Unscrambling the Egg or Redividing the Pie?

Revoking a Chapter 11 Plan Confirmation Order

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Confirmation of a chapter 11 plan providing for the reorganization or liquidation of a debtor and dealing with the claims and interests of various stakeholders is the culmination of the chapter 11 process. In keeping with a fundamental policy promoting the finality of the chapter 11 process, the general rule is that a final confirmation order is inviolable. The absence of certainty that the transactions effectuated under a plan are valid and permanent would undermine chapter 11's fundamental purpose as a vehicle for rehabilitating ailing enterprises and providing debtors with a fresh start.

Even so, a final order confirming a chapter 11 plan can be revoked under very limited circumstances. Precisely what those circumstances are was the subject of a pair of rulings recently handed down by the courts. In *In re Genesis Health Ventures, Inc.*, the Delaware district court held that investors' allegations of pre-confirmation fraud against a chapter 11 debtor represented a disguised attack on the confirmation order and were therefore barred as having been brought more than 180 days after the order was entered. A New York bankruptcy court also denied a challenge to its order confirming a chapter 11 plan in *In re Trico Marine Services, Inc.*, ruling that it would not revoke the order as allegedly procured by fraud because, pursuant to the debtor's plan, new common stock distributed to noteholders and sold to the public had already been widely traded and it was not possible either to restore the *status quo ante* or to protect the investing public.

Revocation of an Order Confirming a Plan

Section 1144 of the Bankruptcy Code provides that, upon the request of a party-in-interest made within 180 days after the entry of an order confirming a chapter 11 plan, the bankruptcy court "may revoke such order if and only if such order was procured by fraud." In the event that the court exercises its discretion to revoke a confirmation order, the statute further provides that the revocation order "shall" (i) contain such provisions as are necessary to protect any entity acquiring rights in good faith reliance on the confirmation order, and (ii) revoke the debtor's discharge. Section 1144 is designed to restore the parties to their pre-confirmation positions, as long as the rights of third parties who relied on the plan in good faith are protected. The extreme difficulty of doing so in many cases means that revocation is regarded as a "drastic remedy."

The 180-day period specified in section 1144 is absolute. Unlike certain other deadlines contained in the Bankruptcy Code, it may not be extended by the court, even if fraud in procuring a confirmation order is not discovered until after the 180-day period expires. This rule represents a compromise between the strong bankruptcy policy against recognizing the validity of a chapter 11 plan procured by fraud and the equally strong policy promoting the finality of a confirmation order.

The court must specifically find that the order was procured by fraud before revoking a confirmation order. The fraud need not have been committed by the debtor or any other proponent of the plan. Fraud committed during a chapter 11 case that is unrelated to plan confirmation is not a basis for revocation — the bankruptcy court can implement other remedies designed to punish the malefactor or remedy any resulting harm, such as the entry of a judgment against the perpetrator. Section 1144, unlike its predecessor provision under the former Bankruptcy Act, does not require on its face that the party seeking revocation have been unaware of the fraud at the time the plan was confirmed. A defense frequently invoked in connection with a revocation request is that the party seeking revocation knew or should have known of the fraud prior to confirmation. Unless the party in question is the plan proponent, who has affirmative duties of disclosure and good faith, such knowledge is not a bar to revocation under section 1144, although the party seeking revocation may be required to justify its failure to call the fraud to the court's attention when it occurred.

Section 1144 does not explain the meaning of "fraud." As a consequence, it has been left to the courts to fashion a definition. They have done so by looking to the traditional elements of fraud under common law and precedent construing section 1144, the revocation provisions under other chapters of the Bankruptcy Code and their predecessors under the former Bankruptcy Act, all of which are similar enough to be informative in assessing the kind of conduct that can justify revocation of an order confirming a chapter 11 plan. Many courts construe "fraud" in section 1144 to mean "fraud on the court." In addition, most courts require a showing of actual fraudulent intent. The fraud can consist of either material misstatements or omissions in the face of a duty to disclose information.

Even if it finds that actionable fraud was committed, the bankruptcy court is not obligated to revoke a confirmation order. Section 1144 gives the court considerable discretion to fashion whatever remedy is appropriate under the circumstances to achieve an equitable outcome. If, for example, it is too late to remedy fraud or impractical to revoke a confirmation order and restore the *status quo ante*, the court may exercise its discretion to deny revocation in lieu of other more effective and less disruptive remedies.

