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SANCTIONS

2

In re W. Die Casting Co., 106 BR 645

[Bankr ND Cal 1989]

3

Facts

- On February 7, 1986, an involuntary bankruptcy case was commenced against the Debtor , Western Die Casting, Co. (now Western Safety Devices, Inc.) under Chapter 7 of the Bankruptcy Code.
- On March 22, 1986, an interim trustee was appointed.
- On March 27, 1986, an order for relief was entered, and the case was converted to a case under Chapter 11 of the Bankruptcy Code. The Trustee was retained as a Chapter 11 trustee.
- Prior to the filing of the bankruptcy petition, the Debtor was represented on various matters by the law firm of Athearn, Chandler & Hoffman ("A, C & H").
- Sometime after her appointment, the Trustee discovered that A, C & H had received an assignment of insurance proceeds within 90 days prior to the filing of the involuntary petition, thus giving rise to a potential preference action on behalf of the estate.

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Facts

- Approximately ten months later, on May 20, 1988, the Trustee filed a complaint to set aside the assignment of the insurance proceeds to Defendants A, C & H as a preferential transfer under 11 U.S.C. § 547(b).
- The complaint was not served until approximately five months later, in October 1988.
- Immediately upon being served with the complaint, Harrington, an attorney with A,C & H contacted the opposite counsel and requested that the complaint be dismissed based on his testimony at the July 17, 1987 deposition and contended that the release of A, C & H's security interest constituted new value under 11 U.S.C. § 547(c)(1)(A), thereby establishing a defense to the preference action.
- At the opposite counsel's request, A, C & H sent her the documents evidencing A, C & H's security interest. A, C & H also represented that these documents had also been produced at the deposition in response to a subpoena duces tecum.

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Facts

- At the status conference, the Trustee's counsel asked the Court for a continuance until February 1989 to complete her review of the documents she had received from the Defendant.
- At about the same time, the Trustee's counsel indicated to Harrington that the Trustee believed it necessary to determine whether the value of the collateral was sufficient to fully secure A, C & H's claim in order to determine whether the release of the security interest constituted an adequate "new value" defense under 11 U.S.C. § 547(c)(1)(A).
- The Defendant sent the opposite counsel a letter in which he made certain representations concerning the value of the collateral. He also sent another set of the documents evidencing A, C & H's security interest.
- The opposite counsel was apparently diverted from further work on the proceeding by other matters, both personal and professional, and did not obtain a final decision from the Trustee concerning dismissal of the proceeding until February 1989.

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Facts

- On February 20, 1989, the Trustee's decision to dismiss the proceeding was communicated to A, C & H. An order dismissing this adversary proceeding was signed by the court on March 2, 1989.
- Thereafter, on March 22, 1989, the Defendants moved for sanctions against plaintiff, the Chapter 11 Trustee and her counsel on the ground that the proceeding was filed in violation of Bankruptcy Rule 9011.

7

Issue

- Whether Rule 11 requires a plaintiff to conduct pre-filing discovery concerning the merits of a defense asserted by a defendant before the case is filed.

8

F.R.B.P. 9011

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10

Arguments

- The Defendants contended that the Trustee violated Bankruptcy Rule 9011 by filing the complaint. The Defendants did not contend that the claim asserted in the complaint was not well grounded in the facts or warranted by the law. Rather, they contended that that claim would have been defeated by their "new value" defense pursuant to 11 U.S.C. § 547(c)(1).
- The Defendants argued that the Trustee's dismissal of the proceeding in March 1989 constituted an acknowledgement that that the Defendant's new value defense would have prevailed at trial. Since the Trustee knew or should have known that the Defendants asserted this defense prior to filing the complaint, she violated Bankruptcy Rule 9011 by filing the complaint.

11

Arguments

- The Trustee admitted that she did not know whether the "new value" defense was even considered at the time the complaint was filed. However, she contended that, even if it had been considered, she would have been justified in filing the complaint because the defense could have been defeated if it were established that: (1) the value of the collateral was insufficient to cover the secured claim; or (2) the creation of the security interest itself was an "insider preference" under 11 U.S.C. § 547(b)(4)(B).
- The Trustee also disputed the contention that the dismissal of the proceeding constituted an acknowledgement that the "new value" defense would have prevailed. She contended that the dismissal was motivated, in part, by practical considerations, such as the expense of litigating the validity of the defense.

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Court's Ruling

- The Court first concluded that it was irrelevant to a determination of the sanctions motion whether Trustee's counsel, who signed the complaint, had actual knowledge that the Defendants asserted a "new value" defense. Since an objective standard applies to Bankruptcy Rule 9011, it was justified to charge her with knowledge of the asserted defense.
- The Court reasoned that it did not matter whether , before filing the complaint, the Trustee had considered either the existence of the "new value" defense or ways in which she might defeat this defense. Under the objective standard applicable to Bankruptcy Rule 9011, the relevant inquiry is what a competent and reasonably diligent attorney would have considered.
- Just as it will be presumed that a competent and reasonably diligent attorney would have discovered a copy of the deposition transcript in the file--and thus the existence of the asserted "new value" defense--it will also be presumed that such an attorney would have considered the obvious ways in which that defense might be defeated.

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Court's Ruling

- The Court next found that the only relevant consideration is the Trustee's counsel's conduct at the time the complaint was filed, not counsel's actions or inactions thereafter. The Court determined that in the case at bar, the Trustee did not act as promptly as might have been desired in serving the complaint, requesting information regarding the value of the collateral, evaluating that information, researching the issues, and making a determination as to how she wished to proceed.
- However, the Court stated that the Trustee's failure to act with greater speed after the complaint was filed cannot possibly constitute or contribute to a violation of Bankruptcy Rule 9011. Bankruptcy Rule 9011 does not impose a burden on a plaintiff to conduct pre-filing discovery of an asserted defense. By its terms, Bankruptcy Rule 9011 requires a plaintiff only to make a reasonable inquiry concerning the factual and legal basis for the plaintiff's own claim. Clearly, this does not require an inquiry into what defenses that might be asserted to defeat that claim. Similarly, it should not require an inquiry into the validity of any particular defense, even if informally asserted by the defendant, at least when that defense depends on facts not clearly beyond dispute.

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Court's Ruling

- The Court denied the Defendants' motion for sanctions against the Trustee and her counsel for filing a preferential treatment action.
- The Court ruled that the complaint was well grounded in the facts and arguable warranted by law. The Trustee had no duty under Rule 9011 to conduct pre-filing discovery concerning an asserted defense which did not indisputably bar her claim.
- The Court reasoned that if a plaintiff were required to fully investigate the basis for a defense before filing a complaint, a defendant would be given an unfair advantage because in such a situation, a defendant could impose a substantial pre-filing burden on a plaintiff by informally asserting myriad defenses with no risk to himself under Bankruptcy Rule 9011.

15

Conclusion

- The Trustee had no duty under Bankruptcy Rule 9011 to conduct pre-filing discovery concerning an asserted defense which did not indisputably bar her claim.

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In re Excello Press, Inc.,

967 F.2d 1109 (7th Cir. 1992)

(Northern District of Illinois)

17

Facts

- A Chicago attorney Daniel Zazove , filed a complaint on the behalf of a Debtor and Plaintiff Excello Press, Inc. against Defendant Associated Agencies, Inc. for recovery of three allegedly preferential payments that Excello made to Associated.
- The alleged payments were made for insurance coverage.
- Associated responded to Excello's complaint by filing a motion for summary judgment wherein, it contended that the payments were made in the ordinary course of business and therefore not recoverable as preferential transfers under 11 U.S.C. § 547(c)(2).
- The bankruptcy court granted Associate's motion for summary judgment and dismissed the Excello's case.

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Facts

- Thereafter Associated moved for the imposition of sanctions against the Debtor's attorney under Bankruptcy Rule 9011(b)
- The bankruptcy judge imposed sanctions on the ground that Zazove failed to make a reasonable pre-filing inquiry into the law and the facts even though the bankruptcy judge considered that Zazove's complaint for Excello was not itself frivolous.
- The bankruptcy judge sanctioned Zazove the amount of $11,916.52 for (1) filing the claim regarding the first two payments without adequate investigation and (2) failing to dismiss the claim regarding the third payment after Zazove learned of this Circuit's decision in *Bonded Financial Services.*

19

Facts

- The District court affirmed the entry of sanctions against the attorney for "inadequate pre-filing investigation as to the first two payments," but reversed the entry of sanctions with respect to Excello's failure to dismiss the complaint since it concluded that Rule 9011(b) does not impose post-filing duties.
- The District court remanded the case to the bankruptcy court to reduce the award of sanctions that had been imposed for failing to withdraw Excello's complaint.
- The attorney appealed.

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Issue

- Whether the District Court erred in upholding 9011 sanctions against Zazove for failing to conduct adequate pre-filing investigation ?
- Whether Zazove's pre-filing investigation was reasonable ?
- Whether the court should impose such sanctions under 28 U.S.C. § 1927?

21

F.R.B.P. 9011

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23

United States Code - 28 U.S.C. § 1927

Any attorney or other person admitted to conduct cases in any court of the United States or any Territory thereof who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct.

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25

Argument

- On appeal, Zazove alleged that the District Court erred in upholding sanctions against him for failing to conduct adequate pre-filing investigation.
- Zazove argued that the sanctions imposed against him were an abuse of discretion because 1) he had no duty to investigate potential affirmative defenses and 2) even if he had such an obligation, he did conduct an objectively reasonable pre-filing investigation.
- Zazove urged the Court to adopt a per se rule that courts can never impose Rule 9011 sanctions for counsel's failure to investigate an affirmative defense.
- Associated did not cross-appeal from the District Court's reversal of Rule 9011 sanctions against Zazove for failing to withdraw its claim

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Court's Ruling

- The Seventh Circuit declined to adopt *per se* rule that the courts can never impose Rule 9011 sanctions for counsel's failure to investigate an affirmative defense.
- The Court recognized that under Rule 9011, an attorney is required to make a "reasonable inquiry" before filing a document. The determination of the reasonableness of an attorney's inquiry necessarily depends upon the circumstances of a particular case. Thus how much investigation is reasonable in a given case is a question of line-drawing.
- The Court added that ordinarily, it will be reasonable for a plaintiff's counsel not to make a pre-filing investigation regarding affirmative defenses. However, at times an attorney may have a responsibility to examine whether any obvious affirmative defenses bar the case.

