IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF IDAHO

IN RE	)	
	)	
LAKE COUNTRY INVESTMENTS, Limited Liability Company,	)	**Case No. 99-20287**
	)	
Debtor.	)	**MEMORANDUM OF DECISION**
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	)	
AGINCOURT, L.L.C., an Idaho Limited Liability Company, and WEST WOOD INVESTMENTS, INC., a Washington corporation,	)	
	)	
Plaintiffs,	)	
	)	
vs	)	**Case No. 00-6064**
	)	
ROGER STEWART, individually, and PATTY STEWART and their marital community; PAUL STEWART JR., individually, and CARRIE STEWART and their marital community; ARROW POINT DEVELOPMENT CO., INC., an Idaho corporation, JOHN NOYES and ALICIA NOYES, individually and their marital community,	)	
	)	
Defendants.	)	
	)	
_____	)	

Michael M. Feinberg, Seattle, Washington, and Robert J. Fasnacht, Coeur d'Alene, Idaho, for Plaintiffs West Wood Investments, Inc. and Agincourt, L.L.C.

John E. Miller, Coeur d'Alene, Idaho, for Defendants Roger and Patty Stewart, Paul and Carrie Stewart, and Arrow Point Development Co., Inc.

R. Wayne Sweney, Coeur d'Alene, Idaho, for Defendants John and Alicia Noyes.

INTRODUCTION AND BACKGROUND

Agincourt, L.L.C. ("Agincourt") and West Wood Investments, Inc. ("West Wood") (together "Plaintiffs") filed an Idaho state court lawsuit against Arrow Point Development Company, Inc. ("APDC") and its principals, members of the Stewart family, alleging four causes of action: fraud, negligent misrepresentation, violation of Idaho securities law, and violation of Idaho consumer protection statutes. An Amended Complaint was filed adding as Defendants John and Alicia Noyes ("Noyes") and adding two additional claims: fraudulent conveyance and/or illegal distribution of corporate assets. These claims related to a 1996 conversion of Noyes' equity position in APDC to a secured creditor status as against APDC and certain APDC real estate.

Noyes removed the lawsuit to this Court based upon its connection with Lake Country Investments, LLC, an Idaho limited liability company and chapter 11 debtor in Case No. 99-20287 ("Lake Country" or "Debtor"). Lake Country has two members, Agincourt and APDC, each holding 50% of its units. West Wood is the managing member and primary owner of Agincourt.

By way of its decision entered on July 10, 2000, reported as *Agincourt v. Stewart (In re Lake Country Investments)*, 00.3 I.B.C.R. 138 (Bankr. D. Idaho 2000), the Court: (1) abstained from hearing and remanded to state court the first four

(of six) causes of action of the Amended Complaint; (2) abstained from hearing and remanded to the state court the first four (of five) counterclaims of APDC; (3) dismissed the fifth counterclaim of APDC; and (4) denied motions to dismiss the fifth and sixth counts of the Amended Complaint, which asserted the cause of fraudulent conveyance against Noyes and APDC and the cause of illegal distribution of corporate assets against Noyes, APDC and the Stewarts.

On April 24, 2000, Noyes filed an Answer and Counterclaim to the Amended Complaint. On September 12, Plaintiffs filed a motion for partial summary judgment, seeking to dismiss Noyes' counterclaims. This is the primary matter now before the Court.

Among their submissions in support of the motion, Plaintiffs filed on September 12 a Declaration of Robert D.C. Malcolm (the "First Malcolm Declaration"); on October 26 a Declaration of Michael Feinberg (the "Feinberg Declaration"); and on October 26 another Declaration of Robert Malcolm (the "Second Malcolm Declaration").

On October 10, Noyes filed a motion to strike the last sentence of ¶10 of the First Malcolm Declaration and Exhibits F and G attached thereto. On November 6, Noyes filed a motion to strike the Feinberg Declaration and all its attachments. On November 6, Noyes moved to strike the Second Malcolm Declaration. On November 22, Plaintiffs filed a "cross-motion to strike" the Declaration of Gary Frame which had been filed by Noyes on November 10.

These motions to strike, and the Plaintiffs' motion for summary judgment, were heard on November 27, taken under advisement, and this Decision resolves them.[1]

DISCUSSION AND DISPOSITION

A. First Motion of Noyes to Strike

As this Court held in the related adversary proceeding[2] of *Esposito v. Noyes* (*In re Lake Country Investments*), 255 B.R. 588, 00.4 I.B.C.R. 175 (Bankr. D. Idaho 2000), motions to strike affidavits and declarations must be resolved and the extent of the record established prior to addressing motions for summary judgment.

Noyes seeks to strike a statement in the First Malcolm Declaration and two exhibits to that Declaration. The attacked sentence addresses Noyes' alleged willingness during 1998 negotiations to pay off a senior secured position (the so-called "APP Note") and the two exhibits are letters from one of Noyes' attorneys on the subject. Noyes argues that the same contravene Fed.R.Evid. 408, which states:

> Evidence of (1) furnishing or offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim

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[1] Extensive briefing and argument has been presented in regard to all the motions, and a significant amount of prior briefing in the case is incorporated by reference. Affidavits and deposition testimony are submitted, and requests have been made for judicial notice of pleadings in the underlying bankruptcy file, including additional affidavits and documents. Then, in December, an additional change in circumstances occurred – the sale of real and personal property under the confirmed plan of liquidation of Lake Country. This included a sale of Debtor's causes and choses of action to Noyes, who then sought leave to amend his counterclaims, generating yet another round of pleading and briefing.

[2] This proceeding, Adv. No. 00-6057, has been consolidated with the instant proceeding for purposes of discovery and trial. *See* Order entered January 25, 2001 herein.

