

# RECENT DEVELOPMENTS

## BANKRUPTCY

### JUDGEMENT CREDITOR'S LIEN ON HOMESTEAD UNENFORCEABLE

In re McCombs, 659 F.3d 503 (5th Cir. 2011)

**FACTS:** Michael McCombs and his wife, Alicia Atkinson, purchased a home and an adjoining vacant lot in 2004. In March 2006, H.D. Smith obtained a judgment against McCombs in the amount of \$538,016.46, and Steve Smith (“the Trustee”) filed the abstract in the real property records. McCombs signed an agreement with Atkinson, stating that she would be entitled to proceeds of the sale of the house. They then executed a contract for sale with a buyer they found. In November 2006, McCombs filed for Chapter Seven bankruptcy. His wife did not join the petition. McCombs listed the homestead and vacant lot as community property and claimed a \$125,000 homestead exemption.

The Trustee then filed an emergency petition to sell the home only, which the court granted, and the home was sold with the Trustee and Atkinson agreeing to place the funds in escrow until the court determined how the proceeds were to be distributed. The sale netted \$398,849.03 in proceeds after payment of the mortgage and other expenses. H.D. Smith filed an adversary action against McCombs, the Trustee, and Atkinson, claiming

that as creditor it was entitled to excess proceeds of the sale in satisfaction of its lien. The Trustee issued a check jointly payable to McCombs and Atkinson for \$125,000, the amount of the homestead exemption McCombs claimed in his petition.

While the bankruptcy court was considering H.D.

Smith’s claim for the house proceeds, the Trustee filed an emergency motion to sell the unimproved lot. The bankruptcy court approved the sale, directing that all proceeds from the sale would become part of the excess proceeds already held in escrow. According to the Trustee, after the sale of the lot, the excess proceeds totaled \$514,095.08.

The court granted summary judgment for H.D. Smith, and rejected Atkinson’s claims that: (1) the property had been partitioned or gifted to her; (2) her homestead rights trumped the dollar limit; (3) she was entitled to compensation for the homestead right; and (4) failure to compensate her for her homestead right was an unconstitutional taking. The bankruptcy court found that Texas homestead law did not prevent H.D. Smith from having an enforceable lien on the excess proceeds. The court held that the lien attached to the property before the bankruptcy proceedings and became enforceable upon application of the § 522(p) \$125,000 homestead exemption.

The Trustee and Atkinson filed a joint certification for

direct appeal to the Fifth Circuit, and the bankruptcy court certified the case for direct appeal.

**HOLDING:** Reversed and remanded.

**REASONING:** The court noted the “basic federal rule” in bankruptcy is that state law governs the substance of claims, Congress having “generally left the determination of property rights in the assets of a bankrupt’s estate to state law.” Therefore, state law governs the substance of claims and a determination of H.D. Smith’s rights in the excess proceeds should be decided under Texas law. In Texas, a lien is unenforceable against homestead property, and the law goes so far as to say that a judgment creditor may even be liable for slander of title for refusing to grant a partial release of its lien against homestead property under a contract to sell.

The property or proceeds from the sale of property may be subject to seizure if the property ever ceases to be the debtor’s homestead. To determine homestead status the court looked to the status of H.D. Smith’s lien at the time of the bankruptcy filing. McCombs’s house and lot were homestead property entitled to protection under Texas law at the time McCombs filed bankruptcy. Therefore, H.D. Smith lacked an enforceable lien at that time.

The court found that the homestead cap in § 522(p) of the bankruptcy code should not make the lien enforceable, because § 522(p) is a federal statute and the court, in the absence of controlling federal interest, should defer to the state code in order to properly define a property interest. The bankruptcy laws that place a cap on the value of a homestead did not convert H.D. Smith’s lien on the homestead from one that was unenforceable pre-petition to one that was enforceable as to the homestead post-petition. The purpose of § 522(p) is to limit the amount of a homestead exemption, thereby increasing the size of the bankruptcy estate available to creditors. The court could not discern any indication that the intent of § 522(p) was to make an otherwise unenforceable lien on homestead property enforceable instantaneously. H.D. Smith should be accorded the same priority as a creditor that it would have enjoyed had the bankruptcy not occurred.

Regardless of whether the lien attached prior to the bankruptcy proceedings, the Trustee took the property with the state-law character it had in the debtor’s hands: a property with an unenforceable lien. The court additionally specified that although H.D. Smith did not have a right specifically enforceable in the excess proceeds, there was no ruling on whether H.D. Smith had an otherwise enforceable interest in the estate.

### BANKRUPTCY LAWYER FINED FOR “UNREASONABLE RELIANCE” ON INFORMATION PROVIDED BY CLIENT

In re Taylor, 655 F.3d 274 (3rd Cir. 2011).

