IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

In re:	§	
	§	**Case No. 19-20497**
Hidalgo County Emergency Service	§	
Foundation,	§	
	§	**Chapter 11**
Debtor.	§	

Motion by the United States for Appointment of Chapter 11 Trustee

Pursuant to BLR 9013-1:

> **This motion seeks an order that may adversely affect you. If you oppose the motion, you should immediately contact the moving party to resolve the dispute. If you and the moving party cannot agree, you must file a response and send a copy to the moving party. You must file and serve your response within 21 days of the date this was served on you. Your response must state why the motion should not be granted. If you do not file a timely response, the relief may be granted without further notice to you. If you oppose the motion and have not reached an agreement, you must attend the hearing. Unless the parties agree otherwise, the court may consider evidence at the hearing and may decide the motion at the hearing.**
>
> **Represented parties should act through their attorney.**

To the Honorable David R. Jones,
Chief United States Bankruptcy Judge:

The United States moves the Court to order the appointment of a chapter 11 trustee.

Summary

The bankruptcy estate is currently asserting claims against the Administrator of the Small Business Administration. Both sides dispute the merits of those claims, but the *bankruptcy estate* is entitled to its day in court. Resolution of those claims is a completely separate issue from this motion.

The *debtor-in-possession* is a different story. The debtor-in-possession made a material misrepresentation in order to obtain a PPP loan. That false statement may result in a $2.5 million administrative claim against the bankruptcy estate, which may jeopardize reorganization and the jobs of those employed by the Debtor.

People can dispute legal positions, factual assertions, the merits of claims, or even the wisdom of policy decisions—but there is no room to dispute that dishonesty by a debtor-in-possession threatens the integrity of the bankruptcy process. The United States requests that the Court appoint a chapter 11 trustee to protect the bankruptcy process while still allowing the bankruptcy estate to pursue whatever claims it may or may not have—and hopefully confirm a plan of reorganization that will preserve jobs.

Background

Between 2015 and when it filed bankruptcy, the Debtor failed to turn over a significant amount of payroll taxes. Together with unpaid income taxes in 2012 and 2013, the Debtor generated a pre-petition debt to the IRS in excess of $3 million. [Claim No. 13].

On October 8, 2019, Hidalgo County Emergency Service Foundation filed a voluntary petition under chapter 11 of the Bankruptcy Code. [Doc. No. 1].

Early in the case, the Debtor filed a motion asking the Court for authority to pay pre-petition claims of certain "critical vendors." [Doc. No. 98]. The Debtor represented to the Court that each "critical vendor" it identified was someone "whom Debtor cannot replace, and *each of whom Debtor reasonably believes will refuse to continue to do business with the Debtor* post petition unless their pre petition claims are satisfied." [Doc. No. 98, p. 2, ¶ 5] (emphasis added). The Debtor listed WFAS and American Express as creditors whom the Debtor believed would stop doing business with it. [Doc. No. 98-1].

The Debtor's schedules did not include a claim by American Express. [Doc. No. 72]. The Debtor's schedules instead included a claim of Kenneth Ponce—who is the Debtor's sole managing member—for "credit card balances." [Doc. No. 72, p. 37]. This suggests that Mr. Ponce—a clear insider in control of the Debtor—labeled himself a "critical vendor" potentially threatening to stop doing business with the Debtor in order to have his pre-petition claim paid.

WFAS also appears to be an insider of the Debtor—Mr. Ponce is or was a director of WFAS Inc. and is currently its registered agent. Despite its status as an insider, the Debtor represented that WFAS was also a "critical vendor" potentially threatening to stop doing business with the Debtor in order to have the pre-petition claim paid.

The Coronavirus Aid, Relief, and Economic Security ("CARES") Act became law in March, 2020, and created Paycheck Protection Program ("PPP") loans. As the Court is aware, the Administrator of the SBA made the policy decision to exclude companies in bankruptcy from receiving PPP loans.

On April 22, 2020, the Debtor asserted claims on behalf of the Bankruptcy Estate against Jovita Carranza in her capacity as Administrator for the U.S. Small Business Administration. [Adv. No. 20-2006, Doc. No. 1]. The Debtor alleged that the Administrator exceeded her statutory authority and violated 11 U.S.C. § 525(a).

