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Problems in the Code

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An Uneven Match

Statutes of Limitations vs. Nondischargeability Actions

In a cause of action governed by state law, a plaintiff must file its complaint within a statutory limitations period or risk losing its rights. This relatively simple concept becomes less clear if the defendant—or potential defendant—files for bankruptcy, and the plaintiff files an action under § 523(a) in order to exclude from discharge a debt that was allegedly incurred by fraud or willful and malicious injury.

The Bankruptcy Code fails to explicitly address the impact of state-imposed limitations periods on § 523(a) nondischargeability actions, which has left courts grappling to fill in the gaps. To illustrate the problem, consider the following scenarios: (1) The plaintiff was unaware that it had a cause of action prepetition and did not file a state court action; (2) the plaintiff filed a state court action but did not plead any cause of action that included elements of fraud or willful and malicious injury; or (3) the plaintiff did not file a state court action within the limitations period at all. In these instances, is there even a claim that the plaintiff as creditor can seek to preserve under § 523(a)?² The Bankruptcy Code is silent in this respect.

Cracking the Code

A “debt” is a liability on a claim.³ A “claim” is defined by the Code as a right to payment, whether or not such right is reduced to judgment, liquidated or unliquidated, fixed or contingent, matured or unmatured, disputed or undisputed, legal or equitable, secured or unsecured.⁴ Courts have broadly interpreted the definition of “claim,” even referring to it as “all-encompassing.”⁵

Section 502 governs allowance of claims. A proof of claim is automatically allowed unless a party in interest objects.⁶ If an objection is raised, the claim will not be allowed if it is “unenforceable against the debtor...[under] applicable law for a reason other than because such claim is contingent or unmatured.”⁷ Unfortunately, the Code lacks definitional guidance as to what Congress meant by “unenforceable.” It would seem that the statute of limitations and other affirmative defenses may render a claim unenforceable, but is that what Congress meant?

What Was Congress Thinking?

Congress also intended the term “claim” to be interpreted broadly. A House Report explains that “[b]y this broadest possible definition...all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case. It permits the broadest possible relief in the bankruptcy court.”⁸ With respect to whether a claim is “unenforceable” under the § 502(b) exception, Congress remarked that appropriate reasons to disallow a claim would be “usury, unconscionability or failure of consideration.”⁹

Judicial Fixes

Although the foregoing does not provide a clear answer with respect to the statute of limitations issues presented, courts have interpreted the Code, legislative intent and bankruptcy policy to fashion their own rules addressing the various issues that arise.



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² Unless the plaintiff files a nondischargeability action in the bankruptcy court, the claim will be discharged. 11 U.S.C. § 523(c).

³ 11 U.S.C. § 101(12).

⁴ 11 U.S.C. § 101(5).

⁵ See also *Ohio v. Kovacs*, 469 U.S. 274, 279 (1985) (finding that “Congress desired a broad definition of claim”) (*In re Baldwin-United Corp.*, 48 B.R. 901, 903 (Bankr. S.D. Ohio 1985)).

⁶ 11 U.S.C. § 502(a).

⁷ 11 U.S.C. § 502(b)(1).

⁸ H.R. Rep. No. 95-595 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6266.

⁹ H.R. Rep. No. 95-595 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6308; S. Rep. No. 98-989 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5848.

Unripe Claims

In re Edge addressed the issue of unripe claims.¹⁰ In this case, the victim of alleged negligence filed a state court action against her dentists, who were in bankruptcy.¹¹ The state court action was answered in the form of the debtors' motions for sanctions in the bankruptcy court for violations of the automatic stay.¹² In turn, the plaintiff initiated an adversary proceeding for a declaratory order that her "claim" for negligence occurred post-petition at the time she discovered it and therefore she had not violated the automatic stay.¹³

Although the question of dischargeability was not before the court, its focus went to the heart of the issue: What is a claim?¹⁴ The court focused on § 502(b), which provides that an "unenforceable" claim will not be disallowed solely because it has not matured or is contingent.¹⁵ The court followed that "creditors may be entitled to allowable claims in bankruptcy even though remedies are not yet (and may never be) available under nonbankruptcy law."¹⁶

The court explained that there are two distinct issues: existence of a claim and allowance of a claim.¹⁷ The bankruptcy court must first determine under state law whether the claim is valid as of the bankruptcy filing and then whether it is allowable under federal law.¹⁸ The court aptly noted that "[i]t is conceptually difficult to refer to state law to determine when a 'right to payment' arises where by federal law a 'right to payment' spawns a claim notwithstanding that the right is contingent, unmatured, etc."¹⁹ The court ultimately held that the plaintiff's claim arose at the time of the pre-petition misconduct, not when it was discovered; thus, although it was an unmatured claim, it still constituted an allowable claim in bankruptcy.²⁰

State Court Claims Omit § 523-Type Allegations

Often, litigation has commenced pre-petition, but claims of fraud or willful and malicious injury have not been pled in the state court. By the time a bankruptcy petition is filed, the state statute of limitations has expired on such claims pre-petition. Can the plaintiff now assert that the claims are nondischargeable? The majority of courts permit the plaintiff to bring § 523 nondischargeability claims as long as the debt was "established" pre-petition.

