A CELEBRATION OF LIBERTY AND JUSTICE FOR ALL:
THE BICENTENNIAL OF THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

THE DISTRICT'S FINANCIAL COURTS: BANKRUPTCY AND THE ECONOMY OF WESTERN PENNSYLVANIA

Panelists:

The Honorable Joy Flowers Conti
Chief United States District Judge

The Honorable Judith K. Fitzgerald
Shareholder, Tucker Arensberg, P.C.
and formerly United States Bankruptcy Judge

The Honorable Carlota M. Böhm
United States Bankruptcy Judge

Douglas A. Campbell, Esq.
Member, Campbell & Levine, LLC

Ronald Schuler, Esq.
Partner, Spilman Thomas & Battle, PLLC

Moderator:

The Honorable Jeffery A. Deller
Chief United States Bankruptcy Judge

BIOGRAPHIES

The Honorable Joy Flowers Conti

Judge Conti is the Chief Judge of the United States District Court for the Western District of Pennsylvania. Prior to her appointment, she was a shareholder with the Pittsburgh office of Buchanan Ingersoll, Professional Corporation, now Buchanan Ingersoll Rooney ("Buchanan"), and prior to joining Buchanan she was a partner with Kirkpatrick, Lockhart, Johnson & Hutchison, now known as K&L Gates LLP. Judge Conti was a Professor of Law at Duquesne University and taught courses on civil procedure, corporations, corporate finance, corporate reorganizations and bankruptcy. She authored several articles and chapters in treatises dealing with bankruptcy and corporate law and was a frequent lecturer at seminars on those matters. Judge Conti is a former President of the Allegheny County Bar Association (1993), is listed in *Who's Who in America* and *Who's Who in American Law,* and while practicing law was listed in *The Best Lawyers in America.* She is a member of the prestigious American Law Institute and the American College of Bankruptcy. She also was Governor-at-Large of the Pennsylvania Bar Association ("PBA"), was the Chair of the PBA's Business Law Section, and received the PBA's 1995 Anne X. Alpern Award, which annually recognizes one outstanding woman lawyer. She was the President of the Third Circuit Historical Society. Judge Conti is a *summa cum laude* graduate of the Duquesne University School of Law, where she served as Editor-in-Chief of the *Duquesne Law Review.* Judge Conti was a member of the Judicial Conference of the United States, and is a former Chair of the Judicial Conference Committee on the Administration of the Bankruptcy System. She served as the Chair of the Local Rules Committee for the United States District Court for the Western District of Pennsylvania from 2003 to September 2010 and as the Chair of the Alternative Dispute Resolution Committee for the United States District Court for the Western District of Pennsylvania from September 2010 until September 2013. Judge Conti is Chair of the Western District of Pennsylvania's U.S. Probation Job Development & Educational Services Advisory Committee. She also received the American Inns of Court 2009 Professionalism Award for the Third Circuit and the W. Edward Sell Business Lawyer Award on November 15, 2016.

The Honorable Judith K. Fitzgerald

Judge Fitzgerald (Ret.) has more than 25 years of experience as a Bankruptcy Judge, having presided over matters in the Western District of Pennsylvania (where she was chief judge for five years) as well as in the District of Delaware (20 years), the Eastern District of Pennsylvania (8 years) and the U.S. Virgin Islands (9 years). During her tenure as a bankruptcy judge, Fitzgerald presided over many significant corporate cases including: *Flintkote, Kaiser Aluminum, Corp., Owens Corning, W.R. Grace, Pittsburgh Corning Corporation, Armstrong World Industries, United States Mineral Products, U.S.G., Specialty Products Holding Corp., Maronda Homes, Fleming Steel Company, Federal-Mogul Global, Innovative Communications Corp., Just For Feet, Inc., WorldClass Processing, Inc., Combustion Engineering, Inc., Peregrine Systems,*

American Pad & Paper Co., PHP Healthcare Corporation, Color Tile, Inc., Italian Oven, Shannopin Mining, Busy Beaver Bldg. Centers, and *Papercraft Corporation.*

Judi has unique experience in mass tort bankruptcies, having adjudicated more cases involving section 524(g) asbestos trusts than any other bankruptcy judge in the country. She has an extensive trial background and frequently served as a settlement judge and mediator. She was the sole judge hearing all chapter 13 cases in the Western District of Pennsylvania and Delaware for many years. She has completed several mediation training courses, including the intensive, 40-hour Bankruptcy Mediation Training course offered by St. John's University and the American Bankruptcy Institute and courses provided by the PA Council of Mediators and the Western PA Council of Mediators, and now serves as a mediator and arbitrator.

In addition to her services as an expert witness and consultant, Judi represents debtors and creditors in bankruptcy. She is a Professor in the Practice of Law at the University of Pittsburgh School of Law where she teaches Bankruptcy and Advanced Bankruptcy Law. Judi is a member of the Tucker Arensberg Board of Directors.

The Honorable Carlota M. Böhm

Judge Böhm was appointed to the U.S. Bankruptcy Court for the Western District of Pennsylvania in 2011. Judge Böhm started her career as a law clerk to two Bankruptcy Judges and was in private practice in the bankruptcy/commercial law area since 1981. She was a Bankruptcy Trustee for over 30 years and a mediator. She practiced law at Houston Harbaugh, P.C. from 1992 – 2011 and was a partner in Schaffler & Böhm prior to that. She is fluent in Spanish, being born in Buenos Aires, Argentina; graduated from the University of Pittsburgh with a B.S. and received an M.A. and J.D. Degree from Duquesne University. Judge Böhm was admitted to the Pennsylvania Bar, the U.S. District Court for the Western District of Pennsylvania and the Supreme Court of the United States. She is very active in numerous organization, including; the Allegheny County Bar Association, Commercial Law League Association, The Judith K. Fitzgerald Western Pennsylvania Bankruptcy American Inn of Court, Turnaround Management Association, International Women's Insolvency & Restructuring Confederation and the National Conference of Bankruptcy Judges. She is a frequent lecturer on various topics, including bankruptcy, legal ethics, and commercial law.

Douglas A. Campbell, Esq.

Douglas Campbell is a founding member of Campbell & Levine, LLC, a law firm with offices in Pittsburgh, Pennsylvania and Wilmington, Delaware, established in 1981. His practice focuses on counseling clients with regard to issues and disputes related to substantial financial obligations, as well as the management of multi-billion dollar asbestos-related personal injury settlement trusts.

Doug obtained a J.D. degree from Harvard Law School in 1976, and a B.A. degree from Carnegie-Mellon University in 1973. During the 1990s, he drafted, negotiated and obtained court confirmation of a plan of reorganization for one of the first asbestos manufacturers to emerge from Chapter 11, H.K. Porter Company; and did the same in the chapter 11 case for the Pittsburgh Penguins in 1999 while representing the team's major unsecured creditor, Mario Lemieux

Ronald Schuler, Esq.

Ron Schuler is the Member in Charge of the Pittsburgh office of Spilman Thomas & Battle, and has been practicing corporate, technology and securities law in Pittsburgh for 30 years. A native Southern Californian and a graduate of Pomona College and Cornell Law, Schuler was a lead member of the team that represented the City of Pittsburgh with regard to the Pittsburgh Pirates and the planning and construction of PNC Park, and was the author of the *Forbes Field II Task Force Final Report* (1996), the urban planning justification for the location of the ballpark. Named *Best Lawyers*' Pittsburgh "Lawyer of the Year" for Mergers and Acquisitions, Schuler has also served as a senior operating officer of a $100 million oil and gas company, and is the founding chairman of Pittsburgh Public Media, which owns Pittsburgh's community-supported jazz radio station, WZUM-FM/AM. He is the author of a soon-to-be-published history of the legal profession in Pittsburgh, *The Steel Bar: Pittsburgh Lawyers and the Making of Modern America*. From the constitutional crisis of the Whiskey Rebellion through the bloody Homestead Strike, to the Johnstown Flood, the creation of the world's largest corporation, and the witch hunts against anarchists in the 1910s and Communists in the 1950s, to a seminal constitutional battle over the rights of workers, the prejudices against women and African Americans in the profession, a 20-year long federal antitrust prosecution, the suspicious suicide of a district attorney accused of graft, and the renaissance of the city after the decline of the steel industry, Schuler's *Steel Bar* is an epic story of the rise and fall and rebirth of the Pittsburgh lawyer.

The Honorable Jeffery A. Deller

The Honorable Jeffery A. Deller is the Chief U.S. Bankruptcy Judge for the Western District of Pennsylvania. In addition to serving as Chief Judge, Judge Deller has volunteered as a member of the Chief Judge Advisory Committee with the Federal Judicial Center in Washington, D.C. and has previously served as the Editor-in-Chief of the prestigious *American Bankruptcy Law Journal*. He has also taught classes at Duquesne University and the University of Pittsburgh.

Prior to his appointment to the bench in 2005, Chief Judge Deller practiced law at the firm of Klett Rooney Lieber & Schorling (now known as Buchanan Ingersoll & Rooney).

Chief Judge Deller is a Past President of the Bankruptcy and Commercial Law Section of the Allegheny County Bar Association (ACBA). He is the recipient of various honors including: the Outstanding Achievement Award by the Duquesne University Law Alumni Association, the Outstanding Young Lawyer Award by the ACBA, the Cornell High School Wall of Fame, and is a Fellow to the American College of Bankruptcy.

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42 U.S.C. § 9601(23). Thus, expenses incurred for monitoring a waste site and developing a clean-up plan are recoverable response costs. *See Artesian Water Co. v. Government of New Castle County,* 851 F.2d 643, 651 (3d Cir.1988) (costs incurred for monitoring and evaluating the impact of a spill are recoverable); *Ascon Properties, Inc. v. Mobil Oil Co.,* 866 F.2d 1149, 1154 (9th Cir.1989) (costs of developing a remedial action plan are recoverable); *Cadillac Fairview/California, Inc. v. Dow Chemical Co.,* 840 F.2d 691, 695 (9th Cir. 1988) (costs of hiring experts to conduct chemical testing and monitoring of a waste site are recoverable).

[8] AL Tech contends that it did not incur any pre-petition response costs as to some of the waste sites at issue. (Brief of appellant at 34–35). Debtor vigorously disputes this contention, arguing that AL Tech incurred response costs as to each of its sites as early as 1987 when it hired an expert "to assess all of the environmental problems at the plants and prioritize AL Tech's efforts with respect to each of its environmental problems." (Brief of appellee at 44). The bankruptcy court conducted a hearing during which "AL Tech d[id] not dispute that it incurred various response costs, such as hiring an in-house environmental specialist and using consultants to perform various tests and evaluations." Slip op. at 22. The bankruptcy court's finding, however, does not detail whether response costs were incurred as to each of AL Tech's waste sites. Therefore, this Court must remand this issue to the bankruptcy court for further findings regarding the response costs incurred by AL Tech as to each of its waste sites. As to each facility, if any costs were incurred pre-petition, then a CERCLA claim arose as to that facility pre-petition, and all response costs incurred and to be incurred remediating the facility are dischargeable. Alternatively, if AL Tech proves that it did not incur any pre-petition response costs for a facility, then a dischargeable CERCLA claim did not arise as to that facility.[7]

7. AL Tech bears the burden of proving that the sites for which it asserts pass-through status constitute facilities distinct from those for which pre-petition response costs were incurred.

III. Conclusion

The bankruptcy court's determination that the non-assignment clause of the 1976 agreement of sale prohibits AL Tech from asserting the indemnity provision of the 1976 agreement is affirmed. The bankruptcy court's entry of summary judgment on debtor's motion and denial of AL Tech's cross-motion are reversed. This matter is remanded to the bankruptcy court for a determination of what response costs were incurred by AL Tech and when, as well as an estimation of AL Tech's claim.

An appropriate Order will be issued.

In re PAPERCRAFT CORPORATION, Debtor-In-Possession.

SECOND PENNSYLVANIA REAL ESTATE CORPORATION, Movant,

v.

PAPERCRAFT CORPORATION, Respondent.

Bankruptcy No. 91-0903 JKF.
Motion No. 91-2790-M.

United States Bankruptcy Court,
W.D. Pennsylvania.

April 30, 1991.

As Amended on Reconsideration
June 14, 1991.*

Lessor moved to compel payment of administrative rent allegedly owed it by Chapter 11 debtor. The Bankruptcy Court, Judith K. Fitzgerald, J., held that: (1) absent any evidence that rent for its business premises was not actual and necessary expense to preserve estate pending rejection of lease and move to new headquarters, debtor was obligated to pay April rent, for first full month following filing, according to lease at contract rate; (2) debtor's pre-

* See 127 B.R. 346.

payment of lease payments prior to bankruptcy filing was preserved for benefit of estate so as to permit estate credit against postpetition rent it owed for prepetition prepayments, despite alleged lack of mutuality; and (3) debtor was entitled to set off insurance and broker commissions that it had paid for benefit of lessor against administrative rent claim.

So ordered.

1. Bankruptcy ⚡2876

Debtor is required to pay contract rate of rents during any of first 60 days postpetition in which it has possession of premises and has not rejected lease, rather than merely being obliged to pay reasonable rent or rent that is not actual and necessary expense to preserve estate. Bankr. Code, 11 U.S.C.A. §§ 365(d)(3), 503(b)(1)(A).

2. Bankruptcy ⚡2876

Absent any evidence that rent for its business premises was not actual and necessary expense to preserve estate pending rejection of lease and move to new headquarters, Chapter 11 debtor was obligated to pay April rent, for first full month following filing, according to lease at contract rate; lessor was unable to rerent premises while debtor remained, and debtor received and kept rent from its subtenant. Bankr. Code, 11 U.S.C.A. §§ 365(d)(3), 503(b)(1)(A).

3. Bankruptcy ⚡2876

Once lease is rejected by debtor or trustee, landlord must establish administrative claim by showing that rent was reasonable and was actual and necessary expense of preserving estate; specific rent provided in lease may or may not be reasonable rental value upon which the landlord will be entitled to postrejection payments. Bankr.Code, 11 U.S.C.A. §§ 365(d)(3), 503(b)(1)(A).

4. Bankruptcy ⚡2675

Chapter 11 debtor's prepayment of lease payments prior to bankruptcy filing was preserved for benefit of estate, so as to permit estate credit against postpetition rent it owed for prepetition prepayments, despite alleged lack of mutuality. Bankr. Code, 11 U.S.C.A. §§ 553, 558.

5. Bankruptcy ⚡2876

Creditors' committee failed to show good cause to withhold payment of Chapter 11 debtor's postpetition rental obligation for requested 60 days, despite contention that general unsecured creditors would suffer irreparable harm if debtor were required to pay administrative rent prior to rejection of lease; debtor filed plan of reorganization containing provision to pay all administrative expenses in full in cash and asserted at preliminary hearing that it had cash available to pay administrative expenses as they became due. Bankr.Code, 11 U.S.C.A. §§ 365(g)(1), 503(b)(1).

6. Bankruptcy ⚡2876

Chapter 11 debtor was entitled to set off insurance and broker commissions that it had paid for benefit of lessor against administrative rent claim to extent paid by debtor, as well as pass through utility expenses actually paid by debtor. Bankr. Code, 11 U.S.C.A. §§ 365(g)(1), 503(b)(1).

7. Bankruptcy ⚡2876

Practice of Chapter 11 debtor and lessor, and local custom, established that taxes were prorated on calendar year rather than on fiscal year of taxing body involved, so that debtor was not entitled to claim credits against administrative rent for alleged prepaid tax deposits on fiscal year theory, even though debtor paid taxes for period of time in which it might not be in possession of property. Bankr.Code, 11 U.S.C.A. §§ 365(g)(1), 503(b)(1).

George M. Cheever, Kirkpatrick & Lockhart, Pittsburgh, Pa., for debtor.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, Pa., for Creditors' Committee.

Robert G. Sable, Sable, Makoroff, Sherman & Gusky, P.C., Pittsburgh, Pa., for Second Pennsylvania Real Estate Corp.

MEMORANDUM OPINION

JUDITH K. FITZGERALD, Bankruptcy Judge.

Before the Court is the motion of Second Pennsylvania Real Estate Corporation (Lessor) to compel payment of administrative rent allegedly owed it by the Debtor-in-Possession, Papercraft Corporation (Debtor). Debtor was not in default prepetition. Debtor filed this Chapter 11 bankruptcy on March 22, 1991. The first rental payments due postpetition were to be paid to Lessor on April 1, 1991. Debtor failed to make the payments required by the written lease agreement and contends that it is entitled either to set off or to recoup against its April rent obligation certain prepetition prepayments it made pursuant to the lease.

The Official Committee of Unsecured Creditors (Committee) also answered the motion and contends that the entire matter should be postponed until May 22, 1991, sixty (60) days post filing, pursuant to 11 U.S.C. § 365(d)(3) because Debtor has filed a motion to reject the lease which is scheduled to be heard on May 16, 1991. Section 365(d)(3) allows the Court, for cause, to extend the time for a debtor's performance of any obligation pursuant to a lease which arises within sixty (60) days after the date of the order for relief, provided that the performance is not extended beyond such sixty (60) days. Lessor asserts that it is entitled to full payment as provided in the lease as administrative rent and that there is no purpose to be served in delay. Debtor intends to vacate the leased premises on or about May 1, 1991, and has entered into a new lease with a different landlord at a different location.

An evidentiary hearing was conducted. From the evidence adduced and the stipulations of the parties, the Court finds as follows: Debtor listed Lessor as one of its largest creditors, holding a claim in excess of $20 million. Lessor's claim arises from a series of transactions in May of 1988 wherein Debtor sold its principal manufacturing facility and warehouse located in O'Hara Township, Allegheny County, Pennsylvania, to First Pennsylvania Real Estate Corporation.[1] As part of that transaction, First Pennsylvania leased back to the Debtor approximately one-third (⅓) of the premises or 292,440 square feet for a period of fifteen (15) years at a base rental of $1 million per year plus certain additional rental payments, reimbursement of taxes, and utility payments. Debtor took possession of the leased space. Some time after May of 1988 and before the bankruptcy petition was filed, Debtor sublet approximately 196,000[2] square feet of its space. Debtor collected the rental payments from its subtenant and received the rent for April. The base rent which Debtor is required to pay to Lessor under the lease is $83,333.33 per month. Debtor's monthly prorated tax payment is $18,437.26 based upon last year's tax assessments. The parties adjust the total tax payments and other "pass through" charges[3] on an annual basis at the end of the calendar year.

The lease contains a detailed explanation of the parties' obligations to apportion and pay various real estate taxes. Both sides agree, however, that the lease was never followed with respect to the taxes. For example, under ¶ 5.1 of the lease, Debtor is liable to Lessor for the payment of all regular taxes and general or special assessments attributed to the property including real estate taxes. Lessor's responsibility is to pay timely all the taxes affecting the property directly to the appropriate taxing authority. Lessor also is required to provide Debtor with a copy of the tax bills and a statement of the amount of taxes owed by Debtor within sixty (60) days before the due date. In turn, Debtor is to pay its

1. First Pennsylvania changed its name to Second Pennsylvania Real Estate Corporation.

2. Debtor's testimony and that of Lessor are not identical regarding the square footage leased, used and sublet by Debtor. The differences are not material for purposes of this opinion. We use Debtor's figures.

3. Debtor makes utility and other payments for all tenants and receives their proportionate shares from Lessor, which collects it from the other tenants and "passes it through" to Debtor.

proportionate share to Lessor not later than thirty (30) days before the due date of any tax. Despite those provisions, Debtor paid all of the applicable real estate taxes directly to the taxing bodies, including that to the Fox Chapel School District which is in issue. In turn, Lessor collected from the other tenants their proportionate share and remitted same back to Debtor at or before the annual reconciliation.[4]

I.

The first issue is whether Debtor, which has not yet rejected the lease, is obligated to pay the full April rent required under the lease, as suggested by Lessor, or is required to pay only a reasonable rental value for the portion of the property which it occupies. Debtor is in actual possession of an office building in the complex which contains approximately 35,000 square feet and of an additional 8,148 square feet of warehouse space. Debtor's subtenant occupies 196,000 square feet. It is not clear from the testimony whether any entity, including Debtor, actually occupies the remainder which Debtor leases but does not sublet. At least 239,158 of the 292,440 square feet leased by Debtor is occupied.

[1] There are two lines of cases covering this subject. The first applies § 503(b)(1)(A) and requires the administrative claimant to establish that the obligations incurred by the Debtor were reasonable rent or were actual and necessary expenses to preserve the estate. *Great Western Savings Bank v. Orvco, Inc.*, 95 B.R. 724 (9th Cir. BAP 1989) (distinguishable in that case dealt with a lease which had been deemed rejected); *In re Tammey Jewels, Inc.*, 116 B.R. 292 (Bankr.M.D.Fla. 1990) (distinguishable in that debtor never took possession of leased space). The other represents the greater weight of authority. These cases rely upon the language of § 365(d)(3) which requires a trustee to perform timely all of the obligations of a debtor concerning payments of rents in the initial sixty (60) days postpetition including, when lessor files a motion demanding same, full payment. *In re Rare Coin Galleries of America, Inc.*, 72 B.R. 415, 416 (D.Mass.1987) (collecting cases); *In re Gillis*, 92 B.R. 461, 465 (Bankr.D.Haw.1988). *See also In re U.S. Fax, Inc.*, 114 B.R. 70, 73–74 (E.D.Pa.1990); *In re Damianopoulos*, 93 B.R. 3, 8 (Bankr.N.D.N.Y.1988); *In re Dieckhaus Stationers of King of Prussia, Inc.*, 73 B.R. 969, 972 (Bankr.E.D.Pa. 1987). In the case at hand, we find that Debtor is obligated to pay the contract rate of rents during any of the first sixty (60) days postpetition in which it has possession of the premises and has not rejected the lease, including the month of April, 1991.

[2] Section 365(d)(3) was added to the Code as the result of a strong commercial landlord's lobby to protect the lessor from providing current services without the ability to collect rents or to regain possession of its property. On that basis alone, Debtor would be responsible for the rent as provided in the lease, but there are other facts which support this conclusion. Debtor owned and occupied the property before the sale to First Pennsylvania. Debtor occupies or has sublet approximately one-third (1/3) of the total premises and has possession of the entire office building. Lessor is unable to rerent the premises while Debtor remains. Debtor receives and keeps the rent from its subtenant. Debtor is operating and recently filed motions to assume certain executory contracts with its key personnel. Obviously, the Debtor needs a location from which to conduct its business and has no other space available until it can take occupancy under its new lease, on or after May 1, 1991. Debtor brought forth no evidence to substantiate that rent for its business premises is not an actual and necessary expense to preserve the estate pending rejection of the lease and Debtor's move to new head-

4. There were a few exceptions to the method by which rents, utilities, and taxes were paid and/or collected. The exceptions were based upon certain lease provisions for tenants who were in occupancy prior to the sale to First

quarters.[5] In the absence of such evidence, the Court determines that Debtor is obligated to pay the April rent according to the lease.

[3] Once the lease is rejected, however, the landlord must establish its administrative claim, if any, pursuant to § 503(b)(1). *In re Orvco,* 95 B.R. 724, 727 (9th Cir. BAP 1989); *In re Patella,* 102 B.R. 223, 226 (Bankr.D.N.Mex.1989). The specific rent provided in the lease may or may not be the reasonable rental value upon which the landlord will be entitled to post-rejection payments. *In re Chandel Enterprises,* 64 B.R. 607, 610 (Bankr.C.D.Cal.1986). That issue is for another day.

II.

[4] Next, the Court must consider Debtor's claim that it is entitled to offset some prepetition prepayments which Debtor made under the lease. Debtor contends that the Court is bound to follow § 558 in this regard rather than § 553 which, Debtor claims, is limited to creditors who want to offset against the Debtor a mutual prepetition debt. Debtor asserts that § 558 provides to the estate any defense available to the debtor, including personal defenses. Further, Debtor argues that even if a setoff theory were determined to be improper because the payments sought to be set off occurred prepetition whereas the rent obligation arose postpetition, it is entitled to recoup the prepetition payments because they arose out of the same transaction, to-wit, the lease. The parties, and some of the cases they rely upon, use the terms "setoff" and "recoupment" interchangeably as applied to an estate's claim to credits against rents it owes and we follow that practice.

The Court agrees with Debtor's suggestion that § 558 governs this situation rather than § 553. Section 558 specifically preserves to the trustee, in this case, to the Debtor-in-Possession, any defenses that the Debtor has to a claim. *In re Standard Furniture Co.,* 3 B.R. 527 (Bankr.S.D.Cal. 1980).[6] Debtor's interpretation is in accord with *Matter of McGuire,* 11 B.R. 649 (Bankr.W.D.Pa.1981) (setoff claimed by creditor distinguished from setoff claimed on behalf of the estate).

Lessor argues that Debtor has no claim to setoff because there is no mutuality of parties and because setoff is inappropriate where prepetition payments would reduce postpetition rent. However, *In re Standard Furniture Co.,* 3 B.R. 527 (Bankr.S.D.Cal.1980), dealt with essentially the same issue and permitted the setoff. In that case, the original lessee deposited $5,000.00 as security prepetition. The lease was assigned to the debtor. Postpetition, the Chapter 7 trustee of the debtor was permitted to offset the estate's postpetition rent obligation (i.e., landlord's claim) against the prepetition security deposit. The court determined that § 553 did not affect the trustee's claim of offset because by its terms that section is limited to the setoff right of a creditor. Rather, the operative section was § 541(e), the predecessor to § 558, which permitted the trustee to assert the offset as a defense to the administrative rent claim. *See also Tavormina v. Alexander Grant & Co.,* 6 B.R. 71 (Bankr.S.D.Fla.1980) (trustee permitted to set off lessor's postpetition claim against debtor's prepetition claim). *Cf. In re Jarvis Kitchenware of D.C., Inc.,* 13 B.R. 230, 232 (Bankr.D.C.1981) (although trustee could not offset because prepetition defaults exceeded the security deposit, the court noted that a trustee may set off postpetition rent owed against prepetition claim to the extent that debtor was not in monetary default prepetition).

Pennsylvania. They are not contested, nor are they material to the pending dispute.

5. Some courts presume that the lease rate is the reasonable rental value of the premises unless an opposing party produces evidence to the contrary. *See In re Gillis,* 92 B.R. 461, 465 (Bankr.D.Haw.1988); *In re Rare Coin Galleries of America, Inc.,* 72 B.R. 415, 417 (D.Mass.1987). No evidence was produced by any party concerning the reasonable rental value of the subject premises.

6. *Standard Furniture* dealt with former § 541(e) of the Code. The 1984 Amendments to the Code replaced § 541(e) with current § 558 without change.

Lessor contends that the cases relied upon by Debtor in support of its § 558 argument are inapposite because they ignore the distinction between a debtor and a debtor-in-possession. The Court of Appeals for the Third Circuit recognizes that a debtor-in-possession is "a new entity, separate and apart from the prebankruptcy company...." *In re Bildisco*, 682 F.2d 72, 78–9 (3d Cir.1982), *aff'd*, 465 U.S. 513, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984). *Cf. Matter of West Electronics, Inc.*, 852 F.2d 79, 83 (3d Cir.1988) (debtor and debtor-in-possession are "closely related ..." and "materially distinct entities."). In a § 558 context, the distinction is of no significance because the very purpose of § 558 is to preserve for the estate the benefit of any defense "available to the debtor as against an entity other than the estate...." 11 U.S.C. § 558. The estate has the benefit of such a defense even if Debtor, after the commencement of the case, waives it. The waiver is not binding upon the estate. *Id.*

Here, but for the bankruptcy, Debtor would have had a claim against Lessor for prepaid rents. Following the filing of the bankruptcy, Debtor has the same defense available to Lessor's claim even if the appropriate name given to that defense is "recoupment"[7] rather than "setoff".

Because § 558 preserves for the estate the benefit of any personal defense available to the Debtor, the lack of mutuality argument must fail. 4 COLLIER ON BANKRUPTCY, ¶ 558.02 (15th ed. 1990) (to defeat improper claims against the estate, debtor-in-possession must be able to assert all defenses that debtor could have asserted had bankruptcy not intervened). *See In re M.W. Ettinger Transfer Co.*, 1988 WL 129334 (Bankr.D.Minn.1988) (unpublished) (refusing to follow *In re Braniff Airways, Inc.*, 42 B.R. 443 (Bankr.N.D.Tex.1984) in that *Braniff* failed to consider the impact of § 558, stating "[m]oreover, even under the *Braniff Airways* analysis, [prepetition-postpetition] crossover would be allowed in a case where justice would require it," and concluding that "the doctrine of mutuality of parties does not foreclose debtor from offsetting its claim to prepaid rent against current rents accruing.").

III.

[5] Having determined that Debtor is entitled to deduct its prepetition prepaid rents from its postpetition rental obligation, the Court must decide (a) whether the Committee's suggestion for a sixty-day (60) deferral of the payment is appropriate and (b) how much of an offset Debtor may make. With respect to the deferral, the Committee asserts that general unsecured creditors will suffer irreparable harm if the Debtor is required to pay administrative rent prior to the rejection of the lease. However, the Court has determined that the Debtor's use of the leased facility constitutes an actual and necessary expense of the estate. Thus, the administrative rent is entitled to priority over and above the general unsecured creditors. There is no point to be served by requiring the Debtor to accrue administrative priority expenses. *See In re Dieckhaus Stationers of King of Prussia, Inc.*, 73 B.R. 969, 973 (Bankr.E.D. Pa.1987) (collecting cases which state that the postpetition, pre-rejection right of landlords to sixty (60) days' rent at the contract rate is a basis upon which to order immediate payment of that sum absent good cause for withholding). *See also* Local Rule Bankruptcy Procedure 2015.1 (requiring, *inter alia*, the payment when due of postpetition rents on real estate). The timing of payment of ordinary administrative claims is within the court's discretion. *In re Rare Coin Galleries of America, Inc.*, 72 B.R. 415 at 417. Here, no good cause to withhold payment has been shown to exist. To the contrary, Debtor filed a plan of reorganization which contains a provision to pay all administrative expenses in full in cash. *See* Article IV, § 4.1 of the Debtor's Plan of Reorganization, Docket Entry No. 3. Debtor also asserted at the preliminary hearing on this matter that it has the cash available to pay administrative expenses as

7. As to recoupment, the prepetition-postpetition time difference is irrelevant. There is no dispute between the parties concerning the fact that the claimed prepayments arose from the same transaction.

they come due. Moreover, Lessor contends that its mortgage on the property is in jeopardy because without the rent payments it cannot meet its mortgage obligation. If any entity were to suffer prejudice as a result of the nonpayment, it would be the Lessor. Thus, to the extent that the prepetition prepaid rents, utility payments, and taxes do not exceed the April rental obligation, the Debtor shall pay the difference forthwith to Lessor.[8]

IV.

[6] We turn now to what, if any, amount Debtor owes Lessor on the administrative rent claim. Debtor contends that it is entitled to a credit for prepaid tax deposits in the amount of $52,204.43, pass through insurance and broker commissions of $4,737.30, prepaid utilities of $70,426.11 and interest as of March 1, 1991, in the amount of $26,229.60 which is owed to Debtor by Lessor on the promissory note. The Court agrees that the promissory note interest which has not yet been paid to Debtor is an appropriate offset and will allow it.

Concerning the insurance and broker commissions, Debtor testified that it has paid all but $480.00, or $4,257.30, to date. The Court agrees that the setoff is appropriate but only to the extent Debtor has paid it. Therefore the $4,257.30 will be allowed as a credit against the April rent due.

Likewise, with respect to the utilities, Debtor acknowledged that it has paid only $37,871.61. The remaining sums represent prepetition, unsecured claims which Debtor cannot pay pending confirmation of a plan. Although Debtor may have to pay these charges through a plan, it is also possible that in the interim the utility companies will be paid by tenants in the building or by the landlord. These utility charges are, in large measure, other "pass through" items which Debtor pays in advance for all tenants in the building and which Lessor rebates to Debtor pursuant to the terms of the lease. Therefore, to allow Debtor to decrease its postpetition rent by a sum of money for which a claim may be filed against it but which it ultimately may not owe would be inequitable and speculative. Of the $70,426.11 that Debtor claims as a credit for prepaid utilities, $37,871.61 will be allowed.

[7] The final offset claim concerns the alleged prepaid tax deposits made by Debtor. Debtor contends it is entitled to a credit based on the fiscal year of the taxing body involved which is the Fox Chapel Area School District. Lessor contends that the parties have established a practice of settling accounts on a calendar year basis and, therefore, Debtor is not entitled to claim credits on a fiscal year theory. The parties stipulated that the school district's fiscal year runs from July 1 through June 30. Debtor counters that the issue was never relevant before and therefore the custom between the parties should not be determinative of the issue of tax proration.

The evidence established that the Fox Chapel School District bills real property owners in July or August and that the billing period runs from July 1 through the following June. The evidence also established that Debtor paid the most recent Fox Chapel School District taxes in full. From a strictly economic point of view, the Court would be inclined to say that Debtor should have the benefit of a prepayment measured from the date of payment and based on the fiscal year within which the school district had the use of the money. However, in the case of *In re Wheeling Pittsburgh Steel Corporation*, 109 B.R. 689 (Bankr.W.D.Pa. 1990), Judge Bentz held that the method of tax proration is governed by contract. In the absence of a contract, local custom will dictate tax proration. Judge Bentz noted that in Allegheny County, the county in which the Fox Chapel School District is located, all real estate taxes are "deemed" to be based on a calendar year running from January 1 through December 31. In

8. This Opinion and Order does not affect Lessor's obligation to prove its § 503(b)(1) claim following Debtor's rejection. Debtor is not required to pay rejection damages as an administrative priority claim. 11 U.S.C. § 365(g)(1). Moreover, in the event that other administrative claimants are not paid in full, Debtor has the right to seek disgorgement. *In re Dieckhaus*, 73 B.R. at 973.

Wheeling Pittsburgh, certain taxes which were billed on August 1, 1988, were deemed by custom to be for calendar year 1988 despite the taxing body's fiscal year or billing periods. In the pending case, the taxes were billed and paid in 1990 and, by local custom and the parties' practice, would be prorated for calendar year 1990. As a result, Debtor is entitled to make no offset for the taxes it paid. If any rebate is due by Lessor to Debtor, the annual reconciliation will account for it. As in *Wheeling Pittsburgh*, it is immaterial that the Debtor paid taxes for a period of time in which it may not be in possession of the property, i.e., after May 1, 1991. However, tax proration is not a matter of fairness or equity but has been established by custom to provide certainty and foreseeability in dividing expenses. Judge Bentz found that the certainty and foreseeability factors outweigh economic fairness or equity between buyer and seller: "Seller's good luck or bad luck at some remote earlier year should have no bearing on the proration of current costs." 109 B.R. at 692.

Wheeling Pittsburgh is not on all fours with the pending case inasmuch as the issue dealt with a tax proration on a sale of real estate. However, in this case the parties have established the practice of settling their mutual obligations at calendar year end. Either party had the option of holding to the lease terms prior to the bankruptcy. Neither did so. For that reason, the Court finds that the parties' practice and local custom must govern on this issue in accord with *Wheeling Pittsburgh.*

Concerning the local custom, Lessor presented testimony from Jeffrey Wagner, a closing officer with Commonwealth Land Title Insurance Company. Mr. Wagner's testimony was received on rebuttal subject to Debtor's objection as to relevance. Mr. Wagner identified the practice followed by closing officers in Allegheny County concerning the proration of taxes. His testimony, consistent with the stipulation of the parties accepted by Judge Bentz in *Wheeling Pittsburgh*, was that taxes are prorated on a calendar year when real estate sales close. Based upon the *Wheeling Pittsburgh* case, the Court finds the testimony to be relevant. Federal Rules Evidence 401, 406. Moreover, it is cumulative to the testimony of Philip Beard, an attorney called as a witness by the Debtor, who testified that the local practice is to prorate taxes on a calendar year basis but who opined that that practice may be incorrect with respect to the Fox Chapel School District taxes because of its fiscal year billing policy.

The Debtor is entitled to credit $68,-358.51 against the rental obligation it owed to Lessor on April 1, 1991. An appropriate Order will be entered.

ORDER

And now, to-wit, this 30th day of April, 1991, for the reasons set forth in the foregoing Memorandum Opinion, it is ORDERED that Debtor shall pay forthwith to its Lessor, Second Pennsylvania Real Estate Corporation, the rents which were due on April 1, 1991, to the extent that they exceed $68,358.31.

In re IAN HOMES, INC., Debtor.

JOHNSON HYDRO SEEDING CORPORATION, Movant,

v.

IAN HOMES, INC., Respondent. (Two Cases)

Bankruptcy No. 90-4-3862-PM. Motion Nos. 91M-0639-PM, 91M-0640-PM.

United States Bankruptcy Court, D. Maryland.

May 9, 1991.

Mechanics' lien claimant moved for relief from stay in order to proceed with state court litigation to perfect its mechan-

mine the rights by and between the parties, the Court exercises discretion to deny the request for declaratory relief. *See Brown v. Ferro Corp.,* 763 F.2d 798, 801 (6th Cir.1985), *cert. denied,* 474 U.S. 947, 106 S.Ct. 344, 88 L.Ed.2d 291 (1985) (concerning ripeness, balancing the need for decision as a "function of the probability and importance of the anticipated injury" with the risks of decision "measured by the difficulty and sensitivity of the issues presented" and the necessity of further factual development) (quoting WRIGHT, MILLER & COOPER, 13A Federal Practice and Procedure, § 3532.1, at 114. Even if this action is ripe, the Court can deal more appropriately with the validity of an affirmative defense in the context of actual litigation.

An appropriate Order will be entered.

ORDER

And now, to-wit, this 28th day of May, 1991, for the reasons set forth in the foregoing Memorandum Opinion, it is ORDERED that the request for declaratory judgment is DENIED; the motion to dismiss the complaint is GRANTED, and the complaint is DISMISSED.

The Clerk shall close this Adversary.

In re PAPERCRAFT CORPORATION, Debtor-In-Possession.

SECOND PENNSYLVANIA REAL ESTATE CORPORATION, Movant,

v.

PAPERCRAFT CORPORATION, Respondent.

Bankruptcy No. 91-00903 JKF. Motion No. 91-2790-M.

United States Bankruptcy Court, W.D. Pennsylvania.

June 14, 1991.

Chapter 11 petition was filed. The Bankruptcy Court, Fitzgerald, J., 126 B.R. 926, ordered debtor to make its postpetition lease payments but permitted certain reductions in April rent based on prepaid items. Debtor and creditors' committee moved for reconsideration. On reconsideration, the Bankruptcy Court, Judith K. Fitzgerald, J., held that: (1) record did not support debtor's contention of surprise with respect to lessor's claim that offset should not be permitted for prepaid taxes on fiscal year proration given that parties conducted their business on calendar year basis; (2) debtor was entitled to credit against postpetition rent payments for prepetition utility services provided to third-party tenants for which debtor had actually paid, but not for unpaid services for which debtor might be liable; (3) debtor had defense of setoff available; and (4) doctrine of recoupment applied, despite debtor's efforts to reject lease.

So ordered.

1. Bankruptcy ⚷2675

Record did not support debtor's claim that it was surprised by creditor-lessor's claim that offset against postpetition rent should not be permitted for prepaid taxes on fiscal year proration in light of parties' use of annual reconciliation at calendar year end, where first and only time that anyone requested change in calendar year adjustments was when debtor decided to reject lease, and, prior to inception of bankruptcy case, parties never used fiscal year calculation.

2. Bankruptcy ⚷2832

Record did not support debtor's contention that real estate taxes should be prorated on fiscal year basis for purposes of setoff against postpetition lease payments, where testimony fully established custom and practice between parties of annualizing credits and debits on calendar year basis.

3. Bankruptcy ⚷2832

Debtor was entitled to reduce its postpetition rent payments by amounts it actu-

ally paid for utility services provided to third-party tenants, but not for utility services for which debtor might be liable but which debtor had not yet paid, where parties had ongoing, competing claims, debtor might or might not pay all unsecured creditors 100 cents on dollar, and sole payment obligation for utilities for third-party tenants might not rest with debtor.

4. Bankruptcy ⇐2675

Debtor was entitled to setoff its prepetition payment of taxes against its postpetition rental obligation in case of sale and leaseback, where debts were mutual and neither debtor's nor lessor's position would be improved. Bankr.Code, 11 U.S.C.A. § 558.

5. Bankruptcy ⇐2674

To establish setoff as defense in bankruptcy case, movant must show that there are mutual prepetition debts and that result of offsets will not improve position of creditor.

6. Bankruptcy ⇐2675

Recoupment doctrine applied to give debtor credit against postpetition rent for prepetition payment of taxes and utilities for third-party tenants, despite debtor's effort to reject lease and fact that lease did not oblige debtor to pay taxes and utilities for third parties, where business practice of parties was to have debtor pay taxes and utilities and to receive credit against rent in exchange and to net out claims via annual reconciliation, and court required debtor to make prerejection, postpetition rent payments in accord with provisions of lease.

George M. Cheever, Kirkpatrick & Lockhart, Pittsburgh, Pa., for debtor.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, Pa., for Unsecured Creditors' Committee.

Robert G. Sable, Stephen J. Laidhold, Sable, Markoroff, Sherman & Gusky, P.C., Pittsburgh, Pa., for Second Pennsylvania Real Estate Corp.

MEMORANDUM OPINION ON MOTION FOR RECONSIDERATION

JUDITH K. FITZGERALD, Bankruptcy Judge.

Before the court are motions for reconsideration filed on behalf of Debtor and on behalf of the Official Committee of Unsecured Creditors concerning the order of this court dated April 30, 1991, 126 B.R. 926 which required the Debtor to make post-petition lease payments but permitted certain reductions in the April rent based on prepaid items. At the hearing on the motion for reconsideration held on May 21, 1991, Movants [1] contended that at the hearing which led to the April 30 order they were surprised by Second Pennsylvania's (Lessor's) claim, based on the parties' use of an annual reconciliation at calendar year end, that an offset should not be permitted for prepaid taxes on a fiscal year proration. The parties conducted their business on the calendar year basis even though the taxing body at issue bills on a fiscal year.

[1] The court provided an opportunity for the Debtor and the committee to cite in the record where surprise was claimed. Despite the requests of both parties for a week following the hearing of May 21 in which to do so, neither party submitted any information to the court.[2] Moreover, a fair reading of the record would substantiate that even if Debtor so claimed, the claim would not be meritorious. If any entity was surprised by a change in a relationship and practice among the parties, it would be Lessor. The first and only time that anyone requested a change in the calendar

1. This motion was filed by Debtor and the Creditors Committee at the same motion number as the original pleading. The references to movants, therefore, refer to them with respect to this motion for reconsideration only.

2. Debtor claimed at argument on this motion that it was surprised because Lessor did not provide its witness, a Mr. Karlton, for deposition prior to hearing. Lessor responds that Mr. Karlton was present in court and available although not called to testify. Had Debtor requested time at the evidentiary hearing to talk with him and/or to depose him about this matter the court would have granted that request. No request was made during that hearing.

year adjustments was when Debtor decided to reject the lease, the motion for which also is pending. Debtor then claimed a credit for prepaid taxes based on a fiscal, rather than calendar, year proration. The testimony establishes that, prepetition, the parties credited prepaid taxes against rent by taking one-twelfth of the previous calendar year tax payments and attributing that twelfth to the monthly rent. Prior to the inception of this bankruptcy case, the parties never used a fiscal year calculation. Therefore, the Debtor's request to offset all of its prepaid tax liability against one month's rent is not supported by the evidence and the motion for reconsideration on this basis must be denied.

[2] The next issue raised also concerned the tax proration. The court requested Debtor and the committee to provide cases which indicated that there was some support for the proposition that because a taxing body bills on a fiscal year basis, the offset, if any, must be determined on the fiscal year of the taxing body rather than on the parties' established method of conducting business. No such cases were submitted. The testimony clearly established a custom and practice between these parties of annualizing credits and debits on a calendar year basis.[3] Despite the clear provisions of the lease concerning who was to pay taxes and when, the parties' actual practice differed from their written contract. They agreed that the lease provisions were never followed. There is no evidence to support Debtor's claim that taxes should be prorated on a fiscal year basis for purposes of the requested setoff. For the reasons expressed by this court in its opinion of April 30, 1991, and by Judge Bentz in *In re Wheeling Pittsburgh Steel Corp.*, 109 B.R. 689 (Bankr.W.D.Pa.1990), the motion for reconsideration on this ground must be denied.

[3] Debtor next contended that its lease obligation is to *provide* utility services for various other tenants in the building, to pay for those utilities and then to be given a credit by Lessor for those payments made on behalf of third-party tenants. A reexamination of the lease reveals this argument to be spurious. There is no such obligation attributed to Debtor in the lease. The lease specifically requires *Lessor* to make electricity, water, sewer service and steam heat available. *See* ¶ 12(a) of the Lease. Debtor's responsibility is to pay for those utilities plus gas, power, telephone, etc., which *it* consumes. The lease specifically provides that Lessee (Debtor) has no obligation to pay for utilities for third-party tenants. *See* ¶ 12(f). Nonetheless, the testimony supports Debtor's contention that it paid for utility services for third-party tenants and was reimbursed for those services by Lessor.

The only issue addressed by the court in the April 30 Memorandum Opinion and Order was whether payments made, or to be made, by Debtor for utilities could be deducted from the April rent. The court determined that it would be appropriate to permit Debtor a credit for the utility services for which it had actually paid. For unpaid services, which are all prepetition unsecured claims, the Debtor may have an entitlement to an offset at some point in the future. The parties have on-going, competing claims. The Debtor may or may not pay all unsecured creditors 100 cents on the dollar. For this reason, it would be inequitable to allow Debtor an offset at 100 cents on the dollar for monies it has not expended against a rent obligation which it clearly owes at a time when it has not made the payment it seeks to offset. The court was concerned that the sole payment obligation for utilities for third-party tenants may not rest with the Debtor. Debtor contended that it is solely liable to the utility companies by contract with those companies but no evidence was introduced on this point. Debtor agreed that the utility companies may seek payment from Lessor, which, if it pays, would seek subroga-

3. The lease itself is silent as to whether the parties would allot payments on a calendar or fiscal year. However, ¶ 5.1(d) of the lease provides for monthly prorations and reimbursements of the 1988 prepaid taxes.

tion from Debtor.[4] However, no utility company is before the court seeking payment. Instead, the Debtor is attempting to reduce its monthly rent obligation to its landlord by the amount of a utility payment for which Debtor may be liable but which Debtor has not made. To the extent that Debtor pays unsecured creditors through its plan of reorganization, Debtor will satisfy its obligation to the utility companies. At that point if the Debtor has expended funds on behalf of third-party tenants, Debtor can seek reimbursement under and to the extent provided by the lease.

Debtor contended that the testimony of Frank Kane would substantiate its position concerning both surprise and the unpaid utilities. The court listened to the tape of Mr. Kane's testimony [5] again and finds no change in its earlier assessment of his testimony. For these reasons, the motion for reconsideration based on the claim for an additional credit for unpaid utilities will be denied.

The committee also contends that the setoff of the unpaid utilities should be permitted. The argument is that in other situations, a creditor who has an outstanding obligation to the Debtor is permitted an offset against unpaid obligations owing to it by the Debtor. Thus, the creditor's entire claim against the Debtor is reduced but no money changes hands. This situation is not analogous. Debtor's obligation in this case is not to make utility payments to Lessor. In fact, according to the lease, Debtor has no obligation to make the utility payments on behalf of third-party tenants at all. To the extent that the Debtor has an obligation to make the utility payments, that obligation runs to the utility which provided the service, not to Lessor. The parties, as a matter of convenience, adopted the practice of having Debtor make utility payments, billing Lessor for the amounts chargeable to third-party tenants, and then receiving reimbursement from Lessor. Debtor has no right to credits from Lessor for amounts which remain unpaid. Debtor is entitled to reimbursement only after it pays the bill and invoices Lessor for the proportionate share.

Even the analogy to triangular setoffs is not appropriate in this situation. If Debtor were permitted to reduce its rent claim 100 cents on the dollar but then to pay the utility company less than in full, it would have received a windfall. Because there will be time to adjudicate the issues in an orderly fashion in claims litigation, the most reasonable solution is to allow the Debtor to deduct from its rent obligation those utility payments which it actually has made on behalf of third parties and to deal later with the issue of reimbursement for the as yet unpaid portion.

[4] The next issue is whether or not the credit allowed against the rent is in the nature of setoff or recoupment.[6] As indicated in the opinion of April 30, 1991, the court did not draw a fine distinction because the parties had not done so at the initial hearings. Although the elemental differences in the doctrines are evident when a creditor attempts to establish a setoff or recoupment, they are blurred when a debtor invokes § 558, particularly in circumstances such as presented in this case. We note at the outset that § 553 of the Bankruptcy Code prescribes setoff but applies only to creditors. Recoupment is not mentioned in the Code but is utilized in bankruptcy by decision. *Lee v. Schweiker*, 739 F.2d 870, 875 (3d Cir.1984). Debtor's

4. Of course, any subrogation claim would be limited to the charges attributable to Debtor's use of the facility, which is significantly less than the total utility payments which Debtor makes. Lessor reimburses Debtor for the portions attributable to third-party usage.

5. The court also instructed Debtor's counsel to provide a transcript of that portion relative to surprise. Counsel did not do so. The court discovered none in its review of Kane's testimony.

6. Recoupment is "the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the abatement or reduction of such claim." 4 COLLIER ON BANKRUPTCY ¶ 553.03 (15th ed. 1991). The doctrine has been utilized in bankruptcy to allow prepetition claims to be reduced by postpetition obligations arising from the same transaction. *See, e.g., Waldschmidt v. CBS, Inc.,* 14 B.R. 309, 314 (M.D.Tenn.1981).

claim to setoff or recoupment, therefore, must be based on the implicit incorporation of the doctrines into § 558, or by way of preservation of the Debtor's defenses by contract, or by some common law entitlement. Thus, we examine only this defensive action by Debtor, invoking § 558, to determine whether the postpetition rent may be reduced by amounts owed to Debtor, prepetition, by Lessor.

Section 558 preserves to the Debtor its prepetition defenses to causes of action. In that context, either setoff or recoupment would be available as a defense and, if established, would result in a netting out of what each party owes the other.

[5] To establish setoff, the movant must show that there are mutual prepetition debts and that the result of the offsets will not improve the position of the creditor. The essential element of recoupment is that the debts must arise out of the same transaction. Setoff is a narrower, more restrictively applied doctrine than is recoupment. *See University Medical Center v. Sullivan*, 122 B.R. 919 (E.D.Pa.1990); *In re California Canners & Growers*, 62 B.R. 18 (9th Cir. BAP 1986); *In re Vaughter*, 109 B.R. 229 (Bankr.W.D.Tex.1989). The issues which typically arise with respect to setoff include how to determine what constitutes a prepetition obligation, how to define what is a mutual debt, and how to determine whether an improvement in position would result. With respect to recoupment, the issues tend to be focused on what constitutes the "same transaction."

Concerning setoff as applied in this case, the parties have substantiated the mutuality[7] of the debts and the court finds that neither Debtor's nor Lessor's position would be improved by virtue of the limitations to rent reduction authorized by the court in these opinions and orders. The problem is that Debtor seeks to offset its prepetition prepayment of taxes against its postpetition rental obligation. Were this a creditor seeking a setoff, that time differential would be fatal to applying setoff principles. However, because § 558 preserves to the Debtor the defenses it would have had prepetition, the court must examine the transaction as though the bankruptcy had not been filed.[8] Doing so eliminates the prepetition/postpetition distinction and, in essence, obliterates the requirement that the mutual debts must both be prepetition obligations in a § 558 context. Removing that distinction further obscures the difference between "setoff" and "recoupment." What remains clear in this case, though, is that without the time line barrier, Debtor has the defense of setoff available.

[6] The recoupment doctrine has a different constraint, i.e., the necessity that the debts arise out of the same transaction. In this case, the parties agree that the obligations at issue derive from the same transaction,[9] i.e., the sale and leaseback of Papercraft Park. *Cf., In re Vaughter*, 109 B.R. 229 (Bankr.W.D.Tex.1989) (obligations

7. Mutuality requires contemporaneous transactions between parties acting in the same capacity. *Stamp v. Insurance Company of North America*, 908 F.2d 1375 (7th Cir.1990). In this case the sale and leaseback were contemporaneous transactions by parties who had the same right and capacity, i.e., Debtor = Sellor and Lessee; Second Pennsylvania = Purchaser and Lessor. *See In re Drexel Burnham Lambert Group, Inc.*, 113 B.R. 830 (Bankr.S.D.N.Y.1990). *See also In the Matter of Bevill, Bresler & Schulman Asset Management Corp.*, 896 F.2d 54 (3d Cir.1990).

8. As stated in 4 COLLIER ON BANKRUPTCY ¶ 558.02 (15th ed. 1991), in order to defeat improper claims against the estate, the Trustee "must be able to assert all the defenses that the Debtor could have asserted had bankruptcy not intervened."

9. We note that setoff is used in situations in which the parties engaged in different transactions but see nothing to prohibit its use in this case. For this purpose, the sale could be seen as one transaction and the lease another. Part of the setoff involves unpaid interest due by Lessor to Debtor on the note and mortgage issued at the sale closing. That obligation is not part of the lease. However, the sale was subject to Debtor's agreement to lease back part of the building. In these circumstances, the parties intended to engage in a course of dealing through their contemporaneous transactions. To separate out the parts of the transaction is contrived. To say that all obligations arose from one contractual instrument is equally as contrived. This sequence of events is not uncommon in today's economic climate and leads to the conclusion that this whole transaction is the sum of its parts. The effort to characterize the events as separate or as one pinpoints even

arising from a lease are part of a recurring transaction which are governed contractually by the terms of the lease). We must then examine whether there is a contractual or other basis for recoupment.

The lease, which is an executory contract, does not require Debtor to pay taxes and utilities for third parties and to receive a credit against rent in exchange. However, the business practice of the parties was to have Debtor do so and to "net out" their claims via an annual reconciliation. There is, therefore, a course of dealing which purportedly recognizes recoupment.[10]

In the context of this case, whether one chooses to apply the label "setoff" or "recoupment" seems of little import. Because the court has required the Debtor to make the prerejection, postpetition rent payments in accord with the provisions of the lease, the court finds that recoupment is appropriate in this case despite Debtor's effort to reject the lease. The court has balanced the equities and exercises its discretion to limit the reduction to the April rent as indicated. In this case the netting out of the claims as provided by this court's opinion and order of April 30 and of today is permissible under either doctrine: setoff or recoupment. *See* footnote 9, *supra.*

Finally, after the court issued its opinion of April 30, Debtor filed an affidavit indicating that Frank Kane's testimony had been incorrect in its computation of the portions of the utilities which had been paid. Because the affidavit substantiates that there was *less* money paid to the utilities than Kane's testimony indicated, Lessor agreed to a recomputation of the setoff amounts based upon the information in the affidavit. Therefore, the motion for reconsideration concerning the amount of the offset will be granted. At page 12 of the Memorandum Opinion of April 30, 1991, the court found that Debtor had paid $37,871.61 with respect to utilities. The affidavit, however, substantiated that Debtor had paid only $26,229.50. Thus, the credit to Debtor against the April rent must be decreased by $11,642.11. The Order of April 30, 1991, will be amended to require Debtor to pay to lessor the rents which were due on April 1 to the extent that they exceed $56,716.40.

An appropriate Order will be entered.

further the confusion in labeling the "netting out" in this case as "setoff" or as "recoupment." The parties routinely conducted their business relationship in this fashion prepetition and it makes little sense to require a different practice while that relationship continues in Chapter 11. One author suggests that the origins of setoff may have their roots in the context of one transaction. *See* Sepinuck, *The Problems With Setoff: A Proposed Legislative Solution,* 30 WILLIAM & MARY L.REV. 51, 52–53 (1988). If this is so, the necessity to find two separate transactions for setoff may be unnecessary on the facts of this case.

10. Authority exists in the case law for the proposition that the Debtor may not recoup unless he *assumes* an executory contract. *See In re Memorial Hospital,* 82 B.R. 478 (W.D.Wis.1988), appeal dismissed, 862 F.2d 1299 (7th Cir.1988). *But see, University Medical Center v. Sullivan,* 122 B.R. 919 (E.D.Pa.1990) (recoupment permitted before executory contract was either assumed or rejected). This Debtor seeks to *reject* the lease and to terminate its landlord-tenant relationship with Lessor. Debtor has substantiated its entitlement to the defense of recoupment through custom and usage.

In re H. Maynard CLARK, Debtor.

McDEVITT & STREET COMPANY, Plaintiff,

v.

HAMMONS/CLARK PARTNERSHIP NO. 1; H. Maynard Clark; W.B. Scott and John Q. Hammons, individually and d/b/a Hammons/Clark Partnership No. 1; and Barclays Bank of North Carolina, Defendants.

C–C–91–102–P.

United States District Court, W.D. North Carolina, Charlotte Division.

April 30, 1991.

Appeal was taken from bankruptcy court orders denying motions for absten-

In re PAPERCRAFT CORPORATION, Debtor-In-Possession.

Bankruptcy No. 91-00903 JKF.
Motion Nos. 91-2790-M, 91-4352-M and 91-4169-M.

United States Bankruptcy Court, W.D. Pennsylvania.

July 11, 1991.

Lessor moved for payment of administrative rent, and debtor claimed offset. The Bankruptcy Court, Judith K. Fitzgerald, J., held that debtor would be permitted to offset its postpetition, administrative rents against note given by lessor which became due postpetition.

Ordered accordingly.

1. Bankruptcy ⟹2675

Debtor would be permitted to offset its postpetition, administrative rents against note given by lessor which became due postpetition. Bankr.Code, 11 U.S.C.A. § 558.

2. Bankruptcy ⟹2674

Lessor could not assert recoupment as equitable defense to debtor's claim that its administrative rental obligation should be offset against note given by lessor; lessor was movant in proceeding to compel payment of rents, with lessee not filing any action or raising any affirmative claim to recovery against it.

George M. Cheever, Pittsburgh, Pa., for Debtor.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, Pa., for Unsecured Creditors' Committee.

Robert G. Sable, Stephen J. Laidhold, Sable, Makoroff, Sherman & Gusky, P.C., Pittsburgh, Pa., for Second Pennsylvania Real Estate Corp.

MEMORANDUM OPINION

JUDITH K. FITZGERALD, Bankruptcy Judge.

Before the Court are various motions. We will discuss them seriatim.

1. May 1991 Rent, Motion No. 91-4352-M

Second Pennsylvania Real Estate Corporation, Debtor's landlord, seeks an order compelling Debtor's payment of administrative rent for May 1991.[1] The Debtor and Creditors' Committee contend that any amounts due for the month of May should be set off, along with any amounts due for the month of April, against an obligation Second Pennsylvania has to Debtor. That obligation consists of a matured note in the principal amount of $1,150,000.00 [2] ("the Note") which was due and payable in full on May 23, 1991. Second Pennsylvania failed to make the payment. The note is secured by a mortgage on real estate, a portion of which Debtor rents from Second Pennsylvania.

In Court during the hearing on June 18, 1991, the parties agreed that the amount of rent at the contract rate for the month of May without any setoffs was $101,770.59. Despite their agreement, the Court must find that the correct amount is $106,770.59. The Court believes the parties made a mathematical error. The $106,770.59 consists of the base rent in the amount of $88,333.33 per month plus the monthly tax allocation in the amount of $18,437.26.[3] In

1. This motion is pending at Motion No. 91-4352-M. Consolidated with this motion is Motion No. 91-2790-M (Second Pennsylvania's Motion to Compel Payment of Administrative Rent for April, 1991) and Motion No. 91-4169-M (Motion to Alter or Amend Judgment or Grant Relief from Judgment [concerning April rent]). These matters are inter-related and are consolidated specifically to enable the parties, if they desire, to file one appeal on all the issues raised in these motions rather than to present another court with pieces of the issues.

2. For purposes of this opinion the note shall be designated in its face amount, i.e., $1,150,000.00.

3. In the opinion explaining Judgment Order dated June 27, 1991, the Court considered the monthly allocation for prepaid taxes to be $18,435.71. The difference of $1.55 in this opinion

addition, the parties agree that Debtor made utility payments during the month of May in the amount of $19,132.43 which the Court finds to be a proper offset against the rental obligation. Therefore, the outstanding obligation at the contract rate of Debtor to Second Pennsylvania for the month of May for rent is $87,638.16.

Debtor filed this bankruptcy on March 22, 1991. By virtue of this Court's opinions of April 30, 1991, and June 14, 1991, at Motion No. 91-2790-M, the Court has determined that for any of the first sixty days postpetition during which Debtor had possession of the premises and had not rejected the lease it was obligated to pay rent at the contract rate. The sixtieth day was May 20, 1991. Debtor vacated the premises on May 22, 1991, but did not turn over full possession to the landlord until May 31, 1991.[4]

Of the $87,638.16 contract rent due for May, $56,540.75 [5] represents the portion which Debtor is obligated to pay according to the lease terms. The remaining $31,097.41 may or may not fall within the provisions of § 365(d)(3) requiring timely performance of nonresidential realty lease obligations depending on whether or not Debtor's pending motion to reject the lease is granted.[6] In the event that Debtor's motion is denied, some or all of the additional $31,097.41 rent at the contract rate may be allowable. In the event that the motion is granted, the issue will arise as to whether the contract rate will apply or whether the provisions of 11 U.S.C. § 502(b)(6) (limiting the allowed claim of lessors in some cases) and § 503(b)(1) (providing for payment of the actual and necessary costs and expenses of preserving the estate as administrative expenses) will apply and thereby alter the allowed rent claim. Until the motion to reject the lease is decided, the Court is in a position neither to determine the allowable rent claim nor its priority under the Bankruptcy Code nor to enter a judgment in favor of Second Pennsylvania for rents owed after May 20, 1991. Therefore, whether the rent owed after May 20, 1991 is due at the contract rate will be held in abeyance pending the outcome of Debtor's motion to reject the lease.

In accord with the earlier opinions of this Court, a judgment will be entered in favor of Second Pennsylvania and against Debtor in the amount of $56,540.75 representing the twenty (20) days in May, i.e., the remainder of the first sixty days postpetition in which the Debtor had actual possession of the premises and had not rejected the lease. By virtue of the judgment entered on June 27, 1991,[7] against Debtor for the $50,776.37 due as April rent and the judgment entered today for the $56,540.75 due as partial May rent, Debtor owes administrative rent at the contract rate in the amount of $107,317.12.

2. Creditors' Committee's Motion to Alter or Amend Judgment, Motion No. 91-4169-M

Debtor [8] and the Committee of Unsecured Creditors requested the Court to alter, amend or otherwise provide relief from the judgment order entered for April rent and, to the extent that the Court would

is based upon Second Pennsylvania's calculations because the parties stipulated to them in Court.

4. Between May 20 and May 31, 1991, Debtor sold certain excess furniture and equipment and allowed the buyer to remove it from the premises.

5. The calculation is as follows: $\$87,638.16 \times 20/31$ days in possession = $56,540.75.

6. Concerning Debtor's motion to reject the lease which was filed in April, 1991, Second Pennsylvania filed a response challenging Debtor's good faith in exercising its business judgment. An evidentiary hearing on that matter has been continued until September 16 and 17, 1991. If the motion is granted, § 365(g)(1) requires that the rejection be treated as a breach occurring immediately before the bankruptcy filing date, i.e., as a prepetition claim.

7. On June 14, 1991, the Court entered judgment in a larger amount but because the amount was incorrect, the judgment was vacated and a new judgment was entered on June 27, 1991.

8. Debtor filed its motion at Motion No. 91-4684-M which has been disposed of in a separate order without opinion. Thus, Debtor's argument is set forth herein.

enter an order concerning May rent, for that purpose as well. Debtor and the Creditors' Committee contend that although there is an obligation to pay administrative rent, Debtor, under § 558, has an additional offset available [9] because, on May 23, 1991, the Note in favor of Debtor granted by Lessor became due and payable in full and the payment was not made. The parties' briefs recite that on June 28, 1991, Debtor confessed judgment on the note in the principal amount of $1,150,000.00. As a result, there are competing judgments by and between Debtor and Second Pennsylvania.

[1] The law in Pennsylvania is well settled that competing judgments may be offset against each other on the theory that it is pointless to require one party to turn over dollars to another party only to receive them back. Therefore, the mutual reduction of the competing judgments is appropriate and Debtor will be permitted to offset [10] its administrative rents for the month of April and the period May 1 through May 20, 1991, in the total amount of $107,317.12 against the Note which Second Pennsylvania owes it. *See Fidelity Bank v. Act of America, Inc.*, 258 Pa.Super. 261, 392 A.2d 784, 785–86 (1978). Because an offset is appropriate, the Debtor's request for relief from payment of the judgment will be granted. Debtor will not be compelled to make a payment of the rents owed from April 1 through May 20, 1991, but shall offset the obligation against amounts owed to it by Second Pennsylvania.

3. Second Pennsylvania's Request for an Offset Under Motion to Compel Payment of Administrative Rent Motion No. 91–4352–M

The final issue for resolution is Second Pennsylvania's contention that its claim for Debtor's breach of the lease should be offset against its obligation to pay on the Note which came due May 23, 1991. The Court finds that this issue is not ripe. First, Debtor's motion to reject the lease has not been adjudicated. Until it is, neither the nature (i.e., pre- or postpetition) nor the amount of Second Pennsylvania's claim can be fixed. In addition, Second Pennsylvania asserts that a portion of its claim is the result of environmental damage caused by Debtor before and after the sale to Second Pennsylvania, which damage Debtor ultimately must remediate. The Court cannot determine at this time whether Second Pennsylvania has an allowable environmental claim or, if one is proven, whether it would qualify for setoff where Second Pennsylvania, a *creditor*, is the movant.[11] Next, Second Pennsylvania contends at page 9 of its Memorandum in Support of its Motion to Compel Payment of Rent filed on June 28, 1991, that if the motion to reject the lease is denied Second Pennsylvania will be in a position to meet the terms of the note. If that is the case, that fact also will be a factor in the determination of whether an offset is necessary or appropriate.

[2] Second Pennsylvania argues that even if it is not entitled to setoff now, recoupment is available to it as an eq-

9. Debtor and the Creditor's Committee both contend that setoff ought to be awarded on equitable grounds, citing Pennsylvania case law, because Second Pennsylvania is insolvent and to fail to allow setoff against an insolvent entity would deprive the Debtor forever of enforcing its valid claim. However, Second Pennsylvania argues with equal force that *Debtor* is insolvent. Thus, the Court is faced with a dispute as to the collectibility of competing judgments based upon the solvency or insolvency of both entities. The Court need not reach this issue now for the reasons stated in this opinion.

10. For the reasons expressed in this Court's opinion of June 14, 1991, the term "offset" is selected because, under § 558 of the Bankruptcy Code, the Debtor need not establish that the obligations to be offset all arose prepetition even though a creditor would have that burden under § 553. "Recoupment" also would apply to permit the netting out of these claims.

11. The parties dispute whether the matured note is a prepetition or postpetition obligation, a matter which the Court would have to decide if a creditor proves a prepetition environmental damage claim, but which is not significant to today's opinion. As movant, a creditor must establish the prepetition status of the mutual claims it wishes to set off under § 553, a requirement not applicable to Debtor's setoff under § 558.

uitable defense. However, Second Pennsylvania is the *movant* in the pending proceeding to compel payment of rents. Debtor has defended the concept of paying in cash by proving that there are credits to which it is entitled and which it may use as a setoff. Second Pennsylvania now tries to defend affirmatively against the defense, an action which is not contemplated in the motions practice in bankruptcy court. Debtor has not filed an action or raised any affirmative claim to recovery against Second Pennsylvania. Debtor's only course has been to establish why it should not be required to pay cash to an entity which owes cash to Debtor. Moreover, the parties dispute that all of Second Pennsylvania's claim would arise from the sale and leaseback transaction. Rather, they argue that some components may involve other events; for example, the environmental problem which Second Pennsylvania alleges was caused by Debtor prior to the sale and leaseback. The Court finds it premature to reach Second Pennsylvania's recoupment defense, which must await an appropriate action.

For the reasons expressed in this opinion, a Judgment Order will be entered against Debtor and in favor of Second Pennsylvania fixing its rent claim at the contract rate for the period from May 1 through May 20, 1991, in the amount of $56,540.75. Further, an Order will be entered granting relief from the Judgment Orders entered at Motion Nos. 91–2790–M and 91–4352–M to provide that those judgments may be set off against the judgment held in favor of Debtor and against Second Pennsylvania on the Note in the principal amount of $1,150,000.00.

ORDER

And now, to-wit, this 11th day of July, 1991, for the reasons expressed in the foregoing Memorandum Opinion, the Court finds:

A. At Motion No. 91–4352–M: the amount of the administrative contract rate rent for the period May 1 through May 20, 1991, owed by Debtor to Second Pennsylvania is $56,540.75 and judgment will be entered in that amount. There is an additional $31,097.41 claimed by Second Pennsylvania as the balance of the contract rate for the period May 21 through May 31, 1991, but whether this sum is entitled to treatment under § 363(d)(3) or must be treated under § 503(b)(1) must await the conclusion of Debtor's motion to reject lease which is scheduled for trial on September 16 and 17, 1991.

B. By virtue of the judgment orders entered this date at Motion No. 91–4352–M and on June 27, 1991, at Motion No. 91–2790–M, Debtor owes Second Pennsylvania $107,317.12 in administrative contract rate rent for the period April 1 through May 20, 1991.

Therefore, it is ORDERED

1. At Motion No. 91–2790–M (regarding April) and Motion No. 91–4352–M (regarding May), Second Pennsylvania's motions to compel payment of administrative rent are granted in part and denied in part as follows:

a. The motions are granted in that the initial sixty (60) day postpetition, pre-rejection rents are fixed at the contract rate and are allowed as administrative claims.

b. However, Debtor has established a valid setoff and recoupment claim against Second Pennsylvania on a judgment entered in favor of Debtor in the Court of Common Pleas against Second Pennsylvania on June 28, 1991. By virtue of that judgment, Second Pennsylvania owes Debtor $1,150,000.00 in principal on an outstanding matured note. Therefore, the motions are denied in that Debtor shall not be compelled to make a physical payment of the rent but shall set off its obligation to Second Pennsylvania against the $1,150,000.00 Note owed to it by Second Pennsylvania; and

2. The motion to alter or amend the judgment filed at Motion No. 91–4169–M is granted as modified herein. Debtor forthwith shall offset its April 1 through May 20, 1991, rental obligations as provided herein against the judgment in its favor held against Second Pennsylvania Real Estate Corporation; and

3. As a result of the setoff, Second Pennsylvania's principal obligation on the Note to Debtor is hereby reduced to $1,042,682.88.

JUDGMENT ORDER

And now, to-wit, this 11th day of July, 1991, it is hereby ORDERED that judgment is entered in favor of Second Pennsylvania Real Estate Corporation and against Debtor, Papercraft Corporation, in the amount of $56,540.75.

HOMEOWNERS FUNDING COMPANY, Appellant,

v.

Kenneth W. SKINNER and Mary K. Skinner, Appellees.

No. 91-66-CIV-5-F.

United States District Court, E.D. North Carolina, Raleigh Division.

May 20, 1991.

Secured creditor objected to confirmation of Chapter 13 plan. The United States Bankruptcy Court for the Eastern District of North Carolina denied objection, and appeal was taken. The District Court, James C. Fox, Chief Judge, held that claim of undersecured creditor, with security interest in debtors' mobile home, could be bifurcated with unsecured claim paid through plan and secured claim paid outside plan over period that extended beyond term of plan.

Affirmed and remanded.

1. Bankruptcy ⟹2852

Bankruptcy Code provision allowing bifurcation of claim into secured and unsecured portions based upon its value applies to Chapter 13 proceedings. Bankr.Code, 11 U.S.C.A. §§ 506(a), 1301 et seq.

2. Bankruptcy ⟹3708(9)

Claim of undersecured creditor, with security interest in debtors' mobile home, could be bifurcated with unsecured claim paid through plan and secured claim paid outside plan over period that extended beyond term of plan.

3. Bankruptcy ⟹3708(8)

When Chapter 13 debtor bifurcates undersecured claim, cures arrearages and maintains regular monthly payments until principal and accrued interest on secured portion has been paid, that secured claim has not been "provided for by the plan," within meaning of Bankruptcy Code cram down provision. Bankr.Code, 11 U.S.C.A. §§ 506(a), 1325(a)(5).

4. Bankruptcy ⟹3708(8)

Even if cram down requirements were applicable to Chapter 13 plan bifurcating undersecured creditor's claim, plan satisfied present value test by providing for payment in full of secured portion of claim plus contract rate of interest, with creditor's lien extinguished only upon satisfaction of debt. Bankr.Code, 11 U.S.C.A. §§ 506(a), 1325(a)(5)(B)(i, ii).

Theodore Adelbert Nodell, Jr., Raleigh, N.C., for Homeowners Funding.

William E. Brewer, Jr., Raleigh, N.C., for Kenneth and Mary Skinner.

ORDER

JAMES C. FOX, Chief Judge.

STATEMENT OF THE CASE

This is an appeal from an Order of the United States Bankruptcy Court for the Eastern District of North Carolina denying the creditor Appellant's objection to the confirmation of debtor Appellees' Chapter 13 Plan (hereinafter, the "Plan") and motion to dismiss said Plan.

Appellant has filed a brief asking that the Bankruptcy Judge's November 20, 1990, Order Regarding Confirmation of the

If there were in fact a transfer, HH defends as to "actual intent" under § 548(a)(1) on the grounds that Branch has failed to plead fraud with particularity. As to constructive fraud under § 548(a)(2), HH argues that BNEC received reasonably equivalent value.

A. *Failure to plead with particularity.*

Branch's pleading is sparse, it is true, and a motion for a more definite statement might be well founded, but I could not grant summary judgment on that basis. There is, however, another reason why Branch's actual fraud demi-count must fail.

The law of this circuit regarding the demonstration of actual intent is well settled. Since "[i]t is often impractical, on direct evidence, to demonstrate an actual intent to hinder, delay or defraud creditors," *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors,* 926 F.2d 1248, 1254 (1st Cir.1991), fraudulent intent may be inferred from the circumstances surrounding the transfer, with particular emphasis on the badges of fraud. *Anchor Properties,* 13 F.3d at 32.

> "Among the more common badges of fraudulent intent at the time of a transfer are: (1) actual or threatened litigation against the debtor; (2) a purported transfer of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and (5) retention by the debtor of the property involved in the putative transfer."

Id.