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Court's Ruling

- The Seventh Circuit addressed the reasonableness of Zazove's pre-filing inquiry based on the circumstances of the case.
- The Court first noted that generally attorneys are required under Rule 11 to make a "reasonable inquiry" before filing a document and such reasonable inquiry may, under appropriate circumstances, include the duty to "examine whether any obvious defenses bar the case". In the case at bar, the Seventh Circuit concluded that based on the review of the circumstances, the attorney likely had a responsibility to examine the ordinary course of business defense prior to filing the complaint if all of the information necessary to conclusively establish that defense was in the Debtor's control.
- The Court rejected Zazove's argument that because the payments were late, they were presumptively outside the ordinary course of business. (citing In re Xonics Imaging Inc., 837 F.2d 763, 765 (7th Cir. 1988)).

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Court's Ruling

- The Court noted that at the time the complaint was filed, the Debtor possessed evidence that showed that the Debtor and Associated had established a continuing pattern of late payments, and that evidence rebutted the *Xonics* presumption.
- Therefore, the Seventh Circuit concluded that Zazove should have reviewed the subjective component of the ordinary course of business defense prior to filing the complaint.
- Next, the Court noted that the ordinary-course-of-business defense also required that the transfers be made according to industry terms under § 547(c)(2)(C). Since information regarding industry terms was not available to Zazove at the time the complaint was filed, the Seventh Circuit found that Zazove could not have determined whether late payments were ordinary within the industry.
- Thus, the Court concluded that Zazove had a viable argument that he did not have access to all of the necessary information and, therefore, the filing of the complaint was not sanctionable

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Court's Ruling

- Next, the Seventh Circuit stipulated that at the time Zazove filed his complaint, the majority of published bankruptcy court decisions interpreted Sec. 547(c)(2)(C) i.e. ordinary business terms to require substantially the same showing as that required by subparagraph (B), i.e., evidence of the ordinary practice between the parties. Only, a minority of bankruptcy court decisions followed an approach that required separate evidence under subparagraph (C)--evidence that the manner and timing of the payments were consistent with ordinary practice in the parties' industry.
- The Seventh Circuit held that Zazove relied upon the minority approach and since the required information was unavailable to Zazove at the time of filing the complaint, a reasonable pre-filing inquiry by the Debtor would not have established whether late payments were ordinary within the insurance industry.

30

Court's Ruling

- The Seventh Circuit next noted that although it acknowledges the bankruptcy judge's feeling of frustration that counsel did not make inquiry of relevant facts which were readily available to him regarding the course of conduct between the parties, it was an abuse of discretion to impose Rule 9011 sanctions against Zazove for his reliance upon the then minority approach when there was a split of authority and neither this Court nor the bankruptcy judges for the Northern District of Illinois had addressed the question.
- The Seventh Circuit held that pursuant to Rule 9011, Zazove could rely on any proposition warranted by existing law or some arguable modification or extension.
- The Seventh Circuit refused to address Associated's vexatious litigation argument under 28 U.S.C. § 1927 as it had been waived off and was raised for the first time in the Court.
- Based on the above, the Seventh Circuit reversed the judgment of the district court upholding the imposition of sanctions against Zazove for supposed failure to conduct reasonable pre-filing inquiry.

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Conclusion

- It is an abuse of discretion to impose Rule 9011 sanctions for reliance upon the then minority approach when there is a split of authority and neither Court had addressed the issue.
- Pursuant to Rule 9011, a party can rely on any proposition warranted by existing law or some arguable modification or extension.
- Under Rule 9011 an attorney is required to make a "reasonable inquiry" before filing a document. The determination of the reasonableness of an attorney's inquiry necessarily depends upon the circumstances of the particular case.

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Leeds Bldg. Prods. v. Moore-Handley, Inc. (in re Leeds Bldg. Prods.),

181 B.R. 1006 (Bankr. N.D. Ga. 1995)

(Northern District of Georgia)

33

Facts

- As part of its Chapter 11 plan of reorganization, Debtor Leeds Building products, Inc. was charged with the prosecution and collection of all preference actions.
- The Debtor filed a preference suit against a Defendant Moore-Handley, Inc., to whom it had paid $ 185,000 in satisfaction of various invoices during the 90 days prior to filing.
- The Debtor sought to recover the pre-petition payments, alleging that they were preferential transfers.
- The Court granted summary judgment to the Defendant under the ordinary course of business exception of § 547(c)(2).
- Subsequently, the Defendant sought sanctions pursuant to Bankruptcy Rule 9011

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Issue :

To what extent does a Rule 9011(b) requires a plaintiff to make a pre-filing inquiry ?

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37

Arguments

- The Defendant argued that the Debtor and its counsel should be sanctioned under FED. R. BANKR. P. 9011 for filing and pursuing the preference action because if the Debtor would have adequately conducted a pre-filing inquiry into the ordinary course of business defense, it would have discovered that its claim lacked merit.
- The Defendant also argued that the Debtor should be sanctioned because the Debtor's complaint was filed for the improper purpose of trying to extract a quick settlement. The Defendant argued that the Debtor filed a complaint merely to create a pressure on the Defendant to extract a settlement.
- The Debtor opposed claiming, that it presented a colorable argument to the Court and denied any allegations of improper conduct.

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Court's Ruling

- Relying upon Excello Press, the Court stipulated that affirmative defenses normally are raised after an action is commenced, and the evidence needed to establish the merits of such a defense is sought through the discovery process.
- The Court held that in the case at bar, to accept the argument that the Defendant asserted, would, in effect, require a plaintiff to conduct discovery prior to filing a complaint. Such a requirement will contravene the purpose of notice pleading embodied in the Federal Rules of Civil and Bankruptcy Procedure. Therefore, the Court declined to find a general requirement in Rule 9011 that a plaintiff has to make a pre-filing investigation into possible affirmative defenses.
- The Court concluded that Rule 9011, and likewise Rule 11, places no pre-filing duty upon a plaintiff to conduct an inquiry into possible affirmative defenses, except in those unusual or extreme circumstances where such a defense is obvious and needs no discovery to establish.

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Court's Ruling

- In considering the facts and circumstances of the case at bar, the Court found nothing improper in the prefiling conduct of the Debtor or its counsel.
- The Court reasoned that the Bankruptcy Code clearly assigns the burden of proof in context of preference action. The Code placed upon the Debtor the burden of presenting its case that the transfers in question were preferential transfers, and Rule 9011 required that such an argument be well grounded in fact and law. There was no question that the Debtor did as much when it filed its complaint.
- Next, the Court held that, the Defendant carried the burden of establishing the ordinary course of business defense. It was not incumbent upon the Debtor to conduct a pre-filing investigation into this defense unless it was so obvious and needed no discovery to establish. Such unusual circumstances did not exist in this case.
- After objectively viewing all the facts and circumstances , the Court held that the Debtor 's complaint was sufficiently well grounded in law and infact in accordance with Rule 9011. The Debtor did enough to learn that it had a colorable preference action, one not defeated by obvious affirmative defenses

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Court's Ruling

- The Court held that the Debtor did not file its complaint for any improper purposes. The Court stated that seeking a settlement after filing a complaint is not sanctionable conduct in and of itself. In fact, such conduct is not at all unusual, since more often than not civil actions are settled before being presented to a court for judgment on the merits. The practice does become objectionable and sanctionable, however, when one party files an action that is objectively baseless and lacking in merit with the hope that the other party will settle to cut its litigation costs.
- In the case at bar, considering the objective facts and circumstances, the Court held that there was no improper conduct on the part of the Debtor even though it attempted to settle its claim with the Defendant prior to an adjudication on the merits because the Debtor's claim was not objectively baseless or lacking in merit.
- The Court denied the Debtor's motion for sanctions.

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Conclusion

- In order to ensure that a court pleading is well grounded in fact or law, Fed. R. Bankr. P. 9011(b) imposes upon an attorney a duty of reasonable inquiry before filing.
- There is no per se rule that courts can never impose sanctions for a party's failure to investigate affirmative defenses. Nevertheless, it seems clear that there is no obligation under Fed. R. Bankr. P. 9011 to factually inquire into any and all affirmative defenses a party might possibly assert after the filing of the complaint, particularly where the party asserting the defense carries the burden of proof.
- Fed. R. Bankr. P. 9011, and likewise Fed. R. Civ. P. 11, places no pre-filing duty upon a plaintiff to conduct an inquiry into possible affirmative defenses, except in those unusual or extreme circumstances where such a defense is obvious and needs no discovery to establish.

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Berger Indus. v. Artmark Prods. Corp. (In re Berger Indus.)

298 B.R. 37 (Bankr. E.D.N.Y. 2003)

(Eastern District of New York)

43

Facts

- Debtor Berger Industries, Inc. was a manufacturer of electric couplings and connectors, steel tubing and conduits.
- Defendant Artmark Products Corp. was an importer of industrial components which were used in the Debtor's manufacturing operations.
- The Debtor filed a complaint against the Defendant to recover about $177,631.36 as alleged preferential payments made during the ninety days preceding commencement of the Debtor's involuntary case.
- The preference action was long, bitter and hotly contested. It endured for close to 6 1/2 years. There was never any serious dispute as to the existence of the elements constituting preferential transfers contained in § 547(b). At issue throughout the litigation were certain affirmative defenses to preferential transfers contained in § 547(c).

