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Case No. 3:24-cv-01479-S

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS, DALLAS DIVISION

IN RE HIGHLAND CAPITAL MANAGEMENT, L.P.,

Debtor

NEXPOINT REAL ESTATE PARTNERS, LLC
(F/K/A HCRE PARTNERS, LLC)

Appellants

v.

HIGHLAND CAPITAL MANAGEMENT, L.P.

Appellee

On Appeal from the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, Case No. 19-34054-slg
The Honorable Chief Judge Jernigan, Presiding

REPLY IN SUPPORT OF APPELLANT'S OPENING BRIEF

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I. INTRODUCTION

In an appellate brief rife with falsehoods, distortions of fact, and unsustainable legal arguments, Highland urges this Court to affirm the bankruptcy court's erroneous finding of bad faith and punitive sanction. In advancing its position, Highland makes three core arguments: (1) that HCRE "knew" its proof of claim was baseless at the time of filing; (2) that HCRE repeatedly attempted to "preserve the substance" of its claim for "another day;" and (3) that, without a full hearing on the merits of HCRE's proof of claim, Highland would have enjoyed only a "pyrrhic" victory because Highland's interest in SE Multifamily "would have remained subject to challenge." As explained in greater detail below, these arguments lack any basis in evidentiary reality and provide no support for the bankruptcy court's decision. In the absence of "clear and convincing" proof of bad faith and without a causal link between that finding and the sanction awarded, vacatur of the bankruptcy court's order is the only appropriate result.

II. HIGHLAND'S ARGUMENTS ARE FACTUALLY AND LEGALLY WRONG

A. Highland Misstates the Standard of Review

In its opening brief, HCRE cited the Fifth Circuit's decision in *Cadle Co. v. Moore (In re Moore)* for the standard of review on appeal from a sanction issued pursuant to the bankruptcy court's inherent authority under Bankruptcy Code § 105.

See Appellant's Opening Brief ("HCRE Br.") at 26. As the Fifth Circuit explained in that case:

> We review de novo a district court's invocation of its inherent power and the sanctions granted under its inherent power for an abuse of discretion. A decision to invoke the inherent power to sanction requires a finding of "bad faith or willful abuse of the judicial process," which finding we review de novo. The finding of bad faith must be supported by clear and convincing proof. In sum, we uphold a lower court's decision to invoke its inherent sanctioning power only if clear and convincing evidence supports the court's finding of bad faith or willful abuse of judicial process. If this high threshold for invoking inherent powers is surmounted, we review the substance of the sanction itself more deferentially, for an abuse of discretion.

739 F.3d 724, 729–30 (5th Cir. 2014) (internal quotations and citations omitted) (cleaned up). Notwithstanding that the bankruptcy court itself cited *Moore* for the standard to be applied by a court invoking its inherent powers, Highland begins its legal argument by insisting that this Court should ignore *Moore*. Highland suggests that "*Moore* appears to be an outlier" because Highland found no other case citing the same standard of review as *Moore*. Appellee Brief ("Highland Br.") at 26 n.70. Highland then urges this Court to adopt a very deferential standard of review. Specifically, Highland argues that this Court should review the bankruptcy court's factual determination that "clear and convincing evidence" supported a finding of bad faith—and the court's invocation of its inherent power—for "clear error." *Id.* at 26.

This Court should reject Highland's invitation to depart from binding Fifth Circuit precedent in favor of a more deferential standard of review. Far from being an "outlier," the Fifth Circuit's opinion in *Moore* has been cited at least 100 times, including by the Fifth Circuit and by this Court. Indeed, in a 2022 opinion cited (incompletely) by Highland in its brief, the Fifth Circuit reaffirmed *Moore*'s iteration of the rigorous standard of review to be applied to a bankruptcy court's factual findings supporting the invocation of inherent power. Specifically, in *Kreit v. Quinn* (*In re Cleveland Imaging & Surgical Hosp., L.L.C.*), the Fifth Circuit explained:

> [W]e usually review the bankruptcy court's legal conclusions *de novo* and its factual findings for clear error. But when the bankruptcy court sanctions a party using its inherent authority, our review is closer. We uphold those sanctions only if (1) the bankruptcy court finds that the party acted in bad faith or willfully abused the judicial process and (2) its finding is supported by clear and convincing evidence.