> which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible. This rule does not require the exclusion of any evidence otherwise discoverable merely because it is presented in the course of compromise negotiations. This rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negativing a contention of undue delay, or proving an effort to obstruct a criminal investigation or prosecution.

The reason for the rule is to avoid ascribing probative value to statements made solely within the context of settlement negotiations. Such statements may be made only in order to facilitate consensual resolution, rather than reflecting any concession of weakness of position. Freely allowing such statements to be used against the speaker in later litigation would discourage settlements. *See generally*, Fed.R.Evid. 408 (Notes of Advisory Committee on Rules, citing 1 McCormick on Evidence, at §§ 76, 251 (5th ed. 1999)).

The rule does not create an automatic exclusion of everything that is said or written during the course of negotiations between parties. The rule does not require exclusion if the evidence is offered for a purpose other than proving liability for, or the invalidity of, the claim or its amount. The rule thus requires that the claim be disputed as to validity or amount. *Id.; accord*, Russell, Bankruptcy Evidence Manual § 408.1, at 507 (2000 ed.), discussing *In re B.D. Intern. Discount Corp.*, 701 F.2d 1071 (2d Cir. 1983).

The Court has considered Noyes' contentions, the Wroe Declaration filed by Noyes on November 16 in support of the motion to strike, and the fact that objections

were made on similar grounds by one of West Wood's attorneys during a May 1999 deposition of Mr. Malcolm. Still, the Court does not find that the contested statement or exhibits address comments by or on behalf of Noyes made within the context necessary to support application of Rule 408. They were essentially statements made in the context of business negotiations rather than in negotiations to settle a claim disputed as to liability or amount. The motion to strike will be denied.

B. The Second Motion of Noyes to Strike

This motion seeks to strike the Feinberg Declaration in its entirety, including its attachments. The Declaration is, in essence, a vehicle for bringing a single page document from the files of U.S. Bank before the Court. Noyes also argues that the Feinberg Declaration was "untimely".

In regard to the question of timeliness, the Court observes that the hearing initially scheduled for October 16 was vacated by agreement of the parties, and rescheduled for November 27. Plaintiffs were allowed 10 days (through October 26) to file additional materials responsive to Noyes' submissions, and Noyes an additional 5 days for reply. Minute Entry, October 16, 2000 (Doc.No. 80). Both the Feinberg Declaration and the Second Malcolm Declaration were filed within this period and a month in advance of November 27. The Court finds no time bar applicable to the Feinberg Declaration. This objection will be overruled.

The substantive objection of Noyes is that Mr. Feinberg lacks the ability to lay the proper foundation for the admission and consideration of the document attached to his Declaration. This issue was also explored in *Esposito*, and the Court held that

Rule 56(e) requires affidavits to be made on "personal knowledge," set forth facts admissible in evidence, and show that the affiant is qualified to testify to the matters set forth in the affidavit including the documents attached thereto. The Court struck attorneys' affidavits which failed to met the requirements of the rule, and established only that the documents had been produced or provided to the attorneys by another person or entity. 255 B.R. at 594-95, 00.4 I.B.C.R. at 176-77.

Here Mr. Feinberg attached to his Declaration an "Affidavit of Records Custodian" attesting to the fact of production of U.S. Bank files under a subpoena duces tecum.[3] The Declaration and the incorporated affidavits are then used in attempted support of a single page document which consists of hand-written notes of some unidentified individual.

At first blush, the same sort of problem exists here as in *Esposito*. Mr. Feinberg and his sub-affiants can establish the existence of the document in the bank's files, but none specifically testify as to its provenance or content. More is required than simply reciting that the bank had a document and now has provided a copy to counsel. There must be some foundation laid as to the document itself or its contents.

However, the "custodian" affidavit at ¶2 recites that "These records [*i.e.,* apparently all documents produced by U.S. Bank under the subpoena] were prepared

[3] There is a second incorporated affidavit of a paralegal in the bank who was a conduit of copies of 1185 pages of such documents.

in the ordinary course of business at or near the time of the act, condition, or event."[4] Since only one page is offered here, the Court can't test this rather sweeping characterization of the produced materials.

The document in question, Exhibit C to the affidavit, is a hand-written note bearing a date of "10/8/97." The author is unidentified and, at this time, unknown. The author appears to memorialize a conversation with, or a communication from,

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[4] It appears the intent is to come within Fed.R.Evid. 803(6) which provides that the hearsay rule does not operate to exclude:

> (6) Records of regularly conducted activity. A memorandum, report, record, or data compilation, in any form, of acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the ordinary course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record, or data compilation, all as shown by the testimony of the custodian or other qualified witness, unless the source of information or the method or circumstances of preparation indicate lack of trustworthiness. The term "business" as used in this paragraph includes business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit.

Roger Stewart of APDC.[5] The note states, in part:

> E. Foo purchase note by year-end? Noyes offering 50% discount on note and/or keep him in 2nd position via note purchase above.

The Court is asked to speculate as to the author, context, meaning and import of this statement. Even if it accurately reports what Stewart said, it doesn't establish that Noyes said it. It is also cumulative to other submissions by Plaintiffs regarding the disclosure in 1997 of the potential purchase of the APP Note and/or Noyes' alleged willingness to negotiate in late 1997 regarding his second position security.

The Court concludes that the motion to strike will be denied. The problems identified go to the value of the exhibit. The affidavit's attachment will be remain part of the record for purposes of the summary judgment motion, but will be given no more weight than it deserves.

C. The Third Motion of Noyes to Strike

Noyes argues that the Second Malcolm Declaration of October 26 is untimely and should be stricken. At hearing it appeared that this motion would be withdrawn. If not withdrawn, this motion will be denied for the reasons set forth above.

