

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

ENTERED ON
SEP 27 2004
DOCKET

IN RE:) CHAPTER 7
)
KIRK DONOVAN) CASE NO. 01-69431-MHM
)
Debtor)

PAUL H. ANDERSON, JR., Trustee)
)
Plaintiff) **ADVERSARY PROCEEDING**
) **NO. 03-9357**
)
v.)
)
HSN, LP)
INGENIOUS DESIGNS, INC.,)
INGENIOUS DESIGNS, LLC,)
JOY MANGANO,)
INGENIOUS DESIGNS, LLC)
)
Defendants)

ORDER

This adversary proceeding is before the court on the motion of Defendants HSN, LP ("HSN"),¹ Ingenious Designs, Inc. ("IDI"), Ingenious Designs, LLC ("IDI, LLC"), and Joy Mangano ("Mangano") (collectively, "Defendants") for abstention pursuant to 28 U.S.C. § 1334(c)(1). Also before the court is the motion of Donovan Group, Inc. ("DGI") to intervene as a plaintiff.

¹ Plaintiff alleges that in 2000 HSN acquired 100% ownership of IDI.

Before filing his Chapter 7 bankruptcy petition, Debtor was the principal and sole shareholder of Donovan Group, Inc. ("DGI"). DGI is a Subchapter S corporation. The stock in DGI is property of the bankruptcy estate. Pursuant to 11 U.S.C. § 541(a), upon being appointed as Chapter 7 trustee in Debtor's bankruptcy case, Plaintiff became the sole of DGI. DGI remains a validly existing Georgia corporation. Plaintiff filed this adversary proceeding in his capacity as Trustee of Debtor's bankruptcy estate.

Plaintiff's complaint alleges four counts against the Defendants: breach of contract, fraud, alter ego liability, and fraudulent transfer. Plaintiff's complaint alleges the following facts: In June 1999, DGI and IDI entered into a joint venture to market and sell music and other products ("Esteban's Works") related to Stephen Paul d/b/a Esteban's CDs and Tapes ("Esteban"). DGI and IDI, acting collectively as Joy Mark Promotions entered into an agreement ("Joy Mark Agreement") with Esteban whereby DGI and IDI acquired the exclusive right to market, distribute, and produce Esteban's Works through home shopping networks. Debtor in his individual capacity was not a party to the transaction. Plaintiff alleges that DGI in reliance on this contractual relationship expended significant sums of money, time, and effort to market Esteban's Works.

The complaint alleges that in exchange for its efforts in connection with the Joy Mark Agreement, DGI was entitled to receive 50% of the profits earned under the Joy Mark Agreement. The Joy Mark Agreement itself does not define this relationship or the financial arrangement between DGI and IDI, but instead addresses only the relationship between Joy Mark Promotions and Esteban.

At the time the Joy Mark Agreement was executed, Defendant Joy Mangano was the Chairman and President of IDI. Plaintiff alleges that after the Joy Mark Agreement was executed, Mangano represented to DGI that Esteban refused to go forward with the deal unless DGI's name was removed from the Joy Mark Agreement. As a consequence, in a Memorandum dated November 11, 1999 (the "Termination Memorandum"), Debtor, as principal of DGI, agreed and executed a one-paragraph agreement terminating DGI's contractual relationship with IDI and Esteban's CDs and Tapes.²

By letter dated January 10, 2000, approximately two months after the execution of the Termination Memorandum, Mangano wrote to Mark Epstein ("Epstein"), a former employee³ of DGI:

In accordance with our recent telephone conversation, I am enclosing a check to your order for \$50,000 as a finder's fee and in consideration and reflecting our understanding of the Esteban Agreement with Ingenious Designs, Inc. And your memo dated November 11, 1999.

Thank you for being you.

A check dated January 19, 2000, made payable to Mark Epstein in the amount of \$50,000 apparently accompanied the letter. On the reverse side of the check is handwritten "in full accordance (sic) and satisfaction on Esteban."

