

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

**U.S. SUPREME COURT**

***Lamar, Archer & Cofrin, LLP v. Appling,***  
**No. 16-1215, 2018 WL 2465174**  
**(S. Ct. June 4, 2018)**

In *Appling*, the Court considered whether a false oral statement respecting a debtor's financial condition was dischargeable under 11 U.S.C. § 523(a)(2)(B). The Court had granted certiorari to resolve a circuit split regarding whether a false representation about a specific asset qualifies as a statement respecting financial condition. Justice Sotomayor wrote the unanimous opinion for the Court. (Justices Thomas, Alito, and Gorsuch did not join in Part III-B of the opinion). *Appling* is the Court's third bankruptcy opinion for the 2017-18 term.

The Petitioner represented the Respondent in a lawsuit with his former business partners. Appling was unable to pay his attorney's fees, and, when the law firm threatened to discontinue representation, Appling stated that he was going to receive a large tax refund of roughly \$100,000 that he would use to pay his attorney's fees. The tax refund was significantly less than expected. Appling did not pay his attorneys but used the tax refund to pay down his business debt. Petitioner filed suit in Georgia state court for the unpaid fees and was awarded a judgment. Appling filed chapter 7 bankruptcy and the law firm filed a dischargeability action against Appling, alleging that the debt was incurred by a false oral statement under § 523(a)(2)(A), which provides in part that false oral statements are nondischargeable. The bankruptcy court found that a statement regarding a single asset (the tax refund) is not a statement "respecting the debtor's financial condition" and found that the two false representations were not dischargeable under § 523(a)(2)(A). The District Court affirmed.

The Eleventh Circuit reversed, finding that a statement respecting a debtor's financial condition may include a statement about a single asset. As such, because Appling's statement about his tax refunds were not in writing, the Eleventh Circuit found that Appling's statements were respecting the debtor's financial condition and that the debt was dischargeable under § 523(a)(2)(B).

The Court granted certiorari to resolve a circuit split. The Court noted that the Fifth Circuit in *In re Bandi*, 683 F.3d 671 (5th Cir. 2012) and Tenth Circuit in *In re Joelson*, 427 F.3d 700 (10th Cir. 2005) both held that a statement about a single asset is not a statement respecting a debtor's financial condition. The Court noted the distinction between § 523(a)(2)(A) and (B), finding that (A) precludes a discharge of debts procured for fraud other than a statement respecting a debtor's financial statement, with (B) that bars a material false statement respecting the debtor's financial condition if the statement is in writing.

The Court based its analysis on the ordinary meaning of the words "statement", "financial condition" and "respecting" because the Bankruptcy Code does not define these words. Further, the Court determined that the key word in its analysis was the word "respecting" which joins

together the words “statement” and “financial condition”. The Court found that “respecting in the legal context generally has a broadening effect, ensuring that the scope of the provision covers not only its subject but also matters relating to that subject.” Appling argued that a statement respecting a financial condition is a direct relation to the balance of all of the debtor’s assets and liabilities or the debtor’s overall financial condition. Moreover, Appling maintained that a statement that describes the existence or value of an element of a debtor’s balance sheet or income statement qualifies as a statement respecting financial condition. The Court concluded that a statement is respecting a debtor’s financial condition if it has a direct relation on the debtor’s overall financial status. As such, a single asset has a direct relation to a debtor’s aggregate financial condition if it can help determine whether a debtor is solvent or is able to pay a debt. Therefore, because Appling’s false statements were not in writing, the debt was discharged.

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## **SECOND CIRCUIT**

***Margulies v. USAA Cas. Ins. Co.***  
***(In re Margulies)***  
**17-1073 (2nd Cir., May 11, 2018)**

The Second Circuit affirmed the judgment of the district court affirming the bankruptcy court's decision holding that (1) the state court default judgment that Dennis Hough ("Hough") obtained against chapter 7 debtor Joshua Margulies ("Margulies") was a non-dischargeable debt; and (2) that no coverage was available under certain insurance policies USAA Casualty Insurance Company provided to Margulies.

