

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)
)
ANCONA BROS. CO.,) CASE NO. BK91-81684
)
DEBTOR) CH. 11
) Filing No. 104 & 326

MEMORANDUM

This memorandum contains finding of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. this is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(A).

Background

Creditor Josephine Upah, (Upah), has filed a motion for appointment of Chapter 11 trustee or, in the alternative, a motion for appointment of examiner. This is a Chapter 11 case which has been pending since August of 1991. Within three months prior to the petition date, Upah obtained a judgment in the Douglas County, Nebraska, District Court for approximately \$3.7 million against the debtor and three officers of the debtor. The judgment followed a jury verdict resulting from a several-week trial on the claim by Upah that the individual defendants and the company conspired to defraud Upah of her rights to stock ownership in and dividends from the debtor.

On November 12, 1991, at Filing No. 104, Upah filed this initial motion for appointment of a Chapter 11 trustee. After various hearings in this case, Upah eventually filed Filing No. 326, a motion for appointment of examiner as an alternative to the appointment of trustee.

Decision

Both the motion for appointment of trustee, Filing No. 104, and the appointment of an examiner, Filing No. 326, are tentatively denied. However, they shall remain pending for reconsideration by the Court following trial on the debtor's Chapter 11 plan of reorganization. The Court is concerned that if the debtor's plan of reorganization is not confirmable, the evidence at such a trial in addition to the evidence presented on these motions may be of such tenor that the Court would determine that it is in the best interest of creditors, equity security

holders and other interests of the estate to appoint a trustee or examiner at that time. By separate order filed recently, the Court has directed the Clerk to schedule a hearing on the most recent amendment to debtor's disclosure statement and on other matters. Resolution of those issues may impact upon the Court's thoughts regarding these motions.

The Statute

The Bankruptcy Code at 11 U.S.C. § 1104 details the requirements for the appointment of a trustee or examiner. That statute states:

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States Trustee, and after notice and a hearing, the Court shall order the appointment of a trustee--

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause. . .; or

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate...

(b) If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, upon request of a party in interest or the United States Trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if--

(1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate...

Discussion

1. Mandatory Appointment of Trustee

The first issue raised by the movant is whether the appointment of a trustee is mandatory under Section 1104(a)(1) because the debtor and debtor's management have been found liable to Upah in a state court for conspiracy to defraud Upah.

Upah argues that the debtor is precluded by collateral estoppel (issue preclusion) concepts from relitigating the issue of fraud liability in the Bankruptcy Court and, therefore, the finding of fraud in the state court should mandate that this Court appoint a trustee. A representative of the Office of the United States Trustee participated in the trial and in written final arguments and memoranda of law. The U.S. Trustee, supporting Upah, recommends the Court find that the state court judgment requires the appointment of a trustee.

The debtor argues that because the standard of proof in the state court was "the greater weight of the evidence" and the traditional standard of proof for a finding of fraud in cases concerning the request for an appointment of a trustee is "clear and convincing," the state court judgment does not have a preclusive effect and the Court is not required to appoint a trustee under 11 U.S.C. § 1104(a)(1).

Upah and the United States Trustee suggest that the decision in Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654 (1991), requires the Court to determine that the standard of proof under Section 1104 is "preponderance of the evidence" which is the equivalent of the state standard of "greater weight of the evidence" rather than "clear and convincing." In Grogan, the Supreme Court ruled that the standard of proof in a Section 523 dischargeability case, whether dealing with fraud or any other dischargeability issue, is "preponderance of the evidence." The court also stated, in dicta, that the preponderance standard governs determinations under 11 U.S.C. § 727(a)(4), which is the section denying a debtor a discharge for fraud if the debtor has committed fraud on the court.

Grogan was before the United States Supreme Court because of a split in the circuit courts of appeal. In some circuits, such as the Eighth Circuit, the rule was that a state court judgment against a debtor for fraud, if it was based upon the "preponderance" standard, was insufficient to collaterally estop the debtor from litigating the issue of fraud in a dischargeability case. In other circuits, a state court judgment based upon the "preponderance" standard was sufficient to

preclude the debtor from relitigating the fraud determination for purposes of a dischargeability complaint. The decision of the Supreme Court in Grogan resolved the split in the circuits. However, the Court did not discuss the standard of proof for fraud under any other sections of the Bankruptcy Code.

