

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF VIRGINIA
Alexandria Division

In re:)
)
THE BENTLEY FUNDING GROUP, LLC) Case No. 00-13386-SSM
) Chapter 11
Debtor)
)
FREDRIC SPAIN *et al.*)
)
Plaintiffs)
)
vs.) Adversary Proceeding No. 01-8027
)
THE BENTLEY FUNDING GROUP, LLC)
)
Defendant)

MEMORANDUM OPINION

This is an action to revoke confirmation of a confirmed chapter 11 plan of reorganization on the ground that confirmation was obtained by fraud. The plaintiffs are three minority members of the reorganized debtor, a limited liability company. The debtor has filed a motion to dismiss the complaint for failure to state a claim for relief. A hearing was held in open court on November 20, 2001, at which the plaintiffs and the reorganized debtor were represented by counsel.

By order entered the same date, the court elected to treat the motion as one for summary judgment, directed the debtor to file an answer, and gave the parties until December 14, 2001, to file any affidavits or other discovery materials. Because the primary contention made by the plaintiffs is that the purported claims which supported the filing of the involuntary

chapter 11 petition were fraudulent, and that those same fraudulent claims were then voted in favor of confirmation, the court deferred ruling on the present motion pending hearings on the objections to those claims. One of the claims was withdrawn prior to the hearing, and the court has now ruled with respect to the remaining three, disallowing two of them and allowing the third in a reduced amount. Having considered the record of the claim objection hearing, as well as the arguments urged by the parties, the court concludes that the complaint should be dismissed.

Background

_____ Bentley Funding Group, LLC, (“Bentley” or “the debtor”) is a Virginia limited liability company that was formed in late 1997 to develop approximately 173 acres of land in a mixed-use development known as “River Oaks” located in the Woodbridge area of Prince William County, Virginia. An unusual feature of Bentley is its tripartite membership and management structure. Bentley has three classes of members, designated as Classes A, B, and C, with each class being represented by its own manager. Class A consists of Peter J. Denger and Peter Horvat, each of whom owns a 33.5% membership interest. Class B consists of Fernando Gomez, James A. Jeffery, Edgar A. Reilly, Jr., and Fredric L. Spain, each of whom own a 7.0% membership interest. Finally, Class C consists of Kenneth Young, who owns a 5.0% membership interest. Only the Class A members were required to invest money in the proposed development. The Class B members had identified the project and had brought it to the table, but neither they nor the Class C member were required to invest any of their own money. Under the company’s operating agreement, most business decisions required the

concurrence of at least two classes. Any decision to file bankruptcy, however, required unanimous consent of the members.

The purchase of the River Oaks property had been financed by a loan from Resource Bank secured by a first-lien deed of trust. When the loan went into default, the note was purchased by SK&R Group, L.L.C. (“SK&R”), which then scheduled a foreclosure sale. Bentley had other serious financial problems as well. It had fallen far behind in payments to its general contractor, S. W. Rodgers Company. Additionally, its failure to complete required public improvements on the River Oaks development caused Prince William County to declare a default with respect to the subdivision performance bonds issued on the debtor’s behalf by AXA Global Risks U.S. Insurance Company (“AXA”).

When the possibility of a voluntary chapter 11 filing to stop the foreclosure was raised by the other members, Reilly, Spain, and Jeffery refused to consent. Horvat and Gomez, together with Peter S. Denger (Peter Denger’s son), “Glem Management, LLC” (a business owned by Peter Denger) and “TBR Associates” (a business owned by Peter Horvat), then filed an involuntary chapter 11 petition against the debtor on August 11, 2000, thereby invoking the automatic stay and preventing the foreclosure from going forward. The petitioning creditors represented that they held claims against the debtor in the aggregate amount of \$295,571.13.¹

¹ Specifically, the amounts shown on the petition for each petitioner’s claim were as follows:

| <u>Petitioning Creditor</u> | <u>Claim</u> |
|-----------------------------|--------------|
| Peter Horvat | \$15,000.00 |
| TBR Associates | \$25,000.00 |
| Peter S. Denger | \$7,600.00 |
| Fernando Gomez | \$183,000.00 |

(continued...)

