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2nd Circuit Upsets Bankruptcy Sanction of Developer Linked to Marc Dreier

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A bankruptcy judge's decision to sanction a prominent real estate developer who hired Marc S. Dreier in 2004 in a scheme to meddle with a rival's bankruptcy has been reversed by a federal appeals court.

The 2nd U.S. Circuit Court of Appeals said that Bankruptcy Court Judge Burton R. Lifland lacked the authority to order $334,583 in sanctions against developer Sheldon Solow, his chief operating officer at Solow Realty & Development Co., Dreier and others in the bankruptcy case of Peter S. Kalikow, a developer and former head of the Metropolitan Transportation Authority.

The circuit made that ruling in *In re Kalikow*, 08-5268-bk, an appeal decided by Judges Roger J. Miner, Reena Raggi and Peter W. Hall.

Ironically, Dreier in 2009 pleaded guilty to securities fraud, wire fraud and money laundering for actions unrelated to the Kalikow bankruptcy and is now in prison. Part of his scheme to defraud investors and steal from clients involved assuming the identity of Solow Realty Development Corp., his biggest client, to market phony promissory notes in Solow's name to hedge funds.

The origins of the bankruptcy dispute go back to 1994, when Kalikow, shortly after he received his Chapter 11 confirmation order from the bankruptcy court, borrowed $7 million from Solow in exchange for an option to buy an interest in Kalikow's business.

Kalikow repaid Solow within four months in 1994 and then repurchased the purchase option for $2 million in 1995, but Solow questioned whether Kalikow had been truthful about his assets.

Solow made a motion in 1997 for the appointment of an examiner to investigate Kalikow's statements. The motion was denied.

Seven years later in February 2004, on the eve of the expiration of a 10-year window to make post-confirmation claims in the bankruptcy, Solow and his COO, Steven M. Cherniak, contacted Dreier.

Dreier, according to the circuit opinion, then contacted Kosta Kovachev, the owner of a defunct Florida corporation, Evergence Capital Advisors Inc., to play the front man and serve as the contact for notices apprising unsecured creditors of possible claims they might have under the 1994 Chapter 11 plan reorganization of Kalikow and Kalikow Real Estate Co.

The legal notices, which were placed in *The New York Times* and the *New York Post*, said, "You may have additional rights of recovery based on a failure by the debtors to make truthful disclosure."

While the notices listed phone and fax numbers for Evergence, people who dialed those numbers were piped directly into lines at Dreier LLP, the then-250-lawyer firm in which Dreier was the sole equity partner.

Kalikow responded on April 14, 2004, by filing to reopen the bankruptcy and ask Judge Lifland for an enforcement motion against Solow, Cherniak, Evergence, Kovachev and Dreier LLP. He claimed that the notices were issued in bad faith, had confused his creditors and harmed his reputation, and he asked the court to order his adversaries to cease and desist and publish corrective notices in the newspapers.

When Dreier was deposed in the offices of Dreier LLP by Kalikow on May 6, 2004, he refused to name Solow and Cherniak as his clients. Lifland later compelled disclosure and Dreier eventually complied by naming the two men at a May 2004 deposition.

Dreier objected to the enforcement motion against his clients, and Kalikow responded by adding Dreier to the motion.

Kalikow prevailed before Lifland on June 10, 2004, with the judge finding the notices were designed to deceive the public. He ordered sanctions in October 2004 against Solow, Cherniak, Evergence, Kovachev, Dreier and his firm in the amount of $334,583, the amount of expenses and costs to compensate Kalikow, on the grounds that they had violated "the release, discharge and injunction provisions of the reorganization plan, the confirmation order, and §§1141 and 524 of the bankruptcy code."

Southern District Judge Deborah Batts affirmed the judgment and orders of the bankruptcy court in September 2008.

The sanctioned parties then turned to the 2nd Circuit in October 2008, just weeks before Dreier and then Kovachev were arrested for defrauding hedge funds of hundreds of millions of dollars. He and Kovachev, who aided in the hedge funds schemes, including impersonating a Solow executive to help pitch fake promissory notes, are now in prison, serving 20 years and 46 months, respectively. The interests of the defunct Dreier LLP are now in the hands of Chapter 11 trustee Sheila M. Gowan, who joined in all the relevant arguments made by Solow and Cherniak.

BANKRUPTCY COURT'S AUTHORITY

Writing for the circuit, Judge Miner first rejected arguments that the bankruptcy judge erred in proceeding by motion instead of conducting a full adversary proceeding.

"We agree with the district court that relief sought by Kalikow, including publication of corrective notices, was to correct the perceived violation of the injunction," Miner said.

But Solow and Cherniak had better luck in arguing that the bankruptcy code's injunctive provisions invoked by Judge Lifland had no relation to their conduct. They said the Kalikow plan and confirmation order did not apply to them because they did not hold pre-confirmation discharged claims.

The circuit agreed, saying the bankruptcy court's authority, "pursuant to §§524(a)(2) and 1141, does not extend to sanctioning the appellants, whose bad-faith conduct did not run afoul of the plain language of the confirmation order."

The remaining question was whether Lifland had an independent basis to impose sanctions, the equitable power vested in the court by §105(a) of the bankruptcy code. The circuit answered in the negative.

"We certainly acknowledge the legitimate concerns of the bankruptcy court and appreciate its attempt to exercise a combination of inherent and statutory authority to remedy the harm caused by the appellants' reprehensible conduct," Miner said.

Citing *In re Dairy Mart Convenience Stores Inc.*, 351 F.3d 86 (2d Cir. 2003), the panel said, "We must hold that the equitable power conferred on a bankruptcy court by 11 U.S.C. §105 'is the power to carry out the Provisions of the bankruptcy code, rather than to further the purposes of the code generally, or otherwise to do the right thing.'"

David M. Gossett and Richard Ben-Veniste of Mayer Brown argued for Solow and Cherniak.

"As we asserted from the beginning and as the 2nd Circuit clarified, the bankruptcy court had no authority to issue sanctions," Ben-Veniste said,

Joan M. Secofsky of Diamond McCarthy argued for Evergence and Gowan.

Randy M. Mastro of Gibson Dunn & Crutcher represented Kalikow.

"From Peter Kalikow's perspective, this was never about money," Mastro said. "This was about exposing those who were responsible for this outrage and having the court find their conduct was 'reprehensible,' and that's now what every court to have reviewed this has held."