UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF MICHIGAN

In re:

CHRISTOPHER PRATT,

Debtor.
_____/

Case No. DK 13-03425
Hon. Scott W. Dales
Chapter 7

MURK'S VILLAGE MARKETS, INC. and STEPHEN L. LANGELAND,

Plaintiffs,

v.

BANK OF AMERICA N.A. and CITIBANK, N.A.,

Defendants.
_____/

Adversary Pro. No. 13-80141

PROPOSED CONCLUSIONS OF LAW
UNDER BANKRUPTCY RULE 9033

PRESENT: HONORABLE SCOTT W. DALES
United States Bankruptcy Judge

I. INTRODUCTION

Because of constitutional limitations on the authority of United States Bankruptcy Judges to enter final judgments in certain non-core proceedings,[1] the court is making its Conclusions of

[1] *See Stern v. Marshall*, 131 S. Ct. 2594 (2011) (bankruptcy court lacks authority to enter final judgment on state law counterclaims against the estate even though proceeding is enumerated as "core" within 28 U.S.C. § 157(b)(2)(C)); *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012) (*dicta* indicating that bankruptcy court lacks authority to enter final judgment in fraudulent transfer controversy). The parties have not consented to the bankruptcy court's entry of final orders, even assuming consent would cure the constitutional problem. *But see Id.*

Law[2] in accordance with Fed. R. Bankr. P. 9033. The bankruptcy court's recommendation relates to the complaint filed by Murk's Village Market, Inc. ("MVM") and chapter 7 trustee Stephen Langeland (the "Trustee," and with MVM referred to as the "Plaintiffs") against Bank of America, N.A. ("BOA") and Citibank, N.A. ("Citi," and with BOA, the "Defendants").

For reasons that follow, the bankruptcy court recommends that the United States District Court dismiss the Plaintiffs' fraudulent transfer count, but preserve the remaining counts to be resolved in the district court under that court's diversity jurisdiction, without reference to the bankruptcy court.

II. ANALYSIS

1. Plaintiffs' Allegations

According to the Plaintiffs' complaint,[3] chapter 7 debtor Christopher Pratt ("Pratt") served as MVM's controller before he filed for relief under chapter 7. During that time, according to the Plaintiffs, Pratt used MVM's funds to pay his (and his wife's) credit card debts owed to the Defendants. Pratt eventually filed for chapter 7 relief in the United States Bankruptcy Court.

Having obtained a substantial prepetition state court judgment against Pratt for the embezzlement, MVM turned its attention to deeper pockets—the Defendants here—and contacted the Trustee about taking steps to collect from them. MVM evidently believed that, prior to Pratt's filing of his bankruptcy petition, the company had claims against the Defendants under Michigan's Uniform Fraudulent Transfer Act, M.C.L. § 566.31 *et seq.*, but could no longer

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[2] Given the nature of motions under Rule 12(b), which test the sufficiency of allegations and jurisdiction, the bankruptcy court is not making any proposed findings of fact but only proposed conclusions of law. *See Kennedy v. R.W.C., Inc.*, 359 F.Supp.2d 636, 639 (E.D. Mich. 2005)("The purpose of a motion under Rule 12(b)(6) is to test the legal sufficiency of the complaint, not the probability of success on the merits.").

[3] Annexed hereto as Exhibit A.

assert any fraudulent transfer claims after Pratt filed for bankruptcy protection, given the role of Pratt's Trustee in avoiding and recovering fraudulent transfers. Accordingly, MVM and the Trustee, evidently believing that Pratt effected fraudulent transfers by embezzling MVM's funds, entered into a stipulation to jointly pursue relief against the Defendants and to split any recovery equally, after payment of expenses. They obtained bankruptcy court approval of their settlement agreement[4] and jointly filed their complaint.