This cross-appeal was centered on incident that occurred when Hough worked as a flag man managing traffic near a construction site in Manhattan. Margulies was driving a car to reach a meeting he was running late for and was stopped by Hough. Margulies became increasingly impatient and eventually lifted his foot off the brakes without Hough's permission. As the car rolled forward, Hough stepped back into its path – Margulies testified that he expected Hough to move, and thought Hough was staying put "simply to annoy" Margulies. Margulies continued to allow the car to move forward toward Hough, and did not apply the brakes until after the car hit Hough. Margulies saw Hough fall and get back up, stated he assumed Hough was unhurt, and continued driving to his meeting. Margulies subsequently pled guilty to misdemeanor assault in the third degree under N.Y. Penal Law § 120.00(2).

Hough subsequently sued Margulies for negligence in state court. Neither Margulies nor USAA defended the action and Hough obtained a \$4.8 million default judgment (the "Judgment"). Hough then sued USAA to collect on the Judgment pursuant to N.Y. Insurance Law § 3420. After Margulies filed for Chapter 7 bankruptcy, Hough commenced an adversary proceeding seeking (1) to have the Judgment declared non-dischargeable under Bankruptcy Code section 523(a)(6) on the ground that Margulies acted willfully and maliciously; or (2) to have

USAA held liable for the Judgment up to the limits of the insurance policies pursuant to N.Y. Insurance Law 3420 because the incident was an "accident" within the meaning of the policies. The bankruptcy court found that (1) Margulies acted willfully and maliciously, and accordingly, his debt to Hough was not dischargeable and (2) the incident was not an accident within the meaning of New York's insurance law, and was therefore not covered by the USAA policies issued to Margulies. The district court affirmed.

On appeal, Hough first argued that the bankruptcy court erred in finding that the incident was not an "accident" within the meaning of the USAA policies, such that the insurer was not obligated to provide coverage. Hough argued that the Judgment established that Margulies's actions were negligent, not intentional, and *res judicata* bars reconsideration of the issue of Margulies's intent in federal court. The Second Circuit disagreed with this argument, finding that the issue of Margulies's intent could not have been raised in the state court negligence action because Margulies could not have defended against Hough's allegations of negligence by arguing that his actions were, in fact, intentional.

The Second Circuit also agreed with the bankruptcy court that because Margulies acted intentionally, the incident was not an "occurrence" within the meaning of the USAA policies and no coverage was available. Under New York insurance law, an injury is "intentionally caused" and thus not accidental if the damages flow directly and immediately from an intended act. Here, Hough's injuries flowed directly and immediately from Margulies's decision not to apply the car's brakes until after the car struck Hough. Accordingly, the incident was not an accident within the meaning of New York law, and thus was not an occurrence as defined in the USAA policies.

Margulies, on the other hand, challenged the bankruptcy court's holding that the debt was nondischargeable. Pursuant to Bankruptcy Code section 523(a)(6), a debt is not dischargeable when it was incurred because of the "willful and malicious injury by the debtor to another." This exception to discharge requires a plaintiff to prove that (1) the debtor acted willfully, (2) the debtor acted maliciously, and (3) the debtor's willful and malicious actions caused injury to the plaintiff or the plaintiff's property. The Second Circuit noted that regardless of whether the applicable standard is objective or subjective, Margulies's decision not to apply the car's brakes until after the car struck Hough could only be viewed as a decision from which consequences were substantially certain to flow. After holding that failing to attempt to apply a car's brakes before striking a person standing in front of the car satisfied the applicable standard for malice, the Second Circuit held that the bankruptcy court did not err in deeming the debt nondischargeable.

***Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC***  
***(In re Sabine Oil & Gas Corp.)***  
**17-1026 (2nd Cir., May 25, 2018)**

The Second Circuit affirmed the judgment of the district court affirming the bankruptcy court's orders authorizing the rejection of certain agreements between debtor Sabine Oil & Gas Corporation ("Sabine") and Nordheim Eagle Ford Gathering, LLC ("Nordheim") pursuant to Bankruptcy Code section 365(a).