**FACTS:** The underlying matter in this case arose when Mr. and Ms. Niles C. and Angela J. Taylor filed for a Chapter 13 bankruptcy in September 2007. In their bankruptcy petition, they listed the bank HSBC, which held the mortgage on their house, as a creditor. To file its pleadings with the bankruptcy court, HSBC,

# RECENT DEVELOPMENTS

using its computerized mortgage servicing database, retained different law firms. The firms retrieved the information from HSBC's computerized mortgage servicing database, NewTrak. HSBC used NewTrak to assign individual firms discrete assignments and provide the limited data the system deemed relevant to each assignment. The firms were selected and the instructions generated without any direct human involvement. Those firms did not have the capacity to check the data provided to them by NewTrak and were not expected to communicate with other firms that may have done related work on the matter.

The Taylors and HSBC were also involved in a payment dispute whereby HSBC took out "forced insurance" for the property and passed the cost on to the Taylors. The Taylors disagreed with the need for flood insurance and made their monthly mortgage payments excluding that amount. HSBC treated the monthly mortgage payments as partial payments. Because of the Taylors' withheld insurance payments, HSBC's records indicated that

## **Rule 9011 of the Federal Rules of Bankruptcy Procedure requires that parties making representations to the court certify that "the allegations and other factual contentions have evidentiary support, or if specifically so identified, are likely to have evidentiary support."**

they were delinquent and HSBC retained the Udren Law Firm to seek relief from the automatic stay on debt collection activities. In the Taylors' case, NewTrak provided the

Udren Firm with only the loan number, the Taylors' name and address, payment amounts, late fees, and amounts past due. It did not provide any correspondence with the Taylors concerning the flood insurance dispute. Udren Firm attorney Doyle filed a motion for relief from the stay, which never mentioned the flood insurance dispute. Doyle did nothing to verify the information in the motion besides checking it against "screen prints" of the NewTrak information.

At the same time as it filed for relief from the stay, the Udren Firm served the Taylors with a set of requests for admission. The Taylors filed a response to the motion for relief from stay, denying that they had failed to make payments and attaching copies of six checks tendered to HSBC during the relevant period. Four of them had already been cashed by HSBC. The Taylors also filed an objection to HSBC's proof of claim, stating that HSBC had misstated the payment due on the mortgage and pointing out the dispute over the flood insurance. However, they did not respond to the requests for admission. Doyle filed a response to the objection to the proof of claim, which did not discuss the flood insurance issue, but stated that all the information in the proof of claim was correct.

The bankruptcy court held a hearing on both the motion for relief and the claim objection. It found that a junior associate at the Udren Firm sought to have the requests for admission admitted as evidence even though he knew they contained falsehoods. The court denied the request to enter the requests for admissions as evidence, finding that the firm had evidence that

the assertions in its motion were not accurate, but that they went ahead like they never knew it. The court found the motion to be in questionable good faith and ordered the Udren Firm to obtain an accounting from HSBC of the Taylors' prepetition payments so the arrearage on the mortgage could be determined correctly. At the next hearing, the Udren Firm attorneys reported that they were unable to contact HSBC directly to verify information that the firm had already represented to be true. The court entered an order directing the Udren lawyers to appear and give testimony concerning the possibility of sanctions. The hearings took place over several days, and consisted of in-depth inquiries into the communications between HSBC and its lawyers as well as the general capabilities and limitations of a system like NewTrak.

The bankruptcy court found that Doyle had violated Rule 9011 for failing to make reasonable inquiry concerning the representations she made in the motion for relief from stay and the response to the claim objection. It required her to take three CLE credits in professional responsibility. Doyle and the other parties the court sanctioned appealed the sanctions order to the district court, which overturned the order. The United States Trustee appealed.

**HOLDING:** Reversed in part, affirmed in part.

**RATIONALE:** Rule 9011 of the Federal Rules of Bankruptcy Procedure requires that parties making representations to the court certify that "the allegations and other factual contentions have evidentiary support, or if specifically so identified, are likely to have evidentiary support." FED. R. BANK. P. 9011(b)(3). A party must reach this conclusion based on "inquiry reasonable under the circumstances." The concern of Rule 9011 is not the truth or falsity of the representation itself, but rather whether the party making the representation reasonably believed it at the time to have evidentiary support. There need not be bad faith on the part of a party who makes a false representation. Instead, an imposition of sanctions requires only a showing of objectively unreasonable conduct.

In this case, the court focused on several statements by appellees, all of which involved false or misleading representations to the court. The appellees argued that the statements were literally true and that they should not be subject to sanctions. However, the court found that they were not actually true, but that even if they were, there was no authority permitting statements under Rule 9011 that were literally true but actually misleading. The court found that the statements, the aim of which was allow HSBC to foreclose on the Taylors' house, were either false or misleading.

