No. 16-1136

IN THE

Supreme Court of the United States

SAM LESLIE,

Petitioner,

v.

HANCOCK PARK CAPITAL II, L.P., ET AL.,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF OF RESPONDENTS HANCOCK PARK CAPITAL II, L.P., HANCOCK PARK ASSOCIATES III, L.L.C., HANCOCK PARK ASSOCIATES, L.P. AND MICHAEL FOURTICQ IN OPPOSITION

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QUESTION PRESENTED

Whether the Ninth Circuit Court of Appeals correctly held that applicable state law governed whether the debtor in this case received reasonably equivalent value in exchange for its pre-petition repayment of promissory notes.

CORPORATE DISCLOSURE STATEMENT

No publicly held corporation owns 10% or more of any class of equity interests in Respondent Hancock Park Capital II, L.P., Hancock Park Associates III, L.L.C., or Hancock Park Associates, L.P.

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BRIEF OF RESPONDENTS HANCOCK PARK CAPITAL II, L.P., HANCOCK PARK ASSOCIATES III, L.L.C., HANCOCK PARK ASSOCIATES, L.P. AND MICHAEL FOURTICQ IN OPPOSITION

Respondents Hancock Park Capital II, L.P. ("Hancock Park"), Hancock Park Associates III, L.L.C., Hancock Park Associates, L.P. and Michael Fourticq respectfully request that this Court deny the petition for a writ of certiorari to review the judgments of the United States Court of Appeals for the Ninth Circuit.

INTRODUCTION

This petition is a belated attempt by Petitioner to challenge a holding that, at every stage of the proceedings below, Petitioner embraced rather than contested. One direct consequence of Petitioner's failure to timely raise the issue is that Petitioner now asks this Court to review an unpublished decision that does not even address Petitioner's Question Presented. Another consequence is that even if the Court

granted certiorari to review that unpublished decision, it could not reach the Question Presented because of waiver. The petition should be denied.

Petitioner, the Chapter 7 bankruptcy trustee of debtor Fitness Holdings, seeks to "recharacterize" certain pre-petition debt owed to Hancock Park in support of claims for fraudulent transfer and breach of fiduciary duty. In *Fitness Holdings I*,[1] the Ninth Circuit held that state law governed recharacterization and, specifically, whether Fitness Holdings received reasonably equivalent value for the repayment of that debt pre-petition. Pet. 47a.[2] State law, the Ninth Circuit concluded, governed under this Court's precedents *Butner v. United States*, 440 U.S. 48 (1979), and *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450 (2007). *Id.* 48a. On remand, the district court held that Hancock Park indeed had a right to payment under applicable state law, and therefore, the debtor received reasonably equivalent value in exchange for the disputed debt repayment. Pet. 6a-24a.

The Ninth Circuit affirmed that decision in *Fitness Holdings II*, an unpublished memorandum decision. Pet. 1a-5a.[3] Petitioner unsuccessfully sought rehearing en banc on the grounds that *Fitness Holdings*

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[1] *Official Committee of Unsecured Creditors of the Estate of Fitness Holdings Int'l Inc. v. Hancock Park Capital II, L.P.*, 714 F.3d 1141 (9th Circ. 2013) ("*Fitness Holdings I*").

[2] The Petition for Certiorari is cited as "Pet. __," Petitioner's Appendix as "Pet. _a," and Respondents' Appendix as "RA_a."

[3] *Leslie v. Hancock Park Capital II, L.P.*, 660 Fed.App'x.546 (9th Cir. 2016) ("*Fitness Holdings II*").

II contradicted *Fitness Holdings I* and had misconstrued state law. Now, in his petition with this Court, Petitioner argues for the first time that *Fitness Holdings I* erred in adopting state law as the standard for determining whether the debtor received reasonably equivalent value in exchange for the repayment of pre-petition debt. According to Petitioner, the Ninth Circuit should have adopted a federal multi-factor test similar to that applied by some other Circuits to the recharacterization of putative claims against the estate. Pet. 7-8. The petition should be denied for several reasons.

First, Petitioner failed to preserve the issue for which he seeks review. At no stage in the proceedings below did Petitioner challenge the Ninth Circuit's holding in *Fitness Holdings I* that state law should govern recharacterization. To the contrary, Petitioner positively embraced *Fitness Holdings I* at every opportunity. Before the *Fitness Holdings II* panel, Petitioner argued that the district court's decision should be reversed as inconsistent with *Fitness Holdings I*. And in seeking en banc review, Petitioner argued that the panel's unpublished decision in *Fitness Holdings II* conflicted with the Ninth Circuit's holding in *Fitness Holdings I* and should be overturned for that reason. Neither of the issues that Petitioner actually preserved below—whether the Ninth Circuit properly applied *Fitness Holdings I* or correctly interpreted California law on recharacterization—merits this Court's review.

Second, even if Petitioner had preserved the issue, this Court's review is both unnecessary and premature. Review is unnecessary because the choice be-

tween a federal and state test for recharacterization has little practical significance. The case law shows that state standards for recharacterization are generally consistent with the federal standards urged by Petitioner. In addition, as long as bankruptcy courts have any authority to recharacterize claims as equity, the incentives for litigants and commercial actors will be similar, regardless of what test prevails. While a Circuit decision holding that bankruptcy courts lack authority to recharacterize under any standard could be consequential, *Fitness Holdings I* eliminated any split among the Circuits as to this fundamental issue. The technical difference among the Circuits as to the specific test for recharacterization is not important.

Review is also premature since the case law remains in development. All of the Circuits that have adopted a federal test did so without the benefit of this Court's decision in *Travelers*—the holding of which underpinned the Ninth Circuit's argument in *Fitness Holdings I* for adopting a state law test. Given that only one of these Circuits has had the opportunity to reconsider its precedent in light of *Travelers*, it is an open question whether and to what extent any disagreement among the Circuits on the standard for recharacterization in bankruptcy will persist. Further, several Circuits have yet to weigh in on the question at all.

Third, even if the choice of test for recharacterization merited review, this case is a poor vehicle for doing so. In most cases in which rechacterization is at issue, the question is whether a claim against the bankruptcy estate should be treated as debt or equity. Precedent thus focuses on the source of a bank-

ruptcy court's recharacterization authority in the claim allowance process. Some courts hold that a bankruptcy court has equitable power under Section 105(a)[4] to recharacterize a claim against the estate in furtherance of the Bankruptcy Code's distributional scheme. Other courts hold that a bankruptcy court's recharacterization authority derives only from Section 502(b), which specifically governs the claim allowance process.

This case raises a different issue. Petitioner does not seek to recharacterize a claim against the estate, and none of the Respondents has received or is seeking to receive a distribution from the estate. Rather, Petitioner alleges that debtor's pre-petition repayment of debt owed to Hancock Park was a fraudulent transfer because Hancock Park's debt was in substance equity (and so the debtor did not receive reasonably equivalent value). Whether a bankruptcy court has the power to recharacterize a pre-petition transaction in this context is a distinct question from whether a bankruptcy court has the authority to recharacterize a claim against the estate. A court could well conclude that state law governs the former inquiry while federal law governs the latter. Accordingly, this Court's review of *Fitness Holdings I* would not necessarily provide guidance for the cases in which recharacterization usually arises.

Finally, there is no need to grant the petition to correct any error, as the Ninth Circuit's holding in *Fitness Holdings I* was correct. It is settled law that a

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[4] All section references are to sections of the Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.*

debtor receives reasonably equivalent value from the repayment of a valid debt. The Bankruptcy Code defines "debt" as "liability on a claim," and "claim" is defined as a "right to payment." *See* §§ 101(5), (12). Thus, the dispositive question here is whether Hancock Park had a right to payment with respect to the debt that was satisfied pre-petition.

The Ninth Circuit correctly concluded that, under this Court's precedents in *Butner* and *Travelers*, this is presumptively a question of state law. Petitioner identifies no federal interest that would override this presumption, apart from a misplaced appeal to a need for uniformity and certainty—a rationale that would justify displacing state law in every case. Moreover, Petitioner's reliance on a bankruptcy court's authority under Section 105(a) ignores the limitations this Court has set on a bankruptcy court's equitable authority under that provision. *Law v. Siegel*, 134 S. Ct. 1188 (2014). Further, even if Section 105(a) supported recharacterization of claims against an estate, as some courts have held, that would not imply that bankruptcy courts have similar authority to recharacterize a debt that was repaid before the petition date. Accordingly, the Ninth Circuit was right to apply state law and the petition should be denied.

STATEMENT OF THE CASE

I. Factual Background

Hancock Park was the sole shareholder of debtor Fitness Holdings, a retailer of home gym and fitness equipment. Pet. 7a. From 2004 to 2007, Hancock Park advanced more than $24 million to Fitness Holdings under a series of promissory notes (the

"Hancock Park Notes"). *Id.*

Under the terms of the Hancock Park Notes, Fitness Holdings was obligated to repay the amounts advanced by Hancock Park at fixed dates with interest. *Id.* Fitness Holdings' other major sources of financing during this period were secured loans from Pacific Western Bank ("PWB"). *Id.* The Hancock Park Notes were subordinate to the PWB loans, but equal in priority to Fitness Holdings' other unsecured creditors.

During this period, Fitness Holdings was struggling financially and did not make timely payments on the Hancock Park Notes or the PWB loans. Both PWB and Hancock Park refrained from exercising remedies against Fitness Holdings in response to these payment defaults. *Id.*

In June 2007, in an effort to improve its financial condition, Fitness Holdings refinanced its debt by taking out a new term loan and revolving credit facility with PWB. *Id.* at 8a. Fitness Holdings used the proceeds of these loans to repay its earlier loan to PWB and, with PWB's consent, to repay approximately $11.9 million of its obligations under the Hancock Park Notes. *Id.*

Although Hancock made further efforts to assist Fitness Holdings, including guaranteeing its debt to PWB, Fitness Holdings was unable to withstand the Great Recession that descended the following year. *Id.* On October 20, 2008, more than a year after the June 2007 refinancing, Fitness Holdings filed for bankruptcy protection. *Id.*

II. Proceedings Below

Shortly after Fitness Holdings filed for bankruptcy, the bankruptcy estate brought an adversary proceeding against Hancock Park,[5] asserting claims for equitable subordination of Hancock Park's claim against the estate (based on the remaining amounts owed under the Hancock Park Notes), recharacterization of the Hancock Park Notes, actual fraudulent transfer, constructive fraudulent transfer, and breach of fiduciary duty. *Id.*[6]

Petitioner's claims for fraudulent transfer and breach of fiduciary duty sought to claw back the amounts that had been paid to Hancock Park in the June 2007 refinancing. The viability of these claims turned on Petitioner's argument that the Hancock Park Notes should be "recharacterized" as equity interests. If the Hancock Park Notes were enforceable debt instruments, the repayment of those notes conferred reasonably equivalent value on Fitness Holdings as a matter of law. This would negate any claim for fraudulent transfer. Similarly, if the Hancock Park Notes were valid debt, it would not have been a breach of fiduciary duty for the defendants to authorize the repayment of those notes.

The bankruptcy court dismissed Petitioner's claims without issuing an opinion. On appeal, the

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[5] The estate was originally represented by the Official Committee of Unsecured Creditors, which was then succeeded by Petitioner, the Chapter 7 Trustee of Fitness Holdings.

[6] Petitioner also asserted claims for breach of fiduciary duty against Michael Fourticq and Kenton Van Harten, former directors of Fitness Holdings, and a claim for aiding and abetting a breach of fiduciary duty against PWB.

district court affirmed. Pet. 54a-74a. With respect to Petitioner's claim to recharacterize the Hancock Park Notes, the district court held that, under the Bankruptcy Code, courts lack the authority to recharacterize debt as equity. *Id.* at 65a-67a. In so holding, the district court relied on a longstanding precedent from the Bankruptcy Appellate Panel for the Ninth Circuit, *In re Pacific Express*, 69 B.R. 112 (B.A.P. 9th Cir. 1986). *Id.* The court concluded that, because the Hancock Park Notes could not be recharacterized, the claims for fraudulent transfer and breach of fiduciary duty failed as well. *Id.* at 62a-65a, 68a-70a.

Petitioner appealed to the Ninth Circuit, arguing that *Pacific Express* should be overruled. RA22a.

By this time, *Pacific Express* was a conspicuous outlier in the case law. The Third, Fourth, Fifth, Tenth, and Eleventh Circuits had all held that, contrary to *Pacific Express*, a bankruptcy court does have authority under the Bankruptcy Code to recharacterize a putative claim against the estate as equity. *See In re Lothian Oil Inc.*, 650 F.3d 539, 542-43 (5th Cir. 2011); *In re SubMicron Sys. Corp.*, 432 F.3d 448, 455-56 (3d Cir. 2006); *In re Dornier Aviation*, 453 F.3d 225, 231 (4th Cir. 2006); *In re Hedged Investments Assocs.*, 380 F.3d 1292, 1298 (10th Cir. 2004); *In re AutoStyle Plastics Inc.*, 269 F.3d 726, 747-48 (6th Cir. 2001); *In re N&D Properties Inc.*, 799 F.2d 726, 740 (11th Cir. 1986). Numerous district and bankruptcy court decisions, including in the Ninth Circuit, likewise had rejected *Pacific Express*. *See, e.g., In re Daewoo Motor Am., Inc.*, 417 B.R. 721, 730 (C.D. Cal 2012); *In re BH S & B Holdings LLC*, 420 B.R. 112, 157 (Bankr. S.D.N.Y. 2009); *In re Felt Mfg. Co. Inc.*, 371 B.R. 589, 629 (Bankr. D. N.H. 2007); *In*

re AtlanticRancher, Inc., 279 B.R. 411, 431 (Bankr. D. Mass. 2002).

A majority of the courts to consider the issue held that a court's power to recharacterize a putative claim against the estate derived from Section 105(a), which empowers bankruptcy courts to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." *See* § 105(a). These courts reasoned that, where appropriate, recharacterization of an alleged claim against the estate furthered the Bankruptcy Code's distributional scheme, which prioritizes claims over equity interests. *See Dornier Aviation*, 453 F.3d at 231 (concluding that recharacterization "facilitates the application of the priority scheme laid out in § 726").

As the standard for recharacterization, these courts generally adopted multi-factor tests drawn from federal tax cases. *See, e.g*., *AutoStyle Plastic*, 269 F.3d at 748-50 (adopting a multi-factor test from *Roth Steel Tube Co v. Comm'r of Internal Revenue*, 800 F.2d 625 (6th Cir. 1986)).[7] Courts differed, however, on what factors are relevant to the recharacterization, *SubMicron*, 432 F.3d at 455 n.8 (noting use of seven-factor, eleven-factor, and thirteen-factor tests), and further "differ[ed] as to the meaning and weight given to" those factors. James M. Wilton and Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1263–64 (2007).

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[7] In *N&D Properties*, the Eleventh Circuit applied a two-factor test to a claim to recharacterize a shareholder loan. 799 F.2d at 733. Since that decision, lower courts in the Eleventh Circuit have used both this two-factor test and the multi-factor tests adopted by some other Circuits. *In re First NLC Fin. Servs., LLC*, 415 B.R. 874, 880 (Bankr. S.D. Fla. 2009).

In *Lothian Oil*, the Fifth Circuit affirmed that courts have the authority under the Bankruptcy Code to recharacterize debt as equity. *See Lothian Oil*, 650 F.3d at 543. But rather than grounding this authority in Section 105(a), the Fifth Circuit relied on Section 502(b), which governs the claim allowance process. *Id*. The Fifth Circuit explained that, under Section 502(b), a court shall allow a claim unless it is unenforceable under "applicable law." *Id*.[8] Citing this Court's decision in *Butner*, the court concluded that "applicable law" was "state law." *Id*. Thus, a bankruptcy court has authority to recharacterize a claim as equity if that claim would be deemed equity rather than debt under applicable state law.

None of these cases resolved the specific question raised by Petitioner's appeal: Whether a bankruptcy court has authority to recharacterize a debt that was repaid before bankruptcy. Nevertheless, Petitioner's appeal did call upon the Ninth Circuit to decide the continuing viability of *Pacific Express*'s categorical holding that bankruptcy courts lack any authority to recharacterize debt as equity.

At oral argument, after signaling its inclination to overrule *Pacific Express*, the panel noted that it would need to decide whether federal or state law governed Petitioner's request to recharacterize the Hancock Park Notes. Petitioner's counsel acknowledged as much but did not express a preference for a

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[8] The term "state law" refers here to "all nonbankruptcy law that creates substantive claims." *Fitness Holdings I*, 714 F.3d at 1146 n.6 (quoting *Grogan v. Garner*, 498 U.S. 279, 284 n.9 (1991)).

federal test.[9] On the contrary, Petitioner's counsel brought the Fifth Circuit's decision in *Lothian Oil* to the court's attention as a potential "path" the court could take. *Id.*

In *Fitness Holdings I*, the Ninth Circuit addressed this question in the context of reviewing the dismissal of Petitioner's constructive fraudulent transfer claim. *See* Pet. 36a-37a. At the outset of its analysis, the Ninth Circuit explained that, to state a claim for constructive fraudulent transfer, Petitioner had to allege that the debtor did not receive reasonably equivalent value in exchange of the repayment of the Hancock Park Notes. *Id.* at 43a. The court explained that "value" included satisfaction of a debt, and that the Bankruptcy Code defined "debt" as "liability on a claim." *Id.* (citing 11 U.S.C. 101(12)). "Claim," in turn, was defined as a "right to payment." *Id.* (citing 11 U.S.C. § 101(5)(A)).

Thus, the key question was whether Hancock Park had a "right to payment" under the Hancock Park Notes at the time of the June 2007 refinancing. *Id.* at 44a. If it did, then the Hancock Park Notes constituted "debt," the repayment of which conferred reasonably equivalent value on the debtor. *Id.*

Turning to how a court should resolve this issue, the Ninth Circuit noted that, under this Court's decisions, "unless Congress has spoken, the nature and scope of a right to payment is determined by state law." *Id.* (citing *Butner* and *Travelers*). Specifically, the court read *Butner* to mean "that when the Bank-

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[9] An audio recording of the oral argument is available at https://www.ca9.uscourts.gov/media/view.php?pk_id=0000010272 (last visited May 18, 2017).

ruptcy 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." *Id.* (internal quotations omitted). Thus, in determining whether an alleged constructive fraudulent transfer was a repayment of debt, "the court must determine whether the purported 'debt' constituted a right to payment under state law." *Id.* at 46a.

Rather than deciding in the first instance whether Hancock Park had a right to payment under applicable state law, the Ninth Circuit vacated the district court's dismissal of the constructive fraudulent transfer claim and remanded the case to the district court. *Id.* at 52a. In a separate unpublished decision, the Ninth Circuit vacated the dismissal of the actual fraudulent transfer and breach of fiduciary duty claims and remanded those claims the lower court. Pet. 28a-34a.[10]

On remand, the bankruptcy court again dismissed Petitioner's claims without a written opinion. And once again, the district court affirmed, holding that (1) applicable state law was California law; (2) under California law, Hancock Park had a right to payment under the Hancock Park Notes, and Fitness Holdings therefore received reasonably equivalent value in exchange for the pre-petition repayment of those notes, and (3) Petitioner's fraudulent transfer and breach of fiduciary duty claims failed. Pet. 6a-23a.

On appeal to the Ninth Circuit, Petitioner did not

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[10] The Ninth Circuit also held that the complaint stated a claim for equitable subordination of Hancock Park's proof of claim against the debtor; following remand, the parties stipulated to the dismissal of that claim. *See* Pet. 26a.

question the holding in *Fitness Holdings I* that state law governed whether Hancock Park had a right to payment.[11] Rather, Petitioner insisted that the bankruptcy and district courts had "disregarded" the Ninth Circuit's instructions in *Fitness Holdings I*. RA87a-88a (insisting that *Fitness Holdings I* was "law of the case" and mandated reversal of the lower courts). Petitioner further argued that the lower courts had misconstrued California law on recharacterization. RA90a.

In *Fitness Holdings II*, the Ninth Circuit affirmed the district court's decision. The Ninth Circuit agreed that, under California law, Petitioner failed to allege facts supporting a plausible inference that the Hancock Park Notes were equity. Pet. 3a. Hence, the debtor received reasonably equivalent value from the pre-petition repayment of those notes, and Petitioner could not state a claim for fraudulent transfer or breach of fiduciary duty. *Id*.

Petitioner filed a petition for rehearing en banc of *Fitness Holdings II*. RA111a. That petition did not challenge *Fitness Holdings I*'s determination that recharacterization was governed by applicable state law. To the contrary, Petitioner complained that the panel in *Fitness Holdings II* "fail[ed] to fully examine California law on this point as instructed by *Fitness Holdings I*," thereby creating intra-circuit conflict. RA128a; *see also* RA121a(arguing that review by the full court was necessary "to enforce the law of the cir-

[11] Petitioner did not appeal the dismissal of claims against Respondents Hancock Park Associates II, L.L.C. or Hancock Park Associates L.P., which are affiliates of Hancock Park. *See* RA50a (Notice of Appeal). Hancock Park Associates II, L.L.C. and Hancock Park Associates L.P. reserve all rights in this regard.

cuit"). The Ninth Circuit denied the petition without a single vote in favor of rehearing. Pet. 75a-76a.

Petitioner then filed the petition, arguing for the first time that the Ninth Circuit had erred in *Fitness Holdings I* in adopting state law as the rule of decision for recharacterization.

