Discovering Fraud Post-Confirmation: Is there recourse after 180 days?

By Erica Harris

Section 1144 of the United States Bankruptcy Code allows a party in interest to seek revocation of a confirmation order[1] within 180 days if the confirmation order was procured by fraud. Section 1144 is strictly construed; in order to promote the finality of bankruptcy confirmations, any challenge to the confirmation order brought after 180 days is untimely and barred.[2]

What happens, then, when a client does not discover fraud until after a plan has been confirmed and the 180 day grace period has passed? Will the general release and injunctive provisions found in most confirmed plans bar a subsequent civil action for relief? Will those provisions stand even where a non-debtor defendant actively worked to conceal the fraud until long after confirmation?

The courts that have addressed the issue have found that Section 1144 is the only available means to *revoke* a confirmation order but is not the exclusive remedy for fraud.[3] Instead, where the action is truly independent such that the claims would not "upset the confirmed plan," a civil action outside Section 1144 may proceed.[4]

However, in determining whether actions are "truly independent," courts diverge substantially in their analysis and outcome. A comparison of *Genesis Health Ventures, Inc. v. Goldman Sachs & Co.*,[5] and *In re California Litfunding*,[6] illustrates the problem.

In *Genesis Health Ventures,* the plaintiff filed a civil action two years after plan confirmation, alleging that parties to the bankruptcy had "cooked" the debtor company's actual and projected EBITDA. The plaintiff alleged that the non-debtor defendants' fraud resulted in a low valuation of the debtor company that resulted in "senior creditors [receiving] almost all of the equity in the reorganized company, while Plaintiffs received almost nothing."

The plaintiff claimed it could not have reasonably known of the fraud until long after the plan had been confirmed. The plaintiff alleged that information revealing the fraud was not published until months after the confirmation of the plan: a subsequently published 10K revealed that reserves had doubled in a year; a 10Q revealed a business that had been represented as being lost was not lost; cost of goods sold was later published to be much lower than presented in the bankruptcy; and certain substantial revenues were revealed to have been excluded from income (and EBITDA) during the relevant period.

Despite this, the fraud could have been discovered if the documents produced in the bankruptcy had been carefully analyzed. As a prior opinion in that case made clear:

> Plaintiffs do not contend that the defendants' wrongfully concealed material facts from them prior to confirmation. Rather, the plaintiffs contend that the documents produced by the defendants prior to confirmation were too voluminous to review adequately, that there was insufficient time to review the materials thoroughly, and that the materials were not reviewed to ferret out fraud, because the prospect of fraud had been committed in connection with management assumptions and adjustments to EBITDA was not yet apparent.[7]

In light of these facts, the court considered whether the action was "truly independent" or whether the action amounted to an attempt to revoke the confirmed plan and "redivide the pie." In holding that the action would not redivide the pie, the court reasoned as follows:

> What if a creditor filed a false or inflated claim and this fact was not discovered prior to plan distributions and was discovered more than 180 days after plan confirmation? The effect would be to unfairly inflate that creditor's distribution while deflating the distributions to other similarly situated creditors. Why deny the adversely affected creditors from pursuing a fraud claim against the wrongdoing creditor, with no impact on the reorganized debtor or the plan? In this Court's view, under the facts alleged here (assuming they are proven at trial), there ought to be a remedy to redress the harms suffered and a mechanism to divest the alleged tortfeasors of their ill-gotten gains, at least where doing so would not affect innocent parties.[8]

Because the guilty creditors would have to satisfy a judgment out of their own pockets, the court found that the plaintiff's action was not a collateral attack on the confirmation order such that section 1144 would be applicable. In addition, the court found that because the plaintiff alleged that defendants had concealed their fraud until after confirmation, the claims were not barred by *res judicata*.

The court in *Litfunding* approached the same general analysis very differently. Just as in *Genesis Health Ventures* court in *Litfunding* considered whether the civil action was "truly an independent cause of action" that would not upset the confirmation order. On very similar facts, however, the *Litfunding* court reached an opposite conclusion.

As in *Genesis Health Ventures*, the plaintiffs in *Litfunding* argued that the fraud could "not have been raised preconfirmation as it was not discovered until after confirmation." The Court rejected this argument:

> The facts that purport to give rise to the fraud were the same statements that were either provided in or omitted from the Debtors' Disclosure Statement. . . . In the exhibits that were attached to the Disclosure Statement and the settlement letter between the parties, the list of all pending cases constituting the "Contract Pool" from which cash flow distributions are to be made, the history/analysis of collections from the Contract Pool, and the projections of gross collection from the Contract Pool include the cases from Ravis who, according to Plaintiffs, entered into a "secret loan" with the Weiner Trust. [9]

The court reasoned that because "[t]he alleged fraudulent representations were available for investigation months before the hearing on confirmation and indeed, months after plan confirmation," the plaintiffs "could have (and should have) conducted their due diligence and investigated the accuracy (or inaccuracy) of the statements made in or omitted from the Disclosure Statement."