26 F.4th 285, 292 (5th Cir. 2022) (citing *Moore*, 739 F.3d at 729–30); *compare* Highland Br. at 25. And the Fifth Circuit has continued to embrace the *Moore* standard of review in several other recent opinions. *See, e.g.*, *National Oilwell Varco, L.P. v. Auto-Dril, Inc.*, 68 F.4th 206, 219 (5th Cir. 2023) ("[W]e uphold a lower court's decision to invoke its inherent sanctioning power only if clear and convincing evidence supports the court's finding of bad faith or willful abuse of process.") (citing *Moore*, 739 F.3d at 730); *Vikas WSP, Ltd. v. Economy Mud Prods. Co.*, 23 F.4th 442, 455 (5th Cir. 2022) (in reviewing a sanction issued pursuant to

the court's inherent power, "[w]e first decide, *without deference*, whether the court established 'bad faith or willful abuse of the judicial process' by 'clear and convincing proof.'") (quoting *Moore*, 739 F.3d at 730) (emphasis added).

This Court has also repeatedly cited *Moore* for the standard to be employed when invoking the inherent power to sanction. *See, e.g.*, *Miller v. Dunn*, No. 3:23-CV-1696-E-BN, 2023 WL 10669799, at *3, 6–7 (N.D. Tex. Oct. 4, 2023), *report and recommendation adopted*, 2024 WL 1303942 (N.D. Tex. Mar. 27, 2024) (finding that the record did not contain "clear and convincing" proof of bad faith sufficient to meeting the "high standard" for exercising inherent power to sanction); *Budri v. FirstFleet, Inc.*, No. 3:19-CV-0409-N-BH, 2021 WL 849012, at *6–7 (N.D. Tex. Feb. 18, 2021), *report and recommendation adopted*, 2021 WL 842123 (N.D. Tex. Mar. 5, 2021) (recommending denial of motion for sanctions and repeating the very high standard for invoking inherent authority to sanction); *Bucklew v. St. Clair*, No. 3:18-CV-2117-N-BH, 2019 WL 2724067, at *4 (N.D. Tex. May 29, 2019), *report and recommendation adopted*, 2019 WL 2716511 (N.D. Tex. June 28, 2019) (movant "fail[ed] to offer 'clear and convincing evidence of bad faith' to warrant sanctions under the Court's inherent powers") (quoting *In re Moore*, 739 F.3d at 730). In other words, *Moore* is hardly an "outlier," as Highland would have the Court believe.

Highland directs the Court to a litany of other cases that Highland says support a more deferential standard of review. *See* Highland Br. at 24–27. But each of those cases (with one exception, discussed herein) are inapposite in meaningful ways.[1] The only case cited by Highland that seems to apply a "clear error" standard to a bankruptcy court's finding of bad faith is *Carroll v. Abide (In re Carroll)*, 850 F.3d 811 (5th Cir. 2017). In that case, the Fifth Circuit was asked to review a bankruptcy court's order declaring debtors and their daughters "vexatious litigants" and imposing a pre-filing injunction against them. *In re Carroll*, 850 F.3d at 813. At the outset, the Fifth Circuit explained that the bankruptcy court had authority to enjoin vexatious litigants either pursuant to its inherent power or pursuant to the All Writs Act, 28 U.S.C. § 1651. *Id.* at 815. But the Fifth Circuit emphasized that,

[1] Three of the cases cited by Highland—*Butler Aviation Int'l v. Whyte (In re Fairchild Aircraft Corp.)*, 6 F.3d 1119 (5th Cir. 1993), *Trendsetter HR L.L.C. v. Zurich Am. Ins. Co. (In re Trendsetter HR L.L.C.)*, 949 F.3d 905 (5th Cir. 2020), and *Galaviz v. Reyes*, 95 F.4th 246 (5th Cir. 2024)—have nothing to do with sanctions or the courts' invocation of inherent authority. The remaining cases likewise do not involve the courts' invocation of the inherent authority to sanction but, rather, involve the courts' invocation of sanctioning power in the context of other rules or statutes empowering redress or in the context of addressing contempt of specific court orders. *See Dondero v. Highland Capital Mgmt., L.P. (In re Highland Capital Mgmt., L.P.)*, 105 F.4th 830, 836 (5th Cir. 2022) (evaluating finding of contempt for violation of temporary restraining order issued under Federal Rule of Civil Procedure 65); *Krueger v. Torres (In re Kroger)*, 812 F.3d 365, 369 (5th Cir. 2016) (upholding dismissal of case for "cause" under Bankruptcy Code § 707); *Smith v. Robbins (In re IFS Fin. Corp.)*, 803 F.3d 195, 205–06 (5th Cir. 2015) (evaluating whether there was "cause" to remove trustee under Bankruptcy Code § 324(a)); *Am. Airlines, Inc. v. Allied Pilots Ass'n*, 228 F.3d 574, 578 (5th Cir. 2000) (analyzing finding of contempt for violation of TRO issued under Federal Rule of Civil Procedure 65); *In re Eichor*, 689 F. Supp. 3d 438, 446 (S.D. Tex. 2023) (evaluating finding of contempt for violation of a bankruptcy court's discharge injunction); *Okorie v. Lentz*, No. 2:24-CV-51-KS-MTP, 2024 WL 4186937, at *4 (S.D. Miss. Sept. 9, 2024) (reviewing bankruptcy court's award of sanctions pursuant to Federal Rule of Bankruptcy Procedure 9011).

