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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re ECS REFINING, INC., Debtor.	Case No. 18-22453 Chapter 7 DCN: DMC-35 **MOTION OF CHAPTER 7 TRUSTEE TO APPROVE COMPOMISE WITH JAMES AND KENNETH TAGGART, INDIVIUALLY AND IN THEIR CAPACITIES AS DIRECTORS AND OFFICERS OF ECS REFINING, INC., SINCLAIR PARTNERS, LLC, ECS BIG TOWN, LLC, AND ALL METALS, INC. PURSUANT TO RULE 9019(a)** Date: August 2, 2021 Time: 9:00 am Courtroom: 501 I Street, Room 28, Dept. A Sacramento, CA 95814 Judge: Hon. Fredrick E. Clement

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I. INTRODUCTION

Plaintiff Kimberly J. Husted, the duly appointed Chapter 7 Trustee (the "Trustee") of the Estate of ECS Refining, Inc. ("ECS" or "Debtor"), hereby moves this Court for approval of a compromise with Kenneth Taggart and James Taggart, individually and in their capacity as directors and officers of ECS ("Individual Defendants" or "Taggarts") and entities Sinclair Partners, LLC, ECS Big Town, LLC, and All Metals, Inc. (the "Entity Defendants") pursuant to Federal Rule of Bankruptcy Procedure 9019(a)[1]. The terms of the compromise are contained in the Settlement Agreement, a copy of which is submitted as Exhibit A to the Motion.

The settlement provides for payment of $1.35 million to the Trustee for the benefit of the Estate in settlement of the claims brought by the Trustee in the adversary proceeding filed against the Individual Defendants and Entity Defendants, assigned Adversary Proceeding No. 20-02093 ("Adversary Proceeding"). In addition to the recovery of a significant sum, the settlement provides for Sinclair Partners, LLC and ECS Big Town, LLC to waive, release, and withdraw their sizeable administrative expense claims for post-petition rent in the amount of $1,301,353.93. Furthermore, pursuant to the settlement, the Taggarts agree to cooperate in good faith with the Trustee's reasonable requests for information relevant to the allegations and defenses made by the parties in the lawsuit filed by the Trustee on behalf of the Estate against Snell & Wilmer, LLP (Snell & Wilmer)—the attorneys that filed the Debtor's bankruptcy—pending in the Superior Court of California for the County of San Joaquin. The Trustee and the Individual and Entity Defendants (collectively, "Parties") will grant full and complete mutual releases, and the Individual and Entity Defendants release any claims under 11 U.S.C. § 502(h).

The proposed settlement is the product of concerted efforts by the Trustee, all defendants, and the insurer of the directors' and officers' insurance policy, Liberty Insurance Underwriters, Inc. ("Liberty"). The Parties along with Liberty took part in extensive arms' length negotiations under the direction of the Honorable Philip J. Shefferly, retired Chief Judge for the U.S. Bankruptcy Court for the Eastern District of Michigan at an all-day mediation held on May 10, 2021. At the mediation, the Parties reached a settlement in principle and immediately went to work in memorializing those terms.

[1] Hereinafter, the Federal Rules of Bankruptcy Procedure will be referred to as "Rule".

The Trustee believes in her informed business judgment and on advice of counsel that the terms of Settlement Agreement are fair and equitable, in the best interest of the estate, and should be approved by the Court. The Settlement Agreement represents a real benefit to the Estate and its creditors in providing (i) prompt cash recovery to the Estate, and (ii) the release of significant claims against the Estate. The settlement is a favorable result for the Estate and the Trustee requests that the Court approve the Settlement Agreement under the applicable Ninth Circuit standards.

II. JURISDICTION AND VENUE

This Court has jurisdiction to consider this Motion under 28 U.S.C. §§ 157 and 1334. Venue is proper pursuant to 28 U.S.C. § 1409. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

III. FACTUAL BACKGROUND

A. Background

ECS was founded by the Taggarts in the 1980s. ECS was primarily engaged in the business of electronics recycling. It started as a processor of post-manufacturing scrap and residues for original equipment manufacturers in Silicon Valley and later shifted its focus to processing post-consumer electronics as a vertically integrated electronics recycler. ECS provided recycling and asset disposition services ranging from e-waste shredding to information technology and industrial asset refurbishment and resale across the country. Declaration of Kimberly J. Husted in Support of the Motion ("Husted Decl.") ¶ 3.

ECS leased commercial space in California, Oregon, Texas, Ohio, and Arkansas. The largest facility was a 262,000 square feet warehouse space in Stockton, California. ECS leased the Stockton facility from Sinclair Partners, LLC pursuant to a 20-year lease dated March 1, 2011. The Taggarts are the managers of Sinclair Partners, LLC and the indirect or direct owners of the LLC. Husted Decl. ¶ 4.

ECS also leased 216,000 square feet of industrial space in Mesquite, Texas. The lessor of the facility was ECS Big Town, LLC. On January 12, 2012, ECS entered into a 10.5 year lease with ECS Big Town, LLC to rent the Mesquite facility. The lease was amended in 2018 to allow ECS to lease additional space. The Taggarts are the indirect or direct owners of ECS Big Town, LLC. Husted Decl. ¶ 5.

All Metals, Inc. is a California Corporation formed in 1980s. The Taggarts are the indirect or direct owners of All Metals, Inc., James Taggart is the CEO of All Metals and Kenneth Taggart is the vice president. Husted Decl. ¶ 6.

