Professor Kenneth N. Klee and Whitman L. Holt on

Supreme Court's Holding in *Midland Funding, LLC v. Johnson*

2017 Emerging Issues 7560

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I. Summary of Holding and Lessons to Be Learned

In a 5-3 majority decision authored by Justice Breyer,[1] the United States Supreme Court concludes that a debt collector does not violate the Fair Debt Collection Practices Act, 91 Stat. 874, 15 U.S.C. § 1692 *et seq.* (the "Act") by filing, in a chapter 13 bankruptcy case, a proof of claim that on its face indicates that the statute of limitations governing collection of the claimed debt has expired. *Midland Funding, LLC v. Johnson*, 581 U.S. ___, 2017 U.S. LEXIS 2949, at *6–7 (May 15, 2017). Reversing the decision of the Eleventh Circuit Court of Appeals, the Court finds that 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 [Act]," and as such, does not give rise to a claim by the consumer debtor for civil damages under the Act. Id. at *18. In reaching this conclusion, the Court relies on the definition of a "claim" as a right to payment, whether or not enforceable under applicable state law, *id.* at *7–8, and the proposition that the bankruptcy system "treats untimeliness as an affirmative defense" to a claim, *id.* at *9–10, 13. Moreover, citing what it believes to be the "different purposes and structural features" of the Bankruptcy Code and the Act, the Court determines that to apply the Act on these facts would upset the "delicate balance" struck by the Bankruptcy Code between the protections and obligations of a debtor. *Id.* at *15–16.

The lessons to be learned from this decision are that even a typically "liberal" justice such as Justice Breyer may be swayed by technical arguments based on abstracted concepts about the operation of the bankruptcy system, even when those concepts are belied by day-to-day consumer practice on the ground. As Justice Sotomayor's dissent correctly details, debt collectors that file proofs of claim based on time-barred debts impose significant negative externalities throughout the bankruptcy system, all in an effort to extract unwarranted profits for themselves. Because a majority of the Supreme Court (and, before it, a majority of circuit judges to consider the issue) has concluded that this valueless (indeed, value-destroying) practice is not "unfair" or "unconscionable," debtors and their counsel will need to find another path—whether legislative, judicial, or technological—to check abusive claims filing practices.

II. Legal Background

Bankruptcy Code section 501(a) provides that a "creditor … may file a proof of claim" in a debtor's bankruptcy case. 11 U.S.C. § 501(a). A "claim" is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A). A creditor's

1 Chief Justice Roberts and Justices Kennedy, Thomas, and Alito joined Justice Breyer's opinion. Justice Sotomayor filed a dissenting opinion, which Justices Ginsburg and Kagan joined. Justice Gorsuch took no part in the consideration or decision of the case.

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"right to payment" in bankruptcy is generally defined by applicable state law, *see Travelers Cas. & Sur. Co. of Am. v. PG&E*, 549 U.S. 443, 450 (2007), and the debtor's bankruptcy estate enjoys "the benefit of any defense available to the debtor as against any entity other than the estate, including statutes of limitation," 11 U.S.C. § 558. A properly filed proof of claim "constitute[s] prima facie evidence of the validity and amount of the claim," Fed. R. Bankr. P. 3001(f), and, in the absence of an objection, such a claim will be "deemed allowed" in the debtor's case, 11 U.S.C. § 502(a). If instead a party in interest objects to allowance of a claim, then the court must determine the amount of the claim and allow the claim in such amount, except to the extent that, *inter alia*, "such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured." 11 U.S.C. § 502(b)(1).

The Fair Debt Collection Practices Act was enacted in 1977 "to eliminate abusive debt collection practices by debt collectors, to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged, and to promote consistent State action to protect consumers against debt collection abuse." 15 U.S.C. § 1692(e). To that end, the Act provides that a "debt collector may not use any false, deceptive, or misleading representation or means in connection with the collection of any debt" and "may not use unfair or unconscionable means to collect or attempt to collect any debt." 15 U.S.C. §§ 1692e & 1692f. Among the conduct expressly prohibited by the Act is the false representation by a debt collector of "the character, amount, or legal status of any debt" and the collection of any amount not "expressly authorized by the agreement creating the debt or permitted by law." 15 U.S.C. §§ 1692e(2)(A) & 1692f(1). A debt collector who violates the Act is subject to civil liability for actual damages, statutory damages, attorneys' fees, and costs.[2] 15 U.S.C. § 1692k(a).

