

Bankruptcy Circuit Update
Featuring cases from April 2019

We will be convening our next section-wide conference call on **Friday, June 28th, at 3:30 E.S.T./12:30 P.S.T.** to present and discuss notable cases from the past few months of the summaries. We are seeking volunteers to summarize significant or interesting cases. Please send an email to csullivan@diamondmccarthy.com if you are interested in presenting. The call-in information is: **dial in 866-690-2070 – code 787-594-2077.**

We hope you will join us for this call.

Fifth Circuit

Latitude Sol., Inc. v. DeJoria et al (In re Latitude Sol., Inc.),
—F. App'x—, No. 18-10382, 2019 WL 1923466 (5th Cir. Apr. 30, 2019).

Latitude Solutions, Inc. (“LSI”) filed for bankruptcy. Trustee alleged that LSI was an illegal pump-and-dump scheme that allowed Howard Appel, Earnest Bartlett, Matthew Cohen, and John Paul DeJoria (collectively “Appellants”) to engage in securities fraud.¹ Trustee filed a lawsuit alleging, in relevant part, that Cohen and DeJoria were liable for breach of fiduciary duty, and that Appel and Bartlett aided and abetted Cohen’s breach of fiduciary duty. A jury trial was held at district court. Trustee and Appellants agreed that Trustee’s damages were limited to: (1) the reasonable cash market value of liabilities incurred by LSI as a proximate cause of each Appellant’s breach of fiduciary duty (“Damage Element No. 1”); and (2) the reasonable market value of any gains to each Appellant proximately caused by that Appellant’s breach of fiduciary duty (“Damage Element No. 2”).

At trial, Trustee argued that Cohen and DeJoria breached their fiduciary duty by entering into a contract with Jabil, Inc. (“Jabil”) who had a claim in LSI’s bankruptcy for unpaid invoices on equipment it provided the debtor. The jury assessed the reasonable cash market value of liabilities owed to Jabil by LSI under Damage Element No. 1, finding that Cohen and DeJoria should pay damages for LSI’s accrued liabilities to Jabil as part of their breach of fiduciary duty. On appeal, the Fifth Circuit reversed all damages awarded under Damage Element No. 1 because Trustee did not have Article III standing to argue that debt owed to Jabil by LSI constituted an injury.

Another argument made by Trustee at trial was that Appel and Bartlett aided and abetted Cohen’s breach of fiduciary duty by receiving gains through sale of LSI stock. The jury assessed damages against Appel and Bartlett under Damage Element No. 2. On appeal, the Fifth Circuit noted that the only evidence produced at trial by Trustee was that entities affiliated with Appel and Bartlett received gains from stock sales. Because Trustee failed to produce evidence against Appel and Bartlett in their individual capacities, and because Trustee did not argue a veil piercing or alter ego theory, the Fifth Circuit reversed damages against Appel and Bartlett under Damage Element No. 2.

The jury at the district court awarded exemplary damages against Appel, Cohen, and DeJoria. The Fifth Circuit’s holding, however, resulted in reversal of all actual damages against Appel and DeJoria and caused portions of the “wrong” alleged against Cohen to be no longer viable as a matter of law.

¹ Mr. Appel was a business consultant to and raised capital for LSI. Mr. Bartlett was affiliated with a company that invested in LSI and entered into a consulting agreement with LSI. Mr. Cohen was LSI’s founder and former chief financial officer. Mr. DeJoria was an investor and prior member of LSI’s board of directors.

Consequently, the Fifth Circuit vacated the exemplary damages award and remanded the case to the district court to consider the legal issues surrounding exemplary damages against Cohen.²

Submitted by:

Erin E. Coughlin
Law Clerk to the Honorable Craig A. Gargotta
United States Bankruptcy Court for the Western District of Texas
615 E. Houston St., Room 505
San Antonio, Texas 78205
Erin_Coughlin@txwb.uscourts.gov

In re Clark
921 F.3d 566 (5th Cir. 2019)

In this case, two of debtor Daniel Clark’s ex-wives (“Appellants”) filed untimely proofs of claim for child-support arrearages. Appellants claimed they did not receive notice of Clark’s bankruptcy and thus were denied the opportunity to file a timely proof of claim. Notice instead was provided to the Illinois Department of Healthcare & Family Services (the “Department”) from which Appellants had previously sought child-support enforcement services. Upon learning of Clark’s bankruptcy, Appellants contacted the Department, which filed the tardy proofs of claim on their behalf. The bankruptcy court ultimately allowed Appellants’ proofs of claim, but afforded them second-priority distribution under 11 U.S.C. § 726(a)(2), rather than the first priority sought by Appellants. The district court affirmed.