The fraud and embezzlement, succinctly described in the Plaintiffs' own words, consists of Pratt's "systematically making unauthorized transfers of funds from MVM's bank account to Pratt's own creditors." Complaint at ¶ 16. The Plaintiffs describe Pratt's "modus operandi" in greater detail at paragraphs 19-21 of the complaint, which states:

> 19. Pratt's fraud and embezzlement scheme included the following elements:
>
> • Making purchases and taking out cash advances using his personal BOA and Citi credit accounts;
>
> • Stealing checks from MVM drawn on MVM's business account;
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> • Making the MVM checks payable to BOA and Citi;
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> • Signing the MVM checks without authorization;
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> • Mailing the MVM checks to BOA and Citi, thus tendering the MVM checks for payment on Pratt's personal BOA and Citi credit accounts; and
>
> • Concealing the theft from MVM.
>
> 20. By mailing checks drawn on MVM's account to BOA and Citi, Pratt intended for the funds, which belonged to MVM, to be used by BOA and Citi to reduce the indebtedness on one or more credit card accounts held by Pratt and/or Pratt's wife.

[4] The Plaintiffs' agreement to split the recovery and the court's order approving the settlement are annexed hereto as Exhibits B and C.

> 21. Unknown to MVM, Pratt stole millions of dollars from MVM by transferring funds from MVM's account and fraudulently incurring obligations in this manner.

See Complaint at ¶¶ 19-21. The Plaintiffs fault the Defendants for turning a blind eye to certain irregularities, mainly that their individual credit card customer (Pratt) was using large third-party checks from MVM to satisfy his own obligations.

Nowhere does the complaint allege that Pratt induced MVM to voluntarily part with title to the funds in its account, through trick or fraud, but instead the complaint exclusively alleges that Pratt exerted the raw control over MVM's funds that he enjoyed by virtue of his longtime role as the company's controller. In other words, he embezzled MVM's funds, as the state court's judgment[5] and the United States District Court's judgment convicting Pratt[6] establish.

2. Dismissal Motions

Perceiving theoretical and jurisdictional deficiencies in the Plaintiffs' complaint, the Defendants filed nearly identical and simultaneous motions to dismiss under Fed. R. Civ. P. 12(b)(6) and 12(b)(1), challenging the Plaintiffs' authority to bring fraudulent transfer claims in Count I (either under § 544 and the Uniform Fraudulent Transfer Act or under § 548), and challenging the court's jurisdiction over the obvious state-law claims in Counts II-IV (aiding and abetting breach of fiduciary duty, conversion and unjust enrichment).

The bankruptcy court heard oral argument regarding the motions to dismiss,[7] after carefully considering the Defendants' motion papers and the Plaintiffs' response.[8]

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[5] Complaint at ¶¶ 27-28.
[6] Complaint at ¶¶ 29-31.
[7] The dismissal motions are annexed hereto as Exhibits D (BOA's motion) & E (Citi's motion).
[8] The Plaintiffs' response is annexed hereto as Exhibit F.

By moving to dismiss Count I under Rule 12(b)(6), the Defendants invite the court to consider whether or to what extent the complaint states a claim for relief. At issue in the dismissal motions is not so much whether the factual allegations are plausible under *Ashcroft v. Iqbal*, 556 U.S. 662, 677-78 (2009), and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007), but whether the complaint states a claim to avoid fraudulent transfers under a cognizable legal theory. By moving to dismiss the remaining counts under Rule 12(b)(1), the Defendants invite the bankruptcy court to consider the extent of federal jurisdiction under 28 U.S.C. § 1334(b).

a. Count I: Fraudulent Transfers

With respect to the fraudulent transfer count—the only statutory "core" matter under 28 U.S.C. § 157(b)(2) within the four corners of the Plaintiffs' pleading—the court finds that the complaint fails to state a claim because it does not plausibly allege the transfer of property of the "debtor" or of "an interest of the debtor in property" as required under either §§ 544 or 548. The complaint clearly alleges that the Debtor transferred *MVM's property* to satisfy his debts, injuring MVM directly. Because the embezzled property belonged to MVM rather than Pratt, and went directly from MVM's coffers to the Defendants, the transfers did not harm Pratt's other creditors at all. Indeed, the only way to read the complaint is that Pratt injured MVM by committing theft, embezzlement, breach of fiduciary duty, or conversion.

