Volume 70 | Issue 1 Article 8

January 2017

Soggy Debt—The Seventh Circuit Widens the Split on FDCPA Liability for Time-Barred Claims in Bankruptcy

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Soggy Debt—The Seventh Circuit Widens the Split on FDCPA Liability for Filing Time-Barred Claims in Bankruptcy

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IN *Owens v. LVNV Funding, LLC*, the Seventh Circuit added its voice to the fray over whether filing a time-barred proof of claim in a Chapter 13 bankruptcy violates the Fair Debt Collections Practices Act (FDCPA).[1] The divided panel declined to follow the Eleventh Circuit[2] and instead joined the Eighth Circuit[3] when it held that filing time-barred claims is permissible.[4] As Chief Judge Wood pointed out in her dissent, the *Owens* majority "miss[ed] the boat" on this one.[5] However, the Supreme Court will soon have an opportunity to calm the waters, having granted certiorari in the Eleventh Circuit's *Johnson v. Midland Funding, LLC* decision.[6]

The facts of the three underlying, consolidated cases are straightforward. In each, a debt collector filed a proof of claim in the debtor's Chapter 13 bankruptcy for a time-barred debt—that is, a stale debt for which the statute of limitations had long since expired.[7] The debtor then filed suit and asserted that filing a proof of claim on a time-barred debt violated the FDCPA as a false, deceptive, misleading, unfair, or unconscionable means to collect the debt.[8] The district court granted the debt collector's motion to dismiss, and the debtor appealed.[9]

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1. 15 U.S.C. §§ 1692e–1692f (2012); Owens v. LVNV Funding, LLC, 832 F.3d 726, 729 (7th Cir. 2016), *petition for cert. filed*, No. 16-315 (U.S. Sept. 12, 2016).
2. Crawford v. LVNV Funding, LLC, 758 F.3d 1254, 1262 (11th Cir. 2014).
3. Nelson v. Midland Credit Mgmt., Inc., 828 F.3d 749, 752 (8th Cir. 2016).
4. *Owens*, 832 F.3d at 737.
5. *See id.* at 740 (Wood, C.J., dissenting).
6. Johnson v. Midland Funding, LLC, 823 F.3d 1334, 1338,42 (11th Cir. 2016), *cert. granted*, No. 16-348, 2016 WL 4944674 (U.S. Oct. 11, 2016) (finding that the Bankruptcy Code did not preclude application of the FDCPA, a question "artfully dodged" in the Eleventh Circuit's earlier *Crawford* case).
7. *Owens*, 832 F.3d at 729.
8. 15 U.S.C. §§ 1692e–1692f; *Owens*, 832 F.3d at 729.
9. *Owens*, 832 F.3d at 729–30.

The *Owens* majority first addressed the debtor's argument that filing a time-barred claim is a per se violation of the FDCPA because a "claim" encompasses only legally enforceable debts.[10] The Bankruptcy Code (the Code) defines a claim as the "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] The court observed that it would be "strange" to limit a claim to only legally enforceable debts when two of the examples in the Code—contingent and unmatured—offer no state law enforcement right.[12] Furthermore, focusing on the Code's definition, which begins with "right to payment," the court noted that, in most states, debt does not simply vanish when the statute of limitations runs.[13] Relying on its prior decision in *McMahon v. LVNV, LLC*,[14] the court asserted that a creditor with a time-barred debt must retain "some right to payment, even if recourse is only grounded in the debtor's moral obligation to pay."[15] Thus, the court held that a claim must be "more extensive than the existence of a cause of action that entitles an entity to bring suit."[16]

The majority then buttressed its broad definition of claim by holding that the Code contemplates a creditor filing claims on stale debt.[17] The court examined two sections of the Code providing that the bankruptcy court must, upon objection, disallow a claim that is barred by a statute of limitations.[18] Moreover, the court posited that the Code requires a stale debt to be listed in the schedules in order to be discharged,[19] and if the debt is not discharged, it "remains collectible."[20] Viewing the Code in whole, the court held that filing a claim on time-barred debt is not inherently misleading or deceptive.[21]

After concluding that filing a time-barred claim is permitted under the Code, the court turned to the debtor's second argument, which is the crux of the issue—whether filing such a claim violated the FDCPA.[22] The FDCPA's purpose is to "eliminate abusive debt collection practices by debt collectors."[23] It does this, in part, by prohibiting false, deceptive,

