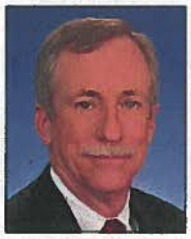
By Daniel H. Slate and Joseph M. Welch

Litigation in the Courts: Getting the Square Peg into the Round Hole



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Generally, litigation has a well-earned reputation for being time-consuming, disruptive to business and, of course, costly. None of those characteristics is compatible with a bankruptcy court's goal of expeditious resolution of issues so as to clear the way toward distribution to creditors either through a reorganization (assuming that a reorganization is available) or through liquidation. Trying to impose the common litigation model, an often cumbersome dispute-resolution paradigm, into the bankruptcy courts is analogous to trying to drive on the freeway in a car that only has one gear: It can work, but not well.

When certain litigation procedures are modified, however, litigation in the bankruptcy courts can provide meaningful avenues for effective and efficient relief. Many of these avenues are buried in local bankruptcy rules. Using the procedures available in the Federal Rules of Civil Procedure (FRCP) can also help speed the process toward resolution. In order to effectively apply these expedited avenues to relief and recovery requires one essential ingredient: *preparation*. The Federal Rules of Bankruptcy Procedure (FRBP) classify disputes into three categories: (1) contested involuntary proceedings (governed by Rule 1018 of the FRBP),[1] (2) "adversary proceedings" (described in Rule 7001 and governed by Part VII of the FRBP) and (3) "contested matters" (defined as everything else not listed in Rule 7001[2] and governed by Rule 9014).

Contested Matters: Expedited Relief

Contested matters are designed to be the most efficient form of litigation. Litigation outside of bankruptcy typically requires a party to file a complaint, litigate to a judgment and then execute on that judgment in order to get paid. That process is designed to take a number of months, if not years, to conclude. Bankruptcy is different. In bankruptcy, parties can bring a *motion* and obtain relief (and often even get paid) within *weeks*.

Rule 9014 generally requires that contested matters be commenced by motion and "reasonable notice and opportunity for hearing." As a result, the moving party does not have to serve a summons and bankruptcy courts can grant relief *even without* a hearing. Section 102 of the Bankruptcy Code[3] clarifies the notice requirement in bankruptcy cases. The phrase "after notice and a hearing" can mean such notice and such opportunity for a hearing as is appropriate. If deemed appropriate, the phrase can also mean *no* notice and *no* hearing. Similarly, § 105(a) allows the bankruptcy court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title," and Rule 9006(c)(1) gives courts "discretion with or without motion or notice [to] order [certain time] period[s] reduced."

Relief on "Negative Notice"

The local bankruptcy rules provide an effective roadmap for getting relief on an expedited basis. For example, in the Central District of California, relief is available upon a showing that (1) proper notice of the motion was given and (2) the appropriate time period—usually 14 days—has passed without objection or request for hearing.[4] In many instances, this procedure is available but not used.[5]

Negative notice procedures are not available in every dispute. The Central District of California does not allow the use of negative notice for a number of matters, including (1) claim objections, (2) automatic stay motions, (3) summary judgment motions, (4) cash collateral stipulation motions, (5) post-petition financing motions, (6) chapter 11 disclosure statement approval motions, (7) plan confirmation and (8) certain motions to value and avoid undersecured junior liens.[6] The ability to file a motion on negative notice may be further curtailed as "otherwise ordered by the court."[7] The applicable local bankruptcy rules should be consulted to determine whether relief on negative notice is available.

Regular Notice: Still Very Effective (and Fast)

Either out of habit or neglect, most disputes in the bankruptcy courts are resolved by way of motions filed on "regular notice" (about 21 days for most motions) with a hearing requested. Rule 9014(c) provides that "unless the court directs otherwise," all discovery rules applicable in adversary

1 Unless otherwise noted, reference to a "Rule" is to the enumerated rule in the Federal Rules of Bankruptcy Procedure.

2 *See* Rule 9014 advisory committee note (whenever there is an "actual dispute, other than an adversary proceeding, the litigation to resolve that dispute is contested matter").