REASONS FOR DENYING THE PETITION

The petition for certiorari should be denied for several reasons. First, as a consequence of Petitioner's failure to raise his Question Presented before the Ninth Circuit panel, the issue was not addressed and has been waived. Second, the Question Presented does not even merit this Court's review, as the difference between federal and state tests for recharacterization has little practical significance. And since the case law on the appropriate test has not fully assimilated this Court's decision in *Travelers*, which confirmed that state law governs claim allowance, review would be premature in any case. Third, this case is a poor vehicle for reviewing the Question Presented, as it does not present the issue of recharacterization in the context in which it ordinarily arises in bankruptcy cases—namely, a challenge to the validity of a claim against the state, as opposed to (here) a challenge to the repayment of a state law debt prior to the petition date. For this reason, review of *Fitness Holdings I* would not necessarily resolve the disagreement among the Circuits as to the source of a bankruptcy court's recharacterization authority. Finally, review is unwarranted because focusing on state law, as the Ninth Circuit's precedent requires, is the correct approach, at least in this context.

I. THIS CASE DOES NOT MERIT REVIEW

A. Petitioner Failed to Preserve the Issue for Which He Seeks Review

The petition should be denied for the fundamental reason that the Question Presented was neither raised by Petitioner nor addressed by the Ninth Circuit in the decision below. The petition is the *first* time that Petitioner has argued that *Fitness Holdings I* erred by adopting state law as the test for recharacterization. Indeed, far from challenging *Fitness Holdings I* in the proceedings below and offering the Ninth Circuit the opportunity to correct its purported error, Petitioner embraced that decision, both before the panel and when petitioning for rehearing en banc.

This Court has made clear that it will not ordinarily consider an issue "raised for the first time in the petition for certiorari." *United States v. Ortiz*, 422 U.S. 891, 898 (1975); *see also, e.g.*, *Kingdomware Techs., Inc. v. United States*, 136 S. Ct. 1969, 1978 (2016). Having never challenged *Fitness Holdings I* before this petition, Petitioner cannot treat this as a court of first resort. This "is a court of final review and not first view." *Dep't of Transp. v. Ass'n of Am. R.R.s*, 575 U.S. ___, 135 S.Ct. 1225, 1234 (internal quotation marks omitted); *see also Sonzinsky v. United States,* 300 U.S. 506, 514 (1937) ("We do not discuss petitioner's contentions which he failed to assign as error below."). Certiorari should be denied for this reason alone.

B. Review is Unnecessary

Even apart from Petitioner's waiver, review of the Question Presented is unnecessary because the difference between a state and federal test for recharacterization has little practical significance for bankruptcy practice.

In many if not most cases, there will not be any material difference between the federal multi-factor approach and the state-law approach adopted by the Fifth and Ninth Circuits. In *Lothian Oil* itself, as Petitioner concedes (Pet. 6), the Fifth Circuit found that Texas law (which was the applicable state law) relied on a multi-factor tests imported from federal tax law—the same multi-factor test adopted by courts applying the majority approach. *See Lothian Oil*, 650 F.3d at 544 ("Texas courts have imported a multi-factor test from federal tax law."). Thus, even if the Fifth Circuit had adopted the majority approach (and employed a multi-factor test), it would not have made any difference to the outcome.

Similar results have obtained in other recharacterization cases. For example, *In re Emerald Casino, Inc.*, 2015 WL 1843271 (N.D. Ill. Apr. 21, 2015), the district court considered a trustee's request to recharacterize as equity certain loans that had been made to a debtor by its former officers and directors. *Id.* at *8. The parties disputed whether the court should adopt the majority or minority approach (as there was no controlling authority in the Seventh Circuit on the issue). *Id.* While finding the majority approach more persuasive, the court observed that there was "little practical difference between the majority and minority approaches in this case[,]"

because under applicable state law, courts "evaluate[] disputed transactions similarly to federal bankruptcy courts." *Id*. at *10.

Similarly, in *Deer Valley Trucking, Inc*., 2017 WL 978989 (Bankr. D. Idaho 2017), the bankruptcy court addressed a trustee's request to recharacterize a factoring loan. *Id*. at *4. At the outset, the court explained that under *Fitness Holdings I*, it had to apply Idaho law in determining whether the loan was debt or equity. *Id*. The court concluded that, in conducting such an inquiry, Idaho courts would apply a multi-factor test drawn from federal case law on recharacterization. *Id* at *5 (noting that Idaho Supreme Court had applied factors from *In re SubMicron Systems Corp*., 291 B.R. 314 (D. Del. 2003)). Again, the state and federal tests pointed to the same result.

Petitioner implies that, in this case, the standard for rechacterization did make a difference to the outcome. *See* Pet. 6. Petitioner fails to substantiate this assertion, but even if Petitioner were correct, that would not be a reason for this Court to grant the petition. The panel decision in *Fitness Holdings II* was unpublished and has no precedential effect. *See* Ninth Cir. Rule 36-3(a). If the panel's interpretation of the standard for recharacterization under California law was erroneous, as Petitioner contends, courts in the Ninth Circuit will be free to construe California law differently.

Indeed, other decisions in the Ninth Circuit interpret the California standard for rechacterization to be consistent with the federal multi-factor test. In *In re UC Lofts on 4th, LLC*, 2014 WL 1285415 (Bankr. S.D. Cal. Mar. 27, 2014), for example, the

bankruptcy court applied *Fitness I* and held that, under California law, "when 'determining whether the transaction is a loan or a forbearance, courts look to substance rather than form.'" *Id.* at *23 (quoting *Sw. Concrete Prods. v. Gosh Constr. Corp.*, 51 Cal.3d 701, 710 (1990)). In another case, the Ninth Circuit affirmed a district court decision that, while decided prior to *Fitness Holdings I*, applied the federal multi-factor test to a recharacterization claim. *See In re Daewoo Motor Am., Inc.*, 554 F. App'x 638, 639 (9th Cir. 2014) (noting that the parties had agreed that the governing state law was "identical to the multi-factor test used by the lower courts").

In the proceedings below, Petitioner urged the Ninth Circuit to adopt the approaches of *UC Lofts* and *Daewoo*, arguing that these decisions correctly applied *Fitness Holdings I*. RA122a-123a. While *Fitness Holdings II* did not apply a multi-factor test as the California standard, there is no obstacle to the Ninth Circuit doing so in a future case.

Even where there is an outcome-determinative difference between the federal multi-factor test and state law standard for recharacterization, it is unlikely that this difference will have a significant effect on commercial activities or litigation incentives. This follows from the fact that every test of recharacterization—whether federal or state law—requires the exercise of some discretion by a bankruptcy court. There is wide discretion in the multi-factor tests, even with respect to which factors are considered and the weight to be accorded to those factors. *See Debt Recharacterization*, 62 BUS. LAW. at 1262 (noting that courts engaging in federal multi-factor tests "emphasize that the process involves an

open-ended inquiry" and that "no one factor is controlling"). Some states' tests take a more restrictive approach to recharacterization but, even in these states, courts have considerable latitude in applying the tests to the facts of a case. *See id.* at 1268-1274 (summarizing case law on recharacterization in Massachusetts and Wisconsin).

For these reasons, there is no way to predict with assurance what the result will be under any particular test. So long as a bankruptcy court has *any* power to recharacterize a claim as equity, litigants and commercial actors must account for the risk that a court will do so. In guarding against this risk, commercial parties are likely to take the same steps—*e.g.*, carefully documenting their loans—regardless of what standard of recharacterization may apply.

Contrast these incentives with the situation before *Fitness Holding I*, when there was a conflict between the Circuits as to whether a bankruptcy court even had the authority to recharacterize debt as equity. It is easy to imagine how such a conflict would lead to forum-shopping. A debtor, for example, who sought to recharacterize debt would have a good reason not to file for bankruptcy in the Ninth Circuit, where *Pacific Express* remained good law. Debtors that sought to protect debt from recharacterization would have the opposite incentive.

Because of the very decision that Petitioner now challenges, *Fitness Holdings I*, there is now no conflict among the Circuits that could lead to such forum-shopping. Indeed, Petitioner all but said as much in his petition for rehearing en banc: "*Fitness Holdings I* brought the Ninth Circuit in line with the

rest of the Circuits by recognizing recharacterization." RA118a. Accordingly, this is simply not an area where there is a pressing need for uniformity and a clear split among the Circuits. Rather, it is an area where there is fundamental agreement on the important question whether to permit recharacterization, and modest variance among the far less consequential test for recharacterization. This Court's intervention is simply not necessary.

C. Review is Premature

Review of the Questions Presented is also premature. While the Circuits have disagreed on whether to apply a state or federal test for recharacterization of claims in bankruptcy, it is unclear whether and to what extent this disagreement will persist.

All of the Circuit cases adopting a federal multi-factor test were decided before this Court's decision in *Travelers*, which reaffirmed that *Butner* governed claim allowance. Of these Circuits, only the Tenth Circuit has had occasion to reconsider its approach in light of *Travelers*. *See In re Alternate Fuels*, 789 F.3d 1139, 1148 (10th Cir. 2015). And several Circuits, including the Second and Seventh (which encompass the centers of the nation's financial activities), have not weighed in at all.

Thus, the nature of any disagreement between the Circuits with respect to the standard for recharacterization, and whether that split will persist in light of *Travelers*, is an open question. Rather than granting certiorari now, this Court should allow the issue to develop further among the lower courts.

II. THIS CASE IS A POOR VEHICLE FOR REVIEW

Even if the Question Presented did warrant immediate review, this case offers a poor vehicle for doing so.

Nearly all of the case law on recharacterization addresses the issue in a materially different factual and legal context from this case. In the typical case in which recharacterization is at issue, the question is whether a claim asserted against the bankruptcy estate should be treated as a claim or an equity interest.[12] That is why courts adopting a federal multifactor test have reasoned that a bankruptcy court has authority to recharacterize debt in furtherance of the distributional priorities of the Bankruptcy Code. *See Dornier Aviation*, 453 F.3d at 231 ("In our view, 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 re Eternal Enter., Inc.*, 557 B.R. 277, 287–88 (Bankr. D. Conn. 2016) ("[R]echaracterization, when warranted, is an essential remedy the bankruptcy court has the power and authority to use to preserve the distributional priority of the Code and encourage the use of chapter 11 reorganization as a

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[12] *See, e.g.*, *Alternate Fuels*, 789 F.3d at 1143 (addressing recharacterization of putative claim against the bankruptcy estate); *SubMicron*, 432 F.3d at 455 (same); *AutoStyle Plastics*, 269 F.3d at 747-48 (same); *Dornier Aviation*, 453 F.3d at 230 (same); *Hedged-Invs.*, 380 F.3d at 1296-97 (same); *N&D Props.*, 799 F.2d at 733 (same); *Lothian Oil*, 650 F.3d at 543 (same).

platform for reinvestment.").[13] Similarly, in holding that state law governed recharacterization, the Fifth Circuit in *Lothian Oil* relied on the claim allowance process under Section 502(b). *See Lothian Oil*, 650 F.3d at 543.

Here, by contrast, Petitioner does not seek to recharacterize Hancock Park's claim against the estate. Rather, in support of affirmative claims for fraudulent transfer and breach of fiduciary duty, Petitioner alleges that the repayment of the Hancock Park Notes in the June 2007 refinancing—which occurred more than a year before the bankruptcy—should be deemed a transfer to equity.

This claim does not squarely implicate either of the two leading, competing rationales for recharacterization, which apply only in the context of the claim allowance process. Since Petitioner is not seeking to recharacterize and thereby disallow a claim against the estate, Section 502(b) is not applicable. Petitioner is therefore wrong in suggesting that the Ninth Circuit in *Fitness Holdings I* relied on Section 502(b) as the basis for its decision. Pet. 19-20. The Ninth Circuit referenced Section 502(b) only in summarizing the Fifth Circuit's decision in *Lothian Oil*, a case in which recharacterization did arise in the claim allowance process. *See* Pet. 49a.

Similarly, to the extent that a bankruptcy court has equitable authority to recharacterize debt in order to effect the Bankruptcy Code's distributional

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[13] Section 726 governs distribution of property of the estate and accords claims priority over equity interests.

priorities, that does not imply that a bankruptcy court has the same authority, or that the same standard should apply, with respect to pre-petition transactions.

Thus, this Court's review of *Fitness Holdings I* would not necessarily resolve the standard for re-characterizing a claim against the estate. Even if this Court held that the Ninth Circuit correctly adopted state law as the standard, it would not follow that bankruptcy courts lack the authority under Section 105(a) to apply a federal recharacterization test to putative claims against the bankruptcy estate. Since recharacterization most frequently arises in the latter context, this case is a poor vehicle for reviewing the source and standard of a bankruptcy court's re-characterization authority.

III. *FITNESS HOLDINGS I* WAS CORRECTLY DECIDED

This Court need not grant review to correct error, because *Fitness Holdings I* correctly held that state law governed whether the debtor received reasonably equivalent value from the pre-petition repayment of the Hancock Park Notes.

It is well-settled that a debtor receives reasonably equivalent value from the repayment of valid debt. *See* Pet. 43a. In the context of a constructive fraudulent transfer claim, such as that asserted by Petitioner here, Section 548(d)(2)(A) defines "value" to include the satisfaction of an antecedent "debt" of the debtor. "Debt," in turn, is defined as "liability on a claim." *Id.* § 101(12). "Claim" is defined as a "right to payment." *Id.* § 101(5)(A).

As the Ninth Circuit recognized, under this Court's precedents in *Butner* and *Travelers*, state law governed whether Hancock Park had a right to payment under the Hancock Park Notes. Pet. 44a-45a. In *Butner*, this Court explained that, because "[p]roperty interests are created and defined by state law," "[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." *Butner*, 440 U.S. at 55.

In *Travelers*, this Court applied the *Butner* principle in holding that a bankruptcy court could not use a federal rule to determine whether a pre-petition contract created a "right to payment" for attorneys-fees against the estate. *Travelers*, 549 U.S. at 449. The Ninth Circuit in *Travelers* had applied a federal *per se* rule in declining to enforce an attorney-fee provision, even though the provision would have been enforceable under applicable state law. *Id*. at 445. Reversing, this Court criticized the Ninth Circuit for relying "solely on a rule of [its] own creation." *Id*. at 451. This Court held that, because the attorney-fee provision was enforceable under applicable state law, it could give rise to a "claim" in bankruptcy. *Id*.

Fitness Holdings I faithfully adhered to this Court's teaching in *Butner* and *Travelers*. Hancock Park's rights under the Hancock Park Notes were governed by California law. *See* Pet. 3a, 15a. Under *Butner*, Petitioner's request to recharacterize the Hancock Park Notes as equity is governed by California law "[u]nless some federal interest requires a different result[.]" *Butner*, 440 U.S. at 55.

The only "interest" identified by Petitioner in sup-

port of departing from state law is a purported need for uniformity and certainty. Pet. 7. But the federal multi-factor tests are notoriously unpredictable and therefore would not provide anything approaching uniformity or certainty. Commentators, for example, have noted that the multi-factor tests have been "applied inconsistently and, as a result, it may be difficult to predict or justify the outcome of debt recharacterization cases in jurisdictions applying" this test. *Debt Recharacterization*, 62 BUS. LAW at 1264.

Moreover, Petitioner's argument ignores the importance of uniformity in treatment of claims between state and federal courts. As this Court recognized in *Butner*, "[u]niform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy." *Butner*, 440 U.S. at 55 (citation omitted). If a federal test governed recharacterization in bankruptcy court, a claim might be enforceable in state court but not in bankruptcy court, or vice versa. That is precisely the result this Court sought to avoid in *Butner*.

Equally misplaced is Petitioner's appeal to the bankruptcy court's authority under Section 105(a). Pet. at 21. This Court has made clear that a bankruptcy court's equitable power under this provision "must and can only be exercised within the confines of" the Bankruptcy Code." *Law*, 134 S. Ct. at 1194–95 (citation omitted). It would exceed the recognized confines of the Bankruptcy Code for a bankruptcy court to recharacterize a pre-petition debt repayment based upon equitable factors of its own creation.

To be sure, several Circuits have held that a bankruptcy court has the authority under Section 105(a) to recharacterize a claim against the estate in furtherance of the Bankruptcy Code's distributional priorities. *See Alternate Fuels*, 789 F.3d at 1146 ("Recharacterization under § 105(a) is essential to a court's ability to properly implement the priority scheme of the Bankruptcy Code."); *Dornier Aviation*, 453 F.3d at 231 (concluding that recharacterization furthered the priority scheme in § 726)). As support for this approach, these courts have invoked this Court's decision in *Pepper v. Litton,* 308 U.S. 295 (1939), which recognized a court's equitable authority to subordinate or, in some cases to disallow, proofs of claim against a bankruptcy estate estate. *See Alternate Fuels*, 789 F.3d at 1148 (citing *Pepper*, 308 U.S. at 305-06).

The reasoning of these cases is questionable. When *Pepper* was decided, the Bankruptcy Act expressly authorized courts to reject claims in whole or in part "according to the equities of the case." *Pepper*, 308 U.S. at 305 & 305 n.12. No comparable authority exists under the Bankruptcy Code. On the contrary, the Bankruptcy Code mandates that applicable state law govern the claim allowance process. *See* § 502(b)(1) (providing that a claim "shall" be allowed unless it is not enforceable under applicable law); *Travelers*, 549 U.S. at 450. This statutory framework cannot be reconciled with a federal test for recharacterization under which courts effectively disallow otherwise valid claims based on equitable factors of their own creation. *See Raleigh v. Illinois Dep't of Revenue,* 530 U.S. 15, 24–25 (2000) (holding that courts may reorder distributions from the bankruptcy estate for equitable reasons but "a bankruptcy court's

equitable power must be understood in light of the principle of bankruptcy law . . . that the validity of a claim is generally a function of the underlying substantive law"); *In re SGK Ventures, LLC*, 2015 WL 7755525, at *20 (Bankr. N.D. Ill. Nov. 30, 2015) ("To treat a claim based on a debt as an equity contribution is a disallowance of the claim, the only ground set out in § 502(b) that could encompass this disallowance is § 502(b)(1), which provides for the disallowance of claims to the extent they are 'unenforceable against the debtor . . . under . . . applicable law.'").

In any event, a bankruptcy court's equitable authority over claims against the state does not necessarily translate into authority to recharacterize a pre-petition transaction, such as the repayment of the Hancock Park Notes. Petitioner does not cite any authority holding that a bankruptcy court's equitable power extends to invalidating debt instruments that were never asserted against the bankruptcy estate as a claim. *Cf. Langenkamp v. Culp*, 498 U.S. 42, 45 (1990) (By filing proof of claim, creditor subjects "himself to the bankruptcy court's equitable power"). Thus, even assuming that a bankruptcy court can apply a federal test in prioritizing distributions from an estate, it does not follow that a bankruptcy court has similar authority with respect to a pre-petition debt repayment. Indeed, it would be wholly unprecedented to hold that Section 105(a) confers such extraordinary power on bankruptcy courts.

In short, regardless of whether Circuits have properly applied federal law to recharacterize claims against an estate, the Ninth Circuit in *Fitness Holdings I* was correct to hold that state law governed the analytically distinct question of whether Hancock

Park had a right to the payments that it received pre-petition from Fitness Holdings.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

[Filed 04/05/2012]

No. 11-56677

(In re FITNESS HOLDINGS INTERNATIONAL, INC., Debtor)

SAM LESLIE-CHAPTER 7 TRUSTEE,

Plaintiff-Appellant,

v.

HANCOCK PARK CAPTIAL II, L.P., *et al*.,

Defendants-Appellees.

On Appeal from Order and Judgment of the United States District Court Central District of California Affirming Order and Judgment of the Bankruptcy Court Dismissing Plaintiff's First Amended Complaint Against Defendants Hancock Park Capital II, L.P. and Michael Fourticq, Sr.

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I. STATEMENT OF PARTIES

Fitness Holding, Inc. ("Debtor") is a privately held Delaware corporation with its principal place of business in Torrance, California. Prior to its bankruptcy case, the Debtor owned and operated retail outlets for home gym and fitness equipment.

Appellant-Plaintiff, Sam Leslie, ("Trustee") is the duly appointed Chapter 7 Trustee for the estate of Fitness Holdings, Inc. The Trustee is the successor-in-interest to the claims presented in the dismissed Complaint and the First Amended Complaint ("FAC") which are now subject to review. The Trustee was appointed by Court Order entered on May 13, 2010. [Excerpts of Record ("ER") Vol. 2:168]

The original plaintiff was the Official Committee of Unsecured Creditors of Fitness Holdings, Inc. ("Committee"). The Committee filed the action which is now subject to this appeal on behalf of the Debtor pursuant to the "Order Re: Stipulation on Standing of Official Committee of Unsecured Creditors to Pursue Avoidance Claims and Related Bankruptcy Law and State Law Claims on Behalf of the Estate" entered on April 24, 2009. [ER Vol. 3:684]

Appellee-Defendant, Hancock Park, LP ("Hancock Park") is a Delaware limited partnership. Hancock Park is the sole shareholder of the Debtor. Appellee-Defendant Hancock Park Associates ("HPA") is a California limited partnership. Appellee-Defendant Hancock Park Associates III, LLC ("HPA III") is a Delaware limited liability company operating and conducting business in California. HPA III is the general partner of Hancock Park. Appellee-Defendant Kenton Van Harten ("Van Harten") is a principal and partner of Hancock Park, a former member of the

Debtor's Board of Directors, and Debtor's former President, CEO, and sole officer. Van Harten also is a partner in Appellee, HPA. Appellee-Defendant Michael Fourticq, Sr. ("Fourticq") is a principal and partner of HPA and the manager of HPA. Fourticq was also a member of the Debtor's Board of Directors. Appellee-Defendant Pacific Western Bank ("PWB") is a California state-chartered bank, formerly known as Pacific Western National Bank.

