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Discovery Issues: A Primer and Recent Developments

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Current Topics in Rule 2004 Discovery

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I. Introduction: The Scope of Federal Rule of Bankruptcy Procedure 2004

- FRBP 2004 provides, upon the motion of *any party in interest*, that the court may order the examination of any entity. The rule also states that any such examination must relate to the "acts, conduct, or property or to the financial liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge."

- Potential examinees include third parties that possess knowledge of the debtor's acts, conduct, liabilities or financial condition which relate to the administration of the bankruptcy estate. *In re Washington Mut. Inc.*, 408 B.R. 45, 50 (Bankr. D. Del. 2009); FRBP 2004(a); *In re Ionosphere Clubs, Inc*., 156 B.R. 414, 432 (S.D.N.Y. 1993).

- An examination can be initiated by, among others, the debtor, the trustee, the creditors' committee, an equity security holders' committee, a creditor, an indenture trustee, the UST, and examiners. 11 U.S.C. 1109, 11 U.S.C. 1104(c), *In re Davis*, 452 B.R. 610, 614 (Bankr. E.D. Mich. 2011).

- Under FRBP 2004(c), the court may "compel the attendance of an entity for examination and for the production of documents." Likewise, under FRBP 2004(d), the court may order the debtor to be examined at any time or place.

- By these terms alone, FRBP 2004 is a powerful tool; however, practitioners should note that local rules and practice factor heavily into the examination process and procedure. For example:

    - The local rules for the Central District of California and the District of Delaware both require the moving party to attempt to confer with the entity to be examined under Rule 2004 to arrange for a mutually

agreeable time and location for an examination or production before the filing of a motion for examination.

- The local rules for the Northern District of Georgia limit examinations under Rule 2004 to six hours (though the entity being examined may consent to a longer examination), unless the court orders otherwise.

II. Limits on the "Fishing Expedition"

Rule 2004 and the corresponding local rules have left significant gaps for case law to fill. The scope of discovery under FRBP 2004 is infamously broad, but is it really a 'fishing expedition,' as some have claimed?

- First and foremost, the Rule 2004 examination must relate to the debtor's bankruptcy proceedings. *In re Board of Directors of Hopewell Intern. Ins. Ltd.*, 258 B.R. 580 (Bankr. S.D. N.Y. 2001) (denying debtor's request for 2004 discovery against a creditor where the discovery sought related to matters being arbitrated in a foreign jurisdiction).

- Courts will not allow Rule 2004 examinations to be used in an abusive manner. "An examination cannot be used for purposes of abuse or harassment." *In re Mittco, Inc.*, 44 B.R. 35, 36 (Bankr. E.D. Wis. 1984) (denying a motion to quash an order authorizing a 2004 examination by a creditor of a debtor finding that the primary purpose of the examination was to investigate the possibility of recovering assets for the benefit of the bankruptcy estate).

- Furthermore, the scope of the examination must be restrained such that it does not present an undue burden. "The examination should not be so broad as to be more disruptive and costly to the party sought to be examined than beneficial to the party seeking discovery." *In re Fearn*, 96 B.R. 135 (Bankr. S.D. Ohio 1992) (denying a motion to quash a Rule 2004 subpoena where the material sought pertained to the debtor's assets and financial condition and would have an effect on the administration of the bankruptcy estate).
- If a party objects, the examiner must establish "good cause, taking into consideration the totality of the circumstances, including the importance of

the information to the examiner and the costs and burdens on the creditor." In re DeShetler, 453 B.R. 295, 302 (Bankr. S.D. Ohio 2011) (limiting the scope of the U.S. Trustee's 2004 examination of a creditor to the "cause" for such examination—to determine whether the creditor was legally entitled to file a proof of claim).

- Compare FRCP 26(b)(1), which introduces the concept of "proportionality" into the discovery process and requires parties to consider the needs of the case, the amount in controversy, relative access to the requested information, the parties' resources, and whether the burden outweighs the likely benefit.