² The copy of the Memorandum which accompanied Defendants' motion to abstain is partially illegible but appears to support this representation of its content.

³ Although characterized by Plaintiff as a former employee of DGI, Mark Epstein signed both the Joy Mark Agreement and the Termination Memorandum on behalf of DGI. Debtor also signed the Joy Mark Agreement and the Termination Memorandum on behalf of DGI. Neither Epstein nor Debtor provided any title or other indication of the authority under which either of them represented DGI.

Plaintiff's complaint alleges a breach of contract claim in Count I. In Count II, Plaintiff asserts a fraud claim based upon allegations that IDI and Mangano fraudulently misrepresented facts to DGI that IDI would continue to account to DGI for 50% of the profits from Esteban's Works after termination of the contractual relationship between DGI and IDI. In Count III, the alter ego liability claim, Plaintiff contends Mangano, as principal of IDI, is personally liable as its alter ego for the acts of IDI; and that IDI, LLC or HSN, as the sole shareholder of IDI, is liable under a piercing-the-corporate-veil theory. Finally, in Count IV, Plaintiff alleges he is entitled to "avoid the transfer of any interest of DGI to Defendants" pursuant to 11 U.S.C. §§ 548 and 544.

Each Defendant has filed a jury demand pursuant to Local Rule 9015-12. Defendants appear to be entitled to a trial by jury, but Plaintiff will be provided an opportunity to show Defendants are not entitled to a jury trial. If Plaintiff fails to oppose Defendants' jury demands, Defendants' jury demands will be deemed proper and, as required by BLR 9015-2, the Bankruptcy Clerk will notify Plaintiffs and Defendants of the right to expressly consent to a trial by jury in the Bankruptcy Court.

In the Motion for abstention, Defendants argue that Plaintiff's claims are non-core claims and that, when coupled with the Defendants' jury demands, discretionary abstention under 28 U.S.C. §1334(c)(1) is appropriate. In connection with the Motion for Abstention, Defendants assert Plaintiff lacks standing to assert DGI's claims against them.⁴ Plaintiff

⁴ Although Defendants initially suggested that they would be filing a separate motion challenging Plaintiff's standing, no such motion has been filed and it appears that the issue has been fully addressed in the two motions – Defendants' motion to abstain and DGI's motion to intervene – that are the subjects of this order.

opposes the Motion for Abstention, asserting this proceeding is a core proceeding, that Plaintiff has standing to pursue DGI's claims, and that discretionary abstention is not appropriate. Additionally, DGI has filed a motion to intervene in this adversary proceeding as a party plaintiff. Defendants oppose the motion to intervene on the grounds that it is procedurally deficient, and that the interests of Plaintiff and DGI are identical.

DISCUSSION

Standing

Standing is a threshold jurisdictional question, which must be addressed *sua sponte* even if the parties do not raise the issue. *Dillard v. Baldwin County Commissioners*, 225 F.3d 1271 (11th Cir. 2000).

To satisfy the constitutional requirements of standing, a plaintiff must make three showings: First, the plaintiff must have suffered an "injury in fact"—an invasion of a legally protected interest which is (a) concrete and particularized, and (b) "actual or imminent, not 'conjectural' or 'hypothetical.'" Second, there must be a causal connection between the injury and the conduct complained of—the injury has to be "fairly ... trace[able] to the challenged action of the defendant, and not ... th[e] result [of] the independent action of some third party not before the court." Third, it must be "likely," as opposed to merely "speculative," that the injury will be "redressed by a favorable decision."

Id. Additionally, a plaintiff must have prudential standing to assert legal interests as a real party in interest in those claims. *Dunmore v. U.S.*, 358 F. 3d 1107 (9th Cir. 2004). A plaintiff cannot rest a claim to relief on the legal rights or interests of third parties. *In re Bli Farms*, 312 B.R. 606 (E.D. Mich. 2004).

