

In re David Lester Howland, Case No. 14-31498-rld7

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Unpublished (545 B.R. 653)

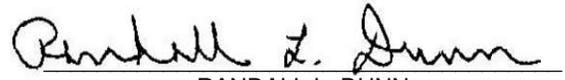
Pre-petition, the debtor David Howland ("David") received cash advances from his father Justin Howland ("Justin") in the total amount of \$580,000. After David filed his chapter 7 petition, Justin filed a proof of claim asserting an unsecured claim in the same dollar amount. Bank of the Cascades (the "Bank") objected to the claim, and the court held an evidentiary hearing on the objection.

Although the court found the purported promissory notes Justin offered in support of his claim unenforceable, the court nevertheless determined that the evidence established the existence of a loan agreement between David and Justin. However, the court went on to conclude that the applicable California statute of limitations period had expired for all but the most recent \$205,000 of the loans. The court rejected Justin's argument that Oregon's longer limitations period applied to the loans, as California was the state having the most relevant connections to the transactions.

The court then considered whether the loans should be subordinated to David's other debts, including his debt to the Bank. Based on the testimony of David and Justin, the court concluded that they had agreed between themselves that David's debt to Justin would be subordinated to his other debts. This agreement was enforceable in David's bankruptcy case pursuant to § 510(a). The court also considered whether Justin's claim should be subordinated under § 510(c). Because Justin had not engaged in inequitable conduct, the court concluded that § 510(c) did not provide an additional ground for subordination.

The court allowed Justin's claim as a general unsecured claim in the amount of \$205,000 but subordinated the claim to the allowed claims of David's other creditors under § 510(a).

Below is an Opinion of the Court.


RANDALL L. DUNN
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF OREGON

In Re:) Bankruptcy Case
DAVID LESTER HOWLAND,) No. 14-31498-rld7
Debtor.) MEMORANDUM OPINION

On October 8, 2015, I held an evidentiary hearing ("Hearing") on Bank of the Cascades' ("Bank") objection to the claim (Claim No. 20) ("Claim") filed by Justin Howland ("Justin")¹ in the chapter 7² case of David Lester Howland ("David"). After admitting exhibits and hearing witness testimony, I closed the evidentiary record and heard argument from counsel. At the close of the Hearing, I gave counsel for the parties time to file supplemental legal memoranda with respect to the following issues: 1) Whether any portion of the Claim should be

¹ Justin is David's father. I refer to them by their first names herein to differentiate them. No disrespect is intended.

² Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all "Rule" references are to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037. The Federal Rules of Civil Procedure are referred to as "Civil Rules."

1 disallowed based on the running of any applicable statute of limitations?

2 2) Whether the Claim should be subordinated under the provisions of
3 § 510(a) or (c) of the Bankruptcy Code? Following the filing of the
4 parties' legal memoranda,³ I took the matter under advisement.

5 In deciding this matter, I have considered carefully the
6 admitted exhibits and the testimony of Justin and David at the Hearing.
7 I also have considered the parties' legal memoranda, and I further have
8 taken judicial notice of the docket and documents filed in David's main
9 chapter 7 case, Case No. 14-31498-rld7, for the purpose of confirming and
10 ascertaining facts not reasonably in dispute. Federal Rule of Evidence
11 201; In re Butts, 350 B.R. 12, 14 n.1 (Bankr. E.D. Pa. 2006). In
12 addition, I have reviewed relevant legal authorities, both as cited to me
13 by the parties and as located through my own legal research.

14 In light of that consideration and review, this Memorandum
15 Opinion sets forth the court's findings of fact and conclusions of law
16 under Civil Rule 52(a), applicable with respect to this contested matter
17 under Rules 7052 and 9014.

18 I. Relevant Facts

19 From as early as September 2008 or February 2009 through
20 February 2014, Justin made a series of advances to David or on David's
21

22
23 ³ At the Hearing, I advised counsel that I intended to consider only
24 one set of legal memoranda, giving the Bank's counsel until October 13,
25 2015 to file its memorandum and Justin's counsel until October 27th to
26 file his responding memorandum. Later, in response to correspondence
from the Bank's counsel, I authorized the Bank's counsel to file a reply
memorandum no later than November 12, 2015, by order entered on October
28, 2015 (Docket No. 128). Following the filing of the Bank's reply
memorandum on November 12, 2015, I took the matter under advisement.

