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UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA – LOS ANGELES DIVISION

In re: VERITY HEALTH SYSTEM OF CALIFORNIA, INC., *et al*., Debtors and Debtors In Possession.	Lead Case No. 2:18-bk-20151-ER Chapter 11 Hon. Ernest M. Robles Adv. Proc. No. 2:19-ap-01166-ER
OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF VERITY HEALTH SYSTEM OF CALIFORNIA, INC., *et al*., Plaintiff, v. UMB BANK, NATIONAL ASSOCIATION, as trustee, Defendant.	**PLAINTIFF'S OPPOSITION TO MOTION OF DEFENDANT UMB BANK, NATIONAL ASSOCIATION TO DISMISS FIRST AMENDED COMPLAINT FOR DETERMINATION OF VALIDITY, PRIORITY, AND EXTENT OF LIENS AND SECURITY INTERESTS** Hearing Date: November 21, 2019 Time: 10:00 AM Location: Ctrm. 1568 Roybal Federal Building 255 East Temple Street Los Angeles, CA 90012



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INTRODUCTION

The attempt by UMB Bank, National Association ("UMB") on behalf of the certain secured creditors (the "UMB Secured Creditors") to deny the Committee[2] its right to prosecute the Challenge, as granted in the Final DIP Order (the "Challenge Right"), should be denied. The First Amended Complaint [Adv. Docket No. 28, Case No. 19-1166] (the "Amended Complaint" or "Am. Compl.") states four claims for relief, seeking determinations that:

(1) The UMB Secured Creditors do not have a perfected security interest in all of the Debtors' assets, but rather only in the Collateral set forth in Exhibit A to the Amended Complaint. Am. Compl. ¶¶ 28–31;

(2) The UMB Secured Creditors do not have a perfected security interest in the Deposit Accounts, entities, or assets of entities set forth in Exhibit B to the Amended Complaint. Am. Compl. ¶¶ 32–34;

(3) The UMB Secured Creditors do not have a perfected security interest in postpetition disbursements to Debtors from California's Hospital Quality Assurance Fee program ("Future QAF Disbursements"). Am. Compl. ¶¶ 35–37; and

(4) If the Court were to grant some or all of the above relief, the UMB Secured Creditors were and are undersecured. Am. Compl. ¶¶ 38–39.

All of these claims are appropriate and timely. And *none* of the inordinately numerous arguments in UMB's Motion to Dismiss [Adv. Docket No. 37, Case No. 19-1166] (the "Motion" or "UMB Mot.") warrants dismissal. The Motion should be denied.

As an initial matter, there is no merit to UMB's argument that the Court's findings as to the UMB Secured Creditors' liens in connection with the Final DIP Order render any of the Committee's claims moot, as those findings are expressly subject to the Challenge Right. Similarly, UMB's suggestion that the Committee was required to challenge any such finding through an appeal is baseless, and entirely inconsistent with the express terms of the Challenge Right.

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[2] Capitalized terms not defined herein shall have meanings ascribed to such terms in the Final DIP Order or Amended Complaint.

The upshot of UMB's positions is that any challenge that could establish that the UMB Secured Creditors were and are undersecured is *per se* improper. But if the Challenge Right could never result in the UMB Secured Creditors having an *allowed* secured claim that is less than the total amount of their *asserted* claim (*i.e.*, in having an undersecured claim), why have a Challenge Right at all? The Debtors expressly granted the Committee standing to contest the amount and validity of the UMB Secured Creditors' liens, and the Court approved that grant. Neither the parties nor the Court contemplated that the Challenge Right would be meaningless. UMB also ignores that, at the outset of these cases, the Debtors and the UMB Secured Creditors improperly represented to this Court that the UMB Secured Creditors possessed a perfected lien on all assets. They did not, and do not, but they are now proceeding as if these inaccurate representations have somehow mooted the Committee's claims.

UMB's arguments also mistakenly presume that this Court's finding in the Final DIP Order that the UMB Secured Creditors were oversecured—subject to the Challenge Right—automatically means that, to the extent that the Challenge is successful and the UMB Secured Creditors are found to be undersecured, they will *automatically* and *necessarily* have suffered a diminution in the value of their collateral. That simply is not the case. Instead, in order to recover on the Section 507(b) claim granted to them under the Final DIP Order, the UMB Secured Creditors will have the burden of establishing both the value of their collateral on the Petition Date and that the value has diminished over the course of these Chapter 11 cases. That will be a tall order given that the Hospitals' continuing postpetition operations have *increased* the net realizable value of the UMB Secured Creditors' collateral and that the UMB Secured Creditors did *not* have a perfected lien on all assets as they represented at the outset.

Ultimately, UMB appears to believe that the UMB Secured Creditors are entitled to all of the value of the Verity enterprise even though (i) the enterprise itself is not being sold (*i.e.*, it is the assets—not equity interests—that are being transferred); (ii) there are substantial holes in their collateral package; and (iii) the net realizable value of Verity's assets depends in large measure on the continuing efforts of a highly skilled workforce on whose labor the UMB Secured Creditors do not have a lien. The UMB Secured Creditors ignore cases in which courts have held that the value

of a secured creditor's collateral must be allocated to the debtor and its unsecured creditors where that value is due, in part, to the contribution of the debtor's labor.

Finally, UMB's claim that some of the Committee's additional allegations in Count I do not relate back to its original complaint [Adv. Docket No. 1, Case No. 19-1166] (the "Original Complaint" or "Original Compl.") is without merit. The gravamen of the Original Complaint was that the UMB Secured Creditors had a lien only on the assets set forth in Exhibit A to the Complaint, and they do not have a lien in *any* of the Debtors' other assets. The Original Complaint provided a non-exhaustive list of examples of assets in which the UMB Secured Creditors do *not* have a lien, along with a non-exhaustive list of the reasons why this was the case. The Amended Complaint did not change this basic premise at all. The challenged portion of the Amended Complaint simply identifies with more specificity an additional asset in which the UMB Secured Creditors do *not* have a lien. Because the new allegations arise out of the same conduct, transactions, and occurrences alleged in the Original Complaint, and because none of those allegations changes the basic premise that the UMB Secured Creditors only have a lien on those items set forth in Exhibit A to the Original Complaint and nothing else, they relate back to the Original Complaint and are proper under Federal Rule of Civil Procedure 15.

For these reasons, and the other reasons set forth below, the Court should deny the Motion in its entirety and allow this case to move forward.

FACTUAL OVERVIEW

There are a few important facts in these cases with which the Court is already familiar (*e.g.*, the contents of the Final DIP Order) and/or of which the Court may take judicial notice in considering the Motion.[3]

[3] Courts may take judicial notice of a fact that "(1) is generally known within the trial court's territorial jurisdiction; or (2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201(b). It is well established that a court can take judicial notice of its own files and records under Rule 201. *See, e.g.*, *Gerritsen v. Warner Bros. Entm't Inc.*, 112 F. Supp. 3d 1011, 1034 (C.D. Cal. 2015) (taking judicial notice of motion filed in same case); *Vasserman v. Henry Mayo Newhall Mem'l Hosp.*, 65 F. Supp. 3d 932, 943–44 (C.D. Cal. 2014) (taking judicial notice of operative complaint in the action).

A. The Committee Was Granted Standing to Pursue Challenges to the Amount, Validity, and Extent of the UMB Secured Creditors' Liens

On October 4, 2018, the Court entered the Final DIP Order. Paragraph 5(e) of the Order, titled "Validity, Perfection and Amount of Prepetition Liens," specifically provides that "[t]he findings and stipulations set forth in this Final Order with respect to the validity, enforceability and amount of the Prepetition Secured Obligation and the Prepetition Liens," as well as the "value of the Prepetition Collateral," shall be "binding" on all parties "unless, and solely to the extent that, a party in interest with requisite standing and authority . . . has timely filed the appropriate pleadings and timely commenced the appropriate proceeding." Final DIP Order ¶ 5(e). Paragraph 5(e) goes on to note that "the Committee shall be deemed to have standing" and that "the Challenge Deadline (as defined) may be further extended to such time as may be agreed by stipulation." *Id.*

In short, all issues relating to the UMB Secured Creditors' claims—the amount of the claims, and the validity and extent of the liens—are subject to the Committee's challenge. Yet, UMB now impliedly disavows that right.

B. The Gravamen of the Committee's Original Complaint Was That the UMB Secured Creditors Do Not Have Valid Perfected Liens in Any Assets Other Than Those Listed in Exhibit A to the Complaint

Consistent with the Final DIP Order, the Committee commenced this adversary proceeding by filing its Original Complaint in June 2019. The Original Complaint contained three claims for relief. Count I addressed what the Committee assumes was a drafting error in the Final DIP Order. Specifically, the Final DIP Order, if read literally, states that *all* the UMB Secured Creditors in these cases have a lien on *all* the assets of *all* the Debtors. *See* Final DIP Order ¶ 5(e); Original Compl. ¶ 27. No party claims a lien on all assets of all the Debtors. To address this error, Count I alleged that the UMB Secured Creditors have a lien *only* on the specific assets set forth on Exhibit A to the Original Complaint and in nothing else. Count I of the Original Complaint specifically alleged: "Defendant does not have a perfected security interest in *all* of the assets of all of the Debtors, but rather only in the Collateral set forth on Exhibit A. *Defendant does not have a perfected security interest in any of the Debtors' other assets* . . . ." Original Compl. ¶ 28 (emphasis added). The

Original Complaint then gave examples of specific assets in which the UMB Secured Creditors do *not* have a lien, "including" certain specific Deposit Accounts, the entities or the assets of entities set forth in Exhibit B to the Complaint, "[a]ny future QAF Disbursements," and any commercial tort claims. *Id*.

In Count II of the original Complaint, the Committee alleged that the UMB Secured Creditors do not have a lien in certain identified Deposit Accounts, setting forth specific factual bases for that contention including that "there are no deposit account control agreements," "there is no possession of the funds . . . by Defendant," and the funds "do not constitute identifiable cash proceeds." Original Compl. ¶ 30.

In Count III, the Committee alleged that the UMB Secured Creditors lack a perfected security interest in Future QAF Disbursements. Count III alleged that the UMB Secured Creditors lack a security interest "because, among other things," the Future QAF Disbursements "do not constitute proceeds of pre-petition collateral," the value of the Disbursements to the UMB Secured Creditors and Debtors was zero as of the Petition Date, and the Disbursements "depended completely upon post-petition services of the Debtors." Original Compl. ¶ 33.

C. The Amended Complaint Does Not Change the Gravamen of the Original Complaint, but Rather Simply Provides Additional Detail

On September 12, 2019—before UMB filed any pleadings responsive to the Original Complaint—the Committee filed the Amended Complaint. The redline of the Amended Complaint filed with the Court shows that the Committee merely provides more details to support the claims for relief already set forth in the Original Complaint. [Adv. Docket No. 28-1, Case No. 19-1166.]

In Count I, for example, the Committee continues to allege that the UMB Secured Creditors had a lien only in the *same* assets set forth in the *same* Exhibit A as the Original Complaint, and that the UMB Secured Creditors do not have a lien "in any of the Debtors' other assets," "*including*" the examples listed in the Original Complaint. Am. Compl. ¶ 31 (emphasis added). The Amended Complaint adds two other examples to the "including" list: the MOB Assets, and the "going concern premium" that has been or will be generated from sales of Debtors' assets. *Id.*

The Amended Complaint does not add any allegations to Count II.

In Count III, the Amended Complaint continues to allege that the UMB Secured Creditors do not have a lien in Future QAF Disbursements, including "because [of], among other things," the four reasons listed in Count III of the Original Complaint. The Amended Complaint adds a fifth, conditional reason: that "to the extent Defendant contends one or more Loan Agreements were modified to include a lien in Future QAF Disbursements, the purported granting of any such lien was a constructive fraudulent conveyance." Am. Compl. ¶ 36. (UMB states that, for the purposes of its Motion, it "makes no such contention." UMB Mot. at 22 n.17.)

Finally, the Amended Complaint adds Count IV, which simply re-alleges the prior factual allegations of the Amended Complaint and seeks a determination that, if the Court grants reliefs on some or all of Counts I through III, the UMB Secured Creditors are undersecured. Am. Compl. ¶ 38–39. Count IV adds no new facts or law; rather, it merely captures the potential consequence of the successful prosecution of the first three claims for relief.

ARGUMENT

Courts will not dismiss a claim pursuant to Fed. R. Civ. P. 12(b)(6) unless it lacks "sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (internal quotation marks and citation omitted). A motion to dismiss should be denied unless "a plaintiff could not possibly succeed after all allegations of material fact in the complaint have been taken as true and construed in the light most favorable to the plaintiff." *Luxury Brands, LLC v. Gulamani*, No. CV 18-586 PA, 2018 WL 5903967, at *4 (C.D. Cal. June 4, 2018); *see also Brookview Apts., L.L.C. v. Hoer (In re Know Weigh)*, 576 B.R. 189, 205 (Bankr. C.D. Cal. 2017). In the Ninth Circuit, courts are "particularly hostile" to motions to dismiss under Rule 12(b)(6). *See, e.g.*, *Robbins v. Oakley, Inc.*, No. CV 18-5116 PA, 2018 WL 5861416, at *1 (C.D. Cal. Sept. 27, 2018). A complaint "should be dismissed only if 'it appears beyond doubt that the plaintiff can prove no set of facts' supporting plaintiff's claim for relief." *Bozajian v. Cty. of Los Angeles*, No. 2:12-cv-00625-ODW, 2013 WL 327409, at *5 (C.D. Cal. Jan. 29, 2013) (quoting *Morley v. Walker*, 175 F.3d 756, 759 (9th Cir.1999)).

The Motion contains numerous arguments, many of which are thematic and cut across multiple claims for relief.[4] For the court's convenience, Point I below is a comprehensive response to UMB's arguments on an issue-by-issue basis, and Point II is a brief, summary response to UMB's arguments (using references to Point I) on a count-by-count basis.

I. NONE OF UMB'S ARGUMENTS WARRANTS DISMISSAL: ISSUE-BY-ISSUE ANALYSIS

A. UMB is Trying to Render the Committee's Challenge Right Meaningless

UMB makes multiple arguments that essentially seek to moot the Committee's Challenge Right altogether. UMB's attempt to ignore the plain language of the Final DIP Order and render the Challenge Right illusory should be rejected.

1. The Final DIP Order Does Not Render Any Claim Moot

Contrary to UMB's contentions, the Committee should not be barred from full exercise of the Challenge Right because Counts II and III of the Amended Complaint have somehow been rendered moot by the Final DIP Order and the Court's determination that, as of the Petition Date, the UMB Secured Creditors had an equity cushion. UMB contends that "regardless whether Plaintiff prevails [on Counts II and III], the Final DIP Order is clear that, if UMB's claim is not satisfied by virtue of the proceeds of its prepetition security interests because of a diminution in such collateral, thereby triggering the Prepetition Replacement Lien, UMB will be entitled to a lien on all of the Debtors' remaining assets," and, thus, "[t]he relief requested by Counts II and III of the Amended Complaint is moot." UMB Mot. at 21–22.

Whether the UMB Secured Creditors are entitled to a Section 507(b) superpriority claim, and the amount of any such claim, is entirely dependent on (i) the extent, validity, and priority of their purported liens, and (ii) whether the UMB Secured Creditors can establish a subsequent diminution in the value of their undisputed collateral. *See In re Residential Capital, LLC*, 501 B.R. 549, 591 (Bankr. S.D.N.Y. 2013) (finding that the burden of proof as to "adequate protection claim based on diminution in value" remains "with the secured creditor"). Given the Committee's challenge as to

[4] Many, but not all, are the same arguments made by U.S. Bank, National Association in its separate Motion to Dismiss [Adv. Docket No. 39, Case No. 19-1165].

the validity, priority, and extent of the UMB Secured Creditors' purported liens on certain assets pursuant to the Challenge Right and the material increase in the net realizable value of the Hospitals because of the ongoing post-Petition Date efforts of the Debtors' staff and employees, proving up a 507(b) claim will be difficult for the UMB Secured Creditors. Indeed, if the extent of the Prepetition Liens proves to be less than what was represented by the Debtors and the UMB Secured Creditors at the Final DIP Hearing—for example, if the liens do not extend to certain Deposit Accounts and the Future QAF Disbursements—and there has been no diminution in value, then the UMB Secured Creditors would not be entitled to a Section 507(b) claim. In that instance, any value ultimately found to be unencumbered because of this action would be available for *pro rata* allocation among unsecured creditors.

The Committee was undeniably granted the mandate to undertake this inquiry. *See* Final DIP Order ¶ 5(e). As a result, the Committee is not bound by the Court's finding that the UMB Secured Creditors were oversecured as of the Petition Date, provided it has brought a timely challenge—which it has.

2. This Action is Not a Disguised Appeal of the Final DIP Order

The Committee also cannot be deprived of its Challenge Right on the theory that it failed to appeal certain aspects of the Final DIP Order. UMB contends otherwise, arguing that "[t]he Court should dismiss both Count I and Count IV pursuant to Rule 12(b)(1) for lack of subject matter jurisdiction because Plaintiff's claims are simply disguised attempts to circumvent the jurisdictional bar to pursue an appeal after the expiration of the appeal period." UMB Mot. at 23. UMB's argument appears to be premised on the erroneous assumption that the Bankruptcy Court's findings of fact and conclusions of law at the Final DIP Hearing are somehow separate from and untethered to the terms of the Final DIP Order, and are thus shielded from the Challenge Right granted to the Committee by Paragraph 5(e) of the Final DIP Order. *See id.* UMB is wrong.

The Final DIP Order expressly provides, as set forth above, that "[t]he findings and stipulations set forth in this Final Order with respect to the validity, enforceability and amount of the Prepetition Secured Obligation and the Prepetition Liens shall be binding" on all relevant parties *unless the Committee commences a Challenge by the Challenge Deadline*. Final DIP Order ¶ 5(e).

For these purposes, the "Final DIP Order" must be understood to comprise the findings and conclusions set forth in (i) the Court's Tentative Ruling [Docket No. 392] (the "Tentative Ruling," made the Order on the Motion by notation dated October 3, 2018); (ii) the record of the Interim and Final DIP Hearings (the "Record"); and (iii) what is referred to in the Tentative Ruling as the "order that has already been submitted by the Debtors" (*i.e.*, the Final DIP Order). All of the foregoing is incorporated by reference into the Final DIP Order by its introductory statement that it is "based upon the record established at the interim and final hearings," as reflected in the "following findings of fact and conclusions of law." Final DIP Order at 6.

It is as to this composite set of findings and conclusions that the Final DIP Order grants the Committee the Challenge Right. Pursuant to Paragraph 5(e) of the Final DIP Order, the Committee never consented to, and was never bound by, any aspect of the Final DIP Order that relates to the "validity, enforceability and amount of the Prepetition Secured Obligation and the Prepetition Liens" or the "value of the Prepetition Collateral." Final DIP Order ¶ 5(e). The Committee's right to revisit any prior findings and conclusions as to such matters was expressly preserved, as it is in virtually all DIP orders, for exercise on a later date through the Challenge. *Id.*

Thus, unlike the Debtors—who expressly waived their rights to challenge any lien perfection or valuation issues—the Committee is entitled to challenge the extent, validity, and priority of the UMB Secured Creditors' purported liens here. The Committee was not required to appeal the Court's findings as to the extent, validity, and priority of the UMB Secured Creditors' purported liens. That it did not do so provides no basis to dismiss Counts I and IV.[5]

UMB further argues that by challenging some of their purported liens in this adversary action while at the same time pursuing an appeal of the Final DIP Order, the Committee is somehow trying to have it "both ways." UMB Mot. at 3. In so arguing, UMB fails to differentiate the specific issues

[5] For all the same reasons, none of the Court's findings regarding the "validity, enforceability and amount of the Prepetition Secured Obligation and the Prepetition Liens" and/or the "value of the Prepetition Collateral" are binding on the Committee as "law of the case" or otherwise. Indeed, the only relevant "law of the case" (*i.e.*, the only "issue previously decided") as to any of these matters is that they were adjudicated by the Court subject to the subsequent exercise by the Committee of the Challenge Right. *See* Final DIP Order ¶ 5(e).

on appeal from the issues raised in this action, or recognize how those issues relate. Moreover, the UMB Secured Creditors fail to comprehend the inconsistency of the positions *they* are taking.

As noted above, the Final DIP Order expressly preserves the Committee's ability to challenge the representations and stipulations contained therein as to the extent, validity, and priority of the UMB Secured Creditors' liens (the "Representations and Stipulations"). *See supra* at pp. 8–9. There was no limit as to how that challenge would ultimately affect the allowance and treatment of the UMB Secured Claims because, as also explained above, that would be wholly inconsistent with the very purpose of the Challenge Right. *See supra* at pp. 1–2.

In its appeal, the Committee challenges only the waiver of the Section 506 and 552 protections (the "Waivers") *if* the UMB Secured Creditors are oversecured as alleged by the Debtors and UMB Secured Creditors (subject to the Challenge Right). Simply put, if the Secured Creditors are truly oversecured as set forth in the Representations and Stipulations, the Secured Creditors did not need to consent to the Debtors' use of cash collateral, and thus no Waivers needed to be offered to obtain that consent. *See, e.g.*, *In re 354 E. 66th St. Realty Corp*., 177 B.R. 776, 782 (Bankr. E.D.N.Y. 1995) ("The purpose or intent of granting adequate protection payments [is] to maintain the *status quo* for that creditor and to protect the creditor from diminution or loss of the value of its collateral during the ongoing Chapter 11 case. If that creditor is oversecured or if there is no reason to believe that the collateral will diminish, then adequate protection payments may not be granted."). Pursuing both paths is not only consistent, but required. The Challenge Right provides the means to attack the validity, priority, and extent of the liens; the appeal right provides the means to attack the Waivers.

By challenging both the appeal and these adversary actions, it is the UMB Secured Creditors who are ironically trying to have it both ways. On the one hand, they are attempting to dismiss this action to protect the Representations and Stipulations that they were oversecured, despite the Challenge Right. At the same time, they are challenging the Committee's appeal, which argues that if they were oversecured (subject to the Challenge Right), their consent predicated on the Waivers was not needed. Either (i) the UMB Secured Creditors are oversecured, and the Waivers were inappropriate, or (ii) the UMB Secured Creditors were undersecured, in which case the Waivers

were appropriate but they then do not have a fully-secured claim. The UMB Secured Creditors cannot credibly attempt to block both paths for relief.

In other words, the Committee possesses two paths to relief but can have only one recovery—either from this action challenging the extent, validity, and priority of liens expressly preserved by the Final DIP Order, or from the appeal of the Final DIP Order as to the impact of the Representations and Stipulations on the Waivers. UMB would have this Court leave the Committee with no path to recovery whatsoever, which is improper.

B. The UMB Secured Creditors Do Not Have a Lien on the Value of Debtors' Going Concern Premium

Moreover, contrary to UMB's contentions, the Committee's going concern premium allegation in Count I is hardly "academic" and, properly construed, finds support in a broad array of cases that have examined its merits. The Secured Creditors plainly have no lien on "going concern premium" value, and their efforts to argue otherwise entangle them in a convoluted maze of inapposite precedent and circular arguments that do not withstand scrutiny.

UMB claims that the Committee's challenge to the UMB Secured Creditor's alleged lien on the "going concern premium" value generated by the Hospital sales is not "cognizable" under controlling precedent. UMB Mot. at 12. Specifically, UMB argues that the Committee's "going concern value" carveout argument is "merely a theoretical, conceptual idea that does not exist outside of academia, has no support in the Bankruptcy Code or applicable law, and has been rejected under controlling precedent in the Ninth Circuit." *Id.* at 14. Thus, according to UMB, the Committee's effort to "reduce the value of UMB's security interest by the difference between such foreclosure value and the amount that the Debtors generated by disposing of UMB's collateral through the going concern sales" must fail. *Id*. UMB is wrong, and it is mischaracterizing the Committee's actual argument.

The UMB Secured Creditors plainly have no lien on the value of the going concern premium generated by the Sales of Hospitals to the County of Santa Clara and to Strategic Global Management, Inc., as alleged in Count I. *See* Am. Compl. ¶¶ 22–24, 31. The Committee is not alleging that the UMB Secured Creditors' collateral must be valued, for all relevant purposes, on a

"liquidation" basis. The Committee accepts, as *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) and Ninth Circuit precedent require, that, under the current circumstances, "going concern value" is the proper measure for ascertaining the value of the Debtor assets that comprise the "Prepetition Collateral." The issue in dispute, and the subject of the Committee's allegation, is not the *value* of the assets potentially subject to the UMB Secured Creditors' liens. It is, rather, the *scope* of the Prepetition Liens and "validity, enforceability and amount" of the Prepetition Obligations. *Rash* and the other caselaw cited by UMB do not speak to this issue.

Stated differently, the Section 506(a) analysis is necessarily a two-prong process, involving assessments of both "asset value" and "lien scope." This process is best illustrated by *In re UAL Corp*., 351 B.R. 916 (Bankr. N.D. Ill. 2006). In *UAL*, the court first determined that the methodology to value a hangar lease to be retained by the debtor airline under a Chapter 11 plan was, as required by *Rash*, the "going concern" or "replacement value" standard. *Id.* at 919–21.