On appeal, Nordheim argued that both lower courts erred by misconstruing the relevant agreements as "personal obligations" as opposed to "real covenants that run with the land." This distinction was significant, because if the agreements constituted real covenants that ran with the land they would not be "executory contracts" that could be rejected pursuant to Bankruptcy Code section 365(a). The bankruptcy court and the district court each reviewed the relevant agreements under Texas state law, which was selected in the choice of law provision in each agreement. The parties agreed that for a real covenant to run with the land under Texas law, it must: 1) touch and concern the land, 2) relate to a thing in existence or specifically bind the parties and their assigns, 3) be intended by the original parties to run with the land; and 4) the successor to the burden must have notice. The parties did not dispute that the agreements satisfied prongs 2, 3, and 4, but disagreed on whether the agreements "touched and concerned" the land and whether the legal test included a requirement of horizontal privity.

The Second Circuit found that Texas still requires horizontal privity and that it was not satisfied in this case, and accordingly, the Second Circuit did not address the "touch and concern" prong. In order for the parties to the original agreement to have been in horizontal privity with one another, there must have been some common interest in the land other than the purported covenant itself at the time it was executed. The bankruptcy court found that horizontal privity remains a requirement under Texas law and that the agreement between Sabine and Nordheim failed to satisfy that requirement.

Nordheim argued that horizontal privity of estate was established through the separate agreements conveying a pipeline easement and a separate parcel of land. The bankruptcy court determined that this separate conveyance was insufficient to establish horizontal privity of estate, explaining that Nordheim failed to identify any authority for the proposition that the requirement may be satisfied if the covenanting parties have horizontal privity of estate only with respect to property separate from the property burdened by the covenant at issue. The Second Circuit agreed with the bankruptcy court that this separate conveyance was insufficient to establish horizontal privity of estate between the parties.

Nordheim argued in the alternative that even if the agreements did not create real covenants, they created equitable servitudes that nonetheless created a property interest that could not be rejected under the Bankruptcy Code. The Second Circuit noted that in order for an equitable servitude to bind successors to the burdened land under Texas law, three elements must be satisfied: (1) the successor to the burdened land took its interest with notice of the restriction, (2) the covenant limits the use of the burdened land, and (3) the covenant benefits the land of the party seeking to enforce it. After reviewing the cases cited by Nordheim, the Second Circuit held that Nordheim had no colorable argument that the agreements at issue created an equitable servitude because there was no benefit to real property of Nordheim. Instead it was Nordheim as an entity—not its real property—that was benefited by the agreement. The district court offered the same analysis when it held there was no equitable servitude created by the agreements. Accordingly, the Second Circuit affirmed the judgment of the district court.

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## **FIFTH CIRCUIT**

***In re Franchise Servs. of N. Am., Inc.,***  
**No. 18-60093, 2018 WL 2325909**  
**(5th Cir. May 22, 2018)**

The matter before the Fifth Circuit answered the question of whether U.S. and/or Delaware law permitted the parties to amend a corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy petition. The court held that neither bankruptcy law nor state law precluded the parties' actions.

In this case Boketo, a shareholder, made a \$15 million investment in exchange for 100% of the debtor's, Franchise Services of North America, Inc. ("FSNA"), preferred stock. Boketo was a subsidiary created by Macquarie Capital (U.S.A.) ("Macquarie") to finance this transaction. As part of this agreement Boketo requested an amendment to the debtor's corporate charter and a \$3 million fee payable to Macquarie. As a result, the debtor reincorporated in Delaware and amended its certificate of incorporation. The amended certificate required consent by a majority of each class of the debtor's common and preferred shareholders as a prerequisite to filing voluntary bankruptcy. Following an acquisition of a subsidiary, the debtor filed for bankruptcy without consent of its shareholders.