There is no split in the circuit courts, district courts or bankruptcy courts with regard to the standard of proof necessary for a finding of fraud and the appointment of a trustee under Section 1104 of the Bankruptcy Code. That burden of proof has historically and uniformly been found to be "clear and convincing." In re Sharon Steel Corp., 871 F.2d 1217, 1226 (3d Cir. 1989) (movant must prove the need for a trustee by clear and convincing evidence); In re TS Indus., Inc., 125 Bankr. 638, 643 (Bankr. D. Utah 1991) (the appointment of a trustee is an extraordinary remedy as there is a strong presumption that debtor should remain in possession absent a showing by clear and convincing evidence that grounds exist for appointment of trustee); In re Colorado-Ute Elec. Ass'n, Inc., 120 Bankr. 164, 173 (Bankr. D. Colo. 1990) (The burden is on the movant to show by clear and convincing evidence that there is cause to appoint a trustee); In re Ionosphere Clubs, Inc., 113 Bankr. 164, 167-68 (Bankr. S.D.N.Y. 1990) (evidence supporting motion for appointment of trustee must be clear and convincing); In re Cardinal Indus., Inc., 109 Bankr. 755, 765 (Bankr. S.D. Ohio 1990) (because appointment of trustee in Chapter 11 case is extraordinary remedy, if creditors are to prevail, the right to such remedy must be shown by clear and convincing evidence); In re Microwave Prod. of Am., Inc., 102 Bankr. 666, 670 (Bankr. W.D. Tenn. 1989) (on motion for appointment of trustee, the moving party has burden of proof and the evidence to support the motion must be clear and convincing); In re PMH Corp., 116 Bankr. 644, 646 (Bankr. N.D. Ind. 1989) (party seeking appointment of trustee in Chapter 11 case bears the burden of showing by clear and convincing evidence that the appointment is necessary); In re Mako, Inc., 102 Bankr. 809, 811-12 (Bankr. E.D. Okla. 1988) ("cause", under 11 U.S.C. § 1104(a)(1), must be proved by clear and convincing evidence); 5 L. King, C. Cyr, K. Klee, H. Minkel, & W. Taggart, Collier on Bankruptcy, ¶ 1104;01 at 1104-21 (15th ed. 1992) ("the evidence supporting the motion for the appointment of a trustee must be clear and convincing"). No case has been found holding that the preponderance of evidence standard is all that must be met under § 1104(a).

Although most of the above-cited cases were decided prior to Grogan, two published cases which were decided after Grogan still recite that the standard of proof is "clear and convincing evidence" and the Grogan case is not even discussed. In re TS Indus., Inc., 125 Bankr. 638 (Bankr. D. Utah 1991); In re Madison

Management Group, Inc., 137 Bankr. 275 (Bankr. N.D. Ill. 1992). One cannot determine from a review of those two opinions whether the Grogan decision was raised by any party but one must assume that the bankruptcy judges writing on the issue of the appointment of a trustee and the standard of proof concerning fraud under Section 1104 were aware that the Supreme Court had spoken to the issue of the standard of proof concerning fraud under Section 523.

It is not appropriate to assume that the Supreme Court in Grogan, when determining the standard of proof for denying the discharge of a particular debt, overruled by inference the decisions of every court that has faced the issue of standard of proof under Section 1104, a section whose interpretation was not before the Supreme Court.

Therefore, since the standard of proof in the state court proceeding is less than the standard of proof required under Section 1104, the debtor should not be precluded from litigating the issue of fraud in the bankruptcy forum because issue preclusion should not apply when the standard of proof in the earlier case is less stringent than the standard of proof in the later case. 18 C. Wright, A Miller, and E. Cooper, Federal Practice and Procedure: Jurisdiction, § 4422 at 214 (1981); Graham v. Billings (In re Billings), 94 Bankr. 803 (Bankr. E.D.N.Y. 1989) at 809-10; United States v. Rylander, 714 F.2d 996, 1002 (9th Cir. 1983), cert. denied, 467 U.S. 1209 (1984).

