United States Bankruptcy Court
Western District of Wisconsin

Cite as: [Unpublished]

Wes Zulty Sports, Inc., Plaintiff, v.
Dana E. Roberts, Mary M. Roberts, Valley Bank N/K/A M & I Madison Bank, and Michael Kepler, Trustee, Defendants
(In re Dana E. and Mary M. Roberts, Debtors)
Bankruptcy Case No. 95-31582-7; Adv. Case No. 95-3106-7

United States Bankruptcy Court
W.D. Wisconsin

January 24, 1996

Kenneth B. Axe, Lathrop & Clark, Madison, WI, for plaintiff.
Leonard G. Leverson, Kravit, Gass & Weber, S.C., Milwaukee, WI, for Dana and Mary Roberts.
Susan V. Kelley, Lee, Kilkelly, Paulson & Kabaker, S.C., Madison, WI, for M&I Bank.
Michael E. Kepler, Kepler & Peyton, Madison, WI, Trustee.

Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

On December 19, 1995, in the absence of any objection, I dismissed this case and adversary proceeding on a joint stipulation and motion, and I took under advisement a motion by defendant M & I Madison Bank ("Bank") against the plaintiff under Bankruptcy Rule 9011. The stipulation and dismissal resolved issues under consideration for summary judgment. However, the Bank continued to seek sanctions in the apparent belief that it would have prevailed on summary judgment, and the conviction that Zulty's claim was objectively frivolous and designed to harass. Some exposition of the issues in the principal dispute is required in order to reach a decision on sanctions.

On January 12, 1994, Dana E. and Mary M. Roberts ("the Roberts" or "debtors") executed a purchase agreement for Wes Zulty Sports, Inc. The purchase was contingent on the Roberts' securing a bank loan and revolving line of credit. The Bank agreed to loan $188,000 to the Roberts "or a corporation to be formed" by them, contingent on Zulty executing a Guaranty and Security Agreement in which Zulty agreed to open an account at the Bank as security for its guarantee of that portion of the loan. At a closing on January 21, 1994, the Roberts, Zulty, and the Bank executed various loan and guarantee documents. Zulty opened a certificate of deposit at the Bank with a $66,500 cashier's check, from RDM Sports, Inc. ("RDM"), a corporation formed on or about January 21, 1994, by the Roberts. The check was issued by the Bank and given to Zulty at the closing.

In August, 1994, RDM became insolvent. The Bank first liquidated RDM's assets and then Zulty's certificate of deposit in partial satisfaction of RDM's debt, leaving

approximately $32,000 owing. In June, 1995, the Roberts filed their bankruptcy and Zulty commenced this adversary proceeding. As a guarantor of the Roberts' personal indebtedness to the Bank, Zulty sought subrogation to the Bank's lien rights in the Roberts' homestead to the extent of $66,500. On October 2, 1995, the Bank filed a motion for summary judgment on two grounds. First, that Zulty is not a guarantor of the Roberts but a co-guarantor with the Roberts of the debt owed by RDM to the Bank, and therefore is not entitled as a matter of law to subrogation in collateral pledged by the Roberts to the Bank. Second, Zulty could not succeed on its claim as a matter of law because Zulty received a portion of the consideration the Bank gave for its claim against the Roberts. The Bank asserts that Zulty's legal positions are frivolous and sanctionable under Bankruptcy Rule 9011.

FRBP 9011 provides in pertinent part:

Rule 9011 Signing and Verification of Papers

(a) Signature. Every petition, pleading, motion and other paper served or filed in a case under the Code on behalf of a party represented by an attorney, except a list, schedule, or statement, or amendments thereto, shall be signed by at least one attorney of record in the attorney's individual name, whose office address and telephone number shall be stated. . . . The signature of an attorney or a party constitutes a certificate that the attorney or party has read the document; that to the best of the attorney's or party's knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay, or needless increase in the cost of litigation or administration of the case. . . . If a document is signed in violation of this rule, the court on motion or on its own initiative, shall impose on the person who signed it, the represented party, or both, an appropriate sanction, which may be include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the document, including a reasonable attorney's fee.

The Rule is identical to former Rule 11 of the Federal Rules of Civil Procedure, and standards established for Rule 11 apply here.

This court retains jurisdiction over this Rule 9011 issue even though the adversary proceeding was dismissed on December 19, 1995. Cooter & Gell v. Hartmarx Corp., 496 U.S. 384, 393-98, 110 S.Ct. 2447, 110 L.Ed.2d 359 (1990) (voluntary dismissal does not deprive a district court of jurisdiction over a Rule 11 motion). This matter is a core proceeding pursuant to 28 U.S.C. § 157(b).

