C.A. Nos. 04-16911; 04-16973; 04-17272

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

DUX CAPITAL MANAGEMENT, et al.,
Plaintiffs, Appellees, and Cross-Appellants

vs.

YAGEO CORPORATION, et al.,
Defendants, Appellants, and Cross-Appellees

Appeal From The United States District Court
For The Northern District Of California
Honorable William Alsup, Judge Presiding
U.S.D.C. No. C 03-00540 WHA
Consolidated with No. C 03-00539 WHA (master file)

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1(a) and (b), defendants, appellants and cross-appellees Yageo Corporation and Yageo Holding (Bermuda) Limited hereby submit this corporate disclosure statement.

As of the date of this filing, (a) there is no publicly-held corporation that owns 10% or more of Yageo Corporation's stock, (b) there is no parent corporation of defendant Yageo Corporation, (c) there is no publicly-held third party that owns 10% or more of Yageo Holding (Bermuda) Limited's stock, and (d) defendant Yageo Corporation is the parent corporation of defendant Yageo Holding (Bermuda) Limited.

TABLE OF CONTENTS

STATEMENT OF JURISDICTION 1

STATEMENT OF ISSUES 2

STATEMENT OF THE CASE 3

A. Parties. 3

B. Nature of the Action. 4

C. District Court Proceedings. 4

1. Pre-trial proceedings. 4

2. The jury's verdict. 5

3. Rulings on standing. 6

4. Post-judgment motions. 8

STATEMENT OF FACTS 10

A. Formation of Long Life And Rextron's Investment. 10

B. Long Life Is A Losing Proposition; Its Founders Resign. 11

C. Dux Becomes Involved. 11

D. Long Life Files Bankruptcy, And Its Plan Of Reorganization Is Confirmed. 12

E. The Trustee Assigns Claims To Plaintiffs. 15

TABLE OF CONTENTS (cont'd)

Page

SUMMARY OF ARGUMENT 17

STANDARD OF REVIEW 20

ARGUMENT 21

I. PLAINTIFFS' CORPORATE GOVERNANCE CLAIMS ARE PREEMPTED BY FEDERAL BANKRUPTCY LAW. 21

A. The Essence Of Plaintiffs' Claims Is That Long Life's Bankruptcy Filing Was In Bad Faith And Misused The Bankruptcy Process. 21

B. The Bankruptcy Code Preempts State-Law Claims Challenging The Propriety Of A Decision To File Bankruptcy. They May Be Brought Only In Bankruptcy Court. 23

1. The Bankruptcy Code's comprehensive scheme for combating the improper use of bankruptcy implicitly preempts plaintiffs' claims. 24

2. State-law claims for improper filing or an abuse of process, such as plaintiffs' claims here, conflict with the bankruptcy scheme and cannot be allowed. 30

a. This Court has rejected the assertion of state-law claims under circumstances like those here. 30

b. California courts have likewise found state-law claims preempted. 34

<u>TABLE OF CONTENTS</u> (cont'd)

Page

c. Other courts are in accord. 35

C. The District Court Erroneously Refused To Apply The Doctrine Of Preemption. 37

1. Preemption, as alleged here, affects the court's subject matter jurisdiction and may be raised at any time. 38

2. An assignment of claims cannot undercut Congress's intent to preempt state-law claims. 39

3. The district court's fear that pre-petition misconduct will be absolved fails to consider the remedies and sanctions Congress created in the Bankruptcy Code for such misconduct. 41

II. RES JUDICATA PRECLUDES PLAINTIFFS FROM LITIGATING THEIR CORPORATE GOVERNANCE CLAIMS. 44

A. The Parties Are Identical Or In Privity. 45

B. The Claims Were Or Could Have Been Brought In The Bankruptcy Proceeding. 46

1. The trustee could have brought a claim for breach of fiduciary duty that plaintiffs assert here. 46

2. Plaintiffs asserted the same claims in the bankruptcy they assert in the present case. 49

TABLE OF CONTENTS (cont'd)

Page

C. The Confirmed Plan Is A Final Judgment On The Merits On All Claims That Plaintiffs, Either As Assignees Or Parties, Brought Or Could Have Brought. 50

D. There Is No Basis For Refusing To Apply Res Judicata. 51

1. The confirmation order's general reservation did not preserve plaintiffs' claims. 51

2. The post-confirmation assignment did not preserve plaintiffs' claims. 53

III. PLAINTIFFS LACK STANDING TO ASSERT A DAMAGES CLAIM AS LONG LIFE'S ASSIGNEES, BECAUSE NO CAUSE OF ACTION ACCRUED BEFORE THE BANKRUPTCY FILING. 54

A. A Cause Of Action For Breach Of Fiduciary Duty Does Not Accrue Until The Claimant Sustains Damage. 55

B. The Jury's Findings Establish That Plaintiffs Sustained No Pre-Petition Damages. 56

C. The District Court's Determination That Plaintiffs Were Entitled To Recover Damages For The Decision To File For Bankruptcy Is Inconsistent With The Jury's Findings And Contrary To The Law Requiring The Fact Of Damages To Be Certain. 60

CONCLUSION 66

CERTIFICATE OF COMPLIANCE 67

STATEMENT OF RELATED CASES 67

TABLE OF AUTHORITIES

Page

Cases

Aguilera v. Pirelli Armstrong Tire Corp.
223 F.3d 1010 (9th Cir. 2000) 20

Alliance Mortgage Co. v. Bothwell
10 Cal. 4th 1226,
44 Cal. Rptr. 2d 352 (1995) 56

Astor Holdings, Inc. v. Rossi
325 F. Supp. 2d 251 (S.D.N.Y. 2003) 36

Bender v. Williamsport Area Sch. Dist.
475 U.S. 534,
106 S. Ct. 1326,
89 L. Ed. 2d 501 (1986) 1, 2

Browning v. Levy
283 F.3d 761 (6th Cir. 2002) 45, 50, 52

Budd v. Nixen
6 Cal. 3d 195,
98 Cal. Rptr. 849 (1971) 63

Cal. ex. rel. Sacramento Metro. Air Quality Mgmt. Dist. v. United States
215 F.3d 1005 (9th Cir. 2000) 2

Choy v. Redland Ins. Co.
103 Cal. App. 4th 789,
127 Cal. Rptr. 2d 94 (2002) 34

TABLE OF AUTHORITIES

Page

Cases (cont'd)

City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.
68 Cal. App. 4th 445,
80 Cal. Rptr. 2d 329 (1998) 55

City of Vista v. Robert Thomas Securities, Inc.
84 Cal. App. 4th 882,
101 Cal. Rptr. 2d 237 (2000) 55

Crowley v. Peterson
206 F. Supp. 2d 1038 (C.D. Cal. 2002) 63

D & K Properties Crystal Lake v. Mutual Life Ins. Co.
112 F.3d 257 (7th Cir. 1997) 51, 52, 53, 54

Eastern Equip. & Servs. Corp. v. Factory Point Nat'l Bank
236 F.3d 117 (2d Cir. 2001) 35

Federated Dept. Stores v. Moitie
452 U.S. 394,
101 S. Ct. 2424,
69 L. Ed. 2d 103 (1981) 44

Gene R. Smith Corp. v. Terry's Tractor, Inc.
209 Cal. App. 3d 951,
257 Cal. Rptr. 598 (1989) 34

Gonzales v. Parks
830 F.2d 1033 (9th Cir. 1987) 17, 23, 28, 30, 31, 41, 42

TABLE OF AUTHORITIES

Page

Cases (cont'd)

Goodworth Holding, Inc. v. Suh
239 F. Supp. 2d 947 (N.D. Cal. 2002) 56

Gospel Missions of America v. City of Los Angeles
328 F.3d 548 (9th Cir. 2003) 20

Gregory v. Widnall
153 F.3d 1071 (9th Cir. 1998) 20

Hillsborough County v. Automated Med. Lab. Inc.
471 U.S. 707,
105 S. Ct. 2371,
85 L. Ed. 2d 714 (1985) 24, 28

Hines v. Davidowitz
312 U.S. 52,
61 S. Ct. 399,
85 L. Ed. 581 (1941) 29

Holman v. Laulo-Rowe Agency
994 F.2d 666 (9th Cir. 1993) 39

Idell v. Goodman
224 Cal. App. 3d 262,
273 Cal. Rptr. 605 (1990) 34, 35

In re Arnold
806 F.2d 937(9th Cir. 1986) 26

In re Cedar Shore Resort, Inc.
235 F.3d 375 (8th Cir. 2000) 25

Cases (cont'd)

TABLE OF AUTHORITIES

Page

In re Chu
253 B.R. 92 (S.D. Cal. 2000) 26

In re City of Desert Hot Springs
339 F.3d 782 (9th Cir. 2003) 25

In re Int'l Nutronics, Inc.
28 F.3d 965 (9th Cir. 1994) 48

In re Kelley
199 B.R. 698 (9th Cir. BAP 1996) 52, 53

In re Marriage of Comer
14 Cal. 4th 504,
59 Cal. Rptr. 2d 155 (1996) 40-41

In re Marsch
36 F.3d 825 (9th Cir. 1994) 25, 26, 27, 47

In re Phoenix Piccadilly, Ltd.
849 F.2d 1393 (11th Cir. 1988) 26

In re Rainbow Magazine
77 F.3d 278 (9th Cir. 1996) 28, 39, 41

In re Sal Caruso Cheese, Inc.
107 B.R. 808 (Bankr. N.D.N.Y. 1989) 26

In re Silberkraus
336 F.3d 864 (9th Cir. 2003) 26

Cases (cont'd)

TABLE OF AUTHORITIES

Page

In re Transcolor Corp.
258 B.R. 149 (Bankr. D. Md. 2001) 32, 36

Ins. Corp. of Ireland, Ltd. v. Compagnie des Bauxite de Guinee
456 U.S. 694,
102 S. Ct. 2099,
72 L. Ed. 2d 492 39

Int'l Paper Co. v. Ouellette
479 U.S. 481,
107 S. Ct. 805,
93 L. Ed. 2d 883 (1987) 24

Johnson v. Armored Transport of California, Inc.
813 F.2d 1041 (9th Cir. 1987) 38

Koch Refining v. Farmers Union Central Exchange
831 F.2d 1339 (7th Cir. 1987) 46, 47

MSR Exploration, Ltd. v. Meridian Oil, Inc.
74 F.3d 910 (9th Cir. 1996) 17, 23, 25, 28, 29, 31, 32, 34, 38, 40, 41, 43