Any sums paid by BNEC to HH were under a contract effective December 23, 1986. *Findings* ¶ *3.* While the quoted list of badges of fraud is not exclusive, it is self-evident that payments under what appears to me to be a not unusual contract for advertising services is not the type of transfer contemplated under the rubric of actual fraud.

Since the Agreement is in evidence, and absent any contrary demonstration of genuine issues of fact by Branch, summary judgment is warranted. *Ralar,* 4 F.3d at 67.

B. *Reasonably equivalent value*

The parties devote a great deal of time in their memoranda to issues involved in "down streaming" value for the benefit of subsidiaries, and the related issues of whether the financial health of the subsidiary makes a difference. See the discussion in *Branch v. Federal Deposit Ins. Corp.,* 825 F.Supp. 384 (D.Mass.1993). It does not make a difference here. The reasonably equivalent value which BNEC received was actual cash transfers from the subsidiaries which were disbursed to HH. *Findings* ¶ *11.* The possibility of benefit to BNEC was not remote or contingent; it was actual and contemporaneous. The payments were not fraudulent transfers.

Conclusion

For the reasons stated, orders will enter granting defendant's motions to strike and for summary judgment.

In re PAPERCRAFT CORPORATION, a Pennsylvania corporation, Debtor.

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS and Committee of Creditors Holding Unsecured Claims, As Estate Representative of Papercraft Corporation, Plaintiffs,

v.

CITICORP VENTURE CAPITAL, LTD., a New York corporation, Defendant.

Bankruptcy No. 91-20903 JKF.
Adv. No. 91-2642.

United States Bankruptcy Court,
W.D. Pennsylvania.

April 22, 1994.

Committee of creditors holding unsecured claims objected to claims filed by cred-

itor in Chapter 11 case. Committee filed motion for partial summary judgment. The Bankruptcy Court, Judith K. Fitzgerald, J., held that: (1) creditor had sufficiently close relationship with debtor to place creditor within Bankruptcy Code's definition of "insider"; (2) creditor breached fiduciary duty by not disclosing, prior to purchase, its identity and its connection with debtor; and (3) creditor's claim would be allowed at face value, but creditor's recovery was limited to amount it paid for claims, without interest.

Motion granted.

1. Bankruptcy ⇐2827

Chapter 11 debtor's insider's fiduciary duty to debtor and estate required, at a minimum, that insider advise debtor, debtor's shareholders, committee of creditors holding unsecured claims, and those from whom it purchased claims against debtor of its identity and its connection with debtor. Bankr. Code, 11 U.S.C.A. § 101(31)(B).

2. Bankruptcy ⇐2827

Corporation had sufficiently close relationship with Chapter 11 debtor to place corporation within Bankruptcy Code's definition of "insider," where corporation had 28% equity position in debtor's parent corporation, corporation controlled at least one seat on boards of directors of parent, debtor, and debtor's principal subsidiaries, and those seats were occupied by corporation's vice president. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

See publication Words and Phrases for other judicial constructions and definitions.

3. Bankruptcy ⇐2827

Financial power over debtor may be insufficient in and of itself to make an entity an "insider," for purposes of Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

4. Bankruptcy ⇐2827

Whereas control, reasonable or otherwise, is not the only test of insider status under Bankruptcy Code, control may be one of many factors to consider in determining insider status. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

5. Bankruptcy ⇐3008.1

Corporations ⇐349

Upon insolvency of corporation, director's fiduciary duty extends to corporation's creditors and is enforceable by bankruptcy trustee.

6. Bankruptcy ⇐3008.1, 3021

Neither trustee nor corporation's director may make profit from bankrupt corporation.

7. Bankruptcy ⇐2827

Creditor, which had insider status under Bankruptcy Code due to its 28% equity interest in Chapter 11 debtor's parent corporation and its control of seats on boards of directors of parent, debtor, and debtor's principal subsidiaries, held same fiduciary duty to debtor as did creditor's vice president who sat on those boards, as though creditor were a de facto director of debtor. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

8. Corporations ⇐349

Although directors may purchase claims against their corporation when corporation is solvent, they are not entitled to do so at discount and enforce claims at full value when corporation is insolvent or has filed bankruptcy.

9. Bankruptcy ⇐3550

When Chapter 11 debtor's insider purchased claims against debtor in situation where Chinese wall was not implemented to prevent misuse of nonpublic information, and in situation which did not have any of the earmarks of arm's length transaction, bankruptcy court was not required to treat those claims equally with those of other creditors.

10. Bankruptcy ⇐2827

Availability of claims for purchase at a discount pursuant to corporation's bankruptcy constitutes a corporate opportunity, for purpose of determining whether corporation's insider has properly exercised that opportunity.

11. Corporations ⇐315

If corporation is unable to use corporate opportunity, director may do so if director

discloses to shareholders, the shareholders consent, and use of corporate opportunity by director is not detrimental to corporation.

12. Corporations ⚷320(11)

Even when purchasing claims against solvent corporation, director has heavy burden to establish fairness of conduct.

13. Corporations ⚷349

Appropriation of corporate opportunities by fiduciary of insolvent entity, even with approval of shareholders, directors, and officers, is impermissible when it results in detriment to creditors.

14. Bankruptcy ⚷2827

Chapter 11 debtor's insider, which held 28% equity position in debtor's parent corporation and which controlled seats on boards of directors of parent, debtor, and debtor's principal shareholders, made improper use of corporate opportunity in violation of fiduciary duty to debtor, its shareholders, and its creditors by purchasing claims against debtor without disclosing its identity and its connection to debtor when making purchases and by failing to obtain consent of shareholders for purchases.

15. Corporations ⚷410

As matter of Pennsylvania law, corporation's vice president was corporation's agent, and, thus, under doctrine of respondeat superior, corporation was liable for breach of fiduciary duty by vice president, who sat on Chapter 11 debtor's board of directors, with regard to purchase of claims against debtor.

16. Corporations ⚷397

Under Pennsylvania law, corporation's respondeat superior liability for actions of its vice president would exist even if vice president was only partially motivated by desire to serve corporation's interests.

17. Bankruptcy ⚷2827

In bankruptcy context, purchase of claims through or by debtor's insider must be governed by rules which differ from "normal market protocol." Bankr.Code, 11 U.S.C.A. § 101(31)(B).

18. Bankruptcy ⚷2827

Corporation that was insider of Chapter 11 debtor due to its 28% equity position in debtor's parent corporation, and its control of seats on boards of directors of parent, debtor, and debtor's principal subsidiaries, was required to disclose its identity and connection with debtor prior to purchasing debtor's notes in secondary market, where purchase had none of the earmarks of arm's length transaction, and failure to disclose was inherently unfair to selling noteholders as well as to debtor's shareholders, which should have had first opportunity to take advantage of that corporate opportunity.

19. Bankruptcy ⚷2827

Committee of creditors holding unsecured claims and Chapter 11 debtor were entitled to know at least the quantity and dollar value of claims being purchased by debtor's insider, particularly because insider and debtor were negotiating with respect to purchase of two subsidiaries of debtor as part of debtor's proposed reorganization plans.

20. Bankruptcy ⚷2827

Fact that member of committee of creditors holding unsecured claims purchased claims against Chapter 11 debtor did not prohibit penalizing debtor's insider for purchasing claims against debtor without disclosing its identity and connection with debtor, where member was not director of debtor and its purchase accounted for only three percent of its total investment in debtor, and member disclosed to sellers its identity and connection with debtor.

21. Bankruptcy ⚷2904

Bankruptcy court has power under Bankruptcy Rule to adjudicate disputes regarding claims transfers. Fed.Rules Bankr. Proc.Rule 3001(e), 11 U.S.C.A.

22. Bankruptcy ⚷2829

When Chapter 11 debtor's insider's purchase of claims against debtor breached fiduciary duty, was not accompanied by disclosures of its identity and connection with debtor, and constituted self-dealing, insider's claim would be allowed at face value, but insider's recovery would be limited to amount

it paid for claims, without interest. Bankr. Code, 11 U.S.C.A. § 101(31)(B).

23. Bankruptcy ⟹2829

Insiders cannot purchase claims from corporation in bankruptcy and enforce claims at their full value. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

24. Bankruptcy ⟹2827

It is improper use of bankruptcy process for insider to gain profits from its undisclosed superior access to information whether or not it took advantage of that access, particularly when it is at expense of prepetition creditors/sellers. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

25. Bankruptcy ⟹2835.1

Allowing award of interest to Chapter 11 debtor's insider, whose recovery on claims had been limited to amount paid for claims due to its breach of fiduciary duty and self-dealing with regard to purchases, would violate provision of Bankruptcy Code prohibiting disparate treatment among class members. Bankr.Code, 11 U.S.C.A. § 1123(a)(4).

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA, and Stephan M. Ray, Stutman, Treister & Glatt, Los Angeles, CA, for plaintiffs.

Paul K. Vey, William Pietragallo, II, Pietragallo, Bosick & Gordon, Pittsburgh, PA, and George J. Wade, Terri Brady, Shearman & Sterling, New York City, for defendant.

MEMORANDUM OPINION

JUDITH K. FITZGERALD, Bankruptcy Judge.

I. *Introduction*

The matter before the court is a motion for partial summary judgment on an objection to claims filed on behalf of the Committee of Creditors Holding Unsecured Claims and the Committee in its separate post confirmation capacity as representative of the estate of Papercraft Corporation (hereafter "Committee" and "Debtor" respectively). Pursuant to 11 U.S.C. § 502(b)(1), the Committee seeks to limit "the allowance of the claims" held by Citicorp Venture Capital, Ltd. (hereafter "CVC"), "to no more than the sum CVC actually paid for such claims." Motion for Partial Summary Judgment, Adversary No. 91–0642 at 1. Post petition, CVC purchased first and second priority notes on the secondary market and filed a claim for their face value. The allowance of the claim at the amount CVC paid would result in a distribution to CVC through the confirmed plan of reorganization (hereafter "the BDK Plan") of less than it expended to purchase the claim. Allowance at face value would result in a profit to CVC of nearly $5.5 million. A third alternative is to limit the plan distribution to CVC without disturbing the allowed amount of its claim.

A bankruptcy court may enter summary judgment "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c); Fed.R.Bankr.P. 7056. We find that this action is appropriate for disposition by summary judgment as there is no dispute of any relevant, material fact. Both parties are in agreement as to the following material facts:

(1) prepetition, CVC held no direct interests in or claims against Debtor.

(2) postpetition, while Debtor was insolvent, CVC purchased notes of Debtor with a face value [1] of $60,849,299.10. Deposition of M. Saleem Muqaddam at 156–61 (hereafter Muqaddam Deposition); Plaintiff's Exhibit 8.

(3) CVC's cost for the notes was $10,553,-541.88. *Id.*

(4) If the claims purchased by CVC are allowed at the face value of the notes, payments to CVC under Debtor's confirmed Chapter 11 plan would result in a profit of

1. Face value includes the actual face value of the notes and any accrued interest up to the date of bankruptcy.

nearly $5.5 million to CVC.[2] Declaration of Samuel M. Victor in Support of Motion for Partial Summary Judgment at ¶ 11.

(5) M. Saleem Muqaddam, at all times relevant, was a vice president of CVC and a member of the boards of directors of Debtor, Debtor's parent, and Debtor's principal subsidiaries.

The Issues

We are called upon to determine in this core proceeding whether CVC acted in bad faith or breached its fiduciary duties to Debtor and creditors of the estate by using inside information while purchasing its claims and formulating its offer to purchase the assets of Debtor's operating subsidiaries. This opinion constitutes findings of fact and conclusions of law.

Summary of Findings

[1] For the reasons which follow, we find, as a matter of law, that CVC is an insider of Debtor and that its fiduciary duty to Debtor and the estate required, at a minimum, that CVC advise Debtor, Debtor's shareholders, the Committee, and those from whom it purchased its claims of its identity and its connection with Debtor. CVC held its insider status through Muqaddam, CVC's representative on Debtor's board of directors, who is an insider by statutory definition. 11 U.S.C. § 101(31)(B). Through Muqaddam, CVC was able to purchase claims and had access to inside information, which was unavailable to other buyers or to the sellers, regarding the potential returns on and value of the notes purchased. It is the access to inside information which removes the purchase from the category of arm's length transactions and results in limitations on insiders' claims being applied to CVC.[3] *See Wolf v. Weinstein,* 372 U.S. 633, 83 S.Ct. 969, 10 L.Ed.2d 33, *rehearing denied,* 373 U.S. 928, 83 S.Ct. 1522, 10 L.Ed.2d 427 (1963). *See also In re Van Sweringen Co.,* 119 F.2d 231, 234 (6th Cir.), *cert. denied,* 314 U.S. 671, 62 S.Ct. 136, 86 L.Ed.2d 537 (1941) (a trustee can make no profit from his trust). We hold that because CVC is an insider its distribution through the plan of reorganization is limited to no more than the amount CVC actually paid for the notes it purchased. *In re UVAS Farming Corp.,* 91 B.R. 575, 577–78 (Bankr.D.N.M.1988). *Cf., In re Van Sweringen Co.,* 119 F.2d at 234 (purchase of claims of debtor corporations by corporation created by directors of debtors "at substantially less than real values" required that the claims be limited to the amount paid for their acquisition).

Accordingly, the Committee's motion will be granted in that CVC's distribution will be

2. The expected profit is calculated as follows:

	Face Value	Cents/Dollar	Plan Distribution
First Priority Notes	$34,725,575.72	33.46¢	$11,619,177.64
Second Priority Notes	26,123,723.38	16.73¢	4,370,498.92
	$60,849,299.10		$15,989,676.56
		Less Cost to Citicorp	10,553,541.88
		Expected Profit	$ 5,436,134.68

The "Face Value" amounts represent the full value, as defined in footnote 1, of First and Second Priority Notes held by CVC. *See* Muqaddam Deposition at 156–61 and Plaintiff's Exhibit 8. The "Cents/Dollar" distribution factors represent the approximate reorganization value of the notes under the BDK plan which was confirmed by this court. *See* Declaration of Samuel M. Victor in Support of Motion for Partial Summary Judgment, Motion for Summary Judgment, Exhibit 2 at ¶ 11. (Samuel Victor is the executive vice president and a principal of Chanin & Company, financial advisor to the Committee.) The "Plan Distribution" calculations are estimates of the amount to be distributed under the plan. The "Expected Profit" is based on the estimated distributions under the plan.

3. The federal securities laws have similar restrictions on persons possessing inside information and require disclosure prior to trading a security, absent which trading is prohibited. *See* Rule 10b–5 of the Securities Exchange Act of 1934. *See also* Rule 14e–3(a) of that Act concerning tender offers. The policies of disclosure and fairness to the public of the securities and bankruptcy laws are similar. For the case against applying federal securities laws to claims trading in bankruptcy *see* Anthony M. Sabino, *No Security in Bankruptcy: The Argument Against Applying the Federal Securities Laws to the Trading of Claims in Bankruptcy,* 23 Pacific L.J. 109 (1992).

limited to the amount it paid to purchase its claims, without interest.

II. Background

Debtor filed a voluntary Chapter 11 bankruptcy petition on March 22, 1991, largely as the result of carrying significant debt stemming from a leveraged buyout (hereafter "LBO") in 1985. The LBO, in which CVC was involved, transformed Debtor from a publicly traded company into a wholly owned subsidiary of its parent, Amalgamated Investment Corporation (hereafter "Amalgamated").[4] Through the LBO, CVC acquired a 28 per cent equity position in Amalgamated which entitled it to a seat on the boards of Amalgamated, Debtor, and Debtor's primary subsidiaries. Muqaddam held those seats, having been nominated by CVC.

During the period from the LBO to the bankruptcy filing, Debtor experienced a decline in business performance and was haunted by its heavy debt burden, resulting in debt restructuring agreements in 1989 and 1990.[5] The 1989 restructuring saw the exchange of approximately 98 per cent of Debtor's debentures for First Priority Notes and Second Priority Notes. *See* Declaration of Pamela M. Cascioli in Support of Motion for Partial Summary Judgment, Motion for Partial Summary Judgment at Exhibit 1. The 1990 agreement was approved unanimously by Debtor's board of directors, including Muqaddam, and was essentially what became the original BDK Chapter 11 plan of reorganization which Debtor filed on March 25, 1991, just three days after filing this bankruptcy. Its terms had been negotiated with the existing creditors prepetition. On March 22, 1991, the date of the bankruptcy filing, Debtor was liable for $90,717,358.00 on First Priority Notes and $56,318,768.00 on Second Priority Notes. On that date CVC held *none* of Debtor's First or Second Priority Notes.

Within one week of Debtor's bankruptcy filing and just a few days after the BDK plan was filed with Muqaddam's concurrence, Muqaddam obtained approval from CVC to expend in excess of $10,000,000 for the purchase of notes owed by Debtor. Without notifying Debtor[6] or the Committee, and without identifying CVC or its connection with Debtor through Muqaddam to the sellers, Debtor's shareholders, or the Committee, CVC authorized Muqaddam to purchase, on CVC's behalf, a total of $60,849,299.10 of Debtor's First and Second Priority Notes for a total expenditure of $10,553,541.83. *See* footnote 2 and Exhibit 8.[7] Muqaddam never sought Debtor's approval for the purchase (Muqaddam Deposition at 167), never dis-

4. Amalgamated filed a chapter 7 petition in this district on October 17, 1991, at Bankruptcy Number 91-3710. The combined debt of Debtor and Amalgamated exceeded $280 million.

5. According to the approved Disclosure Statement, Debtor sold substantial assets prepetition, thereby satisfying all but one of its secured debts. The remaining secured claim was approximately $300,000.00. Thus, at the time the bankruptcy was filed, Debtor's obligations to its noteholders were its largest debts. Its other debts included lease rejection and small priority claims, a pension liability which was assumed by Debtor's subsidiaries, and claims of affiliates and stockholders. For further explanation of the claims, see the Transcript of the Plan Confirmation Hearing dated January 21, 1992. The noteholders were all placed in Class 4, the general unsecured class, in the BDK plan.

6. *See, e.g.* Kane Deposition at 73 wherein Frank Kane, Debtor's former chief financial officer, states that he did not know of the note purchases by CVC until after the fact.

7. After acquiring the claims and before sending a "letter of interest" dated September 13, 1991, to Debtor's CEO, Michael C. Arnold, regarding forming new corporations to acquire assets and liabilities of certain other companies as part of the plan of reorganization, Muqaddam spoke with Pamela Cascioli, Chairperson of the Committee of Unsecured Creditors, and mentioned that CVC had purchased some notes. Muqaddam Deposition at 379–80. *See* Exhibit 14, letter dated September 13, 1991, from M. Saleem Muqaddam of CVC to Michael C. Arnold of Debtor. No details were provided, nor was the fact mentioned that CVC's acquisition put it in voting control of its class of creditors. Muqaddam Deposition at 379–80, 382. In a declaration attached to the Committee's Motion for Partial Summary Judgment, Cascioli stated that, before the September 13 letter, "a member of the Committee briefly mentioned ... that ... a member of the [prepetition] Informal Committee, had sold its notes, and a rumor that Citicorp had been the purchaser...." Motion for Partial Summary Judgment at Exhibit 1, ¶ 7. The discrepancy between Muqaddam's and Cascioli's statements is not material because in neither scenario was the disclosure timely or sufficient.

closed to Debtor or the Committee before it purchased (Muqaddam Deposition at 154–55, 167–68), and never disclosed so much as its identity or its relationship on the board of directors to the sellers (Muqaddam Deposition at 165–66). These purchases gave CVC voting control over Class 4, an impaired class of general unsecured claims, in the BDK plan. All trading occurred between April 1, 1991, and August 30, 1991. Through these purchases, CVC, which had no interest in or claims against Debtor prepetition, acquired approximately forty percent of all outstanding notes, thereby gaining the ability to control the voting in its class on a reorganization plan. As a further result of the purchases, CVC was in a position to gain a potential profit under the confirmed plan of approximately $5.4 million if its allowed claim were equal to the face value of the notes.[8] *See* Footnote 2 and Victor Declaration at ¶ 11.

Although Debtor filed the BDK plan three days after it commenced this case, it did not file an accompanying disclosure statement until October 25, 1991. Thus, the plan confirmation process was stymied. Prior to the confirmation of the BDK Plan and after the purchase of claims by CVC which gave it voting control over a plan, CVC convinced Debtor to take the unusual step of propounding a second, conceptually different plan. Thus, Debtor filed two plans—the previously filed BDK plan and the new CVC plan. The BDK plan essentially provided for a reorganization of Debtor through the formation of a new company by merger, a stock for debt exchange and certain cash payments. The second, "CVC," plan essentially was a cash offer by CVC to buy certain assets and operating subsidiaries of Debtor without acquiring certain associated liabilities. Neither the Debtor nor any other party in interest had solicited this offer. Muqaddam Deposition at 120–21. Thereafter, CVC filed objections to the BDK Plan.[9] After certain hearings, Debtor withdrew the CVC plan.

CVC's actions raise the question of whether CVC acquired its position as a noteholder so as to effect a takeover via its status as a "creditor" with voting control and/or to profit from a distribution significantly in excess of its acquisition cost under the guise of the Bankruptcy Code.[10] CVC did not acquire its claims in the same fashion as the other members of its class, who obtained their claims prepetition without knowledge of the bankruptcy or the anticipated distribution to unsecured creditors. *See Vultures Beware* at 924 and n. 39. Its failure to disclose to the selling noteholders that it had access to inside financial information which could assist in evaluating the return to the sellers through the reorganization if they had held their notes, whether or not the information

8. The ability to cause a rejection of the plan through voting control was a significant issue regarding the confirmability of a plan because of the claims structure in this case.

9. The consequence of this device is not unlike a hostile takeover attempt, albeit one with Debtor's name attached to the alternative plan. *See Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor*, 48 Bus.Law. 915, 924 (May 1993) (hereafter *Vultures Beware*).

The factual pattern just described falls within the prototype of "vulture investing" as it appears in *Vultures Beware:*

> The typical *modus operandi* of a vulture investor is to purchase trade claims, bank debt, or other securities at a discount from the face amount, and often to purchase sufficient voting power to enable the vulture investor to block confirmation of any plan of reorganization proposed for the debtor that the vulture investor does not like. (Footnote omitted.)

Vultures Beware, 48 Bus.Law. at 916.

Vulture investors may control the terms for the reorganization of a debtor in chapter 11 by means of the purchase at bargain prices of a blocking vote position in a significant debt class. This could enable a vulture investor to dictate the terms of the reorganization, which could result in very large rewards for the investor. The reason that vulture investors are able to reap such large returns is that some chapter 11 debtors end up in chapter 11 not so much because their businesses have gone bad, but because of the leveraged debt that they could not shoulder ... The result can [have] ... the vulture ending up with the dominant ownership position in a good business, after having paid a bargain price for a debt position which merely served as a means to acquire the debtor's business through the vehicle of chapter 11. (Footnote omitted.)

Id. at 917.

10. Obtaining voting control and achieving a profit may not be objectionable under other fact patterns. Here, however, an insider placed itself in such a position without making the necessary disclosures and is not entitled to profit from its efforts.

was used in CVC's purchase of claims, prohibited the sellers from accurately assessing the true market value of their claims or the loss or benefit to be derived from the sale. CVC's failure to disclose constituted a misuse or abuse of the bankruptcy process by an insider. *See* Joy Flowers Conti, Raymond F. Kozlowski, Jr., Leonard S. Ferleger, *Claims Trafficking in Chapter 11—Has the Pendulum Swung Too Far?*, 9 BANKRUPTCY DEVELOPMENTS JOURNAL # 2, at 281, 299 (1992) (hereafter *Claims Trafficking*).

III. CVC is an Insider

The Bankruptcy Code defines an insider of a corporate debtor as *including* directors, officers of the debtor, persons in control of the debtor (and other entities not relevant to the issue herein). 11 U.S.C. § 101(31)(B). Although there are numerous bankruptcy court decisions regarding the scope of the definition of "insider," few courts of appeals have passed on the question. Those which have addressed the issue agree that the definition's use of the word "includes" suggests an expansive interpretation of the term rather than a narrow one. *See Matter of Holloway*, 955 F.2d 1008 (5th Cir.1992); *Matter of Newcomb*, 744 F.2d 621, 625 n. 4 (8th Cir. 1984); *Matter of Missionary Baptist Foundation of America, Inc.*, 712 F.2d 206, 210 (5th Cir.1983). The broader view of the scope encompassed by the definition of insider is based on legislative history which teaches that an insider "is an entity or person with a 'sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.'" *Missionary Baptist*, 712 F.2d at 210, citing S.Rep. No. 95–989, 95th Cong., 2d Sess. *See also Matter of Holloway*, 955 F.2d at 1010; *Matter of Newcomb*, 744 F.2d at 625, n. 4. What constitutes a "sufficiently close relationship with the debtor" is a question of fact. *Cf., Matter of Holloway*, 955 F.2d at 1014 ("the determination of insider status is a question of fact.").

[2–4] We find that the undisputed facts[11] establish that CVC had a "sufficiently close relationship" with Debtor to place CVC within the statutory definition of insider.[12] Through its equity position in Amalgamated, Debtor's parent and affiliate as defined in 11 U.S.C. § 101(2), CVC controlled, pre-petition, at least one seat on each of the boards of directors of Amalgamated, Debtor, and Debtor's principal subsidiaries. These seats were occupied by CVC's vice president, Muqaddam. Muqaddam Deposition at 17–18, 21.

11. In its original answer to the Committee's Complaint CVC averred that the Committee's allegation of CVC's insider status was a conclusion of law. In its amended answer filed on December 23, 1991, CVC admitted its insider status, then denied it in its Response to First Request for Admissions filed on January 10, 1992. CVC again admitted its insider status in its Second Amended and Restated Answer to Complaint filed on May 18, 1992.

12. Cases in which insider status has been attributed to those not specifically enumerated in § 101 include *In re Holloway*, 955 F.2d 1008 (5th Cir.1992) (divorced spouses); *In re Tanner*, 145 B.R. 672 (Bankr.W.D.Wash.1992) (lovers); *In re Standard Stores, Inc.*, 124 B.R. 318 (Bankr.C.D.Cal.1991) (corporate debtor's president's ex-brother-in-law); *In re O'Connell*, 119 B.R. 311 (Bankr.M.D.Fla.1990) (friend who made several informal loans to the debtor); *In re Ribcke*, 64 B.R. 663 (Bankr.D.Md.1986) (parents of debtor's deceased wife); *Matter of Montanino*, 15 B.R. 307 (Bankr.D.N.J.1981) (parents of debtor's live-in fiance). Financial power over the debtor may be insufficient in and of itself to make an entity an insider. In *In re Torcise*, 146 B.R. 303 (Bankr.S.D.Fla.1992), the court held that, in order for a bank or its officers to be insiders in a preference action, they must have "unreasonable control" over the debtor or the debtor must have become the bank's alter ego or instrumentality. The instant action does not involve a preference. It involves an attempt to profiteer through a purchase at a deep discount, without disclosure. *Cf. In re Polk*, 125 B.R. 293 (Bankr.D.Colo.1991) (the degree of control as a factor in determining insider status). Whereas control, reasonable or otherwise, is not the only test of insider status, control may be one of many factors to consider in determining insider status. In this case CVC was a large shareholder in Debtor's parent and held seats on the boards of the parent, Debtor and Debtor's subsidiaries. Moreover, Muqaddam, its officer and one of Debtor's directors, was its instrumentality. Muqaddam testified in deposition that he acted for CVC's benefit and on its behalf. Muqaddam Deposition at 5, 11–12. *See also* Muqaddam Deposition at 398–99 (Muqaddam decided to object to confirmation of the BDK Plan because it restricted distribution to CVC). Through Muqaddam CVC achieved its insider status. Through Muqaddam CVC was a de facto director and therefore was in a position to and did exercise some control.

Muqaddam was CVC's representative on the board because Pennsylvania law requires that corporate directors be natural persons. 15 Pa.Cons.Stat.Ann. § 1722. Thus, CVC itself could not serve as a director and had to designate a natural person, i.e., Muqaddam, to act on its behalf. *See Commodity Futures Trading Comm'n v. Weintraub,* 471 U.S. 343, 348–49, 356, 105 S.Ct. 1986, 1991, 1995, 85 L.Ed.2d 372 (1985) (a corporation, as an inanimate object, empowers agents to act on its behalf). Muqaddam testified that his duties as an employee of CVC include investing on CVC's behalf. Muqaddam Deposition at 6. Other duties include serving on the boards of directors of other companies in which CVC holds investments. Muqaddam Deposition at 18–19. As a vice president of CVC, Muqaddam was responsible for acquiring and monitoring CVC's investment in Debtor and related entities. Muqaddam Deposition at 11–13, 153. *See also id.* at 6, 398–99 (Muqaddam objected to confirmation of the BDK plan because it restricted distribution to CVC). He acknowledged in his deposition that he served on Debtor's board on behalf of CVC (Muqaddam Deposition at 15) and that he acted as a director of Debtor to monitor CVC's investment. *Id.* at 20. Through Muqaddam's position on Debtor's board, CVC had access to financial information with respect to Debtor and its reorganization plans.

CVC argued at the hearing on the motion for partial summary judgment that the Committee had the same access "to management of the company" and to "the basic underlying facts." Notes of Testimony of June 24, 1992, at 41. However, it did not go so far as to contend that the Committee had equal access to the analyses of those facts or that the Committee was an entity sufficiently close to Debtor to be an insider. *Id.* Furthermore, CVC took part in various business decisions concerning Debtor, and was in a strategic and unique position regarding Debtor's restructuring and reorganization. This is further evidenced by the fact that when certain objections of CVC to the BDK plan were not withdrawn,[13] the issue of whether the plan was confirmable as fair and equitable without CVC's consent was present.

To illustrate CVC's superior access to financial and business information and its control over Debtor, we set out some of the facts of record. Muqaddam, while on Debtor's board, approached CVC with the proposition that CVC purchase claims against Debtor. CVC then authorized the purchases and provided the funds. Muqaddam testified with respect to CVC's proposed purchase of the assets of subsidiaries, Knomark and Barth & Dreyfuss, that he relied on "information about the businesses and some financial information about these companies from ... periods ... prior to 1990", Muqaddam Deposition 270 at lines 17–21, including data gleaned from a visit to Barth & Dreyfuss, as well as from published sources. Muqaddam Deposition at 270. Muqaddam also had financial projections that had been "supplied to the creditors' committee or were developed for that purpose." *Id.* at 271, lines 6–7. Some aspects of those projections were supplied to the Bank of New York with which CVC was discussing financing arrangements for the asset purchase plan that CVC was attempting to put together. *Id.* at 271. Further, Muqaddam expected CVC's offer through the CVC Plan to be accepted by the Committee because the value was within the range developed by the adviser to the predebt restructuring debenture bondholders. Muqaddam Deposition at 345. Muqaddam acquired this information from Debtor's management.[14] Muqaddam also testified that the CVC plan of reorganization filed by Debtor was based on CVC's proposed asset purchase. Muqaddam Deposition at 449. In order to prepare the asset purchase offer Muqaddam requested and received from Debtor a financial analysis of Debtor prepared by the Committee's accountant. Muqaddam Deposition at 488–89.

13. These entailed CVC's desire for (1) a seat on the board of the reorganized company and (2) a change in the distribution language of the plan. When those goals were achieved, the remaining objections were withdrawn, and the BDK plan was confirmed on January 21, 1992.

14. Muqaddam said he "heard" the range from management and that it was "possible" that he actually had seen valuations prepared by the bondholders' adviser. Muqaddam Deposition at 345–46.

Frank T. Kane, Debtor's former chief financial officer, testified that financial projections prepared by or for Debtor in connection with the bankruptcy were modified at the request of Muqaddam or a member of his staff with reference toward CVC's proposed asset purchase. Kane Deposition at 80–81 (hereafter "Kane Deposition"). Although the projections were a part of Debtor's records, they were never provided to Chanin & Company (the financial advisers to the Committee), to any member of the creditors' committee, or to its counsel. Kane Deposition at 81.[15]

Due to Muqaddam's unique position he was able to obtain financial information not otherwise available.

IV. *Fiduciary Duty*

[5, 6] Generally, a member of the board of directors holds a fiduciary duty "to promote the interests of the corporation." *United States v. Byrum,* 408 U.S. 125, 138, 92 S.Ct. 2382, 2391, 33 L.Ed.2d 238, *rehearing denied,* 409 U.S. 898, 93 S.Ct. 94, 34 L.Ed.2d 157 (1972).

> In general, officers and directors of a corporation are required to devote themselves to the affairs of the corporation with a view to promoting its interests rather than their own. They may not utilize their position in the corporation to obtain any personal profit or advantage beyond that enjoyed by its shareholders.

In re Gailey, Inc., 119 B.R. 504, 511 (Bankr. W.D.Pa.1990). Furthermore, it is a longstanding rule that "directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession." *See Commodity Futures Trading Comm'n v. Weintraub,* 471 U.S. 343, 355, 105 S.Ct. 1986, 1994, 85 L.Ed.2d 372 (1985). *See also Wolf v. Weinstein,* 372 U.S. 633, 649, 83 S.Ct. 969, 979, 10 L.Ed.2d 33, *rehearing denied,* 373 U.S. 928, 83 S.Ct. 1522, 10 L.Ed.2d 427 (1963). Upon insolvency of the corporation, the director's fiduciary duty extends to the corporation's creditors and is enforceable by the trustee. *See Pepper v. Litton,* 308 U.S. 295, 307, 60 S.Ct. 238, 245, 84 L.Ed. 281 (1939); *Brown v. Presbyterian Ministers Fund,* 484 F.2d 998, 1005 (3d Cir.1973). The fiduciary duty of a director of a bankrupt corporation has sometimes been compared to that of a trustee. Neither a trustee nor a director may make a profit from the bankrupt corporation. *See Magruder v. Drury,* 235 U.S. 106, 119–20, 35 S.Ct. 77, 82, 59 L.Ed. 151 (1914).

[7–9] Under the circumstances described in this opinion, CVC was an insider which held the same fiduciary duty to Debtor as did Muqaddam, as though CVC were a de facto director of Debtor. Although directors may purchase claims against their corporation when the corporation is solvent, they are not entitled to do so at a discount and enforce the claims at full value when the corporation is insolvent or has filed bankruptcy. *In re Bridgford Co.,* 237 F.2d 182, 185 (9th Cir. 1956). *See also Manufacturers Trust Co. v. Becker,* 338 U.S. 304, 313–14, 70 S.Ct. 127, 132–33, 94 L.Ed. 107 (1949), *Monroe v. Scofield,* 135 F.2d 725 (10th Cir.1943), *In re UVAS Farming Corp.,* 91 B.R. 575, 577 (Bankr.D.N.M.1988) (when a director purchases claims against its corporation in bankruptcy, recovery is limited to the amount paid for the claims). This is not a situation where a Chinese wall was implemented with policies and procedures effective to prevent the misuse of nonpublic information, *see In re Federated Dept. Stores, Inc.,* 1991 WL 79143 (Bankr.S.D.Ohio, March 7, 1991), nor does it have any of the earmarks of an arm's length transaction. The bankruptcy court is not required to treat these claims equally

15. Although projections were provided to the Committee, they apparently were not the same as those contained in the modifications provided to CVC. Kane Deposition at 80–88. CVC also requested, and was provided, projections of monthly working capital and income distribution but Kane was not sure if the numbers used were those based on CVC's assumptions or if the information was based on Debtor's projections. *Id.* at 85. However, Kane also testified that Muqaddam "or one of his representatives" had asked for "a monthly model for an income statement, balance sheet and cash flow to disclose to [CVC] the working capital changes and income statement movement within a prescribed period of time." *id.* at 87, with respect to the Barth & Dreyfuss subsidiary in order to determine that company's seasonal credit requirements. *Id.* at 88.

with those of other creditors.[16] *See Pepper v. Litton,* 308 U.S. at 306–07, 60 S.Ct. at 245.

Although Muqaddam was a director of Debtor, he acted on behalf of CVC, of which he was an officer, in its best interests and with its express approval. Muqaddam adhered to CVC's directives rather than to his fiduciary obligation to act in the best interests of Debtor and Debtor's estate. In so doing, his actions as a director of Debtor were taken with improper motive; that is, to benefit CVC, not to serve Debtor or its creditors. Through Muqaddam, CVC was able to obtain a blocking position with respect to the plan of reorganization which it then attempted to use in its own self-interest, to its advantage by the proposal of a plan different from the BDK plan.

[10, 11] Furthermore, the availability of claims for purchase at a discount pursuant to a bankruptcy constitutes a corporate opportunity. *Brown v. Presbyterian Ministers Fund,* 484 F.2d at 1004, *citing Weissman v. Weissman, Inc.,* 374 Pa. 470, 97 A.2d 870 (1953). Outside of bankruptcy, if the corporation is unable to use the corporate opportunity, a director may do so *if* the director discloses to shareholders, the shareholders consent *and* the use of the corporate opportunity by the director is not detrimental to the corporation. *CST, Inc. v. Mark,* 360 Pa.Super. 303, 520 A.2d 469, 471, *appeal denied,* 517 Pa. 630, 539 A.2d 811 (1987). *See also Robinson v. Brier,* 412 Pa. 255, 194 A.2d 204, 206–08 (1963). CVC disclosed nothing and failed to obtain the consent of Debtor's shareholder to the purchase.

[12–14] Even when purchasing claims against a solvent corporation, a director has a heavy burden to establish the fairness of the conduct. *Robinson v. Brier,* 194 A.2d at 206. Appropriation of corporate opportunities by a fiduciary of an insolvent entity, even with approval of the shareholders, directors, and officers, is impermissible when it results in a detriment to creditors. *Brown v. Presbyterian Ministers Fund,* 484 F.2d at 1005. Detriment is a relative term. In this case, at least two detriments are identifiable. The first befell the selling noteholders who, at the time of sale, were creditors of Debtor and were deprived of the ability to make an informed decision concerning the sale of their claims. If, after full disclosure, they had elected not to sell they would have received a total distribution of $15,989,676.56 rather than the amount paid by CVC of $10,553,541.88, a difference of more than $5.4 million. If they elected to sell at CVC's price after full disclosure, the harm attendant to them as the result of CVC's nondisclosure would not exist. *See Wolf v. Weinstein,* 372 U.S. 633, 83 S.Ct. 969, 10 L.Ed.2d 33 (1963). Even were there no harm to the selling noteholders, however, the other creditors were harmed. Debtor negotiated the BDK Plan with its creditors before it filed bankruptcy. CVC was not a prepetition creditor but it acquired enough claims postpetition to control the outcome of a plan and to induce Debtor to propound the "CVC Plan" which competed with Debtor's proposed BDK plan. The CVC plan would have turned over to CVC, through a purchase by a company to be formed by CVC, all of the valuable assets of Debtor. CVC's actions diluted the voting rights of the prepetition creditors by enabling CVC to acquire voting control from several entities, any of which, alone, may have been unable to control the class. This detriment was minimized by CVC's decision not to vote its claim, but creditors nonetheless were forced to incur costs and fees to investigate and challenge CVC's actions and their effects on the class of unsecured claims and seek relief through negotiation or court order—none of which would have been necessary had appropriate and timely disclosures been made. Thus, having failed to meet the first two requirements regarding the use of corporate opportunity, CVC similarly failed to meet the third.

16. At the hearing on the instant motion, counsel for CVC referred to *In re Marin Town Center,* 142 B.R. 374 (N.D.Cal.1992). The case concerned allowance of a vote on a plan in the context of good and bad faith in purchasing claims. However, there is no indication in the reported decision that the entity which acquired its creditor status by postpetition claims purchases was an insider or a fiduciary of the debtor. Moreover, CVC did not vote on a plan in this case. The case is not apposite to the situation before us.

V. *Respondeat Superior*

[15, 16] As a matter of law, Muqaddam was CVC's agent and, under the doctrine of respondeat superior, CVC is liable for Muqaddam's breach of fiduciary duty. *See* § IV, Fiduciary Duty, *supra.* CVC "knowingly permit[ted] its agent", Muqaddam, to purchase claims against Debtor, authorized his actions and provided him with the authority and the means to accomplish the purchase. *Moss v. Elan Memorial Park Corp.*, 400 Pa.Super. 555, 583 A.2d 1254, 1257 (1990). CVC, with knowledge of Muqaddam's dual role, expressly granted to Muqaddam the power and funds with which to purchase the claims and so is bound by Muqaddam's actions. *See Lokay v. Lehigh Valley Co-op. Farmers, Inc.*, 342 Pa.Super. 89, 492 A.2d 405, 409 (1985). Muqaddam was acting within the scope of his employment with CVC in purchasing the claims and his conduct was in furtherance of CVC's business inasmuch as he was charged with the responsibility of monitoring CVC's investments and ensuring their performance. Pennsylvania law dictates that under these circumstances CVC is liable for Muqaddam's conduct. *See Johnson v. Glenn Sand and Gravel*, 308 Pa.Super. 22, 453 A.2d 1048, 1050 (1982) (tort liability). In fact, CVC's liability would exist even if Muqaddam was only partially motivated by a desire to serve CVC's interests. *Shuman Estate v. Weber*, 276 Pa.Super. 209, 419 A.2d 169, 173 (1980).

VI. *Disclosure*

Case law under the former Bankruptcy Act warns against the dangers of trading in postpetition claims. Those dangers are present in Bankruptcy Code cases as well. In *Wolf v. Weinstein*, the United States Supreme Court articulated some concerns regarding trading in claims by insiders of an insolvent corporation:

> Access to inside information or strategic position in a corporate reorganization renders the temptation to profit by trading in the Debtor's stock particularly pernicious. The particular dangers may take two forms: On the one hand, an insider is in a position to conceal from other stockholders vital information concerning the Debtor's financial condition or prospects, which may affect the value of its securities, until after he has reaped a private profit from the use of that information. On the other hand, one who exercises control over a reorganization holds a post which might tempt him to affect or influence corporate policies—even the shaping of the very plan of reorganization—for the benefit of his own security holdings but to the detriment of the Debtor's interests and those of its creditors and other interested groups.

Wolf v. Weinstein, 372 U.S. at 642, 83 S.Ct. at 975. *Cf. Pepper v. Litton*, 308 U.S. at 307, 60 S.Ct. at 245 (fiduciary obligation exists to protect creditors as well as stockholders). More recently one commentator stated that

> This lack of disclosure has two effects. First, it is detrimental to the efficiency of the market for claims. An efficient market requires that both the buyer and the seller have access to information so that each party to the transaction can be adequately informed. Under Bankruptcy Rule 3001(e), as amended, large sophisticated purchasers of claims, who have the resources and incentives to closely monitor a chapter 11 case, have more information regarding the value of a claim than a small trade creditor, and the small trade creditor has no reasonable means to acquire that information. Second, because only the name of the transferee of record need be disclosed, parties in interest will be unable to ascertain who the real claims buyer is and the intentions of that claims buyer with respect to the control of a debtor.

Claims Trafficking, 9 BANKR.DEV.J. at 300 (footnotes omitted). The fact that CVC cannot physically maintain a seat on Debtor's board and must designate a natural person to fill its position, under the facts of this case, does not eradicate the dangers articulated in *Wolf v. Weinstein* and the *Claims Trafficking* article.

The filing of a bankruptcy creates a private market in securities and, without disclosure, creditors are at risk of selling claims "at extraordinary discounts, without understanding their rights". *In re Allegheny Int'l., Inc.*, 100 B.R. 241, 242 (Bankr.W.D.Pa. 1988) (footnote omitted). Muqaddam stated

that "normal market protocol" does not require disclosure of the identity of a buyer when claims are purchased through a broker. Muqaddam Deposition at 165–66, 176, 219–20. However, normal market protocol is not necessarily the applicable standard in a bankruptcy context where disclosure is a fundamental precept. *Cf. Commodity Futures Trading Comm'n v. Weintraub,* 471 U.S. at 357, 105 S.Ct. at 1995 ("by definition, corporations in bankruptcy are treated differently from solvent corporations").

[17] Much of the Bankruptcy Code is premised on disclosure.[17] For example, a debtor must disclose all of its assets and liabilities, regardless of their contingent or unmatured nature, 11 U.S.C. §§ 521, 101(5), (12), Fed.R.Bankr.P. 1007. A proof of claim filed by a creditor must identify the nature of the claim and supporting documentation must be attached if it exists. 11 U.S.C. §§ 501, 502, Fed.R.Bankr.P. 3001. A plan of reorganization cannot be confirmed without court approval of a disclosure statement containing "adequate information", 11 U.S.C. § 1125, according to the nature of the case and its creditors. In a bankruptcy context, the purchase of claims through or by an insider must be governed by rules which differ from "normal market protocol." It cannot be gainsaid that the selling noteholders' price demands may have been affected by the knowledge that the purchaser had access to inside information concerning the financial affairs of Debtor, its parent and its subsidiaries and that the purchaser could use such information in offering its bid price.[18]

[18, 19] This situation has none of the earmarks of an arm's length transaction and CVC's failure to disclose its identity and connection with Debtor was inherently unfair to the selling noteholders as well as to the shareholder, which should have had the first opportunity to take advantage of a corporate opportunity, whether or not it had the resources to do so. The Committee and Debtor were entitled to know at least the quantity and dollar value of the claims being purchased by CVC, particularly because CVC and Debtor were negotiating with respect to the purchase of Barth & Dreyfuss and Knomark, two subsidiaries of Debtor, as part of Debtor's proposed reorganization plans. Here, Muqaddam, an insider with a fiduciary duty to Debtor was the conduit through which his employer (CVC—a company in which Muqaddam is an officer and which had acquisition designs on Debtor's subsidiaries) purchased claims with absolutely *no* disclosure to the entities whose interests were affected by these actions.

Cases decided under the Bankruptcy Code express the necessity for the bankruptcy court to exercise its equitable powers and "sift the circumstances surrounding any claim to ensure that injustice or unfairness to creditors does not occur in administration of the bankrupt estate." *In re Allegheny Int'l., Inc.,* 118 B.R. 282, 302 (Bankr.W.D.Pa.1990), citing *Pepper v. Litton,* 308 U.S. at 307–08, 60 S.Ct. at 245–46. *See also In re Allegheny Int'l., Inc.,* 100 B.R. 241 (Bankr.W.D.Pa. 1988); *Matter of Executive Office Centers, Inc.,* 96 B.R. 642, 649–50 (Bankr.E.D.La. 1988); *In re UVAS Farming Corp.,* 91 B.R. 575 (Bankr.D.N.M.1988). In this case the lack of disclosure created an unfairness in that prepetition noteholders sold their claims in a transaction that was not at arm's length and was not on a "level playing field". The resulting sale was accomplished without the knowledge of sellers of the insider status of the buyer and without benefit to the sellers of access to inside information available to the buyer concerning the estimation of dividends the claim holders could anticipate through a plan—information available to all of Debtor's directors, including Muqaddam.

[20, 21] CVC argues that it should not be penalized because a member of the Commit-

17. "Disclosure is fundamental in a bankruptcy case." *Claims Trafficking,* 9 BANKR.DEV.J. at 302. "The interest of sellers in having adequate information available for them to make an informed decision and the interest of nonsellers who may find themselves controlled by a third party whose intent would be to minimize the value that goes to the nonsellers are the two interests that need to be protected in control contests." *Id.* at 304.

18. Whether or not such use actually existed or access to information actually provided the buyer with an advantage via superior knowledge is not dispositive.

tee, Magten Asset Management Corporation, also purchased claims. Magten, however, was not a director. It was Debtor's third largest prepetition creditor and the postpetition claims it purchased accounted for only three per cent of its total investment in Debtor. *See* Stipulation and Order Compromising and Settling Claims, Motion No. 91–9157(B) at Exhibit A. Moreover, Magten disclosed to the sellers its identity and connection with Debtor. Magten settled the causes of action brought against it for claims trading by agreeing to limit its recovery to the amount it paid for the claims, although the settlement included the allowance of the claims at their face value. *See* Stipulation and Order Compromising and Settling Claims, Motion No. 91–9157(b), at 9 ¶ 2.[19] Furthermore Magten's purchases *were on behalf of its customers,* not for its own account. At its customers' direction, Magten also sold claims it held for the benefit of its customers, again disclosing its identity and connection with Debtor to the ultimate purchasers. If CVC had not breached its duties by failing to disclose its activities and the extent thereof to Debtor and the Committee, and its identity and connections with Debtor to the sellers, a different result may have obtained.[20]

VII. Allowance of the Claim

[22–24] We now must determine the allowed amount of CVC's claim and the appropriate measure of payment under the plan. The Committee seeks to limit the amount of the claim to what CVC paid for the claims. There are many possible alternatives but three have been argued: (1) allowance of the claims at full face value of the notes purchased; (2) allowance of the claims limited to their actual cost to CVC; or (3) allowance of the claims at full face value of the notes purchased but limitation of recovery under the plan to actual cost with or without interest. For the reasons discussed below, we hold that the claim is allowed at face value but CVC's recovery is limited to the amount it paid for the claims, without interest. We agree with those cases that hold that insiders cannot purchase claims from a corporation in bankruptcy and enforce the claims at their full value. *See, e.g., In re Bridgford Co.,* 237 F.2d 182, 185 (9th Cir.1956), *cert. denied,* 352 U.S. 1005, 77 S.Ct. 566, 1 L.Ed.2d 550 (1957); *Monroe v. Scofield,* 135 F.2d 725, 728 (10th Cir.1943); *In re UVAS Farming Corp.,* 91 B.R. 575, 577 (Bankr.D.N.M.1988). This limitation removes the unfair advantage to be gained through undisclosed insider status and access to or use of inside information and protects the voting rights of the affected class of creditors. By eliminating the profit, a disincentive to "vulture trading" is established. CVC purchased its claims at a time when it could evaluate the risk of its acquisition to its advantage. It is an improper use of the bankruptcy process for an insider to gain profits from its undisclosed superior access to information whether or not it took advantage of that access, particularly when it is at the expense of prepetition creditors/sellers. By reducing the value of CVC's claim to its actual cost of purchasing the claim, CVC will bear the consequences of its failure to disclose. By limiting the return on CVC's claims there will be an additional distribution to all general unsecured creditors under the plan.

[25] CVC suggests that if its distribution is to be limited, the distribution should not be less than the amount it paid, plus interest. Its argument is that the Bankruptcy Code and the Bankruptcy Act do not provide for damages against an insider who purchases claims of a bankrupt. This argument misses the point. Payment to CVC of the full amount of its allowed, unsecured claim when other unsecured creditors are receiving less is not in accord with the distribution provisions of the Bankruptcy Code. The amount of CVC's recovery will be governed by the distribution provided to the applicable class under the confirmed plan of reorganization, based upon the allowed amount of its claim but capped at CVC's cost of $10,558,541.88. The limitation of the distribution is not a

19. 11 U.S.C. § 1123(a)(4) requires that a plan of reorganization "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment...."

20. The argument that this court cannot deal with this issue pursuant to Federal R.Bankr.P. 3001(e) is without merit. Even as amended in 1991, the bankruptcy court has the power under the Rule to adjudicate disputes regarding claims transfers.

damage award to any other party. It is a determination of Debtor's liability to CVC. Furthermore, CVC is not entitled to payment of interest. No other creditors in CVC's class will receive interest under the plan and there is no basis for providing special treatment to CVC's claim. Indeed, to do so would violate § 1123(a)(4) of the Bankruptcy Code which prohibits disparate treatment among class members.[21] *Cf. United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989) (interest allowed on oversecured claims if certain conditions exist). Furthermore, limiting CVC's distribution will create a disincentive to engage in similar behavior by others in the future when the transaction is not at arm's length and is brought about by or involves insiders who fail to make sufficient disclosure to the appropriate parties.

VIII. Conclusion

The parties argue for and against the existence and/or application of a *per se* rule which limits the allowance of claims purchased postpetition in circumstances such as those at bench. It may be that nondisclosure will not subject an insider who purchases claims to censure in some situations. *See, e.g., In re Federated Dept. Stores, Inc.,* 1991 WL 79143 (Bankr.S.D.Ohio, March 7, 1991) (procedures to safeguard various interests). Therefore, we do not grant partial summary judgment on the basis of a *per se* rule as the Committee asks. However, we find that no material disputed facts exist and, as a matter of law, CVC is an insider whose breach of fiduciary duty, failure to disclose, and self-dealing compel the limitation imposed herein on the distribution to be made on its allowed claim.

The issue of equitable subordination raised in the complaint is not before the court on this motion for partial summary judgment. Therefore, an order will be issued scheduling a conference on that issue.

An appropriate Order will be entered.

ORDER

And now, to-wit, this **22nd** day of **April, 1994,** for the reasons set forth in the foregoing Memorandum Opinion, it is **ORDERED, ADJUDGED AND DECREED** that the motion of the Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims, as Estate Representative of Papercraft Corporation, Plaintiffs, seeking partial summary judgment is **GRANTED.** CVC's claim is allowed as a general unsecured claim in the amount of $60,849,299.10. However, CVC's distribution pursuant to the confirmed plan of reorganization is limited to its cost to purchase the claims, i.e., $10,553,541.88. The $60,849,299.10 represents $34,725,575.72 in First Priority Notes and $26,123,723.38 in Second Priority Notes.

A status conference will be held on **April 25, 1994,** at **1:00 p.m.** as previously ordered.

In re Cosmo D. WALKER and Cynthia J. Walker.

CRESTAR BANK, Plaintiff/Appellant,

v.

Cosmo D. WALKER and Cynthia J. Walker, Defendants/Appellees.

Civ. A. No. 2:93cv343.
Bankruptcy No. 92–23138–B.

United States District Court,
E.D. Virginia,
Norfolk Division.

April 5, 1994.

Secured creditor objected to confirmation of Chapter 11 plan. The Bankruptcy

21. Section 1123(a)(4) of the Bankruptcy Code provides: "(a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall—(4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." CVC's request to have interest added to its allowed claim would give it preferential treatment, not the "less favorable treatment" authorized, upon consent, by the statute because no other creditor in CVC's class will be paid interest.

B.R. 837, 840 (Bankr.D.Colo.1992). In order to constitute proper notice, the notice given must be fair and reasonable under the circumstances. *In re Daniel,* 107 B.R. 798, 801 (Bankr.N.D.Ga.1989).

[4] Here, the notice received by the IRS was sufficient for several reasons. First, the IRS was listed as a creditor, the Debtor mailed notice to the IRS and the IRS acknowledged receipt of that notice. Second, although notice was sent to a service center and not to the special procedures division in Pittsburgh, there are no provisions in the Local Bankruptcy Rules which mandate or suggest that notice to the IRS must be sent to a special procedures division. As the bankruptcy court noted: "the IRS is a sophisticated creditor which files many proofs of claim and the duty to forward the notice to the proper department for filing the claim was solely within the control of the [IRS]." *See* Opinion, p. 6. Third, the Debtor acted diligently and in good faith by providing notice to the IRS at the address available to the Debtor for other important correspondence such as filing income tax returns and requesting refunds. Accordingly, the notice given was "reasonably calculated, under all of the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *Mullane v. Central Hanover Bank & Trust Co.,* 339 U.S. 306, 314, 70 S.Ct. 652, 657, 94 L.Ed. 865 (1950).

[5] In support of its position the IRS asserts that *In re Johnson,* 95 B.R. 197 (Bankr.D.Colo.1989), is "the most direct case on point." The *Johnson* court concluded that "upon a showing of extraordinary and compelling reasons [i.e. lack of timely notice], the period of time might be extended within which a creditor may file a proof of claim." *Id.* at 203. In the instant matter, however, the IRS did not request a time extension and offered no explanation for why "it did not become aware of [this case] until October 17, 1991." The IRS presented no evidence to support its contention that the address the Debtor used was not an address of the IRS. Likewise, the IRS offered no evidence that there was a more appropriate address available to the Debtor.

[6] It is a well settled that the aim of a Chapter 7 liquidation is the prompt closure and distribution of a Debtor's estate. *Pioneer Investment Services Co. v. Brunswick Assoc. Ltd. Partnership,* —— U.S. ——, 113 S.Ct. 1489, 123 L.Ed.2d 74 (1993). This principle could not be maintained if a creditor were permitted to file a late claim where it received adequate notice and simply failed to utilize procedures within its control to assure that such claims are properly forwarded to the appropriate internal division.

Conclusion

For the reasons set forth above, the decision of the Bankruptcy Court for the Western District of Pennsylvania will be affirmed.

In re PAPERCRAFT CORPORATION, a Pennsylvania Corporation, Debtor.

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS and Committee of Creditors Holding Unsecured Claims, as Estate Representative of Papercraft Corporation, Plaintiffs,

v.

CITICORP VENTURE CAPITAL, LTD., a New York Corporation, Defendant.

Bankruptcy No. 91-00903 JKF.
Adv. No. 91-0642.

United States Bankruptcy Court,
W.D. Pennsylvania.

Oct. 12, 1995.

Unsecured creditors committee filed adversary proceeding in Chapter 11 case, seeking equitable subordination and objecting to creditor's claim. The Bankruptcy Court, 165 B.R. 980, granted committee's motion for partial summary judgment. Subsequently,

the Bankruptcy Court, Judith K. Fitzgerald, J., withdrew its prior opinion and held that: (1) creditor that controlled seat on debtor's board of directors was "insider" of debtor, and, thus, was prohibited from purchasing claims against debtor without disclosing its identity and connection with debtor; (2) creditor's purchase of claims against debtor without making disclosures breached its fiduciary duty as director; (3) creditor's claim would be disallowed to extent that it exceeded purchase price of claims; and (4) equitable subordination of creditor's claims was not warranted.

Judgment accordingly.

1. Bankruptcy ⚷2904

Insiders of debtor are per se prohibited from purchasing claims against debtor without disclosing their identity and connection with debtor.

2. Bankruptcy ⚷2904

When claims are purchased by debtor's insiders without requisite disclosure to debtor and creditors, allowed amount of insider's newly acquired claim will be limited to amount paid by acquiring insider and recovery on claim will be limited to percentage distribution provided in plan, as applied to allowed claim.

3. Bankruptcy ⚷2021.1

Corporation had sufficiently close relationship with Chapter 11 debtor to place corporation within Bankruptcy Code's definition of "insider," where corporation had equity position in debtor's affiliate and controlled prepetition at least one seat on boards of directors of affiliate, debtor, and debtor's principal subsidiaries, and those seats were occupied by corporation's vice-president. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

See publication Words and Phrases for other judicial constructions and definitions.

4. Bankruptcy ⚷2021.1

Financial power over debtor may be insufficient in and of itself to make entity an "insider" of debtor, within Bankruptcy Code definition. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

5. Bankruptcy ⚷2021.1

While control, reasonable or otherwise, is not the only test of "insider" status under Bankruptcy Code, control is one of many factors to consider in determining insider status. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

6. Corporations ⚷398(1)

As matter of law, vice-president was corporation's agent and, under doctrine of respondeat superior, corporation was liable for vice-president's breach of fiduciary duty.

7. Corporations ⚷410

Under Pennsylvania law, vice-president was acting within scope of his employment with corporation, which held equity position in Chapter 11 debtor's parent corporation and controlled seats on boards of directors of debtor, parent, and debtor's subsidiaries, by purchasing claims against debtor, and his conduct was in furtherance of corporation's business inasmuch as he was charged with responsibility of monitoring corporation's investments and ensuring their aggrandizement, and, thus, corporation was liable for vice-president's conduct.

8. Corporations ⚷410

Under Pennsylvania law, corporation that held equity position in Chapter 11 debtor's parent corporation and controlled seats on boards of directors of debtor, parent corporation, and debtor's subsidiaries was liable for its vice-president's conduct in purchasing claims against debtor, even if vice-president was only partially motivated by desire to service corporation's interests.

9. Bankruptcy ⚷2904

Even if all records of Chapter 11 debtor were in public domain by virtue of bankruptcy, records constituted inside information when their existence was not disclosed except to insiders, for purpose of determining propriety of insider's purchase of claims against debtor without making disclosures to debtor and creditors.

10. Bankruptcy ⚷2904

Evidence established that all financial information about Chapter 11 debtor was not

of record at time that it was received by vice-president of corporation that held equity position in debtor's parent corporation and controlled seats on boards of directors of debtor, parent corporation, and debtor's subsidiaries, for purpose of determining propriety of corporation's purchase of claims against debtor without first making disclosures to debtor and creditors; unsecured creditors committee did not know that debtor prepared information and gave that information to vice-president, at his request, because he was director of debtor, and vice-president used that information in turn to further corporation's interests.

11. Bankruptcy ⚬=2021.1

Even if all financial information about Chapter 11 debtor had been on public record, that fact would not have changed "insider" status of corporation that held equity position in debtor's parent corporation and controlled seats on boards of directors of parent, debtor, and debtor's subsidiaries. Bankr. Code, 11 U.S.C.A. § 101(31)(B).

12. Bankruptcy ⚬=2021.1

Nothing in Bankruptcy Code indicates that entity's "insider" status is abrogated because some or all of debtor's financial information becomes public. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

13. Bankruptcy ⚬=2021.1

"Insider" status under Bankruptcy Code is function of entity's relationship to debtor and/or other insiders. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

14. Bankruptcy ⚬=2021.1

"Insider" status under Bankruptcy Code is not function of what, if any, financial information debtor publishes. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

15. Bankruptcy ⚬=2904

Evidence showed that intention of corporation, which held equity position in Chapter 11 debtor's parent corporation and controlled seats of boards of directors of parent, debtor, and debtor's subsidiaries, in purchasing claims against debtor was to benefit from its control of directorship by purchasing claims at discount, rather than to prevent loss of credibility in marketplace or obtain return on investment, for purpose of determining propriety of corporation's purchase of claims without first making disclosures to debtor and creditors.

16. Bankruptcy ⚬=2904

Fact and/or extent of unsecured creditors committee's knowledge of rumor that Chapter 11 debtor's insider had purchased claims against debtor was not controlling in determining whether insider had obligation to make disclosures to debtor and creditors before purchasing claims.

17. Bankruptcy ⚬=2904

Corporation that held equity position in Chapter 11 debtor's parent corporation and that controlled seats on boards of directors of parent, debtor, and debtor's subsidiaries had obligation to disclose its identity and status as insider to sellers, debtor, and unsecured creditors committee prior to purchasing claims against debtor.

18. Bankruptcy ⚬=2904

Conduct of corporation, which held equity position in Chapter 11 debtor's parent corporation and which controlled seats on boards of directors of parent, debtor, and debtor's subsidiaries, fell within "vulture investor" category of conduct that cannot be tolerated by fiduciaries in bankruptcy case, where corporation purchased claims against debtor without making prior disclosures to debtor and creditors, purchase of claims allowed corporation to gain control of plan voting in its class, corporation then filed objections to plan which were not withdrawn until it was promised seat on board of reorganized debtor and certain distribution language in plan was changed, and corporation offered plan that essentially was cash offer by corporation to buy certain assets and operating subsidiaries of debtor without acquiring certain associated liabilities.

See publication Words and Phrases for other judicial constructions and definitions.

19. Corporations ⚬=310(1)

Member of board of directors holds fiduciary duty to promote interests of corporation.

20. Bankruptcy ⇐2904

Evidence supported conclusion that while corporation, through its vice-president, served as director of Chapter 11 debtor, corporation acted in furtherance of its interests and did not carry out fiduciary obligation to act in best interests of debtor and its estate, but, rather, corporation sought to salvage or enhance its reputation and sought profit for itself, for purpose of determining propriety of corporation's purchase of claims against debtor; "Chinese wall" had not been implemented to prevent misuse of nonpublic information, and purchases were not at arm's length.

21. Corporations ⇐310(1), 349

Corporate directors of Chapter 11 debtor-in-possession bear same fiduciary obligation to creditors and shareholders as would trustee for debtor-out-of-possession.

22. Bankruptcy ⇐3008.1
Corporations ⇐349

Upon insolvency of corporation, director's fiduciary duty extends to corporation's creditors and is enforceable by bankruptcy trustee.

23. Corporations ⇐315

Directors may purchase claims against their corporation when corporation is solvent.

24. Bankruptcy ⇐2904
Corporations ⇐315

Directors are not entitled to purchase claims against their corporation at discount and enforce claims at full value when corporation is insolvent or has filed bankruptcy.

25. Bankruptcy ⇐2904
Corporations ⇐315

Availability of claims for purchase at discount pursuant to a bankruptcy constitutes corporate opportunity, and, thus, director who purchases claims without first providing corporate debtor with opportunity to make purchase violates his fiduciary duty.

26. Corporations ⇐315

Absent bankruptcy case, director may use corporate opportunity if director discloses to shareholders, shareholders consent, and use of opportunity by director is not detrimental to corporation.

27. Corporations ⇐320(11)

Even when purchasing claims against solvent corporation, director has heavy burden to establish fairness of conduct.

28. Corporations ⇐325

Appropriation of corporate opportunities by fiduciary of insolvent entity, even with approval of shareholders, directors and officers, is impermissible when it results in detriment to creditors.

29. Bankruptcy ⇐2904

Detriment to creditors of Chapter 11 debtor arose as result of debtor's insider's purchase of claims against debtor without first making disclosures to debtor and creditors, for purpose of determining whether insider, which controlled seat on debtor's board of directors, breached fiduciary duty, since selling creditors were deprived of ability to make fully informed decision concerning sale of their claims, corporation's actions diluted plan voting rights of prepetition creditors and resulted in corporation's attempt to wrest valuable assets of debtor from those creditors, and purchase put corporation in position of having conflict of interest.

30. Bankruptcy ⇐2904

When corporate debtor is insolvent in equity sense at confirmation of Chapter 11 plan, purchase by debtor's director of claims against debtor, particularly claims at discount, places too much strain upon director's loyalties.

31. Corporations ⇐314(.5)

Director of bankrupt corporation should have no conflicting interest in dealings on behalf of corporation with those holding claims against it.

32. Bankruptcy ⇐2321

Debtor must disclose all of its assets and liabilities. Bankr.Code, 11 U.S.C.A. §§ 101(5, 12), 521; Fed.Rules Bankr.Proc. Rule 1007, 11 U.S.C.A.

33. Bankruptcy ⇐2901.1

Proof of claim filed by creditor must identify nature of claim and include support-

ing documentation if it exists. Bankr.Code, 11 U.S.C.A. §§ 501, 502; Fed.Rules Bankr. Proc.Rule 3001, 11 U.S.C.A.

34. Bankruptcy ⚷3539.1

For Chapter 11 plan to be confirmed, disclosure statement containing "adequate information" must be approved by bankruptcy court. Bankr.Code, 11 U.S.C.A. § 1125.

35. Bankruptcy ⚷2904

Purchase of claims against Chapter 11 debtor by corporation that controlled seat on debtor's board of directors lacked essential earmark of arm's length transaction and was inherently unfair to selling noteholders and prepetition creditors, for purpose of determining whether purchase was in violation of director's fiduciary duties, where appropriate notice of purchase was not given to debtor and creditors.

36. Bankruptcy ⚷2921

Bankruptcy court is required to sift circumstances surrounding any claim to ensure that injustice or unfairness to creditors does not occur in administration of estate.

37. Bankruptcy ⚷2904, 2968

Usual remedy for improper purchase of claims at discount by fiduciary of debtor is to subordinate or disallow fiduciary's claim to extent that its face value exceeds amount paid.

38. Bankruptcy ⚷2904, 2932

When insider of Chapter 11 debtor improperly purchased claims against debtor at discount without first disclosing its identity and connection to debtor, insider's claim would be disallowed to extent that it exceeded purchase price.

39. Bankruptcy ⚷2968

Equitable subordination of claims of insider of Chapter 11 debtor was not warranted, even though insider failed to disclose its identity and connection with debtor before purchasing claims at discount, where there was insufficient evidence to establish that insider purchased claims with intent to harm debtor or defraud debtor's creditors, and bankruptcy court already had limited the allowed amount of insider's claim to amount it paid for claims.

40. Bankruptcy ⚷2967.5

Although misconduct or wrongdoing is not always prerequisite for subordinating claim, subordination must be considered on case-by-case basis with due regard to equities of particular case.

41. Bankruptcy ⚷2926

Burden rested on unsecured creditors committee to present material evidence of unfair conduct that would warrant equitable subordination of Chapter 11 debtor's insider's claims.

42. Bankruptcy ⚷2926

Once unsecured creditors committee would meet its burden of presenting material evidence of unfair conduct that would warrant equitable subordination of Chapter 11 debtor's insider's claims, insider would have to prove that its transactions with debtor were fair.

43. Bankruptcy ⚷2926

Burden on part of unsecured creditors committee, when seeking equitable subordination of claims of creditor who is not insider or fiduciary of debtor, is to prove that fraud or other culpable conduct occurred.

44. Bankruptcy ⚷2967.5

Subordination of claims is appropriate only to extent necessary to offset any harm to debtor or other creditors on account of untoward conduct.

45. Bankruptcy ⚷2967.5

Threefold test exists for propriety of equitable subordination: there must be (1) inequitable conduct which (2) caused injury to creditor or debtor or resulted in unfair advantage to creditor whose claim is sought to be subordinated and (3) equitable subordination must be consistent with Bankruptcy Code.

Philip E. Beard, Pittsburgh, Stephan M. Ray, Los Angeles, CA, for plaintiffs.

Paul K. Vey, Pittsburgh, PA, for defendant.

MEMORANDUM OPINION

JUDITH K. FITZGERALD, Bankruptcy Judge.

The matter before the court is an action by the Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (hereafter collectively "creditors' committee" or "committee") for equitable subordination and objecting to the claim of Citicorp Venture Capital, Ltd. (hereafter "CVC"). Previously this court addressed the allowance of the claim on a motion for partial summary judgment. By opinion and order dated April 22, 1994, we granted partial summary judgment to the committee. We allowed CVC's claim as a general unsecured claim in the amount of $60,849,299.10, the face value of the notes it purchased, but limited CVC's recovery to $10,553,541.88, the amount CVC paid for its claim. On November 14 and 15, 1994, trial was held to determine whether CVC's claim should be equitably subordinated. At the conclusion of trial the parties requested that we decide all issues raised in the adversary complaint based on the evidence and testimony adduced at trial.

[1, 2] In accordance with that request, we have considered the evidence, testimony, arguments, pleadings and briefs and vacate our order of April 22, 1994, granting partial summary judgment. Accordingly, we withdraw the opinion that accompanied the April 22, 1994, order. We now conclude that it is appropriate to apply a per se rule prohibiting insiders of a debtor from purchasing claims against it without disclosing their identity and connection with the debtor. We further hold that, when claims are purchased by insiders without the requisite disclosure to the debtor and creditors, the allowed amount of the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim.

The following facts were established by stipulation of the parties or from the evidentiary record:

1. In 1985, Debtor completed a leveraged buyout (LBO) with the assistance of an affiliate of CVC.
2. The LBO transformed Debtor from a publicly traded company into a wholly-owned subsidiary of Amalgamated Investment Corporation (hereafter "Amalgamated").
3. CVC acquired a 28% equity position in Amalgamated as a result of the LBO. It wrote off the equity position in 1987 because it expected no return on its investment.
4. At all relevant times, a representative of CVC sat on the boards of directors of Amalgamated, Debtor, Barth & Dreyfuss and Knomark, subsidiaries of Debtor. After 1989, that representative was CVC's Vice President, M. Saleem Muqaddam, who served on the boards of those companies.
5. Barth & Dreyfuss and Knomark were subsidiaries of Debtor at all relevant times.
6. In April of 1989, Debtor completed a restructuring of its debt which resulted in an exchange of approximately 98% of Debtor's debentures for unsecured First Priority and Second Priority notes.
7. The First Priority Notes were issued under an Indenture dated May 15, 1989, and were to mature on October 1, 1994. An aggregate amount of $90,717,398 (principal plus accrued interest) was outstanding on the date Debtor's chapter 11 case was filed.
8. The Second Priority Notes were issued under a separate Indenture, also dated May 15, 1989, and were to mature on April 1, 1995. An aggregate amount of $56,318,767 (principal plus accrued interest) was outstanding on the date the chapter 11 case was filed.
9. Debtor was unable to meet the terms of the notes. Therefore, in the fall of 1990, Debtor sought another restructuring of its unsecured debt and began pre-bankruptcy negotiations with creditors who were part of what has been termed in this case the "Informal Committee".
10. After several months of prepetition negotiations, Debtor and the Informal Com-

mittee reached an agreement on what is called herein the BDK Plan of Reorganization which was to be filed in conjunction with a chapter 11 case.

11. The BDK Plan would effect a reorganized enterprise and was unanimously approved by Debtor's board, including CVC through Muqaddam, in March of 1991.

12. Debtor filed a voluntary chapter 11 petition on March 22, 1991.

13. At that time, CVC held none of Debtor's First or Second Priority Notes and was not a creditor of Debtor.

14. Debtor was insolvent on the filing date and all relevant times thereafter.

15. On March 25, 1991, three days after this bankruptcy began, Debtor filed the BDK Plan, without a disclosure statement. A disclosure statement was not filed until October 15, 1991.

16. In March of 1991, Muqaddam sought the approval of CVC's Investment Committee for CVC to purchase Papercraft notes.

17. On April 1, 1991, CVC's Investment Committee granted approval for CVC to purchase up to $10 million of Papercraft notes.

18. In early May, 1991, Muqaddam prepared a review of CVC's investment in Amalgamated.

19. CVC purchased $60,849,575.72 face value of the Papercraft notes for $10,553,541.88 between April and August of 1991. Approximately $7.4 million (more than 70%) of CVC's purchases of Papercraft notes were made on or after August, 19, 1991.

20. CVC acquired 38.3% of Debtor's First Priority Notes, 46.4% of Debtor's Second Priority Notes, and 40.8% of Debtor's total unsecured claims.

21. CVC neither requested nor obtained the approval of Debtor's board, the creditors' committee, or the court to buy the notes.[1]

22. Debtor learned of CVC's initial purchases of notes by May, 1991, that is, after CVC made the purchases. Its counsel became aware that CVC had purchased some claims by June of that year. Debtor and its counsel also learned of CVC's later purchases.

23. In April of 1991, the committee heard a rumor that CVC was purchasing claims. The committee heard no more about it until CVC made its asset purchase offer in September of 1991. Neither CVC nor Debtor communicated to the committee the status or extent of CVC's purchases.

24. CVC acquired the RTC's First Priority and Second Priority Notes for 25¢ and 12¢ on the dollar, respectively. Magten unsuccessfully bid for the notes at 20.5¢ and 10.5¢. When CVC bought the RTC's notes, Muqaddam estimated that the RTC controlled approximately 20% of Debtor's total unsecured claims.

25. At the values established by this court at the BDK plan confirmation hearing, noteholders received an interest in BDK Units equal to 33.5¢ on the dollar for First Priority Note claims and 16.75¢ on the dollar for Second Priority Note claims.

