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POCs and the FDCPA: A License To File

By Chris Hawkins and Karlene Archer

Buyers and servicers of "stale," or time-barred, debt have been watching the bankruptcy and appellate courts closely of late, as court after court has ruled on whether a key component of their recovery strategy — seeking payment related to such time-barred debts by filing proofs of claim in bankruptcy — violates the Fair Debt Collections Practices Act (FDCPA).

Indeed, some companies may even have modified their automated systems and instructed their employees to beware of the Eleventh Circuit after *Crawford v. LVNV*. Those buyers and servicers likely breathed a sigh of relief on May 15, when the Supreme Court held, in *Midland Funding, LLC v. Johnson*, that the filing of a proof of claim in a bankruptcy case with respect to an obviously time-barred debt is not false, deceptive, misleading, unfair or unconscionable within the meaning of the Fair Debt Collections Practices Act (FDCPA). While the Court's 5-3 decision certainly provides some cover to creditors going forward, these proofs of claim should be filed with care.

History

The case comes after a circuit split, with the U.S. Court of Appeals for the Eleventh Circuit

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Ninth Circuit Finds That 1111(b) Deemed-Recourse Rights Do Not Survive Foreclosure Of Underlying Property

By Craig S. Ganz and Michael A. DiGiacomo

The U.S. Circuit Court of Appeals for the Ninth Circuit recently announced in *Mastan v. Salamon* (*In re Salamon*) that a secured creditor with a non-recourse mortgage cannot assert a claim for any deficiency if the underlying property is foreclosed on during the bankruptcy case. 854 F.3d 632 (9th Cir. 2017).

Section 1111(b)(1)(A) grants the holder of a claim "secured by property of the estate" the same rights as the holder of a recourse mortgage, regardless of whether or not the creditor has such recourse rights against the debtor outside of bankruptcy. *See* 11 U.S.C. § 1111(b)(1)(A) ("A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse … ").

History of Section 1111(b)

Congress enacted § 1111(b) in response to the harsh outcome in *Pine Gate Associates*, where a debtor utilized cramdown to avoid a creditor's undersecured, non-recourse deficiency claim. *Great Nat'l Life Inc. Co. v. Pine Gate Assocs., Ltd.*, 2 Bankr. Ct. Dec. 1478 (Bankr. N.D. Ga. 1976). In *Pine Gate Associates*, a lender provided non-recourse funding for an apartment project, expecting to either be repaid in full or to foreclose on the property in the event of default. However, the debtor filed for bankruptcy during a depressed real estate market, and was able to retain ownership of the property while using cramdown to only pay the lender the present value of its lien rather than the amount of the debt, making no payment on the lender's deficiency. *Id.* at 1487–89.

The debtor, under the Bankruptcy Code then in effect, was able to retain the property, and realize any future appreciation in the property's value, while the

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lender was not paid in full and retained no right to foreclose on the property. *See In re Atlanta West VI*, 91 B.R. 620, 624 (Bankr. N.D. Ga. 1988) (detailing facts and procedural history of *Pine Gate Associates*).

The deemed-recourse rights granted to creditors by § 1111(b)(1)(A) was an attempt to level the playing field between creditors and debtors once the bankruptcy is filed. Congress intended to protect creditors by allowing them a mechanism to ensure they would be treated reasonably under the plan, while at the same time preserving a debtor's ability to reorganize. *See* 7 Collier on Bankruptcy ¶ 1111.03[1][a] (Alan N. Resnick & Henry J. Sommer, eds. 16th ed. 2014) ("Because a [C]hapter 11 plan does not provide for the sale or other liquidation of the collateral, any valuation which determines a deficiency will be a judicial valuation. In promulgating section 1111(b), Congress essentially stated that such a judicial valuation was not part of the nonrecourse creditor's bargain, and provided an avenue for the creditor to elect to have the deficiency recognized.").

Section 1111(b) is also one of the rare exceptions to the idea that bankruptcy law does not disturb entitlements provided by underlying state law. *Id*. Indeed, the text of 1111(b) all but instructs courts to disregard state law regarding deficiency rights, and follow the simple rule that claims secured by property of the estate are entitled to recourse, regardless.

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Factual Background

In *In re Salamon*, the § 1111(b)(1) issue arose in the context of a junior undersecured creditor's attempt to treat its non-recourse claim as one entitled to recourse in the bankruptcy, with the added wrinkle that the property to which the creditor's lean attached was sold during the pendency of the bankruptcy case. Salamon purchased a 28-unit apartment complex (the Property), which was already subject to a first and second deed of trust, totaling $1.03 million. *In re Salamon*, 528 B.R. 171, 173 (9th Cir. BAP 2015). To effect purchase, Salamon wrapped around the existing loans with an "All Inclusive Note and All Inclusive Deed of Trust" in the amount of $1.03 million, and executed a second note for $325,000 secured by the Property, in favor of the seller, Mr. Behren. *Id*.

Pursuant to the wraparound, Salamon made payments on the All Inclusive Deed of Note and All Inclusive Deed of Trust and the second note to Behren, while the latter remained responsible for payments on the preexisting first and second deed of trust. Under California law, both instruments Salamon executed in favor of Behren were purchase money mortgages. Under California's anti-deficiency statute, purchase-money mortgages are excepted from the type of transaction on which a lender can seek recourse from the borrower on a deficiency. *Id*. at 173, n.5.