Defendants have challenged Plaintiff's standing to assert the claims in this adversary proceeding against Defendants on the grounds that the claims belong to the corporation, DGI, and not to the Trustee of Kirk Donovan's Chapter 7 bankruptcy estate. In Plaintiff's response to the standing issue, Plaintiff points out that DGI is a Subchapter S corporation and shows that DGI, although still a valid corporation, is not operating postpetition and has no outstanding creditors.

In a Subchapter S corporation, all profits and losses pass through the corporation directly to the shareholders. The term "Subchapter S" refers to Subchapter S of the Internal Revenue Service Code, 26 U.S.C. §1361 *et seq.* which provides for special tax treatment for eligible corporations that make the appropriate elections to be treated as an "S" corporation. Subchapter S does not alter state corporation law and does not operate to render the corporate form invisible except for tax purposes. Therefore, without more, Subchapter S status alone does not operate to convey to an individual shareholder the standing to pursue the corporation's claims.

In this adversary proceeding, Plaintiff, in his capacity as sole shareholder of DGI, is asserting claims of the corporation against Defendants. This is not a shareholder's derivative suit. Plaintiff cites in support of his assertion of standing *Thomas v. Dickson*, 250 Ga. 772 (1983), in which the Georgia Supreme Court held that a minority shareholder in a closely held corporation may maintain a direct rather than derivative action to recover misappropriated corporate funds under the following limited conditions:

- The plaintiff is the sole injured shareholder;
- No possibility of multiplicity of lawsuits exists;

- No possibility of prejudice to the rights of other shareholders exists;
- The plaintiff will not be adequately compensated by a corporate recovery; and
- Protection of creditors is not an issue.

In the instant case, plaintiff is the sole shareholder and thus no other shareholders exist whose rights may be prejudiced. Also, as a practical matter, it appears the risk of multiple lawsuits does not exist and Plaintiff has shown that protection of creditors of DGI is not an issue.

Most importantly, however, this proceeding is not, and could not be, a shareholder derivative action. *Because* DGI is a Subchapter S corporation, Plaintiff would be adequately compensated if DGI were to recover against Defendants. Therefore, Plaintiff has failed to satisfy the limited conditions under which Georgia law would permit Plaintiff in his capacity as a shareholder to assert a direct action. Thus, the general rule that a shareholder may not bring a direct action to recover claims of the corporation compels the conclusion that Plaintiff lacks standing to proceed against Defendants. *See Bowman v. Walnut Mt. Property Owners Assn.*, 251 Ga. App. 91 (2001); *Phoenix Airline Serv. v. Metro Airlines, Inc.*, 260 Ga. 584 (1990).

Intervention

Apparently in an attempt to remedy the standing issue, DGI has filed a motion to intervene under Bankruptcy Rule 7024, which incorporates Fed. R. Civ. Proc. 24:

- (a) Intervention of Right. Upon timely application anyone shall be permitted to intervene in an action: (1) when a statute of the United States confers an unconditional right to intervene; or (2) when the applicant claims an interest relating to the property or transaction which is the subject of the action and the applicant is so situated that the disposition of the action may as a practical matter impair or impede the applicant's ability to protect that interest,

unless the applicant's interest is adequately represented by existing parties.

(b) Permissive Intervention. Upon timely application anyone may be permitted to intervene in an action: (1) when a statute of the United States confers a conditional right to intervene; or (2) when an applicant's claim or defense and the main action have a question of law or fact in common....

Defendants contend DGI's motion to intervene should be denied because it is procedurally deficient. Fed. R. Civ. Proc. 24(c) provides that a motion to intervene "shall be accompanied by a pleading setting forth the claim or defense for which intervention is sought." DGI's motion to intervene, however, makes clear that it seeks to be made a party plaintiff as to all the claims and defenses involved in this adversary proceeding. Denial of DGI's motion on the grounds of a procedural defect would advocate form over substance.

DGI failed to show a right to intervention under Rule 24(a) because DGI failed to show, assuming Plaintiff's assertions of standing had merit, that DGI's interests would not be adequately protected by Plaintiff. The standards for Rule 24(b) are much more relaxed, but if Plaintiff has standing to pursue this adversary proceeding, at best, intervention by DGI would be superfluous.