On August 28, 2000, Reilly, as Class B manager, filed an answer *opposing* the involuntary petition. On September 5, 2000, however, he filed a new answer on behalf of the debtor *consenting* to chapter 11 relief, and an order granting such relief was entered on September 6, 2000.

No trustee was appointed, and Bentley remained a debtor in possession throughout the chapter 11 case.² Approximately four months into the case, Bentley filed a motion to approve a sale of all but 22 acres of the River Oaks property to SK&R in full satisfaction of the sum (approximately \$2.5 million) due under the deed of trust. As part of the purchase, SK&R also paid \$322,582.69 to the debtor and paid the claims of S. W. Rodgers in the amount of \$608,025.00, AXA in the amount of \$1,900,000.00, and Prince William County in the amount of \$289,645.00. SK&R additionally assumed the debtor's obligation to a paving contractor in the approximate amount of \$25,000. The sale was approved by this court on January 30, 2001, and closed on February 14, 2001.

A hearing was then held on approval of an amended plan of reorganization that had been filed by the debtor on March 6, 2001. Since all of the secured claims had already been paid or otherwise resolved in connection with the sale to SK&R, the only remaining claims

¹(...continued)

Glem Management, LLC \$64,971.13

² Initially, Reilly was named as the debtor's "designated representative" under Fed.R.Bankr.P. 9001(5) (allowing court to designate a person to perform the duties of a debtor when the debtor is not a natural person). On motion of the Class A members, however, the court amended the order of designation to designate Gomez as the debtor's representative.

and interests dealt with by the plan were administrative claims, general unsecured claims (Class 4), “insider” unsecured claims (Class 5), and equity interests (Class 6). Under the plan, Class 4 claims were to be paid in full at confirmation. No payment was to be made on account of the Class 5 claims, which were effectively treated as equity contributions.³ The Class 6 membership interests would simply retain their existing rights. No changes were proposed to the management of the debtor. The remaining 22 acres of land would be developed or sold by the reorganized debtor, with any distributions to the members being governed by the operating agreement.

Classes 4 and 5 voted to accept the plan.⁴ Ballots were not solicited from the equity holders since they were unimpaired by the plan. Spain and Jeffery nevertheless filed an objection to confirmation as well as objections to the claims of Glem Management, TBR Associates, Denger, and Gomez. The primary contention made in opposition to confirmation was that the plan, by failing to remove Denger, Horvat, Young, and Reilly from management control, failed to satisfy 11 U.S.C. § 1129(a)(5), which requires, as a condition of confirmation, that the appointment, or continuance in office, of any individual proposed to

³ The plan does not actually state what happens to the insider claims beyond the fact that they were not being paid. However, it was the understanding of the court, based on the representations made at the confirmation hearing, that the insider claims were not being extinguished but rather were being recharacterized as equity contributions.

⁴ Only one non-insider unsecured creditor – a law firm that had represented Bentley prepetition – voted in Class 4, and it accepted the plan. The report of ballots reflects that four insider unsecured creditors voted in Class 5 and accepted the plan. The report does not name the creditors, however, and only three Class 5 ballots are attached to the report. These are as follows: TBR Associates (\$25,000); Glem Management, Inc. (\$164,595); and Peter Denger (\$7,600).

serve as “a director, officer, or voting trustee” of the debtor after confirmation of a plan be “consistent with the interests of creditors and equity security holders and with public policy.” In particular, Spain and Jeffery contended that Denger and Horvat, abetted by Gomez, wholly mismanaged the project, failed to put in the capital they were required to invest by the operating agreement, and improperly orchestrated the involuntary chapter 11 filing to evade the unanimous-consent requirement of the operating agreement. The fear expressed by Spain and Jeffery at the confirmation hearing was that if the management structure were left unchanged, Denger and Horvat would contrive to siphon off the value of the remaining 22 acres. After considering the evidence and arguments, the court overruled the objections to confirmation and entered an order on May 31, 2001, confirming the plan of reorganization.

