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The Ninth Circuit Bankruptcy Appellate Panel Supports Heightened Service Requirements Against Creditors That Do Not Participate in a Bankruptcy Case

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The Ninth Circuit Bankruptcy Appellate Panel ("BAP") has held that in order for a bankruptcy court to exercise personal jurisdiction over a litigant that has neither filed a proof of claim nor participated in any way in the bankruptcy proceeding, service of process on the litigant must substantially comply with Rule 7004 of the Federal Rules of Bankruptcy Procedure ("Rule 7004"). In *701 Mariposa Project, LLC v. Keys*, BAP No. CC-13-1329-KuBlPa (filed July 31, 2014),[1] the BAP found that appellee 701Mariposa Project, LLC ("Mariposa") failed to effectuate proper service of process on appellant Sherry Keys ("Keys"), who did not participate in Mariposa's Chapter 11 bankruptcy case in any way, because the service of process on Keys failed the mailing requirement of Rule 7004(b)(1).[2]

BACKGROUND

Mariposa purchased an apartment building in Los Angeles, California at a nonjudicial foreclosure sale in July of 2011. Keys, a tenant of the building, paid subsidized rent of $600 per month to an organization called People in Progress ("PIP"), which in turn paid rent to the prior owner of the building. Months prior to the foreclosure sale, PIP stopped making payments to the prior owner of the building and notified tenants that it was discontinuing its affordable housing program and that they would need to leave.

Shortly after its acquisition of the building, Mariposa evicted Keys in September of 2012. Keys sued Mariposa in the United States District Court seeking $4.5 million in damages for allegedly violating local, state and federal law by exhibiting a pattern of forcing out predominantly minority tenants paying below-market rent and replacing them with white tenants who paid market rent of double or triple of what the PIP tenants paid. Meanwhile, Mariposa had filed for chapter 11 bankruptcy protection and neither scheduled Keys as a creditor nor provided Keys with notice of the proof of claims bar date. Instead, Mariposa filed a notice of bankruptcy in the district court lawsuit and a late proof of claim on behalf of Keys. Thereafter, Mariposa filed an objection to the proof of claim asserting that the claim should not be allowed because, *inter alia*, the district court lawsuit lacked merit and that the claim was untimely.

The bankruptcy judge granted the objection to claim on the merits and based on Keys' failure to respond. Keys admittedly had actual knowledge of the objection to claim because she received an email notifying her of the objection, and she was in possession of a full copy of the objection at least three weeks before the hearing. Four months after the order on the objection was entered, Keys moved to vacate the order on the basis that Mariposa did not serve Keys by mail at her "dwelling house or usual place of abode" pursuant to Rule 7004(b)(1). However, the bankruptcy judge found that Keys' actual notice of the claim objection was sufficient to satisfy the minimal requirements of due process and was in substantial compliance for service of process sufficient to give the court personal jurisdiction over Keys.

On appeal, the BAP parsed the defective service of process into two issues: (1) whether Keys was denied due process and (2) whether the bankruptcy court had personal jurisdiction over Keys as a result of the defective service of process.

DUE PROCESS

The BAP agreed with the bankruptcy judge and found that Keys' due process argument lacked merit because she knew about and had a full copy of the objection to claim at least three

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within one year of the alleged violation, 12 U.S.C. §2614. The 9th Circuit found that there was the possibility of equitable tolling in this case until the date that the plaintiffs actually received their loan documents, because the plaintiffs did not receive their loan documents at the loan origination, and they were allegedly misled about the terms of the loan without receiving copies of the completed documents. The court ruled that the language of 12 U.S.C. §2614 that the claim "may be brought ...within 1 year... from the date of the occurrence of violation" was non-jurisdictional and amenable to equitable tolling. The purpose of RESPA, like TILA, was intended to serve consumer-protection purposes, and that when a lender obfuscates or fails to disclose the terms of a loan, equitable tolling occurs until the borrower discovers, or had reasonable opportunity to discover, the violation.