1 behalf totaling \$580,000 ("Advances"). Although Justin and David
2 attempted to document the transactions with promissory notes ("Notes")
3 drafted by David, the Notes were deficient in that they did not include
4 payment terms or maturity dates, and they were signed by Justin as
5 "PAYOR" and David as "PAYEE." See Exhibits 1 and A. The Notes all
6 included "Redding, California" in the line with the date and the amount
7 advanced and provided for interest at the rate of six percent per annum.
8 Justin never demanded payment of any of the Notes and apparently did not
9 retain the original Notes. Hr'g Tr. Oct. 8, 2015, at 28:1-3. At the
10 Hearing, Justin explained his failure to make demand by reiterating
11 testimony from his deposition that:

12 Demand was never made because Justin Howland and his
13 son David Howland had an understanding that the loans
14 would be repaid after [David's] businesses stabilized
 and David was able to take sufficient distributions
 to repay his debt.

15 Hr'g Tr. Oct. 8, 2015, at 19:17-21; 20:13-15.

16 David confirmed his intent to repay Justin in his testimony at
17 the Hearing. Hr'g Tr. Oct. 8, 2015, at 32:21-22. However, at the
18 Hearing, eight of David's financial statements from August 31, 2009
19 through March 12, 2014 were admitted in evidence, and only the March 12,
20 2014 (updated March 18, 2014) financial statement included any debts for
21 "Loan Payable - Family/Friends" as liabilities. See Exhibit 6.

22 David testified that, "[M]y dad had always stated that he would
23 have subordinated to any debt that I was able to procure." Hr'g Tr. Oct.
24 8, 2015, at 43:14-16. In response to my clarifying question, David
25 confirmed that his deal with his father, Justin, "was that any debt
26 between you [David] and him [Justin] would be subordinated to all of your

1 [David's] other debts." Hr'g Tr. Oct. 8, 2015, at 44:5-8. During cross-
2 examination, David further clarified his understanding of the
3 subordination arrangement with his father:

4 Question: You mentioned that you and your father
5 agreed that repayment of these would be subordinated
6 to all other creditors. Can you clarify for me what
7 you meant by that?

8 Answer: [W]hen I mentioned the word "subordinate," at
9 that point in time, I knew that my - if I got any
10 loan, further loan, from the Bank . . . , my Dad's
11 loan would never come into play because he would - he
12 would not demand payment before I paid the
13 Bank That's what I meant by subordination.

14 Hr'g Tr. Oct. 8, 2015, at 51:13-15, 23-25; 52:1-3.

15 David filed for protection in chapter 7 on March 19, 2014. See
16 Main Case Docket No. 1. Justin timely filed the Claim. See Exhibit 4.
17 In the Claim, Justin asserted an unsecured claim for \$580,000, without
18 interest, for "Money Loaned." Attached as page 4 to the Claim was an
19 accounting of the amounts advanced by Justin to David, showing dates of
20 the Advances, totaling \$580,000. See Exhibit 4, at 4. The Bank does not
21 question that Justin in fact advanced a total of \$580,000 to David from
22 as early as September 2008 through February 2014.

23 II. Jurisdiction

24 I have jurisdiction to decide the Bank's objection to the Claim
25 under 28 U.S.C. §§ 1334 and 157(b) (2) (B).

26 III. Discussion

1. Loans or Gifts?

Both Justin and David testified at the Hearing that they
considered Justin's \$580,000 in Advances to David as loans. As I
mentioned at the Hearing, the Notes are problematic and neither probative

1 nor enforceable as loan documents because they do not include payment
2 terms or maturity dates, and, worst of all, Justin signed the Notes as
3 "PAYOR" rather than payee, and David signed the Notes as "PAYEE." If any
4 further evidence were needed that Justin and David did not treat the
5 Notes as enforceable, although the Notes provided for interest at six
6 percent, Justin did not claim any interest owed in his Claim, and he did
7 not retain the original Notes so that he could attempt to enforce them.