II. JURISDICTIONAL STATEMENT

This is an appeal from a final order entered by the United States District Court, Central District of California [ER Vol. 1:6], affirming the Bankruptcy Court's Orders dismissing certain claims in the Complaint [ER Vol. 1:87] and all claims in the FAC [ER Vol. 1:21, 26] for failure to state facts sufficient to support a claim for relief. The Court has jurisdiction pursuant to 28 U.S.C. § 1291. The Notice of Appeal was filed timely, on September 28, 2011. [ER Vol. 2:150]

III. STATEMENT OF ISSUES ON APPEAL

The most significant question presented by this appeal is whether a bankruptcy court has the authority to "recharacterize" a financing transaction as equity rather than debt in addressing state and federal claims brought pursuant to the Bankruptcy Code's avoidance powers set forth in 11 U.S.C.§§ 544 and 548. This issue appears to be one of first impression for this Court.

In granting Appellees' motions to dismiss certain claims in the Complaint and all claims in the FAC without leave to amend, the Bankruptcy Court and subsequently the District Court in affirming the Bankruptcy Court rulings held that Appellant could

neither plead nor seek to prove the recharacterization of certain insider financing transactions. [ER Vol. 1:87, 26 and 6] The lower courts based their holdings on a much criticized and often rejected 9th Circuit BAP decision, *In re Pacific Express, Inc*., 69 B.R. 112 (B.A.P. 9th Cir. 1986) ("*Pacific Express*"); notwithstanding that every other jurisdiction, including the Ninth Circuit, have determined that courts, including bankruptcy courts, have the equitable power to recharacterize commercial transactions. The Trustee contends that in applying the *Pacific Express* "*per se*" rule prohibiting recharacterization, the Bankruptcy Court and the District Court (jointly, "Lower Courts") erred as a matter of law and that the Order dismissing the FAC should be reversed.

The second issue presented in this appeal is whether the Lower Courts erred as a matter of law in ruling that each claim contained in the FAC failed to state facts sufficient to support the claims presented.

The final issue presented in this appeal is whether the District Court incorrectly dismissed the Committee's claim to avoid a portion of PWB's lien against the Debtor's assets on the grounds that a cash collateral stipulation (and order thereon) [ER Vol. 4: 689] ("Stipulation") between PWB and the Debtor purportedly released avoidance claims, even though the Stipulation contains no such release language.

IV. STATEMENT OF THE CASE AND DISPOSITION BELOW

This matter arises from the Chapter 11 bankruptcy case *In re Fitness Holdings, Inc*., Case No. 2:08-bk-27527-BR, and an adversary action originally filed by the Committee titled: *Official Committee of Unsecured Creditors v. Hancock Park Capital II, L.P., et al.*, Adv.

No. 2:09: ap-1610-BR. The Debtor filed its Chapter 11 petition for relief in October 2008. [ER Vol. 4:711] The Debtor is owned by Hancock Park, which in turn is owned by Van Harten and Fourticq. [ER Vol. 3:623, 626-627] Van Harten and Fourticq (collectively, "Insiders") are the Debtor's sole directors, and Van Harten its sole officer. *Id*.

In April 2009, the Bankruptcy Court approved a stipulation granting the Committee standing to pursue the Debtor's claims against Hancock Park, PWB, and the Insiders. [ER Vol. 3:684] The Committee then filed the Complaint. [ER Vol. 3:623] Among other things, the Complaint pled that the Court should employ its equitable powers to recharacterize certain financing transactions between Hancock Park and the Debtor, and alleged claims to avoid certain fraudulent transfers made by the Debtor to Hancock Park. In addition, the Complaint brought claims to equitably subordinate the Proof of Claim filed by Hancock Park, breach of fiduciary duty claims against the Insiders and Hancock Park, claims against PWB for aiding and abetting the breaches of fiduciary duty, and claims to partially avoid PWB's lien against assets of the Debtor. [ER Vol. 3:623]

Defendants' motions to dismiss the Complaint were granted with leave to amend, save and except the avoidance claim against PWB, which was dismissed without leave to amend. [ER Vol. 1:87] After the Committee filed the FAC, Defendants again moved to dismiss. [ER Vol. 3:390, 384, 371] The Bankruptcy Court granted Defendants' motions to dismiss as to all claims for relief contained in the FAC without leave to amend [ER Vol. 1: 26, 21], concluding as a matter of law that it lacked the power to recharacterize the various financing transactions between the Debtor

and Hancock Park. [ER Vol. 1:33] The Committee appealed to the District Court for review. [ER Vol. 2:169] The District Court affirmed the Bankruptcy Court's order, without argument. [ER Vol. 1:6] This appeal was timely filed on September 28, 2011. [ER Vol. 2:150]

V. STATEMENT OF FACTS[1]

Hancock Park originally acquired the Debtor's assets through a leveraged buyout in 2003 for cash in the amount of $4,000,000 and a promissory note in the amount of $4,400,000. The cash for the purchase price came from Hancock Park and a secured loan from PWB. [ER Vol. 3:489, 494-496 (¶¶ 17, 18, 22)]

From September 30, 2003 through November 5, 2006, Hancock Park financed the Debtor's business operations by advancing $24,276,065.74 to the Debtor. These financings were represented by a series of purported unsecured promissory notes, each titled "Subordinated Promissory Note" ("Subordinated Notes"), but the transactions bear the substance of equity infusions. [ER Vol. 3:489, 499-500 (¶38)] After the advances were made, the Debtor: (a) failed to make the interest payments required by the Subordinated Notes, (b) did not establish any sinking fund to prepare for the repayment obligations on the approaching maturity dates on the Subordinated Notes, and (c) failed to act in other ways that would demonstrate that the Debtor viewed the Subordinated Notes as reflections of debt rather than equity. Hancock Park never made demand for payment, and never instituted any collection actions upon the failure of the Debtor

[1] The facts presented are from the FAC, which must be taken as true and viewed in a light most favorable to the Plaintiff. *Pollard v. Geo Group, Inc.*, 607 F.3d 583, 585 n.3 (9th Cir. 2010).

to comply with the terms and conditions of the Subordinated Notes. [ER Vol. 3:489, 499-503 (¶¶ 38, 39, 43, 48)]

On or about July 23, 2004, the Debtor restructured the initial asset financing by obtaining a $12 million loan from PWB, structured as (a) a $7,000,000 revolving loan and (b) a $5,000,000 installment loan (collectively, the "PWB Secured Loan"). The loan was made pursuant to a Business Loan Agreement ("BLA"), was secured by the assets of the Debtor, and was supported by a guarantee issued by Hancock Park. On September 30, 2004, barely 2 months after closing, PWB notified the Debtor that it was in breach of the financial covenants contained in the BLA [ER Vol. 3:489, 495-496 (¶ 21)]

In June 2007, under the guidance of Van Harten and Fourticq, the Debtor obtained a refinancing of the PWB Secured Loan from PWB, by borrowing $25 million from PWB (the "Refinancing"). [ER Vol. 3: 489, 501-503 (¶¶ 44-48)] The Refinancing resulted in a leveraging of substantially all of the Debtor's assets to secure a loan to refinance repayments to Hancock Park. *Id.*

The proceeds from the Refinancing were disbursed: (a) to PWB to repay the secured Revolving Loan principal and interest ($6,800,298.62), (b) to PWB to repay the secured Installment Loan principal and interest ($2,085,905.78), (c) for repayment on the secured "OMNI Seller's Notes" ($2,918,593.85), (d) to Hancock Park for "Paydown Hancock Park Capital II for Fitness Holdings Loan Principal" ($5,059,406.68), (e) to Hancock Park for "Payoff, Hancock Park Capital II for Fitness Holdings Loan Interest" ($4,327,065.98), (f) to Hancock Park for "Payoff, Hancock Park Capital II for Omni Fitness Loan Principal" ($2,150,000.00),

(g) to Hancock Park for "Payoff, Hancock Park Capital II for Omni Fitness Loan Interest" ($459,027.71), (h) loan charges ($1,250.00), and (i) to the Debtor ($1,198,451.38). [ER Vol. 3:489, 501-502 (¶ 47), 551-552 (Ex. 4)]

Approximately $11.995 million of the Refinancing went to Hancock Park as repayment for its prior financing of the Debtor's business operations. [ER Vol. 3: 489, 501-502 (¶¶ 47-50)] The Refinancing was fully secured by all assets of the Debtor. By approving the Refinancing, the Insiders replaced $11,995,500.37 of insider equity contributions with third party secured debt with no benefit to the Debtor. [ER Vol. 3:489, 502-503 (¶ 48)] The Refinancing also released the guaranty of Hancock Park. At the time of the Refinancing, the Debtor had creditors whose claims it was not satisfying, was in breach of its financial covenants to PWB and could not pay its debts as they became due. [ER Vol. 3:489, 500-504, 507-514, 516-517, 520-521 (¶¶ 42, 44, 48, 51-53, 69, 71, 81-83, 97, 100, 102, 114, 115, 133, 135, 137, 147, 153)] Given the structure of the Refinancing and PWB's knowledge of the Debtor's precarious financial position, PWB knew that the Refinancing fully encumbered all of the assets of the Debtor to the full extent of the value of the same, knew that the insiders obtained repayment of their equity contributions in priority over that of the Debtor's unsecured creditors, and knew that the Debtor was insolvent and could not pay its debts as they became due. *Id.*

Almost immediately after the funding of the Refinancing, the Debtor defaulted on its obligations to PWB. [ER Vol. 3:489, 505 (¶ 56)] PWB subsequently declared a default of the Refinancing which ultimately led to the Debtor's bankruptcy. [ER Vol. 3:489, 505

(¶¶ 56, 57)] As a result of the Refinancing the Debtor was left with no unencumbered assets from which to pay its unsecured debt. *Id.*

VI. STANDARD OF REVIEW

A district court's grant of a motion to dismiss for failure to state a claim is reviewed "*de novo*." *Knievel v. ESPN*, 393 F.3d 1068, 1072 (9th Cir. 2005). Dismissal is proper only "if it appears beyond doubt that the non-movant can prove no set of facts to support its claims." *Id.* A bankruptcy court's interpretation of the Bankruptcy Code presents a question of law that is reviewed *de novo*. *Leichty v. Neary*, 375 F.3d 854, 857 (9th Cir. 2004). A district court's findings of fact are reviewed for clear error. *Id.*

VII. ARGUMENT

A. Legal Standards for Ruling on a Motion to Dismiss

The legal standards for ruling on a Rule 12(b)(6) motion to dismiss are well established. To survive a motion to dismiss under Rule 12(b) (6), a plaintiff's complaint must contain sufficient "factual allegations" which, if true, would establish "plausible grounds" for a claim: "the threshold requirement . . . [is] that the 'plain statement' possess enough heft to 'sho[w] that the pleader is entitled to relief.'" *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 557, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007).

In deciding a motion to dismiss under Rule 12(b)(6), a court tests the sufficiency of the factual allegations and evaluates whether a plaintiff is entitled to offer evidence to support the claims, and not whether a plaintiff ultimately will prevail. *Bell Atl. Corp.,* 550 U.S. at 556. 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*, 129 S. Ct. 1937, 1940 (2009) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. at 557) (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).

A motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6), functions to test the legal adequacy of a complaint; it is a vehicle by which courts may evaluate pure legal questions, assuming for purposes of the motion that the facts as presented in the complaint are true. In other words, a motion to dismiss tests whether the "harm" of which the plaintiff complains is recognized as a violation of legal rights. If, as a matter of law, the plaintiff is entitled to relief, the motion must be denied.[2]

B. The District Court Erred As A Matter Of Law In Dismissing Claims To "Recharacterize" the Financing Transactions as Equity.

The FAC presents two related claims against Hancock Park that address the character and treatment of the Subordinated Notes. The Seventh Claim for Relief seeks a determination by the Court that characterizes

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[2] As set forth in the Committee's oppositions to the motions to dismiss [ER Vol. 3:557, Vol. 2:336, 285, and 280], the Complaint [ER Vol. 3:623] and the FAC [ER Vol. 3:489-556], properly set forth and sufficiently plead each and every claim for relief contained therein.

the Subordinate Notes as equity infusions for purposes of the fraudulent transfer claims (Claims 1-6) and breach of fiduciary duty claims (Claims 9,10). [ER Vol. 3:489, 506-514, 517-523] The Eighth Claim for Relief seeks a declaration from the Court equitably subordinating Hancock Park's claim for payment on the balance due on the Subordinated Notes. [ER Vol. 3:489, 514-135 (¶¶ 124-135)]

The Bankruptcy Court dismissed both claims for relief. [ER Vol. 1:26] In affirming the Bankruptcy Court's order, the District Court relied upon the much criticized and oft-rejected BAP decision *Pacific Express* as a bar to the claims. [ER Vol. 1:6] Not only is *Pacific Express* not persuasive authority, its holding has been rejected by every circuit that has considered the issue. *See In re Airadigm Commc'ns, Inc.*, 616 F.3d 642, 657-58 (7th Cir. 2010) (citing cases from the Third, Fourth, Sixth, and Tenth Circuits); *In re N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986). That a bankruptcy court can address a claim for recharacterization is a certainty in every circuit, except perhaps the Ninth Circuit due to *Pacific Express*. As presented in *In re SubMicron Sys. Corp.*, 432 F.3d 448, 456 (3d Cir. 2006):

> [W]e agree with those courts that have determined that "the issues of recharacterization of debt as equity capital and equitable subordination should be treated separately." *Blasbalg v. Tarro (In re Hyperion Enters., Inc.),* 158 B.R. 555, 560 (D.R.I.1993); *see, e.g., In re AutoStyle Plastics,* 269 F.3d at 749 (explaining that "[b]ecause both recharacterization and equitable subordination are supported by the Bankruptcy Code and serve different purposes, we join those courts that have

> concluded that a bankruptcy court has the power to recharacterize a claim from debt to equity" and collecting cases); *Aquino v. Black (In re AtlanticRancher, Inc.),* 279 B.R. 411, 433 (Bankr.D.Mass.2002)(stating that "while once considered solely in conjunction with the doctrine of equitable subordination, bankruptcy courts now consider recharacterization a separate cause of action").

Id. at 455. As noted in *Airadigm*, "[t]he overwhelming weight of authority supports the proposition that bankruptcy courts act within their equitable powers when they recharacterize loans as infusions of equity." *Id*. at 657.

Not only is *Pacific Express* not sound authority for the District Court's decision[3], it is contrary to Ninth Circuit authority. This appeal presents the opportunity for this Court to address this critical issue, to clarify controlling authority on this point and to bring Ninth Circuit authority in-line with the majority of the Courts that have addressed the issue by disapproving *Pacific Express*.[4]

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[3] The Ninth Circuit has never held that BAP decisions are binding on bankruptcy courts. *In re Silverman,* 616 F.3d 1001, 1005 (9th Cir. 2010).

[4] The following are only a few of the many decisions directly on point: 1st Circuit: *Am. Twine Ltd. P'ship v. Whitten, 3*92 F. Supp. 2d 13, 22 (D. Mass. 2005); 2nd Circuit: *In re Argo Communications Corp.,* 134 B.R. 776, 797 (Bankr. S.D.N.Y. 1991); 3rd Circuit: *In re SubMicron Sys. Corp*., 432 F.3d 448, 456 (3d Cir. 2006); 4th Circuit: *In re Dornier Aviation (N. America) Inc.*, 2005 WL 4781236 (Bankr. E.D. Va. Feb. 8, 2005) aff'd sub nom. 453 F.3d 225 (4th Cir. 2006); 5th Circuit: Grossman v. Lothian Oil Inc., (In re Lothian Oil Inc.), 650 F.3d 539 (5th Cir. 2011); *In re Matter of Herby's Foods, Inc.*, 2 F.3d 128, 144 (5th Cir. 1993); 6th

Pacific Express ignores Ninth Circuit authority that a court has the power to address the factual underpinnings of a transaction in the context of a bankruptcy. *See*, *e.g.*, *Fireman's Fund Insurance Companies v. Grover (In re The Woodson Company)*, 813 F.2d 266, 272 (9th Cir. 1987) ("Simply calling transactions 'sales' does not make them so. Labels cannot change the true nature of the underlying transactions.") Moreover, the Ninth Circuit has repeatedly held that a bankruptcy court's equitable powers include the power to "look through the form to the substance of the transaction." *City of San Francisco Market Corp. v. Walsh (In re Moreggia & Sons, Inc.),* 852 F.2d 1179, 1185-86 (9th Cir. 1988); *see also In re Global W. Dev. Corp.,* 759 F.2d 724, 727 (9th Cir. 1985) ("As courts of equity, bankruptcy courts will look through the form to the substance of any particular transaction . . . Substantial right and justice, rather than technical form, control."); *In re United Energy Corp.,* 944 F.2d 589, 596 (9th Cir. 1991) ("Bankruptcy courts . . . possess the power to delve behind the form of transactions and relationships to determine the substance").

Further, the Ninth Circuit and the BAP repeatedly have affirmed a bankruptcy court's characterization of

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Circuit: *In re AutoStyle Plastics, Inc*., 269 F.3d 726, 748 (6th Cir. 2001); 7th Circuit: *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 345 n.3 (7th Cir. 1997); 8th Circuit: *Bunch v. J.M. Capital Fin., Ltd. (In re Hoffinger Indus., Inc.),* 327 B.R. 389, 408 (Bankr. E.D.Ark. 2005); 9th Circuit: *In re Woodson* Co., 813 F.2d. 272; *In re Moreggia & Sons, Inc.,* 852 F.2d 1179, 1185-86 (9th Cir. 1988); 10th Circuit: *Miller v. Dow (In re Lexington Oil & Gas Ltd.),* 423 B.R. 353, 373 (Bankr. E.D. Ok. 2010), *Sender v. Bronze Group, Ltd. (In re Hedged-Investments Assocs.),* 380 F.3d 1292, 1299 (10th Cir. 2004); 11th Circuit: *In re N & D Properties, Inc.,* 799 F.2d 726, 733 (11th Cir. 1986); D.C. Circuit: *In re Lela & Co., Inc*., 551 F.2d 399, 405 (D.C. Cir. 1977).

a transaction by its true nature in connection with claims such as avoidance claims. *See In re Woodson Co.*, 813 F.2d at 268-272 (deciding whether interests in mortgage transactions were loans or purchases/sales of participation interests to determine if certain assets were property of the estate); *In re United Energy Corp.*, 944 F.2d at 596 (characterizing purported sales contracts as investment contracts to determine fraudulent transfer claims); *Bear v. Coben (In re Golden Plan of California, Inc.)*, 829 F.2d 705, 708-09 (9th Cir. 1986) ("the only issue on appeal is how to characterize the transactions between Golden Plan and the Bear investors" for purposes of fraudulent transfer claims); *In re Moreggia & Sons, Inc.,* 852 F.2d at 1184 (deciding how to characterize agreement labeled "Lease" and concluding it was not a lease for purposes of lease rejection motion); *Jonas v. Farmer Bros. Co. (In re Comark)*, 145 B.R. 47 (B.A.P. 9th Cir. 1992) (characterizing "repo transactions" as either securities transactions or loans for purposes of preference avoidance claims); *In re Lendvest Mortg., Inc.,* 119 B.R. 199, 200 (B.A.P. 9th Cir. 1990) (whether to characterize transaction as loan or subsidy for purposes of claim to avoid lien); *In re 3DO Co.,* BKR. 03-31590DM, 2004 WL 3316354 (Bankr. N.D. Cal. July 2, 2004) (rejecting *Pacific Express'* reasoning and holding that bankruptcy courts have power to characterize loan as equity separate and apart from claim for equitable subordination); *Golden West Refining Co. v. Cluj Distribution Co. (In re Thrifty Oil Co.)*, 212 B.R. 147 (Bankr. S.D.Cal. 1997) (deciding whether two allegedly separate transactions should be characterized as one); *In re Hamilton Taft & Co.,* 176 B.R. 895 (Bankr. N.D. Cal. 1995) *aff'd*, 196 B.R. 532 (N.D. Cal. 1995) *aff'd*, 114 F.3d 991 (9th Cir. 1997) (deciding whether to characterize transaction as

securities transaction or reverse repurchase agreement).

Most tellingly, the Ninth Circuit and the BAP have never followed *Pacific Express,* even though the BAP purports to find its opinions to be binding on itself. Rather, in each of the controlling decisions cited above, the Ninth Circuit and BAP continued to affirm the power and duty of a bankruptcy court to characterize a transaction by its true nature.

"Recharacterization" is not a foreign concept to Ninth Circuit law and has been applied routinely in the context of tax cases. *See*, *e.g.*, *Hardman v. United States,* 827 F.2d 1409, 1411 (9th Cir. 1987) ("*Hardman*"). The Ninth Circuit has accepted the concept of "recharacterization" under any number of different scenarios. The rest of the country has also accepted the ability of the bankruptcy court to address issues of "recharacterization" in appropriate cases. This Court should reverse the erroneous decision of the District Court not to consider the concept of recharacterization in determining whether the FAC presents appropriate and sustainable claims for relief, and formally reject *Pacific Express*.

C. The FAC Satisfies the Requirements For a Declaration to Recharacterize the Hancock Park Financing (Subordinated Notes) as Equity.

In defining the recharacterization inquiry, courts have adopted a variety of multi-factor tests borrowed from non-bankruptcy case law. *See*, *e.g. In re SubMicron Sys. Corp*., 432 F.3d 448. As noted by the Court in *SubMicron*,

> While these tests undoubtedly include pertinent factors, they devolve to an overarching inquiry: the characterization as debt or equity

> is a court's attempt to discern whether the parties called an instrument one thing when in fact they intended it as something else. That intent may be inferred from what the parties say in their contracts, from what they do through their actions, and from the economic reality of the surrounding circumstances. Answers lie in facts that confer context case-by-case.

