USING RULE 60(D)(3) OF THE FEDERAL RULES OF CIVIL PROCEDURE TO COMBAT FRAUD

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When Howard Ehrenberg was asked to be the trustee in two reopened cases, little did he know that a tool rarely used by trustees - Rule 60(d)(3) of the Federal Rules of Civil Procedure - would be the key to unraveling a twenty-one-year-old fraud.

Following his appointment, Mr. Ehrenberg quickly learned that two brothers (Harry and Theodosios Roussos) engineered a scheme aimed at divesting a former partner of his interests in two valuable apartment buildings located in the beach front

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KEY POINTS

Key points when determining if an over-encumbered property should be sold:

1. Confirm the debtor's true intentions
2. Determine if the sale is likely to materially benefit the estate
3. Rule out problematic co-owners of the property
4. Establish a strategy with short sale negotiator

communities of Los Angeles. The brothers created sham entities, filed individual chapter 11 cases, and then sought an order approving sales of the properties to the bogus entities for virtually no consideration. The sale motion was granted pursuant to an order entered on August 5, 1994. As it turns out, the then-presiding court based its decision to approve the motion largely on the brothers' separate declarations stating that (i) the sales were arms-length, third party transactions, (ii) neither Harry nor Theodosios were insiders of, or held interests in, either of the two entities, (iii) prior to the sales, neither Harry nor Theodosios knew the purchasers or their insiders, and (iv) the properties were over-encumbered. After the cases were reopened at the urging of the defrauded partner's widow, Mr. Ehrenberg determined that these statements were knowingly false at the time they were made.

In order to remediate the evident fraud, Mr. Ehrenberg filed adversary proceedings in August 2015 against the brothers, their spouses, and the entities which still held title to the properties twenty-one years later. Among other claims, Mr. Ehrenberg sought to vacate the 1994 sales for fraud on the court pursuant to Rule 60(d)(3), applied to bankruptcy cases by Rule 9024 of the Federal Rules of Bankruptcy Procedure. What followed were a series of motions by the debtors and the entities seeking to thwart the trustee's ability to unwind the 1994 sales and have the adversary proceeding dismissed. While not necessarily disputing the allegations of fraud, the debtors argued that the trustee's claims could only arise under Rule 60(b)(3), with its one-year statute of limitations, not Rule 60(d)(3), which allows a court "to set aside a judgment for fraud on the court" and has no limitations period. *Valerio v. Boise Cascade Corp.*, 80 F.R.D. 626 , 640 n.10 (N.D. Cal. 1978), *aff'd*, 645 F.2d 699 (9th Cir. 1981) ("[t]here is no statute of limitations for fraud on the court. And jurisdiction exists to consider such a claim even if there are no adversary parties then present before the court.")

Rule 60(d)(3) is a codification of the court's "inherent power... to investigate whether a judgment was obtained by fraud." *Universal Oil Products Co. v. Root Ref. Co.*, 328 U.S. 575, 580, 66

About the Author

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As explained by the Ninth Circuit in *United States v. Estate of Stonehill*, 660 F.3d 415, 444-45 (9th Cir. 2011), "[m]ost fraud on the court cases involve a scheme by one party to hide a key fact from the court and the opposing party." Perjury or nondisclosure of evidence may constitute fraud upon the court if "that perjury or nondisclosure was so fundamental that it undermined the workings of the adversary process itself." *Id.* at 445.

S. Ct. 1176, 90 L. Ed. 1447 (1946). As explained by the Ninth Circuit in *United States v. Estate of Stonehill*, 660 F.3d 415, 444-45 (9th Cir. 2011), "[m]ost fraud on the court cases involve a scheme by one party to hide a key fact from the court and the opposing party." Perjury or nondisclosure of evidence may constitute fraud upon the court if "that perjury or nondisclosure was so fundamental that it undermined the workings of the adversary process itself." *Id.* at 445.