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[5] Though not established by way of testimony, Plaintiffs assert: "Roger Stewart also raised the subject [of West Wood's possible purchase of the APP Note] in a conversation with U.S. Bank on October 8, 1997." Reply Memorandum (Doc.No. 83), at 10.

D. The Cross-Motion of Plaintiffs to Strike

Plaintiffs argued that their allegedly "late" material either was within the period of extension granted by the Court or was proper rejoinder to Noyes, but that the Frame Declaration[6] submitted by Noyes on November 10 should have been advanced earlier than it was. They seek to have it stricken as untimely.

Rule 56(c) allows the "adverse party" up to the day prior to hearing to file responsive materials.[7] The rule does not address a movant's reply affidavits or a non-movant's surrebuttal submissions. Though arguably the November 10 Frame Declaration should have been filed around November 1 pursuant to the Court's ruling at the October 16 hearing, it was still filed some two weeks prior to hearing.[8] It was filed in order to address an argument in the Plaintiffs' reply briefing. The Court concludes that the Frame Declaration need not be rejected on the basis of "untimeliness." This motion to strike will be denied.

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[6] Frame was a partner in APP and testifies regarding communications in 1997 between APP and attorneys for Lake Country and West Wood.

[7] Both sides cite to varying degrees former Id.L.Civ.R. 7. The local rules of the District Court were amended and repromulgated January 1, 2001. Amended Local Bankruptcy Rules were adopted March 1, 2001. The prior, admittedly confusing inter-relationship of these two sets of local rules has been clarified. *See* LBR 1001.1(b) (providing that the District Court's local rules apply to bankruptcy matters only where reference is withdrawn or on appeal). The Court concludes that former Id.L.Civ.R. 7 should not operate as a bar to any of the submissions herein.

[8] Plaintiffs argue that this situation is similar to that in *Esposito* and that Rule 56(f) was not met. 255 B.R. at 596, 00.4 I.B.C.R. at 178. However, filing in advance of the hearing here sufficiently distinguishes the situation from that in *Esposito*.

E. Plaintiffs' motion for summary judgment

The applicable standards for considering summary judgment were articulated in *Esposito*, 255 B.R. at 597, 00.4 I.B.C.R. at 178-79:

> Summary judgment may be granted if, when the evidence is viewed in a light most favorable to the non-moving party, 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(e); Fed.R.Bankr.P. 7056. *Anguiano v. Allstate Insurance Company*, 209 F.3d 1167, 1169 (9th Cir. 2000); *Margolis v. Ryan*, 140 F.3d 850, 852 (9th Cir. 1998).
>
> The Court does not weigh the evidence in considering summary judgment. Rather, it determines only whether a material factual dispute remains for trial. *Covey v. Hollydale Mobile home Estates*, 116 F.3d 830, 834 (9th Cir. 1997).
>
> The initial burden of showing there is no genuine issue of fact rests on the moving party. *Margolis*, 140 F.3d at 852. If the non-moving party bears the ultimate burden of proof on an element at trial, that party must make a showing sufficient to establish the existence of that element in order to survive a motion for summary judgment. *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); *Nissan Fire & Marine Ins. Co., Ltd. v. Fritz Companies, Inc.*, 210 F.3d 1099, 1102 (9th Cir. 2000). Failure to sustain this burden as to any required element of a cause of action is fatal to that cause, even if issues are shown to exist as to other elements. A complete failure on one element necessarily renders the other elements "immaterial" whether factually disputed or not. *Celotex*, 477 U.S. at 323, 106 S.Ct. 2548.

Plaintiffs seek summary judgment dismissing Noyes' counterclaim. The parties in briefing and oral argument have generally viewed the counterclaim as presenting three basic contentions, and the Court will address them in this Decision as separate counts.

In short, the "first count" asserts that the real estate secured position arising from the April 1993 note and mortgage made by APDC in favor of APP, which was later acquired and is now held by West Wood, should be subordinated to claims of unsecured creditors of the Debtor, Lake Country. The "second count" contends that this secured position of West Wood should be subordinated to Noyes' secured claim on the real property, characterized as Parcels 1 and 3, which secures them both. The "third count" argues that West Wood has waived its secured claim by reason of failure to comply with the "one action rule" of Idaho Code § 6-101. The counts will be addressed here in reverse order.

1. The "One Action Rule" (Third Count)

In ¶33 of the counterclaim,[9] Noyes alleges:

> 33. The Court should also find that WEST WOOD has waived its secured claim by bringing this action without compliance with Idaho Code § 6-101.

This count seeks to defeat West Wood's secured position on the basis that West Wood has failed to comply with Idaho's "one action rule."

This Court has already once considered Noyes' assertion of the one action rule in opposition to West Woods' secured claim, and rejected that contention on the basis that Noyes lacked standing. 00.3 I.B.C.R. at 146. Nothing advanced in this round of

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[9] At hearing on February 13, the Court ruled that leave to amend the counterclaim would be granted. The Order granting Noyes' motion to amend was entered on March 6. The motion for partial summary judgment is addressed to the original counterclaim. While the Court has endeavored to consider the impact of the proposed amendments to the counterclaim, references herein are still to the language of the original counterclaim.

litigation convinces the Court that this ruling should be altered, and Noyes did not strenuously urge its reconsideration.

However, Noyes on December 7, 2000 purchased for $91,000 what was characterized in the confirmed chapter 11 plan of liquidation for Lake Country as "Parcel 8" which included

> all causes and choses in action held by Lake Country ... to the extent that the Trustee/Liquidating Agent is legally able to assign said causes or choses in action, and to the extent said causes or choses in action have not been initiated by the Chapter 11 Trustee on or before a date 30 days beyond the effective date of the Plan, and excluding any and all claims held by the Debtor against Arrow Point Development Company, Inc. and John Noyes.

See, Order Confirming Second Amended Plan of Liquidation, filed October 17, 2000 (Doc.No. 204) in Case No. 99-20287, at ¶5.1.3, p. 14.