Martin v. Deetz
102 Cal. 55, 36 P. 368 (1894) 64

Mason v. Smith
140 N.H. 696,
672 A.2d 705 (1996) 36

Cases (cont'd)

TABLE OF AUTHORITIES

Page

Owens v. Kaiser Foundation Health Plan, Inc.
244 F.3d 708 (9th Cir. 2001) 45, 48

Pepper v. Litton
308 U.S. 295,
60 S. Ct. 238,
84 L. Ed. 2d 281 (1939) 41-42, 46, 47

Road Sprinkler Fitters Local Union No. 669 v. G & G Fire Sprinklers, Inc.
102 Cal. App. 4th 765,
125 Cal. Rptr. 804 (2002) 46

Romano v. Rockwell Intern, Inc.
14 Cal. 4th 479,
59 Cal. Rptr. 2d 479 (1996) 62

Ross v. Universal Studios Credit Union
95 Cal. App. 4th 537,
115 Cal. Rptr. 2d 712 (2002) 35

Saks v. Parilla, Hubbard & Militzok
67 Cal. App. 4th 565,
79 Cal. Rptr. 2d 120 (1998) 34, 35

Sherwood Partners, Inc. v. Lycos, Inc.
__ F.3d __,
2005 U.S.App. LEXIS 490 (9th Cir. Jan. 12, 2005) 33

Cases (cont'd)

Shiner v. Moriarty
706 A.2d 1228 (Pa. Super. Ct. 1998) 36

TABLE OF AUTHORITIES

Page

Smith v. Tele-Communications, Inc.
134 Cal. App. 3d 338,
184 Cal. Rptr. 571 (1982) 19, 64

Trulis v. Barton
107 F.3d 685 (9th Cir. 1995) 50

United States v. Ceja-Prado
333 F.3d 1046 (9th Cir. 2003) 39

United States ex rel. Barajas v. Northrop Corp.
147 F.3d 905 (9th Cir. 1998) 44, 47

United States Liab. Ins. Co. v. Haidinger-Hayes, Inc.
1 Cal. 3d 586 55, 56

Walker v. Pacific Indemnity Co.
183 Cal. App. 2d 513,
6 Cal. Rptr. 924 (1960) 63

Statutes

11 U.S.C. § 105 27

11 U.S.C. § 303 27

11 U.S.C. § 707 27

Statutes (cont'd)

11 U.S.C. § 727 27

11 U.S.C. § 1106 48

<u>**TABLE OF AUTHORITIES**</u>

	Page
11 U.S.C. § 1112	27, 47
11 U.S.C. § 1129	15
28 U.S.C. § 1291	1
28 U.S.C. § 1331	1
28 U.S.C. § 1441	1
28 U.S.C. § 1334	29, 31
California Code of Civil Procedure Section 877.6	12
California Code of Civil Procedure Section 1800	33, 34
Federal Rules of Appellate Procedure, Rule 4(a)(4)	1
Federal Rules of Appellate Procedure 26.1	1

Rules

Bankruptcy Rule 9011	27, 47

TABLE OF AUTHORITIES

Page

Texts

7 *Collier on Bankruptcy*, ¶ 1112.07[1] (2000) 25

18 *Moore's Federal Practice* (3d Ed.2004) 44

Constitutions

United States Constitution, article I § 8, cl. 4 38, 31

STATEMENT OF JURISDICTION

This matter was removed to the United States District Court for the Northern District of California pursuant to 28 U.S.C. §§ 1331 and 1441. (Court Record ("CR") 1.) Final judgment was entered in the district court on June 30, 2004, and amended and reentered on August 31, 2004. (Excerpt of Record ("ER") 268, 322, 334, 338.)

Defendants appealed from the judgment and from the order entered July 14, 2004, partially denying their motions for judgment as a matter of law. The notice of appeal, filed on September 20, 2004, was timely under Federal Rule of Appellate Procedure, Rule 4(a)(4). This Court has jurisdiction pursuant to 28 U.S.C. § 1291.

In addition to their substantive claims, defendants challenge the district court's subject matter jurisdiction, in that they contend that the bankruptcy court maintains exclusive jurisdiction over plaintiffs' claim. Federal appellate courts must satisfy themselves not only of their own jurisdiction, "but also that of the lower courts in a cause under review." *Bender v. Williamsport Area Sch. Dist.*, 475 U.S. 534, 541, 106 S. Ct. 1326, 1331, 89 L. Ed. 2d 501 (1986) (internal quotations omitted). If the district court lacked jurisdiction here, this Court has jurisdiction on appeal only "for

the purpose of correcting the error of the lower court in entertaining the suit," but not for the purpose of considering the merits. *Id.*; *see also Cal. ex. rel. Sacramento Metro. Air Quality Mgmt. Dist. v. United States*, 215 F.3d 1005, 1009 (9th Cir. 2000).

STATEMENT OF ISSUES

The directors of Long Life Noodle Company ("Long Life") decided to take the company into bankruptcy. Plaintiffs allege that in doing so, the directors breached their fiduciary duties to Long Life. They further allege that, through an assignment in Long Life's bankruptcy, they acquired Long Life's right to assert such claims.

The judgment plaintiffs recovered on the alleged assigned claims presents the following issues:

1. Are plaintiffs' state-law claims for breach of fiduciary duty, which are based solely on an allegedly improper bankruptcy filing, preempted by federal bankruptcy law?
2. Are plaintiffs' claims barred by the doctrine of res judicata because either (a) they were or could have been raised in the

bankruptcy proceeding or (b) they were explicitly litigated and rejected?

3. Did plaintiffs, who at most acquired only those claims held by Long Life that accrued before its bankruptcy filing, lack standing to assert those claims because (a) no cause of action accrued before the bankruptcy filing, (b) any claimed pre-petition damages were speculative since the fact of damage was uncertain, and (c) the only injury to the entire corpus of Long Life stock was the cancellation of all shares, which occurred during bankruptcy and so was outside the scope of the assignment?

STATEMENT OF THE CASE

A. Parties.

Plaintiff Dux Capital Management Corporation ("Dux") is incorporated in the Bahamas and has its principal place of business in Nassau, Bahamas. (ER 2.) Plaintiff Jerry Davis holds an unlimited power of attorney from Dux for all matters related to Dux's interest in Long Life. (ER 2.)

Defendant Yageo Corporation is a Taiwan corporation and the parent of defendant Yageo Holding (Bermuda) Limited. (ER 2, 297.) Defendant Rextron International is a subsidiary of Yageo Holding and was Long Life's majority shareholder; it prevailed below and is not a party to this appeal. (ER 266, 268, 322.) The individual defendants, An-Ehr Chen, Yan Sheng Chan and Cheng-Ling Lee, were at one time directors and/or officers of Long Life. (ER 3.)

B. Nature of the Action.

Plaintiffs allege breach of fiduciary duty and other claims arising from the decision to place Long Life into bankruptcy. (ER 18-19.) Dux sues as a purported minority shareholder of Long Life; both plaintiffs sue as assignees, under an assignment from Long Life's bankruptcy trustee, of claims held by Long Life. (ER 18-19, 99-101.)

C. District Court Proceedings.

1. Pre-trial proceedings.

The district court granted defendants partial summary judgment on a number of claims on res judicata grounds, based on the bankruptcy proceeding. (ER 135-53.) However, relying on plaintiffs' assignment from

the bankruptcy trustee, it rejected res judicata as to claims that purportedly arose before the bankruptcy filing. (ER 151.) Ultimately left for trial was a single claim for breach of fiduciary duty, which the parties and court referred to as the corporate governance claim. It assumed two guises: (a) a claim by Dux, purportedly suing as a minority shareholder, for a breach of the fiduciary duties owed Long Life's directors, officers and majority shareholders to minority shareholders; and (b) a claim by both plaintiffs in their capacity as assignees of Long Life's claims, asserting Long Life's purported claim against its former directors for breach of their fiduciary duties to the corporation. (ER 203, 302.)

2. The jury's verdict.

The district court crafted its own jury instructions and special verdict form. (*See*, *e.g.*, ER 224-31 (excerpts of Final Charge to the Jury), 232-34.) As to plaintiffs' claim as assignees of Long Life's pre-petition claims, the jury found the individual defendants liable for breach of fiduciary duty and the corporate defendants liable for those individual defendants' breach. (ER 233.) The jury initially determined by special interrogatory that Long Life stock had no value prior to the filing of bankruptcy, but that Long Life

had nonetheless suffered $400,000 in damages due to a loss in share value because of the bankruptcy. (ER 237-39.)

The jury's conclusion that Long Life's stock had no value prior to the bankruptcy filing could not be squared with its finding that Long Life had suffered $400,000 in damages. (ER 241-44, 253.) The district court sent the jury back for further deliberations. (ER 253.) It instructed the jury that damage was meant to be calculated by comparing the value of the stock before and after the bankruptcy filing, and that it should use that difference as the measure of damages. (ER 253-55.) The court also clarified that the special interrogatory about pre-petition stock value was meant to address its value up to, but not including, the filing of Long Life's petition. (ER 253-55.)

The jury returned a second verdict, finding that the stock was worth $2 per share prior to May 9—the day Long Life filed for bankruptcy. (ER 232.) This finding was now consistent with its conclusion that the difference in stock value before and after bankruptcy was $400,000. The jury assessed punitive damages of $5,800 against An-Ehr Chen and $580,000 against Rextron. (ER 259.)

3. Rulings on standing.

At the close of plaintiffs' case-in-chief, defendants raised various standing issues. (ER 193-201, 256.) These included the related argument of whether plaintiffs had proven that a claim had accrued within the terms of their assignment, that is, before Long Life filed its petition. (ER 264.) At the court's request, defendants filed an additional brief after the verdict, arguing that (a) Dux's claim as an alleged shareholder could not be sustained because Dux did not own any shares during the period when the alleged wrongful conduct occurred; (b) Dux could not assert any shareholder rights under any other theory, such as beneficial ownership; (c) plaintiffs failed to prove any pre-petition damages and thus could not maintain a claim under the terms of the assignment; and (d) there was no evidence of injury to the entire body of Long Life stock, a required element for a corporate claim in California. (CR 247.)

After the jury returned its verdict, the district court ruled that Dux lacked standing to assert shareholder claims, but it rejected defendants' contentions that plaintiffs failed to prove that a viable corporate claim had accrued pre-petition. (ER 256-67.) The district court entered judgment in

the amount of $2,692,306 against all defendants. (ER 268.)[1] The district court vacated the judgment and punitive damages award against Rextron because the shareholder claim against Rextron had been eliminated, but it entered punitive damages of $5,800 against An-Ehr. (ER 266-68.)

