

Use Clarity to Avoid Contempt in Bankruptcy

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September 8, 2021



This is a story about contempt and clarity.

It comes to us from a July 2021 North Carolina district court decision reversing a \$115,000 sanctions order by a North Carolina bankruptcy court. The story offers a lesson and a moral. The lesson is that the bankruptcy court cannot sanction a creditor if there is an objectively reasonable basis for concluding that the creditor's conduct is lawful.

The moral of the story is that a creditor can avoid the time,

expense, and risk associated with litigating contempt and sanctions issues by taking basic steps to ensure that confirmed Chapter 11 plans are clear and precise.

In 2009, the Beckharts filed Chapter 11. At the time, they were almost a year behind on a loan secured by the property at Kure Beach. The loan servicer objected to a plan confirmation because it did not specify how post-petition mortgage payments would be applied to principal and interest. The bankruptcy court confirmed the plan without clarifying the issue, but the servicer did not ask the court to reconsider its order nor did it appeal.

The Beckharts paid for five years. Shellpoint acquired the loan from the original servicer and treated it as in default based on unpaid accrued arrearages. Periodically, Shellpoint sent default letters to the Beckharts, who disputed the default. Counsel for Shellpoint advised that the confirmation order had not changed the loan contract terms and that the loan remained in default. The matter escalated with the Beckharts filing complaints with the Consumer Financial Protection Bureau. Shellpoint commenced foreclosure, then represented to the Beckharts it was ceasing foreclosure, but then posted a foreclosure hearing notice on the Beckharts' door (allegedly due to error).

In January 2020, the Beckharts moved the bankruptcy court to find Shellpoint in contempt and award them monetary sanctions. The court held a hearing in June and, in September 2020, found Shellpoint in contempt. The court tagged Shellpoint with \$115,000 in sanctions for lost wages, "loss of a fresh start," attorney's fees, and travel expenses.

Bankruptcy courts have the power to hold a party in civil contempt and to impose sanctions for violation of a confirmed plan. The test for liability is based on a recent United States Supreme Court decision -- *Taggart v. Lorenzen*. (To read our discussion of *Taggart*, [click here](#).) The *Taggart* test prohibits sanctions if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful." There can be contempt for violating the discharge injunction only "if there is no fair ground of doubt as to whether the order barred the creditor's conduct."

In reversing the bankruptcy court, the district court noted that the plan and confirmation order did not state how much the debtors would owe on confirmation, did not say how the \$23,000 in arrears would be paid, and did not set the amount of the first payment. Confusingly, the confirmation order also said that the original loan terms would remain in effect, except as modified. Finally, the district court pointed out that Shellpoint was repeatedly advised by counsel that their behavior was authorized, and reliance on the advice of outside counsel is a sufficient defense to civil sanctions. Based on all these facts, the district court found that Shellpoint acted in good faith and interpreted the confirmation order in a manner consistent with the contractual terms of the loan, and that was objectively reasonable.

Creditors can take some comfort in the "no fair ground of doubt" test, which is more forgiving than a strict liability standard. Creditors can also solicit and act on the advice of counsel before engaging in perilous conduct, which provides another layer of protection. But the most important takeaway is the self-evident principle that creditors should insist on clear and specific plan terms. Shellpoint ultimately prevailed and avoided sanctions, but only after over 18 months of litigation. All of that could have been avoided had the loan servicer insisted the plan specify how the Beckharts' payments would be applied to satisfy the arrearage.

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