Plaintiffs have briefed and argued at length that several factual and legal impediments exist which undermine or foreclose Noyes' ability to assert some or all of the Lake Country claims which he bought. However, the Court determined at hearing on February 13 that such issues did not rise to the level that would foreclose amendment,[10] and the same arguments could be raised by Plaintiffs in due course after the amended counterclaim was filed.

While Noyes' individual standing to assert the one action rule was and still is lacking, the Court has considered whether Noyes' purchase of Lake Country's rights

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[10] The Court rejected the contention that "futility" of amendment operated to bar Noyes' motion. *See, Murphy v. Wray (In re Wray)*, ___ B.R. ___, 2001 WL 128471 (Bankr. D. Idaho 2001) discussing *Miller v. Rykoff-Sexton, Inc.*, 845 F.2d 209 (9th Cir. 1988).

makes any difference. While the mortgagor is the party most likely to have a basis to assert a one action defense, the Court has assumed -- solely for the purposes of this discussion – that Lake Country, as a non-mortgagor holder of the subject real property, has standing to raise the question.[11]

Even so, the Court concludes the claim fails. As stated in its earlier decision:

> The one action rule is a limitation on the ability of a real estate mortgagee to pursue its mortgagor/ debtor directly on the secured debt without first (or simultaneously) looking to recover upon its real estate security. It is codified at § 6-101 of the Idaho Code.
>
> The function of the rule is to protect the original debtor from a multiplicity of suits on debts secured by a mortgage, ands requires the mortgagee to exhaust the security before seeking a deficiency judgment. *Eastern Idaho Production Credit Association v. Placerton, Inc.*, 100 Idaho 863, 868, 606 P.2d 967, 972 (1980).

00.3 I.B.C.R. at 146 (footnote omitted). *See also, First Security Bank of Idaho, N.A. v. Stauffer*, 112 Idaho 133, 137-39, 730 P.2d 1053, 1057-59 (Ct.App. 1986).

Noyes argues that "by bringing this action" West Wood runs afoul of § 6-101. However, in this action, West Wood does not seek to foreclose its mortgage and recover on the real property security or to collect on the APP Note from its obligor. It seeks, in the causes of action remaining before this Court, to have the 1996 Noyes redemption agreement cast as a fraudulent conveyance or illegal distribution of

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[11] Lake Country, as of today's date, is no longer the holder of the real property. The Trustee sold the property in December, and the estate now administers the proceeds of sale. *See*, Trustee/Liquidating Agent's Auction Report filed December 12, 2000 (Doc.No. 222) in Case No. 99-20287.

APDC's corporate assets.[12] It seeks damages from Noyes and APDC in the event it prevails. It is not seeking in "this action" to recover on the APP Note.[13]

It was sufficient in July to resolve the question on Noyes' lack of standing. In doing so, the Court expressed considerable doubt that the one action rule was implicated at all.[14] It now concludes that the one action rule is inapplicable to the present action, even if asserted by Lake Country (a party with only a slightly more tenable standing argument than Noyes). Therefore, Plaintiffs' motion for summary judgment dismissing this count of the counterclaim will be granted.

2. Equitable subordination (First and Second Counts)

a. Standards

The factors to be considered in determining whether equitable subordination under § 510(c) is appropriate are as follows:

> (I) The claimant [party against whom subordination is sought] must have engaged in some type of inequitable conduct.
> (ii) The misconduct must have resulted in injury to the creditors of the bankruptcy or conferred an unfair advantage on the claimant.
> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.

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[12] There were, of course, other causes originally pleaded which were remanded. Whether the one action rule applies to them can be left to the state court to decide. *Accord*, 00.3 I.B.C.R. at 143 (Court should avoid substantive rulings on parts of actions returned to state court).

[13] In point of fact, West Wood seeks to enforce its rights under the note and mortgage in a separate state court action, which was filed earlier this year and which has been removed to this Court as Adv. No. 01-6503.

[14] *See*, 00.3 I.B.C.R. at 146 (the connection, for § 6-101 purposes, between West Wood's claims against APDC regarding fraudulent conveyance and those against APDC on the secured APP debt was "by no means absolutely clear").

Esposito, 255 B.R. at 604, 00.4 I.B.C.R. at 182, citing *In re Filtercorp, Inc.*, 163 F.3d 570, 583-84 (9th Cir. 1998). *See also*, *In re Pacific Express*, 69 B.R. 112, 116 (9th Cir. BAP 1986); *In re Idaho Falls Associates, L.P.*, 93 I.B.C.R. 74, 81 (Bankr. D. Idaho 1993). The burden of proving all these elements is on the objector.

Where the claimant in question is an insider, its dealings with the debtor are subjected to exacting scrutiny and, if the objector presents sufficient substantiations of misconduct by the insider claimant, the burden will shift to the insider to establish good faith. 93 I.B.C.R. at 81, citing *Pacific Express*, 69 B.R. at 116. Nevertheless:

> Equitable subordination is a judicially created doctrine developed as a policy against fraud in the breach of duty imposed on a fiduciary of the debtor. The reason that the transactions of insiders will be closely studied is because such parties usually have greater opportunities for such inequitable conduct, not because the relationship itself is somehow a ground for subordination. If the alter ego or insider has fiduciary responsibilities to other creditors, then claims that might otherwise be allowable as proved may perhaps be subordinated. But if the insider claimant has no fiduciary responsibilities, its claims, while closely scrutinized, should only be subject to subordination on grounds that would apply equally to outsiders.

