

Post-Confirmation Litigation – Be Careful to Describe Your Litigation or it Will be Lost

On August 12, 2008, the Fifth Circuit Court of Appeals decided the case of *United Operating, LLC*.¹ The case sets forth the standard for preserving post-confirmation litigation under a plan of reorganization. In this case, the Fifth Circuit held that post-confirmation litigation must be adequately described in the disclosure statement or the standing to sue is waived. This case is likely to drastically change the way bankruptcy lawyers draft plans of reorganization and disclosure statements in the Fifth Circuit.



Background

Dynasty Oil and Gas, LLC (“Dynasty”) filed its Chapter 11 bankruptcy case in early 2004. Dynasty owned several oil and gas properties that had been out of production since late 2003. Citizens Bank (“Citizens”) was Dynasty’s largest single creditor and moved the court to appoint an operator to bring Dynasty’s properties back into production. The Court appointed Wildcat Energy LLC (“Wildcat”) to operate the oil and gas wells. Citizens was authorized to pay Wildcat’s fees and expenses out of a debtor in possession account.

In November, 2004, a chapter 11 plan of reorganization was confirmed by the bankruptcy court. The plan, in essence, sold all of Dynasty’s assets to Saber Resources LLC. In return for the assets, Saber paid Citizens an amount of \$2.5 million. Unsecured creditors received cents on the dollar and Dynasty’s equity holders were allocated nothing because the estate lacked sufficient funds to pay all claims in full. Even though Dynasty had been a debtor in possession, the plan specified that Dynasty would not be re-vested with title to any estate assets at confirmation because Saber was purchasing essentially all of Dynasty’s assets.² Notwithstanding the fact that the plan did not vest assets in the “reorganized” debtor, the plan did provide that Dynasty and the Official Unsecured Creditors’ Committee retained limited powers to pursue some claims on behalf of the estate.

After the plan was confirmed, the creditors’ committee filed suit against Citizens and Wildcat. The suit alleged various claims under state law and the Bankruptcy Code. The claims were based, among other things, on the committee’s claim that Wildcat completed unnecessary work on various wells and that Citizens wrongfully paid for the work using the debtor in possession bankruptcy account. The court dismissed the Committee state law claims under Rule 12(b)(6). Thereafter, Wildcat was dismissed from the suit and the remaining claims arising under the Code were settled.

¹ *Dynasty Oil and Gas, LLC v. Citizens Bank; et al. (In re United Operating)*, 2008 WL 3306724 (5th Cir., August 12, 2008).

² Although not specifically set forth in the opinion, it would appear that this was done in order to carry out the absolute priority rule.

Subsequently, in March of 2006, Dynasty filed another action in the Texas state court naming Citizens, Wildcat, and their individual representatives. The second action included claims for the completion of unnecessary work on the wells, failure to complete necessary work, and for misrepresentations. The case was filed in Texas state court, which was subsequently removed to the district court and jurisdiction referred to as the bankruptcy court. The bankruptcy court concluded that Dynasty's claims in the second action were barred by the resolution of the first action and granted dismissal on the basis of *res judicata* and collateral estoppel. The district court affirmed the bankruptcy court's decision on both grounds and Dynasty appealed.

Legal Discussion

Although the bankruptcy court and the district court dismissed the second actions on the basis of *res judicata* and collateral estoppel, the Fifth Circuit Court of Appeals decided that the case turned on a more fundamental question of Dynasty's standing. Because standing is a jurisdictional requirement, the Fifth Circuit analyzed this first and determined that Dynasty as a reorganized debtor did not have standing to pursue claims based upon pre-confirmation management or mismanagement of estate assets.

In beginning its analysis, the Fifth Circuit noted that Dynasty, as a debtor in possession, had most of the powers of the bankruptcy trustee during the chapter 11 case to pursue claims on behalf of the estate. This power is granted to the debtor in possession under Section 1107(a) of the Bankruptcy Code. Upon confirmation of the plan, however, the estate ceased to exist, and Dynasty lost its status as a debtor in possession. 11 U.S.C. § 1101(1). Notwithstanding the loss of standing, the court noted that in some cases the Bankruptcy Code allows a reorganized debtor to bring a post-confirmation action on a claim or interest belonging to the debtor or the debtor's estate. 11 U.S.C. § 1123(b)(3). For example, a debtor may preserve its standing to bring such claims but only if the plan of reorganization expressly provides for the claim's retention and enforcement by the debtor. 11 U.S.C. § 1123(b)(3)(B). The Court noted that "[a]fter confirmation of a plan, the ability of the [debtor] to enforce a claim once held by the estate is limited to that which as been retained in the plan." *Id.*, citing *In re Paramount Plastics, Inc.*, 172 B.R. 331, 333 (Bankr. W.D. Wash. 1994).