III. An In-Depth Look at Two Recent Cases

A. In re Millennium Lab Holdings

In *Millennium Lab Holdings*, the debtors' plan of reorganization contained a settlement resolving disputes between the debtors and certain prepetition lenders.[1] As part of the settlement, two trusts were created (the "Corporate Trust," and the "Lending Trust") to pursue recovery from certain "Excluded" parties.[2] The Trustee for both Trusts filed a Rule 2004 motion (the "Rule 2004 Motion") on behalf of each Trust seeking to examine certain third parties, including several banks, a law firm, and an accounting firm (the "Third Parties").[3] Some of the Third Parties objected on the grounds that (a) the court lacked subject matter jurisdiction over the post-confirmation Rule 2004 motion, and (b) that the information requested was overly broad.[4]

In the Court's memorandum, Judge Silverstein determined that the Court did, in fact, have subject matter jurisdiction over the post-confirmation Rule 2004 Motion. In reaching this determination, the Court indicated that Rule 2004 is a rule of bankruptcy procedure that does not exist independently of the bankruptcy environment, but by its very nature arises from it.[5] Leading up to this conclusion, the Court noted that filing of the Rule 2004 Motion post-confirmation had no effect on the Court's jurisdiction because the determination of such "arising in" jurisdiction rendered the jurisdictional analysis complete.[6]

With respect to the second objection, as to the breadth of the request, the Court's treatment of the Rule 2004 Motion hinged on whether the examination would benefit the debtor's creditors, or merely provide litigants with an unfettered discovery tool in connection with private litigation.[7] One Trust fell into the former category and one into the latter.

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[1] *In re Millennium Lab Holdings II, LLC*, 562 B.R. 614, 619 (Bankr. D. Del. 2016).

[2] *Id.*

[3] *Id.*

[4] *Id*. at 622.

[5] *Id.*

[6] *Id.* (quoting *In re Seven Fields Dev. Corp*., 505 F.3d 237, 240 (3d Cir. 2007)).

[7] *Id.* at 629.

The Court noted that the purpose of the 2004 Motion with respect to the Corporate Trust was to investigate potential causes of action the debtors may have against the Third Parties.[8] Proceeds from claims brought on behalf of the Corporate Trust based on the results of the Rule 2004 investigation would then be distributed to creditors.[9] As such, the Court held "the Trustee's Rule 2004 Motion with respect to the Corporate Trust fits squarely within the purpose of Rule 2004, as he seeks to examine third parties for the purpose of 'discovering assets, examining transactions, and determining whether wrongdoing has occurred' on behalf of the Debtors' estate."[10]

The Trustee's request to use Rule 2004 to investigate claims on behalf of the Lender Trust, on the other hand, was not within the scope or purpose of Rule 2004 because "although the Lender Trust was established pursuant to the plan, it is not comprised of [sic] debtor claims."[11] Because the lenders who contributed claims to the Lender Trust would benefit from the examinations and not the debtor, such a request was outside the scope of Rule 2004 and an attempt to dress the examination "'in the robes of bankruptcy administration.'"[12] Thus, "the fact that the Lender Trust was created by the Plan does not infuse the Lender Trust with bankruptcy tools that would not otherwise be available to third party creditors pursuing claims against non-debtor entities."[13]

B. In re China Fishery Group

In *In re China Fishery Group,* there is currently a dispute over whether a U.S. entity should be subject to discovery under Rule 2004 when a foreign affiliate has possession, custody, or control of relevant documents.[14] The trustee (the "Trustee") filed a Rule 2004 discovery motion (the "Motion"), seeking to issue subpoenas on a foreign entity (the "Foreign Affiliate") and its affiliates. In connection with the Motion, the Trustee sought discovery from a U.S. entity (the "Domestic Party") as such an affiliate (the Domestic Party is owned by the same holding group as the

[8] *Id.* at 627.

[9] *Id*.

[10] *Id*.

[11] *Id.* at 628.

[12] *Millennium Lab Holdings*, 562 B.R. at 628 (quoting *In re J & R Trucking, Inc.*, 431 B.R. 818, 822 (Bankr. N.D. Ind. 2010)).

[13] *Millennium Lab Holdings*, 562 B.R. at 629.