26. At Muqaddam's direction, and with the knowledge and consent of Debtor's management, two employees of CVC, Noelle Cournoyer and Nils Havgestad, visited Barth & Dreyfuss in January or February of 1991. The purpose of the visit was to obtain information about the company in the event that CVC decided to make an asset purchase proposal. During their 1½ day visit, CVC's representatives obtained current Barth & Dreyfuss financial statements, looked at the company's product

1. On or about May 23, 1991, while it was a member of the creditors' committee, Magten purchased, on behalf of clients, approximately $3.8 million in Second Priority Notes from Oppenheimer & Co. for approximately $379,000. Oppenheimer was a member of the Informal Committee and acknowledged in writing that it knew Magten was the purchaser. Magten also made other offers to purchase Papercraft notes, again on behalf of clients. In January, 1991, Magten entered into a settlement agreement by which it agreed to receive no more than its cost of these claims at the time of distribution under the plan. Magten disclosed to those entities from which it purchased notes its position with the committee and the bankruptcy. Unlike CVC, Magten had disclosed its identity and connection with Debtor. Furthermore, Magten was not buying notes for its own account, as was CVC, but for accounts of its customers.

lines, discussed the company with its management, and toured the plant.

27. Cournoyer prepared a written report on Barth & Dreyfuss, drafts of which were provided to Debtor, but not to the committee.

28. Frank Kane, the Chief Financial Officer of Debtor, reviewed drafts of the Barth & Dreyfuss report and gave his comments to Muqaddam. Kane did not discuss the report with or provide it to the committee.

29. Kane, Muqaddam, and a representative of the Bank of New York Credit Corporation (BNYCC), a Barth & Dreyfuss lender, held a meeting on June 14, 1991. At that meeting, Muqaddam made a presentation to BNYCC for financing a possible purchase of Barth & Dreyfuss and Knomark by CVC.

30. At some point during or after the meeting, Muqaddam gave BNYCC a copy of the Barth & Dreyfuss report and a one page summary of a possible structure for an asset purchase transaction.

31. Muqaddam received a financing term sheet from BNYCC dated August 12, 1991. He provided a copy of the term sheet to Kane and obtained Kane's comments on the term sheet. CVC agreed to the terms.

32. After the filing of the bankruptcy, Debtor, through Kane and Andre Francois, Debtor's manager of corporate accounting, reviewed documents prepared by CVC and prepared documents for Muqaddam and Cournoyer with respect to the proposed asset purchase.

33. Chanin and Company was the financial advisor to the committee. On July 18, 1991, Debtor's Chief Executive Officer, Michael Arnold, faxed Chanin and Company's enterprise valuation to Muqaddam. Arnold received the valuation on July 16, 1991.[2]

34. Kane faxed Chanin and Company's distressed sale analysis to Muqaddam on August 6, 1991.

35. At Muqaddam's request, Debtor engaged Arthur Andersen & Co. to analyze whether CVC's note purchases would have any adverse tax effect on Debtor.

36. Debtor received a written tax analysis from Arthur Andersen & Co. dated August 26, 1991. Kane faxed a copy of the tax analysis to Muqaddam.

37. Muqaddam prepared a memo to CVC's Investment Committee dated August 23, 1991, requesting authority to make an offer to purchase the valuable operating subsidiaries of Debtor, i.e., Barth & Dreyfuss and Knomark.

38. Thereafter, in August of 1991, CVC's Investment Committee granted Muqaddam authority to cause CVC to make an asset purchase offer.

39. On August 26, 1991, Muqaddam sought and obtained the approval of CVC's Investment Committee to increase note buying authority from $10 million to $15 million.

40. In the week before CVC made its asset purchase offer, that is, before September 13, 1991, Muqaddam called Pamela Cascioli, chairperson of the creditors' committee, and informed her that CVC was contemplating making an offer to purchase Debtor's assets. He also indicated that CVC had purchased Papercraft notes, including those held by the RTC. This was the first time that CVC informed the creditors' committee that it intended to make an asset purchase offer. It also was CVC's first communication or confirmation to the committee of the fact that CVC had purchased notes.[3]

41. Shortly before September 13, 1991, Muqaddam provided drafts of an asset purchase agreement to Debtor for its review and comment.

2. The parties stipulated to July 16, 1994, but the 1994 date may be a typographical error. The date that Arnold received the information is not material, however. The pertinent fact is that Muqaddam received Chanin and Company's enterprise valuation from Arnold.

3. In his pretrial declaration, Muqaddam states that "CVC made formal disclosure to entities that were members of the Creditors' Committee much earlier" than September of 1991. Defendant's Pre-Trial Evidentiary Submission, Declaration of M. Saleem Muqaddam, Docket Entry 122. However, we do not credit his statement. The weight of other testimony and all of the credible evidence establishes that this did not occur.

42. CVC made its asset purchase offer in a letter to Debtor dated September 13, 1991. BNYCC had agreed to provide financing.
43. On October 15, 1991, Debtor filed an amended version of the BDK Plan which was further amended on subsequent occasions.
44. Debtor also filed a second plan, the CVC Plan, at CVC's suggestion, on October 15, 1991. CVC's asset purchase offer formed the cornerstone of the CVC Plan. CVC consented to the use of its asset purchase offer in the CVC Plan.
45. Debtor filed a disclosure statement for the Amended BDK Plan on October 15, 1991, and a disclosure statement for the CVC Plan on the same date.
46. The court approved the BDK disclosure statement on December 17, 1991.
47. CVC filed objections to confirmation of the Amended BDK Plan on January 14, 1992, because the creditors' committee did not agree to CVC's claim based on the face amount of the notes. The plan was confirmed on January 21, 1992.
48. Debtor retained the exclusive right to file a plan from the date of the filing of the bankruptcy through the plan confirmation.
49. When purchasing claims, CVC did so through brokers which resulted in CVC's identity not being revealed.[4]

For the reasons which follow, we find that CVC's nondisclosure of its claims purchases was inappropriate and we adopt a per se rule against "insider trading" in bankruptcy cases absent pre-purchase disclosure of the insider's identity, connection to the debtor, and nature of the activity. CVC is an insider by definition under the Bankruptcy Code. 11 U.S.C. § 101(31)(B). In our prior opinion we analyzed in detail CVC's insider status by virtue of its relationship with Muqaddam and Amalgamated. *See In re Papercraft Corporation,* 165 B.R. 980, 987 & n. 12 (Bankr. W.D.Pa.1994). We repeat that analysis here.

The Bankruptcy Code defines an insider of a corporate debtor as *including*

> directors, officers of the debtor, persons in control of the debtor and other entities not relevant to the issue herein.[5]

11 U.S.C. § 101(31)(B). Although there are numerous bankruptcy court decisions regarding who an insider might be, few courts of appeals have passed on the question. Those which have addressed the issue agree that use of the word "includes" in defining "insider" suggests an expansive interpretation of the term rather than a limited one. *See Matter of Holloway,* 955 F.2d 1008 (5th Cir. 1992) (rehearing denied); *Matter of Newcomb,* 744 F.2d 621, 625 n. 4 (8th Cir.1984); *Matter of Missionary Baptist Foundation of America, Inc.,* 712 F.2d 206, 210 (5th Cir. 1983). The unrestricted view of the definition of insider is based on legislative history. *In re Missionary Baptist Foundation of America, Inc.,* 712 F.2d at 210. That history teaches that an insider "is an entity or person with a 'sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.'" *Id.,* citing S.Rep. No. 95–989, 95th Cong., 2d Sess. U.S.Code Cong. & Admin.News p. 5787. *See also Matter of Holloway,* 955 F.2d at 1010; *Matter of Newcomb,* 744 F.2d at 625, n. 4. What constitutes a "sufficiently close relationship with the debtor" is a question of fact. *Cf., Matter of Holloway,* 955 F.2d at 1014 ("the determination of insider status is a question of fact").

[3–8] We find that the facts establish that CVC had a "sufficiently close relationship" with Debtor to constitute CVC a statutory insider.[6] Through its equity position in

4. CVC switched brokers, from Citicorp Securities Markets, Inc., to UBS Securities, when Citicorp Securities had been unsuccessful in obtaining the notes held by the RTC for CVC.

5. "Person" is defined as including corporations. 11 U.S.C. § 101(41). However, CVC is not "in control of" Debtor insofar as it lacks voting stock. To the extent that it had its representative (Muqaddam) on Debtor's board CVC had influence but alone could not control Debtor's day-to-day functioning.

6. Cases finding insider status of those not specifically identified in § 101 include *In re Holloway,* 955 F.2d 1008 (5th Cir.1992) (divorced spouses); *In re Tanner,* 145 B.R. 672 (Bankr.W.D.Wash. 1992) (lovers); *In re Standard Stores, Inc.,* 124 B.R. 318 (Bankr.C.D.Cal.1991) (corporate debtor's president's ex-brother-in-law); *In re O'Connell,* 119 B.R. 311 (Bankr.M.D.Fla.1990) (friend

Amalgamated, Debtor's affiliate, 11 U.S.C. § 101(2), CVC controlled, prepetition, at least one seat on the boards of directors of Amalgamated, Debtor, and Debtor's principal subsidiaries. These seats were occupied by CVC's vice president, Muqaddam. Deposition of M. Saleem Muqaddam at 17–18, 21 (hereafter "Muqaddam Deposition"). Through Muqaddam's position on Debtor's board, CVC had access to financial information with respect to Debtor and its reorganization plans. Furthermore, CVC took part in various business decisions concerning Debtor, and was in a strategic position regarding Debtor's restructuring and reorganization. Muqaddam was on Debtor's board because Pennsylvania law requires that corporate directors be natural persons. 15 Pa. Cons.Stat.Ann. § 1722. Thus, CVC itself could not serve as a director of Debtor and, instead, placed on Debtor's board[7] Muqaddam as its representative. Muqaddam testified that his duties as an employee of CVC include investing on CVC's behalf. Muqaddam Deposition at 6. He acknowledged in his deposition that he served on Debtor's board on behalf of CVC and that he acted as a director of Debtor with CVC's best interests in mind. As a vice president of CVC, Muqaddam was responsible for acquiring and monitoring CVC's investment in Debtor and related entities. Muqaddam Deposition at 11–13, 153.

Muqaddam, while on Debtor's board, approached CVC with the proposition that CVC purchase claims against Debtor. CVC then authorized the purchases and provided the funds. Financial projections for two of Debtor's subsidiaries, Barth & Dreyfuss and Knomark, were prepared to assist the committee by the committee's financial advisor, Chanin and Company. The committee shared that information with Debtor. Without the committee's knowledge or consent, it was then given to Muqaddam by Debtor's senior management to assist CVC in constructing an asset purchase offer. Debtor assisted in modifying the projections at Muqaddam's request because he was a director of Debtor. The modifications were made with information obtained by CVC through a site visit to the subsidiaries by Cournoyer and Havgestad. These modified projections, although part of Debtor's records, were never provided to the committee, its counsel, or its financial advisor. Muqaddam evaluated the subsidiaries and knew that the price range at which their acquisition would be made would be below the potential economic values of the companies. He expected CVC to make a

who made several informal loans to the debtor); *In re Ribcke*, 64 B.R. 663 (Bankr.D.Md.1986) (parents of debtor's deceased wife); *Matter of Montanino*, 15 B.R. 307 (Bankr.D.N.J.1981) (parents of debtor's live-in fiance).

Financial power over the debtor may be insufficient in and of itself to make an entity an insider. *In re Torcise*, 146 B.R. 303 (Bankr. S.D.Fla.1992), held that, in order for a bank or its officers to be insiders in a preference action, they must have "unreasonable control" over the debtor or the debtor must have become the bank's alter ego or instrument. *Cf. In re Polk*, 125 B.R. 293 (Bankr.D.Colo.1991) (the degree of control). While this court will not go so far as to find that control, reasonable or otherwise, is the only test of insider status, we agree that control is one of many factors to consider in determining insider status. In this case CVC had Muqaddam, its officer and one of Debtor's directors, as its instrumentality. Muqaddam acted for CVC's benefit and on its behalf. Through Muqaddam CVC achieved its insider status. Through Muqaddam CVC was a de facto director and therefore was in a position to exercise some control.

7. As a matter of law, Muqaddam was CVC's agent and, under the doctrine of respondeat superior, CVC is liable for Muqaddam's breach of fiduciary duty. *See* § V, Fiduciary Duty, *infra.* CVC "knowingly permit[ted] its agent", Muqaddam, to purchase claims against Debtor, authorized his actions and provided him with the authority and the means to accomplish the purchase. *Moss v. Elan Memorial Park Corp.*, 400 Pa.Super. 555, 583 A.2d 1254, 1257 (1990). CVC expressly granted to Muqaddam the power and funds with which to purchase the claims and so is bound by Muqaddam's actions. *See Lokay v. Lehigh Valley Co-op. Farmers, Inc.*, 342 Pa.Super. 89, 492 A.2d 405, 409 (1985). Muqaddam was acting within the scope of his employment with CVC in purchasing the claims and his conduct was in furtherance of CVC's business inasmuch as he was charged with the responsibility of monitoring CVC's investments and ensuring their aggrandizement. Pennsylvania law dictates that under these circumstances CVC is liable for Muqaddam's conduct. *See Johnson v. Glenn Sand and Gravel*, 308 Pa.Super. 22, 453 A.2d 1048, 1050 (1982) (tort liability). In fact, CVC's liability would exist even if Muqaddam was only partially motivated by a desire to serve CVC's interests. *Shuman Estate v. Weber*, 276 Pa.Super. 209, 419 A.2d 169, 173 (1980).

profit based on the valuation of the notes CVC intended to purchase. Muqaddam Deposition at 93, 218–19.

[9] Frank T. Kane, Debtor's former chief financial officer, testified that financial projections prepared by or for Debtor in connection with the bankruptcy were modified at the request of Muqaddam or a member of his staff with reference toward CVC's proposed asset purchase. Deposition of Frank T. Kane, April 10, 1992, at 80–81 (hereafter "Kane Deposition"). Although the projections were a part of Debtor's records, they were never provided to Chanin & Company, any member of the creditors' committee, or to its counsel. Kane Deposition at 81.[8] Thus, even if, as CVC argues, all Debtor's records were in the public domain by virtue of the bankruptcy, the records constitute inside information when their existence is not disclosed except to insiders.

[10] It is the *access* to the inside information that renders trading in claims particularly dangerous in a bankruptcy situation. *Wolf v. Weinstein,* 372 U.S. at 642, 83 S.Ct. at 975–76. CVC had virtually unrestricted access to inside information and significant assistance from Debtor through its employees and staff and its control over its subsidiaries. Muqaddam admitted at trial that prepetition he had been approached to buy Papercraft notes but refused because he had inside information at that time. In his view, postpetition, all financial information was on the public record and, therefore, he considered himself not to be an insider. Contrary to his assertion, the evidence established that all of the information was not of record at the time he received it. Moreover, the committee did not know that Debtor prepared information for and gave it to Muqaddam, at his request, because he was a director of Debtor and which, in turn, Muqaddam used to further CVC's corporate interests.

[11–14] Even if all of the information had been on the public record, that fact would not have changed CVC's insider status. Moreover, nothing in the Bankruptcy Code indicates that an entity's insider status is abrogated because some or all of Debtor's financial information becomes public. Insider status is a function of an entity's relationship to the debtor and/or to other insiders. *See, e.g.,* 11 U.S.C. § 101(31)(B) ("'insider' includes ... (B) if the debtor is a corporation—(i) director of the debtor ... or (vi) relative of a ... director, officer or person in control of the debtor"). Insider status is not a function of what, if any, financial information Debtor publicizes. Although the committee had access to Debtor's records, it was not in a position similar to CVC's with respect to information about Debtor. CVC, as a member of Debtor's board, engaged in various business decisions affecting Debtor and was in a strategic and unique position regarding Debtor's restructuring and reorganization.

In this case, CVC, through Muqaddam, had an advantage available only to insiders. When requests for information were made of Debtor by parties in interest in this case the testimony was undisputed that Muqaddam's requests always received priority treatment because of his position.

[15] In deposition, William T. Comfort, chairman of the board of directors of CVC and a member of the investment committee that approved CVC's note purchases, testified that CVC invested in the Papercraft notes to preserve CVC's reputation. He explained that if an entity in CVC's position is seen to abandon one of its flock in distress, the company loses some of its credibility in the marketplace. He further testified that a secondary consideration was a return on

8. Although projections were provided to the creditors' committee, they apparently were not the same as those contained in the modifications provided to CVC. Kane Deposition at 80–88. CVC also requested, and was provided, projections of monthly working capital and income distribution but Kane was not sure if the numbers used were those based on CVC's assumptions or if the information was based on Debtor's projections. *Id.* at 85. However, Kane also testified that Muqaddam "or one of his representatives" had asked for "a monthly model for an income statement, balance sheet and cash flow to disclose to [CVC] the working capital changes and income statement movement within a prescribed period of time," *id.* at 87, with respect to Barth and Dreyfuss in order to determine that company's seasonal credit requirements. *Id.* at 88.

CVC's investment. Deposition of William Comfort at 31, 36 (hereafter "Comfort Deposition"). His testimony does not fit squarely with that of Michael Arnold, who was Debtor's president and the CEO of Debtor, its subsidiaries and Amalgamated and held a seat on Amalgamated's board of directors. Mr. Arnold stated that in January or February of 1991, he first became aware that CVC was analyzing Barth & Dreyfuss to determine whether a purchase offer would be a possibility. Deposition of Michael Arnold at 63–64 (hereafter "Arnold Deposition"). By letter dated October 4, 1991, from Muqaddam addressed to him, Arnold learned that CVC held claims and was informed that CVC would vote to reject a plan that did not pay it in full. *Id.* at 139. We credit Mr. Arnold whose statement somewhat belies Comfort's assertion that CVC's conduct was only *secondarily* motivated by its desire for profit. What is consistent in both witnesses' testimony is that CVC intended to enhance CVC's goals, by protecting its reputation and/or by adding to its profits, even if that goal conflicted with Debtor's negotiated reorganization.

CVC's defense is further undermined by inconsistencies in Muqaddam's trial, deposition, and declaration testimony. For instance, in its pretrial evidentiary submission, CVC presented a declaration by Muqaddam in which he stated that he believed that he had not requested Chanin and Company's enterprise valuation and its distressed sale analysis. At trial Muqaddam stated that he had asked for the information to illustrate the fairness of CVC's asset purchase offer. In his deposition given in connection with the committee's motion for partial summary judgment, Muqaddam stated that he had not sought the advice of counsel concerning the purchase of Papercraft notes. Muqaddam Deposition at 90. At trial Muqaddam stated that had he consulted with a law firm concerning whether CVC could make the purchase and the propriety of the purchase, but his inquiry was only an informal request concerning regulatory matters.

At trial Muqaddam denied that CVC's particular goal was to purchase the Papercraft notes held by the RTC. In his deposition given in connection with the motion for partial summary judgment, however, he testified that one goal was to buy the RTC notes because he feared another entity, such as Second Pennsylvania, would do so, thereby disrupting, or attaining a position from which to disrupt, the reorganization process. In addition to these inconsistencies in testimony, the court took particular note of Muqaddam's demeanor at trial. On the witness stand, Muqaddam perspired heavily in an air conditioned room and drank huge quantities of water. He is a sophisticated businessman accustomed to pressure but he exhibited extraordinary nervousness given the circumstances. We find from the evidence as a whole that CVC's intention was to benefit from its position as a director of Debtor by purchasing claims at a discount.

[16, 17] CVC tries to excuse its failure to disclose its identity and insider position based on evidence that, in April of 1991, the committee had knowledge of a *rumor* that CVC had purchased some notes. The fact and/or extent of the committee's knowledge is not controlling. CVC, as an insider of Debtor, had an obligation to formally disclose its identity and status as an insider to the sellers, Debtor, and the committee prior to purchasing claims during the bankruptcy. CVC did not disclose its identity to Debtor or the committee before it purchased the notes and never disclosed its identity or its seat on Debtor's board of directors to the sellers. The purchases gave CVC voting control over Class 4, an impaired class of general unsecured creditors under the BDK plan. CVC held no claims against Debtor prepetition but during the period between April 1, 1991, and August 30, 1991, obtained 40 percent of all outstanding notes, thereby gaining the ability to control the voting in its class on a reorganization plan.

CVC never cast a vote for or against the plan. As it was, although it had voted in favor of the BDK plan concept prepetition, CVC filed objections to the BDK plan which were not withdrawn until it was promised a seat on the board of the reorganized debtor and certain distribution language was changed in the plan. Without the withdrawal of CVC's objections (or some form of disen-

franchisement of its voting rights), it was questionable whether the BDK plan could be confirmed as fair and equitable because of the 40 percent interest CVC acquired during the case. As a further result of the purchases, CVC was in a position to gain a profit under the confirmed plan of approximately $5.4 million if its claims were allowed in amounts equal to the face value of the notes.

Because of CVC's postpetition interest acquired in Debtor, a second plan of reorganization, the CVC plan, was filed. The BDK plan had provided for formation of a new company by merger of some of the subsidiaries, a stock for debt exchange, and certain cash payments. The CVC plan essentially was a cash offer by CVC to buy certain assets and operating subsidiaries of Debtor without acquiring certain associated liabilities. CVC's undisclosed claims purchases facilitated this turn of events. Its conduct created litigation that would not have been needed otherwise and was an impropriety, if not actual wrongdoing, that cannot be countenanced.

[18] CVC's conduct falls within the "vulture investor" category. *See Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor,* 48 Bus.Law. 915, 924 (May 1993) (hereafter *"Vultures Beware"*).

> The typical *modus operandi* of a vulture investor is to purchase trade claims, bank debt, or other securities at a discount from the face amount, and often to purchase sufficient voting power to enable the vulture investor to block confirmation of any plan of reorganization proposed for the debtor that the vulture investor does not like.

Id. at 916 (footnote omitted).

> Vulture investors may control the terms for the reorganization of a debtor in chapter 11 by means of the purchase at bargain prices of a blocking vote position in a significant debt class. This could enable a vulture investor to dictate the terms of the reorganization, which could result in very large rewards for the investor. The reason that vulture investors are able to reap such large returns is that some chapter 11 debtors end up in chapter 11 not so much because their businesses have gone bad, but because of the leveraged debt that they could not shoulder ... The result can [have] ... the vulture ending up with the dominant ownership position in a good business, after having paid a bargain price for a debt position which merely served as a means to acquire the debtor's business through the vehicle of chapter 11.

Id. at 917 (footnote omitted). This is precisely the conduct in which CVC engaged and which cannot be tolerated in fiduciaries in a bankruptcy case. CVC's status as an insider, whether or not it used inside information, precluded the sellers from making a fully informed assessment of the consequences of selling their claims and thereby deprived them of the opportunity to make an informed decision regarding the sale.

[19, 20] A member of a board of directors holds a fiduciary duty "to promote the interests of the corporation." *United States v. Byrum,* 408 U.S. 125, 138, 92 S.Ct. 2382, 2391, 33 L.Ed.2d 238 *rehearing denied,* 409 U.S. 898, 93 S.Ct. 94, 34 L.Ed.2d 157 (1972). In this instance CVC used its position on Debtor's board to further its own interests—it sought to salvage or enhance its reputation and it sought a profit for itself. The credible evidence supports the conclusion that, while it served as a director of Debtor, CVC acted in furtherance of CVC's interests.

[21, 22] Furthermore, corporate directors bear "the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession." *See Commodity Futures Trading Comm'n v. Weintraub,* 471 U.S. 343, 355, 105 S.Ct. 1986, 1994, 85 L.Ed.2d 372 (1985). *See also Wolf v. Weinstein,* 372 U.S. 633, 649, 83 S.Ct. 969, 979, 10 L.Ed.2d 33 *rehearing denied,* 373 U.S. 928, 83 S.Ct. 1522, 10 L.Ed.2d 427 (1963). Upon insolvency of the corporation, the director's fiduciary duty extends to the corporation's creditors and is enforceable by the trustee.[9] *See Pepper v. Litton,* 308 U.S. 295, 307, 60 S.Ct. 238, 245–46, 84 L.Ed. 281 (1939); *Brown v. Presbyterian Ministers*

9. Moreover, "a creditors' committee ... may raise and may appear and may be heard on any issue in a case under" chapter 11. 11 U.S.C. § 1109(b).

Fund, 484 F.2d 998, 1005 (3d Cir.1973). In this case Muqaddam utilized his position on Debtor's board to advance CVC's interests. He did not carry out his fiduciary obligation to act in the best interests of Debtor and its estate.

[23, 24] Although directors may purchase claims against their corporation when the corporation is solvent, they are not entitled to do so at a discount and enforce the claims at full value when the corporation is insolvent or has filed bankruptcy. *In re Bridgford Co.*, 237 F.2d 182, 185 (9th Cir.1956), *cert. denied Bridgford v. Sampsell*, 352 U.S. 1005, 77 S.Ct. 566, 1 L.Ed.2d 550 (1957). *See also Manufacturers Trust Co. v. Becker*, 338 U.S. 304, 313–14, 70 S.Ct. 127, 132–33, 94 L.Ed. 107 (1949); *Monroe v. Scofield*, 135 F.2d 725 (10th Cir.1943); *In re UVAS Farming Corp.*, 91 B.R. 575, 577 (Bankr.D.N.M.1988) (when a director purchases claims against its corporation in bankruptcy, recovery is limited to the amount paid for the claim). This is not a situation where a Chinese wall was implemented with policies and procedures effective to prevent the misuse of nonpublic information, *see In re Federated Dept. Stores, Inc.*, 1991 WL 79143 (Bankr.S.D.Ohio, March 7, 1991), nor was it an arm's length transaction and the bankruptcy court is not required to treat these claims equally with those of other creditors. *See Pepper v. Litton*, 308 U.S. 295, 306–07, 60 S.Ct. 238, 244–46, 84 L.Ed. 281 (1939).

[25, 26] The availability of claims for purchase at a discount pursuant to a bankruptcy constitutes a corporate opportunity. *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998, 1004 (3d Cir.1973). Absent a bankruptcy case, a director may use the opportunity if the director discloses to shareholders, the shareholders consent, and the use of the corporate opportunity by the director is not detrimental to the corporation. *CST, Inc. v. Mark*, 360 Pa.Super. 303, 520 A.2d 469, 471 *appeal denied*, 517 Pa. 630, 539 A.2d 811 (1987). *See also Robinson v. Brier*, 412 Pa. 255, 194 A.2d 204, 206, 208 (1963). A director who purchases claims without first providing the debtor with the opportunity to make the purchases violates his fiduciary duty. *See, e.g., In re Cumberland Farms, Inc.*, 181 B.R. 678 (Bankr.D.Mass.1995).

[27, 28] Even when purchasing claims against a solvent corporation, a director has a heavy burden to establish the fairness of the conduct. *Robinson v. Brier*, 194 A.2d at 206. Appropriation of corporate opportunities by a fiduciary of an insolvent entity, even with approval of the shareholders, directors, and officers, is impermissible when it results in a detriment to creditors. *Brown v. Presbyterian Ministers Fund*, 484 F.2d at 1005.

[29] Detriment is a relative term. In this case, at least three adverse effects are identifiable. The first befell the selling noteholders who, at the time of sale, were creditors of Debtor and were deprived of the ability to make a fully informed decision concerning the sale of their claims. If, after full disclosure, they had elected not to sell, they would have received a total distribution of $15,989,676.56 under the plan rather than the amount paid by CVC of $10,553,541.88, a difference of more than $5.4 million. Of course, they may have elected to sell after full disclosure, in which event the court would not be left to second guess their business choices. The harm lies in the fact that the selling noteholders had no opportunity to consider pertinent information.

The second is that CVC's actions diluted the voting rights of prepetition creditors [10] and resulted in CVC's attempt to wrest from the prepetition creditors the valuable assets of Debtor. Lack of disclosure has two effects. First, it is detrimental to the efficiency of the market for claims. An efficient market requires that both the buyer and the seller have access to information so that each party to the transaction can be adequately informed. Under Bankruptcy Rule 3001(e), as amended, large sophisticated purchasers of claims, who have the resources and incentives to

10. CVC did not vote its claims. Nonetheless, its acquisition of claims placed it in the controlling seat in its class and, but for the creditors' committee's actions to contest CVC's claims, we are again left to speculate as to whether CVC would have voted. CVC's non-vote does not nullify the need for a per se rule. Absent a per se rule, CVC would still profit from its purchases of claims monetarily and/or in its enhanced reputation and similar conduct would not be deterred.

> closely monitor a chapter 11 case, have more information regarding the value of a claim than a small trade creditor, and the small trade creditor has no reasonable means to acquire that information. Second, because only the name of the transferee of record need be disclosed, parties in interest will be unable to ascertain who the real claims buyer is and the intentions of that claims buyer with respect to the control of a debtor.

Joy Flowers Conti, Raymond F. Kozlowski, Jr., Leonard S. Ferleger, *Claims Trafficking in Chapter 11—Has the Pendulum Swung Too Far?*, 9 BANKRUPTCY DEVELOPMENTS JOURNAL # 2, at 300 (1992) (hereafter *Claims Trafficking*) (footnotes omitted).

The third is that, by purchasing, CVC put itself in a position of having a conflict of interest by jeopardizing its ability

> to make future decisions on claims as a director free of [its] own personal interests as owner of claims. Adding to the conflict is the fact these purchases were made at a discount from present value. This brings into play a profit motive, accentuating [its] personal interests.

In re Cumberland Farms, Inc., 181 B.R. at 680 (citations omitted).

[30, 31] The filing of a bankruptcy creates a private market in securities and CVC's protestations that its failure to disclose constituted "normal market protocol" are unpersuasive. "[C]orporations in bankruptcy are treated differently from solvent corporations". *Commodity Futures Trading Comm'n. v. Weintraub*, 471 U.S. 343, 357, 105 S.Ct. 1986, 1995, 85 L.Ed.2d 372 (1985). The evidence established that Debtor was insolvent in an equity sense at confirmation. In that circumstance, "[t]he purchase by a director of claims against his own corporation . . ., particularly the purchase of claims at a discount, places too much strain upon the loyalties of the director." *In re Cumberland Farms, Inc.*, 181 B.R. at 680. A director of a corporation in bankruptcy should have no conflicting interest in dealings on behalf of the corporation with those holding claims against it.

The evidence also established that CVC intended to gain influence over the case. Comfort Deposition at 143 (Comfort stated that the note purchases by CVC would put it in a position "to help influence something"). Without disclosure by insiders of their trading in claims, creditors are at risk of selling claims "at extraordinary discounts, without understanding their rights". *In re Allegheny Int'l., Inc.*, 100 B.R. 241, 242 (Bankr. W.D.Pa.1988) (footnote omitted).

[32–34] "Disclosure is fundamental in a bankruptcy case." *Claims Trafficking*, 9 BANKR.DEV.J. at 302. "The interest of sellers in having adequate information available for them to make an informed decision and the interest of nonsellers who may find themselves controlled by a third party whose intent would be to minimize the value that goes to the nonsellers are the two interests that need to be protected in control contests." *Id.* at 304. Several provisions of the Bankruptcy Code are grounded in the concept of disclosure. For example, a debtor must disclose all of its assets and liabilities. *See* 11 U.S.C. § 521 (debtor must file schedule of assets and liabilities); § 101(12) ("'debt' means liability on a claim"), (5) ("'claim' means (A) right to payment, whether or not such right is . . . contingent"); Fed.R.Bankr.P. 1007. A proof of claim filed by a creditor must identify the nature of the claim and include supporting documentation if it exists. 11 U.S.C. §§ 501, 502; Fed. R.Bankr.P. 3001. In order for a plan of reorganization to be confirmed, a disclosure statement containing "adequate information" must be approved by the court. 11 U.S.C. § 1125. Disclosure is equally as significant in the context of claims trading by a trader who is an insider and a fiduciary, who owes a duty of loyalty to the debtor, and who is bound to avoid a conflict of interest. *Wolf v. Weinstein*, 372 U.S. 633, 83 S.Ct. 969, 10 L.Ed.2d 33 (1963).

[35, 36] This situation lacks an essential earmark of an arm's length transaction (i.e., disclosure of relevant information) and was inherently unfair to the selling noteholders and prepetition creditors because of the lack of appropriate notice. We are required to "sift the circumstances surrounding any

claim to ensure that injustice or unfairness to creditors does not occur in administration of the bankrupt estate." *In re Allegheny Int'l., Inc.,* 118 B.R. 282, 302 (Bankr.W.D.Pa.1990), citing *Pepper v. Litton,* 308 U.S. at 307–08, 60 S.Ct. at 246. *See also In re Allegheny Int'l., Inc.,* 100 B.R. 241 (Bankr.W.D.Pa. 1988); *Matter of Executive Office Centers, Inc.,* 96 B.R. 642, 649–50 (Bankr.E.D.La. 1988); *In re UVAS Farming Corp.,* 91 B.R. 575 (Bankr.D.N.M.1988). In this case, unfairness caused by CVC's conduct would not be adequately addressed absent application of a per se rule.

[37, 38] The usual remedy for the improper purchase of claims at a discount by a fiduciary is to subordinate or disallow the fiduciary's claim to the extent its face amount exceeds the amount paid. *See In re Norcor Mfg. Co.,* 109 F.2d 407 (7th Cir.), *cert. denied* 310 U.S. 625, 60 S.Ct. 898, 84 L.Ed. 1396 (1940). *See also In re Philadelphia & Western Ry. Co.,* 64 F.Supp. 738 (E.D.Pa.1946). We have disallowed CVC's claim to the extent that it exceeds the purchase price.

[39–43] Notwithstanding the foregoing, we find that equitable subordination of CVC's claims is not appropriate. There was insufficient evidence to establish that CVC purchased claims with the intent to harm Debtor or defraud its creditors, despite the result. Although misconduct or wrongdoing is not always a prerequisite for subordinating a claim,[11] subordination must be considered on a case by case basis with due regard to the equities of the particular case. *In re Burden,* 917 F.2d 115, 120 & n. 14 (3d Cir. 1990). The burden of proof with respect to equitable subordination in the case of insiders or fiduciaries has been articulated as the burden of "presenting material evidence of unfair conduct". *In re Nutri/System of Florida Associates,* 178 B.R. 645, 657 (E.D.Pa. 1995). That burden rests with the committee in this case. Once that burden is met, the insider must prove that its transactions with the debtor were fair. Other than conduct by an insider or fiduciary, the burden is to prove that fraud or other culpable conduct occurred. *Id.*

The committee contends that the creditors were harmed because Debtor's filing of the BDK disclosure statement was deliberately delayed by CVC to enable it to purchase claims and make the asset purchase offer. The committee asserts that CVC's claim should be equitably subordinated. CVC contends that the delay was occasioned by (1) the litigiousness of Debtor's landlord, Second Pennsylvania Real Estate Corporation and (2) because financial information concerning one of the subsidiaries, American Technical Industries, Inc., (hereafter "ATI"), was not complete, causing indecision as to whether to include ATI in the plan and the tax ramifications of including ATI. CVC contends that until all information was collected and the tax ramifications were examined, the BDK disclosure statement could not be completed.

Regarding the landlord's claims, the record reflects that the Second Pennsylvania litigation required much of Debtor's counsel's time as well as much court time. Nonetheless, although a disclosure statement could have been structured to account for Second Pennsylvania's claim despite the litigation, Debtor chose not to do so.

Regarding the ATI issue, the record reflects that this matter was an important one which affected Debtor's restructuring proposal, although we note that Debtor filed its plan without a disclosure statement three days after it filed this bankruptcy. Thus, some consideration had already been given to the ATI issue or Debtor could not have proposed its plan.

As this bankruptcy progressed, this court approved extensions of Debtor's exclusive period at Debtor's request because we found, with each request, cause for extension. There was no evidence that CVC engaged in conduct designed to delay the plan process. The evidence showed only that during the delay between the filing of the case and the filing of the disclosure statements CVC was active in its own interests in derogation of its fiduciary responsibility toward Debtor and its estate.

[44, 45] Subordination of claims is appropriate only to the extent necessary to offset

11. *See In re Burden,* 917 F.2d 115, 120 (3d Cir. 1990) (regarding nonpecuniary tax penalty).

any harm to the debtor or other creditors on account of the untoward conduct. *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977). *Mobile Steel* established a threefold test for the propriety of equitable subordination. There must be (1) inequitable conduct which (2) caused injury to creditors or the debtor or resulted in an unfair advantage to the creditor whose claim is sought to be equitably subordinated and (3) equitable subordination must be consistent with the Bankruptcy Code. 692 F.2d at 700. In the instant case we find that the first two standards have been met but, because of our limitation on the allowance of CVC's claims, equitable subordination is not consistent with the Code. We have previously held that "principles of fairness would be violated if insiders who create an unfair advantage for themselves were permitted to share equally with other creditors." *In re I.D. Craig Service Corp.*, 1991 WL 155750 at *7 (Bankr. W.D.Pa., August 8, 1991). Because we are limiting the allowed amount of CVC's claim to the amount it paid for the claims, with recovery under the plan gauged to that amount, we have adhered to principles of fairness without the necessity of subordinating CVC's claim. The limitation of recovery removes CVC's profit, discourages similar future conduct and provides a recovery on the claims of creditors in CVC's class which is greater than they would have had absent this limitation. It also removes any economic advantage CVC gained over other insiders who honored their duties and did not purchase claims without the appropriate disclosures. Under these circumstances, equitable subordination of CVC's entire claim is not warranted on the evidence in this case. Therefore, we will deny the committee's request for equitable subordination.

By limiting CVC's recovery to the plan percentage as applied to the amount CVC paid for the claims we create a disincentive for insiders to trade in claims without prior disclosure to the sellers, buyers, debtor and creditors involved. It may be that, under some circumstances, nondisclosure will not subject to censure an insider who purchases claims. *See, e.g., In re Federated Dept. Stores, Inc.*, 1991 WL 79143 (Bankr.S.D.Ohio, March 7, 1991) (procedures to safeguard various interests). This is not such a case.

An appropriate Order will be entered.

JUDGMENT ORDER

And now, to-wit, this **12th** day of **October, 1995,** for the reasons set forth in the foregoing Memorandum Opinion, it is **ORDERED, ADJUDGED AND DECREED** that judgment is entered in favor of plaintiff and against defendant on its First Claim For Relief in that the allowed amount of the claims held by Citicorp Venture Capital, Ltd., is limited to the cost of acquisition and distribution on the claims is controlled by the confirmed Chapter 11 plan. Judgment is entered in favor of defendant and against plaintiff on The Second Claim For Relief seeking equitable subordination and said Second Claim is dismissed with prejudice.

IT IS FURTHER ORDERED that the Order dated April 22, 1994, granting partial summary judgment **IS VACATED** and the accompanying opinion is withdrawn.

The Clerk shall close this Adversary.

SOUTH CAROLINA RENTALS, INC., d/b/a Ace T.V. Rentals, Appellant,

v.

Johnny ARTHUR and Angie S. Arthur, Appellees.

Civ. A. No. 4:93-3251-22.

United States District Court,
D. South Carolina,
Florence Division.

Sept. 28, 1995.

Appliance store objected to proposed Chapter 13 plan, which allowed debtors to keep property under lease-purchase agreements and pay its value through plan. The

In re PAPERCRAFT CORPORATION, a Pennsylvania corporation, Debtor.

CITICORP VENTURE CAPITAL, LTD., a New York corporation, Appellant/Cross-Appellee,

v.

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS and Committee of Creditors Holding Unsecured Claims, as Estate Representative of Papercraft Corporation, Appellee/Cross-Appellant.

Civil Action Nos. 95-1872, 95-1886.
Bankruptcy No. 91-20903.
Adversary No. 91-2642.

United States District Court,
W.D. Pennsylvania.

Aug. 7, 1997.

Unsecured creditors committee filed adversary proceeding in Chapter 11 case, seeking equitable subordination and objecting to creditor's claim. The Bankruptcy Court, 165 B.R. 980, granted committee's motion for partial summary judgment. Following trial, the Bankruptcy Court, 187 B.R. 486, Judith K. Fitzgerald, J., withdrew its prior opinion, denied further subordination of creditor's claims, and, creating and applying per se rule prohibiting insiders of debtor from purchasing claims against debtor without disclosing their identity and connection with debtor, ruled that because the instant creditor-insider purchased claims without proper disclosure, the allowed amounts of its newly acquired claims would be limited to the amounts paid by creditor for them, and recovery on its claims would be limited to the percentage distribution provided in the plan, as applied to the allowed claims. Parties appealed. The District Court, Cindrich, J., held that: (1) bankruptcy court was without authority to adopt its per se rule, which was impermissible formulation of federal common law; (2) evidence supported finding that creditor engaged in inequitable conduct when, as member of debtor's board of directors, it purchased debtor's claims at discount without providing debtor opportunity to make purchases for benefit of all creditors; (3) evidence supported finding that creditor created unfair advantage for itself; and (4) creditor's claims should, at minimum, be limited to amount it paid for such claims so as to eliminate any potential profits, and any further subordination should be supported by findings and reconciled with principles of equity as determined on remand.

Reversed and remanded.

1. Bankruptcy ⚷2904

Bankruptcy court lacked authority to create per se rule prohibiting insiders of corporate Chapter 11 debtor from purchasing claims against debtor without disclosing their identity and connection with debtor; rule constituted impermissible formulation of "federal common law," and bankruptcy rule already existed to address inequitable conduct by insiders trading in debtor's claims. Bankr.Code, 11 U.S.C.A. § 510.

2. Bankruptcy ⚷2904

Nothing in the Bankruptcy Code proscribes insiders from purchasing claims against debtor or requires insiders to conduct themselves in any particular way or make any particular disclosures when so doing.

3. Federal Courts ⚷374

There is no general "federal common law."

4. Federal Courts ⚷374

Cases in which federal rule of decision is necessary to protect uniquely federal interest, such that formulation of "federal common law" is permissible, are those concerned with rights and obligations of the United States, interstate and international disputes implicating conflicting rights of states or the

United States' relations with foreign nations, and admiralty cases.

5. Constitutional Law ⟹70.1(2)

Court's authority to construe statute is fundamentally different from authority to fashion new rule or to provide new remedy which Congress has decided not to adopt.

6. Bankruptcy ⟹2967.1

Bankruptcy Code's subordination provision is codification of common law doctrine of equitable subordination and is grounded in court's equitable powers. Bankr.Code, 11 U.S.C.A. § 510.

7. Bankruptcy ⟹2968

Bankruptcy court may utilize its equitable powers and subordinate insider's claim for harm caused by his or her egregious conduct. Bankr.Code, 11 U.S.C.A. § 510.

8. Bankruptcy ⟹2967.1

Bankruptcy Code's subordination provision requires bankruptcy court to determine on case-by-case basis whether claim should be subordinated. Bankr.Code, 11 U.S.C.A. § 510.

9. Bankruptcy ⟹2967.5

Three conditions must be satisfied before claim may be subject to equitable subordination: claimant must have engaged in some type of inequitable conduct, misconduct must have resulted in injury to creditors of debtor or conferred unfair advantage on claimant, and equitable subordination of claim must not be inconsistent with provisions of the Bankruptcy Code.

10. Bankruptcy ⟹2967.5

Inequitable conduct directed against debtor or its creditors may be sufficient to warrant subordination of claim irrespective of whether it was related to acquisition or assertion of that claim.

11. Bankruptcy ⟹2967.5

Claim or claims should be subordinated only to extent necessary to offset harm which debtor and its creditors suffered on account of the inequitable conduct.

12. Bankruptcy ⟹2967.5

Party seeking equitable subordination of creditor's claim usually has the burden of proof.

13. Bankruptcy ⟹2928

Proof of claim executed and filed in accordance with the Bankruptcy Code constitutes prima facie valid claim.

14. Bankruptcy ⟹2926, 2927

Party objecting to properly executed and filed proof of claim must come forward with enough substantiation to overcome claimant's prima facie case and thus compel him or her to actually prove validity and honesty of claim.

15. Bankruptcy ⟹2926

Although there is initial presumption of validity that attaches to all claims, claims asserted by fiduciaries demand closer scrutiny.

16. Bankruptcy ⟹2827, 2926

In claims context, insider transactions are subjected to rigorous scrutiny and when challenged, burden is on insider not only to prove good faith of transaction, but also to show inherent fairness from viewpoint of debtor-corporation and those with interests therein.

17. Corporations ⟹307, 310(1)

As insider, member of Chapter 11 debtor-corporation's board of directors owed fiduciary duty to debtor and, upon debtor's becoming insolvent, such duty extended to debtor's creditors. Bankr.Code, 11 U.S.C.A. § 101(31)(B).

18. Bankruptcy ⟹2904

Fiduciary who purchases claims of insolvent debtor-corporation at discount without providing debtor opportunity to make purchases for benefit of all creditors has violated

his or her fiduciary duty to act in the best interest of insolvent debtor and creditors.

19. Bankruptcy ⚡2968

Finding that creditor-insider engaged in inequitable conduct, for equitable subordination purposes, was supported by evidence that insider purchased claims of insolvent Chapter 11 debtor-corporation at discount without providing debtor opportunity to make purchases for benefit of all creditors, in violation of insider's fiduciary duty to act in best interest of insolvent debtor and creditors.

20. Bankruptcy ⚡2968

Finding that creditor-insider created unfair advantage for itself, for equitable subordination purposes, was supported by evidence that insider engaged in comprehensive information collection effort made possible by its position on Chapter 11 debtor-corporation's board of directors, that insider used this information to prepare its own asset purchase offer which directly competed with another plan, and that insider utilized debtor's personnel and resources and the creditors committee's financial advisor, all without committee's knowledge.

21. Bankruptcy ⚡2968, 3790

Where creditor-insider engaged in inequitable conduct, for equitable subordination purposes, by purchasing claims of insolvent Chapter 11 debtor-corporation at discount without providing debtor opportunity to make purchases for benefit of all creditors, in violation of insider's fiduciary duty, and creditor further created unfair advantage for itself by using knowledge gained by virtue of its position on debtor's board of directors, creditor's claims were required, at minimum, to be limited to amount it paid for such claims so as to eliminate any potential profits, and any further subordination beyond amount paid for claims had to be supported by findings and reconciled with principles of equity as determined on remand to the bankruptcy court.

Scott J. Davido, Jones, Day, Reavis & Pogue, Pittsburgh, PA, Paul K. Vey, Pietragallo, Bosick & Gordon, Pittsburgh, PA, Richard I. Werder, Jr., Jones, Day, Reavis & Pogue, Cleveland, OH, Shelly Crocker, Perkins Cole, Seattle, WA, Lawrence Slattery, Citcorp Legal Affairs, New York City, for Citicorp Venture Capital, Ltd. in No. 95-1872.

George M. Cheever, Kirkpatrick & Lockhart, Pittsburgh, PA, Philip E. Beard, Stonecipher, Cunningham, Beard & Schmidt, Pittsburgh, PA, Stephen M. Ray, K. John Shaffer, Stutman, Treister & Glatt, Los Angeles, CA, for Committee of Creditors holding unsecured claims and Committee of Creditors holding unsecured claims, as estate representatives of Papercraft Corp. in No. 95–1872.

David Siegel, Ashok W. Mukhey, Peter J. Gregora, Irell & Manella, Los Angeles, CA, for BDK Holdings.

Scott J. Davido, Jones, Day, Reavis & Pogue, Pittsburgh, PA, Paul K. Vey, Pietragallo, Bosick & Gordon, Pittsburgh, PA, Richard I. Werder, Jr., Jones, Day, Reavis & Pogue, Cleveland, OH, for Citicorp Venture Capital Ltd. in No. 95-1886.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmidt, Pittsburgh, PA, Stephen M. Ray, K. John Shaffer, Stutman, Treister & Glatt, Los Angeles, CA, for Committee of Creditors holding unsecured claims and Committee of Creditors holding unsecured claims, as estate representatives of Papercraft Corp. in No. 95–1886.

MEMORANDUM OPINION

CINDRICH, District Judge.

This action arises from an October 12, 1995 Memorandum Opinion and Order (collectively referred as the "October 12 Order") of the United States Bankruptcy Court for the Western District of Pennsylvania (the "Bankruptcy Court"), Bankruptcy Judge Judith K. Fitzgerald presiding. *In re Papercraft Corp.,* 187 B.R. 486 (Bankr.W.D.Pa.1995). Pending before the Court is an appeal and cross-appeal of the October 12 Order by Appellant and Cross–Appellee Citicorp Venture

Capital, Ltd. ("CVC") and Appellee and Cross-Appellant Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (the "Committee").[1] This Court has jurisdiction over this matter pursuant to 28 U.S.C. Section 158(a)(1) and in accordance with Bankruptcy Rule 8001 as the appeal and cross-appeal arise out of a final judgment entered by the Bankruptcy Court.

I. *Facts*

We begin by reciting the Bankruptcy Court's findings of fact.

> The following facts were established by stipulation of the parties or from the evidentiary record:
>
> 1. In 1985, Debtor, [Papercraft Corporation], completed a leveraged buyout (LBO) with the assistance of an affiliate of CVC.
>
> 2. The LBO transformed Debtor from a publicly traded company into a wholly-owned subsidiary of Amalgamated Investment Corporation (hereafter "Amalgamated").
>
> 3. CVC acquired a 28% equity position in Amalgamated as a result of the LBO. It wrote off the equity position in 1987 because it expected no return on its investment.
>
> 4. At all relevant times, a representative of CVC sat on the boards of directors of Amalgamated, Debtor, Barth & Dreyfuss and Knomark, subsidiaries of Debtor. After 1989, that representative was CVC's Vice President, M. Saleem Muqaddam, who served on the boards of those companies.
>
> 5. Barth & Dreyfuss and Knomark were subsidiaries of Debtor at all relevant times.
>
> 6. In April of 1989, Debtor completed a restructuring of its debt which resulted in an exchange of approximately 98% of Debtor's debentures for unsecured First Priority and Second Priority notes.
>
> 7. The First Priority Notes were issued under an Indenture dated May 15, 1989, and were to mature on October 1, 1994. An aggregate amount of $90,717,398 (principal plus accrued interest) was outstanding on the date Debtor's chapter 11 case was filed.
>
> 8. The Second Priority Notes were issued under a separate Indenture, also dated May 15, 1989, and were to mature on April 1, 1995. An aggregate amount of $56,318,767 (principal plus accrued interest) was outstanding on the date the chapter 11 case was filed.[2]
>
> 9. Debtor was unable to meet the terms of the notes. Therefore, in the fall of 1990, Debtor sought another restructuring of its unsecured debt and began pre-bankruptcy negotiations with creditors who were part

1. The Committee is the official unsecured creditors' committee in Papercraft's chapter 11 case, whose members were duly appointed by the United States Trustee under section 1102 of title 11 of the United States Code ("Bankruptcy Code"). The Committee has sued CVC not just in its capacity as a committee entitled to bring suit by virtue of sections 502, 1103, and 1109 of the Bankruptcy Code, but as "Estate Representative" which, under the provisions of the confirmed plan of reorganization, is entitled to enforce the rights of the estate and is empowered by section 1123(b)(3)(B) of the Bankruptcy Code to do so. Opening Brief of Appellee and Cross-Appellant, Committee Of Creditors Holding Unsecured Claims And Committee Of Creditors Holding Unsecured Claims As Estate Representative Of Papercraft Corporation ("Committee's Opening Br") (Doc. No. 4) at 1 n. 1.

2. On the date of the Chapter 11 filing, the holders of First and Second Priority notes included the following: (1) Acacia Mutual Life Insurance Co. ("Acacia"); (2) American Money Management ("American Money"); (3) Drexel Burnham Lambert ("Drexel"); (4) Executive Life Insurance Co. ("Executive"); (5) First Capital Life Insurance Co. ("First Capital"); (6) First Investors; (7) First Stratford Life Insurance Co. ("First Stratford"); (8) Magten Asset Management Corp. ("Magten"); (9) Oppenheimer & Co. ("Oppenheimer"); (10) Pan American Life Insurance Co. ("Pan American"); (11) Presidential Life Insurance Co. ("Presidential Life"); (12) the Resolution Trust Corp. ("the RTC"); (13) Transmark U.S.A. Inc. ("Transmark"); and (14) Venture Advisors ("Venture"). Appellant/Cross-Appellee's Brief In Support Of Appeal Of Order Limiting Recovery On Purchased Claims ("CVC's Opening Br") (Doc. No. 2) at 10 n. 7.

of what has been termed in this case the "Informal Committee".[3]

10. After several months of prepetition negotiations, Debtor and the Informal Committee reached an agreement on what is called herein the BDK Plan of Reorganization which was to be filed in conjunction with a chapter 11 case.

11. The BDK Plan would effect a reorganized enterprise and was unanimously approved by Debtor's board, including CVC through Muqaddam, in March of 1991.

12. Debtor filed a voluntary chapter 11 petition on March 22, 1991.

13. At that time, CVC held none of Debtor's First or Second Priority Notes and was not a creditor of Debtor.

14. Debtor was insolvent on the filing date and all relevant times thereafter.

15. On March 25, 1991, three days after this bankruptcy began, Debtor filed the BDK Plan, without a disclosure statement. A disclosure statement was not filed until October 15, 1991.

16. In March of 1991, Muqaddam sought the approval of CVC's Investment Committee for CVC to purchase Papercraft notes.

17. On April 1, 1991, CVC's Investment Committee granted approval for CVC to purchase up to $10 million of Papercraft notes.

18. In early May, 1991, Muqaddam prepared a review of CVC's investment in Amalgamated.

19. CVC purchased $60,849,575.72 face value of the Papercraft notes for $10,553,541.88 between April and August of 1991. Approximately $7.4 million (more than 70%) of CVC's purchases of Papercraft notes were made on or after August 19, 1991.

20. CVC acquired 38.3% of Debtor's First Priority Notes, 46.4% of Debtor's Second Priority Notes, and 40.8% of Debtor's total unsecured claims.

21. CVC neither requested nor obtained the approval of Debtor's board, the [C]ommittee[4], or the court to buy the notes. [FN1]

FN1. On or about May 23, 1991, while it was a member of the [C]ommittee, Magten purchased, on behalf of clients, approximately $3.8 million in Second Priority Notes from Oppenheimer & Co. for approximately $379,000. Oppenheimer was a member of the Informal Committee and acknowledged in writing that it knew Magten was the purchaser. Magten also made other offers to purchase Papercraft notes, again on behalf of clients. In January, 1991, Magten entered into a settlement agreement by which it agreed to receive no more than its cost of these claims at the time of distribution under the plan. Magten disclosed to those entities from which it purchased notes its position with the committee and the bankruptcy. Unlike CVC, Magten had disclosed its identity and connection with Debtor. Furthermore, Magten was not buying notes for its own account, as was CVC, but for accounts of its customers.

22. Debtor learned of CVC's initial purchases of notes by May, 1991, that is, after CVC made the purchases. Its counsel became aware that CVC had purchased some claims by June of that year. Debtor and its counsel also learned of CVC's later purchases.

23. In April of 1991, the committee heard a rumor that CVC was purchasing claims.

3. The members of the Informal Committee included the following: (1) Acacia; (2) American Money; (3) Columbia Savings & Loan Co.; (4) Drexel; (5) Executive; (6) Far West Savings & Loan; (7) Fidelity Bankers Life Insurance Co.; (8) Magten; (9) Oppenheimer; (10) Pan American; (11) Transmark; and (13) Venture. CVC's Opening Br at 9 n. 5.

4. The members of the Committee included the following: (1) Acacia; (2) Drexel; (3) Executive; (4) First Capital; (5) Guarantee Security Life Insurance Co.; (6) J.F. Karlton Company; (7) Second Pennsylvania Real Estate Corporation; (8) Magten; (9) Pan American; (10) Presidential Life; (11) the RTC; and, (12) Transmark. CVC's Opening Br at 9 n. 6.

The committee heard no more about it until CVC made its asset purchase offer in September of 1991. Neither CVC nor Debtor communicated to the committee the status or extent of CVC's purchases.

24. CVC acquired the RTC's First Priority and Second Priority Notes for 25 cents and 12 cents on the dollar, respectively. Magten unsuccessfully bid for the notes at 20.5 cents and 10.5 cents. When CVC bought the RTC's notes, Muqaddam estimated that the RTC controlled approximately 20% of Debtor's total unsecured claims.

25. At the values established by this court at the BDK plan confirmation hearing, noteholders received an interest in BDK Units equal to 33.5 cents on the dollar for First Priority Note claims and 16.75 cents on the dollar for Second Priority Note claims.

26. At Muqaddam's direction, and with the knowledge and consent of Debtor's management, two employees of CVC, Noelle Cournoyer and Nils Havgestad, visited Barth & Dreyfuss in January or February of 1991. The purpose of the visit was to obtain information about the company in the event that CVC decided to make an asset purchase proposal. During their 1 1/2 day visit, CVC's representatives obtained current Barth & Dreyfuss financial statements, looked at the company's product lines, discussed the company with its management, and toured the plant.

27. Cournoyer prepared a written report on Barth & Dreyfuss, drafts of which were provided to Debtor, but not to the [C]ommittee.

28. Frank Kane, the Chief Financial Officer of Debtor, reviewed drafts of the Barth & Dreyfuss report and gave his comments to Muqaddam. Kane did not discuss the report with or provide it to the [C]ommittee.

29. Kane, Muqaddam, and a representative of the Bank of New York Credit Corporation (BNYCC), a Barth & Dreyfuss lender, held a meeting on June 14, 1991. At that meeting, Muqaddam made a presentation to BNYCC for financing a possible purchase of Barth & Dreyfuss and Knomark by CVC.

30. At some point during or after the meeting, Muqaddam gave BNYCC a copy of the Barth & Dreyfuss report and a one page summary of a possible structure for an asset purchase transaction.

31. Muqaddam received a financing term sheet from BNYCC dated August 12, 1991. He provided a copy of the term sheet to Kane and obtained Kane's comments on the term sheet. CVC agreed to the terms.

32. After the filing of the bankruptcy, Debtor, through Kane and Andre Francois, Debtor's manager of corporate accounting, reviewed documents prepared by CVC and prepared documents for Muqaddam and Cournoyer with respect to the proposed asset purchase.

33. Chanin and Company was the financial advisor to the [C]ommittee. On July 18, 1991, Debtor's Chief Executive Officer, Michael Arnold, faxed Chanin and Company's enterprise valuation to Muqaddam. Arnold received the valuation on July 16, 1991.[FN2]

FN2. The parties stipulated to July 16, 1994, but the 1994 date may be a typographical error. The date that Arnold received the information is not material, however. The pertinent fact is that Muqaddam received Chanin and Company's enterprise valuation from Arnold.

34. Kane faxed Chanin and Company's distressed sale analysis to Muqaddam on August 6, 1991.

35. At Muqaddam's request, Debtor engaged Arthur Andersen & Co. to analyze whether CVC's note purchases would have any adverse tax effect on Debtor.

36. Debtor received a written tax analysis from Arthur Andersen & Co. dated August 26, 1991. Kane faxed a copy of the tax analysis to Muqaddam.

37. Muqaddam prepared a memo to CVC's Investment Committee dated Au-

gust 23, 1991, requesting authority to make an offer to purchase the valuable operating subsidiaries of Debtor, i.e., Barth & Dreyfuss and Knomark.

38. Thereafter, in August of 1991, CVC's Investment Committee granted Muqaddam authority to cause CVC to make an asset purchase offer.

39. On August 26, 1991, Muqaddam sought and obtained the approval of CVC's Investment Committee to increase note buying authority from $10 million to $15 million.

40. In the week before CVC made its asset purchase offer, that is, before September 13, 1991, Muqaddam called Pamela Cascioli, chairperson of the [C]ommittee, and informed her that CVC was contemplating making an offer to purchase Debtor's assets. He also indicated that CVC had purchased Papercraft notes, including those held by the RTC. This was the first time that CVC informed the [C]ommittee that it intended to make an asset purchase offer. It also was CVC's first communication or confirmation to the [C]ommittee of the fact that CVC had purchased notes. [FN3]

FN3. In his pretrial declaration, Muqaddam states that "CVC made formal disclosure to entities that were members of the [C]ommittee much earlier" than September of 1991. Defendant's Pre-Trial Evidentiary Submission, Declaration of M. Saleem Muqaddam, Docket Entry 122. However, we do not credit his statement. The weight of other testimony and all of the credible evidence establishes that this did not occur.

41. Shortly before September 13, 1991, Muqaddam provided drafts of an asset purchase agreement to Debtor for its review and comment.

42. CVC made its asset purchase offer in a letter to Debtor dated September 13, 1991. BNYCC had agreed to provide financing.

43. On October 15, 1991, Debtor filed an amended version of the BDK Plan which was further amended on subsequent occasions.

44. Debtor also filed a second plan, the CVC Plan, at CVC's suggestion, on October 15, 1991. CVC's asset purchase offer formed the cornerstone of the CVC Plan. CVC consented to the use of its asset purchase offer in the CVC Plan.

45. Debtor filed a disclosure statement for the Amended BDK Plan on October 15, 1991, and a disclosure statement for the CVC Plan on the same date.

46. The court approved the BDK disclosure statement on December 17, 1991.

47. CVC filed objections to confirmation of the Amended BDK Plan on January 14, 1992, because the [C]ommittee did not agree to CVC's claim based on the face amount of the notes. The plan was confirmed on January 21, 1992.

48. Debtor retained the exclusive right to file a plan from the date of the filing of the bankruptcy through the plan confirmation.

49. When purchasing claims, CVC did so through brokers which resulted in CVC's identity not being revealed. [FN4]

FN4. CVC switched brokers, from Citicorp Securities Markets, Inc., to UBS Securities, when Citicorp Securities had been unsuccessful in obtaining the notes held by the RTC for CVC.

In re Papercraft Corp., 187 B.R. at 491–94.

On October 31, 1991, the Committee filed a complaint against CVC objecting to the allowance of claims CVC had purchased and seeking equitable subordination of the same. After the close of discovery, the Committee filed a motion for partial summary on its objection. By opinion and order dated April 22, 1994, the Bankruptcy Court granted the Committee's motion allowing CVC's claim as a general unsecured claim in the amount of $60,849,299.10, the face value of the notes it purchased, but limited CVC's recovery to $10,553,541.88, the amount CVC paid for its claim. *In re Papercraft Corp.,* 187 B.R. at 491. The Committee's request for equitable subordination was reserved for trial. *Id.*

A trial was held on November 14 and 15, 1994. Both CVC and the Committee agreed that the previous summary judgment ruling should be withdrawn and requested that the Bankruptcy Court decide all issues in the case based upon the evidence and testimony adduced at trial. *Id.* Accordingly, the Bankruptcy Court withdrew its April 22, 1994 opinion and order and ruled on all issues.

The Bankruptcy Court held that CVC's intention was to benefit from its position as a director of Papercraft by purchasing claims at a discount. *Id.* at 497. The Bankruptcy Court concluded that CVC had not carried out its "fiduciary obligation to act in the best interest of [Papercraft] and its estate [because it had] purchased claims without first providing Papercraft with the opportunity to make the purchases." [5] *Id.* at 499.

The Bankruptcy Court noted further that CVC's conduct had resulted in at least three adverse effects. First, the selling noteholders would have received a total distribution of $15,989,676.56 under the plan rather than the amount paid by CVC of $10,553,541.88 if they had decided not to sell after full disclosure by CVC. Although the noteholders may have still elected to sell after full disclosure, the harm lies in the fact that they "were deprived of the ability to make a fully informed decision concerning the sale of their claims." *Id.* at 499.

Second, "CVC's actions diluted the voting rights of prepetition creditors and resulted in CVC's attempt to wrest frôm the prepetition creditors the valuable assets of [Papercraft] ." *Id.* at 499. The Bankruptcy Court pointed out that without full disclosure the market for claims suffers as an efficient market requires that both buyers and sellers have access to information so that all parties to the transaction can be adequately informed. Also, "because only the name of the transferee of record need be disclosed, parties in interest will be unable to ascertain who the real claims buyer is and the intentions of that claims buyer with respect to the control of a debtor." *Id.* at 500.

Lastly, CVC actions created a conflict of interest which jeopardized its ability "to make future decisions of claims as a director free of [its] own personal interests as [an] owner of claims. Adding to the conflict is the fact these purchases were made at a discount from present value. This brings into play a profit motive, accentuating [its] personal interests." *Id.* at 500 (quoting *In re Cumberland Farms, Inc.,* 181 B.R. 678, 680 (Bankr.D.Mass.1995)).

As a result, the Bankruptcy Court created and applied a per se rule which prohibits a debtor's insiders from purchasing claims against it without disclosing their identity and relationship with the debtor. The Court held that when claims are purchased by insiders without making such disclosures to the debtor and creditors, "the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *Id.* at 491. The Bankruptcy Court concluded that the "unfairness caused by CVC's conduct would not be adequately addressed absent application of a per se rule." *Id.* at 501.

The Bankruptcy Court held that further subordination of CVC's claims pursuant to the principles of equitable subordination was not appropriate. *Id.* at 501. The Court noted that equitable subordination of a creditor's claim is proper when (1) the creditor has engaged in inequitable conduct; (2) such misconduct caused injury to other creditors or the debtor or resulted in an unfair advantage to the creditor; and (3) subordination of the creditor's claim is consistent with the Bankruptcy Code. *Id.* at 502 (citing *Matter of Mobile Steel Co.,* 563 F.2d 692, 700 (5th Cir.1977)). The Bankruptcy Court found that the first two elements had been satisfied but not the third. *Id.* at 502. The Court

5. The Bankruptcy Court explained that "[a]ppropriation of corporate opportunities by a fiduciary of an insolvent entity, even with the approval of the shareholders, directors, and officers, is impermissible when it results in a detriment to creditors." *Id.* at 499 (quoting *Brown v. Presbyterian Ministers Fund,* 484 F.2d 998, 1005 (3d Cir.1973)).

concluded that because it was limiting CVC's allowed claim to the amount it paid for such claim the principles of fairness had already been adhered to, thus, subordination of CVC's entire claim would not be consistent with the Bankruptcy Code. *Id.* at 502.

II. *Standard of Review*

While acting as an appellate court for a bankruptcy appeal, we may not set aside the Bankruptcy Court's factual findings unless we conclude that the determination was "clearly erroneous." Bankruptcy Rule 8013; *Fellheimer, Eichen & Braverman, P.C. v. Charter Technologies, Inc.,* 57 F.3d 1215, 1223 (3d Cir.1995); *First Jersey Nat'l Bank v. Brown (In re Brown),* 951 F.2d 564, 567 (3d Cir.1991). Consequently, we accept the ultimate determination of the factfinder "unless that determination either is completely devoid of minimum evidentiary support displaying some hue of credibility or bears no rational relationship to the supportive evidentiary data." *Hoots v. Commonwealth of Pennsylvania,* 703 F.2d 722, 725 (3d Cir. 1983). In considering the evidence, "due regard shall be given the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bankruptcy Rule 8013; *Fellheimer,* 57 F.3d at 1223.

Our review of the legal determinations made by the Bankruptcy Court is plenary. *Brown v. Pennsylvania St. Employees Credit Union (In re Brown),* 851 F.2d 81, 84 (3d Cir.1988). Mixed questions of law and fact must be divided into their component parts and the appropriate standard applied to each. *See Universal Minerals, Inc. v. C.A. Hughes & Co.,* 669 F.2d 98, 101–103 (3d Cir.1981).

III. *Analysis*

A. *Per Se Rule*

[1–8] The first issue we address is the Bankruptcy Court's adoption of a per se rule. Despite the laudable purpose and intent of the Bankruptcy Court in creating such a rule, for the following reasons, we conclude that it was without the authority to do so. As previously noted, the Bankruptcy Court adopted a per se rule prohibiting insiders of a debtor from purchasing claims against it without disclosing their identity and connection with the debtor. When an insider fails to make the requisite disclosures, his or her allowed claim will be limited to the amount paid for the claim.

The Bankruptcy Court's per se rule is a new rule. As CVC correctly points out, nothing in the Bankruptcy Code proscribes insiders from purchasing claims against a debtor or requires insiders to conduct themselves in any particular way or make any particular disclosures when so doing. Thus, the rule is a formulation of "federal common law."

As the Supreme Court has repeatedly noted, there is "no general federal common law." *Texas Industries, Inc. v. Radcliff Materials, Inc.,* 451 U.S. 630, 640, 101 S.Ct. 2061, 2067, 68 L.Ed.2d 500 (1981) (quoting *Erie R. Co. v. Tompkins,* 304 U.S. 64, 78, 58 S.Ct. 817, 822, 82 L.Ed. 1188 (1938)). "Although it is much too late to deny that there is a significant body of federal law that has been fashioned by the federal judiciary in the common-law tradition, it remains true that federal courts, unlike their state counterparts, are courts of limited jurisdiction that have not been vested with open-ended lawmaking powers." *Northwest Airlines, Inc. v. Transport Workers Union of America, AFL–CIO,* 451 U.S. 77, 95, 101 S.Ct. 1571, 1582, 67 L.Ed.2d 750 (1981).

> Nevertheless, the Court has recognized the need and authority in some limited areas to formulate what has been known as "federal common law." These instances are "few and restricted," and fall into essentially two categories: those in which a federal rule of decision is "necessary to protect uniquely federal interests," and those in which Congress has given the courts power to develop substantive law.

Texas Industries, 451 U.S. at 640, 101 S.Ct. at 2067 (citations and quotations omitted). The instant case falls into neither of these categories, however. There are no uniquely

federal interests at issue[6] nor does the Bankruptcy Code contain a provision giving the federal courts broad power to develop federal common law.[7] *See* 28 U.S.C. Section 2075 ("Bankruptcy rules: The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings, and motions, and the practice and procedure in cases under Title 11. Such rules shall not abridge, enlarge, or modify any substantive right.").

We recognize that "[i]n almost any statutory scheme, there may be a need for judicial interpretation of ambiguous or incomplete provisions. But the authority to construe a statute is fundamentally different from the authority to fashion a new rule or to provide a new remedy which Congress has decided not to adopt." *Northwest Airlines,* 451 U.S. at 97, 101 S.Ct. at 1583. Indeed, the presumption that Congress deliberately omitted the enactment of a rule is strongest when it has enacted comprehensive legislation in an area such as Bankruptcy. *See Id.*[8] As previously noted, there is no requirement in the Bankruptcy Code or Rules equivalent to the Bankruptcy Court's new per se rule. Thus, the Bankruptcy Court's ruling goes beyond judicial interpretation of ambiguous or incomplete provisions of an existing statute. While we agree that there are strong public policy arguments in favor of the Bankruptcy Court's per se rule, Congress and not the court must enact such a rule.

We find it significant that a rule already exists to address inequitable conduct by insiders trading in a debtor's claims, Section 510 of the Bankruptcy Code.[9] Section 510 is a codification of the common law doctrine of equitable subordination and is grounded in the court's equitable powers.[10] As we discuss in the next section, the Bankruptcy Court may utilize its equitable powers pursuant to Section 510 and subordinate an insider's claim for harm caused by his or her egregious conduct. Thus, Section 510 requires the Bankruptcy Court to determine on a case-by-case basis whether a claim should be subordinated. The per se rule, on the other hand, removes the principles of equity

6. Cases in which a federal rule of decision is necessary to protect uniquely federal interest are "those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relations with foreign nations, and admiralty cases." *Texas Industries,* 451 U.S. at 641, 101 S.Ct. at 2067.

7. The Supreme Court has held that Congress empowered the courts to develop substantive law in the area of labor law, *Textile Workers Union of Am. v. Lincoln Mills of Ala.,* 353 U.S. 448, 77 S.Ct. 912, 923, 1 L.Ed.2d 972 (1957) (holding that Section 301(a) of the Labor Management and Relations Act, 29 U.S.C. Section 185(a) not only grants jurisdiction over defined areas of labor law but also vests in the courts the power to develop a common law of labor-management relations within that jurisdiction), and antitrust law, *Texas Industries,* 451 U.S. at 642–43, 101 S.Ct. at 2067–68 (holding that Congress intended to allow federal courts to develop common law with regard to substantive violations of the Sherman Act but not with regard to the formulation of remedies for enforcement). There is nothing in the Bankruptcy Code, however, which intimates that Congress intended to delegate to the federal courts any general power to create federal common law. *See* John T. Cross, *Congressional Power To Extend Federal Jurisdiction To Disputes Outside Article III: A Critical Analysis From The Perspective Of Bankruptcy,* 87 NW. U.L.Rev. 1188, 1227 (1993).

8. *See also Resolution Trust Corp. v. Liebert,* 871 F.Supp. 370, 372 (C.D.Cal.1994) (A Financial Institution Reform, Recovery, and Enforcement Act case. "Once Congress enacts comprehensive legislation in a particular area, the courts may not add extra federal rules not derived from the legislation itself."); *Port Allen Marine Services, Inc. v. Chotin,* 765 F.Supp. 887, 890 (M.D.La. 1991) (A Comprehensive Environmental Response, Compensation and Liability Act case.) "The Court's function is to interpret the law and not to amend or supplement a law enacted by the Congress. For this court '[t]o supply omissions transcends the judicial function.' " (quoting *West Virginia Univ. Hosp. v. Casey,* 499 U.S. 83, 101, 111 S.Ct. 1138, 1148, 113 L.Ed.2d 68 (1991)).

9. Insider trading in a debtor's claims is not a new phenomenon. As exhibited by the case law, litigation arising from insider trading has plagued the courts for at least the last 144 years. *See Hill v. Frazier,* 22 Pa. 320 (1853).

10. We note that the parties have cited to no common law doctrine, nor has our research revealed any, which resembles the Bankruptcy Court's per se rule.

and applies instead a universal penalty for any instance of noncompliance. We are not unmindful of the additional burden placed on the Bankruptcy Court in applying the rules of equitable subordination to cases of this kind. *See* p. 17 *et seq., infra.* Nonetheless, because we can find no support in the law for the adoption of a per se rule, we are compelled to reverse.

B. *Equitable Subordination*

The Committee argues that equitable subordination is an alternative ground to affirm the Bankruptcy Court's decision to limit CVC's claims to the amount it paid for them.

[9] The test for equitable subordination can be found in the often cited case of *Matter of Mobile Steel Co.,* 563 F.2d 692 (5th Cir. 1977). The following three conditions must be satisfied before a claim may be subject to equitable subordination: (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act. *Id.* at 699–700 (citations omitted).