Before the Fifth Circuit, Appellants asserted several arguments, all of which were predicated on their status as a creditor of Clark. The Fifth Circuit, however, held Appellants were *not* creditors because they had sought enforcement of their child support claims through the Department, which was the state agency authorized to “receive and disburse child support payments.” Specifically, the Court examined the Bankruptcy Code’s definition of “creditor” (i.e., “an entity that has a claim against the debtor...”) and “claim” (i.e., “a right to payment...”) and explained the issue turned on whether Appellants had an enforceable obligation against Clark under non-bankruptcy substantive law. Under applicable Illinois law, Appellants had no such right. Rather, Illinois’ child support enforcement services were provided through the Department and, thus, all payments were made directly to the Department before being disbursed to custodial parents. Here, both Appellants had sought enforcement of their claims through the Department and admitted they authorized the Department to receive and disburse their payments from Clark. Thus, the Department, not Appellants, was the creditor entitled to enforce Clark’s child support obligations against him.

Appellants also argued that § 762(a)(1)’s 10-day claim filing deadline re-starts when a trustee files an amended final report, meaning the proofs of claim filed by the Department on their behalf were timely and should receive priority. The Fifth Circuit rejected this argument, finding

² At trial, the jury found Cohen guilty for breach of fiduciary duty and assessed damages under Damage Element No. 2. The Fifth Circuit affirmed those damages in this case.

that such an interpretation would render § 762(a)(1) meaningless, by giving every claim priority status upon amendment of a trustee's final report.

Submitted by:

Sarah Williams
Kirkland & Ellis LLP
609 Main St., Suite 4500
Houston, TX 77002
sarah.williams@kirkland.com

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Seventh Circuit

In re Chlad,

--- F.3d ----, 2019 WL 1950317 (7th Cir. May 2, 2019)

Debtor Monik Chlad (“Chlad”) is the sole owner of a real estate company named Lockwood Development, Inc. (“Lockwood”). Chlad and her husband filed a joint petition under Chapter 7 seeking to discharge approximately \$5 million of debt. After filing the financial disclosures, two creditors brought an adversary proceeding objecting to the discharge, alleging that the filings omitted information material to Chlad’s financial condition, invoking 11 U.S.C. § 727(a)(4) to prevent the discharge.

It is undisputed Chlad failed to disclose: real estate located in Chicago, and that the property secured mortgages; the existence of a significant creditor from an \$800,000 promissory note; a shareholder loan of over \$1 million she had received from Lockwood; two jointly owned bank accounts; rental income and child support that provided her more than \$4,000 per month; and that she also used the first name “Monika” in her business affairs and tax returns (the “Omissions”). Following a bench trial, the bankruptcy court denied the discharge, finding that the Omissions reflected material false statements made with fraudulent intent. The District Court affirmed. Chlad appealed.

One of Chlad’s contentions was that the bankruptcy court’s finding that she acted with fraudulent intent in omitting the required information, was a mixed question of law and fact, and entitled to *de novo* review. The Seventh Circuit clarified that on appeal from a district court’s review of a bankruptcy court’s ruling, it reviews the bankruptcy court’s factual findings for clear error and the legal conclusions of both the bankruptcy court and the district court *de novo*.

Section 727(a)(4) provides a ground for denying discharge where the debtor “knowingly and fraudulently” makes a “false oath or account” in connection with the bankruptcy proceeding. Chlad also contended that the Omissions were not material and neither made with knowledge nor intent to defraud the bankruptcy court or her creditors; they were innocent mistakes. The Circuit found the “knowingly” component was easily met as the record showed Chlad was intimately

aware of her own and Lockwood's financial affairs. Among other things, Chlad devoted time to collect related information and even hired an assistant to determine information about properties she, her husband, and Lockwood owned. The bankruptcy court found she had actual knowledge about the Omissions.