"when sanctions are imposed under the inherent power, this court's investigation of legal and evidentiary sufficiency is *particularly probing* and this court must *probe the record in detail* to get at the underlying facts and ensure the legal sufficiency of their support for the district court's more generalized finding of 'bad faith.'" *Id.* (internal quotations and citation omitted) (emphasis added). The Fifth Circuit went on to conduct a "probing review of the record," and only then did it conclude that the bankruptcy court's finding of bad faith was well supported. *Id.* In other words, while the Fifth Circuit in *Carroll* referenced the "clear error" standard, it actually conducted a de novo review akin to that articulated in *Moore* and its progeny.

The bottom line is, this Court cannot deferentially accept a bankruptcy court's finding of bad faith when reviewing the court's invocation of its inherent power to sanction. To the contrary, "'[b]ecause of their very potency, inherent powers must be exercised with restraint and discretion.'" *Budri*, 2021 WL 849012 at *6 (quoting *Chambers v. NASCO, Inc.*, 501 U.S. 32, 50 (1991)). Thus, "'the threshold for the use of inherent power sanctions is high.'" *Id.* (quoting *Chaves v. M/V Medina Star*, 47 F.3d 153, 156 (5th Cir. 1993)). Inherent power is not "'a broad reservoir of power, ready at the imperial hand, but a limited source; an implied power squeezed from the need to make the court function.'" *Id.* (internal citations omitted). To invoke that power, a bankruptcy court "must make a specific finding of bad faith," which is "not simply bad judgment or negligence" but "the conscious doing of a

wrong because of a dishonest purpose or moral obliquity; . . . a state of mind affirmatively operating with furtive design or ill will." *Id.* (internal quotations and citations omitted). As set forth below, in this case, the limited and speculative evidence of bad faith does not justify the bankruptcy court's invocation of its inherent power to sanction HCRE. And a probing, de novo review is the only appropriate standard by which to evaluate the bankruptcy court's decision to invoke that power.

B. Highland Does Not and Cannot Point to Any "Clear and Convincing Evidence" of Bad Faith

Confronted with a record that clearly contradicts and fails to support the bankruptcy court's finding of bad faith, Highland posits new arguments and justifications that are likewise insufficient to support the court's finding.

1. Highland Does Not Cite Ant Evidence Justifying the Bankruptcy Court's Finding that the POC was *Filed* in Bad Faith

As HCRE explained in its opening brief (and as the bankruptcy court acknowledged), HCRE's proof of claim ("POC") was facially "ambiguous," unliquidated, and expressly dependent upon discovery. *See* Appellant Br. at 32–33; ROA.000187; ROA.000196. Further, at the time HCRE filed its POC, HCRE did not posit any legal theories to support the claim—HCRE merely stated that it "may be entitled to distributions out of SE Multifamily" and that "all or a portion of

[Highland's] equity, ownership, economic rights, equitable or beneficial interests . . . may be the property of [HCRE]." *See* HCRE Br. at 6; ROA.00814. As a result, Highland does not seriously dispute HCRE's contention that the proof of claim HCRE filed was in fact truthful and accurate.

Instead, Highland argues that HCRE "knew" when it filed its POC that the legal *theories* supporting the POC (*e.g.*, mutual mistake, lack of consideration, rescission/reformation, modification) were baseless. *See, e.g.*, Highland Br. at 1–2, 8, 14–19, 27; *see also id.* at 29 ("Dondero and McGraner . . . knew that there was no good faith basis to challenge the Revised Allocation"). To support its argument, Highland cites to testimony adduced in depositions and at the hearing on the POC in which Dondero and McGraner testified about the Revised Allocation set forth in the SE Multifamily amended LLC agreement. *See* Highland Br. at 7, 15–19. According to Highland, this testimony proves that the Revised Allocation "reflected the parties' intent" and that HCRE therefore knew the POC was baseless. *Id*. But this evidence misses the point. HCRE did not file the POC because HCRE believed there was an error in the Revised Allocation at the time the amended LLC agreement was signed. As McGraner testified, HCRE filed the POC because it believed that the agreement mistakenly failed to make clear that the agreement would be amended as the transaction evolved and the members' contributions changed. ROA.004587 at 64:19–65:11; *see also* ROA.004609–08 at 153:25–155:24. As McGraner further