Any order revoking a plan under section 1144 must "protect any entity acquiring rights in good faith reliance on the confirmation order." The myriad transactions provided for under a chapter 11 plan, including distributions to creditors, asset sales, lease assignments, the incurrence of new indebtedness in the form of exit financing and the cancellation and/or issuance of stock and other securities to existing creditors, private investors and the public would in many cases be extremely difficult or impossible to undo once they have occurred. For this reason, any relief ordered under section 1144 must be fashioned to protect the legitimate expectations of any stakeholder not involved in the fraudulent conduct.

Application of the Doctrine of Equitable Mootness

Protecting the legitimate expectations of innocent stakeholders and the difficulty of "unscrambling the egg" are issues that a court is obligated to consider when confronted with any kind of challenge to a confirmation order, whether or not it involves a request to revoke the order under section 1144. Courts faced with various kinds of challenges to a confirmation order will sometimes reject the assault under the "doctrine of equitable mootness" because it is simply too late or too difficult to undo what has already been done.

A court will dismiss a proceeding challenging an order confirming a chapter 11 plan as moot if such relief, although possible, would be inequitable under the circumstances given the difficulty of restoring the *status quo ante* and the impact on all parties involved. The threshold inquiry in applying the doctrine is ordinarily whether a chapter 11 plan has been "substantially consummated" (*i.e.*, substantially all property transfers contemplated by the plan have been completed, the reorganized debtor or its successor has assumed control of the debtor's business and property and plan distributions have commenced). If so, a court is more likely than not to reject a challenge to a confirmation order, even if it is mounted within the statutory period prescribed by section 1144.

The difficulty of protecting blameless stakeholders and/or undoing a series of complicated transactions effectuated under a plan has led many courts to deny revocation. These concerns figured prominently in the courts' rulings in *Genesis Health Ventures* and *Trico Marine*.

Genesis Health Ventures

Genesis Health Ventures, Inc. ("Genesis"), a provider of health care services to the elderly from approximately 200 assisted living and skilled nursing facilities in 12 states, filed for chapter 11 protection in 2000 in Delaware. In the following year, Genesis filed a joint plan of reorganization together with its affiliate Multicare AMC, Inc. ("Multicare"). The bankruptcy court confirmed the plan on September 21, 2001.

Prior to confirmation, Genesis' capital structure included approximately $400 million in senior subordinated notes and nearly $1.3 billion in senior debt. About half of the latter had been purchased by Goldman Sachs & Co. ("Goldman") shortly before the debtors filed for bankruptcy. Goldman was the largest senior creditor of both Genesis and Multicare, and underwrote both debtor-in-possession and exit financing extended to the companies during and upon emergence from the chapter 11 cases. The plan effectuated a merger of Genesis and Multicare, extinguished both companies' existing common stock and distributed 94% of the newly-issued stock of the reorganized, combined entities to Goldman, Highland Capital Partners ("Highland"), another senior debt participant, and Mellon Bank N.A. ("Mellon"), the debtors' lead senior lender bank (collectively, the "Senior Lenders"). Junior creditors (including subordinated noteholders) received a dividend of approximately 7.3%, plus warrants to purchase new common stock.

During the months following confirmation, information came to light that cast into doubt the veracity of the historical and projected earnings figures presented by the debtors in support of their joint chapter 11 plans. Two and a half years after confirmation, 275 investors who collectively held 55% of the senior subordinated notes (more than $205 million in face value) sued Genesis, its chief financial officer and the Senior Lenders. In their complaint, the plaintiffs alleged that the Senior Lenders "conspired with Genesis management to put the Company into bankruptcy and 'cram down' a reorganization plan that would eliminate junior creditors (including plaintiffs) and existing stockholders, while conveying virtually total ownership of Genesis to the senior creditors."

According to the plaintiffs, the enterprise value of Genesis was misrepresented at confirmation as being about $1.3 billion, based upon depressed earnings figures, when it was actually much higher. The complaint stated causes of action for fraud, conspiracy to commit fraud and gross negligence, alleging, among other things, that (i) the Senior Lenders, collaborating with Genesis' chief financial officer, controlled and manipulated the process by which earnings and other financial information were provided to creditors in connection with confirmation of the plan of reorganization; (ii) by virtue of their position as senior creditors of the debtor, and as proponents of a bankruptcy reorganization plan that would drastically affect the junior creditors, the defendants owed the junior creditors a duty of care, including the duty to provide fair, accurate and complete information; and (iii) the defendants violated that duty of care by disseminating false and misleading financial information that misled the bankruptcy court and the plaintiffs concerning the true financial condition and prospects of Genesis.