ECS filed a voluntary petition under chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") on April 24, 2018 (the "Petition Date") in this Bankruptcy Court. The Debtor's bankruptcy was filed by the law firm of Snell & Wilmer. As of the Petition Date, the Taggarts were board members, officers, and shareholders of ECS. Husted Decl. ¶ 7.

On the Petition Date, Snell & Wilmer filed an emergency motion for an order authorizing the Debtor to obtain a $6.0 million post-petition loan from Butch & Sundance, LLC (Bankr. Dkt. No. 12) ("DIP Loan Motion"). The DIP Loan Motion, prepared by Snell & Wilmer, misrepresented certain facts and did not contain adequate disclosures on a number of critical items, including the fact that Butch & Sundance, LLC was completely owned and managed by the Taggarts and that the Debtor's largest landlords who were to be paid from the proceeds of the DIP Loan were also owned and effectively managed by the Taggarts (Second Amended Complaint ("SAC"), ¶¶ 117-137). A review of the Bankruptcy Court filing reveals that the proposed order approving the DIP loan stated that the loan was "negotiated in good faith and at arm's length" between ECS and Butch & Sundance, LLC (DIP Loan Motion 32:9-10) even though insiders were on both sides of the transaction. Husted Decl. ¶ 8.

A continued hearing on the DIP Loan Motion was held on May 1, 2018. The recording of that hearing reveals that this Court stated, that given the onerous terms of the DIP Loan in favor of the lender, it was "troubling" and "striking" that the DIP Loan Motion did not affirmatively disclose to the Bankruptcy Court that Butch & Sundance, LLC was owned by the principals and shareholders of the Debtor. At that hearing, the Court further emphasized that the lack of disclosures was seemingly the product of "skullduggery or incompetence" on the part of the Debtor's attorneys, Snell & Wilmer. During the period that ECS operated as a debtor-in-possession, Snell & Wilmer failed to file any schedules on behalf of the Debtor. Snell & Wilmer's failure to file the schedules added a heavy load to the estate trustees and impeded the management of the estate. Husted Decl. ¶ 9.

On May 2, 2018, the Debtor and SummitBridge National Investments V, LLC ("SummitBridge") stipulated to the appointment of a Chapter 11 trustee (Bankr. Dkt. No. 91). On May

8, 2018, the Court entered an order appointing Donald Gieseke as the Chapter 11 trustee (Bankr. Dkt. 99).

On July 6, 2018, SummitBridge moved to convert the case to a Chapter 7 case (Bankr. Dkt. 256). The motion was continued multiple times and was granted on September 28, 2018. Michael McGranahan was appointed chapter 7 trustee on October 2, 2018 (Bankr. Dkt. No. 575).

On July 6, 2018, the Chapter 11 trustee filed a motion to, among other things, reject the Stockton and Mesquite facility leases (Bankr. Dkt. No. 269). The hearing on the motion was continued four times on the Chapter 11 trustee's request and on August 23, 2018, the Court entered an order extending the deadline for the trustee to assume or reject the leases to November 20, 2018 (Bankr. Dkt. No. 474). On October 30, 2018, Sinclair Partners, LLC and ECS Big Town, LLC both moved to compel the chapter 7 trustee to assume or reject the leases with ECS for the Stockton facility and the Mesquite facility respectively (Bankr. Dkt. Nos. 675-684). On November 19, 2018, the Court entered orders rejecting the leases between Sinclair Partners, LLC and ECS and ECS Big Town, LLC and ECS, effective November 21, 2018 (Bankr. Dkt. No. 817-818).

On December 10, 2018, Kimberly J. Husted was appointed the Chapter 7 Trustee for the bankruptcy estate of ECS.

B. Administrative Expense Claims

On April 30, 2021, ECS Big Town, LLC and Sinclair Partners, LLC filed timely motions for allowance of administrative expense claims for May 2018 through November 2018. ECS Big Town, LLC moved the Court for an order allowing the amount of $420,274.65 in administrative rent under 11 U.S.C. § 503(b), consisting of (1) $297,771.02 from the chapter 11 portion of the bankruptcy case; and (2) $122,503.63 from the chapter 7 portion of the bankruptcy case (Bankr. Dkt. No. 1645). Sinclair Partners, LLC similarly moved for an order allowing $881,079.28 in administrative rent under 11 U.S.C. § 503(b), consisting of (1) $627,675.20 from the chapter 11 portion of the bankruptcy case; and (2) $253,404.08 from the chapter 7 portion of the case (Bankr. Dkt. No. 1648).

C. Litigation

Upon her appointment, the Trustee preliminarily concluded that the Estate held potential claims

against certain ECS insiders and professionals. In that light, the Trustee with assistance of her general counsel, as well as special counsel Felderstein Fitzgerald Willoughby & Pascuzzi, LLP, engaged in a request for proposal process to employ special litigation counsel to investigate and bring potential claims on behalf of the Estate. On May 10, 2019, the Court entered the Order Granting the Application to Employ Diamond McCarthy as Special Counsel Pursuant to a Contingent Fee Arrangement (Dkt. No. 1111). The Court authorized Diamond McCarthy's employment pursuant to § 328(a) of the Bankruptcy Code.

On April 23, 2019, Trustee filed a complaint in San Joaquin Superior Court against Snell & Wilmer and certain attorneys at that firm for legal malpractice and breach of fiduciary duty (*Husted v. Snell & Wilmer et. al.*, STK -UV-UPN-2019-5196) arising out of their negligent advice and conduct related to the Debtor, both pre-and post-petition.

