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IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

In re L. W. GARDNER COMPANY, a partnership, Debtor.	Bankruptcy No. 80-02316 (Chapter 11)
ZIONS FIRST NATIONAL BANK, WILLIAM E. KELLER and LARUE S. KELLER, Plaintiffs-Appellees vs. MORONI W. SANDERS and MILDRED Z. SANDERS, Defendants-Appellants vs. SANDERS LIVESTOCK CO., INC., and DABBLE, INC., Third-Party Defendants.	Memorandum Opinion and Order C-85-0787 J

This litigation involves the parties' conflicting claims to certain real property in Iron County, Utah, known as the Page Ranch. The appellees commenced an adversary proceeding, No. 84PA-1032, in the United States Bankruptcy Court for the District of Utah to quiet their title to the Ranch. The appellants, having previously attempted in state court to foreclose their

trust deed against the Ranch, counterclaimed in the bankruptcy proceeding when the state court judge in effect abstained from ruling. By order of June 22, 1985, the bankruptcy court granted the appellees' motion for summary judgment and denied the appellants' cross-motion for summary judgment. The court entered judgment the same day quieting title in the appellees. The appellants appeal from the order and judgment of the Bankruptcy Court.

The parties submitted briefs and a hearing was held on November 14, 1985. William Thomas Thurman and Scott C. Pierce appeared on behalf of the appellants; Bryce E. Roe and Janette Bloom appeared on behalf of the appellees. After hearing the arguments of counsel, the court reserved on the matter. The court now enters this memorandum opinion and order.

The record on appeal reveals the following facts. The debtor is a partnership whose partners are L. W. Gardner, Blythe M. Gardner and L. Hart Gardner. Those individuals also own an entity called Uneva Enterprises, Inc., a corporation, which in turn owns a cattle ranching operation known as Sanders Livestock Company, also a corporation.[1] On October 28, 1968, the appellants, Moroni and Mildred Sanders, entered into an escrow agreement with Sanders Livestock Company whereby the Company

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1 Although this corporation bears the name of the appellants, it does not appear of record whether they have any ownership interest therein. This court will assume that any interest that the appellants might have derives from their status as creditors of Sanders Livestock Company or as holders of a security interest in the Page Ranch.

agreed to purchase the Page Ranch from them for $210,000. The predecessor in interest of the St. George, Utah, branch of the appellee Zions Bank, was the escrow agent under that agreement. Pursuant to the agreement, Sanders Livestock Company executed a promissory note in favor of the appellants, which note was to be secured by a mortgage on the Ranch. In 1975, Sanders Livestock Company granted the appellants a trust deed on the Ranch, apparently in belated fulfillment of their 1968 agreement. The trust deed was duly recorded in the office of the Iron County Recorder on November 21, 1975.

In 1978, Sanders Livestock Company wished to obtain financing using its equity in the Ranch as security. The appellants agreed to subordinate their interest in the Ranch in order to facilitate that financing. Thus the appellants released the 1975 trust deed on April 21, 1978.[2] The appellants were to receive in its stead a trust deed second in priority on the Ranch. Not until April 21, 1983, however, did L. W. Gardner, purporting to act on behalf of Sanders Livestock Company, sign a trust deed in favor of "Moroni Sanders and Sons."[3] That trust deed was recorded on April 22, 1983. Thus the appellants had no

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2 Interestingly, this is very near the date that the appellee Zions Bank's trust deed on the Page Ranch was recorded. Although this might be an important fact, it is not clear from the record whether Zions (or a predecessor in interest of Zions) was the party to whom the appellants' interest was to be subordinated.

3 The relationship between "Moroni Sanders and Sons" and the appellants is not clear. This court will assume that their interest in the Page Ranch, if any, is identical.

record interest in the Page Ranch from 1975 until April 22, 1983. The 1968 escrow agreement is yet to be performed--hence the appellants' previous state court action, and their counterclaim in the bankruptcy court, to foreclose their alleged security interest in the Page Ranch.

