

**Bankruptcy Circuit Update**  
*Featuring cases from September 2018*

We will be convening our next section-wide conference call on **Friday, November 30th, 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](mailto: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**

*Matter of Davis,*  
\_\_\_ Fed. Appx. \_\_\_, 2018 WL 4232063 (5th Cir. Sept. 5, 2018)

This case arises out of the sale of certain real property by the trustee of the debtor's bankruptcy estate (the "Trustee"). After recovering the property at issue from Appellants in collection of a judgment, the Trustee moved to sell the property to Croix Custom Homes ("Croix") under 11 U.S.C. § 363(f). The bankruptcy court authorized the sale over Appellants' objection. Appellants did not seek a stay pending appeal, and the Trustee subsequently sold the property to Croix.

Appellants filed a notice of appeal to the district court, arguing the bankruptcy court did not have jurisdiction to approve the sale. But the district court dismissed the appeal, agreeing with the Trustee that § 363(m), which provides that modification on appeal of an authorization of a sale does not affect the validity of the sale to a good faith purchaser unless the authorization was stayed pending appeal, mooted Appellants' arguments.

Appellants again appealed to the Fifth Circuit. The Court, however, found Appellants abandoned their argument that the appeal was not moot by failing to address the issue in their initial briefing. Nevertheless, the Court also addressed the substantive issue, affirming the dismissal of the appeal as moot. Specifically, the Court explained that § 363(m) "patently protects" from later modification on appeal any authorized sale where the purchaser acted in good faith and the sale was not stayed pending appeal. This rule holds true even in the face of an argument that the bankruptcy court lacked jurisdiction to authorize the sale. Thus, because it was undisputed that Appellants did not seek a stay pending appeal, their claims were moot unless there was evidence Croix bought the property without good faith. Unfortunately for Appellants, challenges to a purchaser's good faith under § 363(m) cannot be raised for the first time on appeal, and Appellants had not raised the issue with the bankruptcy court.

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***Mandel v. Mastrogiovanni Schorsch & Mersky (In re Mandel),  
No. 17-640392, 2018 WL 4292183 (5th Cir. Sept. 7, 2018).***

The issue before the Fifth Circuit was whether a receiver, who was appointed in Texas state court litigation to represent a start-up company's interests in a lawsuit over ownership of the company, was properly awarded receiver fees in bankruptcy court for work performed in the state court lawsuit and in the bankruptcy proceedings. The Fifth Circuit affirmed the district court's judgment in part, but vacated the fee award and remanded to the bankruptcy court to recalculate the proper fee award.

Debtor Edward Mandel was co-founder of White Nile, a failed search engine start-up company. Pre-petition, Debtor and a number of parties who co-founded White Nile, including Steven Thrasher, entered into a lawsuit in Texas state court over the ownership of White Nile ("White Nile Litigation"). As part of the White Nile Litigation, Debtor and Mr. Thrasher agreed to the appointment of a receiver to protect White Nile's interests in the ownership dispute. The state trial court entered orders that appointed Rosa Orenstein as receiver ("Receiver"), determined how payment of receiver fees would be shared among Debtor and Mr. Thrasher, permitted Receiver to retain counsel to assist in her capacity as receiver, and provided that Receiver would "direct and control White Nile's participation in this litigation" (the "Receivership Orders").

Debtor failed to comply with the payment terms provided in one of the Receivership Orders. In state court, Receiver moved to compel compliance with the Receivership Orders' payment terms. The state court held a hearing that was continued to allow Debtor another opportunity to comply with the payment terms. After initiating failed mandamus proceedings with the Texas Supreme Court concerning the validity of the payment terms described in the Receivership Orders, Debtor filed for bankruptcy. Debtor removed the White Nile Litigation to federal court, and the dispute over ownership of White Nile was addressed as an adversary proceeding in Debtor's bankruptcy case through a derivative claim filed by Mr. Thrasher.

