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Recent Case Shows Final Asset Sales Are Not Always Final

Law360, New York (September 08, 2014, 12:58 PM ET) -- The U.S. Court of Appeals for the Eleventh Circuit, on Aug. 15, 2014, ordered a bankruptcy court to vacate a final asset-sale order almost four years after its entry because of insider misconduct. *In re Global Energies LLC*, (11th Cir. Aug. 15, 2014).

Specifically, the court found that the limited liability company debtor's insiders had used a bankruptcy case: (1) "to rid [the debtor] of [a] business partner"; (2) "for the improper purpose of prevailing over [that partner] in a business dispute"; and (3) to take "control of [the debtor's] assets" while "eliminating [the business partner's] interests." *Id.* at *5.

Reversing the lower courts, the Eleventh Circuit held that the bankruptcy court had applied "the wrong legal standard, … made clear errors of judgment and abused its discretion." *Id.* at *4. In particular, the court criticized the bankruptcy court for ignoring critical new material documentary evidence (emails) showing collusion by the debtor's insiders "in filing" an "involuntary bankruptcy" petition against the debtor "in bad faith" as part of a "plan to wrest" the business partner's "interest in [the debtor] from him." *Id.* at *1, *5. This decision is highly relevant to the finality of asset-sale orders in reorganization cases.

Facts

Three individuals (A, B and C) held equal interests in the LLC debtor. Two of the debtor's partners (A and B) conceived a plan to have B's corporate entity, called "Chrispus," file an involuntary bankruptcy petition against the debtor in order to take control of the business from the third partner, C, with whom they had a business dispute. The unsuspecting C did not contest the petition, but he "later began to suspect collusion by [the other two], particularly when [B's corporate entity, Chrispus,] showed interest in bidding on [the debtor's] assets at [a] bankruptcy sale."

Positing misconduct, C moved to dismiss the bankruptcy petition on the ground of bad faith but could only "proffer … circumstantial evidence in support of his motion." Despite C's requests that A and B produce all documents containing their communications about the debtor, they represented to the bankruptcy court that "all responsive documents" had been produced and "asserted no privilege" justifying withholding of any emails. *Id.* at *2. A and B also falsely testified at their depositions that they had no conversations about a plan to file an involuntary bankruptcy petition or any other misconduct. As a result, the objecting partner withdrew his motion to dismiss without prejudice, and a bankruptcy trustee later sold the debtor's assets to Chrispus in a court-approved sale.

C renewed his motion to dismiss the bankruptcy case a year later. He proffered emails between A and B that only circumstantially supported his claim that A and B had filed the involuntary bankruptcy petition in bad faith. As a result, the bankruptcy court denied his dismissal motion.

Shortly thereafter, C obtained critical emails in related state court litigation showing A and B's involuntary bankruptcy plan and subsequent intention to seize control of the debtor's assets. The emails explicitly discussed Chrispus filing an involuntary "Chapter 11" petition, an affiliate of B's buying the debtor's assets, "eradicat[ing] C's note, and "dissolv[ing]" C's "stock." *Id.* at *1. The newly discovered emails showed that A and B "had testified falsely about that plan in their earlier depositions."

Based on these emails, C moved in the bankruptcy court to vacate the bankruptcy petition and the sale order under Federal Rule of Civil Procedure 60(b) (new evidence of bad-faith bankruptcy filing; fraud, misrepresentation or misconduct), made applicable here by Bankruptcy Rule 9024. The bankruptcy court denied the motion, noting that the new evidence of bad faith "doesn't change anything"; the issue "already had been raised"; and the "bankruptcy is done" because C "had his day in court." Moreover, even if the incriminating documents had been withheld, C knew that the other partners "were all talking." *Id.* at *3. The district court affirmed, explaining that the new email evidence "was insufficient to warrant" relief under Rule 60(b).

The Court of Appeals

The bankruptcy court, held the Eleventh Circuit, "made a clear error of judgment" and "applied the wrong legal standard." It had thus "abused its discretion" in denying relief to C. Not only had C "discovered new evidence of the bad-faith filing," but he was also "entitled to relief from the judgment as a result of fraud, misrepresentation, or misconduct" by A and B.

In particular, C discovered the new evidence only after the sale order had been entered and had exercised "due diligence in discovering that evidence." That evidence "was not merely cumulative or impeaching." The evidence, said the court, "was material … and … was likely to produce a different result." *Id.* at *3.