The court next assessed the scope of the lease. The court determined that all rights and entitlements under the hangar lease should be included in the valuation—other than a 10-year option to extend the lease *that had been negotiated and entered into by the debtor after the petition date. Id.* at 923–24. The court found that the secured creditor's collateral *did not include* the lease extension option. The court reasoned that, because the secured creditor's lien arose *before* the debtor's bankruptcy filing and the debtor acquired the option *after* its bankruptcy filing, any additional collateral value the option furnished was subject to Section 552(a) of the Bankruptcy Code, which "prevents prepetition liens from attaching to property interests that a debtor acquires postpetition," unless such "property interests" can be shown to be "proceeds" of prepetition collateral. *Id.* at 924. The postpetition option to extend, the court concluded, was not "a 'proceed' of [any] collateral that existed at the time of the bankruptcy filing [because] [t]he extension option in no way derived from a conversion of the sublease into a different form." *Id*. Instead, "the extension option was a separately acquired property right, obtained through [the debtor's] postpetition

activity." *Id.* This, the court noted, is "precisely the sort of property right that § 552(a) protects from prepetition security agreements."[6] *Id.*

UAL is fatal to any claim that the Committee's allegations regarding the value of the going concern premium is flawed as a matter of law. The Committee alleges that "[t]he proceeds of the Sales include substantial going concern premiums," and "Defendant is not entitled to those premiums because they are generated by labor—the hard work of the doctors, nurses, and other employees of the medical facilities." Am. Compl. ¶ 23. That labor occurred postpetition and is not subject to the UMB Secured Creditors' liens.

Equally fatal is *In re Cafeteria Operators, L.P.,* 299 B.R. 400 (Bankr. N.D. Tex. 2003), upon which the court in *UAL* relied. In *Cafeteria Operators*, the court held that revenues that were primarily the fruits of employee labor were not proceeds of collateral because the revenue depended on the utilization of estate resources. *Id.* at 403; *see also id.* at 410 ("From a plain reading of § 552, revenues generated post-petition solely as a result of the debtor's labor are not subject to a prepetition lender's security interest."); *In re Premier Golf Props., LP*, 477 B.R. 767 (B.A.P. 9th Cir. 2012) ("Revenue generated post-petition solely as a result of a debtor's labor is not subject to a creditor's pre-petition interest." (internal quotation marks and citation omitted)); *In re Skagit Pacific Corp.,* 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004) ("[R]evenue generated by the operation of a debtor's business, post-petition, is not considered proceeds if such revenue represents compensation for goods and services rendered by the debtor in its everyday business performance.").[7]

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[6] Thus, the Committee has not objected, and would not object, to the Debtors, and the Court, adopting a "going concern value" metric for all relevant purposes, including "valuation" of the Prepetition Liens and Prepetition Obligation, so long as the value of any amounts attributable to Debtors' assets as to which the UMB Secured Creditors have not been able to establish valid, perfected, and enforceable liens is deducted from the value of Prepetition Liens and Prepetition Obligation for distribution purposes.

[7] Numerous other courts, both in the Ninth Circuit and elsewhere, have reached the same or similar conclusions. *See, e.g.*, *Fin. Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. P'ship (In re Days Cal. Riverside Ltd. P'ship),* 27 F.3d 374, 377 (9th Cir.1994) (limiting scope of secured creditor collateral based on premise that room rent was generated from the occupancy of real property and differentiating between revenue from occupancy of rooms and revenue that was generated by other services provided by the hotel); *Philip Morris Capital Corp. v. Bering Trader, Inc. (In re Bering Trader, Inc.),* 944 F.2d 500, 502 (9th Cir. 1991) (distinguishing between income that is "derivative" from the secured property and income that is derived from "services rendered"); *Everett Home Town*

First Southern Nat'l Bank v. Sunnyslope Hous. L.P. (In re Sunnyslope Hous. L.P.) 859 F.3d 637 (9th Cir. 2017), on which UMB relies, is not to the contrary. In *Sunnyslope*, the court first addressed asset value, "tak[ing] the Supreme Court at its word and hold[ing], as *Rash* teaches, that § 506(a)(1) requires the use of replacement value rather than a hypothetical value derived from the very foreclosure that the reorganization is designed to avoid." *Id.* at 640. The court then considered the scope of the secured creditor's lien, and rejected the secured creditor's argument that "the low-income housing requirements do not apply to its security because HUD released its Regulatory Agreement, and all other covenants are junior to its lien." *Id.* at 645; *see also In re Taffi,* 96 F.3d 1190, 1192 (9th Cir. 1996) (*en banc*) (first addressing asset valuation and concluding that "the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral," but then taking into account existence of $250,000 in "senior liens" in determining the value of IRS secured claim), *cert. denied,* 138 L. Ed. 2d 987, 117 S. Ct. 2478 (1997); *Salyer v. SK Foods, L.P. (In re SK Foods, L.P.),* 487 B.R. 257, 262 (Bankr. E.D. Cal. 2013) (concluding that bankruptcy court properly relied upon liquidation value for assets that were to be liquidated and upon going concern value for assets that were to be sold as part of the business as a going concern, and then evaluating scope of adequate protection lien and superpriority claim that underlay challenged settlement).[8]

Ltd. P'ship, 146 B.R. 453, 456 (Bankr. D. Ariz. 1992) (holding that restaurant revenues are not the proceeds of real property but the result of services provided by the business); *In re Zeeway Corp.,* 71 B.R. 210, 211 (B.A.P. 9th Cir. 1987) (stating that restaurant income is not proceeds of real property, but result of services rendered by business owing real property); *see also In re Strick Chex Columbus Two, LLC*, 542 B.R. 914 (Bankr. N.D. Ga. 2015); *In re Inman,* 95 B.R. 479, 480–81 (Bankr. W.D. Ky. 1988); *In re Photo Promotion Assocs.,* 61 B.R. 936 (Bankr. S.D.N.Y. 1986).

[8] The remaining cases cited by the Secured Creditors follow the same template. *See In re Kim,* 130 F.3d 863, 865 (9th Cir. 1997) (accepting, for valuation purposes, proposition that "when the debtor retains property subject to a lien, the proper valuation is fair market value, not foreclosure value," but then turning to scope of lien in asking whether "appellants' security interest . . . amount[ed] to a turn-key operation"); *In re Hawaiian Telcom Commc'ns, Inc.,* 430 B.R. 564, 602, 603 (Bankr. D. Hi. 2009) (accepting applicability of going concern valuation standard "[w]here debtors intend to reorganize and continue to operate their business," but then turning to relative scope of competing liens to address "apportioning going concern value of a company between encumbered and unencumbered assets").

In addition, the UMB Secured Creditors lack a perfected lien on the value of any going concern premium yielded by the Sales for the entirely separate reason that their liens, as recorded, do not expressly cover "enterprise" or "going concern" value and, by their own admission and by virtue of the Committee's investigation, do not encompass either the Debtors' equity or all of the Debtors' assets. If the Committee is correct, there are large gaps in that the UMB Secured Creditors' collateral. Lenders' expectations notwithstanding, liens thought to be "blanket" or "all asset" liens are not always deemed broad enough to encompass the borrower's "enterprise" or "going concern" value.[9]

In *In re Ebbler Furniture and Appliances Inc*., 804 F.2d 87 (7th Cir. 1986), for example, Judge Easterbrook observed that a prepetition lender is not entitled to "going concern" value where it did not contract for a security interest in borrower's "name, reputation, customer list, staff, and so on." *Id.* at 93. "In the retailing business," Judge Easterbrook further observed, "the difference between the wholesale price and the retail price is the 'value added' of the business. It is the amount contributed by storing, inspecting, displaying, hawking, collecting for, delivering, and handling warranty claims on the goods." *Id.* at 92. The secured lender "does not have a security interest in these labors. It has an interest only in its merchandise and cash on hand." *Id.* Thus, the secured creditor's security interest "does not reach the 'going concern' value of the debtor; it had security in

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[9] *See, e.g*., Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 922–23 (2014) ("Yet, not all property can be encumbered by a security interest as a legal or practical matter. Whatever the intentions of the parties, the so-called blanket lien is likely to have gaps."); Edward Janger, *The Logic and Limits of Liens*, ILL. L. REV. 589, 594–95 (2015) (noting that so-called blanket liens under Article 9 of the Uniform Commercial Code may exclude tort claims, real estate, recoupment and setoff claims, insurance claims, and others); Michelle M. Harner, *The Value of Soft Assets in Corporate Reorganizations*, ILL. L. REV. 510, 531 (2015) ("If a company holds a going concern surplus … some portion of that value is attributable to soft variables and, if realized postpetition, is not (or should not be) subject to a prepetition security interest. . . . [There is] support for this position under the [Bankruptcy] Code."); *see generally* AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11: 2012–2014, FINAL REPORT AND RECOMMENDATIONS, 71 n.283 (2014) ("A secured creditor may have interests in only certain of the debtor's assets or something less than the entirety of the enterprise."); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter* 11, 1 J. Legal Analysis 511, 523 (2009) (reviewing prepetition financing arrangements and observing that approximately 97 percent of prepetition financing facilities are secured by liens akin to blanket liens).

the *goods,* not in the *firm.* To value the inventory in a way that reflects 'going concern' value [would be] to give the [the secured creditor] something for which it did not contract." *Id.; see also In re Kim,* 130 F.3d at 865 (evaluating scope of secured lender's lien and asking whether "appellants' security interest . . . amount[ed] to a turn-key operation"); *In re 26 Trumbull Street,* 77 B.R. 374, 376 (Bankr. D. Conn. 1987) (allocating "going concern" value between debtor and secured creditor where secured creditor held security interest in equipment and furnishings, but not in restaurant leasehold interest, and thereby rejecting secured creditor's claim to *all* of "going concern value").

Here, as in the foregoing cases, there are "holes" in the UMB Secured Creditors' collateral. *See, e.g.*, UMB Mot. at 7 n.8 (UMB conceding that it "has never asserted a lien in the MOB Assets, and nothing in the Final DIP Order suggests otherwise"); Am. Compl. ¶ 33 ("Defendant does not have a perfected security interest in the Deposit Accounts set forth in Section I of Exhibit B hereto" because, among other bases, "there are no deposit account control agreements for the Deposit Accounts"). Nor have the Section 363 sales conducted to realize on the value of the Debtors' assets been framed or presented as (i) sales of the "equity" of "all" the Debtors and the control rights such a sale would confer, or (ii) a global sale of "all or substantially all" the assets of "all" of the Debtors.[10] Thus, this is a case where the "secured creditor" has "interests in only certain of the debtor's assets or something less than the entirety of the enterprise." AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11: 2012–2014, FINAL REPORT AND RECOMMENDATIONS, 71 n.283 (2014).

The Committee's allegations in Count I regarding the value of going concern premiums are therefore viable as a matter of law.

C. The UMB Secured Creditors Do Not Have a Lien on the Deposit Accounts

Count II alleges that the UMB Secured Creditors do not have a perfected security interest in the Deposit Accounts. *See* Am. Compl. ¶¶ 32–33. UMB claims that Count II does not present a real case or controversy because the funds in the Deposit Accounts have already been spent. *See* UMB

[10] As the Court is aware, there have been two major sales of discrete Hospital assets (with exclusions), and there are likely to be additional minor sales before the Chapter 11 Cases are closed.

Mot. at 22. But even if all of the Deposit Accounts are empty, the fact that the UMB Secured Creditors lacked a perfected security interest in the Deposit Accounts is still relevant because, as noted throughout UMB's briefing, the UMB Secured Creditors contend that they will have a diminution claim (a faulty contention, as discussed above). To calculate the amount of that alleged diminution, it will first be necessary to establish in what assets the UMB Secured Creditors *did* have a valid, perfected lien in as of the Petition Date. If the UMB Secured Creditors did not have a lien on all of the Deposit Accounts as of the Petition Date, that means a significant amount of cash was unencumbered at that time. Those funds have been consumed in running the Hospitals, thus benefiting the UMB Secured Creditors, when those funds could instead have been made available to unsecured creditors. Count II therefore presents a real case or controversy.

Unable to rebut Count II's allegation that the UMB Secured Creditors do not have perfected liens in the Deposit Accounts because they lack possession or control of these accounts (*i.e.*, there are no executed deposit account control agreements), UMB seeks refuge in the perfected lien it supposedly holds in any cash in these Deposit Account as "proceeds" of other Debtor collateral. *See* UMB Mot. at 6.

The Committee does not disagree, nor does it deny that UMB has made the requisite UCC filings. But the Committee alleges that the cash in the Deposit Accounts was *not* "identifiable cash proceeds" of any other Debtor collateral. Am. Compl. ¶ 33; *see* Cal. Com. Code § 9315(a)(2) (security interest previously perfected as to debtor collateral will thereafter attach to only "any identifiable proceeds of collateral"). That allegation must be accepted as true and in the light most favorable to the Committee for purposes of this Motion. The Committee's position is that cash from all sources was routinely commingled by Debtors, and UMB cannot establish that it can render commingled cash "identifiable" by "a method of tracing, including application of equitable principles, that is permitted under law other than [Article Nine of the UCC] with respect to commingled property of the type involved." Cal. Com. Code § 9315(b)(2). If they cannot satisfy the applicable tracing standard, UCC filings or not, the UMB Secured Creditors cannot have a perfected security interest in either the Deposit Accounts or any cash on deposit in any of these accounts. *See In re Delano Retail Partners, LLC*, No. 11-37711-B-7, 2017 WL 3500391, at *9

(Bankr. E.D. Ca. Aug. 14, 2017) ("[O]nce cash proceeds are deposited into an account and commingled with other money the identifiability of a secured creditor's proceeds is destroyed unless the secured creditor can prove that the money in the account corresponds to its collateral."); *In re Skagit Pacific Corp.*, 316 B.R. at 338 ("The burden of tracing proceeds of collateral is on the party claiming the security interest in the proceeds."). In any event, UMB's attempt to factually dispute the Committee's allegations in Count II is not appropriate for a motion to dismiss, and should be denied.

D. The UMB Secured Creditors Do Not Have a Lien on Future QAF Disbursements

The UMB Secured Creditors do not have perfected security interests in Future QAF Disbursements. *See* Am. Compl. ¶¶ 35–37. *First,* the Future QAF Disbursements are not "proceeds" of any of the UMB Secured Creditors' prepetition collateral. In accordance with (i) Section 552(a)'s general prohibition on security interests in after-acquired property; (ii) the limited exception to that prohibition contained in Section 552(b); and (iii), the definition of "proceeds" under the California Uniform Commercial Code, a secured creditor has an interest in proceeds of collateral only where the funds that comprise the alleged proceeds: (a) "derive" from prepetition collateral; (b) are "traceable" to the prepetition collateral; or (c) "substitute" for the prepetition collateral on a postpetition basis. *See, e.g.*, *Fin. Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. P'ship (In re Days Cal. Riverside Ltd. P'ship)*, 27 F.3d 374 (9th Cir.1994). The Future QAF Disbursements satisfy none of those tests.

- *The Future QAF Disbursements do not "derive" from the Prepetition Collateral*, because they depend entirely on *postpetition* activities by the Debtors. *See* Am. Compl. ¶ 36; *see also In re Karykeion, Inc.,* No. 1:08-bk-17254-MT (Bankr. C.D. Cal. Jan. 21, 2011). In *Karykeion*¸ the court held that QAF Disbursements were not "proceeds" of a secured creditor's prepetition collateral because the debtor's right to receive the disbursements was entirely "*contingent on its performance of several post-petition acts*," including the ongoing payment of QAF Fees. *Id.* at 9 (emphasis added); *see also id.* ("If Karykeion fails to make the [QAF Fee] payments, the law makes it clear that it will have no right to receive the [QAF Disbursements]."

- *The Future QAF Disbursements are not "traceable" to the Prepetition Collateral*, because the UMB Secured Creditors' security interest does not expressly attach to the Future QAF Disbursements.
- *The Future QAF Disbursements are not "substitutes" for the Prepetition Collateral*, because the Disbursements are part of a Medicaid-type reimbursement program that "supplements," and does not "substitute" for, medical welfare payments. *See* Cal. Welf. & Inst. Code § 14169.50(d) ("It is the intent of the Legislature to impose a quality assurance fee to be paid by hospitals, which would be used to increase federal financial participation in order to make supplemental Medi-Cal payments to hospitals.").

Second, the UMB Secured Creditors do not have perfected security interests in the Future QAF Disbursements because their existence and value depend entirely on the postpetition labor of the Debtors' employees. *See* Am. Compl. ¶ 36. As discussed, in the best-known case on this issue, *Cafeteria Operators*, the court determined that revenues that were primarily the result of employee labor were not proceeds of collateral. 299 B.R. at 403. Following *Cafeteria Operators*, the Ninth Circuit B.A.P. in *In re Skagit*, held that, under California law, a security interest does not attach to postpetition income earned through a debtor's labor or service. 316 B.R. at 331–32.

Third, the *Future* QAF Disbursements had no value to the UMB Secured Creditors as of the Petition Date because the Debtors, as was their right, could have ceased operations on the Petition Date and, thereafter, would be ineligible to receive them. *See* Am. Compl. ¶ 36. This is because the Future QAF Disbursements were dependent on the Debtors' continued, postpetition commitments and satisfaction of conditions precedent necessary to have any rights to Future QAF Disbursements. *See id.*

Finally, the Future QAF Disbursements had no value to the UMB Secured Creditors as of the Petition Date because the UMB Secured Creditors lacked the ability to foreclose on any purported security interest in the Disbursements and demand collection from the State of California. *See* Am. Compl. ¶ 36.

E. The Allegations Added to the Amended Complaint Relate Back to the Original Complaint

UMB claims that some (but not all) of the new allegations related to Count I of the Amended Complaint are time-barred because (i) the Amended Complaint was filed after the Challenge Deadline, and (ii) the amendments do not "relate back" to the Original Complaint. *See* UMB Mot. at 16–19. The Amended Complaint was filed before UMB filed any responsive pleading, before any discovery has been undertaken, and before any motion practice. While the Amended Complaint was indeed filed after the Challenge Deadline, the amendments relate back to the Original Complaint and are therefore completely proper.

An amendment will relate back to the date of an original pleading when it "asserts a claim or defense that arose out of the conduct, transaction, or occurrence set out . . . in the original pleading." Fed. R. Civ. P. 15(c)(1)(B). This standard is met when the claim "will likely be proved by the same kind of evidence offered in support of the original pleading." *Asarco, LLC v. Union Pac. R.R. Co.*, 765 F.3d 999, 1004 (9th Cir. 2014) (internal quotation marks omitted). "The relation back standard is more lenient[] when a plaintiff seeks only to amend a claim against an existing defendant, as opposed to adding an entirely new defendant." *United States ex rel. Cericola v. Fannie Mae*, 529 F. Supp. 2d 1139, 1148 (C.D. Cal. 2007) (citing *Martell v. Trilogy, Ltd.*, 872 F.2d 322, 324 (9th Cir. 1989)). The relation back doctrine "is liberally applied, and its basic criterion is whether the original complaint gave the defendant enough notice of the nature of the plaintiff's claim so that he should not have been surprised by the amplification of the allegations." *In re Kempf*, No. CC-11-1317-CaPaMk, 2012 WL 603805, at *3 (B.A.P. 9th Cir. Feb. 14, 2012), *aff'd*, 551 F. App'x 900 (9th Cir. 2013); *see also Asarco*, 765 F.3d at 1007. Thus, "if one can fairly perceive some relationship between what was pleaded in the original and amended complaints, the amended complaint will relate back." *In re Kempf*, 2012 WL 603805, at *3. These standards are easily met here.

UMB challenges an amendment to Count I that adds an additional example to a list of assets in which the UMB Secured Creditors do not have a lien, namely "any going concern premium that

has been or will be generated."[11] Am. Compl. ¶ 31. In the Original Complaint, Count I alleged that the UMB Secured Creditors have a lien *only* in the assets listed in Exhibit A to the Complaint, and further alleged that they do "not have a perfected security interest *in any of the Debtors' other assets*," "*including"* a non-exhaustive handful of examples. Original Compl. ¶ 28 (emphasis added). The Amended Complaint simply adds "any going concern premium that has been or will be generated" to that list. Am. Compl. ¶ 31.

The term "include" means "[t]o contain as a part of something," and "[t]he participle including typically indicates a *partial* list." BLACK'S LAW DICTIONARY (11th ed. 2019) (emphasis added). In *In re Kline*, the court found that the use of the term "including" in an initial complaint indicated that the allegations following the term were "specifically not made exclusive, but only exemplary." *In re Kline*, No. 8:13-bk-11334-TA, 2014 WL 12665719, at *2 (Bankr. C.D. Cal. Mar. 11, 2014). Accordingly, the Amended Complaint, which added an allegation to the list, merely provided "*an additional example* of what ha[d] already been alleged," and was sufficiently connected to allow relation back. *Id.* (emphasis in original). Similarly, the addition of the going concern premium in the list of assets in which the UMB Secured Creditors do not have a lien elaborates on the original allegation that "[a]s of the Petition Date, the [UMB Secured Creditors] do not have a perfected security interest in *all* of the assets of all of the Debtors, but rather only in the Collateral set forth on Exhibit A," and that it "does not have a perfected security interest *in any of the Debtors' other assets*." Original Complaint ¶ 28; Am. Compl. ¶ 31 (emphasis added). As such, this allegation arises from the same conduct, transaction, or occurrence—namely, the scope of the UMB Secured Creditors' liens, and the absence of liens on any assets not listed in Exhibit A. The same types of evidence will be used to support this allegation as would be used to prove the original allegations.[12]

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[11] UMB does not challenge the addition of "the MOB Assets" to the list of examples of assets in Count I.

[12] The cases cited by the Secured Creditors are easily distinguishable. *See Echlin v. PeaceHealth*, 887 F.3d 967, 977–79 (9th Cir. 2018) (finding, where plaintiff waited until *summary judgment* to introduce a new argument, defendant would have been "'substantially prejudiced' by undertaking an entirely new course of defense based on [the new allegations] *so far into litigation*," and noting that the complaint "*expressly disavowed*" and was "*directly contradictory*" to the new claim) (emphasis

Accordingly, the amendments are appropriate and easily pass muster under Rule 15.

II. NONE OF UMB'S ARGUMENTS WARRANTS DISMISSAL: COUNT-BY-COUNT SUMMARY ANALYSIS

Based on the foregoing, each of the four Counts in the Amended Complaint states a valid claim for relief and should be allowed to proceed.

A. Count I, Which Seeks a Determination That the UMB Secured Creditors' Liens Are Limited to Specific Assets, Properly States a Claim for Relief

Count I alleges that, as of the Petition Date, the UMB Secured Creditors "[did] not have a perfected security interest in *all* of the assets of all of the Debtors, but rather only in the Collateral set forth on Exhibit A." Am. Compl. ¶ 31. Count I further alleges that the UMB Secured Creditors do "not have a perfected security interest in any of the Debtors' other assets, including (i) the Deposit Accounts set forth in Section I of Exhibit B . . . , (ii) the entities or the assets of the entities set forth in Section II of Exhibit B . . . , (iii) any going concern premium that has been or will be generated, (iv) the MOB Assets, (v) any Future QAF Disbursements, and (vi) any commercial tort claims." *Id.*

The Challenge Right empowers the Committee to seek the relief set forth in Count I; as a result, Count I is not a disguised appeal or improper collateral attack on the Court's prior findings as to the scope of the UMB Secured Creditors' liens. *See supra* pp. 8–11. In addition, the allegation that the assets in which the UMB Secured Creditors do not have a perfected security interest include any going concern premium that has been or will be generated by the Sales to Santa Clara County and Strategic Global Management, Inc. is fully consistent with applicable law. *See supra* pp. 11–16. And the inclusion of that allegation in the Amended Complaint is proper under Fed. R. Civ. P. 15

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added); *Williams v. Boeing Co.*, 517 F.3d 1120, 1124, 1133 (9th Cir. 2008) (finding in a Section 1981 action with "a complicated procedural history . . . involv[ing] a number of different claims and plaintiff classes" that plaintiffs sought to introduce "a new legal theory depending on different facts," which required "different statistical evidence and witnesses" to prove); *Magno v. Rigsby (In re Magno)*, 216 B.R. 34, 39, 42 (B.A.P. 9th Cir. 1997) (finding that plaintiff added a new cause of action under a completely different section of the Bankruptcy Code with elements that were "clearly distinct" from the cause of action initially pleaded, and provided no facts that would prove those elements).

because the allegation arises from the same conduct, transactions, or occurrences set forth in the Original Complaint; therefore, it relates back. *See supra* pp. 20–22.

Accordingly, Count I states a valid claim for relief.

B. Count II, Which Seeks a Determination That the UMB Secured Creditors' Liens Do Not Extend to Deposit Accounts, Properly States a Claim for Relief

Count II alleges that the UMB Secured Creditors do not have a perfected security interest in "the Deposit Accounts set forth in Section I of Exhibit B . . . ," and "the entities or the assets of the entities set forth in Section II of Exhibit B." Am Compl. ¶¶ 33–34.