2. Cause Other Than Fraud

Since the Court has determined that it is not mandatory to appoint a trustee under the fraud provision of Section 1104(a), it must be considered whether the evidence presented at trial is sufficient for the Court to find "cause" for the appointment of a trustee under the "clear and convincing" standard.

The issues raised by Upah and listed in the pretrial order include twenty separate items. They can be summarized by the following three questions:

1. Does the state court judgment compel the appointment of a trustee?
2. Have the officers improperly used the bankruptcy of the debtor to protect themselves from collection efforts by Upah?
3. Have the officers of the debtor improperly preferred themselves to the detriment of creditors while operating during this bankruptcy?

During the state court trial and prior to bankruptcy, the state judge ruled as a matter of law that Upah was the owner of a certain amount of stock in the debtor and that the issuance of certain stock certificates to the individual defendants who are management of the debtor was unlawful. The judge voided the stock issuance. Then, pre-judgment and prepetition, the individual state court defendants, who are also part of the current management of the debtor, caused the debtor to issue promissory notes to themselves and their spouses secured by assets of the debtor. Their intent was to make certain that they would receive from the corporation something of value for what they claimed was the money they paid the corporation for the stock which the state court voided. They also made it very clear to the corporate lender who had a first lien on all of the assets of the corporation, as well as guarantees from the individual defendants, that they were causing the debtor to issue such promissory notes and security interests to make certain that the interests of the individual defendants would be superior to any judgment obtained by Upah in the state court proceeding.

After the judgment was entered against the individual defendants and the debtor but prior to the bankruptcy petition being filed, management of the debtor caused the debtor to pay two installments on the promissory notes issued during the pendency of the lawsuit. Management also caused the debtor to pay approximately \$10,000.00 to a separate corporation owned by an individual defendant on a promissory note that was at least five years old. The individual defendants in their capacity as management also caused the corporation to pay another member of management, not a state court defendant, approximately \$25,000.00 on a promissory note, the terms of which provided that the payment would not be made unless a request for repayment was made at least one year prior to the payment date. No such request had been made at least one year prior to the payment date, but the corporation paid the amount to the member of the management team anyway.

After the bankruptcy was filed, Upah garnished the wages of various members of management who were the defendants against whom the judgment was entered. The debtor did not immediately pay the garnishments into the court, but apparently used some of the funds garnished to pay back the corporation some of the money used on the installment payments resulting from the promissory notes that were issued during the course of the trial.

The Court finds no other evidence of "mismanagement" or use of the company to benefit management to the detriment of creditors. Evidence was adduced that management continued, after bankruptcy, to receive salaries from the corporation, although on

a reduced basis. Management also continued to receive some of the "perks" of office, such as the use of company-owned vehicles, the use of expense accounts, the benefits of various life insurance policies, etc. All of the actions complained of by Upah appear to be in the ordinary course of business which certainly are not unusual or directed at benefitting management to the detriment of creditors.

In addition, there was evidence that certain companies that owed money to the debtor were granted extensions of time for payment. However, it was explained by the accountants and those persons employed by the debtor who were responsible for collections that the method used for collecting delinquent accounts was consistent pre- and post-filing and resulted in a continuing business relationship and a slow payback of old obligations. The Court finds nothing unusual or improper about the procedures used for collecting old accounts.

This case is before the Court because of the state court judgment. It is not before the Court because the company was losing money pre-bankruptcy, nor is it before the Court because a major secured creditor cut off operating funds. It is here only because of the judgment. The judgment is large and it makes Upah the largest single creditor. The debtor and management, after the filing of the bankruptcy case, must deal with the assets and liabilities of the debtor in a fiduciary capacity. This means that they must act honestly and fairly with regard to all creditors.

There is a state court verdict and judgment against the debtor and some members of management for conspiracy to defraud Upah. That finding of the jury must be considered when determining if there is cause for the appointment of a trustee. However, the fact that there is such a judgment does not require the debtor or management of the debtor to operate the business solely for the benefit of creditor Upah. The only post-petition action which gives any indication that management is preferring itself to the rights of creditor Upah is in the area of the apparent failure to comply with the garnishment orders of the state court. However, even in that circumstance the debtor expressed, and the Court found, a legitimate legal argument for failure to comply. A hearing was held on a motion for relief from the automatic stay to permit future garnishments and the Court made a determination that garnishments should be permitted. There was no finding that the debtor had acted improperly in failing to comply with the state court garnishments.