[14] *In re China Fishery Group Limited (Cayman)*, et al., Case No.16-11895 (S.D.N.Y. 2016).

Foreign Affiliate). Specifically, the Motion seeks to investigate the collection efforts of the Foreign Affiliate to obtain repayment of certain loans made to the debtors. The Domestic party was not specifically identified as an affiliate in the Motion, but was served with the Motion and has filed an objection.

It is the Domestic Party's position that it has no banking or lending relationships with the debtors, cannot access the Foreign Affiliate's documents, and therefore cannot be responsive to the Trustee's requests. In essence, the Domestic Party contends that the Trustee is attempting to use the Domestic Party as a conduit to conduct discovery of the Foreign Affiliate. It is the position of the Domestic Party that, absent a pre-existing relationship related to the topics on which the Trustee intends to seek discovery, it should not be subject to subpoena.

The Domestic Party further contends that it cannot be compelled to produce documents in possession of the Foreign Affiliate, because it has no control over such documents or related information. The Domestic Party supports this position by arguing that though the Foreign Affiliate is a 'sister corporate entity,' the Domestic party has neither the practical ability to obtain any of the requested documents, nor the power to compel the Foreign Affiliate to produce them.

The Trustee's reply brief first focuses on the 'low hurdles' applicable to Rule 2004 requests, and argues that the Domestic Party indeed had enough of a relationship with the debtor to enter its notice of appearance in the debtor's case. The Trustee also alleges that the Domestic Party demonstrated an active involvement in the case, including by filing a proof of claim.

The Trustee then addresses the Domestic party's argument that it lacked a lending relationship with the debtor. The Trustee contends that Rule 2004 examinations are not limited to parties having contractual relationships with the debtor, and avers that the Trustee is not attempting to use the Domestic Party as a conduit. Instead, it is the Trustee's position that the Domestic Party has 'subjected itself' to the Court's jurisdiction through its involvement in the proceeding, and is thus subject to Rule 2004 discovery.

It remains to be seen how the Court will rule on the Motion, but given the broad scope of Rule 2004 examinations, the ever-growing interconnectivity of global lending institutions, and the allegedly significant involvement of Domestic Party in the bankruptcy proceedings, the Court will need to strike a delicate balance in this *Fishery* expedition.

IV. *Other Notable Cases*

- In *In re AOG Entertainment*, the court reaffirmed the axiom that the party seeking Rule 2004 discovery has "the burden to show good cause for the examination it seeks, and relief lies with the sound discretion of the Bankruptcy Court."[15]

    - In *AOG*, a party-in-interest (the "Moving Party") filed a Rule 2004 Motion (the "Motion") seeking to conduct an investigation into the validity of security interests to which the debtors had stipulated in exchange for being allowed to use cash collateral. The Court determined that such investigation was duplicative of that already conducted by the creditors' committee.[16] In denying the Motion, the court noted that the Moving Party failed to establish why the investigation was necessary, or that "denial of [the Motion] would result in unjust hardship or injustice."[17] On the contrary, the court concluded that the "countervailing considerations of cost and delay weigh against granting the Rule 2004 Motion" the court noted that Chapter 11 is an expensive process, and extending the case to allow an investigation "may add significant costs that the Debtors' estates and their creditors will have to bear."[18]

- The court in *In re National Risk Assessment, Inc.* granted the trustee's (the "Trustee") Rule 2004 motion (the "Motion") over the objections of the affected parties (the "Affected Parties"). At the time of the filing of the Motion, the Affected Parties were concurrently defendants in a related state court action, and argued that the Trustee's Motion was prohibited by the "pending proceeding rule."[19]

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[15] *In re AOG Entm't, Inc.*, 558 B.R. 98, 109 (Bankr. S.D.N.Y. 2016).

[16] *Id* at 110.

[17] *Id* at 109.

[18] *Id* at 110.

[19] *In re National Risk Assessment, Inc*., 547 B.R. 63 (Bankr. W.D.N.Y. 2016).