Less than a year after Salamon's purchase, Behren filed Chapter 11, which, after appointment of a Chapter 11 trustee, converted to Chapter 7. *Id*. The Chapter 11 trustee, Mastan, stayed on as Chapter 7 trustee in the converted case. *Id*. Soon after, Salamon and her husband filed their own Chapter 11 case, in which Mastan filed a proof of claim on account of the two liens secured by the Property. *Id*. Salamon and the holder of the first deed of trust secured by the Property stipulated to termination of the automatic stay in Salamon's bankruptcy to allow a foreclosure sale of the Property to go forward. *Id*. at 174.

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The foreclosure sale generated sufficient funds to pay off the first and second deeds of trust, and left a surplus. *Id*. Mastan made demand on the foreclosing trustee for the surplus, which was sufficient to pay off the wraparound mortgage and a portion of the second note Salamon had executed. *Id*. Mastan then filed an amended unsecured proof of claim for the remaining balance (the Deficiency) of about $300,000. *Id*.

Salamon objected to the amended proof of claim, arguing that because the Property had been removed from the bankruptcy estate by the foreclosure sale, Mastan no longer held a claim "secured by property of the estate," § 1111(b)(1) did not apply, and thus Mastan's claim was barred by California's anti-deficiency statute. *Id*. Mastan argued that the only exceptions to the application of § 1111(b) — a class election under § 1111(b)(2) or a sale pursuant to § 363 or the Chapter 11 plan — were not present, and thus § 1111(b) overrode the anti-deficiency statute. The bankruptcy court, looking to the plain language of § 1111(b), disallowed Matson's claim — holding that Matson, upon completion of the foreclosure sale, no longer had a claim "secured by property of the estate." *Id*. The Bankruptcy Appellate Panel for the Ninth Circuit affirmed.

Ninth Circuit's Reasoning

Before the Ninth Circuit, Mastan argued that whether or not a party holds a claim secured by property of the estate must be determined by looking at the situation as it existed on the date the bankruptcy petition was filed. *In re Salamon*, 854 F.3d 632, 635 (9th Cir. 2017). Noting the scant case law on the issue, and the Supreme Court's recent admonition in *Law v. Siegel* that courts may not create unenumerated exceptions to the Bankruptcy Code, the Ninth Circuit held that "§ 1111(b) mandates that it cannot apply if the lien does not exist. As … the lien no longer existed when [Mastan's] claim was challenged … under its plain language, § 1111(b) has no applicability to his claim." *Id*. at 636.

Since Mastan's lien was wiped out and his claim ceased to be secured by any property of the estate upon the foreclosure sale, he had no recourse for his claim under California law, and the bankruptcy court properly disallowed it. *Id*. The Ninth Circuit affirmatively stated, "§ 1111(b)'s requirement that a creditor hold a 'claim secured by a lien on the property of the estate' means that if a creditor's claim, for any reason, ceases to be secured by a lien on property of the estate, the creditor can no longer transform a non-recourse claim into a recourse claim." *Id*. at 637.

The Ninth Circuit's holding in *In re Salamon* is significant as the first circuit-level decision providing any in-depth analysis of the impact of a foreclosure sale on a creditor's deemed-recourse rights. For example, the only cases to which the Ninth Circuit cites in its decision, although circuit-level, either merely state that "a claim secured by a lien on property of the estate" is a prerequisite for deemed-recourse rights (*In re B.R. Brookfield Commons No. 1 LLC*, 735 F.3d 596, 598 (7th Cir. 2003); *680 Fifth Ave. Assocs. v. Mutual Benefit Life Ins. Co.* (*In re Fifth Ave. Assocs.*), 29 F.3d 95, 97 (2d Cir. 1994)) or were based on other grounds (*Tampa Bay Assocs., Ltd. v. DRW Worthington, Ltd.* (*In re Tampa Bay Assocs., Ldt.*), 864 F.2d 47, 51 (5th Cir. 1989). The Ninth Circuit's holding, especially considering the plain-language interpretation of § 1111(b)(1) utilized by other federal courts, is likely to be adopted in other circuits when similar cases reach the courts of appeals.

Practical Considerations

The Ninth Circuit's holding is broad — "if a creditor's claim, *for any reason*, ceases to be secured by a lien on property of the estate, the creditor can no longer transform a non-recourse claim into a recourse claim." *In re Salamon*, 854 F.3d at 637 (emphasis added). This case should serve as a stern warning to junior secured creditors that their recourse rights may be vulnerable, especially where a senior creditor successfully moves for stay relief.

The Ninth Circuit noted as much when it stated that "Mastan had an alternate means of protecting his rights which he chose not to pursue … . He could have objected to the relief from the automatic stay … if he was concerned the foreclosure sale would not adequately protect this rights." *Id*. Junior creditors that wish to retain some control in the bankruptcy case would be well advised to object to any motion for stay relief if there is even a remote possibility that foreclosure will leave a deficiency.

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Time-Barred Debt

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holding that filing a proof of claim based on a time-barred debt violates the FDCPA, and the U.S. Courts of Appeal for the Fourth, Seventh and Eighth Circuits reaching the opposite conclusion.

The underlying case involved a dispute between a debtor in a Chapter 13 case in the U.S. Bankruptcy Court for the Southern District of Alabama, and a creditor holding her 10-year-old credit card debt. In March 2014, the debtor filed her Chapter 13 petition. Midland Funding, LLC (Midland), filed a proof of claim in the debtor's case with respect to the debt. This debt was well past Alabama's six-year statute of limitations. The trustee objected to Midland's claim, and the bankruptcy court entered an order disallowing the claim.

After the claim was disallowed, the debtor filed a lawsuit against

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