testified, he believed—prior to filing the POC—that the members' ownership interests were grossly misallocated based on their relative contributions, that Highland's bankruptcy precluded SE Multifamily from rectifying that problem and making correct distributions to members, and that filing a POC was the only way HCRE saw to rectify the problem. ROA.004586–87 at 60:14–61:13, 62:4–21; *see also* ROA.004588 at 67:23–69:6. In other words, HCRE had a genuine belief at the time the POC was filed that "SE Multifamily's organizational documents improperly allocated the ownership percentages of its members due to "mutual mistake" or "lack of consideration." There is no evidence in the record (and Highland cites none) contradicting this evidence about what HCRE and its managers "knew" and understood at the time of the POC's filing.

Highland's argument that HCRE knew, at the time the POC was filed, that the legal theories underlying the POC were false is also nonsensical. As Highland acknowledges, HCRE's counsel, Wick Phillips, first posited these potential legal theories in HCRE's response to Highland's omnibus objection to proofs of claim—eight months *after* the original POC was filed. *See* Highland Br. at 29 n.76 (arguing that HCRE "removed any alleged 'ambiguity' in the POC when it filed its Response"); ROA.000806 at ¶ 5. In that response, Wick Phillips articulated a "belief" that SE Multifamily's organizational documents improperly allocated the ownership percentages of its members due to "mutual mistake" or "lack of

consideration." HCRE Br. at 8 (citing ROA.000806). But the response also explained that HCRE would require "additional discovery to determine what happened." *Id.* (citing ROA.000807).[2] It only makes sense that there is no evidence of record demonstrating that HCRE knew *at the time of the POC's filing* that lawyer-developed legal theories articulated eight months later lacked merit.

Nonetheless, Highland bizarrely insists that, because "Dondero and McGraner were the only two people authorized to act on HCRE's behalf, one of them caused the Response to be filed in bad faith since both knew those contentions were false." Highland Br. at 29 n.76. This argument, also made for the first time on appeal, makes no sense. Highland does not explain how Dondero (a non-lawyer) or McGraner (a non-practicing lawyer) "knew" the legal theories posited by their lawyers were "false." Nor does Highland explain how legal *argument* made in briefing filed by lawyers could ever be described as "false." And as HCRE pointed out in its opening brief, nobody has ever suggested that the arguments made by Wick Phillips were frivolous or somehow violated Federal Rule of Bankruptcy Procedure

[2] Highland also claims that HCRE's statements about needing discovery were false when made. Highland Br. at 9 n.21. This is a brand-new argument, but it matters little. By the time Wick Phillips responded to Highland's claim objection, Dondero, McGraner, and all of the other core employees who would have had information to corroborate the POC had been fired and locked out of Highland's offices, leaving them without access to any of HCRE's files, agreements, or financials. As a result, HCRE's counsel (first Wick Phillips and then Hoge Gameros) sought and obtained discovery necessary to pursue the POC, and nobody ever suggested along the way that the discovery was improper or unnecessary. *See* ROA.000169–70. Further, the bankruptcy court did not base its finding of bad faith on some supposed wrongful pursuit of discovery by HCRE.

9011. HCRE Br. at 8. In any event, the bankruptcy court made no finding that HCRE's response to Highland's omnibus objection was filed in bad faith, and there is no basis for this Court to do so now.

Moreover, the actual evidence negates any conclusion that HCRE acted with the type of "dishonest purpose or moral obliquity" required to conclude that the company filed the POC in bad faith. As set forth in HCRE's opening brief, although Dondero did not investigate the claim prior to authorizing his lawyers to affix his e-signature to and file the proof of claim form, it does not follow that *HCRE* did nothing to investigate its proof of claim. To the contrary, Matt McGraner—the person actually charged with the day-to-day management of HCRE—testified that he reviewed the "whole gamut" of the company's financials and agreements prior to filing the POC, communicated with in-house counsel, DC Sauter, regarding the claim, and tasked Sauter with conveying information to and discussing the POC with outside counsel, Bonds Ellis. ROA.004583-84 at 46:5–47:14, 48:16–50:22. Both McGraner and Dondero also testified that they relied on the advice of outside counsel in determining whether to file the POC, and outside counsel prepared the description of the claim appended to the claim form. ROA.004582 at 44:17–22; *see also* ROA.004551 128:10–14. McGraner further testified that he believed the SE Multifamily members' ownership interests were misallocated based on the members' relative contributions and that filing a POC was the only way to rectify

that problem. ROA.004587 at 63:15–65:11. In other words, McGraner (and, by extension, HCRE) had a genuine belief *at the time the POC was filed* that "SE Multifamily's organizational documents improperly allocated the ownership percentages of its members due to 'mutual mistake' or 'lack of consideration.'"