Also "troubling" to the court was the conduct of counsel for A and B. He "actively obstructed [C's] efforts to obtain evidence of the plan to file for involuntary bankruptcy." Moreover, he "falsely responded to [C's] … discovery requests," withheld "significant nonprivileged and responsive documents," and stood by while his clients falsely testified during their depositions. "In sum, the parties, who had the evidence that [C] needed to substantiate his claims, blocked his access to it and deliberately prevented him from finding it." *Id.* at *5.

Bad-Faith Involuntary Bankruptcy Filing

First, A and B used bankruptcy to take "over a debtor corporation and its assets" in bad faith. Second, A and B made no "objectively reasonable inquiry into the law and facts before filing" their involuntary bankruptcy petition. Moreover, their filing the involuntary petition "for the improper purpose of prevailing over [C] in a business dispute and taking control of" the debtor's "assets while eliminating [C's] interests" confirmed their improper purpose.

Because A's and B's emails were material in showing bad faith, they also constituted grounds for vacating the sale order. In the court's view, the sale had been part of A's and B's bad-faith plan, requiring the bankruptcy court to have "voided" it. *Id.* at *5 n.5.

Finally, in addition to vacating the sale order, the court directed the bankruptcy court to conduct any necessary hearings and to issue appropriate orders, including an accounting, disgorgement, sanctions and any other orders necessary to ensure that A and B "do not profit from their misconduct and abuse of the bankruptcy process." In addition, the court ordered A and B to "fully compensate [C] for any and all

damages, including … attorneys' fees and costs." *Id.* at *6.

Comment

Global Energies is consistent with other appellate decisions on the troubling bad-faith issue in the asset-sales context. See *In re Abbotts Dairies of Pennsylvania Inc.*, 788 F.2d 143, 147–49 (3d Cir. 1986) (court remanded to determine "good faith" in light of purchaser's "lucrative" offer of employment to chief executive officer of debtor, "manipulated timing" of debtor's bankruptcy petition, and motion for approval of interim agreement that "preclude[d] any truly competitive bidding"; "situation … ripe for collusion and interested dealing, between debtor seller and prospective buyer"), quoting *In re Cada Invs.*, 664 F.2d 1158, 1162 (9th Cir. 1981) ("Courts have generally appeared willing to set aside confirmed sales that were tinged with fraud, error or similar defects which would in equity affect the validity of any private transaction.").

In what may at first seem a contrasting result, despite a provocative fact pattern, the Second Circuit held that a fiercely litigious competitor of the Chapter 11 debtor who bought the debtor's assets (trademark and licensing rights) was a "good-faith" purchaser under Bankruptcy Code Section 363(m) (purchaser of debtor's assets protected from reversal of sale on appeal so long as it acted in good faith). *In re Gucci*, 126 F.3d 380, 394 (2d Cir. 1997). Disgruntled bidders had appealed from the bankruptcy court's order approving the sale but had failed to get a stay pending appeal, resulting in consummation of the sale. The main issue before the Second Circuit, therefore, was whether the asset buyer had acted in "good faith."

Consistent with the reasoning in *Abbotts Dairies* and *Global Energies*, the Second Circuit came to a different conclusion on the existence of good faith. The court found that the buyer's "good faith" in this context was shown by "the integrity of [its] conduct during the course of the sale proceedings." Despite the buyer's hostile tactics, it did not corrupt the sale process. A buyer's good faith may be lost by "fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders."

The court rejected the disgruntled bidders' arguments that the buyer had acted in bad faith by waging a worldwide litigation strategy against the debtor for the purpose of devaluing the debtor's trademarks as assets. According to the court, the buyer's litigation and alleged harassment campaign was not aimed at "controlling the sale price or taking unfair advantage of the [other] bidders." The successful purchaser was a competitor who had adopted "an aggressive litigation strategy" prior to bankruptcy in order to "protect its own trademarks from infringement," conduct that "is the reality of the designer retail business," not "flagrant misconduct" during the sales transaction. 126 F.3d at 390–91. For a court to find bad faith, the misconduct "must involve corruption of the judicial process itself." *In re Met-L-Wood Corp.*, 861 F.2d 1012, 1018 (7th Cir. 1988) (Posner, J.).

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