On April 24, 2020, Diamond McCarthy on behalf of the Trustee initiated this Adversary Proceeding by filing a complaint for: breach of fiduciary duty and corporate waste against the Individual Defendants; avoidance of preferential, actual and constructive fraudulent transfers, and unauthorized post-petition transfers against the Entity Defendants, and recovery of those transfers totaling $3,215,126; equitable subordination of proofs of claims, and objections to proofs of claim filed by the Individual Defendants and the landlords, totaling at least $801,667.

On June 26, 2020, the Individual Defendants and the landlords filed the Conditional Motion for Entry of Order Authorizing Withdrawal of Proofs of Claim (Bankr. Dkt. No. 1342). The Individual Defendants and the landlords sought to withdraw proofs of claim 342-1, 344-1, 343-1, 345-1, 341-1, and 340-1 ("Proofs of Claim") previously filed totaling at least $801,667. The motion requested that if the Court permits withdrawal of the Proofs of Claim, the order should make clear that the withdrawal does not otherwise affect the substantive rights of the Individual Defendants and the landlords in defending the claims brought in the Adversary Proceeding.

On July 27, 2020, the Trustee, Individual Defendants, and the landlords entered into a stipulation allowing for the Proofs of Claim to be withdrawn, without prejudice (Dkt. No. 1360). The withdrawal of the Proofs of Claim was to have no substantive effect on the rights of the Parties, other than the Individual Defendants and the landlords are not entitled to share in any pro rata distributions

to pre-petition general unsecured creditors on the Proofs of Claim. The stipulation did not affect the landlords' ability to file motions for allowance of administrative claims for post-petition rent. The Court approved the stipulation on July 28, 2020 (Dkt. No. 1362).

On June 26, 2020, the Individual Defendants and the Entity Defendants moved to dismiss all the causes of action in the complaint. On July 1, 2020, the Trustee exercised her right to file a First Amended Complaint, and on August 19, 2020, the Individual and Entity Defendants moved to dismiss. The Trustee filed her oppositions on September 15, 2020. On December 15, 2020, in a published 54-page Memorandum (Dkt. No. 76) and Order Granting and Denying Motions to Dismiss First Amended Complaint (Dkt. No. 77), the Court denied the Individual Defendants' efforts to dismiss the Trustee's breach of fiduciary duty and corporate waste claims against the Individual Defendants and the actual fraudulent transfer claims against the Entity Defendants. The Court allowed the Trustee to amend her constructive fraudulent transfer claims against the Entity Defendants and the preference claim against All Metals, Inc.[2] On January 19, 2021, the Trustee filed the operative Second Amended Complaint. The Individual Defendants moved for leave to appeal the decision to the Bankruptcy Appellate Panel. The Bankruptcy Appellate Panel denied the motion for leave to appeal.

The Second Amended Complaint brings the following five causes of action: first cause of action for breach of fiduciary duty against Individual Defendants; second cause of action for waste against Individual Defendants; third cause of action for avoidance of $1,190,000 in preferential transfers to All Metals, Inc.; fourth cause of action for avoidance of actual fraudulent transfers against the Entity Defendants totaling $3,215,126; fifth cause of action for recovery of the avoided transfers against the Entity Defendants.

D. <u>The Trustee's Contentions</u>

The Trustee's investigation identified multiple factual and legal theories of liability against the Taggarts and the Entity Defendants, in addition to the Debtor's counsel. The Trustee contends that the Estate holds claims against the Individual Defendants for breach of fiduciary duties. The Trustee

[2] The Trustee did not oppose the Entity Defendants' motion to dismiss the preference cause of action as to Sinclair Partners, LLC and ECS Big Town, LLC, the avoidance of post-petition transfers as to all defendants, and the objections to the proofs of claim and equitable subordination claim as to all defendants. As a result, those causes of action were dismissed with prejudice.

asserts that to minimize SummitBridge's control over ECS and to maximize their control, in reliance on their professional advisors, the Individual Defendants took actions, both pre-and post-petition, without due consideration to the effect on ECS and its creditors. First, the Trustee contends that the Individual Defendants weakened ECS's financial condition such that by the time of the Petition Date, the Debtor did not have the liquidity needed to continue as a going concern in the bankruptcy. They increased rent payments to the Entity Defendants, paid vendors at increased rates, and failed to adequately address bloated overhead. Second, the Trustee contends that pre-petition the Individual Defendants sought to minimize ECS's assets that were subject to SummitBridge's security interest by ceasing production, spending cash, and segregating incoming inventory. One of the professionals hired by ECS described the strategy as a "great way to put the screws to Summit by squeezing of as much of the [accounts receivable] as possible before filing…So that means once collected it should immediately be used to pay down critical expenses." (SAC ¶ 87). Third, the Trustee contends that the Individual Defendants attempted to capitalize on the pre-bankruptcy strategy with a loan from the newly formed Butch & Sundance, LLC, which the Taggarts owned and controlled, in an effort to take back the company and continue to operate with their preferred clients without SummitBridge. The proposed DIP loan was to be provided a superpriority administrative claim; a first priority security interest against all post-petition assets of the Debtor; a security interest in any and all pre-petition assets, subject only to any existing as of the petition date, valid, perfected and unavoidable liens; and a first priority security interest against any claims arising under Chapter 5 of the Bankruptcy Code (DIP Loan Motion 2:28-4:6).