Rule 9011 contains two separate standards and a violation of either requires sanctions. The first inquiry is whether the attorney filed or served a document which is not well-grounded in fact *or* warranted by existing law or by a good-faith argument for its modification, where a *reasonable inquiry* would have revealed the deficiency. The second inquiry is whether a document was filed or served for an *improper purpose*. A filing made for any improper purpose must be sanctioned, regardless of its support in law or fact, and a filing made in good faith must be sanctioned if it is not based on reasonable inquiry into the law or facts. In re Excello Press, Inc., 967 F.2d 1109, 1112 (7th Cir. 1992).

The reasonable inquiry standard is said to be objective. Mars Steel Corp. v. Continental Bank, N.A., 880 F.2d 928, 932 (7th Cir. 1989) (en banc). The reasonableness of an attorney's inquiry "focuses on inputs rather than outputs, conduct rather than result." Id. The "right question" to ask in this inquiry is "not whether the claim itself was frivolous or nonfrivolous, but whether [the attorney] conducted an adequate inquiry into the facts

and the law before he filed the claim." In re Excello Press, Inc., 967 F.2d at 1112.

Exhaustive research into the legal issues before filing a document is seldom practicable and is not required. In re TCI, Ltd., 769 F.2d 441, 447 (7th Cir. 1985). However, the attorney must demonstrate that he has read and understands current law and that his arguments in the face of the facts and current law are tenable. Szabo Food Service v. Canteen Corp., 823 F.2d 1073, 1079-81 (7th Cir. 1987). The goal of Rule 9011 is to sanction truly frivolous legal arguments, not to quell the original or novel argument or claim. To meet the Rule 9011 threshold, Zulty's arguments must be untenable as either an exposition of current law or as arguments for an extension or modification of law. The standard for sanctionably insufficient legal arguments is suggested by Szabo Food Service, where the plaintiff's pleadings and briefs twisted the standard language of due process claims in order to obtain federal-question jurisdiction and pointedly ignored authoritative state and federal law, citing instead obscure or abrogated decisions as part of an "ostrich-like tactic of pretending that potentially dispositive authority against a litigant's contention does not exist." Id. at 1081, quoting Hill v. Norfolk & Western Ry., 814 F.2d 1192, 1198 (7th Cir. 1987). Had the attorney in Szabo acknowledged that the weight of the law was against him but argued, in good faith, for a modification of that law, the court "would not be keen to impose sanctions; a party is free to ask for reconsideration even when the court is unlikely to respond favorably." Id. The lengthy discussion in Szabo Food Service illustrates that legal arguments that are reasonably well-made after reasonable inquiry cannot be sanctioned for being novel, against the weight of current law, or unlikely to prevail. The test is whether the position is tenable in the face of reasonable inquiry.

The first issue is whether Zulty has at least a tenable argument that he was not a co-guarantor of RDM's corporate debt. The documents in the record suggest sufficient ambiguity regarding Zulty's status to warrant a denial of summary judgment on this issue.[(1)] However, for the purpose of Rule 9011 analysis, it is not necessary to reach the issue. For the sake of argument, assume that Zulty was a co-guarantor. The Bank cited no Wisconsin cases in support of its proposition that Zulty, as a co-guarantor, was entitled only to contribution, not subrogation. In fact, the Bank noted that "Wisconsin courts apparently have not addressed this issue." Bank's Memorandum in Support of Motion for Summary Judgment at 8. The 1994 Wisconsin appellate decision relied on by the Bank for a definition of "contribution" under Wisconsin law expressly declines to decide the issue of whether one co-guarantor of a corporate debt may have a right of subrogation against the other. Kafka v. Pope, 186 Wis.2d 472, 476 n.1, 521 N.W.2d 174 (Wis. Ct. App. 1994). That some other states have so decided--and the Bank cites only two, including one 1919 decision from Michigan--*may* provide a compelling argument for summary judgment, but is not dispositive of an analysis under Rule 9011. Given the lack of definitive Wisconsin law, Zulty's arguments on this issue alone do not reach the level of untenability established in Szabo Food Service and like cases.

In addition, it is an open question whether subrogation rights defined by state law, which are based on common law equitable subrogation principles, limit subrogation rights under 11 U.S.C. § 509. The Seventh Circuit has analyzed § 509 generally but has not addressed this specific issue. In re Bugos, 760 F.2d 731 (1985). Some courts addressing this issue have concluded that § 509 provides additional remedies to those afforded by the state or common law. See In re Spirtos, 103 B.R. 240, 245 (Bkrtcy. C.D. Cal. 1989); In re Topgallant Lines, Inc., 154 B.R. 368, 382 (S.D. Ga. 1993); Mulberry Chesterton Inn v. Citizens and Southern Trust Co., 1992 W.L. 489775 (Bankr. S.D. Ga.); In re Wingspread Corp., 145 B.R. 784 (S.D.N.Y. 1992). Others have determined that state or common law subrogation does not apply to § 509 because § 509 creates an independent federal right to subrogation. Creditor's Committee v. Massachusetts Dept. of Revenue, 105 B.R. 145, 154 (D. Mass. 1989); In re Cooper, 83 B.R. 544, 546

(Bkrtcy. N.D. Ill. 1988). This court has analyzed § 509 but left open the question of whether subrogation principles under § 509 provide additional remedies to state law, abrogate state law, or must be satisfied in addition to state law. In re Carley Capital Group, 118 B.R. 982, 989 (Bkrtcy. W.D. Wis. 1990). Therefore, Zulty's assertion that "under the statute, even co-guarantors may be considered 'co-debtors' for purposes of determining subrogation, and equitable rights," can and should be construed as an argument for an extension of the subrogation rights conferred by § 509 in this jurisdiction, an argument that is not so untenable as to require sanctions under Rule 9011.