If Genesis had been properly valued, the plaintiffs claimed, there would have been sufficient value for the subordinated noteholders to recover the full par value of their notes. The plaintiffs contended that they did not have an opportunity to discover the alleged fraud before the bankruptcy court confirmed the debtors' chapter 11 plan because they did not receive certain of the voluminous earnings reports until six days prior to the confirmation hearing.

The defendants moved to dismiss the complaint, contending that it was untimely under section 1144, and that the claims asserted should be rejected under the doctrines of *res judicata* and collateral estoppel. The bankruptcy court granted the dismissal request, ruling that the plaintiffs' claims against Genesis were time barred because they were asserted more than 180 days after confirmation of Genesis' chapter 11 plan. The court also held that the claims asserted against the remaining defendants were precluded under the doctrines of *res judicata* and collateral estoppel because such claims were "so close to the claim actually liquidated at confirmation" that they should have been asserted at that time. According to the court, the complaint simply attempted to "add additional factual bases to the allegation that the debtor was misvalued."

The plaintiffs fared no better on appeal to the district court, at least with respect to their claim against Genesis under section 1144. Explaining that the 180-day period specified in the statute is "strictly construed," the district court emphasized that courts have adopted a "wider approach" to section 1144 by construing the scope of its proscription to encompass requests for relief that are not expressly denominated as "revocation," but nevertheless represent indirect attacks on the finality of a confirmation order after the period has expired. Independent causes of action based upon a debtor's wrongful conduct, the court noted, are not barred by section 1144. Even so, the district court cautioned, courts must carefully scrutinize such claims to ensure that they are not "an attempt to redivide the pie by a disgruntled participant in a Plan." A truly independent cause of action, the court observed, can be maintained "at least where the alleged fraud could not have been asserted in the bankruptcy proceedings, the underlying factual claims were not actually adjudicated, and the relief sought would not upset the confirmed plan of arrangement."

The bankruptcy court found that awarding money damages to the plaintiffs would be to "redivide the pie, to upset the confirmed plan, and to negatively affect innocent parties and creditors." The district court did not fault its reasoning on appeal, affirming dismissal of the plaintiffs' claims under section 1144 against Genesis. Because, however, the bankruptcy court never addressed whether the time bar in the statute should also apply to the Senior Lenders and Genesis' CFO, it remanded the case below for consideration of that issue. The district court also vacated the order below dismissing the plaintiffs' claims on the basis of *res judicata* and collateral estoppel. In ruling to dismiss, the district court explained, the bankruptcy court did not properly consider the claim that information casting doubt on the veracity of reported earnings only first came to light after confirmation of the plan and other related allegations. It accordingly remanded that issue below as well for additional consideration.

Trico Marine

Another aspect of section 1144 — the court's discretion to refuse revocation if it would be impossible to restore the *status quo ante* and protect innocent third parties — was the subject of the bankruptcy court's ruling in *Trico Marine*. Trico Marine Services, Inc. and two affiliates ("Trico") filed "prepackaged" chapter 11 cases in New York on December 21, 2004. At the time, Trico had approximately $400 million in debt, including approximately $275 million in senior notes.

Under its joint plan of reorganization, Trico proposed to exchange the notes for 100% of the reorganized entity's new common stock, subject to dilution based upon the grant of certain options and warrants. The noteholder class was the only impaired class entitled to vote on the plan and voted to accept it. Trico's existing shareholders received nothing under the plan. Under a separate "plan support agreement" between Trico and the noteholders, however, the noteholders agreed that Trico's existing shareholders would receive warrants that could be exercised for up to 10% of the new common stock.

The bankruptcy court confirmed Trico's plan of reorganization on January 21, 2005. On March 15, 2005 (the plan's effective date), Trico distributed ten million shares of new common stock to its noteholders and nearly one million warrants to its old stockholders.

Steven and Gloria Salsberg (the "Salsbergs"), holders of old common stock that was converted to warrants on the effective date of Trico's chapter 11 plan, commenced litigation in the bankruptcy court on May 19, 2005 seeking revocation of the confirmation order under section 1144. Although the Salsbergs had objected to confirmation of Trico's plan, they chose to seek revocation of the confirmation order rather than appealing it. According to the Salsbergs, Trico's chief financial officer intentionally and significantly underestimated the company's projected revenue when he testified at the confirmation hearing. Based upon this alleged fraud on the court, the Salsbergs sought revocation of the confirmation order, cancellation of all the new common stock and warrants and reinstatement of the notes. Any damages incurred as a consequence of unraveling these transactions, the Salsbergs suggested, could be paid from the increased tax benefits (preservation of net operating losses) that would be realized by Trico from not having experienced a change in control in connection with issuance of the new stock.