Id. at 456. As presented in *Hardman*,

> [The Ninth Circuit] has identified eleven factors which, to varying degrees, influence resolution of the question . . . whether a transfer to a corporation by a shareholder is a sale (debt) or contribution to capital (equity), to wit: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce payment of principal and interest; (5) participation and [sic: in] management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of 'dividend' money; and, (11) the ability of the corporation to obtain loans from outside lending institutions.
>
> *Bauer v. CIR,* 748 F.2d 1365, 1368 (9th Cir.1984); *[citations omitted]* No one factor is decisive. *Bauer, 748 F.2d at 1368.* The court must examine the particular circumstances of each case. *Id.* "The object of the inquiry is not to count factors, but to evaluate them." *Id.*

Hardman, at 1411-12 (footnote omitted) (citations omitted).

The approach the Ninth Circuit takes to recharacterization in taxation cases is the same approach other circuits take with respect to recharacterization in both taxation and bankruptcy cases. *See e.g., Dornier v. Aviation,* 453 F.3d at 233-34; *SubMicron,* 432 F.3d at 455-56*; In re Hedged-Inus. Assocs., Inc.,* 380 F.3d 1292, 1298-99 (10th Cir. 2004); *AutoStyle Plastics*, 269 F.3d at 749-50.

The facts of this case as pled in the FAC meet the factors for recharacterization enumerated in *Hardman*. Among the indicia alleged in the FAC that the Subordinated Notes should properly be characterized as equity are: (a) Hancock Park's failure to enforce interest payments; (b) the lack of a schedule for regular interest payments; (c) Hancock Park's failure to enforce its rights when the Debtor failed to pay all amounts due on the maturity dates; (d) the rolling over of the Subordinated Notes that were not repaid by the Hancock Transfer into subsequent notes with terms that indicate equity infusions; (e) the subordinated nature of the instruments; (f) the relatively minor advances made by Hancock Park that were characterized as equity; (g) the Debtor's failure to establish a sinking fund or otherwise prepare for payments purportedly due on approaching maturity dates; (h) Hancock Park, through the Insiders, dominated and controlled the Debtor's management decisions; (i) Hancock Park provided advances that exceeded by several times the acknowledged capital investment of Hancock Park; (j) Hancock Park advanced funds while the Debtor was thinly capitalized or undercapitalized; (k) no arms'-length lender would have lent the Debtor the amounts advanced under the Subordinated Notes

on the terms contained on those instruments; (l) the cash infusions were documented as "Subordinate Promissory Notes;" (m) when the notes became due, there was no effort to collect; (n) Hancock Park was the 100% owner of the Debtor so a unity of interest existed; (o) the debt (subordinated) was inferior to that of regular corporate creditors; (p) the Debtor was purchased *vis a vis* a "leveraged buy-out" and thus was thinly or inadequately capitalized; and (q) there was no other readily available source of funding for the Debtor. [ER Vol. 3:489, 492-493, 495-499, 505, 515-516 (¶¶ 7-13, 19-23, 25, 26, 29-32, 34, 36, 58, 126-128)]

Thus, the facts as alleged in the FAC satisfy at least nine of the 11 elements this Court considers in addressing recharacterization. Accordingly, this Court should determine that the Lower Courts erred in rejecting recharacterization and further conclude that the facts of the FAC meet the elements necessary to state a claim to recharacterize Hancock Park's subordinated debt as equity. Having satisfied the factual underpinnings for a declaration as to the characterization of the subordinated debt to equity, the Lower Courts' decisions to dismiss the Seventh Claim for relief were in error.

D. The FAC Properly Pleads a Claim for Equitable Subordination of the Insider's Claims.

It is important to distinguish recharacterization from equitable subordination. Both remedies are grounded in the bankruptcy courts' equitable authority to ensure "that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." *Pepper v. Litton,* 308 U.S. 295, 305, 60 S.Ct. 238, 84 L.Ed. 281 (1939). Yet recharacterization and equitable subordination address distinct concerns. Equitable subordination

is proper when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. *See, e.g., Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims,*160 F.3d 982, 986-87 (3d Cir.1998); *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.),* 269 F.3d 726, 749 (6th Cir.2001). In contrast, the focus of the recharacterization inquiry is whether "a debt actually exists." *In re AutoStyle Plastics,* 269 F.3d at 748 (internal quotation marks omitted).

Plaintiff's claim for equitable subordination attacks Hancock Park's claim against the Debtor's estate based upon the balance due on its alleged notes. The standards applicable to equitable subordination are set forth in *Henry v. Lehman Commercial Paper* (*In re. First Alliance Mortg. Co.,*) 497 F.3d 977, 1006 (9th Cir. 2006). As presented therein, under Section 510(c) of the Bankruptcy Code, a court may, based upon equitable considerations, subordinate for purposes of distribution all or a part of a claim or interest to all or part of another. 11 U.S.C. §510(c).[5]

The subordination of claims based on equitable considerations generally requires three findings: "(1) that the claimant 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." *Feder v. Lazar (In re Lazar),* 83 F.3d 306, 309 (9th Cir.1996) (citing *Benjamin v. Diamond (In re Mobile Steel Co.*), 563 F.2d 692, 699-

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[5] The district court's decision to grant or deny equitable relief is reviewed for abuse of discretion. *See Grosz-Salomon v. Paul Revere Life Ins. Co*., 237 F.3d 1154, 1163 (9th Cir.2001).

700 (5th Cir.1977)). 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). "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).

In dismissing the Trustee's claim for equitable subordination, the Lower Courts based their decisions on the fact that six months after the Refinancing, Hancock Park obtained an extension on the Refinancing due date and in exchange guaranteed the Refinancing. The District Court found:

> 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.

[ER Vol. 1:6] The District Court's ruling is based upon an erroneous interpretation of the facts and the law as it applies to guarantees.

Hancock Park's guarantee arose in a separate forbearance agreement seven months after the Refinancing was funded and after Hancock Park used proceeds of the Refinancing in the amount of approximately $11.9

million to reduce its exposure. The Debtor was in constant breach of the Refinancing from the day of funding. [ER Vol. 3:489, 505 (¶ 56)] PWB and Hancock Park entered into a Forbearance Agreement in an effort to keep the Debtor operating, which included Hancock Park's execution of a guarantee. [ER Vol. 1:33, 44 (*ll* 4-19)]

Both as a matter of law, and upon the facts of this case, the giving of a guarantee by Hancock Park provided no value for purposes of the equitable subordination claim. Only the honoring of a guarantee by actual payment provides value, and then only to the extent of the payment. *In re EDC, Inc.,* 930 F.2d 1275, 1282 (7th Cir. 1991) ("the issuance of a guarantee is not the giving of new value"); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1363 (7th Cir. 1990) (a guarantee "may not be treated as new value"); *In re Sovereign Group 1985-27, Ltd*., 142 B.R. 702, 709 (E.D. Pa. 1992) (same); *Bergquist v. Anderson-Greenwood Aviation, Corp. (In re Bellanca Aircraft Corp.*), 56 B.R. 339, 394 (Bankr.D.Minn. 1985), aff'd in part and remanded in part, 850 F.2d 1275 (8th Cir. 1988) ("a guarantee...does not, alone, satisfy the definitional requirements set forth in section 547(a)(2)").

The only cases where courts find guarantees to constitute new value are when the guarantees are given in connection with substantial new funds loaned to the debtor for use by the debtor, not, as here, where the substantial funds are taken from the debtor, leaving the debtor with a secured obligation. See *Kham & Nate's Shoes*, 908 F.2d at 1363 (explaining distinction). The District Court incorrectly concluded that a guarantee, given but not honored seven months after the Refinancing, provided a factual basis to deny

the Trustee's equitable subordination claim. Accordingly, its decision to dismiss the Trustee's Eighth Claim for Relief for Equitable Subordination should be reversed as the District Court erred as a matter of law in the application of the doctrine, and thus abused its discretion in dismissing the claim with prejudice.

E. The Claims for Relief in the FAC and the Complaint to Avoid and Recover Fraudulent Transfers Were Fully and Properly Pleaded.

The FAC alleges with specificity all necessary facts to support avoidance of $11.995 million of funds the Debtor obtained from PWB on a secured basis and disbursed to Hancock Park on June 20, 2007 ("Hancock Transfer"). [ER Vol. 3:489, 501-503 (¶¶ 44-49)] The Complaint alleges with specificity all necessary facts to support avoidance of the security interest provided to PWB in the same amount, $11.995 million ("PWB Transfer"). [ER Vol. 3:623, 633-636, 645-649 (¶¶ 40-46, 49, 117-145)]

The Bankruptcy Code permits a trustee to avoid any transfer of the Debtor's property made within two years of the petition date if: (i) the transfer was made with the intent to hinder, delay or defraud any of the debtor's creditors – actual fraud, or (ii) if the debtor received less than reasonably equivalent value for the transaction and was (a) insolvent or rendered insolvent, (b) left with unreasonably small capital, or (c) unable to pay its debts as they matured – constructive fraud. 11 U.S.C. § 548(a)(1). Section 544 of the Bankruptcy Code provides that a trustee may bring similar claims under Cal. Civ. Code § 3439.04 and 3439.05.

1. The Hancock Transfer is Avoidable as an "Actual" Fraudulent Transfer Under 11 U.S.C. §§ 548(a)(1)(A), 544 and Cal. Civ. Code § 3439.04 (Claims 1 and 3 of the FAC).

A transfer is said to be "actually fraudulent" as to a creditor if the debtor made the transfer "with actual intent to hinder, delay, or defraud any creditor of the debtor." 11 U.S.C. § 548(a)(1)(A) and 11 U.S.C. § 544 and Cal. Civ. Code § 3439.04(a)(1). The determination of whether the subject transfer was made with the requisite intent is typically made inferentially from circumstances consistent with the requisite intent. *In re Beverly*, 374 B.R. 221, 235 (B.A.P. 9th Cir. 2007) *aff'd in part, dismissed in part*, 551 F.3d 1092 (9th Cir. 2008). The UFTA lists 11 nonexclusive factors that historically (since the Statute of 13 Elizabeth in 1572) have been regarded as circumstantial "badges of fraud" probative of intent. *Id.* at 235; *see also Bay Plastics, Inc. v. BT Commercial Corp.,* 187 B.R.315, 322 (Bankr. C.D.Cal. 1995); *Wyzard v. Goller*, 23 Cal. App. 4th 1183, 1191 (Cal. Ct. App. 1994). The "badges of fraud" relied upon by California Courts for delineating devious devices used to defraud creditors are set forth in Cal. Civ. Code § 3439.04(b) and include:

> (1) whether the transfer or obligation was to an insider . . .
>
> (5) whether the transfer was of substantially all the debtor's assets . . .
>
> (8) whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

> (9) whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
>
> (10) whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and
>
> (11) whether the debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor.

Cal. Civ. Code § 3439.04(b). The list provides "neither a counting rule, nor a mathematical formula. No minimum number of factors tips the scales toward actual intent." *In re Beverly*, 374 B.R. at 236. The FAC contains factual allegations that fall within the above listed "badges of fraud" and are sufficient to support Claims 1 and 3. [ER Vol. 3:489, 506-508, 511-512 (¶¶ 61-73, 94-104)]

The FAC alleges that the Debtor (under the control of Fourticq, Van Harten and Hancock Park) borrowed an additional $11.995 million from PWB which required the Debtor to grant a lien on an additional $11.995 million of its assets in favor of PWB so that the Debtor could reimburse Hancock Park for its capital contributions to the Debtor, transactions which Hancock Park structured to look like "loans." [ER Vol. 3:489, 501-503, 506-508 (¶¶ 44-49, 61-74)] All of the funds from the Refinancing (including the $11.995 million) were property of the Debtor at the time of the Hancock Transfer. [ER Vol. 3:489, 501, 506 (¶¶ 45, 62[6], 63)] The

[6] FAC ¶ 62 provides that: "The Debtor was in control of the funds from the Restructured Secured Loan as evidenced by the signatures of its President and Secretary, Van Harten. The

Hancock Transfer was a transfer of Debtor's property to an insider of the Debtor. [ER Vol. 3:489, 492, 506, 509, 510 (¶¶ 8, 63, 79, 89)] At the time of the Hancock Transfer and thereafter, the Debtor was insolvent, the Debtor had creditors whose claims it was unable to satisfy, and the Debtor was not paying its obligations as they became due. [ER Vol. 3:489, 496-501, 502-504, 507, 508, 509, 512 (¶¶ 24-42, 48-53, 69, 71-73, 81, 100, 114)] The Debtor received absolutely no value in exchange for the Hancock Transfer as the Hancock Transfer was not on account of antecedent debt. *See supra* at pp. 8-14; and ER Vol. 3:489, 491-505, 514-516).

This conclusion is the same regardless of whether the recharacterization claim succeeds, as a debtor cannot receive reasonably equivalent value when it is caused to obtain secured financing to satisfy unsecured debt or equity. *Brown v. Mt. Prospect State Bank (In re Muncrief)*, 900 F.2d 1220, 1224 n.4 (8th Cir. 1990) (transfer avoidable where security interest exchanged for loan to repay unsecured creditor); *Leonard v. Norman Vinitsky Residuary Trust (In re Jolly's, Inc.)*, 188 B.R. 832, 844 (Bankr. D. Minn. 1995) (pledging of debtor's assets to provide benefit to shareholders was fraudulent transfer).

2. The Hancock Transfer Is Avoidable As a "Constructive" Fraudulent Transfer (Claims 2, 4 and 5 of the FAC).

The allegations set forth in the FAC sufficiently stated claims for avoidance of the Hancock Transfer

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Debtor executed the Disbursement Forms, Business Loan Agreement, Promissory Notes and all other required documents."

pursuant to 11 U.S.C. § 548(a)(1)(B) and 11 U.S.C. § 544 and Cal. Civ. Code §§ 3439.04(a)(2) and 3439.05.

The Hancock Transfer was made within the two years prior to the Petition Date. The Debtor transferred its funds from the Refinancing obtained from PWB in the amount of $11,995,500.37 to Hancock Park. All of the funds from the Refinancing were property of the Debtor. [ER Vol. 3:489, 501-503, 506, 509, 511, 513 (¶¶ 44-46, 48, 49, 62, 63, 79, 95, 107)] The Debtor was in control of these funds as well as the disbursement (or transfer) of the additional funds as evidenced by the signatures of Van Harten in his capacity as the Debtor's President and Secretary. *Id.* The Debtor executed the Disbursement Forms, Business Loan Agreement, Promissory Notes and all other required documents. [ER Vol. 3:489, 530-554] The Debtor's assets secured the Refinancing. But for the Debtor providing a lien on $11.995 million of its assets, PWB would not have disbursed $11.995 million to Hancock Park. [ER Vol. 3:489, 501-503 (¶¶ 46, 48)]

At the time of the Hancock Transfer, the Debtor was insolvent. [ER Vol. 3:489, 504, 509, 513-514 (¶¶ 51-53, 81-83, 114-115)] At the time of the Hancock Transfer and thereafter, the Debtor had creditors and was not paying its obligations to its creditors as they became due. *Id.* As a result of the Hancock Transfer, the Debtor had insufficient working capital to support its business operations and the Debtor incurred debts that were beyond its ability to pay as such debts matured. [ER Vol. 3:489, 504, 510 (¶¶ 53, 84, 91)] The Hancock Transfer was made to an insider. [ER Vol. 3:489, 492, 493, 510 (¶¶ 7, 12, 89)]

The Debtor did not receive any value in exchange for the Hancock Transfer, but rather was hindered with the burden of a lien against all of its assets. [ER Vol.

3:489, 509, 513 (¶¶ 79, 80, 108)] Although the Ninth Circuit has held that: "[a]s a matter of law, a debtor receives reasonably equivalent value when it pays down *bona fide* debt," *see In re United Energy Corp.*, 944 F.2d 589, 595 (9th Cir. 1991) (emphasis added), the case involved debt of the same priority. Where a debtor is caused to incur secured debt to pay off unsecured debt or equity, the debtor does not receive reasonably equivalent value. *See In re Lexington*, 423 B.R. at 373; *see also Adams v. Anderson* (*In re Superior Stamp & Coin Co.*), 223 F.3d 1004 (9th Cir. 2000) (where a debtor "transfers a security interest in property to the new creditor by offering collateral. . . an unsecured creditor is replaced with a secured creditor, thus diminishing the amount available in bankruptcy for creditors of the same class."). Thus, whether the Subordinated Notes are characterized as unsecured debt or equity, the Debtor did not receive reasonably equivalent value for the Hancock Transfer.

3. The PWB Transfer is Avoidable and Recoverable as an "Actual" and "Constructive" Fraudulent Transfer (Complaint Claims 10, 11, 12, 13, 14, 15).

The facts alleged in the original Complaint support the avoidance of the PBW Transfer as being "constructively" and "actually" fraudulent. The Debtor obtained $25 million from PWB for which PWB received a security interest in all of the Debtor's assets and $11.995 million of the loan proceeds were used to satisfy the unsecured investments of Hancock Park. [ER Vol. 3:623, 633-635 (¶¶ 40-43)] The security interest PWB received in exchange for the $11.995 million, the PWB transfer, is avoidable as a fraudulent transfer under 11 U.S.C. §§548(a)(1)(A) and 544 and California Civil Code §§ 3439.04(a)(1) and (2).

a) PWB Transfer is Avoidable as a "Constructive" Fraudulent Transfer

The Complaint pleads the necessary facts to avoid the PWB Transfer as being "constructively" fraudulent. The refinancing resulted in a transfer of property of the Debtor (a lien on assets of the Debtor in the amount of approximately $11.9 million – the PWB Transfer) to or for the benefit of Hancock Park and PWB, not the Debtor. The Debtor was rendered insolvent as a result of PWB Transfer because the Debtor was unable to satisfy its resulting secured obligations to PWB and unable to meet its financial covenants. The PWB Transfer caused the Debtor to incur debts that were beyond its ability to pay as such debts matured. As a result of the PWB Transfer, the Debtor was engaged in a transaction for which any property remaining in the Debtor was an unreasonably small capital. The PWB Transfer was made to or for the benefit of one or more insiders. [ER Vol. 3:623, 633-635, 645-649 (¶¶ 41-46, 118, 123, 128-132, 138, 142-144)]

By the PWB Transfer, an unsecured equity obligation from an insider was turned into a secured debt obligation in favor of PWB for which the Debtor only received the satisfaction of Hancock Park's equitable contribution. The Debtor received no benefit or value in exchange for the PWB Transfer. [ER Vol. 3:623, 628-635, 645-649 (¶¶ 17-46, 117-145)] "Reasonably equivalent value" was not given to the Debtor in exchange for the PWB Transfer. In exchange for the $11.9 million lien against all of the Debtor's assets, the Debtor with PWB's knowledge and assistance partially satisfied an outstanding unsecured obligation due Hancock Park. The exchange of unsecured debt (or in this case equity) for secured debt <u>does</u> <u>not</u> constitute

"reasonable equivalent value." *In re Health Gourmet, Inc*., 29 B.R. 673, 676-677 (Bankr. Mass. 1983); *Bullard v. Aluminum Company of America,* 468 F.2d 11, 14 (7th Cir. 1972). Moreover, the Hancock Park Transfer was satisfaction of a capital contribution, not general unsecured debt. *See supra.* pp. 8-14.

b) The PWB Transfer is Avoidable as an "Actual" Fraudulent Transfer

The PWB Transfer was made by the Debtor with the intent to hinder, defraud and harm creditors. The PWB Transfer resulted in Hancock Park receiving a return on its investment. The Debtor received no benefit from or value in exchange for the PWB Transfer. *Id.* At the time of the PWB Transfer, PWB had full knowledge of the Debtor's financial status and the fact that $11.9 million of the Refinancing was going to Hancock Park to satisfy unsecured obligations. [ER Vol. 3: 523, 628-635, 645-646, 648 (¶¶ 17-46, 117-126, 134-139)] The exchange of an unsecured debt or in this case equity for a secured debt with the new secured creditor's knowledge results in an avoidable fraudulent transfer as to the security interest received by the new secured creditor. *See Dean v. Davis*, 242 U.S. 438 (1917) (Finding the replacing of unsecured obligations with secured obligations to constitute transfers made with the actual intend to hinder, delay, and defraud creditors.); *In re American Properties, Inc*., 14 B.R. 637 (Bankr. Kan.1981) (Court found the secured creditor's knowledge of the transaction and the fact that the loan proceeds would be used to pay off a specific unsecured creditor to the detriment of other creditors of the debtor "to be 'actual intent' to hinder, delay or defraud creditors within the meaning of § 548(a)(1)). The Debtor, under the control of the

Insiders, acted with the requisite intent when the PWB Transfer was made.

c) The Cash Collateral Stipulation Did Not Release Avoidance Actions Against PWB

The Bankruptcy Court dismissed the avoidance claims against PWB because it found that the cash collateral Stipulation between the Debtor, PWB and the Committee bound the Committee as to "the validity, enforceability, priority, perfection or amount" of PWB's security interest, it must also have released avoidance claims, as avoidance claims would fall within the "enforceability" term. The Bankruptcy Court was incorrect.