No appeal was taken from the confirmation order. Confirmation did not affect the right of Spain and Jeffery to prosecute their pending objections to the insider claims, which were then set for an evidentiary hearing. The Denger claim was withdrawn prior to the December 13, 2001, hearing. The Glem Management claim was disallowed as a sanction for failure to provide timely discovery. The \$25,000.00 TBR claim was disallowed on the merits (without prejudice to the treatment of \$5,000.00 as a capital contribution by Horvat).⁵ In so ruling, the court found that TBR Associates was not a separate legal entity but was a sole

⁵ As noted, both Peter Horvat and TBR Associates were listed as petitioning creditors, with asserted claims of \$15,000.00 and \$25,000.00, respectively. TBR was listed on the schedules as holding an unsecured claim in the amount of \$25,000.00. For whatever reasons, Horvat was not listed on the schedules as a creditor. He did, however, file a timely proof of claim (Claim No. 9) in the amount of \$15,000.00. (TBR did not file a proof of claim). Although the court’s order formally disallowed only the scheduled TBR claim, the memorandum opinion observed that the \$15,000.00 claim (Claim No. 9) filed by Horvat in his own name was a capital contribution rather than a debt.

proprietorship of Horvat. Nevertheless, the court expressly declined to find that the TBR claim was “concocted” or “fraudulent.” The \$206,000.00 Gomez claim was allowed in the reduced amount of \$10,702.38, with the balance of the claim being disallowed.

In the interim, Spain and Jeffery, now joined by Reilly, commenced the present action on August 28, 2001, seeking to have the confirmation order revoked and the case converted to chapter 7.

Discussion

A.

Revocation of an order confirming a chapter 11 plan is governed by § 1144,

Bankruptcy Code:

On request of a party in interest at any time before 180 days after the date of the entry of the order of confirmation, and after notice and a hearing, the court may revoke such order *if and only if such order was procured by fraud*. An order under this section revoking an order of confirmation shall—

(1) contain such provisions as are necessary to protect any entity acquiring rights in good faith reliance on the order of confirmation; and

(2) revoke the discharge of the debtor.

(emphasis added). Although the plaintiffs have unquestionably waited until the last moment to file their complaint, it was nevertheless filed within 180 days after entry of the confirmation order and is therefore timely. The sole issue, accordingly, is whether the confirmation order was procured by fraud. The theory of the plaintiffs is that fraud infected confirmation in two ways: first, that the involuntary petition itself was fraudulent because the purported claims were not valid and were concocted solely to evade the provisions of the operating agreement

requiring unanimous consent for a bankruptcy filing; and second, that the same concocted claims were voted in favor of confirming the plan.⁶

B.

When presented with a motion to dismiss a complaint for failure to state a claim for relief, the court is required to accept the well-pleaded allegations of the complaint as true, and may not dismiss the complaint prior to receiving evidence unless it is clear that the plaintiff cannot prove any facts consistent with the complaint that would provide a basis for relief. *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102, 2 L.Ed.2d 80 (1957); *Scheuer v. Rhodes*, 416 U.S. 232, 236, 94 S.Ct. 1683, 1686, 40 L.Ed.2d 90 (1974). However, in considering a motion to dismiss, the court may, in its discretion, consider matters outside the four corners of the complaint, in which event the motion to dismiss is effectively transformed into a motion for summary judgment. Fed.R.Civ.P. 12(b), as incorporated by Fed.R.Bankr.P. 7012. Summary judgment in turn is appropriate 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), as incorporated by Fed.R.Bankr.P. 7056. Although Rule