What This Means To Lenders: Since the statute of limitations is tolled during the period in which the consumer does not receive their loan documents, the lender should be scrupulous in disclosing all terms required by TILA and RESPA, and making sure that the borrower receives copies of all loan documents together with TILA and RESPA disclosures. No longer can a lender count on prevailing in an action at the outset by alleging a failure to tender the rescindable amount of the loan.

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weeks before the hearing. The BAP articulated the minimal standard for due process as merely notice "reasonably calculated, under all circumstances, to appraise interested parties of the pendency of the action and afford them an opportunity to present their objections."[3] Since Keys had a copy of the objection to claim and ample opportunity to contest it, the BAP found that the due process requirement with respect to the claim objection proceedings was satisfied.

PERSONAL JURISDICTION

Nevertheless, with respect to personal jurisdiction, the BAP found that in a contested matter such as an objection to claim proceeding, when a party has not participated in the bankruptcy proceeding, it must be served in substantial compliance with Rule 7004. In its analysis, the BAP addressed the intersection between the service requirements for objections to claim in Rule 3007(a) of the Federal Rules of Bankruptcy Procedure ("Rule 3007(a)") and the stricter service standard in Rule 7004.[4] Rule 3007(a) provides that "a copy of the objection [to claim] with notice of the hearing thereon shall be mailed *or otherwise delivered to the claimant*…at least 30 days prior to the hearing."[5] The BAP suggested that service of process on Keys was sufficient under Rule 3007(a) because the objection was "otherwise delivered" to her since she had a full copy of the objection.

However, the BAP ultimately applied Rule 7004 after noting that it had previously offered conflicting views of whether the mailing and delivery requirements in Rule 3007(a) are in addition to or in lieu of the requirements of Rule 7004.[6] The BAP's decision to apply Rule 7004 turned on the fact that Keys had not filed a proof of claim or engaged in conduct that could be construed as consent to the court's personal jurisdiction. Since Keys had not previously availed herself of the court's jurisdiction, the BAP held that she was entitled to the more stringent service requirements of Rule 7004, reasoning that when a creditor's rights are at issue, the bankruptcy rules require more than the minimal notice required to satisfy due process concerns.[7]

The BAP then inquired into whether Rule 7004 had been substantially satisfied.[8] Under the "substantial compliance doctrine, a federal court need not dismiss a complaint for insufficient service of process based on technical defects in service of process when: (a) the party that had to be served personally received

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actual notice, (b) the defendant would suffer no prejudice from the defect in service, (c) there is a justifiable excuse for the failure to serve properly, and (d) the plaintiff would be severely prejudiced if his complaint were dismissed."[9] The BAP agreed with the bankruptcy court's findings that Keys had actual notice of the objection to claim and that the service defect was justifiable because Keys had continued to use the service address on her district court filings well after her September 2012 eviction. However, the BAP disagreed with the bankruptcy court's finding of prejudice against Mariposa, reasoning that being denied a "quick victory" by default as opposed to prevailing on the merits constitutes little or no prejudice.[10]

The BAP ultimately found that the service of process on Keys did not substantially satisfy Rule 7004 because the objection was mailed to an address from which Keys was evicted despite her continuing to use that address in her district court filings. Furthermore, Keys' actual knowledge of the objection to claim and the ample opportunity she had to contest it was not sufficient for the bankruptcy court to exercise personal jurisdiction over Keys.[11] While using the substantial compliance doctrine as a platform for its analysis, the BAP applied a much stricter approach to compliance with Rule 7004 on the issue of personal jurisdiction.