Macquarie and Boketo filed a motion to dismiss the bankruptcy petition as unauthorized. The debtor argued that as an unsecured creditor, by virtue of a \$3 million balance the debtor refused to pay, Boketo had no right to prevent the filing. The bankruptcy court disagreed and dismissed the petition. On a motion by the debtor, the bankruptcy court certified a direct appeal of its order.<sup>1</sup> The Fifth Circuit affirmed the bankruptcy court's ruling that declined to allow the bankruptcy to proceed finding no basis in Bankruptcy law or Delaware state law to preclude a shareholder with an unsecured creditor as a controlling entity from exercising its right to prevent the voluntary bankruptcy petition.

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<sup>1</sup> The bankruptcy court certified three questions to the Fifth Circuit:

- 1) Is a provision, typically called a blocking provision or golden share, which gives a party (whether a creditor or an equity holder) the ability to prevent a corporation from filing bankruptcy valid and enforceable or is the provision contrary to federal public policy?
- 2) If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?
- 3) Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share? If the answer to that question is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?

The Fifth Circuit declined to answer the first question and confined its analysis to the second and third questions.

The debtor argued that federal law forbid this arraignment because Macquarie exercised control over the preferred shareholder, and therefore the shareholder is essentially an unsecured creditor posing as a shareholder. The court disagreed:

In FSNA’s view, this is just a wolf in sheep’s clothing—a creditor masquerading as a bona fide equity owner. Boketo is fully controlled by Macquarie, meaning the veto right in fact belongs to Macquarie—an unsecured creditor by virtue of its unpaid fees. . . . There is no prohibition on federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill.<sup>2</sup>

Next, the Fifth Circuit examined whether Delaware law imposes a fiduciary duty on a minority shareholder with the ability to prevent a voluntary bankruptcy petition thereby preventing Bokeo, a minority shareholder, to exercise its blocking right. The court found that the debtor failed to demonstrate or present evidence that Boketo exercised any kind of actual control over the board that would otherwise impose a fiduciary duty on Boketo and therefore prevent Boketo from exercising its blocking right.<sup>3</sup>

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***Matter of Beach,***

**No. 17-10481, 2018 WL 2251672**

**(5th Cir. May 16, 2018) (per curiam).**

The issue before the Fifth Circuit was whether the bankruptcy and district courts abused their discretion in approving a settlement agreement in an adversary proceeding despite objection by the debtor’s primary creditor.

In 2005, Debtor Gary M. Beach formed a partnership with DeepRock Venture Partners, L.P. (“DeepRock”), a New York investment firm, to drill for oil. The partnership soured after several profitless years, and DeepRock obtained a state-court judgment against the debtor. Subsequently, Debtor allegedly fabricated his father’s signature that transferred assets from the family trust account to a new trust account (the “2010 Trust Account”), listing Debtor and his son, Gentry Beach (collectively the “Beaches”), as the trust’s sole beneficiaries. The 2010 Trust

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<sup>2</sup> The court limited its holding to the facts before it, noting that a different result may occur (1) if a creditor with no stake in the company held the right; and (2) if there was evidence that the creditor took an equity stake simply as a means to guarantee a debt.

<sup>3</sup> The court noted that even if the shareholder did breach a fiduciary duty, the remedy would lie under state law, not under an otherwise meritorious motion to dismiss the bankruptcy petition.

Account notably included a spendthrift provision, whereby Debtor sought to insulate his interest from creditors. Soon thereafter, Debtor filed bankruptcy in 2011.

The Chapter 7 Trustee and DeepRock, Debtor's largest unsecured creditor, filed an adversary proceeding against the Beaches, seeking avoidance and recovery of the Beaches' alleged fraudulent transfers of assets under sections 544(b), 548(a)(1)(A), 548(e), and 550(a) of Title 11 of the United States Code and sections 24.005 and 24.008 of the Texas Uniform Fraudulent Transfer Act. The trustee and DeepRock also sought the imposition of a constructive trust over the alleged fraudulent transfer funds and declaratory judgment that the bankruptcy estate included Debtor's interest in the 2010 Trust Account.

The bankruptcy court ordered the parties in the adversary proceeding to mediation, which was unsuccessful. Shortly after mediation, the trustee and the Beaches reached an agreement, but DeepRock objected to the settlement agreement on the grounds that the agreement did not maximize value for Debtor's creditors. After a two-day hearing and receiving evidence, the bankruptcy court approved the settlement agreement despite DeepRock's objection. DeepRock appealed to the district court, which affirmed.