⁶ The complaint also alleged, as a basis for relief, the reorganized debtor's failure to comply with the provisions of the confirmation order requiring the debtor to file delinquent 1999 and 2000 tax returns, and to furnish all the members with a schedule of capital contributions, by a specific date. It is represented by the reorganized debtor that the tax returns and capital contribution schedules have now been prepared, albeit admittedly after the date specified in the confirmation order. A material default with respect to a confirmed plan is one of many grounds for dismissal or conversion of a chapter 11 case. § 1112(b)(8), Bankruptcy Code. However, it is not a basis for revoking the order of confirmation, as the statute is clear that the *only* ground upon which confirmation can be revoked is fraud.

56 does not expressly refer to the court's power to take judicial notice of adjudicative facts, the court concludes that it is appropriate to take judicial notice of, and consider, the record of its own proceedings at the hearing on confirmation and on the four claim objections.

C.

The court will first address the contention that revocation of the confirmation is appropriate because the chapter 11 filing was fraudulent in the first instance. Bankruptcy proceedings may either be commenced by a debtor on its own initiative or may be forced on a debtor by its creditors. §§ 301 and 303, Bankruptcy Code. The former is referred to as a voluntary filing, and the latter as an involuntary filing. With respect to a voluntary petition, any filing by a corporation or other artificial entity must be by a person having authority to do so under applicable state law. *Price v. Gurney*, 324 U.S. 100, 65 S.Ct. 513, 89 L.Ed. 776 (1945); *Hager v. Gibson*, 108 F.3d 35 (4th Cir. 1997). Since Bentley's operating agreement required the unanimous agreement of the members for the filing of a bankruptcy petition, there can be little doubt that a voluntary chapter 11 petition would have been subject to immediate dismissal.

An involuntary petition may be filed against a debtor "by three or more entities, each of which is either a holder of a claim against [the debtor] that is not contingent as to liability or the subject of a bona fide dispute . . . if such claims aggregate at least \$10,775.00."⁷

§ 303(b)(1), Bankruptcy Code. If the debtor has fewer than 12 creditors, there need be only

⁷ Effective April 1, 2001, the minimum aggregate claim amount needed to file an involuntary petition was increased to \$11,625.00.

one petitioning creditor. § 303(b)(2), Bankruptcy Code. However, in this case there is no contention that Bentley had fewer than 12 creditors.

Two of the petitioning creditors in this case were members of Bentley. One – whose claim was ultimately withdrawn – was the son of a member. The remaining two were businesses owned by members. With respect to TBR Associates, the court found in connection with the objection to claim that TBR was not a separate entity but was essentially a sole proprietorship of Peter Horvat. Additionally, it was conceded by Glem Management's attorney that Glem Management was not an entity distinct from Peter Denger. Thus in actuality there were only three, not five, petitioning creditors, and two of them were members of Bentley. Of the \$295,571.13 in claims asserted on the petition, only \$10,702.38 has been allowed (which is less than the \$10,775.00 needed to support the filing of an involuntary petition) although another \$20,000.00 has been recognized as valid capital contributions.

It is clear that Denger, Horvat, and Gomez caused the involuntary petition to be filed because they were unable to obtain the unanimous consent needed for a voluntary chapter 11 petition under the operating agreement, and because they wanted to stop SK&R's scheduled foreclosure sale. Reilly, as the manager of the sole class (Class B) that had *not* consented to the filing, initially filed an answer *opposing* the involuntary petition. However, he subsequently filed an answer *consenting* to the entry of an order for chapter 11 relief. SK&R vigorously argued at the outset of the case that the filing was improper, and it received authority to examine the petitioning creditors under oath concerning the bona fides of their claims. Eventually, however, SK&R choose to settle with the debtor rather than to litigate the issue.