The Trustee was intending to prove that unsecured creditors were harmed by weakening an already frail company, by giving Butch & Sundance, LLC's lien favorable terms, and by decreasing the availability of unencumbered assets to pay unsecured creditors. Furthermore, by reducing ECS's pre-petition earnings and profitability, the "new value" payment necessary under a future contested chapter 11 plan was also reduced, thereby allowing the Individual Defendants to retain their interests even though senior classes would not be paid in full. The Trustee was also intending to establish that the efforts to increase the Debtor's liquidity crisis doomed the chapter 11 and created a chapter 7 fire sale. The Trustee further contends that the above described conduct by the Individual Defendants

shows a lack of substantial consideration and that the Taggarts' reliance on its professionals was not in good faith, thereby establishing a claim for corporate waste.

The Adversary Proceeding also seeks to avoid three payments to All Metals, Inc as preferential and fraudulent transfers all made within one year of the petition date (August 31, 2017 - $400,000; September 19, 2017 - $300,000; and November 28, 2017 - $490,000). Additionally, the Trustee seeks to avoid transfers to Sinclair Partners, LLC in the amount of $1,473,389.16 and transfers to ECS Big Town, LLC in the amount of $551,737.24, all made within one year of the Petition Date. The Trustee contends that certain badges of fraud exist. Namely, at the time of each transfer, the Debtor had unmanageable debt and there was a special relationship between the Entity Defendants and the Debtor because the Entity Defendants are controlled by the Taggarts. Moreover, the Trustee contends that the Taggarts engaged in self-dealing transactions (increased spending of cash prior to the petition, making accelerated payments to preferred creditors, reducing production to avoid obligations to SummitBridge, as well as entering into excessive commercial leases and increased rent pre-petition).

E. Individual Defendant Contentions

The Individual Defendants contest the Trustee's factual assertions. For instance, they contend that any issues of concern regarding the bankruptcy filings and failures were the responsibility of ECS's bankruptcy counsel, Snell & Wilmer, and that the Taggarts did not have bankruptcy experience so that they did not know what disclosures should or should not have been made in the first day motions and the DIP Loan Motion. They assert that they relied completely and in good faith on the lawyers to prepare the bankruptcy documents in accordance with applicable legal standards and requirements. The Individual Defendants also assert that their original plan was not to provide DIP financing themselves, but rather to obtain post-petition financing from a third party, and they contend that the company's advisors expended considerable effort to identify a third-party lender. However, when no alternate source of financing came to fruition, the Individual Defendants assert that they decided to provide the funds in an effort to keep ECS alive.

The Individual Defendants also contend that they did not have the power to direct ECS decisions pre-bankruptcy. The Taggarts assert that the New York based private equity fund, the ZS Fund, LP ("ZS Fund"), legally controlled ECS pre-bankruptcy and that ZS Fund personnel sat on the

board of directors and were heavily involved in ECS's business and decision making prior to the bankruptcy. The Individual Defendants also assert that they acted in good faith with respect to the rent increases at the Stockton and Mesquite facilities. They contend that the rent for the Stockton facility was raised by no more than the annual 3.25% increase per the applicable lease agreement. With respect to the Mesquite facility rent increase, the Taggarts assert that the lease was amended because ECS had expanded its operation at the Mesquite facility and was using additional space and the rent increase was in recognition of that. The Taggarts further assert that the terms of the leases had been established years in advance and were not out of line with market rates.

The Taggarts have also raised a number of defenses. First, they point to Section 141(e) of the Delaware General Corporation Law, asserting that they relied upon the advice of Snell & Wilmer and ECS's restructuring advisor MCA Financial Group, Ltd. and are thus entitled to a complete defense. Second, the Taggarts allege that the business judgment rule bars the Trustee's claims for breach of fiduciary duty and the Trustee will not be able to provide evidence to overcome the presumption that the Taggarts at all times acted in good faith and in accordance with their fiduciary duties. Third, they contend that ECS's Certificate of Incorporation contains an exculpation clause which provides that directors of ECS shall not be held personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty. The Taggarts claim to have anticipated asserting additional defenses to the Trustee's claims in their answer to the Second Amended Complaint.

F. The Entity Defendants' Contentions

With respect to the Trustee's preference claim which seeks recovery of transfers to All Metals, Inc. for $1.19 million, All Metals, Inc. asserts the following defenses. First, All Metals, Inc. has argued that the earmarking doctrine removes the transfers from the scope of the preference claim. It asserts that All Metals, Inc. provided cash management transfers to ECS to ensure that ECS had enough cash to meet business obligations and then ECS returned the funds within a matter of days. Second, All Metals, Inc. asserts that the transfers fall within the ordinary course business exception because the parties had a relationship wherein All Metals, Inc. earmarked specific funds contingent on prompt return of those funds.

Next, with respect to the Trustee's actual fraudulent transfer claims against the landlords, they assert that the transfers were regular rent payments. Additionally, they assert that the commercial spaces rented were not excessive but were needed by ECS and the rent charged was below market rate. Furthermore, they argue the transfers to All Metals, Inc. were not nefarious, but cash management transfers made in the ordinary course.

G. Mediation

On May 10, 2021, the Parties along with Liberty attended a JAMS mediation with the Honorable Phillip J. Shefferly, retired Chief Judge of the U.S. Bankruptcy Court for the Eastern District of Michigan. Prior to the mediation, the Parties exchanged mediation briefs, detailing each party's positions, factual and legal arguments, and defenses. The Parties also exchanged a robust set of documents. The mediation lasted more than 12 hours, at which point the Parties reached a settlement in principle. Since the settlement was reached, the Parties worked on memorializing the terms of the settlement, which are embodied in the Settlement Agreement.

