Client Alert

April 2017

Res Judicata Does not Apply to "Deemed Allowed" Proofs of Claim

In two recent decisions, both the United States Courts of Appeals for the Fourth Circuit (Fourth Circuit) and the Fifth Circuit (Fifth Circuit) concluded that certain orders entered in bankruptcy cases could not be grounds for invocation of *res judicata* with regard to proofs of claim that are deemed allowed. Both addressed the plain language of Section 502(a) of the United States Bankruptcy Code (the Code) in conjunction with relevant Bankruptcy Rules and Official Forms, and congressional intent.

For *res judicata* to apply, the following elements must be present: (1) a prior, final judgment on the merits; (2) identical parties; and (3) the same cause of action in both proceedings. The issue presented in both decisions was whether an order unrelated to claims allowance entered in a bankruptcy case could provide the finality required for the invocation of *res judicata*. The issue was addressed in two completely different contexts, one, an order closing a "no asset" Chapter 7 bankruptcy case and the other, an order confirming a Chapter 13 plan.

Kipp Flores Architects

On March 24, 2017, the Fifth Circuit issued an opinion[1] affirming the District Court for the Southern District of Texas's order granting summary judgment holding that an unobjected-to proof of claim in a "no asset" Chapter 7 bankruptcy case is neither deemed allowed nor a final judgment, and therefore cannot be grounds for the invocation of *res judicata*. In affirming the decision of the district court, the Fifth Circuit held that the plain language of Section 502(a) of the United States Bankruptcy Code, "read in tandem with other provisions of the Bankruptcy Code,"[2] relevant Bankruptcy Rules and Official Forms reinforce that a claim cannot be "deemed allowed" when there are no distributable assets.

Case Background

Kipp Flores Architects (KFA) filed suit in March 2009 against Hallmark Collection of Homes LLC (Hallmark Collection), the limited partnership Hallmark Design Homes, LP (Hallmark Design) and Joe Partain, an individual owner of Hallmark Collection, in district court for violations of federal copyright law, specifically alleging the defendants built homes using plans designed by KFA without paying the requisite licensing fees.[3]

In November 2009, Hallmark Collection and Hallmark Design filed for Chapter 7 bankruptcy protection, prompting the district court to enter an order staying and administratively closing the district court litigation pending resolution of the bankruptcy proceedings.[4] Both Hallmark Collection and Hallmark Design stated in their bankruptcy filings that "after any exempt property is excluded and administrative expenses paid,

[1] *Kipp Flores Architects, LLC v. Mid-Continent Casualty Company*, Case No. 16-20255, 2017 WL 1130861 (5th Cir. Mar 24, 2017).
[2] *Id.* at *3.
[3] *See Kipp Flores Architects, LLC,* 2017 WL 1130861 at *1.
[4] *Id.* at *1.

there will be no funds available for distribution to unsecured creditors."[5] Based on the debtors' bankruptcy filings, the Chapter 7 trustee believed the cases would be "no asset" cases; however, in January 2010, the Chapter 7 trustee determined there may, in fact, be distributable assets in the Hallmark Collection bankruptcy and notified creditors they should file any claims in the case within ninety (90) days.[6] KFA filed a proof of claim for $63 million in the Hallmark Collection bankruptcy.[7] No deadline was set for objecting to claims, and neither the trustee or any party in interest objected to KFA's proof of claim.[8] In August 2010, the Chapter 7 trustee filed a "no asset report" in the Hallmark Collection's bankruptcy, indicating there were no proceeds from the debtor's estate for distribution to creditors.[9] The Hallmark Collection bankruptcy case was closed in September 2010.[10]

Subsequent to the bankruptcy court's entering the order closing the Hallmark Collection case, KFA made demand on Mid-Continent Casualty Company (Mid-Continent), the insurer for both Hallmark Collection and Hallmark Design, to pay off KFA's "final judgment" obtained for its "deemed allowed" proof of claim in the Hallmark Collection bankruptcy.[11] Mid-Continent refused and in September 2014, KFA filed suit against Mid-Continent for breach of contract as a judgment creditor of Hallmark Collection and as third-party beneficiary under Mid-Continent's policies.[12] Both KFA and Mid-Continent filed motions for summary judgment.[13] The magistrate judge concluded that KFA's proof of claim was not "deemed allowed" as a matter of law, based, in part, on the magistrate's conclusion that in cases where there are no distributable assets, the bankruptcy claims' process is "never triggered at all."[14] The district court adopted the magistrate judge's recommendation and granted Mid-Continent summary judgment.[15] KFA appealed the decision of the district court to the Fifth Circuit, which affirmed the decision of the district court.