The bankruptcy court found ample reason to deny the motions to dismiss. The court not only found that Mr. Ehrenberg alleged facts sufficient to state claims for fraud on the court under Rule 60(d)(3), but the alleged false declarations made it impossible for the presiding court to "perform in the usual manner its impartial task of adjudging" the sale motion. *Anand v. CITIC Corp. (In re Intermagnetics Am., Inc.)*, 926 F.2d 912 (9th Cir. 1991). The original court's impartial review was fatally compromised by its lack of awareness of a crucial fact - that the purported arms-length sales were, in reality, sales to entities directly controlled by the debtors and their spouses.

Moreover, the bankruptcy court noted that a sale to insiders is fundamentally different from an arms-length sale. In an arms-length transaction, the asset's exposure to the marketplace insures that the price is reasonable whereas insider sales, by their very nature, lack this characteristic. Insiders do not have an incentive to aggressively market the assets to obtain the highest price. Their incentive is just the opposite - the less marketing, and the lower the price, the better. Consequently, although nothing in the Bankruptcy Code prohibits a sale to insiders, insider sales are subject to "heightened scrutiny to the fairness of the value provided by the sale and the good faith of the parties in executing the transaction." *In re Family Christian, LLC*, 533 B.R. 600, 622 (Bankr. W.D. Mich. 2015).

As a result of the brothers' false declarations, the original court could not apply the heightened scrutiny necessary to ensure that the insider sales yielded optimal value for creditors. *See Simantob v. Claims Prosecutor, LLC (In re Lahijani)*, 325 B.R. 282, 288-89 (B.A.P. 9th Cir. 2005) ("The court's obligation in § 363(b) sales is to assure that optimal value is realized by the estate under the circumstances.") By preventing the court from applying the correct legal standard, the debtors' "perjury ... was so fundamental that it undermined the workings of the adversary process itself." *Stonehill*, 660 F.3d at 445.

In allowing the adversary case to proceed, the court noted similarities between the Roussos brothers' conduct and another case -- *Levander v. Prober (In re Levander)*, 180 F.3d 1114 (9th Cir. 1999) -- where Rule 60(d)(3) was applied where the debtors' perjury was part of a scheme to "hide a key fact from the court and the opposing party." *Stonehill*, 660 F.3d at 445. In *Levander*, the key hidden fact was that a corporation had transferred its assets to a related partnership that neither the court nor the parties knew existed. *Levander*, 180 F.3d at 1120. As a result of the perjured statement that the assets had not been transferred, the *Levander* court imposed attorney's fees upon the wrong party. The perjury was serious enough to constitute fraud upon the court because it was impossible for the court or parties to be aware of the deception.

The false statements presented by the Roussos brothers' fraud were at least as material as those in *Levander*. Similar to *Levander*, the presiding court did not know, and could not have known, that the sham entities purportedly purchasing the properties at arms-length were, in fact, secretly controlled by the debtors. As a result of these hidden facts, the bankruptcy process could not function in its normal fashion as no one knew the true nature of the transactions.

The bankruptcy court's ruling also is noteworthy in that it declined to follow the Seventh Circuit's decision in *Gekas v. Pipin (In re Met-L-Wood Corp.)*, 861 F.2d 1012 (7th Cir. 1988), where that Circuit Court held that it would be fraud against creditors, but not the trial court, for a debtor's controlling officer "to use his control to walk off with [the debtor's] principal assets for a song, shucking off the unsecured creditors in the process." *Id.*, at 1019. As a rationale for its limited holding, *Gekas* points to the necessity of finality in bankruptcy sales to maximize the sales price. *Id.*, at 1019. The bankruptcy court, however, believed that *Gekas* pays insufficient attention to the decreased sale price that inevitably results when debtors collusively sell assets to entities under their secret control. As highlighted, debtors in such schemes have no incentive to aggressively market the assets so that the estate obtains optimal value. Therefore, immunizing fraudulent and collusive sales from later attack decreases sale prices. And allowing the court to remain infected by such serious fraud undermines the legitimacy of the bankruptcy sales process, further deterring serious bidders.