[10–14] "In determining whether these three conditions are satisfied three principles must be kept in mind." *Id.* at 700. First, "inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination of a claim irrespective of whether it was related to the acquisition or assertion of that claim." *Id.* Second, "a claim or claims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct." *Id.* at 701. Finally, a party seeking equitable subordination of a creditor's claim usually has the burden of proof. A proof of claim executed and filed in accordance with the Bankruptcy Code constitutes a prima facie valid claim. *Id.* at 702 n. 11. A party objecting to such a claim "must come forward with enough substantiations to overcome the claimant's prima facie case and thus compel him to actually prove the validity and honesty of his claim." *Id.* at 701 (quotation omitted).

[15, 16] Although there is an initial presumption of validity that attaches to all claims, claims asserted by fiduciaries demand closer scrutiny. *Id.* at 701–02 ("[W]e must examine the conduct of fiduciary-claimants 'with a large measure of watchful care.' ") (citations omitted; quoting *Washburn v. Green,* 133 U.S. 30, 43, 10 S.Ct. 280, 284, 33 L.Ed. 516 (1890)). Indeed, insider transactions are subjected to rigorous scrutiny and when challenged, the burden is on the insider not only to prove the good faith of a transaction but also to show the inherent fairness from the viewpoint of the corporation and those with interests therein. *Pepper v. Litton,* 308 U.S. 295, 306, 60 S.Ct. 238, 245, 84 L.Ed. 281 (1939).

The Bankruptcy Court held that the first two conditions, (1) inequitable conduct and (2) injury or unfair advantage, had been satisfied but not the third, (3) consistency with the Bankruptcy Code. *In re Papercraft,* 187 B.R. at 502. The Court concluded that because CVC's claims were already being limited to the amount it paid for such claims, the principles of fairness had already been adhered to.[11] *Id.* Thus, the Court held, subordination of CVC's entire claim would not be consistent with the Bankruptcy Code. *Id.*

As set forth in the following discussion, we find that CVC's claims should be limited to pursuant to the principles of equitable subor-

11. The Court stated that the limitation of CVC's allowed claim to the amount CVC paid for such claim adheres to the principles of fairness because,

> [t]he limitation of recovery removes CVC's profit, discourages similar future conduct and provides a recovery on the claims of creditors in CVC's class which is greater than they would have had absent this limitation. It also removes any economic advantage CVC gained over other insiders who honored their duties and did not purchase claims without the appropriate disclosures.

Id. at 502.

dination. We do not agree with the Committee, however, that equitable subordination is an alternative grounds to affirm the October 12 Order. As we explain below, a court must make certain findings regarding the amount of subordination, findings which were not made by the Bankruptcy Court in the instant case. We now review the Bankruptcy Court's findings in connection with equitable subordination.

1) Inequitable Conduct

The Bankruptcy Court held that CVC engaged in inequitable conduct. *In re Papercraft,* 187 B.R. at 502. The Court concluded that CVC "did not carry out [its] fiduciary obligation to act in the best interests of [Papercraft] and its estate." *Id.* at 499. Specifically, the Court found that CVC did not engage in an arm's length transaction when it purchased Papercraft's claims. *Id.* at 499. The Court also found that CVC had appropriated a corporate opportunity when it, as a fiduciary, purchased Papercraft's claims at a discount and then sought to enforce such claims at full value. *Id.* Based upon the evidence as a whole, the Court held that "CVC's intention was to benefit from its position as a director of [Papercraft] by purchasing claims at a discount." *Id.* at 497.

[17] We find that there is sufficient evidence to support the Bankruptcy Court's finding that CVC engaged in inequitable conduct. CVC does not dispute that it was an insider as defined by 11 U.S.C. 101(31)(B) because of its representation on Papercraft's Board of Directors. *Id.* at 494–95. As an insider, CVC owed a fiduciary duty to Papercraft, and upon Papercraft's becoming insolvent, such duty extended to Papercraft's creditors. *See Pepper,* 308 U.S. at 307, 60 S.Ct. at 245–46; *Brown,* 484 F.2d at 1005.

[18, 19] A fiduciary who purchases claims of an insolvent debtor at a discount without providing the debtor an opportunity to make the purchases for the benefit of all the creditors has violated his or her fiduciary duty to act in the best interest of the insolvent debtor and creditors. *See, e.g., In re Cumberland Farms, Inc.,* 181 B.R. 678 (Bankr. D.Mass.1995). Such conduct by a fiduciary clearly supports a finding of inequitable conduct. *See, e.g., Bostian v. Schapiro (In re Kansas City Journal–Post Co.),* 144 F.2d 791 (8th Cir.1944); *In re UVAS Farming Corp.,* 91 B.R. 575 (Bankr.D.N.M.1988).

2) Injury or Unfair Advantage

[20] The Bankruptcy Court held that the second element of equitable subordination had been satisfied. As previously noted, the Bankruptcy Court held that CVC's conduct had resulted in at least three adverse effects. The Court's findings also support a finding that CVC created an unfair advantage for itself.

As described more fully in the October 12 Order, CVC engaged in a comprehensive information collection effort made possible by its position on Papercraft's Board. *In re Papercraft,* 187 B.R. at 494–96. CVC then used this information to prepare its own asset purchase offer which directly competed with the BDK plan. That CVC utilized Papercraft's personnel and resources and the Committee's financial advisor, all without the Committee's knowledge, makes its actions even more culpable. Accordingly, we find that the Bankruptcy Court's finding of this element was supported by the evidence and not clearly erroneous.

3) Consistency With The Bankruptcy Code

The Bankruptcy Court concluded that because CVC's allowed claims had already been limited to the amount it paid for such claims pursuant to its per se rule, equitable subordination would not be consistent with the Bankruptcy Code. *Id.* at 502. The Court stated that "because we are limiting the allowed amount of CVC's claim to the amount it paid for the claims, with recovery under the plan gauged to that amount, we have adhered to the principles of fairness without the necessity of subordinating CVC's claim." *Id.*

The Bankruptcy Court's conclusion was with regard to whether CVC's remaining

claim, that is the amount remaining after application of the per se rule, should be subordinated. Apparently, the Court found that further subordination would not be consistent with the Bankruptcy Code because as it correctly noted, equitable subordination is appropriate only to the extent necessary to offset any harm to the debtor or other creditors. *Id.* at 501–02.

[21] Although the Bankruptcy Court identified several harmful effects resulting from CVC's conduct, the Court did not address the amount of harm in economic terms. The Bankruptcy Court concluded instead that "the usual remedy for the improper purchase of claims at a discount by a fiduciary is to subordinate or disallow the fiduciary's claim to the extent its face amount exceeds the amount paid." *In re Papercraft,* 187 B.R. at 501 (citing *In re Norcor Mfg. Co.,* 109 F.2d 407 (7th Cir.1940); *In re Philadelphia & W. Ry. Co.,* 64 F.Supp. 738 (E.D.Pa. 1946)). The Bankruptcy Court stated this conclusion in support of the amount of subordination of CVC's claims pursuant to the per se rule. *In re Papercraft,* 187 B.R. at 501. While we agree with the Bankruptcy Court's conclusion that a fiduciary who purchases claims against an insolvent debtor shall ordinarily have his or her claim subordinated, we do not agree that the amount of such subordination is usually equal to the limitation imposed by its per se rule.[12]

In addition to the cases cited by the Bankruptcy Court, the Committee cites several other cases which allegedly support the proposition that the remedy in such circumstances is that the fiduciary's allowed claim will be limited to his or her purchase price with recovery under the bankruptcy plan being gauged to such reduced claim.[13] The courts in these cases do hold that a fiduciary's claim purchased when the debtor was insolvent will be limited to the amount paid. A more thorough reading of these cases reveals, however, that what is being subordinated is the fiduciary's profits. None of these cases holds that a fiduciary's allowed claim will be limited to the amount paid *with recovery under the plan being gauged to such allowed claim.* To the contrary, these cases apparently hold that a fiduciary's *recovery* on claims purchased when the debtor is insolvent will be limited to the amount paid for such claims.[14]

When stating that a fiduciary's claim would be allowed up to the amount paid, these

12. The economic impact of the Bankruptcy Court's ruling on CVC is severe. As previously noted, CVC purchased a total of $60,849,575.72 in face value of Papercraft's First and Second Priority notes for $10,553,541.88, an average of approximately $0.24 on the dollar for First Priority notes and $0.12 on the dollar for Second Priority notes. CVC's Opening Br at 11–13. At the values established by the Bankruptcy Court at the plan confirmation hearing, noteholders are to receive BDK Units equal to $0.335 on the dollar for First Priority note claims and $0.1675 on the dollar for Second Priority note claims. *In re Papercraft,* 187 B.R. at 492. Under the Bankruptcy Court's holding, which limits CVC's allowed claim to the $10,553,541.88 purchase price with recovery under the plan gauged to this amount, CVC would recover only about $3,063,600 in BDK Units on its claims, approximately $7,489,941.88 less than what it paid. If CVC's claims were allowed at face value, however, it would recover approximately $15,987,600 in BDK Units, $5,434,058.12 more than what it paid for the claims. *See* CVC's Opening Br at 17.

13. The Committee's Opening Br at 35 (citing *Allied Eastern States Maintenance Corp. v. Miller (In re Lemco Gypsum, Inc.),* 911 F.2d 1553, 1558 (11th Cir.1990); *In re Cumberland Farms, Inc.,* 181 B.R. at 681; *Matter of Executive Office Centers, Inc.,* 96 B.R. 642, 649–50 (Bankr.E.D.La. 1988)); Minkel & Baker, *Claims & Control In Chapter 11 Cases: A Call For Neutrality,* 13 Cardozo L.Rev. 35, 61 n. 111 (1991) (citing *Sampsell v. Bridgford (In re Bridgford Co.),* 237 F.2d 182 (9th Cir.1956); *Monroe v. Scofield (In re Gallic-Vulcan Mining Corp.),* 135 F.2d 725 (10th Cir. 1943); *Terminal & Shaker Heights Realty Co. v. Van Sweringen Co. (In re Van Sweringen Co.),* 119 F.2d 231 (6th Cir.1941); *In re Norcor,* 109 F.2d at 407 (7th Cir.1940); *In re Philadelphia & W. Ry. Co.,* 64 F.Supp. 738 (E.D.Pa.1946); *In re Jersey Materials Co.,* 50 F.Supp. 428 (D.N.J. 1943); *In re Los Angeles Lumber Prods. Co.,* 46 F.Supp. 77 (S.D.Cal.1941); *In re McCrory Stores Corp.,* 12 F.Supp. 267 (S.D.N.Y.1935)).

14. *See Sampsell,* 237 F.2d at 186 (Fiduciary "is precluded from collecting more than he paid for a claim against an insolvent corporation to which he owed a fiduciary duty."); *Monroe,* 135 F.2d at 728 (Fiduciary "is limited in his right of recovery to the $200 which he paid for his claim."); *In re Van Sweringen,* 119 F.2d at 235 ("Where the directors of a corporation, contrary

courts did not hold that the fiduciary's recovery would then be gauged to such allowed claim, but instead allowed the claim only to an amount which would disgorge any profits to be made. In contrast, the term "allowed claim" as used in the instant case takes on a more precise meaning as the Bankruptcy Court went one step further by adding to its holding that CVC's recovery under the plan would be gauged to the already reduced claim.

Indeed, these cases rely on the universal precept that a fiduciary may not "serve himself first and his cestuis second." *Pepper,* 308 U.S. at 311, 60 S.Ct. at 247. As Justice Cardozo noted in the often quoted passage from *Meinhard v. Salmon,* 249 N.Y. 458, 164 N.E. 545, 546 (1928):

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held by something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.... Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

The courts have made it clear that a fiduciary is not entitled to any profits resulting from the purchase of claims against an insolvent debtor. Thus, CVC's claims should at a minimum be limited to the amount paid for such claims to eliminate any potential profits. If we affirm the October 12 Order, however, CVC's projected recovery will be reduced by an additional $7,489,941.88. As explained by the Ninth Circuit in *In re Westgate–California Corp.,* 642 F.2d 1174, 1177–78 (9th Cir. 1981):

> Subordination is an equitable power and is therefore governed by equitable principles.
>
> * * * * * *
>
> The time-honored maxim that equity will not enforce a penalty adds another limitation to the subordination power. Bankruptcy courts must take care not to subordinate claims where doing so will operate only to penalize the claimant. "[T]he power of subordination necessarily must be measuredly and not blankly exercised.... It should not operate to take away anything punitively to which one creditor is justly entitled in view of the liquidation finality, and bestow it upon others, who in the relative situation have no fair right to it. It can therefore ordinarily go no farther than to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible, to the point where they will not create unjust disadvantages in claim positions and liquidation results."

(quoting *Bostian,* 144 F.2d at 800–01); *see also, Matter of Mobile Steel Co.,* 563 F.2d at

to their fiduciary duty, have made a personal profit in their dealings with the corporation, equity will compel them to account to the corporation for such profits made at its expense."); *In re Norcor,* 109 F.2d at 411 (Fiduciaries are not "entitled to the allowance of a claim in an amount which would have inured to his individual profit."); *In re Philadelphia & W. Ry.,* 64 F.Supp. at 740–41 ("These directors will not be compelled to account for profits from sales of bonds which had been purchased in good faith before their appointment but only for such profit as they realized from the sales of bonds purchased during their incumbency."); *In re Jersey Materials,* 50 F.Supp. at 431 (Fiduciary "should recover for the bankrupt estate no more than the sum of money paid by him for the mortgage, together with interest from the date he paid it."); *In re McCrory Stores,* 12 F.Supp. at 268–69 (Corporation in bankruptcy in which creditors were to receive full payment of their claims under proposed bankruptcy plan. "A director who acquires claims [when the debtor is insolvent] may enforce them for no more than the cost of acquisition. [Director] then was inhibited from making a profit...."); *Matter of Executive Office Centers,* 96 B.R. at 650 (Denying creditor's motion to subordinate claim because neither it nor any other creditor was harmed citing to *In re Van Sweringen, In re Norcor,* and *In re Philadelphia & W. Ry.,* as standing for the proposition that the basis for limiting a fiduciary's claim is "that a fiduciary shall not be allowed to profit from his trust.").

701 ("[I]f a claimant guilty of misconduct asserts two claims, each worth $10,000, and the injury he inflicted on the bankrupt or its creditors amounted to $10,000, only one of his claims should be subordinated."); *Matter of Pinetree Partners, Ltd.,* 87 B.R. 481, 488 (Bankr.N.D.Ohio 1988) (claims should be subordinated only to extent necessary to offset the harm the bankrupt and its creditors suffered).

As we previously noted, because it adopted a per se rule, the Bankruptcy Court did not have the opportunity to make factual findings as to how an additional $7,489,941.88 reduction in CVC's recovery comports with the principles of equitable subordination. We do not conclude today, however, that CVC's claims may not be subordinated by such an amount but only that any amount of subordination beyond the limitation of CVC's recovery to the amount paid for such claims should be supported by factual findings and reconciled with the principles of equity. We believe this to be a finding of fact best left to the Bankruptcy Court, not this Court sitting as a court of appeal. Accordingly, we will remand the case to the Bankruptcy Court for a finding on the amount CVC's claims should be subordinated pursuant to the principles of equitable subordination.

In re ATLANTIC LITTLENECK CLAMFARMS, INC., Debtor.

Bankruptcy No. 96–72333–W.

United States Bankruptcy Court, D. South Carolina.

March 28, 1997.

Motion was filed to compel Chapter 11 debtor to accept or reject alleged executory contracts. The Bankruptcy Court, John E. Waites, J., held that participation agreements between Chapter 11 debtor and parties "investing" in its clam farming business, pursuant to which these alleged "investors" were allowed to purchase an interest in pooled bed of clams on understanding that debtor would use its knowledge, skill and equipment to grow and harvest these clams and would then offer to repurchase harvested clams at prevailing market rates, qualified as "investment contracts," which were not proper subjects of motion to compel.

So ordered.

1. Bankruptcy ⚷2822.1

Participation agreements between Chapter 11 debtor and parties "investing" in its clam farming business, pursuant to which these alleged "investors" were allowed to purchase an interest in pooled bed of clams on understanding that debtor would use its knowledge, skill and equipment to grow and harvest these clams and would then offer to repurchase harvested clams at prevailing market rates, qualified as "investment contracts" rather than as "debt obligations," and investors who signed these agreements had to be regarded not as "creditors" but as "equity holders" in debtor, where agreements did not contain any unconditional promise to repay nor any definite maturity date, but rather contained numerous warnings that any return to investors would depend on debtor's success in harvesting clams, and where investors did not have the knowledge, skill or equipment to raise clams to maturity and knew when they signed agreements that their profit was dependent upon debtor's operations.

See publication Words and Phrases for other judicial constructions and definitions.

2. Corporations ⚷94, 468.1

Issuance of stock certificate indicates an equity contribution, while issuance of bond, debenture, or note is indicative of bona fide indebtedness.

underwent an extended period of renewed addiction while he was entrusted with a position of responsibility at Circuit City. It is praiseworthy that he sought treatment for his addiction before he was discovered, but there is no evidence that his addiction, as opposed to his drug-related misconduct, caused Circuit City to fire him. The judgment of the District Court will be affirmed.

CITICORP VENTURE CAPITAL, LTD., a New York Corporation

v.

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (D.C. Civil No. 95–cv–01872).

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation,

v.

CITICORP VENTURE CAPITAL, LTD., a New York Corporation (D.C. Civil No. 95–cv–01886).

Nos. 97–3518, 97–3519.

United States Court of Appeals, Third Circuit.

Argued July 21, 1998.

Decided Nov. 24, 1998.

Unsecured creditors committee brought adversary proceeding against fiduciary of Chapter 11 debtor, objecting to allowance of claims against debtor that fiduciary purchased and seeking claims' equitable subordination. The Bankruptcy Court, Judith K. Fitzgerald, 187 B.R. 486, limited fiduciary's recovery on claims, but declined to equitably subordinate them. Parties cross-appealed. The United States District Court for the Western District of Pennsylvania, Cindrich, J., 211 B.R. 813, reversed and remanded. Parties cross-appealed. The Court of Appeals, Stapleton, Circuit Judge, held that: (1) findings regarding fiduciary's purchase of claims established inequitable conduct supporting equitable subordination; (2) fiduciary breached its duty by purchasing debtor's notes without requisite notice to board and committee; (3) evidence supported findings that fiduciary was motivated primarily by self-interest in acquiring claims against debtor; and (4) subordination of claims beyond that required to deprive fiduciary of profit had to be supported by findings that justified remedy chosen by reference to equitable principles.

Affirmed.

1. Bankruptcy ⇨2968

Findings regarding fiduciary's purchase of claims against Chapter 11 debtor established inequitable conduct supporting equitable subordination remedy, including findings that notes were purchased for dual purpose of making profit for fiduciary and influencing reorganization in its self-interest, were purchased with benefit of non-public information acquired as fiduciary, and were acquired without disclosure to bankruptcy court, debtor's board of directors, unsecured creditors committee, or selling noteholders.

2. Bankruptcy ⇨2968

Opportunity to purchase Chapter 11 debtor's notes at discount was corporate opportunity, and therefore failure of fiduciary that purchased notes to provide requisite notice to debtor's board and unsecured creditors committee was breach of fiduciary duty supporting subordination depriving fiduciary of its profit from transactions, despite fiduciary's claims that debtor could not have purchased notes and committee members had no interest in doing so.

3. Bankruptcy ⇨2968

Fiduciary of Chapter 11 debtor failed to show that unsecured creditors committee had knowledge that fiduciary was purchasing claims against debtor until after fiduciary announced its competing reorganization claim, and thus that its conduct in acquiring claims without notice to committee did not

support equitable subordination; although minutes of committee conference call reflected mention of rumor that fiduciary had purchased one creditor's claims, committee chair's testimony, which bankruptcy court credited, indicated that discussion lasted 30 seconds and that such rumors were commonplace and generally did not warrant further inquiry.

4. Bankruptcy ⚷2904

Findings that fiduciary of Chapter 11 debtor intended to profit from purchasing debtor's notes at discount and to gain control of debtor's reorganization through purchases, and thus was motivated primarily by self-interest, were supported by testimony of fiduciary's representative on debtor's board of directors that he expected to make profit from purchases and of fiduciary's chairman that purchases would help fiduciary "influence something."

5. Bankruptcy ⚷2904

Findings that fiduciary of Chapter 11 debtor had access to material, non-public information as insider that influenced its purchases of debtor's notes was supported by evidence that debtor's former chief financial officer conducted valuations of debtor which were based on fiduciary's proposed asset purchase and which were not provided to unsecured creditors committee, and fiduciary's use of special information it obtained in purchasing claims and preparing purchase offer.

6. Bankruptcy ⚷2968

Equitable subordination of claims purchased by fiduciary of Chapter 11 debtor was justified by injuries suffered by selling noteholders as result of being deprived of ability to make fully informed decision to sell, dilution of voting rights and costs of delay in confirmation of debtor's reorganization plan suffered by members of unsecured creditors committee, and conflict of interest created by fiduciary's actions that jeopardized its ability to make decisions in debtor's best interests.

7. Bankruptcy ⚷2967.5

Remedy of equitable subordination must not be inconsistent with other provisions of the Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 510(c).

8. Bankruptcy ⚷2968

Availability of alternative remedies did not make equitable subordination of claims purchased by Chapter 11 debtor's fiduciary, in breach of its fiduciary obligation, incompatible with Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 510(c).

9. Bankruptcy ⚷2968, 3790

Although, at a minimum, remedy for fiduciary's inequitable conduct in buying claims against Chapter 11 debtor at discount without notice to debtor or creditors had to deprive fiduciary of its profit on claims, further subordination was appropriate only if supported by findings that justified remedy chosen by reference to equitable principles, and the absence of such findings necessitated remand. Bankr.Code, 11 U.S.C.A. § 510(c).

10. Bankruptcy ⚷2967.1

In imposing subordination remedy beyond disgorgement of profit in cases in which it is not feasible to quantify loss suffered by those benefitting from subordination, bankruptcy court should attempt to identify nature and extent of harm it intends to compensate in a manner that will permit judgment to be made regarding proportionality of remedy to injury suffered, and, if that is not possible, the court should specifically so find. Bankr.Code, 11 U.S.C.A. § 510(c).

11. Bankruptcy ⚷2967.5

Equitable subordination should not result in a windfall to those benefitted by it based on injury to others outside the benefitted class. Bankr.Code, 11 U.S.C.A. § 510(c).

12. Bankruptcy ⚷2968

Given that injury suffered by those who sold their claims against Chapter 11 debtor to debtor's fiduciary would not be benefitted by equitable subordination of such claims, any injury suffered by sellers could play no role in determination of extent to which claims should be subordinated. Bankr.Code, 11 U.S.C.A. § 510(c).

Amy M. Tonti, Klett, Lieber, Rooney & Schorling, Pittsburgh, PA, Paul K. Vey, Pietragallo, Bosick & Gordon, Pittsburgh, PA,

Lawrence J. Slattery (Argued), Citibank Legal Affairs Office, New York City, for Citicorp Venture Capital, Ltd.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA, Stephan M. Ray (Argued) and K. John Shaffer, Stutman, Treister & Glatt, Los Angeles, CA, for Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation.

BEFORE: STAPLETON and ROSENN, Circuit Judges, and RESTANI,* Judge

OPINION OF THE COURT

STAPLETON, Circuit Judge:

This appeal is from a decision in an adversary proceeding brought by plaintiff-appellant/cross-appellee Committee of Creditors Holding Unsecured Claims (the "Committee") against defendant-appellee/cross-appellant Citicorp Venture Capital, Ltd. ("CVC"). The action arises out of the chapter 11 reorganization of Papercraft Corporation filed in the Western District of Pennsylvania. The Committee claims that CVC, while a fiduciary of Papercraft, secretly purchased millions of dollars of claims against Papercraft at a discount, seeking to control Papercraft's assets and make a profit at the expense of Papercraft's other creditors. CVC contends that the claims were properly purchased and that it acted in the best interests of both the company and its creditors. After a trial, the bankruptcy court entered a judgment against CVC, allowing CVC's purchased claims only to the extent of the discounted amount CVC paid for them and limiting its recovery to the percentage distribution provided in the plan multiplied by that discounted amount. On appeal, the district court agreed with the bankruptcy court's finding that CVC had breached its fiduciary duties, acted inequitably, and caused injury to Papercraft and its creditors. It disagreed, however, with the bankruptcy court's chosen remedy and remanded for a redetermination regarding the appropriate remedial action. This appeal followed.

I. THE FACTS FOUND BY THE BANKRUPTCY COURT*

In 1985, Papercraft completed a leveraged buyout in which CVC invested $5.8 million. As a result of this transaction, CVC was given a 28% equity interest in Papercraft's direct parent, Amalgamated Investment Corp., and the right to seat one representative on the boards of directors of Amalgamated, Papercraft, and Papercraft's wholly-owned operating subsidiaries, Barth & Dreyfuss of California and Knomark, Inc. CVC's vice president, M. Saleem Muqaddam, became CVC's representative on these boards of directors, and he remained such during the time period relevant to this appeal.

Papercraft ran into financial difficulties a few years after the transaction, which forced a restructuring of the leveraged buyout ("LBO") debt. As part of the restructuring, Papercraft exchanged about 98% of its indebtedness for new First Priority Notes and Second Priority Notes. However, beginning in 1990, Papercraft was unable to meet the terms of the notes and sought to negotiate a second restructuring of its unsecured debt. An informal committee of major Papercraft creditors was formed and, after several months of negotiations, an agreement was reached on a restructuring plan. The plan, known as the "BDK plan," called for a merger of Papercraft's operating subsidiaries (Barth & Dreyfuss and Knomark) into a single entity, BDK Holdings, Inc., as part of a voluntary chapter 11 petition to be filed by Papercraft. The creditors' claims against Papercraft would then be converted into "BDK Units" consisting of stock and bonds issued by the new venture. The BDK plan was approved unanimously by Papercraft's directors, including CVC's Muqaddam, in March 1991.

Papercraft filed its voluntary petition under chapter 11 on March 22, 1991. As of the filing date, Papercraft had outstanding $90.7 million in First Priority Notes and $56.3 million in Second Priority Notes, none of which were held by CVC. Pursuant to the agreement among the creditors, Papercraft

* Hon. Jane A. Restani, Judge of the United States Court of International Trade, sitting by designation.

filed the BDK plan with the chapter 11 petition and an official Committee was formed to represent the interests of unsecured creditors.

Though the chapter 11 petition and BDK plan were filed in March 1991, the required Papercraft disclosure statement, a prerequisite to confirmation of the plan, was not filed until October 1991. During this delay, CVC managed to purchase over 40% of the outstanding notes, at a significant discount. CVC, despite its earlier support of the BDK plan, then objected to the confirmation of that plan and offered its own competing plan, which called for a CVC purchase of Papercraft's assets. An account of the specific circumstances under which CVC took these actions follows.

In March 1991, Muqaddam, in a memorandum to CVC's Investment Committee, sought authorization to spend up to $10 million purchasing Papercraft notes. CVC officials granted the request in April 1991. Muqaddam, acting for CVC, then began making anonymous purchases of notes through various brokers. Between April and August 1991, CVC purchased $60,849,575.72 face value of the Papercraft notes for $10,553,541.88. These purchases represented a significant proportion of the outstanding Papercraft debt: CVC managed to acquire 38.3% of Papercraft's outstanding First Priority Notes and 46.4% of outstanding Second Priority Notes. In all, CVC's purchases amounted to 40.8% of Papercraft's total unsecured claims. It thus achieved a "blocking" position in the proposed reorganization. Although Muqaddam was a member of Papercraft's board, and therefore a fiduciary to the company and its creditors, neither he nor anyone else from CVC requested or obtained the approval of the board, the Committee, or the court before purchasing the notes. Nor did CVC disclose to any of the selling creditors its identity as buyer or its fiduciary status.

At the same time CVC was surreptitiously purchasing claims, it also requested or otherwise obtained confidential information about Papercraft's financial stability and assets, including information that was not shared with Papercraft's other creditors. In early 1991, at Muqaddam's direction, two CVC employees visited the headquarters of Papercraft's Barth & Dreyfuss subsidiary to obtain information. During that visit, CVC copied financial statements, looked at the company's product lines, held meetings with management, and toured the facilities. A written report was subsequently completed by CVC, drafts of which were shared with Papercraft personnel. Indeed, Frank Kane, Papercraft's Chief Financial Officer, reviewed the report and gave comments directly to Muqaddam. None of this information was shared with the Committee. Papercraft personnel also forwarded a number of financial analyses and other documents directly to CVC, including a tax analysis that had been completed by a consulting firm at Muqaddam's request. In addition, a valuation of Papercraft assets and a distressed sale analysis completed by Chanin and Company, the Committee's own financial advisor, was given to CVC by Papercraft personnel.

As CVC accumulated Papercraft debt and information between April and August 1991, it also formulated a reorganization plan designed to compete with the previously filed BDK plan. Muqaddam and his staff prepared a series of reports evaluating the possibility of a CVC asset purchase offer. These reports were based, in large part, on the information about Papercraft that had been forwarded to CVC by Kane. In the course of preparing an asset purchase offer, Muqaddam held a meeting with Kane and the Bank of New York Credit Corporation ("BNYCC") to discuss financing for a CVC asset purchase offer. Muqaddam then prepared a memorandum to CVC's Investment Committee requesting authorization to purchase Papercraft's assets. This authority was granted to Muqaddam in August 1991.

In early September 1991, CVC formalized an asset purchase offer by sending a letter to Papercraft detailing the plan and announcing a financing arrangement with BNYCC. Shortly before this announcement, Muqaddam informed the Committee, for the first time, that CVC had been purchasing claims. Soon after the asset purchase offer was announced, it was filed as a plan of reorganization by Papercraft. Papercraft also filed disclosure statements for both the BDK plan and the CVC plan in October 1991.

The BDK plan disclosure statement was approved by the bankruptcy court at a hearing in December 1991. Shortly thereafter, CVC withdrew its plan of reorganization, but then filed objections to confirmation of the BDK plan. The bankruptcy court overruled those objections and confirmed the BDK plan in January 1992.

II. THE PRIOR PROCEEDINGS

In October 1991, the Committee initiated this adversary proceeding against CVC, objecting to the allowance of the claims CVC had purchased and seeking equitable subordination of those claims. After extensive discovery, a trial was held over two days in November 1994. After reviewing the testimony and evidence, the bankruptcy court ruled in favor of the Committee. The court held that CVC had failed to meet its fiduciary obligation to act in the best interest of Papercraft and its creditors. *See In re Papercraft Corp.,* 187 B.R. 486, 497 (Bankr. W.D.Pa.1995). It identified three adverse effects from CVC's breaches of its fiduciary duty. First, the bankruptcy court noted that the note holders who sold their claims to CVC "were deprived of the ability to make a fully informed decision concerning the sale of their claims." *Id.* Although they might have still decided to sell after full disclosure, "[t]he harm lies in the fact that the selling noteholders had no opportunity to consider pertinent information." *Id.*

Second, the court concluded that "CVC's actions diluted the voting rights of prepetition creditors and resulted in CVC's attempt to wrest from the prepetition creditors the valuable assets of [Papercraft]." *Id.* Though CVC did not ultimately vote its claims, the court concluded that "[n]onetheless, its acquisition of claims placed it in the controlling seat in its class," *id.* at 499 n. 10, and that CVC was able to influence the negotiations surrounding the terms of the plan despite its ultimate election not to vote.

Finally, the bankruptcy court decided that CVC's actions created a conflict of interest which jeopardized its ability "to make future decisions on claims as a director free of [its] own personal interests as [an] owner of claims. Adding to the conflict is the fact that these purchases were made at a discount from present value. This brings into play a profit motive, accentuating [its] personal interests." *Id.* at 500 (quoting *In re Cumberland Farms, Inc.,* 181 B.R. 678, 680 (Bankr. D.Mass.1995)).

To remedy the adverse consequences of CVC's behavior, the bankruptcy court applied a "*per se* rule" that when a claim is purchased by an insider at a discount without adequate disclosure to the debtor and creditors, "the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *Id.* at 491. However, the bankruptcy court declined to equitably subordinate CVC's claims.

On appeal, the district court first reviewed the findings of fact made by the bankruptcy court and found none of them clearly erroneous. Applying the facts to the test for equitable subordination, the district court agreed that CVC had acted inequitably and that this behavior had injured creditors. As for a remedy, the district court held that CVC's recovery should, at a minimum, be limited to the amount paid for its claims so as to eliminate any potential profits from the purchase of the notes. It disapproved of the bankruptcy court's *per se* rule, however, and remanded to the bankruptcy court for a determination of "the amount CVC's claims should be subordinated." *Id.*[1]

III. THE RIGHT TO RELIEF

Before ordering equitable subordination, most courts have required a showing involving three elements: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3)

1. The bankruptcy court had jurisdiction over this adversary proceeding pursuant to 28 U.S.C. §§ 157(b) & 1334(b). The district court had appellate jurisdiction over the bankruptcy court's final judgment pursuant to 28 U.S.C. § 158(a)(1). We have jurisdiction over the final decision of the district court pursuant to 28 U.S.C. § 158(d). *See In re Indian Palms Associates, Ltd.,* 61 F.3d 197, 199 n. 2 (3d Cir.1995).

equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code. *U.S. v. Noland*, 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996) (describing existing case law as consistent with the three part test identified in *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir.1977)).[2]

A. *Inequitable Conduct*

1. *The Legal Sufficiency of the Findings of the Bankruptcy Court*

[1] CVC acknowledges that it and its representative, Muqaddam, owed a fiduciary duty to Papercraft and its creditors at all times relevant here. It asserts, however, that neither breached a fiduciary duty. It insists that it is not improper *per se* for a fiduciary to purchase claims against the debtor in a bankruptcy at a discount and it stresses that the bankruptcy court made no finding that the prices paid for the Papercraft notes were unfair or inequitable at the time of the purchases.

We accept, *arguendo*, that the purchase of notes at a discount by a fiduciary of a debtor in bankruptcy is not improper under all circumstances,[3] and we acknowledge the absence of a finding on the fairness of the purchase price. The bankruptcy court found, however, that the Papercraft notes (1) were purchased for the dual purpose of making a profit for CVC on the notes and of being able to influence the reorganization in its own self-interest, (2) were purchased with the benefit of non-public information acquired as a fiduciary, and (3) were acquired without disclosure of its purchasing plans to the bankruptcy court, the Papercraft board, the Committee, or the selling note holders. The bankruptcy court further pointed out that under *Brown v. Presbyterian Ministers*, 484 F.2d 998, 1005 (3d Cir.1973), the opportunity to purchase the notes was a corporate opportunity of which CVC could not avail itself, consistent with its fiduciary duty, without giving the corporation and its creditors notice and an opportunity to participate.

CVC primarily protests that the bankruptcy court's findings of fact concerning inequitable conduct on its part are clearly erroneous. We will address that contention in the following section. We hold here, however, that the above noted findings reflect ample inequitable conduct to support a subordination remedy. Indeed, those findings make this a paradigm case of inequitable conduct by a fiduciary as that concept has been developed in the case law, and we believe further elaboration is not required. Before turning to an analysis of the record support for these findings, we will only comment briefly on two of CVC's justifications for its conduct.

[2] CVC insists that the opportunity to purchase the notes was not a corporate opportunity, and that notice to Papercraft's Board and the Committee was not required because Papercraft could not have purchased the notes at discount and the members of the Committee had no interest in doing so. We agree with the Committee, however, that CVC's argument is fundamentally at odds with our decision in *Brown*.

In *Brown*, we held that the availability of claims for purchase at a discount constitutes a corporate opportunity. After noting that a director of a solvent corporation may take advantage of a corporate opportunity only if he discloses the opportunity to the corpora-

2. This court, in *In re Burden v. United States*, 917 F.2d 115, 120 (3d Cir.1990), concluded that "creditor misconduct is not [always] a prerequisite for equitable subordination." *Burden* involved subordination of a tax penalty in the absence of government misconduct. The Supreme Court, in two recent cases regarding the standards for tax penalty subordination, has refused to decide whether misconduct is required under § 510(c), resolving each case on the principle that "categorical" subordination is not permissible. *See United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 229, 116 S.Ct. 2106, 135 L.Ed.2d 506 (1996); *Noland*, 517 U.S. at 543, 116 S.Ct. 1524. We need not here resolve the issue of whether misconduct is always a prerequisite to equitable subordination because the bankruptcy court properly found misconduct.

3. There is authority arguably to the contrary, but, in light of the findings of the bankruptcy court, we need not, and do not, resolve the issue here. In *Manufacturers Trust Co. v. Becker*, 338 U.S. 304, 313–14, 70 S.Ct. 127, 94 L.Ed. 107 (1949) the court observed, "... [I]f it is clear [as it is] that a fiduciary may ordinarily purchase debt claims in fair transactions during the solvency of the corporation, the lower federal courts seem agreed that he cannot purchase after judicial proceedings for the relief of a debtor are expected or have begun." (citing cases).

tion, we further held that a director of a corporation in bankruptcy owes a fiduciary duty to creditors and cannot seize a corporate opportunity without disclosure to the creditors or their representative. Even though the director in *Brown* had purchased a note at discount with the consent of the corporation and its stockholders, we concluded that a breach of fiduciary duty had occurred: "The opportunity should have been disclosed to the receiver as representative of the creditors." *Id.* at 1005.

CVC contends that *Brown* is distinguishable because Papercraft was not in a financial or legal position to purchase the notes and because the members of the Committee must have been well aware that a market existed in Papercraft debt. It necessarily follows, according to CVC, that neither could have been injured by its purchases. We believe this argument more relevant to the remedy issue than to whether a breach of fiduciary duty occurred. That duty required that it share everything that it knew with Papercraft's board and the Committee before commencing its purchases. Its failure to do so would alone support a subordination depriving it of its profit from the note transactions. The absence of a disclosure in circumstances of this kind makes it extremely difficult to say with confidence what would have happened had no breach of duty occurred[4] and that, in itself, is a compelling reason for insisting on disclosure.

CVC also argues that its failure to disclose its identity to note sellers was not inequitable because its identity was not material to the purchases. It stresses that no note sellers have thus far complained. We agree with the bankruptcy court, however, that CVC's identity and purchasing plans were clearly material to the purchase transaction. The fact that CVC, a party with access to inside information, was seeking to purchase over $10 million in Papercraft debt and to steer the reorganization towards a sale to it of Papercraft's assets would certainly have been of interest to a creditor considering a CVC offer to purchase in the summer of 1991.

In short, we agree with the bankruptcy court, the district court, and the Committee that CVC violated its fiduciary duty in a number of significant respects.

2. *Record Support for the Bankruptcy Court's Findings*

[3] CVC's most fundamental challenge to the factual findings of the bankruptcy court relates to the disclosure issue. It asserts that the court clearly erred in concluding that CVC anonymously purchased the Papercraft notes. While CVC makes no claim that it acted affirmatively to notify anyone of its purchases prior to the consummation of its purchasing plan, it maintains that the sophisticated investors on the Committee knew that CVC was buying claims and chose to keep quiet about it in order to gain a "litigation windfall" by filing suit once CVC announced its position. Specifically, CVC claims that the courts below clearly erred in finding that the Committee had no knowledge of CVC's claims purchases until after CVC announced its competing reorganization plan.

To support its argument, CVC relies upon minutes of a conference call held by the Committee on April 15, 1991. Those minutes reflect that "there was mention of the fact that American Money [a creditor of Papercraft] had sold its notes to Citicorp." App. at 1558. In addition, CVC points to testimony of the Committee's chair, Pamela Cascioli, that she had been made aware of rumors that CVC had purchased American Money's claims. However, the minutes of the conference call and the testimony of Cascioli were illuminated by witnesses at trial, who testified that the discussion during the conference call lasted thirty seconds and that such rumors are commonplace, generally unfounded, and would not normally warrant additional inquiry. The bankruptcy court credited this testimony and specifically found that, other

4. If the attention of the Papercraft board and the Committee had been focused on the potential CVC perceived in its note purchases, it is not at all clear that Papercraft or its creditors would have been unable to tap additional resources, just as CVC did. Either or both might have been able to seize or participate in the opportunity through borrowing, court approved purchases or amendment to the plan of reorganization to include a cash-out option. *See, e.g., In re Cumberland Farms, Inc.*, 181 B.R. 678 (Bankr.D.Mass. 1995).

than the rumor, the "committee heard no more about [claims purchasing activity] until CVC made its asset purchase offer in September of 1991." 187 B.R. at 492. It appears that the bankruptcy court weighed the effect of the rumor in light of the explanatory testimony and credited the Committee's explanation. CVC provides no convincing reason to conclude that this determination was clearly erroneous.[5]

[4] CVC next challenges the court's finding as to its motive in purchasing the notes. It suggests that it was acting in the best interest of the company by offering a cash-out option to creditors that was not available under the BDK plan. As we have noted, however, the court found that CVC intended to profit not only from the purchase of the notes at discount but also from gaining control of the reorganization. These findings were supported, inter alia, by the testimony of CVC's own people. Muqaddam admitted that he expected to make a profit from the note purchases, and the chairman of CVC stated that those purchases would help CVC "influence something." *Id.* at 495–96, 500. The evidence clearly permits an inference that CVC was primarily motivated by its own self-interest in purchasing claims. Accordingly, the court did not clearly err in drawing that inference.

[5] CVC also contests the court's determination that its access to material, non-public information as an insider influenced its purchases of Papercraft notes. The court relied upon evidence establishing that Papercraft's then-Chief Financial Officer, Frank Kane, conducted valuations of the company based on CVC's proposed asset purchase—analyses that were not provided to the Committee. In addition, the court found that some of CVC's information was not public when received, and that CVC was given priority treatment by Papercraft in responding to requests for information. As the court accurately put it, "CVC had virtually unrestricted access to inside information and significant assistance from [Papercraft] through its employees and staff and its control over employees." *Id.* at 496.

CVC argues that though it was an insider, the information it received did not differ materially from that available to the other creditors, who were all sophisticated institutional investors. The bankruptcy court's conclusion to the contrary is supported, however, by evidence that CVC obtained special financial information and financial and tax valuations in order to evaluate its own asset purchase proposal, which was itself directly supported by the note purchases. CVC's argument that the special analyses it received were immaterial rings hollow in light of its use of that information in purchasing claims and preparing its asset purchase offer.

In short, our review of the record convinces us that the crucial findings we have referenced as demonstrating inequitable conduct are not clearly erroneous.

B. *Injury or Unfair Advantage*

[6] As we have noted, the bankruptcy court identified three areas of injury or unfair advantage suffered by the Committee and Papercraft as a result of CVC's secret purchase of claims at a discount. First, the court found that selling note holders were deprived of the ability to make a fully informed decision to sell their claims. Second, the court concluded that CVC diluted the voting rights of members of the Committee. Though CVC ultimately did not vote its claims, the court indicated that its purchased claims secured a position of influence over the reorganization negotiations. Finally, the court held that CVC's actions created a conflict of interest which jeopardized its ability to make decisions in the best interest of the company, free from its competing profit motive.

The district court also found these "injuries and unfair advantages" to be sufficient to warrant an equitable subordination remedy. It emphasized that CVC had "engaged in a comprehensive information collection ef-

5. CVC strenuously argues that the bankruptcy court should not be allowed to simply rest on a credibility determination when documentary evidence supports a different conclusion. However, in this case the documentary evidence was *explained* by the testimony at trial, which the court found credible. There is nothing unusual about a court finding credible one plausible explanation of the significance of documentary evidence.

fort made possible by its position on Papercraft's Board . . . and then used this information to prepare its own asset purchase offer which directly competed with the BDK plan." Op. at 21. While the district court makes no express reference to it, the Committee points us to trial testimony from its financial advisor indicating that this competing reorganization plan and CVC's associated objections to the BDK plan resulted in confirmation delay that inflicted substantial injury on Papercraft's non-selling creditors.

The bankruptcy court did not attempt to quantify the harms caused in economic terms, and CVC characterizes them as "non-economic" harms. We do not agree with this characterization, however, and, like the bankruptcy and district courts, we conclude that they are sufficient to justify subordination.

C. *Consistency with the Code*

[7, 8] Finally, a remedy of equitable subordination under § 510(c) must not be inconsistent with other provisions of the bankruptcy code. This requirement "has been read as a 'reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives the result is inequitable.' " *Noland,* 517 U.S. at 539, 116 S.Ct. 1524 (quoting DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors,* 40 Bus. Law 417, 428 (1985)).

CVC makes the argument that other provisions of the bankruptcy code, including those related to voting of claims and transfer of claims, provide all the remedy necessary for inappropriate insider activity. While these provisions may also be applicable, we perceive no reason why the availability of alternative remedies makes equitable subordination under § 510(c) incompatible with the Code under the circumstances of this case.

IV. THE REMEDY

[9] The bankruptcy court and the district court agreed that CVC's inequitable conduct warranted a remedy and that, at a minimum, it should not be permitted to profit by its purchase of Papercraft notes. Their agreement ended there, however. The bankruptcy court applied a *per se* rule that whenever an insider purchases a claim of a debtor without disclosure to the debtor and its creditors, that claim will be "allowed" under § 201 only to the extent of the amount paid and "recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." 187 B.R. at 491. Having imposed that remedy, the bankruptcy court concluded that equitable subordination of CVC's entire claim would "not [be] consistent with the Code." *Id.* at 502. As it explained:

> In the instant case we find that the first two[elements of equitable subordination] have been met but, because of our limitation on the allowance of CVC's claims, equitable subordination is not consistent with the Code. We have previously held that "principles of fairness would be violated if insiders who create an unfair advantage for themselves were permitted to share equally with other creditors." *In re I.D. Craig Service Corp.,* 1991 WL 155750 at *7 (Bankr.W.D.Pa. August 8, 1991). Because we are limiting the allowed amount of CVC's claim to the amount it paid for the claims, with recovery under the plan gauged to that amount, we have adhered to principles of fairness without the necessity of subordinating CVC's claim.

Id. at 502.

The district court held that the bankruptcy court's *per se* remedy did more than deprive CVC of its profit on its investment in Papercraft notes, an objective that could be accomplished by subjecting CVC claims to subordination to the extent necessary to limit its recovery to the amount paid. The district court estimated that the remedy imposed by the bankruptcy court would reduce CVC's recovery approximately $7.5 million below the amount necessary to deprive it of profit. While it acknowledged that subordination beyond that necessary to deprive CVC of profit might be warranted here, it declined to approve further subordination in the absence of appropriate findings. The court thus held:

> [B]ecause it adopted a per se rule, the Bankruptcy Court did not have the opportunity to make factual findings as to how an additional $7,489,941.88 reduction in

CVC's recovery comports with the principles of equitable subordination. We do not conclude today, however, that CVC's claims may not be subordinated by such an amount but only that any amount of subordination beyond the limitation of CVC's recovery to the amount paid for such claims should be supported by factual findings and reconciled with the principles of equity. We believe this to be a finding of fact best left to the Bankruptcy Court, not this Court sitting as a court of appeal. Accordingly, we will remand the case to the Bankruptcy Court for a finding on the amount CVC's claims should be subordinated pursuant to the principles of equitable subordination.

Op. at 26–27.

We agree with the district court. At a minimum, the remedy here should deprive CVC of its profit on the purchase of the notes. That can be accomplished by subordinating CVC's claim under § 510(c) to the extent necessary in order to limit its recovery to the purchase price of the notes.[6] Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.[7] In the absence of such findings, neither the district court nor we are in a position to fulfill our assigned responsibility of review.

[10] By so concluding, we do not suggest that a bankruptcy court can never impose a subordination remedy beyond disgorgement of profit without putting a specific price tag on the loss suffered by those who will benefit from the subordination. Such quantification may not always be feasible and, where that is the case, it should not redound to the benefit of the wrongdoer. A bankruptcy court should, however, attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination. If that is not possible, the court should specifically so find.

[11, 12] Inherent in what we have just said is the equitable principle that any subordination should not result in a windfall to those benefitted by it based on injury to others outside the benefitted class. *Stoumbos v. Kilimnik,* 988 F.2d 949, 960 (9th Cir. 1993) ("A claim will be subordinated only to the claims of other creditors whom the inequitable conduct has disadvantaged."); *Matter of Herby's Foods, Inc.,* 2 F.3d 128, 131 (5th Cir.1993) (subordination proper only to the extent necessary to offset the harm the creditors suffered as a result of the inequitable conduct). This principle is applicable here because the Papercraft creditors who sold their claims to CVC will not benefit from any subordination. Accordingly, any injury to them must play no role in determining the extent of any subordination here of CVC's claims. If they consider themselves aggrieved, they must be left to the other remedies afforded them by law.

While we agree with CVC's criticism of the bankruptcy court's remedy, we decline to accept its argument that the record is devoid of any evidence that would support a remedy going beyond disgorgement of profit. Without limiting the inquiry of the bankruptcy court in any way, we note that there is evidence which would support a finding that

6. We do not read the case law cited by the Committee and the bankruptcy court to suggest the contrary.

7. In the course of reaching its holding, the district court concluded that § 510(c) is the exclusive remedy available to a bankruptcy court in circumstances like these and that the bankruptcy court was accordingly without authority to fashion a "disallowance" remedy. We do not endorse that conclusion. In *Pepper v. Litton,* 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939), the Supreme Court held that the bankruptcy court exercised its statutory responsibilities as a court of equity and indicated that a purchase of claims against a debtor in bankruptcy by a fiduciary, when consistent with principles of equity, may properly lead either to the "disallowance" of the fiduciary's claim or to the subordination thereof. The rationale of *Pepper* would suggest that under pre-Code law a bankruptcy court was authorized to disallow a portion of the fiduciary's claim when that would produce an equitable result. We find it unnecessary here to resolve the issue as to whether equitable "disallowance" remains an available remedy. The Committee sought subordination under § 510(c), the district court has appropriately remanded this matter to the bankruptcy court for application of § 510(c), and neither side maintains that the authority granted by that section cannot be utilized to fashion a just remedy.

the non-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization. While the bankruptcy court held, with record support, that the delay between the filing of the petition and the filing of the disclosure statement was not attributable to CVC's machinations, it made no similar finding with respect to the period of delay between the filing of the disclosure statement and confirmation of the BDK plan. Moreover, while the bankruptcy court found "no evidence that CVC engaged in conduct designed to delay the plan process," if CVC's pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay. On remand, the bankruptcy court should consider whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.

V. CONCLUSION

The judgment of the district court will be affirmed. In accordance with that judgment, this case will be remanded to the bankruptcy court for further proceedings consistent with this opinion.

BANCA DEL SEMPIONE, Plaintiff–Appellee,

v.

PROVIDENT BANK OF MARYLAND, Defendant–Appellant,

and

Suriel Finance N.V., Defendant,

Jeanne Farnan, Party in Interest.

United States Council on International Banking, Incorporated, Amicus Curiae.

No. 97–2025.

United States Court of Appeals, Fourth Circuit.

Argued April 10, 1998.

Decided Nov. 12, 1998.

Transferee of standby letter of credit sued issuer of letter of credit for breach of contract, wrongful dishonor, negligent misrepresentation, and anticipatory breach. Issuer moved for summary judgment. The United States District Court for the District of Maryland, Walter E. Black, Jr., Chief Judge, 852 F.Supp. 417, granted motion. Transferee appealed. The Court of Appeals, 75 F.3d 951, reversed and remanded. Following bench trial, the District Court, J. Frederick Motz, Chief District Judge, entered judgment in transferee's favor. Issuer appealed. The Court of Appeals, Butzner, Senior Circuit Judge, held that: (1) issuer amended letter of credit to make it available to transferee for life of loan for which it secured interest payments; (2) first beneficiary did not act as transferee's agent when it passed along to issuer letter of credit terms required by transferee; (3) transferee took credit free of all defenses that issuer had against first beneficiary; (4) transferee's sale of zero coupon bonds pursuant to loan agreement was not sale of collateral and did not reduce unpaid loan amount; and (5) transferee was entitled to recover from issuer at default interest rate set by loan agreement, following borrower's default, subject to letter of credit's annual cap.

Affirmed.

1. Banks and Banking ⚷191.10

Under Maryland's version of Uniform Commercial Code (UCC), issuer of standby letter of credit (LOC) amended LOC to make it available to beneficiary's transferee for life of loan for which it secured interest payments when issuer provided letter that changed LOC's terms from one year as origi-

decision at the forthcoming continued confirmation hearing of April 27, 2000.

D. CONCLUSION

An order consistent with our foregoing conclusions will be entered.

In re PAPERCRAFT CORPORATION, Debtors.

Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft, Plaintiffs,

v.

Citicorp Venture Capital, Ltd. a New York corporation, Defendants.

Bankruptcy No. 91–20903 JKF.
Adversary No. 91–2642.

United States Bankruptcy Court,
W.D. Pennsylvania,
Pittsburgh Division.

April 20, 2000.

Unsecured creditors' committee brought adversary proceeding against alleged insider in corporate Chapter 11 debtor, for equitable subordination of claims that insider had purchased against debtor's estate. The Bankruptcy Court, Judith K. Fitzgerald, Chief Judge, 187 B.R. 486, limited defendant's recovery on claims, but declined to equitably subordinate them, and parties cross-appealed. The United States District Court, Cindrich, J., 211 B.R. 813, reversed and remanded, and parties again appealed. The Court of Appeals, Stapleton, 160 F.3d 982, affirmed and remanded for additional findings. On remand, the Bankruptcy Court, Fitzgerald, Chief Judge, held that: (1) subordination of insider's claim was consistent with the Bankruptcy Code and appropriate under facts of case, and (2) subordination of insider's claim, not just to extent necessary to prevent insider from recovering more than discount price which it paid to purchase claims, but to compensate nonselling creditors for lost interest, and for reduction in amounts available to creditors due to increased administrative and professional fees and expenses and to postconfirmation United States Trustee fees that debtor was required to pay, was appropriate remedy for insider's fiduciary breach.

Claim subordinated.

1. Bankruptcy ⚷2968

Partial subordination of corporate insider's claim, to extent necessary to prevent insider from recovering more than the discount price that it paid to purchase claims against Chapter 11 debtor, was minimum remedy that could be imposed for insider's breach of fiduciary duty, in using knowledge that it had based upon its equity position in debtor's parent to acquire such claims in effort to promote its own interests, without ever disclosing its identity and status as insider; subordination of insider's claim was consistent with the Bankruptcy Code and appropriate under facts of case. Bankr.Code, 11 U.S.C.A. § 510(c).

2. Bankruptcy ⚷2968

Subordination of insider's claim, not just to extent necessary to prevent insider from recovering more than the discount price which it paid to purchase claims against Chapter 11 estate, but to compensate nonselling creditors for lost interest, and for reduction in amounts available to creditors due to increased administrative and professional fees and expenses and to post-confirmation United States Trustee fees that debtor was required to pay, was appropriate remedy for insider's breach of fiduciary duty in using knowledge that it acquired, based on its equity position in debtor's parent, to purchase such claims in effort to promote its own interests; insider's actions had significantly delayed reorganization process and had resulted, among other things, in administrative ex-

penses of more than $1.2 million. Bankr. Code, 11 U.S.C.A. § 510(c).

Stephan M. Ray, K. John Shaffer, Stutman, Treister & Glatt, P.C., Los Angeles, CA, Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA, for the Committee.

Amy Tonti, Klett, Lieber, Rooney & Schorling, Pittsburgh, PA, Jeffrey Deller, Lawrence J. Slattery, Citicorp Legal Affairs, New York City, for Citicorp Venture Capital, Ltd.

Paul K. Vey, Pietragallo, Bosick & Gordon, Pittsburgh, PA.

George Cheever, Kirkpatrick & Lockhart, Pittsburgh, PA.

MEMORANDUM OPINION [1]

JUDITH K. FITZGERALD, Chief Judge.

Introduction

This matter is before me on remand from the Court of Appeals. The facts have been detailed in my earlier opinion, 187 B.R. 486 (Bankr.W.D.Pa.1995), the District Court's opinion, 211 B.R. 813 (W.D.Pa. 1997), and the Court of Appeals' opinion, 160 F.3d 982 (3d Cir.1998), and will not be repeated here except to note that Citicorp Venture Capital ("CVC"), an insider of the Debtor owning a 28 percent equity interest in Debtor's parent company, bought notes from creditors of Debtor through brokers without disclosing its identity as a fiduciary and insider of the Debtor. My findings of fact were upheld on appeal by the District Court and the Court of Appeals. The District Court, however, reversed with respect to the remedy imposed. The Court of Appeals affirmed the District Court. The matter is before me now on remand for consideration of the appropriate remedy in light of the harm visited by CVC's conduct.

This court ruled that the amount of CVC's claim would be limited to the amount it paid for the claims, not to the face value of the notes purchased which constituted the claims. I also held that distribution to CVC on its reduced claim would be limited to the percentage distribution provided in Debtor's plan, as applied to the allowed claim. *In re Papercraft Corporation,* 187 B.R. 486, 491 (Bankr.W.D.Pa.1995).

The District Court, while agreeing that CVC should not profit from its conduct, reversed on the basis that I had created a per se rule to apply to all insider trading undertaken without disclosure and had no authority to do so. The District Court noted that § 510 of the Bankruptcy Code exists to address inequitable conduct by insiders and that a per se rule "removes the principles of equity and applies instead a universal penalty for any instance of noncompliance." *In re Papercraft Corporation,* 211 B.R. 813, 822–24 (W.D.Pa. 1997).

The District Court held that my finding of injury to creditors or unfair advantage to CVC based on its inequitable conduct was supported by the evidence and not clearly erroneous. The District Court instructed me to make findings as to the appropriate amount of the limitation on CVC's claim, finding that I did not sufficiently support the amount of the limitation I imposed on CVC's recovery and did not reconcile the limitation with the principles of equity. The District Court did

> not conclude ..., however, that CVC's claims may not be subordinated by such an amount but only that any amount of subordination beyond the limitation of CVC's recovery to the amount paid for

1. The court's jurisdiction was not at issue. This Memorandum Opinion constitutes my findings of fact and conclusions of law. I incorporate the findings made on the record on July 7, 1999, at the hearing on arguments to determine whether the record should be reopened on remand. I conclude that there is no need to reopen the record inasmuch as the parties were afforded the opportunity to litigate all issues at trial. Moreover, the record contains sufficient evidence of quantifiable harm to subordinate CVC's claim beyond simply removing its profit, as is explained in the Opinion proper.

> such claims should be supported by factual findings and reconciled with the principles of equity.

In re Papercraft Corporation, 211 B.R. 813, 827 (W.D.Pa.1997).

The Court of Appeals held that

(1) my findings of inequitable conduct were not clearly erroneous. In fact, the Court of Appeals held that those "findings [of fact] make this a paradigm case of inequitable conduct by a fiduciary as that concept has been developed in the case law. . . .", *Citicorp Venture Capital, Ltd. v. Committee of Unsecured Creditors (Papercraft Corp.),* 160 F.3d 982, 987 (3d Cir. 1998);

(2) the injury or unfair advantage that was found to exist by the bankruptcy and district courts was sufficient to justify equitable subordination of CVC's claim; and

(3) equitable subordination as a remedy is consistent with the Bankruptcy Code.

The Court of Appeals agreed with the District Court that CVC should be deprived of its profit and "[t]hat can be accomplished by subordinating CVC's claim under § 510(c) to the extent necessary in order to limit its recovery to the purchase price of the notes." 160 F.3d at 991. The Court further stated, however, that it was not requiring "a specific price tag" to justify every remedy beyond disgorgement of profit, *id.,* and that further subordination had to be "supported by findings that justify the remedy chosen by reference to equitable principles. . . ." so that an appellate court can determine the proportionality of the remedy to the injury suffered by those benefitting from the subordination. *Id.*

The Court of Appeals disagreed with the District Court's conclusions that § 510(c) is necessarily the exclusive remedy available to me and disagreed that I am without authority to fashion a disallowance remedy. 160 F.3d at 988, n. 7, citing *Pepper v. Litton,* 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939), a pre-Code case.

However, the Court of Appeals required that the

> bankruptcy court should . . . attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination. If that is not possible, the court should specifically so find.

160 F.3d at 991. The Court held that injury to the selling noteholders was not a factor to be considered. It also noted the existence of evidence that would support a finding that the nonselling noteholders were injured by CVC's conduct which caused the delay in the confirmation of the plan.

With respect to the elements of equitable subordination, the Court of Appeals recited:

> Before ordering equitable subordination, most courts have required a showing involving three elements: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code.

Papercraft Corporation, 160 F.3d 982, 986–87 (3d Cir.1998), citing *U.S. v. Noland,* 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996).[2] In my opinion of October 12,

2. 11 U.S.C. § 510(c) provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

Only subsection (1) is applicable in the matter before us.

1995, I found the first two elements to have been satisfied but withheld subordination on the third element because of the form of per se remedy I imposed. In this opinion, therefore, I address the evidence to determine whether subordination is consistent with the Bankruptcy Code.

[1] An examination of the evidence and the Court of Appeals' decision in this case leaves no question that subordination of CVC's claim is consistent with the Bankruptcy Code and appropriate under the facts of this case. Subordination to the extent that it permits CVC to recover no more than the amount it paid for its claims is the minimum remedy to be imposed. The Court of Appeals held that CVC's fiduciary duty required it to "share everything it knew with Papercraft's board and the Committee before commencing its purchases" and that "[i]ts failure to do so would alone support a subordination depriving it of its profit from the note transactions." 160 F.3d at 988. At this point my task is to identify specific harm, if any, supporting a remedy more drastic than subordination of the claim beyond removing all profit.

The Court of Appeals opined that where the harm to be redressed is not quantifiable, "it should not redound to the benefit of the wrongdoer" but the court "should, however, attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding a proportionality of the remedy to the injury that has been suffered by those who will benefit from this subordination", if possible. 160 F.3d at 991.

Discussion

[2] On the issue of what facts support equitable subordination and what harm is quantifiable, I find from the trial record as supplemented by the court's docket, of which I take judicial notice, that CVC's conduct resulted in three categories of economic harm to non-selling noteholder creditors. The first two encompass (a) the delay in confirming the plan which resulted in harm that is quantifiable in terms of dollars and (b) the uncertainty over the amount of CVC's claim distribution thereon that is not easily quantifiable. The third relates to the filing of this adversary which, through the appellate and remand process, has created a delay in fully implementing the confirmed plan of over four years from the date of my initial opinion (October 12, 1995) to today and of eight years since this adversary was filed on October 31, 1991. At the very least, while this adversary has been pursued through three courts and five proceedings,[3] this delay has caused Debtor to incur professional fees and expenses and additional U.S. Trustee quarterly fees which must be paid until the case is, *inter alia,* closed. *See* 28 U.S.C. § 1930(a)(6); *United States Trustee v. Gryphon at the Stone Mansion, Inc.,* 166 F.3d 552, 554 (3d Cir.1999).

1. ***Delay in Plan Confirmation***

In my 1995 opinion I stated that "[t]here was no evidence that CVC engaged in conduct designed to delay the plan process", 187 B.R. at 501, and that "[t]here was insufficient evidence to establish that CVC purchased claims with the intent to harm Debtor or defraud its creditors." *Id.* Notwithstanding lack of evidence that CVC's INTENT was to delay the process in order to harm creditors, there was more than enough evidence to establish that CVC's conduct did, in fact, delay it and that CVC's intent was to benefit itself over and above other creditors to whom it owed a fiduciary duty *not* to self-deal. In requiring Debtor to furnish the financial in-

3. The motion for summary judgment, two opinions by this court (excluding this one) and a trial, two appeals, and the hearing after remand in which the parties presented arguments to determine whether the record should be reopened in light of the Court of Appeals' opinion. After argument and consideration of the parties' briefs and the record, I conclude that the record need not be reopened. All of this, however, has resulted in increased attorneys' fees and costs and increased post-confirmation U.S. Trustee fees. In addition to litigation expenses, professional fees have been increased in fulfilling this court's requirement that status reports be filed during the pendency of the appeals.

formation described below, CVC caused Debtor to divert its resources from reorganization activities it should have undertaken, i.e., preparing the disclosure statement that was to accompany what is now called the BDK plan of reorganization filed at the outset of the case.

When a chapter 11 plan which has been approved by creditors prepetition is filed early in the case, a disclosure statement explaining the basis for the plan should be filed with that plan or shortly thereafter. In fact, the record shows that this was the expectation of all parties when the case was filed. The expectation was not realized in this case because CVC used its insider position to get information from the Debtor that it needed in order to facilitate its claim purchasing. Its claim purchases gave CVC leverage in the reorganization process and enabled it to control votes which, in turn, facilitated its purchase offer. The purchase offer was memorialized in the unusual occurrence of Debtor's filing a competing plan of reorganization (the CVC plan) that proposed an entirely different reorganization (i.e., a sale to Citicorp) from the BDK plan originally filed by Debtor and which Debtor did not withdraw. The Committee's requests for information which would enable it to assist Debtor in drafting the disclosure statement were stymied while Debtor provided information to CVC and delayed providing it to the Committee. *See* Declaration of Samuel M. Victor In Support of Equitable Subordination of CVC's Claims (hereafter "Victor Declaration"), Adv. Docket # 116 attached to Appendix of Opening Brief of Committee, Adv. Docket # 189 at ¶ 14. In that way, CVC caused the delay in Debtor's filing of the disclosure statement for the initial BDK plan and created significant unnecessary expense to this estate—in the millions of dollars in terms of a combination of professional fees, litigation expenses and U.S. Trustee quarterly fees due as the result of a statutory amendment to 28 U.S.C. § 1930(a)(6) and the Third Circuit Court of Appeals' decision in *United States Trustee v. Gryphon at the Stone Mansion, Inc.*, 166 F.3d 552 (3d Cir.1999). CVC's willful conduct in its own self interest in violation of its fiduciary duties to Debtor, the estate and its creditors is sufficient justification for further subordination of its claim to account for the increased costs and expenses it caused the estate so that its recovery is reduced beyond mere removal of its profit.

While CVC was maneuvering behind the scenes, it was tying up Debtor's resources by having Debtor modify financial projections that Debtor had prepared for the Committee and had turned over to CVC. CVC also obtained projections of working capital and income distributions and asked for a monthly model for an income statement, balance sheet and cash flow so that CVC would know the working capital changes and income statement movement within a prescribed period of time with respect to the two valuable operating subsidiaries of Debtor (Barth & Dreyfuss and Knomark). 187 B.R. at 493, 496 n. 8. By virtue of CVC's position in having a director on Debtor's board, CVC's requests for information always received priority over the Committee's.

Postpetition, Debtor repeatedly sought extension of the exclusive period of § 1121(b). It was during this delay that CVC purchased sufficient claims to garner a blocking position for the BDK plan and obtained the information upon which to base its asset purchase offer contained in the CVC plan it caused Debtor to file. Although there was an attempt to blame the delay in filing the BDK disclosure statement on what has been called the Second Pennsylvania litigation, (essentially a landlord-tenant dispute) once the disclosure statement was filed that litigation resolved. This court stated several times during the case before the disclosure statement was filed that there was no reason for the Second Pennsylvania litigation to stall the filing of the disclosure statement. Also involved was an issue regarding American Technical Industries, Inc. ("ATI") which affected Debtor's restructuring. However, the plan was filed almost simultaneously with the bankruptcy

petition, so the ATI issue must have been considered prepetition. *See* 187 B.R. at 501. The ramifications of both issues could have been explained in the disclosure statement and treated in the alternative (or as a range of distributions depending upon the outcome of the litigation) in the plan. Accordingly, there was no basis upon which to delay the filing of the disclosure statement caused by either the Second Pennsylvania or ATI issues. CVC's conduct, not the Second Pennsylvania litigation or ATI issues, caused the delay in plan confirmation.

I find that CVC caused the delay between the filing of the BDK disclosure statement and the confirmation of the BDK plan. CVC objected to confirmation of the BDK plan, even though it was one which CVC helped negotiate prepetition as a member of Debtor's board of directors. The credible evidence supports the conclusion that CVC instigated the stall in order to further pursue its self interest in having Debtor present CVC's alternative plan. This caused specific economic harm and further litigation and attendant professional fees and costs.

2. ***Quantifiable Economic Harm***

The evidence related to the quantifiable harm includes the following. In his declaration submitted with respect to the trial, Samuel Victor of Chanin & Co., financial advisor to the Committee, stated that in his opinion the value of BDK (the reorganized debtor) stock was depressed due to CVC's disputed claim to approximately 40 percent of the reorganized Debtor. *See* Supplemental Remand Brief of the Committee, Adv. Docket # 199, at 13, 16; Victor Declaration at ¶ 22. He also stated that the delay in confirmation resulted in "foregone interest income on their debt securities distributed pursuant to the BDK Plan." Victor Declaration at ¶ 26.[4]

The trial record reflects that as of October, 1994, administrative expenses during the delay in plan confirmation totaled $1,248,000.[5] Victor Declaration at ¶ 26. Mr. Victor included all administrative costs incurred during the four month delay in this total because the Committee was not aware of CVC's actions in purchasing its claims. Thus, the Committee was unable to factor out any particular task for which a fee was incurred as attributable to something other than the delay. *See* Trial Transcript of November 14, 1995, at 71–72. Moreover, once the CVC plan was filed it became necessary for the Committee to address it. Any fees and expenses incurred in connection with the CVC plan, therefore, are attributable to CVC's undisclosed claims purchases and constitute a direct economic harm to the estate.

The trial evidence also established that creditors lost "approximately $956,250 on their debt securities distributed pursuant to the BDK plan."[6] *Id. See* note 4, *supra.* At trial Mr. Victor explained that the interest was lost because creditors could not receive their new securities and, therefore, were unable to earn interest. Trial Transcript of November 14, 1995, at 76–77.

CVC's willful conduct in its own self interest in violation of its fiduciary duties

4. Mr. Victor calculated the interest as follows: "In connection with the BDK Plan, creditors received new debt securities with a face value of $33,750,000 with an annual interest rate on the debt securities of 8.5%. On a monthly basis, this translates into $239,062 of lost income incurred as a result of the delay in confirming the BDK Plan. Again, assuming a four month delay due to the actions of CVC, the cost to creditors in the aggregate is $956,250."
Victor Declaration, *supra,* at ¶ 26b.

5. The figures used herein are based on an estimate of a delay of four months. *See* Victor Declaration at ¶ 26. I find the four month delay to be a conservative estimate inasmuch as the BDK plan was filed shortly after the bankruptcy case was filed in March of 1991 and the plan was not confirmed until January 21, 1992.

6. This figure was increased in the Committee's Supplemental Remand Brief to over $1 million in lost interest and dividends and more than $2 million in postconfirmation attorneys fees and expenses. However, we accept the trial record as the evidence.

to Debtor, the estate and the creditors is a sufficient basis upon which to further subordinate its claim so that its recovery is reduced beyond the amount it paid for the claims to account for the increased costs, expenses, and lost interest it caused to the estate.

3. ***Uncertainty Over the Amount of CVC's Claim***

This harm is not quantifiable but results from the creditors of the estate not knowing what their final distribution will be and, to the extent potential investors in the Reorganized Debtor exist, uncertainty with respect to the extent of CVC's interest in the new company. The latter has the potential to affect both existing shareholders and/or purchasers' negotiating strategies and investors' decisions with respect to the new entity. For example, even if there were a market for shares of the Reorganized Debtor, and I make no findings on this point, that market would be adversely affected because no shareholder can know the extent of his holdings until the proceedings in this adversary conclude and the amount of CVC's claim is determined once and for all.

4. ***The Adversary and Resulting Litigation***

The third type of economic harm caused by CVC's undisclosed claims purchasing relates directly to this adversary. The Committee filed it to redress the harm caused by CVC and the fees and costs incurred for its prosecution have further minimized available funds in the reorganized entity. I cannot calculate the total dollar cost from the existing record. I will require additional submissions to permit that calculation.

During the pendency of the appeals from my 1995 order I required the filing of periodic reports with respect to the amount of compensation paid and expenses reimbursed to professionals for services rendered to the Committee. The Twenty–Fifth Report on Compensation Paid and Expenses Reimbursed, Bankruptcy case docket # 950, reflects a total of $3,242,396.73 incurred post-confirmation in professional fees and expenses on behalf of the Committee from February 15, 1992,[7] through January, 2000. From the reports, which set out only amounts paid but not an itemization of the nature of the services performed, I cannot discern whether all these fees and expenses are attributable to this Adversary. However, to the extent they are, CVC's distribution under the plan should be further subordinated by that amount. The reports do not include U.S. Trustee post-confirmation quarterly fees which have been paid, according to the docket, through the third quarter of 1999.[8] *See* Statement of United States Trustee in Response to 08/26/99 Order of Court, filed September 24, 1999, main docket # 948. The Committee will be given an opportunity to file a statement of fees and expenses related to this adversary, incurred through the date of this opinion. The Committee also shall be required to obtain and file a statement of U.S. Trustee post-confirmation quarterly fees paid. CVC shall have an opportunity to respond to the Committee's submission with respect to the fees and expenses incurred from the date the adversary was filed.[9]

Other Issues

There are two other issues to be addressed that have been raised by CVC on

7. The plan was confirmed on January 21, 1992.

8. The total amount of the U.S. Trustee post-confirmation quarterly fees is not of record at this time.

9. CVC has no basis upon which to challenge the amount of the U.S. Trustee post-confirmation quarterly fees inasmuch as those fees are statutory and their accrual is directly caused by CVC's conduct. That is, but for CVC's wrongdoing, this bankruptcy case would have been closed shortly after plan confirmation on January 21, 1992, well before Congress amended 28 U.S.C. § 1930 to require payment of post-confirmation fees.

this remand. CVC would like me to reevaluate the value of the BDK units (what the confirmed plan provides creditors in classes 4 and 8 in lieu of cash)[10] in light of their fair market value as now evidenced by, CVC alleges, the fact that (1) BDK, the reorganized Debtor, has not yet been sold despite confirmation of the plan eight years ago and (2) CVC would not be able to sell its BDK units if it had received them and, therefore, CVC has not received a profit. I reject this method of valuation in this instance. Valuation of BDK units was determined at the time of plan confirmation to be $1,228 per unit and no different valuation was presented at the trial of this Adversary even though one issue tried was equitable subordination. Other (non-selling) creditors have received distribution based on that valuation. It would exacerbate the harm to these creditors if BDK units were valued differently now and only for CVC's claim. The operative date of valuation for plan purposes and for purposes of this adversary was the date of plan confirmation. CVC must live with the situation it created. The District Court, in examining CVC's profit, also used the values established at the plan confirmation hearing. Accordingly, the original analysis showing that CVC paid $10,553,541.88 for what turned out to be $15,987,600 in value (BDK Units) under the plan is adopted for purposes of this opinion.[11]

CVC contends that my initial finding that CVC's conduct constituted improper usurpation of a corporate opportunity cannot stand unless the committee shows that the corporate opportunity would have been taken advantage of by appropriate parties. I need not consider this matter as all of my findings have been sustained on appeal and the only issue on remand is whether CVC's claim should be equitably subordinated beyond removal of its profit. However, I note that whether another entity would have availed itself of the opportunity is irrelevant. As the Court of Appeals pointed out in its opinion,

> under *Brown v. Presbyterian Ministers*, 484 F.2d 998, 1005 (3d Cir.1973), the opportunity to purchase the notes was a corporate opportunity of which CVC could not avail itself, consistent with its fiduciary duty, without giving the corporation and its creditors notice and an opportunity to participate.