Thus, contrary to Highland's argument, this case is exactly like *In re Cushman*, 589 B.R. 469 (Bankr. D. Me. 2018), where the bankruptcy court held that a sanction was not appropriate merely because the signatory to the proof of claim did not review or investigate the proof of claim. There, as here, a company filed a proof of claim that affixed the electronic signature of one of the company's representatives. *Id.* at 477. There, as here, the signatory had "no knowledge, information, or belief about any debts owed" and reflected in the proof of claim. *Id.* at 478. There, as here, the signatory "did not review" the proof of claim before it was filed. *Id.* And there, as here, others within the company nonetheless made reasonable inquiries to investigate and draft the proof of claim. *Id.* at 477–78. By comparison, in this case, McGraner and Sauter reviewed the SE Multifamily documents and financials at their disposal, discussed their concerns with outside counsel, and worked with outside counsel to prepare the POC. ROA.004583–84 at 46:5–47:14, 48:16–50:22. As in *Cushman*, this investigation—while not done by Dondero as signatory—was nevertheless done, and that is all that was required.

In the end, Highland does not even explain what "dishonest purpose or moral obliquity" may have driven HCRE to file the POC if, as Highland insists, HCRE indeed believed the claim was baseless. Nor is there any "clear and convincing" evidence in this record supporting the bankruptcy court's conclusion that HCRE acted with the requisite bad faith in filing an otherwise truthful and accurate POC. Highland's first argument should be rejected.

2. Highland Fails to Cite Any "Clear and Convincing" Evidence that HCRE Pursued the POC in Bad Faith

HCRE cited extensive evidence in its opening brief that it attempted to withdraw its POC months before any evidentiary hearing on the claim and repeatedly represented to the bankruptcy court that it would agree to a withdrawal "with prejudice." HCRE Br. at 13–14, 16–17, 36. Highland does not cite evidence to the contrary. Instead, Highland argues (largely without any citation to the record) that the bankruptcy court's bad faith finding is correct because (1) HCRE filed a "baseless opposition" to Highland's motion seeking to disqualify HCRE's counsel, Wick Phillips ("Disqualification Motion"); (2) HCRE "sudden[ly] attempt[ed]" to withdraw its POC "without explanation;" and (3) HCRE "repeated[ly] attempt[ed] to preserve its identical litigation positions . . . for use in the future." As set forth below, there is no evidence in the record to support these assertions (much less "clear and convincing" evidence), and none justify the bankruptcy court's bad faith finding.

Highland's first argument—that HCRE opposed the Disqualification Motion in bad faith—is brand new and baseless. Indeed, not even the bankruptcy court found that HCRE filed a "baseless" opposition to Highland's Disqualification Motion. Rather, as HCRE explained in its opening brief, the bankruptcy court merely blamed HCRE for "initiating" the disqualification fight (notwithstanding that Highland, not HCRE, initiated the fight) and used that erroneous observation to bolster the court's conclusion that HCRE "pursued" the POC in bad faith. HCRE Br. at 23. Highland's argument that HCRE's opposition to the Disqualification Motion was itself "baseless" appears rooted in the bizarre (and false) contention that HCRE somehow hid Wick Phillips' prior joint representation of Highland and HCRE from the ethics expert hired to opine regarding whether that representation posed a disqualifying conflict. *See* Highland Br. at 31–32 & n.81. According to Highland, McGraner failed to disclose Wick Phillips' prior joint representation to HCRE's expert, thus discrediting any testimony offered by that expert in support of HCRE's opposition to disqualification. Putting aside that this argument is totally irrelevant—both because it has never been raised before and because it is not part of the evidence the bankruptcy court relied upon in finding bad faith—it is also false. As McGraner testified, he had nothing to do with hiring the lawyers associated with Project Unicorn and did not specifically know what they did (even at the time of the hearing on the POC). ROA.0100196 at 128:17–24. However, he testified that he

believed that Wick Phillips did the "dirt work"—i.e., legal work associated with the actual property acquisition rather than the LLC agreement in dispute. ROA.010195 at 127:7–10. And as HCRE's ethics expert, Ben Selman testified, he was hired *specifically to testify about whether the prior joint representation posed a disqualifying conflict.* ROA.012325-26 at 57:11–58:17. Accordingly, he was readily aware of the joint representation when he gave his expert opinion. And Selman's testimony was consistent with McGraner's: he opined that the prior representation was not a conflict requiring disqualification because Wick Phillips' work for Highland had nothing to do with the amended LLC agreement or the Revised Allocation. ROA.012327 at 59:9–17. In light of this testimony, Highland's argument that HCRE's position in response to the Disqualification Motion was "baseless" (and itself made in bad faith) cannot be credited.