During this entire period, Jeffery and Spain were fully aware of the pendency of the chapter 11 case and filed no pleadings whatsoever challenging the filing or seeking dismissal of the case. It was only eight months after the petition was filed, and in the context of an objection to confirmation of the debtor's plan, that Jeffery and Spain asserted for the first time that the involuntary filing was a fraudulent attempt to evade the restriction on a voluntary filing. Where a party has knowledge of an unauthorized bankruptcy filing yet does nothing for an extended period of time to contest it, the delay will be deemed a ratification of the improper filing. *Gibson*, 108 F.3d at 40.

D.

The plaintiffs next contend that confirmation was obtained by fraud because confirmation was predicated on *acceptance* of the plan by the holders of the “concocted” claims. However, acceptance by Class 5 – which was the class in which the challenged claims were placed – was not necessary as a condition of confirmation.

Confirmation of a chapter 11 plan is consensual if every impaired class of claims or interests votes to accept the plan. § 1129(a)(8), Bankruptcy Code. If all other requirements for confirmation are met, however, a plan may be confirmed over the objection of an impaired dissenting class – a process commonly referred to as “cram-down” – provided at least *one* impaired class of claims has accepted the plan, *and* the plan is fair and equitable to, and does not discriminate against, the non-accepting impaired classes. § 1129(a)(10) and (b)(1), Bankruptcy Code. Under the plan, Class 4, even though it was to be paid in full, was

impaired.⁸ Class 4 voted in favor of confirmation, thereby satisfying the requirement that, if classes of claims or interests are impaired, at least one impaired class of claims must accept the plan.

Class 5 insider claims unquestionably constituted an impaired class, since under the plan no payment was to be made on account of them. As noted, Class 5 voted to accept the plan. But even if the Class 5 votes were excluded,⁹ the plan could nevertheless have been confirmed so long as the treatment of the Class 5 claims was fair and equitable and did not unfairly discriminate. In this connection, had there been an *objection* to confirmation by a Class 5 creditor,¹⁰ confirmation might not have been possible, since in order to provide “fair and equitable” treatment to a non-accepting class of impaired unsecured claims, the plan must, at a minimum, either pay the claim in full *or* must provide that no junior class of claims or interests will receive or retain anything under the plan. § 1129(b)(2)(B), Bankruptcy Code.

⁸ A class of claims is “impaired” unless the plan either “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest” or, alternatively (in the case of a debt that has been accelerated by reason of a prepetition default), the plan cures the defaults and does not otherwise alter the creditor’s legal, equitable, or contractual rights. § 1124, Bankruptcy Code. A plan that pays a class of claims in full but does not pay post-petition interest to which the creditors would be entitled under nonbankruptcy law necessarily alters the rights of the class and thus leaves it impaired.

⁹ Indeed, since there were pending objections to the claims of Denger, TBR Associates, Glem Management, and Gomez, they were not actually entitled to vote unless, after notice and a hearing, the court temporarily allowed their claims for the purpose of accepting or rejecting the plan. Fed.R.Bankr.P. 3018(a), Bankruptcy Code. Accordingly, the votes may have been a nullity in any event.

¹⁰ It is worth stressing that there is a difference between voting to reject a plan and objecting to its confirmation. Rejection is simply an expression of unwillingness to be bound by the plan, while an objection is an assertion that the plan does not meet the legal requirements for confirmation.

This latter requirement – commonly referred to as the “absolute priority rule” – was arguably violated because Class 5 was not to be paid anything, while Class 6, which was junior, retained its existing rights. However, only creditors in the class entitled to the benefit of the absolute priority rule would have had standing to complain of its violation. The plaintiffs, as Class 6 interest holders, lacked standing to make that objection.

In any event, since one impaired non-insider class (Class 4) accepted the plan, and since there were no objections to confirmation by the remaining impaired class (Class 5), confirmation of the plan did not depend on the *votes* of the Class 5 creditors. Thus, even if one or more claims held by the Class 5 creditors were fraudulent – in the sense that they were asserted without a good faith belief that they were valid – the court could nevertheless have confirmed the plan.