The Committee should not be barred from full exercise of the Challenge Right on the theory that Count II has somehow been rendered moot by the Final DIP Order; it has not. *See supra* pp. 7–8. In addition, Count II sets forth an actual case or controversy even if, as UMB contends, the funds in the Deposit Accounts have already been spent. *See supra* pp. 16–18.

Accordingly, Count II states a valid claim for relief.

C. Count III, Which Seeks a Determination That the UMB Secured Creditors' Liens Do Not Extend to Future QAF Disbursements, Properly States a Claim for Relief

Count III alleges that the UMB Secured Creditors do "not have a perfected security interest in Future QAF Disbursements," for five separate reasons. Am. Compl. ¶ 36.

The Committee should not be barred from full exercise of the Challenge Right on the theory that Count III has supposedly been rendered moot by the Final DIP Order; it has not. *See supra* pp. 7–8. Moreover, the Committee's allegations that the UMB Secured Creditors do not have a perfected security interest in the Future QAF Disbursements are viable and consistent with applicable law. *See supra* pp. 18–19.

Accordingly, Count III states a valid claim for relief.

D. Count IV, Which Conditionally Seeks a Determination That the UMB Secured Creditors Are Undersecured, Properly States a Claim for Relief

Count IV alleges that "[i]f the Court were to grant the relief sought in some or all of the first three claims for relief herein, [the UMB Secured Creditors] would be undersecured." Am. Compl. ¶ 39.

The Challenge Right empowers the Committee to seek the relief set forth in Count IV; as a result, Count IV is not a disguised appeal or improper collateral attack on the Court's prior findings as to the scope of the UMB Secured Creditors' liens. *See supra* pp. 8–11.

Accordingly, Count IV states a valid claim for relief.[13]

CONCLUSION

For the reasons set forth above, the Committee respectfully requests that the Court deny the Motion and allow this case to proceed.

DATED: October 17, 2019

MILBANK LLP

/s/ Robert J. Liubicic
Mark Shinderman
Robert J. Liubicic
Daniel B. Denny
Alexandra Achamallah

ARENT FOX LLP
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Robert M. Hirsh (admitted *pro hac vice*)

Counsel for the Official Committee of Unsecured Creditors of Verity Health System of California, Inc., et al.

[13] To the extent the Court is inclined to grant any portion of the Motion, the Committee respectfully request that any dismissal be without prejudice and with leave to amend.

EXHIBIT 1

2013 WL 327409
Only the Westlaw citation is currently available.
United States District Court,
C.D. California.

James BOZAJIAN, Plaintiff,
v.
COUNTY OF LOS ANGELES; Steve Cooley, individually and in his official capacity; Curtis Hazell, individually and in his official capacity; john spillane, individually and in his official capacity; John Zajec, individually and in his official capacity; Jacquelyn Lacey, individually and in her official capacity; Janet Moore, individually and in her official capacity; Sharon Matsumoto, individually and in her official capacity and Does 1–10, Defendants.

No. 2:12–cv–00625–ODW(JCx).
|
Jan. 29, 2013.

Attorneys and Law Firms

Matthew Gerald Monforton, Monforton Law Offices PLLC, Bozeman, MT, for Plaintiff.

Linda C. Miller Savitt, Rami Allon Yomtov, Ballard Rosenberg Golper and Savitt LLP, Glendale, CA, for Defendants.

ORDER DENYING DEFENDANTS' CONVERTED MOTION FOR SUMMARY JUDGMENT [41], MOTION TO DISMISS [34], AND MOTION TO STRIKE [35]

OTIS D. WRIGHT, II, District Judge.

***1** Defendants County of Los Angeles, Steve Cooley, Curtis Hazell, John Spillane, John Zajec, Jacquelyn Lacey, Janet Moore, and Sharon Matsumoto filed three motions with this Court. The first is Defendants' Motion to Dismiss. (ECF No. 34.) The Court converted the Motion to Dismiss into a motion for summary judgment on the sole issue of statute of limitations (i.e., the second motion). (ECF No. 41.) The third motion is Defendants' Motion to Strike. (ECF No. 35.) For the reasons explained below, the three motions are **DENIED.** [1]

I. BACKGROUND

Plaintiff James Bozajian has been employed since 1990 as a Deputy District Attorney ("Deputy DA") for the County of Los Angeles. (SAC ¶ 8.) Defendant Steve Cooley was the District Attorney for the County of Los Angeles, and Defendants Curtis Hazell, John Spillane, John Zajec, Jacquelyn Lacey, Janet Moore, and Sharon Matsumoto were top ranking officials in the Cooley administration. (SAC ¶¶ 10–11.) Bozajian alleges that Defendants illegally discriminated against him at work, in matters pertaining to promotions, transfers, and discipline. (SAC ¶ 11.)

Cooley and Bozajian used to be friends—but through the years, they parted ways. (SAC ¶¶ 23–25.) Bozajian served on the Board of Directors for the Association of Deputy District Attorneys ("ADDA"), an organization that Cooley allegedly approved of at one time. (SAC ¶¶ 23–28.) After Cooley's 2000 election victory, Bozajian claims that Cooley changed —he became critical of the ADDA. (SAC ¶¶ 29–32.) Cooley allegedly urged Bozajian to not seek reelection to the ADDA Board of Directors, and admitted that Bozajian was one of his top political enemies. (SAC ¶¶ 29–30, 33.)

Bozajian's Second Amended Complaint recounts various incidents between 2001 and 2010 where Defendants discriminated against him for either (1) affiliating with the ADDA, or (2) criticizing the Cooley administration. For instance, between 2001 and 2010, Bozajian's duty assignments were changed annually, something Bozajian claims is highly unusual for a Deputy DA of his seniority. (SAC ¶¶ 34–35.) He also alleges that these transfers were punitive, and happened not only to him, but to other top Deputy DAs that criticized Cooley. (SAC ¶¶ 36, 39–42, 88–99.)

Bozajian admits that he publically criticized some of Cooley's actions, as well as those of Cooley's closest allies. For example, in 2005, Bozajian and the ADDA criticized Cooley for: his lawsuit seeking to overturn voter-imposed term limits; his political stance towards California's Three Strikes law; and his derogatory comments concerning a jury that acquitted Robert Blake of murder. (SAC ¶¶ 43–46.) Bozajian also uncovered an instance of prosecutorial misconduct concerning a sexualrelationship cover-up, openly opposed Cooley in his 2008 reelection, and criticized Lacey in her

2009 efforts to become United States Attorney for the Central District of California. (SAC ¶¶ 54–72, 100–104, 114–118.)

***2** In addition to the punitive assignment transfers, Bozajian alleges that Defendants retaliated against his constitutionally protected activities by: unfairly denying him a promotion; improperly lowering his performance review; suspending him; and ransacking his office. (SAC ¶¶ 47–49, 51–53, 73–75, 102–104, 119–131.)

Ultimately, Bozajian received a 30–day suspension, which began on January 25, 2010. In response, Bozajian filed a complaint on January 26, 2010, with the Los Angeles County Civil Service Commission ("LACCSC"). (SAC ¶ 132–133.) Bozajian subsequently filed this federal suit and withdrew his complaint with the LACCSC. (SAC ¶ 135.)

Defendants now seek to dismiss Bozajian's claims, contending that he: (1) is barred under the statute of limitations; (2) fails to allege with sufficient specificity what individual defendants have done; and (3) fails to state a *Monell* claim against the County. (ECF No. 34.) The Court converted the Motion to Dismiss, as to the statute of limitations issue, into a motion for summary judgment under Federal Rule of Civil Procedure 12(d). (ECF Nos. 40, 41.) Defendants also filed a Motion to Strike portions of Bozajian's Second Amended Complaint, alleging those portions are immaterial, impertinent, and scandalous. (ECF No. 35.) The Court first turns to the statute of limitations issue.

II. MOTION FOR SUMMARY JUDGMENT

A. Legal standard

Summary judgment should be granted if there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c). The moving party bears the initial burden of establishing the absence of a genuine issue of material fact. *Celotex Corp. v. Catrett,* 477 U.S. 317, 323–24, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). Once the moving party has met its burden, the nonmoving party must go beyond the pleadings and identify specific facts through admissible evidence that show a genuine issue for trial. *Id.;* Fed.R.Civ.P. 56(c). Conclusory or speculative testimony in affidavits and moving papers is insufficient to raise genuine issues of fact and defeat summary judgment. *Thornhill's Publ'g Co. v. GTE Corp.,* 594 F.2d 730, 738 (9th Cir.1979).

A genuine issue of material fact must be more than a scintilla of evidence, or evidence that is merely colorable or not significantly probative. *Addisu v. Fred Meyer,* 198 F.3d 1130, 1134 (9th Cir.2000). A disputed fact is "material" where the resolution of that fact might affect the outcome of the suit under the governing law. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1968). An issue is "genuine" if the evidence is sufficient for a reasonable jury to return a verdict for the nonmoving party. *Id.* Where the moving and nonmoving parties' versions of events differ, courts are required to view the facts and draw reasonable inferences in the light most favorable to the nonmoving party. *Scott v. Harris,* 550 U.S. 372, 378, 127 S.Ct. 1769, 167 L.Ed.2d 686 (2007).

B. Bozajian's conduct suffices to invoke equitable tolling

***3** Defendants assert that the two-year statute of limitations has run for Bozajian's civil rights claims. (Mot. Summ. J. at 3.) On October 19, 2009, Bozajian received a letter titled "Notice of Intent to Suspend." (SAC ¶ 119.) On January 6, 2010, he received a "Notice of Suspension" letter. (SAC ¶ 129.) He then filed a complaint with the LACCSC on January 26, 2010, to contest his suspension. (SAC ¶ 132.) About two years later on January 24, 2012, he initiated this federal suit.

The controlling statute of limitations for a claim arising under the Civil Rights Acts of 1866 and 1871 is the most appropriate one provided by state law. *Donoghue v. County of Orange,* 848 F.2d 926, 930 (9th Cir.1987). The parties do not dispute that Bozajian's claims are governed by the two-year statute of limitations under California Code of Civil Procedure section 351.1. And depending on the date of accrual for Bozajian's claims, he may have run out of time.

Assuming that the two-year statute of limitations has expired, Bozajian raises the defense of equitable tolling. Along with the limitations period, federal courts borrow a state's equitable tolling rules for cases under the Civil Rights Acts, absent a reason not to do so. *Bd. of Regents v. Tomanio,* 446 U.S. 478, 486–87, 100 S.Ct. 1790, 64 L.Ed.2d 440 (1980). California's equitable tolling doctrine has three requirements: (1) timely notice to the defendant in filing the first claim; (2) lack of prejudice to defendant in gathering evidence against the second claim; and (3) good faith and reasonable conduct by the plaintiff. *Daviton v. Columbia/HCA Healthcare Corp.,* 241 F.3d 1131, 1137–38 (9th Cir.2001). Defendants only attack the good faith and reasonable conduct requirement. The Court finds no evidence suggesting that the first two requirements are not satisfied. And because Defendants have

been on notice of Bozajian's allegations in his LACCSC complaint, there is no prejudice to them in gathering evidence for this federal case.

The good faith and reasonable conduct requirement is not satisfied where a plaintiff "simply allowed the statute on his second claim nearly to run or deliberately misled the defendant into believing the second claim would not be filed." *Id.* at 1138. But equitable tolling can still apply where a plaintiff voluntarily terminated an alternate proceeding. *McDonald v. Antelope Valley Cmty. Coll. Dist.,* 45 Cal.4th 88, 111–12, 84 Cal.Rptr.3d 734, 194 P.3d 1026 (2008).

Defendants allege that the good faith and reasonable conduct requirement is not met because Bozajian strategically dropped his LACCSC complaint. (Mot.Summ. J. 5.) In response, Bozajian explained that:

- An attorney provided by the American Federation of State, County, and Municipal Employees ("AFSCME") represented Bozajian in his LACCSC complaint. (Bozajian Decl. ¶ 3.)
- After about a year, in January 2011, Bozajian's attorney had to withdraw because AFSCME withdrew funding—and so, Bozajian continued pro se in his case because he could not afford an attorney. (*Id.* ¶¶ 14–18, 84 Cal.Rptr.3d 734, 194 P.3d 1026.)

***4** • Despite lasting another five months, Bozajian decided to drop his LACCSC complaint due to his workload and inexperience with civil cases. (*Id.* ¶¶ 17–20, 84 Cal.Rptr.3d 734, 194 P.3d 1026.)

- Bozajian then obtained an attorney on contingency to take up his cause, and filed this federal suit on January 24, 2012. (*Id.* ¶¶ 22–23, 84 Cal.Rptr.3d 734, 194 P.3d 1026.)

Given this evidence, the Court concludes that Bozajian acted reasonably and in good faith under the circumstances. The fact that he dropped his other proceeding does not show that he acted in bad faith. Other than this fact, Defendants cite no other evidence of bad faith.

Defendants also claim that equitable tolling should not apply because Bozajian is now pursuing different remedies than those in his LACCSC complaint. (Mot.Summ. J. 4.) Yet the purpose of equitable tolling is to allow a plaintiff, when possessing several potential remedies as to one wrong, to pursue only one remedy as to that wrong and not lose the possibility of pursuing other remedies down the road. *Daviton,* 241 F.3d at 1141. Here, the wrong that Bozajian alleges in both his LACCSC complaint and this federal suit is that of discrimination and retaliation for exercising his First Amendment rights. The remedies, however, are different—but this does not preclude Bozajian from seeking redress in this lawsuit given the similar underlying facts between his two cases.

Thus, the Court finds that Bozajian is entitled to equitable tolling.

III. MOTION TO DISMISS

Bozajian's Second Amended Complaint asserts four causes of action: (1) violation of the First Amendment (freedom of speech) against all individual Defendants; (2) violation of the First Amendment (freedom of speech) against the County; (3) violation of the First Amendment (freedom of association) against all individual Defendants; and (4) violation of the Fourteenth Amendment (equal protection) against all individual Defendants. Defendants' Motion to Dismiss addresses two overarching problems with the Second Amended Complaint—that it: fails to adequately allege what the individual Defendants have done; and fails to state a *Monell* claim against the County. The Court addresses these two arguments in turn.

A. Legal standard

Dismissal under Rule 12(b)(6) can be based on "the lack of a cognizable legal theory" or "the absence of sufficient facts alleged under a cognizable legal theory." *Balistreri v. Pacifica Police Dep't,* 901 F.2d 696, 699 (9th Cir.1990). A complaint need only satisfy the minimal notice pleading requirements of Rule 8(a) (2)—a short and plain statement—to survive a motion to dismiss for failure to state a claim under Rule 12(b)(6). *Porter v. Jones,* 319 F.3d 483, 494 (9th Cir.2003); Fed.R.Civ.P. 8(a)(2). For a complaint to sufficiently state a claim, its "[f]actual allegations must be enough to raise a right to relief above the speculative level." *Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 555, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007). While specific facts are not necessary so long as the complaint gives the defendant fair notice of the claim and the grounds upon which the claim rests, a complaint must nevertheless "contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face."

Ashcroft v. Iqbal, 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009).

***5** *Iqbal* 's plausibility standard "asks for more than a sheer possibility that a defendant has acted unlawfully," but does not go so far as to impose a "probability requirement." *Id.* Rule 8 demands more than a complaint that is merely consistent with a defendant's liability—labels and conclusions, or formulaic recitals of the elements of a cause of action do not suffice. *Id.* Instead, the complaint must allege sufficient underlying facts to provide fair notice and enable the defendant to defend itself effectively. *Starr v. Baca,* 652 F.3d 1202, 1216 (9th Cir.2011). The determination whether a complaint satisfies the plausibility standard is a "context-specific task that requires the reviewing court to draw on its judicial experience and common sense." *Iqbal,* 556 U.S. at 679.

When considering a Rule 12(b)(6) motion, a court is generally limited to the pleadings and must construe "[a]ll factual allegations set forth in the complaint ... as true and ... in the light most favorable to [the plaintiff]." *Lee v. City of L.A.,* 250 F.3d 668, 688 (9th Cir.2001). Conclusory allegations, unwarranted deductions of fact, and unreasonable inferences need not be blindly accepted as true by the court. *Sprewell v. Golden State Warriors,* 266 F.3d 979, 988 (9th Cir.2001). Yet, a complaint should be dismissed only if "it appears beyond doubt that the plaintiff can prove no set of facts" supporting plaintiff's claim for relief. *Morley v. Walker,* 175 F.3d 756, 759 (9th Cir.1999).

B. Bozajian states sufficient facts to raise a right to relief

Defendants argue that the claims against them are overly broad and fail to "provide any insight as to the conduct of the individual defendants." (Mot. Dismiss 7–8.) Defendants contend that Bozajian's vague allegations, spanning over a ten-year period, lack sufficient details to state a claim for relief, provide insufficient notice to give Defendants an opportunity to defend, and improperly meld all Defendants together as tortfeasors.

The Court notes that Bozajian primarily directs his allegations towards Cooley. For instance, Bozajian alleges that: Cooley told him not to seek re-election to the ADDA Board of Directors (SAC ¶ 29); Cooley ordered punitive transfers for Bozajian (SAC ¶ 38); and Cooley stated that Bozajian was one of his top political enemies (SAC ¶ 33). Bozajian then asserts that the remaining individual Defendants—Hazell, Spillane, Zajec, Lacey, Moore, and Matsumoto—are top ranking Cooley-administration officials that carried out Cooley's discrimination campaign against him. (SAC ¶¶ 11–14.)

Yet there are few specific allegations against these other Defendants. For example, the only allegation specifically against Moore is that she signed the "Notice and Intent to Suspend" letter. (SAC ¶¶ 119–120.) Similarly, the only allegation specifically against Matsumoto is that she wrote and signed the "Notice of Suspension" letter. (SAC ¶ 130.) But Bozajian also alleges that both these acts—along with others—were performed under orders from Cooley and his staff. (SAC ¶¶ 123–128.) Unlike in *Iqbal,* these facts are sufficient to state a cause of action against each of the individual Defendants.

***6** In *Iqbal,* the plaintiff pleaded that his jailers "kicked him in the stomach, punched him in the face, and dragged him across his cell without justification." 556 U.S. at 668. Then, plaintiff concluded that defendants Ashcroft and Mueller "knew of, condoned, and willfully and maliciously agreed to subject him to harsh conditions of confinement as a matter of policy, solely on account of his religion, race, and/or national origin." *Id.* at 680–81. The Supreme Court ruled that while these alleged acts may give rise to a claim of relief against individual jailers (who were not named as defendants), these facts do not suffice for a claim against Ashcroft and Mueller because the pleaded facts do not suggest that the top U.S. law-enforcement officers adopted "a policy of classifying post–September–11 detainees as of high interest because of their race, religion, or national origin." *Id.* at 682–84.

In contrast, Bozajian alleges specific acts committed against him by top officials in the Cooley administration. He also alleges specific acts committed against him by Cooley. Bozajian then concludes that because of the individual Defendants' rank and close relationship with Cooley, they all had knowledge of the wrongdoing and were responsible. This contrasts with *Iqbal,* where the allegedly wrongful acts were committed by low-level employees—many pay grades below that of Ashcroft and Mueller—and presumably committed without express orders from them. But here, Bozajian's allegations plausibly suggest that the individual Defendants—all top ranking Cooley-administration officials—carried out Cooley's order and thus, each had a hand in violating his constitutional rights. Thus, the Court finds that the Second Amended Complaint states sufficient facts for relief against the individual Defendants.

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C. Bozajian states sufficient facts for a *Monell* claim

Municipalities can be held liable under section 1983 actions in three circumstances: (1) the employee acted according to an expressly adopted official policy; (2) the employee acted as a final policymaker; or (3) the employee acted according to a longstanding practice or custom. *Webb v. Sloan,* 330 F.3d 1158, 1164 (9th Cir.2003). In order to establish liability under a custom or practice, the plaintiff must show that the pattern of activity is persistent, widespread, and well-settled policy. *Trevino v. Gates,* 99 F.3d 911, 918 (9th Cir.1996).

Bozajian alleges, as discussed above, retaliatory acts designed to punish him for exercising his first amendment rights, including punitive transfers, denial of promotion, poor performance reviews, and suspension. Although Bozajian only seeks redress for the suspension commencing on January 25, 2010, these other wrongful acts committed against him suggest that the Cooley administration had an informal practice of discriminating against those who affiliated with the ADDA or are critical of the Cooley administration. Further, Bozajian includes additional examples of this discriminatory practice applied to other Deputy DAs, such as the punitive transfers of Steve Ipsen and Marc Debbaudt. (SAC ¶¶ 39–42, 88–99.) Finally, by alleging these wrongful acts in light of his seniority and Cooley's direct remarks against him and the ADDA, Bozajian presents sufficient evidence to suggest that these retaliatory acts carried out by Cooley's staff, were done under direct orders from Cooley himself—the final policymaker at the Los Angeles County District Attorney's Office. In short, assuming all of the allegations are true, the Court finds that the events complained about by Bozajian were plausibly performed under Cooley's orders in retaliation against Bozajian's criticism and his association with the ADDA. And thus, this is sufficient to support a *Monell* claim against the County.

IV. MOTION TO STRIKE

***7** Federal Rule of Civil Procedure 12(f) states that "[t]he court may strike from a pleading an insufficient defense or any redundant, immaterial, impertinent, or scandalous matter." The function of a 12(f) motion to strike is to avoid the expenditure of time and money in litigating spurious issues by disposing of them prior to trial. *Fantasy, Inc. v. Fogerty,* 984 F.2d 1524, 1527 (9th Cir.1993).

As to Defendants' request to strike punitive damages, Bozajian properly seeks punitive damages against the individual Defendants, not in their official capacities, but in their individual capacities. *See Hafer v. Melo,* 502 U.S. 21, 25, 112 S.Ct. 358, 116 L.Ed.2d 301 (1991). And as to Bozajian's allegations of retaliatory acts committed by the individual Defendants towards other Deputy DAs under the Cooley administration, these incidents are relevant to demonstrate a custom or practice, through which Bozajian may establish *Monell* liability against the County. The Court finds no reason to strike these portions of the Second Amended Complaint.

Further, the Court also finds no reason to strike the portions of the Second Amended Complaint that narrate Defendant Hazell's affair with a death penalty witness or refer to Cooley's use of investigators to gag media coverage. The Hazell affair supports Bozaj ian's claims that Cooley retaliated against him for exposing this incident. And the gagging account is another example of Cooley's discrimination against the ADDA and those involved with the organization. Moreover, the Court does not find any of these allegations to be scandalous or offensive. Therefore, Defendants' Motion to Strike is **DENIED.**

V. CONCLUSION

For the above reasons, the Court **DENIES** Defendants' Motion for Summary Judgment, Motion to Dismiss, and Motion to Strike. (ECF Nos. 34, 35, 41.) Defendants shall file their answer to the Second Amended Complaint within 14 days of this order.

IT IS SO ORDERED.

All Citations

Not Reported in F.Supp.2d, 2013 WL 327409

Footnotes

1 Having considered the papers filed in support of and in opposition to these motions, the Court deems the matters appropriate for decision without oral argument. Fed.R.Civ.P. 78; L.R. 7–15.

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2017 WL 3500391
NOT FOR PUBLICATION
United States Bankruptcy Court, E.D. California.

IN RE: DELANO RETAIL PARTNERS, LLC, Debtor.
Susan K. Smith, Chapter 7 Trustee, Plaintiff,
v.
C & S Wholesale Grocers, Inc., a Vermont Corporation, Defendant.
C & S Wholesale Grocers, Inc., a Vermont Corporation, Counterclaimant,
v.
Susan K. Smith, Chapter 7 Trustee, Counterdefendant.

Case No. 11–37711–B–7
|
Adversary No. 16–2146
|
Signed August 14, 2017

Attorneys and Law Firms

Howard S. Nevins, Sacramento, CA, for Plaintiff.

Michael J. Stortz, San Francisco, CA, for Defendant.

MEMORANDUM DECISION GRANTING TRUSTEE'S MOTION FOR SUMMARY JUDGMENT AND DENYING C & S'S MOTION FOR SUMMARY JUDGMENT

Christopher D. Jaime, UNITED STATES BANKRUPTCY JUDGE

INTRODUCTION

***1** There are two motions for summary judgment presently before the court. Plaintiff Susan K. Smith, in her capacity as the trustee appointed in the parent chapter 7 case ("Trustee") captioned In re Delano Retail Partners, LLC, case no. 11–37711, filed one summary judgment motion. Defendant C & S Wholesale Grocers, Inc. ("C & S"), a purported secured creditor in the parent chapter 7 case, filed the other.

Delano Retail Partners, LLC ("DRP") is the debtor in the parent chapter 7 case. Dennis Delano and Harley Delano ("Delanos") are the managers of DRP. DRP's attorney was Joseph Neri ("Neri"). The Delanos also formed another entity by the name of 2040 Fairfax, Inc. ("2040 FF"). The relationship of the parties and these entities is discussed in greater detail below.