- The pending proceeding rule "holds that after the commencement of an adversary proceeding or other contested matter, the parties to that proceeding or matter may no longer utilize the liberal provisions of Bankruptcy Rule 2004, but must seek discovery under the more restrictive standards of Bankruptcy Rule 7026."[20] Thus, the Court observed that although the Affected Parties "may be defendants in an outstanding state court action, the trustee is himself not a party to that action," and, as such, the Trustee has no ability to examine them.[21] The Court then aptly summed-up the pending proceeding rule as it applies to trustees:

    - The pending proceeding rule imposes a potential restraint upon a litigant's ability to conduct an examination. However, with respect to a trustee, the rule's application arises only in those instances where the trustee is already a party to an adversary proceeding or contested matter involving the parties that he seeks to examine under Bankruptcy Rule 2004. Because no such proceeding or matter has been initiated, the pending proceeding rule has no application in the present instance.[22]

V. Concluding Remarks

While there are fewer limits on discovery under Rule 2004 as compared with discovery under the Federal Rules of Civil Procedure, limits do indeed exist. Rule 2004 examinations must be used for a legitimate purpose and may not be used to harass entities or conduct discovery for purposes of private litigation (as demonstrated in *Millennium Lab Holdings*) rather than in connection with the bankruptcy estate. Furthermore, once a formal adversary proceeding has been commenced, the more restrictive rules of 7026-7037 will govern.

As cases continue to grow in complexity, courts will find themselves facing the challenge of defining the limits of Rule 2004 as it applies to globally diverse, and

[20] *In re National Risk Assessment*, *Inc.*, 547 B.R. at 65 (quoting *In re Bennett Funding Group, Inc.* 203 B.R. 24, 28 (Bankr.N.D.N.Y.1996).

[21] *In re National Risk Assessment*, *Inc.*, 547 B.R. at 65.

[22] *Id* at 66.

complex, corporate entities. It remains to be seen how wide of a net Rule 2004 movants will be allowed to cast in these scenarios.

Rule 2004 Fact Pattern

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Background Facts

Emerald Bank ("Emerald") is a regional bank founded in 1947 by three brothers from Muncie, Indiana whose father, Mr. Frank Oz, had served as the CEO of a large national bank before its collapse during the Great Depression. Emerald remains a closely held Bank, controlled by a board of directors (including five descendants of the three founding Oz brothers). Emerald's legal department is small, consisting of Mr. Tim Tinman, the General Counsel, a paralegal and a legal secretary.

In recent years, Emerald Bank has experienced significant growth due to its acquisition of several smaller banks. Buoyed by their recent growth, the Board of Directors recently approved an aggressive growth initiative to become a super-regional bank. Part of that initiative includes significantly growing their commercial portfolio. Additionally, in an effort to target younger customers, Emerald Bank is investing heavily in overhauling its data networks, computer hardware, remote banking technology, and its web presence, including the creation of designated Facebook, Instagram and Twitter accounts.

Recognizing the need for a CIO to manage this new technology, Emerald hired a computer engineering expert, Carl Binks. Though only 21 years old, Mr. Binks is known throughout the dark web as a master level hacker (codename "The Gatekeeper"). If data is out there, he can find it.

Like his father, Jimmy Oz dreams big and as Chairman of the Board at Emerald Bank, Jimmy personally assumed responsibility for the development and growth of Emerald Bank's commercial loan portfolio. Leveraging relationships that he developed at the Yellow Brick Golf Club, Jimmy arranged for a $6 million ABL line of credit to Bobby Lion's cement company, Courageous Cement Suppliers ("CCS"). This loan would be the largest commercial loan ever made by Emerald Bank and, as such, required full Board approval. After going through credit committee, however, the loan to CCS was only rated as marginal; further credit support and collateralization would be needed before the Board would approve the loan.

Wanting to help his friend and also make a big splash in the commercial loan market, Mr. Oz reached out to his tennis partner, Stevie Crow. Mr. Crow owned 30,000 acres of straw fields in Nebraska, enjoyed net worth of $30MM, and was always looking for a new business opportunity as a way to diversify his investment portfolio.