H. The Settlement Agreement Terms

The essential terms of the Settlement Agreement are:

(i) *Payment*: For the benefit of the Estate, the Trustee will receive payment of $1.35 million from the Individual Defendants in settlement of the claims asserted by the Trustee in the Adversary Proceeding.[3]

(ii) *Withdrawal of Administrative Claims*: Sinclair Partners, LLC waives and releases its administrative expense claim in the amount of $881,079.28 (Bankruptcy Case Dkt No. 1648) and ECS Big Town, LLC waives and releases its administrative expense claim in the amount of $420,274.65 (Bankr. Dkt. No. 1645). By the Effective Date, Sinclair Partners. LLC and ECS Big

[3] Pursuant to the Order Granting Application to Employ Diamond McCarthy as Special Counsel Pursuant to a Contingent Fee Arrangement (Dkt. No. 1111), concurrent with this Motion, Diamond McCarthy has filed an application for approval and allowance of earned contingency fees in the amount of $415,933.27 and reimbursement of costs in the amount of $50,208.48. This contingency fee amount is based on the $1,350,000 recovery to the Estate and is calculated by deducting expenses incurred from the settlement payment, to which the 32% applies ($1,350,000 - $50,208.48 = $1,299,791.52 x 0.32 = $415,933.27). Diamond McCarthy at this time is not seeking payment on account of the landlords' release of claims, but may do so through a subsequent application at the close of the bankruptcy case.

Town, LLC are to withdraw these claims. The Individuals Defendants agree to release any and all claims for allowance of administrative expenses related to the post-petition debtor-in-possession loan from Butch & Sundance, LLC

(iii) *Parent Case Order Condition*: The settlement is conditioned on entry of a Final (as defined in the Settlement Agreement) order ("ECS Approval Order"), which (a) approves the compromise under Rule 9019; (b) approves Liberty's contribution to the Settlement Payment as "Loss" under the applicable Policy and provides that Liberty's payment of its portion of the Settlement Payment shall reduce the aggregate Limit of Liability in a like amount; (c) finds the settlement to be in "good faith" within the meaning of California Code of Civil Procedure 877.6 and bars claims of contribution and indemnity against the defendants under any applicable law or principle of equity, including but not limited to California Code of Civil Procedure 877.6 and 10 Del. C. § 6304(b); and (d) authorizes the Trustee to enter into and carry out the terms of the settlement.

(iv) *Dismissal of the Adversary Proceeding:* The settlement is conditioned upon dismissal of the Adversary Proceeding in its entirety with prejudice, without assessment of costs or fees against the Trustee or the defendants.

(iv) *Releases*: The Trustee and defendants will grant full and complete mutual releases of all claims, including waivers under California Civil Code section 1542.

(v) *Release of Unsecured Claims*: Defendants waive and release their possible future claims against the Estate, including claims under 11 U.S.C. § 502(h).

(vi) *Cooperation Clause*: The Individual Defendants agree to cooperate in good faith with reasonable requests by the Trustee for information relevant to the allegations and defenses made by the parties in the lawsuit entitled *Husted v. Snell & Wilmer et. al.*, pending in the Superior Court of California for the County of San Joaquin, Case No. STK-UV-UPN- 2019- 5196. The Individual Defendants are obligated to provide truthful information and/or testimony by making themselves reasonably available for one interview each, and by providing reasonable access to non-privileged relevant documents, and by testifying at depositions and/or trial in response to lawful subpoenas.

(vii) *Effective Date*: The effective day is the first day that the Final ECS Approval Order is entered and the Adversary Proceeding is dismissed with prejudice.

IV. ARGUMENT

A. The Court Should Approve the Proposed Settlement

Rule 9019(a) provides that "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." In order to approve a compromise or settlement under Rule 9019(a), "the court must…find that [it] is fair and equitable." *A&C Properties*, 784 F.2d 1377, 1381 (9th Cir.), *cert denied* 107 S. Ct. 189 (1986). In making this determination, the court must consider: (a) [t]he probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; [and] (d) the paramount interest of the creditors and a proper deference to their reasonable views in the premises.'" *Id.* (citation omitted); *In re Woodson*, 839 F. 2d 610, 620 (9th Cir. 1988).

The Court should not conduct "an exhaustive investigation or a mini-trial on the merits," *In re Spirtos*, No. ADV.AD 02-02726-AA, 2006 WL 6811021, at *10 (9th Cir. BAP May 19, 2006), but instead should simply "'canvas the issues and see whether the settlement falls below the lowest point in the range of reasonableness[,]'" *Id.* (quoting *In re Pacific Gas & Elec. Co.*, 304 B.R. 395, 417 (Bankr. N.D. Cal. 2004)). While the proponent of a settlement has the burden to show that it is fair and equitable, a court generally should give deference to a trustee's exercise of business judgment. *Goodwin v. Mickey Thompson Entm't Group, Inc. (In re Mickey Thompson Entm't Group, Inc.)*, 292 B.R. 415, 420 (9th Cir. BAP 2003).

The Court should approve the proposed Settlement Agreement because it is fair and equitable under the standard set forth in *A&C Properties*.

1. Probability of Success

This factor weighs in favor of the compromise.

With respect to the Taggarts, the breach of fiduciary duty and waste claims depend on the resolution of disputed complex issues of fact and law. The facts and law illustrate the relative strength and possible weaknesses of the Estate's claims. The Individual Defendants contest each allegation of wrongdoing asserted by the Trustee and would advance those arguments in any litigation with vigor

and are represented by effective and capable counsel. They have already filed two motions to dismiss and an appeal to the Bankruptcy Appellate Panel.