As in *Genesis Health Ventures*, the *Litfunding* plaintiffs argued that they could not have known to investigate the accuracy of the statements because the defendants concealed their fraud until after confirmation and that even if they had undertaken an investigation, they would not have been able to discover the secret transaction between two of the defendants that served to conceal the fraud. The Court rejected this argument as well, reasoning that even without that information:

> Plaintiffs were convinced, based on their own expert's opinion, that the Defendants were "lining their pockets with corporate funds derived from their investments and engaging in 'bad acts and financial mismanagement'"

> and never believed the Debtors' projections and representations in the Disclosure Statement. . . . While it may be true that Plaintiffs' may not have voted to accept the Plan or executed the Settlement Agreement if they were aware of the acts of fraud discovered postconfirmation, the events leading up to Plan confirmation suggest that the parties disputed the amount of the proceeds to be collected from the litigation investments comprising the Contract Pool under the Plan. These are the same operative facts that gave rise to the allegations of fraud that they could have investigated and discovered preconfirmation.[10]

Finally, the court concluded that even though the plaintiffs sought only damages from the non-debtor defendants, that claim would nonetheless upset the confirmed plan because others in plaintiff's position would also have a right to sue, and defendants would never have agreed to the settlement in the bankruptcy without the release from plaintiffs. The court reasoned that if the fraud vitiated part of the release then it should vitiate all of the release so that any monies paid to plaintiffs pursuant to the settlement agreement and those who stood in a similar position would have to be undone.

The *Litfunding* analysis is remarkable for several reasons. First, it incentivizes defendants to go to great lengths to conceal their fraud until after confirmation. If a defendant successfully conceals his fraud until 181 days post-bankruptcy, the defendant will be insulated from suit since the representations that were fraudulent were made during the bankruptcy. Second, it compels a plaintiff to conduct exhaustive discovery during the bankruptcy proceeding even where she has no reason to suspect fraud. Because a failure to discover fraud will serve as an absolute bar, a plaintiff will have to go to great expense to protect against the risk of fraud. Finally, because standard releases are mutual and there are generally multiple parties in interest that would be affected by a fraud during bankruptcy, any civil action for damages even if against only one non-debtor defendant will be construed as a collateral attack on the confirmation order. This last holding of the *Litfunding* court begs the question of what civil action could ever be deemed a "truly independent action" that would be allowed to proceed in that court's judgment.

The majority of courts appear to follow *Genesis Health Ventures*. Civil actions brought against non-debtor defendants that seek only monetary relief from the non-debtor defendants are allowed to proceed so long as the alleged fraud claims were not previously tried in the bankruptcy court. Until the United States Supreme Court rules, however, parties in interest beware.

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[1] 11 U.S.C. § 1144.

[2] *See In re Midstate Mortgage Investors, Inc.*, 105 Fed. Appx. 420, 423 (3d Cir. 2004) ("Expiration of the limitations period bars a motion to set aside the confirmation of a reorganization plan even if the fraud is not discovered until the period has passed.").

[3] *Browning v. Prostok*, 165 S.W.3d 336, 344-45 (Tex. 2005) (citing *In re Newport Harbor Assocs.*, 589 F.2d 20, 23-24 (1st Cir. 1978)). *See also In re Coffee Cupboard, Inc.*, 119 B.R. 14, 19 (E.D.N.Y. 1990) ("Section 1144 does not act as a bar to a truly independent courses of action based on a debtor's wrongful conduct.").

[4] *Donaldson v. Bernstein*, 104 F.3d 547, 777 (3d Cir. 1997) (quoting *Newport Harbor Assocs.*, 589 F.2d at 24); *Genesis Health Ventures, Inc. v. Goldman Sachs & Co.*, 355 B.R. 438, 445 (D. Del. 2006) (finding that §1144 did not apply to claims brought two years after confirmation for fraud and conspiracy to defraud

against non-debtor defendants because the claims would not "redivide the pie"); *S.N. Phelps & Co. v. Circle K Corp*., 181 B.R. 457, 462 (Bankr. D. Ariz. 1995) (holding §1144 inapplicable to plaintiff's claim that valuation in bankruptcy had been misrepresented; "[i]f plaintiffs prevail, the Court can fashion a remedy that does not upset the confirmed plan, i.e., monetary damages."); *In re Crown-Globe, Inc*., 107 B.R. 60, 61 (Bankr. E.D. Pa. 1989) (allowing claims of breach of third party beneficiary contract, international misrepresentation and negligent misrepresentation to proceed, while barring a claim for equitable subordination); *In re Emmer Bros. Co*., 522 B.R. 385, 392 (D. Minn. 1985) (holding time limitation in §1144 inapplicable to post-confirmation discovery of fraudulent conduct).

[5] 355 B.R. 438, 445 (D. Del. 2006)

[6] 360 B.R. 310 (C.D. Ca. 2007)

[7] *In re Genesis Health Ventures, Inc*., 340 B.R. at 734.

[8] *Id.*

[9] *In re California Litfunding*, 360 B.R. at 319.

[10] *Id*.