160 F.3d at 987.[12]

Based on the foregoing, we find that CVC's claim should be subordinated so

10. Class 8 consists of all allowed claims that are equitably subordinated. Class 4 contains all allowed prepetition unsecured claims not otherwise classified in Classes 1, 3, 5, 6, or 7 relating to First and Second Priority Notes except for equitably subordinated claims. *See* BDK Plan at 9–10, Bankr.No. 91–20903, Docket # 545.

11. In its Reply Brief to the Committee's Supplemental Brief CVC argues that the cash value of its claim and recovery should be the appropriate measurement of any profit. CVC further asserts that because it did not receive cash and because the valuation of BDK units at plan confirmation was only for the purpose of arriving at an enterprise value of the reorganized Debtor, it is now necessary to recalculate value to determine CVC's profit. Reply Brief of Citicorp Venture Capital, Ltd. to Supplemental Brief of Committee, Docket # 201, at 3–5 and note 11 thereto. CVC has provided no authority for its argument that its claim should be valued on a basis different from that of all other creditors. To do so would be inequitable to other creditors, at least under the circumstances of this case. To achieve parity in distribution in these classes as the Bankruptcy Code requires, the court must maintain the same valuation method utilized for all distributions of BDK units to creditors in classes entitled to them. All creditors in the affected classes will sustain the same increase or diminution in the value of their holdings as CVC. Moreover, the parties had a full opportunity to litigate all issues at trial and specifically requested, prior to trial, that I withdraw my opinion on summary judgment so that the equitable subordination issues could be addressed. I did so and the case was tried in November of 1994 to address these issues. Reopening the record over 5 years after trial concluded would violate principles of finality and create a never-ending round robin of litigation.

12. The court of appeals accepted "arguendo, that the purchase of notes at a discount by a

that its profit is removed and the nonselling creditors are compensated for (1) lost interest, (2) the reduction in amounts available to creditors as reflected in the increased administrative and professional fees and expenses and (3) post-confirmation U.S. Trustee fees the Debtor was required to pay. To the extent CVC has an allowed Class 4 (unsubordinated) claim and receives BDK units, it will share in the distribution to that class.

In re MOUNTAINEER COAL COMPANY, INC., Debtor.

Mountaineer Coal Company, Inc., Plaintiff,

v.

Liberty Mutual Insurance Co., Defendant.

Bankruptcy No. 7–94–00229–WSB–11.
Adversary No. 7–96–00097.

United States Bankruptcy Court,
W.D. Virginia,
Roanoke Division.

April 11, 2000.

Chapter 11 debtor brought adversary proceeding to recover, among other things, for workers' compensation carrier's alleged violation of automatic stay. The Bankruptcy Court, William F. Stone, Jr., J., held that: (1) carrier improperly exercised control over property of estate in willful violation of automatic stay; (2) carrier did not violate stay simply by failing, even without good cause, to pay over to debtor-in-possession or trustee a debt which it owed to estate; and (3) debtor was not entitled to punitive damages.

So ordered.

1. Workers' Compensation ⚷1063

Employer whose unfavorable loss history prevented it from obtaining workers' compensation coverage on its own, and which succeeded in obtaining coverage only by having a sister company obtain policy and then having itself added as additional insured, had to be deemed jointly and severally liable, along with sister company, for premiums that became due prepetition; employer received substantial benefit, given its own inability to obtain insurance, by being added as additional insured on sister company's policy, and never objected to insurer's issuance of joint premium statements, in which premiums were calculated based on total number of persons employed by both companies.

2. Bankruptcy ⚷2837

Though related companies that were named as insureds on workers' compensation insurance policy had to be regarded as jointly and severally liable for any premiums that became due prepetition, once Chapter 11 petitions were filed and separate bankruptcy estate was created for each company, insurer was on notice of need to treat each company separately, and had no right to apply overpayment by one company postpetition to reduce its claim against the other company for premium associated with its postpetition operations.

3. Bankruptcy ⚷2588

Premium payments which Chapter 11 debtor made postpetition to its workers' compensation carrier, subject to contractu-

fiduciary of a debtor in bankruptcy is not improper under all circumstances.'' 160 F.3d at 987. However, it recognized that ''[t]here is authority arguably to the contrary, but, in light of the findings of the bankruptcy court, we ... do not[ ] resolve the issue here.... [I]t is clear ... that a fiduciary may ordinarily purchase debt claims in fair transactions during the solvency of the corporation.'' *Id.* at note 3 (citations omitted). However, ''the lower federal courts seem agreed that he cannot purchase after judicial proceedings for the relief of a debtor are expected or have begun.'' *Id.*

2002 WL 34702177
Only the Westlaw citation is currently available.
United States District Court,
W.D. Pennsylvania.

In re PAPERCRAFT CORPORATION,
a Pennsylvania corporation, Debtor.
Citicorp Venture Capital, Ltd., a
New York corporation, Appellant,
v.
Committee of Creditors Holding Unsecured
Claims, and Committee of Creditors Holding
Unsecured Claims as Estate Representative
of Papercraft Corporation, Appellee.

Civil Action No. 00–2181.
|
Bankruptcy No. 91–20903 JKF.
|
Adversary Proc. No. 91–2642.
|
Feb. 20, 2002.

MEMORANDUM ORDER

ROBERT J. CINDRICH, District Judge.

***1** This action arises from an April 20, 2000 and September 21, 2000 Memorandum Opinion and Order of the United States Bankruptcy Court for the Western District of Pennsylvania (the "Bankruptcy Court"), Bankruptcy Judge Judith K. Fitzgerald presiding. *In re Papercraft Corp.,* 247 B.R. 625 (Bankr.W.D.Pa. Apr.20, 2000) ("April 20 Order") (cited as "247 B.R. at ___"); *In re Papercraft Corp.,* 253 B.R. 385 (Bankr.W.D.Pa. Sep.21, 2000) ("September 21 Order") (cited as "253 B.R. at ___"). Pending before the Court is an appeal of the April 20 and September 21 Orders by Appellant Citicorp Venture Capital, Ltd. ("CVC"). This Court has jurisdiction over this matter pursuant to 28 U.S.C. Section 158(a) (1) and in accordance with Bankruptcy Rule 8001 as the appeal arises out of a final judgment entered by the Bankruptcy Court.

I. *Background*

This appeal arises out of the chapter 11 case of Papercraft Corporation ("Papercraft" or "Debtor"), which was filed in March 1991 in the United States Bankruptcy Court for the Western District of Pennsylvania (Fitzgerald, J.). The Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation (the "Committee"), the official unsecured creditors' committee in Papercraft's chapter 11 case, [1] commenced this action in October 1991 alleging that CVC, while an insider and fiduciary of Papercraft, [2] attempted to take control of Papercraft's assets and reap a significant profit at the expense of other creditors by secretly purchasing $60,849,299.10 in claims against Papercraft for the deeply discounted amount of $10,553,541.88. The Committee contend that CVC breached its fiduciary duty to Papercraft and Papercraft's creditors by engaging in such self-dealing, and therefore sought to have CVC's claims equitably subordinated pursuant to Section 510(c) of the Bankruptcy Code, 11 U.S.C. Section 510(c).

After the close of a three-day trial, the Bankruptcy Court issued an October 12, 1995 Memorandum Opinion and Order, *In re Papercraft Corp.,* 187 B.R. 486 (Bankr.W.D.Pa.1995) (cited as "187 B.R. at ___") wherein the Court made detailed findings of fact. In brief, Papercraft was experiencing difficulty meeting the terms of certain debt obligations in the fall of 1999. An informal committee of Papercraft creditors was formed and after months of negotiations, the committee and Papercraft reached an agreement on a restructuring plan known as the "BDK plan" which was to be filed in conjunction with a voluntary chapter 11 petition. The creditor's claims against Papercraft would then be converted into "BDK units", consisting of stock and bonds issued by the new venture, in proportion to an estimated value of such units. Papercraft's directors, including CVC, unanimously approved the BDK plan in March 1991. Although the chapter 11 petition and BDK plan were filed in March 1991, the required Papercraft disclosure statement, a prerequisite to confirmation of the plan, was not filed until October 1991. CVC secretly purchased the $60.8 million in claims during this delay, more than 40% of the outstanding unsecured claims of Papercraft. Despite its earlier support of the BDK plan, CVC objected to the confirmation of the BDK plan and offered its own competing plan calling for a CVC purchase of Papercraft's assets.

***2** The Bankruptcy Court found that CVC's purchases at a discount, without disclosure, while an insider,

constituted breaches of CVC's fiduciary duty to Papercraft and its creditors. 187 B.R. at 498–99. As a result, the Bankruptcy Court created and applied a per se rule prohibiting a debtor's insider from purchasing claims against it without disclosing his or her identity and relationship with the debtor. The Court held that when claims are purchased by insiders without making such disclosures to the debtor and creditors, "the insider's newly acquired claim will be limited to the amount paid by the acquiring insider and recovery on the claim will be limited to the percentage distribution provided in the plan, as applied to the allowed claim." *Id.* at 491. Under the Bankruptcy Court's holding, which limited CVC's allowed claim to the $10,553,541.88 price with recovery under the plan gauged to this amount, CVC would recover only about $3,063,600 in BDK units on its claims, approximately $7,489,941.88 less than what it paid. If CVC's claims were allowed at face, however, it would recover approximately $15,987,600 in BDK units, using the BDK plan's estimated value of BDK units. Thus, using the BDK plan's estimated value of BDK units, CVC stood to gain $5,434,058.12 in profit on the claims.

The Bankruptcy Court held that further subordination of CVC's claims pursuant to the principles of equitable subordination codified at 11 U.S.C. Section 510(c) was not appropriate. *Id.* at 501. The Court correctly noted that equitable subordination of a creditor's claim is proper' when (1) the creditor has engaged in inequitable conduct; (2) such misconduct caused injury to other creditors or the debtor or resulted in an unfair advantage to the creditor; and (3) subordination of the creditor's claim is consistent with the Bankruptcy Code. *Id.* at 502 (citing *Matter of Mobile Steel Co.,* 563 F.2d 692, 700 (5th Cir.1977). The Bankruptcy Court found that the first two elements had been satisfied. *Id.* at 502. As to the third element, however, the court concluded that the principles of fairness had already been adhered to because it was limiting CVC's allowed claim to the amount it paid for such claim. *Id.* Thus, further subordination of CVC's claim would not be consistent with the Bankruptcy Code. *Id.*

On appeal, we affirmed the Bankruptcy Court's factual findings, i.e., that CVC breached its fiduciary duties, acted inequitably, caused injury to Papercraft and its creditors and gained an unfair advantage. *In re Papercraft Corp.,* 211 B.R. 813 (W.D.Pa.1997) (cited as "211 B.R. at ___"). Although we agreed that pursuant to Section 510(c) CVC's recovery should at a minimum be limited to the amount paid for such claims to eliminate any potential profits on the claims, we reversed the Bankruptcy Court's ruling as to the application of a per se rule finding no authority for the creation of such a rule. *Id.* at 821, 826. Accordingly, we remanded the case to the Bankruptcy Court for a further finding on the amount CVC's claims should be subordinated beyond the amount paid for such claims, if at all, pursuant to the principles of equitable subordination. *Id.* at 827. Both parties appealed our decision.

***3** The United States Court of Appeals for the Third Circuit affirmed our decision concluding that CVC violated its fiduciary duty in a number of significant respects and that CVC's misconduct caused harm justifying subordination. *Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims,* 160 F.3d 982, 988–90 (3d Cir.1998) (cited as "160 F.3d at ___"). The Court of Appeals affirmed the Bankruptcy Court's findings of fact concluding that such "findings make this a paradigm case of inequitable conduct by a fiduciary as that concept has been developed in the case law, and we believe that further elaboration is not required." *Id.* at 987. The Court of Appeals further held:

> At a minimum, the remedy here should deprive CVC of its profit on the purchase of the notes. That can be accomplished by subordinating CVC's claims under Section 510(c) to the extent necessary in order to limit its recovery to the purchase price of the notes. Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.
>
> By so concluding, we do not suggest that a bankruptcy court can never impose a subordination remedy beyond disgorgement of profit without putting a specific price tag on the loss suffered by those who will benefit from the subordination. Such quantification may not always be feasible and, where that is the case, it should not redound to the benefit of the wrongdoer. A bankruptcy court should, however, attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination.
>
> * * *

> While we agree with CVC's criticism of the bankruptcy court's remedy, we decline to accept its argument that the record is devoid of any evidence that would support a remedy going beyond disgorgement of profit. Without limiting the inquiry of the bankruptcy court in any way, we note, that there is evidence which would support a finding that the non-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization. While the bankruptcy court held, with record support, that the delay between the filing of the petition and the filing of the disclosure statement was not attributable to CVC's machinations, it made no similar finding with respect to the period of delay between the filing of the disclosure statement and confirmation of the BDK plan. Moreover, while the bankruptcy court found "no evidence that CVC engaged in conduct designed to delay the plan process," if CVCs pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay. On remand, the bankruptcy court should consider whether the record supports the proposition that non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.

***4** *Id.* at 991–92.

On remand, the Bankruptcy Court found that in accordance with the opinion of the Court of Appeals, CVC's maximum recovery cannot exceed $10,553,541.88, i.e., the cost of CVC's claims. 253 B.R. at 390. The Bankruptcy Court also found that:

> CVC's conduct resulted in three categories of economic harm to non-selling noteholder creditors. The first two encompass (a) the delay in confirming the plan which resulted in harm that is quantifiable in terms of dollars and (b) the uncertainty over the amount of CVC's claim distribution thereon that is not easily quantifiable. The third relates to the filing of this adversary which, through the appellate and remand process, has created a delay in fully implementing the confirmed plan of over four years from the date of may initial opinion (October 12, 1995) to today and of eight years since this adversary was filed on October 31, 1991. At the very least, while this adversary has been pursued through three courts and five proceedings, this delay has caused debtor to incur professional fees and expenses and additional U.S. Trustee quarterly fees which must be paid until this case is, *inter alia,* closed.

247 B.R. at 628 (footnote and citations omitted). The Bankruptcy Court further found that CVC's misconduct resulted in at least a four month delay in connection with the first category of harm—delay in confirmation of the BDK plan. *Id.* at 630. The Bankruptcy Court held, therefore, that CVC's recovery would be further subordinated by (1) $1,248,000 for additional administrative expenses incurred during the four month delay; (2) $956,250 for interest and dividends lost by creditors during the delay; (3) $4,750 in United States Trustee fees incurred and/or paid by the Papercraft bankruptcy estate (the "Estate") from the date of confirmation through May 2, 2000; and (4) $2,974,373.15 for professional fees and expenses incurred and/or paid by the Estate or BDK through April 30, 2000 for a total additional subordination of $5,183,373.15. 253 B.R. at 390. With a starting point of $10,553,541.88 (CVC's actual investment), minus $5,183,373.15 in additional subordination, CVC's total unsubordinated distribution equals $5,370,168.73. *Id.*

II. *Standard of Review*

While acting as an appellate court for a bankruptcy appeal, we may not set aside the Bankruptcy Court's factual findings unless we conclude that the determination was "clearly erroneous." Bankruptcy Rule 8013; *Fellheimer, Eichler & Braverman, P.C. v. Charter Technologies, Inc.,* 57 F.3d 1215, 1223 (3d Cir.1995); *First Jersey Nat'l Bank v. Brown (In re Brown),* 951 F.2d 564, 567 (3d Cir.1991). Consequently, we accept the ultimate determination of the fact finder "unless that determination either is completely devoid of minimum evidentiary support displaying some hue of credibility or bears no rational relationship to the supportive evidentiary data." *Hoots v. Commonwealth of Pennsylvania,* 703 F.2d 722, 725 (3d Cir.1983). In

considering the evidence, "due regard shall be given the opportunity of the bankruptcy court to judge the credibility of the witnesses." Bankruptcy Rule 8013; *Fellheimer,* 57 F.3d at 1223.

***5** Our review of the legal determinations made by the Bankruptcy Court is plenary. *Brown v. Pennsylvania St. Employees Credit Union (In re Brown),* 851 F.2d 81, 84 (3d Cir.1988). Mixed questions of law and fact must be divided into their component parts and the appropriate standard applied to each. *See Universal Minerals, Inc. v. C.A. Hughes & Co.,* 669 F.2d 98, 101–103 (3d Cir.1981).

III. *Analysis*

CVC raises numerous issues in its appeal which we address in turn.

A. *American Rule*

CVC argues that the Bankruptcy Court erred in the subordination of its claims for $2,974,373.15 in professional fees and expenses incurred and/or paid by the Estate. CVC contends that absent some statutory or contractual authorization, the American Rule requires litigants to bear their own attorneys' fees.

As the Bankruptcy Court rightly reasoned, the American Rule does not apply under the circumstances of the instant case. The Committee is not asking for the payment of attorneys' fees as such. The fees and expenses at issue depleted funds that otherwise would have been available to creditors but for CVC's misconduct in breaching its fiduciary duty. To ensure the distribution creditors should have received absent CVC's misconduct, it is necessary to restore the Estate's furds "by subordinating CVC's share of distribution by the amount of fees and expenses incurred by professionals who are to be paid from estate assets that would not have been incurred but for CVC's breach of its fiduciary duty." 253 B.R. at 391.

CVC argues in the alternative that even if fees are properly recoverable, the Bankruptcy Court failed to make a finding that the fees awarded were reasonable. CVC contends that the party seeking fees has the burden of establishing that the fees sought are reasonable and that the court must make a finding that such fees are reasonable before making an award.

In contrast to the typical cases involving fee-shifting statutes, such as federal employment discrimination and civil rights cases where a successful plaintiff is entitled to an award of reasonable attorneys' fees, the Bankruptcy Court determined that it was appropriate to subordinate CVC's claims by the fees and expenses actually incurred as a result of the instant litigation to put Papercraft's creditors in the position they would have been in but for CVC's misconduct. Somewhat akin to the legal maxim that a tortfeasor takes his victim as he finds him, CVC must live with the fees actually incurred by the Estate even if those fees, in hindsight, were high in comparison to some general market rate.

In any event, there is nothing that would indicate that the $2.9 million figure is unreasonable. The Bankruptcy Court required the Committee to file a statement of fees and expenses that had been incurred in connection with the adversary proceeding and gave CVC an opportunity to file objections to the same. Other than one conclusory, general objection to the amount of one category of fees, however, CVC does not identify any specific rates or hours that it objects to as being unreasonable. Indeed, given the protracted litigation surrounding this 1991 case, which entailed numerous hearings, a full evidentiary trial, three appeals and filings measured by the yard, all of which was caused by CVC's illegal self-dealing, the $2.9 million in fees and expenses is not out of line with figures we have seen in cases of similar duration and volume of filings and proceedings. CVC also argues that several categories of fees should not be allowed because they cannot be attributed to any conduct by it. CVC made this same argument before the Bankruptcy Court which held in response "that none of the amount at issue incurred during preconfirmation delay or associated with the Adversary would have been incurred but for CVC's conduct. Therefore, all of it is attributable to CVC and CVC's claim is to be subordinated by that amount." 253 B.R. at 390. This is a finding of fact by the Bankruptcy Court which we must accept unless such determination is either "completely devoid of minimum evidentiary support displaying some hue of credibility or bears no rational relationship to the supportive evidentiary data." *Hoots,* 703 at 725. The Bankruptcy Court's finding most certainly bears a rational relationship to the evidence. For example, CVC used its position on Papercraft's board of directors to arrange for the preparation of financial reports and other information by Papercraft personnel, without the Committee's knowledge, to use in preparation

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of a competing plan. 247 B.R. at 628–29. As a result, the Committee's requests for information were stymied while Papercraft was providing information to CVC. *Id.* at 629. All the while, CVC was surreptitiously purchasing claims. 160 F.3d at 985. CVC submitted its competing plan only to withdraw it shortly after the Bankruptcy Court approved the BDK plan. *Id.* CVC then filed objections to the BDK plan. *Id.* Indeed, based on the facts as found by the Bankruptcy Court, and later affirmed by this court and the Court of Appeals, it is quite clear that CVC has acted at every turn to stymie the fair and efficient administration of the Estate in an effort to capitalize on its self-dealing.

***6** Lastly, CVC maintains that it should not be responsible for any of the fees and expenses associated with the various appeals and should only be accountable for fees and expenses incurred during proceedings before the Bankruptcy Court. We disagree. None of these proceedings would have been necessary, including these appeals, but for CVC's misconduct. Papercraft's creditor's should not have to bear the expanse of these appeals which were caused solely by CVC's actions. Subordination of CVC's claims for these fees is necessary to make the Estate whole.

Accordingly, the Bankruptcy Court's decision to further subordinate CVC's claims by $2,974,373.15 for professional fees and expenses will be affirmed.

B. *Delay Costs*

1. *Delay Between Filing of Petition and Disclosure Statement*

CVC argues that the Bankruptcy Court did not make sufficient findings to support subordination of its claims for the delay between the filing of the bankruptcy petition and the disclosure statement. CVC further contends that the evidence does not support a finding that it is responsible for any such delay.

In its initial decision, the Bankruptcy Court commented that it had found no evidence that CVC had engaged in conduct designed to delay the plan process. 187 B.R. at 501. The Court of Appeals held, however, that although the Bankruptcy Court had already made a finding of no designed delay, "if CVC's pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on the delay." 160 F.3d at 992. The Bankruptcy Court was instructed to consider on remand, therefore, "whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan." *Id.* The Bankruptcy Court did just that.

The Bankruptcy Court explained its ruling as follows:

> When a chapter 11 plan which has been approved by creditors prepetition is filed early in the case, a disclosure statement explaining the basis for the plan should be filed with that plan or shortly thereafter. In fact, the record shows that this was the expectation of all parties when the case was filed. The expectation was not realized in this case because CVC used its insider position to get information from the Debtor that it needed in order to facilitate its claim purchasing. Its claim purchases gave CVC leverage in the reorganization process and enabled it to control votes which, in turn, facilitated its purchase offer. The purchase offer was memorialized in the unusual occurrence of Debtor's filing a competing plan of reorganization (the CVC plan) that proposed an entirely different reorganization (i.e., a sale to Citicorp) from the BDK plan originally filed by Debtor and which Debtor did not withdraw. The Committee's requests for information which would enable it to assist Debtor in drafting the disclosure statement were stymied while Debtor provided information to CVC and delayed providing it to the Committee. *See* Declaration of Samuel M. Victor In Support of Equitable Subordination of CVC's Claims (hereafter "Victor Declaration"), Adv. Docket # 116 attached to Appendix of Opening Brief of Committee, Adv. Docket # 189 at P 14. In that way, CVC caused

> the delay in Debtor's filing of the disclosure statement for the initial BDK plan and created significant unnecessary expense to this estate—in the millions of dollars in terms of a combination of professional fees, litigation expenses and U.S. Trustee quarterly fees due as the result of a statutory amendment to 28 U.S.C. Section 1930(a)(6) and the Third Circuit Court of Appeals' decision in *United States Trustee v. Gryphon at the Stone Mansion, Inc.,* 166 F.3d 552 (3d Cir.1999).

***7** 247 B.R. at 629.

Federal Rule of Civil Procedure 52(a) requires a Bankruptcy Court to "find the facts specifically and state separately its conclusions of law thereon ....“

> One of its chief purposes is to 'aid the appellate court by affording it a clear understanding of the ground or basis of the decision of the trial court.' 9 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE, Section 2571, at 679. Where the trial court provides only conclusory findings, unsupported by subsidiary findings or by an explication of the court's reasoning with respect to relevant facts, a reviewing court simply is unable to determine whether or not those findings are clearly erroneous.

Lyles v. United States, 759 F.2d 941 (D.C.Cir.1985) (citations and footnote omitted). Despite CVC's contention to the contrary, the Bankruptcy Court's detailed findings as to the delay are very specific and most certainly satisfies Rule 52(a)'s requirements. A reviewing court would have a clear understanding of the ground or basis of the Bankruptcy Court's decision and the facts which the court relied on.

As to the sufficiency of the evidence, CVC selectively cites certain facts in support of its version of events and argues that its activities did not cause a delay. The Bankruptcy Court, however, is the fact finder in this case and reached a different conclusion. Indeed, the Bankruptcy Court made detailed findings of fact as to CVC's covert commandeering of Papercraft's resources to assist in the preparation of a competing plan and cites testimonial evidence of Samuel M. Victor indicating that CVC's actions caused a delay. Although CVC would have us weigh this evidence differently, we cannot say that the Bankruptcy Court's finding on this point was clearly erroneous. [3]

We find, therefore, that the Bankruptcy Court's decision to subordinate CVC's claims for the delay between the filing of the bankruptcy petition and plan confirmation was not clearly erroneous. Accordingly, the Bankruptcy Court's ruling on this issue will be affirmed.

2. *Delay Between Filing of Disclosure Statement and Plan Confirmation*

CVC argues that the there is insufficient evidence to find' that it is responsible for any delay between the time of the filing of the disclosure statement and confirmation of the BDK plan. More specifically, CVC contends that the Bankruptcy Court's finding that CVC instigated a stall in order to pursue its self-interest in having Papercraft present its competing plan was based solely on the fact that it objected to the BDK plan. CVC contends, therefore, that the only fact cited in support of the finding that it was responsible for the delay was renounced by the Bankruptcy Court.

We disagree with CVC's assessment of the significance of the Bankruptcy Court's comment. The Bankruptcy Court did state in its April 2000 opinion that CVC caused the delay, but subsequently stated in its September 2000 opinion that CVC's objections "did not necessarily cause a delay." 253 B.R. at 389 n. 8; *see* 247 B.R. at 630. In its September 2000 opinion, the Court stated:

> ***8** After the BDK disclosure statement was approved, the plan confirmation hearing was set but CVC used its new position as a noteholder to assert objections to the plan, despite having participated in approving it prepetition. Although CVC's assertion of objections to the plan did not necessarily cause a delay between the filing of the disclosure statement and confirmation of the plan, its conduct led to increased professional fees in this case because its objections had to be addressed and plan language changed to

> reflect a compromise reached by the parties. 253 B.R. at 389 n. 8. Thus, CVC put itself in a position via self-dealing in Papercraft claims to raise objections to the BDK plan in pursuit of its self-interest. CVC's objections, in turn, caused the Estate to incur additional fees and expenses to the detriment of the non-selling creditors separate and apart from any expenses caused by a delay. In other words, CVC would not have been in a position to pursue its self-interest by raising objections to the BDK plan absent its self-dealing. Thus, the added fees and expenses the Estate was forced to incur as a result of CVC's objections, were fairly included in the subordination of CVC's claims.

Moreover, we do not interpret the September 2000 opinion as a retraction of the Bankruptcy Court's earlier finding that CVC caused a delay in plan confirmation. The Court stated in the April 2000 opinion:

> I find that CVC caused the delay between the filing of the BDK disclosure statement and the confirmation of the BDK plan. CVC objected to confirmation of the BDK plan, even though it was one which CVC helped negotiate prepetition as a member of Debtor's board of directors. The credible evidence supports the conclusion that CVC instigated the stall in order to further pursue its self interest in having the Debtor present CVC's alternative plan. This caused specific economic harm and further litigation and attendant professional fees and costs.

247 B.R. at 630. The Court's discussion of delay in the September 2000 opinion, with regard to delay between the filing of the petition and disclosure statement and delay between the filing of the disclosure statement and plan confirmation, appears under the heading "Delay in Confirmation." 253 B.R. at 388–89. The Court opined that,

> [t]he fair inference from the events is that CVC used its status on Debtor's board of directors and on Debtor's affiliates' board of directors, together with its then newly acquired vote blocking position for the BDK plan to influence Debtor to file the CVC plan, thereby delaying the entire process.

253 B.R. at 388 n. 7.[4] Shortly thereafter, the Court makes the statement that CVC's assertion of objections "did not necessarily cause a delay" as quoted in full above. *See* 253 B.R. at 388–89. In this context, the statement "did not necessarily cause a delay" is more fairly interpreted as conveying the opinion that CVC's conduct caused economic harm regardless of whether such conduct actually caused a delay. Indeed, as we explain above, CVC's objections to the BDK plan did cause economic harm to the non-selling creditors regardless of whether those objections caused any delay between the filing of the disclosure statement and plan confirmation.

***9** We find, therefore, that the Bankruptcy Court's decision to subordinate CVC's claims for the delay between the filing of the bankruptcy petition and plan confirmation was not clearly erroneous. Accordingly, the Bankruptcy Court's ruling on this issue will be affirmed.

C. *Calculation of Damages*

CVC argues that the Bankruptcy Court's calculation of damages was erroneous.

1. *Pre–Confirmation Administrative Expenses*

CVC argues that the Bankruptcy Court erroneously assessed all of the $1,248,000 in administrative expenses against its claims. More specifically, CVC references various categories of expenses arguing that certain charges are not attributable to any delay caused by it and/or would have been incurred regardless of any delay. CVC maintains that it is responsible for at most $584,812.19 for these expenses.

The Bankruptcy Court's finding on administrative expense is subject to a clearly erroneous standard. Thus, we must accept the Bankruptcy Court's finding unless it is completely devoid of minimum evidentiary support or bears no rational relationship to the supportive evidentiary data. The Bankruptcy Court concluded as follows in connection with administrative expenses:

> The trial record reflects that as of October, 1994, administrative expenses during the delay in plan confirmation totaled $1,248,000.[F N5] Victor Declaration at P 26. Mr. Victor included all administrative costs incurred during the four month delay in this total because the Committee was not aware of CVC's actions in purchasing its claims. Thus, the Committee was unable to factor out any particular task for which a fee was incurred as attributable to something other than the delay. See Trial Transcript of November 14, 1995, at 71–72. Moreover, once the CVC plan was filed it became necessary for the Committee to address it. Any fees and expenses incurred in connection with the CVC plan, therefore, are attributable to CVC's undisclosed claims purchases and constitute a direct economic harm to the estate.
>
> [F N5] The figures used herein are based on an estimate of a delay of four months. See Victor Declaration at P 26. I find the four month delay to be a conservative estimate inasmuch as the BDK plan was filed shortly after the bankruptcy case was filed in March of 1991 and the plan was not confirmed until January 21, 1992.

247 B.R. at 630. Thus, the Bankruptcy Court arrived at the $1.2 million dollar figure based on the supportive evidence of record. Contrary to CVC's position, the Bankruptcy Court did not have to arrive at this figure with precise accuracy. *See* 160 F.3d at 991 ("[W]e do not suggest that a bankruptcy court can never impose a subordination remedy beyond disgorgement of profit without putting a specific price tag on the loss suffered ...."). CVC's surreptitious self-dealing inhibited the Committee's ability to factor out any particular task for which a fee was incurred as attributable to something other than the delay. Thus, the difficulty at arriving at such quantification should not redound to the benefit of CVC —the wrongdoer in this case. *Id.* (Specific "quantification may not always be feasible and, where that is the case, it should not redound to the benefit of the wrongdoer.").

***10** We find, therefore, that the Bankruptcy Court's decision to subordinate CVC's claims for $1,248,000 in administrative expenses was not clearly erroneous. Accordingly, the Bankruptcy Court's finding on this issue will be affirmed.

2. *Lost Interest*

CVC argues that the Bankruptcy Court erroneously calculated the amount of lost interest income attributable to the delay. [5]

Under the BDK plan, creditors expected to receive on confirmation, and did receive, new debt securities with a face value of $33,750,000 bearing interest at the rate of 8.5% for ten years. The Bankruptcy Court found that CVC's actions caused a four month delay in plan confirmation, which in turn resulted in a four month delay in the issuance of the new debt securities. The Bankruptcy Court concluded, therefore, that the amount of lost interest attributable to the delay was $965,250, the amount of interest that would have been earned on the new notes over a four month period. The calculation was as follows:

> — $33,750,000 x 8.5% = $2,868,750 interest per year
>
> — $2,868,750 / 12 months = $239,062.50 interest per month
>
> — $239,062.50 x 4 months = $956,250

253 B.R. at 389.

CVC contends that the new debt securities issued under the BDK plan were ten year notes, and were always intended to be ten year notes. Thus, the creditors expected to receive on confirmation, and did receive, a note bearing interest at the rate of 8.5% for ten years, not nine years and eight months. CVC argues, therefore, that the four month delay only resulted in the loss of the time value of the first four months of interest on the new debt securities. We agree.

The creditors expected to receive, and did receive, ten year notes bearing interest at 8.5%. In other words, the total amount of interest that the creditors will receive on these notes would not be different regardless of whether they had been issued four months earlier. If the four month delay had not occurred, for example, the creditors would

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not have received $33,750,000 in notes bearing interest at a rate of 8.5% for ten years and four months. Likewise, as CVC points out, the creditors did not receive notes bearing interest at a rate of 8.5% interest for a period of nine years and eight months because of the delay. Thus, the only harm the creditors could have suffered as a result of the four month delay was the loss of the time value money on the accrual of the first four months of interest earned on the notes. We agree with CVC that the simplest way to calculate this amount is to take the monthly interest of $239,062 and calculate the interest that would have accrued had the first semi-annual installment been made four months earlier. Taking the rate assigned to the notes, 8.5% per annum, times the four month interest "payment" of $956,250, you arrive at $81,281.25 as the "annual interest", divided by three [four months of the year is one-third], equals $27,093.75. Because it is now approximately ten years later than the expected confirmation date, the lost interest of $27,093.75 should be multiplied by 8.5% to determine the interest that could have been earned on the lost interest over one year, [6] which totals $2,302.97, which in turn should be multiplied by ten years [7] for a total of $23,029.70. Thus, the creditors' total time value loss of the first four months of interest equals $50,123.45 ($27,093.75 + $23,029.70).

***11** We find, therefore, that the Bankruptcy Court's calculation of the amount of lost interest income attributable to the four month delay was clearly erroneous. Accordingly, the Bankruptcy Court's decision on this issue will be reversed and the case remanded to the Bankruptcy Court for the entry of an order subordinating CVC's claims for lost interest income in the amount of $50,123.45.

3. *Post–Confirmation U.S. Trustee Fees*

CVC argues that although there were other open matters affecting the accrual of U.S. Trustee fees post-confirmation, the Bankruptcy Court attributed the entire first post-confirmation quarter fees of $4,750 to CVC's conduct. [8]

The Bankruptcy Court held as follows in connection with the U.S. Trustee Fees:

> CVC has no basis upon which to challenge the amount of the U.S. Trustee post-confirmation quarterly fees inasmuch as those fees are statutory and their accrual is directly caused by CVC's conduct. That is, but for CVC's wrongdoing, this bankruptcy case would have been closed shortly after plan confirmation on January 21, 1992 ....

247 B.R. at 631 n. 9. In support of its objection to the Bankruptcy Court's determination, CVC merely cites "General Bankruptcy Court Docket" and conclusively argues that the trustee fees would have been incurred regardless of its actions due to other pending matters. CVC's Br. (Doc. No. 2) p. 29. CVC does not specify, however, what those matters were and how they affected the continuation of the bankruptcy case. We cannot find that the Bankruptcy Court's ruling on the trustee fees was clearly erroneous based on such a vague objection.

Accordingly, the Bankruptcy Court's decision to subordinate CVC's claims for $4,750 in U.S. Trustee fees will be affirmed.

D. *Fair Market Value of BDK Units*

CVC argues that the Bankruptcy Court erred in finding that it profited from the purchases of Papercraft claims because the court failed to consider the fair market value of the BDK units disbursed under the BDK plan in exchange for those claims. More specifically, CVC contends that the parties agree that the proper date for determining whether it made a profit is January 1992, when the BDK plan was confirmed. CVC maintains that although it purchased its claims for approximately $10.5 million in cash, the BDK plan provided a distribution of BDK units to creditors instead of cash. CVC contends, therefore, that calculation of profit must be based on the cash equivalent of BDK units as of January 1992, which reveals that it made no profit on its purchases.

The Bankruptcy Court rejected CVC's argument that its claims should be revalued to calculate CVC's profit. The Bankruptcy Court explained:

> I reject this method of valuation in this instance. Valuation of BDK units was determined at the time of plan confirmation to be $1,228 per unit and no different valuation was presented at the trial of this Adversary even though one issue tried was equitable subordination. Other (nonselling) creditors

> have received distribution based on that valuation. It would exacerbate the harm to these creditors if BDK units were valued differently now and only for CVC's claim. The operative date of valuation for plan purposes and for purposes of this adversary was the date of plan confirmation. CVC must live with the situation it created.... [FN 11]
>
> ***12** * * *
>
> FN11.... CVC has provided no authority for its argument that its claim should be valued on a basis different from that of all other creditors. To do so would be inequitable to other creditors, at least under the circumstances of this case. To achieve parity in distribution in these classes as the Bankruptcy Code requires, the court must maintain the same valuation method utilized for all distributions of BDK units to creditors in classes entitled to them. All creditors in the affected classes will sustain the same increase or diminution in the value of their holdings as CVC. Moreover, the parties had a full opportunity to litigate all issues at trial and specifically requested, prior to trial, that I withdraw my opinion on summary judgment so that the equitable subordination issues could be addressed. I did so and the case was tried in November of 1994 to address these issues. Reopening the record over 5 years after trial concluded would violate principles of finality and create a never-ending round robin of litigation.

247 B.R. at 632.

The Committee makes a persuasive argument that under res judicata principles CVC is precluded from arguing for a revaluation of its claims to calculate profits. As the Committee correctly points out, the existence and amount of profit attributable to CVCs claims purchasing has been at the heart of this litigation from its inception. The parties and the courts have always proceeded on the assumption that the value of BDK units as described in the BDK plan is the value upon which CVCs profits are calculated. This is the first time CVC has argued that its BDK units should be revalued. Apparently, CVC did not appeal the order confirming the BDK plan and accepted a distribution of BDK units based on the values established therein. [9] The value of the BDK units and the methodology for their distribution under the BDK plan were at issue during plan confirmation proceedings and the final disposition of those issues should be binding on CVC under res judicata principles. *See, e.q., Laborer's Int'l Union, AFL–CIO v. Foster Wheeler Corp.,* 26 F.3d 375, 396–97 n. 24 (3d Cir.1994) ("If an appeal is taken from only part of the judgment, the remaining part is res judicata ...." (citation omitted)).

In any event, we agree with the Bankruptcy Court and the Committee in that CVC's profits should be calculated in relation to the estimated value of BDK units appearing in the BDK plan. The Bankruptcy Code provides that a reorganization plan cannot be confirmed unless each creditor will receive at least as much in reorganization as it would in liquidation. *See* 11 U.S.C. Section 1129(a)(7)(A)(ii). Thus, the BDK units had to be valued in order to confirm the BDK plan. The valuation method used for the BDK units, a discounted cash flow analysis based on forward-looking income projections, is the methodology typically employed for such valuations and satisfies the Bankruptcy Code. [10]

***13** After an appropriate valuation, Section 1129 of the Bankruptcy Code requires parity in distribution among the different classes of creditors. The same valuation method must be used for all distributions of BDK units to achieve such parity. As a result, all creditors will be subject to the same increase or diminution in value of their interest in the reorganized entity. If the court were to accept CVC's revaluation argument, however, CVC would in essence receive a cash distribution for its BDK units while the remaining non-selling creditors bear the risk of receiving less in value than what they paid for their claims. Thus, revaluing only CVC's claims would subvert the parity achieved in distribution and expose the non-selling creditors to even greater harm. In other words, the non-selling creditors' exposure to a diminution in value of their claims caused by normal market risk would be exacerbated by a reduction in their proportionate share of the reorganized entity as a result of CVC's claims being assigned a higher cash value. This cannot be. As the Bankruptcy Court noted, CVC, the wrongdoer here, must live with the situation it created.

Accordingly, the Bankruptcy Court's decision not to revalue CVC's claims to calculate its profits will be affirmed.

E. *Other Purchasers*

CVC contends that neither Papercraft nor members of the Committee could have or would have purchased the claims it purchased. CVC maintains, therefore, that it did not divert a corporate opportunity when it purchased the claims, and thus did not cause harm to the Estate.

With regard to this issue, the Bankruptcy Court stated:

> I need not consider this matter as all of my findings have been sustained on appeal and the only issue on remand is whether CVC's claim should be equitably subordinated beyond removal of its profit. However, I note that whether another entity would have availed itself of the opportunity is irrelevant. As the Court of Appeals pointed out in its opinion,
>
> > under *Brown v. Presbyterian Ministers,* 484 F.2d 998, 1005 (3d Cir.1973), the opportunity to purchase the notes was a corporate opportunity of which CVC could not avail itself, consistent with its fiduciary duty, without giving the corporation and its creditors notice and an opportunity to participate.

247 B.R. at 632 (quoting 160 F.3d at 987). We agree with the Bankruptcy Court's assessment of the narrow issue that was to be considered on remand and also agree that CVC's corporate opportunity argument should not be revisited. CVC made the same argument, and lost, both at trial and on appeal to this court and the Court of Appeals.

Based on a partial quote from the Court of Appeals' decision, however, CVC argues that the corporate opportunity issue is still a live issue because it concerns the matter of what is an appropriate remedy. CVC cites the Court of Appeals as stating that “[w]e believe [CVC's corporate] opportunity argument more relevant to the remedy issue than to whether a breach of fiduciary duty occurred.” 160 F.3d at 988.

***14** CVC's partial quote of the Court of Appeals' discussion is somewhat misleading. A more complete quote reads as follows:

> CVC contends that *Brown* is distinguishable because Papercraft was not in a financial or legal position to purchase the notes and because the members of the Committee must have been well aware that a market existed in Papercraft debt. It necessarily follows, according to CVC, that neither could have been injured by its purchases. We believe this argument more relevant to the remedy issue than to whether a breach of fiduciary duty occurred. That duty required that it share everything that it knew with Papercraft's board and the Committee before commencing its purchases. **Its failure to do so would alone support a subordination depriving it of its profits from the note transactions.**

160 F.3d at 988 (emphasis added). The Court went on to conclude that “[a]t a minimum, the remedy here should deprive CVC of its profits on the purchase of the notes.... Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.” *Id.* at 991. As previously noted, therefore, the Court held that “[o]n remand, the bankruptcy court should consider whether the record supports the proposition that the non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.” *Id.* at 992.

Thus, as the Court of Appeals makes quite clear, CVC's conduct in breaching its fiduciary duty requires at a minimum the remedy of disgorgement of CVC's profit, regardless of whether any one else could have or would have purchased the claims in lieu of CVC. The Court goes on to explain that CVC's conduct in pursuing its own interest in advocating a competing plan may have caused harm to creditors in the nature of delay in plan confirmation. Indeed, harm caused by CVC's attempt to control the reorganization was the only matter the Bankruptcy Court was to consider on remand. This type of harm, which the Bankruptcy Court properly found was caused by CVC's conduct, is distinct from the harm caused by a usurpation of a corporate opportunity. In other words, it was CVC's self-dealing and related conduct in advocating a competing plan that caused harm in the form of delay regardless of whether any one else could have purchased the claims.

Accordingly, the Bankruptcy Court's decision to reject CVC's corporate opportunity argument will be affirmed.

On a final note, we think it necessary to address a troubling comment contained in CVC's brief. CVC states:

> In its Final Order, however, **the Bankruptcy Court, apparently straining to find a basis to subordinate CVC's claim beyond any factual justification,** asserted that CVC's request for financial information—most of which were made before the bankruptcy proceeding was commenced—somehow delayed the filing of the disclosure statement by diverting Debtor's resources from preparation of the disclosure statement.

***15** CVC's Br. (Doc. No. 2) pp. 20–21 (emphasis added). CVC's comment could be interpreted as a thinly veiled attack on the Bankruptcy Judge's integrity and/or impartiality. We want to make it clear that based on our review of the extensive record and court opinions in this case, we believe that the Bankruptcy Judge has at all times acted impartially and fairly to all parties concerned. If CVC reasonably believes that the Bankruptcy Judge is unfairly biased against it, there is a proper way to address that concern. Such allegation must, of course, have evidentiary support other than the fact that the Judge's rulings have not gone its way. *See* Fed.R.Civ.P. 11. Otherwise, CVC's comment, standing alone, might be taken by the reviewing court as an attack on a distinguished judge based on nothing more than CVC's displeasure with her rulings. Needless to say, pouting of this sort is not persuasive and does nothing to further CVC's position on the legal issues.

For the foregoing reasons, **IT IS HEREBY ORDERED** that the April 20, 2000 and September 21, 2000 orders of the Bankruptcy Court are **REVERSED** as to the subordination of CVC's claims for lost interest income in the amount of $956,250. The balance of the April 20, 2000 and September 21, 2000 orders are **AFFIRMED. IT IS FURTHER ORDERED** that this case is **REMANDED** to the Bankruptcy Court for the entry of an order subordinating CVC's claims for lost interest income in the amount of $50,123.45.

SO ORDERED this *20* day of February, 2002.

The Clerk is directed to mark Civil Action No. 00–2181 **CLOSED.**

160 F.3d at 990.

All Citations

Not Reported in F.Supp.2d, 2002 WL 34702177

Footnotes

1 The Committee is the official unsecured creditors' committee in Papercraft's chapter 11 case, whose members were duly appointed by the United States Trustee under section 1102 of title 11 of the United States Code ("Bankruptcy Code"). The Committee has sued CVC not just in its capacity as a committee entitled to bring suit by virtue of sections 502, 1103, and 1109 of the Bankruptcy Code, but as "Estate Representative" which, under the provisions of the confirmed plan of reorganization, is entitled to enforce the rights of the estate and is empowered by section 1123(b)(3)(B) of the Bankruptcy Code to do so. Brief of Appellee Committee Of Creditors Holding Unsecured Claims And Committee Of Creditors Holding Unsecured Claims As Estate Representative Of Papercraft Corporation ("Committee's Br.") (Doc. No. 4) at 1 n. 1.

2 A representative of CVC sat on the boards of directors of Papercraft and Papercraft subsidiaries Barth & Dreyfuss and Knomark.

3 CVC makes much of the Bankruptcy Judge's comments at an August 29, 1991 hearing regarding certain satellite litigation that she believed necessitated the granting of an extension of time to file the disclosure statement. CVC argues that the Bankruptcy Judge improperly ignored these prior comments when later finding that CVC was responsible for the delayed filing of the disclosure statement. The Bankruptcy Judge's prior comments and instant findings are not inconsistent. At the subsequent trial in this matter, the Bankruptcy Judge heard extensive evidence and concluded that the delay in the filing of the disclosure statement was not caused by the satellite litigation. *See* 253 B.R. at 388. Contrary to CVC's position, the Bankruptcy Judge was not bound by her prior comments in connection with the extension of time when making a finding as to the cause of the delay after a full trial. Indeed, as the Bankruptcy Court points out, "at the August, 1991, hearing neither Debtor nor CVC disclosed CVC's efforts to acquire financial information and its trading in claims. Thus, the court was not given the complete picture of the circumstances that caused delay at that time." 253 B.R. at 388 n. 7.

4 It is certainly a fair inference that CVC took unfair advantage of its position to push the CVC plan resulting in a delay in plan confirmation. In fact, the Court of Appeals indicated that the evidence of record was sufficient to support subordination of CVC's claims because of the delay. The Court stated:

> [T]he Committee points us to trial testimony from its financial advisor indicating that this competing reorganization plan and CVC's associated objections to the BDK plan resulted in confirmation delay that inflicted substantial injury on Papercraft's non-selling creditors.
>
> The bankruptcy court did not attempt to quantify the harms caused in economic terms, and CVC characterizes them as "nonecomonic" harms. We do not agree with this characterization, however, and, like the bankruptcy and district courts, we conclude that they are sufficient to justify subordination.

5 CVC also contends that it should not have been charged for any lost interest because it is not responsible for any delay. We have already held that the Bankruptcy Court's finding that CVC caused a delay in plan confirmation is not clearly erroneous. Thus, we need not address CVC's delay argument again here.

6 The 8.5% time value rate should equal the actual market rate of interest that could have been earned on the funds. There is no evidence of record as to what the actual market rate was during the relevant time period. Thus, the market rate could have been more or less than 8.5% at various points in time. However, because CVC used this rate and the Committee did not object to, we will accept the 8.5% rate.

7 CVC uses nine years in its calculation which was the correct number at the time its brief was filed. As of the date of this memorandum order, however, more than ten years has elapsed since the expected confirmation date.

8 CVC also argues that its claims should not be charged with any U.S. Trustee fees incurred pre-confirmation, because it is not responsible for any delay. We have already held that the Bankruptcy Court's finding that CVC caused a delay in plan confirmation is not clearly erroneous. Thus, we need not address CVC's delay argument again here.

9 Indeed, the Committee notes that the CVC's competing cash offer provided that CVC would pay approximately $40 million for Papercraft as an alternative to the BDK plan, which CVC represented was a fair value for the company. Committee's Br. (Doc. No. 4) pp. 25–26. The BDK plan's valuation of $40,052,000 is nearly identical to CVC's $40 million offer. *Id.* at p. 26.

10 *See* *Consolidated Rock Prods. Co. v. DuBois,* 312 U.S. 510, 525–26, 61 S.Ct. 675, 85 L.Ed. 982 (1941):

> Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sine qua non to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule ....
>
> [T]he commercial value of property consists in the expectation of income from it.... Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity. The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. A sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate.
>
> (citations and quotations omitted).

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amount to an assumption of control or authority over the Trust Funds....”). Therefore, the failure to establish a record-keeping system is not evidence of an exercise of authority or control either.

I, therefore, dissent.

CITICORP VENTURE CAPITAL, LTD., a New York Corporation, Appellant

v.

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation

Citicorp Venture Capital, Ltd., a New York Corporation,

v.

Committee of Creditors Holding Unsecured Claims, and Committee of Creditors Holding Unsecured Claims as Estate Representative of Papercraft Corporation Appellant.

No. 02–1815, 02–1905.

United States Court of Appeals, Third Circuit.

Argued Dec. 16, 2002.

Filed March 19, 2003.

Unsecured creditors committee brought adversary proceeding against insider of Chapter 11 debtor-corporation, seeking equitable subordination of insider's claims for its alleged breach of its fiduciary duties. After the courts determined that subordination was warranted, on remand, the United States Bankruptcy Court for the Western District of Pennsylvania, Judith K. Fitzgerald, Chief Judge, 253 B.R. 385, found that additional subordination was justified. Insider appealed. The District Court, Robert J. Cindrich, J., affirmed, but reduced the lost interest income component of the subordination. Insider appealed, and committee filed cross-appeal. The Court of Appeals, Nygaard, Circuit Judge, held that: (1) bankruptcy court did not violate the “American Rule” by subordinating attorney fees; (2) district court did not err by holding that insider was responsible for all fees incurred during delay in the plan process; (3) district court did not err by affirming bankruptcy court's calculation of insider's profit; and (4) district court did not err by calculating lost interest by a four-month delay of the ten years of interest.

Affirmed.

1. Bankruptcy ⚷3782

Court of Appeals exercises plenary review over legal determinations of a district court sitting as an appellate court in a bankruptcy proceeding.

2. Bankruptcy ⚷3786

Court of Appeals may only overturn factual findings if they are clearly erroneous. Fed.Rules Bankr.Proc.Rule 8013, 11 U.S.C.A.

3. Bankruptcy ⚷3786

Court of Appeals must accept district court's factual findings unless they are completely devoid of a credible evidentiary basis or bear no rational relationship to the supporting data.

4. Bankruptcy ⚷2183

Pursuant to the American Rule, prevailing litigant is ordinarily not entitled to

collect reasonable attorney fees from the loser.

5. Bankruptcy ⚷2183

Element of all American Rule exceptions is a determination that the litigant "prevailed" and should be awarded attorney fees.

6. Bankruptcy ⚷2125, 2967.5

In the exercise of its powers as a court of equity, bankruptcy court may subordinate claims for cause, applying traditional principles of equitable subordination. Bankr.Code, 11 U.S.C.A. § 510(c).

7. Bankruptcy ⚷2967.5

Although the Bankruptcy Code codifies the doctrine of equitable subordination, it does not detail the requirements of such subordination, instead merely stating that the doctrine is to be applied under the principles of equitable subordination. Bankr.Code, 11 U.S.C.A. § 510(c).

8. Bankruptcy ⚷2967.5

Doctrine of equitable subordination is remedial, and the goal is to undo or to offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results. Bankr.Code, 11 U.S.C.A. § 510(c).

9. Bankruptcy ⚷2967.5

Through the doctrine of equitable subordination, bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankruptcy estate. Bankr.Code, 11 U.S.C.A. § 510(c).

10. Bankruptcy ⚷2967.5

Inequitable conduct, justifying equitable subordination, may arise out of any unfair act by the creditor as long as the conduct affects the bankruptcy results of the other creditors. Bankr.Code, 11 U.S.C.A. § 510(c).

11. Bankruptcy ⚷2967.5

Because equitable subordination is remedial rather than penal, a claim should be equitably subordinated only to the extent necessary to offset the harm suffered by debtor and its creditors as a result of the inequitable conduct. Bankr.Code, 11 U.S.C.A. § 510(c).

12. Bankruptcy ⚷2967.5

Remedy of equitable subordination must remain sufficiently flexible to deal with manifest injustice resulting from violation of the rules of fair play. Bankr. Code, 11 U.S.C.A. § 510(c).

13. Bankruptcy ⚷2967.5

Where ingenuity spawns unprecedented vagaries of unfairness, bankruptcy courts should not decline to recognize their marks, nor hesitate to turn the twilight for offending claimants into a new dawn for other creditors, through use of equitable subordination. Bankr.Code, 11 U.S.C.A. § 510(c).

14. Bankruptcy ⚷2183, 2968

Bankruptcy court did not violate the American Rule, which provides that prevailing litigant is ordinarily not entitled to collect attorney fees from the loser, by subordinating debtor's insider's attorney fees; bankruptcy court did not award a money judgment for attorney fees to penalize insider but, rather, the court analyzed the record facts, found specific damages, and used its equitable powers to return non-selling creditors to the position they would have been in had insider not acted inequitably, by subordinating insider's share of distribution by the amount of fees and expenses incurred by professionals who were to be paid from estate assets that would not have been incurred but for

insider's breach of its fiduciary duty. Bankr.Code, 11 U.S.C.A. § 510(c).

15. Bankruptcy ⚷2967.5

Although the pursuit of one's legal rights may not be grounds for equitable subordination, protracted and unjustified litigation tactics that harm the estate by causing it to incur fees may justify subordination. Bankr.Code, 11 U.S.C.A. § 510(c).

16. Bankruptcy ⚷2968

Debtor's insider was responsible for all fees incurred during delay in plan process, as warranted equitable subordination of its claim by such amount, where conduct of insider in pursuing its own interest over and above other creditors to whom it owed a fiduciary duty not to self-deal delayed plan confirmation by at least four months, to the detriment of non-selling creditors. Bankr.Code, 11 U.S.C.A. § 510(c).

17. Bankruptcy ⚷2972

Evidence of reorganization value at time of plan confirmation supported finding that debtor's insider made a profit on claims against debtor that it secretly purchased, for purposes of equitable subordination of insider's claims. Bankr.Code, 11 U.S.C.A. § 510(c).

18. Bankruptcy ⚷2968

Where debtor's insider's pursuit of its own interest over and above other creditors to whom it owed a fiduciary duty not to self-deal delayed plan confirmation by at least four months, district court properly reduced the equitable subordination of insider's claim on account of lost interest income from $956,250.00, which figure represented the $239,062.00 in monthly interest on all the debt securities multiplied by four, to $50,123.00; the securities were ten-year notes that would provide unsecured creditors committee ten years of interest regardless of when they were issued, and so district court did not err by calculating the lost interest by a four-month delay of the ten years of interest. Bankr.Code, 11 U.S.C.A. § 510(c).

Lawrence J. Slattery, (Argued), Morgan, Lewis & Bockius, New York, NY, Amy M. Tonti, Reed Smith, Pittsburgh, PA, for Appellant/Cross Appellee.

Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, PA, Stephen M. Ray, (Argued), Stutman, Treister & Glatt, Los Angeles, CA, for Appellee/Cross Appellant.

Before NYGAARD, ALITO, and RENDELL, Circuit Judges.

OPINION OF THE COURT

NYGAARD, Circuit Judge.

This case arises out of the Chapter 11 filing of Papercraft Corporation and the subsequent litigation. Here, in our second review of determinations made by the Bankruptcy Court and the District Court, we must assess justifications for the subordination of several of Citicorp Venture Capital's ("CVC") claims, and we must evaluate the accompanying calculations. First, CVC argues that the District Court erroneously upheld the Bankruptcy Court's subordination of certain administrative costs and professional fees. Second, CVC contends that the District Court erroneously upheld the Bankruptcy Court's subordination of CVC's claim by an additional amount incurred during a delay in the plan process. Third, CVC asserts that the finding that CVC made a profit on its note purchases is error. Finally, in a cross appeal, the Committee of Creditors Holding Unsecured Claims and Committee of Creditors Holding Unse-

cured Claims as Estate Representative of Papercraft Corporation (the "Committee") argues that the District Court erred in reducing the Bankruptcy Court's equitable subordination remedy on account of lost interest income. We hold that the "American Rule" should not be applied to the subordination of the administrative and professional costs, and that the District Court's findings are not clearly erroneous. We will affirm.

I. Background

In 1991, an informal committee of Papercraft creditors and Papercraft agreed to a restructuring plan known as the "BDK plan," which was to be filed in conjunction with a voluntary Chapter 11 petition. The creditors' claims against Papercraft would be converted into "BDK units," consisting of stock and bonds issued by the new venture, in proportion to an estimated value of such units. Papercraft's directors, including CVC, approved the BDK plan, and the Chapter 11 petition and the BDK plan were filed.

The Committee commenced litigation, alleging that CVC, while an insider and fiduciary of Papercraft, attempted to take control of Papercraft's assets and reap significant profit at the expense of other creditors by withdrawing its support for the BDK plan and offering a competing plan, secretly purchasing $60,849,299.10 in claims against Papercraft for the discounted amount of $10,553,541.88, and delaying confirmation of the original plan. The Committee asserted that because CVC breached its fiduciary duty to Papercraft and Papercraft's creditors by engaging in such self-dealing, CVC's claims should be equitably subordinated pursuant to § 510(c) of the Bankruptcy Code, 11 U.S.C. § 510(c).

The Bankruptcy Court issued an October 12, 1995, Memorandum Opinion and Order, finding that CVC's purchases at a discount, without disclosure, while an insider, constituted breaches of CVC's fiduciary duty to Papercraft and its creditors. *In re Papercraft Corp.,* 187 B.R. 486, 498–99 (Bankr.W.D.Pa.1995). The Bankruptcy Court limited CVC's allowed claim to the $10,553,541.88 price, and held that further subordination of CVC's claims pursuant to the principles of equitable subordination codified at 11 U.S.C. § 510(c) was not appropriate because the Bankruptcy Court was already limiting CVC's allowed claim to the amount it paid for such claim. *Id.* at 501–02.

On appeal, the District Court affirmed the Bankruptcy Court's factual findings that CVC breached its fiduciary duties, acted inequitably, caused injury to Papercraft and its creditors and gained an unfair advantage. *In re Papercraft Corp.,* 211 B.R. 813 (W.D.Pa.1997). However, the District Court remanded the case to the Bankruptcy Court for a further finding on the amount CVC's claims should be subordinated beyond the amount paid for such claims, if at all, pursuant to the principles of equitable subordination. *Id.* at 827. Both parties appealed.

We affirmed the District Court's opinion, finding that CVC violated its fiduciary duty in a number of significant respects and that CVC's misconduct caused harm justifying subordination. *In re Papercraft Corp.,* 160 F.3d 982, 988–90 (3d Cir.1998). We explicitly stated that the findings of fact "make this a paradigm of inequitable conduct by a fiduciary as that concept has been developed in the case law, and we believe that further elaboration is not required." *Id.* at 987. We explained that,

> Further subordination may be appropriate, but only if supported by findings that justify the remedy chosen by reference to equitable principles.... While the bankruptcy court held, with record

> support, that the delay between the filing of the petition and the filing of the disclosure statement was not attributable to CVC's machinations, it made no similar finding with respect to the period of delay between the filing of the disclosure statement and confirmation of the BDK plan. Moreover, while the bankruptcy court found "no evidence that CVC engaged in conduct designed to delay the plan process," if CVC's pursuit of its own interest in fact resulted in delay of the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay. On remand, the bankruptcy court should consider whether the record supports the proposition that non-selling creditors suffered loss as a result of a delay in confirmation caused by CVC advocacy of its competing plan and objections to the BDK plan.

Id. at 991–92. Our mandate to the Bankruptcy Court was clear: determine whether the record supports the additional subordination of CVC's claims.

On remand, the Bankruptcy Court found three kinds of economic harm to non-selling noteholder creditors: (1) the quantifiable monetary harm that resulted from the delay in confirming the plan; (2) the harm that resulted from the uncertainty over the amount of CVC's claim distribution; and (3) the harm that resulted from the delay in fully implementing the confirmed 1991 plan that can be measured by the professional fees and expenses of three courts and five proceedings. *In re Papercraft Corp.,* 247 B.R. 625, 628 (Bankr.W.D.Pa. Apr.20, 2000). The Bankruptcy Court held, therefore, that CVC's recovery would be further subordinated by (1) $1,248,000 for additional administrative expenses incurred during the four-month delay; (2) $956,250 for interest and dividends lost by creditors during the delay; and (3) $2,974,373.15 for professional fees and expenses incurred and/or paid by the Estate or BDK through April 30, 2000.[1] *In re Papercraft Corp.,* 253 B.R. 385, 390 (Bankr.W.D.Pa.2000).

The District Court affirmed the Bankruptcy Court's decision, except that it reduced the lost interest income component of the subordination from $956,250 to $50,123.45. Memorandum Order at 36. CVC filed a timely appeal.

II. Jurisdiction and Standard of Review

The District Court had subject matter jurisdiction over the appeal below pursuant to 28 U.S.C. § 158(a) and appellate jurisdiction in accordance with Local Bankruptcy Appellate Rule 8007.1. We have jurisdiction pursuant to 28 U.S.C. §§ 158(d) and 1291.

[1–3] We exercise plenary review over legal determinations of a district court sitting as an appellate court in a bankruptcy proceeding. *Fellheimer, Eichen & Braverman, P.C. v. Charter Techs., Inc.,* 57 F.3d 1215, 1223 (3d Cir.1995). We may only overturn factual findings, however, if they are "clearly erroneous." *Id;* Fed. R. Bankr.P. 8013. We must accept the District Court's factual findings "unless they are 'completely devoid of a credible evidentiary basis or bear[ ] no rational relationship to the supporting data.' " *Moody v. Security Pac. Bus. Credit, Inc.,* 971 F.2d 1056, 1063 (3d Cir.1992) (citation omitted).

III. Discussion

First, CVC argues that the Bankruptcy Court violated the American Rule by su-

1. The Bankruptcy Court also held that CVC's recovery would be further subordinated by $4,750 in United States Trustee fees incurred and/or paid by the Papercraft bankruptcy estate from the date of confirmation through May 2, 2000. 247 B.R. at 630.

bordinating the attorneys' fees. We disagree.

[4, 5] The expression of the American Rule is found in *Alyeska Pipeline Service Co. v. Wilderness Soc'y*, where the Supreme Court explained that, "[i]n the United States, the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser." 421 U.S. 240, 247, 95 S.Ct. 1612, 44 L.Ed.2d 141 (1975). There are, however, numerous exceptions to this rule. An element of all American Rule exceptions is a determination that the litigant "prevailed" and should be awarded attorneys' fees. For example, 42 U.S.C. § 1988 was enacted with the express intent of negating the effect of the *Alyeska* decision in statutory civil rights cases. 1976 U.S.C.C.A.N. 5908–09 ("[T]he purpose of this amendment is to remedy anomalous gaps in our civil rights laws created by the United States Supreme Court's recent decision in *Alyeska Pipeline* ...."). Under § 1988, a party must show it "prevailed" in the underlying action.

The District Court affirmed the Bankruptcy Court's subordination of attorneys' fees, explaining:

> The Committee is not asking for the payment of attorneys' fees as such. The fees and expenses at issue depleted funds that otherwise would have been available to creditors but for CVC's misconduct in breaching its fiduciary duty. To ensure the distribution creditors should have received absent CVC's misconduct, it is necessary to restore the Estate's funds 'by subordinating CVC's share of distribution by the amount of fees and expenses incurred by professionals who are to be paid from estate assets that would not have been incurred but for CVC's breach of its fiduciary duty.'

In re Papercraft Corp., Memorandum Order *11 (W.D.Pa. February 20, 2002). We agree with the District Court's logic.

[6, 7] In the exercise of its powers as a court of equity, the bankruptcy court may subordinate claims for cause, applying traditional principles of equitable subordination. 11 U.S.C. § 510(c); *Pepper v. Litton,* 308 U.S. 295, 307–11, 60 S.Ct. 238, 84 L.Ed. 281 (1939); *Taylor v. Standard Gas & Elec. Co.,* 306 U.S. 307, 322, 59 S.Ct. 543, 83 L.Ed. 669 (1939); *see also Comstock v. Group of Institutional Investors,* 335 U.S. 211, 229, 68 S.Ct. 1454, 92 L.Ed. 1911 (1948) (narrowing the application of equitable subordination to situations in which bad faith by the claimant is found). Although § 510(c) codifies the doctrine of equitable subordination, it does not detail the requirements of such subordination. Instead, it merely states that the doctrine is to be applied "under the principles of equitable subordination," and the legislative history states that Congress intended that the courts develop these principles. 124 Cong. Rec. 32,398 (1978) (statement of co-sponsor Rep. Edwards); 124 Cong. Rec. 33,998 (statement of co-sponsor Sen. DeConcini); *Burden v. United States,* 917 F.2d 115, 118 (3d Cir.1990).

[8–15] The doctrine of equitable subordination is remedial, and the goal "is to undo or to offset any inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results." ' *Burden,* 917 F.2d at 117 (citation omitted); *see also In re Papercraft Corp.,* 160 F.3d 982, 991 (3d Cir.1998) (stating that the purpose of equitable subordination is "to compensate in a manner that will permit a ... remedy to the injury that has been suffered by those [creditors] who will benefit from the subordination"). " '[T]he bankruptcy court has the power to sift the circumstances surrounding any claim to

see that injustice or unfairness is not done in the administration of the bankrupt estate.' " *Burden,* 917 F.2d at 117 (quoting *Pepper,* 308 U.S. at 307–08, 60 S.Ct. 238). The inequitable conduct may arise out of any unfair act by the creditor as long as the conduct affects the bankruptcy results of the other creditors. *Matter of Mobile Steel Co.,* 563 F.2d 692, 700 (5th Cir.1977). Because equitable subordination is remedial rather than penal, a claim should be equitably subordinated only to the extent necessary to offset the harm suffered by the debtor and its creditors as a result of the inequitable conduct. *Mobile Steel,* 563 F.2d at 701. A New York bankruptcy court has eloquently stated:

> The remedy of equitable subordination must remain sufficiently flexible to deal with manifest injustice resulting from the violation of the rules of fair play .... 'where ingenuity spawns unprecedented vagaries of unfairness, [bankruptcy courts] should not decline to recognize their marks, nor hesitate to turn the twilight for [offending claimants] into a new dawn for other creditors.'

In re Teltronics Servs., Inc., 29 B.R. 139, 172 (Bankr.E.D.N.Y.1983) (citations omitted). We hold that because the Bankruptcy Court subordinated attorneys' fees pursuant to its equitable powers, the American Rule is not implicated. The Bankruptcy Court did not award a money judgment for attorneys' fees to penalize CVC. Rather, the Bankruptcy Court analyzed the record facts, found specific damages, and used its equitable powers to return the non-selling creditors to the position they would have been in had CVC not acted inequitably.

We directed the Bankruptcy Court to make findings as to the amount of CVC's claims that should be subordinated pursuant to the principles of equitable subordination, and to identify specific harm resulting from CVC's wrongdoing. *In re Papercraft Corp.,* 160 F.3d at 991. The Bankruptcy Court did so, and concluded that CVC's inequitable conduct justifies subordination of attorneys' fees. We hold that the finding is not clearly erroneous.

At trial, the Bankruptcy Court stated that "none of these litigation costs would have been incurred" but for CVC's inequitable conduct, 5 app. at 1364, and that "some reasonable litigation costs may actually be a direct consequence of CVC's activities in this case." 5 app. at 1365. The Bankruptcy Court found that, but for CVC's inequitable conduct, the Committee would not have incurred such substantial fees and costs. *In re Papercraft Corp.,* 247 B.R. at 628; 28 app. at 8004–05. The Bankruptcy Court analyzed the depletion of available funds in the reorganized entity, and determined that the economic harm is directly attributable to CVC's inequitable actions. *In re Papercraft Corp.,* 247 B.R. at 628; 29 app. 8326. The Bankruptcy Court also found that the fees and costs related to the litigation were a "third type of economic harm caused by CVC's undisclosed claims purchasing." *In re Papercraft Corp.,* 247 B.R. at 631. The amount of attorneys' fees does not include all litigation costs of the Committee. Rather, more than $700,000 is deducted from the attorneys' fee award for fees and costs that are unrelated to CVC's inequitable conduct. 29 app. 8211–48.

CVC's inequitable conduct includes repeatedly litigating issues that were decided against it by our earlier decision, as well as earlier decisions of the District Court and the Bankruptcy Court. For example, in this case, CVC has incessantly relitigated the issue of whether it profited from its illegal claims trading, even though this issue had already been decided against it in the District Court, and reviewed by us. *In re Papercraft Corp.,* 165 B.R. 980, 983–

84 (Bankr.W.D.Pa.1994); *In re Papercraft Corp.,* 187 B.R. 486, 492, 498–99 (Bankr. W.D.Pa.1995); *In re Papercraft Corp.,* 211 B.R. 813, 825 n. 12 (W.D.Pa.1997); *In re Papercraft Corp.,* 160 F.3d 982, 990–91 (3d Cir.1998). Also, in the briefs filed with the Bankruptcy Court on remand, 29 app. 8133–87, CVC attempted to relitigate that it did not usurp a corporate opportunity, even though all three courts had already found against CVC on this issue in previous *In re Papercraft Corp.* decisions. 160 F.3d at 987–88. Finally, CVC's collateral proceedings, for which CVC only had standing because it illegally purchased claims against Papercraft, were aimed at preventing the reorganized debtor from engaging in a value-enhancing sale transaction, and depleted monies that would have otherwise been available to the creditors. 29 app. 8216–17, 8245–46.

The Bankruptcy Court also determined that the testimony of CVC's representatives during the litigation was not credible. *In re Papercraft,* 187 B.R. at 493 n. 3 (finding that all other credible testimony and evidence shows that the testimony of CVC's Saleem Muqaddam is false); *id.* at 497 (dismissing the testimony of CVC's William Comfort, which contradicted other evidence); *id.* (disbelieving testimony of Muqaddam). Each of these instances of inequitable conduct resulted in legal fees and costs that decreased the funds available the non-selling creditors.

The Bankruptcy Court spent a substantial amount of time and effort considering the narrow issue of whether to include the professional fees and expenses in the subordination, 28 app. 8004–05; 29 app. 8288–335, and ruled on the issue in two written opinions. *In re Papercraft Corp.,* 247 B.R. at 631; *In re Papercraft Corp.,* 253 B.R. at 387–90. We conclude that the Bankruptcy Court found facts sufficient to establish the egregious conduct warranting subordination of CVC's claims, and those facts are not clearly erroneous. Although the pursuit of one's legal rights may not be grounds for equitable subordination, protracted and unjustified litigation tactics that harm the estate by causing it to incur fees may justify subordination. The Bankruptcy Court has been involved in overseeing this litigation for a decade and has had the best opportunity to observe first hand CVC's conduct and evaluate its motives. We are hard-pressed to disagree with its determinations based on the extensive record and proceedings before it, and its obvious familiarity with what we previously termed CVC's "machinations."

We reject CVC's other two arguments, as well as the Committee's argument on cross-appeal.

[16] First, we conclude that the District Court did not err by holding that CVC was responsible for all fees incurred during a delay in the plan process. In our previous decision, we indicated that CVC's actions could have led to the delay in the BDK Plan's confirmation:

> Without limiting the inquiry of the bankruptcy court in any way, we note that there is evidence which would support a finding that the non-selling Papercraft creditors suffered injury from CVC's attempt to control the reorganization.... [I]f CVC's pursuit of its own interest in fact resulted in delay in the confirmation, we do not read that finding as inconsistent with subordination based on injury resulting from that delay.

In re Papercraft, 160 F.3d at 991–92. The Bankruptcy Court evaluated the evidence, and found ample support to establish that CVC's conduct delayed the plan process by at least four months, and that CVC's intent was to benefit itself over and above other creditors to whom it owed a fiduciary duty not to self-deal. *In re Papercraft,* 247 B.R. at 628. We have determined that the Bankruptcy Court's findings are not clear error.

[17] Second, we conclude that the District Court did not err by affirming the Bankruptcy Court's calculation of CVC's profit. CVC argues that because it could only have realized a profit on the claim purchases if the cash equivalent of the BDK Units that it could receive under the BDK Plan exceeded the $10.5 million that CVC paid for the claims, the calculation must be the fair market value of those BDK Units. More than sufficient evidence demonstrates that the Bankruptcy Court did not err by valuing CVC's profit based on the reorganization value at the time of the BDK Plan confirmation. All of the creditors, including CVC, were to receive BDK Units on an equal basis, determined by their proportional share of interests in the reorganized entity, and we uphold the District Court's affirmation of the Bankruptcy Court's calculations.

[18] Finally, the Committee argues that the District Court erred by reducing the subordination on account of lost interest income from $956,250 to $50,123. This argument is meritless. Because there was a four-month delay in the issuance of the debt securities, the Bankruptcy Court came to the $965,250 figure by multiplying the $239,062 in monthly interest on all the debt securities by four. The District Court correctly noted that the securities were ten-year notes, which would provide the Committee ten years of interest regardless of when they were issued. Mem. Order (Feb. 20, 2002), at 24–25. We therefore conclude that the District Court did not err by calculating the lost interest by a four-month delay of the ten years of interest.