4. Post-judgment motions.

Defendants filed post-judgment motions, arguing that (a) there was no substantial evidence of any breach of fiduciary duty, (b) there was no substantial evidence of the value of Long Life common shares, (c) no claim had accrued pre-petition, and thus plaintiffs had no basis on which to bring their assigned pre-petition claim, (d) plaintiffs' claims were preempted by the Bankruptcy Code ("Code") or precluded under the doctrine of res judicata, and (e) alternatively, any damage award must be reduced to reflect the number of common shares that existed when the alleged wrongful conduct took place, and any punitive damage award must be vacated.

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[1] The district court extrapolated plaintiffs' purported damages as assignees from the $2 per common share value found by the jury (i.e., $2/share x 1,346,153 shares = $2,692,306). (ER 266.) The court later found that the absence of evidence as to the value of the whole body of stock (common + preferred shares) was not fatal to plaintiffs' claim. (*See* ER 315 (while "the calculation only covered the value of the common stock . . . the remedy should be to limit plaintiffs' recovery to that amount, not to deny recovery altogether").)

(CR 276-80.) The district court rejected all of defendants' arguments, except that (a) it reduced the award on the assigned corporate claim by excluding Rextron's shares from the damages calculation (*see* n.1, above), and (b) it vacated the remaining punitive damages against An-Ehr on the ground that assignees may not recover punitive damages under California law. (ER 319-22.)

Ultimately, the district court ruled that plaintiffs, as assignees of Long Life's claims, could recover damages for defendants' alleged improper bankruptcy filing on a state-law breach of fiduciary duty theory. (ER 304-21.) The district court reasoned that the decision to file bankruptcy, in and of itself, was the relevant actionable wrong. (ER 294, 316.) The court concluded that the jury could properly have concluded that defendants decided to file bankruptcy "without evaluating any other alternatives that might have yielded greater value for the corporation" and that they made their decision specifically to "thwart[] the attempts by [Dux] to assert its right to participate in governing the company." (ER 294.)

The district court entered an amended judgment in the amount of $1,292,306 ($2/share x 646,153 common shares), and this appeal timely followed. (ER 323-24.)

STATEMENT OF FACTS

A. Formation of Long Life And Rextron's Investment.

George Chen ("Chen"), George Murphy and others formed a limited partnership that sought to establish a national chain of fast-food Asian noodle stores. (ER 5, 296.) Long Life, incorporated in 1996, was the general partner. (ER 5.)

In late 1998, Chen pitched the restaurant concept to Pierre Chen, then CEO and president of Yageo Corporation. (ER 5-6, 297.) Pierre directed An-Ehr Chen, an assistant and project manager, to investigate the investment opportunity for Yageo. (ER 297.)[2] An-Ehr recommended that Yageo invest, which it did through an affiliated company, Rextron. (ER 6, 297.)

Rextron agreed to invest $1.2 million. (ER 6.) In connection with Rextron's investment, Murphy and Chen restructured Long Life and dissolved the limited partnership, so that Long Life became the business entity. (ER 6-7, 297.) Rextron became Long Life's majority shareholder, with the ability to vote in three of the corporation's five directors; Murphy

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[2] Pierre Chen, George Chen and An-Ehr Chen are not related.

and Chen became minority shareholders, with the collective right to vote in two directors. (ER 6-7, 297.)

Thereafter, Murphy and Chen repeatedly sought funding from Rextron until Rextron had loaned Long Life $1,115,130 in addition to its $1.4 million capital investment. (ER 178-79.)

B. Long Life Is A Losing Proposition; Its Founders Resign.

By the end of 2000, Long Life was operating at a negative net income of $281,681.27. (ER 186-87.) In February 2001, Chen resigned as an officer and director. (ER 9.) Murphy soon followed. (ER 10.) Long Life was still operating at a net loss and had outstanding payables of roughly $500,000. (ER 172.) The resignation of Murphy and Chen created two vacancies on the board of directors. (ER 298.)

C. Dux Becomes Involved.

While Rextron, as the majority shareholder, was trying to untangle Long Life's financial problems (*see* ER 208-09), Dux and its agent, Jerry Davis, arrived on the scene.

Dux and Chen settled a lawsuit that apparently arose when Chen defaulted on a loan from Dux. (ER 210-17, 298.) Their settlement agreement, dated April 25, 2001, required Chen to transfer 200,000 of his shares of Long Life common stock to Dux. (ER 210-11.) The transfer was subject to two conditions: First, the stock had to be held in escrow, pending the expiration of a right of first refusal held by Long Life's other shareholders. (ER 211.) Second, both the consummation of the transfer and the effectiveness of any voting rights associated with the shares were conditioned on a court finding, under California Code of Civil Procedure Section 877.6, that the settlement was in good faith. (ER 216.) That did not occur until July 25, 2001. (ER 257.)

D. Long Life Files Bankruptcy, And Its Plan Of Reorganization Is Confirmed.

On May 3, 2001, Long Life's directors decided to pursue bankruptcy "due to an overwhelming amount of bad debt" that was "discovered by the new management team" put in place after Chen and Murphy resigned. (ER 207.) They made this decision after conferring with independent accountants and attorneys. (*See*, *e.g.*, ER 191.) Long Life filed its chapter 11 bankruptcy petition on May 9. (ER 301.)

Plaintiffs participated fully in the chapter 11 proceedings, seeking the appointment of a trustee and objecting to Long Life's disclosure statements and plan of reorganization. (*See*, *e.g.*, ER 33-51, 68-78, 85-86, 141.)[3] Among plaintiffs' objections was their claim that Long Life's directors and majority shareholder breached their fiduciary duty by filing bankruptcy for the purpose of eliminating Dux's alleged shareholder interest. (ER 37-38, 47-48, 69, 85-86.) Plaintiffs also asserted a malicious prosecution claim against the estate, alleging that Long Life had wrongfully interfered with the Dux/Chen state-court litigation by opposing the settlement agreement. (ER 85, 93-94.)

The bankruptcy court initially denied plaintiffs' motion to appoint a trustee. (ER 120, 142.) It concluded that their claimed "parade of horribles"— including Long Life's alleged abusive and improper use of bankruptcy and its supposed failure to consider other alternatives to bankruptcy—could be "tested in the confirmation process." (ER 121-22,

[3] Although the bankruptcy pleadings in the record were filed on behalf of Dux, plaintiffs acknowledged that Davis also participated in the proceedings. (ER 15; CR 141.) Moreover, Dux and Davis were treated as one in the bankruptcy. (*See*, *e.g.*, ER 85 (Trustee's Report).)

142.) If plaintiffs' allegations were true, the court ruled, it could deny confirmation of Long Life's plan of reorganization. (ER 122, 142.)

The bankruptcy court then held three hearings on confirmation. (ER 79.) After the first hearing, it appointed a trustee to investigate the issues plaintiffs had raised (ER 86), because, according to the trustee, the court was concerned with the circumstances surrounding Long Life's bankruptcy— including its decision to file. (ER 85 (Trustees Report); *see also* ER 108-10.)

After investigating the case, the trustee recommended confirmation of the plan, finding that (a) the bankruptcy and the plan were in the best interests of Long Life and its creditors; (b) plaintiffs' malicious prosecution suit was inconsequential to the bankruptcy; and (c) disputes over the ownership of Long Life shares were among individual shareholders and would not affect either the debtor's estate or the confirmation of the plan. (ER 87, 93-94.) The trustee suggested that Dux, as an alleged minority shareholder, should retain "whatever rights" it had against Rextron. (ER 87.) Nothing in the trustee's report suggested that Dux, Davis, Long Life, or the trustee should retain any rights to bring a claim against Long Life's directors on the basis of their decision to file bankruptcy.

After reviewing the trustee's report, the bankruptcy court confirmed the plan of reorganization, concluding that it met the requirements of 11 U.S.C. § 1129. (ER 80.) The court explicitly overruled all objections to confirmation. (ER 80.)

The confirmed plan called for an auction of Long Life. (ER 144.) At the auction, plaintiffs were outbid by Equity Plus, a secured creditor owned by two employees of Yageo. (ER 144.) All shareholder interests, including Rextron's, were extinguished. (ER 61.)

E. The Trustee Assigns Claims To Plaintiffs.

After the plan was confirmed, the trustee entered into negotiations with plaintiffs regarding their malicious prosecution claim, which remained pending. (ER 96-97.) Plaintiffs agreed to waive any general unsecured claims they had against the estate in exchange for an assignment of all claims belonging to Long Life prior to its bankruptcy filing on May 9, 2001. (ER 99-100.) Over defendants' objections, the bankruptcy court authorized the assignment. (ER 103-04.) The assignment, by way of a letter agreement that the court approved and incorporated in its order, purported to assign to plaintiffs "[a]ll [Long Life] claims that existed as of May 9, 2001 (i.e. immediately prior to the Chapter 11 filing and excluding avoidance actions

or other actions arising under the Bankruptcy Code) against [defendants].” (ER 99-100, 103.) The order authorizing the assignment stated that nothing in the order “shall be deemed to transfer or assign any rights, claims or causes of action that cannot be transferred or assigned as a matter of law.” (ER 103.)

Both the letter agreement and order disclaimed any warranty or decision as to the validity of any supposedly assigned claim. (ER 100 (trustee “makes no representations or warranties of any kind concerning the validity, extent or value of the assigned claims,”; “assignment is on an as is, where is and with all faults basis”); ER 103 (“nothing contained in this Order shall be deemed to constitute a finding as to the existence of any such claims, rights or causes of action”).)

Plaintiffs then filed this litigation, alleging various claims arising from the decision by Long Life’s directors to file bankruptcy.

SUMMARY OF ARGUMENT

Plaintiffs' claims are preempted. Plaintiffs claimed that defendants breached their fiduciary duties by placing Long Life into bankruptcy for an improper purpose—to strip Dux's interests of any value—instead of choosing some alternative course of action that would have provided Long Life and its shareholders with more value. Only the bankruptcy courts, operating under the Code, have jurisdiction to determine whether a bankruptcy petition was wrongfully filed. This limitation includes claims that the petition was the result of pre-filing misconduct or an improper motive. Congress has granted federal courts exclusive jurisdiction over bankruptcy petitions precisely to preclude the kind of collateral attack under state tort law that this case exemplifies. *MSR Exploration, Ltd. v. Meridian Oil, Inc*., 74 F.3d 910, 914-15 (9th Cir. 1996) ("*MSR Exploration*"); *Gonzales v. Parks*, 830 F.2d 1033, 1035-36 (9th Cir. 1987) ("*Gonzales*").