The debtor filed a petition for relief under Chapter 11 of the United States Bankruptcy Code on November 14, 1980. It does not appear in the record whether the partners in the debtor also filed individually. Schedule B-1 filed in the debtor's Chapter 11 proceeding listed the Page Ranch as property of the debtor, along with other property owned not by the debtor but by various other entities controlled by the debtor or its partners. The schedule indicates that the Page Ranch is subject to a "contract" to "Moroni Sanders and Sons," although, as explained above, no such interest appears of record until April 22, 1983. Neither "Moroni Sanders and Sons" nor the appellants are listed as creditors of the debtor, nor were they given notice that the debtor had filed a petition for reorganization or that the Page Ranch was included among the debtor's assets.

The debtor's First Amended Disclosure Statement and First Modified Plan of Reorganization, dated October 28, 1981, provided that the Page Ranch would be sold, and the Order Confirming Debtor's Plan, dated February 15, 1982, authorized the sale of the Ranch. The appellants were not notified of the debtor's plan and did not participate in the confirmation thereof. Between March 22 and March 24, 1983, the clerk of the bankruptcy court

sent to all persons listed on the matrix of creditors a notice that a hearing would be held on the trustee's intent to sell the debtor's real property. Because the appellants were not listed on the matrix, they received no notice of the hearing.

On April 26, 1983, a hearing was held in the bankruptcy court to consider the trustee's proposed sale of the debtor's property. By order dated May 19, 1983, the court authorized the trustee to sell the debtor's real property, including the Page Ranch. On June 22, 1983, the trustee conveyed the Page Ranch along with other real property to the appellee Zions Bank, purportedly free and clear of all liens except those specifically listed in Exhibit A to the deed. The appellants' interest was not listed. At the time of the trustee's sale, the debtor was indebted to Zions in excess of $2.7 million, which indebtedness was secured by trust deeds on several properties. Those trust deeds included one to Zions Bank on the Page Ranch, allegedly recorded before the trust deed from Sanders Livestock Company to Moroni Sanders and Sons on April 22, 1978. On October 3, 1983, Zions conveyed the Ranch to the appellees William E. and LaRue S. Keller. This litigation ensued.

On June 22, 1985, the Bankruptcy Court entered an order denying the appellants' motion for summary judgment and granting the appellees' motion, "quieting in them title to the real property described in the complaint and the counterclaim." Although the parties offered several arguments in support of their cross-motions, the Court's order does not specifically

discuss those arguments or indicate the basis for its decision.

On appeal, the appellants renew their argument that they were not given notice of or an opportunity to participate in any stage of the debtor's bankruptcy proceeding and that they were therefore deprived of their purported lien interest in the Page Ranch without due process of law when the Ranch was sold free and clear of their lien.[4] The appellees counter that the appellants were not creditors of the debtor, had no valid superior lien and indeed had no record interest at all in the Ranch until April 22, 1983, and thus were not entitled to notice or an opportunity to participate in the bankruptcy proceedings.

The record on appeal leaves many questions unanswered. The relationships among the various entities and the exact status of the appellants vis-a-vis Sanders Livestock Company and the debtor are obscure. Moreover, it is not at all clear to this court how the Page Ranch came to be included in the debtor's estate in the first place. For all that appears of record, the Ranch is the property of Sanders Livestock Company, a separate corporate entity. No conveyance of the Ranch from Sanders Livestock Company to the debtor appears of record. The appellees suggest that the property was "dedicated" to the debtor and thus came to be included in the property of the debtor. They do not indicate how or when the "dedication" occurred. Similarly, the bankruptcy

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4 The appellants also argue that the Page Ranch was fraudulently conveyed to the debtor's estate. That argument was not clearly made at the trial level, and this court will not consider it on appeal.

court indicates that the property, as well as other property ostensibly owned by other separate entities, was "submitted" to the court's jurisdiction by those entities.

