



Reliance on Client's Automated Information System May Support Rule 9011 Liability

By Marcos A. Ramos – November 14, 2011

A recent decision of the Third Circuit, *In re Taylor*, 2011 WL 3692440 (3d Cir. Aug. 24, 2011), a personal bankruptcy case, suggests that, in certain circumstances, counsel's reliance on a client lender's information systems can lead to the imposition of sanctions against not only the client, but also against counsel. The decision underscores the need for bankruptcy litigators to take steps to verify the accuracy of information provided to them by their client and, in particular, to speak to their clients to ensure that the information that they are putting before the court is not obviously erroneous.

The case involved a home mortgage lender's representations to the Bankruptcy Court in support of the lender's claim and request for relief from stay. The Third Circuit was presented with an appeal from the district court's reversal of the Bankruptcy Court's entry of sanctions against the home mortgage lender and its counsel under Federal Rule of Bankruptcy Procedure 9011.

The Third Circuit reversed the district court in substantial part, holding that the Bankruptcy Court's award of Rule 9011 sanctions against one of the attorneys and her law firm was appropriate. The Third Circuit also vacated the district court's reversal of the Bankruptcy Court's entry of sanctions against the home mortgage lender, holding that the district court lacked jurisdiction to consider the Bankruptcy Court's order, as the lender did not separately appeal from the Bankruptcy Court's order.

Mr. and Mrs. Taylor filed for bankruptcy protection under Chapter 13 in September 2007. HSBC was the Taylor's home mortgage lender. HSBC's general business practices with regard to foreclosure matters was at issue during the case. HSBC used a computerized database (the NewTrack system) as its central depository for information related to its delinquent home mortgages. Law firms engaged by HSBC to pursue HSBC's delinquent loan and/or foreclosure matters were required to use NewTrack as the essential source of



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information regarding such mortgages and, other than access to NewTrack and the information available through NewTrack, HSBC generally did not communicate with its counsel regarding individual matters. The NewTrack system was maintained by a third party and not by HSBC.

During the bankruptcy case, the Taylors remained in dispute with HSBC as to the propriety of HSBC's charge of forced flood insurance coverage to the Taylors. The Taylors continued to pay their mortgage, but refused to pay the additional flood insurance charge. HSBC treated each such payment as a partial and delinquent payment. As a result of the continuing dispute, HSBC moved the Bankruptcy Court for relief from the automatic stay to foreclose on its collateral. HSBC's attorneys relied solely on the information supplied by NewTrack with regard to the Taylor's loan and did not seek to verify any of the information supplied through the NewTrack system. The NewTrack-derived information was inaccurate in several respects, and counsel did not disclose the parties' dispute regarding flood insurance in HSBC's application for relief from the automatic stay. Further, HSBC's counsel served requests for admission in connection with the motion for relief from the automatic stay that were in part overbroad and sought admissions regarding alleged facts that were not supported by information otherwise available to HSBC. For example, the requests asked the Taylors to admit that no mortgage payments were made, even though HSBC's records reflected that amounts were received on account of the Taylor's mortgage obligations. HSBC also filed a proof of claim in the Taylor's case that contained inaccuracies regarding the Taylor's mortgage and payment history.

When the Taylors opposed HSBC's request for relief from the stay and its proof of claim, HSBC's counsel continued to rely on information supplied through the NewTrack system and to include such information in filings to the Bankruptcy Court. HSBC's counsel did not otherwise confer with HSBC regarding the matter. HSBC's counsel asked the court to grant HSBC's requested relief, citing the Taylor's failure to respond to HSBC's requests for admissions, even after information supplied through the NewTrack system continued to be proven to be inaccurate.

The Bankruptcy Court refused to grant preclusive effect to the Taylor's failure to respond to HSBC's requests for admission, denied HSBC's motion for relief from stay, and questioned whether the motion was brought in good faith. The court also directed HSBC's counsel to obtain additional information regarding the Taylor's loan from HSBC.



