No. ________

In The
Supreme Court of the United States

SAM LESLIE, Chapter 7 Trustee of the estate of Fitness Holdings International, Inc.,

Petitioner,

v.

HANCOCK PARK CAPITAL II, L.P., a Delaware Limited Partnership, et al.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The question presented by this petition addresses a split among the Circuit Courts as to whether a bankruptcy court's authority to recharacterize putative debt as equity arises from the bankruptcy court's general equitable powers under 11 U.S.C. § 105(a) as announced in *Pepper v. Litton*[1] (as five Circuits have held) or arises under 11 U.S.C. § 502(b), thus restricting the bankruptcy court's equitable powers to applicable state law (as two Circuits have held).[2]

[1] 308 U.S. 295, 304, 60 S.Ct. 238, 244, 84 L.Ed. 281 (1939).

[2] The Question Presented above is similar to the Question Presented in the Petition For a Writ of Certiorari currently pending and filed in the case entitled *PEM Entities LLC v. Eric M. Levin & Howard Shareff*, United States Supreme Court, Case No. 16-492.

PARTIES TO THE PROCEEDINGS BELOW AND RULE 29.6 STATEMENT

The following list provides the names of all of the parties to the proceedings below:

1. Petitioner Sam Leslie, Chapter 7 Trustee of the estate of Fitness Holdings International, Inc.

2. Hancock Park Capital II, L.P., a Delaware Limited Partnership

3. Pacific Western Bank, a California state chartered bank (f/k/a Pacific Western National Bank).

4. Kenton Van Harten, an individual.

5. Michael Fourticq, Sr., an individual.

6. Hancock Park Associates, III, LLC, a Delaware limited liability company.

7. Hancock Park Associates, a California limited partnership.

Pursuant to Rule 29.6, the Appellant represents that there is no parent or publicly held company owning 10% or more of the Debtors' corporate stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Sam Leslie, chapter 7 trustee for Fitness Holdings International, Inc., respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the Ninth Circuit Court of Appeals, *In re Fitness Holdings International, Inc.*, United States Court of Appeals, Ninth Circuit, November 8, 2016, 660 Fed.Appx. 546, is unreported ("*Fitness Holdings II*"). App., *infra*, 1-5.

The opinion of the District Court Central District of California is unreported. App., *infra*, 6-24.

The order of the Ninth Circuit Court of Appeals denying the petition for panel rehearing and the petition for rehearing *en banc* entered on December 15, 2016. App., *infra*, 75-76.

The opinion of the Ninth Circuit Court of Appeals, *Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P.* (*In re Fitness Holdings International, Inc.*), 714 F.3d 1141 (9th Cir. 2013) ("*Fitness Holdings I*"). App., *infra*, 35-52.

The opinion of the Ninth Circuit Court of Appeals, *In re Fitness Holdings Intern., Inc.*, 529 Fed. Appx. 871

(9th Cir. 2013), and Amended Memorandum. App., *infra*, 28-34.

The opinion of the District Court, Central District of California, *In re Fitness Holdings Intern., Inc.*, United States District Court, C.D. California. August 31, 2011, 2011 WL 7763674. App., *infra*, 54-74.

JURISDICTION

The judgment of the court of appeals, denying petitioner's motion for rehearing *en banc* was entered on December 15, 2016. App., *infra*, 75-76. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 105(a) and 502 of Title 11 of the United States Code are reproduced in full in an appendix attached hereto. App., *infra*, 77-79.

STATEMENT OF THE CASE

Sam Leslie, chapter 7 trustee ("Trustee") for the bankruptcy estate of Fitness Holdings International ("Debtor"), sought to recover a pre-bankruptcy transfer of approximately $12 million (the "Transfer") that the Debtor made to its sole shareholder, Hancock Park Capital II, LP ("Hancock Park"). App., *infra*, 2. The Transfer was made a little over one year before the

Debtor filed for bankruptcy protection in October 2008. *Fitness Holdings I*, 714 F.3d at 1143-44. App., *infra*, 38; App., *infra*, 55-56.

The Debtor, a home fitness company, was acquired in 2003 by its sole shareholder, Hancock Park in a leveraged buyout, a portion of which was funded by Pacific Western Bank ("PWB"). *In re Fitness Holdings Int'l, Inc*. ("*Fitness Holdings*"), No. CV 10-0647 AG, 2011 WL 7763674, *2-3 (C.D. Cal. Aug. 31, 2011). App., *infra*, 56-57; App., *infra*, 7.

From September 30, 2003 thru November 5, 2006, Hancock Park financed the Debtor's business operations by advancing $24,276,065.74 to the Debtor. *Fitness Holdings I*, at p. 1143-44, App., *infra*, 37; App., *infra*, 7-8, 56-57. These financings were documented by a series of *self-described* unsecured subordinated promissory notes. *Id*.

Most of the Hancock Park notes had a maturity date of November 5, 2006, and required interest to be paid quarterly. However, the interest payments were never made, and the principal wasn't paid when due. No demand for payment of either principal or interest was ever made. App., *infra*, 37.

In June 2007, the Debtor obtained a $25,000,000 secured loan from PWB (the "Refinancing"), in the form of a Term Loan in the amount of $17,000,000 and a line of credit for $8,000,000. App., *infra*, 8, 38. The proceeds from the Refinancing went, *inter alia*, to pay off PWB's prior loans, with $11,995,500 going to Hancock Park, as a reduction of its indebtedness. From

the Refinancing the Debtor received approximately $1 million. *Id.* In addition, Hancock Park's partners obtained releases of their personal guaranties. *Id.* At the time of the advances from Hancock Park and the Refinancing, the Debtor had substantial amounts due and owing to its unsecured vendor creditors, and was not paying its obligations when due.

Based upon the foregoing, the Trustee sought through the First Amended Complaint ("Complaint") a declaration from the bankruptcy court that Hancock Park's unsecured advances be recharacterized as equity contributions. The Trustee also asserted claims for equitable subordination (claim allowance/determination) as to Hancock Park's general unsecured claim, for avoidance of the Transfer as a fraudulent transfer and for breach of fiduciary duty. App., *infra*, 2, 8, 38-39.

The bankruptcy court dismissed all claims against Hancock Park with prejudice. The Trustee appealed to the District Court, which affirmed the bankruptcy court and dismissed the case for failure to state a claim. *Fitness Holdings*, 2011 WL 7763674, *1, App., *infra*, 54. The District Court held that, under longstanding precedent of the Ninth Circuit Bankruptcy Appellate Panel, Hancock Park's advances were loans and, as a matter of law, it was barred from recharacterizing such loans as equity investments. *Id.* at *5 (citing *In re Pacific Express*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986)).

Upon appeal, the Ninth Circuit disapproved *In re Pacific Express*, finding that bankruptcy courts may

recharacterize debt as equity. *In re Fitness Holdings I*, 714 F.3d at 1148-49. App., *infra*, 47 and App., *infra*, 9. The Ninth Circuit vacated and remanded the matter so that the lower court could determine through the application of California State law[3] whether the transactions at issue were debt or equity. *Id.*

Fitness Holdings I departed from the majority of the Circuits and lower courts that followed the teachings of *Pepper v. Litton* and employed the equitable powers of the bankruptcy court under 11 U.S.C. § 105(a), to fashion a multi-point test to determine whether an alleged shareholder debt should be recharacterized as equity, *Fitness Holdings I*, 714 F.3d at 1148-49. App., *infra*, 45, 50, 52; App., *infra*, 9, 13. In so doing the Ninth Circuit took the road less traveled, adopting the approach taken by the Fifth Circuit in *Grossman v. Lothian Oil Inc*., (*In re Lothian Oil)*, 650 F.3d 539, 542-43 (5th Cir. 2011), which determined that the issue of recharacterization was a request to disallow the lender's claim under 11 U.S.C. § 502, thus mandating the court to limit its review to state law.[4] *Fitness Holdings I*, 714 F.3d at 1148-49. The Ninth Circuit came to this conclusion despite the fact that Hancock Park's claim was addressed separately in the Complaint through an equitable subordination claim and

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[3] There exists no California cases or statutory law that directly address the equitable bankruptcy concept of recharacterization.

[4] Despite this finding, the *Lothian Oil Court* ultimately relied upon a federal multi-factor test which Texas courts imported from federal tax law. *In re Lothian Oil*, 650 F.3d at 542-44.

that recharacterization was presented to support the elements of the Trustee's claims for avoidance of fraudulent transfer and breach of fiduciary duty. App., *infra*, 28-34, 36, 53.

On remand, the District Court again dismissed the complaint.[5] Unlike *Lothian Oil*, it did not use the factors identified in federal tax cases through the guise of determining "applicable" state law. Instead, it created its own test that focused on California contract law and placed form over substance by looking only to the four corners of the documents. App., *infra*, 6-24. Thus, while *Lothian Oil's* result created a false conflict because it effectively aped the majority Circuits' analysis, it invited the potential for a conflict (through application of state law) that materialized in *Fitness Holdings II*.

Upon review, the Ninth Circuit adopted the findings and conclusions of the District Court and determined that the Hancock Park notes gave Hancock Park a 'right to payment' under state law. *Fitness Holdings II*. App., *infra*, 1-5. In so doing, contrary to every other circuit court in the country, the Ninth Circuit rejected an equitable analysis regarding the bona fides of Hancock Park's advances to the Debtor (a substance over form test) applying California state contract law,

[5] The District Court addressed the Complaint after the bankruptcy court granted the defendants' motions to dismiss filed after the *Fitness Holdings I* decision. App., *infra*, 6. On remand, the bankruptcy court dismissed Claims 1, 3, 4, 5, 6, 9 and 10 with prejudice. App., *infra*, 25-26. The Trustee appealed this decision to the District Court.

instead of the equitable principles that are necessary to address a recharacterization determination.

REASONS FOR GRANTING THE PETITION

This Petition should be granted to resolve the split of authorities existing in the Circuit Courts as to the proper basis for determining whether a corporate debtor's debt to its shareholder should be recharacterized as equity as part of the claim analysis process.

Five Circuits apply the equitable powers of the bankruptcy court as authorized under 11 U.S.C. § 105(a) as described in *Pepper v. Litton*. Two Circuits limit review to state law, based upon their determination that recharacterization is a claim adjudication process and subject to 11 U.S.C. § 502(b). Thus, the question presented is whether the analysis employed in determining whether to recharacterize debt as a capital contribution is rooted in 11 U.S.C. § 105(a) and subject to broad equitable considerations, or rooted in 11 U.S.C. § 502(b) and subject to varying state law.

Adoption of a single uniform equitable analysis under the principles presented in *Pepper v. Litto*n, for recharacterization will provide certainty and uniformity in bankruptcy cases. Recharacterization of debt to equity is an equitable remedy essential to bankruptcy cases. Requiring bankruptcy courts to ascertain state law to determine whether the transactions at issue should be recharacterized as equity could result in a patchwork of up to 50 state law based rules

for recharacterization or, in the case of *Fitness Holdings II*, state-based recharacterization rules that place form over substance.

Given the split of authorities among the Circuits, the Supreme Court should establish a uniform standard to be used in addressing the issue of recharacterization in the context of a bankruptcy proceeding.

I. THERE IS A CIRCUIT CONFLICT REGARDING WHETHER STATE LAW OR FEDERAL LAW PROVIDES THE RULE OF DECISION FOR BANKRUPTCY COURTS RECHARACTERIZING CLAIMS AS EQUITY

The weight of federal authority holds that bankruptcy courts are vested with authority to recharacterize debt as equity. At least seven Circuits [3rd, 4th, 5th, 6th, 9th, 10th, and 11th] have embraced this concept and district courts within two other Circuits [2nd and 7th], likewise, have affirmatively adopted this concept. The Circuits embracing recharacterization do so on the theory that the substance of a transaction, rather than its form, should control the transaction's characterization in the first instance. *See In re SubMicron Systems Corp.*, 432 F.3d 448, 454 (3d Cir. 2006) (finding recharacterization "grounded in bankruptcy courts' equitable authority to ensure 'that substance will not give way to form' ") (footnote omitted) quoting *Pepper v. Litton*, 308 U.S. 295, 305-06, 60 S.Ct. 238, 84 L.Ed 281 (1939). But, while the guiding principles appear to be the same, the analytical framework for application of recharacterization falls into two distinct camps.

The five-circuit majority's equity considerations flow from the bankruptcy court's "general equitable powers under 11 U.S.C. § 105(a)".[6] Rooted in the equitable powers provided under 11 U.S.C. § 105(a), as described in *Pepper v. Litton*, the Third, Fourth, Sixth, and Tenth Circuits employ variations of a multi-factor test as the analytical framework to determine whether recharacterization is warranted. *Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Dornier Aviation)*, 453 F.3d 225, 231 (4th Cir. 2006) (focused on five factors); *In re AutoStyle Plastics, Inc.*, 269 F.2d 726 (6th Cir. 2001) (focused on eleven factors); *In re Hedged-Investments*, 380 F.3d 1292, 1298 (10th Cir. 2004) (applying thirteen factors). The Eleventh Circuit, while applying a federal rule of decision, focused on only two of the many factors that have been advanced by the jurisdictions in the majority. *See N&D Properties, Inc.*, 799 F.2d 726, 733 (11th Cir. 1986). The Third Circuit, while acknowledging the various multifactor test "include pertinent factors," applies an "overarching inquiry" designed to determine "whether the parties called an instrument one thing when in fact

[6] The lower courts in the Second and Seventh Circuits also have embraced Section 105(a) as the statutory authority for recharacterization. *See In re Outboard Marine Corp.*, 2003 WL 21697357 (N.D. Ill. July 22, 2003) (embracing Sixth Circuit's reliance on Section 105(a)); *In re Emerald Casino, Inc.*, 2015 WL 1843271 (N.D. Ill. Apr. 21, 2015) ("Though the Seventh Circuit has not explicitly adopted the majority approach, this court finds the reasoning supporting that approach persuasive."); *In re Franklin Indus. Complex, Inc.*, 2007 WL 2509709 (N.D.N.Y. Aug. 30, 2007) (recognizing bankruptcy court's authority to recharacterize debt as equity pursuant to Section 105).

they intended it as something else." *SubMicron Systems*, 432 F.3d at 455-56.

While stated differently, the majority analysis focusing on some or all of the specific factors identified, see discussion *infra*, share a common thread: "These factors all speak to whether the transaction 'appears to reflect the characteristics of . . . an arm's length negotiation.' This test is a highly fact-dependent inquiry." *Dornier Aviation*, 453 F.3d at 234 *quoting AutoStyle Plastics*, 269 F.3d at 750 *quoting In re Cold Harbor Assocs.*, 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (amendment in original; footnote omitted).

Eschewing the application of 11 U.S.C. § 105(a) as the predicate for recharacterization, the Fifth and Ninth Circuits, instead, hold that bankruptcy courts are vested with the power to recharacterize debt as equity pursuant to 11 U.S.C. § 502(b). *See Lothian Oil*, 650 F.3d at 543; *Fitness Holdings I*, 714 F.3d at 1148-49. Under this statutory provision, these Circuits require recharacterization to be determined based on applicable state law. Coincidentally, the decisions in these two minority Circuits did not actually identify state law specific factors to apply. The Fifth Circuit circuitously applied federal law insofar as the Texas state law it relied upon aped the federal multi-part test and, in fact, was similarly founded in federal tax cases. *See Lothian Oil*, 650 F.3d at 544.

The Ninth Circuit in this case, while requiring the application of a state law test, in accord with 11 U.S.C. § 502(b), did not identify any specific California state

law to apply, remanding the case to the District Court for a determination of the appropriate California state law to apply to recharacterization of debt to equity. *Fitness Holdings I*, 714 F.3d at 1148-49. In turn, the District Court did not identify a set of factors *per se*, but defaulted instead to basic rules of California state contract interpretation.

Thus, on the one hand, there are five Circuits (and lower courts in two other Circuits) in the majority that have based their analysis of recharacterization claims employing the equitable powers of the bankruptcy courts as vested under Section 105(a). Four of these Circuits (and the two lower courts in the Second and Seventh Circuits) set forth a substantially similar multi-factor test that provides uniformity to bankruptcy courts in assessing whether, in the first instance, purported debt should be recharacterized as equity. On the other hand, there are two Circuits that have found recharacterization rooted in Section 502(b) requiring an analysis of state law that, in the case of the Fifth Circuit, borrows wholesale from federal authority or, in the case of the Ninth Circuit, identifies no factors and provides no guidance at all and utilized California contract interpretation law as the basis for its "equitable decision."