After trying the White Nile ownership dispute, the bankruptcy court issued an order in the bankruptcy case allowing Receiver and her retained counsel to receive fees incurred from the time of appointment through the adversary proceeding, including work performed in the state court proceedings, bankruptcy proceedings, and representing White Nile as a creditor in Debtor's bankruptcy estate. Debtor appealed the fee award to the district court, which affirmed the award.

In his appeal to the Fifth Circuit, Debtor contested the district court's legal findings to support the fee award. Relying on the language in the Receivership Orders, the Fifth Circuit determined that Receiver and her retained counsel were entitled to fees to the extent work was performed to represent White Nile's interests in the ownership dispute. As such, the Fifth Circuit

agreed with the bankruptcy court's factual finding that it was appropriate to grant Receiver and her counsel fees for assisting Mr. Thrasher in litigating his derivative claim against Debtor's estate. The Fifth Circuit found that the bankruptcy court erroneously awarded fees to Receiver and her counsel for their representation of White Nile as a creditor in the bankruptcy because the work performed in that regard exceeded the authority granted by the Receivership Orders. The Fifth Circuit determined that fees incurred by Receiver's hired counsel were permitted to the extent they assisted Receiver in her capacity as the receiver in litigating the issue of White Nile's ownership interests. Finally, because the Receivership Orders did not allow Receiver to represent White Nile as a creditor, the Fifth Circuit refused to address the legal issue of whether Receiver's post-petition fees were allowed under the Bankruptcy Code.

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### **Eighth Circuit**

***In re AFY, Inc.*,  
902 F.3d 884 (8th Cir., September 6, 2018)**

The Eighth Circuit affirmed the decision of the Bankruptcy Appellate Panel affirming the bankruptcy court's dismissal of the plaintiffs' claims and addressed jurisdictional questions presented.

A group of relatives owned shares in a corporation called Ainsworth Feed Yards Company, Inc. ("AFY"). Three relatives ("Defendants") sold their interests to AFY and another relative through a stock sale agreement. In 2010, AFY filed for bankruptcy, and the bankruptcy court ultimately concluded that AFY was liable for the purchase price of the stock sold by Defendants and that Defendants had not breached any duty under the agreement.

In October 2014, the two remaining shareholders of AFY ("Plaintiffs") filed a lawsuit in Nebraska state court, alleging (1) Defendants breached a stock sale agreement; (2) two of the Defendants breached their fiduciary duty to AFY; (3) Defendants were unjustly enriched by distributions from AFY's bankruptcy; (4) Defendants conspired and interfered with AFY's business expectancies during AFY's bankruptcy; and (5) Defendants abused the bankruptcy process. Defendants removed the complaint to federal bankruptcy court. The bankruptcy court ultimately dismissed the complaint on the ground that the shareholder standing rule and the doctrine of claim preclusion barred Plaintiffs' claims. The BAP affirmed.

The Eighth Circuit first addressed Plaintiffs' threshold argument, that the bankruptcy court lacked jurisdiction. This was rejected as the outcome sought by the Plaintiffs, requiring a redistribution of the AFY bankruptcy estate, could alter AFY's liabilities and impact the administration of the estate. Therefore, at a minimum, the case was "related to" a case under Title 11. Under 28 U.S.C. § 1334(b), a bankruptcy court, on referral from a district court, has jurisdiction in cases "arising under title 11, or arising in or related to cases under title 11."

Plaintiffs alternatively argued that removal was improper under the well-pleaded complaint rule. That rule, however, ensures that a defendant's removal of a case based on federal-question jurisdiction under 28 U.S.C. § 1331 presents a federal question of the face of a properly plead complaint. This too was rejected because the bankruptcy court invoked jurisdiction based on § 1334(b), where the well-pleaded complaint rule is inapplicable.