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At the next hearing, HSBC's counsel informed the Bankruptcy Court that he had made unsuccessful requests for additional information through the NewTrack system, but otherwise was not able to speak directly with HSBC regarding the matter. The Bankruptcy Court thereafter issued an order requiring HSBC's counsel and others to appear and give testimony at hearing concerning the possibility of sanctions related to HSBC's and its counsel's failure to provide accurate information in the Taylor's case.

The Bankruptcy Court held four hearings over several days. During those hearings, the court elicited testimony regarding the NewTrack system and the manner in which that system was used by HSBC and its counsel. In essence, the court found that HSBC's counsel relied exclusively on the NewTrack system and the accuracy of the information contained in that system and did not take any other action to verify such information, even after counsel had become aware of information that suggested that the information contained within the system was not accurate. The court also found that HSBC encouraged its counsel's sole reliance on the NewTrack system and discouraged them from otherwise contacting HSBC.

Ultimately, the Bankruptcy Court entered sanctions under Rule 9011 against the attorneys and the law firm representing HSBC and against HSBC for its promotion of a system that required counsel to interact solely with an electronic system even where that system produced information known by its counsel to be in error. Counsel and the law firm appealed to the district court, which reversed the orders, even against HSBC who had not separately appealed from the Bankruptcy Court. The Third Circuit reversed the district court.

The Third Circuit's opinion reinforces a number of issues related to potential Rule 9011 liability. First, Rule 9011 is not necessarily concerned with the truth or falsity of the representation but rather the objective reasonableness of the party at the time as to the basis for evidentiary support for such representation. In addition, if it is reasonably foreseeable that a representation, while literally true, may nevertheless be misleading, such representation can be found to violate Rule 9011. Third, if found to be misleading, the reasonableness of the maker will be judged by its objective knowledge for the basis of the misrepresentation at the time the misrepresentation was made. Also, reasonableness is not specifically defined and must be judged by an examination of all relevant circumstances. While as a general matter a "lawyer need not routinely assume the duplicity or gross negligence of her client . . . [and] [i]t is therefore usually reasonable for a lawyer to rely on information provided by a client," counsel may not ignore warning signs regarding the veracity of information supplied to counsel by its client and still rely on such information to justify counsel's reasonableness in making representations to the

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court. Moreover, “reasonable reliance on a client’s representations assumes a reasonable attempt to eliciting them by the attorney.” Finally, Rule 9011 sanctions can be imposed against an offending attorney’s law firm.

The Third Circuit cited particular concern with the NewTrack system and the degree to which HSBC and its counsel relied solely on it to communicate with each other and to obtain the information HSBC included in its filings with the Bankruptcy Court. In this regard, the Third Circuit noted that counsel’s reliance on the NewTrack system as operated by HSBC was not synonymous with reliance on HSBC, stating that counsel’s “reliance on HSBC was particularly problematic because she was not, in fact, relying directly on HSBC. Instead, she relied on a computer system run by a third-party vendor” and had no capacity to evaluate the integrity of such information or communicate directly with HSBC regarding that information. “In her relationship with HSBC, [counsel] essentially abdicated her professional judgment to a black box.”

The Third Circuit noted further that while it did “not mean to suggest that the use of computerized databases is inherently inappropriate . . . the NewTrack system, as it was being used at the time of this case, permits parties at every level of the filing process to disclaim responsibility for inaccuracies. . . . It cannot be that all the parties’ involved can insulate themselves from responsibility by the use of such a system.”

Further particularizing its holding to the facts at issue, the Third Circuit held that:

Rule 11 requires more than a rubber-stamping of the results of an automated process by a person who happens to be a lawyer. Where a lawyer systematically fails to take any responsibility for seeking adequate information from her client, makes representations without any factual basis because they are included in a ‘form pleading’ she has been trained to fill out, and ignores obvious indications that her information may be incorrect, she cannot be said to have made reasonable inquiry.

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