The Trustee commenced this adversary proceeding by filing a complaint on July 22, 2016. The first four claims for relief in that complaint are for declaratory relief. For lack of a better description, those claims concern funds identified as four "buckets" of money which consist of the following:

(1) approximately $429,505.00 received or to be received from the settlement of the estate's claims against the Delanos, 2040 FF, and Neri that C & S purchased from the Trustee, thereafter prosecuted, and ultimately settled (the "Settlement Funds");

(2) approximately $384,000.00 of an original balance of approximately $560,000.00 that DRP transferred from its bank account to Neri's client trust account prepetition and which thereafter was transferred from Neri's client trust account to the Trustee (the "Neri Trust Account Funds");

(3) approximately $153,410.08 the Trustee collected from 2040 FF postpetition for 2040 FF's lease of DRP's furniture, fixtures, and equipment under a prepetition asset lease agreement (the "Asset Lease Payments"); and

(4) approximately $37,661.60 the Trustee received from the sale of DRP's liquor licenses (the "Liquor License Proceeds").

The Trustee seeks a declaration that the funds in each of the "buckets" are not subject to C & S's prepetition security interest and therefore belong to the estate free and clear. The fifth claim for relief in the complaint is a claim under 11 U.S.C. § 542(a) for turnover of the Settlement Funds.

C & S filed an answer and counterclaim on September 6, 2016. The counterclaim asserts the same four claims for declaratory relief that are asserted in the complaint (but in different order). It seeks a declaration opposite of that requested in the complaint. In other words, whereas the Trustee seeks a declaration that all of the funds in each of the four above-referenced "buckets" are not subject to C & S's prepetition security interest, C & S seeks a declaration that all of the funds in each of those "buckets" are subject to its prepetition security interest.

The Trustee filed the initial summary judgment motion on May 5, 2017. C & S opposed the Trustee's summary judgment motion on May 23, 2017, and the Trustee replied on May 30, 2017. C & S filed a memorandum of points and authorities on May 5, 2017, and its summary judgment motion on May 9, 2017. The Trustee opposed C & S's summary judgment motion on May 23, 2017, and C & S replied on May 30, 2017. A hearing on the parties' cross-motions for summary judgment was held on June 9, 2017. Appearances at that hearing were noted on the record.

***2** In reaching its decision, the court has reviewed and considered the following documents: (i) with regard to the Trustee's summary judgment motion, docket nos. 32–39, 49–56, 64–70, 76, 82, 86 & 89; and (ii) with regard to C & S's summary judgment motion, docket nos. 40–48, 57–63, 71–74, 75, 83, 86 & 88. The court also takes judicial notice of the dockets in this adversary proceeding and in the parent chapter 7 case, the dockets in related adversary proceedings nos. 12–02686 and 13–02250 filed in this court, and the dockets in related case nos. 2:13–cv–01413–TLN–AC, 2:14–CV–02215–TLN–DAD, and 2:14–cv–02263–TLN filed in the district court. [1] The court has also relied on the parties' stipulated undisputed facts and facts the parties submitted that the court has discerned are not in dispute. [2]

FACTUAL BACKGROUND

I. Generally

C & S is a grocery wholesaler that sold store inventory to DRP before DRP filed its voluntary chapter 7 petition. In 2006 C & S and DRP executed a supply agreement, promissory note, and security agreement. In connection with those agreements, C & S loaned DRP $2,000,000.00 to purchase assets and equipment for stores, including stores that DRP acquired from Ralph's Grocery Company and specifically including a store located at 2040 Sir Francis Drake Blvd., Fairfax, California.

The loan from C & S to DRP is evidenced by the promissory note, which is secured by the security agreement. The security agreement grants C & S a security interest in numerous classes of DRP's assets, all of which are identified in the security agreement submitted as an exhibit to the motion. Relevant here are all claims, accounts, general intangibles, chattel paper, deposit accounts, leases, inventory, furniture, fixtures, and equipment, and all proceeds of the foregoing. C & S's security interest in this collateral is perfected by a UCC–1 financing and two continuation statements.

II. As Specifically Relating to Each of the Four "Buckets"

A. The Settlement Funds: Trustee's First Claim for Relief in the Complaint & C & S's Fourth Claim for Relief in the Counterclaim [$429,505.00]

In November 2012 C & S filed an adversary complaint that named the Delanos, 2040 FF, and Neri as defendants. That complaint alleged fraudulent transfer claims, and claims for conspiracy to commit and aiding and abetting in the commission of fraudulent transfers.

In March 2013 the Delanos, 2040 FF, and Neri moved to dismiss the adversary complaint. Those defendants asserted that the claims alleged in the complaint belonged to the estate and therefore C & S lacked standing to prosecute them on its own behalf. The Trustee also asserted ownership of the claims. After C & S moved in April 2013 to prosecute the estate's claims in place of the Trustee and for the benefit of the estate, C & S and the Trustee entered into a stipulation in May of 2013 that authorized C & S to prosecute the estate's claims, including those alleged in the 2012 adversary complaint. There are two significant paragraphs in that stipulation.

The first is ¶ 1 which pertains to the consideration that C & S agreed to pay the Trustee for its purchase—and the Trustee's sale—of the estate's claims. Paragraph 1 states that "in consideration of payment to the Trustee for the benefit of DRP's estate out of any settlement, judgment or other recovery" C & S would pay the Trustee (i) a minimum of $250,000.00, (ii) an additional $50,000.00 of any amount between $300,000.00 and $1,000,000.00, and (iii) the $250,000.00 and the $50,000.00 plus 25% of any amount over $1,000,000.00.

The second is ¶ 3 which states as follows:

> ***3** The terms for payment as set forth herein shall be without prejudice to, and shall not affect, C & S' assertion of any secured and unsecured claims herein, as well as the Trustee's right to dispute, contest, or otherwise object to any such claims, all of which rights and remedies are hereby preserved and unaffected by this stipulation.

The Trustee filed a motion to approve the stipulation in May 2013. The court (Holman, J.) heard that motion on June 18, 2013, and also treated it as a motion to sell the estate's claims to C & S. During the hearing on the motion, and without any objection from or disagreement by C & S, the Trustee explained ¶ 3 of the stipulation as follows:

> And as the trustee made clear in her reply to the Fund's opposition, the ability to object to C & S's claim is preserved to the estate. All rights are reserved here. If the trustee feels that there has been some sort of double dipping or double recovery to C & S as a result of the litigation, she retains the ability under the Bankruptcy Code to object to that proof of claim and will do so if that serves the interest of the estate.

Hr'g Tr. at 6:9–17 (emphasis added).

The order granting the motion and approving the May 2013 stipulation and sale of the estate's claims to C & S was entered in July 2013. Thereafter, C & S owned 100% of the estate's claims and it asserted its ownership of those claims in pleadings filed in subsequent litigation involving the purchased claims. C & S also characterizes all of the claims it bought from the estate as its collateral and the proceeds received in settlement of the estate's claims as a replacement for its damaged or destroyed collateral.

C & S settled the estate's claims against the Delanos and 2040 FF in January of 2015. That settlement agreement requires 2040 FF to make 42 monthly payments of $10,833.00 each from February 2015 to July 2018, with increasing payments thereafter to and including January 2022. Under that settlement agreement, 2040 FF agreed to pay a total of $1,518,020.00 to C & S by January 2022. C & S also settled the estate's claims against Neri in July of 2015. That settlement agreement requires Neri to pay $40,000.00. Based on the amounts of those settlements, $429,505.00 is at issue with regard to this "bucket".

B. Neri Trust Account Funds: Trustee's Fourth Claim for Relief in the Complaint and C & S's First Claim for Relief in the Counterclaim [$384,000.00]

From 2009 to 2010, several of DRP's grocery stores in Northern California experienced a downturn in business and began shutting down. As the remaining DRP stores (other than Fairfax) went out of business, DRP sold inventory.

In late 2010, DRP transferred $560,000.00 from its bank account to Neri's client trust account. There is also deposition testimony that inventory proceeds were deposited into Neri's client trust account in late 2010. That same deposition testimony also reflects that whatever the extent of inventory proceeds that went into Neri's client trust account, those proceeds were not segregated and, in fact, were commingled with other funds that belonged to a "Peterson" and other unidentified operational funds.

In any case, of the $560,000.00 that was deposited into Neri's client trust account in late 2010, $384,000.00 was transferred from Neri's client trust account to the Trustee in July 2011. The reduction resulted from withdrawals from the trust account to pay DRP's taxes, payroll, and employment department claims. An order entered in prepetition state court litigation also authorized a withdraw from the account to pay expenses associated with that litigation.

C. Asset Lease Funds: Trustee's Third Claim for Relief in the Complaint & C & S's Second Claim for Relief in the Counterclaim [$153,410.08]

***4** In 2008 the Delanos formed 2040 FF with Neri's assistance. DRP terminated its rights under an existing sublease of the Fairfax store and, simultaneously, 2040 FF negotiated a new long-term lease for that store. DRP and 2040 FF executed a sublease agreement for the Fairfax store under which DRP agreed to pay the monthly rent due under 2040 FF's new long-term lease. DRP and 2040 FF also executed an agreement under which DRP agreed to use its license, permits, employees, and other resources to operate the Fairfax store on behalf of 2040 FF.

Relevant for purposes of this "bucket" is that in January 2010 DRP entered into what is referred to as an "Asset Lease" with 2040 FF under which DRP leased its furniture, fixtures, and equipment in the Fairfax Store to 2040 FF in exchange for semi-annual payments from 2040 FF. After DRP filed its chapter 7 petition, payments under the Asset Lease were collected directly by the Trustee. Prepetition those payments

were made to DRP. The Trustee has collected approximately $153,410.08.

D. Liquor License Sale Funds: Trustee's Second Claim for Relief in the Complaint & C & S Third Claim for Relief in the Counterclaim [$37,661.60]

DRP owned several liquor licenses which were used in connection with grocery store operations. The Trustee sold those liquor licenses to third parties during the administration of the bankruptcy case. The Trustee received net sales proceeds of approximately $37,661.60 from those sales. C & S claims those funds as proceeds of its collateral consisting not of the liquor licenses themselves but, rather, as proceeds of the liquor licenses as general intangibles.

JURISDICTION

Federal subject matter jurisdiction is founded on 28 U.S.C. § 1334. This adversary proceeding is a core proceeding under 28 U.S.C. §§ 157(b)(2) (A), (B), (E), (K), and (0). To the extent this adversary proceeding may ever be determined to be a matter that a bankruptcy judge may not hear and determine without consent, the parties nevertheless consent to such determination by a bankruptcy judge. See 28 U.S.C. § 157(c)(2). Venue is proper under 28 U.S.C. § 1409.

LEGAL STANDARD

Summary judgment is proper where "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); Fed. R. Bankr. P. 7056. The moving party has the burden of demonstrating the absence of a genuine issue of fact. Anderson v. Liberty Lobby. Inc., 477 U.S. 242, 256 (1986). That burden may be discharged by showing, i.e., pointing out, that there is an absence of evidence to support the nonmoving party's case. Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). Thereafter, the nonmoving party bears the burden of designating specific facts demonstrating genuine issues for trial. In re Oracle Corp. Sec. Litig., 627 F.3d 376, 387 (9th Cir. 2010).

In examining a motion for summary judgment, "the inferences to be drawn from the underlying facts ... must be viewed in the light most favorable to the party opposing the motion." U.S. v. Diebold, Inc., 369 U.S. 654, 655 (1962). However, the nonmoving party's allegation that factual disputes persist will not automatically defeat an otherwise properly supported motion for summary judgment. See Fed. R. Civ. P. 56(e). And a "mere 'scintilla' of evidence will be insufficient to defeat a properly supported motion for summary judgment; instead, the nonmoving party must introduce some 'significant probative evidence tending to support the complaint.' " Fazio v. City & County of San Francisco, 125 F.3d 1328, 1331 (9th Cir. 1997) (quoting Anderson, 477 U.S. at 249, 252). The court does not weigh conflicting evidence; rather, it asks whether the nonmoving party has produced sufficient evidence to permit the factfinder to hold in its favor. Ingram v. Martin Marietta Long Term Disability Income Plan for Salaried Employees of Transferred GE Operations, 244 F.3d 1109, 1114 (9th Cir. 2001).

***5** Cross-motions for summary judgment evaluated separately, giving the nonmoving party in each instance the benefit of all reasonable inferences. A.C.L.U. of Nev. v. City of Las Vegas, 466 F.3d 784, 790–91 (9th Cir. 2006) (quotation marks and citation omitted); Pintos v. Pac. Creditors Ass'n, 605 F.3d 665, 674 (9th Cir. 2010). In evaluating the motions, "the court must consider each party's evidence, regardless under which motion the evidence is offered." Las Vegas Sands, LLC v. Nehme, 632 F.3d 526, 532 (9th Cir. 2011).

DISCUSSION

I. The Cross–Motions for Summary Judgment

A. The Settlement Funds are not Collateral or Proceeds that Replace Damaged or Destroyed Collateral.

This "bucket" contains the proceeds received and to be received in settlement of the estate's claims against the Delanos, 2040 FF, and Neri. C & S maintains those funds, including the consideration it is obligated to pay the Trustee for its purchase of those claims from the Trustee, are encumbered by its security interest either as its collateral, *i.e.*, the claims, or as the replacement of damaged or destroyed collateral, *i.e.*, the settlement proceeds. The Trustee, on the hand, maintains that the consideration portion of the Settlement Funds are not subject to any security interest. For the reasons explained below, the Trustee is correct.

It is true that DRP granted C & S a security interest in "all claims." It is also true that settlement proceeds can be a replacement for original collateral that is damaged or destroyed. O.H. Kruse Grain and Milling v. United California Bank (In re Wiersma), 324 B.R. 92, 106 (9th Cir. BAP 2005), aff'd in part, rev'd in part, 483 F.3d 933 (9th Cir. 2007), and aff'd in part, 277 Fed. Appx. 603 (9th Cir. 2007); In re Endresen, 530 B.R. 856, 869 (Bankr. D. Or. 2015), aff'd in part, rev'd in part, 548 B.R. 258 (9th Cir. BAP 2016). However, at least in this case, an admission by C & S negates the possibility of any such outcome.

The Trustee cites In re Ice Mgmt. Sys., Inc., 2014 WL 6892739 (9th Cir. BAP 2014), for the proposition that the portion of the Settlement Funds described in the May 2013 stipulation as the consideration C & S is obligated to pay the Trustee for its purchase of the estate's claims are not encumbered by C & S's prepetition security interest. In an effort to distinguish Ice Management from this case, and to refute the Trustee's argument, C & S makes the following statement which the court treats as an admission: [3]

> Unlike in *Ice*, the Trustee here did *not* sell an encumbered asset, such as an intellectual property right belonging to DRP or, for example, an item of real or personal property that was subject to an existing lien or security interest. Rather, *the Trustee sold the Estate's claims-claims* that only *she* had standing to prosecute.

Dkt. 71 at 9:8–12 (emphasis in original).

***6** Short of buying claims from the same individual who sold Jack his magic beanstalk beans, the admission that the estate's claims, *i.e.*, the very claims that C & S bought from the Trustee, prosecuted, and settled resulting in the Settlement Funds, are not (and when bought were not) encumbered can only mean those claims are not (and when bought were not) subject to any security interest under the security agreement between C & S and DRP. That means the claims are not (and could not be) collateral. That also means proceeds received in settlement of the unencumbered claims likewise are not (and could not be) a replacement for original collateral—damaged, destroyed, or otherwise.

The admission by C & S that the Trustee did not sell it encumbered claims also sheds light on the purpose of ¶ 3 of the May 2013 stipulation. The purpose of that paragraph could not be to preserve a security interest in the consideration portion of the Settlement Funds—or any portion of the Settlement Funds for that matter—because the paragraph cannot be read to preserve that which C & S admits does not (and when it bought the estate's claims from the Trustee did not) exist, i.e., a security-interest.

The Trustee's statements during the hearing on the motion to approve the stipulation and sale of the estate's claims to C & S are also independent evidence that the purpose of ¶ 3 of the May 2013 stipulation was not to preserve any security interest. Rather, as the Trustee explained, the purpose of that paragraph was to preserve the secured and unsecured claims that C & S asserted in its proof of claim and the Trustee's ability to object to the proof of claim to prevent a double recovery by C & S on both the proof of claim and the estate's claims. C & S did not object to or otherwise dispute the Trustee's explanation of ¶ 3 when it was given. And it does not do so now with any admissible evidence.

Finally, it is also worth noting that the motion to approve the stipulation and Trustee's sale of the estate's claims to C & S was considered in the context of the Woodson and A & C factors. [4] That standard requires the court to find that a proposed settlement and compromise provides some benefit to the estate and creditors. If Judge Holman understood that the consideration C & S agreed to pay the Trustee for its purchase of the estate's claims was subject in its entirety to a security interest so that the estate effectively received nothing in exchange for the sale of its claims to C & S, he could not have found that the stipulation and motion to approve it satisfied the Woodson and A & C factors.

The benefit to the estate from the stipulation and the Trustee's sale of the estate's claims to C & S comes in the form of the "consideration" that C & S is now obligated to pay the Trustee for its purchase of the estate's claims. That consideration is a clearly-defined structured payment arrangement pursuant to which C & S is obligated to pay the Trustee a total of $429,505.00. In other words, what the estate has following approval of the stipulation and the Trustee's sale of the estate's claims to C & S is an unencumbered postpetition bargained-for contract and right to payment. Both are property of the

estate under § 541(a)(7) of the Bankruptcy Code which includes "[a]ny interest in property that the estate acquires after the commencement of the case." 11 U.S.C. § 541(a)(7); see also Carroll v. Tri–Growth Centre City, Ltd. (In re Carroll), 903 F.2d 1266, 1270 (9th Cir. 1990) (typical § 541(a)(7) property of estate is a postpetition contract); In re MCEG Productions. Inc., 133 B.R. 232, 235 (Bankr. C.D. Cal. 1991) (postpetition compromise agreement). [5]

***7** In short, C & S is obligated to pay $429,505.00 as consideration for its purchase of the estate's claims from the Trustee. That payment—like the entirety of the Settlement Funds—is not subject to any security interest and is property of the estate. Therefore, for the foregoing reasons, the court will grant summary judgment for the Trustee on the First Claim for Relief in the complaint and will deny summary judgment for C & S on the Fourth Claim for Relief in the counterclaim.

B. The Neri Trust Account Funds are not Encumbered by C & S's Security Interest.

This "bucket" includes the funds that were transferred from DRP's bank account to Neri's client trust account in late 2010, and thereafter transferred from Neri's client trust account to the Trustee in 2011. DRP's bank account from which these funds came is a "deposit account" within the meaning of California Commercial Code § 9102(a)(29). So too is Neri's client trust account. In re Allied Respitory Care Services, Inc., 182 B.R. 589, 593–595 (Bankr. S.D. Fla. 1995).

A financing statement is not effective to perfect a security interest in a deposit account. See Cal. Comm. Code § 9310(b)(8). In fact, except when proceeds in a deposit account are already subject to a perfected security interest under California Commercial Code §§ 9315(c) and (d), a security interest in a deposit account is perfected only by control. See Cal. Comm. Code §§ 9312(b) & (b)(1); §§ 9314(a) & (b). A secured party has control over a deposit account for purposes of perfection of a security interest under any of the following conditions: (i) the secured party is the bank where the funds are deposited; (ii) the secured party, the debtor, and the bank enter into a deposit control agreement; or (iii) the security agreement becomes the bank's customer with respect to the deposit account. See Cal. Comm. Code §§ 9104(a)(1)–(3).

C & S has produced no evidence of control over any DRP bank account, much less any bank account into which inventory proceeds were supposedly deposited. The same is true with regard to Neri's client trust account. There is no evidence that C & S exercised control over either account. For example, C & S is not the bank where the funds were deposited, it produced no deposit control agreement for either account, and it has not established that it is a customer of the institutions where either account was maintained with respect to either account. Consequently, C & S has failed to establish that it has a perfected security interest in DRP's bank account and in Neri's client trust account as deposit accounts. But that does not end the inquiry.

A secured creditor can retain a perfected security interest in a deposit account as proceeds to the extent funds credited to the deposit account are proceeds of the secured creditor's primary collateral. Stierwalt v. Associated Third Party Administrators, 2016 WL 2996936, *3 (N.D. Cal. 2016). However, a "transferee" of funds from a deposit account takes the funds from the deposit account free of any security interest. See Cal. Comm. Code § 9332. And as explained below, that includes the Trustee who is, and who C & S acknowledges is, a "transferee."

The parties stipulated that $560,000.00 went from DRP's bank account to Neri's client trust account in late 2010. There is also deposition testimony that in late 2010 inventory proceeds were deposited into Neri's client trust account. Construing that evidence favorably to C & S, that could mean that the funds that went *into* Neri's client trust account in late 2010 were all inventory proceeds and, as such, were subject to C & S's security interest. But even if that is the case, when those funds were *transferred out* of Neri's client trust account to the Trustee they were free and clear of any security interest when received by the Trustee. There are two paths to this conclusion.

***8** In Orix Fin. Serv., Inc. v. Kovacs, 167 Cal. App. 4th 242 (Cal. App. 2008) (as modified October 16, 2008), a debtor business defaulted on its financial obligation to Orix which was secured by all of the business's goods, chattels, and property. Id. at 246. Separately, defendant Kovacs obtained a judgment against the business and executed on the business's deposit account. Id. All of the funds in that deposit account were proceeds from the sale of the business's inventory and collection of its accounts receivables, which meant all of the deposits were subject to Orix's security interest. Id. Kovacs' execution on the business's deposit account prompted Orix's suit against Kovacs. Id. The trial

court sustained a demure by Kovacs and Orix appealed. Id. at 245.

On appeal, Kovacs conceded that Orix's position as a secured creditor was superior to its own as a judgment creditor. Id. at 246. However, Kovacs argued that such an analysis was irrelevant to the question of the satisfaction of his judgment from the funds in the business's deposit account, which it maintained was wholly free of any such priority analysis because of California Commercial Code § 9332(b). Id. The California appellate court agreed with Kovacs and held that, as a judgment creditor, Kovacs was a transferee under California Commercial Code § 9332(b) who took funds from the business's deposit account free and clear of *any* security interest. Id. at 245, 251. Notably, the court supported its holding by reference to Harley–Davidson Motor Co. v. Bank of New England–Old Colony N.A., 897 F.2d 611, 622 (1st Cir. 1990), in which U.S. Supreme Court Justice Breyer referred to comment 2(c) of U.C.C. § 9–306 from which California Commercial Code § 9332(b) is derived to note that the purpose behind § 9–306 was (and thence § 9332(b) is) to explicitly exclude any judicial efforts to trace identifiable secured proceeds paid out of a commingled deposit account. Orix Financial, 167 Cal. App. 4th at 248.

More recently, Stierwalt, supra, involved a similar dispute between a judgment creditor who levied on funds in the judgment debtor's bank account and a secured creditor who claimed a security interest in the judgment debtor's bank account as a deposit account and as proceeds of its collateral. Stierwalt, 2016 WL 2996936 at *1, *2. In the absence of the requisite control, the court concluded that the secured creditor lacked a perfected interest in the bank account as a deposit account. Id. at *3. More importantly, the court recognized that the proceeds in the bank account were identifiable proceeds and, as such, subject to the secured creditor's security interest as proceeds of its contract rights collateral. Id. at *4–*5. Nevertheless, relying on Orix Financial, the court concluded that the secured creditor's security interest in the funds as proceeds of its contract rights collateral did not survive the transfer of those funds out of the deposit account to the judgment creditor who, as in Orix Financial, was a transferee under California Commercial Code § 9332(b). Id. at *6–*8.

The Trustee cites Orix Financial to support her position that the $384,000.00 transferred to her from Neri's client trust account is not encumbered by C & S's security interest. In response to that argument, C & S acknowledges that Orix Financial holds that a judgment creditor is a transferee under § 9332(b) of. the California Commercial Code who takes funds from a deposit account free and clear. However, C & S maintains that Orix Financial and § 9332(b) are inapplicable because the Trustee is not, and when she received the $384,000.00 from Neri's client trust account was not, a judgment creditor. More precisely, C & S states as follows:

> ***9** [T]he Trustee cites [Orix], but as the Orix court explained, 'This case presents a very narrow question-one of first impression in California: Is an unsecured judgment creditor, who satisfied its judgment from deposit account funds, included in the definition of a 'transferee' as contemplated by section 9332(b), such that it may take those funds free of any security interest?' Id. at 245. The court held that the answer to that question was 'yes.' In other words, an unsecured judgment creditor may satisfy its judgment from deposit accounts [sic] funds and take such funds 'free and clear.' But it is undisputed that the Trustee was not a judgment creditor and did not obtain what remained of the $560,000 by way of a lawsuit and subsequent satisfaction of judgment.

Dkt. 71 at 15:14–16. And that is where C & S's argument collapses.

C & S fails to recognize that § 544(a) of the Bankruptcy Code confers upon the Trustee the status of a hypothetical judgment creditor and lienholder as of the date a bankruptcy petition is filed. See 11 U.S.C. § 544(a); Neuton v. Danning (In re Neuton), 922 F.2d 1379, 1383 (9th Cir. 1990); In re Lloyd, 511 B.R. 657, 659 (Bankr. D. Ariz. 2014). Thus, as C & S acknowledges and Orix Financial and Stierwalt hold, that makes the Trustee a transferee under § 9322. And that means the Trustee took the Neri Trust Account Funds from Neri's client trust account free and clear of any existing security interest. Therefore, for the foregoing reasons, the court will grant summary judgment for the Trustee on the Fourth Claim for Relief in the complaint and will deny summary judgment for C & S on the First Claim for Relief in the counterclaim.