Next Highland argues that HCRE's "sudden" attempt to withdraw the POC "without explanation" justifies the bankruptcy court's bad faith finding. But HCRE did give an explanation for its motion to withdraw, as the evidence cited by HCRE demonstrates. *See* HCRE Br. at 11 (citing ROA.001766). By contrast, the only evidence Highland cites to support its argument is the bankruptcy court's rank speculation that HCRE's withdrawal motion was "gamesmanship." Highland Br. at 32. As HCRE explained in its opening brief, the Fifth Circuit has held—in reversing another Judge Jernigan sanction order—that "the bankruptcy court's mere

suspicions do not add up to clear and convincing evidence of bad faith." HCRE Br. at 35 (citing *Moore*, 739 F.3d at 731). HCRE does not attempt to distinguish *Moore* or explain why the bankruptcy court's mere suspicion of gamesmanship could support a finding of bad faith in this case.

Finally, Highland repeats the bankruptcy court's erroneous assertion that "before, during, and after the hearing on the Withdrawal Motion, HCRE sought to preserve its claims for another day." Highland Br. at 3, 31–32. Again, however, there is no evidence in the record to support this assertion, and Highland cites none. Instead, Highland cites to its own legal arguments at pages 19–22 of its brief. *See* Highland Br. at 33. Those pages likewise contain no citation to *any* evidence demonstrating that HCRE attempted to preserve its POC for another day or even "hedged" about that issue, as Highland now argues. Indeed, the *only* relevant "evidentiary" citations on pages 19-22 of Highland's brief are to (1) HCRE's opening brief in this appeal, where HCRE argues that it did *not* attempt to preserve its claims; (2) HCRE's opposition to Highland's objection to the POC, which (as explained above) merely posited potential legal theories that might support the POC; and (3) a single remark made by HCRE's counsel in closing arguments at the evidentiary hearing on the POC. *See id.* at 19–22 & nn. 62–65. In that remark, HCRE's counsel argued that it would be improper for the bankruptcy court to "make findings" in its order disallowing the POC stating that HCRE could not raise "other

issues, recissions, stays, et cetera, going forward." ROA.011084-85 at 180:17–181:2 (cited in Highland Br. at 22 n.65). Counsel's point was hardly controversial: a bankruptcy court's order on a proof of claim is limited to allowing or disallowing that particular claim, and it would be improper for the court in that context to make findings of fact or rulings of law regarding *other*, future issues or claims not before the court. In any event, that single remark made by HCRE's counsel is hardly "clear and convincing" evidence that Highland tried to preserve the substance of its POC for another day.

C. Highland's Analysis of "But For" Causation is Wrong

In its opening brief, HCRE argued that the sanctions award should be vacated in its entirety because there is insufficient evidence of bad faith to support the bankruptcy court's invocation of its inherent authority. HCRE Br. at 41–42. But in addition, HCRE argued that the requisite "causal link" between HCRE's supposed bad behavior and the sanction awarded was missing, further warranting reversal of the sanction. *Id.* at 42–45. In particular, HCRE argued that it was the bankruptcy court's (and Highland's) refusal to accept the withdrawal of HCRE's proof of claim *with prejudice*—as HCRE repeatedly offered—that caused all parties to incur hundreds of thousands of dollars of additional fees.

In response, Highland makes three arguments, none of which makes any sense. First, Highland argues that had it just "taken the win" and consented to

HCRE's withdrawal of the POC with prejudice, that victory "would have been pyrrhic" because "Highland's interest in SE Multifamily would have remained subject to challenge." Highland Br. at 37; *see also id.* at 3 (arguing that the bankruptcy court required "ironclad" language in any order approving withdrawal that the issues in the POC would not be litigated in the future). But as HCRE pointed out in its opening brief, the bankruptcy court's order disallowing the POC does not contain *any* of the "ironclad" language that Highland now insists was required to prevent a full-blown evidentiary hearing. *See* HCRE Br. at 44–45. The order does not say that Highland would hold a 46.06% interest in SE Multifamily in perpetuity. *See* ROA.010764. It does not say that HCRE can never again raise issues of modification, reformation, or rescission in challenging the SE Multifamily LLC agreement or its members' interests under that agreement. *Id.* And the order does not even disallow the POC "with prejudice." *Id.* In other words, Highland is indeed in the exact same position it would have been had it accepted HCRE's withdrawal of the POC.[3]