In the case of *Resolution Trust Corp. v. McKendry*, Resolution Trust Corp. was the receiver and successor for New American Federal (NAF) in an adversary proceeding seeking nondischargeability of debt against McKendry under § 523(a)(2).²¹ The bankruptcy court agreed with the debtor's argument that the nondischargeability action was barred by the state statute of limitations because NAF's pre-petition deficiency judgment against the debtor did not plead fraud, although it did establish the existence and amount of the

debt.²² On appeal, the issue before the court was, "[W]here a debt has been reduced to judgment in state court, can the bankruptcy court be barred by a state statute of limitations from considering the underlying nature of the debt in determining whether that debt is dischargeable[?]"²³ Under these circumstances, the Tenth Circuit held that the plaintiff was *not* barred by the state statute of limitations.²⁴

Congress could codify the case law to reflect that in a nondischargeability action, a bankruptcy court must first establish whether the claim is valid under state law.

With the doctrine of *res judicata* in mind, the court reasoned that "allowing state statutes of limitations to decide if a claim can be brought to determine that a debt is nondischargeable under sec. 523(c) would allow the exclusive jurisdiction of the bankruptcy courts over core proceedings to be divested by operation of state law and would be inimical to the philosophy underlying the Bankruptcy Code."²⁵ This court also recognized that there are "two distinct issues": establishment of the debt governed by the state statute of limitations and dischargeability governed by the Code.²⁶ Because NAF filed the deficiency lawsuit within the statute of limitations, NAF had sufficiently "established" the debt, regardless of the fact that the claim did not include fraud.²⁷ The nondischargeable nature of the debt is therefore to be decided by the bankruptcy court.²⁸

In *Banks v. Gill Distrib. Ctr. Inc.*, the Ninth Circuit similarly held that the plaintiff was not barred from filing a nondischargeability action under § 523(a)(4) and (6), although the timely state court action filed by the plaintiff only alleged breach of contract and not fraud or willful and malicious injury.²⁹ This case is unlike *McKendry* in that the state court action was still pending when the debtor filed for bankruptcy; thus, the debt was not "established" by a judgment.³⁰ The *Banks* court held that the act of filing the state court action within the statutory limitation period was sufficient to "establish" the debt³¹ and confirmed that there is no rule that the allegations in state court must correspond to the grounds for nondischargeability in § 523.³² "Otherwise, plaintiffs in state court would be required to anticipate the bankruptcy of every defendant and litigate every conceivable issue under § 523(a) in the event a defendant should subsequently file bankruptcy. Such needless litigation is not required by the Bankruptcy Code."³³

22 *Id.* at 333-34.

23 *Id.* at 334.

24 *Id.* at 337.

25 *Id.* at 335.

26 *Id.* at 337.

27 *Id.*

28 *Id.*

29 *Banks v. Gill Distrib. Ctr. Inc.* (In re Banks), 263 F.3d 862, 868 (9th Cir. 2001).

30 *Id.* at 866.

31 *Id.* at 868; see also *In re Glunk*, 343 B.R. 754, 761 (Bankr. E.D. Pa. 2006) (finding that where "[p]laintiffs filed their state court lawsuit within the applicable limitations period...that filing is sufficient to remove the timeliness issue from the determination whether the debt is nondischargeable in the bankruptcy case").

32 *Banks*, 263 F.3d at 868; see also *In re Moran*, 152 B.R. 493, 496 (Bankr. S.D. Ohio 1993) ("[T]here is no requirement that the allegations of a complaint filed in state court prior to a debtor filing a petition in bankruptcy correspond to the elements of the grounds contained in § 523(a) of the Bankruptcy Code.").

10 *In re Edge*, 60 B.R. 690 (Bankr. M.D. Tenn. 1986).

11 *Id.* at 691.

12 *Id.*

13 *Id.*

14 *Id.* at 692.

15 *Id.* at 692-93.

16 *Id.* at 695.

17 *Id.* (citing *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 162 (1946)).

18 *Id.* Reference to unenforceable claims "is most naturally understood to provide that, with limited exceptions, any defense to a claim that is available outside of the bankruptcy context is also available in bankruptcy." *Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Electric Co.*, 549 U.S. 443, 450 (2007).

19 *Edge*, 60 B.R. at 696.

20 *Id.* at 705.

21 *Resolution Trust Corp. v. McKendry* (In re McKendry), 40 F.3d 331, 333 (10th Cir. 1994).