E.

Although knowledge at the time of the confirmation hearing that one of the petitioning creditor claims would be withdrawn and that two would be disallowed in their entirety might have affected the court’s decision to confirm the plan, it is by no means certain that confirmation would have been denied. It must be remembered that the primary focus of a bankruptcy case is on getting *creditors* paid. In the present case, confirmation of the plan, combined with the previously-approved sale to SK&R, resulted in the payment, assumption or agreed compromise of *all* non-insider claims and left the reorganized debtor with a valuable piece of real estate and *no debt*. All that remained were internal company disputes among the members. Disputes among equity interest holders are ordinarily not the concern of bankruptcy courts. The relief the plaintiffs are seeking is in effect a judicial winding up of Bentley in the

form of a chapter 7 administration. However, chapter 7 administration would not be appropriate for the simple reason that there are no longer any *creditors* to be paid. The court was fully aware at confirmation that there were ongoing state court lawsuits by Spain and Jeffery against Horvat and Denger. Counsel for the debtor acknowledged at the confirmation hearing that nothing in the plan affected claims by one member against the other and that such claims would continue to be litigated in the state courts following confirmation.

Certainly, the court had the discretion to deny confirmation, and could have converted the case to chapter 7. In hindsight, that route would likely have avoided a great deal of subsequent litigation – or at least confined it to this court – since a chapter 7 trustee would simply have sold the remaining 22 acres, paid the allowed unsecured claims, and distributed the surplus funds to the members. As it was, confirmation left festering issues to be resolved by other courts. Nevertheless, a challenge to the confirmation order on the ground that the court made an error of law or abused its discretion in confirming the plan could only be raised by a timely appeal. In this case, no appeal was taken. Section 1144 embodies a strong policy in favor of finality with respect to chapter 11 orders of confirmation. Even if the court's decision was unwise or contrary to law, it cannot be attacked after the appeal period has run unless confirmation was obtained by fraud.

Here, confirmation may possibly have been improvident, but it was not procured by fraud in connection with voting on the plan. Additionally, even assuming that one or more claims upon which the involuntary petition was predicated were “concocted” and were not really valid claims at all, that issue should have been raised by a motion to dismiss the case or to vacate the order for relief. Instead, Reilly (who was the Class B manager) *consented* to the

entry of an order for relief, while Spain and Jeffery – who were aware of the issue from the inception of the case and who were represented by counsel at the hearing to decide whether Reilly should remain the debtor’s designated representative – inexplicably did nothing for eight months and waited until the confirmation hearing to assert for the first time that the involuntary petition was invalid. In retrospect – particularly as it is now clear that “Glem Management” and “TBR Associates” were simply trade names through which Denger and Horvat conducted business – the involuntary petition would likely have been dismissed had a party in interest timely pursued the issue. Indeed, SK&R vigorously asserted from the inception of the case that the filing was improper. However, SK&R dropped its challenge and instead chose to settle with the debtor. Spain and Jeffery were not free to sit back and do nothing while the case then took its course and while orders were entered that settled or paid the claims of SK&R, AXA, Rodgers, and Prince William County. By their unexplained inaction, Spain and Jeffery effectively waived any challenge to the propriety of involuntary filing and the entry of the order for relief. Certainly, Reilly did so by filing an answer to the involuntary petition *consenting* to chapter 11 relief. But even assuming that the court erred at the confirmation hearing in treating the issue as waived, the proper avenue for challenging that ruling would have been by appeal of the confirmation order. For whatever reason, the plaintiffs chose not to do so.

IV.

For the reasons stated, the plaintiffs cannot carry their burden of showing that confirmation of the plan was obtained by fraud. Accordingly, the court will enter an order granting summary judgment to the reorganized debtor and dismissing the complaint.

Date: January 29, 2002

Alexandria, Virginia

/s/ Stephen S. Mitchell
Stephen S. Mitchell
United States Bankruptcy Judge

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