The Stipulation first provides for a variety of admissions and releases by the Debtor, and then binds the Committee to certain of these admissions by providing 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. . ." [ER Vol. 4:689] But while the Stipulation includes the Debtor's admission that PWB's security interest is a valid lien, it does not release avoidance actions. Thus, the Stipulation's terms to bind the Committee to the Debtor's admissions and releases cannot preclude the Committee, Debtor or any other third party from pursuing claims seeking to avoid fraudulent transfers or aiding and abetting claims. Had PWB wanted to preclude such claims, the Stipulation should have stated that the Debtor – and therefore, the Committee (and any third party including a chapter 7 trustee) – are precluded from bringing any claims against PWB. This language is not included in the Stipulation. *Id.*

While admitting to the validity and priority of PWB's security interests, the Debtor does not, anywhere in the Stipulation, release PWB of Chapter 5 avoidance claims. This is why the Debtor did not file a Rule 4001 Statement as required by LBR 4001-2(d). The Rule 4001 Statement [Form 4001-2] is necessary if releases of avoidance actions are provided. No such form was filed. [Bankruptcy Docket, ER Vol. 4:711-777] Thus, as the Stipulation only binds the Committee to the Debtor's releases, there is no release of avoidance claims that can be enforced against the Committee.

The Lower Courts overlooked the fact that there is no initial release of avoidance claims in the Stipulation, but instead concluded that the avoidance claim was barred by the Stipulation because it provides that the Committee is bound as to "the validity, enforceability, priority, perfection or amount" of PWB's security interest. The Bankruptcy Court reasoned that if a lien is "enforceable", then it means that an avoidance action cannot be brought against it.

But the Bankruptcy Court had this issue backwards. If a lien is not enforceable, then a debtor, committee or trustee has no need to pursue an avoidance action against it. An enforceable lien is a prerequisite to an avoidance action, not a bar. See, e.g. *Official Creditors' Comm. for Qmect, Inc. v. Electrochem Funding, LLC*), 349 B.R. 620, 624 (Bankr. N.D. Cal. 2006) ("A claim may be valid and enforceable under state law and still be avoidable.").

The Lower Courts accepted PWB's argument that Paragraph 25 operates as a separate release of avoidance actions against PWB, by finding that the term "enforceability" includes avoidance actions. As stated by the Bankruptcy Court:

> So it seems to me the stipulation deals with this – it could be because enforceability if it's a preference or a fraudulent transfer or any other avoidable action, it's no longer enforceable, is it?

[ER Vol. 1:94, 100(*l* 8) - 101(*l* 6)] The Bankruptcy Court was mistaken. The Debtor's release covered claims going to whether PWB holds "a valid, perfected and first-priority security interest," which is a different proceeding from an avoidance action. The Stipulation language does provide specifically for a release of any claims, and the Court's interpretation of the Stipulation clearly is erroneous.

In 28 U.S.C. §157, Congress laid out sixteen separate categories of "core" proceedings within a bankruptcy court's jurisdiction. Two of those are: 28 U.S.C. §157(H) and (K). 28 U.S.C. §157(H) includes proceedings to determine, avoid, or recover fraudulent conveyances; and, 28 U.S.C. §157(K) includes determinations of the validity, extent or priority of liens. 28 U.S.C. §157(H) and (K).

These two proceedings are separate because each is derived from a distinct source of law. A proceeding to "determine, avoid, or recover fraudulent conveyances" arises under Chapter 5 of the Bankruptcy Code, while a proceeding to determine "the validity, extent or priority of liens" arises under the applicable state's Uniform Commercial Code. Thus, the Debtor's release of claims going to whether PWB holds "a valid, perfected and first-priority security interest" cannot be a release of avoidance claims without specific language identifying such separate claims, as well as a Rule 4001 statement giving notice of such a release. *See Official Creditors' Comm. for Qmect, Inc. v.*

Electrochem Funding, LLC, 349 B.R. 620, 624 (deadline to file claims regarding "the validity, priority, perfection, enforceability" of lender's lien was not release of avoidance actions); *In re Daisy Systems Corp*., Case No. C92-1845-DLJ, 1993 WL 491309, at *7 (N.D. Cal. Feb. 3, 1993) (release of claims challenging the "validity, perfection, priority and enforceability of the liens and security interests" was not a release of equitable subordination or avoidance claims); *see also In re Broadway City, LLC*, 358 B.R. 628, 635-636 (Bankr. S.D.N.Y. 2007).

The Debtor did not release its avoidance actions against PWB, and therefore the terms that bind the Committee to parts of the Stipulation did not release avoidance actions against PWB. The Lower Courts erred in so finding.

F. The Trustee's Ninth Claim for Relief Presents Facts Sufficient To Maintain A Claim For Breach Of Fiduciary Duty.

"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).

The District Court sustained the Defendants' Motion to Dismiss the Trustee's Ninth Claim for Relief, Breach of Fiduciary Duty, based upon its erroneous factual finding that the Refinancing provided significant benefit to the Debtor, in that it "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." [ER Vol. 1:6, 17] The breach that occurred and which the District Court failed to recognize was that $11.995 million of the Refinancing was completely unnecessary

yet the Debtor, under the control and guidance of the Insiders and Hancock Park, was caused to borrow these funds on a secured basis solely to pay back Hancock Park on its investment. The District Court further found that Hancock Park guaranteed the amount of the Refinancing and that this "fact" demonstrates that Hancock Park and the Insiders were not trying to exploit the Debtor. *Ibid.* Based thereon, the District Court held that the Trustee failed to allege a plausible claim for breach of fiduciary.[7]

As discussed above, the Lower Courts erroneously refused to recognize their power to recharacterize the Subordinated Notes and carried this error through the entirety of their reasoning on the remainder of the claims. A review of the facts, again, considered in light most favorable to the Plaintiff, clearly established a plausible factual premise for the claim presented, particular when compared to authority that addresses the issue in question.

The critical issue (and the issue missed by the District Court) is not whether the Debtor received <u>any</u> benefit from the entire $25 million Refinancing, but whether the Debtor benefited when it was forced to borrow an additional $11.995 million on a secured basis for the sole purpose of satisfying the Subordinated Notes. The Debtor received no benefit by having equity converted into secured debt which it could not afford to carry. Additionally, the guarantee provided by Hancock Park, absent actual payment, provided the

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[7] In the briefing on this issue before the Bankruptcy Court, much discussion was presented to address the issue of standing as to the Trustee's right to bring the claims. The District Court held that that Plaintiff has standing to bring this claim. [ER Vol. 1:6] Accordingly, the Trustee will not present argument on this point.

Debtor with no benefit. *In re EDC, Inc.,* 930 F.2d at 1282; *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d at 1363; *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. at 709.

To establish a claim against a corporate director for breach of fiduciary duty, specifically the breach of the duty of loyalty, under Delaware law, the plaintiff need only prove that the director was on both sides of the transaction. *In re The Brown Sch.*, 386 B.R. 37, 47 (Bankr. D. Del. 2008); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."). The same is true for a corporate shareholder. *See In re Greater Se. Cmty. Hosp. Corp. I*, 353 B.R. at 333. The burden then shifts to the defendant to prove that the transaction was entirely fair. *Id.* This burden is greater than meeting the business judgment rule inherent in duty of care cases. *In re The Brown Sch.*, 386 B.R. at 47.

In the case before this Court, just as was done in the case of *Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Corp. I),* the sole shareholder, officer and directors of the Debtor breached their fiduciary duty to the Debtor by allowing the Debtor to take on additional secured obligations (in this case additional unnecessary obligations in the amount of at least $11.995 million) in a fiscally irresponsible manner constituting a misuse the debtor's assets. *See In re Greater Se. Cmty. Hosp. Corp. I*, 353 B.R. at 333. In *Tuft,* the Court found the taking on of additional debt to be a breach of the officers and directors fiduciary duties of care and loyalty. *Id.* at 336-337.

In authorizing and completing the Refinancing, Hancock Park, the Debtor's sole shareholder, and the Debtor's directors Van Harten and Fourticq breached their fiduciary duties to the Debtor and its creditors. [ER Vol. 3:489, 492-493, 501-504, 508, 517-521 (¶¶ 7-12, 43-53, 72-73, 137-154)] The breach occurred not because of the Refinancing in its entirety, but because $11.995 million of the Refinancing funds (funds for which the Debtor was required to provide PWB with a first position lien on all of its assets for an additional $11.995 million) went directly to Hancock Park, burdening the Debtor with secured debt for which the Debtor received no benefit. As the Debtor was insolvent,[8] Hancock Park, Van Harten and Fourticq owed a fiduciary duty to the entire corporate enterprise, both the Debtor and its creditors. *In re Touch Am. Holdings, Inc.*, 401 B.R. 107, 129 (Bankr. D. Del. 2009). This fiduciary duty included the obligation to preserve the asset value of the Debtor for the benefit of the corporation and its creditors. *Id.*

The overall effect of the Hancock Transfer was to exchange equity for secured debt, something that makes absolutely no business sense and certainly was not a legitimate exercise of business judgment, by Hancock Park, Fourticq or Van Harten or in the best interest of the Debtor. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) ("We have generally defined a director as being independent only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by

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[8] The FAC not only states that Debtor was insolvent but sets forth specific allegations to support this allegation. [ER Vol. 3:489, 500-504, 507-509, 511-514, 516-517, 520-521 (¶¶ 42, 48, 51-53, 69, 71, 81-83, 97, 100, 102, 114, 115, 133, 135, 137, 147, 153)]

personal or extraneous considerations. By contrast, a director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent."). "The primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences." *Schoon v. Smith*, 953 A.2d 196, 207 (Del. 2008).

The District Court's finding that the $11.995 million of Refinancing benefitted the Debtor is contrary to the facts as alleged and contrary to the standard for ruling on a motion to dismiss. As a result of the breach of fiduciary duties to the Debtor by Van Harten, Fourticq and Hancock Park, the Debtor's value diminished tremendously because the Debtor granted PWB approximately $11.995 million of additional security in its assets, and the Debtor was unable to pay its obligations as they came due, yet the Refinancing provided tremendous benefit to Hancock Park - the payment of $11.995 million and a release from the Hancock Park guarantees to PWB in the amount of $8,886,204.40. [ER Vol. 3:489, 520-521 (¶ 151)] Out of the $25 million Refinancing, the Debtor received only $1,198,451.38 to be used to fund operations. The balance of the Refinancing funds went to Hancock Park to satisfy equity contributions ($11,995,500.37), pay down loans used to finance the purchase of the Debtor including the PWB Secured Loan ($11,804,798.25), and cover loan charges ($1,250,000). [ER Vol. 3:489, 501-502 (¶ 47)]

The Insiders breached their fiduciary duties to the Debtor and its creditors by causing the Debtor to take on such unnecessary and unsupportable secured debt. The FAC properly alleges facts to support the claim

that the Debtor received no benefit from the new $11.995 million in secured debt that was paid to Hancock Park, and that the Defendants breached their fiduciary duties by leveraging the Debtor's assets for their own personal gain and profit. The District Court erred in dismissing the Trustee's breach of fiduciary duty claims.

G. The Bankruptcy Court Erred By Dismissing the Claim Against PWB for Aiding and Abetting a Breach of Fiduciary Duty.

The Bankruptcy Court dismissed the Tenth Claim for Relief, Aiding and Abetting Breach of Fiduciary Duty by PWB, primarily based upon the Bankruptcy Court's erroneous conclusion that the FAC failed to present a claim for breach of fiduciary duty by the Insiders and Hancock Park, which decision was influenced by the Lower Courts' conclusion that bankruptcy courts are without authority to recharacterize the subordinated debt of the Insiders. As demonstrated above, the Bankruptcy Court's dismissal of the claim for breach of fiduciary duty was erroneous. Its dismissal of the Aiding and Abetting claim was likewise erroneous.

Under Delaware law, applicable here, to establish a cause of action for aiding or assisting in the breach of a fiduciary, a plaintiff must prove that: (1) the fiduciary breached an obligation to plaintiff; (2) the defendant knew that the fiduciary's conduct constituted a breach of duty; and (3) damages were sustained as a result of the breach. *LaSala v. Bordier Et Cie,* 519 F.3d 121, 130 (3d Cir. 2008); *Miller v. Greenwich Capital Fin. Prods. (In re Am. Bus. Fin. Servs.),* 375 B.R. 112, 118 (Bankr. Del. 2007). The FAC satisfies the first two elements by pleading a breach of fiduciary duty claim. [ER Vol. 3:489, 517-521 (¶¶ 138-

153)] The FAC also pleads that PWB had actual knowledge of the breach and knowingly participated in the same. [ER Vol. 3:489, 521-523 (¶¶ 156-163)] The FAC properly alleges a claim for aiding and abetting breach of fiduciary duties as against PWB.

VIII. CONCLUSION

Based on the foregoing, Appellants request that the decisions of the Lower Courts be reversed, and this Court remand this matter to the Bankruptcy Court with an order that defendants answer the FAC.

Respectfully Submitted,

Dated: April 5, 2012

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Dated: April 5, 2012

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Dated: April 5, 2012

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APPENDIX B

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
LOS ANGELES DIVISION

[Filed 11/05/14]

District Court Case No. CV 14-1059 AG

IN RE FITNESS HOLDINGS INTERNATIONAL, INC.,
a Delaware corporation,

Debtor.

OFFICIAL COMMITTEE OF UNSECURED CREDITORS,

Appellants,

v.

HANCOCK PARK CAPITAL II, L.P., *et al.*,

Appellees.

NOTICE OF APPEAL TO UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

Sam Leslie, the duly appointed and acting Chapter 7 Trustee for the bankruptcy estate of Fitness Holdings International, Inc. and the Appellant herein ("Appellant"), appeals to the United States Court of Court of Appeals for the Ninth Circuit from the "[In Chambers] Order Affirming Bankruptcy Court's Ruling on Motion to Dismiss First Amended Complaint" of the United States District Court, Central District of California" ("District Court"), entered on October 9, 2014 ("Order"), affirming the Bankruptcy Court's: (1) Order Dismissing Claims Against Defendants Hancock Park Capital II, L.P. and Michael J.

Fourticq, Sr. entered on January 27, 2014 [Docket No. 146]; (2) Order Dismissing the Tenth Cause of Action in First Amended Complaint entered on January 27, 2014 [Docket No. 148]; and, (3) Order Dismissing Plaintiff's Adversary Action Against Defendant Kenton Van Harten entered on January 27, 2014 [Docket No. 149], in which the Bankruptcy Court dismissing claims one, three, four, five, six, nine and ten. A copy of the Order is attached hereto as Exhibit "1."

The parties to the Order appealed from and the names and addresses of their respective attorneys, if any, are as follows:

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Dated: November 5, 2014

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By: /s/ Larry W. Gabriel
Larry W. Gabriel
Attorneys for Appellant

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 reharacterize 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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APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

[Filed 03/13/15]

No. 14-56766

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.

From a Decision of the United States District Court for the Central District of California
Andrew J. Guilford, District Judge
Case No. 2:14-CV-01059-AG

APPELLANT'S OPENING BRIEF

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I. JURISDICTIONAL STATEMENT

This is an appeal from a final order entered by the United States District Court, Central District of California affirming the bankruptcy court's Orders granting Defendants' 12(b)(6) motions to dismiss with prejudice as to the Plaintiff/Appellant, Sam Leslie's First Amended Complaint ("FAC") for failure to state facts sufficient to support claims for relief. Excerpts of Record ("ER") Vol. 1:18. The claims presented in the FAC address the equitable powers of the bankruptcy court to recharacterize debt to equity, and involve core bankruptcy claims under Bankruptcy Code §§ 544, 548 and 550. Accordingly, the Court has jurisdiction pursuant to 28 U.S.C. § 1291. The Notice of Appeal was filed timely on November 5, 2014. ER Vol. 1: 1.

II. STATEMENT OF ISSUES ON APPEAL

The principal issue presented on appeal is whether, applying California state law, the Trustee alleged sufficient facts to demonstrate that the Defendants intended that their purported loans to the Fitness Holding, Inc. ("Debtor") were in actuality, equity, given the factual circumstances of the transactions. The issue presented is one of first impression. No previous Ninth Circuit decision has directly addressed this issue in in the context of California law. The issue has never been directly addressed by the California Supreme Court.

III. STATEMENT OF THE CASE AND DISPOSITION BELOW

A. Statement of the Case

The Trustee's action alleges, among other things, that the Debtor's transfer of funds to its sole shareholder, Hancock Park, L.P., a Delaware limited partnership ("Hancock Park"), as repayment of a

purported loan, is an avoidable fraudulent transfer under 11 U.S.C. §§ 544, 548(a)(1) and 550 and California Civil Code §§ 3439.04 and 3439.05. In addition, the Trustee claims that Defendants Hancock Park, Kenton Van Harten ("Van Harten") and Michael Fourticq, Sr. ("Fourticq," collectively "Insiders") breached their fiduciary obligations owed to the Debtor and its creditors. The FAC also alleges that Defendant Pacific Western Bank ("PWB") aided and abetted Defendants breach of fiduciary duty in funding a loan that went to pay off the Insiders' purported debt obligation. ER Vol. 3, FAC.

This is the second time this matter comes before this Court for review of the bankruptcy court's dismissal of the FAC with prejudice and without leave to amend. See, *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 Holding I*") finding that the lower courts erred in dismissing the FAC based upon their erroneous conclusion that the bankruptcy court did not have the equitable power to recharacterize rejecting the holding of *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986). In *Fitness Holding I*, this Court held 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." 714 F.3d. 1141, ER: Vol. 1:46. See also, unpublished companion memorandum decision, *In re Fitness Holdings Int'l, Inc.*, 11-56677, 2013 WL 2151401 (9th Cir. May 20, 2013) ("*Fitness Holdings II*"), ER Vol. 1:42.

This Court also provided the lower courts with explicit instructions for reviewing the FAC upon remand:

> [T]o 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). 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 dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure.

Fitness Holdings I, 714 F.3d at 1149. ER Vol. 1:46. This Court further concluded that both the bankruptcy court and the district court (collectively, "Lower Courts") failed to "view the trustee's constructively fraudulent transfer claim through this lens." *Id.* at 1149 - 1150.

This Court also found that the FAC plausibly alleged that the "insiders 'contrived' to benefit themselves by knowingly funneling money to themselves out of a

failing company," which conduct "injured creditors or conferred unfair advantage." *Fitness Holdings II*, at *2, (emphasis added).

> In the course of remanding the case, this Court held:
>
> 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).

Fitness Holdings II at *2 (Emphasis added). ER Vol. 1:42.

Notwithstanding this Court's specific instruction that the Lower Courts were to review the FAC through the lens of plausibility, the Lower Courts not only refused to put on the lenses suggested by this Court, they failed to even take them out of the box before concluding that the FAC should be dismissed.

At the initial status conference following remand, before the Defendants filed their motions to dismiss and before the bankruptcy court reviewed this Court's decisions, the bankruptcy court made up its mind to dismiss the FAC, stating in response to the possibility that the Defendants would again present Rule 12(b)(6) challenges: "I mean, I assume that's what it's going to be and I assume I'll make the same ruling and I guess we'll see." ER Vol. 1:102, Tr. Aug. 15, 2013, 9:2-4.

The bankruptcy court paid even less heed to this Court's rulings at the hearing on the Defendants'

motions to dismiss (collectively, "Motions to Dismiss"). At the outset of the hearing, the bankruptcy court stated:

> I've already ruled on this, dismissed with prejudice. And the only thing I was to decide or two – two things. One was the recharacterization that – according to the Circuit – don't know if "infected" is the right word, but I forget exactly that applied to the other counts. And then as far as that, as well as the in pari delicto and some other things as far as Pacific, but that's basically what I'm supposed to decide, is it not?

ER Vol. 2: 54Tr. at p.5:13-21. The bankruptcy court then stated: ". . . they didn't send it back to re-argue the entire matter. They sent it back to determine that issue. Isn't that what the opinion says?" *Id.*, Tr. at p. 15: 9-12. The bankruptcy court further commented:

> And by the way, as far as the argument here, I'm only going to hear argument on recharacterization. That's what I've been told to do if the Circuit – if the District Court looks at it differently. That's – I've read all your papers, but I'm not going to rehear all the arguments.

Id., Tr. at p. 16:10-14.

It is based upon this erroneous and myopic view of this Court's instructions that the bankruptcy court refused to even consider the Trustee's claims and the facts supporting them, *de novo* in a light most favorable to the Trustee. The district court did no better, affirming the bankruptcy court's decision relying entirely on California contract law and failing to recognize that no California State law exists on the

issue of recharacterization of debt as equity. ER Vol. 1:18.

Moreover, the district court interpreted the facts of the FAC in a light most favorable to the Defendants in making a factual determination that it was the "intent" of the parties to enter into a debt obligation. Not only did the district court fail to look at the facts in a light favorable to the Trustee, it made a factual determination on the merits (the intent of the Defendants), which ordinarily cannot be made by a simple review of the complaint. ER Vol. 1:18. Indeed, this finding is also contrary to this Court's determination that the FAC presented facts that plausibly presented claims that supported a conclusion that the Insiders engaged in inequitable conduct, and (2) that the misconduct injured creditors or conferred unfair advantage on the Defendants. *Fitness Holdings II*, 2013 WL 2151401 at *2.

This Court's *de novo* review of the FAC, should (a) disregard the Lower Court's reasoning in its entirety, (b) reject the bankruptcy court's order of dismissal affirmed by the district court, (c) reverse the order dismissing the Motions to Dismiss and, (d) order the Defendants to answer the FAC.