Although the Supreme Court has not addressed the issue under the modern Bankruptcy Code, it has previously described the filing of a proof of claim as "a traditional method of collecting a debt." *Garner v. New Jersey*, 329 U.S. 565, 573, 91 L. Ed. 504 (1947).

III. Facts and Proceedings Below

In March 2014, Aleida Johnson (the "Debtor") filed an individual bankruptcy case under chapter 13 of the Bankruptcy Code. *Midland Funding, LLC*, 2017 U.S. LEXIS 2949, at *6. Two months later, Midland Funding, LLC ("Midland") filed a proof of claim in the Debtor's case asserting a credit-card debt in the amount of $1,879.71 and disclosing that the last activity on the Debtor's account was in 2003. Id. The Debtor filed a short objection to the claim, Midland failed to respond, and the bankruptcy court disallowed the claim. Id. Thereafter, the Debtor sued Midland in district court for actual damages, statutory damages, attorneys' fees, and costs for an alleged violation of the Fair Debt Collection Practices Act. Id. On Midland's motion to dismiss, the district court first determined that there is "an obvious tension between the Act and the Code" because "except where expiration

2 The Fair Debt Collection Practices Act applies only to "debt collectors," defined as "any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due asserted to be owed or due another." 15 U.S.C. § 1692a(6). A debt collector who appears to have violated the Act can avoid liability by showing, by a preponderance of the 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." 15 U.S.C. § 1692k(c).

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of the limitations period extinguishes the debt under applicable state law, the Code permits creditors to file proofs of claim in Chapter 13 proceedings on debts known to be time-barred," whereas "the Act prohibits debt collectors from engaging in such conduct." *Johnson v. Midland Funding*, 528 B.R. 462, 470 (S.D. Ala. 2015). Finding the Code and the Act to be "in irreconcilable conflict" on this point, the district court then applied the doctrine of implied repeal, concluding that the 1977 Act must yield to the more recently enacted 1978 Code to the extent of the conflict. Id. at 470, 473 (citing *EC Term of Years Trust v. United States*, 550 U.S. 429, 435, 167 L. Ed. 2d 729 (2007), for the proposition that a more recent law constitutes an implied repeal of an earlier law to the extent of irreconcilable conflicts between the two laws). Accordingly, the district court dismissed the Debtor's lawsuit under the Act. *Johnson*, 528 B.R. at 473.

The Debtor appealed, and the Eleventh Circuit Court of Appeals reversed. *Johnson v. Midland Funding, LLC*, 823 F.3d 1334, 1342 (11th Cir. 2016). The Debtor argued on appeal that the district court's decision conflicts with Eleventh Circuit precedent that "held that a debt collector violates the [Act] by knowingly filing a proof of claim in a bankruptcy proceeding on a debt that is time-barred." Id. at 1337 (citing *Crawford v. LVNV Funding, LLC*, 758 F.3d 1254, 1261 (11th Cir. 2014)). In *Crawford*, the Eleventh Circuit had declined to resolve the second question addressed by the district court in *Midland Funding*, namely whether the Bankruptcy Code precludes application of the Act when creditors misbehave in bankruptcy cases. *Johnson*, 823 F.3d at 1338 (citing *Crawford*, 758 F.3d at 1262 n.7). Turning to that question, the Eleventh Circuit concluded that although "the Code allows creditors to file proofs of claim that appear on their face to be barred by the statute of limitations," when a creditor who is designated as a debt collector under the Act files such a claim, "that debt collector will be vulnerable to a claim under the [Act]." *Johnson*, 823 F.3d at 1338. The court determined the Code does not preclude application of the Act in the context of a chapter 13 bankruptcy case because the Code and the Act are not, in fact, in irreconcilable conflict. Id. at 1340. Rather, the Act and the Code "differ in their scopes, goals, and coverage, and can be construed together in a way that allows them to coexist"—namely, the "Code establishes the ability to file a proof of claim," whereas the Act "addresses the later ramifications" when a debt collector files a claim in certain circumstances. Id. The court thus "read[s] these regimes together as providing different tiers of sanctions for creditor misbehavior in bankruptcy," including first, an objection to and disallowance of the claim under section 502(b) of the Code; second, sanctions for creditor misbehavior under section 105(a) of the Code; and third (only if the creditor is a debt collector whose behavior is unconscionable or deceptive), civil liability under the Act for damages to the debtor. Id. at 1341. Because the Act and the Code may be read to coexist, the court held "the Code does not preclude an FDCPA claim in the bankruptcy context." Id. at 1342.