For example, the complaint alleges that the Van Buren County Circuit Court entered judgment against Pratt and in favor of MVM in the amount of $6,777,210.07 on January 11, 2013. *See* Complaint at ¶ 27. This ruling depends upon a finding of direct injury to MVM by misappropriation of MVM's own property. It is axiomatic that a bankruptcy trustee may not use the chapter 5 avoidance powers to avoid transfers of property in which the debtor does not have

an interest. *See* 11 U.S.C. §§ 544 (authorizing avoidance of "transfer of property of the debtor") & 548 (authorizing avoidance of "any transfer . . . of an interest of the debtor in property"); *cf. Lewis v. Summers (In re Summers)*, 320 B.R. 630, 648-49 (Bankr. E.D. Mich. 2005) (dismissing cause of action brought by shareholder's bankruptcy trustee to avoid transfers by the shareholder's wholly-owned corporation). The bankruptcy court finds that Pratt, as MVM's controller, did not have an interest in his employer's property when (accepting the complaint's allegations as true) he caused MVM's funds to be transferred from MVM's accounts to the Defendants.

The Plaintiffs' reliance on the Sixth Circuit's decision in *McLemore v. Third Nat'l Bank (In re Montgomery)*, 983 F.2d 1389 (6th Cir. 1993), to establish Pratt's property interest in MVM's funds is misplaced. It is true that the Sixth Circuit emphasized the control that the dishonest debtor exercised over the funds the trustee sought to recover as preferences in *Montgomery*, but the "funds" the debtor was spending in that case were provisional credits extended to him by his bank—funds that he "borrowed" in a sense, albeit corruptly. Because he exercised control over the loan proceeds in his own bank account, the court found there was sufficient interest of the debtor in the property to support avoidance of the transfer as a preference. In other words, the Bank voluntarily parted with its property by giving provisional credits for check deposits, even though under false pretenses. The fact that the debtor in *Montgomery* got to decide where to spend his ill-gotten gains was sufficient to find that he had an interest in the property.

But here, unlike the check-kiting debtor in *Montgomery*, Pratt was an embezzler. This means that at no time did MVM intend to voluntarily transfer title to its funds or extend Pratt any credit. As the Sixth Circuit explained in *Kitchen v. Boyd (In re Newpower)*, 233 F.3d 922, 930

(6th Cir. 2000), "under Michigan law, the critical difference between larceny crimes and false pretense crimes is the passage of title." The debtor in *Montgomery* used false pretenses in a check-kiting scheme, inducing the lender to grant provisional credits; Pratt, according to the complaint, committed embezzlement which "involves the fraudulent appropriation of property of which the embezzler is rightfully in possession" but "the owner of the property retains title to the funds because he never intends for it to pass to the embezzler." *Id.* at 930. In other words, it has been "long established at common law, that a thief has no title in the property that he steals." *Id.* at 929.

Because the complaint plainly alleges that Pratt embezzled funds from MVM, and because an embezzler, like any thief, lacks a property interest in the embezzled property, it follows that the Trustee cannot state a claim for avoidance of fraudulent transfers. No one could plausibly suggest that, just because Pratt served as MVM's controller and exercised control over that company's accounts, his creditors would somehow have a claim to MVM's funds. Indeed, it is shocking that MVM itself suggests this very thing. MVM's estate was diminished by the transfers as the state court found; Pratt's estate was not. Yet, MVM's own attorney is advocating that Pratt's creditors are entitled to MVM's money.