The Court held a hearing on April 24, 2020, to consider the entry of a temporary restraining order. The Court entered a TRO over the United States' objection, but the Court was specific about what it ordered. The Court ordered that the Debtor could modify its PPP application by striking "or presently involved in any bankruptcy." [Transcript, p. 33, lines 2-3]; [Adv. No. 20-2006, Doc. No. 18]. The Court was very clear that it was *not* authorizing the Debtor to make a misrepresentation—the Court was allowing the Debtor to modify the application then answer the modified application *truthfully*.

The Court held a second hearing on May 8, 2020, to consider the entry of a preliminary injunction. The Court entered a PI over the United States' objection, but the Court was again very clear about its order. The Court's PI was similar to its TRO in that it authorized the Debtor to submit a truthful but modified PPP loan application striking the words "or presently involved in any bankruptcy." [Adv. No. 20-2006, Doc. No. 33].

The United States timely appealed, and on May 11, 2020, the District Court stayed this Court's preliminary injunction. [Case No. 2:20-cv-108, Doc. No. 7].

The problem giving rise to this motion occurred on May 14, 2020, when the Debtor submitted the application attached as Exhibit A. On that date, the Debtor could not rely on this Court's preliminary injunction without violating the District Court's order staying the injunction. It also could not answer the PPP loan application truthfully without risking denial of the application. Faced with these two problems, the Debtor-in-Possession under the control of Mr. Ponce chose to be dishonest:

Question	Yes	No
1. Is the Applicant or any owner of the Applicant presently suspended, debarred, proposed for debarment, declared ineligible, voluntarily excluded from participation in this transaction by any Federal department or agency, or presently involved in any bankruptcy?	☐	☑

. . .

NP I further certify that the information provided in this application and the information provided in all supporting documents and forms is true and accurate in all material respects. I understand that knowingly making a false statement to obtain a guaranteed loan from SBA is punishable under the law, including under 18 USC 1001 and 3571 by imprisonment of not more than five years and/or a fine of up to $250,000; under 15 USC 645 by imprisonment of not more than two years and/or a fine of not more than $5,000; and, if submitted to a federally insured institution, under 18 USC 1014 by imprisonment of not more than thirty years and/or a fine of not more than $1,000,000.

. . .

Kenneth Ponce — 5/14/2020

Signature of Authorized Representative of Applicant — Date

70.124.25.246 / 2020-05-14 14:42:01

Kenneth Ponce — CEO/Owner

Print Name — Title

Exhibit A, pp. 1-2.

Legacy Bank relied on the Debtor-in-Possession's misrepresentation in submitting paperwork to the SBA.

- The Applicant has certified to the Lender that neither the Applicant nor any owner (as defined in the Applicant's SBA Form 2483) is presently suspended, debarred, proposed for debarment, declared ineligible, voluntarily excluded from participation in this transaction by any Federal department or agency, or presently involved in any bankruptcy. ■ Yes ❑ No

Exhibit B, p. 2. Legacy Bank then made a $2,559,600 loan to the Debtor—apparently without the knowledge that the Debtor was ineligible for a PPP loan. [Doc. No. 248, p. 10].

If SBA decides that the Debtor's misrepresentation makes it ineligible for loan forgiveness, then Legacy Bank will have a large unsecured claim against the Debtor. *See* [Doc. No. 240]; 11 U.S.C. § 364. If Legacy Bank demands payment of this loan in full on the effective date of a plan, as it is entitled to do under 11 U.S.C. § 1129(a)(9)(A), then this loan may prevent the Debtor from reorganizing.[1]

The Debtor's June monthly operating report reflects that it has spent approximately $1.3 million of PPP loan proceeds. [Doc. No. 268, p. 10].

[1] The SBA may also object to any plan that does not repay this loan in the manner required by 11 U.S.C. § 1129(a)(9)(A).

Relief Requested

The United States requests that the Court appoint a chapter 11 trustee. The bankruptcy system cannot tolerate a debtor-in-possession who is dishonest.

Section 1104 provides that:

> the court *shall* order the appointment of a trustee . . . for cause, including *fraud*, *dishonesty*, incompetence, or gross mismanagement of the affairs of the debtor by current management . . .