For the foregoing reasons, we will affirm the judgment of the District Court.

Richard X. SUTTON; Robert X. Wise; Michael X. Walker, Appellants

v.

Imam Adeeb RASHEED; James Smith, Chaplain; Francis Menei, Chaplain; John Palakovich; Kenneth Kyler; Martin F. Horn;

United States of America (Intervenor in District Court).

No. 97–7096.

United States Court of Appeals, Third Circuit.

Argued March 6, 2002.

Filed March 19, 2003.

State prisoners brought §1983 action against personnel of Pennsylvania Department of Corrections alleging infringement upon their rights under free exercise clause of First Amendment. The United States District Court for the Middle District of Pennsylvania, Edwin M. Kosik, J., granted summary judgment for defendants. Prisoners appealed. The Court of Appeals, held that: (1) prisoners' claims for declaratory and injunctive relief were moot; (2) prisoners had justiciable claim for damages; (3) prisoners stated claim for damages against administrator of religious services; (4) regulation was invalid as applied to restrictive status prisoners; (5) prisoners' requests for Nation of Islam texts stemmed from constitutionally protected interest; and (6) defendants were protected by qualified immunity from prisoners' claims for damages.

Affirmed.

Scirica, Circuit Judge, filed a concurring opinion.

the New Jersey Bankruptcy Court issued an order "Annulling Stay and Allowing Prospective in Rem Relief as to Real Property." The Order states that the "automatic stay is annulled," and expressly allows the Appellants to proceed with "the eviction process without further Order of this Court...." Therefore, there is no question that the New Jersey Bankruptcy Court order annulled the automatic stay.

C. Conclusion

Given these facts, the Bankruptcy Court for the Eastern District of Pennsylvania correctly found that the New Jersey Bankruptcy Court had entered annulment orders and retroactively validated the Sheriff's sale. Therefore, there is no material issue of fact as to whether the Appellants violated the automatic stay.

For the preceding reasons, the judgment of the Bankruptcy Court of the Eastern District of Pennsylvania is AFFIRMED.

In re EARNED CAPITAL CORPORATION, Debtor.

Mary Geruschat, Dolores Speney, Antoinette Morocco, Donna Morocco Buxton, et al., Plaintiffs,

v.

Ernst & Young, LLP and Charles Modispacher, Defendants.

Bankruptcy No. 86-21474.
Adversary No. 04-3236.

United States Bankruptcy Court, W.D. Pennsylvania.

Sept. 2, 2005.

Background: "Investors" in Ponzi-type scheme operated by Chapter 11 debtors brought state court action against accountants that had represented debtors in Chapter 11 case for their alleged malpractice, and cause of action was removed to bankruptcy court.

Holdings: On investors' motion to remand and accountants' motion to dismiss, the Bankruptcy Court, Warren W. Bentz, J., held that:

(1) state court lawsuit could be removed directly to bankruptcy court;

(2) notice of removal did not have to be stricken on ground that, at time notice of removal was filed, underlying Chapter 11 case had been closed;

(3) court could exercise postconfirmation jurisdiction over proceeding;

(4) court would not exercise its discretion to abstain;

(5) malpractice claims were derivative claims, that "investors" lacked standing to pursue;

(6) "investors" were barred by res judicata effect of confirmed plan from pursuing malpractice claims; and

(7) application of doctrine of non-mutual offensive collateral estoppel against accountants was unfair.

Motion to remand or to strike notice of removal refused; motion to dismiss granted.

1. Bankruptcy ⟹2088

State court lawsuit asserting claims against Chapter 11 debtors' accountants for their alleged malpractice during bankruptcy case could be removed directly to bankruptcy court in which Chapter 11 petition was filed, and did not have to be removed to district court.

2. Bankruptcy ⟹2089, 3444.30(1)

Notice of removal of state court action to bankruptcy court, as asserting claims

arising in bankruptcy case, did not have to be stricken on ground that, at time notice of removal was filed, underlying Chapter 11 case had been closed; to extent that reopening of bankruptcy case was necessary or required, court would direct clerk to reopen case so that matters that had a significant connection with administration of case could be addressed.

3. Bankruptcy ⟹2057

Bankruptcy court's jurisdiction does not evaporate upon the closing of bankruptcy case.

4. Bankruptcy ⟹3444.50(2)

Bankruptcy court may reopen bankruptcy case on its own motion. 11 U.S.C.A. §§ 105(a), 350(b).

5. Bankruptcy ⟹3570

Bankruptcy court could exercise postconfirmation jurisdiction over adversary proceeding brought by "investors" in Ponzi-type scheme operated by Chapter 11 debtors to recover from debtors' accountants for their alleged malpractice during bankruptcy case, as proceeding that involved claims arising in bankruptcy case. 28 U.S.C.A. § 1334.

6. Bankruptcy ⟹3570

Retention of postconfirmation jurisdiction is normally appropriate with respect to matters having a close nexus to bankruptcy plan or proceeding.

7. Bankruptcy ⟹2053

Cause of action against Chapter 11 debtors' accountants for their alleged malpractice during bankruptcy case, based on services they provided under supervision, and subject to approval, of bankruptcy court, came within "core" jurisdiction of court, as one arising in bankruptcy case. 28 U.S.C.A. § 1334.

See publication Words and Phrases for other judicial constructions and definitions.

8. Federal Courts ⟹47.5

Bankruptcy court would not exercise its discretion to abstain from adjudicating proceeding brought by "investors" in Ponzi-type scheme operated by Chapter 11 debtors to recover from debtors' accountants for their alleged malpractice during bankruptcy case; claims were "core" claims that involved nature of services that accountants performed for bankruptcy estate as court-appointed professionals, and went to heart of bankruptcy court's jurisdiction. 28 U.S.C.A. § 1334(c)(1).

9. Federal Courts ⟹47.5

Bankruptcy courts have discretion whether to abstain from hearing "core" proceeding. 28 U.S.C.A. § 1334(c)(1).

10. Federal Courts ⟹41

Federal courts generally should exercise their jurisdiction if it is properly conferred, and abstention is the exception rather than the rule.

11. Federal Courts ⟹47.5

Factors that bankruptcy courts consider in determining whether to exercise their discretion to abstain from hearing proceeding are as follows: (1) effect or lack thereof on efficient administration of estate; (2) extent to which state law issues predominate; (3) difficulty or unsettled nature of applicable state law; (4) presence of related proceeding commenced in state or other non-bankruptcy court; (5) whether basis for federal jurisdictional exists apart from debtor's bankruptcy filing; (6) degree of relatedness or remoteness of proceeding to main bankruptcy case; (7) substance, rather than form, of asserted "core" proceeding; (8) feasibility of severing state law claims from "core" bankruptcy matters; (9) burden of bankruptcy court's docket; (10) likelihood that there has been forum shopping by one of parties; (11) existence of

right to jury trial; and (12) presence in proceeding of non-debtor parties. 28 U.S.C.A. § 1334(c)(1).

12. Federal Courts ⚷47.5

Factors which bear on propriety of decision by bankruptcy court to abstain from hearing proceeding should be applied flexibly, and no one factor is necessarily determinative. 28 U.S.C.A. § 1334(c)(1).

13. Bankruptcy ⚷2154.1

Proceeding brought by "investors" in Ponzi-type scheme operated by Chapter 11 debtors, to recover from debtors' accountants for their alleged malpractice during bankruptcy case in incorrectly determining that debtors were in fact insolvent, with result that debtors' assets were sold too quickly at unfavorable prices, asserted claims for corporate injury which "investors," never having made demand on trustee to pursue such claims, lacked standing to pursue.

14. Corporations ⚷206(2)

Prior to commencing a shareholder derivative lawsuit, shareholders must ordinarily make demand on board of directors or comparable authority to pursue claim. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

15. Corporations ⚷211(3, 4)

Shareholders may not bring derivative action unless their complaint alleges, with particularity, the efforts made by shareholders to obtain corporate action and reason for failing to obtain it. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

16. Bankruptcy ⚷2154.1

"Investors" in Ponzi-type scheme operated by Chapter 11 debtors were not excused, as prerequisite to asserting derivative claims against debtors' accountants for their alleged malpractice during bankruptcy case, from first making demand on trustee to pursue such claims, upon theory that debtors had ceased to exist and that any demand on trustee would have been futile; agent of "investors" knew that trustee had authority to pursue such claims and that trustee had actually exercised such authority on more than one occasion.

17. Judgment ⚷584, 714(1)

Doctrines of claim preclusion and issue preclusion bar action when foundation on which claims rest has already been litigated.

18. Bankruptcy ⚷3568(2)

"Investors" in Ponzi-type scheme operated by Chapter 11 debtors, having obtained confirmation of plan that provided for substantive consolidation of debtor entities based on their collective insolvency, were barred by res judicata effect of confirmed plan from pursuing professional malpractice claims against debtors' accountants, on theory that accountants had incorrectly determined that debtors were insolvent, with result that debtors' assets were sold too quickly at unfavorable prices.

19. Bankruptcy ⚷3568(2)

Confirmed Chapter 11 plan is binding on all parties, and all questions that were raised or could have been raised pertaining to such plan are res judicata.

20. Bankruptcy ⚷3568(2)

Preclusive effect of confirmed plan of reorganization binds every entity that holds claim or interest in bankruptcy, irrespective of whether this entity is impaired under plan or whether entity has accepted plan.

21. Judgment ⚷542, 586(2)

Bankruptcy court's approval of fees sought by Chapter 11 debtors' court-appointed accountants was res judicata as to any subsequent claims for malpractice or

misconduct as to work that accountants performed under supervision of court.

22. Judgment ⚬632

"Offensive collateral estoppel" occurs when plaintiff seeks to estop defendant from relitigating an issue which defendant previously litigated and lost against another plaintiff.

See publication Words and Phrases for other judicial constructions and definitions.

23. Judgment ⚬713(1)

Collateral estoppel is permissible as to a given issue if: (1) identical issue was previously adjudicated; (2) issue was actually litigated and decided in previous proceeding; (3) party had full and fair opportunity to litigate issue; and (4) resolution of issue was necessary to support valid and final judgment on merits.

24. Judgment ⚬713(1)

Fact that each of the four requirements for application of collateral estoppel has been established does not necessarily mean that prior judgment must be given issue preclusive effect; court must satisfy itself that application of collateral estoppel doctrine is fair.

25. Judgment ⚬828.21(2)

Judgment entered against Chapter 11 debtors' accountants in state court action brought by former shareholders, in which state court, based largely on accountants' "deemed admissions" rather than upon actual evidence presented at trial, determined that accountants were negligent in performing services for debtors, would not be applied offensively against accountants in proceeding brought by other "investors"; accountants did not have full and fair opportunity to litigate in prior state court action, and inconsistency between state court's findings and findings previously made by bankruptcy court made application of doctrine of non-mutual offensive collateral estoppel unfair.

Christopher P. Schuller, Pittsburgh, PA, for Defendants.

Victor H. Pribonic, White Oak, PA, for Plaintiffs.

OPINION

WARREN W. BENTZ, Bankruptcy Judge.

I. Introduction

The within Adversary Complaint was commenced when the Defendants in a state court action removed the pending Complaint to this Court and then filed a Motion to Dismiss the Complaint. The Plaintiffs contest this Court's jurisdiction and have filed Motion to Remand to the state court.

We have considered the numerous pleadings and briefs filed by the parties and have heard the argument of counsel on both the Motion to Remand and the Motion to Dismiss and find that the matters are ripe for decision.

II. Pleadings

A. Notice of Removal

The Defendants, Ernst & Young, LLP ("E & Y") and Charles Modispacher ("Modispacher") or ("E & Y and Modispacher", collectively the "Defendants") commenced this Adversary by filing a Notice of Removal of State Court Action to Bankruptcy Court ("Notice of Removal") on November 5, 2004. Defendants removed an action that was pending in the Court of Common Pleas of Butler County, Pennsylvania ("State Court") at Civil Action No. AD04–11170 ("State Court Action").

B. Complaint

Mary Geruschat, Dolores Speney, Antoinette Morocco and Donna Morocco Buxton (collectively, "Plaintiffs")[1] filed a three count Complaint in which they assert causes of action for: Count I—Professional Negligence; Count II—Fraud and Deceit; and Count III—Negligent Misrepresentation.

Plaintiffs allege that while serving as accountants in the bankruptcy case of the predecessor entities to Seven Fields Development Corporation ("Seven Fields"), the Defendants, during the course of the bankruptcy proceedings, made false and erroneous statements concerning the solvency of the Debtor entities when the accountants improperly characterized certain amounts of equity as debt. The Plaintiffs assert that the accountants' actions caused the successor entity, Seven Fields, to liquidate its assets in a manner calculated to liquidate the assets as soon as possible rather than judicially manage and develop the assets in a way to maximize the return to the Plaintiffs (and other shareholders) and that as a result of such actions, Plaintiffs and the class that they purport to represent have suffered significant damage.

C. Jury Demand

In response to the Notice of Removal, Plaintiffs filed a Demand for Trial by Jury.

D. Plaintiffs' Statement

On November 22, 2004, Plaintiffs filed PLAINTIFFS' STATEMENT PURSUANT TO BANKRUPTCY RULE 9027(e)(3) ("Statement"). In the Statement, Plaintiffs deny Defendants' allegation that the within Complaint involves a "core" matter and assert that the action is "non-core." The Plaintiffs further state that they do not consent to the entry of final orders on judgments by the bankruptcy judge and that "neither the bankruptcy court nor the federal court has jurisdiction" over the pending cause of action.

E. Defendants' Response to Plaintiffs' Statement

In response to the Plaintiffs' Statement, Defendants reassert that this is a core matter and further assert that the Plaintiffs waived the right to challenge the Defendants' allegation that the Adversary proceeding is a core proceeding by failing to file the Statement Pursuant to Fed. R.Bankr.P. 9027(e)(3) within ten days after the Defendants filed the Notice of Removal.

F. Motion to Remand

PLAINTIFFS' MOTION TO REMAND CASE TO STATE COURT ("Motion to Remand") is also before the Court. The Plaintiffs assert that Removal is improper because the State Court Action is not related to and has no "close nexus" to the bankruptcy case and therefore, this Court lacks subject matter jurisdiction over the proceeding; that the matter is not a "core" proceeding under 28 U.S.C. § 157(b)(1) and, therefore, the Court must necessarily abstain from exercising jurisdiction under 28 U.S.C. § 1334(c)(2); that even if the matter could be considered a core proceeding, the Court should abstain from asserting jurisdiction under § 1334(c)(1); and finally that remand to the State Court is required as the Notice of Removal was incorrectly filed in the Bankruptcy Court

1. Plaintiffs also assert that the Complaint is filed on behalf of a larger class of persons comprised of Plaintiffs and other similarly situated individuals.

rather than in the United States District Court.[2]

G. Motion to Strike

PLAINTIFFS' MOTION TO STRIKE DEFENDANTS' NOTICE OF REMOVAL ("Motion to Strike") was filed on December 20, 2004. Plaintiffs assert that the Court must strike the Defendants' Notice of Removal because a party may not remove a state court action to bankruptcy court where the underlying bankruptcy case to which the state court action is being removed was closed prior to the existence of the state court action and because Defendants failed to reopen the case prior to filing the Notice of Removal.

H. Defendants' Response to Motion to Strike

Defendants respond that an open bankruptcy case is not required for bankruptcy court jurisdiction; that if the case need be reopened, the Court can act *sua sponte;* that the Notice of Removal should be treated as a Motion to Reopen; or, if reopening is required, Defendants request leave to file an appropriate motion.

I. Motion to Dismiss

Three days after the filing of the Notice of Removal, DEFENDANTS' MOTION TO DISMISS PLAINTIFFS' COMPLAINT ("Motion to Dismiss") was docketed. Defendants assert that the Complaint must be dismissed for various reasons which, *inter alia,* include:

1. Plaintiffs' claims are shareholder derivative claims which they have inappropriately commenced in their individual capacities and prior to making a demand that the corporate entity itself pursue the claims.

2. Plaintiffs' claims are barred by the Statute of Limitations.

3. Plaintiffs' claims are barred by the doctrines of res judicata, collateral estoppel and/or judicial estoppel.

4. The Defendants have immunity for the statements made during judicial proceedings.

5. The professional negligence claim must be dismissed for the reason of lack of privity between the Defendants and the Plaintiffs.

J. Plaintiffs' Response to Motion to Dismiss

The Plaintiffs oppose the Motion to Dismiss. Plaintiffs assert that:

1. Defendants lack standing to challenge Plaintiffs' claims on the basis that the claims are derivative.

2. Defendants' reliance on items outside the record to challenge the specific date on which the Plaintiffs discovered their cause of action is not appropriately presented in a Motion to Dismiss.

3. The Defendants are themselves precluded from raising the defenses of res judicata, collateral estoppel and judicial estoppel as a basis to dismiss the Complaint because the State Court has previously decided such issues to their detriment. For this same reason, Plaintiffs oppose the remainder of Defendants' Motion to Dismiss wherein they assert that Plaintiffs have failed to state claims for professional negligence, fraud, negligent misrepresentation, and that Defendants are "immune" from liability.

2. Along with the Motion to Remand, Plaintiffs filed a Motion to Hold in Abeyance Defendants' Motion to Dismiss (the "Abeyance Motion") pending resolution of the Motion to Remand. By Order dated December 7, 2004, we granted the Abeyance Motion, but by Order dated February 15, 2005, vacated the Order and ordered Plaintiffs to file a response and brief in opposition to the Motion to Dismiss.

III. Factual Background

On June 3, 1986, Earned Capital Corporation, Managed Properties, Inc., Canterbury Village, Inc. and Eastern Arabian, Inc. (collectively, the "Debtors") filed separate voluntary Petitions under Chapter 11 of the Bankruptcy Code. By Order dated June 5, 1986, the Court ordered that the separate cases be jointly administered under the case entitled Earned Capital Corporation at Case No. 86–21474 (the "Bankruptcy Case").

The Debtors were engaged in the business of selling shares of investment in various property where investors were promised a certain annual return on investment. Shares were oversold when Debtors had to continue the selling program in order to maintain the payments to investors.

Debtors' financial affairs were in disarray and the affairs of each of the Debtors were substantially intertwined. E & Y was engaged as accountants for the Debtors in the Bankruptcy Case. The Debtor had minimal debt to ordinary trade creditors and some $6,000,000 in debt to creditors holding secured claims against Debtors' property. The vast majority of Debtors' obligations, which totaled over $60,000,000, were owed to those thousands of individuals who had made investments in the Debtors ("Investors")[3]. In exchange for depositing monies with the Debtors, the Investors had received various documents entitled "Agreement of Sale" for fractional interests in real estate, various agreements to document the purchase of fractional interests in horses, documents entitled "Lease and Breeding Management Agreement" and "Bond and Warrant." The exact status of the Investors was unknown, i.e., whether they were investors, bondholders, or some other form of general creditor. They were all referred to as the investor class or the Investors and were treated as the only creditors in the Bankruptcy Case who were impaired and at risk. Many of the Investors, including Plaintiffs Antoinette Morocco and Donna Morocco Buxton, filed proofs of claim as unsecured creditors.

The Investors were appointed to and represented by the Official Committee of Unsecured Creditors in the Bankruptcy Case ("Committee"). The Committee was represented by legal counsel and took a very active role in the Bankruptcy Case.

The Debtors and the Committee filed competing plans of reorganization. Both plans contemplated substantive consolidation of the assets and liabilities into one surviving reorganized corporation. The Amended Plan of Reorganization of Committee of Unsecured Creditors (the "Plan") was confirmed by the Court on October 21, 1987 after an evidentiary hearing to consider whether substantive consolidation was appropriate. This Court found that each of the Debtors was insolvent and that substantive consolidation was appropriate.

The Investor class of creditors voted overwhelmingly in favor of the Plan. The Investor class cast 2,286 ballots representing claims of $77,072,274. The voting was as follows:

Number of Ballots	*Yes/No*	*Amount*
2,179	Yes	$62,639,067
87	No	13,758,972

The preamble to the Plan identifies the makeup of the Committee:

"The COMMITTEE OF UNSECURED CREDITORS, being commonly referred to as consisting of 'investors' and/or 'bondholders' hereby submits the following Plan...." The Disclosure Statement which

3. Plaintiffs allege that there are as many as 2,700 similarly situated individuals.

accompanied the Plan sets forth the unsecured debt of the Debtors:

> F. Unsecured debt
>
> 1. Trade creditors—These are itemized at Schedule A–3–1 filed by Debtors. The total is $56,402.98.
>
> 2. "Bondholders" and "Investors"—these groups of creditors were designated as indicated in the Schedules filed by Debtors. These designations may not be wholly accurate, depending upon characterizations of the relationships between the named persons in the schedules and the Debtors. However, for purposes of the Bankruptcy Code and the Plans filed these parties are all unsecured creditors. The total scheduled debt is $69,194,842.74.

Under the Plan, the Debtors were merged into one successor entity that was eventually named Seven Fields. All of the Debtors' assets were pooled and became assets of Seven Fields.

The only impaired class of creditors under the Plan was the Investor class of unsecured creditors (described in the Plan as the Class 5 claims). Secured creditors and trade creditors were paid in full. Under the Plan, each unsecured creditor received common stock in Seven Fields at a par value equal to 5% of its allowed claim. The remaining 95% of each allowed claim remained as an unsecured, nondischargeable debt. The Investors became the new shareholders of the reorganized Seven Fields and thus were in control of the assets, sale or development of those assets, and distribution of funds. The former equityholders of the Debtor retained no interest under the terms of the Plan.

The Plan contemplated that the Investor class of creditors would manage Seven Fields with a goal of full recovery of the invested amounts. The Plan provides:

> 6.08 The surviving corporation, as may be authorized by its Board of Directors, shall periodically distribute available funds, without interest, in prorata repayment of the aforesaid waived non-discharged Class 5 debts.
>
> 6.09 Assets will be sold or managed frugally, carefully, responsibly and utilizing sound business practices. Undeveloped assets will be developed as and when fair and reasonable proposals have been received, studied and approved. All activities of the surviving reorganized corporation shall seek to achieve the goal of full payment to Class 5 creditors.

The Plan provides for the Debtors' Chapter 11 cases to remain open until all unsecured claims are paid in full:

> 8.05 These Chapter 11 cases shall not be closed or deemed closed until all non-discharged Class 5 claims have been fully paid and all matters set forth in section 9.01 have been finally concluded.

Section 9.01 of the Plan sets forth the retention of jurisdiction provisions. It provides in relevant part:

> The Bankruptcy Court shall retain exclusive jurisdiction [in] this case as long as necessary for the following purposes:
>
> . . .
>
> (b) to determine and fix (1) all administrative claims. . .
>
> . . .
>
> (d) to adjudicate any matters or disputes arising under or in connection with (I) the Plan and (ii) such other matters as may be provided for in the Confirmation Order;
>
> . . .
>
> (f) to hear and determine any and all pending applications, motions, adversary proceedings or contested matters;
>
> (g) to amend, or to correct any defect, cure any omissions or reconcile any in-

consistency in the Plan or the Confirmation Order as may be necessary, to carry out the purpose and intent of the Plan...

...

(I) to issue such orders as may be necessary to enable the surviving reorganized Debtor to implement this Plan and effect distributions to holders of claims.

(j) to hear and determine any and all adversary proceedings or contested matters to be filed subsequent to the Confirmation Date.

...

E & Y was engaged by the Debtors. E & Y's work product was shared with the Committee. E & Y filed Applications for Allowance of Compensation. Each Application was the subject of an objection by the Committee. An evidentiary hearing was held and partial interim fees were awarded. The unpaid portion was the subject of subsequent stipulation between E & Y and Seven Fields for the payment of remaining fees in a reduced amount. The Stipulation was approved by the Court.

On April 30, 1996, Seven Fields filed a Motion for Final Decree. On May 14, 1996, the Final Decree was entered and the case closed on the Court's docket.

IV. Discussion

1. Motion to Remand

A. Removal to Bankruptcy Court

[1] The Plaintiffs assert that the Defendants' removal of the Complaint from State Court to the Bankruptcy Court was improper, and that the Complaint should have been removed to the United States District Court. This issue was recently addressed in the case of *In re Coastal Plains, Inc.,* 326 B.R. 102 (Bankr.N.D.Tx., 2005):

The Plaintiffs argue that the Trustee's removal of this proceeding from state court to the bankruptcy court was improper, and that the proceeding instead should have been removed to the district court. Plaintiffs state that the remedy for this error is to remand the case to state court, where any further attempt at removal will be untimely. The Trustee argues that removal to the bankruptcy court was proper.

Some authority supports Plaintiffs' position. *See In re Schuler,* 45 B.R. 684, 686 (Bankr.D.N.D.1985) (finding that "No mention is made of the bankruptcy court" in section 1452). However, the majority of courts to look at this issue have found that removal to the bankruptcy court is proper. *Braden Partners, L.P. v. Hometech Medical Services, Inc.,* 2003 WL 223423 (N.D.Cal. 2003) (citing *In re Aztec Industries, Inc.,* 84 B.R. 464 (Bankr.N.D.Ohio 1987)); *In re Princess Louise Corp.,* 77 B.R. 766, 768 (Bankr.C.D.Cal.1987); *In re Convent Guardian Corp.,* 75 B.R. 346, 347 (Bankr.E.D.Pa.1987); *Matter of Centro de Transmisiones Automaticas,* 73 B.R. 297, 298 (Bankr.D.Puerto Rico 1987); *In re North American Funding Corp.,* 64 B.R. 795, 796 (Bankr.S.D.Tex.1986); *In re Finley,* 62 B.R. 361, 365 (Bankr. N.D.Ga.1986); *Matter of Cassidy Land & Cattle Co.,* 62 B.R. 93, 96 (Bankr. D.Neb.1986); *In re Commercial Oil Service, Inc.,* 58 B.R. 311, 314 (Bankr. N.D.Ohio 1986), aff'd sub nom. *State of Ohio v. [In re] Commercial Oil Service, Inc.,* 88 Bankr.[B.R.] 126 (N.D.Ohio 1987); *In re Gianakas,* 56 B.R. 747, 750–753 (N.D.Ill.1985); *In re Philadelphia Gold Corp.,* 56 B.R. 87, 89–90 (Bankr.E.D.Pa.1985). This Court finds the majority view to be the correct one.

Id.

We likewise agree with the majority view and find that removal to the Bankruptcy Court is proper.

B. Closed Case

[2] The Plaintiffs assert that the Notice of Removal must be stricken because Defendants are pursuing removal without first reopening the Bankruptcy Case.

The case was closed on the Court's docket on May 14, 1996. The terms of the Plan can be construed to mean that even though the case is closed on the docket, the case remains open until all Class 5 claims have been paid in full.

[3] Even if the case is considered closed, "[a] court's jurisdiction 'does not evaporate with the closing of a bankruptcy case.'" *In re Sterling Optical Corp.,* 302 B.R. 792, 808 (Bankr.S.D.N.Y.2003) *quoting Speleos v. McCarthy,* 201 B.R. 325, 329 (D.D.C.1996). "To the contrary, the closing of a bankruptcy case is simply an administrative matter, and 'does not affect a bankruptcy court's jurisdiction to determine matters relevant to the case'". *Sterling Optical* at 808 *quoting In re Taylor,* 216 B.R. 515, 521 (Bankr.E.D.Pa.1998).

[4] Further, 11 U.S.C. § 350(b) provides that "[a] case may be reopened in the court in which such case was closed to administer assets, to accord relief to the debtor, or for other cause." 11 U.S.C. § 350(b). "While no party sought the reopening, 11 U.S.C. § 105(a) empower[s] the bankruptcy court to reopen the case on its own motion." *Donaldson v. Bernstein,* 104 F.3d 547, 552 (3rd Cir.1997).

To the extent that reopening is necessary or required, we will direct the Clerk to reopen the case so that these matters that have a significant connection with the administration of the case can be addressed.

C. Jurisdiction

[5] Federal bankruptcy jurisdiction was recently discussed by the Court of Appeals for the Third Circuit in the case of *In re Combustion Engineering, Inc.,* 391 F.3d 190 (3rd Cir.2005):

> Federal bankruptcy jurisdiction is defined by 28 U.S.C. § 1334. Section 1334(b) confers upon the district courts "original and exclusive jurisdiction of all cases under title 11," and "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." 28 U.S.C. § 1334(b). Section 157(a) of the Bankruptcy Code permits district courts to refer most matters to a bankruptcy court. See 28 U.S.C. §§ 157(a), 151. This broad jurisdictional grant allows bankruptcy courts to "deal efficiently and expeditiously with all matters connected with the bankruptcy estate." *Celotex Corp. v. Edwards,* 514 U.S. 300, 308, 115 S.Ct. 1493, 131 L.Ed.2d 403 (1995) (*quoting Pacor, Inc. v. Higgins,* 743 F.2d 984, 994 (3d Cir.1984)).
>
> "Bankruptcy court jurisdiction potentially extends to four types of title 11 matters: '(1) cases under title 11, (2) proceeding[s] arising under title 11, (3) proceedings arising in a case under title 11, and (4) proceedings related to a case under title 11.'" *Binder v. Price Waterhouse & Co., LLP (In re Resorts Int'l, Inc.),* 372 F.3d 154, 162 (3d Cir. 2004) (*quoting Torkelsen v. Maggio (In re Guild & Gallery Plus),* 72 F.3d 1171, 1175 (3d Cir.1996)). Cases under title 11, proceeding arising under title 11, and proceedings arising in a case under title 11 are referred to as "core" proceedings; whereas proceedings "related to" a case under title 11 are referred to as "non-core" proceedings.[38] *In re Resorts Int'l, Inc.,* 372 F.3d at 162 (citing 1 Collier on Bankruptcy, ¶ 3.02[2], at 3–35 (15th ed. Rev.2003))...

. . .

38. "[C]ases under Title 11," as used in 28 U.S.C. § 1334(a), "refers merely to the bankruptcy petition itself." *In re Marcus Hook Dev. Park, Inc.*, 943 F.2d 261, 264 (3d Cir. 1991) (*quoting Matter of Wood*, 825 F.2d 90, 92 (5th Cir.1987)). The term "proceeding," on the other hand, as used in 28 U.S.C. § 1334(b), refers "to the steps within the 'case' and to any subaction within the case that may raise a disputed or litigated matter." *In re Wolverine Radio Co.*, 930 F.2d 1132, 1141 n. 14 (6th Cir.1991) (citing 2 Collier on Bankruptcy ¶ 301.03 (15th ed.1990)). Put differently, "anything that occurs within a case is a proceeding," see 1 Collier on Bankruptcy ¶ 3.01[4][b] at 3–19 (15th Ed. Rev. 2003) (*quoting* H.R.Rep. No. 595, 95th Cong., 1st Sess. 445 (1977)[, U.S.Code Cong. & Admin.News 1978, pp. 5963, 6401]), including all "controversies, adversary proceedings, contested matters, suits, actions or disputes." *Id.* ¶ 3.01[3] at 3–13.

In re Combustion Engineering, Inc., 391 F.3d at 225–26 (3d Cir.2005).

> On its face, section 1334 does not distinguish between pre-confirmation and post-confirmation jurisdiction. Nonetheless, courts sometimes have found a need to curtail the reach of related to jurisdiction in the post-confirmation context so that bankruptcy court jurisdiction does not continue indefinitely. *See, e.g., In re Pegasus Gold Corp.*, 394 F.3d 1189, 1193–94 (9th Cir.2005) (suggesting that post-confirmation bankruptcy court jurisdiction is necessarily more limited than pre-confirmation jurisdiction); *In re Resorts Int'l, Inc.*, 372 F.3d 154, 164–69 (3d Cir.2004) (similar).

In re Boston Regional Medical Center, Inc., 410 F.3d 100, 106 (1st Cir.2005).

[6] The Court of Appeals for the Third Circuit has also recently addressed the jurisdiction of the bankruptcy court to hear an action commenced after confirmation of a plan of reorganization. *In re Resorts Int'l, Inc.*, 372 F.3d 154 (3d Cir. 2004) "[W]here there is a close nexus to the bankruptcy plan or proceeding...retention of post-confirmation bankruptcy court jurisdiction is normally appropriate." *Id.* at 168–69.

In *Resorts*, the basis of the claim was misconduct by the accounting firm for a Litigation Trust *post-confirmation*. *Id.* at 169. *Resorts* is unlike the situation here, where the Plaintiffs' claims are claims against a court appointed professional for work performed during the bankruptcy case.

The facts of the present case are analogous to the facts in *In re Southmark Corp.*, 163 F.3d 925 (5th Cir.1999), where the claims of professional malpractice were based on services provided during the bankruptcy, under the supervision of, and subject to the approval of, the bankruptcy court. *Id.* The Plaintiffs' claims against the Defendants "implicate the integrity of the bankruptcy process." *Donaldson v. Bernstein*, 104 F.3d at 553. The claim is a claim "arising in" a bankruptcy case and as a result, this court has jurisdiction. *Heck–Dance v. Cardona–Jimenez*, 102 Fed. Appx. 171 (1st Cir.2004); *Grausz, M.D. v. Englander*, 321 F.3d 467, 471 (4th Cir. 2003); *In re Southmark Corp.*, 163 F.3d 925 (5th Cir.1999); *In re LGI, Inc.*, 322 B.R. 95 (Bankr.D.N.J.2005).

D. Core v. Non–Core Matter

[7] "A proceeding is core under [28 U.S.C.] § 157 if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case." *In re The Guild and Gallery Plus, Inc.*, 72 F.3d 1171, 1178 (3d Cir.1996) *quoting In re*

Marcus Hook Dev. Park, Inc., 943 F.2d 261, 267 (3d Cir.1991).

As the Court in *Southmark* stated in concluding that the malpractice claims against the accounting firm were core matters:

> Southmark also disputes that its claims could arise "only in the context of a bankruptcy case," inasmuch as Southmark could have sued any accounting firm that worked for it on similar grounds of disloyalty, non-disclosure and malpractice. It is somewhat disingenuous for Southmark to attempt to pry these claims out of their bankruptcy setting. Southmark's petition alleges *inter alia* claims for breaches of fiduciary duty and of the contract whose terms were approved by the bankruptcy court. Southmark prays for actual damages including return of the entire $4 million fee it paid Coopers from money belonging to the debtor's estate. The fee award was both approved by the bankruptcy court and subjected to the bankruptcy court's later disgorgement order.
>
> In this case, the professional malpractice claims alleged against Coopers are inseparable from the bankruptcy context. A *sine qua non* in restructuring the debtor-creditor relationship is the court's ability to police the fiduciaries, whether trustees or debtors-in-possession and other court-appointed professionals, who are responsible for managing the debtor's estate in the best interest of creditors. The bankruptcy court must be able to assure itself and the creditors who rely on the process that court-approved managers of the debtor's estate are performing their work, conscientiously and cost-effectively. Bankruptcy Code provisions describe the basis for compensation, appointment and removal of court-appointed professionals, their conflict-of-interest standards, and the duties they must perform. See generally 11 U.S.C. §§ 321, 322, 324, 326–331. Although standards for the conduct of court-appointed professionals, the breach of which may constitute bankruptcy malpractice, are not comprehensively expressed in the statute, the Code need not duplicate relevant, also-applicable state law. It is evident that a court-appointed professional's dereliction of duty could transgress both explicit Code responsibilities and applicable professional malpractice standards. For instance, in *Billing v. Ravin, Greenberg & Zackin, P.A.,* 22 F.3d 1242 (3d Cir.1994), the professional malpractice allegations included the attorneys' failure to comply with court orders and to submit a plan of reorganization to the bankruptcy court. Award of the professional's fees and enforcement of the appropriate standards of conduct are inseparably related functions of bankruptcy courts.
>
> Supervising the court-appointed professionals also bears directly on the distribution of the debtor's estate. If the estate is not marshaled and liquidated or reorganized expeditiously, there will be far less money available to pay creditors' claims. Excessive professional fees or fees charged for mediocre or, worse, phantom work also cause the estate and the creditors to suffer.
>
> . . .
>
> Although surprisingly few court of appeals cases have explored the boundaries of bankruptcy courts' core jurisdiction in the wake of Marathon, at least three decisions are premised on the understanding that professional malpractice claims against court-appointed professionals are indeed core matters. *See Billing,* 22 F.3d 1242; *Walsh v. Northwestern Nat'l Ins. Co.,* 51 F.3d 1473,

1476 (9th Cir.1995); *Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 483 n. 4 (6th Cir.1992). No appeals court decision has held otherwise. In one case against a bankruptcy trustee to recover property that did not belong to the debtors' estate, the court rejected subject matter jurisdiction founded on either core or related-to-bankruptcy jurisdiction. *In re Guild and Gallery Plus, Inc.*, 72 F.3d 1171, 1173 (3d Cir.1996).

Southmark's lawsuit draws into question Coopers' performance of its duties under court order, and it seeks in part to recover on the claim Southmark would have had against Drexel. For these and other reasons just discussed, we conclude that Southmark's case against Coopers is a core proceeding in bankruptcy.

In re Southmark Corp., 163 F.3d at 930–31.

We likewise conclude that the Plaintiffs' Complaint against the Defendants is a core proceeding.

E. Abstention

[8] 28 U.S.C. § 1334(c)(1) provides:

(c)(1) Nothing in this section prevents a district court in the interest of justice, or in the interest of comity with State courts or respect for State law, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11.

28 U.S.C. § 1334(c)(1).

[9–11] "Because this is a core proceeding, the bankruptcy court [has] discretion whether to abstain from hearing it." *Southmark* at 931. "[W]e are mindful that federal courts generally should exercise their jurisdiction if it is properly conferred, and that abstention is the exception rather than the rule." *In re Phelps Technologies, Inc.*, 238 B.R. 819, 822 (Bankr.W.D.Mo. 1999) *citing Matter of Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 6 F.3d 1184, 1189 (7th Cir.1993); *see also In re Williams*, 256 B.R. 885, 893–94 (8th Cir. BAP 2001).

We have considerable latitude in deciding whether to abstain.

"Permissive abstention from core proceedings under 28 U.S.C. § 1334(c)(1) is left to the bankruptcy court's discretion." *In re Petrie Retail, Inc.*, 304 F.3d 223, 232 (2d Cir.2002).

In determining whether to exercise permissive abstention under § 1334(c) courts have considered one or more (not necessarily all) of twelve factors: (1) the effect or lack thereof on the efficient administration of the estate if a Court recommends abstention, (2) the extent to which state law issues predominate over bankruptcy issues, (3) the difficulty or unsettled nature of the applicable state law, (4) the presence of a related proceeding commenced in state court or other non-bankruptcy court, (5) the jurisdictional basis, if any, other than 28 U.S.C. § 1334, (6) the degree of relatedness or remoteness of the proceeding to the main bankruptcy case, (7) the substance rather than form of an asserted "core" proceeding, (8) the feasibility of severing state law claims from core bankruptcy matters to allow judgments to be entered in state court with enforcement left to the bankruptcy court, (9) the burden of [the court's] docket, (10) the likelihood that the commencement of the proceeding in a bankruptcy court involves forum shopping by one of the parties, (11) the existence of a right to a jury trial, and (12) the presence in the proceeding of non-debtor parties.

In re Balco Equities, Ltd., Inc., 323 B.R. 85, 92–93 (Bankr.S.D.N.Y.2005) *quoting In*

re Cody, Inc., 281 B.R. 182, 190–91 (S.D.N.Y.2002).

[12] "Courts should apply these factors flexibly, for their relevance and importance will vary with the particular circumstances of each case, and no one factor is necessarily determinative." *Matter of Chicago, Milwaukee, St. Paul & Pacific Railroad Co.,* 6 F.3d at 1189.

Applying these factors, we conclude that abstention is not appropriate. Of particular relevance to our determination are the facts that the issues presented by the Complaint represent a core proceeding, and therefore, all of the factors pertaining to non-core proceedings are inapplicable; and the fact that the Complaint involves the nature of the services that the Defendants performed for the bankruptcy estate as court appointed professionals and the fees awarded under supervision of this court. The issues are at the heart of the bankruptcy court's jurisdiction and are inextricably related to the bankruptcy case. The interests of justice would be disserved were we to abstain from hearing and deciding these issues.

The Plaintiffs' Motion to Remand Case to State Court will be refused.

2. Motion to Dismiss

A. Standard for Motion to Dismiss

"In considering a motion to dismiss, a court must accept all of the factual allegations in the complaint and draw all reasonable inferences from those facts in favor of plaintiffs." *Lum v. Bank of America,* 361 F.3d 217, 223 (3d Cir.2004) *citing Moore v. Tartler,* 986 F.2d 682, 685 (3d Cir.1993). "A court may dismiss the Complaint only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Lum* at 223 *citing Hishon v. King & Spalding,* 467 U.S. 69, 73, 104 S.Ct. 2229, 81 L.Ed.2d 59 (1984). In the present case, accepting all of the allegations in the Complaint as true and drawing every reasonable inference in favor of the Plaintiffs, we conclude that Plaintiffs fail to state a claim for relief, for the reasons discussed below.

B. Shareholder Derivative Lawsuit

Pennsylvania law defines a shareholder's derivative action as an "action or proceeding brought to enforce a secondary right on the part of one or more shareholders of a business corporation against any present or former officer or director of the corporation because the corporation refuses to enforce rights that may properly be asserted by it." 15 Pa.C.S. § 1782(a). See also Pa.R.Civ.P. 1506(a) (a shareholder's derivative action is one brought "to enforce a secondary right brought by one or more stockholders or members of a corporation or similar entity because the corporation or entity refuses or fails to enforce rights which could be asserted by it").

In Davis v. U.S. Gypsum Co., 451 F.2d 659 (3rd Cir.1971), the Third Circuit distinguished between a derivative action and an individual action as follows:

> It is hornbook law that claims asserted for the benefit of stockholders *qua* stockholders in a corporation because of the tortious acts of its officers or those actions in conjunction with them is a class suit, a derivative action, and recovery is for the benefit of the corporation directly and indirectly to its stockholders. It is equally clear that where a corporation, tortiously conspires with others to damage an individual and does so a cause of action arises which belongs to the individual.

451 F.2d at 662. Pennsylvania corporate commentators also recognize this distinction:

> Where there is a breach of the contract existing between the corporation and a shareholder by reason of his status as a shareholder, as distinguished from a breach of a contract between the corporation and a third person; or where there is a breach of the fiduciary duty which the directors, officers, or majority shareholders owe to a shareholder or the minority shareholders, as such, as distinguished from the breach of such a duty owed to the corporation, the shareholder injury by such breach has a direct, personal cause of action.
>
> W. Edward Sell & William H. Clark, Jr., Pennsylvania Business Corporations (1997) § 1782.2. See also *William M. Fletcher*, 12B Cyclopedia of the Law of Private Corporations ("Fletcher") § 5911 ("[i]f the injury is one to the plaintiff as a shareholder as an individual, and not to the corporation, as where the action is based on a contract to which the shareholder is a party, . . . it is an individual action").

First Republic Bank v. Brand, No. 147 Aug. Term 2000, 2001 WL 1807749 (Pa. Com.Pl. June 1, 2001).

[13] The Court agrees with the Defendants that the Plaintiffs' claims are shareholder derivative claims that can only be presented by the Plaintiffs through a shareholder derivative lawsuit. In the Complaint, Plaintiffs assert that they "are now or formerly [were] shareholders of Seven Fields Development, Inc." Plaintiffs further assert that the Complaint is filed on behalf of all current or former shareholders of Seven Fields stock and assert that "the damages suffered by each of the Plaintiff class in the form of investments lost in respect to the relative share they could have received" are common to all members of the class. The Plaintiffs further allege that "as investors/shareholders, the relationship of each of them to the Defendants and the successor corporation are substantially identical" and all holders of Seven Fields stock have "suffered identical losses relative to the amounts of the investment and the potential for return loss."

The Plaintiffs allege to have suffered indirect harm through asserted losses on their stock investment which stems from the alleged diminution in value of their corporation. This type of injury is a corporate injury. Plaintiffs have no standing to prosecute litigation in their own name to recover for this type of injury.

> A stockholder of a corporation does not acquire standing to maintain an action in his own right, as a shareholder, when the alleged injury is inflicted upon the corporation and the only injury to the shareholder is the indirect harm which consists in the diminution in value of his corporate shares resulting from the impairment of corporate assets. In this situation, it has been consistently held that the primary wrong is to the corporate body and, accordingly, that the shareholder, experiencing no direct harm, possesses no primary right to sue. *Ash v. International Business Machines,* 353 F.2d 491 (3 Cir.1965), cert. denied, 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *Loeb v. Eastman Kodak Co.,* 183 F. 704 (3 Cir.1910).

Kauffman v. Dreyfus Fund, Inc., 434 F.2d 727, 732 (3d Cir.1970). The only way Plaintiffs can bring the claims is through a shareholder derivative lawsuit.

[14] Prior to commencing a shareholder derivative lawsuit, shareholders must ordinarily make a demand on the board of directors or comparable authority to pursue the claim. Fed.R.Civ.P. 23.1; *Warden v. McLelland,* 288 F.3d 105, 110–111 (3d Cir.2002).

> Under Pennsylvania law, a shareholder cannot ordinarily bring an action on be-

half of the corporation without first making demand on the board of directors to pursue the action. *Cuker v. Mikalauskas,* 547 Pa. 600, 692 A.2d 1042, 1049–50 (1997). In *Cuker,* the Pennsylvania Supreme Court expressly adopted several sections of the American Law Institute's *Principles of Corporate Governance,* including the section setting forth the demand requirement. Section 7.03(b) provides, "Demand on the board should be excused only if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result, and in such instances demand should be made promptly after commencement of the action." *Id.* at 1050. Prior to *Cuker,* "[s]ufficient averments of fraud excused a demand based upon its futility." *Drain v. Covenant Life Ins. Co.,* 551 Pa. 570, 712 A.2d 273, 278 (1998). But "*Cuker,* which established that a demand is excused only if irreparable harm to the corporation is shown, changed the law on demand requirements in derivative actions." *Id.* *Id.* (footnote omitted).

[15] A shareholder may not bring a derivative action unless the "complaint alleges, with particularity, the efforts made by the shareholders to obtain corporate action and the reason for failure to obtain it." *Shlensky v. Dorsey,* 574 F.2d 131, 140 (3d Cir.1978).

[16] Plaintiffs assert that "[t]he corporation that defendants insist should have had the initial opportunity to prosecute plaintiffs' cause of action has not existed for many years, thus rendering any such prerequisite 'unavailing' or 'futile'."

Public records may be considered in ruling upon a motion to dismiss. *Children's Seashore House v. Waldman,* 197 F.3d 654, 661 n. 7 (3d Cir.1999); *Shaffer v. South State Machinery, Inc.,* 995 F.Supp. 584, 586 n. 3 (W.D.Pa.1998). As the Defendants state in their Reply Memorandum of Law, undisputed public records reveal that:

> As of October 11, 1994, Seven Fields Development Corporation and Seven Fields Development Company (a Pennsylvania business trust) merged and continued operating as a business trust under the name of "Seven Fields Development Company." (Reply Affirmation, Exhibit B).
>
> Under the merger agreement, all property rights of Seven Fields Development Corporation, including all choses in action, became property of the Seven Fields Development Company. (Reply Affirmation, Exhibit B, ¶ 7(a)(ii)).
>
> Within the past year, the trustee for Seven fields Development Company ("Trustee") has participated in litigation to assert property rights of Seven Fields Development Corporation. (Reply Affirmation, Exhibit C).
>
> On June 8, 2004, the Trustee commenced litigation against the state court judgment creditor Barbara L. Reilly ("Mrs.Reilly") arguing that any recovery by Mrs. Reilly against Defendants arising out of the bankruptcy is property of the 2,600 shareholders of Seven Fields Development Corporation (including Plaintiffs) who are now the beneficiaries of the trust. (Reply Affirmation, Exhibit C).
>
> Plaintiffs had actual notice through their agent that the Trustee was pursuing claims on behalf of Seven Fields Development Corporation. On June 8, 2004, the Trustee commenced litigation against Mrs. Reilly (Reply Affirmation, Exhibit B). On August 20, 2004, Mrs. Reilly filed a motion to dismiss, and was represented by Pribanic & Pribanic, P.C. (Reply Affirmation, Exhibit D and E). On September 29, 2004, Plaintiffs'

attorneys Pribanic & Pribanic, P.C. commenced the instant action. Prior to filing the instant action, therefore, Plaintiffs' agent Pribanic & Pribanic, P.C. knew that the Trustee had authority to pursue claims owned by Seven Fields Development Corporation and had exercised such authority on more than one occasion.

The Plaintiffs failed to make the required demand before initiating the Complaint. Plaintiffs' assertion that such demand would have been "unavailing" or "futile," is without merit.

Plaintiffs further assert that the Defendants lack standing to enforce the demand requirement for a shareholder derivative claim. "[I]t is well settled, contrary to the plaintiffs' contention, that defendants other than the corporation whose rights the shareholder plaintiffs are seeking to vindicate may successfully raise the defense of failure to comply with rule 23.1." *Shlensky,* 574 F.2d at 142.

Plaintiffs have brought this suit in their individual capacities and also to represent other identically situated individual shareholders. Plaintiffs demand that damages be paid directly to themselves. Plaintiffs did not bring an action in the name of the corporation seeking to enforce the corporation's rights, nor have they alleged that any demand was made upon the corporation to commence such action. Plaintiffs' claims must be dismissed.

C. *Res Judicata, Collateral Estoppel and Judicial Estoppel*

Having concluded that the within Complaint must be dismissed as an improper shareholder derivative lawsuit, we need go no further. However, we feel compelled to address the doctrines of res judicata, collateral estoppel and judicial estoppel.

This Bankruptcy Case involved a Debtor which operated a scheme whereby Investors were duped into putting money into the debtor corporation with promises of unrealistically high rates of return over short periods of time. At filing, Debtor owed these Investors in the neighborhood of $69 million dollars. Other debt, consisting of secured claims and usual and ordinary trade debt, paled in comparison. A Committee of unsecured creditors was formed. The Committee was comprised of and represented all of those individuals who were duped into making investments in the Debtor corporations. The status of the Investors was unclear. They were called *inter alia* investors, bondholders or shareholders. No matter what label they were given, they were all considered and treated as unsecured creditors in the Bankruptcy Case. The Plaintiffs who bring the within Complaint were members of that constituency. They were represented by the creditors Committee which took a very active part in the case. Plaintiffs, whether directly or through their Committee, had every opportunity to litigate, investigate and question every aspect of the Debtor's operation, finances, assets and valuations. If they had any concern about insolvency or valuation analyses, they had every right and opportunity to engage their own professionals. It was the Plaintiffs' constituency by and through their Committee that proposed a competing plan of reorganization and sought confirmation of that plan by the Court. It was the Plaintiffs' constituency that objected to E & Y's fee application and eventually, following confirmation, it was the Plaintiffs' company that reached a settlement of the amount of the fee that E & Y would receive, and sought Court approval of that settlement. Upon confirmation of the Plan, the Plaintiffs and the class that they purport to represent became the shareholders of the new corporation, later

known as Seven fields, and were solely in control of all of the Debtor's assets and were free to choose whether to develop or to liquidate those assets as they saw fit.

[17] The doctrines of claim preclusion and issue preclusion (res judicata and collateral estoppel) bar an action when the foundation upon which the claims rest has already been litigated. *CoreStates Bank, N.A. v. Huls America, Inc.*, 176 F.3d 187 (3d Cir.1999).

In *Board of Trustees of Trucking Employees Welfare Fund, Inc. v. Centra*, 983 F.2d 495 (3d Cir.1992), we explained that claim preclusion (or res judicata as it is also called) "gives dispositive effect to a prior judgment if a particular issue, although not litigated, *could have been raised* in the earlier proceeding. Claim preclusion requires: (1) a final judgment on the merits in a prior suit involving: (2) the same parties or their privities; and (3) a subsequent suit based on the same cause of action." *Centra*, 983 F.2d at 504 (emphasis added; citations omitted). If these three factors are present, a claim that was or could have been raised previously must be dismissed as precluded.

We have elaborated on the third element of the *Centra* test, both in general and in the context of bankruptcy proceedings. In deciding whether two suits are based on the same "cause of action," we take a broad view, looking to whether there is an "essential similarity of the underlying events giving rise to the various legal claims." *United States v. Athlone Indus.*, 746 F.2d 977, 984 (3d Cir. 1984); *see also* Restatement (Second) of Judgments § 24 cmt. a ("The present trend is to see claim in factual [as opposed to legal] terms and to make it coterminous with the transaction regardless of the number of substantive theories...that may be available to the plaintiff..."); *id.* cmt. b ("In general, the expression ['transaction'] connotes a natural grouping or common nucleus of operative facts."). Because a "bankruptcy case" is fundamentally different from the typical civil action, however, comparison of a bankruptcy proceeding with another proceeding is not susceptible to the standard res judicata analysis. "Rather, we scrutinize the totality of the circumstances in each action and then determine whether the primary test of *Athlone*, i.e., essential similarity in the underlying events, has been satisfied." *Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 419 n. 5 (3d Cir.1988).

The principle of claim preclusion applies to final orders overruling objections to a reorganization plan in bankruptcy proceedings just as it does to any other final judgment on a claim. See *Wallis v. Justice Oaks II, Ltd. (In re Justice Oaks II, Ltd.)*, 898 F.2d 1544, 1552 (11th Cir.1990) ("Because the claims raised in the Wallises' adversary complaint were already raised, or could have been raised, in their objection to confirmation, we hold that the doctrine of claim preclusion bars them from relitigating those claims."); *see also Katchen v. Landy*, 382 U.S. 323, 334, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966) ("The normal rules of res judicata and collateral estoppel apply to the decisions of bankruptcy courts."); *Donaldson v. Bernstein*, 104 F.3d 547, 554 (3d Cir.1997) ("[A] confirmation order is res judicata as to all issues decided or which could have been decided at the hearing on confirmation.") (quoting *In re Szostek*, 886 F.2d 1405, 1408 (3d Cir.1989)); *Crop-Maker Soil Servs. v. Fairmount State Bank*, 881 F.2d 436, 440 (7th Cir.1989) ("Public policy supports res judicata generally, but in the bankruptcy context in particular."); cf. 11 U.S.C. § 1141(a) ("[T]he

provisions of a confirmed plan bind...any creditor...whether or not the claim or interest of such creditor...is impaired under the plan and whether or not such creditor...has accepted the plan.").

Id. at 194–95.

[18] The Plaintiffs and the class that they purport to represent proposed a Plan which provided for substantive consolidation of the Debtor entities based on their collective insolvency. Following an evidentiary hearing at which the issue was litigated, we found that the Debtor entities were in fact insolvent and confirmed the Committee Plan. The Plaintiffs herein, as constituents of the Committee, may not now change their position regarding the Debtor's solvency.

Plaintiffs' instant claims are based upon a single premise: the Debtor entities were not insolvent and because of the perception of insolvency, Seven Fields sold assets too quickly at a loss to Plaintiffs' interests.

[19, 20] A Plan is binding upon all parties once it is confirmed, and all questions that were raised or could have been raised pertaining to such plan are *res judicata. B.R. Eubanks, M.D. v. Federal Deposit Insurance Corp.,* 977 F.2d 166, 170 (5th Cir.1992); *Donaldson v. Bernstein,* 104 F.3d 547, 554 (3d Cir.1997) ("[A] confirmation order is *res judicata* as to all issues decided or which could have been decided at the hearing on confirmation."); *Crop–Maker Soil Services, Inc. v. Fairmount State Bank,* 881 F.2d 436, 440 (7th Cir. 1989). The preclusive effect of a confirmed plan of reorganization is binding upon every entity that holds a claim or interest in the bankruptcy irrespective of whether a creditor is impaired under the plan or whether such creditor has accepted the plan. *Id.; see also 5 Collier on Bankruptcy* ¶ 1141.02[1] (15th ed.2004).

This Court expressly stated in its confirmation order that "[e]ach Debtor Corporation is insolvent." The Committee, which represented the interests of all investors-turned-shareholders, actively participated in and was a "party" to the bankruptcy. Plaintiffs, whether directly or through the Committee, had numerous opportunities to litigate, investigate and question the debtors' insolvency prior to confirmation of the Plan.

The confirmation order constitutes a full and final judgment on the merits as to the debtors' insolvency, and Plaintiffs cannot reopen or relitigate that issue. Because the foundation upon which Plaintiffs' claims rest may not be relitigated as a matter of law, their claims fail and must be dismissed.

[21] Similarly, this Court's approval of E & Y's fees is *res judicata* as to any subsequent claims for malpractice or misconduct as to work performed under the supervision of the Court. *See Grausz, M.D. v. Englander,* 321 F.3d 467 (4th Cir. 2003); *In re Iannochino,* 242 F.3d 36 (1st Cir.2001); *In re Intelogic Trace, Inc.,* 200 F.3d 382, 387–88 (5th Cir.2000); *In re Southmark Corp.,* 163 F.3d 925 (5th Cir. 1999); *In re Coastal Plains, Inc.,* 326 B.R. 102 (Bankr.N.D.Tx.2005); and *In re Blair,* 319 B.R. 420 (Bankr.D.Md.2005).

Here, E & Y filed fee applications. The Committee (representing the unsecured creditors including the Plaintiffs and the class that they purport to represent) actively participated in the fee application process and filed objections to the fees claimed by E & Y. Thereafter, following confirmation of the Plan proposed by the Committee, E & Y and Seven Fields (then owned and operated solely by the Plaintiffs and the class they purport to represent) filed a Stipulation which proposed to settle E & Y's fees. This Court approved the Stipulation and a $125,000 payment to E &

Y. The doctrine of *res judicata* bars Plaintiffs from relitigating all issues pertaining to the nature, quality and scope of Defendants' work.

The Plaintiffs direct our attention to the case brought against E & Y by the former shareholders of the Debtors, Barbara L. Reilly and Thomas Reilly. *Reilly v. Ernst & Young, LLP,* No. Civ. Div. AD 97–1002, 2003 WL 22761810 (Pa.Com.Pl. Nov.20, 2003) (hereinafter the "Reilly State Court Action"). Barbara L. Reilly and Thomas Reilly (collectively, the "Reillys") were the prepetition shareholders of the Debtor. Under the Plan, all of the Reillys' interest was eliminated. The Reillys brought suit in State Court against E & Y, 16 years after confirmation of the Plan and seven years after the case was closed on the Bankruptcy Court docket, on theories of negligence, civil conspiracy and fraudulent misrepresentation. The Reillys asserted that they suffered a loss of their property in the Bankruptcy Case due to the misdeeds of E & Y. E & Y raised many of the same defenses in that case that it now raises before this Court. The State Court entered a verdict in favor of Barbara Reilly. That decision is presently on appeal.

Plaintiffs assert that the doctrine of non-mutual offensive collateral estoppel (also known as non-mutual issue preclusion) bars the Defendants from asserting the defenses they now raise because an earlier trial court has passed judgment on these same defenses when the Defendants raised them in Reilly State Court Action.

[22] "Offensive collateral estoppel occurs when a plaintiff seeks to estop a defendant from relitigating an issue which the defendant previously litigated and lost against another plaintiff." *Raytech Corp. v. White,* 54 F.3d 187, 190 n. 5 (3rd Cir. 1995) *citing Parklane Hosiery Co. v. Shore,* 439 U.S. 322, 329, 99 S.Ct. 645, 651, 58 L.Ed.2d 552 (1979).

[23, 24] Collateral estoppel is permissible as to a given issue if: (1) the identical issue was previously adjudicated; (2) the issue was actually litigated and decided in the previous proceeding; (3) the party had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits. *Bear, Stearns & Co., Inc. v. 1109580 Ontario, Inc.,* 409 F.3d 87, 91 (2d Cir.2005). "These four factors are required but not sufficient." *Id.* "In addition, a court must satisfy itself that application of the doctrine is fair." *Id. See also Parklane Hosiery,* 439 U.S. 322, 331, 99 S.Ct. 645, 58 L.Ed.2d 552 (1979); *Raytech Corp. v. White,* 54 F.3d 187, 190 (3d Cir.1995).

[25] In the Reilly State Court Action, Defendants were prohibited from introducing into evidence much of the proof of what took place in the Bankruptcy Case. It is not possible for the Defendants to have had a full and fair opportunity to litigate when the most essential facts were excluded by the State Court. Further, many of the factual findings of the State Court were based on "deemed admissions" rather than upon actual evidence presented at trial.

"The inconsistency of opinions where multiple parties are suing one defendant in similar (albeit not identical) fact situations is the exact instance where it would be unfair. . . to allow the use of offensive collateral estoppel against the defendant." *Erbeck v. United States,* 533 F.Supp. 444, 447 (S.D.Oh.1982) *citing Parklane,* 439 U.S. at 330–31 n. 14, 99 S.Ct. at 651 n. 14.

This Court determined that the Debtors were insolvent. The state court based its judgment on findings to the contrary.

The use of offensive collateral estoppel is not appropriate in this case.

For all of the above reasons, dismissal of the Complaint is warranted under the doctrines of res judicata, collateral estoppel and judicial estoppel.

D. Other Grounds for Dismissal

The Defendants raise other issues such as Statute of Limitations, Failure to State a Claim for Professional Negligence, Fraud or Negligent Misrepresentation, and Immunity from Liability. Having concluded that the Complaint must be dismissed as an improper shareholder derivative suit and for reasons of res judicata, collateral estoppel and judicial estoppel, we need not address the additional grounds that are raised by the Defendants in the Motion to Dismiss.

V. Conclusion

After confirmation of the Plan, all of the Debtors' assets were transferred to Seven Fields. The Plaintiffs and the class that they purport to represent then owned all of the stock of Seven Fields and had complete and total control of its assets. Seven Fields elected to liquidate those assets.

The Plaintiffs now assert that the assets would have been more valuable had they been held for development rather than liquidated. They seek to hold the Defendants liable for causing the sale. They assert that the sale occurred because the Defendants erroneously classified the Plaintiffs and their class as creditors in the bankruptcy case rather than investors, and as a result it appeared that the Debtor had a significant amount of debt rather than having significant equity and that if the Plaintiffs had known that there was equity, they wouldn't have felt compelled to promptly liquidate the assets at reduced prices.

The Complaint is a sham. The status of the Plaintiffs and their class was always unclear in the bankruptcy case. As the Committee's own Plan states:

> "Bondholders" and "Investors"—these groups of creditors were designated as indicated in the Schedules filed by Debtors. These designations may not be wholly accurate, depending upon characterizations of the relationships between the named persons in the schedules and the Debtors. However, for purposes of the Bankruptcy Code and the Plans filed these parties are all unsecured creditors. The total scheduled debt is $69,194,842.74.

The Committee represented the Plaintiffs and the purported class. No matter whether they were equityholders or creditors, they were the only impaired class of creditors under the Plan and under the terms of the Plan, all of the Debtors' assets were transferred to Seven Fields and the Plaintiffs and the Class received all of the stock of Seven Fields and it was the Plaintiffs and their class who were given the task under the Plan of achieving the goal of full payment to its group:

> Assets will be sold or managed frugally, carefully, responsibly and utilizing sound business practice. Undeveloped assets will be developed as and when fair and reasonable proposals have been received, studied and approved. All activities of the surviving reorganized corporation shall seek to achieve the goal of full payment to Class 5 creditors.

E & Y's engagement ended upon confirmation of the Plan. The Plaintiffs and their class were in charge of the assets and of making a determination how to maximize the value of the assets. All other creditors were paid in full under the terms of the Plan and the Plaintiffs were the only creditor group left to benefit from the development or liquidation of the assets. Whether they were considered cred-

itors or equityholders in the Bankruptcy Case was an insignificant point.

Bankruptcy lawyers in drafting plans of reorganization lately have included release clauses for professionals. This Court has refused to allow them. If a professional is at fault, he should be held accountable. But, this case is spurious.

The Complaint will be dismissed.

An appropriate Order will be entered.

ORDER

This 2nd day of September, in accordance with the accompanying Opinion, it shall be, and hereby is, ORDERED as follows:

1. The Bankruptcy Clerk is directed to reopen the bankruptcy case.

2. Plaintiffs' Motion to Strike Defendants' Notice of Removal is REFUSED.

3. Plaintiffs' Motion to Remand Case to State Court is REFUSED.

4. Defendants' Motion to Dismiss Plaintiffs' Complaint is GRANTED.

In re Kevin L. CARNES and Belinda R. Carnes, Debtors.

Henry Ray Pope III, Trustee, Plaintiff,

v.

Interbay Funding LLC, Defendant.

Bankruptcy No. 04–10075.
Adversary No. 05–1011.

United States Bankruptcy Court,
W.D. Pennsylvania.

Oct. 4, 2005.

Background: Following sale of real property owned by Chapter 7 debtors as tenants by the entireties, trustee brought adversary proceeding against mortgagee, challenging validity of liens purportedly created by mortgage and assignment of rents signed by debtor-husband only. Trustee moved for judgment on the pleadings.

Holding: The Bankruptcy Court, Warren W. Bentz, J., held that mortgagee lacked valid security interest in property.

Motion granted.

1. Bankruptcy ⚷2705

Bankruptcy Code's "strong-arm" clause, defining trustee's powers over rival creditors, confers upon trustee, as of the date of the petition's filing, the rights of a bona fide purchaser when real property is at issue. 11 U.S.C.A. § 544(a)(3).

2. Bankruptcy ⚷2704

Scope of trustee's strong-arm powers under Bankruptcy Code is defined by the law of the situs where real property is located. 11 U.S.C.A. § 544(a).

3. Bankruptcy ⚷2705

For purposes of Bankruptcy Code's strong-arm clause, a "bona fide purchaser for value" is one who takes title to property without notice, actual or constructive, of any claim to the property. 11 U.S.C.A. § 544(a).

See publication Words and Phrases for other judicial constructions and definitions.

4. Bankruptcy ⚷2705

As a hypothetical purchaser under Bankruptcy Code's strong-arm provision, trustee is deemed to have conducted a title search of real property, paid value for property, and perfected his interest in property as of the date of commencement of bankruptcy case. 11 U.S.C.A. § 544(a).

truck laying dormant on the premises because it "might" be helpful in advancing the sale. See, for example, *Continental Energy Assocs. L.P. v. Hazelton Fuel Mgmt. Co. (In re Continental Energy Assocs. L.P.)*, 178 B.R. 405, 408 (Bankr. M.D.Pa.1995) ("During the period prior to assumption or rejection of an executory contract or unexpired lease, the estate must pay the reasonable value of any contractual benefits the estate receives during that period, as an administrative expense.")

[3] The party claiming an administrative priority has the burden of proof (with the possible exception of § 365(d)(10) charges, found in § 365(d)(5) of the current code). *Ford Motor Credit Co. v. Dobbins, supra* at 866 (C.A.4 (Va.),1994); *In re Mid Region Petroleum, Inc., supra.* at 1132.

I deem this record insufficient to support an administrative allowance through the first 60 days of the Debtor's bankruptcy.

An Order will follow.

ORDER

For those reasons indicated in the Opinion filed this date, **IT IS HEREBY**

ORDERED that Motion for an Order Allowing Administrative Expense Obligations is granted, in part, and denied, in part. The Motion of VFS Leasing Co. pursuant to § 365(d)(5) is granted in the amount of $12,346.28. Its Motion requesting administrative allowance for the initial two months of the bankruptcy is denied.

In re EARNED CAPITAL CORPORATION, Debtor.

Ernst & Young, LLP successor to Arthur Young & Company, Plaintiff

v.

Barbara L. Reilly and Thomas Reilly, Defendants.

Bankruptcy No. 86–21474.
Adversary No. 07–2496.

United States Bankruptcy Court,
W.D. Pennsylvania.

Sept. 11, 2008.

Background: Accounting firm that had represented corporate Chapter 11 debtors in their substantively consolidated cases, and whose negative valuation of each debtor had ultimately led to confirmation of plan under which old equity was stripped of any interest in reorganized entity, reopened debtors' Chapter 11 cases and sued for injunctive relief to prevent former equity holders from continuing to prosecute state court malpractice action against it.

Holdings: The Bankruptcy Court, Warren W. Bentz, J., held that:

(1) firm had standing to seek injunctive relief under the Anti-Injunction Act exceptions;

(2) Bankruptcy Code, and specifically the Code section authorizing court to enter "necessary or appropriate" orders, is "expressly authorized" exception to the Anti-Injunction Act, which authorizes the bankruptcy court to enjoin state court proceedings under proper circumstances; and

(3) firm was entitled to injunctive relief.

So ordered.

1. Courts ⚷508(1)

Federal Courts ⚷10.1

Anti-Injunction Act and All Writs Act function in concert, so that if an injunction falls within one of the Anti-Injunction Act's three exceptions, the All Writs Act provides positive authority for federal courts to enjoin state court proceedings. 28 U.S.C.A. §§ 1651, 2283.

2. Courts ⚷508(1)

Absolute bar against federal injunctive measures contemplated by the Anti-Injunction Act is qualified only by specifically defined exceptions, exceptions which are to be read narrowly and not enlarged by loose statutory construction, or whittled away by judicial improvisation. 28 U.S.C.A. § 2283.

3. Courts ⚷508(1)

Any doubts as to propriety of federal injunction against state court proceedings should be resolved in favor of permitting state courts to proceed in orderly fashion to finally determine the controversy. 28 U.S.C.A. § 2283.

4. Courts ⚷508(1)

Unless one of three specific exceptions to the Anti-Injunction Act applies, because injunction is expressly authorized by Congress, necessary in aid of federal court's jurisdiction, or necessary to protect or effectuate federal court's judgment, federal courts are absolutely prohibited from enjoining a state judicial proceeding. 28 U.S.C.A. § 2283.

5. Bankruptcy ⚷2369, 3570

Accounting firm that had represented corporate Chapter 11 debtors in their substantively consolidated cases, and whose negative valuation of each of the debtors had ultimately led to confirmation of plan under which old equity was stripped of any interest in reorganized debtor, had standing to seek injunctive relief, under the Anti-Injunction Act exceptions, to prevent former equity holders from continuing to prosecute professional malpractice claims against it based on contentions previously rejected by bankruptcy court when it consolidated debtors and confirmed plan. 28 U.S.C.A. §§ 1651, 2283.

6. Bankruptcy ⚷2126, 2369

Bankruptcy Code, and specifically the Code section authorizing court to enter "necessary or appropriate" orders, is "expressly authorized" exception to the Anti-Injunction Act, which authorizes the bankruptcy court to enjoin state court proceedings under proper circumstances. 11 U.S.C.A. § 105(a); 28 U.S.C.A. § 2283.

7. Courts ⚷508(1)

While policy underlying Anti-Injunction Act is desire to avoid disharmony between federal and state systems, the Act's exceptions reflect Congressional recognition that injunctions may sometimes be necessary in order to avoid that disharmony. 28 U.S.C.A. § 2283.

8. Bankruptcy ⚷2369, 3570

Accounting firm that had represented corporate Chapter 11 debtors in their substantively consolidated cases, and whose negative valuation of each debtor had ultimately led to confirmation of plan under which old equity was stripped of any interest in reorganized entity, were entitled to injunctive relief, pursuant to Anti-Injunction Act exceptions, to prevent former equity holders from continuing to prosecute in Illinois state court the professional malpractice claims that had previously led to entry of $102 million judgment against it, before state appellate court vacated judgment and remanded for further proceedings, where these professional malpractice claims were based on contention that debtors were not all insolvent, and that plan stripping equity holders of any interest in

reorganized debtor should not have been confirmed, a contention that was previously rejected by bankruptcy court following hearings at which former equity holders were active participants, and where state court action, despite having been pending for eleven years, was back to square one, and none of these state courts had made final determination such that doctrines of res judicata, collateral estoppel or judicial estoppel were inapplicable. 11 U.S.C.A. § 105(a); 28 U.S.C.A. §§ 1651, 2283.

9. Federal Courts ⚐3.1, 25

Federal court has inherent power and jurisdiction to issue injunction to effect its prior judgments and protect against future attempts to attack or evade those judgments.

10. Courts ⚐508(1)

If exception to the Anti-Injunction Act applies, federal court may enjoin state proceedings at any point in time from institution to the close of the final process. 28 U.S.C.A. § 2283.

Christopher P. Schuller, Esq. and Timothy P. Palmer, Esq., Pittsburgh, PA, for Plaintiff.

Vincent A. Coppola, Esq. and Victor A. Pribanic, Esq., White Oak, PA, for Defendants.

OPINION

WARREN W. BENTZ, Bankruptcy Judge.

I. *Introduction.*

Ernst & Young, LLP, successor to Arthur Young & Company ("E & Y") filed the within Complaint on September 27, 2007. E & Y seeks a permanent injunction barring Barbara L. Reilly ("Mrs.Reilly") and Thomas Reilly ("Mr.Reilly") (or Mrs. Reilly and Mr. Reilly collectively, the "Reillys") from continued prosecution of a tort action in the Court of Common Pleas of Butler County, Pennsylvania (the "Court of Common Pleas"), which is captioned *Reilly v. Ernst & Young, LLP,* Civil Action No. 97-10022 (the "State Action").

Presently before the Court are the Reillys' Motion to Dismiss, or in the Alternative, For Abstention and E & Y's Motion for Summary Judgment.

The Motion for Recusal was withdrawn at the Argument held on August 6, 2008. We have considered the numerous pleadings and the Briefs filed by the parties and heard oral argument and find that the remaining issues are ready for decision.

II. *Factual Background.*

The within bankruptcy case was commenced on June 3, 1986 when Earned Capital Corporation, Managed Properties, Inc., Canterbury Village, Inc. and Eastern Arabian, Inc. (collectively, the "Debtors") each filed separate voluntary Petitions under Chapter 11 of the Bankruptcy Code. By Order dated June 5, 1986, the Court ordered that the separate cases be jointly administered under the case entitled Earned Capital Corporation at Case No. 86-21474 (the "Bankruptcy Case").

At the time of the bankruptcy filing, the Reillys jointly owned as tenants by the entireties, one-half of the stock of Canterbury Village, Inc. and one-third of the stock of Eastern Arabian, Inc.

The Debtors were engaged in the business of selling shares of investment in various property where investors were promised a certain annual return on investment. Shares were oversold when Debtors had to continue the selling program in order to maintain the payments to investors.

Debtors' financial affairs were in disarray and the affairs of each of the Debtors were substantially intertwined.

Arthur Young & Company, the predecessor to E & Y, was engaged by the Debtors to serve as their accountant in the bankruptcy case.[1] The Motion for Approval of E & Y as accountant was granted by Order dated June 12, 1986.