This conflict presents this Court with an opportunity to weigh in and clarify the proper source of the standards governing recharacterization. Ultimately, the reconciliation of these competing tests will rest in whether recharacterization finds its footing in Section 105(a) or, alternatively, Section 502(b).

Adoption of a single uniform methodolgy for recharacterization will provide certainty and consistency in bankruptcy cases. Recharacterization of debt to equity is an equitable remedy unique to bankruptcy (and federal tax) cases and looking to state law to ascertain whether the transactions at issue should be recharacterized as equity will result in a chaotic patchwork of disparate state law based rules.

Given the split among the Circuits, only this Court is able to provide a uniform approach to this important question. Accordingly, the Court should accept review to:

1. Resolve the split in authorities as between the Circuits;

2. Rectify the Ninth Circuit's adoption of an erroneous legal standard for recharacterization cases so that future bankruptcy estates may proceed to address recharacterization appropriately and avoid years of needless litigation contesting the bona fides of the *Fitness Holdings* rulings.

3. Eliminate jurisdictional "forum shopping" in cases where the claim will have a major impact on the administration of the bankruptcy estate and the debtor seeks to avoid the standard of recharacterization as established by the Ninth and Fifth Circuits – looking solely to state law regarding recharacterization of a debt obligation.

II. RECHARACTERIZATION IS ROOTED IN THE EQUITABLE POWERS OF THE BANKRUPTCY COURTS [11 U.S.C. § 105(a)]

A. The Genesis of Recharacterization

The equitable jurisdiction of the bankruptcy court is a certainty as is its "power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate." *Pepper v. Litton*, 308 U.S. at 308. That is particularly true "when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder." *Id.*

Although the issue of recharacterization is just being addressed by the Ninth Circuit, the "doctrine" and the legal standards applicable to the same are not without historical perspective. Recharacterization, as a concept in bankruptcy, has its genesis in tax cases. *See Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625 (6th Cir. 1986); *see also Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968).

In *Roth Steel*, the Sixth Circuit was faced with ascertaining whether a transaction should be classified as debt or equity for income tax liability purposes. As posited by the *Roth Steel* court:

> The determination of whether advances to a corporation are loans or capital contributions depends on whether the objective facts establish an intention to create an unconditional obligation to repay the advances. *Raymond*, 511 F.2d at 190. "Advances between a parent

> corporation and a subsidiary . . . are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt'." *United States v. Uneco, Inc.*, 532 F.2d 1204, 1207 (8th Cir. 1976) (quoting *Cuyuna Realty Co. v. United States*, 382 F.2d 298, 300-01 (Ct.Cl. 1967)).

Roth Steel, 800 F.2d at 629-30.

Having posited the question for determining classification of a transaction, the *Roth Steel* court identified the following eleven factors to assist in reaching the answer:

> This court has identified a number of factors to be used in making the capital contribution versus loan determination: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments. See *Raymond*, 511 F.2d at 190-91; *Austin Village, Inc. v. United States*,

> 432 F.2d 741, 745 (6th Cir. 1970); *Berthold v. Commissioner*, 404 F.2d 119, 122 (6th Cir. 1968); *Smith*, 370 F.2d at 180. No one factor is controlling or decisive, and the court must look to the particular circumstances of each case. *Smith*, 370 F.2d at 180.

Id. at 630.

The Circuits in the majority, seizing on the debt or equity analysis in tax cases, embrace both the concept of recharacterization, as well as the test (with variations) referenced above. *See, e.g., Alternative Fuels*, 789 F.3d at 1149; *see also Dornier Aviation*, 453 F.3d at 233; *AutoStyle Plastics*, 269 F.3d at 748. Even the Fifth Circuit, while purportedly deferring to Texas state law, recognized that the applicable Texas state law, consistent with the Circuits adopting the majority approach,

> imported a multi-factor test from federal tax law. *Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n. 3 (Tex. Ct. App. 1997) ("For an oft-cited discussion of the distinction between debt and equity, including a list of sixteen distinguishing factors, see *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968)."). Other courts that have permitted recharacterization have also borrowed tests from federal tax cases. *See, e.g.*, *Hedged-Invs.*, 380 F.3d at 1298. In the tax context, this court has employed several multi-factor tests. *See Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (13-factor test); *Jones v.*

> *United States*, 659 F.2d 618, 622 n. 12 (5th Cir. 1981) (11-factor test).

In re Lothian Oil, 650 F.3d at 544.

Indeed, while some courts have questioned generally the application of the recharacterization concept in tax cases to bankruptcy cases on the basis that they are purportedly focused on distinct policy considerations, the jurisdictions in the majority continue to employ this analysis. As explained in *Outboard Marine*,

> No court, however, has identified what those different policy considerations are, let alone why those differences should preclude a bankruptcy court that is determining whether recharacterization is appropriate from relying on the factors that tax courts employ in conducting the same type of analysis. These factors serve their purpose; they enable the finder of fact to assess the true nature of a transaction. The Court will not jettison this effective set of factors simply because the factual inquiry occurs in a bankruptcy setting.

Outboard Marine, 2003 WL 21697357 *5.

B. Section 105(a), Not Section 502(b), Vests Equitable Power In Bankruptcy Courts To Analyze Transactions And Determine The True Nature Of A Transaction

Petitioner submits that recharacterization is separate and distinct from claim allowance [11 U.S.C. § 502(b)] or, for that matter, equitable subordination

[11 U.S.C. § 510(c)]. Recharacterization does not focus on whether a valid claim should otherwise be disallowed or subordinated, but on the preliminary issue of what was the true nature of the transaction. *See Dornier Aviation*, 453 F.3d at 231 ("recharacterization requires a different inquiry and serves a different function" than disallowance or equitable subordination).

As recently explained by the Tenth Circuit:

> Although related, disallowance and recharacterization require different inquiries and serve different functions. Under § 502(b), disallowance of a claim is appropriate "when the claimant has no rights vis-à-vis the bankrupt, i.e., when there is 'no basis in fact or law' for any recovery from the debtor." *In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225, 232 (4th Cir. 2006). Recharacterization, on the other hand, is not an inquiry into the enforceability of a claim; instead, it is an inquiry into the true nature of a transaction underlying a claim. In this way, recharacterization is part of a long tradition of courts applying the "substance over form" doctrine. *Id.* at 233; see also *Pepper v. Litton*, 308 U.S. 295, 305-06, 60 S.Ct. 238, 84 L.Ed. 281 (1939) ("[Courts] have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."). Unlike disallowance of a claim, recharacterization of a loan as equity does not ultimately relieve a

> debtor from his obligation to repay the claimant. Although the claimant may not proceed in bankruptcy – since he no longer holds an allowed "claim" – he may still hold a valid interest in equity to be paid upon satisfaction of the debtor's other outstanding obligations.
>
> Because disallowance and recharacterization are distinct inquiries, "[e]ven if a claimant is able to meet § 502's minimal threshold for allowance of the claim," a court must still "determine the claim's proper priority" by scrutinizing the true substance of a contested transaction. *In re Dornier Aviation*, 453 F.3d at 232. We therefore reject Mr. Jenkins' contention that a court's power to recharacterize arises solely from the disallowance provision of § 502(b), rather than from § 105(a).

In re Alternate Fuels, Inc., 789 F.3d 1139, 1148 (10th Cir. 2015) ("*Alternate Fuels")*; *see also In re AutoStyle Plastics, Inc*. 269 F.3d at 748 (recognizing that "[b]ankruptcy courts that have applied a recharacterization analysis have stated that their power to do so stems from the authority vested in the bankruptcy courts to use their equitable powers to test the validity of debts"); *Dornier Aviation*, 453 F.3d 225 at 231 ("recharacterization is well within the broad powers afforded a bankruptcy court in § 105(a) and facilitates the application of the priority scheme laid out in § 726").

In so holding, the Tenth Circuit acknowledged the holdings in *Fitness Holdings I* and *Lothian Oil*, but demonstrated why their reliance on Section 502(b) was

misplaced. The Tenth Circuit also reconciled its holding with this Court's holdings in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007) ("*Travelers*"), and *Law v. Siegel*, 571 U.S. ___, 134 S.Ct. 1188, 188 L.Ed.2d 146 (2014). As the Tenth Circuit noted, neither of these cases dealt with the concept of recharacterization and reliance thereon served only to conflate the distinct concepts of disallowance and recharacterization. *Alternate Fuels, Inc.*, 789 F.3d at 1147-48.

While related, those concepts are not the same. Therein lies the deficiency in the analysis of those minority Circuits that have relied upon Section 502(b) for recharacterization authority and, in turn, state law. Specifically, in *Lothian Oil*, the Fifth Circuit noted that other circuits allowing recharacterization found that such authority rested in Section 105(a). Nevertheless, *Lothian Oil* dismissed this analysis out of hand apparently premised on the Fifth Circuit's "cautious view" of Section 105(a). *Lothian Oil*, 650 F.3d at 543. Based thereon, the *Lothian Oil* court defaulted to Section 502(b) without actually conducting any reasoned analysis as between the two bankruptcy provisions and why the other Circuits were incorrect in their reliance on Section 105(b).

Indeed, *Lothian Oil* quotes Section 502(b) for the proposition that "the court, after notice and a hearing, shall determine the amount of such claim . . . and shall allow such claim in such amount, except to the extent that – (1) such claim is unenforceable against the

debtor and property of the debtor, under any agreement or applicable law. . . ." *Lothian Oil*, 650 F.3d at 543. But, it never connects the dots between this passage and the act of recharacterizing a transaction. Once *Lothian Oil* summarily adopted Section 502(b) as the source for recharacterization, it had no choice but to apply state law. *Id., citing Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979).

The flaw, of course, is that the *Lothian Oil* court never performed any rigorous analysis and merely defaulted to Section 502(b). Thus, its application of state law was preordained by its initial decision to rely upon Section 502(b), and was not grounded in any sound analysis that recharacterization of debt to equity should be treated the same as disallowance of a claim. Moreover, its reliance on *Butner* is suspect given that *Butner* did not implicate recharacterization. The issues addressed in *Butner* – whether the petitioner had a security interest in rent from property owned by the debtor or whether such income should be distributed in the same fashion as an unsecured claim – provides no guidance with respect to the distinct concept of recharacterization.

Ultimately, the Fifth Circuit ended up applying the same equitable factors enunciated by the majority Circuits insofar as it relied upon a Texas state court decision that, in turn, adopted its factors from a federal tax decision. Thus, the Fifth Circuit applied the correct equitable factors, but for the wrong reason. *Lothian Oil*, 650 F.3d at 544.

This Court need not give Section 105(a) a broad interpretation to conclude that recharacterization is appropriate under this Section and that federal equitable principals should apply. As recently articulated by a Connecticut bankruptcy court, this Court's interpretation of Section 105 supports the conclusion that recharacterization is appropriate under this statutory framework:

> When warranted by the facts and circumstances of the case, a bankruptcy court's exercise of its equitable powers under 11 U.S.C. § 105(a) to recharacterize purported debt as equity is both necessary and appropriate to carry out the provisions of the Bankruptcy Code. *See, Law v. Siegel*, ___ U.S. ___, 134 S.Ct. 1188, 1194, 188 L.Ed.2d 146 (2014). The equitable remedy of recharacterization is necessary to ensure that the substance of a party's rights is not determined by its form. *See, Pepper v. Litton*, 308 U.S. 295, 305-06, 60 S.Ct. 238, 84 L.Ed. 281 (1939) ("[Courts] have been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done."). Whether a party is a creditor with a claim against the bankruptcy estate or an equity security holder with an interest in the debtor-in-possession significantly affects the rights and remedies available to such a party under the Bankruptcy Code.

In re Eternal Enterprise, Inc., 557 B.R. 277, 286-287 (Bankr. D. Conn. 2016) (footnotes omitted). The Connecticut bankruptcy court recognized the difference in the priority and distribution scheme depending on the classification of a claim. Thus, the court concluded that recharacterization under Section 105(a) "is an essential remedy the bankruptcy court has the power and authority to use to preserve the distributional priorities of the Code and encourage the use of chapter 11 reorganization as a platform for reinvestment." *Id.* at 287; *see also Dornier Aviation*, 453 F.3d at 231 ("implementation of the Code's priority scheme requires a determination of whether a particular obligation is debt or equity. Where, as here, the question is in dispute, the bankruptcy court must have the authority to make this determination in order to preserve the Code's priority scheme.").

III. THE *FITNESS HOLDINGS II* DECISION EXEMPLIFIES THE DOWNSIDE OF A NON-UNIFORM APPROACH TO RECHARACTERIZATION

In *Fitness Holdings I*, the Ninth Circuit embraced the concept of recharacterization holding that a bankruptcy court "may recharacterize an obligation that does not constitute 'debt' under state law" in bankruptcy proceedings, thus "join[ing] sister circuits, which have reached the same conclusion." *Fitness Holdings I*, 714 F.3d at 1147, 1148. In doing so, the *Fitness Holdings I* court reversed the District Court's

determination that it could not look past the operative transaction documents:

> The district court did not view the trustee's constructively fraudulent transfer claim through this lens. Because the court erroneously concluded that it was barred from considering whether the complaint plausibly alleged that the promissory notes could be recharacterized as creating equity interests rather than debt, it failed to apply the correct standard in considering whether the trustee's allegation that Fitness Holdings did not receive reasonably equivalent value for its transfer of $11,995,500 . . .

Id. at 1149.

Although *Fitness Holdings I* brought the Ninth Circuit in line with six other Circuits that recognized recharacterization, it followed the Fifth Circuit's lead as presented in *Lothian Oil*, and determined that 11 U.S.C. § 502(b) was the beginning and end of the recharacterization analysis. Like *Lothian Oil*, *Fitness Holdings I* also relied on this Court's decision in *Travelers* for the proposition that "courts may not rely on 11 U.S.C. § 105(a) and federal common law rules 'of their own creation' to determine whether recharacterization is warranted." *Id*. at 1148-49.

Travelers, however, says no such thing. In *Travelers*, this Court was presented with the question of whether an unsecured creditor could recover attorney's fees under a pre-petition contract that were incurred post-petition. In this context, where Section

502(b) was directly implicated, this Court held that "we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Travelers*, 549 U.S. at 452.

As recognized by the Tenth Circuit in *Alternate Fuels, Travelers* did not present a recharacterization analysis. *Alternate Fuels*, 789 F.3d at 1148. It does not mention recharacterization or discuss it in any context, and it does not expressly overrule *Hedged-Investments* or any recharacterization case from any other circuit. *Id.* The Ninth Circuit's reliance on *Travelers* was unwarranted and certain error. This error infected its decision to reject Section 105(a) in deference to Section 502(b).

The Ninth Circuit's decision to animate recharacterization through Section 502(b) and, thus, have state law apply to the exclusion of the federal rule of law led to a series of events that resulted in a holding that applies no factors whatsoever and completely ignores the equitable concept of recharacterization. First, rather than enunciating what those factors were or referencing state law that addresses recharacterization, the Ninth Circuit remanded to the District Court to establish this criteria. *Fitness Holdings I*, 714 F.3d at 1149.

Second, on remand, no such findings were made by the District Court. Instead, the District Court applied basic state court contract principles and never looked beyond the form of the transaction – *i.e.*, the four corners of the transaction documents – an analysis

directly at odds with the fundamental equitable purpose of recharacterization insofar as the District Court elevated form over substance. App., *infra*, 6.

The District Court, had it been guided by the federal equitable common law principals and the multi-part tests employed by the majority of Circuits that have adopted recharacterization, would have been required to conduct a fulsome analysis of the transaction in question and look beyond the paper form of the transaction. While the District Court abdicated its obligation to elucidate the factors to consider in determining whether to recharacterize debt to equity, its failings were brought on, in part, by the Ninth Circuit's determination that state law, not federal law, should apply.