The state court judgment, although on appeal to the Nebraska Supreme Court, is a final judgment, obligating the debtor and

impacting upon the financial condition of the debtor. The entry of the judgment made the debtor insolvent. The debtor raises issues, both in the bankruptcy case and in the Supreme Court, with regard to the propriety of the judgment, but for purposes of this hearing, the judgment stands as a final and binding order.

Since the judgment is final and creates insolvency for purposes of this hearing, the payments to the corporation owned by one of the members of management, to the other members of management on promissory notes issued immediately prior to the entry of the judgment, and to one member of management on a promissory note which, by its terms, prohibited payment for a year after a request for payment was made, are probably avoidable, as preferences or fraudulent transfers.

Notwithstanding the apparent avoidability of the above-listed transfers, the statute of limitations has not run on the use of the avoiding powers. In addition, some of the transfers complained of are dealt with in the plan and disclosure statement filed in this case. Therefore, even though Upah is not satisfied with the action being taken by management to collect avoidable transfers, there is nothing in the statute which requires management to act at this time to recover such transfers. If the transfers are not fully dealt with in the plan or the debtor fails to proceed with avoidability actions within the statute of limitations, the Court will not hesitate to find, upon a properly filed motion for reconsideration or review, that the debtor and management of the debtor are acting for the benefit of insiders and to the detriment of other creditors and parties in interest.

Conclusion

In conclusion, the Court does not find cause for the appointment of either a trustee or an examiner. Even if the evidence was close to sufficient for the appointment of a trustee for cause, the Court would hesitate to do so. The post-petition loan agreement between the debtor and its major secured lender provides that if a trustee is appointed in this case, the loan agreement terminates and the debtor will be without operating funds. Since the case is in a position where a plan and disclosure statement have been filed, and a hearing is being scheduled on the latest amendment, there seems to be very little reason to prematurely end the case by appointing a trustee which will trigger the loss of operating funds.

There also seems to be very little reason for the appointment of an examiner to look into the transactions referred to above. All parties are aware of the transactions and they have been discussed in several hearings. The issue seems to be

when the debtor will act to attempt to avoid the transactions complained of. The debtor has time under the statute to make such decisions. If the debtor fails to make such decisions and take such action, any party may request either the appointment of an examiner or trustee based upon the evidence previously presented or request authority to act on behalf of the estate to bring the appropriate actions to void the complained-of transactions.

As an editorial aside, the debtor's management should not get the idea that this Court takes the complaints of Upah lightly. The debtor and debtor's management have acted, at least prior to the bankruptcy case, for their benefit and to the detriment of Upah. The Bankruptcy Code gives post-petition management time both to file and obtain confirmation of a plan and to bring appropriate actions to avoid prepetition transfers. The Court expects the debtor and debtor's management to properly provide for the rights of Upah in the plan and properly provide for the rights of all parties by bringing the appropriate avoidance actions on a timely basis.

As has been stated before and undoubtedly will be stated again by this judge, for the benefit of all involved, this case should be settled. The debtor, unless it is successful very shortly in the Supreme Court of the State of Nebraska, must acknowledge an obligation to Upah and provide for a payment in some amount to Upah. Upah must realize, as this Court does, that this debtor does not have the capacity to immediately pay the full amount of the judgment from its assets or its short-term cash flow. The longer this case continues and the more litigation that ensues, the more money will go for administrative expenses, the energy and interest of management will eventually be sapped and debtor will eventually lose whatever business goodwill and going concern value currently remains in this company.

This is a family fight and everybody knows it. It needs to be resolved in a forum other than this Court. If it cannot be so resolved, and it has not appeared to this date that it can be, this Court will resolve it, but probably not in a way that will be satisfactory to any party.

DATED: February 12, 1993.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Clerk shall send copies to counsel of record.