Other circuit courts of appeals had rejected the central premise of *Crawford*—that debt collectors violate the Act by filing proofs of claims based on time-barred debts—often in split opinions. *See Dubios v. Atlas Acquisitions LLC (In re Dubois)*, 834 F.3d 522 (4th Cir. 2016) (2-1 decision); *Owens v. LVNV Funding, LLC*, 832 F.3d 726 (7th Cir. 2016) (2-1 decision); *Nelson v. Midland Credit Mgmt.*, 828 F.3d 749 (8th Cir. 2016) (3-0 decision). Still other circuit courts of appeals had issued decisions about the preclusion issue that, although arising in a different context, were at odds with the Eleventh Circuit's reasoning in *Midland Funding. See, e.g.*, *Walls v. Wells Fargo Bank, N.A.*, 276 F.3d 502 (9th Cir. 2002). In October 2016, the Supreme Court granted a petition for writ of certiorari

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raising both the question regarding the applicability of the Act in the first instance and the preclusion question.

IV. Analysis

A. Majority Opinion

After explaining the relevant factual and statutory background, the Supreme Court determines it is "reasonably clear" that the filing of an obviously time-barred proof of claim in a bankruptcy case is not false, deceptive, or misleading within the meaning of the Act. *Midland Funding, LLC*, 2017 U.S. LEXIS 2949, at *7. In reaching that conclusion, the Court begins its analysis with the Bankruptcy Code's definition of a "claim" as a "right to payment" as determined under applicable state law. Id. (citing 11 U.S.C. § 101(5)(A) and *Travelers Casualty*, 549 U.S. at 45–51). In *Midland Funding*, the relevant state law is the law of Alabama, which "provides that a creditor has the right to payment of a debt even after the limitations period has expired." *Midland Funding, LLC*, 2017 U.S. LEXIS 2949, at *7. Rejecting the Debtor's argument that the Code's use of the word "claim" refers only to an "enforceable claim," the Court notes that the "word 'enforceable' does not appear in the Code's definition of 'claim'" and that such an interpretation would conflict with the proposition that "'Congress intended … to adopt the broadest available definition of 'claim.''" Id. at *8 (quoting *Johnson* v. *Home State Bank*, 501 U.S. 78, 83, 115 L. Ed. 2d 66 (1991)). The Court further reasons that because, for example, section 502(b)(1) of the Code disallows a "claim" that is "unenforceable against the debtor" and the definition of "claim" includes a "contingent" claim that is unenforceable in the event the contingency fails to arise, an "unenforceable claim is nonetheless a 'right to payment,' and hence a 'claim,' as the Code uses those terms." *Midland Funding, LLC*, 2017 U.S. LEXIS 2949, at *9. The Court finds further support for its holding in the law's treatment of the "unenforceability of a claim (due to the expiration of the limitations period) as an affirmative defense," which "the debtor is to assert after a creditor makes a 'claim.'" *Id.* at *9–10 (citing 11 U.S.C. §§ 502 & 558; Fed. R. Civ. P. 8(c)(1)). The Court therefore finds "nothing misleading or deceptive in the filing of a proof of claim that, in effect, follows the Code's similar system," particularly given that the audience in a chapter 13 bankruptcy case includes a trustee who "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)." *Midland Funding, LLC*, 2017 U.S. LEXIS 2949, at *10.