The court assessed the reasonableness of the appellee's inquiry before they made their false representations. Specifically, it discussed the degree to which an attorney may reasonably rely on representations from her client. Because lawyers constantly and appropriately rely on information provided by their clients, especially when the facts are contained in a client's computerized records, it is usually reasonable for a lawyer to rely on information provided by a client, especially where that information is superficially plausible and the client provides its own records which appear to confirm the information. However, the court found that Doyle's behavior was unreasonable, both as a matter of her general practice and in ways specific to this case. The court found that an attorney must, in her independent professional judgment, make a reasonable effort to determine what facts are likely to be relevant

# RECENT DEVELOPMENTS

to a particular court filing and to seek those facts from the client. She cannot simply settle for the information her client determines in advance – by means of an automated system – that she should be provided with. The court agreed with the bankruptcy court that Doyle had no relationship with the client. Instead, she worked solely with NewTrak, which no one at the firm seemed to have understood. It found that Doyle permitted HSBC to define – perilously narrowly – the information she had about the Taylors' matter. That HSBC was not providing her with adequate information through NewTrak should have been evident to Doyle from the file. She did not have any information concerning the Taylors' equity in the home, yet she made a statement before the court specifically denying that they had any.

More generally, a reasonable attorney would not file a motion for relief from stay for cause without inquiring of the client whether it had any information relevant to the alleged cause, that is, the debtor's failure to make payments. Had Doyle made even that most minimal of inquiries, HSBC presumably would have provided her with the information in its files concerning the flood insurance dispute, and Doyle could have included that information in her motion for relief from stay – or, perhaps, advised the client that seeking such a motion would be inappropriate under the circumstances.

With respect to the Taylors' case in particular, Doyle ignored clear warning signs as to the accuracy of the data that she did receive. In responding to the motion for relief from stay, the Taylors submitted documentation indicating that they had already made at least partial payments for some of the months in question. In objecting to the proof of claim, the Taylors pointed out the inaccuracy of the mortgage payment listed and explained the circumstances surrounding the flood insurance dispute. Although Doyle certainly was not obliged to accept the Taylors' claims at face value, they indisputably put her on notice that the matter was not as simple as it might have appeared from the NewTrak file. At that point, any reasonable attorney would have sought clarification and further documentation from her client, in order to correct any prior inadvertent misstatements to the court and to avoid any further errors. Instead, Doyle mechanically affirmed facts (the monthly mortgage payment) that her own prior filing had already contradicted.

The court found that Doyle's reliance on HSBC was particularly problematic because she was not, in fact, relying directly on HSBC. Instead, she relied on a computer system run by a third-party vendor. She did not know where the data provided by NewTrak came from. She had no capacity to check the data against the original documents if any of it seemed implausible. And she effectively could not question the data with HSBC. In

her relationship with HSBC, Doyle essentially abdicated her professional judgment to a black box. The court did not find that this case presented an instance of extreme complexity, nor of extraordinary deadline pressure such as would affect its analysis of reasonableness. Although the initial data the Udren Firm received was not, in itself, wildly implausible, it was factually inadequate. In short, the court concluded that Doyle's inquiry before making her representations to the bankruptcy court was unreasonable.

The court made a point of acknowledging that the use of computerized databases can be appropriate. However, it found that the NewTrak system, as it was used in this case, permitted parties at every level of the filing process to disclaim responsibility for inaccuracies gleaned from not particularly accurate records. The attorneys, the final link in the chain of information transmission, claimed reliance on NewTrak's records, but the court disagreed that all the parties involved could insulate themselves from responsibility by the use of such a system. Instead, it held responsible the attorneys who certified to the court that the representations they made were "well-grounded in law and fact."

The court found that Rule 11 requires more than a rubber-stamping of the results of an automated process by a person who happens to be a lawyer. Where a lawyer systematically fails to take any responsibility for seeking adequate information from her client, makes representations without any factual basis because they are included in a form pleading she was trained to fill out, and ignores obvious indications that her information may be incorrect, she cannot be said to have made reasonable inquiry. Additionally, the Udren Firm itself was appropriately sanctioned because the system it put in place emphasized high-volume, high-speed processing of foreclosures to such an extent that it led to violations of Rule 9011. Therefore, the court found that the bankruptcy court did not abuse its discretion in imposing sanctions on Doyle or the Udren Firm itself. The court reversed the district court with respect to Doyle and Udren, affirming the bankruptcy court's imposition of sanctions.

**The attorneys, the final link in the chain of information transmission, claimed reliance on NewTrak's records, but the court disagreed that all the parties involved could insulate themselves from responsibility by the use of such a system.**