3 All citations to a "section" are to the title 11 of the U.S. Code, 11 U.S.C. § 101, *et seq.* (the "Bankruptcy Code").

4 *See, e.g.*, Bankr. C.D. Cal. R. 9013-1(o)(3).

5 The major expenses in litigation are often centered on defending objections and preparing for hearings. Through negative notice, practitioners can effectively reduce expenses and risks for their clients.

6 Bankr. C.D. Cal. R. 9013-1(o)(2).

7 *See, e.g.*, Bankr. C.D. Cal. R. 9013-1(o)(1).

proceedings (Rules 7026-7037) apply in contested matters, except for Rule 7027 (related to the timing of certain depositions) and portions of Rule 7026 (*i.e.*, those requiring mandatory initial disclosures, disclosures regarding expert testimony, additional pretrial disclosure and mandatory meeting before scheduling conference/discovery plan).

As a result, the discovery rules (and discovery battles) available in general federal litigation are for the most part also available in litigation in the bankruptcy courts. Those rules and battles could delay (or, indeed, prevent) the expeditious delivery of dispute resolution. For most, the discovery rules and carveouts from adversary proceedings do not materially affect—or slow down—contested matters because (1) local bankruptcy rules typically require that motions and oppositions be supported by all legal and evidentiary support in the form of competent declarations and memorandums of points and authorities, and (2) courts often use initial hearings on motions as preliminary hearings that, if not readily resolved on the declarations and arguments at the hearing, will be continued for evidentiary hearing(s) or supplemental briefing (usually on the issues identified by the court).

Continued hearings for evidentiary or legal support are generally uncommon and do not unduly lengthen the time period for relief. Some Bankruptcy Code provisions even require expedited hearings. For example, § 362(e)(1) provides that "[i]f the hearing under this subsection [for relief from the automatic stay] is a preliminary hearing, then such final hearing shall be concluded *not later than* thirty days after the conclusion of such preliminary hearing, unless the 30-day period is extended with the consent of the parties in interest or for a specific time which the court finds is required by compelling circumstances."[8]

Once the bankruptcy court has the evidentiary and legal support it needs (which usually happens at the initial hearing), the parties often get a ruling. In bankruptcy court, the prevailing party is frequently asked to draft the form of order. This can give counsel a chance to help defend, in advance, the order from attack on appeal (either direct or collateral).[9]

Ex Parte, Emergency and Shortened-Time Motions

Practitioners looking for the fastest relief often consider a stipulation (or motion) to shorten notice, either on an emergency or *ex parte* basis.[10] Motions brought on an *ex parte* (meaning that notice is provided, but not "regular" notice) basis are most common (and appropriate) when resolving administrative or proprietary matters (*e.g.*, motions to exceed page limits in briefs or to file confidential documents under seal of court). The Bankruptcy Code still identifies situations where substantive relief may also be granted "with or without a hearing" and "before there is an opportunity for notice and a hearing."[11] Practically, however, *ex parte* motion practice is largely governed by individual judges on a case-by-case basis.

Emergency motions often require both notice and a hearing. They are usually reserved for true emergencies and frequently include motions to avoid some immediate and irreparable harm.[12] Local bankruptcy rules often govern emergency motions and can require a hearing and ruling within 48 hours' notice.[13] FRBP provisions also limit what relief can be obtained on an expedited basis or within 21 days of the petition date.[14]

When a matter must be quickly decided but it is not appropriate for either *ex parte* or emergency relief (*e.g.*, when a ruling must be obtained in a week), an application for an order shortening time may be filed.[15] Typically, that application must be filed concurrently with the motion and must describe the nature of the relief requested in the underlying motion and the reasons for shortening time, supported by declarations that both justify shortening time and establish a *prima facie* basis for the underlying motion.[16]

Adversary Proceedings

Unlike contested matters, adversary proceedings are not considered "expedited matters" since they follow the same general procedures as federal civil litigation.[17] Rule 7001 only requires 10 types of proceedings that can be commenced as an adversary proceeding.[18] Part VII of the FRBP incorporates many—but not all—of the FRCP. As a result, the rules applicable to adversary proceedings are inbred with timeframes that can substantially delay resolution of the dispute.