10. *Id.* at 730.
11. 11 U.S.C. § 101(5)(A) (2012).
12. *Owens*, 832 F.3d at 730.
13. *Id.* at 731.
14. McMahon v. LVNV Funding, LLC, 744 F.3d 1010, 1020 (7th Cir. 2014).
15. *Owens*, 832 F.3d at 731.
16. *Id.* (quoting *In re* Keeler, 440 B.R. 354, 362 (Bankr. E.D. Pa. 2009) (internal quotations omitted).
17. *Id.* at 732.
18. 11 U.S.C. §§ 502(b)(1), 558 (2012); *Owens*, 832 F.3d at 732.
19. 11 U.S.C. § 1328(a) (2012) ("[T]he court shall grant . . . a discharge of all debts provided for by the plan.").
20. *Owens*, 832 F.3d at 732. The dissent argued that the majority "miss[ed] the boat" in making this statement because a statute of limitations provides a complete shield against collection and does not need to be supplemented by a discharge in bankruptcy. *Id.* at 740 (Wood, C.J., dissenting).
21. *Owens*, 832 F.3d at 734 (majority opinion).
22. *Id.*
23. 15 U.S.C. § 1692(e) (2012).

misleading, unfair, or unconscionable conduct in connection with the collection of any debt.[24] The debtor argued that filing a time-barred claim violated the FDCPA because the business model of the debt collector exploits inefficiencies and failures of the bankruptcy process, compelling collection on what is legally uncollectible.[25] The debtor relied on the Seventh Circuit's prior opinion in *Phillips v. Asset Acceptance, LLC*,[26] which outlined three primary reasons for holding that *filing a lawsuit* on time-barred debt violated the FDCPA: (1) the consumer may not recall the debt or have documentation to raise a limitations defense; (2) few consumers would be aware that time is a defense; and (3) even if the consumer is aware of the statute of limitations, she may give in rather than embarrass herself by going to court.[27] However, the majority rejected an attempt to analogize state court proceedings to bankruptcy proceedings and reasoned that the concerns in *Phillips* are "less acute" in bankruptcy.[28]

The *Owens* court downplayed the three concerns of *Phillips* by providing three mitigating distinctions found in bankruptcy proceedings.[29] First, the court noted that, unlike a lawsuit, a proof of claim must "inform the debtor about the age and origin of the debt."[30] The "consumer [therefore] need not have a memory of it or records documenting it to file an objection—the affirmative defense is evident on the face of the claim."[31] Second, debtors "usually" hire an attorney who would be aware of a statute of limitations defense.[32] And, even if a debtor is not represented, "a bankruptcy trustee who is duty-bound[[33]] to object to improper claims is appointed to oversee the proceedings."[34] Third, the court supposed that a debtor, by filing a bankruptcy case, has "demonstrated a willingness to participate" and is "unlikely to give in rather than fight the claim."[35]

After minimizing *Phillips*, the court then applied the "competent attorney" standard, rather than the "unsophisticated consumer" standard, to evaluate the debt collector's conduct.[36] In assessing an alleged violation of the FDCPA, the unsophisticated consumer standard asks "whether a person of modest education and limited commercial savvy would be likely to be deceived," while the competent attorney standard asks

24. §§ 1692e–1692f.
25. *Owens*, 832 F.3d at 734.
26. Phillips v. Asset Acceptance, LLC, 736 F.3d 1076, 1079 (7th Cir. 2013).
27. *Owens*, 832 F.3d at 734 (citing *Phillips*, 736 F.3d at 1079).
28. *Id.* at 735.
29. *Id.* at 735–36.
30. *Id.* at 735.
31. *Id.*
32. *Id.* at 736.
33. Although the *Owens* majority did not cite to a statute, it is most likely referring to the Chapter 13 trustee's duties in 11 U.S.C. § 1302(b)(1) (2012), which incorporate the duties of Chapter 7 trustees listed in 11 U.S.C. § 704(a)(5) ("The trustee shall . . . if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper.").
34. *Owens*, 832 F.3d at 736.
35. *Id.*
36. *Id.*

whether an attorney of average competence would be deceived.[37] The court opined that the unsophisticated consumer standard is inappropriate to evaluate whether communications made directly to a debtor's lawyer violated the FDCPA.[38] Because it was undisputed that the debtor was represented by counsel during the bankruptcy proceedings, the court found that the competent attorney standard applied.[39] Under this more lenient standard, the court found no violation of the FDCPA.[40]