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Facts

- The Defendant asserted that the challenged transfers were not avoidable on the grounds of the new value and/or ordinary course of business affirmative defenses.
- The parties made recurring efforts to settle the matter.
- The Defendant filed a pre-trial motion requesting sanctions for commencing the preference action, which motion was denied without prejudice, as premature.
- Acknowledging the new value defense, the Debtor reduced its claim for preferential payments to $ 55,029.37.
- The Court finally sustained the Defendant's ordinary course of business affirmative defense and dismissed the preference action.
- The adversary proceeding was closed.
- About four months later, relying upon Bankruptcy Rule 9011, the Defendant filed a motion for sanctions against the Debtor's counsel, Angel & Frankel, P.C., ("A&F") for commencing the preference action on behalf of the Debtor.

45

Issue

- Whether Defendant's motion for 9011 sanctions be granted by the Court ?
- Whether Bankruptcy Rule 9011(b) places a duty upon a plaintiff to make inquiry into possible affirmative defenses ?

46

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50

Arguments

- The Defendant contended that the imposition of sanctions upon the Debtor's counsel, A&F, was mandated because the complaint in the preference action was filed without any inquiry or investigation by the Debtor's counsel, regarding the validity of the Debtor's claims.
- Under Bankruptcy Rule 9011, A&F was required to consider the applicability of possible affirmative defenses to the Debtor's preference claim prior to commencing the suit against the Defendant and since A&F failed to investigate whether affirmative defenses were available to prevent recovery of what would otherwise constitute preferential transfers under § 547(b), the Defendant stands entitled to recover the costs and disbursements in the sum of $ 99,511.39.00 that it incurred in defending the preference action.

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Arguments

- The Defendant also argued that the affidavit submitted by the Debtor's director was perjurious and the purpose was to fabricate facts to rebut the Defendant's ordinary course defense.
- The Debtor and its counsel filed a cross-motion for sanctions, arguing that the Defendant embroidered its claims with scurrilous charges of criminality.
- The Debtor's counsel requested the court to impose monetary sanctions against the Defendant and direct the Defendant to file a written retraction reasonable acceptable to the Debtor and A&F of their charges of perjury, subornation of perjury, fabrication evidence and extortion.
- The Defendant thus sought sanctions pursuant to 28 U.S.C. § 1927, alleging that the Debtor vexatiously caused the preference action to be multiplied, in a misguided attempt to defeat the ordinary course of business defense.

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Court's Ruling

- The Court found that the Defendant failed to offer any evidentiary proof that A&F did not conduct an inquiry.
- The Court rejected the Defendant's argument that since the affirmative defenses to preference actions are contained in § 547(c), i.e., the statute itself, the pre-filing duty of inquiry or investigation by a plaintiff as to affirmative defenses is no different than that required for a prima facie case under § 547(b).
- The Court reasoned that requiring a plaintiff to anticipate affirmative defenses to avoid Bankruptcy Rule 9011 sanctions reorders traditional burdens of pleading and would, in effect, impermissibly change the requirement for a reasonable pre-filing inquiry into pre-filing discovery.

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Court's Ruling

- The Court relied upon the holdings in *Nolden v. Athearn, Chandler & Hoffman (In re W. Die Casting Co.) and Togut v. Sun Bank/Miami, N.A. (In re Concorde Nopal Agency, Inc.),* determined that the Bankruptcy Rule 9011 does not impose a burden on a plaintiff to conduct pre-filing discovery of an asserted defense. Bankruptcy Rule 9011 requires a plaintiff only to make a reasonable inquiry concerning the factual and legal basis for the plaintiff's own claim.
- The Court held that in the case at bar, the Debtor had no pre-litigation duty to conduct an inquiry into possible affirmative defenses that the Defendant could raise, except for obvious defenses that could be proven without discovery.

54

Court's Ruling

- Further, the Court added that the success of the Defendant's ordinary course of business defense was hardly obvious at the time the complaint was filed. A&F had information from its client, on which it was entitled to rely, which suggested that the payments made by the Debtor during the preference period were not made in the ordinary course. A&F could not have been expected to obtain more information prior to the commencement of action as all necessary facts are not available to plaintiff, when potential defense is factually complex.
- The Court agreed that although, the Debtor's director's affidavit did lack credibility and reliability, the absence of testimonial credibility and reliability must not be confused with perjury and subornation of perjury. Moreover, the Court highlighted that the director's statements were marked by a common thread which, absent proof to contrary, appeared to have been declared in good faith and therefore did not rise to the level of warranting sanctions under 28 U.S.C. § 1927

55

Court's Ruling

- Further, the Court held that the Defendant did not present any evidence whatsoever of perjury or subornation of perjury within the meaning of the federal criminal statute
- The Court admonished the Defendant and its counsel for their loose usage of such technical terms that have far reaching consequences.
- The Court rejected the Debtor's request for written retraction by the Defendant and its counsel because it will only invite more pointless litigation and incur a further waste of judicial time.
- The Court denied both the Defendant's sanctions motion and the cross motion filed by the Debtor and A&F.

56

Conclusion

- A debtor has no pre-litigation duty to conduct an inquiry into possible affirmative defenses that a defendant could raise, except for "obvious" defenses that could be proven without discovery.
- Sanctions are not appropriate in the cases where potential defenses are factually complex and not obvious to the plaintiff.
- The absence of testimonial credibility and reliability must not be confused with perjury and subornation of perjury.

57

Berman v. Bill Fields Trucking (In re HNRC Dissolution Co.),

330 B.R. 555 (Bankr. E.D. Ky. 2005)

(Kentucky)

58

Facts

- On October 1, 2004, Geoffrey L. Berman was appointed as a liquidating trustee for the Debtor HNRC Dissolution Co.
- On November 7, 2004, the Trustee filed its complaint to avoid and recover preferential transfers from the Defendant Bill Fields Trucking. The Trustee filed the preference actions after the statute of limitations had expired.
- On March 3, 2005, the summon service was executed
- On March 5, 2005, the Defendant filed its Answer to the Trustee's complaint.
- On May 10, 2005, the Trustee filed a motion to voluntarily dismiss adversary proceedings.
- On May 19, 2005, the Defendant filed a response to the motion to voluntarily dismiss the complaint.

59

Facts

- The Court granted the Trustee's motion to dismiss the complaint and the proceeding was closed on June 17, 2005.
- Subsequently, two months later, the Defendant filed its motion for sanctions pursuant to Bankruptcy Rule 9011.
- The Trustee responded to the Defendant's motion for sanctions.
- By the time the Defendant moved for sanctions, the Trustee's complaint had already been dismissed.

60

Issue :

- Whether the Trustee violated Bankruptcy Rule 9011(b) because he presented the complaint with an improper purpose to harass or cause unnecessary delay or needless increase in the cost of litigation.
- Whether the Defendant complied with 21-day safe harbor provision pursuant to FRBP 9011 (c)(1)(A)

61

F.R.B.P. 9011

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, :

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a non-frivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

62

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63

F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1)

(A) By Motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b).

64

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65

Arguments

- The Defendant filed Motion for sanctions and sought the imposition of costs, attorney fees, expenses, and any other relief deemed proper against the Trustee and its law firm for the signing and filing of a knowingly frivolous complaint, without obtaining any relevant documents or conducting a reasonable investigation or due diligence to determine the merits (or lack thereof) of the alleged causes of action.
- The Trustee argued that the Court should deny the Defendant's frivolous and baseless motion as the Trustee had duly complied with Rule 9011 requirements and did conduct a wide-spread pre-suit investigations before filing the suit.
- The Trustee next argued that the motion was untimely as a matter of law pursuant to Rule 9011(c) (1) (A) and established 6th Circuit precedent.

66

Court's Ruling

- The Court held that in the Sixth Circuit, a motion for sanctions cannot be filed or presented to the court without satisfying the 21-day safe harbor rule.
- In the case at bar, the Trustee's complaint had been dismissed by the time the Fed. R. Bankr. P. 9011 motion was filed. So, no 21-day safe harbor notice was given. The Court added that even if the Defendant would have given the notice, still no sanctions would have been imposed as the offending pleading had already been dismissed.
- The Court next stated that the standard in the Sixth Circuit for imposing sanctions is whether the individual attorney's conduct was reasonable under the circumstances.
- The Court held that the Trustee's attorney was operating in a restricted time frame in its efforts to investigate and timely file preference actions and he could not be charged with knowledge of the viability of each matter at its inception. It was in no better position to make such a determination without an opportunity to investigate than any law firm would have been.

67

Court's Ruling

- The Court noted several factors that should be applied to the determination of whether conduct is reasonable, including (1) the time available to the signor for investigation, (2) whether the signor had to rely on a client for information as to the facts underlying the pleading, motion or other paper, or (3) whether the pleading motion or other paper was based on a plausible view of the law.
- The Court denied the Defendant's Motion for Sanctions.

68

NEGT Energy Trading Holdings Corp. v. Orrick, Herrington & Sutcliffe LLP (In re Nat'l Energy & Gas Transmission, Inc.),

Nos. 03-30459PM, 03-30461PM, 03-30464PM, 03-30686PM, 03-30687PM, 03-30459PM), 05-09048PM, 2009 Bankr. LEXIS 1037 (U.S. Bankr. D. Md. Mar. 27, 2009)

(District of Maryland)

69

Facts

- Plaintiff Chapter 11 Debtor NEGT Energy Trading Holdings ("ET Holdings") brought an adversary proceeding against a Defendant law firm Orrick, Herrington & Sutcliffe LLP, to avoid and recover transfers worth $ 678,839.00 as preferences under 11 U.S.C.S. § § 547 and 550 of the Bankruptcy code.
- Orrick had been employed by and was a creditor of the parent company, PG&E Corporation.
- In reality, Orrick was paid by Power Services Company ("Power Services"), a non-debtor subsidiary of NEGT owned by PG&E Corporation, within 90 days of July 8, 2003, the date NEGT and other related debtors filed bankruptcy petitions.
- Orrick submitted to PG&E Corporation ten invoices for the legal services rendered. PG&E Corporation forwarded those invoices to ET Holdings, which approved them for payment and Power Services transmitted funds to Orrick accordingly . It later sought reimbursement of these funds from the Debtor. All these payments were made during the preference period.