8 However, those facts are not necessarily dispositive as to how
9 the \$580,000 should be characterized because Justin and David may have
10 had an oral agreement that the \$580,000 would be treated as loans that
11 David was obliged to repay. Both California and Oregon follow the
12 Restatement (Second) of Contracts § 1, which defines a contract as "a
13 promise or a set of promises for the breach of which the law gives a
14 remedy, or the performance of which the law in some way recognizes as a
15 duty." See, e.g., Schaefer v. Williams, 15 Cal. App. 4th 1243, 1246
16 (Cal. App. 1993); and Ashby v. Emp't Div., 21 Or. App. 265, 268-69 (Or.
17 App. 1975).

18 In addition to the Howlands' direct testimony that they treated
19 the \$580,000 Advances as loans, circumstantial evidence supports that
20 characterization. Justin testified that he made the Advances from his
21 trust that had a net worth of approximately \$5 million. He further
22 testified that he also lent some money to his son Craig, who had made
23 some effort at repayment. David testified that he had four siblings and
24 that he was the executor of his father's estate. To the extent he was
25 unable to repay the Advances before his father's death, he would set them
26 off against his right to an inheritance. Both Justin and David testified

1 that David was paying off a separate \$300,000 obligation to his father,
2 not included in the subject Advances.

3 Where Justin's trust was worth about \$5 million, and he made
4 Advances to one of five children in the amount of \$580,000 (in excess of
5 ten percent of the trust's net worth), I do not find it reasonable to
6 assume that such large Advances would be considered gifts at the expense
7 of the interests of David's siblings. The Notes themselves, while they
8 do not represent enforceable obligations on their own, constitute some
9 additional evidence that Justin and David treated the \$580,000 Advances
10 as loans. I ultimately find, based on all of the evidence before me,
11 that the total of \$580,000 that Justin advanced to David should be
12 treated as loans rather than gifts.

13 2. Limitations Issues

14 Under California law, the limitations period for a "contract,
15 obligation or liability" not based on a writing generally is two years.
16 See Cal. Code Civ. Pro. § 339(1). Also, under California law, where no
17 time is specified by which a loan is to be repaid, a presumption arises
18 that the loan is to be treated as a demand obligation, and the statute of
19 limitations begins to run from the time that the loan is made. See,
20 e.g., Huynh v. Chase Manhattan Bank, 465 F.3d 992, 998-99 (9th Cir.
21 2006); Miguel v. Miguel, 184 Cal. 311, 314 (Cal. 1920); Dorland v.
22 Dorland, 66 Cal. 189, 190 (Cal. 1884); Buffington v. Ohmert, 253 Cal.
23 App. 2d 254, 256 (Cal. App. 1967); and Taketa v. State Bd. Of
24 Equalization, 104 Cal. App. 2d 455 (1951).

25 The Bank's position is that if I determine, as I have, that
26 Justin's Advances to David should be treated as loans, and there is no

1 enforceable written loan agreement(s), as I also have determined, the
2 two-year statute of limitations under Cal. Code Civ. Pro. § 339(1)
3 applies from the date each advance was made. Accordingly, based on the
4 schedule included on Page 4 of the Claim, the limitations period had run
5 as to all but \$205,000 of the Advances on the date of David's bankruptcy
6 filing, and the balance of \$375,000 of the Claim should be disallowed.

7 Justin argues that because David at all material times was an
8 Oregon resident, and all but \$155,000 of the Advances were deposited
9 either in David's Oregon bank accounts or in the trust accounts of Oregon
10 counsel, Oregon's six-year statute of limitations for contract claims
11 under O.R.S. § 12.080 should apply. If I apply O.R.S. § 12.080 in this
12 case, the statute of limitations would not have run by the petition date
13 on any of the Advances included in the \$580,000 Claim.

14 In federal bankruptcy cases, federal choice of law rules apply.

15 In federal question cases with exclusive jurisdiction
16 in federal court, such as bankruptcy, the court should
17 apply federal, not forum state, choice of law rules.
18 (Multiple citations omitted.) In such cases, the risk
19 of forum shopping which is avoided by applying state
20 law has no application, because the case can only be
litigated in federal court. The value of national
uniformity of approach need not be subordinated,
therefore, to differences in state choice of law
rules.

21 Lindsay v. Beneficial Reins. Co. (In re Lindsay), 59 F.3d 942, 948 (9th
22 Cir. 1995). See Huynh v. Chase Manhattan Bank, 465 F.3d at 997.