After meeting, Mr. Lion and Mr. Crow decided to enter into business together by creating an entirely new cement supply company called Lionheart's Cement Suppliers. Mr. Crow would serve as a silent partner and offer his credit and capital support to help make LCS the preeminent cement supplier in the Midwest. Mr. Lion would serve as the face of the company and together, they would leverage their personal relationship with Mr. Oz to secure critical working capital needed to launch LCS successfully.

Based largely on a personal guaranty from Mr. Crow (also secured by a mortgage on over 10,000 acres of his straw fields), Emerald Bank's Board of Directors ultimately approved a $7MM asset-based revolving loan ("ABL") and a $6MM term loan to LCS. Both loans were also secured by a first priority security interest in all of LCS's equipment, inventory, accounts and receivables (as well as by Mr. Lion's own personal guaranty).

The LCS loan was a HUGE deal for Emerald Bank. Professional photographers were brought in for the closing. Pictures of Mr. Oz, the Board of Directors, and Mr. Lion were taken at LCS' new state of the art cement production facility in Muncie. All of these photos were posted to Emerald Bank's Facebook and Instagram Accounts. Mr. Oz tweeted a link to a local news story about the startup of LCS and Emerald Bank's lending role, with the tag "Super excited to be helping Muncie grow! #LCScementtakingtheMidwestbystorm #EmeraldBankapartneryoucancounton."

Initially things went well. Together, Mr. Oz and Mr. Lion coached their kids' golf team in the Muncie Municipal Munchkin Golf Championship to first place. Mr. Oz joined Mr. Lion's fishing and hunting club in Colorado, where the two men successfully harvested a bull moose in their first hunt together. Mr. Oz and Mr. Lion also worked closely together on several major projects for the Muncie Kiwanis Club. Mr. Lion frequently invited Mr. Oz over to his new 12,000 square foot mansion (complete with bowling alley and indoor archery range) for BBQ parties. Pictures of the two men together in these various settings were posted everywhere, including on Emerald Bank's Facebook Page, Instagram Account, and its Homepage. Mr. Oz and Mr. Lion also texted each other on a daily basis about

things they saw in the news, funny stories they had heard and new purchases each had made (including an Emerald Mirror that Mr. Lion had recently purchased "in honor of" Mr. Oz). Mr. Oz's relationship with Mr. Lion strengthened; Mr. Oz truly was a partner that Mr. Lion could count on.

During the Bank's first annual review of the LCS loans however, things began to unravel. The ABL loan was teetering on overadvance. LCS's debt coverage service ratio was hovering around 1.00. Aging receivables were increasing and new receivables were decreasing. Mr. Lion told Mr. Oz during one of his (now famous) Friday night BBQ parties that he may need Emerald Bank to work with him to avoid a payment default. Mr. Oz told him he would be happy to help in any way he could. The next day, Mr. Oz texted Mr. Lion "I got you buddy. Let me take care of what we discussed last night. As your trusted partner, we want to see LCS succeed!"

Mr. Oz used his influence on the Board to convince the credit committee to enter into a loan modification with LCS, which essentially deferred LCS' repayment obligations for six months. In exchange for the deferral, Emerald Bank required Mr. Crow to mortgage another 5,000 acres of straw fields to the Bank. During this process, Mr. Lion worked closely with Mr. Oz and Mr. Tinman on the Modification package. It was common for Mr. Lion and Mr. Oz to trade ideas on the modification package via email and text messaging. Mr. Crow was only consulted when it came time for the documents to be executed.

Six months after the Modification Package was signed, however, Mr. Crow's personal accountant, Ms. Witch, asked to review LCS' financial records. Ms. Witch quickly discovered a pattern of abuse within LCS. Mr. Lion frequently took out unexplained lump sum cash withdrawals from the company's operating accounts at Emerald Bank and was using company monies to make monthly lease payments on a new Audi RS7 (Emerald Package). Mr. Lion also expensed all of his travel to and from his hunting lodge (first class of course) to LCS. Ms. Witch even discovered a receipt indicating that Mr. Lion had used $285,000 from an LCS reserve account to purchase a genuine emerald mirror (which apparently now hung in his mansion).