70

Facts

- So, the alleged transfers at issue were the payments for the attorney's fees made to Orrick within 90-days of filing of the ET Holding's bankruptcy petition.
- The Court granted Orrick's motion for summary judgment on the Debtor's claims.
- Subsequently, Orrick filed a motion for sanctions, pursuant to F.R.B.P. 9011(b), against the Debtor and its counsels, Whiteford, Taylor & Preston LLP.

71

Issue

- Whether the conduct of the Plaintiff and its attorney sanctionable, pursuant to F.R.B.P. 9011?

72

F.R.B.P. 9011

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, :

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73

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74

Arguments

- The law firm argued that the sanctions should be imposed on the Debtor and its counsel, pursuant to F.R.B.P. 9011(b), 28 U.S.C. § 1927 and the inherent powers of this court. The Defendant reasoned that the Debtor chose to initiate a baseless action, possibly with the goal of forcing settlement resulting in a quick return.
- The Defendant further alleged that the Debtor and its attorney knowingly filed the action that was not warranted by existing law, made false statements of fact and failed to include relevant facts in the complaint and amended complaint.
- The Plaintiff argued that the sanctions motion filed by the Defendant against the Plaintiff and its counsel was without merit and should be denied. The Plaintiff contended that the pursuit of claims against the Defendant was legitimate, reasonably founded in law and was not interpreted for any improper purpose. The Plaintiff argued that the Defendant cannot meet its burden to establish that it was entitled to sanctions under Bankruptcy Rule 9011, so there was no basis for sanctioning Plaintiff under any applicable law.

75

Court's Ruling

- The Court determined that Power Services provided a bill paying service to the Debtor entities and was nothing more than an intercompany creditor performing its designated responsibilities.
- The Court further held that the record also reflected that the Debtor did not view the payments made to the law firm as originating from its estate and that the transfers did not dissipate its estate. The Debtor listed ownership of several bank accounts on its Schedule B, none of which showed that it had any control or interest in the non-debtor subsidiary's accounts.
- The Court held that §§ 547 and 548 were not applicable in the case and the Debtor launched this action against the law firm, concocting a very different scenario than that reflected in its records.

76

Court's Ruling

- The Court next ruled that the law firm was entitled to recover part of the costs it incurred to defend the Debtor's adversary proceeding because there was no legitimate basis for the Debtor's claim that money transferred to the law firm was a preferential transfer.
- The Court also found that the cases relied upon by the Debtor were not relevant to the facts of the case at bar. Thus, the Debtor and its counsel perpetuated the litigation by relying on those cases that they should have known were factually distinguishable.
- The Court ruled that the law firm incurred additional costs to defend the action because the Debtor and its counsel made false statements of fact, failed to include relevant facts in their complaint and their amended complaint, improperly and without justification shifted legal theories, and abused the rules on discovery.
- Although, the Court acknowledged the law firm's claim that it devoted several hundred thousand dollars of billable time to defending the action, the court declined to allow the law firm the same compensation as might be awarded a third party it represented.

77

Anderson & Assoc. PA v S. Textile Knitters De Hond. Sewing Inc. (In re S. Textile Knitters),

65 F App'x 426 [4th Cir 2003]

78

Facts

- Debtor was a manufacturer and seller of t-shirts.
- The Debtor was a closely held corporation with the sole ownership stake split between the company's president, Samuel Simchon, his father Levy Simchon, his mother Rebecca Simchon, and his brother Oded Simchon and Samuel's sister Hava.
- The Debtor was financially successful until its competitors moved offshore to take advantage of cheap labor. In order to strengthen its business, the Debtor attempted to subcontract some operations to a Mexican manufacturer.
- However, the attempt failed and the Debtor's shareholders decided to create a Honduran corporation which would sew cut parts into finished goods and Southern Textile Knitters de Honduras, Inc. (STKH) was formed.

79

Facts

- Samuel owned 99% of the shares and Levy owned the remaining 1%. Debtor paid all of STKH's operating costs and also shipped sewing equipment and inventory to STKH, retaining title to both.
- In return, STKH provided sewing services to Debtor at cost. STKH was contractually obliged to pay Debtor $ 3,000 per month for the sewing equipment, but that rent was never paid.
- The Debtor's financial situation continued to deteriorate. Samuel then formed Southern Textile Knitters of Greenwood, Inc. (STKG) with himself as sole shareholder. He transferred all the inventory he purchased from Debtor to STKG and used STKG as the vehicle to sell the purchased products to Debtor's existing customers.
- Despite these and a few other maneuvers, the Debtor was unable to reverse its financial position and creditors filed for involuntary bankruptcy petition against the Debtor.

80

Facts

- The Trustee brought an action against the Defendants – STKH, STGH, the president of the Debtor, members of the president's family, Old Fort and several corporations, for fraudulent misappropriation of cash and inventory.
- The Trustee sought following relief among others : (1) avoidance of preferential transfers under 11 U.S.C. § 547; (2) avoidance of fraudulent transfers under 11 U.S.C. § 548; (3) avoidance of post-petition transfers pursuant to 11 U.S.C. § 549.
- The bankruptcy court rejected the Trustee's major substantive claims and held in favor of Trustee on certain minor counts.
- The bankruptcy court sanctioned the Trustee's counsel $1,000 for failing to withdraw the Trustee's claim against Old Fort. The bankruptcy court also fined the Trustee's counsel $ 750 for pursuing claims that required insolvency before July 31, 1998 as a necessary element.
- The district court upheld the bankruptcy court's decision.
- The Trustee appealed.

81

Issue

- Whether the sanctions imposed by the bankruptcy court on the Trustee's counsel pursuant to Fed. R. Bankr. P. 9011(b)(3) proper ?

82

F.R.B.P. 9011

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, :

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83

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(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

84

Arguments

- The Trustee argued that the Defendants had fraudulently misappropriated large sums of cash and inventory from the Debtor while they were in control of its activities.
- The Trustee argued the claims against the Defendants under several causes of action involving fraud or unfairness, including breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, and fraudulent transfer under S.C. Code § 27-23-10 and 11 U.S.C. § 548(a)(1)(A).
- The Trustee contentions of fraud and unfair dealing center on his characterization of a series of transactions between Debtor, Samuel, STKG, and STKH as fraudulent or bad-faith transfers from Debtor to insiders. The Trustee pointed specifically to the transfer of inventory and operating funds to STKH, the sale to Samuel and STKG of inventory from the Debtor's warehouses, and the payment of a salary and stock bonus to Samuel.
- The Trustee contended that these transfers must be avoided as fraudulent pursuant to § 548(a)(1)(A). He alleged that the fraudulent nature of these transfers justified piercing the corporate veil so that creditors could pursue their claims directly against the individual Defendants.

85

Court's Ruling

- The bankruptcy court held that the key decisions challenged by the Trustee were made by the Defendants as part of a bona fide effort to save the Debtor in the face of rapidly changing market conditions. The bankruptcy court's finding was based on a careful, extensive, credibility-based review of testimony and evidence presented by the parties.
- The Fourth Circuit agreed and held that there was no clear error in this finding and therefore affirmed the trial court's rejection of the fraudulent transfer and breach of fiduciary duty charges, as well as its refusal to pierce the corporate veil.
- The Court next found that the Debtor temporarily transferred inventory to STKH for assembly into salable finished goods and sent equipment and cash to STKH to cover the local costs of that assembly. The Court held that this was simple and straightforward production outsourcing; as the bankruptcy court noted, "the transfer of inventory and operating funds to STKH appears to be a result of the Debtor's attempt to move its sewing operation off-shore to reduce its costs" and stay competitive with other t-shirt manufacturers. The Fourth Circuit held that it was not clearly erroneous for the bankruptcy court to hold that these transactions were proper.

86

Court's Ruling

- The Fourth Circuit thus held that the bankruptcy court did not commit clear error in holding that the sale of inventory to Samuel and STKG was a stopgap effort to generate cash to keep the company afloat.
- The Court reasoned that the facts and findings like "the transfer of inventory to [Samuel] and STKG [was] an attempt [to] pay down SouthTrust's loan . . . and to aid Debtor during its financial downturn,"….that "STKG ultimately purchased the inventory and sold it to third parties at no profit."…..And like STKH, STKG also "lost considerable amounts of money during its short existence" were sufficient to justify the bankruptcy court's conclusion that the inventory sales were not improper.
- Next, the bankruptcy court had sanctioned the Trustee's counsel for its failure to withdraw Trustee's claims against Old Fort under 11 U.S.C. § 547, 11 U.S.C. § 548, and S.C. Code § 27-23-10. The sanctions were based on the court's holding that Rule 9011 of the Federal Rules of Bankruptcy Procedure requires affirmative, formal withdrawal of any claims which, though proper when made, later turn out to have no evidentiary basis.

87

Court's Ruling

- The Fourth Circuit here disagreed with the bankruptcy court and held that the sanctions were improper because Fed. R. Bankr. P. 9011(b)(3) did not require withdrawal of claims that were not initially frivolous. The Court found that the sanctions were levied by the bankruptcy court because the trustee "failed to withdraw the allegations despite a knowledge of a lack of evidentiary support."
- The Fourth Circuit pointed out that imposition of sanctions hinges on the theory that Rule 9011 requires litigants to formally withdraw claims which were proper when made, but turn out during the course of litigation to have an insufficient evidentiary basis. However, the Fourth Circuit highlighted that "Presenting to the court" is carefully defined in the rule; it includes "signing, filing, submitting, or later advocating" a meritless position. It does not include failing to formally withdraw a meritless position.