L. King, Collier on Bankruptcy (15th rev. ed. 2000) ¶510[3][c], p. 510-23.

b. The "Second Count"

Noyes argues that the separate legal identities of West Wood and Agincourt should be disregarded and that Plaintiffs are merely alter egos of one another. *See*, Answer and Counterclaim at 8, ¶¶ 9-12. Thus West Wood's conduct is allegedly attributable to Agincourt, which allegedly has certain fiduciary duties to Lake Country. The breaches of fiduciary duty which are presented by Noyes concern a failure to fund Lake Country in order that it could assume the senior APP Mortgage on the real property APDC contributed to the Debtor, a subsequent purchase of the APP Note and secured position instead of making a capital contribution to Lake Country for the purpose of retiring that obligation, and the direct purchase of properties adjoining the Debtor's property. *Id.*, at 10 -11, ¶¶ 21 - 26.

In ¶¶27 and 31, Noyes alleges:

> 27. As a direct and proximate result of the above described breaches of fiduciary duties and implied covenants of good faith and fair dealing, the lien and secured claim of WEST WOOD should be subordinated to the lien and secured claim of JOHN NOYES.
>
> 31. The claims of the plaintiffs against the debtor and its properties should be subordinated to the claims of NOYES.

Answer and Counterclaim, at 11 - 12. The gravamen of the Second Count is that, given what are alleged to be grounds for treating Agincourt and West Wood as alter egos, and as a result of a breach of fiduciary duties by Agincourt as a member of

Lake Country, the lien and secured claim of West Wood should be subordinated to the lien and secured claim of Noyes.[15]

These predicate allegations are the same for the so-called First Count; only the extent of the subordination remedy changes.

c. The "First Count"

Noyes alleges in ¶¶ 29-30 and 32 of the Answer and Counterclaim[16] that, as a result of the conduct of Plaintiffs, Lake Country suffered monetary damages (¶29); that when Plaintiffs attained the position of senior secured creditor they harmed both the Debtor and "other secured creditors, including NOYES" (¶30, emphasis supplied); and that Noyes "as well as the other junior and good faith creditors of this bankruptcy estate" are entitled to equitable protection, presumptively subordination (¶32, emphasis supplied). *Id.*, at 12.

i. Standing to assert First Count

The litigants take the view that Noyes thus alleges a claim for equitable

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[15] That such equitable subordination might elevate Noyes' secured position runs counter to the fact that here Noyes in February 1996 contractually subordinated his lien to the then-existing APP mortgage. West Wood purchased the APP Note and position almost two years later in December 1997.

[16] Since it was discussed above, ¶31 is not repeated here.

subordination of Plaintiffs' secured interests[17] to all creditor claims. Plaintiffs contend that Noyes, who holds but a non-recourse secured claim in this matter, lacks standing to advance the cause of subordination for Lake Country, its estate or its creditors.[18] Under the Court's prior analysis of the issue of standing to assert equitable subordination, *see* 00.3 I.B.C.R. at 144, this argument is well taken.

However, as noted above, Noyes bought the "causes and choses in action" of Lake Country when the same were liquidated under the confirmed plan. Under the circumstances, it would be premature to dispose of the First Count on standing grounds and the motion of Plaintiffs would need to be denied.[19]

d. Noyes' approach to equitable subordination

All of the equitable subordination theories presented in the counterclaim flow from the same wellspring:

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[17] The attack is primarily on West Wood's acquisition of the APP Note and the subordination of the position represented thereby. The counterclaim could be read to allege that all secured claims of Plaintiffs (at times defined so as to include Fortress, LLC as well as West Wood and Agincourt), whether on parcels 1 and 3 or on other real property, should be subordinated. *See, e.g.,* ¶¶ 26, 31 and Prayer at ¶ C.

[18] The Court concludes Noyes has standing to assert equitable subordination as to their own lien claim. *See, Energy Income Fund, L.P. v. Compression Solutions, Co., L.L.C. (In re Magnolia Gas Co., L.L.C.)*, 255 B.R. 900, 924 (Bankr. W.D. Okla. 2000).

[19] The Court appreciates, as discussed previously, that Plaintiffs have yet to be heard on the merits of their several arguments that assertion of Lake Country's claims by Noyes is or should be barred.

(1) Agincourt, as a member of the LLC, owed express fiduciary duties to Lake Country under the formative and operating agreements of that LLC and/or fiduciary duties implied under Idaho law;

(2) West Wood is the alter ego of Agincourt, and the two should be treated as the same, and their separate legal identities should be disregarded;

(3) West Wood/Agincourt breached the fiduciary duties owed Lake Country when the APP Note and related secured position against Lake Country was acquired and held instead of being discharged through additional capital contribution; and

(4) Noyes and/or Lake Country's creditors generally were harmed by that conduct.[20]

The failure of Noyes to sustain the burden of showing the existence of genuine factual issues to be tried on any one required element would be fatal to the claim, whether as set out in the First Count or in the Second Count. *Esposito*, 255 B.R. at 597, 00.4 I.B.C.R. at 179, citing *Celotex*, 477 U.S. at 322-23 and *Nissan Fire & Marine Ins. Co., Ltd. v. Fritz Companies, Inc.*, 210 F.3d 1099, 1102 (9th Cir. 2000).

The Court concludes that Noyes has presented genuine issues of material fact on the contention that West Wood and Agincourt are alter egos. However, even assuming that Noyes will be able to prove that element, the Court is persuaded by Plaintiffs that Noyes fails to carry this burden as to the other elements. The Plaintiffs

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[20] Should Noyes be unsuccessful in attempts to prove this cause of action on the basis of breach of express or implied fiduciary duties, it is evident that he would contend the conduct of Plaintiffs was still inequitable, unfair, and injurious and therefore actionable against non-fiduciary insiders under the case law mentioned earlier.

are therefore entitled to entry of summary judgment dismissing these two equitable subordination counts of the counterclaim.

e. Fiduciary duty and breach

In order for Noyes to prevail on the cause of equitable subordination based on a breach of fiduciary duty, he must establish first the existence of a fiduciary duty and, second, the breach of that duty. *Jordan v. Hunter*, 124 Idaho 899, 865 P.2d 990, 995 (Ct. App. 1993). Noyes views the duty as arising from the agreements for the formation and operation of the Debtor, and from Idaho law generally.