Third, the Ninth Circuit compounded its reliance on 502(b) by affirming the District Court's approach that provided no state-based factors and, instead, effectively placed form over substance by applying contract rules that eliminated the possibility of a recharacterization claim unless there was shown first to be an ambiguity on the face of the Hancock Park notes,

> The district court correctly applied California law in concluding that the notes were contracts that created a right to payment. *See Poseidon Dev., Inc. v. Woodland Lane Estates, LLC*, 62 Cal. Rptr. 3d 59, 63 (Cal. Ct. App. 2007). The Trustee did not allege any ambiguity in the promissory notes and did not offer any extrinsic evidence that could have

> triggered application of the parol evidence rule. *See Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 989-90 (9th Cir. 2006) ("Because California law recognizes that the words of a written instrument often lack a clear meaning apart from the context in which the words were written, courts may preliminarily consider any extrinsic evidence offered by the parties.") (citing *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 644-46 (Cal. 1968)) (applying California parol evidence rule).
>
> We see no basis under California law to ignore basic contract law and to adopt the Trustee's proposed usury law approach to determine whether the promissory notes at issue here were "real" or "sham" transactions.

App., *infra*, 3-4.

The Ninth Circuit decision in *Fitness Holdings II*, if left to stand, renders the entire concept of recharacterization a nullity in this jurisdiction, insofar as courts will, absent an ambiguity, never look past the four corners of a document even if the substance of the transaction bears no resemblance to the unambiguous form.[7] *Hedged-Investments*, 380 F.3d at 1297

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[7] Petitioner concurs with respondent in its Opposition to Petition for Writ of Certiorari in the current petition pending before this Court styled *PEM Entities LLC v. Eric M. Levin & Howard Shareff*, United States Supreme Court, Case No. 16-492 (filed on February 28, 2017) in its view that *Fitness Holdings II* provided the appropriate vehicle for this Court's review of a state-based alternative to the federal rule of decision on recharacterization. *Id.* at p.12 ("*Fitness Holdings II* is the only circuit case that has even

(recharacterization "effectively ignore[s] the label attached to the transaction at issue and instead recognize[s] its true substance").

While purporting to follow *Lothian Oil*, the Ninth Circuit's lack of any enumerated factors serves merely to demonstrate the fundamental problem in defaulting to state law in determining the equitable issue of recharacterization. The Ninth Circuit decision ignores altogether the equitable principles used by all of the other Circuits, including the Fifth Circuit, to address a claim for recharacterization. In doing so, the Ninth Circuit even refused to consider analogous California state law claims that used an equity type pronged test regarding the legality of a contract. *See* App., *infra*, 4.

Fitness Holdings II reflects the extreme downside of a non-uniform approach to applying recharacterization and the attempt to apply disparate state law concepts to this inquiry. While even its companion, *Lothian Oil*, ultimately applied the same factors as those set out in the majority Circuits, *Fitness Holdings I* embraces recharacterization under state-based rules, but the analysis subsequently adopted by *Fitness Holdings II* places form over substance, further reflecting the conflict with the federal rule of law.

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considered what a state-based rule would look like when the state has not adopted the *AutoStyle* factors. Because that case directly addresses the issue of a proposed 'state law rule,' *Fitness Holdings II* . . . would offer a more appropriate vehicle for this Court to consider this unformed doctrine.").

If left to stand, *Fitness Holdings II* serves to cement the conflict between the majority and minority jurisdictions on the issue of recharacterization and whether Section 105(a) and the federal rule of decision or Section 502(b) and state law govern this inquiry. The *Fitness Holdings II* ruling compels review by this Court to address the split between the Circuits, and establish Section 105(a) as the vehicle for a recharacterization analysis.

CONCLUSION

For the reasons expressed herein, this Court should grant the petition and issue a writ of certiorari to resolve the conflict that exists among the Circuits with respect to the proper rule of decision for recharacterizing debt to equity in bankruptcy proceedings.

Respectfully submitted,

Date: March 15, 2017

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NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re FITNESS HOLDINGS INTERNATIONAL, INC., Debtor, —————— SAM LESLIE, Chapter 7 Trustee of the estate of Fitness Holdings International, Inc., Appellant, v. HANCOCK PARK CAPITAL II, L.P., a Delaware limited partnership; et al., Appellees.	No. 14-56766 D.C. No. 2:14-cv-01059-AG MEMORANDUM* (Filed Nov. 8, 2016)

Appeal from the United States District Court
for the Central District of California
Andrew J. Guilford, District Judge, Presiding

Argued and Submitted October 21, 2016
Pasadena, California

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* This disposition is not appropriate for publication and is not precedent except as provided by Ninth Circuit Rule 36-3.

Before: TALLMAN, PARKER,** and CHRISTEN, Circuit Judges.

Sam Leslie, chapter 7 trustee ("Trustee") for the bankruptcy estate of Fitness Holdings International, Inc. (the "Debtor"), appeals from an order of the district court affirming the bankruptcy court's order granting the Appellees' motions to dismiss all claims. The Trustee seeks to recover a pre-bankruptcy transfer of approximately $12 million (the "Transfer") from the Debtor to Hancock Park Capital II, LP ("Hancock Park"), the Debtor's sole shareholder. The Transfer paid down prior advances from Hancock Park to the Debtor. The advances were evidenced by promissory notes totaling approximately $25 million. The Trustee argues that the notes did not create debt and that the pre-bankruptcy transfers were therefore equity infusions in disguise. Seeking to recover the Transfer, the Trustee brings claims of constructive and actual fraud, breach of fiduciary duties, and aiding and abetting breach of fiduciary duties. We have jurisdiction under 28 U.S.C. § 158(d)(1) and 28 U.S.C. § 1291, and we affirm.

We "review de novo a district court's judgment on appeal from a bankruptcy court." *IRS v. Snyder*, 343 F.3d 1171, 1174 (9th Cir. 2003). We apply the same standard of review applied by the district court, "reviewing the bankruptcy court's legal conclusions de

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** The Honorable Barrington D. Parker, Jr., United States Circuit Judge for the U.S. Court of Appeals for the Second Circuit, sitting by designation.

novo and its factual determinations for clear error." *Id.* To survive a motion to dismiss, a party must allege "sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." *Telesaurus VPC, LLC v. Power*, 623 F.3d 998, 1003 (9th Cir. 2010) (quoting *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009)). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 556 U.S. at 678. In reviewing a dismissal for failure to state a claim, [a]ll well-pleaded allegations of material fact in the complaint are accepted as true and are construed in the light most favorable to the non-moving party." *Faulkner v. ADT Sec. Servs., Inc.*, 706 F.3d 1017, 1019 (9th Cir. 2013) (citations omitted).

The Trustee failed to plausibly allege that the promissory notes from Hancock Park to the Debtor created equity and not debt. The district court correctly applied California law in concluding that the notes were contracts that created a right to payment. *See Poseidon Dev., Inc. v. Woodland Lane Estates, LLC*, 62 Cal. Rptr. 3d 59, 63 (Cal. Ct. App. 2007). The Trustee did not allege any ambiguity in the promissory notes and did not offer any extrinsic evidence that could have triggered application of the parol evidence rule. *See Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 989-90 (9th Cir. 2006) ("Because California law recognizes that the words of a written instrument often lack a clear meaning apart from the context in which the words were

written, courts may preliminarily consider any extrinsic evidence offered by the parties.") (citing *Pacific Gas & Elec. Co. v. G. W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 644-46 (Cal. 1968)) (applying California parol evidence rule).

We see no basis under California law to ignore basic contract law and to adopt the Trustee's proposed usury law approach to determine whether the promissory notes at issue here were "real" or "sham" transactions. Because the Trustee failed to show that the promissory notes in question did not create debt, the constructive fraudulent conveyance claim was properly dismissed. This finding also compels the dismissal of the Trustee's claim for actual fraudulent conveyance, because the Trustee failed to demonstrate that the Transfer was not applied to a valid, antecedent debt that Fitness Holdings owed to Hancock Park. *See Goodman v. H.I.G. Capital, LLC* (In re *Gulf Fleet Holdings, Inc*.), 491 B.R. 747, 767-68 (W.D. La. 2013) (dismissing claim for actual fraudulent transfer where the transfer was that of a "debtor attempting to comply with its contractual obligations.").

The Trustee's breach of fiduciary duties and aiding and abetting breach of fiduciary duties claims were also properly dismissed. The Trustee brought the breach of fiduciary duties claim as a direct claim, but under Delaware law, the Trustee must bring such claims as "derivative claims on behalf of the insolvent corporation." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007). The Trustee had "*no right to assert direct* claims for

breach of fiduciary duty against corporate directors." *Id.* Because a breach of fiduciary duties is an element of the aiding and abetting a breach of fiduciary duties claim, *see Casey v. U.S. Bank Nat'l Ass'n*, 26 Cal. Rptr. 3d 401, 405 (Cal. Ct. App. 2005); *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 386 (Del. Ch. 1999), and we hold that the Trustee failed to allege plausibly a breach of fiduciary duties claim, the aiding and abetting claim was properly dismissed as well.

Each party shall bear its own costs.

AFFIRMED.

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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES – GENERAL

Case No.	CV 14-1059 AG	Date	October 9, 2014
Title	IN RE FITNESS HOLDINGS INTERNATIONAL, INC.		

Present: The Honorable	ANDREW J. GUILFORD

Lisa Bredahl	Not Present	
Deputy Clerk	Court Reporter/Recorder	Tape No.

Attorneys Present for Plaintiffs:	Attorneys Present for Defendants:

Proceedings: [IN CHAMBERS] ORDER AFFIRMING BANKRUPTCY COURT'S RULING ON MOTION TO DISMISS FIRST AMENDED COMPLAINT

This primary issue in this bankruptcy appeal is whether a series of purported loans were really loans. The bankruptcy court concluded that the loans were loans, and it dismissed the claims in the First Amended Complaint ("FAC") that were premised on the loans being equity infusions in disguise. Chapter 7 Trustee Sam Leslie ("Appellant") appeals the dismissal by the bankruptcy court. Appellees Hancock Park, Michael Fourticq, Kenton Van Harten, and Pacific

Western Bank ("PWBank") argue that the dismissal was appropriate.

The Court agrees that the loans, which bear all of the indicia of loans, created debt, and that the FAC does not plausibly suggest otherwise. Accordingly, the Court AFFIRMS the dismissal by the bankruptcy court.

BACKGROUND

Fitness Holdings International, Inc. ("Fitness Holdings") is the debtor in this bankruptcy case. Appellant seeks to undo a pre-bankruptcy transfer of roughly $11,995,500 from Fitness Holdings to Hancock Park, its sole shareholder, to pay down existing unsecured debt. The primary issue in this appeal is whether that debt should be recharacterized as equity.

Between 2003 and 2006, Fitness Holdings executed eleven promissory notes to Hancock Park for a total of $24,276,065. (FAC ¶ 18-40.) Each note required Fitness Holdings to pay Hancock Park a specified principal amount plus interest on or before the note's maturity date, but Fitness Holdings was in constant breach of these notes. (*Id.* ¶ 39.) In July 2004, PWBank loaned $12 million to Fitness Holdings, secured by all of Fitness Holdings' assets. (*Id.* ¶ 21.) Hancock Park guaranteed the loans to PWBank. (*Id.*) PWBank and Fitness Holdings amended these agreements multiple times up until June 2007, extending the maturity dates and waiving past breaches. (*Id.* ¶¶ 24-41.)

In June 2007, Fitness Holdings refinanced its $12 million in secured loans with PWBank, replacing them with $25 million in secured loans. (*Id.* ¶¶ 44-48.) This transaction released Hancock Park from its guarantee. (*Id.* ¶ 48.) Fitness Holdings then made a payment of $11,995,500 to Hancock Park, paying down roughly $7.2 million in principal and $4.8 million in accrued interest. (*Id.* ¶ 54.) Because of these transactions, Fitness Holdings gained an additional $1 million in working capital, and the new loans were set to mature months or years later than the loans they replaced. (*Id.* ¶¶ 21, 39, 55.)

Fitness Holdings was again in constant default under the new loans. (*Id.* ¶¶ 56-57.) Even so, Hancock Park continued to loan money to Fitness Holdings. (*Id.* ¶¶ 58-59.) And in February 2008 – about eight months after the June 2007 refinancing transaction – Hancock Park agreed to guarantee the entire $25 million that Fitness Holdings borrowed from PWBank. (*Id.* ¶ 56.) But Fitness Holdings continued to flounder and, about sixteen months after the refinancing transaction, declared bankruptcy. (*Id.* ¶ 73.)

A committee of unsecured creditors, acting on behalf of Fitness Holdings and its estate, filed a complaint against Hancock Park, PWBank, and the two directors of Fitness Holdings, Kenton Van Harten and Michael Fourticq. The committee seeks to recover the 2007 payment of $11,995,500 from Fitness Holdings to Hancock Park, asking the court to recharacterize the financing Hancock Park had provided to Fitness Holdings between 2003 and 2006 as equity investments rather

than extensions of credit. Appellant Trustee Sam Leslie has since replaced the committee in this litigation.

The bankruptcy court granted motions to dismiss the First Amended Complaint. (*See* Orders, ER tab nos. 5-7.) This Court affirmed the dismissal. *See In re Fitness Holdings Int'l, Inc.*, 2011 WL 7763674 (C.D. Cal. Aug. 31, 2011). Underlying the dismissal of some of the claims was this Court's conclusion that the Bankruptcy Code does not permit courts to recharacterize claims as equity or debt. *Id.* at *5 (citing *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986)). The Trustee then appealed to the Ninth Circuit.

In two separate dispositions, the Ninth Circuit affirmed in part, reversed in part, vacated in part, and remanded. *See In re Fitness Holdings Int'l, Inc.* ("*Fitness I*"), 714 F.3d 1141, 1148-49 (9th Cir. 2013); *In re Fitness Holdings Int'l, Inc.* ("*Fitness II*"), 529 F. App'x 871 (9th Cir. 2013). The Ninth Circuit concluded that "the Bankruptcy Code gives courts the authority to recharacterize claims in bankruptcy proceedings," and that courts must look to state law in making that determination. *In re Fitness Holdings Int'l, Inc.* ("*Fitness I*"), 714 F.3d 1141, 1148-49 (9th Cir. 2013) Therefore, this Court had erred in concluding "that it was barred from considering whether the complaint plausibly alleged that the promissory notes could be recharacterized as creating equity interests rather than debt." *Id.* at 1149. The Ninth Circuit vacated the dismissal of the

claims resting on the presmise that courts can't recharacterize debt and remanded. *See Fitness I*, 714 F.3d at 1150; *Fitness II*, 529 F. App'x at 873-75.

(The Ninth Circuit also reversed the dismissal of the equitable subordination claim. *Fitness II*, 529 Fed. App'x at 874-75. That claim was since dismissed after the parties stipulated to its dismissal. (*See* SER 1-8.) Accordingly, that claim is not part of this appeal. The claims in the original complaint against PWBank are also no longer part of this case, as the Ninth Circuit affirmed the dismissal of these claims. *Fitness II*, 529 Fed. App'x at 874.)

On remand, the bankruptcy court again dismissed the claims in the FAC. This appeal followed.

PRELIMINARY MATTERS

Appellant makes a passing request to revoke the reference to the bankruptcy court, "given the bankruptcy court's previous rulings, its complete disregard of the directions of the Ninth Circuit and the obvious prejudice it has exhibited to the bona fides of the Trustee's claims." (Trustee's Opening Brief, Dkt. No. 17, at 5.)

Beyond the mere fact that the bankruptcy court ruled against Appellant, the Court finds no basis to conclude that the bankruptcy court has exhibited "obvious prejudice" to Appellant's claims. As the Court will discuss, the Court believes the bankruptcy judge followed the directive of the Ninth Circuit and ruled correctly. The request to withdraw the reference is DENIED.

STANDARD OF REVIEW

On appeal, a district court must view a bankruptcy court's findings of fact under the clearly erroneous standard, and its conclusions of law under the de novo standard. Fed. R. Bankruptcy P. 8013; *see also In re Van DeKamp's Dutch Bakeries*, 908 F.2d 517, 518 (9th Cir. 1990); *Zurich Am. Ins. Co. v. Int'l Fibercom, Inc.*, 503 F.3d 933, 940 (9th Cir. 2007). The test for clear error is not whether the appellate court would make the same findings, but whether the reviewing court, on the entire evidence, has a definite and firm conviction that a mistake was made. *Anderson v. Bessemer City*, 470 U.S. 564, 573-74 (1985).