23 Applying federal choice of law rules requires that I analyze the "points
24 of contact" of a transaction to determine which state has the most
25 relevant connections to the subject transaction. Advani Enter., Inc. v.
26 Underwriters at Lloyds, 140 F.3d 157, 162 (2d Cir. 1998), quoting

1 Lauritzen v. Larsen, 345 U.S. 571, 582 (1953).

2 More concretely, this choice-of-law analysis should
3 include an assessment of the following contacts: (1)
4 any choice-of-law provision contained in the contract;
5 (2) the place where the contract was negotiated,
6 issued, and signed; (3) the place of performance; (4)
7 the location of the subject matter of the contract;
8 and (5) the domicile, residence, nationality, place of
9 incorporation, and place of business of the parties.

10 Advani Enter., Inc. v. Underwriters at Lloyds, 140 F.3d at 162 (citations
11 omitted). See also Huynh v. Chase Manhattan Bank, 465 F.3d at 997 (Court
12 considers which state has "a more significant relationship to the parties
13 and the occurrence").

14 In this case, among their other deficiencies, the Notes do not
15 include any choice of law provisions. However, the inclusion of
16 "Redding, California" in the amount and date line of each Note provides
17 at least some evidence that the Notes were prepared and signed in
18 California. Except for the last two Advances, totaling \$95,000, paid to
19 counsel in Oregon, the Advances were used to fund the needs of David's
20 businesses in California. All of the funds for the Advances were
21 withdrawn from Justin's bank accounts in Redding, California, although
22 all but \$155,000 of the Advances were deposited either into David's
23 Oregon bank accounts or into the trust accounts of Oregon counsel.
24 Justin lives in California, and David lives in Oregon, but David's
25 businesses that ultimately received and used most of the Advances are in
26 California.

27 In these circumstances, I find and conclude that overall, the
28 most significant contacts for the loan transactions between Justin and
29 David are in California, and the two-year statute of limitations under

1 Cal. Code Civ. Pro. § 339(1) applies. Accordingly, I conclude that
2 \$375,000 of the Advances included in the Claim are barred by the
3 applicable statute of limitations, but \$205,000 of the Claim is allowed
4 as a general unsecured claim.

5 3. Subordination

6 A. § 510(a)

7 Section 510(a) provides that, "A subordination agreement is
8 enforceable in a case under this title to the same extent that such
9 agreement is enforceable under applicable nonbankruptcy law." As noted
10 above, both California and Oregon follow the Restatement (Second) of
11 Contracts which generally defines a contract as "a promise or a set of
12 promises for the breach of which the law gives a remedy, or the
13 performance of which the law in some way recognizes as a duty." The
14 parties do not disagree as to the authorities or standards for
15 recognition and enforcement of subordination agreements in bankruptcy.
16 See Justin Howland's Post Hearing Memorandum, Docket No. 126
17 ("Opposition"), at 4. They do disagree, however, as to whether the
18 evidence submitted at the Hearing supports a finding that an enforceable
19 subordination agreement exists.

20 "A contractual subordination agreement is simply a contractual
21 arrangement whereby one creditor agrees to subordinate its claim against
22 the debtor in favor of the claim of another." In re Best Products Co.,
23 Inc., 168 B.R. 35, 69 (Bankr. S.D.N.Y. 1994) (citations omitted). See In
24 re Air Safety Int'l, L.C., 336 B.R. 843, 857-58 (S.D. Fla. 2005). A
25 subordination agreement does not need to be in any particular form, or in
26 writing. See, e.g., Advanced Analytics Labs., Inc. v. Evtl. Aspects,

1 Inc. of N.C. (In re Env'tl. Aspects, Inc.), 235 B.R. 378, 396-97 (E.D.N.C.
2 1999); and In re Smith, 77 B.R. 624, 627 (Bankr. N.D. Ohio 1987). A
3 creditor can agree with the debtor to subordinate its interests to the
4 interests of other creditors. See, e.g., In re Env'tl. Aspects, Inc., 235
5 B.R. at 397. "[C]reditors may agree to subordinate their claims in a
6 rehabilitation effort in the hope of eventual full payment." 4 Collier
7 on Bankruptcy ¶ 510.03[1] (Alan N. Resnick & Henry J. Sommer eds., 16th
8 ed.).