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[3] Highland also attempts to distinguish the Fifth Circuit's ruling in *The Charitable DAF Fund, L.P. v. Highland Cap. Mgmt., L.P. (In re Highland Cap. Mgmt., L.P.)*, 98 F.4th 170, 175 (5th Cir. 2024), in which the Fifth Circuit reversed a sanction issued by Judge Jernigan as impermissibly punitive because the requisite causal link between the contemnor's alleged actions and the sanction was lacking. According to Highland, *Charitable DAF Fund* is inapposite because there, unlike here, the contemnor's "*only* contumacious conduct" was filing a motion in the wrong court, whereas here, the bankruptcy court's sanction awarded "fees and costs incurred only as a result of HCRE's bad-faith conduct." Highland Br. at 38–39. That is a distinction without a difference. As HCRE

Further, as the Fifth Circuit and this Court have held, the voluntary dismissal of a claim "with prejudice" has the *same legal effect* as a final judgment on the merits—either way, res judicata bars the claimant from relitigating the claim. *See, e.g.*, *Derr v. Swarek*, 766 F.3d 430, 441 (5th Cir. 2014) ("If the plaintiff chooses to extinguish his rights forever[,] he is entitled to do so, and *the defendant will reap the benefit of a res judicata bar to any attempt by the plaintiff to re-litigate the dismissed claims*.") (emphasis added); *Houston v. Citi Mortgage Corp.*, 2016 WL 3182003, at *3 (N.D. Tex. June 8, 2016) ("'Plaintiff's voluntary dismissal with prejudice is the legally operative principle necessary to satisfy res judicata's requirement of a final judgment.'") (quoting *Arias v. Napolitano*, 2014 WL 2987109, at *1 (S.D. Ohio July 2, 2014), *aff'd*, 599 Fed. App'x 242 (6th Cir. 2015)). Given this legal reality, Highland does not and cannot explain why withdrawal of HCRE's POC "with prejudice" would have been "pyrrhic," much less how Highland is better off now than it would have been had it just consented to the withdrawal.[4]

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pointed out in its opening brief, the very problem with the bankruptcy court's sanction in this case is that *it is not tethered to HCRE's conduct* in any meaningful way, which was the precise problem in *Charitable DAF Fund*. *See* HCRE Br. at 41–45. Highland's mere insistence that there is a but-for causal link does not make it so, as the evidence squarely demonstrates.

[4] Notably, HCRE did not appeal the bankruptcy court's denial of HCRE's motion to withdraw the POC because HCRE repeatedly committed to "waive" any appeal relating to its POC in an effort to demonstrate to the court that HCRE did not seek to relitigate its claim or to obtain a tactical advantage by withdrawal. *See* HCRE Br. at 14–17.

Second, Highland argues that HCRE failed to meet any of the *Manchester* factors for withdrawing its claim, which—according to Highland—is evidence that the withdrawal motion was filed in bad faith. Highland Br. at 37. This argument is largely irrelevant—the bankruptcy court did not tether its sanction to HCRE's failure to meet the *Manchester* factors. But it is also strange to suggest that HCRE's legal position taken in the motion to withdraw was itself bad faith, particularly in light of the federal courts' liberal standards for allowing withdrawal of claims. As Judge Houser explained in *Manchester*, "since the general policy under Rule 41(a) is to permit withdrawal of a complaint, withdrawal of a proof of claim should be permitted unless that withdrawal results in a 'legal harm' or 'prejudice' to a non-moving party." *In re Manchester*, Case No. 08-03163-BJH, 2008 WL 5273289, *3 (Bankr. N.D. Tex. December 19, 2008) (Houser, C.J.). Moreover, as HCRE pointed out in its withdrawal motion, "legal prejudice" in this context means some significant prejudice to a legal interest, claim, or defense, such as when dismissal would strip a litigant of an important legal position (e.g., the statute of limitations), or where dismissal is requested to avoid an adverse ruling. *See* ROA.001769 (citing cases). By contrast, the prospect of a second lawsuit (the type of prejudice cited by the bankruptcy court and Highland), or the fact that plaintiff may obtain some tactical advantage, are *not* sufficient to establish legal prejudice under *Manchester*. *Id*. (citing cases). In other words, in all likelihood, the bankruptcy court got the

Manchester analysis wrong, and that analysis should not inform whether the court appropriately shifted fees incurred after the withdrawal hearing.