The Plaintiffs also contend that they seek an order avoiding Pratt's "obligations," noting that the avoidance statutes authorize not only avoidance of transfers but also of obligations. Unfortunately, the complaint does not specify which obligations the court should avoid. For example, the Plaintiffs allege that "Pratt stole millions of dollars from MVM by transferring funds from MVM's account and fraudulently incurring obligations in this manner," and that "[u]sing the MVM Checks, Pratt made the transfers of funds to BOA and Citi, and incurred

obligations on the MVM Checks, with actual intent to defraud MVM." *See* Complaint at ¶¶ 21 & 78.

In responding to the dismissal motions, the Plaintiffs attempted to explain their theory regarding avoidance of "obligations":

> First, Pratt's repeated draws of credit from his BOA and Citi credit accounts, during a period in which he was insolvent, with the intent to pay off the obligations to the banks via fraudulent checks drawn on MVM's account, were fraudulently incurred obligations. Second, Pratt's forgeries of Stephen Murk's signature on the MVM checks which he then sent to Defendants, whereby he became obligated to pay the amount of the checks to Defendants, constitute fraudulently incurred obligations. See M.C.L. 440.3412.

See Plaintiffs' Response in Opposition to Defendants' Motions to Dismiss (DN 17) at pp. 10-11. Plaintiffs' counsel failed to explain during oral argument what obligations were at issue and how avoidance would benefit the estate. Candidly, the court is unwilling to rely on the Plaintiffs' perplexing argument to avoid the dismissal of what seems to be a palpably untenable count under any avoidance theory. As confirmed in a case the Plaintiffs themselves cite, a trustee may avoid an obligation but that avoidance does not necessarily give rise to any right of recovery:

> If the trustee avoids a "transfer," he can recover the property transferred or the value of the property under § 550. If, on the other hand, he avoids an obligation, the obligation is rendered unenforceable, there is nothing to return and § 550 affords no remedy.

In re Asia Global Crossing, Ltd., 333 B.R. 199, 202-03 (Bankr. S.D.N.Y. 2005). Here, whether the court regards the "obligation" as the debt Pratt incurred on his credit cards, or some sort of obligation under the Uniform Commercial Code, avoidance of obligations already satisfied (albeit with MVM's funds) provides no benefit to the estate given that the estate. Moreover, Plaintiffs' citation to 15 U.S.C. § 1666d—a consumer protection provision included within the Truth In Lending Act to regulate credit card company billing practices—is not persuasive.

Congress could not have intended this consumer protection measure to create a right of action in favor of the consumer whose fraud produced the supposed credit balance. *Cf. Caplin*, 406 U.S. 416, 429-30 (1972) ("petitioner has at most described a situation where [debtor] and [defendant] were in *pari delicto*"). The Plaintiffs' attempt to unwind Pratt's settled credit card obligations using the Trustee's avoidance powers is untenable.

The only other case cited by the Plaintiffs, *In Re Tanglewood Farms, Inc. of Elizabeth City*, 2013 WL 1405729, Slip. Op. (Bankr. E.D.N.C. April 8, 2013), does not meaningfully support their position and is distinguishable. In that case, the court assumed that the corporate debtor, Tanglewood Farms, received no benefit when it incurred commercial obligations on a line of credit, the proceeds of which flowed to the debtor's principal. When Tanglewood Farms made payments on the line of credit, the court concluded that those payments were avoidable. In effect, the lender could not use the existence of Tanglewood Farms' obligation to insulate the payments from recovery by the bankruptcy trustee because there was no benefit to Tanglewood Farms in the first place.

In this case, the complaint alleges that Pratt used his credit card to purchase "millions of dollars of goods and services," but unlike the debtor in *Tanglewood Farms*, Pratt received value from the targeted creditor. Consequently, *Tanglewood Farms*, is neither binding nor persuasive.