The Debtors had minimal debt to ordinary trade creditors and some $6,000,000 in debt to creditors holding secured claims against Debtors' property. The vast majority of Debtors' obligations, which totaled over $60,000,000 were owed to those thousands of individuals who had made investments in the Debtors ("Investors"). In exchange for depositing monies with the Debtors, the Investors had received various documents entitled "Agreement of Sale" for fractional interests in real estate, various agreements to document the purchase of fractional interests in horses, documents entitled "Lease and Breeding Management Agreement" and "Bond and Warrant." The exact status of the Investors was unknown, i.e., whether they were investors, bondholders, or some other form of general creditor. They were all referred to as the investor class or the Investors and were treated as the only creditors in the Bankruptcy Case who were impaired and at risk. Many of the Investors filed proofs of claim as unsecured creditors. *In re Earned Capital Corp.*, 331 B.R. 208 (Bankr.W.D.Pa.2005) *aff'd sub nom Geruschat v. Ernst & Young, LLP*, 346 B.R. 123 (W.D.Pa.2006), *aff'd sub nom In re Seven Fields Dev. Corp.*, 505 F.3d 237 (3d Cir.2007) (the "*Geruschat*" case).

The Investors were appointed to and represented by the Official Committee of Unsecured Creditors in the Bankruptcy Case ("Committee"). The Committee was represented by legal counsel and took a very active role in the Bankruptcy Case.

The Reillys retained separate legal counsel to represent their interests in the bankruptcy case. The Reillys, through counsel, strenuously objected to substantive consolidation of the separate corporate cases. The Reillys also sought to withdraw the bankruptcy cases for Canterbury Village, Inc. and Eastern Arabian, Inc.

The Debtors and the Committee filed competing plans of reorganization. Both plans contemplated substantive consolidation of the assets and liabilities into one surviving reorganized corporation. The Amended Plan of Reorganization of Committee of Unsecured Creditors (the "Plan") was confirmed by the Court on October 21, 1987 after an evidentiary hearing to consider whether substantive consolidation was appropriate. The Court found that each of the Debtors was insolvent and that substantive consolidation was appropriate. The Reillys' objections to substantive consolidation and their Motion to Withdraw or Dismiss the Canterbury Village, Inc. and Eastern Arabian, Inc. Petitions were denied and the Reillys' objections to the Plan were dismissed. The Plan was confirmed. The Plan provided that former equity holders of the Debtor retained no interest.

The Reillys filed an appeal from the Confirmation Order. The Reillys list in the Statement of Issues presented on appeal:

> . . .
>
> 2. Did the proponents of the substantive consolidation sustain their burden of proof as required under the law?
>
> 3. Did the proponents of the substantive consolidation fulfill all of the criteria necessary for a substantive

1. The accounting firm is referred to in this Opinion as E & Y.

> consolidation in order for such equitable relief to be granted?
>
> . . .
>
> 6. Is CANTERBURY VILLAGE, INC. a separate solvent corporation, which should not be in bankruptcy?
>
> 7. Can the issue of substantive consolidation be determined without an audit of each corporation?

The Appeal was dismissed as moot by the District Court on December 18, 1990. The District Court found that the Reillys had appealed only the confirmation Order and had not filed an appeal of the motion regarding substantive consolidation.

Under the Plan, the Debtors were merged into one successor entity that was eventually named Seven Fields. All of the Debtors' assets were pooled and became assets of Seven Fields.

The only impaired class of creditors under the Plan was the Investor Class of unsecured creditors (described in the Plan as the Class 5 claims). Secured creditors and trade creditors were paid in full. Under the Plan, each unsecured creditor received common stock in Seven Fields at a par value equal to 5% of its allowed claim. The remaining 95% of each allowed claim remained as an unsecured, nondischargeable debt. The Investors became the new shareholders of the reorganized Seven Fields and thus were in control of the assets, sale or development of those assets, and distribution of funds. The former equityholders of the Debtor, including the Reillys, retained no interest under the terms of the Plan.

The Plan contemplated that the Investor class of creditors would manage Seven Fields with a goal of full recovery of the invested amounts. The Plan provides:

> 6.08 The surviving corporation, as may be authorized by its Board of Directors, shall periodically distribute available funds, without interest, in prorata repayment of the aforesaid waived non-discharged Class 5 debts.
>
> 6.09 Assets will be sold or managed frugally, carefully, responsibly and utilizing sound business practices. Undeveloped assets will be developed as and when fair and reasonable proposals have been received, studied and approved. All activities of the surviving reorganized corporation shall seek to achieve the goal of full payment to Class 5 creditors.

The Plan provides for the Debtors' Chapter 11 cases to remain open until all unsecured claims are paid in full:

> 8.05 These Chapter 11 cases shall not be closed or deemed closed until all non-discharged Class 5 claims have been fully paid and all matters set forth in section 9.01 have been finally concluded.

Section 9.01 of the Plan sets forth the retention of jurisdiction provisions. It provides in relevant part:

> The Bankruptcy Court shall retain exclusive jurisdiction [in] this case as long as necessary for the following purposes:
>
> . . .
>
> (b) to determine and fix (i) all administrative claims . . .
>
> . . .
>
> (d) to adjudicate any matters or disputes arising under or in connection with (i) the Plan and (ii) such other matters as may be provided for in the Confirmation Order;
>
> . . .
>
> (f) to hear and determine any and all pending applications, motions, adversary proceedings or contested matters;

(g) to amend, or to correct any defect, cure any omissions or reconcile any inconsistency in the Plan or the Confirmation Order as may be necessary, to carry out the purpose and intent of the Plan ...

...

(i) to issue such orders as may be necessary to enable the surviving reorganized Debtor to implement this Plan and effect distributions to holders of claims.

(j) to hear and determine any and all adversary proceedings or contested matters to be filed subsequent to the Confirmation Date.

...

E & Y was engaged by the Debtors. E & Y's work product was shared with the Committee. E & Y filed Applications for Allowance of Compensation. E & Y's Application was the subject of an objection by the Reillys and the Committee. An evidentiary hearing was held and partial interim fees were awarded. The unpaid portion was the subject of subsequent stipulation between E & Y and Seven Fields for the payment of remaining fees in a reduced amount. The Stipulation was approved by the Court.

On April 30, 1996, Seven Fields filed a Motion for Final Decree. On May 14, 1996, the Final Decree was entered and the case closed on the Court's docket.

On January 8, 1997, the Reillys filed the State Action. The Defendants are E & Y and Charles Modispocher ("Modispocher") (or E & Y and Modispocher collectively, "the Defendants"). Modispocher is a former E & Y partner who was in charge of E & Y's engagement with the Debtors. The Reillys filed an Amended Complaint in the Court of Common Pleas on January 13, 1999. The Reillys assert claims for negligence, civil conspiracy, and fraudulent misrepresentation or nondisclosure.

The Reillys assert that the Defendants erroneously determined that each of the Debtors was insolvent and therefore the Debtors were placed within the jurisdiction of the Bankruptcy Court; that Defendants substantially understated the value of Canterbury Village, Inc. and Eastern Arabian, Inc. and overstated the liabilities of all of the Debtor entities; that the Defendants improperly treated the assets and liabilities of each of the Debtors as commingled, and failed to correct the errors after receiving information that their work was inaccurate. The Reillys assert that the Defendants acts and omissions "led to the partial or complete loss of the value of the stock which [the Reillys] owned in Canterbury Village, Inc. and Eastern Arabian, Inc., by virtue of the treatment of the corporations while in the bankruptcy court and as a result of the disposition of assets of both corporations at values well below their then fair market value."

On November 20, 2003, the Court of Common Pleas entered a judgment in favor of Mrs. Reilly in the amount of $102,718,989. *Reilly v. Ernst & Young, LLP,* No. 97-1002, 2003 W.L. 22761810 (Pa.Com.Pl., November 20, 2003), 66 Pa. D. & C. 4th 252 *reversed* 929 A.2d 1193, 2007 Pa.Super. 216 (Pa.Super.2007). The Court of Common Pleas refused to enter judgment for Mr. Reilly under the legal standard that a person shall not benefit from their own wrongdoing. On appeal, the Pennsylvania Superior Court vacated the Court of Common Pleas' Order, finding that "the severe sanction of deemed admissions" imposed upon E & Y for discovery violations was improper and remanded the case to the Court of Common Pleas for a new trial. *Reilly v. Ernst & Young, LLP,*

929 A.2d 1193, 2007 Pa.Super. 216 (Pa.Super.2007).

Following the Court of Common Pleas' verdict in favor of Mrs. Reilly, on November 20, 2005, a putative class of former shareholders of Earned Capital Corp. sued E & Y and Modispocher in the Court of Common Pleas in a case captioned *Geruschat v. Ernst & Young,* LLP. E & Y removed the *Geruschat* action to this Court on November 5, 2004 which was assigned Adversary No. 04-3236. The *Geruschat* Plaintiffs alleged that while serving as accountants for the Debtors during the course of the bankruptcy proceedings, E & Y and Modispocher made false and erroneous statements concerning the solvency of the Debtor entities by, *inter* alia, mischaracterizing certain amounts of equity as debt, and as a result of E & Y's negligence, the *Geruschat* Plaintiffs lost significant value of their interests.

E & Y filed a Motion to Dismiss the *Geruschat* case which we granted by Opinion and Order dated September 2, 2005. *In re Earned Capital Corp.,* 331 B.R. 208 (Bankr.W.D.Pa.2005) *aff'd sub nom Geruschat v. Ernst & Young, LLP,* 346 B.R. 123 (W.D.Pa.2006), *aff'd sub* nom *In re Seven Fields Dev. Corp.,* 505 F.3d 237 (3d Cir.2007).

The underlying facts of this matter are nearly identical to those in the *Geruschat* case. *Id.*

Both the *Geruschat* case and this action are based upon the premise that the Debtor entities were not insolvent and because of the negligence of E & Y in failing to use ordinary skill and reasonable care in making an analysis of the books and records of the Debtor corporations, the Plaintiff lost valuable property.

Both the Reilly and the *Geruschat* Plaintiffs allege that E & Y erroneously mischaracterized substantial debt as equity and that as a result of E & Y's mischaracterizations value was lost.

The *Geruschat* Complaint was dismissed *inter alia* under the doctrines of res judicata, collateral estoppel and judicial estoppel. *Id.*

III. *Jurisdiction, Abstention, Core v. Non-Core Proceeding, Case Reopening.*

As previously stated, the underlying facts and the issues in this case are nearly identical to those in the *Geruschat* case. For all of the same reasons that were explained in detail in the *Geruschat* case, we find that the within Complaint is a core proceeding; that the claim is a claim "arising in" a bankruptcy case and that as a result, jurisdiction in this Court is appropriate; the case was appropriately reopened; and the Motion for Abstention must be denied. *Id.*

IV. *Standard for Summary Judgment.*

Fed.R.Civ.P. 56(c) made applicable to these proceedings pursuant to Fed. R.Bankr.P. 7056, provides that summary judgment "shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law." Fed. R.Civ.P. 56(c).

Summary judgment is proper if there is no genuine issue of material fact and if, viewing the facts in the light most favorable to the non-moving party, the moving party is entitled to judgment as a matter of law. *Pearson v. Component Tech. Corp.,* 247 F.3d 471, 482 n. 1 (3d Cir.2001) citing *Celotex Corp. v. Catrett,* 477 U.S. 317, 322, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986).

V. *Injunctive Relief.*

E & Y seeks a permanent injunction under 11 U.S.C. § 105, 28 U.S.C. § 1651(a) and 28 U.S.C. § 2283 barring the Reillys from continuing the State Court Action. E & Y asserts that this Court is expressly authorized to enjoin the State Action pursuant to 11 U.S.C. § 105 and under two exceptions to the Anti-Injunction Act ("AIA"), 28 U.S.C. § 2283.

The Reillys oppose an injunction. They assert that E & Y lacks standing to enjoin the State Action; that E & Y's request for an injunction is not appropriate after litigating the State Action for over ten years; that the relitigation exception to the AIA is inapplicable; that the State Action does not threaten the integrity of prior Bankruptcy Court Orders; and that the issues raised in the State Action are not precluded by the doctrine of *res judicata* with respect to issues addressed in the bankruptcy case.

The All Writs Act empowers federal courts to "issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." 28 U.S.C. § 1651. The authority imparted by the All Writs Act is limited, however, by the AIA, which prohibits injunctions "to stay proceedings in a State Court except as expressly authorized by Acts of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments." 28 U.S.C. § 2283.

[1–4] The two statutes act in concert, and "[i]f an injunction falls within one of [the Anti-Injunction Act's] three exceptions, the All-Writs Act provides the positive authority for federal courts to issue injunctions of state court proceedings." *In re Diet Drugs (Phentermine/Fenfluramine/ Dexfenfluramine) Products Liability Litigation,* 369 F.3d 293, 305 (3d Cir. 2004) *quoting In re General Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig.,* 134 F.3d 133, 143 (3d Cir.1998).

> The absolute bar against federal injunctive measures contemplated by the Act is "qualified only by specifically defined exceptions," *Richman Bros.,* 348 U.S. at 516, 75 S.Ct. at 455,—exceptions to be read narrowly: not "enlarged by loose statutory construction," *Chick Kam Choo,* 486 U.S. at 146, 108 S.Ct. at 1689, or "whittled away by judicial improvisation," *Richman Bros.,* 348 U.S. at 514, 75 S.Ct. at 454. Moreover, "[a]ny doubts as to the propriety of a federal injunction against state court proceedings should be resolved in favor of permitting the state courts to proceed in an orderly fashion to finally determine the controversy." *Atlantic Coast Line,* 398 U.S. at 297, 90 S.Ct. at 1748. Unless one of the exceptions governs the order, federal courts are "absolute[ly] prohibit[ed]" from enjoining a state judicial proceeding. *Vendo Co. v. Lektro-Vend Corp.,* 433 U.S. 623, 630, 97 S.Ct. 2881, 2887, 53 L.Ed.2d 1009 (1977); *Mitchum,* 407 U.S. at 228–29, 92 S.Ct. at 2154–55.

United States Steel Corp. Plan for Employee Ins. Benefits v. Musisko, 885 F.2d 1170, 1176 (3d Cir.1989).

[5] E & Y has standing to pursue an injunction. Professionals who participate in the administration of a bankruptcy estate, as did E & Y in this case, are entitled to seek injunctive relief under the exceptions to the AIA. *Samuel C. Ennis & Co., Inc. v. Woodmar Realty Co.,* 542 F.2d 45 (7th Cir.1976).

To succeed in obtaining an injunction, E & Y must show that the injunction (1) is expressly authorized by Congress; (2) is necessary in aid of the federal court's jurisdiction; or (3) is necessary to protect or

effectuate the federal court's judgment. 28 U.S.C. § 2283.

VI. *Expressly Authorized by Congress.*

[6] The Bankruptcy Code is an "expressly authorized" exception to the AIA. *In re Parker,* 499 F.3d 616, 626–29 (6th Cir.2007); *In re Davis,* 691 F.2d 176, 177–78 (3d Cir.1982).

> Section 105(a) of the Bankruptcy Code is an "expressly authorized" exception to the Anti–Injunction Act. *See In re Baptist Medical Center of New York,* 80 B.R. 637, 641 (Bankr. E.D.N.Y.1987); *Davis v. Sheldon (In re Davis),* 691 F.2d 176, 177–78 (3d Cir.1982); *Kranzdorf v. Alter (In re Fidelity America Financial Corp.),* 53 B.R. 930, 932–33 (Bankr.E.D.Pa.1985); H.R.Rep. No. 595, 95th Congress, 1st Sess.317 (1977); S.Rep. No. 95–989, 95th Congress, 2d Sess. 29 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5814, 6274. It authorizes the Bankruptcy Court to enjoin state court proceedings under proper circumstances. *In re Davis, supra., In re Fidelity America Financial Corp. supra.;* 2 Collier on Bankruptcy ¶¶ 105.02 (15th ed.1987). As Collier observes, "[t]he basic purpose of the section [§§ 105] is to enable the court to do whatever is necessary to aid its jurisdiction, i.e., anything arising in or relating to a bankruptcy case." 2 Collier on Bankruptcy, supra. §§ 105.02 at 105–3. In fact, section 105(a) contemplates injunctive relief in precisely those instances where parties are " 'pursuing actions pending in other courts that threaten the integrity of a bankrupt's estate.' " *Manville Corporation v. Equity Security Holders Committee (In re Johns–Manville Corp.),* 801 F.2d 60, 63 (2d Cir.1986) (quoting *In re Davis,* 730 F.2d 176, 183–84 (5th Cir.1984)). Accordingly, the bankruptcy exception to the Anti–Injunction Act allows this Court, pursuant to sections 105, 524 and 1141 of the Bankruptcy Code, together with the relevant case law, to enforce the injunction provisions in its Order Confirming the Debtors' Plan. The Anti–Injunction Act, therefore does not bar this Court from enforcing its own Confirmation Order.

In re U.S.H. Corp. of New York, 280 B.R. 330, 338–39 (Bankr.S.D.N.Y.2002).

[7] "While the policy underlying the Anti–Injunction Act is the desire to avoid disharmony between federal and state systems, certain exceptions reflect congressional recognition that injunctions may sometimes be necessary in order to avoid that disharmony." *In re U.S.H. Corp. of New York,* 280 B.R. at 338.

[8] The Reillys' claims are identical to those in the *Geruschat* case. In both cases, it is alleged that the negligence of E & Y caused the Bankruptcy Court to find that each of the Debtor entities was insolvent, and that as a result of the perception of insolvency the Plaintiffs, both in *Geruschat* and here the Reillys, lost valuable property.

[9] The Reillys were represented by counsel and were active participants in the bankruptcy case. The Reillys opposed consolidation and asserted in the bankruptcy case that the Debtor entities were solvent and opposed substantive consolidation. The Reillys had every opportunity to challenge E & Y's findings and testimony when the Reillys opposed the Motion to Consolidate. The Reillys also opposed the fees requested by E & Y for services that it performed under the auspices of the Bankruptcy Court. The matters raised in the State Court Action were fully adjudicated years ago after protracted and acrimonious litigation in this Court. The Reil-

lys, as the losing party, even after appeal, simply refuse to be bound by the outcome.

> A federal court has the inherent power and jurisdiction to issue an injunction to effect its prior judgments and protect against future attempts to attack or evade those judgments. The Third Circuit has itself issued such injunctions on several occasions. *See Gambocz v. Yelencsics,* 468 F.2d 837 (3d Cir.1972); *Silverman v. Constitution Life Insurance Company,* 345 F.2d 177 (3d Cir.1965) *See also Adams v. American Bar Assoc.,* 400 F.Supp. 219 (E.D.Pa.1975). Other federal courts as well have recognized their ability to enjoin vexatious attempts at relitigation of prior federal court judgments, such as those with which we are confronted in these proceedings. *See Walter E. Heller & Co., Inc. v. Cox, supra.; Boruski v. Stewart,* 381 F.Supp. 529 (S.D.N.Y.1974)

Albright v. R.J. Reynolds Tobacco Co., 463 F.Supp. 1220, 1229 (W.D.Pa.1979)

[10] "The court may enjoin state proceedings at any point in time from the institution to the close of the final process." *Atlantic Coast Demolition and Recycling, Inc. v. Board of Chosen Freeholders of Atlantic County,* 988 F.Supp. 486, 495 (D.N.J.1997) citing *Hill v. Martin,* 296 U.S. 393, 403, 56 S.Ct. 278, 282, 80 L.Ed. 293 (1935); *see generally 17 Moore's Federal Practice* ¶ 121.04[3] (3d ed.1997); 17A Charles A. Wright, Arthur R. Miller, Edward H. Cooper & Vikram David Amar, *Federal Practice and Procedure* § 4222 (2d ed.1988).

While the State Court Action has been pending for eleven years, its present status is back to square one, having been remanded by the State Appellate Court for a new trial. There has been no final order in which the State Court has made a determination that the doctrines of res judicata, collateral estoppel and judicial estoppel are inapplicable. It remains appropriate for this Court to consider those issues. *See Parsons Steel, Inc. v. First Alabama Bank,* 474 U.S. 518, 523–24, 106 S.Ct. 768, 88 L.Ed.2d 877 (1986).

For all of the same reasons stated in the *Geruschat* case, the doctrine of res judicata, collateral estoppel and judicial estoppel apply and the Reillys cannot reopen and relitigate those issues in State Court. Such litigation amounts to a collateral attack on the Order of Confirmation of the Debtor's Plan of Reorganization and of the Order of Approval of E & Y's fees. An injunction is necessary in order to protect and effectuate the prior decisions of this Court.

E & Y's Motion for Summary Judgment will be granted. The Reillys' Motion to Dismiss, or in the Alternative, For Abstention, will be denied. An appropriate Order will be entered.

ORDER

This 11th day of September, 2008, in accordance with the accompanying Opinion, it shall be, and hereby is ORDERED as follows:

1. The Motion for Recusal is marked as WITHDRAWN.

2. The Motion to Dismiss, or in the Alternative, For Abstention filed by Barbara L. Reilly and Thomas Reilly, is DENIED.

3. The Motion for Summary Judgment filed by Ernst & Young, LLP, successor to Arthur Young and Company, is GRANTED.

4. Barbara L. Reilly and Thomas Reilly are permanently enjoined from continuing to prosecute Civil Action No. 97–10022 in the Court of Common Pleas of Butler County, Pennsylvania.

ORDER

This 11th day of September, 2008, upon consideration of the MOTION TO DISMISS, OR IN THE ALTERNATIVE, FOR ABSTENTION OR WITHDRAWAL OF REFERENCE, it appearing that the Motion to Dismiss or in the Alternative, for Abstention is appropriately before this Court, but that a Motion for Withdrawal of Reference, however, must be heard by the District Court. See Fed.R.Bankr.P. 5011.

It is therefore ORDERED that if Barbara L. Reilly and Thomas Reilly wish to pursue a Motion for Withdrawal of Reference, they shall request such relief by a separate motion which is filed with the Bankruptcy Clerk for transmission to the District Court.

In re LAUREL HILL PAPER COMPANY, Debtor.

All Points Capital Corp., Plaintiff,

v.

Laurel Hill Paper Company, et al., Defendants.

Bankruptcy No. 07–10187C–11G.
Adversary No. 07–2040.

United States Bankruptcy Court,
M.D. North Carolina,
Greensboro Division.

July 22, 2008.

Background: Adversary proceeding was brought to determine whether contractors and material suppliers asserting mechanics' and materialmen's liens under North Carolina law had perfected liens against proceeds of assets sold by Chapter 11 debtor.

Holdings: Following trial, the Bankruptcy Court, William L. Stocks, J., held that:

(1) debtor's paper making machine and pulp preparation and deinking equipment did not become "fixtures" under North Carolina law and were not improvements to real property, as required for claimants to establish their statutory liens;

(2) supplier waived its statutory lien rights as to materials delivered prior to execution of promissory note received from debtor;

(3) supplier's notice of claim of lien was filed within 120-day window allowed by lien statute with respect to materials furnished on open account;

(4) last day on which contractor provided labor and materials on open account fell outside 120-day window preceding contractor's notice of claim of lien, and therefore contractor failed to perfect its claim of lien;

(5) descriptions of materials and labor supplied in claims of lien satisfied statute; and

(6) suppliers' failure to file notices of lis pendens, as required to commence action to enforce claims of lien, resulted in discharge of claims of lien.

Ordered accordingly.

1. Bankruptcy ⟹2052

Adversary proceeding to determine whether claimants asserting statutory liens pursuant to North Carolina statutes governing mechanics' and materialmen's liens had perfected liens against proceeds from assets sold by Chapter 11 debtor was "core proceeding" that bankruptcy court could hear and determine. 28 U.S.C.A.

ber 3, 1985 Order are unpersuasive. The October 4, 1985 Order, authorizing investigation did not apply to either of those items. Therefore, the debtor was free to make those distributions. When this Court finally authorized said distribution of January 9, 1986, we did so without notice to Equibank, the only investigatory body in this case. We are sufficiently satisfied that the Court's Order of October 3, 1985, was challenged and modified the very next day, and that the October 3, 1985 Order was final *only* to the extent it was not modified on October 4, 1985. Therefore, we find no error was committed by this Court.

At the hearing on January 9, 1986, much clamoring occurred as to the October 3, 1985 Order; however, no party saw fit to advise this Court of the modification on October 4, 1985. This Court would not have entered the January 9, 1986 Order without notice to Equibank, had we been so informed. This Court has vacated its Order of January 9, 1986 because the decision was rendered without notice to the only true objector and/or investigator in this case.

[23] The Sapps also assert that this Court erred in disallowing their claim at the trial on subordination. While the trial was not specifically on the objection to the claim's allowance, the hearing did raise the issue of validity of the lien and the subordination of the claim. The credible testimony of record indicated that the debt due to the Sapps was the obligation of Frank Bilotta, not Dan–Ver.

§ 502(b)(1) of the Bankruptcy Code states:

> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, *except to the extent that—*
>
> (1) *such claim is unenforceable against the debtor and property of the debtor*, under any agreement or applicable law *for a reason other than because such claim is contingent or unmatured;*

(Emphasis added).

The entire trial upon which our April 26, 1988 Order was founded, surrounded the validity and priority of substantial claims. Upon finding that the claim of the Sapps was not properly a claim against either the Debtor or property of the Debtor, this Court was obligated to disallow this claim.

This Court is not persuaded that it committed an error in its evaluation of the testimony. The only documentary evidence supplied to this Court was a check made payable to Frank Bilotta, not to Dan–Ver. No documents were provided indicating any payments to Dan–Ver. This Court heard the testimony of Louis Sapp and found same to be self-serving and less than credible. The lack of dispute between the Sapps and the other Dan–Ver insiders as to the validity of the judgment is similarly unconvincing. These parties acted in concert, perhaps even in conspiracy, to detrimentally affect the claims of the then-present and future creditors. The Motion for Reconsideration will be denied.

In re SHARON STEEL CORPORATION, Debtor.

Bankruptcy No. 87-207E.
Motion No. 87-1019.

United States Bankruptcy Court, W.D. Pennsylvania.

May 2, 1988.

Motion was made for appointment of reorganization trustee. The Bankruptcy Court, Warren W. Bentz, J., held that appointment of trustee was mandatory given

Chapter 11 debtor's insider transfers of assets and gross mismanagement.

Trustee appointed.

Bankruptcy ⇐3624

Appointment of Chapter 11 trustee was essential to maintain viability of debtor business where debtor had transferred significant assets to other companies under common control and away from reach of creditors, stripped debtor of cash, failed to cure operating losses after Chapter 11 filing, and failed to maintain bookkeeping system which could accurately report month-to-month profit or loss. Bankr. Code, 11 U.S.C.A. § 1104(a)(1, 2).

Campbell & Levine, Pittsburgh, Pa., for debtor.

Haythe & Curley, Michael Blumenthal, New York City, for DWG Corp.

Mansmann, Cindrich & Titus, Paul H. Titus, Pittsburgh, Pa., for DWG Corp. and Victor Posner.

Rose, Schmidt, Hasley & DiSalle, Lawrence Palmer, Pittsburgh, Pa., for trustee, James Toren.

Steven Goldring, Pittsburgh, Pa., Asst. U.S. Trustee.

Arthur Linker, New York City, for I. B. J. Schroder, Rosen, Mann & Colin.

OPINION ON APPOINTMENT OF A TRUSTEE

WARREN W. BENTZ, Bankruptcy Judge.

I. Introduction

Sharon Steel Corporation ("Sharon" or "debtor") filed its voluntary petition under Chapter 11 of the Bankruptcy Code on April 17, 1987. Its schedules show $742 million in liabilities and $478 million in assets.[1]

Sharon is a steel maker, with blast furnaces and principal manufacturing equipment located in the vicinity of Sharon, Pennsylvania. It has some 28 subsidiary corporations, although not all are active. Sharon is controlled and principally owned by a Mr. Victor Posner ("Posner") through various affiliated companies. Its executive offices, essential management departments, cash inflow and outflow control, receivables and payables have been maintained at the Miami, Florida headquarters of other Posner corporations on a cost-sharing basis.

The Official Committee of Unsecured Creditors ("Creditors Committee" or "Committee") on September 28, 1987 filed a motion for the appointment of a trustee under § 1104. Evidentiary hearings and arguments were heard October 15 and November 3, 1987.

Negotiations on an amicable resolution, which would have provided independent management, terminated and on January 11, 1988, an order was entered directing the U.S. Trustee to appoint a reorganization trustee. After argument on a motion to reconsider, we entered an order on January 15, 1988 approving the U.S. Trustee's appointment of James W. Toren as trustee in this case. That order, by necessary inference, disposed of the motion for reconsideration and motions to enforce an alleged settlement stipulation, as made clear by order of March 4, 1988.

The issues decided by the orders of this court directing and approving the appointment of a trustee were:

1) Whether a trustee should be authorized and appointed in this Chapter 11 case under 11 U.S.C. § 1104(a)(1) or § 1104(a)(2).

2) Whether the court should have compelled the enforcement of a stipulation which was still in the process of negotiation; and

3) Whether sufficient grounds existed to vacate the January 11, 1988 order authorizing the appointment of a trustee as requested in the various motions for reconsideration.

II. Applicable Law

The appointment of a trustee is governed by 11 U.S.C. § 1104, which provides:

"(a) At any time after the commence-

1. This opinion constitutes the findings of fact and conclusions of law required by Bankruptcy Rule 7052, made applicable by Bankruptcy Rule 9013 and mandated by the Honorable Donald E. Ziegler, United States District Judge, on appeal, with respect to our order dated January 15, 1988, which approved James W. Toren as trustee and necessarily denied a motion to vacate our January 11, 1988 order authorizing the appointment of a trustee.

ment of the case but before confirmation of a plan, on request of a party in interest, and after notice and a hearing, the court shall order the appointment of a trustee—

(1) for cause, including fraud, dishonesty, incompetence, or gross management of the affairs of a debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(2) if such appointment is in the interest of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

A succinct discussion of the applicable principles and standards under § 1104 is contained in *In re Parker Grande Development, Inc.*, 64 B.R. 557 (Bankr.S.D.Ind. 1986). The relevant portions are as follows:

[1] Chapter 11 is designed to allow the debtor in possession to retain management of the business operations unless a party in interest can prove that the appointment of a Trustee is warranted. *In re BAJ Corp.*, 42 B.R. 595 (Bkrtcy.D. Conn.1984); *In re General Oil Distributors, Inc.*, 42 B.R. 402 (Bkrtcy.E.D.N.Y. 1984); *In re La Sherene, Inc.*, 3 B.R. 169 (Bkrtcy.N.D.Ga.1980).

[2] The appointment of a Trustee in a Chapter 11 case is an extraordinary remedy which should not be granted lightly, as it may impose a substantial financial burden on a hard-pressed debtor seeking relief under the Bankruptcy Code. *In re General Oil Distributors, Inc., supra; In re Hotel Associates, Inc.*, 3 B.R. 343, (Bkrtcy.E.D.Pa.1980).

[3] Furthermore, the party seeking the appointment of a Trustee in a Chapter 11 case bears the burden of proving by clear and convincing evidence that such appointment is necessary. *In re General Oil Distributors, Inc., supra.*

[4] A debtor-in-possession has all the rights and duties of a Trustee in a Chapter 11 case. *In re Hawaii Dimensions*, 47 B.R. 425 (Dist.Ct.Hawaii, 1985); *Sabre Farms, Inc. v. Bergendahl*, 42 B.R. 649 (D.Or.1984). The duties of a debtor-in-possession, therefore, include the duty to protect and to conserve property in his possession for the benefit of creditors. *In re Devers*, 759 F.2d 751 (9th Cir.1985). [5] Furthermore, a debtor-in-possession is a fiduciary of his creditors. *In re Van Brunt*, 46 B.R. 29 (Bkrtcy.W.D.Wisc. 1984); *See also, Matter of Royal Bedding Co.*, 42 B.R. 257 (Bkrtcy.W.D.Pa. 1984). Because the debtor-in-possession stands in a fiduciary relationship with his creditors, his fiduciary obligation includes refraining from acting in a manner which could damage the estate, or hinder a successful reorganization of the business. *In re Thurmond*, 41 B.R. 464 (Bkrtcy.D.Or.1983). [*See also In re Modern Office Supply, Inc.*, 28 B.R. 943 (Bankr.W.D.Okla.1983).]

[6] Under 11 U.S.C. § 1104(a)(1), a creditor must prove the existence of fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management. However, 11 U.S.C. § 1104(a)(2) provides a flexible standard for the appointment of a Trustee. *See, In re Deena Packaging Industries, Inc.*, 29 B.R. 705 (Bkrtcy.S.D.N.Y. 1983); *In re Hotel Associates, Inc., supra*; also, *see generally 5 Collier on Bankruptcy* 1104.01 (15th Ed.1979) at 1104–17. Under 11 U.S.C. § 1104(a)(2), the Court may utilize its broad equity powers to engage in a cost-benefit analysis in order to determine whether the appointment of a Trustee would be in the interests of creditors, equity security holders, and other interests of the estate. *In re Hotel Associates, Inc., supra.* Consequently, the analysis becomes one of whether the cost of appointing a Trustee is outweighed by the benefits derived by the appointment.

* * * * * *

[7] In order to determine the benefits of appointing a Trustee [under subsection (a)(2)], a close and careful scrutiny of a debtor-in-possession's prior and present conduct must be made and from that a

> determination must be made that a Trustee will accomplish the goals of the Chapter 11 Plan more efficiently and effectively. This examination makes critical an assessment of the overall management of the debtor corporation; the experience, skills and competence of the debtor-in-possession both past and present, and the trust and confidence in the debtor-in-possession by members of the business community with whom debtor-in-possession has had business transactions and must, of necessity, continue to have the same.

64 B.R. at 560–561.

Under § 1104(a)(1), the words "or similar cause" and § 102(3) indicates that the grounds for appointing a trustee are not limited to those specifically enumerated. *See e.g., In re Brown,* 31 B.R. 583 (D.Col. 1983); *In re Denrose Diamond,* 49 B.R. 754 (Bankr.S.D.N.Y.1985); *In re Ford,* 36 B.R. 501 (Bankr.W.D.Ky.1983); *and In re Main Line Motors, Inc.,* 9 B.R. 782 (Bankr. E.D.Pa.1981).

In reported opinions, the most common basis for appointing a trustee under § 1104(a)(1) is for gross mismanagement and incompetence. *See In re Paolino,* 60 B.R. 828 (E.D.Pa.1986); *In re Horn & Hardart Baking Co.,* 22 B.R. 668 (Bankr.E.D. Pa.1982). The various factors used to determine whether current management is guilty of gross mismanagement and incompetence will vary depending on the facts of the individual case. A summary of two cases provides clarification.

In *In re La Sherene, Inc.,* 3 B.R. 169 (Bankr.N.D.Ga.1980)[2], former Bankruptcy Judge Norton listed a multitude of factors which compelled the appointment of a trustee. The court stated:

> It is undisputed that [current management] ... directed or sanctioned acts which, if not constituting fraud, were deceptive and in wanton and reckless disregard of the financial reality of the business and its creditors ... Furthermore, ... without an overseer of the business affairs of this Debtor, the enterprise lacks managerial and operational credibility, and essential suppliers may decline further dealings with the Debtor, either because of past unpleasant experiences with current management or because of a distrust of such management altogether ... Only an independent ... trustee can supply the leadership and credibility needed ... to salvage [the Debtor's] possibilities.

Id. at 175–76. The court appointed a trustee notwithstanding the fact that current management provided certain talents which might have contributed to the debtor's success. The debtor's future plans to cure the lack of fiscal and managerial controls and procedures were also not sufficient to negate the appointment of a trustee.

In *In re Main Line Motors, Inc.,* 9 B.R. 782 (Bankr.E.D.Pa.1981), the court found sufficient cause under § 1104(a)(1) where the president and sole shareholder of the debtor had withdrawn substantial sums from the debtor's operations and placed them in control of two non-debtor affiliates. The actions of the debtor's president and sole shareholder were sufficient to constitute mismanagement and incompetence.

As a final point, we note that if there is insufficient cause to appoint a trustee under § 1104(a)(1), or if the cause cannot be proven, a trustee may still be appointed if it is in the interest of creditors, some group of equity security holders, and other interests of the estate. *See In re L.S. Good & Co.,* 8 B.R. 312 (Bankr.N.D.W.Va.1980). In general, the factors which have been the basis for appointing a trustee under § 1104(a)(2) are diverse and in essence reflect the practical reality that a trustee is needed. *See In re McCorhill Pub, Inc.,* 73 B.R. 1013 (Bankr.S.D.N.Y.1987). *See also In re Evans,* 48 B.R. 46 (Bankr.W.D.Tex. 1985); *In re William H. Vaughn & Co.,* 40 B.R. 524 (Bankr.E.D.Pa.1984); *In re Humphreys Pest Control Franchises, Inc.,* 40 B.R. 174 (Bankr.E.D.Pa.1984); *and In re L.S. Good & Co.,* 8 B.R. 312 (Bankr.N.D.W. Va.1980).

2. The Honorable William L. Norton, Jr. is the Author and Editor-in-Chief of Norton Bankruptcy Law and Practice, one of the leading treatises in the field.

III. Facts and Discussion

That facts exist warranting the appointment of a trustee is amply supported by the record, largely through admissions of Sharon.

One day before filing the Chapter 11 petition, Sharon's management transferred $3.7 million by wire transfer to DWG Corporation ("DWG"). This was either for an antecedent debt, in which case it would be a voidable preference, or if the antecedent debt cannot be established, it would be a fraudulent conveyance. DWG and Sharon are under common control. Sharon has a fiduciary duty to attempt to recover such funds. Sharon management has not brought suit to recover from DWG. Indeed, it cannot—management of Sharon is the same as management of DWG.

In December 1986, four months before filing this case, Sharon management transferred an airplane of a value of not less than $750,000 and a yacht of a value not less than $750,000 to NPC Leasing Company. There were arguments that the airplane and the yacht had higher values, but the precise values need not be determined now. These transfers were prima facie voidable either as insider preferences or fraudulent conveyances. Because NPC Leasing ("NPC") is under common control with Sharon, management has not and cannot make appropriate demand and institute the litigation necessary to avoid these transfers.

On March 16, 1987, one month before filing, Sharon management transferred 141,000 shares of common stock in Chesapeake Financial Corporation to Insurance & Risk Management, Inc. ("IRM"), in a paper transaction to cancel an antecedent debt in the amount of $1,512,493.75. IRM and Sharon are under common control. The transfer is prima facie at least an insider voidable preference, and if the value of the stock was understated, is voidable as a fraudulent conveyance. Being under common control, there is no way Sharon management can or will seek to recover for Sharon the transferred stock.[3]

Sharon management argues that the above transfers were at fair value, were made to extinguish antecedent debt and may be voidable as preferences, but were not fraudulent and therefore disclose no bad conduct. However, all of the transfers were to companies under common control with Sharon. The obvious purpose of the transfers was to shield the transferred assets from Sharon's outside creditors and thereby hinder and delay recovery by them if not defeat completely any collection efforts by such creditors.

Sharon management also argues that these transfers were disclosed in its bankruptcy schedules and such disclosure "cures" the effect of such insider preferential or fraudulent transfers, even though the assets so transferred have not been returned to Sharon. We do not draw any inference of "cure" merely by such disclosure. Failure to make such disclosures would have rendered the oath to the schedules false, and could have had serious repercussions to the offending individuals and to counsel. Those transfers, made at a time of mounting financial crisis, show a manifest disdain for the interests of outside creditors.

When we issued our order directing the appointment of a trustee, no action had been undertaken by Sharon management to recover on the above causes of action. The indication is that no such action would or could be brought. First, because to do so would require the directors and officers of Sharon to authorize such suits, but those same persons are also the directors and officers of the transferee-defendant companies; such interlocking directors and officers (all under the control of Victor Posner) could not fulfill their fiduciary responsibilities to both plaintiff corporation and its creditors, and to the defendant-transferee corporations. Second, as part of the settlement negotiations, Sharon management and the Committee stipulated that the Com-

3. At this writing, the trustee has initiated action and asserts that the value of the transferred stock was $24 million.

mittee could pursue such claims. At the request of the parties, we entered an order on November 25, 1987, approving the stipulation, even though it was understood that it was to be in tandem with a stipulation for an independent board of directors which was expected to be concluded promptly. But Sharon management filed an appeal from that order, which appeal is still pending, thus revealing an intent by Sharon management to block any effort by any party to pursue such claims, even though Sharon management has a fiduciary obligation itself to prosecute those claims.

Sharon management also argues that the transferee companies have defenses to any preference or fraudulent conveyance actions which may be brought against them. But that argument ignores the fact that Sharon has a fiduciary duty to pursue such claims diligently, win or lose, and that is a duty Sharon management cannot fulfill because the persons constituting Sharon management also have fiduciary obligations to the transferee companies.

Postpetition operations of the debtor have continued to lose money. From April 17, 1987 through the commencement of the hearings on the Committee's motion in October, losses were estimated by all parties to be running at least $2 million per month, even though the market for steel had strengthened and other steel companies had improved earnings. Accurate figures on monthly losses are not available because Sharon has not been able to close its books as of April 17, 1987 and provide subsequent profit and loss information.

Sharon management has failed after nine months of operation under the protection of Chapter 11 to remedy a $4 million annual ongoing unnecessary excessive interest expense on its borrowed working capital. Sharon operates on a $30 million working capital loan on which the interest rate is 28% to 30%. The annual interest cost on that loan is $8.4 to $9.0 million. At a reasonable rate of 14% to 15%, the cost would be $4.2 to $4.5 million.

Sharon argues that it cannot accomplish refinancing because of Creditors Committee hostility, apparently urging the court to conclude that the Committee is at fault in its hostility and therefore, Sharon management should be left in place. Our view is that both management and the Committee have substantial interests at stake. Irrespective of "fault," if the conflict among the interested parties threatens the viability of the business and is detrimental to the welfare of the estate, the appointment of an independent trustee is appropriate in order to insulate the ongoing business activities from such conflict. Furthermore, this Creditors Committee is composed of very sophisticated investors and trade creditors, having in excess of $150 million at stake, and representing the holders of hundreds of millions more, and its hostility may well be justified by the prepetition transfers noted above, the postpetition failure of Sharon management to remedy such transfers, the continuing operating losses, and the other matters discussed below.

DWG is under common control with Sharon. Its offices are in Miami, Florida and it provides office space and financial management services to Sharon and numerous other companies under control of Posner. For the year 1986, DWG charged Sharon $3.58 million. Included in that annual amount is rent on the portion of the Posner building used by Sharon. Sharon management asserts that the fair rent for approximately 13,000 square feet of space occupied by Sharon is $24 per square foot. Based on the testimony, the fair rent for the space occupied is $12.50 per square foot. Thus, there is a significant overcharge as to the rent item alone. It indicates that other cost items charged against Sharon by DWG may also be excessive, such as the $122,433.31 charged to Sharon for the Chairman's office, the $74,465.53 for yacht use, the $170,483.26 for aircraft use (even though Sharon owned the aircraft and the yacht), the $230,422.28 for Victoria Plaza guest apartments, the $100,833.21 for Waldorf Astoria usage, all of which an independent trustee might want to examine. Only an independent trustee can be in a position to evaluate the various elements of the $3.58 million annual charge and take appropriate remedial action.

Moreover, the adequacy of the accounting services being provided by Posner's Miami offices may be questioned in view of the absence of reliable postpetition monthly profit and loss statements and inability to complete the schedule of executory contracts necessary to any party contemplating a plan of reorganization. Up to November 3, 1987, Sharon had not been able to close its books as of the date of bankruptcy, April 17, 1987, so that it could not produce reliable profit and loss figures. Even a business as large as Sharon should not operate in the dark for five and one-half months after filing. Such failure may not constitute gross mismanagement or incompetence, but in conjunction with all of the other problems herein mentioned, is a basis for appointment of a trustee under § 1104(a)(2).

During 1985 and 1986 Sharon repaid debt of $294 million to four secured bank creditors. The Committee alleged, but no proofs were offered, that the purpose was to facilitate new loans from those banks to other Posner companies. Sharon argues that repayment of secured debt was necessary and proper, and that failure to pay might have precipitated this proceeding earlier. The response is that perhaps this case *should* have had judicial supervision much earlier; part of the $294 million could have been used to assure Sharon's continued existence. The court concludes that this is gross mismanagement in view of the fact that Sharon's # 2 blast furnace was shut down for lack of money for relining, and # 3 blast furnace, the only one operating, was nearing the end of its useful life and if it were shut down, the company would be out of the steel making business. These factors might also be considered with Sharon's losses and Posner's compensation.

That the compensation was excessive, and possibly recoverable as fraudulent conveyances, is shown by the following:

Year	Operating Profit (Loss)	Compensation	
		Victor Posner	Stephen Posner
1983	$17.3 million	$2,518,765	$365,004
1984	6.4 million	3,550,641	476,672
1985	(53.3 million)	3,868,445	515,008
1986	(44.5 million)	5,331,592	425,112
1/1/87 to 4/17/87	(14.7 million)	630,641	unknown
4/17/87 to 9/29/87	(10 million, est.)	285,658	unknown

This compensation includes the $4.4 million dollars that Posner caused Sharon to pay for his personal defense of criminal charges of tax evasion. That $4.4 million has never been repaid by Posner. No facts were offered to justify such compensation, or the $4.4 million.

Thus, at a time when Sharon's manufacturing facilities desperately needed repair, Posner withdrew millions of dollars for personal use and paid off $294 million in secured bank loans while putting in place, or leaving in place, a $30 million working capital loan at a 28%–30% interest per annum, allowing the facility to deteriorate, and so denuding Sharon of cash that trade credit became unavailable. Such manifest self-interest and total disregard for the welfare of Sharon and its creditors exceeds any standard necessary to show gross mismanagement.

Posner was subpoenaed for depositions in connection with the Committee's motion. He refused to appear and be deposed even though he never obtained a protective order. As the principal control person of Sharon and its affiliates, and as Chairman, President and Chief Executive Officer, he was an appropriate party to be examined. His refusal was not in good faith, and demonstrates his incompetence and gross mismanagement in that it was bound to engender creditor hostility inimical to a successful plan of reorganization.

Posner's conduct before this court also evidenced a lack of good faith. In our

opinion of October 21, 1987, explaining our order of August 19, 1987 refusing to extend the period during which the debtor maintains the exclusive right to propose a plan, we stated:

"The Committee has expressed great concern for the immediate future of Sharon, asserting that Sharon's plant is in danger of permanently shutting down. The basis for such a concern is well founded. At present, Sharon is operating inefficiently with only one blast furnace which itself is in danger of shutting down. Sharon has admitted almost from the beginning that it has two blast furnaces in need of repair. The blast furnace which is newer, larger and more efficient [# 2] is not operational and requires $18,000,000 to overhaul and reline. The other blast furnace [# 3] which is older and less efficient has been operated since it was last relined in 1979. At that time, its expected life was five years before further relining would be required. It has now operated for eight years and is in imminent danger of being shut down. If Sharon's only operational blast furnace is shut down, the result would be, in all likelihood, a shut down of major plant operations.

Sharon has shown no meaningful progress toward obtaining the $18,000,000 financing package necessary to reline the idle blast furnace and assure continued operation." *In re Sharon Steel Corp.*, 78 B.R. 762, 765–66 (Bankr.W.D.Pa.1987).

On September 18, 1987, Posner caused the debtor's counsel to hand to the court, while attending the Judicial Conference in Philadelphia, an emergency motion to approve $18 million in financing for the relining of blast furnace # 2. A keystone of the motion was:

"A. A secured loan from Victor Posner in the amount of five million dollars ($5,000,000) (the "Posner Loan")"

since $13 million could be generated from other sources. At the expedited hearing on September 25, 1987, counsel for the debtor produced Posner's written commitment; that "commitment":

1) was in the form of a letter from Sharon Steel on Sharon Steel letterhead to Sharon Steel signed by Victor Posner as "Chairman and President and Chief Executive Officer;"

2) provided only that someone (Sharon?) would "arrange for a bank or other commercial lender" to make the $5 million loan;

3) required that the loan be secured by a lien on *all* debtor's assets and its first lien must be upon property having a value of $12.5 million and be granted a superpriority lien by the Bankruptcy Court;

4) required as a pre-condition that Sharon shall have entered into a new collective bargaining agreement with the United Steelworkers of America ("USW"); and

5) provided that the loan would become due and payable upon the appointment of a trustee.

Thus, the "Posner Loan" was only a commitment by Sharon to arrange a bank loan for Sharon. Posner was committed to nothing.

The pre-condition that a collective bargaining agreement shall have been entered with USW was an attempt to coerce such agreement.

The provision that the loan would become due and payable upon the appointment of a trustee would have cut off any attempt to have a trustee appointed, since repayment of the $5 million on short notice would have been impossible for this cash-poor debtor.

The "Posner Loan" portion of the $18 million financing package for the relining of the blast furnace was therefore not seriously considered by any party, even Sharon's attorneys. When the court received the emergency motion in Philadelphia on September 18th, it was favorably impressed by Posner's willingness to lend personal funds of $5 million to aid the debtor. That impression turned sour when the $5 million disappeared in open court on September 25th.

The Creditors Committee immediately filed an amended motion, replacing the "Posner Loan" with loan commitments from various creditors, totalling $5 million. As so amended, the motion for approval of

the $18 million financing package to reline blast furnace # 2 was approved on September 29th. Thus, five and one-half months into the case, the reline job was commenced while everyone crossed their fingers and hoped the job could be completed before the one operating blast furnace failed.

Sharon management argues that it has restructured its management team, which should now be left in place. However, that was admittedly done after the Committee filed its motion for the appointment of a trustee. Even so, the ultimate control over management decisions remained unchanged, and the inherent conflicts of interest were not cured.

Attorneys for Sharon have applied for fees of $279,872.50 for the period September 28, 1987 to December 31, 1987 solely for legal work in defending the motion for the appointment of a trustee. While the equity owners are entitled to representation and to assert their rights, one must speculate whether the expenditure of such resources was appropriate, and whether Sharon's counsel in doing so was fulfilling its fiduciary duty to the debtor's estate, or was defending the private position of the equity owners. The funds expended come from the estate, and in view of the admitted insolvency, will likely be borne chiefly by creditors.

Taken as a whole, or even considering only the admissions of the debtor, it is apparent that independent management is essential to maintain the viability of the business. The court so advised the parties on November 3, 1987. The Committee preferred, however, to settle the matter by stipulation providing for independent management, presumably out of fear that the U.S. Trustee, new to this District, might appoint as trustee incapable of handling a business of Sharon's magnitude, to the detriment of all parties. (That fear, we think, has proved unjustified.) The court, therefore, allowed the parties 48 hours to complete their negotiations.

Numerous joint telephone conferences with counsel for both parties and contacts during Sharon hearings on other matters indicated that progress was being made, and the 48 hours drifted to over two months. However, in a joint telephone conference call at 5:00 p.m., Friday, January 8, 1988, Sharon's counsel advised that the parties were still negotiating and settlement appeared hopeful; Committee's co-counsel agreed that the parties were still negotiating but he advised the court that the Committee's instruction to him was to request that the court proceed with appointment of a trustee. On Saturday, January 9, 1988, the court had its first opportunity to read a four page letter from the Committee's lead counsel dated Thursday, January 7, 1988 and telefaxed to the court that day, with copies to all counsel. That letter recited the difficulties encountered in the negotiations, but more importantly stated:

> "The Creditors' Committee has requested that we advise the court that negotiations concerning the Stipulation have terminated and to respectfully request that the court enter an order approving the Trustee Application."

It concluded:

> "For the foregoing reasons, we respectfully request the court to enter an Order directing the United States Trustee to appoint a reorganization trustee in this case."

There having been conclusive evidence of self-dealing, transfer of huge assets to other companies under common control with Sharon and away from the reach of creditors, stripping the debtor of cash, depleting the assets of the debtor so as to require working capital loans at an unreasonably high interest rate, failure to cure the operating losses after the Chapter 11 filing, failure to have a bookkeeping system which could accurately report month to month profit or loss, all as spelled out above, the appointment of a trustee was mandatory under both § 1104(a)(1) or § 1104(a)(2). Hence, on Monday, January 11, 1988, the order was issued directing the U.S. Trustee to appoint a trustee for this case.

IV. The Motions for Reconsideration and the Stipulation

On January 7, 1988 Posner and DWG filed a motion to enforce the November 25,

1987 stipulation, asserting that the stipulation was an enforceable agreement. That "stipulation" was incomplete; it had never been executed as to all its paragraphs; it was contingent upon approval of the court which required notice and hearing; and contained language which relieved Posner of his obligations thereunder if court approval was not obtained before December 31, 1987. That date was important because of certain perceived tax benefits to Posner if he repaid the $4.4 million before December 31, 1987. Also, the stipulation contemplated an order of approval carrying additional terms, which is where the impasse finally occurred. On January 11, 1988, there was no stipulation in existence.

Upon the entry of the order of January 11, 1988, ordering the U.S. Trustee to appoint a trustee, the negotiations which had broken down the week before were revitalized in earnest and on Wednesday, January 13, 1988, counsel jointly called to ask if argument could be heard on a motion for reconsideration. On January 14 a new stipulation now completed for the first time, was filed together with a companion motion to approve a loan; the motion to approve a loan was necessary because the new stipulation provided for Posner to lend Sharon $4.4 million (the amount of Sharon's money used to defend Posner's tax fraud case) and for DWG to lend Sharon $0.6 million. The intent was to get the $5 million to Sharon immediately as a loan, and then Posner would forgive repayment of the $4.4 million.

The motions were argued Friday, January 15. The Committee and Sharon agreed that since November, Sharon had been managed independently, that Walter Sieckman, who had been fired by Posner in the spring, was rehired in early October 1987, and since then had managed Sharon without Posner interference, that Sharon was being well and effectively managed, and that Sharon badly needed the $5 million to be provided under the stipulation. It was implied that it was almost obligatory that the January 11 order be vacated and the stipulation approved, because Sharon owed the contractor doing the blast furnace reline job $2 million and if not paid on Tuesday, January 19th, 250 men would walk off the reline job imperiling its completion and the future of Sharon. The court did not accept gracefully this pressure argument. We viewed this calamitous forecast as evidence of bad management; effective management would not have gotten into such a predicament. The court's view was that we had better bite the bullet now, get the trustee on board, let him cope with the $2 million problem looming the next Tuesday, and prevent such crises in the future.

Also, Posner's $5 million had disappeared once before and it might do so again. As the old banker said, "Fool me once, shame on you; fool me twice, shame on me."

Having reviewed the qualifications of James W. Toren whom the U.S. Trustee had designated as trustee, and being satisfied of his competence for the task at hand, we executed our approval of his appointment that afternoon, January 15th.

Notwithstanding the difficulties of selecting counsel, and getting up to speed, the trustee was in New York arranging a loan on January 19th. (January 18th was a holiday.) An expedited hearing was arranged for Friday, January 22nd to consider a motion for approval of a loan, in part to meet the $2 million payment. On January 21st, the emergency hearing was cancelled on the advice that $5 million had been "found." The trustee had ascertained that Mueller Brass Company, a Sharon subsidiary, owed Sharon $5 million under a tax treaty and had the cash to make payment. The immediate crisis was solved. And that solution dissolved any remaining doubt as to whether a trustee is necessary in this case.

Had the January 13th stipulation been filed *before* the January 11th order to appoint a trustee, it might have been considered differently. But nothing in the stipulation, the various motions for reconsideration, or the hearings thereon disclosed any fact which preceded January 11th which was not considered in making the January 11th order. Hence, there was no basis for changing or vacating that order. *See* Bankruptcy Rules 9023 and 9024.

While we considered carefully the arguments in favor of vacating the January 11th order to appoint a trustee, in retrospect, we realize that it became public knowledge immediately that a trustee would assume command and that to reverse that order could cause substantial harm by creating an atmosphere of uncertainty, and that the order should not be vacated except upon substantial cause. Stable, reliable and respected management is essential to this debtor, and as long as the facts existed on January 11th to support the order, it should be left in place. To do otherwise would be disruptive and detrimental to the interests of all parties.

V. Conclusions of Law

1. Sharon's prepetition transfers to DWG of

(a) $3.7 million to DWG,

(b) a $750,000 yacht to NPC Leasing,

(c) a $750,000 aircraft to NPC Leasing, and

(d) 141,000 shares of Chesapeake Financial Corporation of a value of not less than $1.2 million to IRM,

were prima facie voidable as preferences, and possibly were fraudulent conveyances to insiders or to entities under common control with the debtor, for the purpose of preserving those assets for the owners, with intent to hinder and delay creditors, constitute gross mismanagement and cause for appointing a trustee under § 1104(a)(1) and also constitute grounds for appointment of a trustee in the interest of creditors, non-controlling equity security holders and other interests of the estate under § 1104(a)(2).

2. The transfers of $9.8 million to Victor Posner and $940,000 to Stephen Posner, his nephew, in 1985, 1986 and January–March 1987, were not shown to be for an adequate consideration, and prima facie constitute fraudulent conveyances; none of such funds have been repaid to Sharon, and since Victor Posner is also the control person, only an independent trustee for Sharon can effect an appropriate remedy. Such action constitutes gross mismanagement and cause for appointing a trustee under § 1104(a)(1) and § 1104(a)(2).

3. The failure of Sharon management to pursue recovery of insider preferences and fraudulent conveyances, and its apparent inability to do so because of conflicts of interest, is a violation of its fiduciary duty, amounts to gross mismanagement and warrants the appointment of a trustee under either § 1104(a)(1) or § 1104(a)(2).

4. The debtor's inability to extricate itself from a 28%–30% interest expense on its working capital loan, costing it over $4 million per year in *unnecessary* interest constitutes gross mismanagement pre- and postpetition and is cause for appointing a trustee either under § 1104(a)(1) or § 1104(a)(2).

5. The necessity for the high interest working capital loan was created by payment in 1985 and 1986 by Sharon of $294 million to four secured bank creditors, by continuing losses, and by withdrawals and transfers to Posner and Posner-controlled companies; such practices constitute gross mismanagement and cause for appointing a trustee under § 1104(a)(1) or § 1104(a)(2).

6. The repayment of $294 million to secured bank creditors and the transfers of substantial sums to Posner and Posner companies, leaving Sharon with inadequate cash when it needed to refurbish its facilities constitutes gross mismanagement under § 1104(a)(1).

7. Sharon management's payment of $294 million in secured bank loans and millions of dollars to Posner while suffering huge losses and while its manufacturing facilities desperately needed repair and were allowed to deteriorate, and while incurring a $30 million working capital loan at a 28%–30% interest, and so stripping Sharon of cash that trade credit became unavailable reveals manifest self-interest and total disregard for the welfare of Sharon and the rights of its creditors which exceeds any standard necessary to show gross mismanagement and grounds for appointing a trustee under either § 1104(a)(1) or § 1104(a)(2).

8. The continuing losses averaging some $2 million per month postpetition,

even while operating under the protective umbrella of the Bankruptcy Court, are causing further harm to creditors and other parties in interest and reveal that Sharon management cannot achieve the goal of reorganization, and constitute incompetence and gross mismanagement and cause for appointing a trustee under § 1104(a)(1) or § 1104(a)(2).

9. The ongoing problem of fair allocation of costs of the Miami offices among Sharon and other Posner-owned businesses is exacerbated by the conflicts in interest, and only an independent trustee can make a proper investigation and determination of the best interests of Sharon. The appointment of a trustee is in the interest of creditors, non-controlling equity security holders, and other interests of the estate, under § 1104(a)(2).

10. No facts were shown after January 11, 1988 which were not considered prior thereto, which could form a basis for vacating the January 11, 1988 order directing the appointment of a trustee.

11. Victor Posner's huge withdrawals from Sharon at a time of financial crisis, his refusal to be deposed, and his erratic conduct before the court, constitute gross mismanagement, incompetence in terms of managing and directing the course of Sharon in these reorganization proceedings, and constitute a basis for the appointment of a trustee under § 1104(a)(1) or § 1104(a)(2).

12. Consideration of all of the facts of this case as a whole requires the conclusion that it is in the best interest of creditors, non-controlling equity security holders and other interests of the estate that a trustee be appointed under § 1104(a)(1).

13. In a case of this magnitude, the cost of having a trustee in place is insignificant when compared with the other costs of administration and when compared with the enormous benefit to be achieved by the establishment of trust and confidence in Sharon's management.

VI. Conclusion

The foregoing is intended to accompany this court's order of January 11, 1988, directing the U.S. Trustee to appoint a reorganization trustee, our approval of the appointment of James W. Toren on January 15, 1988, and our refusal of motions to reconsider.

In re ALLEGHENY, INC. t/d/b/a Allegheny Paper Company; Allegheny Products Company; Allegheny Circulation Supply Company and A & E Plastics, Debtor.

ALLEGHENY, INC., Plaintiff,

v.

BASIC PACKAGING SYSTEMS, INC. and BPS Kansas, Inc., Defendant.

Bankruptcy No. 85-2136.
Adv. No. 87-252.

United States Bankruptcy Court, W.D. Pennsylvania.

May 27, 1988.

Chapter 11 debtor brought action to recover preferences. The Bankruptcy Court, Bernard Markovitz, J., held that: (1) transferees were judicially estopped from denying status as creditors, and (2) transfers occurred when property was actually transferred, rather than earlier date when parties reached settlement agreement.

Judgment for debtor.

1. Bankruptcy ⟹2726(6), 2727(2)

Burden of proving statutory elements of preference, by preponderance of evidence, is on trustee or debtor-in-possession; once elements have been proven, transferee has burden of proving that transfer falls within one or more statutory exceptions to trustee's avoiding powers. Bankr. Code, 11 U.S.C.A. § 547(b).

trict court for the district court to resentence in light of the supplemented record.[6]

If the district court determines that it did not rely upon the table contained in the presentence report which sets forth sentences given to other fraud defendants, the original sentence may, in the district court's discretion, be reinstated. On the other hand, if the district court did rely upon the data, and misinterpreted its meaning, the district court should resentence Cannistraro in accordance with a correct understanding of the presentence report table.

IV.

Having considered all the contentions raised by the defendant, we will affirm the district court's order of restitution but will vacate the sentence of imprisonment and remand to the district court for resentencing consistent with this opinion.

In re SHARON STEEL CORPORATION, Debtor.

Appeal of DWG CORPORATION and Victor Posner.

No. 88–3651.

United States Court of Appeals, Third Circuit.

Submitted Under Third Circuit Rule 12(6) March 30, 1989.

Decided April 7, 1989.

Creditors' committee moved for appointment of Chapter 11 trustee. The United States Bankruptcy Court for the Western District of Pennsylvania, Warren W. Bentz, J., 86 B.R. 455, appointed trustee, and debtor-in-possession appealed. The United States District Court for the Western District of Pennsylvania, Donald E. Ziegler, J., affirmed, and further appeal was taken. The Court of Appeals, Gibbons, Chief Judge, held that appointment of Chapter 11 trustee was not abuse of discretion where there was evidence of systematic siphoning of debtor's assets to other companies under common control on eve of bankruptcy, and continuing postpetition mismanagement.

Affirmed.

1. Bankruptcy ⇐3782, 3786

When reviewing ultimate finding, appellate court must accept bankruptcy court's findings of historical or narrative facts unless they are clearly erroneous, but it must exercise plenary review of court's choice and interpretation of legal precepts and its application of those precepts to historical facts.

2. Stipulations ⇐1

Bankruptcy court properly rejected purported "stipulation" between debtor-in-possession and creditors' committee not to appoint trustee, where document included several lapsed conditions and unexecuted provisions, and committee asserted that negotiations had broken down.

3. Bankruptcy ⇐3784

Bankruptcy court's decision to appoint Chapter 11 trustee for cause is reviewed for abuse of discretion. Bankr.Code, 11 U.S.C.A. § 1104(a).

4. Bankruptcy ⇐3624

Appointment of Chapter 11 trustee was not abuse of discretion where there

6. We see no difficulty with remanding to the same district judge for resentencing. In *Baylin,* 696 F.2d at 1043, n. 30, we recognized that it is the practice of the district courts in this circuit to assign a case on remand to the judge who originally heard it. Occasionally we may use our supervisory power to reassign cases on remand, *e.g. Johnson v. Trueblood,* 629 F.2d 302 (3d Cir.1980), *cert. denied,* 450 U.S. 999, 101 S.Ct. 1704, 68 L.Ed.2d 200 (1981) *and Lewis v. Curtis,* 671 F.2d 779 (3d Cir.), *cert. denied,* 459 U.S. 880, 103 S.Ct. 176, 74 L.Ed.2d 144 (1982) (where justice requires reassignment to preserve appearance of impartiality). Cannistraro has failed to show a substantial reason, other than dislike of the sentence imposed, which would require us to reassign the case on remand.

was evidence of systematic siphoning of debtor's assets to other companies under common control on eve of bankruptcy, and continuing postpetition mismanagement. Bankr.Code, 11 U.S.C.A. § 1104(a)(1, 2).

Paul H. Titus, Mansmann, Cindrich & Titus, Pittsburgh, Pa., Michael V. Blumenthal, Haythe & Curley, New York City, for appellants.

Russell J. Ober, Jr., Steven Petrikis, Rose, Schmidt, Hasley & DiSalle, Pittsburgh, Pa., for appellee James W. Toren, trustee of Sharon Steel Corp.

Herbert P. Minkel, Jr., Vincent J. Coyle, Jr., Fried, Frank, Harris, Shriver & Jacobson, New York City, Philip E. Beard, Stonecipher, Cunningham, Beard & Schmitt, Pittsburgh, Pa., for appellees, The Official Committee of Unsecured Creditors.

Before GIBBONS, Chief Judge, and SCIRICA and NYGAARD, Circuit Judges.

OPINION OF THE COURT

GIBBONS, Chief Judge:

DWG Corporation and Victor Posner appeal from a district court decision affirming a bankruptcy court order appointing a trustee-in-bankruptcy for debtor Sharon Steel ("the debtor" or "Sharon") pursuant to 11 U.S.C. § 1104. DWG and Posner contend that the bankruptcy court should have denied the committee of unsecured creditors' ("the committee") petition for a trustee because the request violated contractual obligations between the committee and the debtor-in-possession.[1] In the alternative, they assert that the district court erred as a matter of law in affirming the appointment of a Chapter 11 trustee both because the postpetition corrective measures taken by the debtor's management should have defeated the petition and because the debtor's alleged acts of postpetition mismanagement fail to satisfy the clear and convincing burden of proof required for appointment of a trustee. Because no binding agreement existed to prevent the committee from petitioning for appointment of a trustee and because the bankruptcy court did not err in appointing a trustee for Sharon, we will affirm.

I.

Sharon Steel Corporation manufactures steel in a facility located near Sharon, Pennsylvania. The Sharon facility includes two blast furnaces. By April, 1987, only one of these—number 3—was operational. Sharon's most efficient blast furnace, number 2, was shut down pending $18 million in repairs. Furthermore, furnace number 3, which was three years overdue for relining, faced imminent shutdown. On April 17, 1987, confronted with $742 million in liabilities, only $478 million in assets, and pressing creditors, Sharon filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code. 11 U.S.C. §§ 1100–1174 (1982 & Supp. IV 1986).

Sharon management remained in control of the corporation's operations as debtor-in-possession. At all times relevant to this case, appellant Victor Posner served as Sharon's chairman, president, and chief executive officer. Appellant DWG, under common control with Sharon, provided financial management services to Sharon and other Posner-controlled companies. It operated out of a Miami office building owned by Posner and provided 13,000 square feet of office space to Sharon to house its executive offices, charging Sharon $24 per square foot.

Some five months after Sharon filed for reorganization, the committee, dissatisfied with the progress—or lack thereof—made by Sharon's management, petitioned the bankruptcy court for appointment of a trustee pursuant to 11 U.S.C. § 1104. On the following day, September 29, 1987, the

1. Posner and DWG half-heartedly contend that the trustee cannot be a party to this appeal because the stipulation allegedly entered into by the parties withdrew the trustee motion, the committee did not oppose the reconsideration motion, and the office of the United States Trustee took no position on the reconsideration motion or the district court appeal. The district court correctly dismissed this argument.

court approved an $18 million loan package to enable the debtor to reline blast furnace number 2.[2] The bankruptcy court held hearings on the committee's petition on October 15 and November 3, 1987. On that second day of hearings, the bankruptcy court informed the parties that it considered "independent management ... essential to maintain the viability of the business." App. 2119. The court, however, apparently at the committee's request, *see* App. 2119, gave the parties forty-eight hours to negotiate a stipulation providing for independent management and thus obviate the need for a trustee.

Because early negotiations seemed promising, the court extended the deadline.[3] The parties reached some sort of agreement on a stipulation, however, for they moved on to negotiate an order to enforce it. The order was to secure court approval of the stipulation and to settle "various other pending matters." App. 1559. The negotiations foundered,[4] however, and the committee requested a ruling on the trustee motion in a letter faxed to the court on January 7.

On January 11, 1988, the bankruptcy court entered an order appointing a trustee. Meanwhile, the parties renewed their negotiations. Sharon owed a $2 million installment on the relining job on January 19. Failure to pay would stop all work. Thus, the possibility of quick access to $4.4 million owed Sharon by Posner as reimbursement for amounts spent by Sharon on Posner's defense in a personal criminal matter,[5] apparently lured the committee back to the table.[6] The two sides finally reached agreement on a loan agreement[7] between Posner and Sharon for $4.4 million and an order approving the stipulation. On January 13, they jointly requested a hearing on a motion for reconsideration of the trustee's appointment. As part of their motion, they submitted a "completed" stipulation. The parties also filed a companion motion seeking authorization of the loan agreement between Sharon, Posner, and DWG. The bankruptcy court held a hearing the following day and entered an order approving the appointment of James W. Toren as trustee, which had the effect of denying the parties' motion to approve the stipulation and vacate the order authorizing a trustee.

On January 21, Posner and DWG filed a motion to reconsider or, in the alternative, to stay the appointment pending appeal. Sharon later joined in this motion, which was opposed by the committee and the trustee. The bankruptcy court held yet another hearing and, on March 4, 1988, denied the motions to reconsider or to stay. App. 1769–70. Posner and DWG then ap-

2. Posner made a show of participating in this loan package. The bankruptcy court characterized Posner's role as "only a commitment by Sharon to arrange a bank loan for Sharon. Posner was committed to nothing." App. 2217. Furthermore, Posner's participation evaporated in open court on September 25. App. 2117.

3. The parties offer differing accounts regarding when and if a stipulation was executed. Because the documentation ultimately submitted to the bankruptcy court belies the existence of a binding agreement at the time the court rendered its decision, no reconciliation of the parties' accounts is required.

4. On January 4, 1988, counsel for the committee telecopied to counsel for Sharon and DWG and Posner a proposed order for signature by 9:00 a.m., January 6. App. 1237. They returned via fax a signed copy of the order late on the night of January 5. App. 1243. That order, however, contained language extending the period during which the committee could not file a plan for reorganization, App. 1247, a condition the committee claims the debtors knew was unacceptable to them. App. 1249. The committee then sent its letter to the court asking for a ruling. App. 1248–51.

5. In April 1982, Posner was criminally indicted in the United States District Court for the Southern District of New York for personal income tax evasion and conspiracy. See generally App. 192–209. The charges covered the period from 1975 to 1979. App. 195. Posner entered a plea of nolo contendere. App. 553.

6. The committee, probably doubting Sharon's, DWG's, and Posner's sincerity, refused to withdraw its request for a ruling, App. 2119, even though the parties had scheduled a meeting to approve the stipulation for January 11, the day the court issued its ruling. App. 2119, 1562. The parties finally reached an agreement on January 13. App. 2121, 1563.

7. The agreement provided that once the order became final, Posner would forgive the loan.

pealed this last decision to the United States District Court for the Western District of Pennsylvania pursuant to 28 U.S.C. § 158(a) (1982 & Supp. IV 1986). The district court affirmed the denial of the stay. It also ordered the bankruptcy court to file findings of fact and conclusions of law for its January 15 order. App. 2099.

The bankruptcy court's Opinion on Appointment of a Trustee, dated May 2, 1988, 86 B.R. 455, sets forth its reasons for granting the motion for appointment of a trustee and denying the motion to vacate that order and approve the stipulation. It relied on 11 U.S.C. § 1104, which provides:

> (a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest ...,[8] and after notice and a hearing, the court shall order the appointment of a trustee—
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
>
> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

11 U.S.C. § 1104 (1982 & Supp. IV 1986) (footnote added). The facts before the court, it found, satisfied both subparts. It cited numerous prepetition transfers of Sharon assets that amounted at best to voidable preferences and at worst to fraudulent conveyances, none of which had been questioned by the debtor-in-possession.[9]

8. The bankruptcy court and, indirectly, the district court mistakenly relied upon a superseded version of § 1104. In 1986, Congress amended subsection (a) to allow the United States trustee to request appointment of a trustee. *See* Bankruptcy Act of 1986, Pub.L. No. 99-554, § 222, 100 Stat. 3088, 3102 (1986). Because this amendment does not affect the outcome in this case, the error is harmless.

9. These either preferential transfers or fraudulent conveyances include a $3.7 million wire transfer made by Sharon to DWG on April 16, 1986 apparently in payment of a $3.58 million annual charge including $122,433.21 rent for the chairman's office, $74,465.53 for use of a yacht that Sharon owned, $170,483.26 for airplane usage (although the plane also was owned by Sharon), $230,422.28 for use of the guest apartments in Miami, and $100,833.21 for accommodations in the Waldorf-Astoria; a December 1986 transfer by Sharon to NPC Leasing Company, under common control with Sharon, of title to a yacht and airplane, each minimally valued at $750,000; a March 16, 1987 transfer of 141,000 common shares in Chesapeake Financial Corporation, valued by the trustee at $24 million, to Insurance and Risk Management, also connected to Sharon by interlocking directors, in satisfaction of an antecedent debt of $1,512,493.75; and approximately $16 million in compensation paid to Victor Posner between 1983 and September 1987, including $4.4 million paid by Sharon for his defense in a criminal action for individual tax evasion and conspiracy, and approximately $1.8 in compensation paid to Stephen Posner. App. 2107–08, 2112, 2114.

In its conclusions of law, the bankruptcy court held the transfers of the $3.7 million to DWG, the yacht and plane to NPC Leasing, and the 141,000 shares of Chesapeake Financial Corporation to Insurance and Risk Management constituted prima facie voidable preferences. It also held that the 1985 through March 1987 transfers of $9.8 million to Victor Posner and $940,000 to Stephen Posner "were not shown to be for an adequate consideration, and prima facia [sic] constitute fraudulent conveyances." App. 2124. The bankruptcy court also credited expert testimony that valued the Miami office space at $12.50 per square foot and noted that DWG charged Sharon $24. App. 2112.