In allowing plaintiffs to proceed and recover on their assigned corporate claims, the district court apparently assumed that if the bankruptcy trustee authorized the assignment of pre-petition claims, there must have been something to assign. But the assignment carried no guaranty that any

such claims existed and specifically excluded "actions arising under the Bankruptcy Code." (ER 100.) This is such an action, and it is preempted.

Plaintiffs' claims are barred by res judicata. The district court refused to apply settled principles of res judicata. The bankruptcy court's order confirming Long Life's plan of reorganization extinguished forever all claims that were or could have been brought in the bankruptcy proceeding, and merged them into the final order. Because the trustee—plaintiffs' predecessor in interest as to Long Life's claims—did not challenge defendants' decision to file the bankruptcy petition in the bankruptcy case, the order confirming Long Life's reorganization bars plaintiffs from doing so in a separate lawsuit, and the district court erred in concluding otherwise. Moreover, plaintiffs specifically raised breach of fiduciary duty claims when they objected to Long Life's bankruptcy and sought the appointment of a trustee. (ER 37-38, 47-48.) The bankruptcy court overruled these objections and confirmed the plan, thus extinguishing any future breach of fiduciary duty claims collaterally attacking the propriety of Long Life's bankruptcy filing, including the decision to file. (ER 80.)

Plaintiffs had no standing to assert their claims. In their assignment from Long Life's bankruptcy trustee, plaintiffs acquired only causes of

action that accrued prior to the bankruptcy filing. However, the jury's verdict— considered in light of the district court's instruction that its damage award had to represent a comparison of the value of Long Life's shares before and after the bankruptcy filing—conclusively established that Long Life sustained no pre-petition damage. The only alleged pre-petition wrongful conduct was the board's decision to file bankruptcy; until the board acted on that decision— until the actual bankruptcy filing—there was only a threat of future harm. Since plaintiffs acquired only pre-petition claims, and since no cause of action accrued before the bankruptcy filing, plaintiffs had no standing to sue.

In addition, because plaintiffs were only asserting claims held by Long Life, in order to show damage they had to show injury to Long Life's whole body of stock. (*Smith v. Tele-Communications, Inc.*, 134 Cal. App. 3d 338, 342, 184 Cal. Rptr. 571 (1982) (injury to entire body of stock necessary for valid corporate claim). But there was no such injury before the bankruptcy filing—any "injury" to the whole body of stock occurred only when all shares were cancelled by the order confirming reorganization. That purported post-petition injury is beyond the express scope of plaintiffs' assignment from the trustee, which assigned only pre-petition claims.

STANDARD OF REVIEW

All the issues defendants raise—preemption, res judicata and standing—involve pure questions of law. Accordingly, this Court will review the district court's rulings *de novo*. *Aguilera v. Pirelli Armstrong Tire Corp.*, 223 F.3d 1010, 1014 (9th Cir. 2000) (preemption); *Gregory v. Widnall*, 153 F.3d 1071, 1074 (9th Cir. 1998) (res judicata); *Gospel Missions of America v. City of Los Angeles*, 328 F.3d 548, 553 (9th Cir. 2003) (standing).

ARGUMENT

I. PLAINTIFFS' CORPORATE GOVERNANCE CLAIMS ARE PREEMPTED BY FEDERAL BANKRUPTCY LAW.

A. The Essence Of Plaintiffs' Claims Is That Long Life's Bankruptcy Filing Was In Bad Faith And Misused The Bankruptcy Process.

The beginning and end of plaintiffs' corporate governance claims—both Dux's shareholder claim and plaintiffs' assigned corporate claim—was that Long Life's directors and majority shareholder took Long Life into bankruptcy in bad faith and for an improper purpose. These are among the various ways plaintiffs characterized their claims:

- The board voted to file for bankruptcy for the improper purpose of "depriv[ing] [Dux] of the value of [its] interest in Long Life." (ER 13, 19 (Complaint).)
- The board's decision was based on "no valid reason," and resulted in an "unwarranted bankruptcy proceeding." (ER 13, 18-19 (Complaint).)

- The board improperly used the bankruptcy to strip Dux of its alleged interest in Long Life. (ER 157-58 (Joint Proposed Final Pretrial Statement).)
- The board decided to "put the company into bankruptcy" even though Long Life was allegedly not in financial distress. (ER 170 (Opening Statement); *see also* ER 13 (Complaint).)

The district court saw the case the same way—that the gravamen of plaintiffs' claims was an improper use of the bankruptcy process. (ER 256-57, 294.) In its "last word" on the matter, the court stated that Long Life's directors put the company into bankruptcy "for the purpose of thwarting the attempts by [Dux] to assert its right to participate in governing the company." (ER 294-95; *see also* ER 225 (Jury Inst. XIX) ("[i]n this case, plaintiffs challenge [defendants'] decision to commence bankruptcy proceedings as having not been in the best interest of the corporation," as measured by the directors' failure to exercise "good faith").) Indeed, the district court specifically charged the jury that "[l]iability in this case depends, in the first instance, upon whether the board's decision to commence bankruptcy proceedings was *improper*." (ER 229 (emphasis added).)

In short, plaintiffs claimed that Long Life's bankruptcy was commenced in bad faith. This places the case squarely within the exclusive jurisdiction of the bankruptcy court. Plaintiffs' collateral attack on the decision to file bankruptcy therefore should have been dismissed for want of subject matter jurisdiction.

B. The Bankruptcy Code Preempts State-Law Claims Challenging The Propriety Of A Decision To File Bankruptcy. They May Be Brought Only In Bankruptcy Court.

This Court has squarely held that preemption applies to state-law claims that arise from allegedly improper bankruptcy filings. *See Gonzales*, 830 F.2d at 1035; *MSR Exploration*, 74 F.3d at 914-15. This is so because, among other reasons, the Code embodies a comprehensive legislative scheme, and to allow state-law claims to invade that scheme would destroy the Code's uniformity. *Id.*

Like the claims for abuse of process and malicious prosecution addressed in *Gonzales* and *MSR Exploration*, state-law claims attacking the propriety of a decision to file for bankruptcy must be preempted. Otherwise,

the Code's scheme will be undermined and the uniformity of its application impaired.

1. The Bankruptcy Code's comprehensive scheme for combating the improper use of bankruptcy implicitly preempts plaintiffs' claims.

Under the doctrine of implied preemption, challenges to the improper use of the bankruptcy system based on state law are barred because the Code provides a comprehensive scheme for addressing these challenges, and to hold otherwise would conflict with Congress's intent. *See Int'l Paper Co. v. Ouellette*, 479 U.S. 481, 491, 107 S. Ct. 805, 811, 93 L. Ed. 2d 883 (1987) (intent to preempt state law will be implied from a federal statute where Congress has legislated comprehensively and occupied an entire field of regulation, thus leaving no room for supplemental state regulation); *Hillsborough County v. Automated Med. Lab. Inc.*, 471 U.S. 707, 712-13, 105 S. Ct. 2371, 2375, 85 L. Ed. 2d 714 (1985) (preemption can be found where state law conflicts with federal law, confounding the purpose of the federal legislation). Such challenges must be "brought in the bankruptcy court itself, and not as a separate action in the district court." *MSR Exploration,* 74 F.3d at 916.

This Court has stated that "a mere browse through" the Code "demonstrates Congress's intent to create a whole system under federal control which is designed to bring together and adjust all of the rights and duties of creditors and embarrassed debtors alike." *MSR Exploration*, 74 F.3d at 914. Central to this system is the watershed act of filing a bankruptcy petition. That filing must be in good faith; if it isn't, the bankruptcy must be dismissed. *In re City of Desert Hot Springs*, 339 F.3d 782, 792 (9th Cir. 2003) (good faith "is a requirement of all bankruptcies and without it a bankruptcy is to be dismissed for 'cause' under 11 U.S.C. § 1112(b)"); *In re Marsch*, 36 F.3d 825, 828 (9th Cir. 1994). The requirement is "'designed to prevent abuse of the bankruptcy process, or the rights of others, involving conduct or situations only peripherally related to the economic interplay between the debtor and the creditor community.'" *In re Cedar Shore Resort, Inc.*, 235 F.3d 375, 379 (8th Cir. 2000) (quoting 7 Collier on Bankruptcy, ¶ 1112.07[1] (2000)).

Because the scope of the good-faith inquiry is extremely broad, it easily sweeps within its reach any claim attacking the propriety of a bankruptcy filing. It considers the totality of the circumstances, including whether the debtor engaged in any pre-petition misconduct and whether the

petition was filed for an improper purpose. *In re Marsch*, 36 F.3d at 828. It also takes into account the debtor's motives for seeking bankruptcy protection, and acts to deter filings that seek to achieve objectives outside the legitimate scope of the bankruptcy laws. *In re Arnold*, 806 F.2d 937, 939 (9th Cir. 1986) (good-faith examination includes assessing motives of debtor); *In re Marsch*, 36 F.3d at 828; *see also In re Silberkraus*, 336 F.3d 864, 867 (9th Cir. 2003) (reviewing dismissal of petition for improper purpose of delaying state-court litigation of a commercial dispute); *In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393, 1394 (11th Cir. 1988) (intent to abuse the process is a ground for dismissal); *In re Chu*, 253 B.R. 92, 95 (S.D. Cal. 2000) (collecting cases).

Many bankruptcy courts have concluded that evaluating the motives behind a filing may include consideration of "the breach of a debtor's fiduciary duty." *In re Sal Caruso Cheese, Inc.*, 107 B.R. 808, 816 (Bankr. N.D.N.Y. 1989) (collecting cases; finding bad faith based, in part, on director's pre-petition breach of fiduciary duties).

Not surprisingly, the Code gives the courts multiple tools to combat bad-faith filings. For instance:

- 11 U.S.C. § 105(a) provides that the court "may issue any order, process, or judgment that is necessary and appropriate" "to prevent an abuse of process."

- 11 U.S.C. § 1112(b) provides that "on request of a party in interest," "and after notice and a hearing, the court may" "dismiss a case under this chapter" if to do so "is in the best interest of creditors and the [debtor's] estate."

- 11 U.S.C. § 707(b) authorizes the dismissal of a petition under chapter 7.

- 11 U.S.C. § 727(a)(4)(B) authorizes the denial of a discharge for presenting fraudulent claims.