If, however, Plaintiff lacks standing, intervention is perhaps not the appropriate vehicle for bringing DGI into this adversary proceeding as a plaintiff. More appropriately, DGI should be joined as a plaintiff under Fed. R. Civ. Proc. 19 (incorporated in Bank. Rule 7019). Defendants have asserted no grounds for refusal to allow DGI to be joined as a necessary party. Therefore, the court will construe the motion to intervene as a motion to join DGI as a real party in interest and will grant that motion.

Core versus Non-Core

A significant portion of Defendants' argument in favor of abstention relates to whether Plaintiff's claims are core or non-core claims under 28 U.S.C. § 157(b)(2)(A). Title 28 sets forth in section 157(b)(2)(A) a list of core proceedings under Title 11 of the United States Code. The Eleventh Circuit has made the following distinction between core and "otherwise related," or "non core," proceedings:

If the proceeding involves a right created by the federal bankruptcy law, it is a core proceeding...If the proceeding is one that would arise only in bankruptcy, it is also a core proceeding...If the proceeding does not invoke a substantive right created by the federal bankruptcy law and is one that could exist outside of bankruptcy it is not a core proceeding; it may be related to the bankruptcy because of its potential effect, but under 157(c)(1) it is an "otherwise related" or non core proceeding.

Continental Nat'l Bank of Miami v. Sanchez (In re Toledo), 170 F.3d 1340, 1348 (11th Cir. 1999)(citing *Wood v. Wood (In re Wood)*, 825 F.2d 90 (5th Cir. 1987)). Even though subject matter jurisdiction may exist, a contract action that could have proceeded in state court if no bankruptcy case had been filed is not a core proceeding. *Id.* at 1349.

In the instant proceeding, Plaintiff's breach of contract, fraud, and alter ego liability claims are claims based on Georgia law, do not invoke a substantive right created by bankruptcy law, and could occur without the existence of a bankruptcy case. Only Plaintiff's fraudulent transfer claim purports to invoke a substantive right under the

Bankruptcy Code. Plaintiff seeks to avoid an unspecified⁵ transfer of "any interest of DGI to Defendants pursuant to 11 U.S.C. §§ 548 and 544."

The Bankruptcy Code sections upon which Plaintiff relies, however, authorize a trustee to avoid a transfer "of an interest of the *debtor*" or "of property of the *debtor*." DGI is not a "debtor" and DGI's property is not property of Debtor. As stated above, Subchapter S does not alter state corporation law and does not operate to render the corporate form invisible except for tax purposes. Therefore, Subchapter S cannot operate to permit a Chapter 7 Trustee to avoid transfers of a non-debtor. Neither 11 U.S.C. § 548 nor § 544 are applicable to transfers of any interest of DGI. Therefore, Plaintiff has failed to state a claim under §548 or §544. A fallacious claim cannot be the basis for finding this adversary proceeding to be a core proceeding. See *Toledo*, 170 F.3d 1340. Therefore, as Plaintiff presents no claims arising from substantive rights created by bankruptcy law, this adversary proceeding must be characterized as a non-core proceeding.

Abstention

Section 1334 of Title 28 of the United States Code provides in part:

(a) Except as provided in subsection (b) of this section, the district courts shall have original and exclusive jurisdiction of all cases under title 11.

(b) Notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of

⁵ Defendants emphasize that Plaintiff has fail to specify any specific property whose transfer might be avoided. Plaintiff has specified the transactions which occurred and it is apparent that DGI relinquished its rights under the Joy Mark Agreement. Preliminarily, it appears those rights may have been valuable and Plaintiff alleges the Termination Memorandum is unsupported by consideration.

all civil proceedings arising under title 11, or arising in or related to cases under title 11.

(c) (1) Nothing in this section prevents a district court in the interest of justice, or in the interest of comity with State courts or respect for State law, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11....