In an adversary proceeding, everything slows down. If a complaint is filed and the related summons is issued on Jan. 1, under Rule 7012, the answer, without extension, would be due on Jan. 31. If the answer were filed on that date, under Rule 7015, the complaint can still be amended until Feb. 21, and then the defendant can amend the answer until March 6. If the defendant includes a counterclaim in the amendment, then the plaintiff has until March 27 to respond. After three months, the matter is not yet "at issue." Nevertheless, with planning and cooperation, adversary proceedings can still be resolved efficiently in bankruptcy.

For example, personal service of the complaint and summons on defendants is not required.[19] Service by first-class mail for any pleading (except subpoenas) is complete when made to a party's last known address anywhere in the U.S.[20] Problems associated with serving those difficult or impossible-to-reach parties is avoided in bankruptcy litigation.

All discovery methods available in federal district court are also available in adversary proceedings.[21] Local bank-

8 Emphasis added. Bankr. C.D. Cal. R. 4001-1(c)(2) provides that "[u]nless the court orders otherwise at the time of the hearing, the preliminary hearing under [Bankruptcy Code section] 362(e) is consolidated with the final hearing under [Code section] 362(d)."

9 Some local rules, however, mitigate this benefit by requiring proposed form of orders to be served on other parties with some period (usually seven days) to object to the proposed form of order.

10 Per Rule 9019, certain settlements require court approval after notice to creditors, the U.S. Trustee, the debtor and others.

11 *See, e.g.*, 11 U.S.C. § 362(f) (authorizing relief without notice or hearing where relief from the automatic stay is "necessary to prevent irreparable damage to the interest of an entity in property").

12 Many of the "first-day motions" filed in chapter 11 cases are on an "emergency" basis.

13 *See, e.g.*, Bankr. C.D. Cal. R. 9075-1(a).

14 *See, e.g.*, Rules 4001 and 6003.

15 Court-approved forms F 9075-1.1 and F 9075-1.2 are often required when submitting an application for order shortening time and uploading a corresponding order to the bankruptcy court.

16 *See, e.g.*, Bankr. C.D. Cal. R. 9075-1(b)(2) and (3).

17 The FRCP provides the procedural framework for proceedings in bankruptcy courts while Rule 9002 explains how terms in the FRCP are interpreted in the bankruptcy context.

18 Under Rule 7001, the following proceedings are included: (1) to recover money or property; (2) to determine the validity, priority or extent of a lien; (3) to sell property free and clear of co-ownership claims; (4) to object to a chapter 7 discharge; (5) to revoke confirmation of a plan; (6) to determine the dischargeability of debt under § 523; (7) to obtain equitable relief; (8) to subordinate a claim or interest; (9) to obtain declaratory relief; and (10) to determine a removed action.

19 Rule 7004(b).

20 Rule 9006. Courts have upheld the constitutionality of serving summons and complaints by mail in bankruptcy proceedings. *See In re Cossio*, 163 B.R. 150, 156 (9th Cir. B.A.P. 1994); and *In re Levoy*, 182 B.R. 827, 833 (9th Cir. B.A.P. 1995).

21 *See* Rules 7026-7037 incorporating Federal Rules of Civil Procedure 26-37 verbatim.

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ruptcy rules often provide specific procedures for motions to compel discovery.[22] In addition, pretrial procedures of the FRCP are incorporated by Rule 7016, and local bankruptcy rules in many districts specify additional pretrial procedures aimed at allowing the bankruptcy court to closely monitor and control the progress of adversary proceedings.[23]

Rule 26 of the Federal Rules of Civil Procedure, which requires initial disclosures of relevant discoverable information and the obligation to supplement those disclosures, is also applicable to adversary proceedings. Rule 26(f) provides an important tool for managing discovery disputes. Under Rule 26(f), the parties are to confer to consider the nature and basis of the claims, the possibilities for promptly settling or resolving the adversary proceeding, and to develop a proposed discovery plan. The disclosure procedure is deemed so critical that it must be certified by counsel, and sanctions are specifically authorized under Rule 7026(g)(3).

Parties have 30 days within which to respond to interrogatories,[24] document production[25] and requests for admission.[26] They should consider whether these timeframes may be shortened as part of the discovery plan addressed at the Rule 26(f) conference. A hearing to address any discovery issues that arise at the end of discovery should also be considered.

