BY-LINED ARTICLE

Failure to Amend Claim Can Violate Bankruptcy Rule Equivalent to Rule 11

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In *In re Hannon*, the U.S. Bankruptcy Court for the Middle District of Pennsylvania held that a claimant had potentially violated Federal Rule of Bankruptcy Procedure 9011 by effectively advocating an erroneous claim, where the claimant failed to amend its proof of claim post-confirmation and continued to collect payments pursuant to the claim.

Facts and Background

According to the bankruptcy court's opinion, Countrywide Home Loans Inc. was a mortgagee of Mary Alice Margaret Hannon, a debtor who filed a Chapter 13 petition on Oct. 24, 2006. Countrywide filed its proof of claim on Nov. 6, 2006, claiming an arrearage of $9,294.53, which included $5,000 identified by Countrywide as a "sheriff deposit" in two $2,500 increments. On Dec. 12, 2006, Countrywide received Hannon's draft of a Motion for Rule 9011 Sanctions and a threat to file the motion "if the claim has not been amended to contain a fully accurate statement… ." In response, on Dec. 29, 2006, Countrywide filed an amended proof of claim that eliminated one of the two $2,500 increments identified as a sheriff's deposit. Fourteen days later, pursuant to a stipulation between the debtor and Countrywide, the Chapter 13 Plan was confirmed, addressing the balance of the arrearage on the Countrywide mortgage.

After confirmation of the Chapter 13 Plan, the sheriff refunded Countrywide $2,158 on Jan. 25, 2007. More than one year later, on May 1, 2008, the debtor filed a request for sanctions against Countrywide for violation of Rule 9011, alleging in her request that Countrywide's proof of claim was "incorrect." Following the request for sanctions, Countrywide filed a second amended proof of claim on June 5, 2008, in the amount of $4,294.53 thereby eliminating the remaining "sheriff deposit" entry. On December 3, 2008, the debtor filed another motion seeking sanctions against Countrywide pursuant to Section 105 of the Bankruptcy Code and the court's inherent powers. In the Dec. 3 motion, the debtor alleged the same facts set forth in the May 1 motion, also alleging that Countrywide had behaved similarly in neglecting to amend claims after receipt of sheriff's refunds in six other unrelated bankruptcy cases. Both the May 1 and Dec. 3 motions were heard by the court.

Countrywide's Arguments

Countrywide advanced several arguments in support of the position that it was not under a duty to amend the proof of claim. First, Countrywide argued that Rule 9011 does not apply to proofs of claim. Second, Countrywide noted that the claim was accurate when filed and, as such, urged that it had no duty to correct the claim to reflect receipt of the funds from the sheriff following confirmation. Third, Countrywide asserted that the court's confirmation of the debtor's plan gave rise to an estoppel, which precluded the debtor from challenging the claim. Finally, Countrywide advanced the argument that the motion was "stale" because the letter sent to Countrywide in advance of the motion was dated more than 16 months before filing of the motion.

The Court's Analysis

The court first addressed Countrywide's arguments in opposition to the May 1 motion. The court made short shrift of Countrywide's argument that Rule 9011 is not applicable to proofs of claim, citing numerous cases rejecting precisely that argument, and noting that other courts have found Rule 9011 applicable to the filing of proofs of claim.

Turning to Countrywide's second argument, the court acknowledged that there was precedent in the 3rd Circuit supporting the proposition that a claimant had no duty to modify a proof of claim that was accurate when filed. However, the court was quick to point out that this precedent was developed through the interpretation of Federal Rule of Civil Procedure 11, as the rule read prior to its amendment in 1993. That amendment, the court pointed out, expanded the rule to include "advocating" of an earlier paper. The court reasoned that Countrywide, by collecting payments under the proof of claim, effectively advocated the accuracy of the claim, even after the claim was no longer accurate.

The court next addressed Countrywide's argument that plan confirmation estopped Hannon from challenging Countrywide's claim. Countrywide relied on the 7th U.S. Circuit Court of Appeals' decision in Adair v. Sherman , for the proposition that confirmation of a plan estops a debtor from challenging a claim. In dismissing this argument, the court cited to the Adair case, where the 7th Circuit specifically stated that parties who commit fraud are subject to sanctions pursuant to Rule 9011, notwithstanding plan confirmation.