Alternatively, it is true as C & S points out, a security interest attaches to identifiable proceeds of collateral. See Cal. Comm. Code § 9315(a)(2). It also is true that a security interest in proceeds is perfected if the security interest in the original collateral was perfected. See Cal. Comm. Code § 9315(c). However, a security interest in proceeds only remains perfected for twenty days and becomes unperfected

on the twenty-first day unless one of three conditions is satisfied. See Cal. Comm. Code § 9315(d).

The first condition applies to maintain perfection if (i) a filed financing statement covers the original collateral, (ii) the proceeds are collateral that could be perfected by filing a financing statement, and (iii) the proceeds are not acquired with cash proceeds. See Cal. Comm. Code § 9315(d)(1)(A)–(C). Here, the proceeds are either cash or a deposit account. A security interest in either is not perfected by a financing statement. The former requires possession for perfection, see Cal. Comm. Code §§ 9312(b)(3) & 9313(a), and, as explained above, the latter requires control for perfection. There is no evidence that C & S took possession of any inventory cash proceeds (the testimony is that they were deposited into bank accounts) and, as noted above, there is no evidence that C & S had control over any deposit account. Thus, while a security interest in the original collateral, *i.e.*, inventory, could be perfected by a financing statement, a security interest in proceeds of that collateral, *i.e.*, cash or a deposit account, could not. Consequently, the first condition is not satisfied.

The second condition is also not satisfied. The second condition allows perfection to be maintained in "identifiable proceeds." See Cal. Comm. Code § 9315(a)(2). However, once cash proceeds are deposited into an account and commingled with other money the identifiability of a secured creditor's proceeds is destroyed unless the secured creditor can prove that the money in the account corresponds to its collateral. Arkison v. Frontier Asset Mgmt., LLC (In re Skagit Pacific Corp.), 316 B.R. 330, 338 (9th Cir. BAP 2004). That is done by tracing proceeds in the commingled account to the collateral. See Cal. Comm. Code § 9315(b)(2). The burden of tracing rests with the secured creditor claiming a security interest in the proceeds. Id. (citing Stoumbos v. Kilimnik, 988 F.2d 949, 957 (9th Cir. 1993)); Chrysler Credit Corp. v. Superior Court, 17 Cal. App. 4th 1303, 1311 (Cal. App. 1993). The secured creditor meets that burden by submitting detailed testimony or documentary evidence that establishes a transactional link between the proceeds and the collateral. Arkinson, 316 B.R. at 338 (citing Stoumbos, 988 F.2d at 958); see also In re Sunrise R.V., Inc., 107 B.R. 277, 282 (Bankr. E.D. Cal. 1989).

***10** The burden here is on C & S, as the secured creditor claiming a security interest in the funds transferred from Neri's client to the Trustee, to establish those funds are proceeds of its inventory collateral. Evidence of tracing, if it can be considered that, is limited to conclusory and speculative deposition testimony that inventory proceeds went into Neri's client trust account in late 2010 and a spreadsheet that reflects "approximately five deposits" over a three-month period between October and December 2010. Even if that sufficed to establish what went into Neri's client trust account, it does not establish a link between the funds that Neri transferred from his client trust account to the Trustee back to C & S's original inventory collateral. In other words, it is not *detailed* evidence of tracing.

For example, there is no evidence that once in Neri's client trust account inventory proceeds were and remained segregated. In fact, the same deposition testimony on which C & S relies to establish that inventory proceeds went into Neri's client trust account also reflects that once in that account the inventory proceeds were commingled with at least $100,000.00 in other funds that did not belong to DRP and some other unidentified operational funds. Moreover, because $100,000.00 in the account did not belong to DRP and belonged to someone named "Peterson," sometime after inventory proceeds were deposited in Neri's client trust account and thereafter commingled with other funds in that account Neri transferred $100,000.00 to a separate "Peterson" account. But what $100,000.00 did Neri transfer? C & S does not answer that question with any admissible evidence. And what of the other operational funds in the account—what where they and where did they come from? Again, C & S does not answer those questions with admissible evidence.

The problem for C & S is that there is no detailed evidence in the form of deposition testimony or documentation that traces the $384,000.00 that was transferred to the Trustee in 2011 back through Neri's client trust account to funds apparently transferred from DRP's bank account and finally back to proceeds of original inventory collateral. Thus, even if all the deposits that went into Neri's client trust account in late 2010 were inventory proceeds going in, C & S has failed to establish they remained identifiable in the account and when thereafter transferred out of the account. Consequently, the second condition is also inapplicable.

The third condition is the simplest. If the proper steps for perfecting a security interest in the type of collateral that constitutes proceeds are taken before the twenty-first day after the security interest attaches to the proceeds, perfection is maintained. See Cal. Comm. Code. § 9315(d)(3). Again, there is no evidence that C & S ever took possession of any inventory proceeds within twenty days of any inventory sales

and, as explained above, there is no evidence it had control over any deposit account. Accordingly, this third condition is likewise inapplicable.

In sum, and alternatively, even if the Neri Trust Account Funds were proceeds of DRP's inventory collateral when they went into Neri's client trust account in late 2010, there is no evidence that C & S retained a perfected security interest in those proceeds in 2011 when they were transferred out of the trust account to the Trustee. That would mean when the funds were transferred from Neri's client trust account to the Trustee in 2011, at best, C & S would have had an unperfected security-interest in the inventory proceeds. That would also mean that, as a hypothetical judgment creditor and lienholder under § 544(a), the Trustee's interest in the Neri Trust Account Funds would be superior to C & S's unperfected security interest in the same funds. Therefore, on this alternative basis, the court would grant summary judgment for the Trustee on the Fourth Claim for Relief in the complaint and deny summary judgment for C & S on the First Claim for Relief in the counterclaim.

C. The Asset Lease Funds are not Encumbered by C & S's Security Interest.

***11** The Asset Lease is chattel paper. NetBank, FSB v. Kipperman (In re Commercial Money Center, Inc.), 350 B.R. 465, 469 (9th Cir. BAP 2006) ("Commercial Money I"). The security agreement between C & S and DRP grants C & S a security interest in chattel paper. C & S perfected its interest in chattel paper with a properly filed financing statement. See Cal. Comm. Code § 9312(a). But here, at least with respect to payments under the Asset Lease collected directly by the Trustee, we're not dealing with chattel paper.

In Commercial Money I, the bankruptcy appellate panel held that there is a critical distinction between a lease and a payment stream under a lease when the payment stream is stripped from the lease and paid to a third-party. When the payment stream is stripped from the lease and paid to a third party, the bankruptcy appellate panel held that the payment stream is no longer chattel paper but, instead, becomes a newly-created, and a wholly separate and distinct, payment intangible which is a subset of general intangibles. Id. at 469, 476, 478; Federal Deposit Ins. Corp. v. Kipperman (In re Commercial Money Center, Inc.), 392 B.R. 814, 824 (9th Cir. BAP 2008) ("Commercial Money II"). This critical distinction is explained in context below.

"Th[e] estate and the Chapter 7 trustee appointed to administer the estate are separate and distinct entities from the pre-petition debtor." In re Central Louisiana Grain Co–Op, Inc., 467 B.R. 390, 396 (Bankr. W.D. La. 2012). That legal distinction is crucial because it means that when DRP filed its bankruptcy petition a new legal entity in the form of the estate was created by operation of federal law. That also means when the Trustee thereafter collected the lease payments under the Asset Lease directly from 2040 FF and on behalf of the estate the payment stream under the Asset Lease was paid to a separate legal entity and thereby stripped from the original payee under the lease agreement. That did two things.

First, stripping the lease payments from the Asset Lease and paying them directly to the estate as a third party made the payment stream a new and distinct postpetition intangible that did not exist prepetition when the payment stream remained with the Asset Lease, i.e., was paid to DRP. Second, as a newly-created postpetition payment intangible that did not exist prepetition, the Asset Lease payment stream was not (and could not have been) encumbered by C & S's prepetition security interest. See 11 U.S.C. § 552(a). Nor could it have been proceeds, products, offspring or profits of prepetition collateral. See 11 U.S.C. § 552(b)(1). In fact, perfecting an interest in the postpetition payment stream as a payment intangible would have required C & S to file a financing statement that covered it, see In re Commercial Money Center, Inc., 2007 WL 7144803, *3–4 (Bankr. S.D. Cal. 2007) (on remand from Commercial Money I, 350 B.R. 465), aff'd, Commercial Money II, 392 B.R. 814, which C & S did not do.

In sum, the $153,410.08 in postpetition Asset Lease payments collected directly by the Trustee are not C & S's collateral or proceeds of its collateral, which means those payments are not subject to C & S's security interest. Therefore, the court will grant summary judgment for the Trustee on the Third Claim for Relief in the complaint and will deny summary judgment for C & S on the Second Claim for Relief in the counterclaim.

D. The Liquor License Funds are not Encumbered by C & S's Security Interest.

***12** California law prohibits the use of a liquor license as collateral for a loan. California Business & Professions Code § 24076 states that "[n]o licensee shall enter into any agreement wherein he pledges the transfer of his license as security for a loan or as security for the fulfillment of any

agreement[.]" See also In re Morev, 2015 WL 9264937, *4 (Bankr. S.D. Cal. 2015). And perhaps that is why C & S does not assert a security interest *directly* in the liquor licenses sold by the Trustee. Instead, C & S maintains that DRP's liquor licenses are general intangibles which makes the funds that the Trustee received from the sale of those liquor licenses proceeds of its collateral and thereby subject to its security interest. C & S relies primarily on two cases: Concorde Equity II, LLC v. Bretz, 2011 WL 5056295 (Cal. App. 2011), and Mola Dev. Corp. v. Orange County Assessment Appeals Bd., 80 Cal. App. 4th 309 (Cal. App. 2000). Neither are persuasive.

An analysis of this issue must begin with Sulmeyer v. California Dept. of Employment Dev. (In re Professional Bar Co.), 537 F.2d 339 (9th Cir. 1976) (per curium), in which the Ninth Circuit stated as follows: "The bankrupt estate, insofar as it includes liquor licenses, has only the limited value of the licenses encumbered as they may be by the terms of the statutes which create the licenses and provide the conditions of their transfer." Id. at 340. And on that basis, Concorde Equity is not helpful or persuasive. More important, it is not applicable.

Concorde Equity involved a priority dispute under California Business & Professions Code § 24074 over proceeds from the sale of a liquor license claimed by two judgment creditors. Concorde Equity, 2011 WL at *12011 WL at *1. The sale proceeds were insufficient to satisfy both creditors' claims against the judgment debtor/liquor license owner. Id. Therefore, in order to determine which creditor had priority to the proceeds from a receiver's sale of the liquor license *for purposes of distribution under California Business & Professions Code § 24074*, the court characterized the proceeds as a business asset of the judgment debtor, which made the judgment creditor with a pre-existing security interest in the judgment debtor's business assets a "secured creditor" for purposes of third priority distribution under § 24074. Id. at *3.

The problem with Concorde Equity is that both federal and California courts recognize that its analysis does not apply inside a bankruptcy case. Citing Gough v. Finale, 39 Cal. App. 3d 777, 783–84 (Cal. App. 1974), the Ninth Circuit in Professional Bar also stated as follows: "Although Cal. Bus. and Prof. Code § 24074 (West Supp. 1975) establishes a system of priorities among creditors in the transfer of a state liquor license, federal rather than California law must be applied in deciding priority when the net proceeds in issue have become available to the [bankruptcy] trustee." Id. at 340. In other words, Professional Bar's reliance on Gough is convincing evidence that Concorde Equity is a state law priority distribution case and, as such, its analysis is inapplicable in this federal bankruptcy case.

As to Mola, it is true that the court in that case made a passing reference to a liquor license as an intangible. Mola, however, is a taxation case. And just because a liquor license may be characterized as an intangible under state tax law, that does not necessarily mean it is an intangible under the Uniform Commercial Code for bankruptcy purposes.

In order for a liquor license or its proceeds to qualify as general intangible under Article 9 in the context of a bankruptcy case, and thereby subject to a security interest as such, the liquor license must first qualify as personal property under state law. See In re Circle 10 Restaurant, LLC, 519 B.R. 95, 128 (Bankr. D.N.J. 2014). This is because Article 9 defines a "general intangible" as "any personal property." Cal. Comm. Code § 9102(a)(42). Thus, in states where a liquor license is not property under state law, it also is not (and cannot be) a general intangible under the state's version of Article 9. See, e.g., Circle 10, 519 B.R. at 135–37; In re Chris–Don, Inc., 367 F. Supp. 696, 699 (D.N.J. 2005). On the other hand, in states where a liquor license is personal property under state law, a liquor license can be a general intangible subject to an Article 9 security interest. See, e.g., In re Ciprian Ltd., 473 B.R 669, 672 (Bankr. W.D. Pa. 2012). Therefore, the threshold question is whether DRP's liquor licenses are personal property under California law for purposes of applying the California Commercial Code in this bankruptcy case. This court is not persuaded that they are.

***13** The court is aware that there are some federal and state cases that characterize a California liquor license as "property." However, they do so in the context of a *federal* statute and for *federal* law purposes. See e.g., Golden v. State, 133 Cal. App. 2d 640, 643–45 (1955) (for purposes of federal tax lien under federal tax law); Dash, Inc. v. Alcoholic Beverage Control Appeals Bd., 683 F.2d 1229, 1233 (9th Cir. 1982) (for purposes of federal due process analysis). Characterization of a liquor license as property for *federal law* purposes in general, and particularly for federal tax and due process purposes, does not mean that a liquor

license is property under *state law* in general and for purposes of defining the scope of intangibles under a state's commercial code in particular, at least in the context of a bankruptcy case. Circle 10, 519 B.R. at 133. That is because the bankruptcy code is unlike the tax code or federal due process analysis because under Butner v. United States, 440 U.S. 48 (1979), what is "property" for the "federal purpose" of the bankruptcy code is defined by state law. [6] See Circle 10, 519 B.R. at 133.

In determining whether a California liquor license is personal property under California state law for purposes of the commercial code, one could argue that California law draws a distinction between rights as between the licensee and the state and rights as between the licensee and a third party. That distinction seems to find some support in Roehm v. County of Orange, 32 Cal. 2d 280 (1948), in which the California Supreme Court stated: "Although a liquor license is merely a privilege so far as the relations between the licensee and the state are concerned, it is property in any relationship between the licensee and third persons, because the license has value and may be sold." Id. at 283. But after noting that distinction, which actually appears to be the court's recitation of a party's argument, the California Supreme Court ultimately rejected it. Instead, the supreme court framed the question before it as follows: "The controlling question is whether under present constitutional and statutory provisions such [liquor] licenses can now be regarded as personal property for the purposes of taxation." Roehm, 32 Cal. 2d at 284. It answered that question in the negative concluding that a liquor license is not taxable personal property under state law. Id. at 290 ("Although liquor licenses are not taxable as property...."). Thus, Roehm holds that a liquor license, albeit an intangible for state taxation purposes, is not taxable (or taxed as) personal property under state constitutional and statutory provisions. See American Sheds, Inc. v. County of Los Angeles, 66 Cal. App. 4th 384, 392 (Cal. App. 1988).

The California legislature and numerous California cases also describe a liquor license not as a "right" but as a "privilege" conferred by state law. See California Business & Professions Code § 24079 (describing alcoholic beverage license as a "privilege"); Hevren v. Reed, 126 Cal. 219, 222 (Cal. 1899) (liquor license is neither property nor a contract, in any constitutional sense); Yu v. Alcoholic Bev. Etc. Appeals Bd., 3 Cal. App. 4th 286, 297 (Cal. App. 1992) ("While a license to practice a trade is generally considered a vested property right, a license to sell liquor is a *privilege* that can be granted or withheld by the state."); Cornell v. Reilly, 127 Cal. App. 2d 178, 184 (Cal. App. 1954) (proceeding to revoke liquor license is not for the primary purpose of punishment but "to protect the public, that is, to determine whether a licensee has exercised his *privilege* in derogation of the public interest, and to keep the regulated business clean and wholesome"); Saso v. Furtado, 104 Cal. App. 2d 759, 763–64 (Cal. App. 1951) (explaining that a liquor license is a privilege rather than a state law, contract, or constitutional right).

***14** The court also finds unpersuasive the argument that a liquor license has value apart from the license which transforms the license into personal property and thence into a general intangible under the California Commercial Code. The court in Circle 10 addressed that issue under New Jersey law, which characterizes a liquor license as a privilege and not personal property under state law but also recognizes that a liquor license and its transferability have value to the licensee. The Circle 10 court resolved that conflict by reasoning that any value to the licensee is created and exists solely as a result of the issuance of the license by the state and therefore cannot be bifurcated from the license itself. Circle 10, 519 B.R. at 131–32. Thus, the Circle 10 court ultimately concluded that any value to the licensee did not make the liquor license personal property and that, in turn, meant that proceeds from the sale of the license could not be subject to a security interest as a general intangible. Id. at 132. That analysis is persuasive. Like New Jersey, the value that a California liquor license has to a licensee is created by and exists only as a result of the issuance of the license by the state. That makes the value inseparable from the license.

In sum, a California liquor license is not personal property under state law for purposes of defining it as a general intangible under the California Commercial Code in a bankruptcy case. That means the Liquor License Funds in the approximate amount of $37,661.60 are not (and cannot be) collateral subject to C & S's security interest. Put another way, DRP's liquor licenses are not general intangibles under the California Commercial Code because in the context of this bankruptcy case they are not personal property under state law. Therefore, the court will grant summary judgment for the Trustee on the Second Claim for Relief in the complaint and will deny summary judgment for C & S on the Third Claim for Relief in the counterclaim.

II. The Trustee's § 542(a) Turnover Claim

C & S maintains the stipulation does not state when it has to pay the Trustee. That may be the case. But the Bankruptcy Code does insofar as property of the estate is concerned.

An entity, other than a custodian, in possession, custody, or control, during the case, of property of the estate *shall* deliver to the trustee, and account for, the property or the value of the property unless the property is of inconsequential value. 11 U.S.C. § 542(a). Section 542(a) "creates an affirmative obligation on the part of the party holding estate property to turn the property over[.]" In re Rutheford, 329 B.R. 886, 892 (Bankr. N.D. Ga. 2005). Moreover, "[t]his affirmative obligation is self-executing and does not require the holding of a hearing or the entry of an order by the bankruptcy court." In re Prince, 2012 WL 1095506, *9 (Bankr. E.D. Tex. 2012) (citing Knaus v. Concordia Lumber Co. (In re Knaus), 889 F.2d 773, 775 (8th Cir. 1989); Boyer v. Carlton, Fields, Ward, Emmanuel, Smith & Cutler, P.A. (Matter of USA Diversified Products, Inc.), 100 F.3d 53, 56 (7th Cir. 1996)).

The court concludes that $429,505.00 is not of inconsequential value. And inasmuch as the court has determined that the May 2013 stipulation and the payment that the Trustee is entitled to receive under that agreement are property of the estate, as a matter of law C & S now has an affirmative obligation to turn over $429,505.00 to the Trustee. And while C & S may think the timing of that turnover obligation is in dispute because the stipulation is silent on that point, that is a non-issue. The Ninth Circuit has long-recognized that "[i]t is well settled that existing laws are read into contracts in order to fix the rights and obligations of the parties." Rehart v. Clark, 448 F.2d 170, 173 (9th Cir. 1971). In other words, the Bankruptcy Code fills in any gap or any silence in the stipulation with regard to the timing of C & S's payment obligation which, as noted, is an affirmative obligation on the part of C & S to turn over to the Trustee the Settlement Funds as property of the estate. Therefore, for the foregoing reasons, the court will grant summary judgment for the Trustee on the § 542(a) turnover claim in the Fifth Claim for Relief of the complaint. C & S is ORDERED to turn over $429,505.00, or such portion of the Settlement Funds currently in its possession, to the Trustee within ten days of the entry of judgment.

CONCLUSION

***15** For all the foregoing reasons, the Trustee's motion for summary judgment will be granted and judgment will be entered for the Trustee and against C & S on the First, Second, Third, Fourth, and Fifth Claims for Relief in the complaint. C & S's motion for summary judgment will be denied and C & S will take nothing on the First, Second, Third, and Fourth Claims for Relief in the counterclaim.

All Citations

Slip Copy, 2017 WL 3500391, 93 UCC Rep.Serv.2d 472

Footnotes

1 The requests for judicial notice at dkts. 44, 53, & 60 are granted.

2 Except for plaintiff's objection 1.a. [dkt. 59] which is sustained inasmuch as it is not necessary for the court to reach the "equities of the case issue," all other objections at dkts. 51 and 59 are overruled.

3 The court exercises its discretion to treat the statement as an admission. See American Title Ins. Co. v. Lacelaw Corp., 861 F.2d 224, 227 (9th Cir. 1988). The statement was not inadvertent. It was made in the context of a request by C & S for affirmative relief. The court pointed out the statement to C & S's attorney when the parties' summary judgment motions were heard on June 9, 2016, and since that time C & S has not amended, retracted, or assigned any error to the statement. See Sicor Ltd. v. Cetus Corp., 51 F.3d 848, 859–860 (9th Cir.), cert. denied, 116 S.Ct. 170 (1995) (stating that where "the party making an ostensible judicial admission explains the error in a subsequent pleading or by amendment, the trial court must accord the explanation due weight"); see also Westgate Communications, LLC v. Chelen County, Fed. Appx. 708 (9th Cir. 2013) (district court properly declined to treat statement in memorandum as admission where statement was read out of context, inadvertent, party making statement timely confessed error, and statement retracted).

4 Woodson v. Fireman's Fund Ins. Co. (In re Woodson), 839 F.2d 610 (9th Cir. 1988); Martin v. Kane (In re A&C Properties), 784 F.2d 1377 (9th Cir. 1986).

5 The significance of this conclusion is discussed in Section II, infra. This conclusion also raises interesting questions not presently before the court, but which perhaps could be: By withholding payment from the estate does the Trustee, on behalf of the estate, now have a claim against C & S for violation of 11 U.S.C. § 362(a)(3) which prohibits an "act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate[?]" And if C & S violated § 362(a)(3) is it now liable to the estate for actual, and potentially punitive, damages under 11 U.S.C. § 362(k)?

6 This should not be confused as to what is "property of the estate" for the *federal* bankruptcy purpose. A California liquor license is property of the estate under 11 U.S.C. § 541(a) for the federal purpose of bankruptcy. In re Quaker Room, 90 F. Supp. 758, 760–61 (S.D. Cal. 1950).

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UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

In re: KARYKEION, INC., a California Corporation Debtor and Debtor in Possession,	Case No.: 1:08-bk-17254-MT Adversary No.: 1:10-ap-01444-MT Chapter: 11
BUSINESS LOAN CONDUIT NO. 2, LLC, a Delaware limited liability company, as assignee of COMMUNITY REINVESTMENT FUND, INC., a Minnesota corporation, as assignee of CDC DIRECT CAPITAL, a California corporation. Plaintiff, Vs. KARYKEION, INC., a California Corporation Defendant(s).	**MEMORANDUM OF DECISION RE DEFENDANT'S MOTION TO DISMISS ADVERSARY PROCEEDING**

I. INTRODUCTION

Business Loan Conduit No. 2, LLC ("BLC2") filed its complaint for declaratory relief deeming certain supplemental Medi-Cal reimbursements the debtor anticipates receiving ("AB 1383 funds") to be collateral for BLC2's pre-petition loans to the debtor. Karykeion, Inc. ("Karykeion"), the debtor/defendant, contends that BLC2's pre-petition lien is cut off as to the AB 1383 funds by virtue of 11 U.S.C. §552(a).[1] Karykeion has filed a motion to dismiss the complaint for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6) ("12(b)(6) motion"). For the reasons set forth below, the motion to dismiss will be granted.

II. FACTUAL BACKGROUND

BLC2's complaint alleges the following. In 2007, CDC Direct Capital ("CDC") made two loans to Karykeion in the amount of $1,975,000 (the "302401 Loan") and $515,000 (the "302402 Loan"), respectively. Each of the two loans was secured by a deed of trust. Additionally, as to each loan, Karykeion granted CDC a security interest in

> [a]ll inventory, Chattel Paper, Accounts, Equipment and General Intangibles, whether any of the foregoing is owned now or acquired later, all accessions, additions, replacements, and substitutions relating to any of the foregoing: all records of any kind relating to any of the foregoing; all proceeds relating to any of the foregoing (including insurance, general intangibles and other accounts proceeds).

Complaint, Exhibits A & B.

CDC perfected its security interest in the loans by filing UCC-1 Financing Statements. Through a series of assignments, BLC2 became CDC's successor in interest and holds the 302401 and 302402 Loans, including the Notes, UCC-1 Financing Statements, the Assignments of Rents, and the Deeds of Trust. Both loans are in default.