Incensed, Mr. Crow confronted Mr. Lion, but Mr. Lion denied any wrongdoing. Mr. Crow then turned this information over to Emerald Bank. Needless to say, the Board of Directors was horrified. The LCS loans were immediately downgraded and put into the Bank's special assets department. Mr.

Tinman prepared a standard notice of default and gave LCS 10 days to cure all defaults.

When Mr. Lion received the Notice of Default, he took a picture of it with his cellphone and texted Mr. Oz saying, "Got to help me out brother. It's all a big misunderstanding. You know me." Mr. Oz texted back immediately "I know, I know. I'll convince the Board to sit tight for a few months while this all gets worked out, ok? No worries." Mr. Lion responded "Thanks Partner!"

Mr. Oz was able to convince the Board to slow walk enforcement for a few weeks, but further investigation revealed that Mr. Lion had transferred all of his personal assets to an irrevocable trust and also sold some of LCS' assets to another cement company based in Wichita, Kansas (Wichita's Twisted Cement) that was owned by his lifelong friend, Ms. Dorothy Gale, a resident of Kansas. Mr. Lion was now also working for WTC as a "consultant."

Despite Mr. Oz' pleas for patience, Emerald Bank immediately filed foreclosure proceedings in state courts in Indiana (LCS Assets) and Nebraska (Mr. Crow's straw fields). Mr. Lion was devastated and texted Mr. Oz that he "felt betrayed; how could you do this to me?….your friend and partner."

Mr. Lion and LCS lawyered up. They responded to the Indiana foreclosure action by asserting affirmative defenses and filing counter-claims against the Bank alleging bad faith breach of contract (for not honoring its obligations to forebear). For his part, Mr. Crow sued Mr. Lion, WTC, Ms. Gale and Emerald Bank in federal district court, alleging fraud, bad faith, and a variety of federal violations.

LCS and Mr. Crow each propounded discovery in both state and federal court on Emerald Bank, seeking the production and turnover of all emails, text messages, and Facebook/ Instagram posts of *all* employees and directors at the Bank that may in any way relate to the LCS loans.

Mr. Tinman worked with Mr. Binks (aka the Gatekeeper) on gathering this data and documentation for review. Using predictive coding searches and related algorithms, the Gatekeeper's initial sweep revealed a large amount of responsive data. He determined that he was able to account for around 98% of all data requested in the discovery.

Mr. Tinman presented the Board with discovery findings and was immediately blasted by Mr. Oz. He absolutely forbade Mr. Tinman from turning

over any of his personal texts or emails to either LCS or Mr. Crow. In fact, in a fit of rage, Mr. Oz ordered the Gatekeeper to delete all of the Boards' texts and emails related to the LCS loans right then and there, which the Gatekeeper proceeded to do in dramatic fashion.

Pending Emerald's discovery responses, several unsecured creditors of LCS (including another regional bank and competitor to Emerald Bank) banded together and filed an involuntary petition against LCS. LCS did not challenge the petition and several weeks later an order of relief was entered. A Trustee was appointed and an unsecured creditor's committee was constituted. The UCC immediately filed several motions seeking to conduct 2004 exams of Mr. Lion, Mr. Crow, Ms. Dorothy Gale, WTC, and Mr. Oz (as representative of the Bank). The 2004 exams were very broad in scope, basically seeking the turnover of any and all documents, information, texts, emails, Facebook/Instagram posts, and other electronic data related in any way to the relationships between the various parties.

Questions to Consider

1. How does Emerald Bank respond to the 2004 exam in light of the pending state court and federal court discovery? Consider the pending proceeding rule, forum-subpoena issues, Local Rule compliance, and proportionality.

2. Would Emerald Bank respond differently if the 2004 Motions were filed by the Trustee post-confirmation? *See Millennium*.

3. Spoliation issues; duty to preserve; sanctions. How do you minimize the impact? How do you avoid sanctions? What do you tell your client and what if he refuses to comply?

4. Confidentiality issues and complications, especially with respect to Emerald Bank's competitor. How do you strike the balance between need to know and fair competition?