On October 30, 1996, Lake Country was organized as an Idaho limited liability company (LLC).[21] APDC and Agincourt were and are the two equal members of this LLC. Before the Court are the Formation Agreement between Agincourt, APDC and John A. McKay, dated November 26, 1996, an Addendum thereto dated January 31, 1997, and an Operating Agreement dated January 31, 1997.[22] A First Amended Operating Agreement ("AOA") was entered into on August 1, 1997. *See* Declaration of Roger Stewart of October 10, 2000 (Doc.No. 77) at Exhibit 2. These documents establish and define the mutual rights and obligations of the members of the LLC. *See* AOA at ¶2.01.

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[21] Greatly simplified, an LLC is an entity with the tax advantages of a general partnership but with corporate limited liability for the protection of its members. It is addressed in and governed by chapter 6 of Title 53, Idaho Code. The Idaho courts have not spoken to LLC's in any specific way helpful to the issues presented in this case.

[22] These documents appear as Exhibits A, B and C to the Affidavit of Roger L. Stewart, filed April 8, 1999 in Case No. 99-20287 as Doc.No. 10.

Noyes argues that the AOA reflects the intent of the members that additional loans would be provided if additional capital infusions to Lake Country were necessary. Memorandum in Opposition to Motion for Summary Judgment at 3, citing to "¶3.01(b)" of the AOA. He further quotes from the AOA to establish the alleged obligation of Agincourt to loan funds to Lake Country:

> 3.01(a) Additional Capital Needs. . . . AGINCOURT to the extent necessary, may lend or arrange for loans to the Company . . . to meet any agreed Development Plan or operating expense. . . . Such agreed Development Plan or operating expense to be paid via loans by or arranged by AGINCOURT include, . . .
>
> (i) payments required to be made to any Existing Third Party Encumbrancer or any refinancing thereof or any mortgage encumbering the Property[.]

Id., at 5.[23] This quotation, however, is incomplete. It omits those portions that set forth the optional nature of such advances and the requirement of unanimous agreement of the members for any loans:

> Paragraph 3.02 Subsequent Contributions
>
> (a) Additional Capital Needs: It is the agreed intent of the parties hereto that, in lieu of additional capital contributions by the parties, any Member, to the extent necessary, may lend or arrange for loans to the Company, without recourse against any Member, any and all funds deemed required by the unanimous consent of the Executive Committee to meet any agreed Development Plan or operating expense. The Members agree that all financing for any and all construction other than the construction for the golf course shall come from outside financing. No Member can be compelled by any other Member, creditor or third party to make such loans. Any loan given by any Member or obtained pursuant to this Paragraph 3.02(a) shall be recourse indebtedness as to the Company with

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[23] The reference to ¶3.01 is an apparent typographical error. The AOA at ¶3.01 discusses initial capital contribution; it addresses subsequent contributions including additional capital needs at ¶3.02.

> preferential payment treatment prior to distributions related to Sharing Ratios of Members. Such agreed Development Plan or operating expense to be paid via loans by or arranged by AGINCOURT include, but are not limited to those items listed below:
>
> > (i) payments required to be made pursuant to any Existing Third Party Encumbrance or any refinancing thereof or any mortgage encumbering the Property[.]

AOA at ¶3.02 (subparts (ii) through (v) omitted).

Under Lake Country's organizational documents, the members were not partners, general or limited. *See*, AOA at ¶2.08. Both members had to agree to any action, and neither could bind the other without the other's written consent. *Id.*, at ¶¶ 6.01 - 6.06. Members had no obligation to contribute capital or make loans to Lake Country, and could not be compelled by the other member, creditors or third parties to advance funds, either by loan or capital infusion. *Id.*, at ¶ 3.02. Recapitalization required unanimous consent. *Id.*, at ¶2.07.

In its entirety, the Agreement acknowledges that neither member can be compelled to lend. Failure of Agincourt to lend, therefore, was not a breach of the agreements. Noyes has not shown how a member of an LLC breaches a fiduciary duty by acting (or failing to act) in a manner specifically permitted by the LLC's operating agreement. The Court concludes that a genuine issue of material fact as to breach of express fiduciary duty has not been established.

As an alternative to construction of the agreements, Noyes argues that statutory law also creates a fiduciary duty between the members, relying on Idaho Code § 53-662(a)(2).[24]

Limited liability companies are neither general corporations nor general or limited partnerships. They are a specially recognized form of entity under chapter 6 of Title 53, Idaho Code.[25] The case law applicable to partnerships and construing partnership law, which has been briefed and discussed at length, is of limited utility.[26] The specific written agreements must be given effect, and even the statute relied upon by Noyes recognizes the primacy of the structural and organizational documents in

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[24] **53-622. Duties of managers and members. —** Unless otherwise provided in an operating agreement:

. . .

(2) Every member or manager must account to the limited liability company and hold as trustee for it any profit or benefit derived by that person without the consent of more than one-half (½) by number of the disinterested managers or members, or other persons participating in the management of the business or affairs of the limited liability company, from:

(a) Any transaction connected with the conduct or winding up of the limited liability company[.]

[25] *See* also, AOA at ¶2.08 (declaring that the LLC is not a general or limited partnership or joint venture, and that no member shall be considered a partner or joint venturer); ¶2.01 (providing that the rights and obligations of the members shall be as set forth in the Idaho Limited Liability Company Act except to the extent otherwise provided in the agreements.)