More generally, the Plaintiffs seem to regard the Uniform Fraudulent Transfer Act and § 548 (its Bankruptcy Code counterpart) as triggered simply by the presence of fraud (such as Pratt's embezzlement as clearly alleged in the complaint). The court does not agree. These remedies, dating back to Elizabethan times, are not intended to address all frauds but a particular type of fraud, by which a debtor seeks to avoid paying his creditors by either rendering himself insolvent or putting his own property beyond their reach. The bankruptcy court cannot endorse

or recommend Plaintiffs' extravagant view of these statutes, when simple tort remedies for misconduct such as the misdeeds described in the complaint fit more comfortably.

Having carefully reviewed the allegations of the complaint, the bankruptcy court recommends that Count I be dismissed for failure to state a claim.

b. Counts II-IV: State Law Claims

The other Counts (II through IV) all depict injuries that MVM allegedly suffered as a result of the Defendants' acts or omissions. These supposed prepetition injuries to MVM are not injuries to Pratt (and therefore the corresponding causes of action are not included within his bankruptcy estate under § 541). Nor does the complaint describe any injury to creditors generally, such as might come within the ambit of § 544, rather than injury to a discrete creditor. *Caplin*, 406 U.S. at 430; *DSQ Property Co., Ltd. v. DeLorean*, 891 F.2d 128, 131 (6th Cir. 1989) (*Caplin* survived enactment of the Bankruptcy Code).

In their motions, the Defendants do not address the merits of these claims, but instead contend that they are not sufficiently "related to" Pratt's bankruptcy case to come within the limits of bankruptcy jurisdiction under 28 U.S.C. § 1334. In other words, but-for the postpetition agreement between the Trustee, BOA and Citi to split the recovery from this adversary proceeding, the estate would have no meaningful stake in the outcome of any controversy between two non-debtor, non-estate entities. *See Spradlin v. Williams (In re Alma Energy, LLC)*, 2012 WL 243746, Slip Op. (Bankr. E.D. Ky. Jan 24, 2012) ("Parties may not contract to create jurisdiction as against a third party."); *Ilardo v. Al's Diesel, Inc.* (*In re World Parts, LLC)*, 322 B.R. 37 (Bankr. W.D.N.Y. 2005) (same). As the Plaintiffs' counsel conceded during oral argument, the Plaintiffs do not (and cannot) depend upon the postpetition agreement between

MVM and the Trustee to manufacture subject matter jurisdiction. *Cf. Insurance Corp. of Ireland, Ltd. v. Compagnie Des Bauxites De Guinea*, 456 U.S. 694 (1982) (where the court lacks subject matter jurisdiction to hear a case, the parties cannot create jurisdiction by agreement or consent). This is so, even though, as a practical matter, after deducting expenses, half of any recovery against the Defendants on the state law claims would have a "conceivable effect" on the bankruptcy estate by augmenting it. *Robinson v. Michigan Consolidated Gas Co., Inc.*, 918 F.2d 579, 583 (6th Cir. 1990) (quoting *Pacor, Inc. v. Higgins (In re Pacor, Inc.),* 743 F.2d 984 (3rd Cir. 1984)).

Except for the postpetition sharing agreement with the Trustee, the dispute between MVM, BOA, and Citi would not fall within 28 U.S.C. § 1334(b). Certainly, the claims are not among those "arising under title 11" as they owe their existence to state tort law. Nor may the claims fairly be described as "arising in a case" under title 11, as they all pre-date Pratt's bankruptcy petition.

Therefore, the Plaintiffs must establish bankruptcy court jurisdiction under the "related to" jurisdictional hook of § 1334(b). This is impossible because (but for the sharing agreement) the remaining claims would not materially affect Pratt's bankruptcy estate or his discharge. In fact, any recovery that reduced MVM's claim against the estate would give rise to a corresponding increase in a subrogation claim against the Pratt estate by either BOA or Citi. *Caplin*, 406 U.S. at 430. Under the circumstances presented in the complaint, involving at most attenuated connections to the bankruptcy proceeding or estate, bankruptcy courts have no difficulty dismissing such obviously non-core claims for want of "related to" jurisdiction. *Id.* at 584 ("situations may arise where an extremely tenuous connection to the estate would not satisfy the jurisdictional requirements").