On September 22, 2008, Karykeion filed its chapter 11 bankruptcy petition. On October 12, 2009, Assembly Bill 1383[2] ("AB 1383") was enacted. AB 1383 assesses a Quality Assurance Fee ("QAF") on hospitals. The funds collected from the QAF are to be matched by federal Medicaid funds. The funds from the fee and the matching federal funds will be used to supplement reimbursements to hospitals that provided services to Medi-Cal patients in the 2007-2008 fiscal year. With regard to

[1] All section references are to the United States Bankruptcy Code (the "Code") except as otherwise noted.
[2] AB 1383 has been codified at CAL. WEL. & INST. CODE §14167.1 *et seq.*

Karykeion, the anticipated benefit from the AB 1383 funds is approximately $15,395,990.75. BLC2 asserts that these AB 1383 funds are "based upon services rendered during Fiscal Year 2007-2008," and therefore constitute accounts, the proceeds of accounts, or payments relating to the Fiscal Year 2007-2008 pre-petition accounts in which BLC2 maintains a perfected security interest. BLC2 seeks declaratory relief deeming the AB 1383 funds to be collateral subject to its pre-petition security interests.

III. JURISDICTION

This Court has jurisdiction over this case pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper in this Court pursuant to 28 U.S.C. §§ 1408 and 1409. This adversary proceeding is a core proceeding under 28 U.S.C. § 157(b)(2). This Court has exclusive jurisdiction to determine whether the AB 1383 funds constitute proceeds subject to BLC2's pre-petition lien or whether 11 U.S.C. §552(a) cuts off BLC2's security interest as to the AB 1383 funds.

IV. STANDARD

A 12(b)(6) motion challenges the sufficiency of the allegations set forth in the complaint. "A Rule 12(b)(6) dismissal may be based on either a 'lack of a cognizable legal theory' or 'the absence of sufficient facts alleged under a cognizable legal theory.'" Johnson v. Riverside Healthcare Sys., 534 F.3d 1116, 1121 (9th Cir. 2008) (*quoting* Balistreri v. Pacifica Police Dept., 901 F.2d 696, 699 (9th Cir. 1990)). In resolving a 12(b)(6) motion, the court must construe the complaint in the light most favorable to the plaintiff, and accept all well-pleaded factual allegations as true. Johnson, 534 F.3d at 1122; Knox v. Davis, 260 F.3d 1009, 1012 (9th Cir. 2001). On the other hand, the court is not bound by conclusory statements, statements of law, and unwarranted inferences cast as factual allegations. Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555-57 (2007); Clegg v. Cult Awareness Network, 18 F.3d 752, 754-55 (9th Cir. 1994).

"While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, a plaintiff's obligation to provide the 'grounds' of his 'entitlement to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do." Twombly, 550 U.S. at 555 (citations omitted). "In practice, a complaint . . . must contain either direct or inferential allegations respecting all the material elements necessary to sustain recovery under some

viable legal theory." Id. at 562 (*quoting* Car Carriers, Inc. v. Ford Motor Co., 745 F.2d 1101, 1106 (7th Cir. 1984)).

In Ashcroft v. Iqbal, 129 S.Ct. 1937, 1949 (2009), the Supreme Court elaborated on the Twombly standard: "To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face . . . . 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 . . . . Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." Id. (citations and internal quotation marks omitted). Further, the allegations of the complaint, along with other materials properly before the court on a motion to dismiss, can establish an absolute bar to recovery. *See* Weisbuch v. County of Los Angeles, 119 F.3d 778, 783 n. 1 (9th Cir. 1997) ("If the pleadings establish facts compelling a decision one way, that is as good as if depositions and other expensively obtained evidence on summary judgment establishes the identical facts."). While the court generally must not consider materials outside the complaint, the court may consider exhibits submitted with the complaint. Durning v. First Boston Corp., 815 F.2d 1265, 1267 (9th Cir. 1987).

In addition, facts properly subject to judicial notice may be used to establish that the complaint does not state a claim for relief. Intri-Plex Techs., Inc., 499 F.3d 1048, 1052 (9th Cir. 2007); Estate of Blue v. County of Los Angeles, 120 F.3d 982, 984 (9th Cir.1997); Mullis v. Bankruptcy Ct., 828 F.2d 1385, 1388 (9th Cir. 1987). In this regard, a court can properly take judicial notice of court papers filed in related litigation. Estate of Blue, 120 F.3d at 984. Further, court documents filed in an underlying bankruptcy case are subject to judicial notice in related adversary proceedings and district court lawsuits. O'Rourke v. Seaboard Sur. Co. (In re E.R. Fegert, Inc.), 887 F.2d 955, 957-58 (9th Cir. 1989); Mullis, 828 F.2d at 1388.

A complaint seeking declaratory relief must allege facts showing the existence of an actual controversy over which the court otherwise has subject matter jurisdiction. 28 U.S.C. §2201.

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V. ANALYSIS

Section 541(a) provides that property of the bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case," as well as the "[p]roceeds, product, offspring, rents, or profits" from such legal or equitable interests in property, and "[a]ny interest in property that the estate acquires after the commencement of the case." 11 U.S.C. §541(a)(1), (6) & (7). Section 552(a) dictates that property acquired post-petition by the bankruptcy estate or by the debtor is not subject to any pre-petition security interest. 11 U.S.C. §552(a). This exclusion of property acquired post-petition from pre-petition security interests is subject to an important exception. If a pre-petition security interest "extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case . . . ." 11 U.S.C. §552(b)(1).

Against this statutory framework, the ultimate question before the Court is whether the AB 1383 funds constitute proceeds within the meaning of section 552(b)(1). If so, then the language contained in the UCC Financing Statements securing the 302401 Loan and the 302402 Loan may fall within the exception created by section 552(b)(1), thereby extending BLC2's security interest to the AB 1383 funds. Karykeion asserts that BLC2's pre-petition lien does not extend to the AB 1383 funds because Karyekion's right to those funds did not arise until 2009, well after the petition date in this case.

This court looks to state law to define "proceeds" under section 552(b). Fin. Sec. Assurance, Inc. v. Days California Riverside Ltd. P'ship (In re Days California Riverside Ltd. P'ship), 27 F.3d 374, 376 (9th Cir. 1994). The Uniform Commercial Code ("UCC") defines "proceeds" very broadly. Under the UCC, the term "proceeds", with an exception not relevant here, is defined as:

> (A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
> (B) whatever is collected on, or distributed on account of, collateral;
> (C) rights arising out of collateral . . . .

UCC §9-102(64)(A)-(C) (2011). The definition is identical under California law. *See* CAL. COMM. CODE §9102 (2011)).

As discussed below, the courts that have confronted the issue of whether the estate has a legal or equitable interest in funds received by the debtor from government "assistance" programs enacted post-petition generally agree that the answer is in the negative. Section 552(b) "balances the Code's interest in freeing the debtor of pre-petition obligations with a secured creditor's rights to maintain a bargained-for interest in certain items of collateral." In re Bering Trader Inc., 944 F.2d 500, 502 (9th Cir. 1991). It is a "*narrow* exception to the general rule of 552(a)." Id. (*citing* In re Transportation Design, 48 B.R. 635, 641 (Bankr. C.D. Cal. 1985); In re Lawrence, 41 B.R. 36, 37-38 (Bankr. D.Minn. 1984), *aff'd*, 56 B.R. 727 (D. Minn. 1984)) (emphasis in original).

While no court has addressed the post-petition influx of AB 1383 stabilization funds, there are a number of cases addressing analogous situations. In In re Schmitz, the Ninth Circuit addressed the issue of whether the trustee could recover the proceeds from the debtor's sale of fishing quota rights to which the debtor became entitled as a result of government regulations enacted post-petition, and which were calculated with reference to the debtor's pre-petition catch-history. Sliney v. Battley (In re Schmitz), 270 F.3d 1254 (9th Cir. 2001). In Schmitz, the debtor filed his chapter 7 case in April 1992 and did not list any potential fishing rights or similar "asset" on his schedules. Id. at 1255. Roughly 19 months after the petition date, the Secretary of Commerce issued final regulations implementing a fish management plan. Id. The regulations did not become effective until January 1, 1994. Id. The fish management plan permitted qualified fishermen to apply for and be awarded "Quota Share" and "Individual Fishing Quotas," an annual catch limit on a going-forward basis. Id. at 1256. The quotas were based on the total weight of the fisherman's catch history for 1988 through 1990. The debtor applied for and was awarded quotas, the rights to which he eventually sold. Id. The trustee sought to have the quotas deemed property of the estate and require turnover of the sale proceeds. Id.

The Schmitz court held that the quotas did not constitute property of the estate because they were not proceeds of pre-petition assets. In so holding, the court reasoned that at the time the case was filed the debtor's 1988-1990 catch history was valueless, and any possibility that it might be relevant if a fishing quota program were ever adopted was so "nebulous" that it could not constitute property. Id. at 1257. Therefore, the court held that the trustee could not force turnover of the proceeds from the sale of the quota rights because they were created under the government program *after* the case commenced,

even though they were defined by the debtor's pre-petition catch history. Id. at 1258-59.

In reaching its decision, the Schmitz court was guided by In re Vote, a decision by the Bankruptcy Appellate Panel for the Eighth Circuit just four months earlier. 261 B.R. 439 (B.A.P. 8th Cir. 2001). As in Schmitz, the issue in Vote was whether the chapter 7 trustee was entitled to turnover of certain post-petition payments received by the debtor pursuant to government programs enacted post-petition. Id. at 440. Instead of fishing quotas, however, Vote dealt with proceeds received under two federal agricultural assistance and crop disaster programs. Id. After the debtor filed his chapter 7 bankruptcy, Congress enacted legislation that provided compensation to farmers meeting certain requirements, including the debtor, for crop losses occurring in pre-petition years. Id. In holding that the payments were not property of the estate, the court reasoned that because the "federal legislation that authorized and funded those payments *had not yet been enacted*," the right to receive payments did not exist at the time the case was filed, and therefore the debtor had no cognizable legal right to those payments at the time of filing. Id. at 441 (emphasis added). Therefore, the right to those payments inured to the debtor and not the estate. Id. at 442.

In a similar case, the bankruptcy court for the district of Idaho addressed whether a secured creditor's security interest was enforceable against government payments received by the debtors pursuant to a federal program enacted post-petition. In re Stallings, 290 B.R. 777 (Bankr. D. Idaho 2003). In Stallings, after the debtors filed their bankruptcy, Congress appropriated funds for reimbursement for crop damage resulting from the use of certain herbicides in Idaho. Id. at 780. The debtors applied to share in the funds, and received $326,000 from the government. Id. at 781.

After discussing Schmitz and Vote at length, the Stallings court concluded that the creditor's security interest did not extend to the payments received by the debtors pursuant to the federal program. This was so despite the fact that the creditor's pre-petition security agreement covered the debtor's crops, general intangibles and payments under various government programs. Id. at 782. In making this determination, the court noted that section 552(a) makes any pre-petition security interest unenforceable as to property acquired by the estate or the debtor after the commencement of the case. Id. The court rejected the creditor's argument that it could enforce its security interest as to the payments because the payments constituted "proceeds" of the debtor's pre-petition crops, and were therefore excepted from

section 552(a) by the provision of section 552(b)(1). Id. at 782-83. Under the court's analysis, section 552(b)(1) only creates an exception for proceeds, product, *et cetera*, generated by pre-petition collateral, and the government payment was not something the debtors acquired or became entitled to acquire in exchange for the sale or disposition of their pre-petition crops. Id. at 783. As the debtors had no legal or equitable right to the government payment at the time they filed bankruptcy, the payment could not constitute "proceeds" of the debtors' pre-petition crops. Id.

Likewise, the Eleventh Circuit in In re Bracewell, 454 F.3d 1234, 1239 (11th Cir. 2006), rejected the same overly broad reading of "proceeds" that BLC2 advances. In Bracewell, the court determined that a crop disaster payment made post-petition as the result of post-petition legislation did not constitute proceeds of the pre-petition crop that was lost. Id. The court rejected the dissent's analogy to the UCC definition of proceeds, stating that if the "legislation is not law at the time of filing, the debtor at that time has no legal or equitable interest in the payment and so there is no property of the estate to generate proceeds."

At its core, BLC2's proceeds argument is no different from the arguments made in Schmitz, Stallings, Vote, or Bracewell. The complaint does not allege, nor could it, that Karykeion had any right to the payments it stands to receive under the provisions of AB 1383 prior to filing its bankruptcy. Karykeion filed its bankruptcy on September 22, 2008. Over a year later, AB 1383 was enacted. Because the right to the AB 1383 funds did not arise until after the bankruptcy was filed, Karykeion had no legal or equitable interest in the funds pre-petition, and therefore the payments can neither constitute "proceeds" under section 541(a)(6) nor fall within the exception in section 552(b)(1). BLC2 alleges no facts that make the supplemental funds property of the estate pre-petition.

Even if the term "proceeds" is read in the broadest way to cover any property into which property subject to the security interest is converted, there is no allegation in the complaint that the pre-petition property somehow converted to these post-petition funds. The closest the complaint comes is the repeated allegation that the supplemental reimbursements are "based on services rendered during Fiscal Year 2007-2008." The complaint is silent as to how exactly the fact that there were services rendered in 2007-2008 translates into generating these stabilization funds.

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There is no dispute that the statutory language of AB 1383 provides that the amount of funds Karykeion is ultimately entitled to may be "based upon services rendered during Fiscal Year 2007-2008." BLC2's allegation, however, that the funds are "proceeds" of BLC2's pre-petition collateral is insufficient without an allegation of a greater nexus either factually or legally. A date computation reference for the amount of funds to which Karykeion is entitled is a different question than the source or origination of the funds. As in Stallings, "it is too much of an interpretive stretch" to view the AB 1383 funds as falling within the definition of "proceeds." 290 B.R. at 783. Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice in a complaint. Iqbal, 129 S. Ct. at 1949. As Bering reminds us, the proceeds and other excepted types of property "enumerated in section 552(b) is derivative . . . . [t]hat is, it necessarily derives from the sale, exchange, or other dispensation of other encumbered property." 944 F.2d at 502. BLC2's threadbare allegation of the legal elements of a claim to proceeds does not, and cannot, allege at all how its pre-petition accounts can turn into this unexpected gift post-petition. In re Skagit Pacific Corp, 316 B.R. 330, 338 (B.A.P. 9th Cir. 2004) (proceeds must be identifiable and traceable).

In any event, as alleged in the complaint and as a matter of law, Karykeion's right to receive the AB 1383 funds is further contingent on its performance of several post-petition acts. In order to be entitled to receive any of the AB 1383 funds, Karykeion is required to make several QAF payments. If Karykeion fails to make the QAF payments, the law makes it clear that it will have no right to receive the AB 1383 funds. "It must be emphasized that subsection (b)(1) creates an exception for proceeds, products, offspring or profits *generated* by pre-petition collateral, and not for "after-acquired" property obtained by debtor or the estate post-petition." 16 COLLIER ON BANKRUPTCY ¶552.02[1]. Given what the debtor must do post-petition to obtain the AB 1383 funds, as a matter of law, the supplemental funds are not subject to BLC2's pre-petition security interests.

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VI. CONCLUSION

Karykeion's motion to dismiss is granted. No leave to amend will be granted as these issues have been discussed extensively for the last year in the bankruptcy case and at a lengthy oral argument in this adversary proceeding, and BLC2 has proffered no facts or law that might change the above analysis. The bankruptcy case is now going into its third year and needs to be concluded. Karykeion should submit an order in accordance with this ruling.

DATED: January 21, 2011

United States Bankruptcy Judge

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Notice is given by the court that a judgment or order entitled (*specify*) **MEMORANDUM OF DECISION RE DEFENDANT'S MOTION TO DISMISS ADVERSARY PROCEEDING** was entered on the date indicated as "Entered" on the first page of this judgment or order and will be served in the manner indicated below:

I. SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING ("NEF") – Pursuant to controlling General Order(s) and Local Bankruptcy Rule(s), the foregoing document was served on the following person(s) by the court via NEF and hyperlink to the judgment or order. As of January 21, 2011, the following person(s) are currently on the Electronic Mail Notice List for this bankruptcy case or adversary proceeding to receive NEF transmission at the email address(es) indicated below.

- Steven G Polard spolard@perkinscoie.com
- Nathan M Smith nsmith@perkinscoie.com
- United States Trustee (SV) ustpregion16.wh.ecf@usdoj.gov
- Michael H Weiss mw@weissandspees.com, lm@weissandspees.com;jb@weissandspees.com

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2012 WL 603805
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NOT FOR PUBLICATION
United States Bankruptcy Appellate Panel,
of the Ninth Circuit.

In re Peter David KEMPF, Debtor.
Peter David Kempf, Appellant,
v.
Hitachi Capital America Corp., Appellee.

Bankruptcy No. 8:09–bk–16783–TA.
|
Adversary No. 8:09–AP–01661–TA.
|
BAP No. CC–11–1317–CaPaMk.
|
Argued and Submitted Jan. 19, 2012.
|
Filed Feb. 14, 2012.

Appeal from the United States Bankruptcy Court for the Central District of California, Honorable Theodor C. Albert, Bankruptcy Judge, Presiding.

Attorneys and Law Firms

Allan Leguay of the Law Offices of Allan Leguay, argued on behalf of Appellant Peter David Kempf.

Frank T. Pepler of DLA Piper (US), LLP, argued on behalf of Appellee Hitachi Capital America Corporation.

Before CASE[2], PAPPAS, and MARKELL, Bankruptcy Judges.

[2] Hon. Charles G. Case II, United States Bankruptcy Judge for the District of Arizona, sitting by designation.

MEMORANDUM[1]

[1] This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have *(see* Fed. R.App. P. 32.1), it has no precedential value. *See* 9th Cir. BAP Rule 8013–1.

***1** In this appeal, Debtor/Appellant Peter David Kempf ("Kempf") argues that: (1) the bankruptcy court erred in deciding that Creditor/Appellee Hitachi Capital America Corporation's ("Hitachi") amended complaint (the "First Amended Complaint"), on which trial was held, related back to its initial complaint that initiated the action (the "Original Complaint"); (2) this Panel should review the bankruptcy court's factual findings de novo; and (3) the bankruptcy court erred in concluding that Hitachi reasonably relied on Kempf's fraudulent financial statement in extending credit to Kempf's business, CardioCura Capital West, LLC ("CardioCura"), thereby excepting Hitachi's claim based on Kempf's guaranty from discharge under section 523(a)(2)(B) of the Bankruptcy Code[3]. For the reasons below, we AFFIRM.

[3] Unless specified otherwise, all "Chapter" and "Section" references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532, all "Rule" references are to the Federal Rules of Bankruptcy Procedure, Rules 1001–9037, all "Civil Rule" references are to the Federal Rules of Civil Procedure, 1–86, and all "Evidence Rule" references are to the Federal Rules of Evidence, Rules 101–1103.

I. Facts

Kempf was the principal and owner of CardioCura, a start-up mobile CT business, and Hitachi is an equipment lessor. In January 2006, CardioCura, through Kempf, signed a $1,400,000 lease financing proposal for a mobile Phillips CT device that included a proposed limited personal guaranty from Kempf (the "Guaranty").

In February 2006, Hitachi prepared a transaction analysis that analyzed CardioCura's: (1) feasibility; (2) working capital, including Kempf's $300,000 contribution; (3) projected gross and net revenue; (4) risks; and (5) credit enhancements, including Kempf's $600,000 Guaranty (later increased to $736,538). Kempf also provided Hitachi with his and his wife's: (1) 2003 and 2004 joint tax returns; and (2) a joint personal financial statement (the "Financial Statement"), that indicated the Kempfs' net worth to be $4,207,084, including a $2,699,188 investment known as the Angel Trust (the "Trust"). While the tax returns suggest that Kempf's wife is the sole beneficiary of the Trust, no such reference is made on the Financial Statement. It was undisputed at trial that Kempf had no right of access to the assets of, or income from, the

Trust.

Hitachi lent CardioCura $1,440,000 on March 16, 2006 (the "Loan"), and CardioCura executed a master equipment lease (the "Lease") on March 22, 2006. The Lease went into default in August 2007, and Hitachi obtained a California state court judgment against CardioCura for $1,410,635.37 and Kempf for $736,538.

Kempf filed his Chapter 7 petition on July 7, 2009; his schedules made no reference to the Trust. Hitachi timely filed an adversary proceeding to determine the state court judgment's dischargeability.

In its Original Complaint, Hitachi relied on section 523(a)(2)(A), claiming that Kempf obtained the Loan through fraud. Hitachi's First Amended Complaint, filed December 31, 2009, included a second claim for relief based on section 523(a)(2)(B), claiming that Kempf obtained the Loan through use of a false financial statement. Hitachi argued that Kempf knowingly misrepresented his net worth because he knew that he held no interest in the Trust, which constituted a major percentage of his purported net worth. Kempf filed a motion to dismiss the First Amended Complaint arguing that it did not relate back to the Original Complaint under Civil Rule 15, incorporated in Rule 7015, and therefore was untimely. The bankruptcy court denied the motion.

***2** At trial, the bankruptcy court found that Kempf knew that neither Kempf nor the community had an interest in the Trust and that including it in the Financial Statement was a false representation that he and the community did have such an interest. The bankruptcy court noted that Kempf was a sophisticated businessman and knew that it was highly unlikely that Hitachi would lend him capital for a start-up business if he did not include the Trust as part of his net worth. It also noted that no evidence was presented to suggest that the issue was "red-flagged" for review regarding Kempf's Financial Statement. The bankruptcy court found that: (1) the Financial Statement as written was materially false; (2) Kempf had a duty to make the status of the Trust clear; (3) Kempf intended to deceive Hitachi when he prepared and submitted the Financial Statement, which showed a higher net worth than in reality; and (4) Hitachi reasonably relied on Kempf's Financial Statement in extending credit to him. The bankruptcy court entered judgment in favor of Hitachi on June 9, 2011, holding Hitachi's state court judgment against Kempf non-dischargeable under section 523(a)(2)(B). Kempf filed a timely appeal from the judgment on June 21, 2011.

II. Jurisdiction

The bankruptcy court had jurisdiction over this core proceeding pursuant to 28 U.S.C. §§ 1334 and 157(b)(1)(I). This Panel has appellate jurisdiction pursuant to 28 U.S.C. § 158.

III. Issues

Did Hitachi's First Amended Complaint relate back to the facts alleged in its Original Complaint under Civil Rule 15, as made applicable by Rule 7015?

What standard of review should the Panel apply to the factual findings in this case?

Did Hitachi reasonably rely on Kempf's fraudulent financial statement as required under section 523(a)(2)(B)?

IV. Standards of Review

We review a bankruptcy court's statutory construction and conclusions of law, including interpretation of Bankruptcy Code provisions, de novo. *Einstein/Noah Bagel Corp. v. Smith (In re BCE W., L.P.),* 319 F.3d 1166, 1170 (9th Cir.2003); *see Hoopai v. Countrywide Home Loans, Inc. (In re Hoopai),* 369 B.R. 506, 509 (9th Cir.BAP2007), *aff'd in part, vacated in part, rev'd in part,* 581 F.3d 1090 (9th Cir.2009); *USAA Fed. Sav. Bank v. Thacker (In re Taylor),* 599 F.3d 880, 887–88 (9th Cir.2010).

We review the bankruptcy court's factual findings, including a finding that a creditor reasonably relied upon false financial statements, under the clearly erroneous standard. Fed. R. Bankr.P. 8013; *see Hughes v. Lawson (In re Lawson),* 122 F.3d 1237, 1240 (9th Cir.1997); *Hansen v. Moore (In re Hansen),* 368 B.R. 868, 875 (9th Cir.BAP2007); *Candland v. Ins. Co. of N. Am. (In re Candland),* 90 F.3d 1466, 1469 (9th Cir.1996); *see also Mendez v. Salven (In re Mendez),* 367 B.R. 109, 113 (9th

Cir.BAP2007); *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC),* 391 B.R. 25, 32 (9th Cir.BAP2008). A factual finding is clearly erroneous if the appellate court, after reviewing the record, has a firm and definite conviction that a mistake has been committed. *Anderson v. City of Bessemer City, N.C.,* 470 U.S. 564, 573–74 (1985); *see Mendez,* 367 B.R. at 113. If two views of the evidence are possible, the trial judge's choice between them cannot be clearly erroneous. *Anderson,* 470 U.S. at 573–75; *see Hansen,* 368 B.R. at 874–75.

***3** Whether an amended complaint relates back to the date of the original under Civil Rule 15 is a legal question that is reviewed de novo. *Dominguez v. Miller (In re Dominguez),* 51 F.3d 1502, 1509–10 (9th Cir.1995); *see also Magno v. Rigsby (In re Magno),* 216 B.R. 34, 37–38 (9th Cir.BAP1997).

V. Discussion

A. *Relation Back of Hitachi's First Amended Complaint to the Original Complaint*

Kempf moved to dismiss Hitachi's First Amended Complaint on the grounds that the second claim for relief did not relate back to the Original Complaint and therefore was time-barred under Rule 4007(c). He claimed that the First Amended Complaint did not arise out of the same conduct, transaction, or occurrence set forth in the Original Complaint because it "outlined a new set of facts and legal theories involving a previously unmentioned Angel Trust ... and completely new allegations under Section 523(a)(2)(B) of the Bankruptcy Code." Aplt ER p. 28.