These opinions lead to an incongruous result from a debtor's point of view. Claims relating to fraud and willful and malicious injury may not have been asserted in pre-petition litigation and the state law statutes of limitations may long have passed, but the filing of the bankruptcy petition resurrects these potential causes of action. A plaintiff may share in the debtor's estate when it would otherwise have no ability to recover under state law for § 523-type claims. The opinions reflect the policy that a creditor's interest in recovering full payment for § 523-type claims outweighs a debtor's interest in a fresh start.

Expired Claims

The decisions vary in circumstances where the debt has not been "established" pre-petition. In *In re Dunn*, the plaintiff filed an adversary proceeding under § 523(a)(6) based on conversion.³⁴ The creditor had not initiated any state court tort proceeding prior to the expiration of the statute of limitations.³⁵ The court examined § 502 and the corresponding legislative history that "requires disallowance if the claim is unenforceable against the debtor for any reason such as usury, unconscionability, or failure of consideration."³⁶ Although not specifically enumerated, the court reasoned that the statute of limitations is a "reason" that would make a claim "unenforceable," which is similar to affirmative defenses such as usury, unconscionability or failure of consideration.³⁷ The court held that the claim was unenforceable and not subject to a dischargeability challenge because the limitation period expired without commencement of any action in the state court.³⁸

In the recent case of *In re Claudio*, a Massachusetts bankruptcy court considered whether a proof of claim may be filed if enforcement would be barred under the state law statute of limitations.³⁹ Rather than objecting to the claims, the chapter 13 debtor filed an adversary proceeding for sanctions against the creditor.⁴⁰ The court denied the sanctions,⁴¹ reasoning that filing the proofs of claim based on stale debt was not improper in Massachusetts because the statute of limitations only bars enforcement of the debt; it does not extinguish the debt.⁴² The claims were valid under state law. Turning to whether the claims were allowable under § 502(b)(1), the court noted that the statute of limitations is an affirmative defense that should have been raised in an objection to the proofs of claim,⁴³ since the debtor did not object to the claims, they were otherwise deemed allowed the court did not need to address the issue.⁴⁴ At least in a *Claudio* jurisdiction, if a debtor does not object to a proof of claim, the creditor may share in the debtor's estate even if the statute of limitations has expired. Likewise, it stands to

reason that a claim may be excepted from discharge unless the debtor successfully raises the statute of limitations as a defense in an adversary proceeding.

Other courts have found workarounds to the problems presented by expired limitation periods. For instance, a Connecticut bankruptcy court faced with an expired limitations period for fraud under Connecticut law exercised independent judgment to create federal common law pertaining to choice of law and instead applied the limitations period applicable in New York, which had not yet expired.⁴⁵

Conclusion

Bankruptcy judges have crafted appropriate solutions to address the Bankruptcy Code's uncertainty as to the impact of state statutes of limitations on nondischargeability actions. Their just decisions have supported the competing policies of protecting honest debtors and providing fairness to creditors by excepting from discharge debts created by malfeasant activities. However, to provide uniformity and certainty, Congress could codify the case law to reflect that in a nondischargeability action, a bankruptcy court must first establish whether the claim is valid under state law and in doing so, consider state law affirmative defenses raised by the debtor, including expiration of a statute of limitations period, to determine enforceability. If the claim is valid and enforceable, the court must then determine whether the claim is nondischargeable under the § 523 exceptions. **abi**

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33 *Id.* See also *Glunk*, 343 B.R. at 761 ("A debtor should not be allowed to let the state statute of limitations run on a fraud cause of action, file for bankruptcy protection and then be shielded from a fraud dischargeability complaint in the Bankruptcy Court because the state statute ran.") (quoting *In re Boyer*, 1999 WL 33954735 at *9 (E.D. Va. Aug. 24, 1999)).

34 *General Electric Credit Corp. v. Dunn (In re Dunn)*, 50 B.R. 664, 665 (Bankr. W.D.N.Y. 1985).

35 *Id.*

36 *Id.* at 666 (quoting H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 352 (1977)).

37 *Id.*

38 *Id.* See also *Kovalsky-Carr Electric Supply Co. v. Young (In re Young)*, 313 B.R. 555, 560 (Bankr. W.D.N.Y. 2004) (following *Dunn*).

39 *Claudio v. LVNV Funding LLC (In re Claudio)*, 434 B.R. 190 (Bankr. D. Mass. 2012).

40 *Id.* at 192.

41 *Id.* at 197.

42 *Id.* at 195 (citing *Don v. Soo Hoo*, 912 N.E.2d 18, 24 n. 9 (Mass. App. Ct. 2009) (noting that where obligation is unenforceable in court, it can be collected in other ways)).

43 *Id.*

44 *Id.*

45 *In re Segre's Iron Works Inc.*, 258 B.R. 547, 551 (Bankr. D. Conn. 2001). Although the debtor was a Connecticut resident, the creditor was a New York entity and the alleged fraud occurred in New York. *Id.*