even if the creditor were not making such an effort, debtor's counsel would have to answer to the debtor as to why monies paid into the plan did not satisfy the secured claim. Those funds would instead have gone to unsecured claims, leaving the debtor to pay the secured claim post-discharge.

What this means is that debtor's counsel must be even more vigilant and must utilize Fed. R. Bankr. Pro.3005 to file proofs of claim for any secured creditor who has not timely done so, and who the debtor wants to see paid. Fed. R. Bankr. Pro. 3005(a) permits the debtor to file a proof of claim on behalf of a non-filing creditor, during a 30-day window after expiration of the time for filing claims by the creditor.

It might not be surprising to see in a few years an uptick in malpractice claims as a result of this decision. While good practice has always dictated a timely review of the claims filed, *Pajian* has now put a strict timeline on doing so.