POTENTIAL CONSEQUENCE

The BAP's decision seems to favor a strict compliance approach to Rule 7004 with respect to the bankruptcy court's ability to exercise personal jurisdiction over a creditor who does not participate in any way in the bankruptcy proceeding. As a potential consequence, requiring service of process pursuant to Rule 7004 against creditors who do not participate in a bankruptcy case whatsoever may prove problematic for debtors who propose plans of reorganization that impair the rights of such creditors by, for example, providing for avoidance or modification of disputed liens, valuation of collateral securing claims, fixing treatment of disputed claims and modifying the terms of pre-bankruptcy agreements. But requiring strict compliance with Rule 7004 against non-participating creditors appears to be the correct approach and is consistent with numerous bankruptcy cases that have held that a bankruptcy plan cannot be used as a platform to conduct what needs to be conducted in a contested matter or adversary proceeding unless the plan is served pursuant to Rule 7004 in lieu of Rule 2002 of the Federal Rules of Bankruptcy Procedure.[12]

CONCLUSION

The ultimate import of this case remains to be seen as it is currently pending an appeal to the Ninth Circuit. However, the BAP's opinion in the interim should be persuasive to bankruptcy judges. Thus, any party in interest who wishes to effectuate service of process of an adversary proceeding or contested matter against a non-participating creditor should do so in strict compliance with Rule 7004. The creditor's actual knowledge or the opportunity to defend against the action will likely not overcome a technical defect in Rule 7004.

1 This case is currently pending an appeal to the Ninth Circuit.

2 Rule 7004(b)(1) provides in relevant part that service of a summons and complaint must be made by first class mail to an individual's "dwelling house or usual place of abode or to the place where the individual regularly conducts a business or profession." Fed. R. Bankr. P. 7004(b)(1). Rule 7004 incorporates Rule 4 of the Federal Rules of Civil Procedure in bankruptcy adversary proceedings.

3 *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950).

4 Rule 7004 applies in both bankruptcy adversary proceeding and contested matters by operation of Rule 9014 of the Federal Rules of Bankruptcy Procedure. Fed. R. Bankr. P. 9014.

5 Fed. Bankr. R. 3007(a) (emphasis supplied)

6 See *United States v. Levoy (In re Levoy)*, 182 B.R. 827, 834 (9th Cir. BAP 1995); Jorgenson v. State Line Hotel, Inc. (In re State Line Hotel, Inc.), 323 B.R. 703, 711-12 (9th Cir. BAP 2005).

7 See *Beneficial Cal., Inc. v. Villar (In re Villar)*, 317 B.R. 88, 93.94 (9th Cir. BAP 2004).

8 Curiously, although the BAP applied "substantial compliance doctrine" in its analysis, it suggested that it should not be applied as a "sword" against defaulting defendants attempting to set aside default judgments based on errors in service of process; rather, it should only be used as a "shield" to protect plaintiffs from dismissal of their complaints based on technical service defects.

9 *Whale v. United States*, 792 F.2d 951, 953 (9th Cir. 1986).

10 See *Baltman v. U.S. Postal Service*, 231 F.3d 1220, 1224-25 (9th Cir. 2000).

11 The BAP also briefly addressed the "arguable basis" standard for exercising jurisdiction articulated in *United Student Aid Funds, Inc. v. Francisco J. Espinosa*, 559 U.S. 260, 271 (2010). The BAP summarily dismissed the arguably basis standard as applicable to subject matter jurisdiction, not personal jurisdiction. Indeed, United Student Aid Funds, Inc. had filed a proof of claim in the bankruptcy case and thereby submitted itself to the bankruptcy court's jurisdiction over its claim.

12 *Piedmont Trust Bank v. Linkous (In re Linkous)*, 990 F.2d 160 (4th Cir.

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1993); *Green Tree Acceptance, Inc. v. Calvert (In re Calvert),* 907 F.2d 1069 (11th Cir. 1990); *Boykin v. Marriot Int'l, Inc. (In re Boykin),* 246 B.R. 825, 828 (Bankr. E.D. Va. 2000).