[26] Such precedent includes *Thomas v. Schmelzer*, 118 Idaho 353, 796 P.2d 1026 (Ct. App. 1990) upon which Noyes strongly relies. There a partner's purchase of a note and related secured position, and his concealment thereof, was found to be a breach of fiduciary duty. But not only was this in a partnership, rather than LLC, context, the concealment of the conduct distinguishes the case from that presented here.

the context of limited liability companies. *See, e.g.*, § 53-662 ("Unless otherwise provided in an operating agreement ..."), and § 53-668(1) ("It is intended that the provisions of this chapter give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.)

Noyes points to no helpful decisional law in support of the contention that there is a statutory fiduciary duty, similar to § 53-521 which makes partners accountable as fiduciaries, which was here violated.[27] Plaintiffs acted in a way not prohibited by the AOA, and nothing in § 53-662 requires that the Court ignore the limits that the parties themselves structured in their formation and operating agreements.

f. Inequitable, unfair or injurious conduct by non-fiduciary insider

Noyes also argues that, even if not a breach of a fiduciary duty, taking the APP secured position was itself wrongful. It is still, according to Noyes, the sort of "inequitable conduct" or "unfair advantage" sufficient to support subordination under the case law.

Lake Country was not obligated to pay the APP debt, APDC was. However, the real property contributed to Lake Country stood as collateral for that debt. APDC was in default to APP, and APP issued notice accordingly in September 1997.

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[27] In opposition, Plaintiffs discuss *McConnell v. Hunt Sports Enterprises*, 725 N.E.2d 1193 (Ohio App. 1999). That court recognized that, while a limited liability company involves a fiduciary relationship among members and from member to LLC, the terms of the operating agreement may effectively limit or define the scope of such duties. *Id.*, at 1214-16.

Agincourt/West Wood, APDC, and Lake Country therefore all had cause to be concerned about, and reason to try to avert, an APP foreclosure.

There was no evident ability of Lake Country to deal with the APP debt absent loan from or capital infusion by the members. But neither member could be compelled by the other to make such an advance, and the Agreements required unanimity by the two members before taking action. There was at this point in 1997, as there has been throughout this bankruptcy, a resolute impasse.

West Wood therefore did not usurp an opportunity presented to Lake Country which Lake Country could have pursued. And in acquiring the position of APP, it prevented foreclosure on Lake Country property by either that creditor or Noyes.

Additionally it is noted, in considering the alleged inequities, that the acquisition of the APP Note was disclosed to Lake Country and APDC, and not concealed. *See* First Malcolm Declaration, at Exhibit C (10/23/97 minutes Executive Committee meeting), Exhibit D (12/10/97 letter from Agincourt/West Wood to APDC and Lake Country counsel), and Exhibit E (12/11/97 letter to Lake Country counsel). Exhibit A to that same Declaration reflects disclosure as early as May 1997 that one of Edward Fu's companies might buy the APP note and maintain that secured position on the property.

Noyes also had knowledge of the APP interest at the time he gained his secured position through the 1996 redemption agreement, and he contractually subordinated his lien on Parcels 1 and 3 to the APP lien. The identity of the secured party, whether APP or someone else, was not material. Who held the right to receive

payment did not alter the fact that the debt existed and that the property was encumbered until it was paid. The acquisition by West Wood caused no detriment to Lake Country or Noyes. Inequitable conduct, to the injury of general creditors or conferring unfair advantage upon West Wood, is not established.[28]

Machinery Rental, Inc. v. Herpel (Matter of Multiponics, Incorporated), 622 F.2d 709 (5th Cir. 1980) supports the Court's approach to the issue. Multiponics had borrowed $2,900,000 from Chase Manhattan Bank, and went into default on that loan. Chase required and received security interests on Multiponics's assets and personal guarantees of several directors, including founding stockholder Carl Biehl. Multiponics also borrowed $450,000 from Deposit Guaranty National Bank, similarly guaranteed. In 1971, when Multiponics defaulted, both creditors made demand on Biehl for the balance then due which approximated $1,700,000. Machinery Rental, a corporation whose capital stock was entirely owned by Biehl, purchased the promissory notes. 622 F.2d at 722.

Multiponics's trustee sought to subordinate Machinery Rental's claim on the theory that it was Biehl's alter ego but failed to convince the Bankruptcy Court. The District Court disagreed, and concluded that subordination was proper. The Court of

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[28] It should be observed that the interests of the debtor generally, or of its unsecured creditors, is not what drives this litigation. This is a close quarters fight among those who were most intimately involved with the LLC and its real estate development. They are all financially sophisticated. Their many agreements are detailed. They all have had the assistance of expert counsel, at the time of the transactions in question and now in this litigation. The causes of action urged by each of the litigants are aimed at recharacterizing prior transaction, altering the financial effect of those earlier events, and shifting the relative strengths and weaknesses of position as among this very limited group.

Appeals reversed, concluding that the alter ego allegation was not substantiated. It also found that Machinery Rental gave real value and had a valid business purpose for making the acquisition of the banks' claims. *Id.* at 722-25.[29]

Similarly, Plaintiffs here had a credible business purpose in acquiring the APP Note and Mortgage, as this protected prior investment and prevented both APP and Noyes from foreclosing. No argument is advanced that inadequate value was given.[30] Lake Country benefitted from the elimination of threat of foreclosure, and suffered no detriment from the substitution of secured creditor.