"Whether Midland's assertion of an obviously time-barred claim is 'unfair' or 'unconscionable'" within the meaning of the Act presents a closer question (and the one on which the dissent focuses), which the Court ultimately answers in the negative as well. *Id.* at *10, *17–18. The Debtor argued 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.'" *Id.* at *10–11 (citing cases). The Court, however, determines that "the context of a civil suit differs significantly" from a chapter 13 bankruptcy case because ordinary concerns that an unsophisticated consumer might pay a stale debt due to an absence of records or to avoid the cost of a suit "have significantly diminished force in the context of a Chapter 13 bankruptcy" where the consumer initiates the proceeding, a "knowledgeable trustee is available," and procedural rules "more directly guide the evaluation of claims" through a "streamlined" process, thereby making it "considerably more likely that an effort to collect upon a

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stale claim in bankruptcy will be met with resistance, objection, and disallowance." *Id.* at *11–12. The Court is also not persuaded by the argument advanced by the Debtor and the United States, as *amicus curiae*, that it is obviously unfair "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." Id. at *13. Rather, the Court again observes that it is the trustee who "normally bears the burden of investigating claims and pointing out that a claim is stale" and that "protections available in a Chapter 13 bankruptcy proceeding minimize the risk to the debtor." *Id.* at *13–14. Moreover, the Court admonishes that "a change in the simple affirmative-defense approach, carving out an exception" for claims filed by debt collectors would require non-bankruptcy courts applying the Act to define that exception and answer bankruptcy-related questions, such as whether the prohibition applies only where "a claim's staleness appears 'on [the] face] of the proof of claim" and whether it applies "to other affirmative defenses or only to the running of a limitations period." *Id.* at *14–15.

More generally, the Court finds that the "Act and the Code have different purposes and structural features" as the "Act seeks to help consumers, not necessarily by closing what [the Debtor] and the United States characterize as a loophole in the Bankruptcy Code, but by preventing consumer bankruptcies in the first place." Id. at *15. As such, the Court determines that to apply the Act on these facts would upset the "delicate balance" struck by the Code between the protections and obligations of a debtor. Id. at *15–16. Substantively, "it would authorize a new significant bankruptcy-related remedy [under the Act] 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" to determine whether the violation of the Act was intentional; and 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." *Id.* Finally, the Court dismisses the United States' argument that Bankruptcy Rule 9011 is dispositive of the issue, explaining that although Rule 9011 imposes a general obligation on a claimant to certify that he or she has undertaken a reasonable inquiry to determine that a claim is warranted by law, that requirement does not impose an affirmative obligation on a creditor to make a pre-filing investigation into any potential statute of limitations defense and, in 2009, the Advisory Committee on Rules of Bankruptcy Procedure "specifically rejected a proposal that would have required a creditor to certify that there is no valid statute of limitations defense." *Id.* at *16–17.

Accordingly, the Court "conclude[s] 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" and reverses the decision of the Eleventh Circuit to the contrary. Id. at *18.

The Court did not formally reach the second question presented regarding whether the Bankruptcy Code precludes application of the Act in the bankruptcy context, although the Court's discussion of the "delicate balance" struck by the Bankruptcy Code has some potential relevance to that question.

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B. Justice Sotomayor's Dissent

Justice Sotomayor writes a dissent, joined by Justices Ginsburg and Kagan. The dissent would hold that the practice 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," is "both 'unfair' and 'unconscionable'" within the meaning of the Act. *Id.* at *18–19 (Sotomayor, J., dissenting). The dissent observes that after the Act's prohibitions on misleading and unfair conduct successfully stymied debt collectors from knowingly filing lawsuits to collect time-barred debts in state court, "debt buyers have 'deluge[d]' the bankruptcy courts with claims 'on debts deemed unenforceable under state statutes of limitations,'" prompting the government to sue one such debt buyer "'to address [its] systemic abuse of the bankruptcy process.'" *Id.* at *22–24.

The dissent asserts that the same dynamics that have led courts to conclude that a debt collector violates the Act by knowingly filing suit in an ordinary civil court to collect a time-barred debt are likewise present in bankruptcy cases because 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," and requires "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." *Id.* at *26–27. The dissent rejects the majority's conclusion that "structural features of the bankruptcy process reduce the risk that a stale debt will go unnoticed and thus be allowed" as inconsistent with the empirical evidence and contends that "the rules of bankruptcy in fact facilitate the *allowance* of claims" and thus a "debtor is arguably more vulnerable in bankruptcy—not less—to the oversights that the debt buyers know will occur." *Id.* at *28–30. Finally, the dissent challenges the majority's suggestion that some debtors may benefit from the filing of proofs of claim on account of stale debts (the majority explains that once filed and disallowed, such debts will eventually be discharged), because obtaining a discharge of such a debt first requires the trustee to notice and object to the stale debt and second requires the debtor to fully perform under his or her chapter 13 plan so as to obtain a discharge, neither of which may occur in many cases. *Id.* at *30–31. Instead, the dissent opines, "most debtors who fail to object to a stale claim will end up worse off than had they never entered bankruptcy at all" because they "will make payments on the stale debts, thereby resuscitating them, and may thus walk out of bankruptcy court owing more to their creditors than they did when they entered it." Id. at *31.