This court can assume, without deciding, that such an informal procedure might suffice under applicable state law to bring property into a partnership from a related entity, and thus to convert the property of that entity into "property" of the partnership for purposes of a reorganization in bankruptcy.[5] If that is the case, however, the bankruptcy court must exercise due care to identify those who might be affected by such a transaction and to ensure that such a transaction does not work an injustice to them.

This court is of the opinion that the level of care due under the particular ciucumstances of this case can be found in an analagous situation under the Code. When an insolvent entity is involved in a reorganization proceeding, the Code provides for pooling the assets and liabilities of that entity and its related entities in appropriate cases. That is known as "substantive consolidation." See 5 Collier on Bankruptcy ¶ 1100.06, at 1100-32

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5 The debtor in this case is a partnership. Under the Utah Uniform Partnership Act, "partnership property" includes "[a]ll property originally brought into the partnership stock, or subsequently acquired by purchase or otherwise on account of the partnership . . . ." Utah Code Ann. § 48-1-5. The general partners of the debtor might have agreed to "dedicate" or otherwise "acquire" the Page Ranch on behalf of the partnership pursuant to this provision of the Uniform Partnership Act. Thus the Ranch could conceivably become a "legal or equitable interest of the debtor in property" within the meaning of Section 541 of the Code, 11 U.S.C. § 541(a)(1), even without a formal conveyance.

et seq. (15th ed. 1985). The law recognizes substantive consolidation as one of the general equitable powers of the bankruptcy court, set forth in Section 105 of the Code.[6] *See In re Continental Vending Machine Corp.*, 517 F.2d 997, 1000 (2d Cir. 1975). Consolidation, however, is rare--particularly when one or more of the consolidated entities are solvent--because of the serious potential for injustice to creditors. *See* 5 *Collier on Bankruptcy*, at 1100-46. Thus the Court of Appeals for the Tenth Circuit has observed:

> Consolidation has been used primarily when necessary to avoid fraud or injustice, but not for the purpose of promoting either or both. Courts have been reluctant to consolidate related corporations due to the possibility of creating an unfair program from the standpoint of creditors who have dealt with a corporation having a surplus or who have dealt solely with one debtor without knowledge of there being a relationship with others.

Matter of Gulfco Investment Corp., 593 F.2d 921, 928 (10th Cir. 1979). Therefore, when considering a proposed substantive consolidation, the bankruptcy court should be careful to identify creditors whose rights will likely be affected, to notify them and to give them an opportunity to challenge the consolidation.

The danger that substantive consolidation poses to creditors of the consolidated entities is only heightened when the consolidation is accomplished not after notice and a hearing but by means of a "dedication" or other such informal inter-entity

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6 11 U.S.C. § 105(a) provides:
"The bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

transfer of property. The facts of the case at bar well illustrate that heightened danger. Apparently, the Page Ranch was the sole asset of the Sanders Livestock Company. By bringing the Ranch into the debtor's estate, the bankruptcy court in effect allowed a de facto substantive consolidation of related entities. The record does not show, however, that the court ever received an application for consolidation; attempted to ascertain the status and claims of creditors, if any, of the related entities; gave notice to those creditors; held a hearing; made findings of fact and conclusions of law that "consolidation" was appropriate; or even considered in an informal way what effect bringing the Page Ranch into the debtor's estate might have on the creditors of the related entities.

Assuming, then, without deciding, that the bankruptcy court acted properly in bringing the Page Ranch into the debtor's estate in the first place, the bankruptcy court should have determined the nature of the appellants' "contract" interest, notified the appellants, as alleged creditors or holders of a security interest, of the proposed action, and given them some opportunity to be heard. These are the fundamental requirements of due process. See Mullane v. Central Hanover Trust Co., 339 U.S. 306, 314 (1950). As two commentators have noted:

> If . . . the objective of the trustee is to pool the assets and liabilities of all of the entities, then the creditors of the solvent entity or entities are vitally concerned. The bankruptcy court . . . should not take any action that would prejudice the creditors thereof without giving them an opportunity to be heard. Failure to do so would clearly

constitute a denial of due process of law.