88

Court's Ruling

- The bankruptcy court also sanctioned the Trustee's counsel for its pursuit of claims against Samuel for preferential transfer under § 547 and fraudulent transfer under § 548(a)(1)(B). Specifically, it sanctioned Trustee's decision to pursue those claims despite the fact that a necessary element of each was the Debtor's insolvency at the time of the challenged transfers. The trial court based this ruling on two findings: first, that Trustee's counsel knew and conceded that Debtor had been solvent at least through July 31, 1998; second, that the challenged transfers all took place before that date.
- The Fourth Circuit rejected this finding too and found that the parties reported that there was no dispute as to the fact that the transfer of the salary and stock to [Samuel] took place while Debtor was still solvent. So, the Fourth Circuit held that since the sole basis for these sanctions was the erroneous conclusion that the Trustee's counsel knew (or should have known) and conceded that the Debtor was solvent prior to July 31, 1998, it reversed the bankruptcy court's order and dismissed the Defendants' motion for sanctions.

89

Conclusion

- The bankruptcy court erroneously imposed sanctions on the Trustee's attorney for failing to withdraw its claim.
- The sanctions were improper because Fed. R. Bankr. P. 9011(b)(3) did not require withdrawal of claims that were not initially frivolous.
- It is an abuse of discretion for a trial court to base its ruling on an erroneous view of the law or on a clearly erroneous assessment of the evidence.

90

Aphton Corp. v. Sonafi Pasteur (In re Aphton Corp.),
423 B.R. 76 (Bankr. D. Del. 2010)

91

Facts

- Debtor Aphton Corporation is a biopharmaceutical company that researches, develops, and commercializes pharmaceutical products for the treatment of cancer and gastrointestinal disease.
- Defendants Aventis Pharmaceuticals and SP are in the business of research, development and production of pharmaceuticals.
- The Debtor filed a voluntary petition under Chapter 11 of the Bankruptcy Code in May, 2006.
- The Trustee brought an adversary proceeding to avoid the transfers that Debtor had made prepetition, in connection with its redemption of a debenture sold to Aventis that had joined with Debtor in co-promoting a new drug to fight cancer and through payment to its former noteholders.

92

Facts

- Counts I through III of the Complaint set forth constructive fraudulent conveyance claims against Aventis. Counts V through VII set forth constructive fraudulent conveyance claims against the former noteholders.
- Counts I and V of the Complaint filed by the Trustee asserted that the Trustee was a lien creditor pursuant to § 544(b) of the Bankruptcy Code and that the $3 million transferred to a pharmaceutical company by the Debtors to jointly promote a new drug and the $3 million transferred to the Debtors former noteholders were each fraudulent transfers under the "Pennsylvania and/or Delaware Uniform Fraudulent Transfer Act.
- The Defendants moved to dismiss the complaint.

93

Rule 9. Pleading Special Matters

(a) Capacity or Authority to Sue; Legal Existence.

(1) In General. Except when required to show that the court has jurisdiction, a pleading need not allege:

(A) a party's capacity to sue or be sued;

(B) a party's authority to sue or be sued in a representative capacity; or

(C) the legal existence of an organized association of persons that is made a party.

(2) Raising Those Issues. To raise any of those issues, a party must do so by a specific denial, which must state any supporting facts that are peculiarly within the party's knowledge.

(b) Fraud or Mistake; Conditions of Mind. In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally.

94

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95

Rule 9011

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(1) *How Initiated.*

(A) *By Motion.* A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b). If warranted, the court may award to the party prevailing on the motion the reasonable expenses and attorney's fees incurred in presenting or opposing the motion. Absent exceptional circumstances, a law firm shall be held jointly responsible for violations committed by its partners, associates, and employees.

(B) *On Court's Initiative.* On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

96

Rule 9011

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(B) *On Court's Initiative.* On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

97

Issue :

- Whether the Complaint should be dismissed for failure to state an adequate claim for relief under Fed. R. Civ. P. 9(b)
- Whether the Former Noteholders' motion for sanctions pursuant to Bankruptcy Rule 9011 be granted

98

Arguments

- The Former Noteholders and Aventis sought to dismiss the Complaint, alleging that the Complaint failed to state a claim upon which relief can be granted.
- The Former Noteholders also filed a motion for sanctions pursuant to Federal Rule of Bankruptcy Procedure 9011. They argued that legal research would have revealed that the alleged payment was not recoverable under sections 544, 548, or 550 of the Bankruptcy Code, both because it was a payment for antecedent debt and because it was a "settlement payment" under section 546(e). Still, the Trustee's counsel took no action to voluntarily dismiss the Complaint or to remedy its infirmities.
- The Trustee argued that the alleged transfers from the Debtor to the Former Noteholders and Aventis were avoidable pursuant to Sections 544 and 548 of the Bankruptcy Code as they were made within two years of the petition date; (ii) the Debtor received less than reasonably equivalent value for the transfer; and (iii) the transfers occurred at a time when the Debtor was insolvent.

99

<u>Court's Ruling</u>

- The Court found that the facts in the Complaint were not pled with sufficient particularity to satisfy Rule 9(b)
- Counts I and V of the Complaint merely plead that the Trustee was a lien creditor pursuant to § 544 of the Bankruptcy Code and asserted that the $3 million transfer to Aventis and the Former Noteholders, respectively, violated the Pennsylvania and/or Delaware Uniform Fraudulent Transfer Act. The Court stated that the Trustee did not recite the elements of the Pennsylvania and/or Delaware Uniform Fraudulent Transfer Act, nor did he allege the specific facts that met those elements.
- The Court stated that these counts were just "blanket assertions" and did not state the ground on which these claims rest.

100

<u>Court's Ruling</u>

- The Court further concluded that Counts II and VI were plead with allegations of "date, place or time" and therefore fulfilled the function of Rule 9(b) by placing the defendants on notice of the misconduct with which they were charged.
- The Complaint identified the alleged constructively fraudulent transfers by date and face amount. Since, the Complaint described the circumstances surrounding the transfers and alleged that the Debtor was insolvent at the time of both transfers, the Court found that Counts II and VI of the Complaint complied with Rule 9(b).
- The Court further concluded that while the Trustee properly showed that the Debtor was insolvent at the time the collaboration agreement was terminated, the Trustee failed to allege when the redemption payment was made, how the termination and redemption transactions were related, and which transaction involved less than reasonably equivalent value.

101

<u>Court's Ruling</u>

- Based on the analysis, the Court granted Aventis's motion to dismiss and dismissed Counts I, II, III of the Complaint. The Court also granted in part the Former Noteholders' motion to dismiss as to Count V of the Complaint and denied in part as to Counts VI and VII of the Complaint.
- The Court further determined that the standard for imposing sanctions under Rule 11 is stringent because such sanctions are in "derogation of the general American policy of encouraging resort to the courts for peaceful resolution of disputes,“ and tend to "spawn satellite litigation counter-productive to efficient disposition of cases,"
- The Court ruled that the Complaint sets out facially plausible causes of action against the Former Noteholders and there was no evidence that the Trustee's counsel's claims were "frivolous, legally unreasonable, . . . without factual foundation," or that the firm intended to abuse the bankruptcy system by filing the original Complaint. Therefore, the Court denied the Former Noteholders' motion for sanctions.

102

Visteon Corporation v. Global Asset Protection Services, LLC
(In re Visteon Corporation),

Adv. Proc. No. 11-52070 (Bankr. Del. July 21, 2011)

(Delaware)

103

Facts

- Debtor Visteon Corporation entered into certain purchase orders and supply agreements with Defendant Global Asset Protection, LLC (GAPS).
- Pursuant to an agreement between the Debtor and the Defendant, the Defendant provided and delivered certain goods and/or services to the Debtor.
- On May 28, 2009, the Debtor and its affiliates filed for bankruptcy.
- Subsequently, the Plaintiff brought an adversary proceeding against the Defendant to recover alleged transfers worth $149,000.00, which the Debtor previously made to the Defendant during the ninety day period prior to the petition date, as preferential transfers.

104

Facts

- The Plaintiff's complaint neither provided sufficient description of alleged preferential transfers or the alleged underlying antecedent debt nor did it mention the nature of relationship between the Debtor and GAPS, the prepetition payment by the Debtor to GAPS, or the services provided by GAPS to the Debtor.

105

Issue

- Whether the Plaintiff's complaint be dismissed in its entirety, with prejudice and without leave to amend and Visteon and its counsel be required to pay GAPS attorney's fees and expenses ?

106

F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1)

(A) By Motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b).

B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

107

F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

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B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

108

Arguments

- The Plaintiff asserted claims against GAPS for recovery of preferential and fraudulent transfers pursuant to Sec. 547 and Sec. 548 of the Bankruptcy Code.
- GAPS asserted that the Plaintiff's complaint failed to allege sufficient facts to establish a plausible basis for any of its claims and hence should be dismissed.
- GAPS further alleged that the nearly complete absence of factual basis for the claims asserted in the complaint not only mandates dismissal of the complaint, but demonstrates the complete and utter lack of any pre-filing investigation by the Plaintiff or its counsel, as required by the Civil Rule 11 and Bankruptcy Rule 9011.

109

Arguments

- GAPS further stressed that the failure of the Plaintiff's counsel to conduct a reasonable pre-filing investigation was obvious from the face of the complaint. GAPS reasoned that since the plaintiff was the reorganized debtor and not a Chapter 7 trustee, the ignorance of background facts simply cannot be excused. Further, the Plaintiff neither responded to the Defendant's detailed email describing GAPS defenses nor considered it, instead continued with his "threadbare allegations".
- GAPS contended that therefore, the complaint should be dismissed in entirety with prejudice and without leave to amend and the Plaintiff's counsel should be required to pay GAPS's attorney's fees and expenses and sanctions be imposed pursuant to Rule 9011

110

Court's Ruling

- Judge Christopher S. Sontchi partially agreed with the Defendant and imposed sanctions against the Plaintiff's counsel for the "filing of a grossly deficient" complaint pursuant to Rule 9011 (c)(1)(B) seeking recovery of preferential transfers under Section 547 and constructively fraudulent transfers under Section 548(a)(1)(B).
- However, at the same time, Judge Sontchi also denied the Defendant's motion to dismiss and granted leave to the Plaintiff to file the amended complaint.
- The Court awarded the Defendant and directed the Plaintiff's counsel to pay all of the Defendant's attorneys fees and costs incurred in connection with the motion.
- The Court held that the above fees/costs shall be paid within 14 days of receipt of invoice from the GAPS.