In closing, the dissent reproves the majority for setting "a trap for the unwary" by permitting debt collectors "to profit on the inadvertent inattention of others," and effectively invites Congress to amend the Act to make explicit that it applies to prohibit debt collectors from knowingly filing claims on account of time-barred debts in bankruptcy cases. Id.

V. Practice Tips

Midland Funding is an unfortunate decision that ignores the practical realities of consumer bankruptcy practice. Proofs of claim based on stale debts are a pox on the system, one that imposes costs on numerous parties. If an objection is pursued, bankruptcy trustees and debtors need to devote their resources to disallowing claims that never should have been filed, and bankruptcy

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courts need to unnecessarily devote their limited judicial resources to processing these objections. If an objection is not pursued, which may often be the case insofar as the sunk costs of the objection can exceed the economic benefit of disallowing a relatively small claim in a case paying claims in "bankruptcy dollars," the debt collectors extract value that properly belongs to other creditors. When the debtor has nondischargeable debts, such as student loans, the end result is that the debtor continues to owe other creditors more than he or she would if distributions had not been diluted in part by the time-barred claim. All of this is unjustifiable and not how Congress would have intended the bankruptcy system to function. It is regrettable that a majority of the Court did not perceive the inherent unfairness in large debt collectors' practices.

Right or wrong, *Midland Funding* is now the law under which consumer debtors and chapter 13 trustees must live. Debt collectors will undoubtedly continue to file proofs of claim based on time-barred debts, and may even be emboldened to do so after *Midland Funding*. What can be done about this?

One route would be to try to achieve legislative change, as Justice Sotomayor suggests. This route probably is unfeasible, at least in the near term. An alternative, and potentially more fruitful, legislative option may be to pursue legislation in the States to switch timeliness of consumer debts from an affirmative defense (i.e., a statute of limitations) to a more definitive liability bar (i.e., a statute of repose).

Another route would be to try to police creditor misconduct through litigation. Although *Midland Funding* eliminates civil liability under the Act, some bankruptcy courts may be willing to use their sanctioning power under Rule 9011 or their inherent authority to regulate debt collectors who make a practice of regularly filing proofs of claims for debt they know or should know is uncollectible.

A final route would be to try to address the problem through technological change. Just as the debt collectors have developed computer systems to reduce the administrative costs associated with filing proofs of claim, so too could associations of chapter 13 trustees and consumer debtor advocates attempt to develop a streamlined system for identifying and objecting to proofs of claim based on time-barred debt. Although this process will never be costless, technology may be able to assist in reducing the costs to a level that allows many more meritless proofs of claim to be weeded out of the system. If the Federal Rules of Bankruptcy Procedure are amended to require a plain statement by the claimant that the statute of limitations has run or to require that the claimant specifically identify the applicable nonbankruptcy law, it would make the technological solution more feasible.

In sum, the dispute in *Midland Funding* is not one that the Court resolved through technical statutory interpretation or based on its prior precedent. Instead, the issue presented was an instinctive one for most people—is the practice being utilized by debt collectors in bankruptcy cases "unfair"? Unfortunately for consumer debtors and the bankruptcy system, a majority of the members of the Supreme Court (like a majority of circuit judges before them) concluded that the practice of filing proofs of claims based on time-barred debts is not unfair. That conclusion, however, does not mean the practice is good social policy, and consumer debtors and advocates

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should continue to fight to eliminate the scourge of frivolous proofs of claim from consumer bankruptcy cases.

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The views stated herein are those of the authors individually, not of the UCLA School of Law; Klee, Tuchin, Bogdanoff & Stern LLP; or any client. In the interests of disclosure, the authors note that they served as counsel of record and principal authors of an *amici curiae* brief submitted to the Supreme Court in the *Midland Funding* case by the National Association of Consumer Bankruptcy Attorneys and the National Consumer Bankruptcy Rights Center.

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