The trustee has instituted several actions to recover various of these assets for the estate. He has sued Posner in United States district court for reimbursement of the criminal defense costs, excessive compensation paid to him, and damages caused by his mismanagement of the debtor. Civil Action No. 88-1850 (originally filed in the bankruptcy court on July 12, 1988 as Adversary No. 88-0042). The trustee also has brought two actions in the bankruptcy court: on August 19, 1988, Adversary No. 88-0052 to obtain books, records and financial information from DWG, Posner, and others; and on March 11, 1988, Adversary No. 88-0019 to recover the 141,000 shares of Chesapeake Financial Corporation stock from Insurance and Risk Management. The trustee also filed suit against Posner in the bankruptcy court on June 3, 1988 for the return of 14 original Norman Rockwell oil paintings that belonged to Sharon. Adversary No. 88-0030. In October 1988, the bankruptcy court approved without prejudice a stipulation requiring Posner to return the paintings.

Not only had Sharon failed to sue for recovery of these transfers, but the bankruptcy court questioned the current management's ability to fulfill its fiduciary duty to pursue these claims since Sharon shares common management with the recipients of the transfers, who also owe conflicting fiduciary duties to the recipients. Disclosure of the transfers did not cure the preferential or fraudulent transfers.

The bankruptcy court also faulted Sharon's day-to-day management of the estate. Sharon, which continued to rely on DWG for financial services, had not yet closed out its books for the period preceding reorganization. Thus, not only was the debtor continuing to hemorrhage money at an estimated $2 million per month at a time when steel prices were rising, but the debtor could not even measure the precise size of these losses since it had no postpetition profit and loss statements.

Similarly, the court also criticized Sharon's failure to renegotiate its $30 million working capital loan from the 28% to 30% interest rate originally agreed to to a reasonable 14% to 15%—an action that would save Sharon $4 million a year. It also impugned the wisdom (and the propriety) of Sharon's repayment during 1985 and 1986 of $294 million in secured bank loans "in order to facilitate new loans from those banks to other Posner companies." App. 2113. Given Sharon's blast furnace crisis and the fact that the payments left Sharon so cash-poor that it was forced to enter into the $30 million, high-interest working capital loan, it concluded such actions amounted to gross mismanagement. *Id.*

Last, the bankruptcy court raised an even more fundamental issue when it questioned the $279,872.50 in attorneys' fees expended during the last quarter of 1987 to fight the appointment of the trustee:

> While the equity owners are entitled to representation and to assert their rights, one must speculate whether the expenditure of such resources was appropriate, and whether Sharon's counsel in doing so was fulfilling its fiduciary duty to the debtor's estate, or was defending the private position of the equity owners. The funds expended come from the estate, and in view of the admitted insolvency, will likely be borne chiefly by creditors.

App. 2118. The bankruptcy court determined that the sum of the above behavior amounted to cause under section 1104(a)(1). It also demonstrated the necessity of new management just to keep Sharon operating, therefore implicating the interests of the creditors and equity holders alike specified for appointment of a trustee under subsection (b).

Because the bankruptcy court wrote its opinion long after its involvement in the events ended, it also incorporated into its opinion its reasons for denying the parties' subsequent motions. With regard to the stipulation, it found that the parties had not reached an agreement prior to the court's January 11 decision. As support, it recited the history of the stipulation. Originally the court at the committee's request had given the parties forty-eight hours to negotiate a settlement to the trustee dispute. Early signs of progress resulted in an extension that lasted until early January. On January 7, 1988, the committee through its attorney informed the court that negotiations had reached an end and that the committee wished a ruling on its motion. The same day, Posner and DWG also filed a motion to enforce the stipulation dated November 25, 1987 [10] as an enforceable agreement. On January 8, 1988, a telephonic conference held between the court and counsel for the debtor and for the committee revealed continuing negotiations. The committee, however, stated that it still desired a ruling on the motion.

After reviewing the case before him, the bankruptcy judge concluded that stipulation was incomplete and therefore unenforceable. He found that it had not been executed as to all of its provisions and was contingent upon court approval, which required notice and a hearing. In addition, the parties envisioned that the order would contain additional terms. Furthermore, the stipulation's provision obligating Posner to

10. Sharon and Posner and DWG refer to this as the November 4 stipulation.

reimburse Sharon for the $4.4 million in defense costs specified court approval by December 31, 1987 to be effective—a date that had come and gone. Thus, it had elapsed. Without a stipulation, the Sharon situation had not changed since the hearing, and thus the judge held that section 1104 required him to appoint a trustee.

Regarding the motion to approve the stipulation and order and vacate the trustee appointment, the court noted that at the hearing the parties argued that Sharon had been managed independently since November by Walter Sieckman, hired as chief operating officer in October. They pressed for urgent action by the bankruptcy court because the relining would stop if payment of the $2 million were not made on time. The court found this to be another manifestation of mismanagement that supported, rather than challenged, its appointment of a trustee. The bankruptcy court, citing Bankruptcy Rules 9023–24,[11] concluded that none of the facts presented by the parties antedated the January 11 order and therefore did not manifest substantial cause to upset that order. It also noted that a reversal at this point would further shake public confidence in Sharon's reorganization.

The district court affirmed the bankruptcy court's decision to appoint a trustee in a brief decision dated September 15, 1988. Apparently applying a clearly erroneous standard to the bankruptcy court's decision, the district court concluded that the evidence before the court pointing to pre- and postpetition mismanagement was clear and convincing. As to the stipulation, it upheld the ruling that no stipulation existed on January 11, 1988. It agreed that approval of the stipulation in the instant case would have resulted in more harm than good. Thus, the bankruptcy judge had not abused his discretion in refusing to vacate the order appointing the trustee. See generally App. 2129–30. This appeal followed.

II.

The parties to this appeal dispute the proper standard of review to be applied in this case. At the outset, it should be noted that this court's review of the district court effectively amounts to review of the bankruptcy court's opinion in the first instance. *See Ram Constr. Co., Inc. v. American States Ins. Co.*, 749 F.2d 1049, 1053 (3d Cir.1984) (citing *Universal Minerals, Inc. v. C.A. Hughes & Co.*, 669 F.2d 98, 102 (3d Cir.1981)). Beyond this basic premise, it is settled law that this court applies a clearly erroneous standard to findings of fact, conducts plenary review of conclusions of law, and must break down mixed questions of law and fact, applying the appropriate standard to each component. *See, e.g., Resyn Corp. v. United States*, 851 F.2d 660, 664 (3d Cir.1988); *In re Jersey City Medical Center*, 817 F.2d 1055, 1059 (3d Cir.1987); *Ram Constr. Co., Inc.*, 749 F.2d at 1052–53; *Universal Minerals, Inc.*, 669 F.2d at 101–02. The district court reviewed the bankruptcy court's decision to appoint a trustee using a clearly erroneous standard. The committee and the trustee have embraced this standard. In contrast, Posner and DWG argue that the district court should have conducted a plenary review. They accurately define the problem as one of characterization; what they see as questions of law, the committee and the trustee perceive as questions of fact.

This court discussed at length the proper standard of review of issues containing mixed questions of fact and law and how to separate the two in *Universal Minerals, Inc. v. C.A. Hughes & Co.*, 669 F.2d 98, 102–03 (3d Cir.1981). *Universal Minerals*, also a bankruptcy proceeding, arose from a determination by the bankruptcy court that C.A. Hughes had abandoned certain personal property. The district court, substituting its own findings of fact for those of the bankruptcy court, reversed. Holding that the bankruptcy court's inference of intent to abandon from the facts presented was not clearly erroneous, this court reversed the district court.

To reach this conclusion, *Universal* reiterates the well-settled rule that this court

11. These rules make Fed.R.Civ.P. 59 and 60 generally applicable to bankruptcy cases.

applies a clearly erroneous standard to findings of fact, but conducts plenary review of legal conclusions. *Id.* The opinion then distinguishes between three different types of facts. "Basic facts are the historical and narrative events" presented for the court's consideration. *Id.* at 102. "Inferred factual conclusions are drawn from basic facts and are permitted only when, and to the extent that, logic and human experience indicate a probability that certain consequences can and do follow from the basic facts. No legal precept is implicated...." *Id.* (citation omitted). Therefore, courts apply a clearly erroneous standard to findings of basic and inferred facts. *Id.*

[1] In contrast, an ultimate fact is "a legal concept with a factual component," *id.* at 103, and "is usually expressed in the language of a standard enunciated by caselaw rule or by statute, *e.g.*, an actor's conduct was negligent; the injury occurred in the course of employment; the rate is reasonable," *id.* at 102 (quoting *Smith v. Harris*, 644 F.2d 985, 990 n. 1 (3d Cir.1981) (Aldisert, J., concurring)). When reviewing an ultimate finding, this court "must accept the trial court's findings of historical or narrative facts unless they are clearly erroneous, but [it] must exercise a plenary review of the trial court's choice and interpretation of legal precepts and its application of those precepts to the historical facts." *Id.* at 103 (footnote omitted).

III.

Posner and DWG correctly assert that the committee and the trustee mischaracterize the bankruptcy court's conclusion that no binding stipulation existed as a factual question. To the extent that the bankruptcy court made any findings concerning whether, for example, certain events had occurred or certain actions were taken, it made findings of basic facts. These findings must be reviewed under a clearly erroneous standard. The same standard would govern review of any factual inferences drawn from these facts. Whether the stipulation presented to the court prior to its decision to appoint the trustee was binding upon the parties, however, clearly presents a question of law: it requires the court to determine whether the sum of the facts presented to the court as a matter of law resulted in a stipulation that bound the parties.

In *Ram Construction Co., Inc. v. American States Insurance Co.*, 749 F.2d 1049 (3d Cir.1984), this court held that contract construction, as distinguished from interpretation, is a matter of law subject to plenary review. In *Ram*, the district court had applied a clearly erroneous standard to a bankruptcy court determination that an agreement to perform a large amount of work on a round-the-clock basis constituted a new contract, rather than an agreement to perform additional work under the terms of an existing contract. While affirming the district court's result, we corrected its mischaracterization of the question before the bankruptcy court as one of interpretation, rather than one of construction.

Ram defines construction as " 'a process by which legal consequences are made to follow from the terms of the contract and its more or less immediate context, and from a legal policy or policies that are applicable to the situation.' " *Id.* at 1053 (quoting Patterson, *The Interpretation and Construction of Contracts*, 64 Colum. L.Rev. 833, 835 (1964)). Because the issue in question did not involve a dispute over material facts, it implicated legal questions and therefore required plenary review. *Id.*

As noted above, the parties, with the bankruptcy court's permission, entered into settlement negotiations to avert appointment of a trustee. Some two months later, the court received two very different communications from the adverse parties. On January 7, 1988, the committee submitted its request that the court rule on its motion for appointment of a trustee, stating that negotiations had ended without agreement. On the same day, both Sharon and Posner and DWG filed motions to enforce a stipulation they claimed the parties executed in November. In effect, the motions were counterresponsive.

The stipulation submitted in support of Sharon's motion was in such a shambles

that the bankruptcy court properly rejected it as nonbinding. *See* App. 1257–64 (Sharon's motion; DWG and Posner's motion does not even append a copy of the stipulation). It contains nineteen paragraphs, covering management control issues, (paragraphs 1–6, 12), reimbursement by Posner of the $4.4 million expended in his defense, (paragraph 13), a loan from DWG of another $600,000, (paragraph 14), proper recordkeeping by DWG, (paragraphs 9–10), and resolution of numerous actual or potential committee-debtor disputes, (see generally paragraphs 15–17), including those over Sharon's choice of legal counsel, (paragraph 8), and an extension of Sharon's exclusivity period, (paragraph 7). The stipulation also contains a provision requiring the committee to withdraw its motion for appointment of a trustee, (paragraph 11), and another provision making its effectiveness dependent upon court approval, (paragraph 18). Last, paragraph 19 conditions effectiveness of the stipulation upon agreement on the outside directors by November 11, 1988 (see also stipulation paragraph 3).

The stipulation is undated, despite Sharon's and DWG and Posner's references to it as the November 4, 1987 stipulation. Paragraph 3 contains four blank lines awaiting entry of the names of the outside directors.[12] Paragraph 13 binds Posner to return the $4.4 million only if the court approves the stipulation on or before December 31, 1987. The document is signed by the committee's cochairmen, who expressly limit their agreement to "Sections 9, 10, 14, 15 and 16 only." App. 1264. Thus, the committee agreed only to the provisions governing DWG's role as financial manager, an obligation for all parties to meet to negotiate settlement of all disputes, and a continued right to go to court to enforce the stipulation in the event of a default. Its failure to agree to the $4.4 million payback is conspicuous. Posner, on the other hand, agreed only to the payback sections. App. 1265 (sections 13 and 16, only in so far as Section 16 shall relate to Section 13).

[2] The bankruptcy court, when confronted with this document in the context of the committee's assertions that negotiations had broken down, properly concluded that no agreement existed. No other explanation exists for an alleged binding contract that includes so many elapsed conditions and unexecuted provisions. Clearly it represents an agreement under negotiation.[13]

Posner and DWG assert that the January 5 letter indicating agreement on the directors, *see supra* note 9, represents a waiver by the committee of the November 11 requirement. We cannot say the bankruptcy court clearly erred by rejecting the agreement. It reasonably could conclude that that agreement represented one more facet of the negotiations that ultimately had collapsed. Furthermore, even were this stipulation binding, it could bind the committee only to the agreed-upon provisions. These did not include the promise not to seek appointment of a trustee, the

12. A letter dated January 5, 1988 from Paul H. Titus, counsel for Posner and DWG, to Philip Beard, counsel for the committee, indicates that agreement on the four outside directors occurred long after the November 11, 1987 deadline. App. 1243 ("this will also confirm that we have agreed that the four outside Directors will be Matthew S. Metcalfe, John Kirkwood, Eugene Frank and Ronald Davenport.").

Posner and DWG incorporated this letter as an exhibit to their motion to enforce the stipulation, claiming it showed the committee had waived the November 11 deadline.

13. After the bankruptcy court appointed the trustee, the parties finally *did* reach agreement on the stipulation and order. When the parties moved for approval of the stipulation and vacation of the trustee order, they submitted a "completed" stipulation that is identical to the stipulation submitted in early January by Sharon except that the names of the four outside directors have been entered. This fact should not be used to challenge the bankruptcy court's decision. The court had to base its decision on the record before it. That the parties should have chosen to agree to the identical stipulation later cannot be considered in reviewing the court's ruling.

Furthermore, the parties' submission of the virtually identical stipulation, many of whose provisions had elapsed and whose acceptance was limited, reflects inexcusably bad lawyering. Although the order compensates for some of the elapsed conditions, the stipulation remains the sloppy and confusing document it was in January.

crux of DWG and Posner's claims regarding the stipulation.

Posner and DWG challenge the bankruptcy court's statement that the stipulation's enforceability was defeated by its incompleteness, caused in part by the provision requiring court approval to render it effective. They argue that the absence of the court order does not free the parties of their obligations under the agreement. For support, they rely heavily on *In re Lamarre,* 34 B.R. 264 (Bankr.D.Me.1983). In *Lamarre,* a city tried to rescind its contract to buy a debtor-in-bankruptcy's property so that it might condemn the property instead. When sued for breach of contract, the city asserted that Lamarre's acceptance failed because he had conditioned it upon bankruptcy court approval. The *Lamarre* court held that an acceptance containing an implied-in-law condition does not nullify the acceptance. A principle often applied in cases involving contracts for the sale of real property is that an acceptance containing an implied-in-law condition does not defeat the acceptance. *See, e.g., Townsend v. Stick,* 158 F.2d 142 (4th Cir. 1946) (inclusion in offeree's acceptance of condition that title to real property be examined for marketability did not render acceptance conditional since marketability requirement is implied in law); *O'Halloran v. Oechslie,* 402 A.2d 67 (Me.1979) (acceptance made contingent upon obtaining financing not conditional since this condition implied in the offer).

By analogy, Posner and DWG contend that the stipulation binds the committee here because bankruptcy court approval is implied at law, and the parties, by expressly including such a condition in their contract did not render it conditional. Accordingly, they maintain, the committee is bound contractually to refrain from seeking appointment of the trustee.

The *Lamarre* rule, however, has a limited application: it tempers the common law rule that an acceptance containing new or different terms rejects the underlying offer. It has no applicability here where the question the court addresses is the existence of an underlying offer. The stipulation bears no indication of acceptance, either of the allegedly conditional provision, or of the trustee provision.

DWG and Posner also cite *Lamarre* to support their contention that failure to agree on the order by the deadline unilaterally set by the committee could not defeat the underlying contractual obligations. In *Lamarre,* the court held that time was not of the essence. *Lamarre,* 34 B.R. at 266. In addition to the fact that no contract was formed here, the instant facts are distinguishable from *Lamarre's* because there the court found that the delay had not diminished the benefits of the city's bargain. That cannot be said of the instant case, where additional delay endangered Sharon's ability to reorganize.

IV.

[3] As with its appeal of the bankruptcy court's refusal to enforce the stipulation, Posner and DWG assert that the proper standard under which to review the bankruptcy court's decision to appoint a trustee is a plenary one. Once again, the trustee and the committee argue for a clearly erroneous standard. While support clearly exists for their position, *see In re Oklahoma Refining Co.,* 838 F.2d 1133, 1136 (10th Cir.1988); *In re Brown,* 31 B.R. 583, 584–85 (D.D.C.1983); *In re Garland Corp.,* 6 B.R. 456, 460–61 (Bankr. 1st Cir. 1980), we agree with Posner and DWG that such a standard is inappropriate. We do not agree with Posner an DWG, however, that we exercise plenary review over appointment of a trustee. Instead, we join the Fourth Circuit in adopting an abuse of discretion standard. *See Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc.,* 828 F.2d 239, 242 (4th Cir.1987). Such a standard best comports with the language, structure, and purpose of section 1104(a).

[4] It is settled that appointment of a trustee should be the exception, rather than the rule. *E.g., In re McCorhill Publishing, Inc.,* 73 B.R. 1013, 1016–17 (Bankr. S.D.N.Y.1987) (citing 11 U.S.C. § 1108 (1982 & Supp. IV 1986)); *In re General Oil Distribs., Inc.,* 42 B.R. 402, 408 (Bankr.E.

D.N.Y.1984); *In re Main Line Motors,* 9 B.R. 782, 784 (Bankr.E.D.Pa.1981); *see* 11 U.S.C. § 1108 (1982 & Supp. IV 1986); H.R. Rep. No. 595, 95th Cong., 1st Sess. 233 (1977), *reprinted in* 1978 U.S.Code Cong. & Admin.News 5787, 5963, 6192 ("[V]ery often the creditors will be benefitted by continuation of the debtor-in-possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case."). While 11 U.S.C. § 1104(a) mandates appointment of a trustee when the bankruptcy court finds cause—seemingly requiring plenary review, "a determination of cause ... is within the discretion of the court," *Committee of Dalkon Shield Claimants,* 828 F.2d at 242.

Subsection (a)(2) also creates a flexible standard, instructing the court to appoint a trustee when doing so addresses "the interests of the creditors, equity security holders, and other interests of the estate." 11 U.S.C. § 1104(a)(2) (1982 & Supp. IV 1986); *see, e.g., Committee of Dalkon Shield Claimants,* 828 F.2d at 242; *In re Parker Grande Dev., Inc.,* 64 B.R. 557, 561 (Bankr. S.D.Ind.1986); *In re Russell,* 60 B.R. 42, 45 (Bankr.W.D.Ark.1985); *In re Crescent Beach Inn, Inc.,* 22 B.R. 155, 160 (Bankr.D. Me.1982). Subsection (a)(2) allows appointment of a trustee even when no "cause" exists. 5 L.P. King, Collier on Bankruptcy ¶ 1104.01, at 1104–20 (15th ed. 1988) (citing 124 Cong.Rec. H11,102 (daily ed. Sept. 28, 1978); S17,419 (daily ed. Oct. 6, 1978)). Because subsection (a)(2) envisions a flexible standard, an abuse of discretion standard offers the most appropriate type of review for this subsection as well.

For the reasons already discussed, section 1104(a) decisions must be made on a case-by-case basis. Subsection (a)(1) requires the bankruptcy court, upon motion, to appoint a trustee when the movant has proved "cause," which the statute defines to include incompetence and gross mismanagement. Subsection (a)(2) emphasizes the court's discretion, allowing it to appoint a trustee when to do so would serve the parties' and estate's interests.

The movant, in this case the committee, must prove the need for a trustee by clear and convincing evidence. *E.g., In re Clinton Centrifuge, Inc.,* 85 B.R. 980, 984 (Bankr.E.D.Pa.1988); *In re Paolino,* 53 B.R. 399, 401 (Bankr.E.D.Pa.1985), *aff'd,* 60 B.R. 828 (E.D.Pa.1986); *In re General Oil Distribs., Inc.,* 42 B.R. 402, 408 (Bankr.E. D.N.Y.1984); 5 L.P. King, Collier on Bankruptcy ¶ 1104.01, at 1104–20 (15th ed. 1988). The bankruptcy court found that the committee satisfied its burden under both subsections, and we cannot say that it abused its discretion in so concluding.

The bankruptcy court opinion conveys the image of a titanic industrial vessel foundering on the shoals of bankruptcy, steered there by at best careless management practices. These practices include payment of $294 million to secured creditors and $9.8 million and $970,000 without consideration to Victor and Stephen Posner respectively during a period when Sharon was so cash-poor that it could not afford to reline the vital number 2 blast furnace—so cash-poor that to continue operations on a daily basis it borrowed $30 million at 28% to 30% interest.

Other questionable management actions cited by the court include the petition-eve payment of $3.7 million to DWG, transfer of Sharon's yacht and plane to NPC, and transfer of the 141,000 shares of Chesapeake Financial Corporation stock to Insurance and Risk Management. At no time did Sharon's postpetition management try to recover any part of these transfers (or any part of the sums paid to Victor and Stephen Posner).

DWG and Posner claim that the court's November 1988 authorization for the committee to sue for recovery of these transfers cures its failure and eliminates any management conflicts of interest, rendering the court's determination erroneous. In fact, they claim that all of the alleged prepetition incidents of gross mismanagement have been corrected, forcing the court to rely on postpetition mismanagement, which they claim falls short of providing clear and convincing proof that a trustee is required. Specifically, they point

to the appointment of Walter Sieckman as chief operating officer, and the court-acknowledged management improvements he had wrought since coming aboard. They also claim that Sharon's by-laws, in compliance with Pennsylvania law, authorized payment of Posner's $4.4 million in legal fees. According to Posner and DWG, these factors make the court's reliance upon the prepetition management problems improper. *But see,* 5 L.P. King, Collier on Bankruptcy, ¶ 1104.01, at 1104–20 (15th ed. 1988) (current management must be free from previous management's taint).

For support, they rely on three cases [14] that they contend stand for the proposition that appointment of a trustee is inappropriate where prepetition gross mismanagement has been corrected and no postpetition gross mismanagement has occurred: *In re General Oil Distributors, Inc.,* 42 B.R. 402 (Bankr.E.D.N.Y.1984), *In re Crescent Beach Inn, Inc.,* 22 B.R. 155 (Bankr. D.Me.1982), and *In re Concord Coal Corp.,* 11 B.R. 552 (Bankr.S.D.W.Va.1981). This argument, however, fails for two reasons.

First, each of these cases is distinguishable. For example, *General Oil* involves questionable prepetition conduct by the two brothers serving as officers, directors, and principle shareholders, including borrowing from the already insolvent debtor, receiving bonuses, and personal use of debtor-owned luxury cars. One of the brothers had remained at the debtor's helm. The court, however, concluded that while the brothers' behavior approached gross mismanagement, on balance, appointment of a trustee would cause more harm than good. The court was influenced by the fact that the motion came late in the bankruptcy, after the debtor had turned the corner. It also considered that the plea came from a creditor that had been an active member of the creditors' committee from the committee's inception and that that committee, with court approval, had hired a manager, which had performed the same function that a trustee would have performed. The committee had dismissed the manager after the basics of the reorganization plan had been set and the debtor had begun to show a profit. The court refused, under these circumstances, to appoint a trustee where no signs of postpetition mismanagement appeared.

In *In re Crescent Beach Inn, Inc.,* 22 B.R. 155 (Bankr.D.Me.1982), the court found simple mismanagement, resulting primarily from lack of sophistication, insufficient to satisfy the gross mismanagement standard of section 1104(a)(1), particularly in the absence of postpetition mismanagement. Last, in *In re Concord Coal Corp.,* 11 B.R. 552 (Bankr.S.D.W.Va.1981), the court did not detail the fraud and dishonesty attributed to current management. Instead, it relied on subsection (a)(2) to appoint a trustee, finding questionable current management's commitment to rehabilitation and its ability to maintain the confidence of creditors and lenders. Thus, its conclusion that Congress did not intend "that massive fraud by former management would ... automatically require ... a trustee where corrective action had already been initiated by the debtor," *id.* at 553, is dictum.

These cases present very different scenarios than does the case at hand. Unlike *Crescent Beach,* management here is extremely sophisticated. This sophistication colors interpretation of their actions. While DWG and Posner cite other case law holding that business dealings between a debtor and its subsidiaries or related entities does not per se create a conflict of interests, *In re F.A. Potts & Co.,* 20 B.R. 3, 4 (Bankr.E.D.Pa.1981); *In re Tyler,* 18 B.R. 574, 578 (Bankr.S.D.Fla.1981). *But see In re L.S. Good & Co.,* 8 B.R. 312, 315

14. The committee and the trustee cite at least as many cases maintaining that prepetition dealings with subsidiaries alone may suffice to require appointment of a trustee. *See, e.g., In re McCorhill Publishing, Inc.,* 73 B.R. 1013, 1017 (Bankr.S.D.N.Y.1987); *In re Humphreys Pest Control Franchises, Inc.,* 40 B.R. 174, 176–77 (Bankr.E.D.Pa.1984); *In re Main Line Motors, Inc.,* 9 B.R. 782, 784 (Bankr.E.D.Pa.1981); *see also In re L.S. Good & Co.,* 8 B.R. 312, 315 (Bankr.N.D.W.Va.1980) (over $1 million in intercompany transactions resulted in conflict of interests between current management and creditors requiring appointment of trustee).

(Bankr.N.D.W.Va.1980) (holding that although no clear proof of fraud, dishonesty, or gross mismanagement had been presented, intercompany transactions exceeding $1 million justified appointment of trustee under § 1104(a)(2) because size and number of transactions "places current management ... in a position of having grave potential conflicts of interest and the presumption arises that the current management ... will be unable to make the impartial investigations and decisions demanded"), they ignore the presence of "something more" in this case.

Unlike *General Oil,* Sharon's management appears to have engaged on the eve of bankruptcy in a systematic syphoning of Sharon's assets to other companies under common control. Despite DWG and Posner's contention to the contrary, such behavior raises grave questions about current management's ability to fulfill its fiduciary duty as debtor-in-possession to Sharon's creditors. Judicial intervention enabling the committee to sue for recovery of per se voidable preferences and fraudulent conveyances may have solved that isolated management problem, but it has not cleared up the question about current management's fitness to continue running Sharon Steel and its commitment to see it through to a successful reorganization. *See In re Concord Coal Corp.,* 11 B.R. 552 (Bankr.S.D.W.Va.1981) (trustee appointed under 11 U.S.C. § 1104(a)(2) on grounds that debtor's many competing business interests rendered questionable his commitment to rehabilitation and that debtor could not secure and maintain lenders' and creditors' trust).

Second, DWG and Posner's reliance on these cases presumes plenary review, when in fact our review looks only for an abuse of discretion by the bankruptcy court. This reduces still further the persuasiveness of the cited case law, which never was binding on this court anyway.

Believing that they had cleared the prepetition gross mismanagement determinations, Posner and DWG hoped to sail past the trustee appointment by arguing that the court's remaining determinations of postpetition gross mismanagement do not satisfy the heavy burden of proof imposed on the movants. The court concluded that current management's failure to negotiate a reduction in the interest rate on the $30 million operating loan, to obtain up-to-date, comprehensive postpetition financial statements from DWG, and to cut or eliminate the estimated $2 million lost monthly despite the protection of the bankruptcy laws satisfied both subsections of section 1104(a). Furthermore, it held "[t]he ongoing problem of fair allocation of costs of the Miami offices among Sharon and other Posner-owned businesses is exacerbated by the conflicts of interest, and only an independent trustee can make a proper investigation and determination of the best interests of Sharon." App. 2126.

Once again, we cannot say that the bankruptcy court abused its discretion. Under the discretionary determination of cause required by 11 U.S.C. § 1104(a)(1) and the flexible standard embodied in (a)(2), the court acted within its discretion in concluding that the totality of the circumstances signaled the need for a trustee. Despite improvements instituted by Walter Sieckman, too many major problems remained—problems symptomatic of potential bankruptcy despite the calm harbor provided by Chapter 11. Failure to force closure of the prepetition books and production of current financial statements nine months after filing,[15] combined with continued losses exacerbated by the failure to cut a major expense like the approximately $4 million in added interest on the operating loan, signaled the court that as captain, the debtor-

15. The trustee and the committee also cite a number of cases maintaining that inaccurate, incomplete recordkeeping alone amounts to cause requiring appointment of a trustee under 11 U.S.C. § 1104(a)(1). *E.g., In re McCorhill Publishing, Inc.,* 73 B.R. 1013, 1017 (Bankr.S.D.N.Y.1987); *In re Colby Constr. Co.,* 51 B.R. 113, 117 (Bankr.S.D.N.Y.1985); *In re Humphreys Pest Control Franchise, Inc.,* 40 B.R. 174, 177 (Bankr.E.D.Pa.1984); *In re Main Line Motors, Inc.,* 9 B.R. 782, 784 (Bankr.E.D.Pa.1981); *In re Hotel Assocs., Inc.,* 3 B.R. 343, 345–46 (Bankr.E.D.Pa.1980).

in-possession had continued to steer Sharon toward bankruptcy rather than to turn her about toward solvency.[16] Corrective measures that are too few too late cannot defeat a change in command. The bankruptcy court's opinion clearly indicates it felt appointment necessary to save Sharon from bankruptcy. We agree.

V.

We conclude that the bankruptcy court did not abuse its discretion by appointing a trustee. Therefore, we will affirm the judgment of the district court. Thus, we need not address whether the stipulation should be approved. In addition, the trustee's motion to strike portions of DWG and Posner's appendix and brief will be denied.

AMERICANS DISABLED FOR ACCESSIBLE PUBLIC TRANSPORTATION (ADAPT) et al.

v.

James BURNLEY, in his capacity as Secretary of Transportation.

Nos. 88–1139, 88–1177/78.

United States Court of Appeals, Third Circuit.

April 19, 1989.

Present: GIBBONS, Chief Judge, SEITZ, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN and NYGAARD, Circuit Judges.

ORDER

A majority of the active judges having voted for rehearing in banc in the above appeal, it is

ORDERED that the Clerk of this court vacate the panel's opinion and judgment entered February 13, 1989, and list the above case for rehearing before the court in banc at the convenience of the court.

Jose S. DE LEON, M.D.; Maria G. De Leon, his wife, Plaintiffs–Appellants,

v.

SAINT JOSEPH HOSPITAL, INC.; William L. Macon, IV, M.D., Defendants–Appellees.

No. 88–1018.

United States Court of Appeals, Fourth Circuit.

Argued Oct. 31, 1988.

Decided April 6, 1989.

Surgeon who had been denied admitting privileges brought defamation action against hospital and chief of surgery. The United States District Court for the District of Maryland, Alexander Harvey, II, Chief Judge, granted defendants' motions

16. Once again, the committee and the trustee supply precedents where other courts have found a combination of factors—most often unsatisfactory financial records and conflicts of interest-constitute § 1104(a)(1) cause. *See, e.g., In re John Peterson Motors, Inc.*, 47 B.R. 551, 553 (Bankr.D.Minn.1985) (under 11 U.S.C. § 151104(a), identical in language to § 1104 and now repealed, court found cause including fraud or dishonesty, bad books, and pre- and postpetition losses); *In re Horn & Hardart Baking Co.*, 22 B.R. 668, 670–71 (Bankr.E.D.Pa.1982) (incomplete records and continued losses); *In re La Sherene, Inc.*, 3 B.R. 169, 175 (Bankr.N.D.Ga.1980) (facts giving rise to finding of "cause" included absence of financial controls and planning, no general management, commingling of affairs of debtor with those of related entity). The trustee examines *La Sherene* extensively, advancing it as a clear parallel to the instant facts. Because our abuse of discretion standard must emphasize the facts before us, thus limiting the precedential value of such cases, we need not enter into a detailed discussion of that case.

[10, 11] Finally, the trustee argues that this court should equitably subordinate the Shopping Center's claim. However, the trustee raised the issue only in her post-trial brief. Section 510(c) of the Bankruptcy Code requires notice and a hearing before a bankruptcy court can equitably subordinate a claim. Merely raising the issue in a brief does not provide sufficient notice to parties in interest. Therefore, the request for equitable subordination will be denied. Even if equitable subordination was properly raised, it still would not apply in this case because the Shopping Center's right to the insurance proceeds is not a "claim" against the bankruptcy estate within the meaning of § 510(c) of the Bankruptcy Code. Rather, it is a "claim" to insurance proceeds as to which we find it is and at all relevant times was the named insured on the policy and the intended beneficiary of the proceeds. The insurance proceeds are not property of this estate or subject to the claims of creditors of this estate.

An appropriate order will be entered.

ORDER

And now, to-wit, this **22nd** day of **December, 1993**, for the reasons set forth in the foregoing Memorandum Opinion, it is **ORDERED, ADJUDGED and DECREED** that the relief requested in the Complaint for Declaratory Judgment is **GRANTED** and this court declares that A.K. Nahas Shopping Center, Inc., is the named insured and sole beneficiary under Travelers Insurance Company Policy No. 779J8334.

It is **FURTHER ORDERED** that the trustee shall remit the proceeds to A.K. Nahas Shopping Center, Inc., within ten (10) days of this order.

In re SHARON STEEL CORPORATION, et al., Debtor.

METROPOLITAN LIFE INSURANCE CO., Movant,

v.

SHARON STEEL CORPORATION, United Steelworkers of America and Citibank, N.A., as Agents, Respondents.

Bankruptcy No. 92-10958.

United States Bankruptcy Court, W.D. Pennsylvania.

Jan. 3, 1994.

Life insurer that provided postpetition coverage for Chapter 11 debtor's employees filed request for payment of its past-due premiums as administrative priority expense. The Bankruptcy Court, Warren W. Bentz, J., held that: (1) life insurer was entitled to administrative expense priority claim for unpaid premiums due in connection with insurance coverage provided postpetition, but (2) insurer was not entitled to immediate payment of its administrative expense priority claim from collateral of debtor's secured lenders.

So ordered.

1. Bankruptcy ⚷2871

To be entitled to administrative expense priority, creditor must establish that its claim arises from transaction with debtor-in-possession that benefits bankruptcy estate. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

2. Bankruptcy ⚷2875

Life insurer could not be denied administrative expense priority claim for unpaid premiums due on accidental death and dismemberment insurance that it provided to debtor's employees postpetition, on theory that life insurer's claim arose solely out of its prepetition contracts and not out of any transaction with debtor-in-possession, where debtor-in-possession elected to continue to receive benefits under policy pending its de-

cision to assume or reject. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

3. Bankruptcy ⟹2875

Coverage that life insurer continued to provide postpetition for debtor-in-possession's employees conferred a benefit on estate, so as to entitle insurer to administrative expense priority claim for unpaid premiums, where debtor had not only willingly accepted benefits of policy, but fought to retain coverage postpetition, on theory that this would assist debtor in negotiating with labor union and in developing its Chapter 11 plan. Bankr.Code, 11 U.S.C.A. § 503(b)(1)(A).

4. Bankruptcy ⟹2854(3.1)

To be entitled to immediate payment of its administrative expense priority claim, for insurance coverage that it provided postpetition, from collateral of debtor's secured lenders, insurer had to show that premiums owing under policy were necessary to preservation or disposition of debtor's assets, and that policy actually benefitted secured lenders. Bankr.Code, 11 U.S.C.A. § 506(c).

5. Bankruptcy ⟹2854(3.1)

Life insurer that provided accidental death and dismemberment insurance for debtor's employees postpetition was not entitled to immediate payment of its administrative expense priority claim from collateral subject to the interest of debtor's secured lenders, where lenders did not insist on continuation of policy or object to its termination and were not shown to have received any direct benefit from continuation of policy. Bankr.Code, 11 U.S.C.A. § 506(c).

6. Bankruptcy ⟹3591(1)

Debtor's counsel should not permit debtor to remain in Chapter 11 if debtor is accruing administrative expenses that will not be paid in Chapter 11 proceeding.

Herbert P. Minkel, New York City, for debtor.

William H. Schorling, Pittsburgh, PA, for Citibank, N.A., as Agent for Various Bank Lenders.

Philip E. Beard, Pittsburgh, PA, for Official Committee of Unsecured Creditors.

Richard E. Gordon, Pittsburgh, PA, for United Steelworkers of America.

Alan R. Lepene, Cleveland, OH, for Metropolitan Life Ins. Co.

Alexandra Margolis, New York City, for Mueller Industries, Inc.

REQUEST BY METROPOLITAN LIFE INSURANCE COMPANY FOR PAYMENT OF ADMINISTRATIVE EXPENSE

WARREN W. BENTZ, Bankruptcy Judge.

OPINION

Introduction

Before the Court is Metropolitan Life Insurance Company's ("MetLife") Request for Payment of Administrative Expense ("Request") and the objections to the Request filed by Sharon Steel Corporation ("Debtor"), Mueller Industries, Inc. ("Mueller") and Citibank, N.A., as agent for the Bank Lenders ("Citibank"). After consideration of the Request, the Debtor's Response in Opposition to the Request, the Objections of Mueller and Citibank, Metlife's Memorandum in Support of its Request, Citibank and Mueller's Joint Memorandum of Law in Opposition to MetLife's Request, the Debtor's November 3, 1993 letter requesting delay and MetLife's November 10, 1993 letter in response, the Reply of MetLife to Citibank and Mueller's Joint Memorandum of Law, the Debtor's Supplemental Response, MetLife's Reply to Debtor's Supplemental Response, Mueller's December 3, 1993 letter and Citibank's December 10, 1993 letter, we find that the matter is ripe for decision.

Factual Background

In July, 1991, the Debtor and MetLife entered into a group insurance policy (the "Policy") to provide life and accidental death and dismemberment insurance for the Debtor's employees and retirees. The Debtor filed its voluntary petition under Chapter 11 of the Bankruptcy Code on November 30,

1992 (the "Filing Date"). Prior to the Filing Date, the Debtor failed to remit its November premium payment on the Policy. The premium for November 1 through November 29 remains unpaid and MetLife is entitled to a general unsecured claim for that portion of its premium. Postpetition, the Debtor failed to pay the Policy premiums due for November 30, 1992 and the months of January—August, 1993 except for a partial payment of $53,294.84 in April, 1993 attributable to pre-1987 retirees and an additional payment of $53,000 in July, 1993. The Debtor has accumulated a significant postpetition arrearage.

On March 3, 1993, MetLife filed its Motion for Determination That Automatic Stay is Inapplicable or to Lift Automatic Stay and/or For Order Determining Contract Termination for Nonpayment of Premiums or Compelling Assumption or Rejection of Executory Contract ("Motion"). In effect, MetLife sought either that the Debtor pay the premiums due under the Policy or relief from the automatic stay so that it could terminate the coverage.

The Debtor and the United Steelworkers of America ("USWA") objected to the Motion. Hearings were held on June 7, June 30, and July 21, 1993. While admitting that it had no ability to assume the Policy and bring the premium payments current, the Debtor stated that it had funds to pay the portion of the premium attributable to pre-1987 retirees which are funded by a third-party. As to the balance of the premiums, the Debtor "anticipated that under the terms of a plan of reorganization, [the Debtor] would be able to assume the [Policy]." The USWA shared the position that MetLife could be compelled to continue to provide insurance coverage until a plan of reorganization is confirmed without any assurance that MetLife could eventually be paid. The Debtor affirmatively opposed the Motion claiming that continuation of the Policy was necessary while the Debtor negotiated with the USWA over voluntary modifications to the USWA's Collective Bargaining Agreement with such modifications being necessary to enable the Debtor to formulate a plan of reorganization.

After allowing some time for the Debtor to negotiate with the USWA and to seek replacement coverage for the pre-1987 retirees, by Order dated July 22, 1993, we directed that the Debtor pay MetLife one month's premium ($53,290) within 7 days and granted MetLife relief from stay effective August 20, 1993 to terminate the Policy, unless by that date, the Debtor had cured its delinquencies. The Debtor failed to cure the delinquencies and the Policy was terminated on August 20, 1993.

On September 13, 1993, MetLife filed its Request. MetLife seeks payment of $345,427.42 as an administrative expense under 11 U.S.C. § 503(b)(1)(A) for the unpaid premiums due under the Policy for the postpetition period from November 30, 1993 through August 20, 1993. MetLife asserts that the premiums due arose from a transaction with the debtor-in-possession; that MetLife's postpetition performance under the Policy provided a direct benefit to the bankruptcy estate; that the amount claimed due, $345,427.42, is supported by adequate documentation; and that under 11 U.S.C. § 506(c), the cash collateral of Mueller and Citibank (collectively, the "Secured Lenders") should be used as a source of funds for the immediate payment of MetLife's administrative claim because the Secured Lenders have assumed control of the Debtor's affairs and have utilized the bankruptcy process to liquidate their collateral for their own benefit.

The Debtor asserts that the rights and obligations under the Policy arose prepetition and, therefore, MetLife's claim did not arise from a transaction with the debtor-in-possession and that MetLife's performance did not confer a benefit on the Debtor. The Debtor further asserts that if an administrative claim exists, it need not be paid prior to confirmation of a Chapter 11 plan of reorganization.

The Secured Lenders object to payment out of their cash collateral. They further assert that the validity of MetLife's claim has not been established and that there can be no present payment to MetLife as it has not been demonstrated that there exist sufficient assets to pay administrative claims in full.

Issues

1. Whether MetLife is entitled to administrative priority for the amount of its unpaid postpetition premiums?

2. Whether the Secured Lenders' cash collateral can be used to satisfy MetLife's request for payment of an administrative expense?

Discussion

I. Administrative Priority

[1] The parties agree that in order to be entitled to an administrative expense priority, a creditor must establish that the debt (1) arises from a transaction with the debtor-in-possession, and (2) benefits the bankruptcy estate. *See In re Jartran, Inc.*, 732 F.2d 584 (7th Cir.1984); *In re Mammoth Mart, Inc.*, 536 F.2d 950 (1st Cir.1976). The parties disagree on whether this test has been satisfied.

"[A] debtor receiving necessary benefits from a prepetition executory insurance contract must accord the nondebtor party an administrative expense priority for the pro rata share of the premium, during the period in which the estate received benefits from the contract." *In re Gamma Fishing Co., Inc.*, 70 B.R. 949 (Bankr.S.D.Cal.1987). In reaching that conclusion, the Court reasoned as follows:

> Requiring a debtor to reasonably compensate for the value of post petition benefits received pending the assumption or rejection of a pre petition executory contract for insurance is in furtherence with the equitable objectives of the bankruptcy court. When the debtor filed its petition, the automatic stay imposed by 11 U.S.C. § 362(a)(3) served to prevent Cutri from terminating the agreement even though the debtor was in default. The debtor's right to receive the benefit of insurance coverage continued until either the contract was rejected, assumed, expired on its own terms, or Cutri was granted a relief from stay pursuant to 11 U.S.C. § 362(d). The debtor was under no time restrictions in which to reject or assume the contract and could have received post petition benefits until the contract expired on its face. Allowing the debtor to escape full liability for these post petition benefits would impose a harsh inequity upon Cutri. *See, In re Nordyke*, 43 BR 856, 863 (Bankr.D.Or. 1984). (footnotes omitted)

Gamma, 70 B.R. at 954–55.

The Debtor cites *In re Jartran, supra*, to support the assertion that MetLife is not entitled to an administrative expense claim because "MetLife received no new additional inducement from Sharon Steel as a debtor-in-possession to perform in the post-petition period." In *Gamma*, upon consideration of a prepetition insurance policy, the Court distinguished *Jartran*, which concerned a prepetition agreement for the placement of classified advertisements in various directories:

> Due to the peculiar nature of the directory industry, the placement of classified ads were irrevocable six months before the publication date. The six month cut-off date became effective *before* the petition was filed. The *Jartran* court, in denying the creditor's request for an administrative expense priority, repeatedly underscored in its opinion that the key fact in its decision was the irrevocable commitment resulting in the trustee's inability to "elect" to receive or reject the benefits under the contract after the filing of the petition. The court's emphasis on "election" implies that the rationale behind § 503(b)(1)(A) is not solely to protect creditors who extend credit to the debtor after the filing of the petition, but may as well protect pre petition creditors who provide benefits to the estate pending assumption or rejection of an executory contract.

Gamma, 70 B.R. at 954.

[2] Here, the Debtor elected to continue to receive the benefits under the Policy pending its decision to assume or reject. Accordingly, the obligation arises from a transaction with the debtor-in-possession and the Debtor has an obligation to pay the premiums as an administrative expense.

[3] The Debtor now asserts that MetLife's performance did not confer a benefit on the bankruptcy estate. Yet, at the time MetLife sought to cancel the coverage, the Debtor affirmatively opposed the cancellation. The Debtor previously argued that postpetition continuation of the Policy was necessary in order to allow negotiations to

continue with the USWA over a voluntary modification to the Collective Bargaining Agreement which was necessary to formulate a plan of reorganization.

The Debtor not only willingly accepted the benefits of the entire Policy, but fought to retain the coverage. Keeping the Policy in force assisted the Debtor in negotiations with the USWA and in development of a plan of reorganization—a direct benefit to the bankruptcy estate.

The Debtor has evinced a desire to play it both ways—to compel MetLife to continue the coverage and then refuse to pay the premiums claiming no benefit to the estate. We will not condone such desires. MetLife is entitled to an administrative claim based on the total number of persons covered by the Policy regardless of how such individuals are categorized by the Debtor.

The Debtor also disputes the amount of MetLife's claim. MetLife's calculations include an increased premium for July and August, 1993. The Policy fixed the rate of premium for two years from July 1, 1991 through June 30, 1993. After MetLife reviewed its claim experience rate, it advised the Debtor that the basic premiums for periods after July 1, 1993 would increase. The Debtor could have elected to terminate the Policy. Instead, the Debtor elected to continue its efforts to compel continued coverage despite the increase in premium. After review of MetLife's documentation (which the Debtor provided to MetLife) and the Debtor's calculations with an allowance for the increase in premiums for July and August, we find that MetLife is entitled to an administrative claim in the amount of $345,427.42.

Payment of the Claim

MetLife relies on 11 U.S.C. § 506(c) for its assertion that immediate payment of its administrative expense claim from the Secured Lenders' cash collateral is appropriate because the Secured Lenders have assumed operating control of the Debtor's affairs and are liquidating their collateral solely for their own benefit.

Section 506(c) authorizes the recovery, from property securing an allowed secured claim, the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the secured creditor. 11 U.S.C. § 506(c).

MetLife points to our Order of April 23, 1993 in support of its assertion that the Secured Lenders have assumed control over the Debtor's affairs and have utilized the bankruptcy process to liquidate their collateral for their own benefit. The Order of April 23, 1993 provided that:

> The Debtor shall cooperate with the secured lenders and limit expenditures to those the secured lenders deem necessary to protect the Debtor's assets.

Under 11 U.S.C. § 363, the use of cash collateral is conditioned upon the secured party's consent or authorization by the Court upon a finding that the secured party is adequately protected. Exercise of this right to consent, as reflected by the April 23, 1993 Order does not give the Secured Lenders "control" of the Debtor. The Debtor has elected to liquidate certain of its excess assets, reduce its obligations to the Secured Lenders and attempt a reorganization of a smaller entity with the remaining assets.

[4] To establish a viable claim under § 506(c), MetLife must prove that the premiums due under its Policy were necessary to the preservation or disposition of the Debtor's assets and that the Policy actually benefitted the Secured Lenders. *See In re McKeesport Steel Castings Co.,* 799 F.2d 91 (3d Cir.1986).

MetLife directs us to *United States v. Boatmen's First National Bank of Kansas City* ("Boatmen's"), 5 F.3d 1157 (8th Cir. 1993), in support of its position that the Secured Lenders' cash collateral can be used to pay MetLife's administrative claim under § 506(c). In *Boatmen's,* the Court held that the Internal Revenue Service could recover postpetition payroll taxes from the secured lender's collateral under § 506(c). There, the secured lender made postpetition loans to the debtor to allow for the continued operation of the debtor's stores to preserve the going concern value in order to maximize the lender's return.

In contrast to the lender in *Boatmen's,* the record in this bankruptcy case contains numerous pleadings which indicate the Secured Lenders' opposition to the use of their cash collateral to fund the resumption of the Debtor's operations.

[5] The Secured Lenders' position was not affected by whether the Policy was assumed, rejected or terminated. The Secured Lenders did not insist on continuation of the Policy, object to its termination or object to MetLife's Motion. The status of the Policy during this Chapter 11 case would not have had an effect on the Secured Lenders' legitimate goal of maximizing the recovery on their secured claims. MetLife has not even alleged, and there is no support for the proposition, that the Secured Lenders received any direct benefit from the continuation of the Policy. Absent a benefit to the Secured Lenders, MetLife is precluded from receiving payment from the Secured Lenders' cash collateral.

The likelihood of success of this Chapter 11 case is unknown. Failure is a real possibility. There may or may not be sufficient unencumbered assets to pay all Chapter 11 administrative claims in full. We will therefore decline to order the immediate payment of MetLife's claim. Payment will have to await the confirmation of a Chapter 11 plan or a distribution under Chapter 7 of the Bankruptcy Code.

[6] A final note is appropriate. This Court continually reminds counsel that we will treat harshly the accrual of expenses during a Chapter 11 which cannot be paid. Such actions amount to a fleecing of creditors under the auspices of the Bankruptcy Court. Debtor's counsel is cautioned that it should not permit the Debtor to remain in Chapter 11 if the Debtor is accruing administrative expenses that will not be paid at the end of the day.

In re Kenneth W. ZERBE, Debtor.

Jeffrey J. BEATON, Yolanda R. Zerbe, and Beaton & Hart, P.C., Plaintiffs/Appellees,

v.

Kenneth W. ZERBE, Defendant/Appellant.

No. 2:93cv856.

United States District Court,
E.D. Virginia,
Norfolk Division.

Jan. 5, 1994.

Chapter 7 debtor sought discharge of divorce decree obligation. The Bankruptcy Court held that debt was nondischargeable, and appeal was taken. The District Court, Rebecca Beach Smith, J., held that debtor's divorce decree allegation to pay ex-wife's attorney fees and costs of action was support or maintenance, and thus was not dischargeable.

Affirmed.

1. Bankruptcy ⚷3422(10.1)

Party to whom debt is owed has burden of proving, by preponderance of evidence, that debt is nondischargeable. Bankr.Code, 11 U.S.C.A. § 523.

2. Bankruptcy ⚷3349

Federal law, not state law, governs question of whether debt is nondischargeable support or maintenance obligation. Bankr.Code, 11 U.S.C.A. § 523(a)(5).

3. Bankruptcy ⚷3350(6)

Debtor's divorce decree obligation to pay ex-wife's attorney fees and costs of action was support or maintenance, and thus was not dischargeable; though wife had waived alimony in divorce action, divorce court imposed obligations upon consideration of parties' respective incomes, assets, and ability to defray cost of divorce. Bankr.Code, 11 U.S.C.A. § 523(a)(5).

6) The time for appeal is extended for an additional 15 days.

In re ALLEGHENY INTERNATIONAL, INC., Sunbeam Corporation, Sunbeam Holdings, Inc., Almet/Lawnlite, Inc., Chemetron Corporation, Integrated Specialties, Inc., Allegheny International (USA), Inc., Al-Industrial Products, Inc., Allegheny International Exercise Co., Woodshaft, Inc., Chemetron Investments, Inc., Infoswitch, Inc., and Eliskim, Inc., Debtors.

Bankruptcy No. 88–00448.
Motion Nos. 90–2458M, 90–2529M, 90–2789M and 90–4219M.
Adv. No. 90–260.

United States Bankruptcy Court, W.D. Pennsylvania.

July 12, 1990.

As Amended July 25, and Aug. 2, 1990.

Reconsideration Granted in part and Denied in part Aug. 2, 1990.

Debtor moved to confirm its plan of reorganization, and various parties objected. The Bankruptcy Court, Joseph L. Cosetti, Chief Judge, held that: (1) alternative plan proponent's actions with respect to purchase of claims against debtor were in bad faith, and thus, votes cast by proponent in connection with those claims would be designated and disqualified; (2) settlement of litigation between debtor and banks, which settlement was proposed as integral part of debtor's reorganization plan, was fair and equitable and could be approved as part of reorganization plan; and (3) control provision of reorganization plan which insured that premium paid to acquire control of debtor would be shared with all stockholders was enforceable against plan proponent which had acquired shares in reorganized debtor through purchase of claims against debtor.

So ordered.

1. Bankruptcy ⚷3544

Alternative plan proponent's actions with respect to purchase of claims were in "bad faith" for purposes of authorizing court to "designate" or "disqualify" ballot of plan proponent, where proponent filed plan of reorganization at eleventh hour, became voluntary claimant after debtor's disclosure statement was approved, purchased clear blocking position making confirmation of debtor's plan extremely difficult, and proponent's interest was to take over and control debtor. Bankr.Code, 11 U.S.C.A. § 1126(e).

See publication Words and Phrases for other judicial constructions and definitions.

2. Bankruptcy ⚷3544

Votes may be designated or disqualified when creditor has cast his vote with ulterior purpose aimed at getting some advantage to which he would not otherwise be entitled in his position. Bankr.Code, 11 U.S.C.A. § 1126(e).

3. Bankruptcy ⚷3544

Even if attempted transaction between entity seeking to obtain control of debtor and secured banks was not in good faith, disqualification as a voter on a Chapter 11 plan, of other remaining claimants who knew nothing about transaction would not be authorized. Bankr.Code, 11 U.S.C.A. § 1126(e).

4. Bankruptcy ⚷3544

Court should designate votes of only those creditors or interest holders who were engaged in wrongdoing. Bankr.Code, 11 U.S.C.A. § 1126(e).

5. Bankruptcy ⚷3544

Attempted transaction between entity seeking to obtain control of debtor and secured banks did not furnish grounds for designating votes of those banks accepting debtor's reorganization plan, where banks voted for debtor's plan because they

thought it would be in their best interest and not for ulterior purpose. Bankr.Code, 11 U.S.C.A. § 1126(e).

6. Bankruptcy ⚩3544

Plan proponent's strategic purchases of claims in strategic classes to advance its proposed reorganization plan constituted at least "bad faith," if not unlawful act, in pursuit of confirmation of plan, warranting designation of proponent's ballots. Bankr. Code, 11 U.S.C.A. §§ 1126(e), 1129(a)(3).

7. Bankruptcy ⚩3560

Debtor may not pay creditors outside of plan of reorganization.

8. Bankruptcy ⚩3546

Plan proponent was "insider" and "fiduciary" for purposes of reorganization, even though proponent did not have actual control or legal decision-making power, where proponent attempted to influence, in not very subtle ways, decisions of debtor, became deeply involved in debtor's insurance coverage and disposal of certain assets, and exploited its special access to information, personnel and premises of debtor in attempt to assert its influence and control. Bankr.Code, 11 U.S.C.A. § 101(30).

See publication Words and Phrases for other judicial constructions and definitions.

9. Bankruptcy ⚩2187

Control transaction provision of debtor's reorganization plan, that insured that any premium paid to acquire control of debtor would be shared with all stockholders, was enforceable against alternative plan proponent which had purchased claims against debtor, and thus, received common stock pursuant to debtor's reorganization plan, proponent knew of control provisions before it purchased claims, and proponent's inequitable and bad-faith behavior required that intent and substance of control provisions be enforced as sanction.

10. Bankruptcy ⚩2125

Equitable relief under provision of Bankruptcy Code governing general equitable powers of bankruptcy court is appropriate to prevent "end runs" on bankruptcy process, that is, to insure creditor may not do indirectly that which he is forbidden to do directly. Bankr.Code, 11 U.S.C.A. § 105.

11. Bankruptcy ⚩3544

Plan proponent's interference with management and attempt to seize control of debtor, its abuse and manipulation of bankruptcy process, and its unilateral resort to out-of-court measures to impose its will upon debtors and creditors in manner not permitted by Bankruptcy Code warranted order requiring that shares in reorganized debtor that were to be distributed under reorganization plan to alternative plan proponent or its affiliates be held in trust by debtor and prevented from voting on any matter while in trust or owned by proponent.

12. Bankruptcy ⚩3550

There is no authority in Bankruptcy Code for discriminating against classes who vote against plan of reorganization.

13. Bankruptcy ⚩3563

Even when impaired class of claims or interest does not accept reorganization plan, court may approve settlement and plan if court determines that plan is fair and equitable to those impaired classes. Bankr.Code, 11 U.S.C.A. § 1129(b)(1).

14. Bankruptcy ⚩3033

Bankruptcy court has discretion to approve settlement as part of reorganization plan.

15. Bankruptcy ⚩3033

In considering fairness and reasonableness of settlement proposed as part of reorganization plan, bankruptcy court is not required to perform exact valuation of each issue, is not required to conduct minitrial of facts, and is not required to use rigid mathematical formula to set dollar values, rather, court must determine whether terms of proposed compromise and settlement fall within reasonable range of litigation possibilities.

16. Bankruptcy ⚩2967

Doctrine of subordination is remedial, not penal, and is applied only to extent necessary to offset specific harm caused by

inequitable conduct. Bankr.Code, 11 U.S.C.A. § 510(c).

17. Bankruptcy ⚩3033

Proposed settlement of litigation between debtor and banks, as integral element of debtor's plan of reorganization, was fair and reasonable, where proposed settlement included significant monetary concessions by banks, elimination of substantial expenses to estate that would otherwise be incurred if litigation continued, elimination of risk of unfavorable verdict, and ability to proceed with reorganization without risk of delay arising from litigation. Bankr.Code, 11 U.S.C.A. § 1129(b)(1).

18. Bankruptcy ⚩3033

Settlement between debtor and holders of institutional unsecured claims pursuant to which debtors would pay holders of claims full amount of their allowed claims, including claims based on interest, was within range of reasonableness, and thus, could be approved by bankruptcy court in context of confirmation of reorganization plan, where debtor was solvent and thus settlement merely gave class interest without enormous costs of additional litigation.

19. Bankruptcy ⚩2836

Although as general rule accrual of interest on debt is suspended upon filing of petition in bankruptcy, and insolvent debtors are not required to pay postpetition interest to unsecured creditors, where debtor proves to be solvent, postpetition interest which accrues on unsecured claims may be allowed.

20. Bankruptcy ⚩3550

Requiring general unsecured creditors to file application for payment of postpetition interest, while awarding interest to contractual loan creditors without application, did not constitute discrimination under Bankruptcy Code; substantial difference existed between classes in that contractual loan agreements provided for interest whereas general unsecured creditors had no contractual agreement for interest.

21. Bankruptcy ⚩3560

Objecting creditors of debtor affiliate were receiving substantially more under reorganization plan than they would under Chapter 7 liquidation, and thus, plan satisfied "best interest of creditors" test for confirmation, where claims of retirees, products liability claimants, and various industrial revenue bond claimants would require liquidation before distribution could be made to objecting creditors and separate liquidation of affiliate would substantially delay distribution for affiliate's claimants and could defeat their payment. Bankr. Code, 11 U.S.C.A. §§ 701 et seq., 1129(a)(7).

Stephen I. Goldring, Asst. U.S. Trustee, W.D. Pa., Pittsburgh, Pa., for U.S. Trustee.

Douglas A. Campbell, Campbell & Levine, Pittsburgh, Pa., for The Official Committee of Unsecured Creditors for Sunbeam.

Robert G. Sable, Sable, Makoroff & Libenson, Pittsburgh, Pa., for The Official Committee of Unsecured Creditors for Allegheny International, Inc.

David A. Murdock, Kirkpatrick & Lockhart, Pittsburgh, Pa., for the Mellon Bank Group.

Denis F. Cronin, Wachtell, Lipton, Rosen & Katz, New York City, for Marine Midland Bank, N.A.

M. Bruce McCullough, Buchanan Ingersoll, P.C., Pittsburgh, Pa., for Allegheny Intern., Inc.

Richard S. Toder, Zalkin, Rodin & Goodman, New York City, for Chemical Bank.

Joseph A. Katarincic, Katarincic & Salmon, Pittsburgh, Pa., James W. Giddens, Hughes Hubbard & Reed, Herbert P. Minkel, Jr., Fried Frank Harris Shriver & Johnson, Andrew Levander, Shereff, Friedman, Hoffman & Goodman, New York City, for Japonica Partners, L.P.

Richard A. Gitlin, Hebb & Gitlin, P.C., Hartford, Conn., for Ins. Co. Lenders.

David T. Sykes, Duane, Morris & Heckscher, Philadelphia, Pa., for AI Investments, L.P.

Joel M. Walker, Pollard, Walker & Vollmer, Pittsburgh, Pa., for Prudential

Capital Investments and Prudential Ins. Co. of America.

John M. Elwood, Director of Reorganization, Allegheny International, Inc., Pittsburgh, Pa., for Allegheny Intern., Inc.

Securities & Exchange Com'n, New York City, for Securities & Exchange Com'n.

Larry D. Henin, Olwine, Connelly, Chase, O'Donnell & Weyher, New York City, for Official Committee of Equity Security Holders.

Timothy T. Brock, Gordon Hurwitz Butowsky Weitzen Shalov & Wein, New York City, for Fidata Trust Co. New York.

Rhoda J. Freeman, Cowen & Co., New York City, for Cowen & Co.

MEMORANDUM OPINION

JOSEPH L. COSETTI, Chief Judge.

The matter presently before the court is the debtor's [1] motion to confirm its plan of reorganization and the objections of various parties to confirmation. The court confirms the plan of reorganization, subject to the conditions and limitations set forth below. Intertwined with the motion to confirm is the Debtor's Motion Under Bankruptcy Code Section 1126(e) to Designate and Disqualify Votes of Claims and Interests Directed by Japonica Partners and Others Acting in Concert (the "debtor's motion to designate"). Also pending are Japonica's Motion Under Bankruptcy Code Section 1126(e) to Designate and Disqualify Votes of Claims and Interests Not Solicited or Procured in Good Faith ("Japonica's motion to designate") and the Motion of the Official Committee of Equity Security Holders of Allegheny International, Inc. to Disqualify All Votes on the Debtor's Stock Plan Pursuant to Bankruptcy Code Section 1126(e) (the "Equity Committee's motion to designate").

In addition, the group of 16 banks who were prepetition secured lenders to the debtor have brought an adversary action at Adversary No. 90-260 seeking equitable relief against Japonica Partners, L.P. ("Japonica") and its affiliates.

The debtor's motion to designate is granted; the votes of which are the subject of that motion are disqualified. Japonica's motion to designate and the Equity Committee's motion to designate are denied, but based on those facts certain limitations, discussed below, are imposed on certain of the secured lenders and the debtor's insiders, as well as Donaldson, Lufkin and Jenrette ("DLJ") and its affiliates. With respect to the action against Japonica by the bank group, Japonica and its affiliates are enjoined, as set forth below.

The instant matters are core proceedings, involving confirmation of a plan of reorganization, 28 U.S.C. § 157(b)(2)(L), and "other proceedings affecting ... the adjustment of the debtor-creditor or the equity security holder relationship...." 28 U.S.C. § 157(b)(2)(O). This court has jurisdiction over the parties and subject matter pursuant to 28 U.S.C. § 1334.

This opinion shall constitute findings of fact and conclusions of law, pursuant to Bankruptcy Rule 7052.

I. THE MOTIONS TO DESIGNATE

In preparation for trial on the instant matters, intense discovery occurred. The discovery took the form of multitudinous depositions, including multiple depositions of the same person—compressed into a short time. The discovery activity included allegedly "cloak and dagger" activities to serve deposition notices on certain parties and equally clever methods to avoid depositions. Especially of note for reasons we will discuss infra, Japonica was unable to serve a deposition notice on Daniel Lufkin, the secured lenders' designated member of the board of directors of the reorganized debtor.

Unless it is necessary to repeat certain facts in the interest of clarity, the court will not burden readers with the history of

1. In this opinion, the court refers to Allegheny International, Inc. ("AI"), Sunbeam Corporation ("Sunbeam"), Sunbeam Holdings, Inc., Almet/Lawnlite, Inc., Chemetron Corporation ("Chemetron"), and ten of the fourteen subsidiaries that filed for chapter 11 relief on May 3, 1988 collectively as the debtor.

the first 22 months of this case. The parties to these matters are painfully aware of those facts. For the uninitiated, those facts are available in numerous memorandum opinions by this court, both published and unpublished. For the motions to designate, we take up the saga, beginning on December 29, 1989, when the debtor filed the instant plan of reorganization. The court conducted several days of hearings on the disclosure statement in January 1990.[2] The court approved the debtor's disclosure statement on February 5, 1990, setting the last day to ballot on the debtor's plan as March 30, 1990, at 5:00 P.M.

However, on January 24, 1990, near the conclusion of the hearings on the debtor's disclosure statement, Japonica filed its plan of reorganization (the "Japonica plan") and disclosure statement which mirrored and utilized in large part the debtor's material and organization. The court was urged by Japonica not to approve the debtor's disclosure statement until Japonica's disclosure statement could be approved and a joint ballot distributed. Japonica requested an extraordinary reduction in the time the rules provided for confirmation. The court feared additional delay and denied the request. The court set separate schedules for confirmation of the plans and promised Japonica an opportunity for creditors to vote on the Japonica plan before any order of confirmation would be issued.

The Japonica plan offered cash equivalent to $6.42 per share with holdbacks, as compared to the debtor's proposed stock plan which offered $7.00 per share. Under the Japonica plan, Japonica would acquire control of the debtor. Deposition of Michael G. Lederman, Esq., 4/20/90, 290; 5/3/90, 66. Although Japonica had indicated its interest in acquiring control of the debtor as early as July 1989, Japonica held no interest as a creditor or equity holder of the debtor until immediately prior to the filing of its proposed plan and disclosure statement. To qualify as a party in interest authorized to file a plan, Japonica purchased public subordinated debentures of the debtor with a face value of $10,000 for $2,712. At that time, the court was unaware that the purchase of claims would be the tactic used by Japonica to gain control.

A. *Acquisition of Claims by Japonica*

On February 23, 1990, Japonica began purchasing claims of the secured bank lenders, Class 2.AI.2. This occurred after the debtor's disclosure statement was approved and the debtor's plan balloting had commenced. This was also after Japonica had proposed a plan and disclosure statement and had become a proponent of a plan. The purchase of the following claims gave Japonica control of approximately 27% of the claims in Class 2.AI.2:

NAME OF BANK	DATE SOLD	FACE AMOUNT	PRICE PAID	% OF FACE AMOUNT
Canadian Imperial Bank of Commerce ("CIBC")	2/23/90	$12,614,800	$10,121,543.25	80.24%
Israel Discount Bank of New York	2/23/90	2,803,289	2,247,005.25	80.16%
The Northern Trust Company	2/26/90	5,606,578	4,498,462.50	80.24%
Harris Trust and Savings Bank	2/26/90	11,213,154	8,966,925.00	79.97%
NCNB National Bank of North Carolina	3/13/90	8,409,868	6,747,237.00	80.23%
First National Bank of Boston	3/23/90	9,811,511	8,339,784.35	85%

2. Japonica's counsel was present, but did not participate, at those hearings.

Debtor's Exhibit D–1. On or about March 26, 1990, Japonica purchased the claim of Continental Bank, N.A. ("Continental"), with a face amount of $12,614,800, for $11,984,060, or 95% of the face amount. Following the purchase of the claim of Continental, Japonica held 33.87% of the claims in Class 2.AI.2, enabling Japonica to block an affirmative vote by that class on the debtor's plan of reorganization. 11 U.S.C. § 1126(c).[3] After achieving its blocking position, Japonica purchased the claim of Bank of Hawaii, with a face amount of $2,242,630, for $1,838,956.60, or 82% of the face amount. Under the terms of the assignments by the aforementioned banks, Japonica caused the votes of the claims it purchased to be voted against the debtor's plan.[4]

In addition to purchasing the claims for cash, Japonica agreed to indemnify the assigning banks for all expenses and liability arising from certain lawsuits against the members of Class 2.AI.2. At least some of the assigning banks would not sell their claims unless Japonica agreed to assume such liability. For example, CIBC would not have sold its claim at any price unless Japonica agreed to assume the expenses and liability arising from those lawsuits. The most notable of those lawsuits is an adversary action in this court, at Adversary No. 88–186, in which the Official Committee of Unsecured Creditors of Allegheny International, Inc. (the "Creditors' Committee")[5] has sued the secured bank lenders under theories of preference, fraudulent conveyance, equitable subordination, and lender liability.[6]

Japonica also purchased claims from senior unsecured creditors in Class 4.AI.2. Japonica purchased the claims of Swiss Volksbank and certain other holders of Swiss Franc notes, with a face amount of $21,793,590, for $14,383,769.40, or 66% of the face amount. Japonica caused the votes of these claims to be voted against the debtor's plan. Although Japonica purchased less than 1/3 of the claims in Class 4.AI.2, its negative votes were sufficient to defeat the debtor's plan in that class because of the large number of claims in Class 4.AI.2 that did not vote. It should be noted that Swiss Volksbank was a member of the Creditors' Committee and the Creditors' Committee had recommended a favorable vote on the debtor's plan. It should also be noted that the Creditors' Committee, on behalf of all these unsecured creditors, is a plaintiff in the bank litigation. Unsecured creditors, such as the holders of the Swiss Franc notes, have interests adverse to the interests of the secured bank lenders and would benefit from a favorable result in the litigation. Therefore, Japonica has purchased claims which constitute a blocking position in two classes whose interests are diametrically opposed in the bank litigation.

B. *The Debtor's Motion to Designate*

Section 1126(e) of the Bankruptcy Code, 11 U.S.C. § 1126(e), empowers the court to "designate" (i.e., disqualify) the ballot of "any entity whose acceptance or rejection ... was not in good faith or was not solicited or procured in good faith...." However, the Bankruptcy Code does not define "good faith." There are few precedents, none controlling, concerning 11 U.S.C. § 1126(e); therefore, we look to the plain language of the section and section 203 of

3. Section 1126(c) of the Bankruptcy Code, 11 U.S.C. § 1126(c), provides as follows:

(c) A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

4. One other bank, Chase Manhattan Bank, N.A., voted against the debtor's plan. That bank has been identified as a potential lender to Japonica.

5. The Official Committee of Equity Security Holders of Allegheny International, Inc. (the "Equity Committee") has intervened as a plaintiff.

6. See the Settlement of Adversary No. 88–186, which is discussed in detail at Section IV(A).

the Bankruptcy Act, the precursor of section 1126(e), as well as the cases interpreting section 203 of the Act.

Section 203 of the Bankruptcy Act provided that "[i]f the acceptance or failure to accept a [Chapter X] plan by the holder of any claim or stock is not in good faith, in light of or irrespective of the time of acquisition thereof, the judge may ... direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance." In *Young v. Higbee Co.*, 324 U.S. 204, 211, 65 S.Ct. 594, 598, 89 L.Ed. 890 (1945), the Supreme Court declared that "the history of [section 203] makes clear that it was intended to apply to those stockholders whose selfish purpose was to obstruct a fair and feasible reorganization...." The history of section 203, which the court discussed in a footnote, remains relevant:

> A year before the House Committee on the Judiciary held its extensive hearings on the Chandler Act a Circuit Court of Appeals held that a creditor could not be denied the privilege of voting on a reorganization plan under Sec. 77B, although he bought the votes for the purpose of preventing confirmation unless certain demands of his should be met. *Texas Hotel Corporation v. Waco Development Co.*, 5 Cir., 87 F.2d 395. The hearings make clear the purpose of the Committee to pass legislation which would bar creditors from a vote who were prompted by such a purpose. To this end they adopted the 'good faith' provisions of Sec. 203. Its purpose was to prevent creditors from participating who 'by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages from the other stockholders who are cooperating.' Bad faith was to be attributed to claimants who opposed a plan for a time until they were 'bought off'; those who 'refused to vote in favor of a plan unless ... given some particular preferential advantage.' Hearings on Revision of the Bankruptcy Act before the Committee on the Judiciary of the House of Representatives, 75th Cong., 1st Sess. on H.R. 6439, Serial 9, pp. 180–182.

Id. at 211 n. 10, 65 S.Ct. at 598 n. 10.

From the preceding paragraph, it is clear that section 203 of the Bankruptcy Act was enacted, inter alia, in response to *Texas Hotel Securities Corp. v. Waco Development Co.*, 87 F.2d 395 (5th Cir.1936), *cert. denied sub nom., Waco Development Co. v. Rupe.*, 300 U.S. 679, 57 S.Ct. 671, 81 L.Ed. 883 (1937); *see also* S. Neely, *Claims Assignments*, Southeastern Bankruptcy Law Institute Program Material, K–19 (1990). That case is strongly analogous to the case at bar. Because of the strong similarity, and because section 203 is the precursor of section 1126(e), it is appropriate to examine that decision.

In 1928, Waco Development Company ("Waco") deeded a vacant lot to Texas Hotel Securities Corporation ("THSC"), an entity run by Conrad Hilton. THSC built and furnished a hotel on the lot with money raised from the issuance of mortgage notes. The hotel, but not the furniture, was then deeded back to Waco which assumed the mortgage notes. THSC then leased the hotel and made further improvements to the hotel not required by the lease. THSC ultimately defaulted on the lease. In a Texas state court proceeding, the lease was canceled and the furnishings and the value of the improvements were forfeited to Waco.

Waco subsequently sought to reorganize under section 77B of the Bankruptcy Act. THSC acquired claims against Waco for the avowed purpose of controlling the plan of reorganization so that THSC could ostensibly recover losses associated with the cancellation and forfeiture and regain management of the hotel. In this connection, Hilton voted against the plan of reorganization, which had provided that the hotel would be leased to another entity.

The Court of Appeals for the Fifth Circuit held that Hilton's negative vote, which resulted in failure to confirm, was not improper or unlawful. However, William O. Douglas, who was then a commissioner of the Securities and Exchange Commission, saw Hilton's actions as "extort[ing] tribute