This Court has already decided that Delaware law controls the Trustee's breach of fiduciary duty and waste claims. Delaware law is considerably more protective to directors and officers and does not apply the "trust fund doctrine." California courts follow the trust fund doctrine pursuant to which all of the assets of a corporation, immediately upon becoming insolvent, become a trust fund for the benefit of the corporation's creditors. *Berg & Berg Enter., LLC v. Boyle*, 100 Cal.Rptr.3d 875, 893 (2009); *In re Jacks*, 266 B.R. 728, 737 (9th Cir. BAP 2000). In contrast, under Delaware law, the fiduciary's duty is "to maximize the value of the insolvent corporation for the benefit of all those having an interest in it" not just for the benefit of the creditors. *See North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007).

While the Trustee is confident that the Estate's claim for breach of fiduciary duty is valid, she along with her counsel, have diligently evaluated the Individual Defendant's defenses to assess their importance as part of the settlement process. For instance, the Taggarts have raised the Business Judgment Rule. This rule "presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company." *In re Orchard Enters., Inc. Stockholder Litig.*, 88 A.3d 1, 34 (Del. Ch. 2014) (internal quotation marks omitted). Directors' decisions are respected by courts unless the directors are interested, lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by grossly negligent process. *Brehm v. Eisner*, 746 A.2d 244, 264 fn. 66 (Del. 2000). While the Trustee contends that the Taggarts acted with reckless indifference to the interest of ECS and its creditors, engaged in self-dealing and demonstrated a lack of good faith, these issues are fact intensive, heavily contested and the outcome is inherently unpredictable.

The Taggarts also assert that Section 141(e) of the Delaware General Corporation Law, shields them from any liability. Section 141(e) provides in part that:

> A member of the board of directors…shall, in the performance of such member's duties, be fully protected in relying in good faith upon…such information, opinions,

> reports, or statements presented to the corporation by any other person as to matters the member reasonably believes are within such person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

8 Del. C. § 141(e). The Taggarts claim that they are "fully protected" because they relied in "good faith" on the expertise and advice of MCA Financial Group, Ltd. and Snell & Wilmer. Whether the Taggarts can rely on this affirmative defense is a fact intensive inquiry, which will turn on whether the Insider Defendants acted in good faith in relying on the advice and information provided by Snell & Wilmer and MCA Financial Group, Ltd, and if the professionals were acting on behalf of ECS as opposed to the Taggarts personally. The Trustee would hope to prove that the Taggarts are not eligible for protection under section 141(e); however, the Trustee recognizes the strength of this affirmative defense and the risks inherent in litigating this defense and the costs and delays of litigation.

One of the Taggarts' defenses is also the presence of an exculpatory provision in ECS's certificate of incorporation. ECS's certificate of incorporation provides in pertinent part, that "[t]o the fullest extent permitted by the DGCL as the same exists or may hereafter be amended, a director of this Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty." Delaware General Corporation Law permits a corporation to exculpate directors from liabilities, provided that the provision does not eliminate or limit the liability of directors for any duty of loyalty, acts or omissions not in good faith, and any transaction for which the director derived in improper personal benefit. Del. Code Ann. Tit. 8, § 102(b)(7) (2020). As the duty of loyalty is excepted under section 1207(b)(7)(iii), Trustee believes that the Taggarts would not be shielded entirely by the exculpation clause. On the other hand, in order to show breach of the duty of care, the Trustee must prove that the Individual Defendants' conduct cannot be excepted because they acted in bad faith and for improper personal benefit. This is a fact intensive, difficult burden, with no guarantee of success.

In addition to the breach of fiduciary duty, the Trustee has brought a claim for waste against the Taggarts. It is uncertain whether the Trustee will be able to recover on the waste claim. The Trustee is cognizant of the fact that waste is only found in limited circumstances, in the "rare, 'unconscionable case where directors irrationally squander or give away corporate assets." *In re Walt Disney Co.*

Derivative Litig., 906 A.2d 27, 74 (Del. 2006).

The Individual Defendants have challenged causation, including proximate cause. Causation presents complex factual issues, including the effect of intervening events on the chain of causation. The Taggarts contend that SummitBridge's conduct in opposing the DIP Loan Motion, pushing for an appointment of a trustee, and efforts to lift the automatic stay and convert the case to chapter 7 should be considered in evaluating the causal link between the Taggarts conduct and the liquidation of ECS. There are complex issues related to causation that create litigation risks on both sides.

The outcome is similarly uncertain with respect to the Trustee's actual fraudulent transfer claims against the landlords. The landlords appear to have a strong argument that the vast majority of the transfers were monthly rent payments pursuant to lease agreements entered into over five years prior to the bankruptcy. While the proper amount of the rent is an issue of fact, the landlords are adamant based on a broker's opinion, that the rent charged was at market rate, and that the space was not excessive given their operational needs. Additionally, proving intent to hinder or delay creditors and demonstrating the badges of fraud is a difficult and fact intensive burden with substantial uncertainty of the outcome and significant risk of no recovery for the Estate on these claims.

With respect to the transfers to All Metals, Inc., the Trustee is aware that preference litigation is an extremely fact-intensive inquiry subject to affirmative defenses. All Metals, Inc. has principally asserted two defenses, the earmarking doctrine and the ordinary course of business exception. All Metals, Inc. alleges that sums were earmarked and transferred to ECS to ensure that the Debtor had enough cash to meet business obligations and then the sums were returned within a matter of days. Additionally, it asserts that the parties had established an ordinary relationship wherein All Metals, Inc. earmarked specific sums on a short-term basis contingent on return. The Entity Defendants contest each allegation of wrongdoing asserted by the Trustee and would advance these arguments in any litigation with vigor and are represented by effective and capable counsel.