Hitachi argued that its Original and First Amended Complaints both relate to Kempf's intentional, willful, wanton, and/or negligent signing of the Lease and Guaranty with no intent to repay the Loan. It argued that Counts I and II both arise out of the same underlying Loan transaction to CardioCura and Kempf's inducement of Hitachi to enter into the Loan by fraud. Additionally, Hitachi noted that it only discovered evidence relating to Count II after Kempf admitted in his adversary proceeding deposition to having no property rights in the Trust. Therefore, Hitachi claimed that it was "disingenuous for Debtor to claim that Hitachi's further allegations of fraud, **which Debtor concealed from Hitachi** ... prejudices this bankruptcy discharge." Aple. ER 232 (emphasis in original). The bankruptcy court denied Kempf's motion.

An amendment to a pleading relates back to the date of the original pleading when it asserts a claim or defense that arose out of the same conduct, transaction, or occurrence set out in the original. *See* Fed.R.Civ.P. 15(c)(1)(B); Fed. R. Bankr.P. 7015. This link will be found when the claim to be added is likely to be proven by the same kind of evidence that would be used to support the original pleading. *Magno,* 216 B.R. at 39; *see Dominguez,* 51 F.3d at 1510. The relation back doctrine is liberally applied, and its basic criterion is whether the original complaint gave the defendant enough notice of the nature of the plaintiff's claim so that he should not have been surprised by the amplification of the allegations. *Santamarina v. Sears, Roebuck & Co.,* 466 F.3d 570, 573 (7th Cir.2006); *see Miller v. Am. Heavy Lift Shipping,* 231 F.3d 242, 248 (6th Cir.2009); *Tiller v. Atl. Coast line R. Co.,* 323 U.S. 574, 581 (1945); *Rural Fire Prot. Co. v. Hepp,* 366 F.2d 355, 362 (9th Cir.1966). Thus, if one can fairly perceive some relationship between what was pleaded in the original and amended complaints, the amended complaint will relate back. *Gelling v. Dean (In re Dean),* 11 B.R. 542, 545 (9th Cir.BAP1981).

***4** Hitachi's Original Complaint alleged fraud and misrepresentation under section 523(a)(2)(A) relating to Kempf's promise to pay his Guaranty. The First Amended Complaint added allegations under section 523(a)(2)(B) stating that Kempf fraudulently included a high asset entity in his Financial Statement in order to induce Hitachi to lend to CardioCura. While Hitachi's First Amended Complaint includes an additional claim for relief, both complaints concern Kempf's alleged fraudulent misrepresentations made to secure the Lease and will likely be proven by the same kind of evidence—the Lease, statements Kempf made to secure the Lease, documents relating to Lease, etc. Kempf even admits that "the two complaints share the fact that they arise out of the same [L]ease transaction." Aplt. Br. 25.

Because both Hitachi's Original and First Amended Complaints are based upon events and circumstances surrounding Kempf's execution and delivery of the Lease and Guaranty with no intention of repayment, the Original Complaint gave Kempf enough notice about the nature of Hitachi's claim so that he would not be surprised by the additional allegations in the First Amended Complaint. Thus, the bankruptcy court did not err in holding that Hitachi's First Amended Complaint related back to the Original Complaint under Civil Rule 15(c)(1)(B).

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B. *The standard under which this Panel will review the bankruptcy court's factual findings*

It is a well-known rule in the federal courts generally, and the Ninth Circuit specifically, that findings of fact are reviewed on appeal under a clearly erroneous standard. *See Lawson,* 122 F.3d at 1240; *Hansen,* 368 B.R. at 874–75; *Candland,* 90 F.3d at 1469; *see also Mendez,* 367 B.R. at 113; *PW, LLC,* 391 B.R. at 32. Kempf contends that because the bankruptcy court was presented with uncontested facts and did not make credibility determinations, the facts should be reviewed de novo since the "evidentiary palate" here is identical to that of summary judgment.

In support of this argument, Kempf cites to *In re Burdge,* where the panel applied de novo review because the facts were undisputed. *AT & T Universal Card Servs. v. Burdge (In re Burdge),* 198 B.R. 773, 776 (9th Cir.BAP1996). The *Burdge* panel noted that factual findings are reviewed under the clearly erroneous standard and legal conclusions are reviewed de novo; and it concluded that because there were no facts in dispute, the only issue was a question of law to be reviewed de novo. *Burdge,* 198 B.R. at 776. *Burdge,* therefore, does not stand for the proposition that both facts and law may be reviewed de novo but merely reasserts the established legal rule that legal conclusions are reviewed de novo. *Id.*

While Kempf is correct that summary judgment determinations are reviewed de novo, this case is not remotely similar to a summary judgment case because there were a number of facts in dispute and credibility determinations were made. *See Padfield v. AIG Life Ins. Co.,* 290 F.3d 1121, 1124 (9th Cir.2002); *Turtle Rock Meadows Homeowners Ass'n. v. Slyman (In re Slyman),* 234 F.3d 1081, 1085 (9th Cir.2000).

***5** A review of the record reveals a number of factual disputes. Even with only Hitachi's witness, Donald O. Link, present at trial, the trial ran for approximately five hours and included a thorough cross and re-cross examination of Mr. Link by Kempf's counsel, which was quite hostile at times. During Mr. Link's cross-examination, Kempf's attorney asked whether CardioCura's business plan was the reason Hitachi entered into the Lease and Guaranty. Mr. Link disagreed with this conclusion stating that Hitachi entered the Lease because it approved the structure of the transaction. While Mr. Kempf's counsel tried to elicit from Mr. Link that the Trust was important for the transaction's approval, Mr. Link pointed out that Kempf's representations on his Financial Statement as a whole, and not necessarily only the representations of the Trust, were important in the transaction.

At another point in the cross-examination, Kempf's attorney tried to impeach Mr. Link by arguing that he presented conflicting facts in his deposition as compared to his trial testimony regarding his exposure to the transaction at issue. Even the bankruptcy court noted that Kempf's counsel was making "a very questionable assertion" from Mr. Link's declaration, his testimony, and documents entered into evidence that the Trust was the most important element in Hitachi's agreement to extend credit to CardioCura. Hr'g Tr. 53:23.

A simple review of the record establishes that many facts were in dispute and that the bankruptcy court was left with a number of credibility determinations after the cross, redirect, and re-cross examination of the only witness. Therefore, clearly erroneous is the correct standard of review with respect to the bankruptcy court's factual findings.

C. *The level of reliance required by creditors for section 523(a)(2)(B) non-dischargeability complaints*

Kempf argues that the bankruptcy court erred by absolving Hitachi of any duty to make even a minimal inquiry or investigation, stating that reasonable reliance requires the application of a community standard of conduct. *See Field v. Mans,* 516 U.S. 59, 70–71 (1995). Hitachi argues that Kempf ignores the plethora of facts that demonstrate its reasonable reliance, which included: (1) investigating Kempf's financial status; (2) preparing a transaction analysis; and (3) ordering a separate background report on Kempf that did not show any reason for alarm.

At trial, Hitachi based its non-dischargeability theory on section 523(a)(2)(B), which reads in pertinent part:

> (a) A discharge under ... this title does not discharge an individual debtor from any debt—(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—(B) use of a statement in writing—(I) that is materially false;

> (ii) respecting the debtor's ... financial condition; (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive[.]

***6** 11 U.S.C. § 523(a)(2)(B) (2010); *see Field,* 516 U.S. at 64. This code section requires "reasonable reliance," a term that courts can apply without additional help and is determined on a case-by-case basis. *Candland,* 90 F.3d at 1471; *Gertsch v. Johnson & Johnson (In re Gertsch),* 237 B.R. 160, 170 (9th Cir.BAP1999); *Deutsche Fin. Serv. Corp. v. Osborne (In re Osborne),* 257 B.R. 14, 21 (Bankr.C.D.Cal.2000). When there is evidence of materially fraudulent statements, little investigation is required for a creditor to have reasonably relied on the debtor's representations. *Gertsch,* 237 B.R. at 170; *see Gosney v. Law (In re Gosney),* 205 B.R. 418, 421 (9th Cir.BAP1996); *Candland,* 90 F.3d at 1471; *La Trattoria, Inc. v. Lansford (In re Lansford),* 822 F.2d 902, 904 (9th Cir.1987).

Lenders do not have to hire detectives before they are found to have reasonably relied upon the debtor's false financial statements. *Gertsch,* 237 B.R. at 170; *see, e.g., Candland,* 90 F.3d at 1471; *Ashley v. Church (In re Ashley),* 903 F.2d 599, 604–05 (9th Cir.1990). The mere fact that a creditor could have performed a more thorough investigation or could have avoided its loss by independently attempting to verify the information contained in the debtor's financial statement is no defense in a proceeding to except the debt from discharge. *See Merch. Bank of Cal. v. Oh (In re Oh),* 278 B.R. 844, 856 (Bankr.C.D.Cal.2002).

With respect to "red-flags," a creditor is not entitled to rely on obviously false representations; but, minor clues of falsity in a debtor's financial statement, which on the whole had a complete and reliable appearance, do not make a creditor's reliance unreasonable for dischargeability purposes, where the statements asserted that debtors owned significant property which they did not actually own. *Gosney,* 205 B.R. at 420–21; *Gertsch,* 237 B.R. at 170; *see also Siriani v. Nw. Nat'l Ins. Co. (In re Siriani),* 967 F.2d 302, 307 (9th Cir.1992).

The standard in the Ninth Circuit for "reasonable reliance" does not require adherence to any particular list of factors; rather, as *Candland* and *Gertsch* make clear, the bankruptcy court is to make its determination on a case-by-case basis in light of the totality of the circumstances. *See Candland,* 90 F.3d at 1471; *Gertsch,* 237 B.R. at 170.

Thus, we will only reverse the bankruptcy court's decision if, after reviewing the entire record, we have a firm and definite conviction that a mistake has been committed. *See Anderson,* 470 U.S. at 573; *Mendez,* 367 B.R. at 113; *see also Eugene Parks Law Corp. Defined Benefit Pension Plan v. Kirsh (In re Kirsh),* 973 F.2d 1454, 1456 (9th Cir.1992); *Candland,* 90 F.3d at 1469. If, however, two views of the evidence are possible, the trial judge's choice between them cannot be clearly erroneous. *Anderson,* 470 U .S. at 573–75; *see Hansen,* 368 B.R. at 874–75.

***7** There is sufficient evidence in the record upon which to affirm the bankruptcy court's decision that Hitachi reasonably relied on Kempf's fraudulent financial statements consistent with the applicable Ninth Circuit legal standard. In reviewing this evidence, the bankruptcy court found that Hitachi was deliberate and careful in considering whether to extend credit to Kempf, because of: (1) the lengthy transaction analysis it prepared; (2) the exchange of emails between Kempf and Hitachi; and (3) the background report on Kempf, which the court found showed little or no reason for alarm. Finally, it noted that there was nothing in the record to suggest that Hitachi did not adhere to its normal business practices. With regards to the Trust, the bankruptcy court found that it was not so obvious to discern the truth as to who owned the Trust because while the tax returns did indicate that Julie Kempf is the only owner, this information was "buried some 18 pages into the returns." Aplt. ER 139. Furthermore, it concluded that there was no evidence to suggest that the tax returns were submitted for the purposes of verifying ownership instead of simply establishing historical earning capacity.

Thus, we affirm the bankruptcy court's decision that Hitachi reasonably relied upon the financial statement in extending credit to CardioCura and Kempf.

VI. Conclusion

For the reasons set forth, the judgment of the bankruptcy court is AFFIRMED.

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United States Bankruptcy Court, C.D. California,
Santa Ana Division.

IN RE: Dennis P. KLINE, Debtor.
Pride Mobility Products Corporation, Plaintiff,
v.
Dennis P. Kline, Defendant.

Case No.: 8:13–bk–11334–TA
|
Adv. No. 8:13–ap–01250–TA
|
Signed March 11, 2014
|
Date: February 6, 2014, Time: 11:00 a.m.,
Location: Courtroom 5B

Attorneys and Law Firms

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ORDER DENYING DEFENDANT'S MOTION TO DISMISS PLAINTIFF'S FIRST AMENDED COMPLAINT

Theodor C. Albert, United States Bankruptcy Judge

***1** Defendant Dennis P. Kline's *Motion to Dismiss the First Amended Complaint* having been considered, for reasons set forth in the tentative ruling, and good cause appearing,

IT IS ORDERED as follows:

This is the defendant's motion to dismiss the First Amended Complaint under Rule 12(b)(6). The complaint is one objecting to discharge under 11 U.S.C. §§ 727(a)(2)(3)(4a)(A) and (5). Thethrust of the motion is that: (1) although the original complaint was timely, the amended complaint raises new facts and issues which are not sufficiently related to the original complaint so as to "relate back," and since the original complaint was filed on the last possible day, the new portions of the complaint must be dismissed with prejudice on limitations grounds; and (2) even if the new material did relate back, it still is not stated with sufficient detail to pass muster under Rule 9. Most of the new material relates to an alleged account at Citibank which debtor reportedly failed to list on his schedules, failed to reveal at the § 341a meeting, failed to reveal despite repeated discovery requests and which was material considering it contained many thousands both before and after the petition date.

First, the court must dispose of the plaintiff's arguments based on equitable tolling, equitable estoppel or exercise of some similar, vague powers under § 105. Because these principles have to be exercised only to the extent not inconsistent with plain language of specific rules, and the purposes served by those rules, they are largely unavailing in discharge and dischargeability matters. *Schunk v. Santos (In re Santos)*, 112 B.R. 1001, 1006–08 (9th Cir. BAP 1990). This is because FRBP 4004(a) and (b), 4007(c) and 9006(b)(3) carefully specify that the limitations can only be extended by court order within the original time period. The limitations are strictly construed in the Ninth Circuit and are not susceptible to expansion for equitable reasons or under § 105. *Id.*; see also *Kamjoo v. Wright (In re Wright)*, 2010 WL 6259968 (9th Cir BAP 2010).

But a closer question is whether there is any need for resort to equitable remedies. Plaintiff contends the amendments relate back to the original, timely-filed complaint. Plaintiff argues that the purpose of Rule 15 [governing amendments] is to facilitate decisions on the merits rather than pleadings or technicalities, and is applied more leniently when amendments are only against a single defendant and not adding additional parties. *United States ex rel. Cericola v. FNMA*, 529 F.Supp.2d 1139, 1148 (C.D. Cal. 2007), citing *Martell v. Trilogy, Ltd.*, 872 F.2d 322, 324 (9th Cir. 1989). The "relation back" standard of Rule 15 (c) is articulated in defendant's cited case *Gelling v. Dean (In re Dean)*, 11 B.R. 542, 545 (9th Cir. BAP 1981), *aff'd* 687 F.2d 307 (9th Cir. 1982): "In determining whether an amended cause of action is to relate back, the emphasis is not on the legal theory of the action, but whether the specified conduct of the

defendant, upon which the plaintiff is relying to enforce his amended claim, is identifiable with the original claim. (*Citing* 3 Moore's Federal Practice ¶ 15.15(3) pp. 15–196–205 (2d ed. 1980)). The basic test is whether the evidence with respect to the second set of allegations could have been introduced under the original complaint liberally construed; or as a corollary, that in terms of notice, one may fairly perceive some identification or relationship between what was pleaded in the original and amended complaints." citing *Rural Fire Protection Co. v. Hepp*, 366 F.2d 355 (9th Cir. 1966).

2** The original complaint contains allegations regarding ownership of RSL, accounts in the Cook Islands, sales of watches and reference is made to a safety deposit at Chase Bank, and a wine collection only disclosed post-petition. ¶¶ 81–103. The plaintiff in the original complaint observes a marked discrepancy between a prepetition financial statement and the amounts listed on the schedules, suggesting missing assets. ¶ 84–85 and 88–89, 91. Similarly, the plaintiff in the complaint notes that the loss of Source One's (debtor's corporation) assets is unexplained. ¶¶ 104–111. No specific reference is made to an account at Citibank. However, the stated facts are all by reference run through the more expansive charging allegation of the First Claim for Relief found at ¶ 113: "The debtor has, with intent to hinder, delay, or defraud his creditors, transferred, removed or concealed property within one year prior to filing the Bankruptcy Petition, ***including by selling his shares in RSL and using the Cook Islands Trust to conceal assets." (emphasis added) So the alleged specific instances of transfers and concealments, though not including reference to Citibank, are specifically not made exclusive, but only exemplary. A similar analysis could be done for the Second Claim for Relief and use of the word "including" at ¶ 116 as well as the incorporation of all preceding paragraphs in ¶ 115. So, adopting the *Dean* standard, the court has little doubt that evidence of a hidden and omitted bank account at Citibank would be admissible concerning the First and the Second Claims for Relief "liberally construed."

Moreover, the court views the teaching of *Cericola* as instructive here. The relator plaintiff in *Cericola* outlined in her original timely complaint a scheme to defraud the government by FNMA's procurement of insurance on loans not qualified for HUD insurance. The original complaint was woefully short of details on the specific loans in question, but nevertheless the court viewed the original complaint sufficient for relation back purposes (and thus avoiding a limitations issue) because it put the defendant on notice as to the general outlines of the scheme. 529 F.Supp.2d at 1149. Similarly, in the case at bar, no doubt the plaintiff would have originally mentioned Citibank had it known of same. But that does not mean that there is not sufficient notice of the more general failure to account for assets and attempts to hinder, delay and defraud creditors and conceal from the trustee and creditors the defendant's assets.

Defendant's authorities are largely distinguishable. *In re Magno,* 216 B.R. 34 (9th Cir. BAP 1997) involved the question of whether a § 523 theory of relief was a "lesser included" offense within a timely-filed § 727 complaint. The BAP correctly determined there was little connection between the elements of an individual fraud theory and the more general intent to hinder, delay or defraud and/or a false oath in the case. *Id.* at 42. Somewhat closer, but still not persuasive, is *Stodd v. Mufti (In re Mufti)*, 61 B.R. 514 (Bankr. C.D.Cal. 1986). In *Mufti,* the facts alleged in the original timely complaint concerned a fraudulent pre-petition transfer of real estate, but this did not sufficiently relate to amended (and untimely) allegations concerning fraudulent concealment of same. This is logical: the original complaint dealt with a prepetition *transfer* that was fraudulent as to creditors; the second theory necessarily related to a post-petition failure to *testify* truthfully regarding same, an entirely different theory. But here, the undisclosed Citibank account is only *an additional example* of what has already been alleged regarding prepetition attempts to conceal or transfer assets out of the reach of creditors and failures post-petition to account in testimony or in schedules when the duty arose. The court finds these sufficiently connected to allow relation back (and thus timely) assertion of the theories set forth in the amended complaint. Surely the law cannot be that a plaintiff is kept from introducing more recently-discovered further examples of the same sort of offense as described in the original complaint.

Even less persuasive is the defendant's second basis for the motion. Here, defendant, citing the *Twombly* and *Iqbal* cases and Rule 9, argues that the amended complaint still does not contain sufficient detail allowing reasonable formation of an answer. Actually, the amended complaint contains a considerable (and more than sufficient) quantity of factual detail. First, *Twombly* and *Iqbal,* properly understood, merely hold for the proposition that a complaint must contain sufficient allegations of fact so as to create a plausible basis for relief. That standard is easily surpassed here. Second, although Rule 9 requires a greater allegation of factual detail to support fraud, this does not mean that a complaint must contain every conceivable fact supporting the claim. For example, the court doubts that the plaintiff has to allege exactly what debtor received in exchange for his Maserati or what the alleged value of RSL was. This sort of detail will come out in discovery. Nor is it

necessary that Mr. Maahs and Ms. Vallefuco fit within the statutory definition of "insiders" found at § 101(31). "Insiders" can be as expressed in common parlance in this context. The purpose in the federal pleading system is to give adequate notice of what must be defended, with sufficient detail to raise theories of liability beyond a speculative level. The rest is properly dealt with during the course of the litigation.

***3** The Defendant's motion to dismiss is DENIED.

The Defendant shall file an answer to Plaintiff's first amended complaint within thirty (30) days of entry of this order.

All Citations

Not Reported in B.R. Rptr., 2014 WL 12665719

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Only the Westlaw citation is currently available.
United States District Court, C.D. California.

LUXURY BRANDS, LLC
v.
Shaukat GULAMANI, et al.

Case No. CV 18-586 PA (GJSx)
|
Filed 06/04/2018

Attorneys and Law Firms

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Proceedings: IN CHAMBERS - COURT ORDER

PERCY ANDERSON, UNITED STATES DISTRICT JUDGE

***1** Before the Court is a Motion to Dismiss ("Motion") filed by defendants Shirley Jung ("Jung") and Shawn Kochendorfer ("Kochendorfer,") (collectively "Moving Defendants"). (Docket No. 24.) Plaintiff Luxury Brands, LLC ("Plaintiff") has filed an Opposition (Docket No. 29), to which Moving Defendants have filed a Reply (Docket No. 30). Pursuant to Rule 78 of the Federal Rules of Civil Procedure and Local Rule 7-15, the Court finds this matter appropriate for decision without oral argument. The hearing calendared for June 4, 2018, is vacated, and the matter taken off calendar.

I. FACTUAL & PROCEDURAL BACKGROUND

This action is based primarily on allegations of trade secret misappropriation. As alleged in the Complaint, Plaintiff is a designer, developer, and seller of premium hair care products and tools. (Compl. ¶ 11.) "Plaintiff is a successor-in-interest to FHI Brands, LLC ('FHI Brands'), having acquired all assets of FHI Brands, including the claims alleged herein, in 2017. FHI Brands was the successor-in-interest to AG Global Products, LLC ('AG Global'), having acquired all assets of AG Global in 2015." (Id. at ¶ 4.) These companies have constantly researched, developed, and tested new potential products in order to remain at the forefront of innovation in the hair care industry. (Id. at ¶¶ 12–13.)

Defendant Shaukat Gulamani aka Shauky Gulamani ("Gulamani," collectively with Jung and Kochendorfer, "Individual Defendants") was previously the President and CEO of FHI Brands, and prior to that, President of AG Global. (Id. at ¶ 5.) Gulamani resigned from FHI Brands in May 2017. (Id. at ¶ 22.) Jung was previously the Product Development and Production Manager of FHI Brands, and before that, was employed by AG Global. (Id. at ¶ 8.) Jung's final working day was July 12, 2017. (Id. at ¶ 26.) Kochendorfer was previously the Purchasing and Planning Manager of FHI Brands. (Id. at ¶ 7.) Kochendorfer's final working day was June 16, 2017. (Id. at ¶ 30.)

The Complaint defines Plaintiff's trade secrets (the "Trade Secrets," also referred to in the Complaint as "Confidential and Trade Secret Information and Documents") as: "FHI Brands' and AG Global's research, development and testing data and materials, technical components, specifications and requirements for its products (and proposed products), market research data, feedback from customers, distributors, and other industry professionals, warranty information, the identification of vendors, suppliers and distributors, pricing and costing data for their products, the identification of their customers, including the pricing and purchasing history for their customers, strategic planning and development, and potential new products ...." (Id. at ¶ 14.) The Complaint alleges that the Trade Secrets are now owned by Plaintiff. (Id.)

FHI Brands and AG Global took measures to protect and limit access to the Trade Secrets. (Id. at ¶ 15.) The Trade Secrets were accessible only to FHI Brands and AG Global's employees through password protected programs and computer systems. (Id.) Only those employees that have a legitimate business reason for viewing and accessing the Trade Secrets were able to access this information through either FHI Brands' or AG Global's computer system; other employees could not access it. (Id.)

***2** "In addition, all employees of AG Global and FHI Brands were required, as a condition of employment, to sign a confidentiality, non-use and non-disclosure agreement which precluded the disclosure or use of the Confidential and Trade Secret Information and Documents." (Id.) The Agreement provides that it "will be for the benefit of FHI Brands [and] ...

its successors and assigns." (Id. at ¶¶ 21, 25, 29; id., Ex. A.) Each Individual Defendant signed an Agreement in January 2016. (Id. at ¶¶ 21, 25, 29.) In their roles at AG Global and FHI Brands, Individual Defendants had access to the Trade Secrets. (Id. at ¶¶ 19, 24, 28.)

Prior to his resignation from FHI Brands, but after signing the Agreement, Gulamani developed a plan to create defendant Life Marketing Group, LLC ("Life Marketing Group," collectively with Individual Defendants, "Defendants") to compete with Plaintiff. (Id. at ¶¶ 32, 38.) Gulamani took active steps to delay FHI Brands' products in order to usurp those products for Life Marketing Group. (Id. at ¶¶ 42, 45, 46.) On May 15, 2017, Gulamani caused the formation of Life Marketing Group while still employed by FHI Brands. (Id. at ¶ 38.)