111

Conclusion

- A Delaware court imposed sanctions on a plaintiff, where the plaintiff had filed a grossly deficient complaint . The Court concluded that the plaintiff was a reorganized debtor and not a Chapter 7 trustee, had all books and records available and still failed to address or respond to the Defendant counsel's efforts to resolve the issue through informal dialogue.

112

In re Flashcom, Inc. v Communs Ventures III, LP (In re Flashcom, Inc.

503 BR 99 [CD Cal 2013]

113

Facts

- Debtor Flashcom was an internet service provider, founded by Andra Sachs and Brad Sachs, involved in reselling DSL (digital subscriber line) service to consumers and business users.
- Defendants were the VC Funds and they had appointed certain partners to Flashcom's Board of Directors - ComVentures appointed David Helfrich and Mayfield appointed Todd Brooks and Kevin Fong.
- Flashcom's Board comprised of five directors, i.e., the three directors Defendants plus Andra and Brad .
- The director Defendants had concerned about Andra's management style and wanted to remover her form the board of directors.
- Andra refused to voluntarily remove herself from management absent a substantial payment.

114

Facts

- To end Andra's day-to-day involvement in Flashcom, Andra and the VC Funds executed a loan and pledge agreement, wherein the VC Funds would pay Andra $1,000,000.The parties also agreed on many other terms in the event Flashcom completed a Series B "Qualified Financing" by obtaining at least $30 million with venture capital and other institutional investors . In exchange, Andra would withdraw from Flashcom's operations.
- To implement the Series B financing and to provide Flashcom with short-term working capital and to sustain its operations prior to the Series B financing, the VC Funds made a series of bridge loans to Flashcom, totaling approximately $9,000,000.
- By December 1999, Andra had threatened litigation against Flashcom, the VC Funds, the director Defendants, Brad, and other representatives of Flashcom's Board and management.

115

Facts

- Flashcom's Board and management were concerned that any threatened or actual litigation by Andra, irrespective of its merits, would prevent or impair the completion of the Series B financing.
- Subsequently, the VC Funds, Andra, and Flashcom executed a stock purchase agreement, pursuant to which, Andra agreed to sell some of her common stock to the VC Funds in exchange for $1,000,000, and the sale was deemed accomplished by the payment already made by the VC Funds in connection with the loan and pledge agreement. Flashcom also agreed to repurchase some of Andra's common stock for $9,000,000 under the stock purchase agreement, conditioned on satisfaction of the Financing Condition for the Series B offering.
- Concurrently with this agreement, Flashcom, the director defendants, the VC Funds, and Andra executed a settlement agreement and release . In exchange for the $9,000,000 payment to Andra provided for in the stock purchase agreement, Andra agreed to release all claims against Flashcom, Brad, and the Defendants.

116

Facts

- The Financing Condition got satisfied. The Series B offering had originally contemplated raising only $40 million, but it was oversubscribed due to interest in Flashcom and instead raised $84 million.
- Flashcom decided to close the offering at $84 million to prevent dilution in advance of an anticipated initial public offering.
- Flashcom repurchased Andra's stock and paid her $9,000,000 through a wire transfer.
- Flashcom met with several investment banks about its anticipated IPO, but by the time Flashcom filed a SEC Form S-1 registration statement with the Securities and Exchange Commission, the market in the telecom industry had changed dramatically.

117

Facts

- The downturn in the economy made it difficult to obtain the additional financing, and Flashcom was forced to file for bankruptcy on December 8, 2000.
- The Trustee filed suit on July 19, 2002, asserting various claims against Andra, Brad, and the Defendants.
- The Trustee moved for partial summary judgment to recover $9 million from the Defendants under the theory that Flashcom's payment to Andra for her common stock, or agreement to make that payment, was a fraudulent transfer pursuant to 11 U.S.C. § 548 and that the payment was a "preference" under § 547
- On July 28, 2004, the bankruptcy court granted the motion as to the fraudulent transfer claims under 11 U.S.C. § 548 and Cal. Civ. Code § 3439.04(a), and claims for breach of fiduciary duty, negligence, and corporate waste under Delaware law

118

Facts

- Thereafter in September 2005, the Trustee entered into a settlement agreement with Andra and Brad.
- The settlement agreement provided that without admitting any liability, and in furtherance of this settlement, Andra shall consent to entry of a judgment for the avoidance of preferential transfers in the principal amount of $9,000,000 under 11 U.S.C. 547(b). In exchange, the Trustee would recover either $50,000 or $62,500 from Andra, depending on whether the Trustee recovered more than $2,000,000 from the Defendants within 36 months of the settlement's approval.
- After notice and a hearing, the bankruptcy court approved the settlement agreement and entered the stipulated judgment , which provided that Flashcom's transfer of $9,000,000, "which was a transfer made for the benefit of Andra Sachs, is avoided as a preferential transfer pursuant to 11 U.S.C. § 547(b)."

119

Facts

- The Trustee moved for partial judgment, alleging that based on the stipulated judgment, avoidability of the transfer as a preferential transfer under 11 U.S.C. § 547(b) was already established, and since the Defendants were persons for whose benefit the transfer was made under 11 U.S.C. § 550, the bankruptcy court should enter an order for the recovery of the $9,000,000 transfer from the Defendants.
- The bankruptcy court denied the Trustee's motion, holding that the entry of the stipulated judgment did not avoid the transfer and that the Defendants had a Fifth Amendment due process right to defend the claims against them before they could be deprived of their property.
- The Trustee sought reconsideration of bankruptcy court’s above order which was denied.

120

Facts

- The Trustee also requested leave to file an interlocutory appeal to the court, which was also denied, noting that there was "no substantial ground for a difference of opinion that warrants granting an interlocutory appeal .
- The Trustee further sought reconsideration of the court's denial of leave to prosecute an interlocutory appeal, which was also denied.
- Prior to trial, the Trustee filed a motion in limine to preclude Defendants from introducing evidence concerning the avoidability of the $9,000,000 transfer and requesting that the court enter judgment against the Defendants.
- On October 9, 2008, the Defendants filed a motion for sanctions pursuant to Federal Rule of Bankruptcy Procedure 9011.

121

Facts

- The bankruptcy court deferred ruling on both the motion in limine and the motion for sanctions until after the conclusion of the trial.
- Thereafter, the Defendants filed a supplemental brief requesting sanctions in the amount of $97,047 ($35,183 incurred in connection with the motion in limine and $61,864 incurred in connection with the motion for sanctions).
- On October 22, 2012, the bankruptcy court issued an order granting the Defendants' motion and imposing sanctions of $60,000 on the Trustee and her counsel, jointly and severally.
- The bankruptcy court granted the Defendants summary judgment on the Trustee's constructive fraudulent transfer claim under 11 U.S.C.S. 548(a)(1)(B)(i) because the Debtor received reasonably equivalent value for the transferred property.

122

Issue

- Whether the bankruptcy court properly granted the Defendants summary judgment on the Trustee's constructive fraudulent transfer claim under 11 U.S.C.S. § 548(a)(1)(B)(i) ?
- Whether the sanctions imposed by the bankruptcy court on the trustee, her counsel, and his firm under Fed. R. Bankr. P. 9011 for filing a motion in limine justified ?

123

F.R.B.P. 9011

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, :

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a non-frivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

124

F.R.B.P. 9011

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(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

125

F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1)

(A) By Motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b).

B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

126

F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

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B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

127

Arguments

- The Trustee filed a motion in limine to preclude appellees from introducing evidence concerning the avoidability of the $9,000,000 transfer and requesting that the court enter judgment against the Defendants.
- The Defendants filed a motion for sanctions pursuant to Federal Rule of Bankruptcy Procedure 9011, arguing that the motion in limine constituted an improper fifth attempt to re-litigate the court's decision that the stipulated judgment did not preclude appellees from contesting the avoidability of the transfer.
- The Trustee appealed the bankruptcy court's judgment on fraudulent transfer count and also against the sanctions imposed on her attorney and her personally for violation of Federal Rule of Bankruptcy Procedure 9011

128

Ninth Circuit Ruling

Fraudulent Transfer

- On the fraudulent transfer, the Ninth Circuit affirmed the bankruptcy court's ruling and held that the court's finding was not illogical, implausible, or without support in the record and therefore was not clearly erroneous.
- The Ninth Circuit held that the bankruptcy court rightfully found that Flashcom received reasonably equivalent value for the $9,000,000 transfer because, there was no negative "net effect" on Flashcom's estate.
- The Court stipulated that in the case at bar,, the Trustee focused on Flashcom's redemption of Andra's stock in exchange for the $9,000,000 payment in isolation, arguing that a corporation received nothing of value when it redeems a shareholder's stock. However, the Court added that when reviewing the net effect of a transaction, we must consider the entire context in which the transaction took place, including other related transactions.

129

Ninth Circuit Ruling

Fraudulent Transfer

- The appellate court stipulated that Flashcom's repurchase of Andra's shares must be analyzed along with the Series B offering, the net effect of which was positive. Flashcom received the benefit of a net gain of $75 million of new financing (after the $9,000,000 transfer) and a release of all of Andra's claims against Flashcom. While Flashcom may have transferred $9,000,000 from its account to Andra's account, it was never really Flashcom's money; it was the investors' money.
- The Court added that the method of payment of the $9,000,000 from the investors to Andra made no difference to Flashcom or its assets. Flashcom issued $9,000,000 more in Series B shares than it had originally planned, but it received $9,000,000 of Andra's common stock shares, so again, the net effect is the same. Under the original "unit purchase" plan, the investors would have held Andra's common stock, so it is not as though Flashcom would have otherwise been entitled to Andra's stock in exchange for nothing.
- So, the Ninth Circuit agreed with the bankruptcy court's conclusion that Flashcom received reasonably equivalent value for the transfers.