In reviewing a motion to dismiss, a court should dismiss a complaint when, "accepting all factual allegations in the complaint as true and construing them in the light most favorable to the nonmoving party," the complaint fails to state a claim upon which relief can be granted. *Skilstaf, Inc. v. CVS Caremark Corp.*, 669 F.3d 1005, 1014 (9th Cir. 2012); *see* Fed. R. Civ. P. 12(b)(6). "[D]etailed factual allegations" aren't required. *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (internal quotation marks omitted). But there must be "sufficient allegations of underlying facts to give fair notice and to enable the opposing party to defend itself effectively . . . [and] plausibly suggest an entitlement to relief, such that it is not unfair to require the opposing party to be subjected to the expense of discovery and continued litigation." *Starr v. Baca*, 652 F.3d 1202, 1216 (9th Cir. 2011). A court should not accept "threadbare recitals of a cause of action's elements, supported

by mere conclusory statements." *Iqbal*, 556 U.S. at 678; *see also Eclectic Properties E., LLC v. Marcus & Millichap Co.*, 751 F.3d 990, 995-97 (9th Cir. May 7, 2014).

If a court dismisses a claim, it must also decide whether to allow the plaintiff to amend the complaint. "The court should freely give leave when justice so requires." Fed. R. Civ. P. 15(a)(2). But the "court may deny a plaintiff leave to amend if it determines that allegation of other facts consistent with the challenged pleading could not possibly cure the deficiency or if the plaintiff had several opportunities to amend its complaint and repeatedly failed to cure deficiencies." *Telesaurus VPC, LLC v. Power*, 623 F.3d 998, 1003 (9th Cir. 2010) (internal quotation marks and citation omitted).

ANALYSIS

1. CLAIMS TWO AND SEVEN

The second and seventh claims in the FAC, for avoidance of a constructively fraudulent transfer under § 548(a)(1)(B) and for declaratory relief, both require deciding whether Fitness Holdings' transfer of $11,995,500 to Hancock Park was made in repayment of a debt, as that term is defined in the Bankruptcy Code. *See Fitness I*, 714 F.3d 1145-46 & n.4. That decision, in turn, requires determining whether the financing Hancock Park extended to Fitness Holdings from 2003 to 2006 was debt or equity. The Ninth Circuit vacated the dismissal of these claims, held that this Court erred in concluding that it lacked the authority to recharacterize debt as equity, and remanded for a

determination of whether the debt should be recharacterized as equity. *See id.* at 1145-50.

The Ninth Circuit outlined the following framework for making this determination. The Bankruptcy Code defines "debt" as "liability on a claim." 11 U.S.C. § 101(12). A claim, in turn, is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." *Id.* § 101(5)(A). The Bankruptcy Code "thus broadly defines 'debt' as liability on virtually any type of 'right to payment.'" *Fitness Holdings I*, 714 F.3d at 1146. The Ninth Circuit held that courts must look to applicable state law in determining whether a right to payment exists, asking "whether the purported 'debt' constituted a right to payment under state law." *Id.* at 1147.

Thus, this Court must decide whether, under the appropriate state's law, whether the transfers from Hancock Park to Fitness Holdings between 2003 and 2006 gave Hancock Park a "right to payment."

1.1 Choice of Law

The Ninth Circuit did not decide which state's law applies in this case. Appellant argues that California law applies. Each of the promissory notes provides: "This Note shall be governed by and construed in accordance with the internal laws (and not the law of conflicts) of the State of California." (*See, e.g.* ER 229.) But Appellees argue that, under "the internal affairs doctrine,"

Delaware law should govern because Fitness Holdings is a Delaware corporation. Because the Court believes the internal affairs doctrine is inapplicable here, the Court will apply California law. "Claims involving 'internal affairs' of corporations . . . are subject to the laws of the state of incorporation." *Davis & Cox v. Summa Corp.*, 751 F.2d 1507, 1527 (9th Cir. 1985) (citing Restatement (Second) of Conflict of Laws §§ 302, 309 (1971)). Matters falling under the internal affairs doctrine are those peculiar to a corporation, such as "steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, the issuance of corporate shares [], the holding of directors' and shareholders' meetings, methods of voting including any requirement for cumulative voting, the declaration and payment of dividends and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its own stock." Restatement (Second) of Conflict of Laws § 302 comment e. By contrast, matters arising from acts that could have also been performed by an individual – such as the commission of torts, the making of contracts, and the transfer of property – are not within the scope of the internal affairs doctrine. *Id. §§* 301, 302 comment e.

Appellees have not persuaded the Court that the internal affairs doctrine applies to determining whether promissory notes executed by a corporation create a right to payment. The execution of promissory notes to

obtain financing is not an act concerning corporate governance, but an act that can be done by corporations and other persons and entities alike. Appellees cite no authority holding that such an act is governed by the internal affairs doctrine. And the only authority the Court is aware of specifically addressing the issue held that the internal affairs doctrine is not applicable to recharacterization claims. *See In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747, 764-65, 773 & n.7 (Bankr. W.D. La. 2013).

The Court thus applies California law in determining whether the promissory notes created a right to payment. And even if Delaware law were to apply, none of the parties appear to believe that the choice of law would affect the outcome. (*See* Response Brief of Appellees, Dkt. No. 21, at 16-17 (stating that "the choice of law is not dispositive here" because "the same principle should govern" in both states); Trustee's Reply Brief, Dkt. No. 26, at 6 n.2 ("Even if Delaware law did apply, the outcome would be identical, as Delaware law on characterization of the transaction . . . is identical to the "substance over form" holdings of California law. . . .").)

1.2 Right to Payment Under California Law

The purported right to payment in this case derives from the promissory notes executed by Hancock Park to Fitness Holdings. Under California law, the execution of a promissory note creates a contract, and the terms of the note are subject to the parol evidence rule

and other principles of contract interpretation. *See Poseidon Dev., Inc. v. Woodland Lane Estates, LLC*, 62 Cal. Rptr. 3d 59, 63 (Cal. App. 2007); *FPI Dev., Inc. v. Nakashima*, 282 Cal. Rptr. 508, 516-17 (Ct. App. 1991); *Montgomery v. Riess*, 176 Cal. App. 2d 711, 717 (1959). The promissory notes here were executed, so the Court first looks to their terms to determine whether they gave Hancock Park a contractual right to payment.

The first step in interpreting a contract is determining whether the contract is ambiguous. In determining whether the contract is ambiguous under California law, "courts may *preliminarily* consider any extrinsic evidence offered by the parties." *Miller v. Glenn Miller Prods.*, Inc., 454 F.3d 975, 989-90 (9th Cir. 2006) (emphasis added). "If the court decides, after consideration of this evidence, that the language of a contract, in the light of all the circumstances, is 'fairly susceptible of either one of the two interpretations contended for,' extrinsic evidence relevant to prove either of such meanings is admissible." *Id.* at 990. If, by contrast, this preliminary analysis reveals that the contract is unambiguous, the case may be decided by the court because interpretation of an unambiguous contract is "solely a question of law." *See Brobeck, Phleger & Harrison v. Telex Corp.*, 602 F.2d 866, 871-72 (9th Cir. 1979).

Here, the terms of the notes unambiguously give Hancock Park a right to repayment of the funds transferred to Fitness Holdings. The notes state that Fitness Holdings "promises to pay" Hancock Park the principal amount plus interest. (ER 225.) The notes provide for

an annual interest rate of 10 percent, dates of payment four times per year, and a maturity date when the entire unpaid balance must be paid. (*Id.*) In the event of default, Hancock Park "*may* . . . declare all or any portion of the outstanding principal amount of the Note due and payable and demand immediate payment of all or *any portion* of the outstanding principal amount of the Note. (ER 228.) The notes also provide that Hancock Park does not waive any of its rights under the notes if it delays in exercising them. (*Id.*)

Appellant does not point to any ambiguity in the terms of the notes. Nor does Appellant argue that the terms of the notes are ambiguous if extrinsic evidence is considered. Appellant does not sufficiently develop any argument that the executed promissory notes failed to create a valid contract giving Hancock Park a right to payment from Fitness Holdings. Instead, Appellant argues that the contract is not determinative and urges the Court to adopt alternative tests to decide the issue. The Court addresses these arguments next.

1.3 Appellant's Alternative Recharacterization Tests

Appellant criticizes viewing the "right to payment" issue as a matter of contract law, arguing that contractual rights cannot determine whether there exists a right to payment because then the parol evidence rule would always bar an action to recharacterize purported debt as equity. But that is not so. For example,

in appropriate circumstances, courts can consider parol evidence in determining whether a promissory note is enforceable. *See FPI Dev., Inc. v. Nakashima*, 282 Cal. Rptr. 508, 518-30 (Ct. App. 1991). If the promissory note was not enforceable, then there would be no right to payment under state law. Further, even when a document describes itself as a "loan" document, courts may nonetheless find that the substantive terms of the document create equity rather than debt. *Cf In re Lothian Oil, Inc.*, 650 F.3d 539, 544 (5th Cir. 2011) (affirming recharacterization when a document, while using the term "loan," lacked a fixed interest rate, terms of repayment, or a maturity date, and provided for payments out of royalties).

Thus, under the approach the Court has followed in assessing whether a right to payment exists, recharacterization will remain a viable remedy in appropriate cases. In this case, however, the promissory notes are enforceable and the terms of the notes are standard terms for the repayment of debt.

Next, Appellant seems to urge the Court to adopt a multi-factor test from federal precedent. Appellant cites *A.R. Lantz Co.*, a federal tax law case where the court employed an eleven-factor test to determine whether a payment created debt or equity. *See A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970). But the Ninth Circuit rejected this approach for recharacterizing debt in bankruptcy. In *Fitness I*, the court noted that some circuits "fashioned a federal test for recharacterizing debt," such as the Sixth Circuit, which used an "eleven-factor test, derived from federal

tax law," for distinguishing between debt and equity. 714 F.3d at 1148 (citing *In re AutoStyle Plastics*, Inc., 269 F.3d 726, 748 (6th Cir. 2001).) The Ninth Circuit refused to follow the Sixth Circuit, instead concluding that courts must determine whether the party has a "right to payment" under state law. *Id.* at 1148-49. It is California law, not the factors in federal tax cases, that determines whether Hancock Park had a right to payment.

Turning to California law, Appellant argues that the Court should use the test California courts employ in usury cases. In usury cases, the courts ask "whether or not the bargain of the parties, assessed in light of all the circumstances and with a view to substance rather than form, has as its true object the hire of money at an excessive rate of interest." *Sw. Concrete Products v. Gosh Constr. Corp.*, 51 Cal. 3d 701, 705, 798 P.2d 1247 (1990). The purpose of this rule is to allow courts to strike "down as usurious arrangements bearing little facial resemblance to what is normally thought of as a loan," as some lenders "fashion[] transactions designed to evade the usury law." *Boerner v. Colwell Co.*, 21 Cal. 3d 37, 44 (1978).

Even if usury precedent were applicable in this context, the outcome in this case would be the same. In *Ghirardo v. Antonioli*, although the California Supreme Court held that courts should "look beyond the surface of the transaction" in usury cases to determine whether a transaction is a loan, it declined to characterize a transaction as a loan when "the settlement notes [bore] none of the attributes of a loan." 8 Cal. 4th

791, 802 (1994). It follows that, were California courts in the usury context to assess a document that bears all of the attributes of a loan, as here, they would be unlikely to characterize it as anything but a loan.

Nor do the circumstances "beyond the surface of the transaction" change this result. The allegations that Fitness Holdings was perpetually in default, and that Hancock Park did not demand or receive any payment until June 2007, do not plausibly suggest that the parties intended for Hancock Park to have no right to demand payment.

"It can hardly be argued that forbearance in the face of financial stress by itself supports a finding of recharacterization." *In re Daewoo Motor Am., Inc.*, 471 B.R. 721, 738 (C.D. Cal. 2012), *aff'd*, 554 F. App'x 638 (9th Cir. 2014). According to the FAC, Fitness Holdings was financially distressed and "unable to satisfy its obligations [to Hancock Park and other creditors] as they became due." (FAC ¶¶ 22-42.). The promissory notes provide that Hancock Park may delay in enforcing its right to payment without waiving that right, and such waiver clauses in promissory notes are enforceable in California. *See Posey v. Leavitt*, 229 Cal. App. 3d 1236, 1248 n.11 (1991). The decision of Hancock Park to delay demanding payment, when it had the right to delay demanding payment and Fitness Holdings was unable to meet its obligations, does not plausibly suggest that the parties didn't intend the promissory notes to give Hancock Park a right to payment. It is not unusual for creditors to delay collection efforts on debts.

It is also not plausible that the parties intended the transfer of funds from Hancock Park to Fitness Holdings to create equity because, at the time of the transfers, Fitness Holdings already wholly owned Hancock Park. (FAC ¶ 7.) Fitness Holdings thus had no greater ownership stake to gain.

Thus, even applying Appellant's preferred test from California usury cases, recharacterization of the debt as equity is not warranted.

1.4 Conclusion

Under California law, the executed promissory notes gave Hancock Park a contractual "right to payment." Appellant's proposed methods for assessing recharacterization aren't viable alternatives, as they do not assess whether Hancock Park had a right to payment and are otherwise unsupported by law. And even if the Court were to consider the additional circumstances alleged by Appellant, those circumstances would not plausibly suggest that Hancock Park lacked a right to payment.

Therefore, the Court AFFIRMS the dismissal of claims two and seven.

2. CLAIMS ONE, THREE, FOUR, FIVE, SIX, NINE, AND TEN

The Ninth Circuit vacated the dismissal of claims one, three, four, five, six, nine, and ten in the FAC because this Court's "erroneous assumption that a court lacked

authority to recharacterize" debt as equity "infected its analysis" of these claims. *Fitness II*, 529 F. App'x at 873-74 (9th Cir. 2013). The Ninth Circuit remanded these claims for proceedings consistent with its holding that courts may recharacterize purported debt as equity.

As detailed earlier in this order, upon reconsidering whether the debt should be recharacterized as equity, the Court has concluded that the FAC does not make a plausible case for recharacterization. In other words, after following further instruction from the Ninth Circuit, the Court still treats the debt as debt. Thus, the Court's conclusion that these claims should be dismissed remains the same.

The Court is not persuaded by Appellant's argument that the Ninth Circuit's reversal of claim eight (equitable subordination) – a claim not a part of this appeal – dictates a different outcome for the actual fraudulent transfer claims. The Ninth Circuit held that allegations that some of the Appellees sought "to benefit themselves by knowingly funneling money to themselves out of a failing company plausibly alleged the elements of a claim for equitable subordination." *Fitness II*, 529 Fed. App'x at 874-75. But equitable subordination has different elements than actual fraudulent transfer, and the Ninth Circuit did not reverse the actual fraudulent transfer claims or suggest that its holding as to equitable subordination should impact this Court's consideration of the fraudulent transfer claims on remand.

Further, under the law cited in the Court's original order, the fact that some Appellees sought to benefit themselves does not establish an actual fraudulent transfer claim. The Court held in its previous order that "abundant caselaw makes clear [that] a debtor can favor, indeed prefer, any one or several of its unsecured creditors with a transfer of assets to the detriment of such debtor's remaining unsecured creditor body, even in the face of such debtor's insolvency, and such transfer, as a matter of law, cannot, without more, then be avoided as a fraudulent conveyance." *See In re Fitness Holdings Int'l, Inc.*, 2011 WL 7763674, at *5 (quoting *In re Foxmeyer Corp.*, 296 B.R. 327, 337 (Bankr. D. Del. 2003).) Appellant does not sufficiently explain how, under this precedent, its claims survive.

PWBank argues that the tenth claim fails for an additional reason, the *in pari delicto* doctrine. Because the tenth claim fails regardless of the merits of that defense, the Court need not reach that issue.

The Court AFFIRMS the dismissal of claims one, three, four, five, six, nine, and ten.

DISPOSITION

The Court AFFIRMS the decision of the bankruptcy court. The Court reaches this result after reviewing all

arguments in the parties' papers. Any arguments not specifically addressed were either unpersuasive or not necessary to reach given the Court's holdings.