- 11 U.S.C. § 303(i)(2) authorizes the imposition of sanctions for involuntary petitions filed in bad faith.

- Bankruptcy Rule 9011 authorizes sanctions for improper filings in the bankruptcy court.

These powers go beyond simply dismissing a petition filed in bad faith; the bankruptcy courts may order any other appropriate remedy or sanction. *See, e.g.*, *In re Marsch*, 36 F.3d at 830 (approving imposition of sanctions); *see also* 11 U.S.C. § 105(a), Bankruptcy Rule 9011. And the power goes beyond the debtor; this Court has held that sanctions for an improper

bankruptcy filing may reach beyond the debtor to the debtor's principals. *In re Rainbow Magazine*, 77 F.3d 278, 282 (9th Cir. 1996).[4]

There can be no doubt that Congress's comprehensive scheme regulating bankruptcy filings was intended to preempt the field. The scheme provides remedies and sanctions for a bad-faith filing that deter debtors and their principals alike. It "'should be read as an implicit rejection of other penalties, including the kind of substantial damage awards that might be available in state court tort suits.'" *MSR Exploration*, 74 F.3d at 916 (quoting *Gonzales*, 830 F.2d at 1035-36).

Although a comprehensive scheme may not by itself be enough to implicitly preempt a field, *see Hillsborough County*, 471 U.S. at 719, preemption is warranted when "special features" are present. *Id*. Special features are present here. For instance, the Constitution expressly grants Congress the power "[t]o establish . . . uniform laws on the subject of bankruptcies throughout the United States," U.S. Const., art. I, § 8, cl. 4, and this grant generally indicates federal supremacy in the field. *See*, *e.g.*,

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[4] Although the Court relied on the bankruptcy court's inherent power rather than on an express grant of power under the Code, the inherent power nevertheless flows from the Code: "The inherent power is recognized in the statutory grant Congress has provided the bankruptcy courts." 77 F.3d at 284.

Hines v. Davidowitz, 312 U.S. 52, 62-69, 61 S. Ct. 399, 401-05, 85 L. Ed. 581 (1941) (in concluding state law regarding alien registration preempted, Court noted "supremacy of the national power" in the field was made clear by the Constitution). The uniformity in the administration of bankruptcy—including the administration of the circumstances surrounding the filing of a petition— also indicates "that Congress wished to leave the regulation of parties before the bankruptcy court in the hands of the federal courts alone." *MSR Exploration*, 74 F.3d at 915. Indeed, Congress has expressly granted jurisdiction to the federal courts over bankruptcy matters. *See* 28 U.S.C. § 1334(a); *MSR Exploration*, 74 F.3d at 913-15 (exclusive jurisdiction among reasons supporting preemption of state-law claim by the Code). Lastly, the Code contains the exhaustive remedies and sanctions detailed above.

Regardless of how plaintiffs may characterize their claims, they boil down to an allegation that Long Life's bankruptcy was filed in bad faith. Resolution of that claim falls squarely within the field that Congress impliedly reserved to the bankruptcy courts, and the district court had no power to act.

2. State-law claims for improper filing or an abuse of process, such as plaintiffs' claims here, conflict with the bankruptcy scheme and cannot be allowed.

a. This Court has rejected the assertion of state-law claims under circumstances like those here.

In decisions from 1987 to the present, this Court has consistently barred the assertion of state-law claims that conflict with the Code's comprehensive scheme.

Gonzales laid the groundwork. There, a debtor facing foreclosure filed for bankruptcy. The creditor filed an action in California state court alleging that the bankruptcy filing was an abuse of process. *Gonzales*, 830 F.2d at 1033-34. The creditor claimed that the debtor filed the petition "solely to delay" a foreclosure sale instituted by the creditor. *Id.* at 1034 n.1. After the creditor obtained a state-court default judgment, the debtor filed an adversary proceeding in bankruptcy court, which granted summary judgment for the debtor and declared the state-court judgment void at its inception. *Id.* at 1034.

In affirming the decision, this Court stated that "[i]mplicit in [creditor's] appeal is the notion that state courts have subject matter jurisdiction to hear a claim that the filing of a bankruptcy petition constitutes an abuse of process." *Id.* at 1035. Rejecting that assumption, it held that allowing a state-law claim for abuse of the bankruptcy process "would be inconsistent with and subvert the exclusive jurisdiction of the federal courts by allowing state courts to create their own standards as to when persons may properly seek relief in cases Congress has specifically precluded those courts from adjudicating." *Id.* The Court further concluded that collateral attack on bankruptcy petitions under state law would also threaten the uniformity requirement of federal bankruptcy law. *Id.* (citing U.S. Const., art. I, § 8, cl. 4).

MSR Exploration picked up *Gonzales*'s theme. There, a debtor brought a malicious prosecution action in district court against a creditor, asserting that the creditor had maliciously pursued claims against the debtor in its bankruptcy. *MSR Exploration*, 74 F.3d at 911. The district court dismissed the action, concluding that it lacked subject matter jurisdiction because the action was "entirely preempted by the provisions of the bankruptcy law." *Id.* In affirming, this Court stated that "the adjustment of

rights and duties within the bankruptcy process itself is uniquely and exclusively federal." *Id.* at 914. Thus, "[i]t is very unlikely that Congress" created a comprehensive scheme yet "intended to permit the superimposition of state remedies on the many activities that might be undertaken in the management of the bankruptcy process." *Id.* The Court concluded that "the highly complex laws needed to constitute the bankruptcy courts and regulate the rights of debtors and creditors also underscore the need to jealously guard the bankruptcy process from even slight incursions and disruptions brought about by state malicious prosecution actions." *Id.*

MSR Exploration voiced an additional concern: Allowing state-law claims to invade the bankruptcy process "asks for a world where the specter of additional litigation must haunt virtually every actor in a bankruptcy proceeding." *Id.* at 916. Rejecting this daunting prospect, another court has stated that parties "who counsel or influence a debtor to file bankruptcy" cannot be subject to liability in a collateral proceeding brought under state law: "If the law were otherwise, there would be an endless array of lawsuits against insiders and others alleged to be in control of debtors who filed proper bankruptcy petitions." *In re Transcolor Corp.*, 258 B.R. 149, 151 (Bankr. D. Md. 2001).

The Court revisited these issues very recently in *Sherwood Partners, Inc. v. Lycos, Inc.*, __ F.3d __, 2005 U.S. App. LEXIS 490 (9th Cir. Jan. 12, 2005). There, the Court held that the Code preempted California Code of Civil Procedure Section 1800, which allows an assignee for the benefit of creditors to avoid preferential transfers. In doing so, the Court yet again referred to the "pervasive" and "dominant" nature of federal bankruptcy law, and noted that the Code "carefully delineate[s] the circumstances under which federal bankruptcy proceedings are to be initiated." *Id.* at *4, *18. State laws that "sharpen or blunt" these Code provisions were intended to be preempted. *Id.* at *18.

Allowing a state-law claim that, like plaintiffs' claims here, attacks a board's decision to pursue bankruptcy would undercut or "blunt" the Code's uniform application of its good-faith filing requirement. For instance, officers and directors could be liable for improperly deciding to file under a state-law theory, even after a bankruptcy court exonerated them under the good-faith requirement.

The conflict cannot be avoided by attempting, as plaintiffs and the district court did, to draw a distinction between a board's decision to file bankruptcy and the filing itself, carving out the former for potential state-

court liability. (ER 316.) There is no meaningful distinction—if there was bad faith, the decision to file is where the court is most likely to find it. Allowing state courts to adjudicate the propriety of the decision itself would foster inconsistent or conflicting adjudications whenever a bankruptcy court had to consider the "many activities" that may influence the good-faith inquiry. *MSR Exploration*, 74 F.3d at 914. This is exactly the type of invasion or "superimposition" that, as *Gonzales*, *MSR Exploration*, and *Sherwood Partners* explain, Congress never intended to allow.

b. California courts have likewise found state-law claims preempted.

California courts of appeal agree that California remedies are not available to those who seek to challenge actions taken pursuant to the Code. In *Choy v. Redland Ins. Co.*, 103 Cal. App. 4th 789, 798, 127 Cal. Rptr. 2d 94 (2002), the court held that the propriety of a bankruptcy petition may not be questioned in a subsequent proceeding based on state-law claims. *Accord*, *Gene R. Smith Corp. v. Terry's Tractor, Inc.*, 209 Cal. App. 3d 951, 257 Cal. Rptr. 598 (1989); *Idell v. Goodman*, 224 Cal. App. 3d 262, 271, 273 Cal. Rptr. 605 (1990). Likewise, in *Saks v. Parilla, Hubbard & Militzok*, 67 Cal. App. 4th 565, 573, 79 Cal. Rptr. 2d 120 (1998), the "gist"

of plaintiff's complaint was that "the defendants misused the bankruptcy process" by filing an adversary proceeding. *Id.* There, the plaintiff had remedies in the bankruptcy court, but "chose not to invoke them." *Id.* The court held: "That was a mistake: parties may not avail themselves of state court tort remedies to circumvent federal remedies for their opponents' alleged misuse of the bankruptcy process." *Id.* at 573-74. This is so, in part, because allowing parties to pursue damages awards based on state-law claims for abuses in bankruptcy would "undercut" the Code's statutory scheme. *See Idell*, 224 Cal. App. 3d at 271; *Ross v. Universal Studios Credit Union*, 95 Cal. App. 4th 537, 542, 115 Cal. Rptr. 2d 712 (2002).

c. Other courts are in accord.

This Court and the California courts are not alone. Other state and federal courts have routinely concluded that the Code provides the exclusive remedy, and the bankruptcy court is the exclusive forum, for claims of abuse of the bankruptcy process or improper filing of bankruptcy petitions. *See, e.g.*, *Eastern Equip. & Servs. Corp. v. Factory Point Nat'l Bank*, 236 F.3d 117, 121 (2d Cir. 2001) (district court lacked jurisdiction to hear state-law tort claims alleging violations of automatic stay based on preemption); *Astor Holdings, Inc. v. Roski*, 325 F. Supp. 2d 251, 263 (S.D.N.Y. 2003) ("no

liability can attach to [the debtor's] filing for bankruptcy because the Bankruptcy Code preempts any state-law remedy for improper bankruptcy filings"); *In re Transcolor Corp.*, 258 B.R. at 153-54 (allegations that defendant directed debtor to file bankruptcy "should have been raised, if at all, in the . . . bankruptcy case"); *Shiner v. Moriarty*, 706 A.2d 1228, 1238 (Pa. Super. Ct. 1998) ("the Bankruptcy Code permits no state law remedies for abuse of its provisions"); *Mason v. Smith*, 140 N.H. 696, 701, 672 A.2d 705 (1996) ("the federal interest in maintaining exclusive control over the incentives and penalties for entry into the bankruptcy system is paramount"; thus state-law tort claims for wrongful filing of involuntary petition are implicitly preempted by Code).