Seligson & Mandell, Multi-Debtor Petition--Consolidation of Debtors and Due Process of Law, 73 Comm. L. J. 341, 345 (1968) (quoted in 5 Collier on Bankruptcy, at 1100-44). For all that appears of record in this case, the vital concerns of the appellants were never aired. The court therefore concludes that the failure to notify the appellants that the property in which they claimed an interest was included among the debtor's property and to give them an opportunity to be heard constituted a denial of due process of law.

The appellees correctly argue that when the debtor filed its petition for reorganization, and presumably when the Ranch was "dedicated" or "submitted" to the debtor's estate, the appellants had no interest of record in the Page Ranch. Nevertheless, the appellants' alleged interest appears on Schedule B-1 as a "written agreement relating to" the property. This indicates that the debtor had actual knowledge of the appellants' potential claim even though their trust deed was then unrecorded. Thus the appellants could have been notified that the property in which they claimed an interest was to be the subject of bankruptcy proceedings, and they could have been afforded an opportunity to assert their claim. Fundamental principles of fairness inherent in "due process" require such notice in the particular circumstances of this case in order to avoid prejudice to creditors of whose claims the debtor partnership has actual knowledge.

The court finds that the appellants were denied the process due in another respect. The appellants were not given notice of the debtor's plan of reorganization or an opportunity to contest that plan, even though the plan called for the sale of the Page Ranch free of all liens and encumbrances, including theirs. According to the case of Reliable Electric Co., Inc. v. Olson Construction Co., 726 F.2d 620 (10th Cir. 1984), due process does not permit such a patently unfair result.

Reliable was the electrical subcontractor on a construction project; Olson was the general contractor. Reliable withdrew from the project, claiming that Olson had breached the subcontract agreement. Reliable then filed a petition for Chapter 11 reorganization, listing Olson on its schedules as an account receivable but not as a creditor. Reliable later sued Olson for breach of the subcontract agreement, but Olson successfully counterclaimed, receiving a $10,378.00 judgment against Reliable. Reliable sought to have that claim discharged under its previously confirmed plan of reorganization.

The court first observed that Reliable was put on notice of Olson's status as a potential creditor once Olson filed its counterclaim. Despite that, no formal notice of the reorganization proceedings or of the time and manner of filing a claim was ever given to Olson. The court noted:

> The Supreme Court has repeatedly held that "[a]n elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency

> of the action and afford them an opportunity to present their objections."

726 F.2d at 622 (quoting Mullane v. Central Hanover Trust Co., 339 U.S. 306, 314 (1950)). The court continued:

> As specifically applied to bankruptcy reorganization proceedings, the Court has held that a creditor, who has general knowledge of a debtor's reorganization proceeding, has no duty to inquire about further court action. The creditor has a "right to assume" that he will receive all of the notices required by statute before his claim is forever barred. Thus, Olson acted reasonably when it expected the same formal notice of the confirmation hearing which was sent to other identifiable creditors. Inasmuch as Olson was deprived of the opportunity to comment on Reliable's Third Amended Plan of Reorganization, it was denied due process of law.

726 F.2d at 622. The court went on to find that, even though sections 1141(c) and (d) of the Code appear to allow any claim to be discharged whether notice was given or not, the constitutional requirement of due process must circumscribe that statutory discharge.[7]

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[7] 11 U.S.C. § 1141 provides in part as follows:

> (c) Except as provided in subsections (d)(2) and (d)(3) of this section [inapplicable here] and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors . . . ."

The court cited the well reasoned cases of New York v. New York, N. H. & H. R.R., 344 U.S. 293 (1953); In re Intaco Puerto Rico, Inc., 494 F.2d 94 (1st Cir. 1974); and In re Harbor Tank Storage Co., Inc., 385 F.2d 111 (3d Cir. 1967), to support its conclusion that, notwithstanding the above statutory language, a creditor should not be forever barred by a plan that it had no opporunity to dispute. The court further found it immaterial that the opportunity might have been relatively meaningless because the plan was overwhelmingly approved by other creditors. 726 F.2d at 623 n.5.