The bankruptcy court also rejected the argument that it was bound to follow the Ninth Circuit's decision in *Robertson v. Isomedix, Inc. (In re Int'l Nutronics, Inc.)*, as restated in *Stan Lee Media, Inc. v. Conan Sales Co., LLC*. *Robertson v. Isomedix, Inc. (In re Int'l Nutronics, Inc.)*, 3 F.3d 306 (9th Cir. 1993); *Stan Lee Media, Inc. v. Conan Sales Co.*, LLC, 2012 U.S. Dist. LEXIS 191257 (C.D. Cal. Feb. 8, 2012) (unpublished disposition), *aff'd*, 546 Fed. Appx. 725 (9th Cir. 2013). In *Nutronics*, a chapter 7 trustee rejected two competing offers to purchase the debtor's assets. *Nutronics*, 28 F.3d at 967. The trustee then instructed the bidders to submit new bids. Upon learning that they were the only two bidders, the bidders formed a joint venture and submitted a much lower combined bid, which the trustee ultimately accepted. The trustee then sought and obtained approval of the combined bid from the court. In so doing, the trustee expressed no objection to the joint bid. Twenty-two months after obtaining court approval of the sale to the joint venture bidders, the trustee filed an action against the bidders seeking to invalidate the sale. The trustee alleged that the combined bid constituted an unlawful business combination in violation of the Sherman Anti-Trust Act and the sale should be avoided under Section 363(n) of the Bankruptcy Code, which provides that sales may be avoided "if the sale price was controlled by an agreement among potential bidders at such sale."

The Ninth Circuit affirmed the dismissal of the trustee's complaint. *Nutronics*, 28 F.3d at 971. The Court explained that the trustee's claim under Section 363(n) was more appropriately characterized as a motion for relief from a final order under Rule 60(b)(3). *Id.*, at 969. As such, the claim was barred by Rule 60(b)'s one-year statute of limitations. The Ninth Circuit also found that the claims were barred by *res judicata*. *Id.*, at 970. In making this finding, the Court emphasized that the trustee was fully aware of the collusive behavior at the time he sought court approval of the sale order. As the Court explained, "[i]If the joint bid was unduly low because of unlawful collusion, and that fact was known to the trustee at the time, then it should have been brought to the attention of the bankruptcy court." *Id.*, at 970.

The bankruptcy court found that the Roussos brothers' case bore little similarity to *Nutronics*. The trustee's complaint in *Nutronics* did not even assert a claim for fraud on the court under Rule 60(d)(3), which was the centerpiece of Mr. Ehrenberg's efforts to invalidate the 1994 sales. Importantly, the Ninth Circuit based its decision upon Rule 60(b), not Rule 60(d)(3), and upon the fact that the trustee was precluded from asserting the collusion claim as a result of his failure to do so previously. In determining that the trustee's complaint could be characterized only as a motion under Rule 60(b), the Ninth Circuit implicitly concluded that whatever fraud may have occurred was not serious enough to constitute fraud on the court. By rejecting the application of *Nutronics*, the bankruptcy court noted that the fraud alleged by the trustee in *Nutronics* (bid rigging) was far less serious than the fraud alleged by Mr. Ehrenberg (the creation of sham entities and the submission of perjurious declarations). To hold otherwise would eviscerate the bankruptcy court's broad equitable powers to cleanse itself of fraud and would render Rule 60(d) meaningless, at least with respect to bankruptcy sales.

Having survived multiple attempts to strip away various claims, especially the Rule 60(d)(3) claims, the debtors and the sham entities capitulated and entered into a series of court-approved settlements with Mr. Ehrenberg which (i) voided, *ab initio*, the 1994 sales, (ii) cancelled the grant deeds conveying title to the two sham entities, and (iii) confirmed that the buildings were property of the individual estates. A sale of one of the recovered buildings ensued, and creditors left holding the bag in 1994 will now receive significant distributions due to the extraordinary power of Rule 60(d)(3).

Conclusion

A guiding principle in bankruptcy is that what is done, is done. What the saga of the Roussos brothers shows, however, is that a court is never precluded from protecting itself from fraud. This tool can be very powerful if a trustee is presented with a case where a party obtained relief by defrauding the court.