In reviewing the bankruptcy court's findings based on the three-prong test,<sup>4</sup> the Fifth Circuit held that there was no abuse of discretion. The bankruptcy court found that the Chapter 7 Trustee had a high probability of success on its claims in the adversary proceeding and noted that the adversary litigation "would cost hundreds of thousands of dollars in legal and expert witness fees." With regard to the third prong, DeepRock argues that the bankruptcy court lacked sufficient evidence to approve the settlement agreement because the Chapter 7 Trustee did not obtain an expert valuation of Debtor's interest in certain business assets. Debtor's son testified at the two-day settlement approval hearing regarding the valuation of Debtor's interest in said assets, and DeepRock failed to provide evidence refuting the testimony of Debtor's son. The Fifth Circuit concluded that the bankruptcy court heard sufficient evidence to determine that the settlement agreement was "fair and reasonable" when considering the likely rewards, costs, and risks of litigation and properly exercised its discretion in assessing the evidence related to any associated damages.

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<sup>4</sup> A three-part balancing test is applied to compare the settlement terms with the "likely rewards of litigation." *See Official Comm. of Unsecured Creditors v. Moeller (In re Age Ref., Inc.)*, 801 F.3d 530, 540 (5th Cir. 2015)(internal citations omitted). The bankruptcy court must evaluate: (1) the probability of success in litigating the claims; (2) the complexity and expense of litigation; and (3) "all other factors bearing on the wisdom of the compromise." *Id.* The Fifth Circuit considers "other factors" to include the best interest of the creditors and the "extent to which the settlement is truly the product of an arms-length bargaining, and not of fraud or collusion." *Id.*

## NINTH CIRCUIT

***Phillips v. Gilman***  
***(In re Gilman)***,  
**F.3d. — (9th Cir. 2018)**

In *Gilman*, the Ninth Circuit vacated the bankruptcy court's order disallowing Debtor's homestead exemption and remanded for a determination of whether the Debtor had sufficient intent to establish residency in the property.

Debtor claimed a homestead exemption under California law which was denied by the Bankruptcy Court after Debtor failed to answer an objection filed by creditor Phillips. Debtor filed amended exemptions and a Rule 60(b) motion arguing that his counsel's mistaken failure to oppose Phillips's objection constituted excusable neglect. The bankruptcy court granted Rule 60(b) relief and denied Phillips's renewed objection to the exemption. Phillips sought reconsideration based on newly discovered evidence that the property was in escrow at the time of filing and therefore Debtor was not entitled to claim the homestead exemption. The bankruptcy court denied the motion for reconsideration and concluded that escrow did not eliminate the Debtor's right to a homestead exemption. The district court affirmed the bankruptcy court's orders.

The Ninth Circuit first held that the Supreme Court's holding in *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (2015), did not alter controlling Ninth Circuit precedent in *Preblich v. Battley*, 187 F.3d 1048 (9th Cir. 2008), that an order denying an exemption is a final order because the pre-*Bullard* test similarly looked to whether the order "1) resolves and seriously affects substantive rights and 2) finally determines the discrete issues to which it is addressed." (quoting *In re SK foods LP*, 676 F.3d 798, 802 (9th Cir. 2012)). The Panel also held that the bankruptcy court did not abuse its discretion in granting the Rule 60(b) motion.

Turning to the merits of the exemption, the Panel held that under California law, a debtor has an automatic homestead exemption in the principal dwelling in which the debtor resided on the petition date and in which the debtor continuously resided thereafter. The fact that the home was in escrow did not affect the exemption so long as the Debtor resided in the property. However, in order to determine if a debtor "resides" in a property for homestead purposes, the bankruptcy court must consider physical occupancy *and* the debtor's intent to reside there. The Ninth Circuit remanded to the bankruptcy court to determine whether Debtor intended to reside in the property.