KFA's Claim Was Not "Deemed Allowed"

The question on appeal was what "deemed allowed" means when a proof of claim is filed in a no-asset bankruptcy case, no deadline is set for objections to claims and no "party in interest" objects.[16] The Fifth Circuit based its holding on (1) an analysis of case law, (2) a plain language reading of Section 502(a), (3) an analysis of the relevant Bankruptcy Rules and (4) an analysis of the current official bankruptcy forms.[17]

The Fifth Circuit noted that while Section 502(a) states that a proof of claim filed under Section 501 is "deemed allowed," it further stated that "[p]refatory to allowance, however, Section 501 states that a creditor 'may' file a proof of claim."[18] The Fifth Circuit proceeded to perform an analysis of the word "may" as used generally throughout the Bankruptcy Code and as it applies to filing a proof of claim in bankruptcy cases with no assets available for distribution. Ultimately, the court concluded that if a case is a "no asset" bankruptcy case, then the Rules and Official Forms specifically discourage creditors from filing proofs of claim. Absent a requirement for filing proof of claim, the court concluded that the "claims allowance procedure" was not implemented in a manner that would result in *res judicata*.

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[5] *Id.*
[6] *Id.*
[7] *Id.* at *2.
[8] *Id.*
[9] *See Kipp Flores Architects, LLC,* 2017 WL 1130861 at *2.
[10] *Id.* at *2.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.* at *3.
[15] *Id.*
[16] *Id.* at *1.
[17] *See Kipp Flores Architects, LLC,* 2017 WL 1130861, *generally*.
[18] *See Kipp Flores Architects, LLC,* 2017 WL 1130861 at *4.

LVNV Funding

On March 30, 2017, the Fourth Circuit issued an opinion[19] affirming the judgments of the United States Bankruptcy Court for the District of South Carolina in two separate Chapter 13 bankruptcy proceedings that disallowed claims of unsecured creditor LVNV Funding, LLC (LVNV). The Bankruptcy Court disallowed LVNV's claims following the Debtors' post-confirmation objections based on the applicable statute of limitations, to which LVNV appealed.

Case Background

On July 11, 2014, Jeffrey Rhodes (Rhodes) filed a voluntary petition for relief under Chapter 13 in the United States Bankruptcy Court for the District of South Carolina.[20] Rhodes' Chapter 13 plan was confirmed on October 17, 2014.[21] On June 26, 2015, Derrick and Teresa Harling (the Harlings; collectively with Rhodes, the Debtors) filed their own Chapter 13 bankruptcy petition in that same court.[22] The bankruptcy court confirmed the Debtors' Chapter 13 plans.[23] LVNV filed proofs of claim in both cases before entry of the Confirmation Orders.[24] Neither Debtors, nor their trustees, took action regarding LVNV's claims before confirmation.[25] Subsequent to confirmation, the Debtors objected to LVNV's claims based on the relevant statute of limitations, which, in fact, LVNV conceded to in the bankruptcy court.[26] However, LVNV alleged the Confirmation Orders were final judgments with respect to the validity of its claims, and, therefore, *res judicata* precluded the Debtors' post-confirmation objections.[27]

***Res Judicata* Not Applicable to Post-Confirmation Objection to Proof of Claim**

In affirming the judgments of the Bankruptcy Court, the Fourth Circuit addressed whether a claim presumed allowed at the time of the confirmation hearing was final for purposes of *res judicata*. The court concluded that the processes for plan confirmation and claims allowance are distinctly separate and held that while LVNV's unobjected-to claims were presumed allowed at the time of the confirmation hearing, the issue of claims allowance was not raised until post-confirmation. The court determined that because none of the issues addressed at the confirmation hearing stage were relevant to the claims allowance process, *res judicata* did not bar the Debtors' subsequent post-confirmation objections.

Conclusion

The Fourth Circuit decision reinforced the claims allowance and Chapter 13 plan confirmation process as separate and distinct processes. Because the issue of claim allowance is not before the court during plan confirmation, *res judicata* cannot apply to bar a debtor's post-confirmation objections. The Fifth Circuit's decision reinforced that Section 502(a) is directed to claims deemed allowed where a debtor's estate may actually afford a distribution on account of those claims. Read together, these decisions provide that the claims allowance process must be looked at in the grand scheme of the bankruptcy universe—with an eye to an analysis of Section 502(a) as it interacts with other Code provisions.

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[19] *See LVNV Funding, LLC v. Harling*, et al., Nos. 16-1346 and 16-1347, 2017 WL 1190965 (4th Cir. Mar. 30, 2017).
[20] *Id.* at *1.
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.* at *2.
[27] *Id.*

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