The Complaint alleges that Gulamani "[i]Instructed and conspired with others employees of FHI Brands (including Jung and Kochendorfer) to take, retain and transmit to him documents and information constituting the Confidential and Trade Secret Information and Documents, including but not limited to the following: information regarding potential new products; development and testing data; technical specifications; pricing and market research data; supplier and customer data and purchasing histories." (Id. at ¶ 34(c).) It further alleges that Moving Defendants disclosed the Trade Secrets to Gulamani and each other. (Id. at ¶¶ 35–36.) More specifically, Kochendorfer received model numbers for FHI Brands products after she left employment with FHI Brands and received sample products with the purpose that they be given to Gulamani after he resigned. (Id. at ¶¶ 35, 36.) For her part, Jung "e-mailed proprietary warranty information and instruction manuals to Gulamani at his private e-mail address following his resignation from FHI Brands"; "provided samples of products, including a curling iron, a flat iron, a blow dryer and the Beyond flat iron to Kochendorfer (who was to provide them to Gulamani) following Gulamani's resignation from FHI Brands"; "gave Kochendorfer the model number for FHI Brand [sic] products, including the Intra Ceramic hairdryer, after she left her employment with FHI Brands"; and "provided Gulamani with proprietary vendor and consultant information, including contact information, after he left the company." (Id. at ¶ 35 (capitalizations altered).)

On January 23, 2018, Plaintiff filed this action against Defendants alleging claims for (1) violation of the Defend Trade Secrets Act (DTSA); (2) violation of the California Uniform Trade Secrets Act (CUTSA); (3) breach of fiduciary duties and duty of loyalty; (4) violation of the Computer Fraud and Abuse Act; (5) breach of contract; and (6) violation of California's Unfair Competition Law. Only the first, second, fourth, [1] and fifth causes of action are alleged against Moving Defendants.

The Complaint alleges that as a result of Defendants' conduct, Plaintiff has suffered significant injury, including actual damages, harm to its reputation, lost market share, lost profits, and diminution of value of its Trade Secrets. (Id. at ¶¶ 64, 55.) Plaintiff seeks damages; disgorgement of profits, financial gains, and certain amounts paid to Individual Defendants; preliminary and permanent injunctions; punitive damages; interest; attorneys' fees; and costs. (See id. at pp. 24–25 (Prayer for Relief).)

***3** Gulamani and Life Marketing Group have filed Answers to the Complaint. (Docket Nos. 14, 15.) Moving Defendants now seek dismissal of all of Plaintiff's claims for lack of standing, and of the CUTSA, DTSA, and breach of contract claims for failure to state a claim.

II. LEGAL STANDARD

a. Standing

Article III of the United States Constitution requires that a litigant have standing to invoke the power of a federal court. Because Article III's standing requirements limit subject matter jurisdiction, a plaintiff's standing to pursue a claim is properly challenged by a Federal Rule of Civil Procedure 12(b)(1) motion to dismiss. See Chandler v. State Farm Mut. Auto. Ins. Co., 598 F.3d 1115, 1121–22 (9th Cir. 2010). "Standing addresses whether the plaintiff is the proper party to bring the matter to the court for adjudication." Id. at 1122. For the purpose of ruling on a motion to dismiss for lack of standing, a court must accept as true all material allegations of the complaint and must construe the complaint in favor of the plaintiff. Maya v. Centex Corp., 658 F.3d 1060, 1068 (9th Cir. 2011).

To have standing under the Constitution, a party must show it has suffered an "injury in fact," that there is a "causal connection between the injury" and the defendant's complained-of conduct, and that it is likely "that the injury will be redressed by a favorable decision." Lujan v. Defenders of Wildlife, 504 U.S. 555, 560–61, 112 S. Ct. 2130, 119 L.Ed. 2d 351 (1992). To demonstrate an injury in fact, a plaintiff must establish "an invasion of a legally protected

interest which is (a) concrete and particularized and (b) 'actual or imminent, not conjectural or hypothetical.' " Id. (internal citations omitted) (quoting Whitmore v. Arkansas, 495 U.S. 149, 155, 110 S. Ct. 1717, 109 L.Ed. 2d 135 (1990)). In addition to the constitutional requirements for standing, federal courts adhere to certain prudential principles. Valley Forge Christian Coll. v. Americans United for Separation of Church & State, Inc., 454 U.S. 464, 474, 102 S. Ct. 752, 70 L.Ed. 2d 700 (1982). Such principles include the requirement that "the plaintiff generally must assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties." Id. (internal quotation marks omitted). In addition, courts refrain "from adjudicating 'abstract questions of wide public significance' which amount to 'generalized grievances,' pervasively shared and most appropriately addressed in the representative branches. Finally, the [Supreme] Court has required that the plaintiff's complaint fall within 'the zone of interests to be protected or regulated by the statute or constitutional guarantee in question.' " Id. (internal citations omitted).

Rule 12(b)(1) jurisdictional attacks can be either facial or factual. In a facial attack, the Court presumes the allegations to be true; however, the "challenger asserts that [those allegations] are insufficient on their face to invoke federal jurisdiction. By contrast, in a factual attack, the challenger disputes the truth of the allegations that, by themselves, would otherwise invoke federal jurisdiction." Safe Air For Everyone v. Meyer, 373 F.3d 1035, 1039 (9th Cir. 2004). Courts should refrain from resolving factual issues where "the jurisdictional issue and substantive issues are so intertwined that the question of jurisdiction is dependent on the resolution of factual issues going to the merits." Augustine v. United States, 704 F.2d 1074, 1077 (9th Cir. 1983); Williston Basin Interstate Pipeline Co. v. An Exclusive Gas Storage Leasehold & Easement, 524 F.3d 1090, 1094 (9th Cir. 2008) ("As a general rule, when 'the question of jurisdiction and the merits of the action are intertwined,' dismissal for lack of subject matter jurisdiction is improper." (quoting Safe Air, 373 F.3d at 1039)).

b. Failure to State a Claim

***4** Generally, plaintiffs in federal court are required to give only "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a). While the Federal Rules allow a court to dismiss a cause of action for "failure to state a claim upon which relief can be granted," they also require all pleadings to be "construed so as to do justice." Fed. R. Civ. P. 12(b)(6), 8(e). The purpose of Rule 8(a)(2) is to " 'give the defendant fair notice of what the ... claim is and the grounds upon which it rests.' " Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555, 127 S. Ct. 1955, 167 L.Ed. 2d 929 (2007) (quoting Conley v. Gibson, 355 U.S. 41, 47, 78 S. Ct. 99, 2 L.Ed. 2d 80 (1957)). The Ninth Circuit is particularly hostile to motions to dismiss under Rule 12(b)(6). See Gilligan v. Jamco Dev.Corp., 108 F.3d 246, 248–49 (9th Cir. 1997) ("The Rule 8 standard contains a powerful presumption against rejecting pleadings for failure to state a claim." (internal quotation marks omitted)).

However, in Twombly, the Supreme Court rejected the notion that "a wholly conclusory statement of a claim would survive a motion to dismiss whenever the pleadings left open the possibility that a plaintiff might later establish some set of undisclosed facts to support recovery." 550 U.S. at 561, 127 S. Ct. 1955, 167 L.Ed. 2d 929 (internal quotation omitted). Instead, the Court adopted a "plausibility standard," in which the complaint must "raise a reasonable expectation that discovery will reveal evidence of [the alleged infraction]." Id. at 556, 127 S. Ct. 1955, 167 L.Ed. 2d 929. In construing the Twombly standard, the Supreme Court has advised:

> [A] court considering a motion to dismiss can choose to begin by identifying pleadings that, because they are no more than conclusions, are not entitled to the assumption of truth. While legal conclusions can provide the framework of a complaint, they must be supported by factual allegations. When there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief.

Ashcroft v. Iqbal, 556 U.S. 662, 679, 129 S. Ct. 1937, 173 L.Ed. 2d 868 (2009). Thus, if a plaintiff could not possibly succeed after all allegations of material fact in the complaint have been taken as true and construed in the light most favorable to the plaintiff, then a motion to dismiss should be granted. See Twombly, 550 U.S. at 558, 127 S. Ct. 1955, 167 L.Ed. 2d 929; Daniel v. Cnty. of Santa Barbara, 288 F.3d 375, 380 (9th Cir. 2002).

III. ANALYSIS

a. Standing

First, Moving Defendants assert that the Complaint should be dismissed for lack of standing. (Mot. 6.) They contend that Plaintiff has not adequately alleged that "the rights and liabilities it may have inherited from AG Global and FHI Brands include rights to FHI Brands or AG Global's employment agreements, trade secret information or the right to bring a claim for purported trade secrets or breach of contract ...." (Id.) This is a purely facial challenge to whether Plaintiff has standing.

Moving Defendants' description of the Complaint's allegations is not wholly accurate. As they concede, the Complaint alleges that Plaintiff "is a successor-in-interest to FHI Brands ... having acquired all assets of FHI Brands, including the claims alleged herein, in 2017." (Compl. ¶ 4.) The Complaint further provides that "[a]ll Confidential and Trade Secret Information and Documents of FHI Brands and AG Global is [sic] now owned by [Plaintiff] and therefore, now constitute [Plaintiff]'s trade secrets." (Id. at ¶ 14.) In addition, the Agreements at issue provide that they "will be for the benefit of FHI Brands, LLC [and] ... its successors and assigns." (Id. at ¶¶ 21, 25, 29; id., Ex. A.)

***5** Such allegations are sufficient to adequately allege that Plaintiff has a legal interest in its claims and standing to pursue them. To the extent the Motion is premised on lack of jurisdiction, it is denied.

b. Failure to State a Claim

1. Defend Trade Secrets Act and California Uniform Trade Secrets Act

Next, Moving Defendants argue that the Complaint fails to state a claim for violation of the Defend Trade Secrets Act or the California Uniform Trade Secrets Act because it does not identify any specific trade secrets at issue. (Mot. 8.) Moving Defendants also contend that the Complaint fails to adequately allege that Moving Defendants committed any acts of misappropriation. (Id. at 11–13.)

Under the DTSA, the "owner of a trade secret that is misappropriated may bring a civil action ... if the trade secret is related to a product or service use in, or intended for use in, interstate or foreign commerce." 18 U.S.C. § 1836(b)(1). Similarly, the CUTSA creates a cause of action for the misappropriation of trade secrets, and offers injunctive relief for "actual or threatened misappropriation," Cal. Civ. Code § 3426.2, monetary damages for actual loss and unjust enrichment, Cal. Civ. Code § 3426.3(b), and exemplary damages "[i]f willful and malicious misappropriation exists," Cal. Civ. Code § 3426.3(c). Thus, the DTSA and CUTSA require a plaintiff to plead (1) the existence of a trade secret and (2) misappropriation of that secret. 18 U.S.C. §§ 1836(b), 1839; Cal. Civ. Code §§ 3426 et seq.; AccuImage Diagnostics Corp. v. Terarecon, Inc., 260 F. Supp. 2d 941, 950 (N.D. Cal. 2003) (citing Cal. Civ. Code § 3426.1(b)). Given the substantial similarities in claims of misappropriation under the DTSA and CUTSA, courts often assess them together. See Veronica Foods Co. v. Ecklin, No. 16-cv-07223-JCS, 2017 WL 2806706, at *12, 2017 U.S. Dist. LEXIS 101325 at *42 (N.D. Cal. June 29, 2017) (collecting cases); see, e.g, Becton, Dickinson & Co. v. Cytek Biosciences Inc., No. 18-cv-00933-MMC, 2018 WL 2298500, at *2, 2018 U.S. Dist. LEXIS 85121 at *5 (N.D. Cal. May 21, 2018) (noting that the elements of misappropriation of trade secrets claim under the DTSA and the CUTSA are essentially the same).

Trade secrets are defined under the DTSA as follows:

> all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if--
>
> > (A) the owner thereof has taken reasonable measures to keep such information secret; and
> >
> > (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information ....

Similarly, the CUTSA defines a trade secret as follows:

> "Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

(1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and

***6** (2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Cal. Civ. Code § 3426.1(d). "The complaint need not 'spell out the details of the trade secret' but must identify the trade secret with sufficient particularity to give defendants 'reasonable notice of the issues which must be met at the time of trial and to provide reasonable guidance in ascertaining the scope of appropriate discovery.' " MedioStream, Inc. v. Microsoft Corp., 869 F. Supp. 2d 1095, 1112–13 (N.D. Cal. 2012) (quoting Farhang v. Indian Inst. of Tech., Kharagpur, No. C-08-2658, 2010 WL 2228936, at *13, 2010 U.S. Dist. LEXIS 53975, at *13 (N.D. Cal. 2010)).

"Misappropriation," under both the DTSA and CUTSA includes "disclosure or use of a trade secret of another without express or implied consent by a person who ... at the time of disclosure or use, knew or had reason to know that the knowledge of the trade secret was ... acquired under circumstances giving rise to a duty to maintain the secrecy of the trade secret or limit the use of the trade secret ...." 18 U.S.C. § 1839(5); Cal. Civ. Code § 3426.1(b); (see Opp'n 8 (limiting relevant definition of misappropriation)).

Having reviewed the allegations of the Complaint, the Court concludes that Plaintiff has alleged sufficient facts to state plausible claims for violations of CUTSA and DTSA against the Moving Defendants. Accordingly, the Motion is denied as to these claims.

2. Breach of Contract

Moving Defendants argue that Plaintiff's breach of contract claim should be dismissed because the Complaint fails to adequately allege breach or damages. (Mot. 13–14.) "A cause of action for damages for breach of contract is comprised of the following elements: (1) the contract, (2) plaintiff's performance or excuse for nonperformance, (3) defendant's breach, and (4) the resulting damages to plaintiff." Daniels v. Select Portfolio Serv., Inc., 246 Cal. App. 4th 1150, 1173, 201 Cal. Rptr. 3d 390 (2016) (quoting Careau & Co. v. Sec. Pac. Bus. Credit, Inc., 222 Cal. App. 3d 1371, 1388, 272 Cal. Rptr. 387 (1990)). The Court has reviewed the Complaint's allegations and concludes that Plaintiff has plausibly alleged that Moving Defendants have breached the Agreements, and that Plaintiff has suffered resulting damages. Thus, the Motion is denied to the extent it seeks dismissal of Plaintiff's claim for breach of contract.

Conclusion

For the foregoing reasons, the Motion to Dismiss is denied. Moving Defendants are ordered to file an appropriate response to Plaintiff's Complaint on or before June 25, 2018. Failure to file a appropriate response may result in the entry of a default.

IT IS SO ORDERED.

All Citations

Slip Copy, 2018 WL 5903967

Footnotes

1 While counsel for Moving Defendants attests that Plaintiff agreed to dismiss the violation of the Computer Fraud and Abuse Act claim as to Moving Defendants (Declaration of Ryan Duckett ISO Mot. ¶ 7), Plaintiff has not filed a dismissal of that claim as of the date of this Order.

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United States District Court, C.D. California.

Donald ROBBINS
v.
OAKLEY, INC.

Case No. CV 18-5116 PA (KSx)
|
Filed 09/27/2018

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Proceedings: IN CHAMBERS – COURT ORDER

PERCY ANDERSON, UNITED STATES DISTRICT JUDGE

***1** Before the Court is a Motion to Dismiss filed by defendant Oakley, Inc. ("Oakley") (Docket No. 14). Oakley challenges the sufficiency of the Complaint filed by plaintiff Donald Robbins ("Plaintiff"). Pursuant to Rule 78 of the Federal Rules of Civil Procedure and Local Rule 7-15, the Court finds that this matter is appropriate for decision without oral argument. The hearing calendared for October 1, 2018, is vacated, and the matter taken off calendar.

I. Factual and Procedural Background

Plaintiff's Complaint alleges that he is a "highly acclaimed artist[ ], well known in the contemporary graffiti art world." Plaintiff alleges that he painted a mural in San Francisco in 2015. The mural "consisted of the stylized pseudonym[ ] and signature[ ]" of Plaintiff. (Compl. ¶ 43.) Plaintiff alleges that Oakley featured his mural as part of a marketing campaign in 2017 without his consent, including reproducing portions of the mural in Oakley's retail stores, advertising materials, and product catalogues. (Id. at ¶ 3.) According to the Complaint:

> Oakley rearranged and removed portions of [Plaintiff's] signature[ ] from the reproductions of the [mural]. By altering the signature[ ] in the reproduction, Oakley intentionally altered/removed copyright management information with the intent to induce, enable facilitate, or conceal an infringement of [Plaintiff's] rights under the Copyright Act.

(Id. at ¶ 43; see also ¶ 45 ("Defendants' removal of copyright management information was done intentionally, knowingly and with the intent to induce, enable, facilitate, or conceal Defendants' infringement of [Plaintiff's] original work. Defendants also knew, or had reason to know, that such removal and alteration of copyright management information would induce, enable, facilitate, or conceal Defendants' infringement of [Plaintiff's] copyrights in the [mural].").)

The Complaint alleges a claim for copyright infringement and a claim for falsification, removal, and alteration of "copyright management information" pursuant to the Digital Millennium Copyright Act ("DMCA"), 17 U.S.C. § 1202. In the pending Motion to Dismiss, Oakley asserts that, despite Ninth Circuit precedent to the contrary, Plaintiff lacks standing to pursue his copyright infringement claim because at the time he filed this action, Plaintiff had applied for, but not obtained, copyright registration of his artwork. Oakley also contends that the Complaint fails to allege sufficient facts to state a plausible claim under the DMCA.

II. Legal Standard

Generally, plaintiffs in federal court are required to give only "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a). While the Federal Rules allow a court to dismiss a cause of action for "failure to state a claim upon which relief can be granted," they also require all pleadings to be "construed so as to do justice." Fed. R. Civ. P. 12(b)(6), 8(e). The purpose of Rule 8(a)(2) is to " 'give the defendant fair notice of what the ... claim is and the grounds upon which it rests.' " Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 555, 127 S. Ct. 1955, 1964, 167 L.Ed. 2d 929 (2007) (quoting Conley v. Gibson, 355 U.S.

41, 47, 78 S. Ct. 99, 103, 2 L.Ed. 2d 80 (1957)). The Ninth Circuit is particularly hostile to motions to dismiss under Rule 12(b)(6). See, e.g., Gilligan v. Jamco Dev. Corp., 108 F.3d 246, 248–49 (9th Cir. 1997) ("The Rule 8 standard contains a powerful presumption against rejecting pleadings for failure to state a claim.") (internal quotation omitted).

***2** However, in Twombly, the Supreme Court rejected the notion that "a wholly conclusory statement of a claim would survive a motion to dismiss whenever the pleadings left open the possibility that a plaintiff might later establish some set of undisclosed facts to support recovery." Twombly, 550 U.S. at 561, 127 S. Ct. at 1968 (internal quotation omitted). Instead, the Court adopted a "plausibility standard," in which the complaint must "raise a reasonable expectation that discovery will reveal evidence of [the alleged infraction]." Id. at 556, 127 S. Ct. at 1965. For a complaint to meet this standard, the "[f]actual allegations must be enough to raise a right to relief above the speculative level." Id. at 555, 127 S. Ct. at 1965 (citing 5 C. Wright & A. Miller, Federal Practice and Procedure § 1216, pp. 235–36 (3d ed. 2004) ("[T]he pleading must contain something more ... than ... a statement of facts that merely creates a suspicion [of] a legally cognizable right of action") (alteration in original)); Daniel v. County of Sant Barbara, 288 F.3d 375, 380 (9th Cir. 2002) (" 'All allegations of material fact are taken as true and construed in the light most favorable to the nonmoving party.' ") (quoting Burgert v. Lokelani Bernice Pauahi Bishop Trust, 200 F.3d 661, 663 (9th Cir. 2000)). "[A] plaintiff's obligation to provide the grounds of his entitlement to relief requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do." Twombly, 550 U.S. at 555, 127 S. Ct. at 1964–65 (internal quotations omitted). In construing the Twombly standard, the Supreme Court has advised that "a court considering a motion to dismiss can choose to begin by identifying pleadings that, because they are no more than conclusions, are not entitled to the assumption of truth. While legal conclusions can provide the framework of a complaint, they must be supported by factual allegations. When there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief." Ashcroft v. Iqbal, 556 U.S. 662, 679, 129 S. Ct. 1937, 1950, 173 L.Ed. 2d 868 (2009).

III. Analysis

A. Copyright Infringement

Oakley argues that Plaintiff's claim for copyright infringement should be dismissed because Plaintiff did not have a copyright registration for the allegedly infringed work at the time he filed the Complaint. As Oakley acknowledges, however, the Ninth Circuit has held that receipt by the Copyright Office of a complete application satisfies the registration requirement. See Cosmetic Ideas, Inc. v. IAC/Interactivecorp, 606 F.3d 612, 621-22 (9th Cir. 2010). Although the Supreme Court has granted certiorari to resolve a circuit split on the issue, this Court is currently bound by Cosmetic Ideas. The Court therefore denies the Motion to Dismiss the copyright infringement claim.

B. DMCA

The DMCA defines "copyright management information" to mean "any of the following information conveyed in connection with copies or phonorecords of a work or performances or displays of a work, including in digital form ... (2) The name of, and other identifying information about, the author of a work ... (3) The name of, and other identifying information about, the copyright owner of the work, including the information set forth in a notice of copyright ... [and] (7) Identifying numbers or symbols referring to such information or links to such information." 17 U.S.C. § 1202(c).

At least two other Courts in the Central District of California have rejected arguments made at the pleading stage to dismiss claims involving stylized graffiti signatures of pseudonyms as falling outside the DMCA's definition of "copyright management information." See Tiermy v. Moschino S.p.A., 2:15-CV-5900 SVW (PJWx), 2016 WL 4942033, at *4-5 (C.D. Cal. Jan. 13, 2016); Williams v. Roberto Cavalli S.p.A., CV 14-6659 AB (JEMx), 2015 WL 1247065, at *2 (C.D. Cal. Feb. 12, 2015) ("Plaintiffs properly allege that the signatures were conveyed in connection with the display of their mural. The signatures appeared in the mural itself. ... If the signatures were part of the mural, they necessarily were conveyed in connection with the mural. Since Plaintiffs allege that the signatures fall into § 1202(c)(2) and were conveyed in connection with the mural, Plaintiffs adequately claim that the signatures constitute CMI."). This Court has similarly concluded that such allegations involving stylized signatures appearing in graffiti murals fall are adequate at the pleading stage to plausibly fall within the DMCA's definition of "copyright management information." See Travis Baird v. ROK Drinks, LLC, Case No. CV 17-4703 PA (AFMx) (C.D. Cal. Jan. 9, 2018).

***3** Relying on the Ninth Circuit's recent decision in Stevens v. Corelogic, Inc., 899 F.3d 666 (9th Cir. 2018), Oakley

contends that Plaintiff has failed to allege sufficient facts to state a plausible DMCA claim under 17 U.S.C. § 1202(b). Section 1202(b) of the DMCA provides:

> No person shall, without the authority of the copyright owner or the law —
>
> (1) intentionally remove or alter any copyright management information, [or]
>
> ...
>
> (3) distribute, import for distribution, or publicly perform works, copies of works, or phonorecords, knowing that copyright management information has been removed or altered without authority of the copyright owner or the law,
>
> knowing, or with respect to civil remedies under section 1203, having reasonable grounds to know, that it will induce, enable, facilitate, or conceal an infringement of any right under this title.

17 U.S.C. § 1202(b). While it is true that Stevens held that both §§ 1202(b)(1) and 1202(b)(3) "require the defendant to possess the mental state of knowing, or having a reasonable basis to know, that his actions 'will induce, enable, facilitate, or conceal' infringement," 899 F.3d at 673, Stevens was decided on summary judgment, not at the pleading stage. According to the Ninth Circuit, it was the plaintiffs' failure to "offer[ ] any evidence to satisfy [the] mental state requirement" that was fatal to the DMCA claim alleged in that action. Id. A plaintiff's burden at the pleading stage is not so exacting. At least at this stage of the proceedings, the Court concludes that Plaintiff's § 1202(b) claim alleges sufficient well-pleaded facts to satisfy the Twombly pleading standard.

Conclusion

For all of the foregoing reasons, the Court denies the Motion to Dismiss. Oakley shall file its Answer to the Complaint by no later than October 15, 2018. The Clerk shall issue an Order Setting Scheduling Conference.

IT IS SO ORDERED.

All Citations

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On (*date*) October 17, 2019, I served the following persons and/or entities at the last known addresses in this bankruptcy case or adversary proceeding by placing a true and correct copy thereof in a sealed envelope in the United States mail, first class, postage prepaid, and addressed as follows. Listing the judge here constitutes a declaration that mailing to the judge will be completed no later than 24 hours after the document is filed.

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3. SERVED BY PERSONAL DELIVERY, OVERNIGHT MAIL, FACSIMILE TRANSMISSION OR EMAIL (state method for each person or entity served): Pursuant to F.R.Civ.P. 5 and/or controlling LBR, on (*date*) October 17, 2019, I served the following persons and/or entities by personal delivery, overnight mail service, or (for those who consented in writing to such service method), by facsimile transmission and/or email as follows. Listing the judge here constitutes a declaration that personal delivery on, or overnight mail to, the judge will be completed no later than 24 hours after the document is filed.

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I declare under penalty of perjury under the laws of the United States that the foregoing is true and correct.

October 17, 2019	Beth Aalberts	/s/ Beth Aalberts
Date	*Printed Name*	*Signature*

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