Chief Judge Wood dissented, challenging first the majority's treatment of the Seventh Circuit's prior decisions in *McMahon* and *Phillips*.[41] From *McMahon*, the majority found implied support for the notion that *some* methods of collecting time-barred debts must be permitted.[42] The dissent, however, explained that "[n]othing in *McMahon* suggested that . . . a demand for payment under color of legal right, is permissible."[43] The dissent pointed out that "'[s]eeking' repayment [based on moral obligation] is one thing," which "could be accomplished by a polite, non-threatening letter advising the debtor of the debt's existence, *and* the fact that a lawsuit is time-barred."[44] A simple letter, however, "is in stark contrast with the use of any type of legal process, whether a suit in state court . . . or the filing of a claim in bankruptcy."[45] Additionally, *Phillips* held that filing a lawsuit to collect a stale debt violated the FDCPA.[46] The Chief Judge said that, because the Code does not distinguish bankruptcy proceedings from the state court proceedings found in *McMahon* and *Phillips*, she would have applied those cases' prohibition on the use of legal process to collect time-barred debts to the bankruptcy context as well.[47]

The dissent then admonished the majority for viewing the Code in isolation from the Federal Rules of Bankruptcy Procedure (the Rules).[48] Specifically, under Rule 9011, by filing a proof of claim, the debt collector "is certifying that to the best of the person's knowledge, information, and belief, . . . the claims . . . are *warranted by existing law*."[49] The Chief Judge announced that the public policy of Rule 9011 requires that any debt subject to "an ironclad statute of limitations defense . . . should not be eligible to be submitted in a proof of claim."[50]

Additionally, the dissent took issue with the majority's idealistic view, which assumed that debtors are "usually" represented by counsel.[51] It

37. Evory v. RJM Acquisitions Funding L.L.C., 505 F.3d 769, 774–75 (7th Cir. 2007).
38. *Owens*, 832 F.3d at 736.
39. *Id.*
40. *Id.* at 736–37
41. *Id.* at 737–38 (Wood, C.J., dissenting).
42. *Id.* at 731 (majority opinion).
43. *Id.* at 738 (Wood, C.J., dissenting).
44. *Id.* (emphasis in original).
45. *Id.*
46. *Id.* at 737.
47. *Id.* at 738.
48. *Id.* at 739.
49. Fed. R. Bankr. P. 9011(b)(2) (emphasis added).
50. *Owens*, 832 F.3d at 739-40 (Wood, C.J., dissenting).
51. *Id.* at 740.

noted that roughly nine percent of debtors in the Northern District of Illinois went unrepresented by counsel.[52] The dissent said that "[i]t is unrealistic to think that the *pro se* litigant or the busy trustee will catch every scheduled stale claim."[53] Indeed, according to the dissent, the only reason a debt collector will file a time-barred claim is in the "hope that it will slip through the cracks and be reborn as an allowed claim in bankruptcy."[54] Even though the majority may have left room to later find a violation when a debtor is *not* represented by counsel and the trustee fails to object to the claim, the dissent doubted a favorable result for that debtor given the majority's rationale.[55] The dissent declared that it would follow the Eleventh Circuit and hold that knowingly filing a proof of claim on a time-barred debt violates the FDCPA.[56]

This Note does not attempt to quibble with the majority's broad definition of claim as it applies in the bankruptcy context. The Eleventh Circuit in *Johnson* (the sole circuit finding a violation of the FDCPA for filing a time-barred claim) held that "[t]here is no blanket prohibition on filing a time-barred claim in bankruptcy."[57] The *Johnson* court found that the FDCPA and the Bankruptcy Code peacefully coexist, one overlaying the other, "so as to provide an additional layer of protection against [debt collectors]."[58] Thus, even if the *Owens* court correctly defined claim, it still erred in holding that filing such a claim is permitted by the FDCPA.