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UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

LOS ANGELES DIVISION

In re: FITNESS HOLDINGS INTERNATIONAL, INC., a Delaware corporation, Debtor.	Case No. 2:08-27527-BR Chapter 11 Honorable Barry Russell
OFFICIAL COMMITTEE OF UNSECURED CREDITORS of the estate of Fitness Holdings International, Inc., Plaintiff, v. HANCOCK PARK CAPITAL II, L.P., a Delaware limited partnership, PACIFIC WESTERN BANK, et al., Defendants.	Adv. No. 2:09-01610-BR **ORDER DISMISSING CLAIMS AGAINST DEFENDANTS HANCOCK PARK CAPITAL II, L.P. AND MICHAEL J. FOURTICQ, SR.**

	Hearing Held: December 4, 2013 Hearing Time: 10:00 p.m. Courtroom: 1668

On December 4, 2013, the Court held a hearing on the motion of defendants Hancock Park Capital II, L.P., Hancock Park Associates II, LLC, Hancock Park Associates (the "Hancock Park Defendants"), and Michael Fourticq, Sr. (collectively with the Hancock Park Defendants, the "Moving Defendants") to dismiss the First, Second, Third, Fourth, Fifth, Sixth, Seventh, and Ninth Claims asserted against them in the First Amended Complaint (the "Motion"). Counsel for plaintiff and counsel for the Moving Defendants presented argument on the Motion at the hearing.

On January 22, 2014, plaintiff and the Hancock Park Defendants submitted a stipulation to dismiss with prejudice the Eighth Cause of Action in the First Amended Complaint against the Hancock Park Defendants (the "Stipulation") [Docket No. 142].

Having considered the pleadings, the papers, and the arguments presented at the December 4 hearing, and the Stipulation,

IT IS HEREBY ORDERED:

(1) The First, Second, Third, Fourth Fifth, Sixth, Seventh, and Ninth Claims asserted in plaintiff's First Amended Complaint against Hancock Park Capital II, L.P., Hancock Park Associates II, LLC, and Hancock Park Associates are dismissed with prejudice; and

(2) The Eighth Claim asserted against the Hancock Park Defendants is dismissed with prejudice pursuant to the Stipulation; and

(3) The Ninth Claim asserted against defendant Fourticq is dismissed with prejudice, and

(4) The Moving Defendants are entitled to a judgment of dismissal in the above-referenced adversary proceeding.

Submitted by:

MUNGER, TOLLES & OLSON LLP

By: /s/ Bradley R. Schneider

Attorneys for Defendants
HANCOCK PARK CAPITAL II, L.P.
MICHAEL J. FOURTICQ, SR.

Approved as to form by:

EZRA, BRUTZKUS & GUBNER

By: Robyn B. Sokol
(w/ permission 1/21/14 5:09 p.m. email)

Attorneys for Plaintiff
Sam Leslie, Chapter 7 Trustee of the
estate of Fitness Holding International, Inc.

Date: January 27, 2014

/s/ Barry Russell
Barry Russell
United States Bankruptcy Judge

529 Fed.Appx. 871
This case was not selected for
publication in the Federal Reporter.
Not for Publication in West's Federal Reporter See
Fed. Rule of Appellate Procedure 32.1 generally
governing citation of judicial decisions issued on or
after Jan. 1, 2007. See also Ninth Circuit Rule 36-3.
(Find CTA9 Rule 36-3)
United States Court of Appeals,
Ninth Circuit.

In the Matter of FITNESS HOLDINGS
INTERNATIONAL, INC., Debtor.
Official Committee of Unsecured Creditors, of the
Estate of Fitness Holdings International, Inc.,
Appellant,
v.
Hancock Park Capital II, L.P., a Delaware Limited
Partnership; Pacific Western Bank; Kenton Van
Harten; Michael Fourticq, Sr.; Hancock Park
Associates, III; Hancock Park Associates,
Appellees.

No. 11-56677.
|
Argued and Submitted Feb. 4, 2013.
|
Filed May 20, 2013.

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Appeal from the United States District Court for the Central District of California, Andrew J. Guilford, District Judge, Presiding. D.C. No. 2:10-cv-00647-AG.

Before: CALLAHAN, IKUTA, and HURWITZ, Circuit Judges.

ORDER

Pacific Western Bank's Petition for Clarification or Rehearing is GRANTED IN PART AND DENIED IN PART. Its request for clarification is GRANTED. The clarifications are made in the amended memorandum disposition filed concurrently with this order. Its request for a rehearing is DENIED.

No further petitions for rehearing or rehearing en banc will be entertained.

AMENDED MEMORANDUM*

In this Chapter 7 bankruptcy case, the bankruptcy court dismissed all the trustee's claims against defendants under Rule 12(b)(6) of the Federal Rules of Civil Procedure. The bankruptcy court affirmed. We have jurisdiction under 28 U.S.C. §§ 158(d)(1) and 1291, and now affirm in part, reverse in part, and vacate and remand in part.[1]

As explained in our opinion in *In re Fitness Holdings Int'l*, the district court erred in concluding that the trustee's argument that Hancock Park's loan to Fitness Holdings should be recharacterized as equity was not cognizable as a matter of law. 714 F.3d at 1144. Because of this legal error, the district court failed to consider whether the trustee plausibly alleged that the $11,995,500 transfer from Hancock Park to Fitness Holdings should be recharacterized as creating an equity interest rather than debt. As a result, the district court failed to apply the correct standard in considering whether the trustee's allegations that Fitness Holdings made its transfer to Hancock Park without reasonably equivalent value plausibly gave rise to an entitlement to relief. *Fitness Holdings*, 714 F.3d at 1149-50. Accordingly, we vacated the district court's

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* This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3.

[1] We address trustee's claim that the complaint sufficiently alleged that Fitness Holdings' transfer to Hancock Park was avoidable under 11 U.S.C. § 548(a)(1)(B) (Claims 2 and 7 of the First Amended Complaint) in an opinion filed concurrently with this disposition.

dismissal of the 11 U.S.C. § 548(a)(1)(B) constructive fraudulent conveyance claim and remanded for further proceedings. *Fitness Holdings*, 714 F.3d at 1150.

The district court's legal error also infected its analysis of many of the trustee's other claims. First, because the district court erred in failing to consider whether applicable state fraudulent conveyance law allowed a court to recharacterize a loan as an equity interest, it failed to apply the correct standard in considering whether the trustee's allegations that Fitness Holdings transferred $11,995,500 to Hancock Park without receiving reasonably equivalent value plausibly alleged a claim for relief under 11 U.S.C. § 544(b)(1), which incorporates applicable state law (claims 3, 4 and 5 of the First Amended Complaint).

Second, the district court's erroneous assumption that a court lacked authority to recharacterize Hancock Park's $11,995,500 as equity rather than debt prevented the court from properly evaluating the trustee's allegations (claim 1 of the First Amended Complaint) that Fitness Holdings' transfer of $11,995,500 to Hancock Park in return for an equity investment was actually fraudulent for purposes of 11 U.S.C. § 548(a)(1)(A).

Third, because the court failed to properly address the fraudulent transfer claims, it also did not properly address the claim for recovery of an avoided transfer under 11 U.S.C. § 550(a) (claim 6 of the First Amended Complaint).

Finally, the court's erroneous assumption prevented it from properly evaluating the trustee's allegations that Hancock Park, Van Harten and Fourticq breached their fiduciary duties to Fitness Holdings (claim 9 of the First Amended Complaint), and that Pacific Western aided and abetted the alleged breach of fiduciary duties (claim 10 of the First Amended Complaint).

Because the district court did not review these claims (claims 1, 3, 4, 5, 6, 9, and 10 of the First Amended Complaint) under the correct standard, we vacate dismissal of these claims and remand them to the district court to consider them in the first instance. *See Salmon Spawning & Recovery Alliance v. Gutierrez*, 545 F.3d 1220, 1230 n. 6 (9th Cir.2008). We likewise decline to reach the merits of Pacific Western's argument that the *in pari delicto* doctrine shields it from aiding and abetting liability, and leave it to the district court to consider this theory on remand.

We affirm the district court's dismissal of the trustee's claims that Fitness Holdings' transfer of a security interest in its assets to Pacific Western should be avoided as an actually fraudulent transfer (claims 10, 11, and 13 of the original complaint). The complaint asserts only that Fitness Holdings conveyed a security interest to Pacific Western in order to obtain a $25 million loan. We cannot reasonably infer that Fitness Holdings was attempting to "hinder, delay, or defraud" its creditors, § 548(a)(1)(A); Cal. Civ.Code § 3439.04(a)(1), simply because it took on secured debt to replace unsecured debt; borrowers regularly give security interests

to obtain financing. Because the complaint fails to plausibly allege any other facts showing that the trustee has an entitlement to relief, the district court properly dismissed the claims alleging an actually fraudulent transfer to Pacific Western.

The district court also properly dismissed the trustee's claims that Fitness Holdings' transfer of a security interest in its assets to Pacific Western should be avoided as a constructively fraudulent transfer (claims 12 and 14 of the original complaint). Because the complaint alleges that Fitness Holding granted Pacific Western the security interest in exchange for a $25 million loan, and does not allege that the value of the security interest exceeded the value of the loan, the trustee failed to plausibly allege that the security interest was given for less than reasonably equivalent value, which is a necessary element of a claim for a constructively fraudulent transfer under both the Bankruptcy Code and state law. §§ 548(a)(1)(B)(i); 548(d)(2)(A); § 544(b)(1); Cal. Civ.Code § 3439.04(a)(2).

Because the district court properly dismissed the trustee's claims for constructively and actually fraudulent transfers, the dismissal of the trustee's claim for avoidance of these transfers (claim 15 of the original complaint) was also correct. *See* 11 U.S.C. § 550.

The trustee's allegations (in claim 8 of the First Amended Complaint) that insiders "contrived" to benefit themselves by knowingly funneling money to themselves out of a failing company plausibly alleged the elements of a claim for equitable subordination,

namely: "'(1) that the [defendants] engaged in some type of inequitable conduct, (2) that the misconduct injured creditors or conferred unfair advantage on the claimant, and (3) that subordination would not be inconsistent with the Bankruptcy Code.'" *In re First Alliance Mortg. Co.*, 471 F.3d 977, 1006 (9th Cir.2006) (quoting *In re Lazar*, 83 F.3d 306, 309 (9th Cir.1996)). We therefore reverse the district court's dismissal of this claim. Each party will bear its own costs on appeal.

AFFIRMED IN PART, REVERSED IN PART, VACATED IN PART, AND REMANDED.

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714 F.3d 1141
United States Court of Appeals,
Ninth Circuit.

In the Matter of FITNESS HOLDINGS INTERNATIONAL, INC., Debtor.
Official Committee of Unsecured Creditors, of the Estate of Fitness Holdings International, Inc., Appellant,
v.
Hancock Park Capital II, L.P., a Delaware Limited Partnership; Pacific Western Bank; Kenton Van Harten; Michael Fourticq, Sr.; Hancock Park Associates, III; Hancock Park Associates, Appellees.

No. 11-56677.
|
Argued and Submitted Feb. 4, 2013.
|
Filed April 30, 2013.

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Lawrence C. Barth and M. Lance Jasper (argued), Munger, Tolles & Olson, LLP, Los Angeles, CA, for Appellees Hancock Park Capital II, L.P., Michael Fourtieq, Sr., Hancock Park Associates, III and Hancock Park Associates.

Appeal from the United States District Court for the Central District of California, Andrew J. Guilford, District Judge, Presiding. D.C. No. 2:10-cv-00647-AG.

Before: CONSUELO M. CALLAHAN, SANDRA S. IKUTA, and ANDREW D. HURWITZ, Circuit Judges.

OPINION

IKUTA, Circuit Judge:

This case presents the question whether a debtor's pre-bankruptcy transfer of funds to its sole shareholder, in repayment of a purported loan, may be a constructively fraudulent transfer under 11 U.S.C. § 548(a)(1)(B). In order to answer this question, we must determine whether a bankruptcy court has the power to recharacterize the purported loan as an equity investment. We hold that a court has the authority to determine whether a transaction creates a debt or an equity interest for purposes of § 548, and that a transaction creates a debt if it creates a "right to payment" under state law. *See* 11 U.S.C. § 101(5), (12); *Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) (noting that "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law"). Because the

district court concluded that it lacked authority to make this determination, we vacate the decision below and remand for further proceedings.[1]

I

Fitness Holdings International, Inc., the debtor in this bankruptcy case, was a home fitness corporation. Before declaring bankruptcy, the company received significant funding from two entities: Hancock Park, its sole shareholder, and Pacific Western Bank. Defendants Kenton Van Harten and Michael Fourticq both served on Fitness Holdings' board of directors. Fourticq was also a manager of Hancock Park.

Between 2003 and 2006, Fitness Holdings executed eleven separate subordinated promissory notes to Hancock Park for a total of $24,276,065. Each note required Fitness Holdings to pay a specified principal amount to Hancock Park, plus interest of ten percent per year, on or before the note's maturity date.[2]

In July 2004, Pacific Western Bank made a $7 million revolving loan and a $5 million installment loan to Fitness Holdings, both of which were secured by all of

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[1] In this opinion, we address only the trustee's claim for avoidance of a constructively fraudulent transfer under § 548(a)(1)(B) and his request for declaratory relief (claims 2 and 7 of the First Amended Complaint). We resolve the remaining claims in a memorandum disposition filed concurrently with this opinion.

[2] The maturity dates of the eleven notes were set for September 30, 2006, November 5, 2006, and October 1, 2009.

Fitness Holdings' assets. Hancock Park guaranteed these loans. Fitness Holdings and Pacific Western Bank amended the loan agreement multiple times. The amendments eased Fitness Holdings' obligations in various ways, for example, by extending the maturity dates on the revolving loan and waiving past breaches.

Finally, in June 2007, Fitness Holdings and Pacific Western Bank agreed to refinance Fitness Holdings' debt. Under the terms of the agreement, Pacific Western Bank made two loans to Fitness Holdings: a $17 million term loan, and an $8 million revolving line of credit. These loans were also secured by all of Fitness Holdings' assets. The loan agreement provided that upon closing, $8,886,204 would be disbursed to pay off Pacific Western Bank's original secured loan, and $11,995,500 would be disbursed to Hancock Park to pay off its unsecured promissory notes. The payoff of Pacific Western Bank's prior secured loan had the effect of releasing Hancock Park from its guarantee.

These attempts to save Fitness Holdings proved unsuccessful, and the company filed for Chapter 11 bankruptcy on October 20, 2008. A committee of unsecured creditors, acting on behalf of Fitness Holdings and its estate, filed a complaint against Hancock Park, Pacific Western Bank, Van Harten, and Fourticq to recover the payments made to Hancock Park as a result of the refinancing transaction with Pacific Western Bank. The complaint also requested declaratory relief, asking the court to characterize the financing Hancock Park provided to Fitness Holdings in connection with the promissory notes as equity investments in Fitness

Holdings, rather than extensions of credit. As a result, the complaint alleged, the transfer of $11,995,500 to Hancock Park was constructively fraudulent.

On January 15, 2010, the bankruptcy court dismissed all claims against Hancock Park with prejudice. The case was subsequently converted to a Chapter 7 filing on April 6, 2010, *In re Fitness Holdings Int'l, Inc.*, No. 2:08-bk-27527-BR, Dkt. # 291 (Bankr.C.D.Cal. April 6, 2010). The following month, the bankruptcy court appointed a trustee for Fitness Holdings, who replaced the committee of unsecured creditors in the litigation.

The trustee appealed the bankruptcy court's dismissal of the complaint to the district court, which affirmed the bankruptcy court and dismissed the case for failure to state a claim. *In re Fitness Holdings Int'l, Inc. (Fitness I)*, No. CV 10-0647 AG, 2011 WL 7763674, *1 (C.D.Cal. Aug. 31, 2011). The district court held that, under longstanding precedent of the Ninth Circuit Bankruptcy Appellate Panel, Hancock Park's advances to Fitness Holdings were loans and, as a matter of law, it was barred from recharacterizing such loans as equity investments. *Id.* at *5 (citing *In re Pacific Express*, 69 B.R. 112, 115 (B.A.P. 9th Cir.1986)).[3]

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[3] The district court erred in holding it was bound by a decision of the Bankruptcy Appellate Panel. *See Bank of Maui v. Estate Analysis, Inc.*, 904 F.2d 470, 472 (9th Cir.1990) ("As article III courts, the district courts must always be free to decline to follow BAP decisions and to formulate their own rules within their jurisdiction.").