The main issue was whether the bankruptcy court clearly erred in finding she acted "fraudulently" as required by Section 727(a)(4). This inquiry focuses on the mindset; whether Chlad intended to deceive her creditors and the bankruptcy court. The totality of circumstances must rise above mere negligence. Evidence of reckless disregard for the truth is sufficient to prove fraudulent intent.

Here, the Seventh Circuit noted Chlad's active role in her financial affairs and actual knowledge of her assets and liabilities; that she was aware of her bankruptcy proceedings and the need to file accurate disclosures; and that she met with her attorney numerous times, and reviewed her filings page by page with him before they were filed. The result was a series of omissions and errors that deprived the court and Chlad's creditors of accurate and complete information. The Circuit stated that some of the Omissions, if viewed in isolation, may look like mistakes. In totality, however, it was evident there was a broad pattern of inaccuracies which reflected a reckless indifference for the truth made in her filings. Therefore, there was no clear error in bankruptcy court's finding that Chlad acted fraudulently, and the Circuit affirmed.

Submitted by:

Quentin Roberts

Diamond McCarthy LLP

150 California Street, Suite 2200

San Francisco, CA 94111

quentin.roberts@diamondmccarthy.com

Eighth Circuit

Hill v. Snyder (In re Hill),
919 F.3d 1081 (8th Cir. 2019)

The Eighth Circuit affirmed the District Court's decision that the bankruptcy court did not abuse its discretion in extending the deadline for the US Trustee to object to discharge under § 727 without an evidentiary hearing when the bankruptcy court held that six days was insufficient to investigate allegations raised by a party in interest.

Six days before the original deadline to object to the debtor's discharge, a party in interest filed his first motion seeking an extension of the objection deadline and authorization to conduct a Rule 2004 examination of the debtor. The bankruptcy court authorized the Rule 2004 examination and extended the deadline to object to discharge. A few days after the Rule 2004 examination, the party in interest filed his second motion seeking a further extension.

Contemporaneously with the second motion, the US Trustee filed his own motion under Rule 4004(b)(2)(B) seeking an extension of the deadline.

The debtor objected to the US Trustee's motion, arguing that the first motion had provided the US Trustee with sufficient facts to object to discharge by the original deadline. The US Trustee responded that nobody in the Trustee's office had seen the first motion until shortly before the Rule 2004 examination and, even if it had been reviewed, six days would have been insufficient to prepare allegations that would satisfy Fed. R. Civ. P. 8. In his reply, the debtor argued that the US Trustee failed to demonstrate that it did not have knowledge of the first motion when there was evidence it was sent to the US Trustee's CM/ECF mailbox. The bankruptcy court extended the deadlines, holding that it is the US Trustee's actual knowledge that matters, not constructive knowledge. Furthermore, the bankruptcy court held that the US Trustee could not have filed an objection that satisfied the pleading requirements until after the Rule 2004 examination regardless of whether the US Trustee had actual or constructive knowledge of the first motion. The bankruptcy court subsequently denied the debtor's discharge on the basis of 11 U.S.C. § 727(a)(2)(A) for making prepetition transfers with the intent to remove funds from the reach of a creditor.

On appeal to the district court, the debtor argued that the bankruptcy court committed reversible error by extending the US Trustee's deadline to object to discharge because the first motion had provided constructive knowledge of sufficient facts to file an objection by the original deadline or, in the alternative, that the bankruptcy court should have held an evidentiary hearing on whether the US Trustee had actual knowledge of the first motion. The district court held that the bankruptcy court did not abuse its discretion because its decision rested on factual findings that the US Trustee had neither actual nor constructive knowledge of sufficient facts to object to discharge by the original deadline.

On appeal to the Eighth Circuit, the debtor again argued that the bankruptcy court committed reversible error by not conducting an evidentiary hearing on the issue of the US Trustee's knowledge of facts supporting an objection to discharge. The Eighth Circuit held that it did not need to decide whether constructive knowledge is sufficient to satisfy the knowledge requirement of Rule 4004(b)(2)(B) because the bankruptcy court made findings of fact that six days would not have been enough time for the US Trustee to investigate and file an objection to discharge regardless of whether the US Trustee had actual or constructive knowledge of the factual allegations in the first motion.