To truly grasp why the majority incorrectly decided this case, it is helpful to get a glimpse of what lies under the surface. The Federal Trade Commission (FTC) published a study in 2013, which found that the nine largest debt buyers in the industry purchased over $142 *billion* in debt on the cheap, averaging a mere $0.045 for every dollar of debt.[59] The FTC's study further found that, while most states' statutes of limitations were between three and six years, 19.3% of debt purchased was between three and six years old (over $27 billion), and 12.1% of the debt was greater than six years old (over $17 billion).[60] Meanwhile, in 2015, over 300,000 Chapter 13 bankruptcies were filed.[61] LVNV alone participated in 69,064

52. *Id.* This percentage does not, and cannot, reflect the percentage of debtors that were *underrepresented*—that is, debtors who receive practically, but not constitutionally, ineffective assistance of counsel.

53. *Id.* at 740–41.

54. *Id.* at 741.

55. *Id.*

56. *Id.*

57. Johnson v. Midland Funding, LLC, 823 F.3d 1334, 1341 (11th Cir. 2016), *cert. granted*, No. 16-348, 2016 WL 4944674 (U.S. Oct. 11, 2016).

58. *Id.*

59. Fed. Trade Comm'n, The Structure and Practices of the Debt Buying Industry T-2 tbl. 2 (2013), https://www.ftc.gov/reports/structure-practices-debt-buying-industry [https://perma.cc/2XCE-QL4C].

60. *Id.* at 42–43, T-2 tbl 2.

61. Admin. Office of the U.S. Courts, U.S. Bankruptcy Courts Judicial Facts and Figures, tbl 7.3 (2015), http://www.uscourts.gov/statistics/table/73/judicial-facts-and-figures/2015/09/30 [https://perma.cc/EHM4-U4RQ].

of those bankruptcies and filed 107,608 claims.[62] Extrapolating the percentages established by the FTC, elementary arithmetic would estimate that, of the claims LVNV filed in 2015, more than 20,000 claims (19.3% x 107,608) were a mix of time-barred and non-time-barred, and more than 13,000 claims (12.1% x 107,608) were likely time-barred. LVNV is just one creditor—the problem is rife.

With this perspective, one can see that the majority failed to properly consider the "deluge" that is drowning the bankruptcy process.[63] Indeed, "[t]he phenomena of bulk debt purchasing has proliferated and the uncontrolled practice of filing claims . . . presents a challenge for the bankruptcy system."[64] The economics are simple. If a debt buyer purchases a portfolio of time-barred debt for around 4.5 pennies on the dollar[65]—very likely a high estimate for time-barred debt[66]—the debt collector can still turn a profit so long as five percent of the debt slips through unnoticed and gets paid. At least one bankruptcy court has described part of the issue: "Chapter 13 trustees in this district do not object to proofs of claim based on statute of limitations defenses . . . because [it] . . . would require trustees to examine the details of virtually every unsecured proof of claim, which is simply impracticable."[67] This impracticability is the only reason debt collectors file these claims to begin with, for "if trustees performed their duties flawlessly, [debt collectors] would have little incentive to engage in [this] scheme."[68] Under this scheme, debt collectors are rewarded only when the system breaks down and fails.

The majority also sidestepped the powerful policies behind statutes of limitations. The Supreme Court described statutes of limitations as "a pervasive legislative judgment that . . . 'the right to be free of stale claims in time comes to prevail over the right to prosecute them.'"[69] The legislatures in every state provide what they consider a reasonable time to collect on a claim, but after that, the statutes kick in to "protect defendants and the courts from having to deal with cases in which the search for truth may be seriously impaired by the loss of evidence, whether by . . . fading memories, disappearance of documents, or otherwise."[70] These policies should not vanish once a debtor files bankruptcy, for the Supreme Court has also famously cautioned that state law property rights should not be examined differently solely on account of a bankruptcy fil-

62. AM. INFOSOURCE, AIS INSIGHT: 2015 YEAR IN REVIEW 14 (2016), http://www.americaninfosource.com/assets/AIS%20Insight_2015%20Annual.pdf [https://perma.cc/R35L-DJ4T].

63. *See* Crawford v. LVNV Funding, LLC, 758 F.3d 1254, 1256 (11th Cir. 2014).

64. *In re* Andrews, 394 B.R. 384, 387 (Bankr. E.D.N.C. 2008).

65. *See* FED. TRADE COMM'N, *supra* note 59, at T-2 tbl. 2 (referring to the average price paid for all debt purchased).