The trustee timely appealed, claiming that the district court should have: (1) recharacterized Hancock Park's payment of $11,995,500 to Fitness Holdings as a payment in satisfaction of an equity interest rather than a debt, and then (2) avoided Fitness Holdings' $11,995,500 transfer to Hancock Park as a constructively fraudulent transfer under § 548(a)(1)(B) of the Bankruptcy Code.

II

We have jurisdiction under 28 U.S.C. §§ 158(d)(1) and 1291. Because the district court dismissed the trustee's complaint for failure to state a claim, we review de novo. *Telesaurus VPC, LLC v. Power*, 623 F.3d 998, 1003 (9th Cir.2010). In order to survive a motion to dismiss, a party must allege " 'sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face.' " *Id.* (quoting *Ashcroft v. Iqbal*, 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009)). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 556 U.S. at 678, 129 S.Ct. 1937. In reviewing a dismissal for failure to state a claim, "[a]ll well-pleaded allegations of material fact in the complaint are accepted as true and are construed in the light most favorable to the non-moving party." *Faulkner v. ADT Sec. Servs., Inc.*, 706 F.3d 1017, 1019 (9th Cir.2013).

A

We begin by setting forth the legal framework for fraudulent transfers under § 548(a)(1)(B) of the Bankruptcy Code.[4]

Filing a petition in bankruptcy creates an estate made up of the debtor's assets. *Schwab v. Reilly*, 560 U.S. 770, 130 S.Ct. 2652, 2657, 177 L.Ed.2d 234 (2010). In a Chapter 7 bankruptcy, a trustee is appointed or elected to administer the estate. 11 U.S.C. §§ 701-04. In order to protect the interests of the estate, a bankruptcy trustee may bring an action to avoid a transfer made before the bankruptcy that is allegedly either intentionally fraudulent, 11 U.S.C. § 548(a)(1)(A), or constructively fraudulent, § 548(a)(1)(B); *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994). A transfer is constructively fraudulent, and thus can be avoided by the trustee, 11 U.S.C. § 550, if the debtor made the transfer on or within two years before the date of filing the bankruptcy petition, the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation," § 548(a)(1)(B)(i), and one of four circumstances obtains.[5]

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[4] The trustee brought a "recharacterization" claim as a separate cause of action (claim 7 of the First Amended Complaint). We interpret this claim as a request for a determination that Fitness Holdings' transfer to Hancock Park was not made in repayment of a "debt" as that term is defined in the Code. 11 U.S.C. § 101(12).

[5] 11 U.S.C. § 548(a)(1)(B) (defining constructive fraudulent transfers) provides in pertinent part:

In construing the statutory requirement that the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation," § 548(a)(1)(B)(i), we must turn to a series of interlocking statutory definitions. The key phrase in § 548(a)(1)(B)(i), "reasonably equivalent value," is not defined in the Code. *BFP*, 511 U.S. at 535, 114 S.Ct.

> (a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily –
>
> . . . .
>
> > (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> >
> > (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> >
> > (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
> >
> > (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
> >
> > (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

1757. "Value" is defined, however, and includes the "satisfaction or securing of a present or antecedent debt of the debtor." § 548(d)(2)(A). Under this definition, "[p]ayment of a preexisting debt is value, and if the payment is dollar-for-dollar, full value is given." 5 Collier on Bankruptcy ¶ 548.03[5] (16th ed. 2012). Therefore, to the extent a transfer constitutes repayment of the debtor's antecedent or present debt, the transfer is not constructively fraudulent. *See Freeland v. Enodis Corp.*, 540 F.3d 721, 735 (7th Cir.2008) (holding that there is "reasonably equivalent value" where "payment of the accrued interest constituted 'dollar-for-dollar forgiveness of a contractual debt.'") (quoting *In re Carrozzella & Richardson*, 286 B.R. 480, 491 (D.Conn.2002)).

We next address the definition of the term "debt." The Bankruptcy Code defines "debt" to mean "liability on a claim." 11 U.S.C. § 101(12); *see also Johnson v. Home State Bank*, 501 U.S. 78, 84 n. 5, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991) (noting that "'debt' . . . has a meaning coextensive with that of 'claim.'") (citing *Penn. Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 558, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990)). "Claim" is defined, in relevant part, to mean "a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A). The Code thus broadly defines "debt" as liability on virtually any type of "right to payment."

Under these interlocking definitions, to the extent a transfer is made in satisfaction of a "claim" (i.e., a "right to payment"), that transfer is made for "reasonably equivalent value" for purposes of § 548(a)(1)(B)(i). And a determination that a transfer was made for "reasonably equivalent value" precludes a determination that it was constructively fraudulent under § 548(a)(1)(B). *See In re United Energy Corp.*, 944 F.2d 589, 595-96 (9th Cir.1991).

B

This analysis raises the further question of how courts are to determine whether there is a "right to payment" that constitutes a "claim" under the Code. Supreme Court precedent establishes that, unless Congress has spoken, the nature and scope of a right to payment is determined by state law.[6] The Supreme Court has "long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims, Congress having generally left the determination of property rights in the assets of a bankrupt's estate to state law." *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007) (internal quotation marks omitted). This principle was given its clearest statement in *Butner*, 440 U.S. 48, 99 S.Ct. 914, which held

[6] The term "state law" is often used "expansively . . . to refer to all nonbankruptcy law that creates substantive claims." *Grogan v. Garner*, 498 U.S. 279, 284 n. 9, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991). "We thus mean to include in this term claims that have their source in substantive federal law." *Id.*

that because "[p]roperty interests are created and defined by state law," *id.* at 55, 99 S.Ct. 914, "[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Id.* This means that "when the Bankruptcy Code uses the word 'claim' – which the Code itself defines as a 'right to payment,' – it is usually referring to a right to payment recognized under state law." *Travelers*, 549 U.S. at 451, 127 S.Ct. 1199 (internal citation omitted).

Relying on the *Butner* principle, the Supreme Court held in *Travelers* that a court should not use a federal rule to determine whether a pre-petition contract guaranteeing attorneys' fees created a "right to payment" giving rise to a "claim" under the Code. *Id.* at 446-47, 453-54, 127 S.Ct. 1199. *Travelers* arose from a Ninth Circuit case in which we had relied on circuit precedent holding that attorneys' fees are not recoverable in bankruptcy "for litigating issues peculiar to federal bankruptcy law." *Id.* at 451, 127 S.Ct. 1199 (internal quotation omitted). In a unanimous reversal, the Supreme Court criticized us for relying "solely on a rule of [our] own creation." *Id.* According to the Court, because the creditor's contractual right to attorneys' fees could be enforceable under the law of California, the pre-petition contract could give rise to a "claim" in bankruptcy, and so the Ninth Circuit erred in holding that, as a per se rule, a right to attorneys' fees for litigating bankruptcy issues never gives rise to a claim in bankruptcy. *Id.* at 450-52, 127 S.Ct. 1199; *see also*

Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15, 21, 120 S.Ct. 1951, 147 L.Ed.2d 13 (2000) (holding that where there was "no sign that Congress meant to alter" a state substantive right, the *Butner* rule required a creditor's claim to be assessed in light of state law, including the allocation of the burden of proof).

Under the *Butner* principle, therefore, a court may not fashion a rule "solely of its own creation" in determining what constitutes a "claim" for purposes of bankruptcy. Rather, "subject to any qualifying or contrary provisions of the Bankruptcy Code," *Raleigh*, 530 U.S. at 20, 120 S.Ct. 1951, a court must determine whether the asserted interest in the debtor's assets is a "right to payment" recognized under state law, *id.*

We now construe § 548(a)(1)(B) in light of the *Butner* principle. Because the Code defines debt as "liability on a claim," § 101(12), and defines "value" as including "satisfaction or securing of a . . . debt," § 548(d)(2)(A), we conclude that a transfer is for "reasonably equivalent value" for purposes of § 548(a)(1)(B)(i) if it is made in repayment of a "claim," i.e., a "right to payment" under state law. Therefore, in an action to avoid a transfer as constructively fraudulent under § 548(a)(1)(B), if any party claims that the transfer constituted the repayment of a debt (and thus was a transfer for "reasonably equivalent value"), the court must determine whether the purported "debt" constituted a right to payment under state law. If it did not, the court may recharacterize the debtor's obligation to the transferee under state law principles.

Because we hold that a court may recharacterize an obligation that does not constitute "debt" under state law, we disagree with *In re Pacific Express, Inc.*, which held that the Code did not authorize courts to characterize claims as equity or debt, but limited courts to the statutory remedy of equitable subordination under 11 U.S.C. § 510. 69 B.R. 112, 115 (B.A.P. 9th Cir.1986). This is incorrect, because "recharacterization and equitable subordination address distinct concerns." *In re SubMicron Sys.*, 432 F.3d 448, 454 (3d Cir.2006). Under the Code, the statutory equitable subordination remedy allows a court, under equitable principles, to subordinate "all or part of an allowed claim to all or part of another allowed claim." § 510(c)(1). In contrast, a court considering a motion to avoid a transfer as constructively fraudulent under § 548(a)(1)(B) must determine whether the transfer is for the repayment of a "claim" at all. Therefore *Pacific Express* erred in holding that the "characterization of claims as equity or debt" is governed by § 510(c). 69 B.R. at 115.[7]

C

In concluding that the Bankruptcy Code gives courts the authority to recharacterize claims in bankruptcy proceedings, we join our sister circuits, which have reached the same conclusion. *See In re Lothian*

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[7] In this opinion, we do not address whether the trustee has adequately pleaded a claim for equitable subordination. We resolve this issue in the memorandum disposition filed concurrently with this opinion.

Oil, 650 F.3d 539, 542-43 (5th Cir.2011); *SubMicron*, 432 F.3d at 454; *In re Dornier Aviation*, 453 F.3d 225, 231 (4th Cir.2006); *In re Hedged-Investments Associates, Inc.*, 380 F.3d 1292, 1298 (10th Cir.2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir.2001). But despite their broad agreement that the Code authorizes courts to recharacterize claims, the circuits have taken different approaches in identifying the legal framework for this recharacterization. *Compare Lothian Oil*, 650 F.3d at 543 (holding that, under the *Butner* principle, courts are required to define claims by reference to state law, and are thus required to recharacterize purported "debt" as equity where state law would treat the asserted interest as an equity interest) *with SubMicron*, 432 F.3d at 454-56 (holding that a court has the equitable authority to recharacterize a transaction and determine if it is more like "debt" or "equity") *and AutoStyle Plastics*, 269 F.3d at 749-50 (announcing an eleven-factor test, derived from federal tax law, for determining whether a purported "debt" is in fact "equity").

We agree with the approach adopted by the Fifth Circuit in *Lothian Oil*, 650 F.3d at 543, which is consistent with the *Butner* principle. *Lothian Oil* considered two pre-bankruptcy loan agreements which stated that the debtor would repay the loan in the form of equity interests and royalties, and did not specify interest rates or maturity dates. 650 F.3d at 541. When the debtor asked the court to recharacterize the loans as equity interests, the court construed this as a request to disallow the lender's claim under 11 U.S.C.

§ 502 on the ground that the purported loans were "unenforceable against the debtor and property of the debtor, under any agreement or applicable law." *Id.* at 543 (quoting 11 U.S.C. § 502(b)(1)). Recognizing the Supreme Court's determination in *Butner* that " 'applicable law' is *state* law," *id.* at 543, *Lothian Oil* looked to Texas law, which employed a multi-factor test to "distinguish between debt and equity," *id.* at 544 (quoting *Arch Petrol., Inc. v. Sharp*, 958 S.W.2d 475, 477 n. 3 (Tex.Ct.App.1997)). Under Texas law, the interests created by the lender's agreements with the debtor constituted "common equity interests at best," and not debt. *Id.* Therefore, the court disallowed the claims and recharacterized them as equity interests. *Id.*

We believe the Fifth Circuit's approach is more consistent with Supreme Court precedent than that of the circuits that have fashioned a federal test for recharacterizing an alleged debt in reliance on their general equitable authority under 11 U.S.C. § 105(a).[8] *See, e.g.*, *AutoStyle*, 269 F.3d at 749-50; *Hedged-Investments*, 380 F.3d at 1298-99. Such an equitable approach is inconsistent with Supreme Court precedent requiring us to determine whether a party has a "right

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[8] 11 U.S.C. § 105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

to payment," i.e., a "claim," § 101(5), by reference to state law, *see Butner*, 440 U.S. at 55, 99 S.Ct. 914; *Travelers*, 549 U.S. at 451, 127 S.Ct. 1199. Given the Supreme Court's direction, courts may not rely on § 105(a) and federal common law rules "of [their] own creation" to determine whether recharacterization is warranted. *Travelers*, 549 U.S. at 451, 127 S.Ct. 1199; *cf.* James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 Bus. Law. 1257, 1278 (Aug. 2007) ("Federal courts, if they are to follow Supreme Court precedent, cannot create a separate legal standard for the enforceability of insider debt in bankruptcy and should follow the state law of debt recharacterization."). Therefore, we agree with *Lothian Oil* that in order to determine whether a particular obligation owed by the debtor is a "claim" for purposes of bankruptcy law, it is first necessary to determine whether that obligation gives the holder of the obligation a "right to payment" under state law.

III

We now consider the application of these principles to this case. The question before the district court was whether the trustee's complaint plausibly alleged that Fitness Holdings' transfer of $11,995,500 to Hancock Park was a constructively fraudulent transfer under § 548(a)(1)(B). As explained in our decision today, to survive a motion to dismiss, the trustee was required to plausibly allege that the interests created by Hancock Park's agreements with Fitness Holdings constituted equity investments (rather than debt)

under applicable state law, and that therefore Hancock Park had no "right to payment" of $11,995,500 from Fitness Holdings. By making such allegations, the trustee could then claim that Fitness Holdings' transfer was not for reasonably equivalent value. *See* § 548(d)(2)(A).[9] Such allegations, combined with plausible allegations of the other elements of a claim for a constructively fraudulent transfer under § 548(a)(1)(B), could potentially "nudge" the trustee's claims "across the line from conceivable to plausible," *Iqbal*, 556 U.S. at 680, 129 S.Ct. 1937 (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007)), and show an entitlement to relief sufficient to withstand a motion to

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[9] The trustee also contends that Fitness Holdings did not receive "reasonably equivalent value" because it paid down unsecured preexisting debt with newly acquired secured financing. We reject this argument, because it is not supported by either the Code or our case law. Section 548(d)(2)(A) defines "value" to include the "satisfaction or securing of a present or antecedent debt." Under this definition, a debtor who grants a security interest in its property in exchange for funds has received reasonably equivalent value, *see In re Northern Merch., Inc.*, 371 F.3d 1056, 1059 (9th Cir.2004), as has a debtor who pays down preexisting debt. We therefore see no basis for holding that a debtor who takes both actions simultaneously (obtaining a secured loan and simultaneously paying down pre-existing debt) has received something less than "reasonably equivalent value." The trustee's reliance on *In re Superior Stamp & Coin Co.*, 223 F.3d 1004, 1008 n. 3 (9th Cir.2000), is misplaced, because that case considered the circumstances that might give rise to a voidable preference under § 547(b), not whether the debtor obtained reasonably equivalent value under § 548.

dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure.

The district court did not view the trustee's constructively fraudulent transfer claim through this lens. Because the court erroneously concluded that it was barred from considering whether the complaint plausibly alleged that the promissory notes could be recharacterized as creating equity interests rather than debt, it failed to apply the correct standard in considering whether the trustee's allegation that Fitness Holdings did not receive reasonably equivalent value for its transfer of $11,995,500 to Hancock Park plausibly gave rise to a claim for relief under § 548(a)(1)(B).

Analyzing the trustee's constructive fraudulent transfer claim under the proper legal framework requires the identification of the pertinent legal principles under applicable state law. Rather than ruling on these issues in the first instance, *see Salmon Spawning & Recovery Alliance v. Gutierrez*, 545 F.3d 1220, 1230 n. 6 (9th Cir.2008), we vacate the district court's dismissal of the complaint's constructive fraudulent transfer claim and remand for further proceedings consistent with this opinion. Each party will bear its own costs on appeal.

VACATED AND REMANDED.

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Unpublished Disposition
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NOTE: THIS OPINION WILL NOT APPEAR IN A PRINTED VOLUME. THE DISPOSITION WILL APPEAR IN A REPORTER TABLE.
United States Court of Appeals,
Ninth Circuit.