Section 1334(c)(1) describes discretionary abstention. In the case of *Twyman v. Wedlo, Inc.* (*In re Wedlo, Inc.*), 204 B.R. 1006, 1016 (Bankr.N.D.Ala.1996), the bankruptcy court enumerated the following factors to be considered under § 1334(c)(1):

- The extent to which state law issues predominate over bankruptcy issues;
- The difficulty or unsettled nature of the applicable law;
- The presence of a related proceeding commenced in state court or other non-bankruptcy court;
- The basis of bankruptcy jurisdiction, if any, other than 28 U.S.C. § 1334;
- The degree of relatedness or remoteness of the proceeding to the main bankruptcy case;
- The substance rather than form of an asserted "core" proceeding;
- The feasibility of severing state law claims from core bankruptcy matters to all judgments to be entered in state court with enforcement left to the bankruptcy court;
- The burden of the bankruptcy court's docket;
- The likelihood that the commencement of the proceeding in bankruptcy court involves forum shopping by one of the parties;
- The existence of a right to a jury trial; and
- The presence in the proceeding of non-debtor parties.

Analysis of these factors, however, is a matter of discretion and the weight accorded to each factor is not equal. This adversary presents all state law issues but the applicable law is neither difficult nor unsettled.⁶ No related state court or other non-bankruptcy court proceeding is present. This proceeding is a non-core proceeding but, especially because DGI is a Subchapter S corporation, any recovery against Defendants will pass through directly to Debtor's estate for administration by the Chapter 7 Trustee. The burden of the bankruptcy docket is certainly heavy but unlikely heavier than that in state court. This court sees no evidence or grounds to believe Plaintiff engaged in forum shopping. Defendants do appear to be entitled to a jury trial, but the Local Rules for the Bankruptcy Court for the Northern District of Georgia provide a defined and efficient method for handling adversary proceedings in which the parties do not consent to a jury trial in the bankruptcy court.⁷ Finally, all parties to this adversary proceeding are non-debtors. Although the Plaintiff, in his capacity as shareholder of DGI, lacks standing, DGI, who will be joined as a plaintiff, does have standing to maintain this action. Thus, factors exist which both favor and disfavor abstention. The most important factor, however, appears to be the close relation of the claims in this case

⁶ The unsettled nature of fraudulent conveyance law cited by Defendants has recently been "settled" by the Eleventh Circuit's opinion in *Chepstow Limited v. Hunt*, entered August 19, 2004, ____ F3d ____, 2004 WL 1852808.

⁷ BLR 9015-3 provides:

- (a) **Transfer to District Court.** If the parties do not consent to jury trial in Bankruptcy Court and if a timely demand has been made in a case triable by jury, the Bankruptcy Judge shall transfer the adversary proceeding to the District Court when the Bankruptcy Judge determines that the case is ready for trial. Prior to transferring the case, the Bankruptcy Judge shall rule on all discovery motions, other pretrial motions, and summary judgment motions, as provided by law, and the pretrial order shall be entered by the Bankruptcy Judge.

to the main bankruptcy case. Any recovery by DGI will flow directly to the estate for the benefit of Debtor's creditors. Accordingly, it is hereby

ORDERED that DGI's motion to intervene is construed as a motion under Bankruptcy Rule 7019, which incorporates Fed. R. Civ. Proc. 19, to join DGI as a plaintiff in this adversary proceeding and that motion is granted. It is further

ORDERED that Defendants' motion to abstain is denied. It is further

ORDERED that, within 30 days of the date of entry of this order, Plaintiffs may file a pleading in opposition to a determination that Defendants are entitled to a jury trial. If Plaintiffs fail to oppose Defendants' jury demands, Defendants' jury demands will be deemed proper.

The Clerk, U.S. Bankruptcy Court, is directed to serve a copy of this order upon Plaintiff's attorney, Defendant's attorney, and the Chapter 7 Trustee.

IT IS SO ORDERED, this the 23rd day of September, 2004.



MARGARET H. MURPHY
UNITED STATES BANKRUPTCY JUDGE