In assessing the probability of success on the merits factor, the Trustee has utilized a settlement litigation decision process that includes factors such as her counsel's confidential and privileged estimates of the likelihood of success on the merits, the projected cost to litigate, and the value and timing of possible net recoveries to the Estate. The settlement provides a prompt cash recovery to the

Estate of $1,350,000, in addition to a release of claims against the ECS Estate, including future unsecured claim under 11 U.S.C. § 502(h).

Importantly, pursuant to the Settlement Agreement, the landlords have agreed to waive and release their claims for allowance of post-petition rent for a seven-month period. By the Effective Date, the landlords are to withdraw their claims for chapter 11 administrative expenses in the amount of $925,446.22 and chapter 7 administrative expenses in the amount of $375,907.71 (Dkt. Nos. 1645, 1648). The release provides a significant benefit to the estate by freeing up monies for potential payments to other chapter 7 and 11 claimants that would have received less or no recoveries due to the amounts claimed by the landlords.

The Trustee respectfully submits that the probability of success on the merits factor strongly supports approval of this settlement.

2. Difficulties of Collection

This factor also supports settlement. The D&O insurance policy has a policy limit of $2 million, a substantial portion of which was consumed prior to the mediation. The Trustee is certain that if the Settlement Agreement is not approved, and if the Adversary Proceeding were to continue to trial, the D&O insurance policy limit would be exhausted well in advance of trial; thereby, diminishing potential recovery for the Estate.

The Trustee and her counsel have substantial experience in litigating and collecting judgments and are familiar with the delay and issues that can arise during collection efforts. The settlement allows the Trustee to avoid that risk and delay by providing a substantial and prompt recovery. This factor weighs in favor of the settlement.

3. Complexity, Expense, Inconvenience and Delay of Litigation

This factor weighs in favor of the compromise. The law favors compromise and not litigation for its own sake. *In re Blair*, 538 F.2d 849, 851 (9th Cir. 1976). Given the high stakes and multiple legal disputes, determination would not likely be completed until years from now and at great expense. The Individual Defendants and Entity Defendants are sophisticated parties represented by high quality counsel who are experienced in defending claims such as those alleged by the Trustee. It is reasonable to anticipate that absent settlement, the Trustee's claims would be defended vigorously by both the

Taggarts and the Entity Defendants, and that the defendants would appeal any loss with the attendant costs, delays, and uncertainty of ultimate recovery for the Estate.

As described in the discussion of the Trustee's probability of success, the dispute between the Trustee and the Taggarts and the Entity Defendants involve complex issues of law and fact and substantial affirmative defenses. Without the settlement, the Trustee would likely continue to engage in extensive and costly litigation that would delay and erode the Estate's recovery. Diamond McCarthy estimates as many as 10 fact witness depositions would have been conducted, including but not limited to the depositions of the defendants in the Adversary Proceeding, representatives of ZS Fund, former ECS employees and officers, representatives of SummitBridge, and attorneys at Snell & Wilmer. There are hundreds of thousands of documents, and there would be significant written discovery. The Individual Defendants have made clear that but for the settlement, they would engage in substantial discovery. The discovery process would have likely extended for at least a year or longer at significant expense to the Estate, vastly reducing any ultimate recovery received.

The settlement provides an immediate recovery without the costs, risks, and delays associated with further litigation. This factor heavily supports approval of the Settlement.

4. Paramount Interests of Creditors

Based on the Trustee's and her counsel's analysis, the Trustee believes that the actual value to the Estate gained from the settlement exceeds the value that would be gained from litigation taking into account the costs of the litigation and the risk of losing the litigation.

The settlement provides for $1.35 million recovery despite genuine and substantial challenges to establishing liability and damages. Per the Court order approving Diamond McCarthy's employment under 11 U.S.C. § 328 (Dkt. No. 1111), subject to Court approval, Diamond McCarthy seeks approval of contingency fees in the amount of $415,933.27 and reimbursement of costs in the amount of $50,208.48.

The settlement provides for additional value in the withdrawal of administrative expense claims totaling $1.3 million. Moreover, approving the settlement will best position the bankruptcy case for total resolution and administration of the Estate.

The settlement also provides for the Taggarts' good faith cooperation in the Trustee's state

court litigation against Snell & Wilmer. Prior to the Petition Date and after, the Taggarts communicated with Snell & Wilmer and have personal knowledge of that firm's conduct. The settlement dictates for the Taggarts to provide truthful information related to the Estate's claims against Snell & Wilmer and allows the Trustee to conduct interviews, obtain documents and testimony at trial or depositions pursuant to subpoenas. The Trustee contends that she has valid and strong claims against Snell & Wilmer and the cooperation clause provides important assistance in her efforts to recover additional sums for the benefit of the Estate.

Based on the foregoing and based on all the other information and analysis that she has available to her and her counsel, the Trustee believes that the present value to the ECS Estate from the settlement exceeds what the Estate could reasonably expect to receive net of fees and costs after litigation, and that approval of the settlement is in the best interest of the Estate and its creditors. Accordingly, the Trustee requests that that the Court approve the Settlement Agreement.