In the Matter of FITNESS HOLDINGS INTERNATIONAL, INC., Debtor. Official Committee of Unsecured Creditors, of the Estate of Fitness Holdings International, Inc.,
Appellant,
v.
Hancock Park Capital II, L.P., a Delaware Limited Partnership; Pacific Western Bank; Kenton Van Harten; Michael Fourticq, Sr.; Hancock Park Associates, III; Hancock Park Associates,
Appellees.

No. 11-56677.
|
Argued and Submitted Feb. 4, 2013.
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Filed April 30, 2013.

Opinion amended and superseded on rehearing. For superseding opinion, see 2013 WL 2151401.

2011 WL 7763674
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United States District Court,
C.D. California.

In re FITNESS HOLDINGS INTERNATIONAL, INC., Debtor.
Official Committee of Unsecured Creditors, Appellants,
v.
Hancock Park Capital II, L.P., et al., Appellees.

No. CV 10-0647 AG.
|
Aug. 31, 2011.

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ORDER AFFIRMING BANKRUPTCY COURT'S RULING ON MOTION TO DISMISS FIRST AMENDED COMPLAINT

ANDREW J. GUILFORD, District Judge.

This matter arises from the Chapter 11 bankruptcy case *In re Fitness Holdings, Inc.*, Case No. 2:08-bk-27527-BR, and adversary action *Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P., et al.*, Case No. 2:09:ap-1610-BR. The Court now considers the appeal by Appellant Sam Leslie, Chapter 7 Trustee, of the Order and Judgment of the Bankruptcy Court Dismissing First Amended Complaint and also the appeal of the Bankruptcy Court's dismissal of certain claims from the original complaint. The Court determined that no hearing was necessary on this appeal. After considering all papers submitted, the Court AFFIRMS the Bankruptcy Court's ruling.

BACKGROUND

Debtor Fitness Holdings, Inc. ("Debtor") filed its Chapter 11 petition for relief in October 2008. (Appellant's Excerpt of Record ("ER") 2:22.) The Debtor is owned by Hancock Park, which in turn is owned by Kenton Van Harten and Michael Fourticq. (ER 5:121-22.) Van Harten and Fourticq (together, "Insiders" of the Debtor) are the Debtor's sole directors and Van Harten is its sole officer. (*Id.*) In April 2009, the Bankruptcy Court approved a stipulation between the Debtor and the Committee of Unsecured Creditors ("Committee" or "Plaintiff") granting the Committee

standing to pursue the Debtor's claims against Hancock Park, Pacific Western Bank ("PWBank"), and the Insiders. (ER 4:112.) The Committee then filed a complaint against Hancock Park, PWBank, and the Insiders. (ER 5:118.)

This appeal focuses on a refinance transaction ("Refinance Transaction") that the Debtor undertook in June 2007. The Debtor replaced a $12 million loan from PWBank with two secured loans from PWBank totaling $25 million. Out of the $25 million, the Debtor paid $11.9 million to Hancock Park, to pay down existing unsecured debts. The Committee now primarily seeks to undo the transfer of $11.9 million to Hancock Park.

With these basics, the Court turns to a more detailed review. The following facts are mostly set forth in the FAC. (ER tab 7.) Between 2003 and 2006, the Debtor borrowed over $20 million from Hancock Park. (FAC ¶ 18-40.) These loans were unsecured, under eleven "Subordinated Promissory Notes" ("Hancock Park Notes"). (*Id.*) The Debtor was in constant breach of the Hancock Park Notes. (*Id.* ¶ 39). Around the same time, the Debtor also borrowed approximately $12 million from PWBank on a secured basis. (*Id.* ¶ 21-44.) Hancock Park provided a guaranty for those PWBank loans. (*Id.*) PWBank and the Debtor agreed to a series of extensions for these debts through June 2007. (*Id.* 24-41.)

As noted, in June 2007, the Debtor refinanced its existing $12 million loan with PWBank, replacing it

with two secured loans totaling $25 million in secured debt. (*Id.* ¶ 44.) PWBank allegedly knew that much of the $25 million would be paid to Hancock Park. (*Id.* ¶ 50.) This $11.9 million payment to Hancock Park reduced the Debtor's outstanding principal obligations by about $7.2 million and satisfied accrued interest of about $4.8 million. (*Id.* ¶ 54.) Plaintiff alleges that the $11.9 million transfer "transmuted" the unsecured debt to Hancock Park into secured debt to PWBank. (*Id.* ¶ 66.)

The Refinance Transaction had little net effect on the Debtor's balance sheet. (*Id.* ¶ 47.) But the Refinance Transaction provided some benefits to the Debtor. After the Refinance Transaction, the Debtor paid off some outstanding debts and gained an additional $1 million in working capital. (*Id.*) The loans under the Refinance Transaction were set to mature many months or years later than the loans they replaced. (*Id.* ¶ 21, 39, 55.)

The Debtor again was in constant default under the Refinance Transaction loans. (*Id.* ¶¶ 56-57.) Even so, Hancock Park continued to loan money to the Debtor after the Refinance Transaction. (*Id.* ¶ 58-59.) And in February 2008 – about eight months after the Refinance Transaction – Hancock Park agreed to guarantee the entire $25 million that the Debtor borrowed from PWBank. (*Id.* ¶ 56; Supplemental Excerpted Record ("SER") 223-239.) Regardless, the Debtor continued to flounder, and approximately sixteen months after the Refinance Transaction, the Debtor declared bankruptcy. (*Id.* ¶ 73.)

As noted, the Committee then filed a complaint against Hancock Park, PWBank, and the Insiders. The Bankruptcy Court granted motions to dismiss the Original Complaint, with leave to amend most claims but dismissing with prejudice six fraudulent transfer claims against PWBank. (ER 6:180.) The Committee then filed a First Amended Complaint ("FAC").

The FAC alleged ten claims, numbered as follows:

(1) recovery of actual fraudulent transfers under 11 U.S.C. § 548(a)(1)(A), against Hancock Park;

(2) recovery of constructive fraudulent transfers under 11 U.S.C. § 548(a)(1)(B), against Hancock Park;

(3) avoidance of security interests under 11 U.S.C. § 544 and Cal. Civ.Code § 3439.04(a)(1), against Hancock Park;

(4) avoidance of security interests under 11 U.S.C. § 544 and Cal. Civ.Code § 3439.04(a)(2), against Hancock Park;

(5) avoidance of security interests under 11 U.S.C. § 544 and Cal. Civ.Code § 3439.05, against Hancock Park;

(6) recovery of avoided transfers under 11 U.S.C. § 550, against Hancock Park;

(7) declaratory relief characterizing the Hancock notes, against Hancock Park;

(8) equitable subordination, against Hancock Park;

(9) breach of fiduciary duties, against Hancock Park, Fourticq, and Van Harten; and

(10) aiding and abetting breach of fiduciary duties, against PWBank.

The Insiders and PWBank then filed motions to dismiss the FAC, which the Bankruptcy Court granted without leave to amend. (ER 8:257-58.) The Bankruptcy Court did not issue a written order but discussed the reasons for dismissal on the record. (SER at 48.)

As noted, the Committee now appeals the order dismissing the FAC and the order dismissing with prejudice the fraudulent transfer claims in the Original Complaint against PWBank.

STANDARD OF REVIEW

On appeal a district court must view a Bankruptcy Court's findings of fact under the clearly erroneous standard and its conclusions of law de novo. Fed. R. Bankruptcy P. 8013; *see also In re Van DeKamp's Dutch Bakeries*, 908 F.2d 517, 518 (9th Cir.1990); *Zurich Am. Ins. Co. v. Int'l Fibercom, Inc. (In re Int'l Fibercom, Inc.)*, 503 F.3d 933, 940 (9th Cir.2007). The test for clear error is not whether the appellate court would make the same findings, but whether the reviewing court, on the entire evidence, has a definite and firm conviction that a mistake was made. *Anderson v. Bessemer City*, 470 U.S. 564, 573-74, 105 S.Ct. 1504, 84 L.Ed.2d 518 (1985).

In reviewing a motion to dismiss, a court should dismiss a complaint when its allegations fail to state a claim upon which relief can be granted. Fed.R.Civ.P. 12(b)(6). A complaint need only include "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed.R.Civ.P. 8(a)(2). "'[D]etailed factual allegations' are not required." *Ashcroft v. Iqbal*, 556 U.S. 662, 129 S.Ct. 1937, 1940, 173 L.Ed.2d 868 (2009) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 554, 555 (2007) (stating that "a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations")). The Court must accept as true all factual allegations in the complaint and must draw all reasonable inferences from those allegations, construing the complaint in the light most favorable to the plaintiff. *Pollard v. Geo Group, Inc.*, 607 F.3d 583, 585 n. 3 (9th Cir.2010).

But the complaint must allege "sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Iqbal*, 129 S.Ct. at 1949 (quoting *Twombly*, 550 U.S. at 570). "A claim has facial plausibility when the pleaded factual content allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 129 S. Ct at 1940 (citing *Twombly*, 550 U.S. at 556). A court should not accept "threadbare recitals of a cause of action's elements, supported by mere conclusory statements," *id.*, or "allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences," *Sprewell v. Golden State Warriors*, 266 F.3d 979,

988 (9th Cir.2001). The Ninth Circuit recently addressed post-*Iqbal* pleading standards in *Starr v. Baca*, 652 F.3d 1202, 2011 WL 2988827, at *14 (9th Cir. July 25, 2011). The *Starr* court stated, "First, to be entitled to the presumption of truth, allegations in a complaint or counterclaim may not simply recite the elements of a cause of action, but must contain sufficient allegations of underlying facts to give fair notice and to enable the opposing party to defend itself effectively. Second, the factual allegations that are taken as true must plausibly suggest an entitlement to relief, such that it is not unfair to require the opposing party to be subjected to the expense of discovery and continued litigation." "A district court may deny a plaintiff leave to amend if it determines that allegation of other facts consistent with the challenged pleading could not possibly cure the deficiency . . . or if the plaintiff had several opportunities to amend its complaint and repeatedly failed to cure deficiencies." *Telesaurus VPC, LLC v. Power*, 623 F.3d at 998, 1003 (9th Cir.2010); see also *Jackson v. Carey*, 353 F.3d 750, 758 (9th Cir.2003).

ANALYSIS

Appellant identifies various issues on appeal that do not track well in the papers. They include whether the Bankruptcy Court erred in finding that the FAC failed to state facts sufficient to support a claim against the Insiders or the Bank, or both; whether the FAC states facts sufficient to support a breach of fiduciary duty claim against the Insiders and an aiding and abetting claim against PWBank; whether the

Bankruptcy Court incorrectly dismissed the FAC's claims seeking to characterize the Insider's alleged loans as equity and to subordinate their claim; and whether the Bankruptcy Court incorrectly dismissed the Committee's claim to avoid the Bank's lien against the Debtor's assets.

The Court now reviews each of these issues in the context of analyzing each claim or group of closely related claims.

1. CLAIMS ONE THROUGH SIX: FRAUDULENT TRANSFER

The parties do a poor job of differentiating between the various fraudulent transfer claims, though Hancock Park's analysis is more helpful than Plaintiff's. Claims one through six are alleged only as to Hancock Park.

1.1 Constructive Fraudulent Transfer

Some of these claims come under the Bankruptcy Code, and others under the California Civil Code. Constructive fraudulent transfer depends on whether the transfer was made "without receiving reasonably equivalent value." If the debtor received reasonably equivalent value, then there is no constructive fraudulent transfer.

Under Cal. Civil Code § 3439.03, "Value is given for a transfer or an obligation if, in exchange for the

transfer or obligation, property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person." Effectively the same standard applies to 11 U.S.C. § 548.

The transfer at issue in these claims is the payment of $11.9 million to Hancock Park, after the Debtor borrowed $25 million from PWBank. (E.g., FAC ¶ 76.) Using simple terms, as previously explained, here's what happened. Over the course of several months or years, the Debtor borrowed at least $11.9 million from Hancock Park. The Debtor then went to PWBank and got a loan for $25 million. With that new infusion of $25 million, the Debtor paid off the $11.9 million loan from Hancock Park and paid off several other debts.

Plaintiff now argues that the payment of $11.9 million to Hancock Park was not in exchange for reasonably equivalent value. But Cal. Civil Code § 3439.03 and 11 U.S.C. § 548(d) both specifically state that "value" includes the satisfaction of an antecedent debt. Here, the Debtor owed an antecedent debt to Hancock Park. The Debtor then paid off that debt.

The issue is made complicated if the Court accepts Plaintiff's argument that the $11.9 million from Hancock Park to the Debtor was actually equity, not debt. But as discussed in Section 2, the $11.9 million is alleged to be debt, has the trappings of debt, and the Court declines to recharacterize this debt as equity.

Plaintiff also argues that questions of reasonable equivalence are highly factual and can't be decided at the motion to dismiss stage. But this skips the threshold requirement: a claim must be plausible. Plaintiff has not stated a plausible claim for constructive fraudulent transfer.

Thus, the payment of $11.9 million to Hancock Park was a dollar-for-dollar satisfaction of an antecedent debt. Because this is reasonably equivalent value, there was no constructive fraudulent transfer under either California state law or federal bankruptcy law.

1.2 Actual Fraudulent Transfer

The remaining fraudulent transfer claims are for actual fraudulent transfer. A transfer is actually fraudulent if made with "actual intent to hinder, delay, or defraud" any creditor of the debtor. 11 U.S.C. § 548(a)(1)(A); Cal. Civ.Code § 3439.04. Again, the transfer at issue is the payment of $11.9 million to Hancock Park by the Debtor.

Plaintiff fails to set forth sufficient allegations of intent. Further, a preference – that is, choosing one creditor over another – is not enough to establish actual fraud. "[A]s abundant caselaw makes clear, a debtor can favor, indeed prefer, any one or several of its unsecured creditors with a transfer of assets to the detriment of such debtor's remaining unsecured creditor body, even in the face of such debtor's insolvency, and such transfer, as a matter of law, cannot, without more,

then be avoided as a fraudulent conveyance." *In re Foxmeyer Corp.*, 296 B.R. 327, 337 (Bankr.D.Del.2003). Here, as in *In re Foxmeyer*, there was no "more" to show actual intent.

Plaintiff argues that the refinancing transaction dealt a "fatal blow" to the Debtor. (Reply Brief to Response Brief of Hancock Park, et al., at 9.). But the Debtor didn't declare bankruptcy until approximately 16 months after the transfer to Hancock Park.

1.3 Conclusion

Plaintiff has failed to state claims for either constructive or actual fraudulent transfer. Accordingly, the Court AFFIRMS the Bankruptcy Court's dismissal of Claims One through Six.

2. CLAIM SEVEN: RECHARACTERIZING NOTES AS EQUITY

Plaintiff's Claim Seven asks the Court to recharacterize Hancock Park's contributions to the Debtor as equity rather than debt. Plaintiff alleged in the FAC that the true nature of the Hancock Park contributions to the Debtor was equity. (ER 7:214.) But the case *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir.1986) bars this claim. *In re Pacific Express* held that "[w]hile the [Bankruptcy] Code supports the court's ability to determine the amount and the allowance or disallowance of claims, those provisions do not provide for the characterization of claims as equity or debt." *Id.* at 115.

Plaintiff argues that the Court shouldn't follow *In re Pacific Express.* But Hancock Park argues that *In re Pacific Express* is binding authority on this Court and, furthermore, the only plausible interpretation is that the Hancock Park notes were actually notes. The FAC alleges that the Hancock Park notes were " 'debt' " (e.g., FAC ¶ 18) and alleges many of the trappings of notes, such as being called promissory notes (e.g., FAC ¶¶ 18-20).

While Plaintiff correctly points out that other circuits have allowed claims for recharacterization, *In re Pacific Express* remains good authority here and the Court therefore rejects Plaintiff's claim for recharacterization. Accordingly, the Court AFFIRMS the Bankruptcy Court's dismissal of Claim Seven.

3. CLAIM EIGHT: EQUITABLE SUBORDINATION

Hancock Park first argues that Plaintiff waived its argument about equitable subordination by failing to address it adequately in the Opening Brief. Plaintiff counters that it raised the issue that the Bankruptcy Court dismissed this claim improperly and without discussion, and argues that it need not guess Hancock Park's arguments. The Court agrees that Plaintiff has sufficiently – though not robustly – preserved its appeal regarding Claim Eight and therefore addresses the merits of the parties' arguments.