The primary vehicle for closely monitoring and pushing adversary proceedings is through regular status conferences. An often-overlooked—and very effective—tool for handling delivery deadlines (and other problems) with opposing counsel is to file a motion requesting a status conference under Rule 26(f) and have the court step in to encourage timely disclosure and cooperation.[27] Failure to attend scheduled status conferences is not countenanced by many bankruptcy courts. Moreover, some courts will push the parties into mediation shortly after the initial status conference to try to resolve lingering disputes.

Conclusion

With planning, litigation in the bankruptcy courts can be cost-effective and provide the parties with an opportunity to resolve factual and legal issues with expedition. Under certain circumstances, relief is available within 21 days of filing a motion. Even in an adversary proceeding, with planning, bankruptcy can provide an effective forum for efficient relief. Practitioners should understand the policies undergirding bankruptcy, as well as the governing rules and statutes to more effectively speed the process along. abi

22 *See, e.g.*, Bankr. C.D. Cal. R. 7026-1(c) requiring parties to (1) meet and confer to try resolving a discovery dispute before filing a motion to compel and (2) submit motions to compel in stipulation form setting forth disputed issues and each party's position on such issues.

23 *See, e.g.*, Bankr. C.D. Cal. R. 7016-1. Failure to follow these requirements may result in sanctions and dismissal.

24 Rule 7033.

25 Rule 7034.

26 Rule 7036.

27 The discovery cutoff should exclude any items that are the subject of motions to compel, and, at the status conference, the court should set a hearing, after the discovery cutoff, to address and resolve any open discovery issues.

Equitable Disallowance of Claims in Bankruptcy

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for the Third Circuit's decision in *Citicorp* indicates that a court called upon to redress fiduciary misconduct should first identify the inequity at issue and the parties harmed, then determine whether equitable subordination under § 510(c) is sufficient to fashion an appropriate remedy.[16] If so, the court need look no further. However, if equitable subordination is not adequate, courts may then consider whether equitable disallowance is necessary to completely "undo the wrong." Under either equitable subordination or equitable disallowance, it appears that an appropriate remedy should, at a minimum, deprive the fiduciary of any profit arising from its wrongdoing, plus any damages caused to the debtor's estate attributable to its conduct.[17]

Conduct That May Implicate Equitable Disallowance

The *Adelphia* and *Washington Mutual* decisions indicate that the remedy that was initially used to disallow an individual's $33,468 claim in *Pepper* may apply with equal force to multi-billion dollar claims asserted by sophisticated investors in some of the largest bankruptcies in history. Regardless of the size of the claim or the identity of the creditor, the outcome is derived by the simple application of the threshold factor that implicates equitable disallowance: abuse of a position of trust or control in the debtor's affairs that gives a party the opportunity to manipulate claims in its own favor. In complex modern bankruptcy cases, sophisticated distressed-debt investors such as banks and hedge funds are among those that routinely occupy positions of trust or control prior to the bankruptcy filing or may subsequently come to occupy the position. *Adelphia* and *Washington Mutual* are two cases wherein the bankruptcy courts found sufficient allegations of misconduct to raise the prospect of equitable disallowance.

In *Adelphia*, a creditors' committee sought, among other things, the equitable disallowance of claims held by certain banks that lent approximately $5.6 billion to the debtors via "co-borrowing" facilities.[18] The committee alleged that the loans permitted a family that controlled the debtors, the Rigas family, to siphon more than $3.4 billion from the debtors because the facilities were structured in such a way that allowed the Rigases to draw on the loans but leave the debtors responsible for repayment.[19] The committee further

16 *Citicorp*, 160 F.3d at 991; *see also Adelphia*, 365 B.R. at 73 (remedy should be "the most measured means to correct any inequities that have been found").

17 *Citicorp*, 160 F.3d at 991.

18 *Official Comm. of Unsecured Creditors for Adelphia Communications Corp. v. Bank of America NA*, Adv. Pro. No. 03-04942, D.I. 1, pages 9-10 (Bankr. S.D.N.Y. July 6, 2003).

19 *Id.*