C. The District Court Erroneously Refused To Apply The Doctrine Of Preemption.

The district court rejected defendants' preemption argument for three reasons. *First*, it found that preemption was not properly raised during trial. (ER 319.) *Second*, it found that because the bankruptcy court "authorized the transfer and assignment of all pre-bankruptcy claims of Long Life against its directors and Yageo-affiliated defendants to plaintiffs," plaintiffs' state-law claim for improper filing could not possibly have been preempted.

(ER 319 (emphasis omitted).) *Third*, it believed that "[t]o accept defendants' contention [that plaintiffs' claim was preempted] would provide categorical absolution to the tactic of running companies through bankruptcy to squeeze out equity interests in favor of creditor interests allied with majority shareholders, regardless of the viability of non-bankruptcy alternatives." (ER 320.)

These grounds were all erroneous as a matter of law.

1. Preemption, as alleged here, affects the court's subject matter jurisdiction and may be raised at any time.

Because it concerns subject matter jurisdiction, preemption may be raised at any time, including for the first time on appeal. *See MSR Exploration*, 74 F.3d at 911 (preemption is matter of subject matter jurisdiction); *Johnson v. Armored Transport of California, Inc.*, 813 F.2d 1041, 1043 (9th Cir. 1987) (preemption may be raised at any time, including on appeal).

Moreover, defendants *did* raise preemption in a supplemental memorandum of law in support of a Rule 50(a) motion, as well as during oral argument on Rule 50 motions. (ER 191A-91B, 220 (arguing it is

"unprecedented to allow a civil jury to second-guess a bankruptcy filing"; propriety of bankruptcy filing is jurisdictional matter that must be litigated in bankruptcy); *see also* CR 229.)

2. An assignment of claims cannot undercut Congress's intent to preempt state-law claims.

An assignment of a claim over which the bankruptcy court has exclusive jurisdiction, regardless of whether the assignment is blessed with court authority, cannot override Congress's intent. Otherwise, private parties could circumvent constitutional and statutory mandates defining the power and jurisdiction of those courts. *See In re Rainbow Magazine*, 77 F.3d at 283-84 (bankruptcy courts created under Article I, and their powers are derived wholly from statute).

Subject matter jurisdiction is derived from the Constitution and statutes, and "no action of the parties can confer subject-matter jurisdiction upon a federal court." *Ins. Corp. of Ireland, Ltd. v. Compagnie des Bauxites de Guinee*, 456 U.S. 694, 701-02, 102 S. Ct. 2099, 2103-04, 72 L. Ed. 2d 492; *see also United States v. Ceja-Prado*, 333 F.3d 1046, 1049-50 (9th Cir. 2003) (citing *Holman v. Laulo-Rowe Agency*, 994 F.2d 666, 668 n.1 (9th

Cir. 1993)). The trustee's agreement with plaintiffs can no more confer jurisdiction than any other "action of the parties."

The district court's reasoning—that the assignment somehow saved plaintiffs' claims from the reach of preemption and conferred jurisdiction upon the district court—is also undercut by the express terms of the assignment and the bankruptcy court's order authorizing it. The bankruptcy court carefully preserved its jurisdiction by authorizing the assignment of only those claims that could in fact be transferred or assigned *as a matter of law*. (ER 103.) Claims collaterally attacking the propriety of a bankruptcy petition are preempted by federal law and may only be brought in bankruptcy court. *See MSR Exploration*, 74 F.3d at 916. Thus, as a matter of law, the bankruptcy court cannot have intended to permit the assignment of that type of claim. In addition, the assignment itself makes clear that claims "arising under the Bankruptcy Code" were *not* assigned. (ER 99-100.) Plaintiffs' claim arises under the Code.

Lastly, the assignment and the bankruptcy court's order expressly disclaim warranting the viability of any assigned claim. (ER 100, 103.) There is no basis for the district court's inference that something must have been saved from preemption simply because there was an assignment. An

assignment conveys only what the assignor holds: "'assignment of a sow's ear to [plaintiffs] cannot transform it into a silk purse.'" *In re Marriage of Comer*, 14 Cal. 4th 504, 524, 59 Cal. Rptr. 2d 155 (1996). The assignment was a quitclaim, giving to plaintiffs only those rights that the trustee held after confirmation of the bankruptcy plan. Those rights do not include preempted state claims, or claims barred as a matter of law. (*See* Section II, below.)

3. The district court's fear that pre-petition misconduct will be absolved fails to consider the remedies and sanctions Congress created in the Bankruptcy Code for such misconduct.

To reach the result defendants seek on this appeal would not amount to "categorical absolution" for filing a petition in bad faith, as the district court erroneously assumed. As discussed above (Section I.B.1.), the Code provides remedies and sanctions for improper bankruptcy filings and abuses of the bankruptcy process, and these can include sanctions against the debtor's principals. *See Gonzales*, 830 F.2d at 1034; *MSR Exploration*, 74 F.3d at 915; *In re Rainbow Magazine*, 77 F.3d at 283. If a debtor's directors or officers breached their duties in connection with filing the

bankruptcy, the trustee can bring the claim for the benefit of the debtor's estate and its creditors. *Pepper v. Litton*, 308 U.S. 295, 306-07, 60 S. Ct. 238, 245, 84 L. Ed. 281 (1939) (once petition filed, breach of fiduciary duty claims vest in the trustee). With the availability of Code remedies, sanctions, and a trustee's claim for breach of fiduciary duty, there is no safe harbor for directors and officers when they improperly pursue bankruptcy.

The facts that the petition was not dismissed and that no other remedies or sanctions were ordered do not somehow transform this into a case of director "absolution." And even if they did, "[i]t is for Congress and the [bankruptcy] courts, not the state courts, to decide what incentives and penalties are appropriate for use in connection with the bankruptcy process and when those incentives or penalties shall be utilized." *Gonzales*, 830 F.2d at 1036. To the extent that existing federal remedies do not deter bad-faith behavior in bankruptcy proceedings, Congress may enact appropriate laws to address the difficulties. *See id.* Courts do not have that power.

* * *

This case dramatically illustrates why state-court remedies conflict with the Code. Because of the district court's misplaced concern about "categorical absolution," plaintiffs were allowed to revive claims that were

asserted and rejected in the bankruptcy court. And they were allowed to build a damages award on the very reorganization plan they unsuccessfully objected to, since it was under the reorganization plan that Long Life's outstanding shares were cancelled. It is as though the bankruptcy never happened.

Affirming the judgment will create debilitating inroads into the power of the bankruptcy court to fully resolve the debtor's affairs. Not only would "the specter of additional litigation . . . haunt virtually every actor in a bankruptcy proceeding," *MSR Exploration,* 74 F.3d at 916, but the bankruptcy court's orders would quickly come to have little meaning. Skillful pleading—"this case concerns the decision to file, not the actual filing"— would enable those disappointed with a reorganization plan to get the litigation equivalent of a mulligan or "do-over."

Congress cannot have intended such a result. It cannot be squared with the law of this Circuit.

II. RES JUDICATA PRECLUDES PLAINTIFFS FROM LITIGATING THEIR CORPORATE GOVERNANCE CLAIMS.

Under the doctrine of res judicata, a final judgment in an action precludes a plaintiff from relitigating claims that either were or could have been brought in the action—that is, claims that arise from "the same transactional nucleus of facts." *United States ex rel. Barajas v. Northrop Corp.*, 147 F.3d 905, 910 (9th Cir. 1998). The rationale is that all such claims are merged into the final judgment and are forever extinguished. *See* 18 Moore's Federal Practice, § 131.01 (3d ed. 2004).

Res judicata is a rule of "fundamental and substantial justice, of public policy and private peace"; it "should be cordially regarded and enforced by the courts." *Federated Dept. Stores v. Moitie*, 452 U.S. 394, 401, 101 S. Ct. 2424, 2429, 69 L. Ed. 2d 103 (1981) (internal quotation marks omitted). The doctrine must be applied even if the result might be inequitable or unjust. *See id*. ("There is simply no principle of law or equity which sanctions the rejection by a federal court of the salutary principles of *res judicata*").

Res judicata applies if (1) the parties in the first and second lawsuits are identical or in privity; (2) the claim in the second suit was or could have

been brought in the first suit; and (3) there was a final judgment on the merits in the first suit. *See Owens v. Kaiser Foundation Health Plan, Inc.*, 244 F.3d 708, 713 (9th Cir. 2001). The present case fully satisfies all three requirements.

A. The Parties Are Identical Or In Privity.

By their own admission, plaintiffs are successors in interest to the trustee, since they sue as assignees of the trustee's pre-petition claims. Plaintiffs are therefore in the same position the trustee would have been in for purposes of the res judicata effect of the bankruptcy proceeding. *See, e.g.*, *Browning v. Levy*, 283 F.3d 761, 772 (6th Cir. 2002). Moreover, Dux and Davis were parties in interest in the bankruptcy proceeding in that they participated in those proceedings and asserted the very claims raised here. (*See* ER 33-51, 68-78.) As for the defendants, Long Life was the debtor in the bankruptcy and its directors and affiliated companies were parties in interest. (*See, e.g.*, ER 79, 85.)

B. The Claim Was Or Could Have Been Brought In The Bankruptcy Proceeding.

1. The trustee could have brought a claim for breach of fiduciary duty that plaintiffs assert here.

As assignees of the trustee, plaintiffs "'stand[] in the shoes'" of the trustee, and their "rights are not greater than those of the assignor." *Road Sprinkler Fitters Local Union No. 669 v. G & G Fire Sprinklers, Inc.*, 102 Cal. App. 4th 765, 775, 125 Cal. Rptr. 2d 804 (2002). Any claim the trustee brought or could have brought necessarily limits plaintiffs' ability to collaterally attack the bankruptcy proceeding.

A corporation's claims against officers, directors, and shareholders for breach of fiduciary duties "become property of the estate which the trustee alone has the right to pursue after the filing of a bankruptcy petition." *Koch Refining v. Farmers Union Central Exchange*, 831 F.2d 1339, 1343 (7th Cir. 1987) (citing *Pepper v. Litton*, 308 U.S. at 306-07). The bankruptcy estate includes "any actions that a debtor corporation may have to recover damages for fiduciary misconduct, mismanagement or neglect of duty, and the

bankruptcy trustee succeeds to that right for the benefit of all creditors of the estate." *Koch*, 831 F.2d at 1343-44.