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sale, the lender would have foreclosed on both the Shafter and Wasco properties together in the judicial foreclosure action and would have obtained a deficiency. If other courts adopt Jude Poochigian's reasoning, then we may see a trend towards requiring borrowers to show prejudice before they can assert the one action rule as an affirmative defense to a *judicial* foreclosure action, similar to the current requirement for borrowers to show prejudice in order to set aside a *nonjudicial* foreclosure sale. Alternatively, we may see the legislature take action to create alternative remedies in cases where violations of section 726 only cause "hypothetical prejudice that can be cured by a lesser sanction."[17]

It remains to be seen whether the lender will ultimately be successful in obtaining a deficiency judgment in this case, as the appellate court remanded the case for further proceedings in the trial court. Regardless of whether the California Supreme Court or state legislature decide to take action to address the harshness of the "one action" rule, it is clear from *McDonald* that lenders should mindful of these issues when assessing their options to collect on defaulted loans secured by multiple pieces of real property.

1 *First Cal. Bank v. McDonald* (2014) 2014 Cal. App. LEXIS 967.

2 *McDonald* at *5.

3 John's children were appointed as the personal representatives of the probate estate. Due to her bankruptcy discharge, no deficiency was sought against Sally.

4 Notably, the Court did not address whether the lender violated the broader "one action rule" by authorizing the short-sale of the Shafter Property before filing the nonjudicial foreclosure complaint. This distinction is important because a violation of the "one action rule" could have resulted in the lender losing its entire security interest against the Wasco Property opposed to simply losing its ability to obtain a deficiency judgment.

5 *First Cal. Bank v. McDonald* (2014) 2014 Cal. App. LEXIS 967 at *18 (citing *Pacific Valley Bank v. Schwenke* (1987) 189 Cal.App.3d 134, 140) (internal quotations omitted).

6 *McDonald* at *15 (internal citations omitted).

7 *McDonald* at *18-19.

8 *McDonald* at *19 (citing Schwenke, 189 Cal.App.3d at 142-143).

9 *McDonald* at *19 (citing *Thoryk v. San Diego Gas & Electric Company* (2014) 225 Cal.App.4th 386, 393).

10 *McDonald* at *19-20.

11 *McDonald* at *27.

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12 *McDonald* at *22 (citing *Schwenke*, 189 Cal.App.3d at 137).

13 *McDonald* at *28.

14 *McDonald* at *30.

15 *McDonald* at *30 (citing Hibernia S. & L. Soc. v. Thornton (1895) 109 Cal. 427, 429).

16 *McDonald* at *32. Judge Poochigian, issuing a concurring opinion, determined that the Court's decision ultimately hinged on the application of the Hibernia Rule.

17 *McDonald* at *41.

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mortgage payments. In 2009, they applied to lender Bank of America N.A. (BofA) to have their loan modified under the Making Homes Affordable Act. For months thereafter, telephone calls and letters to BofA yielded either, and sometimes both, of two alternate responses from the BofA representatives contacted: (1) everything was proceeding according to plan or (2) the representative had no knowledge of any loan modification application.

Because the Fleets were representing themselves, the court stated that their complaint was not in the form to which courts are accustomed.[1]

In November 2011, BofA informed the Fleets by letter that they had been approved for a trial period plan (TPP) under a Fannie Mae modification program. All they had to do, the Fleets were told, was to make three monthly payments of $957.43, starting on December 1, 2011. If they made the payments, then they would move to the next step – verification of financial hardship. If they passed that test, their loan would be permanently modified.

The Fleets promptly made payment for both December 2011 and January 2012. A BofA representative confirmed BofA's timely receipt of both payments. The representative also assured the Fleets that foreclosure proceedings had been suspended. Toward the end of January 2012, the Fleets' home was sold at a trustee's sale.

The Fleets sued BofA and others, including three BofA employees who had been involved in handling their loan modification. They asserted causes of action for breach of contract, fraud, promissory estoppel and accounting. The trial court sustained the defendants' demurrers to the Fleets' first amended complaint without leave to amend. The court of appeal affirmed in part and reversed in part, holding that the allegations in the Fleets' complaint were sufficient to state causes of action for breach of contract, fraud and promissory estoppel.

According to the agreement alleged in the complaint and memorialized by the TPP letter, the Fleets were accepted into a program that would have led to a permanent modification of their mortgage. The first step of this program was timely payment of the three monthly amounts specified in the letter. Despite the Fleets' timely remittal of the first two payments,