B. Disposition Below

This action was instituted on June 6, 2009. On October 26, 2009, the FAC was filed. ER Vol. 3:286. Defendants filed motions to dismiss the FAC on November 18, 2009. ER Vol. 3:361, Adv. Bankruptcy Docket ("Adv. Doc.") Nos. 59, 61, 63, 65, 66. The bankruptcy court granted the Defendants' motions. ER Vol. 3:286, Adv. Doc. Nos. 87, 89, 90, 91. The orders and judgment dismissing the FAC with prejudice were affirmed by the district court. *Official Comm. Of*

Unsecured Creditors v. Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l), No. 10-0647, 2011 WL 7763674, *1 (C.D. Cal. Aug. 31, 2011). Upon review, this Court reversed and remanded as to Claims 1, 2, 3, 4, 5, 6, 7, 9 and 10; affirmed as to Claims 10-14 of the original complaint (as against PWB); and reversed as to Claim 8. *Fitness Holdings I*, 714 F.3d 1141; *Fitness Holdings II*, 11-56677, 2013 WL 2151401 *2. ER Vol. 1:46 and 42.

Upon remand, the Defendants again moved to dismiss the Trustee's claims in their entirety. ER Vol. 3:361, Adv. Doc. Nos. 119, 120, 121, 126, 127. The Trustee opposed the Motions to Dismiss. *Id.*, Adv. Doc. No. 129, 130. After argument, the bankruptcy court granted the Motions to Dismiss, failing to consider the entirety of the FAC and the plausibility of the same, as it was instructed to do by this Court. ER Vol. 1:32, 36, 39, 54. The Trustee timely appealed to the district court. ER Vol. 1:1.

On or about October 9, 2014, the district court issued its "[In Chambers] Order Affirming Ruling On Motion To Dismiss First Amended Complaint" ("District Court Order"). ER Vol. 1:18. The District Court by and through the District Court Order affirmed the bankruptcy court's dismissal of the FAC and each of the remaining claims for relief (Claims 1-7, 9, 10). *Id.*

IV. STATEMENT OF FACTS

The Debtor in this bankruptcy case was a home fitness corporation. Before declaring bankruptcy, the Debtor received significant funding from two entities: Hancock Park, its sole shareholder, and PWB. *Fitness Holdings I*, 714 F.3d at 1143. Van Harten and Fourticq

both served on Debtor's board of directors. Fourticq was also a manager of Hancock Park. *Id.*

Hancock Park originally acquired the Debtor's assets through a leveraged buy-out in 2003, for cash in the amount of $4,000,000 and a promissory note in the amount of $4,400,000. The cash for the purchase price came from Hancock Park and a secured loan from PWB. ER Vol. 3:286, FAC ¶¶ 17, 18, 22.

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. These financings were represented by a series of *purported* unsecured promissory notes each entitled "Subordinated Promissory Note" ("Subordinated Note(s)"), but the transactions bear the substance of equity infusions.[1] ER Vol. 3:286, FAC ¶ 38,4; *Fitness Holdings I*, 714 F.3d 1141, 1143. After the advances were made, the Debtor: (a) failed to make the interest payments required by the Subordinated Notes, (b) did not establish any sinking fund to prepare for the repayment obligations on the approaching maturity dates on the Subordinated Notes, (c) never made demand for payment, and (d) never instituted any collection actions upon the failure of the Debtor to comply with the terms and conditions of the Subordinated Notes. In other words, the purported loans were treated as equity, rather than a debt obligation. ER Vol. 3:286, FAC ¶¶ 38, 39, 43, 48.

On or about July 23, 2004, the Debtor obtained a $12 million loan from PWB, structured as a: (a) $7,000,000 revolving loan; and, (b) $5,000,000 installment loan (collectively, the "PWB Secured Loan"). The loan was

[1] Copies of the Subordinated Notes are contained in ER Vol. 2:231.

secured by the assets of the Debtor, and supported by a guarantee issued by Hancock Park. On September 30, 2004, barely two months after closing, PWB notified the Debtor that it was in breach of the financial covenants contained in the loan agreement. ER Vol. 3:286, FAC ¶ 21.

Rather than collecting on the loan upon breach, the Debtor and PWB amended the loan agreement multiple times, extending the maturity dates on the revolving loan and waiving past breaches. In June 2007, the Debtor and PWB agreed to refinance the Debtor's debt. *Fitness Holdings I*, 714 F.3d at 1143, ER Vol. 3:286, FAC ¶¶ 24, 27, 28, 33, 35, 37, 40, 41.

In June 2007, PWB agreed to completely refinance the PWB Secured Loan by providing the Debtor a fully secured $25,000,000 loan ("Refinancing"), thereby fully leveraging all of the Debtor's assets. The Insiders used $11,995,500.37 of the Refinancing to pay off Hancock Park's purported subordinated debt. *Id.* at FAC ¶¶ 44-48. In so doing the Insiders replaced $11,995,500.37 of insider unsecured subordinated debt (recharacterized equity) with third party secured debt. Accordingly, the Refinancing provided the Debtor with no significant benefit. *Id.* FAC ¶ 48. The transfer of $11,995,500.37 by the Debtor to Hancock Park is the transfer the Trustee seeks to avoid ("Transfer").

Significantly, the Refinancing also eliminated the guaranty of Hancock Park. At the time of the Refinancing, the Debtor had creditors whose claims it was not satisfying, was in breach of its financial covenants to PWB and could not pay its debts as they became due. *Id.* FAC ¶¶ 42, 44, 48, 51-53, 69, 71, 81-83, 97, 100, 102, 114, 115, 133, 135, 137, 147, 153. Given the structure of the Refinancing and PWB's knowledge of the Debtor's precarious financial position, PWB knew

that the Refinancing fully encumbered all of the assets of the Debtor to the full extent of the value of the same, knew that the Insiders obtained repayment of their equity contributions in priority over that of the Debtor's unsecured creditors, and knew that the Debtor was insolvent and could not pay its debts as they became due. *Id.*

Almost immediately after the funding of the Refinancing, the Debtor defaulted on its obligations to PWB. *Id.*, FAC ¶ 56. PWB subsequently declared a default of the Refinancing which ultimately led to the Debtor's bankruptcy. *Id.*, FAC ¶¶ 56, 57. As a result of the Refinancing, the Debtor was with no unencumbered assets from which to pay its unsecured debt. *Id.*

V. STANDARD OF REVIEW

As the district court dismissed the FAC for failure to state a claim, the allegations of the FAC must be reviewed *de novo*. *Telesaurus VPC, LLC v. Power*, 623 F.3d 998, 1003 (9th Cir.2010). 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 (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). A district court's interpretation of state law is reviewed under the same *de novo* standard. *Salve Regina College v. Russell*, 499 U.S. 225, 231 (1991).

VI. SUMMARY OF ARGUMENT

In dismissing the FAC, the Lower Courts failed to apply any equitable considerations or standards to their decisions, accepting at face value the validity of the promissory notes, ignoring the age old adage that if it looks like a duck, quacks like a duck, and swims like a duck, it's a duck−not a swan. Here, the Lower Courts looked *only* to the written documents, and on that basis alone, determined the duck was a swan. In so doing the Lower Courts ignored the import of *Iqbal*, 556 U.S. at 680, and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007), which as this Court noted in *Fitness Holdings, I*, is to determine whether the Trustee's factual allegations plausibly support a conclusion that when the Debtor made the Transfer to Hancock Park it was for less than reasonably equivalent value. *Fitness Holdings, I*, ER Vol. 1:46. Further, in so doing, the Lower Courts completely ignored the recharacterization test under California law – that is, to look at the substance of the transaction rather than the form of the transaction. Applying this test, it is clear that the Subordinated Notes were a disguised equity play, issued with the intent to satisfy Hancock Park's equity position ahead of creditors in the event the leveraged buy-out failed.

As a matter of "law of the case," this Court determined that the factual underpinnings of the FAC supported the Trustee's eighth cause of action for equitable subordination. ER Vol. 1:42. In so doing this Court determined that the Trustee's allegations plausibly demonstrate that the Insiders "contrived" to benefit themselves by knowingly funneling money to themselves out of a failing company and as such the FAC plausibly alleged the elements of a claim for

equitable subordination. *Fitness Holdings II*, 2013 WL 2151401 *2.

In rendering their decisions to dismiss the FAC, the Lower Courts abused their discretion in ignoring this Court's finding that the FAC plausibly alleged that the Defendants engaged in inequitable conduct, and that such misconduct injured creditors or conferred unfair advantage on Defendants. These findings support a conclusion that not only is an equitable remedy available, but that the FAC plausibly alleges sufficient facts to support Claims 1, 3 (actual fraud) and 9 (breach of fiduciary duty).

In remanding the case to the Lower Courts, this Court also instructed that the claims of the Trustee must be viewed through a lens which allows for recharacterization and to determine whether the Trustee plausibly alleged that the Subordinated Notes were equity investments rather than debt. *Fitness Holdings, I*, 714 F.3d 1141, 1149; *Fitness Holdings II*, 2013 WL 2151401. Specifically, this Court stated that:

> 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.

Fitness Holdings, I, 714 F.3d 1141, 1149.

In granting the Motions to Dismiss, the Lowers Courts disregarded this instruction, and the bankruptcy court refused to reconsider the factual underpinnings of the FAC, limiting its review to the

issue of recharacterization, and further ignoring this Court's legal and factual determinations.

The FAC plausibly alleges that the Subordinated Notes are equity under California state law. ER Vol. 3:286, FAC ¶¶ 18-43, 48. Applying the California "circumstances test" the FAC presents facts that are plausible and that support the claims presented in the FAC.

VII. ARGUMENT

A. The Law of the Case Controls A Review of the Efficacy of the FAC.

The "law of the case" doctrine states that the decision on a legal issue by the same or a superior court must be followed in all subsequent proceedings in the same case. *Planned Parenthood of Cent. & N. Ariz. v. Arizona*, 718 F.2d 938, 949 (9th Cir.1983). Though the rule is discretionary, in general, "in order to maintain consistency during the course of a single case, reconsideration of questions previously decided should be avoided." *United States v. Mills*, 810 F.2d 907, 909 (9th Cir.1987). For the doctrine to apply, "the issue in question must have been decided explicitly or by necessary implication in [the] previous disposition." *Milgard Tempering, Inc. v. Selas Corp. of Am.*, 902 F.2d 703, 715 (9th Cir.1990) (internal quotation marks omitted) (edit in original). This rule promotes finality, and thus, the discretion of a court to revisit issues previously decided should be exercised sparingly. *Moore v. James H. Matthews & Co.*, 682 F.2d 830, 833–34 (9th Cir.1982). However, "the law of the case rule does not bind a court as absolutely as res judicata, and should not be applied woodenly when doing so would be inconsistent with considerations of substantial justice." *Id.* (internal quotation marks and citations

omitted). The Ninth Circuit has held that a court may exercise its discretion to depart from the law of the case doctrine in the following five circumstances: (1) the first decision was clearly erroneous; (2) there has been an intervening change in law; (3) the evidence before the court when reconsidering the issue is substantially different; (4) there are other changed circumstances; or (5) a manifest injustice would result from applying the doctrine. *United States v. Cuddy*, 147 F.3d 1111, 1114 (9th Cir.1998). "Failure to apply the doctrine of the law of the case absent one of the requisite conditions constitutes an abuse of discretion." *United States v. Alexander*, 106 F.3d 874, 876 (9th Cir.1997).

As noted, this Court, previously found that the FAC plausibly presented a claim for equitable subordination. This legal ruling, based upon a recognition that the FAC presented facts that were sufficient to allow for the conclusion that the Defendants engaged in some type of inequitable conduct, and that the misconduct injured creditors or conferred unfair advantage on the Defendants. In granting the Motions to Dismiss, the Lower Courts completely ignored this Court's determination that the FAC plausibly stated facts that support the Trustee's claw back claims (inequitable conduct) and breach of fiduciary duty claims (misconduct conferred an unfair advantage to the Defendants and harmed creditors.)

As none of the exceptions to the rule exist as to the application of the law of the case doctrine, and in ignoring this Court's legal and factual determinations, the Lower Courts abused their discretion. *United States v. Alexander,* 106 F.3d 874, 876 (9th Cir.1997).

B. Analogous California Law Supports the Trustee's Claims That The Subordinated Notes Are Equity And Not Debt

On the merits, the issue of whether or not a subordinate note instrument can be recharacterized as equity rather than a debt obligation presents a legal issue of apparent first impression under California law. The Trustee has found no California case addressing the issue, and the briefs and authorities submitted in the Lower Courts by the parties acknowledge that no direct authority or precedent exists. ER Vol. 2:115, 134, 176. Without certifying a question to the California Supreme Court, this Court is "required to ascertain from all the available data what the state law is and apply it." *Insurance Co. of Pennsylvania v. Associated Int'l Ins. Co.*, 922 F.2d 516, 520 (9th Cir.1990) (citation and ellipses omitted). In addition to decisions from California intermediate appellate courts, "'well-reasoned decisions from other jurisdictions' may also be considered." *Id.* (*quoting Takahashi v. Loomis Armored Car Serv.*, 625 F.2d 314, 316 (9th Cir.1980)). This Court is required to use its "'own best judgment in predicting' how the Supreme Court of California would interpret this . . . contract." *Id.* Accordingly, this Court should look both to California cases examining recharacterization in general as well as examine analogous case authorities that may be instructive on the issue.

Although there is no California case directly on point, California courts have addressed the issue of recharacterization in a variety of different contexts. In so doing, California courts utilize a form over substance test, with the determination being a question of fact, rather than one of law. A particularly instructive

case is *Ghirardo v. Antonioli*, 8 Cal. 4th 791 (1994), in which the California Supreme Court wrote:

> The circumstances giving rise to the transaction in dispute—including whether the parties intended a loan rather than a sale—are generally disputed by the parties. A question of disputed intent, in particular, is rooted in the facts of the case. The court must therefore determine the true nature of the transaction. *West Pico, supra*, 2 Cal.3d at pp. 603-604, 86 Cal.Rptr. 793, 469 P.2d 665. It is that determination which presents a question of fact." (emphasis added).

Ghirardo v. Antonioli, 8 Cal. 4th at 800. The *Ghirardo* Court continued:

> Viewed in the context of the transactions leading to this action, the settlement notes bear none of the attributes of a loan. To paraphrase Justice Mosk's often-quoted invocation of folk wisdom, if it does not look like a duck, does not walk like a duck, and does not quack like a duck, it is not likely to be a duck. *In re Deborah C.* (1981) 30 Cal.3d 125, 141, 177 Cal.Rptr. 852, 635 P.2d 446 (conc. opn. of Mosk, J.); *Phillippe v. Shapell Industries*, 43 Cal.3d 1247, 1256, 241 (1987). We are not suggesting that courts should not look beyond the surface of a transaction. To the contrary, "Sensitive to the ingenuity and creativity of those entrepreneurs willing to engage in legal brinkmanship to maximize profits, courts have carefully scrutinized the form of seemingly innocuous commercial transactions to determine whether the substance amounts to a usurious arrangement." *DCM Partners v.*

> *Smith*, supra, 228 Cal.App.3d 729, 733, 278 Cal.Rptr. 778; *Southwest Concrete*, supra, 51 Cal.3d 701, 705, 274 Cal.Rptr. 404, 798 P.2d 1247.

Id. at 800-801.

California's long and well-established case authorities addressing characterization in the context of usury cases remain consistent in their refusal to provide a list of specific factors to consider in determining the character of a transaction. Rather, they nearly universally declare that substance shall be favored over form as the proper "test" for determining the real character of transactions. *See Hollywood State Bank v. Wilde*, 70 Cal. App. 2d 103, 109 (1945) (*citing People v. Yant*, (1938) 26 Cal. App. 2d 725) (holding that it should be and is an established principle of law that the substance and not the mere form of transactions constitutes the proper test). *See also Boerner v. Colwell Co.*, 21 Cal.3d 37, 44 (1978); *O'Connor v. Televideo Sys., Inc.*, 218 Cal. App. 3d 709, 713-14 (1990) (*citing Burr v. Capital Reserve Corp.*, 71 Cal.2d 983, 989 (1969)) ("To determine whether a transaction is usurious, we must look to the substance rather than the form of the transaction. The pivotal question is '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.")

The Subordinated Note financing that is the subject of the fraudulent transfer claims alleged in the FAC, was an equity play by Hancock Park, disguised in the form of loans. ER. Vol. 3: 286, FAC ¶¶ 17-43. As alleged in the FAC, Hancock Park initially acquired the Debtor in 2004 in a transaction that was structured as a leveraged buy-out, with equity coming in

the form of subordinated debt. *Id.* For the following three years the investors avoided making cash infusions that were specifically described as capital investments, but instead documented their investments in their company by causing the Debtor to issue unsecured subordinated "notes." If the Subordinated Notes were truly debt, then the Debtor would have been perpetually undercapitalized and insolvent. Instead, the Subordinated Notes were capital contributions. *Id.*

By June 2007, Hancock Park had invested over $24 million in the Debtor, characterizing the capital infusions as "notes." *Id.* at FAC ¶ 43. Despite purporting to loan such funds to the Debtor, the Insiders never enforced the Subordinated Notes as loans; including ignoring maturity dates and ignoring missed interest payments, such that by June 2007 there was over $4.3 million in unpaid interest that had accrued under the "notes." *Id.* at FAC ¶¶ 38, 48, 50. When it became obvious that the debtor was either insolvent, or close to it, the Insiders caused the Debtor to fully leverage its assets by borrowing another $13 million on a secured basis, $11.9 million of which was paid to Hancock Park to pay off principal and accrued interest purportedly due on the Subordinated Notes. *Id.* at FAC ¶¶ 42, 44-48, 50. The PWB loan documents themselves acknowledge the parties viewed the Subordinated Notes as equity rather than debt, in providing that the Debtor's Debt/Worth ratio would be calculated by *excluding* the Subordinated Notes from the category of debt. *Id.* at FAC, Exh. 1, ¶ 3.3.

When viewed in its entirety, the transaction was a leveraged buyout stretched over three years, with the Insiders simply waiting until they were uncomfortable with the level of their risk before leveraging the

Debtor's assets to provide cash for payments to themselves. In this context, the "duck" in question was undoubtedly equity, rather than true debt. The Lowers Courts' decision to dismiss based upon a strict reading of the promissory note (ER Vol. 1:18, 102) was error as a matter of law, given that California law requires a substance over form "test." As noted by this Court in *Fitness Holdings II*, the FAC presented facts that plausibly presented claims that supported a conclusion that the Defendants engaged in some type of inequitable conduct, and that the misconduct injured creditors or conferred unfair advantage on Defendants. *Fitness Holdings II*, 2013 WL 2151401 *2 (ER Vol. 1:42). Given these two conclusions – as the law of the case, the substance over form analogy compels a finding that the Trustee's claims for recharacterization are also plausible, and that the claim should not be determined by looking only at the four corners of the Subordinated Notes.

C. The Fraudulent Transfer Claims Against Hancock Park State Valid Claims for Relief.

Section 548 of the Bankruptcy Code permits a trustee to avoid any transfer of the debtor's property made to an insider within two years of the petition date if: (A) the transfer was made with intent to hinder, delay or defraud any of the debtor's creditors ("actual" fraudulent transfer claim), or (B) if the debtor received less than reasonably equivalent value for the transaction and was (a) insolvent or rendered insolvent, (b) left with unreasonably small capital, (c) unable to pay its debts as they matured, or (d) made such transfer to an insider on account of a non-ordinary employment contract ("constructive" fraudulent transfer claim). 11 U.S.C. § 548(a)(1)(A) and (B).

The fraudulent transfer claims (Claims 1 - 5) set forth in the FAC seek to recover the transfer of $11,955,500.37 from the Debtor to Hancock Park on the grounds that the Insiders caused the Debtor (1) to borrow approximately $13 million in new secured loans from PWB, and (2) to transfer $11,955,500.39 of the loan proceeds to Hancock Park on account of capital contributions (equity). ER Vol. 3:286, FAC ¶¶ 17-48, 50, 56, 60-116.

The FAC's claims for avoidance of constructive fraudulent transfer (Claims 2, 4, 5) must be analyzed from the perspective of this Court's holding that the Trustee may seek to recharacterize the Subordinated Notes as equity. *In re FHI I*, 714 F.3d at 1149. In its unpublished companion opinion, the Ninth Circuit held that the FAC's claims for recovery of a fraudulent transfer under 11 U.S.C. § 544(b)(1) (Claims 3, 4 and 5), the claim for recovery of an actually fraudulent transfer under 11 U.S.C. § 548(a)(1)(A) (Claim 1), and the claim for recovery of an avoided transfer under 11 U.S.C. § 550(a) (Claim 6), must also be analyzed under the "correct standard" that starts with the recognition that the Trustee may allege that "Hancock Park's loans to Fitness Holdings should be recharacterized as equity." *In re FHI II*, 2013 WL 2151401 *1. As the FAC plausibly alleges that the Subordinated Notes are instruments of equity, it follows that the FAC also plausibly alleges the elements of both intentional and constructive fraudulent transfer claims under 11 U.S.C. §§ 548 (a)(1)(A) and (B) and 11 U.S.C. §544 and Cal. Civ. Code §§ 3439.004 and 3439.005.