Here, the trustee held, and therefore could have brought, a breach of fiduciary duty claim against Long Life's directors alleging pre-petition director misconduct and mismanagement in deciding to file Long Life's bankruptcy. *See Pepper v. Litton*, 308 U.S. at 309-10. The trustee also could have asserted various claims unique to bankruptcy itself. Among other things, he could have sought dismissal of the petition for having been filed in bad faith, and in that context could have asserted claims for pre-petition misconduct and breach of fiduciary duty by Long Life's directors in voting to put Long Life into bankruptcy. *Id.*; *see also* 11 U.S.C. § 1112(b). The trustee could also have sought sanctions for director or officer misconduct leading to the bankruptcy filing. *See*, *e.g.*, Bankruptcy Rule 9011; *In re Marsch*, 36 F.3d at 830.

Plaintiffs' present claims flows from "the same transactional nucleus of facts," *United States ex rel. Barajas*, 147 F.3d at 910, that the bankruptcy trustee faced—namely the central act of filing the bankruptcy petition and the conduct of Long Life's directors which led to it, including any breaches of fiduciary duty. Since the trustee unquestionably had the power to assert

these claims—indeed, he was specifically charged with investigating them and had a duty to raise them if he found they had merit, ER 85-86; *see also* 11 U.S.C. § 1106(a)(4)(A)—they fall under the res judicata rubric of claims that could have been brought. They are accordingly barred. *Owens*, 244 F.3d at 713 (res judicata applies to claims that were or *could have been* brought); *see also In re Int'l Nutronics, Inc.*, 28 F.3d 965, 970-71 (9th Cir. 1994) (trustee could have brought antitrust claim in bankruptcy, but didn't, and claim was thus barred by res judicata).[5]

Although it is irrelevant for res judicata purposes why a claim was not asserted in prior litigation—the "opportunity" to bring a claim is all that matters, *In re Int'l Nutronics*, 28 F.3d at 970—here there was no inadvertence in the trustee's failure to seek relief. After fully investigating plaintiffs' allegations, the trustee allowed the bankruptcy to continue and

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[5] *In re Int'l Nutronics* notes the factors this Court considers regarding the related issue of whether successive suits involve the same cause of action. 28 F.3d at 970. Each factor is satisfied here: (1) rights and interests affected by confirmed plan—including the good-faith determination—will be undermined by current claim; (2) both actions involved (or would have involved) evidence surrounding Long Life's decision to file; (3) the same right—redress from a bad-faith filing—is at the core of this claim and the claims the trustee could have brought; and (4) both plaintiffs' claims and the claims that were or could have brought in bankruptcy arise out of the same transaction. (*See* Section II.B.2., below.)

concluded that the proposed plan of reorganization was in the best interests of Long Life and its creditors. (ER 84, 95.) He presumptively concluded that there was no viable claim. But regardless of his reasons, settled principles of res judicata bar plaintiffs from urging their claims as a collateral attack on the reorganization plan.

2. Plaintiffs asserted the same claims in the bankruptcy they assert in the present case.

Independently of the fact that plaintiffs are precluded from raising claims held by the trustee, plaintiffs are precluded because they actually litigated breach of duty claims in their status as parties to the bankruptcy, *and they lost*. (*See*, *e.g.*, ER 44, 47-49, 69-71 (claiming that trustee must be appointed because debtor breached fiduciary duties; claiming that debtor engaged in bad faith scheme).) Plaintiffs alleged that defendants filed the bankruptcy petition without considering alternatives and for an improper purpose. (ER 69-71, 109-10 (plaintiffs urge that bankruptcy proposed in bad faith; bankruptcy court notes plaintiffs' objections, which include lack of consideration of alternatives).) The pleadings plaintiffs filed in the bankruptcy proceeding alleged virtually the same set of facts and

circumstances that plaintiffs pled in the district court. (*Compare* ER 37-43, 69-71 (bankruptcy pleadings) *with* ER 5-17 (Complaint).)

The trustee, appointed at plaintiffs' insistence, examined those claims and declined to assert them; the bankruptcy court overruled plaintiffs' objections asserting those same claims; and the bankruptcy court confirmed Long Life's plan of reorganization, again implicitly rejecting plaintiffs' claims. The claims have been thoroughly aired and rejected; there is no basis for their further assertion.

C. The Confirmed Plan Is A Final Judgment On The Merits On All Claims That Plaintiffs, Either As Assignees Or Parties, Brought Or Could Have Brought.

Res judicata also requires a final judgment on the merits in the prior litigation. An unappealed order confirming a reorganization plan is such a final judgment: "[I]t is binding on all parties, and all questions that could have been raised pertaining to the plan are entitled to *res judicata* effect." *Trulis v. Barton*, 107 F.3d 685, 691 (9th Cir. 1995); *Browning v. Levy*, 283 F.3d at 772. Accordingly, any and all claims that were or could have been brought are merged into the plan and extinguished. Here, that includes

plaintiffs' claim for breach of fiduciary duty, their claim that the petition was filed in bad faith, and their claim that the petition constituted an improper bankruptcy filing.

D. There Is No Basis For Refusing To Apply Res Judicata.

To avoid the effect of res judicata, plaintiffs are likely to argue either that the confirmation order itself reserved all claims for the benefit of the estate, or that the assignment they received put pre-petition claims beyond res judicata's reach. Neither contention has any merit.

1. The confirmation order's general reservation did not preserve plaintiffs' claims.

The *express* reservation of a litigant's right to bring a *specific claim* can save that claim from the preclusive effects of res judicata. *D & K Properties Crystal Lake v. Mutual Life Ins. Co.*, 112 F.3d 257, 259-60 (7th Cir. 1997) ("*D & K*"). But specificity is essential; without it, a reservation of rights does nothing to prevent the preclusive effect of a confirmed plan. *Id.*

Here, the confirmation order contains an omnibus reservation stating that "[a]ll claims, defenses, cause of action, and objections to claims are reserved for the benefit of the estate and may be asserted by the Disbursing Agent." (ER 81.) This sweepingly general reservation falls far short of the specificity needed to protect a claim from res judicata. It is nothing but a blanket reservation, and "[a] blanket reservation that seeks to reserve all claims reserves nothing." *D & K*, 112 F.3d at 261; *see Browning*, 283 F.3d at 774 ("a general reservation of rights does not suffice to avoid res judicata"). The plan itself also contains nothing more than a general reservation. (ER 57, 62.)

In *In re Kelley*, the Ninth Circuit Bankruptcy Appellate Panel explained that "[i]f a confirmed plan expressly reserves the right to litigate a specific cause of action after confirmation, then res judicata does not apply. On the other hand, if the debtor fails to mention the cause of action . . . then he will be precluded from asserting it postconfirmation." *In re Kelley*, 199 B.R. 698, 704 (9th Cir. BAP 1996) (citations omitted). There, it found too general an attempted reservation of the right to bring "adversary proceedings to contest the amount, allowability, priority and/or secured

status of any claims which the Debtors believe are not proper," holding it was insufficient to prevent the application of res judicata. *Id.*

Here, both the plan and the confirmation order are even more general than in *In re Kelley*. They say nothing about any specific claim, or even about a specific type of claim. The reservation language cannot save any breach of fiduciary duty claim from the preclusive effects of res judicata.

2. The post-confirmation assignment did not preserve plaintiffs' claims.

The trustee "cannot abandon rights greater than those granted to it in the confirmed plan." *D & K*, 112 F.3d at 262. To paraphrase *D & K*, "because the plan extinguishe[d] suits among parties to the plan, unless expressly reserved, the disbursing agent had no claim for [breach of fiduciary duty] that was not barred by res judicata." *Id.* And since the trustee had no such claim, plaintiffs could take nothing under the assignment. *Id.*

Moreover, the assignment itself is limited to those claims that could be assigned as a matter of law and that fall outside the Code. (ER 99-100, 103.) By its very terms, the assignment does not include claims that were or could have been brought *under* the Code—such as a claim by the trustee for

improper filing or breach of fiduciary duty—that have since been merged into and extinguished by the final order. Allowing plaintiffs' claims would improperly "give the disbursing agent, and thus in this case [plaintiffs], powers beyond those accorded by the final order, or by the law." *D & K*, 112 F.3d at 262.

III. PLAINTIFFS LACK STANDING TO ASSERT A DAMAGES CLAIM AS LONG LIFE'S ASSIGNEES, BECAUSE NO CAUSE OF ACTION ACCRUED BEFORE THE BANKRUPTCY FILING.

Assuming arguendo that the cancellation of shares during Long Life's bankruptcy may have caused injury that could support a damages claim, it is not a claim that accrued in favor of plaintiffs as assignees of Long Life's claims. The bankruptcy trustee assigned plaintiffs only those corporate claims that existed on May 9, 2001, "immediately prior to the [bankruptcy] filing." (ER 99.) Thus, for plaintiffs to recover as assignees, any cause of action would have had to accrue pre-petition, not post-petition.

The jury's findings establish that the only injury here—determined, pursuant to explicit jury instructions, to be the loss of value to Long Life's

shares—did *not* happen before the bankruptcy filing. (ER 228, 232, 315.) No injury means no cause of action. The district court's attempt to justify a damages award is untenable and contrary to law.

A. A Cause Of Action For Breach Of Fiduciary Duty Does Not Accrue Until The Claimant Sustains Damage.

In California, damages are an element of a claim for breach of fiduciary duty. *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 68 Cal. App. 4th 445, 483, 80 Cal. Rptr. 2d 329 (1998); *see also City of Vista v. Robert Thomas Securities, Inc.*, 84 Cal. App. 4th 882, 886, 101 Cal. Rptr. 2d 237 (2000). And "[w]hen damages are an element of a cause of action, the cause of action does not accrue until the damages have been sustained." *Robert Thomas Securities, Inc.*, 84 Cal. App. 4th at 886 (citing *United States Liab. Ins. Co. v. Haidinger-Hayes, Inc.*, 1 Cal. 3d 586, 597, 83 Cal. Rptr. 418 (1970)).