66. *See* Buchanan v. Northland Grp., Inc., 776 F.3d 393, 395 (6th Cir. 2015) ("LVNV buys 'uncollectable' debts at a discount—the older the debts, the greater the discount.").

67. *In re* Edwards, 539 B.R. 360, 365 (Bankr. N.D. Ill. 2015).

68. *In re* Dubois, 834 F.3d 522, 534 (4th Cir. 2016) (Diaz, J., dissenting).

69. United States v. Kubrick, 444 U.S. 111, 117 (1979).

70. *Id.*

ing.[71] After all, a debtor files bankruptcy to get a "fresh start"—indeed, to be free of debt—not to enable uncollectible debt to rise from the deep.[72]

Finally, the majority erred when it applied the competent attorney standard rather than the unsophisticated consumer standard. The unsophisticated consumer standard "takes into account that consumer-protection laws are not made for the protection of experts, but for the public—that vast multitude which includes the ignorant, the unthinking, and the credulous."[73] The precedent relied upon by the majority carved out an exception to the unsophisticated consumer standard when the debt collector sends a communication, such as a letter, directly to the consumer's lawyer, as directed by the statute.[74] The idea is that a lawyer can explain a letter to his client.[75] However, this narrow exception does not apply to the proof of claim context. Filing a proof of claim is neither a collection letter nor a communication sent directly to a lawyer. It is conduct—*legal action*—in an attempt to collect a debt, aimed directly at the debtor. Therefore, this conduct should have been evaluated under the unsophisticated consumer standard, which likely would have led to a very different result in this case.

The problem of stale debt collection in bankruptcy has been, no doubt, a difficult one to address for many of the courts that have considered it. In fact, the issue divided another panel in the Fourth Circuit shortly after *Owens*.[76] Tellingly, a petition for certiorari to the Supreme Court has been granted in the Eleventh Circuit's *Johnson* decision.[77] While a petition for certiorari has also been filed in the present *Owens* case, as of the writing of this note, the petition is still pending.[78] Hopefully, the high court will take up *Owens* as well and settle the issue.

When the Supreme Court considers *Johnson* (and if it takes up *Owens*), it will find that the result is binary. It must decide whether or not filing a time-barred claim is a false, deceptive, misleading, unfair, or unconscionable means to collect the time-barred debt. The Fourth Circuit has offered up a solution not to impose FDCPA liability but to allocate additional resources to trustees.[79] Presumably, this proposal gives trustees the armada they need to review the details of the millions of proofs of

71. *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

72. *See* Marrama v. Citizens Bank, 549 U.S. 365, 367 (2007).

73. Crawford v. LVNV Funding, LLC, 758 F.3d 1254, 1258–59 (11th Cir. 2014).

74. *See* Evory v. RJM Acquisitions Funding L.L.C., 505 F.3d 769, 773–74 (7th Cir. 2007).

75. *See id.* at 773 ("The lawyer receives the notice and shares it with, or explains it to, his client.").

76. *In re* Dubois, 834 F.3d 522, 525 (4th Cir. 2016).

77. Johnson v. Midland Funding, LLC, 823 F.3d 1334, *cert. granted*, No. 16-348, 2016 WL 4944674 (U.S. Oct. 11, 2016).

78. *Owens*, 832 F.3d 726, *petition for cert. filed*, No. 16-315 (U.S. Sept. 12, 2016).

79. *In re Dubois*, 834 F.3d at 531.

claims filed every year.[80] This solution is inefficient at best. To get to the right answer, one should look to the two possible results. On the one hand, allowing time-barred claims in bankruptcy only further burdens debtors, trustees, and courts when the Bankruptcy Code contemplates that such claims *never* be paid. On the other hand, finding a violation would simply put a stop to the practice without overburdening debt collectors.[81] The FDCPA's purpose is to "eliminate abusive debt collection practices."[82] As debt collectors continue to flood the bankruptcy system with unfounded claims, the FDCPA remains the only lifeboat in sight.

80. *See* Am. Infosource, *supra* note 62, at 18.

81. Finding a violation would not impose uncircumscribed liability for debt collectors. There is a statutory damage cap of $1,000 (plus attorney's fees) in addition to a safe harbor provision for debt collectors who do not intentionally file a time-barred claim. *See* 15 U.S.C. § 1692k(a), (c) (2012).

82. 15 U.S.C. § 1692(e) (2012).