The FAC properly pleads the necessary facts (which must be taken as true) to avoid the Transfer for the benefit of the Estate (Claims 1 through 5), to wit:

- within two years of the Petition Date, the Debtor (controlled by the Insiders) borrowed approximately $13 million in new secured debt from PWB and disbursed nearly $12 million of the proceeds to Hancock Park (ER Vol. 3:286, FAC ¶¶44-49 and ¶¶61-74);
- the proceeds from the Financing were property of the Debtor (*Id.*, FAC ¶¶ 45, 62-63);
- the Financing was made by the Debtor with the actual intent to hinder, delay and defraud creditors of the Debtor (*Id.*, FAC ¶¶ 64, 96);
- FAC ¶¶ 17-39, 50);
- the exchange of equity for secured debt hindered the Debtor's ability to obtain additional funds to support its ongoing business operations (*Id.*, FAC ¶¶ 67-68, 70, 72-73, 94, 103);
- the Transfer "was not for reasonably equivalent value" (*Id.*, FAC ¶¶ 48, 61, 68, 79, 80, 208, 115);
- the Financing rendered the Debtor unable to satisfy its obligations as they came due and led to the filing of the Petition (*Id.*, FAC ¶¶ 73, 99, 103);
- at the time of the Financing, and thereafter, the Debtor was insolvent (*Id.*, FAC ¶¶ 42, 48, 51, 52, 71, 72), was not paying its obligations as they became due (*Id.*, FAC ¶¶ 24, 27, 28, 33, 35, 37, 40-42, 52, 53, 69, 72, 81, 100, 114), had insufficient working capital and a diminished value, and could not obtain funding because of PWB's increased lien *(Id.* ¶¶ 69-70, 81-84, 97, 99-101).

1. FAC Sufficiently Pleads Constructive Fraud (Claims 2, 4, 5)

As set forth above, the FAC contains the allegations that satisfy the standard for each of the claims that seek to avoid and recover a constructive fraudulent transfer. The FAC alleges that "the interest created by Hancock Park's agreements with Fitness Holdings constituted equity investments (rather than debt) under applicable state law," and alleges a series of facts that demonstrate that the Subordinated Notes constitute equity under applicable state law. ER Vol. 3: 286, FAC ¶¶ 17-39, 50.

The FAC also contains the allegation that the transfer of $11,995,500 from the Debtor to Hancock Park "was not for reasonably equivalent value" *(Id.* ¶¶ 48, 61, 68, 79) and the FAC contains additional allegations *(Id.* ¶¶ 51, 53, 56, 63-67, 69-74) to state the "other elements of a claim for a constructively fraudulent transfer under § 548(a)(1)(B)." *In re FHI I*, 714 F.3d at 1149.

2. The FAC Sufficiently Pleads Actual Fraud (Claims 1 and 3)

This Court has already held that the FAC plausibly alleges that the Insiders acted to divert funds from the failing debtor at the expense of creditors and to benefit themselves. *Fitness Holdings II*, at * 2. Such a holding demonstrates that the "intent" requirement is plausibly stated. The FAC further alleges that such actions rendered the Debtor insolvent, benefited Insiders, and that the Debtor received less than reasonably equivalent value for the Transfer, plausibly alleging the claim for avoidance of an actual fraudulent transfer under 11 U.SC. §548 (a)(1)(A) and Cal. Civ. Code § 3439.004(a)(1). ER Vol. 3, FAC ¶¶ 42, 44, 48, 51-53,

69, 71, 81-83, 97, 100, 102, 114, 115, 133, 135, 137, 147, 153.

The starting point for analysis of Claims 1 and 3 is the same as the constructive fraudulent transfer claims – the allegations that the Subordinated Notes are actually instruments of equity. *Id.*, FAC ¶¶ 17-48, 50. The allegations that the Defendants obtained secured financing of nearly $12 million solely to repay equity plausibly alleges fraudulent intent. *See Michaelson v. Farmer (In re Appleseed's Intermediate Holdings, LLC)*, 470 B.R. 289, 300 (D. Del. 2012) (finding sufficient allegations of actual fraudulent intent where complaint alleged that parent company and shareholder caused debtor to dividend secured loan proceeds to defendants, for which the debtor received no equivalent value, at a time when the debtor was insolvent or rendered insolvent). The requisite allegations to support Claims 1 and 3 are contained in the FAC at ¶¶ 17-48, 50, 61 73, 94-104. ER Vol. 3:286.

This Court has already found that the requisite intent is plausibly pled in the FAC, albeit for a different cause of action, but alleging the identical facts and circumstances. This Court analyzed the FAC's equitable subordination claim and found that it was plausibly stated, including the allegations of requisite intent:

> 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 . . .

In re FHI II, 2013 WL 2151401 *2. This finding that the FAC plausibly alleged knowing intent is the law of

the case. The FAC's allegations of intent, showing that the Defendants "'contrived' to benefit themselves by knowingly funneling money to themselves out of a failing company," are the same for the equitable subordination claim (Claim 8) and the actual fraudulent transfer claims (Claims 1, 3). The allegations of intent for these claims are set forth in the FAC as follows:

- That Hancock Park intentionally carried out the Refinancing to cause the Debtor to borrow $11.9 million on a secured basis and use those funds topay the Hancock Park's equity interests (ER Vol. 3, FAC ¶¶ 65, 133);
- That Hancock Park's actions to cause the Debtor to borrow an additional $11.9 million to pay to equity holders was an intentional effort to prefer their equity interests over the interests of creditors (Id., FAC ¶¶ 65-66, 133);
- That the Debtor was insolvent at the time of the transaction, or rendered insolvent by it, and received no value in return for funneling $11.9 million to Hancock Park (Id., FAC ¶¶ 68, 69, 71, 131, 133).

Other courts have denied motions to dismiss claims for recovery of an actually fraudulent transfer where the complaint made allegations virtually identical to those alleged in the FAC. *See In re Appleseed's Intermediate Holdings, LLC*, 470 B.R. 289, 300 (Bankr. D. Del. 2012)(denying motion to dismiss claim against parent company and shareholders who caused debtor to dividend loan proceeds); *Responsible Person of Musicland Holding Corp. v. Best Buy Co. (In re Musicland Holding Corp.)*, 398 B.R. 761 (Bankr. S.D.N.Y. 2008) (denying motion to dismiss where parent caused

subsidiary to upstream cash on account of equity investments disguised as debt).

The decision in *Musicland Holding* is particularly instructive and similar to the facts of this case. The Court in *Musicland Holding* denied the defendants' motion to dismiss a complaint similar to the FAC. The *Musicland Holding* Court first explained that the complaint alleged a recharacterization claim on which the fraudulent transfer claims were based, by alleging that (much like the Subordinated Notes) the parties had not made interest payments on alleged notes, ignored maturity dates, and otherwise treated the parent company's cash infusions as equity rather than debt. *Id.* at 775. The Court then turned to the fraudulent transfer claims, and found that the complaint presented the claims with particularity, including fraudulent intent, where it alleged that the parent company desired a return of its investment, controlled the subsidiary, and caused the subsidiary to repay the investment as if it were debt, while it was insolvent. On these grounds, the *Musicland Holding* Court denied the motion to dismiss. *Id.* at 777.

Like the very similar claims asserted in *Musicland Holding* and *Appleseed Intermediate Holdings*, *supra* – and based in part on this Court's holding that the FAC plausibly alleges that Hancock Park contrived to funnel cash to itself from a failing subsidiary – the FAC plausibly alleges a claim for recovery of an actual fraudulent transfer. ER Vol. 3, FAC ¶¶ 8, 24-42, 44-53, 61-74, 79, 81, 89, 100, 114.

D. The Bankruptcy Court Erred by Dismissing the Breach of Fiduciary Duty Claim Against the Insiders (Claim 9).

In the course of dismissing the entire FAC, the Lower Courts said little about why they dismissed the breach of fiduciary duty claims against Fourticq and Van Harten. The bankruptcy court never addressed this claim, concluding that the case should be dismissed based on its view that the FAC does not state a claim for the recharacterization of the Subordinated Notes. ER Vol. 2:54, Tr. at p. 28: 19-23, 29:18-25. The district court never addressed the breach of fiduciary duty claim, but affirmed the bankruptcy court's dismissal of Claim 9. ER Vol. 1:18. Not only were the Lower Courts in error in failing to specifically address Claim 9, this Court's upholding of the equitable subordination claim alone is sufficient to establish that the breach of fiduciary duty claim presented by the Trustee was sufficiently pleaded.

1. The Claims in the FAC Are the Debtor's Claims

Before filing its original complaint, the Committee obtained standing to pursue the Debtor's claims against the Defendants. The claims presented in the FAC are stated on behalf of the "Debtor and [its] creditors." *See e.g.*, ER Vol. 3:286, FAC ¶¶ 140, 142, 164.[2] Now, the Trustee has stepped in as successor plaintiff, following conversion of the bankruptcy case

[2] This is not a limitation of the claims stated, nor an allegation of claims on behalf of individual creditors, but a catchall phrase that covers all possible grounds for the Committee's standing. In the past, many pages of briefs were devoted to the mistaken red herring claim that the FAC asserted claims belonging to creditors, not the Debtor.

to Chapter 7 and dissolution of the Committee, and the Trustee pursues such claims in his capacity as the representative of the Debtor's estate. Thus, the issue for this appeal is whether the Insiders breached their duties to the Debtor when they caused it to borrow approximately $13 million in new secured debt and distribute nearly all of it to Hancock Park.

2. The FAC Properly Pleads Breach of Fiduciary Duty

A properly pleaded breach of fiduciary duty claim must allege that a fiduciary duty exits, that it was breached and that damage was proximately caused by the breach. *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 68 Cal.App.4th 445, 483 (1998). The FAC properly alleges that the Insiders owed a fiduciary duty to the Debtor (ER Vol. 3:286, FAC ¶¶ 138-141), that this duty was breached (*id.*, ¶¶ 142-150) and that the Debtor was injured by such breach (*id.*, ¶¶ 151-153). Further the law of this case is that the FAC plausibly alleges that the Insiders engaged in inequitable conduct, and that the misconduct injured creditors or conferred unfair advantage on the Insiders. *Fitness Holdings II*, 2013 WL 215 1401 at *2. This Court's conclusion on this point supports the Trustee's claim for breach of fiduciary duty. *Id.*

The Insiders argued before the Bankruptcy Court that they owed fiduciary duties to no one but themselves, as shareholders, under the Delaware Supreme Court's decisions in *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006) and *N. Am. Catholic Educ. Programming Found, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) *("Gheewalla")*.

The Insiders misinterpret both cases. As the Third Circuit has explained, citing to *Trenwick*, if the

subsidiary becomes insolvent, or is rendered insolvent by a transaction, then the directors of the subsidiary owe a broader duty of "care and loyalty" to the subsidiary that is no longer measured by benefit to shareholders:

> While we normally assume that a corporation's primary interest is in maximizing its economic value, the only interest of a wholly owned subsidiary is in serving its parent. Id. at 1174. That doing so may not always involve maximizing the subsidiary's economic value is of little concern. *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 192 (Del. Ch. 2006). If the subsidiary is not wholly owned, however, in the interest of protecting minority shareholders we revert to requiring that whoever controls the subsidiary seek to maximize its economic value with requisite care and loyalty. See *id.* at 192 n.66. Similarly, if the subsidiary is insolvent, we require the same in the interest of protecting the subsidiary's creditors. *Id.* at 204 n.96.

In re Teleglobe Comm. Corp., 493 F.3d 345, 367 (3d Cir. 2007)("Teleglobe").

In *Trenwick*, the Delaware court explained that the rationale behind this duty is that stockholders are no longer the residual claimants of a corporation once it is rendered insolvent:

> If the firm is insolvent, its residual claimants are the creditors and it is for their benefit that the directors must now manage the firm. A purposeful fraudulent transfer to stockholders who are "out of the money" is obviously inconsistent with the best interest of the creditors,

> the firm's new residual claimants. 906 A.2d at 204, n. 96. See also *Gheewalla*, 930 A.2d at 101 ("When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.").

Trenwick, 906 A.2d at 204, n. 96. *See also Gheewalla"*, 930 A.2d at 101 (Del. 2007). *Teleglobe*, *Trenwick* and *Gheewalla* all explain that harm to creditors is harm to the corporation when the corporation is rendered insolvent, and gives rise to a claim brought by or in the name of the corporation.

In a *post-Trenwick* and *post-Gheewalla* case that is remarkably similar to the instant case, *Seidel v. Byron,* 405 B.R. 277 (N.D. Ill. 2009), a chapter 7 trustee sued the debtor's director/shareholders for causing the debtor to pledge its assets to secure a loan for an affiliate, for the ultimate benefit of the director/shareholders. *Id.* at 283. The directors filed a motion to dismiss, citing to *Trenwick* for support. The court denied the motion, finding that *Trenwick* supported the complaint:

> The Court disagrees that Plaintiff's claims should be dismissed under *Trenwick.* As Plaintiff points out, the rule in *Trenwick* does not apply when the subsidiary is insolvent or where the transaction at issue would render the subsidiary unable to meet its legal obligations. Notably, in *Trenwick*, the court dismissed the plaintiff's breach of duty claims against a subsidiary's former directors based on transactions that solely benefitted the parent company, because there were no allegations that the subsidiary was "insolvent before any of the challenged transactions or that any of

> the challenged transactions would, when consummated, leave [the subsidiary] unable to satisfy its creditors.

Seidel v. Byron, 405 B.R. at 285. The court in *Seidel* went on to construe the allegations of the complaint in the "light most favorable" to plaintiffs, noting that the complaint alleged that the asset pledge "quickly diminished [the debtor's] value and its ability to pay creditors and survive." *Id.* at 286.

The court in *Seidel* applied the proper standard for a motion to dismiss, and properly interpreted Delaware law. The FAC states plausible claims for the Defendants' breach of their fiduciary duty to the corporation, which is measured by harm to the corporation as a whole, not benefit to shareholders. *Trenwick*, 906 A.2d at 204, n. 96.

The Lower Courts erred in dismissing the breach of fiduciary duty claim by failing to consider the plausible allegations of breach of fiduciary duty (ER Vol. 3: 286, FAC ¶¶ 138-153) and this Court's ruling that Insiders acted with the intent to protect their own interests at the expense of others including creditors which is the law of this case.

E. The Bankruptcy Court Erred By Dismissing the Claim Against PWB for Aiding and Abetting a Breach of Fiduciary Duty

The Lower Court's dismissal of the claim for aiding and abetting breach of fiduciary duty was erroneous. Under Delaware law, applicable here, to establish a cause of action for aiding or assisting in the breach of a fiduciary, a plaintiff must plausibly allege that: (1) the fiduciary breached an obligation to plaintiff; (2) the defendant knew that the fiduciary's conduct constituted a breach of duty; and (3) damages were

sustained as a result of the breach. *LaSala v. Bordier Et Cie*, 519 F.3d 121, 130 (3d Cir. 2008); *Miller v. Greenwich Capital Fin. Prods. (In re Am. Bus. Fin. Servs.)*, 375 B.R. 112, 118 (Bankr. Del. 2007).

The FAC satisfies the first two elements by pleading a breach of fiduciary duty claim. ER Vol. 3:286, FAC ¶¶ 138-153. The FAC also pleads that PWB had actual knowledge of the breach and knowingly participated in the same. *Id.*, FAC ¶¶ 156-163, Exh. 1 ¶ 3.3 and Exh. 4. PWB not only knew that nearly $12 million of the secured lending was to be paid to the Insiders, PWB actually disbursed the funds directly to Hancock Park on account of the Subordinated Notes, even while refusing to acknowledge the Subordinated Notes as debt when calculating the Debtor's debt/worth ratio. *Id.*, FAC ¶¶ 44-48, and Exh. 1, ¶ 3.3 and Exh. 4.

The bankruptcy court erroneously accepted PWB's argument that it would not have intentionally furthered a plan that would have led to the Debtor's demise. Those facts are not alleged in the FAC, and cannot be considered by the bankruptcy court in ruling on PWB's Motion to Dismiss. Further, whether PWB knew or should have known that the Debtor would immediately and repeatedly breach the new loan agreement is irrelevant. Banks make misguided loans all the time, often driven by fees and their own balance sheet requirements. Rather, the test is whether the FAC plausibly states that: (i) the Insiders carried out a transaction that transferred funds of the Debtor to themselves, either intentionally or for no reasonably equivalent value; (ii) whether the Debtor was rendered insolvent by the transfer; (iii) whether PWB had knowledge of the transaction – the Refinancing, and that it occurred at the direction of the Insiders for the benefit of the Insiders; and, (iv) whether the Debtor

was injured as a result. See e.g. *In re. First Alliance Mortgage Co.*, 471 F.3d 977 (9th Cir. 2006)(warehouse lender aided and abetted fraudulent loan practices by providing financing with knowledge of the fraud.)

The FAC plausibly alleges all four of these elements, and plausibly alleges a claim for aiding and abetting breach of fiduciary duties. ER Vol. 3:286, FAC ¶¶ 44-48, 138-153, 156-163, Exh. 1, ¶3.3, and Exh. 4.

F. The Claims Against PWB Are Not Precluded By The Doctrine of *In Pari Delicto*.

In its motion to dismiss, PWB argued before the bankruptcy court that the doctrine of *In Pari Delicto* ("Doctrine") bars the claims brought by the Trustee, contending that the Insiders' knowledge is imputed to the Debtor, that the Trustee stands in the Debtor's shoes, and that therefore the Trustee cannot sue PWB for a misdeed involving both the Debtor and PWB. PWB is wrong for any number of reasons. The bankruptcy court dismissed the Trustee's claim against PWB for aiding and abetting the Defendants' breach of fiduciary duty, apparently determining that the Doctrine precluded the Trustee's claim. ER Vol. 2:54, Tr. at p. 32. The District Court did not reach this issue. ER Vol. 1: 18.

A motion to dismiss under Rule 12(b)(6) cannot be granted based upon an affirmative defense unless that "defense raises no disputed issues of fact." *Scott v. Kuhlmann*, 746 F.2d 1377, 1378 (9th Cir.1984).

Application of the Doctrine is controlled by California law. *See O'Melveny & Myers v. FDIC*, 512 U.S. 79, (1994); *FDIC v. O'Melveny & Myers* 61 F.3d 17 (9th Cir. 1995) (collectively, *"O'Melveny")* (State law applies to the application of the Doctrine to state court receivers). Under California state law defenses based

on a party's unclean hands or inequitable conduct (in pari delicto) do not generally apply against that party's receiver. *Camerer v. California Sav. & Commercial Bank*, 4 Cal.2d 159, 170-71 (1935).

There is no reason that California's rule exempting receivers from application of the defense should not be extended to bankruptcy trustees. *FDIC v. O'Meleny & Meyers*, 61 F. 3d 17 ("a receiver, like a bankruptcy trustee, and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank. Rather, the receiver is an independent fiduciary thrust into those shoes."). A receiver is a statutory administrator of the assets of a third party appointed by the court. The same is true of the bankruptcy trustee, to wit: the trustee, like a receiver is a third party that administers assets of the bankruptcy estate appointed by the court. Each are afforded rights that are beyond those of the owners of the entity that is now under the jurisdiction of the court. As noted *In re Plaza Mortg. And Finance Corp.* 187 B.R. 37 (Bankr. N.D. Ga. 1995):

> Is there any reason why the rationale of the Ninth Circuit in *O'Melveny* on remand and the Seventh Circuit in *Scholes* shouldn't apply to the trustee here? A trustee in bankruptcy has a role similar to the FDIC in O'Melveny and the Illinois receiver in *Scholes*, and a trustee in bankruptcy should be in no worse position than a state or federal receiver. Indeed, the courts in both those cases analogized their receivers to trustees in bankruptcy.

In re Plaza Mortg. And Finance Corp. 187 B.R. 37, 47.

Because the Doctrine should not apply to bankruptcy trustees, or alternatively presents issues of fact regarding a defense, the Doctrine does not bar the claims presented against PWB at this stage of the proceedings. As presented in the FAC, PWB had actual knowledge of the acts and conduct of the Insiders, in structuring the notes as debt when in fact they were equity. PWB also knew that the Debtor was insolvent, and knew that the transfer of the assets could cause damage to the Debtor. ER Vol. 3:286, FAC ¶¶ 21, 24, 27, 28, 33, 35, 37, 40-42, 46-48, 50, 52, 157-164. As this is not a case of non-disclosure but one of full knowledge under California law. See, a breach of fiduciary duty presented against PWB by the Trustee. *In re. First Alliance Mortgage Co.*, 471 F.3d 977 (9th Cir. 2006).

The *in pari delicto* defense also does not apply to claw back claims asserted by the Trustee under 11 U.S.C. §§ 544 and 548. While this defense may be raised against a debtor's claims under 11 U.S.C. § 541, it cannot be brought against avoidance claims. *In re Financial Resources Mortg., Inc.*, 454 B.R. 6, 24 (Bankr. D.N.H. 2011). The reasoning is that these avoidance claims are brought under a trustee's avoiding powers and not under his status as a successor in interest to the debtor. *Sender v. Simon,* 84 F.3d 1299, 1304 (10th Cir.1996); *In re Dow,* 132 B.R. 853, 861 (Bankr. S. D. Ohio 1991). "Courts have held that, while the *in pari delicto* defense applies to actions brought by trustees as the successor to the debtor's interest under § 541, it does not apply to avoidance actions under chapter 5." *In re Financial Resources Mortg., Inc.,* 454 B.R. at 24.

VIII. CONCLUSION

Based on the foregoing, the Appellant requests that the decisions of the Lower Courts be reversed, and this Court find that the facts presented in the FAC plausibly support all claims for relief. The orders dismissing the FAC should be reversed and the Defendants should be required to answer the FAC.

Dated: March 13, 2015

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STATEMENT OF RELATED CASES
[9th Cir. R. 28-2.6]

I certify that there are no known related cases pending before this Court.

Dated: March 13, 2015

/s/ Larry W. Gabriel
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APPENDIX D

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

[Filed 11/22/2016]

No. 14-56766

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.