9 The clearest evidence of the existence of a subordination
10 agreement in this case was presented when, in response to my clarifying
11 question, David confirmed that the deal with his father "was that any
12 debt between [David] and [Justin] would be subordinated to all of
13 [David's] other debts." Hr'g Tr. Oct. 8, 2015, at 44:5-9. Justin's
14 counsel argues that David's testimony does not establish that Justin
15 agreed to "this purported subordination agreement." "[T]here is
16 insufficient evidence before the court to establish a meeting of the
17 minds as to the existence of an enforceable subordination agreement in
18 this matter." Opposition, at 5. However, additional circumstantial
19 evidence tends to establish that an informal agreement did exist between
20 Justin and David to the effect that repayment of Advances to David would
21 not be made until David's other obligations were satisfied.

22 Justin testified as to his understanding that "the loans would
23 be repaid after [David's] businesses stabilized and David was able to
24 take sufficient distributions to repay his debt." The logical import of
25 that testimony is that the deal between Justin and David with respect to
26 repayment of the Advances to David was that Justin would wait for payment

1 until David's other creditors had been satisfied, and David could repay
2 Justin from equity distributions. That is why Justin never made demand
3 on David for repayment of the Advances.

4 In addition, seven of the eight financial statements that David
5 delivered to the Bank between August 2009 and March 2014 did not
6 reference any loans from Justin as liabilities. (The March 12, 2014
7 financial statement that did reference \$745,878 in "Loan Payable -
8 Family/Friends" apparently was delivered to the Bank on or about March
9 18, 2014 - one day before David's chapter 7 filing.) David is an
10 accountant. It makes no sense that David would not disclose Justin's
11 loans to him in those financial statements unless he considered them as
12 irrelevant to his financial situation with respect to payment of his
13 obligations to the Bank, i.e., subordinated. In fact, David testified
14 under questioning from Justin's counsel that "when I mentioned the word
15 'subordinate,' at that point in time, I knew that . . . if I got any
16 loan, further loan, from the Bank . . . my dad's loan would never come
17 into play because he would - he would not demand payment before I paid
18 the Bank That's what I meant by subordination." David further
19 testified as to his intention to repay Justin's loans to him eventually,
20 in spite of his bankruptcy discharge.⁴

21 Based on the foregoing evidence, I find that there was an
22 agreement, albeit informal, between Justin and David that repayment of
23 the Advances to David would be subordinated to payment of the claims of
24 David's other creditors. Accordingly, I conclude that payment of the

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26 ⁴ Nothing in this Memorandum Opinion is to be construed as approval
of a reaffirmation agreement by David as to Justin's claimed debt.

1 Claim is properly subordinated pursuant to § 510(a).

2 B. § 510(c)

3 Section 510(c)(1) provides, in relevant part, that "the court
4 may - (1) under principles of equitable subordination, subordinate for
5 purposes of distribution all or part of an allowed claim to all or part
6 of another allowed claim." In the Ninth Circuit,

7 Equitable subordination **requires** that: (1) the
8 claimant who is to be subordinated has engaged in
9 inequitable conduct; (2) the misconduct results in
injury to competing claimants or an unfair advantage
to the claimant to be subordinated; **and** (3)
subordination is not inconsistent with bankruptcy law.

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11 Paulman v. Gateway Venture Partners III, L.P. (In re Filtercorp, Inc.),
12 163 F.3d 571, 583 (9th Cir. 1998) (quotation marks and citations
13 omitted).

14 Based on the evidence submitted in this case, I find that
15 Justin's only purpose in making the \$580,000 in Advances to or for the
16 benefit of David was to assist his son in overcoming the business
17 difficulties he was experiencing. I find nothing inequitable in Justin's
18 conduct in making those Advances to his son. Accordingly, I conclude
19 that it would not be appropriate to subordinate the Claim under § 510(c).

20 IV. Conclusion

21 Based on the foregoing findings and conclusions, I will allow
22 the Claim as a general unsecured claim in the amount of \$205,000, and I
23 will subordinate the Claim to the allowed claims of other general
24 unsecured creditors under § 510(a). I conclude that it would not be
25 appropriate to subordinate the Claim under § 510(c). I will enter an
26 order consistent with the findings and conclusions in this Memorandum

1 Opinion contemporaneously.

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