On October 24, 2005, Trico completed a public offering of an additional 4,273,500 shares of common stock at $24 per share. Reorganized Trico's stock is publicly traded through NASDAQ. Trico moved to dismiss the Salsbergs' complaint on November 28, 2005. Its basis for dismissal was the doctrine of equitable mootness. Treating its request as a motion for summary judgment, the bankruptcy court granted Trico's motion.

The doctrine of equitable mootness, the court explained, is "closely related" to the ability of a court to grant relief under section 1144 — both require the court to consider whether disturbing a confirmation order, although possible, would be inequitable under the circumstances given the difficulty of "unscrambling the egg" and the impact on all parties involved. Because section

1144 spells out the standard to govern a request for revocation, the court acknowledged, it is unclear whether the doctrine of equitable mootness has any role in a revocation proceeding. Still, the court concluded that it need not answer that "thorny" question because the Salsbergs' complaint failed to pass muster under either standard.

According to the court, "[a]lthough the Plan is deceptively simple to describe, it would be exceedingly difficult to unwind and impossible to protect innocent third parties." The plan was substantially consummated in March of 2005, the court noted, and common stock issued under the plan and pursuant to Trico's subsequent public stock offering had been widely traded. Revocation, the court emphasized, would "possibly render the common stock valueless" and convert some unsuspecting shareholders into noteholders by canceling new Trico stock and reinstating the notes, causing "substantial uncertainty that the Court cannot even begin to predict." Finally, the court explained, because the Salsbergs are the only parties seeking to revoke the confirmation order, it would be more practical to leave the order intact and allow the Salsbergs to seek an award of damages if they are able to prove the existence of fraud.

Epilogue

The bankruptcy court in *Trico Marine* granted summary judgment dismissing the action seeking revocation of the order confirming the debtor's plan, but gave the plaintiffs leave to amend their complaint to seek other appropriate relief. Instead, the plaintiffs sought to supplement the evidentiary record with additional information concerning Trico's financial condition. Treating the request as a motion for reargument of its January 6, 2006 ruling, the court adhered to its original disposition.

During the three month period ending on March 14, 2006, the average daily trading volume for Trico's common stock was 143,000 shares. This meant that approximately 13 million of the over 14.6 million shares outstanding as a result of the plan, the public offering and exercised warrants exchanged hands during this period. As a consequence, the bankruptcy court concluded that even if the plaintiffs could prove fraud, the court could not fashion a remedy that would satisfy the requirements of section 1144 because it was impossible to restore the *status quo ante* or protect investors who purchased Trico's new common stock.

Outlook

Genesis Health Ventures and *Trico Marine* illustrate the importance of finality in the context of an order confirming a chapter 11 plan, and the exacting scrutiny that bankruptcy courts will bring to bear on any attempt to attack a confirmation order outside of the normal appellate process. The requirements of section 1144 are strictly construed and a bankruptcy court has considerable discretion to rebuff a challenge to a confirmation order — even in demonstrated cases of fraud — if it concludes that more harm than good would result from revocation or that less drastic remedies are available to remedy misconduct.

Interestingly, neither the Delaware district court nor the New York bankruptcy court felt it necessary to delve too deeply into the allegations of procurement fraud in the cases before them. Such a "bigger picture" approach is precisely what section 1144 was intended to achieve. In a typical chapter 11 scenario, much more is at stake than the parochial concerns of a single disgruntled stakeholder. That is not to say that a court cannot or would not unravel the fabric of a chapter 11 plan by revoking a confirmation order under appropriate circumstances — it means that a court has considerable leeway to decide what is most fair in any given case, based upon the severity of the alleged infraction, its impact on all stakeholders and the likely consequences of revocation.

Finally, courts disagree as to whether section 1144 is the exclusive vehicle for revoking a confirmation order. Some courts have held that it is, while others have ruled that Rule 60(b) of the Federal Rules of Civil Procedure, which specifies several grounds for "relief" from any judgment or order (*e.g.*, mistake, inadvertence, surprise, excusable neglect, newly discovered evidence or fraud) also provides a basis for revocation.

Haskell v. Goldman, Sachs & Co. (In re Genesis Health Ventures, Inc.), 340 B.R. 729 (D. Del. 2006).

Salsberg v. Trico Marine Services, Inc. (In re Trico Marine Services, Inc.), 337 B.R. 811 (Bankr. S.D.N.Y.), *on reargument*, 343 B.R. 68 (Bankr. S.D.N.Y. 2006).

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