The California Supreme Court has explained that the "[m]ere threat of future harm, not yet realized, is not enough," and "[b]asic public policy is best served by recognizing that damage is necessary to mature such a cause of action." *United States Liab. Ins. Co.*, 1 Cal. 3d at 597; *accord*,

Goodworth Holding, Inc. v. Suh, 239 F. Supp. 2d 947, 959 (N.D. Cal. 2002) (Alsup, J.) (recognizing that claim based on speculative damages must fail as a matter of law). That court has also held that damages must consist of "actual monetary loss." *Alliance Mortgage Co. v. Rothwell*, 10 Cal. 4th 1226, 1240, 44 Cal. Rptr. 2d 352 (1995).

B. The Jury's Findings Establish That Plaintiffs Sustained No Pre-Petition Damages.

The jury initially returned an inconsistent verdict on damages: It found that Long Life stock had no value prior to bankruptcy, but that the bankruptcy filing had nevertheless caused plaintiffs $400,000 in damages. (ER 237-39.)

The district court issued an oral corrective instruction to supplement Jury Instruction No. XXXVIII.[6] The court began its corrective instruction

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[6] As originally drafted by the court, this instruction read:

> "If you find that plaintiffs have proven any liability by any defendant, then you would have to decide whether plaintiffs have proven by the preponderance of the evidence any damages. To do so, plaintiffs would have to prove the value of the shares held by the common stockholders as of the date of the decision to commence bankruptcy proceedings. The measure of damages would be the value of those shares as of

(continued...)

by rereading a portion of Jury Instruction No. XXXVIII that told the jury that to prove damages, "plaintiffs would have to prove the value of the shares held by the common stockholders as of the date of the decision to commence bankruptcy proceedings." (ER 253.) The court then explained to the jury that the special verdict asked it to determine "what value, if any, the stock had immediately before the bankruptcy proceedings commenced." (ER 254.) The court continued:

> And why is that? It's because it is a before and after comparison. If you were to find that there were any value immediately before and that that got wiped out in the bankruptcy and that there was another alternative that would have preserved more value to the shareholders, then that is what we are trying to get at is that comparison.

(ER 255.)

By this corrective instruction, the district court in essence told the jury that, for purposes of determining damages, it must *ignore* the date of the

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[6] (...continued)
that date less the expected value of those shares in bankruptcy proceedings expected as of the date of the board's vote." (ER 230.)

decision to file, May 3. Instead, the jury was to measure the loss caused by the May 9 filing of the bankruptcy petition by making a "before and after" comparison turning on that event.

That's exactly what the jury did. The jury found that Long Life shares had value up to the moment of filing the petition. (*See* ER 232 (Special Verdict Form, Question 1) (common stock had value "as of the company's petition to commence bankruptcy proceedings on May 9, 2001").) It also found that the value of the shares transferred by George Chen to Dux was $400,000—or $2 a share—up to that moment. (ER 232 (Special Verdict Form, Questions 1, 2).) Finally, making the before-and-after determination, the jury found that the damages *resulting from the filing* were $400,000—the value of the transferred shares at the moment of filing that "got wiped out in the bankruptcy," presumably per the stipulated fact that all shares were cancelled pursuant to the order confirming reorganization. (ER 161, 255; *see also* 234 (Special Verdict Form, Question 6).)[7]

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[7] As mentioned (see footnote 1, above), the district court extrapolated plaintiffs' purported damages as assignees from the $2 per common share value found by the jury (i.e., $2/share x 1,346,153 shares = $2,692,306. (ER 266.)

The inescapable conclusion from the instructions and findings is that Long Life incurred no injury that could be translated into damages *prior to the filing of bankruptcy*. Rather, the loss in value of the shares, and hence plaintiffs' loss as assignees, must have occurred as a result of the bankruptcy filing itself or events occurring during the bankruptcy. Indeed, that was plaintiffs' explicit theory of damages. (*See*, *e.g.*, ER 146, 157-59; CR 286:3-5.)

Since plaintiffs' assignment was limited to pre-petition claims, but the jury only found post-petition damages, plaintiffs have no claim to assert.

C. The District Court's Determination That Plaintiffs Were Entitled To Recover Damages For The Decision To File For Bankruptcy Is Inconsistent With The Jury's Findings And Contrary To The Law Requiring The Fact Of Damages To Be Certain.

In rejecting defendants' argument that no damages accrued pre-petition, the district court drew a distinction between the *decision* to file a bankruptcy petition, which in its view was a wrongful act that was actionable under state law, and the *implementation* of that decision by the actual filing of the petition, an act within the jurisdiction of the bankruptcy court. (*See* ER 316 (jury to determine whether directors breached fiduciary duty by "choosing the bankruptcy option," and "ignoring the alternatives," a choice or decision which occurred "before the petition").)

From the perspective of the accrual of a claim for breach of fiduciary duty, the distinction is a false one. In order for the decision to pursue bankruptcy over some other alternative to be separately actionable—that is, for the decision to be the basis of a separate tort, unhooked from its implementation for purposes of permitting a damages award—plaintiffs would have to prove a separate injury that caused separate damages before

the bankruptcy filing. That is because, as shown above (Section III.A.), damages are an element of a breach of fiduciary duty claim.

But even if it were theoretically possible to prove a separate harm with separate damages, that did not happen here. The jury found that the shares had a $2 value up to the moment of bankruptcy; the bankruptcy wiped out that value, presumably when the shares were cancelled. (Section III.B., above.) There is no other finding of damages.

The May 3 decision to file bankruptcy raised only the *possibility* of future harm, so damages at that point were purely speculative. In insisting that damages were not speculative as of May 3, the district court simply looked to the jury's finding that the shares had a certain value, $2 per share. But that finding means no more than that the shares had a value that might or might not be lost through bankruptcy, and that might or might not have been lost had some other alternative been pursued. (*See*, *e.g.*, ER 316 (jury found "pre-petition expected value of two dollars per share versus the zero expected value in bankruptcy"); ER 255 (jury was comparing value that got wiped out in bankruptcy and "another alternative that would have preserved more value to the shareholders").) In other words, the value might or might

not have been lost *regardless* of what action the board ultimately took—the outcome was uncertain and unknowable.

This just isn't enough. Under settled California law, a damages claim does not accrue unless and until some event occurs to convert the possibility of harm, which is all that existed on May 3, into a certainty.

Squarely on point is the California Supreme Court decision in *Romano v. Rockwell Int'l, Inc.*, 14 Cal. 4th 479, 59 Cal. Rptr. 2d 479 (1996). In that case, Rockwell decided to fire Romano, telling him "we're going to fire you." 14 Cal. 4th at 486. But Rockwell took no action on this threat until six months later. In Romano's wrongful termination suit, Rockwell sought to invoke the statute of limitations, arguing that Romano's claim accrued as of the date Rockwell decided to fire him. The California Supreme Court disagreed, holding that the claim accrued on the date of Romano's actual termination, *not* the date the company decided to fire him. *Id.* at 502-03.

The present case is identical. As in *Romano*, there were two key events. On May 3 the board decided to file bankruptcy, a decision comparable to the decision to fire Romano. But, comparable to Romano's actual termination, the board did not actually file bankruptcy until May 9.

Only the *realization* of the threat to file bankruptcy and the damages that resulted from that act converted the mere decision to file into a cause of action—just as in *Romano*, in which the realization of the decision to fire came later and effected the accrual of Romano's claim.

In this case it is inescapable that any alleged damage accrued, at the earliest, upon the filing of the petition. Before then, nothing existed except a plan by the board to do something—"we're going to file bankruptcy" being comparable to "we're going to fire you." Even if the decision was wrongful, it gave rise only to the "mere possibility" or at best a "probability, that an event causing damage" would result from the "wrongful act." *Walker v. Pacific Indemnity Co.*, 183 Cal. App. 2d 513, 517, 6 Cal. Rptr. 924 (1960) (claim based on negligent procuring of an insurance policy did not accrue when the negligent act occurred but only when client was found liable and hence incurred damages); *see also Crowley v. Peterson*, 206 F. Supp. 2d 1038, 1043-44 (C.D. Cal. 2002) ("'the mere breach of a professional duty, causing only nominal damages, speculative harm, or the threat of future harm—not yet realized—does not suffice to create a cause of action for negligence'") (citing *Budd v. Nixen*, 6 Cal. 3d 195, 200, 98 Cal. Rptr. 849 (1971)).

The district court's conclusion that the fact of damages—derived from the cancellation of shares during the bankruptcy—was certain as of the date of the decision to file makes no sense, because actual or certain harm depended on the occurrence of a myriad of events. For instance, the board had to follow through with the decision and actually file the petition (there was nothing to stop the board from changing its mind), and the resulting bankruptcy had to wind up adversely affecting shareholders. "Remote results, produced by intermediate sequences of causes, are beyond the reach of any just and practicable rule of damages." *Martin v. Deetz,* 102 Cal. 55, 68, 36 P. 368 (1894).

Since no claim accrued before the bankruptcy filing—it accrued only upon the filing of the petition or afterwards—plaintiffs do not own whatever claim there might be, because there was no such claim within the limited scope of their assignment.

To put the question differently but to the same end, when did Long Life suffer injury to the "whole body of its stock," which is the predicate of a corporate claim in this case? *See Smith*, 134 Cal. App. 3d at 342 ("The action is in the corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock and property without any

severance or distribution among individual holders.") (emphasis omitted). The only evidence of injury to the whole body of Long Life's stock was the cancellation of all shares pursuant to the order confirming the reorganization plan. (*See* ER 61, 80, 161, 315.) That injury and whatever dollar loss derived from it again does not fall within the assignment, so plaintiffs do not own the claim.

In sum, the cancellation of the shares, and thus the accrual of damages, did not occur as the result of the *decision* to file bankruptcy, but as a result of *the bankruptcy itself*. Until the bankruptcy had run its course, it was pure speculation whether shareholders would be harmed. No cause of action accrued pre-petition, so plaintiffs have no claim.

CONCLUSION

Plaintiffs' claims fail under fundamental legal principles. They are preempted. They are precluded by res judicata. They never accrued. Even the express terms of plaintiffs' assignment itself render plaintiffs' claims of pre-petition conduct and harm untenable.

The judgment must be reversed and the district court directed to enter judgment for defendants.

Dated: February 7, 2005

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CERTIFICATE OF COMPLIANCE

Pursuant to Ninth Circuit Rule 32(a)(7)(B), I certify that this Appellants' Opening Brief is proportionately spaced Times New Roman, has a typeface of 14 points and contains 11,957 words.

STATEMENT OF RELATED CASES

Defendants know of no related cases pending in the Ninth Circuit Court of Appeals. 9th Cir. R. 28-2.6.

Dated: February 7, 2005

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