When preserving a claim, the Court noted that the plan must expressly retain the right to pursue such actions. The reservation must be specific and unequivocal. Thus, if a debtor does not make an effective reservation of standing, it is lost by virtue of the confirmation of the plan. According to the Fifth Circuit "[t]his is a logical consequence of the nature of a bankruptcy, which is designed primarily to 'secure prompt, effective administration and settlement of all debtor's assets and liabilities within a limited time'" reserving specific causes of action has the effect of essentially putting creditors on notice of claims that the debtor may wish to pursue post-confirmation. This allows creditors proper notice and ability to evaluate the plan in light of such reservations of standing before they vote to approve the plan.

Dynasty failed to adequately describe the reserved litigation

The Fifth Circuit held that Dynasty failed to adequately reserve the claims that were brought against the appellees. The plan contained a blanket reservation of "any and all claims" arising under the Code and specifically reserved other

types of claims under the Code such as breach of fiduciary duty and negligence. However, these blanket reservations were held to be insufficient. The court provided that, “[i]f Dynasty had wanted to bring a post-confirmation action for mal-administration of the estate’s property during the bankruptcy, it was required to state as much clearly in the plan.” Because Dynasty did not specifically preserve those claims, they were deemed lost and left the post-confirmation debtor and committee without standing to assert those claims.

Result for Future Chapter 11 Plan

Under the *United Operating* decision, the Fifth Circuit has essentially put the burden on debtors in possession and other plan proponents to specifically identify litigation to be reserved under a plan of reorganization. For the practitioner, this means that a higher level of due diligence will be required prior to proposing and confirming a chapter 11 plan of reorganization. It will require pre-suit analysis before the disclosure statement is approved by the bankruptcy court. Moreover, it would appear that specific reservations will also be required in any plan of reorganization that is ultimately confirmed.

The *United Operating* decision raises unique issues in other circumstances as well. For example, it does not clearly identify whether or not causes of action not known at the confirmation date but which subsequently become known may be reserved under a plan of reorganization. If these claims are not reserved because they cannot be described, this will result in a windfall to potential defendants and a loss to creditor recovery. Another uncertainty that must be considered is whether or not all transactions that may be subject to avoiding powers must be identified in the plan and disclosure statement. For example, if the debtor incorrectly scheduled payments to vendors within the 90 days prior to bankruptcy, claims in excess of those amounts scheduled by the debtor may not be available for avoidance.

While the concept of notice to creditors regarding post-confirmation litigation is a sound fundamental concept, the brightline established in *In re United Operating, LLC* may result in future disputes and uncertainty for counsel proposing plans of reorganization. Therefore when drafting a plan of reorganization a plan proponent must be very careful to identify and reserve litigation in the plan.

Atlanta ■ Washington ■ Dallas ■ Charlotte

One Atlantic Center
Fourteenth Floor
1201 West Peachtree Street, NE
Atlanta GA 30309
Tel: 404.572.6600 | Fax: 404.572.6999

Third Floor
901 New York Avenue, NW
Washington DC 20001
Tel: 202.347.0066 | Fax: 202.624.7222

JP Morgan Chase Tower
2200 Ross Avenue, Suite 3300
Dallas TX 75201
Tel: 214.721.8000 | Fax: 214.721.8100

One Wachovia Center, Suite 3700
301 S. College Street
Charlotte NC 28202
Tel: 704.749.8999 | Fax: 704.749.8990

www.pogolaw.com

For information on topics covered in this alert, please contact:

Keith Aurzada | 214.721.8041 | kaurzada@pogolaw.com

This PoGo Alert is prepared by the Bankruptcy & Financial Restructuring Practice Group of Powell Goldstein LLP as a PoGo service. The information discussed is general in nature and may not apply to your specific situation. Legal advice should be sought before taking action based on the information discussed.