Plaintiff seeks to equitably subordinate Hancock Park's bankruptcy claims, but Hancock Park argues

that Plaintiff has failed to allege facts that could meet the standard for equitable subordination.

In *In re Pacific Express*, the Ninth Circuit B.A.P. adopted the three-part standard for equitable subordination from *Matter of Mobil Steel Co.*, 563 F.2d 692, 700 (5th Cir.1977). Those requirements are: (i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act. *In re Pacific Express*, 69 B.R. at 116. When the claimant – here, Hancock Park – is an insider, the scrutiny of its conduct is higher. "Where the trustee seeks to subordinate a claim arising from the dealings between a debtor and an insider, the court will give the insider's actions rigorous scrutiny." *Stoumbos v. Kilimnik*, 988 F.2d 949, 959 (9th Cir.1993) (internal quotations omitted). Equitable subordination is a remedial, not penal, measure, and should be used only sparingly. *In re First Alliance Mortgage Co.*, 298 B.R. 652, 666 (C.D.Cal.2003). "If the claimant is a fiduciary, the plaintiff must present material evidence of unfair conduct." *In re Daisy Systems Corp.*, Case No. C-92-1845-DLJ, 1993 WL 491309, at *7 (N.D.Cal. Feb.3, 1993).

Hancock Park argues, among other things, that Plaintiff fails to sufficiently allege inequitable conduct. The Court agrees. In the relevant Reply Brief, Plaintiff argues that Hancock Park's impure motives are evidenced by Hancock Park's intention to reduce its own

"risky investment" in the Debtor by swapping unsecured debt for secured debt. (Reply Brief by Appellant to Response Brief of Appellees Hancock Park, et al., at p. 15.) But this argument is contradicted by the facts, including the key fact that Hancock Park provided a guarantee for the loans from PWBank. *See* FAC ¶ 21, 24, 56, Supplemental Excerpted Record 226 (listing Hancock Park as guarantor of unlimited amount in the Forbearance and Modification Agreement). By guaranteeing the debt owed by Debtor to PWBank, Hancock Park did not act to reduce its own risk but, rather, increased its risk of being on the hook for a large amount of money. Because Plaintiff has not shown sufficient facts supporting the first part of the inequitable subordination test, the Court does not consider the other two parts. The facts alleged fail to support a claim for equitable subordination.

The Court AFFIRMS the Bankruptcy Court's dismissal of Claim Eight.

4. CLAIM NINE: BREACH OF FIDUCIARY DUTIES

Plaintiff alleged that Hancock Park, Fourticq, and Van Harten breached their fiduciary duties to the Debtor. Plaintiff spends several pages in its Opening Brief arguing that it has standing to bring this claim on behalf of the Debtor, but Hancock Park and Fourticq quickly note that they've never disputed standing. Thus, the Court finds that Plaintiff has standing to bring this claim.

Instead, defendants Hancock Park, Fourticq, and Van Harten argue that Plaintiff has failed to allege any plausible factual basis to support a claim for breach of fiduciary duties. "A claim for breach of fiduciary duty requires proof of two elements: (1) that a fiduciary duty existed and (2) that the defendant breached that duty." *Beard Research, Inc. v. Kates*, 8 A.3d 573, 601 (Del.Ch.2010). It appears undisputed that Hancock Park, Fourtiqc, and Van Harten owed a fiduciary duty to the Debtor, but Plaintiff has not plausibly alleged how their breached their duty to the Debtor. Plaintiff alleges that "Hancock Park and the Insider Defendants breached that duty by causing the Debtor to obtain the Restructured Secured Financing from PWBank and use over $20 million of such funds for the benefit of Hancock Park. It is undisputable that the Hancock Transfer . . . solely benefitted Hancock Park and damaged the Debtor and its creditors." (FAC ¶ 142.) Further, Plaintiff alleges that "the Refinancing . . . provided minimal benefit, if any, to the Debtor." (*Id.* ¶ 146.)

But Hancock Park and Fourtiqc correctly argue that the refinancing provided significant benefit to the Debtor. They point out that the transaction "increased [the Debtor's] working capital; extended the maturity of its outstanding loans; lowered its interest costs; and had virtually no effect on its aggregate debt load." (Response Brief of Hancock Park and Michael Fourtiqc, Sr. at 1.) Further, as noted previously, Hancock Park guaranteed the amount of the Refinance Transaction,

which demonstrates that Hancock Park and the Insiders were not trying to exploit the Debtor. (FAC ¶ 56, Supplemental Excerpted Record 226.)

The Court finds that Plaintiff has failed to allege a plausible claim for breach of fiduciary duties. Accordingly, the Court AFFIRMS the Bankruptcy Court's dismissal of Claim Nine.

5. CLAIM TEN: AIDING AND ABETTING BREACH OF FIDUCIARY DUTIES

Against PWBank, Plaintiff alleges a claim for aiding and abetting a breach of fiduciary duties. Such a claim "require[s] that the following elements be pleaded with sufficient supporting facts: (1) the existence of a fiduciary relationship, (2) the fiduciary breached its duty, (3) a defendant, who is not a fiduciary, knowingly participated in a breach, and (4) damages to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary." *Jackson Nat. Life Ins. Co. v. Kennedy*, 741 A.2d 277, 386 (1999).

This claim fails because Plaintiff has failed to allege the underlying breach of fiduciary duty claim. *See* Section 4. Because Plaintiff has not plausibly alleged that Hancock Park and the Insiders breached their duty, there was no breach in which PWBank could have participated. It is also uncertain whether Plaintiff sufficiently alleged PWBank's "knowing" participation, but the Court need not decide this issue.

The Court AFFIRMS the Bankruptcy Court's dismissal of Claim Ten.

6. CLAIMS FROM ORIGINAL COMPLAINT: FRAUDULENT TRANSFER

Plaintiff asserted six claims for fraudulent transfer against PWBank in the Original Complaint, for both actual fraudulent transfer and constructive fraudulent transfer. The property subject to these alleged fraudulent transfer claims seems to be PWBank's security interest in $11.9 million of the Debtor's collateral, namely, the same amount paid to Hancock Park after the Refinancing Transaction.

The threshold issue is whether a stipulation released the Debtor's fraudulent transfer claims against PWBank. PWBank argues that it did – and that it never would have signed the Stipulation otherwise – but Plaintiff argues that it does not.

Here's the relevant background. In November 2008, PWBank, the Committee, and the Debtor signed a "Stipulation for the Use of Cash Collateral for the Weeks Ending November 15 Through November 30, 2008" ("Cash Collateral Stipulation") (ER 3). Among other terms, in paragraph 25 the Cash Collateral Stipulation stated that PWBank, the Committee, and the Debtor agreed that:

> The stipulations and admissions in this stipulation, including paragraph 26, shall be binding upon the Committee solely as to the validity, *enforceability*, priority, perfection or

> amount of the Bank's security interest, unless the Committee timely files an adversary proceeding by no later than the date that is sixty (60) calendar days from the date [of this stipulation]. (Emphasis added.)

And paragraph 26 of the Cash Collateral Stipulation stated:

> On the Petition Date, the Bank had a valid, perfected and first-priority security interest in the Collateral, as defined in the Security Agreement.

The analysis turns on the term "enforceability" in paragraph 25 of the Cash Collateral Stipulation. PWBank argues that this means the Committee agreed that PWBank had an enforceable security interest that could not later be avoided – unless the Committee filed an adversary proceeding within 60 days as provided in paragraph 25. The Court agrees with PWBank. If the Committee wanted to challenge the enforceability of PWBank's security interest, the Cash Collateral Stipulation established a time frame for doing so. But the Committee missed the deadline. The fact that there was a deadline for challenges to enforceability strongly suggests that the parties intended to bind the Committee to the enforceability of the security interest after the deadline passed. As PWBank argues, "the Committee now wants to wiggle out of the deal it made at the start of the case." (PWBank Response Brief, at 11.) If the security interest were now *avoidable*, it would not be *enforceable.* But the parties agreed through the stipulation that the security interest was enforceable.

Plaintiff argues that the language of the Cash Collateral Stipulation should "not suffice as a 'gotcha' release." (Reply to PWBank Response Brief, at 2.) But this ignores the fact that the Cash Collateral Stipulation gave Plaintiff 60 days to challenge the release – which they didn't do until approximately seven months later. Missing a clear deadline isn't a "gotcha."

The Court concludes that the Cash Collateral Stipulation released the fraudulent transfer claims against PWBank. But there is another reason to dismiss those claims, which is that Plaintiff fails to state a claim under Rule 12(b)(6).

The parties – and especially the Plaintiff – spend little time addressing the merits of these fraudulent transfer claims. Perhaps this is because Plaintiff's allegations aren't so clear about the relevant transfer *to PWBank* that should be avoided. The only transfer to PWBank seems to be the security interest in the Debtor's assets that PWBank obtained as collateral for $11.9 million of the $25 million loan. As discussed in more depth in Section 1.1, a constructive fraudulent transfer requires, among other things, a transfer for less than reasonably equivalent value. But here, PWBank obtained a security interest in $11.9 million of the Debtor's assets, in exchange for a loan. The Court fails to see what isn't "reasonably equivalent" about that, and the parties don't address this point. And as discussed in more depth in Section 1.2, an actual fraudulent transfer requires intent to hinder, delay, or defraud other creditors. Plaintiff's allegations about PWBank's intent are conclusory and not plausible.

Accordingly, the Court AFFIRMS the Bankruptcy Court's dismissal of Claims Ten through Fifteen from the Original Complaint.

DISPOSITION

For the reasons stated in this Order, the decision of the Bankruptcy Court is AFFIRMED. The Court has considered all arguments raised by the parties, whether or not the Court specifically addressed those arguments in this Order. The Court found unconvincing the arguments not addressed in this Order.

IT IS SO ORDERED.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: FITNESS HOLDINGS INTERNATIONAL, INC., Debtor, ---------------------------------- SAM LESLIE, Chapter 7 Trustee of the estate of Fitness Holdings International, Inc., Appellant, v. HANCOCK PARK CAPITAL II, L.P., a Delaware limited partnership; et al., Appellees.	No. 14-56766 D.C. No. 2:14-cv-01059-AG Central District of California, Los Angeles ORDER (Filed Dec. 15, 2016)

Before: TALLMAN, PARKER,* and CHRISTEN, Circuit Judges.

The panel has voted to deny the petition for panel rehearing; Judges Tallman and Christen have voted to deny the petition for rehearing en banc and Judge Parker so recommends.

The full court has been advised of the petition for rehearing en banc and no judge has requested a vote

* The Honorable Barrington D. Parker, Jr., United States Circuit Judge for the U.S. Court of Appeals for the Second Circuit, sitting by designation.

on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for panel rehearing and the petition for rehearing en banc are DENIED.

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11 U.S.C. § 105. Power of court

Effective: December 22, 2010

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

(b) Notwithstanding subsection (a) of this section, a court may not appoint a receiver in a case under this title.

(c) The ability of any district judge or other officer or employee of a district court to exercise any of the authority or responsibilities conferred upon the court under this title shall be determined by reference to the provisions relating to such judge, officer, or employee set forth in title 28. This subsection shall not be interpreted to exclude bankruptcy judges and other officers or employees appointed pursuant to chapter 6 of title 28 from its operation.

(d) The court, on its own motion or on the request of a party in interest –

(1) shall hold such status conferences as are necessary to further the expeditious and economical resolution of the case; and

(2) unless inconsistent with another provision of this title or with applicable Federal Rules of

Bankruptcy Procedure, may issue an order at any such conference prescribing such limitations and conditions as the court deems appropriate to ensure that the case is handled expeditiously and economically, including an order that –

(A) sets the date by which the trustee must assume or reject an executory contract or unexpired lease; or

(B) in a case under chapter 11 of this title –

(i) sets a date by which the debtor, or trustee if one has been appointed, shall file a disclosure statement and plan;

(ii) sets a date by which the debtor, or trustee if one has been appointed, shall solicit acceptances of a plan;

(iii) sets the date by which a party in interest other than a debtor may file a plan;

(iv) sets a date by which a proponent of a plan, other than the debtor, shall solicit acceptances of such plan;

(v) fixes the scope and format of the notice to be provided regarding the hearing on approval of the disclosure statement; or

(vi) provides that the hearing on approval of the disclosure statement may be combined with the hearing on confirmation of the plan.

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11 U.S.C. § 502. Allowance of claims or interests

(a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that –

> **(1)** such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;
>
> **(2)** such claim is for unmatured interest;
>
> **(3)** if such claim is for a tax assessed against property of the estate, such claim exceeds the value of the interest of the estate in such property;
>
> **(4)** if such claim is for services of an insider or attorney of the debtor, such claim exceeds the reasonable value of such services;
>
> **(5)** such claim is for a debt that is unmatured on the date of the filing of the petition and that is excepted from discharge under section 523(a)(5) of this title;

(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds –

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of –

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

(7) if such claim is the claim of an employee for damages resulting from the termination of an employment contract, such claim exceeds –

(A) the compensation provided by such contract, without acceleration, for one year following the earlier of –

(i) the date of the filing of the petition; or

(ii) the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract; plus

(B) any unpaid compensation due under such contract, without acceleration, on the earlier of such dates;

(8) such claim results from a reduction, due to late payment, in the amount of an otherwise applicable credit available to the debtor in connection with an employment tax on wages, salaries, or commissions earned from the debtor; or

(9) proof of such claim is not timely filed, except to the extent tardily filed as permitted under paragraph (1), (2), or (3) of section 726(a) of this title or under the Federal Rules of Bankruptcy Procedure, except that a claim of a governmental unit shall be timely filed if it is filed before 180 days after the date of the order for relief or such later time as the Federal Rules of Bankruptcy Procedure may provide, and except that in a case under chapter 13, a claim of a governmental unit for a tax with respect to a return filed under section 1308 shall be timely if the claim is filed on or before the date that is 60 days after the date on which such return was filed as required.

(c) There shall be estimated for purpose of allowance under this section –

(1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or

(2) any right to payment arising from a right to an equitable remedy for breach of performance.

(d) Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

(e)(1) Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that –

(A) such creditor's claim against the estate is disallowed;

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; or

(C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

(2) A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the

same as if such claim had become fixed before the date of the filing of the petition.

(f) In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(g)(1) A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(2) A claim for damages calculated in accordance with section 562 shall be allowed under subsection (a), (b), or (c), or disallowed under subsection (d) or (e), as if such claim had arisen before the date of the filing of the petition.

(h) A claim arising from the recovery of property under section 522, 550, or 553 of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection

(d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(i) A claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(j) A claim that has been allowed or disallowed may be reconsidered for cause. A reconsidered claim may be allowed or disallowed according to the equities of the case. Reconsideration of a claim under this subsection does not affect the validity of any payment or transfer from the estate made to a holder of an allowed claim on account of such allowed claim that is not reconsidered, but if a reconsidered claim is allowed and is of the same class as such holder's claim, such holder may not receive any additional payment or transfer from the estate on account of such holder's allowed claim until the holder of such reconsidered and allowed claim receives payment on account of such claim proportionate in value to that already received by such other holder. This subsection does not alter or modify the trustee's right to recover from a creditor any excess payment or transfer made to such creditor.

(k)(1) The court, on the motion of the debtor and after a hearing, may reduce a claim filed under this section based in whole on an unsecured consumer debt by not more than 20 percent of the claim, if –

(A) the claim was filed by a creditor who unreasonably refused to negotiate a reasonable alternative repayment schedule proposed on behalf of the debtor by an approved nonprofit budget and credit counseling agency described in section 111;

(B) the offer of the debtor under subparagraph (A) –

(i) was made at least 60 days before the date of the filing of the petition; and

(ii) provided for payment of at least 60 percent of the amount of the debt over a period not to exceed the repayment period of the loan, or a reasonable extension thereof; and

(C) no part of the debt under the alternative repayment schedule is nondischargeable.

(2) The debtor shall have the burden of proving, by clear and convincing evidence, that –

(A) the creditor unreasonably refused to consider the debtor's proposal; and

(B) the proposed alternative repayment schedule was made prior to expiration of the 60-day period specified in paragraph (1)(B)(i).