This court finds that the appellants were similarly denied due process of law. As in Reliable, no definite claim appeared of record during the confirmation process. Nevertheless, the debtor was aware of at least a potential claim by the appellants on their contract, as reflected in Schedule B-1. Again, it is not clear in the record whether the appellants' status was ever examined. But if the appellants were "creditors" of Sanders Livestock Company, they should have been given notice of and an opportunity to participate in the confirmation of the reorganization plan.

If the appellants' claim was not discharged upon confirmation of the debtor's plan, then the trustee's sale did not divest the appellants of whatever interest they might have in the Page Ranch. The appellants claim to have a record lien or at least an equitable lien that is superior to Zions Bank's lien, and that therefore Zions and the Kellers took the property subject to that superior lien. Alternatively, the appellants might have a junior lien on the Page Ranch pursuant to their 1975 agreement to subordinate their prior interest. If that is the case, the trustee's sale was ineffective to divest appellants of their claim because they were not given notice of or an opportunity to participate in that sale to protect their alleged security interest.[8] In either event, those questions appear

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[8] Although research uncovered no Utah case law on point, two Kansas cases support the court's conclusion on this issue. In Lenexa State Bank & Trust Co. v. Dixon, 559 P.2d 776 (Kan. 1977), a mortgagee foreclosed on its mortgage without joining junior mechanics' lien holders. The Kansas Supreme Court

to raise genuine issues of material fact to be resolved at trial in the bankruptcy court.

It appears to this court that the appellants have never had the chance in any proceeding, formal or informal, to have their claim heard on its merits. Thus the court concludes that summary judgment quieting in the appellees the title to the Page Ranch was inappropriate. This case must be remanded to the bankruptcy court for further consideration, including but not limited to the questions of the appellants' status vis-a-vis Sanders Livestock Company and the debtor; whether the Page Ranch could or should be included in the debtor's estate; and whether the appellants have any valid security interest in the Page Ranch that would entitle them to notice of and participation in any trustee's sale.

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stated:

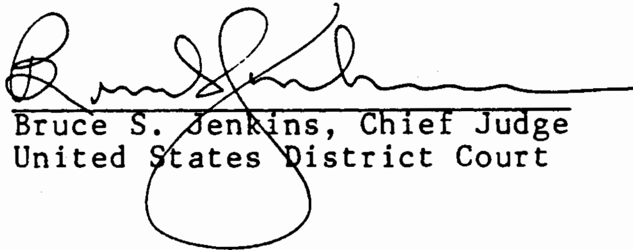
> [I]n order to bar a junior lienor from foreclosing his lien and securing a second sale, if his lien exists when the senior lien is foreclosed and the senior lienor is on notice of its existence, the junior lienor must be made a party to the suit in which the senior lien is foreclosed. In that way the validity of the junior lien can be established and its priority determined--i.e., the lien can be "adjudicated." If that is done the junior lienor may make a meaningful bid at the foreclosure sale . . . .

559 P.2d at 783. The later case of McGraw v. Premium Finance Co., 637 P.2d 472 (Kan. App. 1981), makes clear that the holding in Lenexa is not limited to mechanics' liens, but "applies to all junior liens." 637 P.2d at 474-75. In effect, the trustee's sale in this case foreclosed Zions Bank's lien on the Page Ranch without inviting junior lienholders to participate and protect their interests by bidding in at the sale. At the time of the hearing on the trustee's sale--and of course at the time of the sale itself--the appellants' trust deed was recorded. Therefore, the appellants should have been given the notice due any other record lienholder.

Accordingly, the Order and Judgment of the bankruptcy court, dated June 22, 1985, are hereby reversed and vacated. The case is hereby ordered remanded to the bankruptcy court for further proceedings consistent with this opinion.

DATED this 19 day of February, 1986.

BY THE COURT



Bruce S. Jenkins, Chief Judge
United States District Court

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