The Court in *In re ASI Reactiviation, Inc.*, 934 F.2d 1315 (4th Cir. 1991) reached a similar conclusion, and refused to subordinate a senior secured position acquired at a discount by a debtor's former president and principal stockholder. It stated:

> As to the purchase of the secured note, there was simply no evidence that it was either fraudulent or injurious. The record indicates Narayanan used his own funds to buy the note. There is nothing in the bankruptcy act which per se forbids a principal from obtaining and asserting rights as a lien creditor. <u>Here there is also evidence that Narayanan bought the note to stave off a foreclosure, for the company's benefit, as well as to solidify his position.</u> If some

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[29] *Multiponics* also recognized, at 622 F.2d at 725, that the District Court's imposition of equitable subordination would have the effect of overriding "clear contractual subordination to which the parties themselves agreed" which operated in favor of the creditors whose position was acquired by Machinery Rental. That the purchased claims in *Multiponics* benefitted from such a contractual priority is analogous to the position enjoyed by West Wood here given Noyes' contractual subordination to the APP debt in 1996.

[30] Noyes argues that West Wood paid less than the full amount of the APP debt, but the fact that APP would discount the obligation to the extent indicated on this record has not been shown to be significant.

> particular creditor was deceived into dealing with this corporation by this transaction, that was not demonstrated. Thus, the debt underlying the note and the lien were properly recognized by the bankruptcy court.

Id. at 1321 (emphasis supplied).

The decision in *In re Mr. R's Prepared Foods, Inc.*, 251 B.R. 24 (Bankr. D. Conn. 2000) also supports the Plaintiffs' position. There the debtor was a closely held corporation owned and managed by Rotanelli. Not only was Rotanelli a secured creditor of the debtor through prepetition loans, a limited liability company he and his wife formed (T&B Investments, L.L.C.) also became a secured creditor through purchase of a bank's notes and security interests. Though the chapter 11 plan of the debtor was confirmed, it was never consummated and the case was converted to chapter 7. When Rotanelli and T&B sought relief from stay, the chapter 7 trustee and certain governmental administrative expense creditors objected, contending that these insiders' security interests should be equitably subordinated. *Id.* at 27- 28.

The court applied a three-pronged test for subordination identical to that enunciated by *Filtercorp* and *Pacific Express*. *Id.* at 28-29. It further noted that the status of the movants as insiders only went to establish the level of scrutiny applied in reviewing their conduct, but that in order to subordinate their claims, the creditor-insiders must be shown to have actually used their power to control the debtor to their own unfair advantage, and to the other creditors' detriment. *Id.* at 29. *Accord*, 4 Collier on Bankruptcy ¶ 510.05[3][c] (15th ed. rev. 2000).

The court concluded that the acquisition of the bank's claims by T&B did not confer an unfair advantage on it or Rotanelli, nor inflict harm on other creditors, as those creditors were left in the same position as if the bank continued to hold the claims. Id. at 28-29.[31]

All three of these cases validate the idea that an insider's acquisition of secured debt is not *per se* actionable. In each, the interests of the debtor and the debtor's other creditors remained subject to the secured claim to the same extent and in the same relative position regardless of the identity of the holder of that secured claim.

Each also recognizes that the acquisition of a secured claim by an insider is not sufficient grounds, standing alone, to warrant subordiantion. The burden is on the claimant to establish that the conduct complained of injured the debtor or other creditors, or gave the actor an unfair advantage. *Multiponics*, 622 F.2d at 720-21, 723-25; *ASI Reactivation*, 934 F.2d at 1320-21; *Mr. R's Prepared Foods*, 251 B.R. at 29-30. *See also, Idaho Falls Assoc.*, 93 I.B.C.R. at 81. As discussed in *Liberty Mutual Insurance Co. v. Leroy Holding Co.*, 226 B.R. 746, 755-56 (N.D.N.Y. 1998), the element of inequitable conduct cannot be premised upon a generalized allegation but must fall within one of three recognized classes: (a) fraud, illegality, or breach of

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[31] The court treated T&B's purchase of the notes as tantamount to Rotanelli's purchase, and considered the objector's claims that Rotanelli unfairly benefitted because he was a guarantor of that bank debt. However, since the performing guarantor would be subrogated to the rights of the satisfied creditor, T&B's purchase left the debtor's other creditors in exactly the same position as had the bank collected from Rotanelli directly. *Id.* at 28-29.

fiduciary duty; (b) undercapitalization; or (c) control or use of the debtor as an alter ego for the benefit of the claimant, and the specifically alleged inequitable conduct must be shown to have harmed the debtor or other creditors.

This burden is unmet. Noyes has not established genuine issues as to the Plaintiffs' conduct as nonfiduciary insiders sufficient to reach the necessary threshold.

The Court has been sensitive to the fact that, in considering the Plaintiffs' motion for summary judgment, it is not to weigh the evidence but, rather, to evaluate the submissions in order to determine the existence of a genuine issue of material fact. In doing so, particular attention has been paid to Noyes' submissions on two elements of his cause of action for equitable subordination: first, whether the conduct of Plaintiffs injured the debtor, Lake Country or its creditors; and, second, whether the conduct of Plaintiffs breached an express or implied fiduciary duty, or otherwise constituted unfair or inequitable conduct by an insider within the reach of the case law. In regard to both facets, the Court concludes that Noyes has failed to establish the requisite issue of fact to avoid summary adjudication.

CONCLUSION

The Court concludes that necessary elements of the cause of action of equitable subordination set out in the First Count and Second Count of the counterclaim are not established. Such a failure on any element on which the non-moving party bears the burden justifies entry of summary judgment even if there are genuine issues of material fact as to other elements. *Celotex*, 477 U.S. at 323;

Nissan Fire & Marine Ins., 210 F.3d at 1102. The Court also concludes that the cause of action in Count Three premised upon the one action rule, is not well taken.

Summary judgment is appropriate and will be entered in favor of Plaintiffs, dismissing Noyes' counterclaims in the particulars noted. Counsel for Plaintiffs shall submit a proposed form of Order in accord herewith.

Dated this 19th day of March, 2001.

TERRY L. MYERS
UNITED STATES BANKRUPTCY JUDGE