The bankruptcy court's only hesitation in recommending dismissal of all counts, whether core or non-core, is that the complaint includes jurisdictional allegations suggesting a mandatory role for the district court, whose jurisdiction is much broader than that of the bankruptcy court. Specifically, the complaint includes more than colorable allegations regarding diverse citizenship and an amount in controversy exceeding the $75,000.00 jurisdictional floor of 28 U.S.C. § 1332. *See* Complaint at ¶¶ 5-9. Moreover, the Plaintiffs have filed a motion to withdraw the reference, expressing a preference for resolving their dispute in the district court. Finally, because the bankruptcy court is a "unit" of the district court as a matter of statute,[9] it would be fair, in a statutory sense, to regard the complaint as having been filed in the district court—a court endowed with subject matter jurisdiction, albeit under a statute other than the one most strenuously asserted in the bankruptcy court.

Given Pratt's long-standing involvement with MVM, and the Plaintiffs' allegations of misconduct occurring over a period longer than 6 years, the bankruptcy court is not recommending dismissal of the remaining counts because it is reasonable to infer that some transactions likely occurred outside the applicable limitations periods. Dismissal of a complaint that, in some sense, was timely filed in the appropriate forum may have the unintended effect of insulating additional transactions from judicial review, if the Plaintiffs re-file it in the district court or some other forum (as seems likely).

For these reasons, the court recommends against dismissal of Counts II-IV, but in favor of withdrawing the reference as Plaintiffs have requested by separate motion under Fed. R. Bankr. P. 5011.

c. Plaintiffs' Post-Argument Motion to Amend

[9] 28 U.S.C. § 151.

After the oral argument on the dismissal motions, and after these Proposed Conclusions of Law were substantially drafted, Plaintiffs filed a motion to amend their complaint evidently in further response to the dismissal motions.[10] The court reviewed the motion to amend, and the proposed amendment, and entered a separate order denying that motion for the same reasons set forth above in Part II(2)(a).

III. SUMMARY OF PROPOSED FINDINGS & ORDER

Given the nature of motions under Rule 12(b), which test the sufficiency of allegations and jurisdiction, the bankruptcy court is not making any proposed findings of facts but only proposed conclusions of law.

The bankruptcy court recommends that the district court find that the Plaintiffs have failed to state a claim to avoid any transfers under 11 U.S.C. § 544 (and the Uniform Fraudulent Transfer Act) and § 548 because the complaint does not plausibly allege a transfer of Pratt's interest in any property or an obligation within the scope of these acts. Accordingly, the bankruptcy court recommends dismissal of Count I.

The bankruptcy court further recommends that the district court deny the motion to dismiss the remaining counts. Although the bankruptcy court does not perceive a basis for jurisdiction under 28 U.S.C. § 1334, it appears that the dispute between the Plaintiffs and the Defendants falls within the district court's diversity jurisdiction under 28 U.S.C. § 1332. Accordingly, the bankruptcy court recommends that the district court withdraw the reference to the bankruptcy court of this adversary proceeding under 28 U.S.C. § 157(c) "for cause": the reference is no longer proper given the absence of a sufficient nexus to Pratt's bankruptcy proceeding, and the nature of the remaining state law counts.

[10] The motion to amend is annexed hereto as Exhibit G.

The bankruptcy court also recommends that the United States District Court conduct further proceedings as if this proceeding had been commenced in the Article III forum in the first instance.

NOW, THEREFORE, IT IS HEREBY ORDERED that the Clerk shall forthwith serve copies of these Proposed Conclusions of Law upon the parties in accordance with Fed. R. Bankr. P. 9033, and otherwise arrange for transmittal of the same to the Clerk of the United States District Court in accordance with this court's usual procedures.

IT IS SO ORDERED.

Dated August 30, 2013

Scott W. Dales
United States Bankruptcy Judge