130

Ninth Circuit Ruling

9011 Sanctions

- The Ninth Circuit ruled that the bankruptcy court appropriately sanctioned the Trustee Dye, her counsel, David Weinstein, and his firm for bringing a motion in limine, thereby preventing the Defendants from contesting § 547(b) because of the stipulated judgment. The Court added the Trustee's theory had already been rejected four times. At pretrial conference, the court warned that the Trustee can bring whatever motion they want [on this question]. . . . And if Rule 11 sanctions are appropriate, then they may be imposed."
- Inspite of above, the Trustee and her counsel pushed on, and brought in the motion in limine. The Ninth Circuit ruled that the motion frivolously sought relief that was contrary to law of the case, without citing a change in the law or the facts, and that the motion was brought with an improper purpose.

131

Ninth Circuit Ruling

9011 Sanctions

- The Court further ruled the sanctions imposed on the Trustee and her counsel by the bankruptcy court was not an abuse of its discretion.
- The Ninth Circuit determined that although it was not improper for the Trustee and her counsel to seek reconsideration of the ruling or to seek interlocutory appeal and reconsideration of the denial thereof, as they did, but trying to litigate the issue again without a change in the law or facts was frivolous.
- Next, the Ninth Circuit agreed with the bankruptcy court that there was an intent to injure the Defendants because the Trustee and her counsel knew that their filing would force the Defendants to defend, yet again, their right to litigate the § 547 question. Thus, in light of this, the bankruptcy court's conclusion regarding the Trustee and her counsel's intent to injure was not illogical, implausible, or without support in the record.

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Ninth Circuit Ruling

9011 Sanctions

- The Ninth Circuit further held that the bankruptcy court's decision to award $60,000 was not an abuse of discretion and was sufficient to deter repetition of such vexatious litigation by the Trustee and her counsel and "others similarly situated.
- The Court held that the Defendants had reasonably expended $97,000 responding to the motion in limine and bringing sanctions and Rule 9011 specifically authorizes the award of fees for bringing sanctions pursuant to Fed. R. Bankr. P. 9011(c)(1)(A).

133

Conclusion

- The sanctions imposed on the Trustee and her counsels under Fed. R. Bankr. P. 9011 were appropriate, as their motion in limine was frivolous in that they knew or should have known that it was barred by the law of the case, and their attempt to re-litigate the issue while the Defendants were supposed to be preparing for trial was evidence of an improper purpose.
- With respect to a trustee's constructive fraudulent transfer claim, a debtor receives reasonably equivalent value if there is no negative net effect on the estate. The court examines the net effect of an integrated transaction as a whole and does not formalistically look at only some part of it
- The purpose of Fed. R. Bankr. P. 9011, which is to deter bad conduct rather than compensate the injured party. A sanction shall be limited to what is sufficient to deter repetition of such conduct or comparable conduct by others similarly situated. Fed. R. Bankr. P. 9011(c)(2).

134

Heritage Realty Assocs. Corp. v. First Citizen's Bank (In re Heritage Realty Assocs. Corp.)

Nos. 15-41859-cec, 15-01183-cec, 2016 Bankr. LEXIS 2192 (U.S. Bankr. E.D.N.Y. June 2, 2016)

(Eastern District of New York)

135

Facts

- On April 24, 2015, Heritage commenced its bankruptcy case.
- The bankruptcy case primarily concerned a dispute between Heritage and its only major creditor, FCB.
- Debtor Heritage Realty Associates Corp. ("Heritage") brought an adversary proceeding against First Citizen's Bank ("FCB") and few other entities (" Defendants") to avoid a transfer of real property, which was allegedly fraudulently transferred for the benefit of FCB.

136

Facts

- Heritage borrowed $1,625,000.00 from Temecula Valley Bank to buy real property located at Tuckerton, renovate that property, purchase inventory, purchase equipment, pay the SBA guaranty fee and fund soft costs and reserves.

137

Facts

- The mortgages for the Tuckerton Property, the Staten Island Property and the Little Egg Harbor Property were assigned to FCB.
- Heritage defaulted on its obligations under the loan, and FCB sent Heritage a notice of default .

138

Facts

- FCB informed Heritage that before FCB would consider any settlement, the Tuckerton Property and associated personal property collateral would have to be liquidated.
- FCB suggested that Heritage convey the Tuckerton Property to FCB through a deed in lieu of foreclosure, but Heritage opted instead to sell the Tuckerton Property to a third party for $500,000.
- After the closing on the Tuckerton Property, FCB received the proceeds of the sale and recorded a release of the mortgage on the Tuckerton Property.
- The Complaint alleged among other that the sale of the Tuckerton Property was a preference transfer pursuant to § 547 and a fraudulent transfer pursuant to 11 U.S.C. § 548(a)(1)(B)

139

Facts

- Although the Debtor's complaint was never served, FCB served the sanctions motion pursuant to Fed. R. Bankr. P. 9011 on Heritage, through counsel, on November 4, 2015.
- On December 11, 2015, FCB filed a motion to dismiss the complaint
- On January 12, 2016, the Plaintiffs filed a notice of voluntary dismissal more than 21 days later.
- In response, FCB filed a motion to vacate the voluntary dismissal on January 19, 2016, contending that the dismissal should be with prejudice
- Subsequently, FCB moved for sanctions pursuant to Fed. R. Bankr. P. 9011, requesting $25,012.49 in fees incurred defending against the claims made in the complaint and another $2,722.50 in expenses accrued in connection with the defense.

140

Issue :

Whether monetary sanctions be warranted against the Debtor's counsel for violations of Bankruptcy Rule 9011(b) in signing the complaint in this adversary proceeding ?

141

F.R.B.P. 9011

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, :

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
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142

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143

F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1)

(A) By Motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b).

B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

144

F.R.B.P. 9011

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B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

145

Arguments

- FCB's sanctions motion stated that the claims asserted in the complaint were baseless and that Heritage and its counsel knew or should have known that at the time the complaint was filed.
- FCB alleged that the Complaint was not withdrawn during the 21 day safe harbor provided by Bankruptcy Rule 9011
- Heritage objects to the sanctions motion because, although the Complaint was not dismissed until after the expiration of the safe harbor period provided under Fed. R. Bankr P. 9011(c), the Complaint was never served.
- Heritage argued that the FCB's counsel was notified that the complaint would be amended before service; and that Heritage's objective had been to resolve the underlying obligation with the least cost possible to the Debtor and its estate.
- Heritage also argued that the complaint was certified in good faith based upon evidence gathered and was not in violation of Rule 11 or Rule 9011.

146

Court's Ruling

- The Court found that the Paragraph 111 of the complaint alleged fraudulent transfer as a preference. The Court concluded that the sale of the Tuckerton Property resulted in payment to FCB of proceeds of its collateral, which collateral was acquired outside the 90 day preference period.
- The Court held that this was not a preferential transfer under § 547 because a transfer to a fully secured creditor is immunized from preference attack because the creditor would have been paid in full in a hypothetical Chapter 7 liquidation by virtue of its realization on its collateral.

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Court's Ruling

- The Court also rejected the Heritage's next claim that the sale of the Tuckerton Property was a fraudulent transfer pursuant to 11 U.S.C. § 548(a)(1)(B). The Court found that Heritage's contention did not match the facts of the case as alleged in its complaint. Heritage did not transfer the Tuckerton Property to FCB, but sold it to a third party, which resulted in the fair market value purchase.
- The Court held that these facts failed to state a claim that the sale of the Tuckerton Property was for less than reasonably equivalent value. In any event, FCB was not the transferee of the Tuckerton Property; FCB merely received the proceeds of the sale, as it was entitled to.

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Court's Ruling

- The Court next held that although the complaint violated Fed. R. Bankr. P. 9011(b)(2), the court had the discretion to determine whether to impose a sanction and to determine the amount of any sanction; the purpose of a sanction under Rule 9011 was to deter repetition of such conduct or comparable conduct by others similarly situated.
- In light of aforesaid, the Court added that in the case at bar, a sanction in the amount of reasonable attorney's fees incurred by FCB as a result of the filing of the complaint, would accomplish that goal.
- The Court found that FCB had provided time records to show the fees it incurred in seeking dismissal of the complaint and Heritage had not filed any objection to FCB's time records.

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Court's Ruling

- Although, the Court acknowledged that the pleading was not withdrawn in the 21-day window provided by Bankruptcy Rule 9011, but then the Court also stated that the complaint was voluntarily dismissed too; none of the claims in the complaint were prosecuted.
- The Court held that had the complaint been withdrawn in the safe harbor period provided by Rule 9011(c) (1)(A), FCB would still have presumably sought a dismissal with prejudice, and would not have been entitled to costs for that dismissal. Under these facts, the Court held that the time spent drafting a motion to dismiss the complaint, and then to have the voluntary dismissal vacated, was not appropriately awarded as a deterrent to the type of conduct engaged in by the Debtor's counsel.
- The Court awarded sanctions against the Debtor's attorney in the amount of $4,744 in attorneys' fees and $2,722.50 in expenses, which constituted approximately 79 percent of the retainer received by the Debtor's counsel in this case.

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Court's Ruling

- The Court ordered that FCB was entitled to fees in the amount of $4,744.00, which represented the fees incurred in drafting the Sanctions motion and for appearing at the hearings on matters relating to the complaint.
- The Court also held that FCB was entitled to expenses in the amount of $2,722.50. These expenses were incurred by FCB's attorneys, who were required to hire special counsel pursuant to their malpractice insurance, to defend them against allegations made in the complaint.
- The Court declined to award legal fees for drafting the motion to dismiss the complaint or the motion to vacate a voluntary dismissal. The Court reasoned that FCB spent more than a reasonable number of hours moving to dismiss complaint. Although the complaint clearly violated Bankruptcy Rule 9011(b), the complaint was never served, and therefore, no response was ever required.