PETITION FOR PANEL REHEARING
AND FOR REHEARING EN BANC

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STATEMENT PURSUANT TO
FRAP 35 and FRAP 40

Plaintiff-Appellant, Sam Leslie, chapter 7 trustee for the estate of Fitness Holdings, Inc. ("Trustee"), petitions for rehearing en banc or before the Panel to examine the decision the Panel expressed in its Memorandum Decision of November 7, 2016 [Docket No. 47-1] ("Decision").[1] In counsel's opinion, en banc review is necessary as the Decision impermissibly conflicts with, and the Panel failed to follow, the law of the circuit and of the case established in *Fitness Holdings International, Inc. v. Hancock Park Associates*, 714 F.3d 1141 (9th Cir. 2013) ("*Fitness Holdings I*") (on matter of first impression, recognizing the equitable principle of "recharacterization" and requiring lower court to determine the applicable factors under California state law for determining whether to recharacterize an investment as "equity" when it is otherwise documented as a "debt" transaction). Fed. R. App. P. 35(1).

On remand, the District Court ignored the directive from *Fitness Holdings I*, and the Panel, in turn, affirmed the District Court's form over substance analysis that failed to identify any California state law factors, let alone consider whether in light of the transaction as a whole promissory notes could be recharacterized as creating equity interests rather than debt. Rather, the Decision incorrectly applied basic contract interpretation principles and affirmed a four-corners contract interpretation analysis by the District Court that is the antithesis of the recharacterization analysis mandated by the controlling *Fitness Holdings I* holding. *See Rodriguez v. Robbins*, 804 F.3d 1060,

[1] A true and correct copy of the Decision is attached hereto.

1080 (9th Cir. 2015) ("pursuant to the "'law of the circuit' rule," "a published decision of this court constitutes binding authority which 'must be followed unless and until overruled by a body competent to do so'") *quoting Gonzalez v. Arizona*, 677 F.3d 383, 389 n.4 (9th Cir. 2012) (en banc) *quoting Hart v. Massanari*, 266 F.3d 1155, 1170 (9th Cir. 2001). Accordingly, consideration by the full court is necessary to secure and maintain uniformity of the Court's decision, to enforce the law of the circuit, and eliminate the intracircuit conflict created by the Decision.

In addition, the Trustee submits that the Decision is based on clear errors of law insofar as it dismissed the breach of fiduciary duty claim even though the Plaintiff had been assigned the debtor's rights by stipulation and order of the court, stood in the shoes of the debtor, and thus was entitled to proceed with a direct claim for relief. This, too, may be redressed en banc. *See U.S. v. Burdeau*, 180 F.3d 1091, 1092 (9th Cir. 1999) (Tashima, J. concurring) ("we should review the statements in three judge panel opinions only to "determine whether the [panel's] legal error resulted in an erroneous judgment....") quoting *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842 (1984).

I. INTRODUCTION

In *Fitness Holdings I*, this Court determined 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 so holding, this Court singled out the fundamental flaw in the lower court's analysis:

> 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.

Fitness Holdings I brought the Ninth Circuit in line with the rest of the Circuits by recognizing recharacterization. While the *Fitness Holdings I* court expressly sanctioned a claim for recharacterization, it declined to apply federal law recharacterization factors in deference to California state law, and remanded the matter to the lower court to identify those factors. *Id.*, at 1149.

The District Court again failed to look at the transaction as instructed by *Fitness Holdings I,* abandoned any traditional concepts of recharacterization (substance over form), failed to ascertain what factors California state courts would apply, and again "failed to apply the correct standard" by merely applying California's contract interpretation law to the promissory notes, as if this was a suit involving an ambiguity in the language of a contract instead of an examination of the true nature of a transaction that had been disguised as debt:

> 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.

ER:1:15. The Panel affirmed the District Court's conclusion, finding that "[t]he district court correctly applied California law in concluding that the notes were contracts that created a right to payment" and that 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." Decision, p. 3.

By not identifying factors to consider in animating the equitable recharacterization claim (in deference to California's well-settled contract interpretation principles), the Panel failed to implement the holding in *Fitness Holdings I* and, more generally, the equitable concept of "recharacterization" as recognized by every other Circuit that has addressed the issue – adopting a multi-factor test to determine the substance of the transaction rather than the form. *See e.g. In re Lothian Oil*, 650 F.3d 539, 542–43 (5th Cir. 2011); *In re Dornier Aviation, Inc.,* 453 F.3d 225, 231, 233 (4th Cir.2006) (citing *In re SubMicron Sys. Corp.,* 432 F.3d 448 (3d Cir.2006); *In re Hedged–Investments Assocs., Inc.,* 380 F.3d 1292 (10th Cir.2004); *In re AutoStyle Plastics, Inc.,* 269 F.3d 726 (6th Cir.2001).

Moreover, the Panel failed to consider how the California Supreme Court would address the issue as it was obligated to do, as the test for recharacterization is: (1) one of first impression; and, (2) has not been directly addressed by the California Supreme Court with respect to recharacterizing debt to equity. *Ileto v. Glock, Inc*., 349 F. 3d 1191, 1200 (9th Cir. 2003).

Alternatively, the Panel should have referred the matter to the California Supreme Court for a decision as to how to address a recharacterization claim pursuant to Rule 8.548 of the California Rules of Court. *See e.g. Kremen v. Cohen,* 325 F.3d 1035, 1037-38 (9th Cir. 2003).

Furthermore, the Panel failed to follow the instructions issued in *Fitness Holdings I* that to survive a motion to dismiss, the allegations in the First Amended Complaint ("FAC") must "plausibly allege that the interests created by Hancock Park's agreements with Fitness Holdings constituted equity investments (rather than debt) under applicable state law." *Fitness Holdings I,* 714 F.3d 1141, 1149, ER:1:46. Neither the District Court nor the Panel considered the allegations in the FAC when analyzing the transactions. Rather both Courts bypassed the mandate of *Fitness Holdings I* by concluding—without regard to the concept of recharacterization or the allegations in the FAC—that form (the promissory notes) rather than substance (the transactions as a whole and the intent of the parties) dictate whether the transactions are debt or equity.

As framed by *Fitness Holdings I*, the transactions alleged in the FAC must be examined in the aggregate taking into consideration all allegations in the complaint to determine whether the transactions as a whole are equity investments or debt. This instruction is not rooted in the form of the promissory notes, and the Panel's decision to look only to the four corners of the promissory notes, is error and against the law of this Circuit as established in *Fitness Holdings I.*

If the Decision is left to stand, it renders the entire concept of recharacterization a nullity insofar as courts would never look past the four corners of an agreement

even if the substance of the transaction bears no resemblance to the form.

II. REASONS FOR GRANTING THE PETITION

A. Consideration by the Full Court is Necessary to Secure and Maintain Uniformity of the Court's Decisions, to Address an Intracircuit Conflict and to Enforce the Law of the Circuit

The Ninth Circuit recognizes that en banc hearings are appropriate to decide intracircuit conflicts. *See In re Complaint of Ross Sand & Gravel,* 266 F.3d 1015, 1018 (9th Cir. 2000) ("[a]n intracircuit conflict is grounds for en banc review").

Here, the Decision created such an intracircuit conflict when the Panel ignored both the law of the case and the law of the circuit by affirming a District Court decision that ignored *Fitness Holdings I*, which instructed the District Court to determine California state law factors to consider in determining whether to recharacterize debt into equity. Indeed, no one contested that the "form" of the agreements reflected debt; the purpose of the remand was to determine the "substance" of the transaction and whether equity dictated that the form be ignored in deference to the true nature of the transaction.

In *Fitness Holdings I*, this Court held that:

> 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.

Fitness Holdings I, 714 F. 3d at 1150; *see id.*, at 147 ("[C]ourt 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 and that such determination is to be based upon California law.").

The lower courts and the Panel did not consider the test California would most likely adopt in addressing a recharacterization (debt to equity) claim. Rather, the District Court and the Panel adopted a "test" contrary to the very concept of recharacterization—one that looks solely at the four corners of the instrument, placing form over substance. ER:1:18, 25-28, Decision, p. 3-4. In so doing, the Panel rejected the holding in *Fitness Holdings I* on the application of the equitable principle of recharacterization, which is to "effectively ignore the label attached to the transaction at issue and instead recognize its true substance." *SubMicron,* 432 F.3d at 454–56.

The Decision, if left to stand, violates the law of the Circuit established by *Fitness Holdings I,* as all promissory notes will be considered debt instruments regardless of the intent of the parties, or how the parties actually treated the obligation in the conduct of its business. On its face, the Decision fails to apply the law of the Circuit established in *Fitness Holdings I,* requiring the lower court to determine the applicable factors under California state law for determining whether to recharacterize an investment as "equity" when it is otherwise documented as a "debt" transaction.

The recharacterization analysis dictated by the *Fitness Holdings I* decision has been followed by lower courts in this Circuit and affirmed by this Circuit. *See Gladstone v. McHaffie (In re UC Lofts on 4th, LLC*), 2014 WL 1285415 (Bankr. S.D. Cal. March 27, 2014); *In re Daewoo Motor America, Inc.,* 554 Fed.Appx. 638, 639 (9th Cir. 2014). In *Daewoo,* this Circuit affirmed

the *Daewoo* District Court's decision which included an analysis that went far beyond the four corners of the documents and applied the multi-factor test used by the lower courts. In *Gladstone*, the bankruptcy court found that:

> . . . debt recharacterization focuses on the substance of the transaction. [citations omitted]
>
> State law provides the applicable framework for distinguishing between debt and equity. *In re Fitness Holdings Int'l, Inc.*, 714 F.3d at 1148. In California, when "determining whether the transaction is a loan or a forbearance, courts look to substance rather than form." [citations omitted] Specifically, the court will look to the parties' intent to determine their status as equity interest holder or creditor.

Gladstone, 2014 WL 1285415 at p. 23.

The Decision did not merely diverge from or distinguish *Fitness Holdings I*, it simply chose not to follow the prior holding in deference to an altogether different legal analysis. Accordingly, there were no equitable factors identified by the Panel and no recharacterization analysis performed.

Under both the law of the case and, more importantly, law of the circuit, the Panel was not free to disregard the legal test established by *Fitness Holdings I*. Ninth Circuit precedent establishes that the first published Ninth Circuit panel decision is afforded law of the circuit status. *Rodriguez*, 804 F.3d at 1080. Moreover, because the prior published decision is in the same matter, it is also law of the case that can only be set aside based on specific findings not made by the Panel.

In light of the clear conflict between *Fitness Holdings I*, which established the right to seek recharacterization of certain debt instruments and instructed the District Court to determine the California state law factors to apply, and the subsequent Panel decision that applied a fundamentally different contract interpretation analysis, a clear conflict exists that can only be resolved by en banc hearing and enforcement of law of this Circuit established in *Fitness Holdings I.*

B. *Fitness Holdings I* and the Cases Cited Therein Provided Guidance to the District Court for Ascertaining Relevant Factors to Consider in the Context of Recharacterization, Which Authorities the District Court and the Panel Ignored

"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." *Fitness Holdings I,* 714 F. 3d at p. 1148 citing *Lothian Oil,* 650 F.3d at 542–43; *SubMicron,* 432 F.3d at 454; *Dornier Aviation,* 453 F.3d at 231; *Hedged–Investments,* 380 F.3d at 1298; *AutoStyle Plastics,* 269 F.3d 726 at 748. These other circuits are in accord that this legal theory "effectively ignore[s] the label attached to the transaction at issue and instead recognize[s] its true substance." *Hedged–Investments,* 380 F.3d at 1297. "The funds advanced are no longer considered a loan which must be repaid in bankruptcy proceedings as corporate debt, but are instead treated as a capital contribution." *Id; see also AutoStyle Plastics*, 269 F.3d at 749 (The practical effect of recharacterizing a putative debt claim as an equity interest is subordination, since a corporation repays capital contributions only if and when it has satisfied all other obligations); *Hedged–*

Investments, 380 F.3d at 1298 ("recharacterization ensures that "controlling equity owners of a troubled corporation [do not] jump the line of the bankruptcy process and thwart the company's outside creditors' and investors' priority rights.") citing *In re Mid–Town Produce Terminal, Inc.,* 599 F.2d 389, 391–92 (10th Cir.1979).

The *Fitness Holdings I* decision identified the three competing approaches adopted by other circuits and opted to apply the approach as presented in *Lothian Oil*, which requires application of state law. The Ninth Circuit in *Fitness Holdings I* then remanded the matter to the lower court to ascertain and apply California state law factors to a recharacterization claim.

It is indisputable that the lower court and the Panel never performed this analysis, never identified a single factor, and never considered any of the factors identified by other courts that have allowed for recharacterization in contravention of the mandate of *Fitness Holdings I*.

C. Although the California Supreme Court Has Not Directly Established Recharacterization Factors, It Has Adhered to the Substance Over Form Analysis and Identified Factors in Analogous Situations

This Court must follow the California Supreme Court's pronouncements regarding interpretations of state law. *Orkin v. Taylor*, 487 F.3d 734, 741 (9th Cir.2007). If the California Supreme Court has not addressed the question, then this Court "must predict how the state's highest court would decide the question." *Id*. Such is the posture of this case as the California Supreme Court has yet to address the issue of "recharacterization" as it relates to a corporate debt

obligation owed to shareholders of the corporation. Indeed, there does not appear to be any California State Court published decision directly on point.[2]

However, there do exist decisions issued by the California Supreme Court that address this issue in the context of other types of cases that indicate that the California Supreme Court would not limit its review to only that of the instrument or note in question. *See Ghirardo v. Antonioli*, 8 Cal. 4th 791 (1994) (in reviewing the transaction, the California Supreme Court noted that it was the trial court's obligation to look at the substance of the transaction and not limit review to the form of the agreements); *Southwest Concrete Products v. Gosh Construction Corp*. 51 Cal.3d 701,705 (1990) (a court must look to the substance rather than the form of the transaction in determining whether a transaction constitutes a loan or forbearance, and thus falls under California usury laws.); *West Pico Furniture Co*. v. *Pacific Finance Loans,* 2 Cal.3d 594, 603 (1970); *Glaire v. La Lanne-Paris Health Spa, Inc*., 12 Cal. 3d 915, 927 (1974) (holding substance of a transaction showed charged

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[2] One California Supreme Court decision, *California-Calaveras Mining Co., v. Walls*, 170 Cal. 285 (1915), adopted the substance over form concept in addressing a corporate promoters fraud: "The mere form, however, which the transaction between Manson and the corporation took may not be interposed to defeat what was the evident purpose and intent of all the parties interested in the organization of the corporation and the acquirement of the property by it. The court will look beyond the form which the transaction took and to its substance and the obvious intent of the parties in the entire matter for the purpose of preserving and securing the rights of the real parties in interest and to circumvent fraud." *Walls* 170 Cal. at 300; *see also Fashion Valley Mall LLC v. County of San Diego*, 176 Cal. App. 4th 871, 880 & fn.10 (4th Dist. 2009).

interest rate was usurious); *Boerner v. Colwell Co*., 21 Cal. 3d 37, 52 (1978) (inquiring into substance of a transaction to determine whether it involved "bona fide credit sales" or "usurious loans").

The California Supreme Court has applied the same "substance over form" test to tax cases. *See e.g. Microsoft v. Franchise Tax Bd*, 39 Cal. 4th 750, 760-761 (2006) ("In applying this doctrine of substance over form, the [United States Supreme] Court has looked to the economic realities of a transaction rather than to the particular form the parties employed."); *Frank Lyon Co. v. United States* 435 U.S. 561 (1978) ("Thus, we focus on the actual rights and benefits acquired, not the labels used"); *Metropolitan Life Ins. Co. v. State Bd. of Equalization,* 32 Cal.3d 649, 656–657 (1982) (case law is clear that substance, not form, determines whether a transaction gives rise to income).

In a recent unpublished decision on the issue of recharacterization (outside the context of taxes and usury), a California appellate court addressing recharacterization of profits as loans adopted this Circuit's test used in tax cases to address the recharacterization issue. *Abassi v. Abassi,* 2016 WL 3476722 *5 (4th Dist. June 20, 2016) (unpublished)[3] Of note, the *Lothian* case, upon which *Fitness Holdings I* relies, cites a Texas state court case that, like *Abassi*, imported its

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[3] *Abassi* identified those factors as follows: "(1) whether the promise to repay is evidenced by a note or other instrument; (2) whether interest was charged; (3) whether a fixed schedule for repayments was established; (4) whether collateral was given to secure payment; (5) whether repayments were made; (6) whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and (7) whether the parties conducted themselves as if the transaction were a loan." *Id.*

state court recharacterization multi-factor test from federal tax cases. *See Lothian*, 650 F.3d at 544 *citing Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n. 3 (Tex. Ct. App. 1997).

The Panel erred in rejecting California's "substance over form" test, let alone the recharacterization analysis applied in usury and tax cases, to analyze whether the FAC properly alleged a claim for recharacterization of the alleged debt obligations to equity. Decision, p. 4. The Panel's failure to fully examine California law on this point as instructed by *Fitness Holdings I* needs to be re-examined, and the Trustee urges this Court to reaffirm the substance over form test dictated by *Fitness Holdings I*, which is compatible with the concept of recharacterization as presented in *Abassi* and the California Supreme Court in cases cited above.

D. The FAC Alleges Facts That Plausibly Support A Claim to Recharacterize The Transactions As Equity.

The Panel's summary decision that the allegations of the FAC lacked "plausibility" likewise is unsupportable. Decision, p. 3. The Panel did not consider all, let alone any, allegations contained in the FAC supporting the Trustee's assertion that the promissory notes were actually equity. ER:3:286, 288, FAC ¶¶ 9-43, 44-48, 50, Exh. 1, ¶ 3.3. Coupled with the fact that the Panel never identified relevant factors to consider, the pronouncement carries no weight.

The Panel's decision completely ignores the alleged basis for the loans including the fact that the loans were set up to facilitate a leveraged buyout on the part of Hancock Park [ER:3:286, 288, FAC ¶¶ 9-17], which establishes the foundation for the claim that the loans should be recharacterized. The FAC sets forth numerous and specific allegations that plausibly

support the Trustee's claim that the promissory notes should be recharacterized as equity because the transactions when examined as a whole were capital contributions. ER:3:286, 288, FAC ¶¶ 9-43, 44-48, 50, Exh. 1, ¶ 3.3.

The Panel also ignored the prior finding by this Court, again law of the case, that the FAC plausibly alleges that certain insiders "contrived" to benefit themselves by knowingly funneling money to themselves out of a failing company, the Debtor. ER:1:42, *Fitness Holdings International, Inc. v. Hancock Park Capital II, L.P.*, 529 Fed. Appx. 871, 874-875 (9th Cir. 2013). This finding supports the Trustee's Claims for avoidance of actual fraudulent transfers, his breach of fiduciary duty related claims and a finding that the promissory note transactions were disguised equity investments.

The recharacterization claim is also the lynch pin to the other claims against the Defendants, *to wit*: for avoidance of actual and constructive fraudulent transfers, breach of fiduciary duty and aiding and abetting breach of fiduciary duty. The Panel's failure to properly address the characterization issue resulted in the erroneous dismissal of the remainder of the Trustee's claims.

E. The Panel's Ruling on the Breach of Fiduciary Duty Claim Is Not Supported by Delaware Law.

The Panel in the Decision also dismissed the breach of fiduciary duty claims on the grounds that the claims should have been brought derivatively rather than directly by the Trustee relying on *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 103 (Del. 2007) ("*Gheewalla*"). Decision, p. 5. Critically, this ruling ignores a Bankruptcy Court

Order which assigned the Debtors' claims to the Creditor's Committee so that Plaintiff stood in the shoes of the Debtor for the benefit of all creditors. FAC ¶ 6, Bankruptcy Doc. Nos. 174 and 187.

Gheewalla held that individual creditors of an insolvent corporation have no right to assert direct claims on their own account for breach of fiduciary duty against corporate directors; these creditors nevertheless may bring derivative claims on behalf of the insolvent corporation. *Gheewalla*, 930 A.2d at 103. *Gheewalla* is limited solely to the factual scenario involving a creditor bringing breach of fiduciary duty claims on its own behalf. *See Mukamal v. Bakes*, 378 Fed.Appx. 890, 899 (11th Circuit 2010) (applying Delaware law and interpreting *Gheewala* as limiting creditor on its own behalf to a derivative breach of fiduciary duty claim, but recognizing that entity standing in debtor's shoes, such as trustee, may bring such claim directly either on debtor's behalf or on behalf of entire creditor body).

Gheewalla did not address the fundamentally different situation presented here: namely the assertion of the Debtor's rights by the creditors' committee ("Committee") pursuant to a stipulation that assigned the Debtor's rights to the Committee. FAC ¶ 6, Bankruptcy Doc. No. 174. By court order, the Committee (and now the Trustee) has standing to bring a direct action for breach of fiduciary duty. The Panel simply ignored the allegations in the FAC referencing the Stipulation that provided for the assignment of the Debtor's rights and, more importantly, the Bankruptcy Court order confirming Plaintiff's standing:

> ORDERED that the Committee is granted standing to pursue the alleged Claims against all potential defendants on behalf of the

> Debtor's estates, for the benefit of all creditors. . .

Bankruptcy Court Docket No. 187. In light of the Bankruptcy Court Order (FAC ¶ 6), the finding that the Committee and now the Trustee did not have standing to pursue the Debtor's claims for breach of fiduciary duty is confounding. The Committee was authorized by court order to bring the action directly on behalf of the Debtor as the real party in interest and, thus, it was properly couched as a direct action. *See Mukamal*, 378 Fed.Appx. at 899.

III. CONCLUSION

Based on the foregoing, the Trustee respectfully requests an en banc hearing.

Respectfully Submitted,

Dated: November 21, 2016

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NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

[Filed 11/08/16]

No. 14-56766
D.C. No. 2:14-cv-01059-AG

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.

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

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Argued and Submitted October 21, 2016
Pasadena, California

MEMORANDUM*

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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 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*

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

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.