B. The Court Should Determine the Adversary Proceeding Settlement Agreement is in Good Faith Under California Code of Civil Procedure 877.6

Where, as here, California law governs a settlement agreement, the Ninth Circuit authorizes federal district courts to make a finding of good faith settlement pursuant to California Code of Civil Procedure ("C.C.P.") §§ 877 and 877.6. *See Federal Sav. & Loan Ins. Corp. v. Butler*, 904 F.2d 505, 509 (9th Cir. 1990). Evaluating a settlement under these statutes, in turn, typically involves analysis of the *Tech-Bilt* factors set forth in the California Supreme Court opinion of *Tech-Bilt, Inc. v. Woodward-Clyde Associates*, 38 Cal.3d 488, 499 (1985). *See Mason & Dixon Intermodal, Inc. v. Lapmaster Int'l LLC*, 632 F.3d 1056, 1064 (9th Cir. 2011) (applying the *Tech-Bilt* factors).

Tech-Bilt directs a court to consider the following non-exclusive factors to determine whether a settlement is made in good faith (1) a rough approximation of plaintiff's total recovery and the settling defendant's proportionate liability; (2) the settlement amount; (3) the allocation of settlement proceeds among plaintiffs; (4) the recognition that a settling party should pay less in settlement than it would if it were found liable after trial; (5) evidence, or lack thereof, of collusion, fraud, or tortious conduct aimed to injure the interests of non-settling defendants; (6) the financial conditions and insurance policy limits of the settling defendant; and (7) information available at the time of settlement. *See*

Tech-Bilt, 38 Cal.3d at 499. Ultimately, the overarching principle is that "a defendant's settlement figure must not be grossly disproportionate to what a reasonable person, at the time of the settlement, would estimate the settling defendant's liability to be." *Id.* Here, the settlement is clearly within the "ball park" in relation to the *Tech-Bilt* factors and is consistent with the objectives of Section 877.6. *Id.* at. 489. All of the Tech-Bilt factors show that the Settlement Agreement was made in good faith.

The first *Tech-Bilt* factor is satisfied given that the settlement covers all parties in this action. Here, the Trustee sets forth two claims against the Individual Defendants for breach of fiduciary duty and corporate waste and three claims against the Entity Defendants for avoidance and recovery of fraudulent transfers. The Individual Defendants believe strong legal and factual arguments effectively negate the Trustee's claims but acknowledge the risks of litigation, especially given that these claims have proceeded past the pleading stage. As the Parties directed their efforts toward settlement, they identified a range of potential liability from which a fair settlement could be reached. The settlement payment of $1,350,000.00 reflects a fair compromise that is proportionate to the Individual Defendants' liability based on what the Parties know at this stage in the litigation.

The same is true for the Entity Defendants' compromise. While the Trustee challenged $2,025,126.40 in transactions to the Entity Defendants as avoidable transfers, the Entity Defendants believe that the vast majority of them are subject to complete defenses. Moreover, the Entity Defendants filed administrative expense claims in the Main Case totaling $1,301.353.90. Thus, any potential recovery on the fraudulent transfer claims is subject to a potential offset that exceeds the Trustee's potential liability. For this reason, the Entity Defendants' agreement to withdraw the administrative expense claims in exchange for a full settlement of the Trustee's claim represents a reasonable outcome that ensures the Settlement Payment goes back into the estate for distribution to creditors unrelated to this litigation.

Tech-Bilt factor two indicates good faith because the $1.35 million settlement plus the withdrawal of the Entity Defendants' administrative expense claims resulted in a settlement agreement that resolved this entire litigation.

Tech-Bilt factor three indicates good faith as the Settlement Amount will be paid to the ECS bankruptcy Estate and the Entity Defendants will withdraw their administrative expense claims from the Estate.

Tech-Bilt factor four indicates good faith as well. As the Parties progressed toward mediation, the Parties made good faith efforts to identify an appropriate settlement range given the claims and potential liability in this adversary proceeding.

The settlement agreement meets *Tech-Bilt* factor five as well. The settlement is the product of a thirteen-hour mediation before the Honorable Phillip Shefferly, retired Chief Judge of the United States Bankruptcy Court for the Eastern District of Michigan, in which all Parties personally participated. Thus, there is no plausible basis for claiming collusion, fraud, or tortious conduct by any Party.

The settlement satisfies *Tech-Bilt* factor six as well. The Individual Defendants are insured under a Directors and Officers liability insurance Policy from Liberty. The entire remaining amount under that Policy, after payment of defense costs, will be used to fund the majority of the settlement payment and the Individual Defendants have agreed to pay the balance out of their own pockets.

Finally, *Tech-Bilt* factor seven indicates good faith as the Parties placed their proverbial "chips on the table" in terms of claims and defenses at the mediation before Judge Shefferly. Therefore, the Parties had all the information available to negotiate a good faith settlement.

V. CONCLUSION

For all of the foregoing reasons, the Trustee respectfully requests that the Court to enter an order granting the relief requested in the Motion. Namely, that the Court:

(i) Approve the Settlement Agreement under Federal Rule of Bankruptcy Procedure 9019;

(ii) Approve Liberty's contribution to the Settlement Payment as Loss under the D&O Policy and that Liberty's portion of the Settlement Payment shall reduce the Policy's aggregate Limit of Liability in a like amount;

(iii) Find the Settlement Agreement to be in good faith within the meaning of California Code of Civil Procedure section 877.6 and that claims of contribution and indemnity against the defendants under that or any other applicable law or principle of equity, are barred, including but not

limited to California Code of Civil Procedure 877.6 and 10 Del. C. § 6304(b); and

(iv) Authorize the Trustee to enter into and carry out the terms of the settlement.

Dated: July 2, 2021

DIAMOND McCARTHY LLP

By: */s/ Christopher D. Sullivan*
Christopher D. Sullivan
Special Litigation Counsel
for Plaintiff Kimberly J. Husted, Chapter 7 Trustee