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Conclusion

- Where the claims asserted in a debtor's complaint meet the standard of "objective unreasonableness", the Court concluded that the purpose of Fed. R. Bankr. P. 9011 sanction was to deter repetition of such conduct or comparable conduct by others similarly situated. The Court accomplished this by sanctioning the amount of reasonable attorney's fees at its discretion, incurred by the Defendant as a result of the filing of complaint.

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Lanik v. Smith (In re Cox Motor Express of Greensboro, Inc.),

Nos. 14-10468, 15-02023, 2017 Bankr. LEXIS 233 (U.S. Bankr. M.D.N.C. Jan. 27, 2017)

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Facts

- Debtor, Cox Motor Express of Greensboro, Inc., was a trucking company.
- Defendant James W. Smith Jr., was the president of the Debtor on the petition date and executed the Debtor's bankruptcy petition and schedules under penalty of perjury in his capacity as the President.
- Prior to, and including, the one year period prior to the Petition Date the Defendant made loans to the Debtor totaling $194,200.00.
- During the Preference Period, the Debtor paid the Defendant $176,600 for the purposes of paying down the balance due and owing upon the Loans.
- After providing the Defendant with the benefit of new value provided to the Debtor, the Trustee sought to recover the preferential transfers totaling
- $97,600.00 pursuant to 11 U.S.C. § § 547 and 550(a).

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Facts

- On November 13, 2015, the Plaintiff duly served the Discovery requests on the Defendants.
- On December 28, 2015, the Defendant responded to the Plaintiff's Discovery Requests.
- On January 13, 2016, the Trustee, in accordance with Rule 37 of the Federal Rules of Civil Procedure, sent the Defendant's counsel an email requesting that the Defendant clarify Defendant's responses to certain Discovery Requests regarding the total amount of payments received by Defendant from the Debtor. The Plaintiff specifically identified deficient and confusing responses to said Requests and requested that the Defendant couple of times to provide more complete answers to these questions
- The Defendant's counsel responded to the Plaintiff's email only to confirm receipt thereof, but did not substantively respond to the Plaintiff's requests.

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Facts

- Pursuant to Rule 37 of the North Carolina Rules of Civil Procedure, the Plaintiff filed a Motion to compel the Defendant to fully respond to Plaintiff's Discovery requests.
- Subsequently the Plaintiff withdraws its Motion to compel and filed his motion for summary judgment. In opposition to the Trustee's motion for summary judgment, Defendant filed an affidavit of James W. Smith Jr. In his affidavit, the Defendant attempted to submit evidence that contradicted the schedules to which he had averred, and which would have been responsive to the Trustee's outstanding discovery requests, but which previously had not been produced.
- The Court granted judgment in favor of the Plaintiff. Specifically the Court entered judgment (1) granting Trustee's motion to strike Defendant's affidavit (2) granting partial summary judgment under the elements of § 547(b)(1), (2), (4), and (5), (3) granting partial summary judgment on the issue of § 547(c)(2), finding that the Defendant cannot establish the ordinary course of business defense; and (4) denying summary judgment with regard to all remaining issues.

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Facts

- The Trustee later filed two motions in limine under Fed. R. Civ. P. 37 requesting that the Court to exclude any evidence offered by the Defendant regarding the solvency or insolvency of Debtor to the extent that such evidence was not included in Defendant's responses to discovery and to establish any non-disputed loans and repayments as facts for trial and exclude any evidence offered by Defendant regarding the disputed loans which had not been previously disclosed in discovery.
- On November 4, 2016, the Court entered its Memorandum Opinion and an order granting Motion in Limine. The Court: (1) excluded for trial any evidence offered by Defendant of Debtor's solvency, including evidence of value, to the extent such evidence contradicts or supplements Debtor's schedules filed in this case; (2) established as facts for purposes of trial all loans and loan repayments as supplemented by Defendant prior to summary judgment, not labeled "disputed;" and (3) excluded any expert testimony offered by Defendant at trial.

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Facts

- Subsequently, the Trustee moved for sanctions pursuant to Fed. R. Civ. P. 37 and 11 U.S.C. § 105 against Defendant and his attorney, Norman B. Smith.
- The Trustee contended that Defendant and his counsel: (1) made misrepresentations to Trustee and the Court in regard to the disputed $50,000 payment ; (2) concealed certain real property owned in part by Defendant and previously undisclosed; and (3) defamed Trustee and his counsel in Defendant's response to the Motions in Limine by criticizing Trustee and characterizing his actions as an attempt to "churn" the case to provide a higher fee for himself.

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Issue

- Whether the Defendant's conduct was sanctionable under F.R.C.P. 37 ?
- Whether the Court should impose sanctions against the Defendant and his counsel *sua sponte* in violation of Fed. R. Bankr. P. 9011 ?

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F.R.C.P 37

(c) Failure to Disclose, to Supplement an Earlier Response, or to Admit.

(1) Failure to Disclose or Supplement. If a party fails to provide information or identify a witness as required by Rule 26(a) or (e), the party is not allowed to use that information or witness to supply evidence on a motion, at a hearing, or at a trial, unless the failure was substantially justified or is harmless. In addition to or instead of this sanction, the court, on motion and after giving an opportunity to be heard:

(A) may order payment of the reasonable expenses, including attorney's fees, caused by the failure;

(B) may inform the jury of the party's failure; and

(C) may impose other appropriate sanctions, including any of the orders listed in Rule 37(b)(2)(A)(i)—(vi).

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F.R.C.P 37

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(B) may inform the jury of the party's failure; and

(C) may impose other appropriate sanctions, including any of the orders listed in Rule 37(b)(2)(A)(i)—(vi).

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F.R.B.P. 9011

(b) Representations to the Court. By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, :

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a non-frivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

162

F.R.B.P. 9011

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(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

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F.R.B.P. 9011

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1)

(A) By Motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b).

B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

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F.R.B.P. 9011

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B) On Court's Initiative. On its own initiative, the court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

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Arguments

- The Trustee contended that the Defendant and his counsel made misrepresentations to the Trustee and the Court in regard to the disputed payment and concealed certain real property owned in part by Defendant and previously undisclosed.
- The Trustee also asserted that the Defendant defamed Trustee and his counsel by criticizing the Trustee and characterizing his actions as an attempt to "churn" the case to provide a higher fee for himself.
- The Trustee cited Fed. R. Civ. P. 11, Fed. R. Civ. Pro. 37, and 11 U.S.C. § 105 as bases for the Court to award further sanctions against Defendant.

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Court’s Ruling

Rule 9011 Sanctions

- The Court noted that the Plaintiff cited Fed. R. Civ. P. 11, Fed. R. Civ. Pro. 37, and 11 U.S.C. § 105 as bases for the Court to award further sanctions against Defendant and Fed. R. Bankr. P. 9011(c)(1)(A), requires a movant to serve any motion seeking sanctions 21 days prior to filing the motion with the Court, which the Plaintiff didn’t fulfill. However, the Court added that prior to the initial hearing on the motion, Plaintiff withdrew all reference to Fed. R. Civ. P. 11 and relied solely upon Fed. R. Civ. P. 37 and section 105.
- The Court further held that despite the Trustee's withdrawal of any request under Rule 11, the Court may consider imposing sanctions under Fed. R. Bankr. P. 9011(c)(1)(B) on its own initiative in appropriate circumstances.
- The Court concluded that the Defendant and his counsel did violate Rule 9011(b) by signing and filing, respectively, the Defendant's affidavit at summary judgment averring that Defendant did not receive the disputed transfer.

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Court’s Ruling

Rule 9011 Sanctions

- The Court held that the Defendant and his counsel have shown a pattern in this case by failing to provide the information they are required to provide and then, upon being challenged for their failures, producing additional explanations or documents that should have been produced in discovery.
- After carefully considering the record in this case, and, in exercising its discretion, the Court warned the Defendant that it will not tolerate any further violations of the rules of disclosure and candor to the tribunal . The Court refused to *sua sponte* impose sanctions pursuant to Fed. R. Bankr. P. 9011(c)(1)(B) against the Defendant or the Defendant's counsel.

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Court's Ruling

F.R.C.P. 37 Sanctions

- The Court ruled that the Defendant has failed to adequately respond to discovery in this case, and has made representations to the Court that are inconsistent with the evidence and his testimony at trial The Court finds that Defendant's conduct is sanctionable under Rule 37. The Court added that the Defendant and his counsel have shown a pattern in this case by failing to provide the information they are required to provide and then, upon being challenged for their failures, producing additional explanations or documents that should have been produced in discovery.

- However, the Court added that while the actions by Defendant were sanctionable, the Court will not impose sanctions in this case because Trustee failed to offer any evidence of the damages directly caused by Defendant's conduct.

- The Court held that at the hearing on the Motion for Sanctions, the Court did inform the Trustee that it would consider the Motion for Sanctions at trial and Trustee could present evidence of damages at that time. Inspite of that the Trustee failed to present any evidence on the damages caused to the Debtor,. Thus, the Court cannot determine what "reasonable expenses" pursuant to Rule 37(c)(1)(A) would be and therefore denied the motion.

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Court's Ruling

F.R.C.P. 37 Sanctions

- The Court added that although the Defendant's conduct was liable to be sanctioned, the Court declined to impose sanctions because the Trustee failed to offer any evidence of the damages directly caused by the Defendant's conduct.

- The Court entered judgment in favor of the Trustee and against the Defendant, avoiding the transfers pursuant to § 547(b); awarding a monetary judgment in the amount of $97,600 under 11 U.S.C. § 550 for the benefit of the estate; and denying Trustee's Motion for Sanctions.

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Conclusion

- The Court may impose sanctions at its own discretion pursuant to Bankruptcy Rule 9011(c)(1)(B)

- Failure to present any evidence of the damages directly caused by the conduct of a party is a determining factor for the Courts to arriving at the conclusion regarding imposing sanctions under FRCP 37

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