11 U.S.C. § 1104(a)(1) (emphasis added). After a court finds "cause" under 11 U.S.C. § 1104, the appointment of a trustee becomes mandatory. *In re Sillerman*, 605 B.R. 631, 642 (Bankr. S.D. N.Y. 2019).

The word "dishonesty" covers a broad range of conduct—any that involves a "lack of honesty." *In re Amerejuve, Inc.*, 2015 WL 2226344 at*9, Case No. 14-35482 (Bankr. S.D. Tex. Apr. 29, 2015) (collecting cases). At a time when it knew it was ineligible to receive a PPP loan due to this bankruptcy, the Debtor-in-Possession represented on a loan application that it was not in bankruptcy, and that representation was false when made. These facts require a finding of dishonesty, the finding of dishonesty requires a finding of cause, and the finding of cause requires the appointment of a chapter 11 trustee.

Section 1104(a) does not provide a definition of "fraud," so many cases have incorporated the state common-law definition. *In re LHC, LLC*, 497 B.R. 281, 305 (Bankr. N.D. Ill. 2013). The elements of fraud in Texas are:

(a) That a material representation was made;

(b) The representation was false;

(c) When the representation was made, the speaker knew it was false . . . ;

(d) The speaker made the representation with the intent that the other party should act upon it;

(e) The party acted in reliance on the representation; and

(f) The party thereby suffered injury.

Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of America, 341 S.W.3d 323, 337 (Tex. 2011) (quoting *Aquaplex, Inc. v. Rancho La Valencia, Inc.*, 297 S.W.3d 768, 775 (Tex. 2009) (per curiam)).

The representation by the Debtor-in-Possession about bankruptcy in the PPP loan application was material because it dictated whether the Debtor was eligible for the loan. Mr. Ponce's representation about the Debtor's status in bankruptcy was false, and Mr. Ponce knew it to be false. Because he made this representation in an application seeking a loan, the Court can find that the Debtor-in-Possession intended for Legacy Bank to rely on it. Legacy Bank relied on the misrepresentation in funding the PPP loan, and it has suffered injury by now being placed at risk of the SBA not forgiving the loan and the Debtor being unable to repay it. Worse, the Bankruptcy Estate has suffered injury by potentially becoming saddled with an administrative claim that it will not be able to pay on the effective date of a plan. The Court should find fraud under 11 U.S.C. § 1104.

Even if "cause" under 11 U.S.C. § 1104(a)(1) was not present, the Court has grounds to appoint a trustee under 11 U.S.C. § 1104(a)(2). The Debtor filed this case in October 2019, and the IRS has filed a claim in excess of $3 million. The Debtor must pay within sixty months of the petition date both (a) the portion entitled to priority treatment, and (b) the portion that would be entitled to priority treatment but for its secured status. 11 U.S.C. § 1129(a)(9)(C) & (D). The Debtor-in-Possession has used ten of those available sixty months, and if no one proposes a plan soon, the Debtor may not be able to pay the IRS's claim in the remaining time. The delay by the Debtor-in-Possession in proposing a plan means that a trustee, who hopefully will not delay in filing a plan, is in the best interests of creditors.

Accordingly, the United States requests that the Court order the appointment of a chapter 11 trustee and grant the United States such other and further relief as is equitable and just.

Dated: August 15, 2020.

Respectfully submitted,

RYAN K. PATRICK,
United States Attorney

By: *s/ Richard A. Kincheloe*

Richard A. Kincheloe
Assistant United States Attorney
Attorney-in-Charge
United States Attorney's Office
Southern District of Texas
Texas Bar No. 24068107
S.D. Tex. ID No. 1132346
1000 Louisiana St., Suite 2300
Houston, Texas 77002
Telephone: (713) 567-9422

Facsimile: (713) 718-3033
Email: Richard.Kincheloe@usdoj.gov
Attorney for the United States of America

Certificate of Service

The undersigned certifies that he served/will serve the foregoing Motion on the parties listed on the attached service list (a) by ECF notification on August 15, 2020, and/or (b) by first-class U.S. mail, postage prepaid, on August 18, 2020. The undersigned will also serve the foregoing Motion on the party listed below by first-class U.S. mail, postage prepaid, on August 18, 2020.

Legacy Bank
c/o R. Stephen Carmack
101 W. Main
Hinton, OK 73047

s/ Richard A. Kincheloe
Richard A. Kincheloe
Assistant United States Attorney