Submitted by:

Karl Johnson
Hellmuth & Johnson PLLC
8050 West 78th Street
Edina, MN 55439
Email: kjohnson@hjlawfirm.com

Ninth Circuit

Vibe Micro, Inc. v. SIG Capital, LLC (In the Matter of 8Speed8, Inc.),
921 F.3d 1193 (9th Cir. 2019)

In *Vibe Micro, Inc. v. SIG Capital, LLC (In the Matter of 8Speed8, Inc.)*, appellant Vibe Micro, Inc. is a 50% owner of 8Speed8, Inc.'s voting stock. Appellee SIG Capital, Inc. is a creditor of 8Speed8 and owns 20 million contingent shares. SIG filed an involuntary petition. Vibe Micro moved to dismiss the bankruptcy and also asked for costs, fees, and actual and punitive damages under Section 303(i) of the Bankruptcy Code. The bankruptcy court dismissed the case but denied Vibe Micro's request for statutory attorney's fees and damages because it concluded that Vibe Micro did not have standing under Section 303(i). The district court affirmed the bankruptcy court's decision and an appeal to the panel followed. The issue before the Ninth Circuit court was whether a 50% shareholder of an involuntary debtor may seek damages under 11 U.S.C. § 303(i).

The panel held that Vibe Micro -- a shareholder of the debtor -- lacked standing to seek damages under 11 U.S.C. § 303(i) because it was not the debtor. Section 303(i) of the Bankruptcy Code, in relevant part, provides: "[T]he court may grant judgment (1) against the petitioners and *in favor of the debtor* (A) for costs or (B) a reasonable attorney's fees; or (2) against any petitioner that filed the petition in bad faith, for (A) any damages proximately caused by such filing or (B) punitive damages." 11 U.S.C. § 303 (i) (emphasis added). In *Miles v Okun (In re Miles)*, 430 F.3d 1083, 1093-94 (9th Cir. 2005), the Ninth Circuit considered whether third parties may seek damages under this section by examining two interpretations of standing: (1) the presence of the phrase "in favor of the debtor" in Section 303(i)(1) limiting standing to collect all damages to the debtor or (2) the omission of that phrase from Section 303(i)(2). The *In re Miles* court considered legislative history, relevant case law, and public policy to determine the proper interpretation of the statute and concluded that Section 303(i) limits standing to recover statutory damages resulting from an involuntary bankruptcy proceeding only to the debtor. According to the court, these factors lead to the same result in this case.

Submitted by:

Karen K. Diep

Diamond McCarthy LLP

150 California Street, Suite 2200

San Francisco, CA 94111

kdiep@diamondmccarthy.com

Tenth Circuit

***In re The Falls Event Center, LLC, et al.,*
2019 WL 1549727 (Bankr. D. Utah April 8, 2019)**

In this case the court granted a motion filed by the chapter 11 trustee to substantively consolidate multiple, affiliated chapter 11 debtors as well as non-debtor affiliates. The court noted, among other things, that the debtor and non-debtor entities were affiliates, all wholly-owned by the main debtor (The Falls Event Center (TFEC)), all of the debtors shared common managers and TFEC directed all actions of the affiliated entities, none of which had ever had a source of income and whose debts were paid by TFEC which guaranteed loans to the affiliates to purchase real estate. TFEC and its affiliates operated from a single office space which housed all of the affiliated entities' business records. None of the affiliates had employees—those were provided by TFEC—and the companies' tax returns were filed on a consolidated tax basis. The court explained that substantive consolidation was appropriate because certain of the affiliates were alter egos of TFEC, substantive consolidation would (i) render unnecessary the quantification and prosecution of intercompany claims, (ii) resolve corporate governance issues, allow for the affiliates to be part of a chapter 11 plan or orderly liquidation, streamline the affiliates' chapter 11 cases and benefit creditors of the substantively consolidated estates. The court conducted an analysis required under applicable case law, and found that the relevant facts warranted substantive consolidation. The court further found that substantive consolidation should be effective *nunc pro tunc* to the petition date. The court did not provide authority for the substantive consolidation of the non-debtor affiliates, which is noteworthy because other published decisions from the District of Utah bring into question whether a bankruptcy court has the authority to do so. *See, e.g., In re Horsley*, 2001 WL1682013, *7 (Bankr. D. Utah 2001) (noting split of authority), one of the decisions cited to in TFEC in support of substantive consolidation.

Submitted by:

Paul Avron
Berger Singerman
One Town Center Road, Suite 301
Boca Raton, FL 33486
PAvron@bergersingerman.com