Finally, the court turned to Countrywide's "staleness" argument. In addressing this argument, the court acknowledged that Countrywide had filed its first amended proof of claim 17 days following the "safe harbor" letter required by Rule 11. The court stated that Countrywide's first amendment to the proof of claim rectified all of the inaccuracies cited in the "safe harbor" letter well within the 21 day "safe harbor" provided by the rule. The court then reasoned that Countrywide's first amended claim satisfactorily addressed all of the issues raised in the "safe harbor" letter. Consequently, the May 1 motion for sanctions was not preceded by a "safe harbor" letter. Therefore, the May 1 motion was improperly filed and the court was compelled to deny it.

Having disposed of the May 1 motion, the court turned to the Dec. 3 motion for sanctions pursuant to Section 105 of the Bankruptcy Code. In addressing the Dec. 3 motion, the court expressed concern that Countrywide had not amended its claim to reflect the January 25 sheriff's refund until June 5, 2008, after the motion for sanctions was filed. The court further stated that Countrywide either knew or should have known that distributions under the confirmed plan were based on the amount of the claim and stressed that Countrywide's neglect affected not only the debtor, but other claimants as well. Having so stated, the court turned to whether Countrywide had a duty to amend its claim when it received the sheriff's refund.

The court first referred to Rule 3.3 of the Pennsylvania Rules of Professional Conduct, which deals with candor toward the tribunal. The court quoted the following material provisions of Rule 3.3: "A lawyer shall not knowingly . . . make a false statement of material fact or law to a tribunal *or fail to correct a false statement of material fact* or law previously made to the tribunal by the lawyer [emphasis added]." The court reasoned that this rule undoubtedly implied counsel's continuing duty to correct false statements, and that this responsibility had been made clear in a number of cases dealing with Rule 3.3. Despite this reasoning, the court stated that because it had denied the May 1 motion seeking sanctions pursuant to Rule 9011, unless the court sua sponte initiated a Rule 9011 hearing, the issue was no longer before the court.

Having determined that the Rule 9011 issue was no longer before it, the court next turned to the debtor's request that it issue sanctions pursuant to its power under section 105 of the Code. The court stated that for a court to issue sanctions pursuant to its inherent powers, a finding of "bad faith" is usually required. The court additionally said that, "When there is bad-faith conduct . . . that could be adequately sanctioned under the Rules, the court ordinarily should rely on the Rules rather than the inherent power [emphasis added]."

In reviewing the debtor's Dec. 3 motion, the court emphasized that the motion added allegations not mentioned in the May 1 motion, which relied solely on Rule 9011. Specifically, the court pointed to the debtor's allegations in the Dec. 3 motion that Countrywide had behaved in similar fashion in five instances in the month of Dec. 2006. That month, Countrywide had received sheriff's refunds but failed to amend its claims actively, arguably constituting a pattern of conduct "tantamount to 'bad faith.'" Despite this, the court felt that it need not exercise its inherent power, as it could sua sponte rely on Rule 9011.

In returning to Rule 9011, the court noted that were it to find a violation, it would be required to issue a sanction. Further, the court found that because Countrywide had no procedure to adjust Proofs of Claim to reflect refund of sheriff's deposits, Countrywide "knowingly allowed the inaccurate Proof of Claim to be treated by the parties as accurate to the detriment of others." The court sua sponte ruled that Countrywide show cause why it should not be sanctioned under Rule 9011(c)(1)(B) for failing to timely amend its proof of claim upon receipt of the sheriff's refund, for intentionally disregarding the responsibility to amend proofs of claim, and for laying claim on funds based upon a false proof of claim. Finally, the court acknowledged that Rule 9011 may not be "up to the task of providing sufficient authority to compel a claimant to keep [its] Proofs of Claim updated." However, the court believed that in such a case, section 105(a) provided ample judicial authority to compel a claimant to timely amend its claims. Therefore, the court ruled that the motion for sanctions under section 105 would be held in abeyance pending a determination of whether the court's sua sponte Rule 9011 Motion was sufficient to address the issue.

Conclusion

While a proof of claim may be accurate when filed, claimants are well advised to amend the claim when changed circumstances make the claim erroneous or inaccurate. The *Hannon* case provides a valuable warning that: (i) a claimant's failure to amend its proof of claim once circumstances change may result in sanctions; and (ii) a claimant continuing to collect payments under a now-erroneous claim (even following confirmation of a plan) may give rise to a sanction order.

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