The Bank finally contends that under any plausible interpretation of § 509, Zulty is precluded from asserting subrogation rights because "as between the debtor and the entity [Zulty], the entity [Zulty] received the consideration for the claim." 11 U.S.C. § 509(b)(2). The Bank's claim, in this case, is against the Roberts, to whom it loaned money in exchange for liens against real property and an assignment of insurance policies. Because Zulty received a check from RDM Sports as part of the loan closing, the Bank insists that Zulty intercepted proceeds intended for the Roberts and for which they, and they alone, gave up value. In response, Zulty argues that it did not intercept loan proceeds intended for the Roberts, but was paid $66,500 by the Roberts as consideration for the sale of Zulty's assets to the Roberts. Curiously, the Bank admits as much: "Zulty received this consideration as part of the purchase price for the business assets [of] Zulty." Bank's Memorandum in Support of Motion for Summary Judgment at 6. Since the Bank concedes that Zulty was due consideration from the Roberts and appears to concede that the check received by Zulty at the closing constituted some or all of that consideration, Zulty's assertion that it did not receive "consideration for the claim" as defined in § 509(b)(2) is at least tenable, and Zulty cannot be sanctioned under Rule 9011 for making the argument.

Even though Zulty's legal arguments meet the reasonable inquiry standard, Zulty can still be sanctioned if it filed the adversary proceeding, or continued the action in the face of summary judgment, for an improper purpose such as delay or harassment. A showing of subjective bad faith would be dispositive but is not required because the "purpose" of a filed document can be evaluated objectively. Brown v. Federation of State Medical Boards of the United States, 830 F.2d 1429, 1436 (7th Cir. 1987) (evaluating the standard under Rule 11), abrogated on other grounds, Mars Steel Corp. v. Continental Bank, N.A., 880 F.2d 928, 933 (7th Cir. 1989) (en banc). That is, if the filed document does, in fact, lead to needless delay or cost, the filing party can be sanctioned regardless of the tenability of its claims or a subjective belief that the filing was proper.

It is not self-evident that Zulty began the adversary proceeding for delay or to harass the Bank or the Roberts, and the Bank points to no evidence in the documents, other than its contentions regarding the sufficiency of Zulty's legal arguments, suggestive of intentional bad faith in Zulty's response to the summary judgment motion. Nor did the Bank suffer undue delay and costs in its prosecution of the summary judgment motion. The Bank insists that the fact that the Roberts and Zulty did not agree to the stipulation and dismissal until just days before the hearing scheduled on summary judgment indicates undue delay on Zulty's part. However, the result was that the matter was brought to resolution on the same day, December 19, 1995, that the matter was scheduled for resolution of the summary judgment issue, and the Bank received, through the stipulation and dismissal, the relief it sought through summary judgment. Even if this matter could have been resolved earlier, that alone is not sufficient grounds for sanctioning a party under the improper purpose standard. As discussed above, Zulty's claims were tenable. Zulty was entitled to a hearing on the merits of the Bank's summary judgment motion on December 19, 1995. Given the procedural posture of this case when the motion for sanctions was made, there was no undue delay. No sanction

ought to be imposed against Zulty under Rule 9011, and the motion therefore must be denied.

It is so ordered.

END NOTE:

1. The various purchase, loan, and guarantee documents executed on January 12 and January 21, 1994, inconsistently identify the principal debtor and do not clearly establish Zulty's status as guarantor or co-guarantor nor its knowledge that it was guaranteeing a corporate loan rather than a personal loan. The Bill of Sale executed between the Roberts and Zulty on January 12, 1994, lists the Roberts as purchasers, with no mention of a corporation to be formed by them. The loan documents executed between the Roberts and the Bank on January 21, 1994, name the debtor as "the Roberts or a corporation to be formed," with Wes Zulty Sports, Inc., by Wes J. Zulty, signing as guarantor below the individual signatures of Dana and Mary Roberts. The Guaranty and Security Agreement executed between the Roberts and the Bank names RDM as the principal debtor. However, on a similar agreement between Zulty and the Bank signed at the same meeting, the space for principal debtor is left blank, and it is unclear whether Zulty saw and examined the guarantee agreement signed by the Roberts.