Because the bankruptcy court did not correctly apply the law to the facts, the Ninth Circuit did not decide two related questions: (1) whether a state law allocation of the burden of proof for exemptions is controlling in bankruptcy court where the state has opted out of the federal exemption scheme; *see In re Diaz*, 547 B.R. 329 (9th Cir. BAP 2016), and (2) whether state law equitable considerations can preclude exemptions taken under state law; *see In re Gray*, 523 B.R. 170 (9th Cir. BAP 2104).

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***Lee v. Field***  
**(*In re Lee*) 889 F.3d 639**  
**(9th Cir. May 7, 2018)**

In *Lee v. Field*, Lee consulted with his bankruptcy attorney in September 2010 about possibly filing for bankruptcy. A few days later, Lee transferred his 90 percent interest in real property 4014 Palua Place #1 (Palua 1) and his 75 percent interest in real property 4014 Palua Place #2 (Palua 2) to himself and his spouse as tenants by the entirety. In August 2013, about three years after these transfers, Lee filed a Chapter 7 bankruptcy petition. Lee's Schedule A listed his real property interests, including his tenancy by the entirety interests in Palua 1 and 2. Lee also in his Schedule C elected to claim state-law exemptions under 11 U.S.C. § 522(b)(3) and claimed exemptions under Hawaii state law for his tenancy by the entirety interest in those two properties. Four months later, the trustee held a meeting of creditors under 11 U.S.C. § 341 that concluded on December 19, 2013. During this meeting, Lee testified that he transferred his interests in Palua 1 and 2 to the tenancy by the entirety estate for "exemption planning." On January 14, 2014, the trustee filed an adversary proceeding against Lee and his spouse seeking to set aside Lee's transfers of his interests in Palua 1 and 2 to his tenancy by the entirety estate as a fraudulent transfer. The complaint, however, neither cited 11 U.S.C. 522(b)(3) nor asked the court to deny Lee's claimed state-law exemptions in his Schedule C.

In February 2015, the bankruptcy court found that the trustee had proved, by clear and convincing evidence, that Lee transferred his interest in the Palua properties to himself and his spouse with actual intent to hinder, delay, or defraud creditors and issued a final judgment avoiding the transfers but did not expressly state that it was denying the exemptions. Lee appealed this ruling to the district court and moved for a stay pending appeal. The district court denied the stay and affirmed the bankruptcy court's judgment. While Lee's appeal of the bankruptcy court's judgment in the fraudulent transfer proceeding was pending in district court, the trustee filed a motion in bankruptcy court seeing the turnover of the Palua properties. The bankruptcy court granted the trustee's turnover motion finding that the complaint satisfied the requirements of Rule 4003, the district court affirmed, and Lee timely appealed.

The issue before the Ninth Circuit court is whether the trustee's fraudulent transfer complaint met the requirements of Federal Rule of Bankruptcy 4003. The court held that Rule 4003 was satisfied and the bankruptcy court correctly determined that Lee's exemptions were invalid.

The Court noted that Rule 4003(b), unlike some other bankruptcy rules, proscribes no particular form for objections to exemption claims, and its purpose is to provide the debtor with timely notice that the trustee or other interested party objects to a debtor's claimed exemption. The Ninth Circuit found that the adversary complaint gave Lee more than adequate notice that the trustee objected to Lee's claimed exemptions given that the adversary action and an objection

under Rule 4003 were inextricably intertwined. In particular, because property held in a tenancy by the entirety was exempt from Lee's creditors under Hawaii law, the trustee had no legal basis for objecting to the claimed exemptions unless he could avoid the transfer of that property interest. In order to set aside Lee's transfers and recover some portion of the challenged interests in the Palua properties for the benefit of the bankruptcy estate, the trustee had to bring an adversary proceeding. Moreover, the Court also found that the adversary complaint and proceeding met Rule 4003's procedural requirements. The time period for Rule 4003 objections began to run when the trustee concluded the meeting of creditors on December 19, 2013 and it expired on January 18, 2014. Prior to that date, the trustee filed an adversary complaint on January 14, 2014. In addition, as required by Rule 4003(c), the fraudulent transfer proceeding provided a hearing after notice.

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