Plaintiffs next asserted that the bankruptcy court lacked authority to enter a final order. In a case proceeding under "related to" jurisdiction, there are two procedural avenues that a case may follow. First, the bankruptcy court submits proposed findings of fact and conclusions of law to the district court, and the district court enters a final order after conducting *de novo* review of the proposals. 28 U.S.C. § 157(c)(1). Or second, the parties may consent, expressly or impliedly, to the bankruptcy court entering appropriate final orders, and the district court is not involved. § 157(c)(2). The Eighth Circuit determined Plaintiffs had impliedly consented to the bankruptcy court's entry of dismissal because they did not follow the rules of procedure in which a party "shall file a statement" within fourteen days of removal to declare whether the party consents to entry of final orders by the bankruptcy court. Fed. R. Bankr. P. 9027(e)(3). Further, after entry of a final order of dismissal, Plaintiffs chose to appeal to the BAP rather than the district court, reinforcing that Plaintiffs were content to resolve the matter without the district court.

Plaintiffs also argued that the bankruptcy court lacked authority to enter the dismissal order because the rights at issue were private rights that an Article I court cannot adjudicate. However, a party may impliedly consent to a bankruptcy court's authority to consider private rights and Plaintiffs failed to raise this constitutional challenge despite numerous opportunities.

Finally, on the merits of the case, the Eighth Circuit agreed with the BAP in finding that the shareholder standing rule barred the Plaintiffs' claims. It reasoned that Plaintiffs' alleged only injuries that were derivative of AFY—that the Plaintiffs, as shareholders, would have benefited only derivatively if the corporate entity received the funds. Further, the exception to the shareholder standing rule did not apply as the injuries alleged by the Plaintiffs were no different from what any other shareholder of AFY might have suffered when AFY's bankruptcy estate was diminished.

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### **Tenth Circuit**

***In re Kearney,***  
**No. 17-12274-t11, 2018 WL 4440652 (Bankr. D. N.M. Sept. 14, 2018)**

A recent case from the Bankruptcy Court in the District of New Mexico is instructive on the scope of Federal Bankruptcy Rule 2004 discovery requests served on third parties. The court noted that the scope of a Rule 2004 examination can be broad, but it has limits, and cannot “be used as a device to launch into a wholesale investigation of a non-debtor’s private business affairs.” The court explained that Rule 2004 is properly used as a pre-litigation device, and therefore a trustee is not required to establish he or she would prevail in litigation before obtaining discovery. Where, like in the facts before the court, the claims are not estate assets, i.e., direct claims of the debtor, that militates against granting the requested discovery. In other words, the more attenuated the claim, the less likely discovery would be allowed as against a third party. When used as a pre-litigation device, courts balance the estate’s right to such discovery against the target’s right to be protected against unwarranted or unduly burdensome discovery. Another factor weighing against third party discovery is if litigation in another forum raise preclusion principles, i.e., the possibility that the estate would be barred from prosecuting the claim for which discovery is sought under res judicata or collateral estoppel. Practitioners should keep the foregoing points in mind when seeking Rule 2004 discovery from third parties, and be aware that while Rule 2004 can be used as a pre-litigation device, such discovery does have limits.

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### **Eleventh Circuit**

***In re Hintze,***  
**— Fed. App’x —, No. 18-11720, 2018 WL 4361156 (11th Cir. Sept. 13, 2018)**

Creditors sought denial of debtors’ discharge in individual chapter 7 case where debtors, pre-petition, transferred assets out of a wholly owned business entity, rendering it virtually worthless. The bankruptcy court denied the debtors’ discharge pursuant to Section 727(a)(2)(A) of the Bankruptcy Code, finding (1) that the transfer of assets out of the business “destroyed” the asset (the ownership interest), and (2) that the transfer of assets from the business was, in actuality, a transfer of the debtors’ assets because the business was the alter ego of the debtors.

The Eleventh Circuit affirmed the bankruptcy court's holding that the transfer of assets from the business entity "destroyed" the debtors' asset—the ownership interest in the business—and therefore supported denial of the debtors' discharge. The appellate court agreed with the bankruptcy court's conclusions that "destroy" as used in Section 727(a)(2)(A) does not require physical destruction. A debtor "destroys" intangible property (such as a membership interest in a company) when it suffers a significant enough reduction in value such that restoring the asset's value "would require the same or nearly the same investment of labor and resources as building it from scratch." *Hintze*, at \*4. The Eleventh Circuit affirmed the bankruptcy court's decision and declined to address the bankruptcy court's alternative holding based on alter ego theory.

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