Highland lastly argues that HCRE's failure to proffer a proposed order on the withdrawal motion justifies the bankruptcy court's shifting of $375,000 in legal fees to HCRE. That argument on its face does not pass the smell test, but it is also highly misleading. As Highland acknowledges, the bankruptcy court requested that *the parties* submit a proposed order on the motion to withdraw. Highland Br. at 12 n.31; *see also* ROA.002849–50 at 57:18–58:1. Thus, an order proposed unilaterally by HCRE would not have sufficed. That *the parties* could not agree on a proposed order is the fault of both parties, not one. Further, as HCRE pointed out in its opening brief, the bankruptcy court was well within its discretion to grant the motion to withdraw on any conditions it saw fit. HCRE Br. at 47 (citing Fed. R. Bankr. P. 3006). In other words, the bankruptcy court could have crafted an order granting the motion to withdraw that contained the bevy of conditions that the court and Highland now insist were required (but that the bankruptcy court dd not give even after a full evidentiary hearing on the merits). That the bankruptcy court chose not to do so is not HCRE's fault. To the extent the bankruptcy court chose to shift $375,000 of fees to HCRE for this failure, that was an abuse of discretion.

Under the circumstances, there can be no question that Highland could have avoided incurring an additional $375,000 in legal fees had it simply agreed to

HCRE's offer to withdraw the POC with prejudice. That Highland and the bankruptcy court refused that offer is a problem of their own making, not HCRE's. The requisite causal link between HCRE's actions and the sanction is lacking, and the sanction should be reversed.

D. Highland's Arguments About the Reconsideration Motion are Wrong

In support of the bankruptcy court's order denying reconsideration, Highland simply regurgitates the same bases the bankruptcy court cited in its order denying the relief. Yet again, Highland merely repeats the bankruptcy court's factually baseless findings that HCRE (1) refused to agree to withdraw the proof of claim with prejudice, (2) failed to submit an order to the court permitting the withdrawal of HCRE's POC, and (3) supposed attempts to "preserve" the POC. Highland Br. at 40-42. These arguments are no more availing in justifying the bankruptcy court's order on reconsideration than they are in justifying the court's finding of bad faith. Yet again, Highland fails to point out any evidence to support its or the bankruptcy court's reasoning. And yet again, it is clear from the record that the bankruptcy court's findings were in direct contravention of the evidence.

At the end of the day, neither the bankruptcy court nor Highland addresses the actual record, which HCRE cited extensively in its opening brief. As HCRE pointed out, the company and its representatives stated *three different times* that the

company was willing to withdraw the POC with prejudice and to forego any appeals relating to the claim. HCRE Br. at 14–19. HCRE even agreed not to challenge Highland's interest in SE Multifamily. *Id.* at 14–17. In pressing its argument that the facts did not unfold as the record reveals, Highland cites a single quote from the motion to withdraw hearing. *See* Highland Br. at 41. But the cited quotation is the bankruptcy court asking HCRE if it was willing to withdraw its claim with prejudice. *Id*. Highland conveniently fails to cite HCRE's immediate response to that question, stating unequivocally that it was willing to do just that. ROA.002825 at 33:5–7. If this Highland's best evidence-based defense of the bankruptcy court's order denying reconsideration, it is no defense at all.

Further, Highland's repeated assertion that HCRE could and should have submitted an order on the motion to withdraw is wrong for the reasons set forth above. As Highland acknowledges, the bankruptcy court requested an *agreed* order *from the parties* to grant the withdrawal of the POC, not some unilateral order from HCRE. *See* Highland Br. at 12 n.31; *see also* ROA.002849–50 at 57:18–58:1. That HCRE could not obtain Highland's agreement is the fault of both parties, not just the fault of HCRE.

The bankruptcy court's refusal to rectify obvious errors of fact when given an opportunity to do so was an abuse of discretion and provides an additional reason to reverse the bankruptcy court's orders and vacate the sanction awarded.

III. CONCLUSION

For all the foregoing reasons, the bankruptcy court erred in invoking its inherent power to sanction HCRE, and the Court should reverse that order and vacate the sanction in its entirety.

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Respectfully Submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that on November 12, 2024, a true and correct copy of this document was served electronically via the Court's CM/ECF system to the parties registered or otherwise entitled to receive electronic notices in this case.

/s/ Amy L. Ruhland
Amy L. Ruhland

CERTIFICATE OF COMPLIANCE

I hereby certify that this document complies with the type-volume limitations of Federal Rule of Bankruptcy Procedure 8015(h) as it contains 6,173 words, excluding the portions of the document exempted by 8015(g).

I further certify that this document complies with the typeface requirements of Rule 8015(a)(5) and the type-style requirements of Rule 8015(a)(7)(B) because it has been prepared in a proportionally spaced typeface using Microsoft Word in 14-point Times New Roman.

/s/ Amy L. Ruhland
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