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**A PRIMER: STRATEGIES TO EFFECTIVELY AND EFFICIENTLY MANAGE
LITIGATION IN A POST-CONFIRMATION LIQUIDATION TRUST**

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INTRODUCTION

Whether through a failed reorganization attempt or a “pre-packaged” sale of substantially all of a debtor’s assets, chapter 11 liquidations have become very familiar territory for bankruptcy professionals in recent years. Indeed, today’s debtors often commence chapter 11 proceedings hand-in-hand with their prospective buyers with the intent of selling key assets in an expedited 363 sale or through an expedited liquidating plan process. The remaining estate assets are typically administered through a liquidation trust (*a.k.a.* litigation trust or creditor trust) or a by a plan administrator. The post-confirmation liquidation process can be managed in a cost-effective manner and result in greater recoveries for creditors with strategic planning and the advice of experienced counsel. The focus of this paper is to highlight practical strategies to effectively manage litigation in a post-confirmation liquidation trust.

I. Get Involved in the Plan Process as Early as Possible

(A) Gain Insight and Build Relationships. The plan, the confirmation order and the trust documents approved in connection with the plan, are the central documents guiding a liquidation trust. As such, it is absolutely critical (in a perfect world) that a prospective trustee of a liquidation trust get involved in the plan drafting and approval process as early as possible. First-hand knowledge of the case dynamics and the parties’ respective positions in plan negotiations will give the liquidating trustee invaluable insight when interpreting the plan documents post-confirmation. Moreover, participation in the plan process will help the trustee build essential relationships with debtor’s counsel, committee counsel, financial advisors and key former employees. These relationships can play a vital role in the management of the liquidation trust by helping to

maintain continuity and to streamline the trustee's factual investigation. It is especially important to have a relationship with former employees from the debtor's accounting staff to assist with the liquidating trust's forensic accounting efforts and to provide "inside" information regarding suspicious transactions.

(B) Draft Trust Formation Documents. If the trustee is involved early in the plan process, he/she can ensure that the trust formation documents provide the appropriate authority and discretion to carry out his/her duties under the plan. Most importantly, the trust documents should include appropriate provisions for the retention and compensation of the trustee, counsel, experts, accountants, and other professionals for the trust that will be critical to the litigation process. Depending on the size and complexity of the case, the trust may also provide for an oversight committee to act as a sounding board for the liquidating trustee. Finally, the trustee may desire to negotiate for indemnification through an errors and omissions policy and/or from the assets of the estate, with any premiums to be satisfied by the trust directly. Involvement in drafting the trust formation documents is just one way for the trustee to define his/her role in the liquidation process and to begin to manage the expectations of the trust's beneficiaries.

(C) Preserve Claims. Finally, through participation in the plan process, the trustee can make certain that the plan preserves the claims that the liquidating trust will be responsible for prosecuting. In doing so, the trustee must ensure that the plan does not provide overly broad releases for potentially liable directors, officers, insiders, affiliates and professionals. Participating in the plan process is also an opportunity for the trustee to make certain that potential claims are not inadvertently released by failing to adequately disclose them in the plan and disclosure statement. Equitable estoppel,

judicial estoppel, and/or res judicata¹ could prevent the trustee from litigating claims post-confirmation that were not disclosed by the debtor in the schedules, disclosure statement, and/or plan. Finally, the trustee should be sure that the plan contains appropriate provisions under 11 U.S.C. § 1123(b)(3) to designate the trust as the “estate representative” to retain and prosecute claims on behalf of the estate.

II. The First Order of Business is to Preserve and Gather Evidence

To develop a working knowledge of the debtor’s business, the players, and the underlying reasons for the debtor’s failure, the trustee must gather and manage evidence from a variety of sources, including the debtor’s own records, third party document production, 2004 examinations, and depositions. To efficiently manage this process, the trust must have a game plan. The following section discusses practical strategies for obtaining and managing information in a cost-effective manner.

(A) *Use a Web-Based Communication Link.* In order to prevent the unnecessary duplication of documents and to maintain communication with the trustee’s other professionals, it is often beneficial to establish a web-based communication link to manage information obtained and make it available for everyone’s simultaneous use. This can be a cost-effective tool for providing the trustee and other professionals immediate access to pleadings and an electronic database of relevant documents. In high volume cases, it is virtually impossible (not to mention undesirable) to have every

¹ A discussion of these doctrines is beyond the scope of this paper, but for a more detailed discussion of the res judicata effect of a confirmation order and other preclusive doctrines, the following articles provide an excellent discussion of the relevant issues: (i) Seymour Roberts, Jr., *Preserving Claims for Post-Confirmation Litigation*, 2007 Ann. Surv. Of Bankr. Law Part I § 8 (September 2007); (ii) Bruce H. White and William L. Medford, *Post-Confirmation Standing and Estoppel: How Much Disclosure is Necessary?*, Am. Bankr. Inst. J. 38 (May 24, 2005); (iii) Deborah A. Crabbe, *How Much Specificity is Required by 11 U.S.C. § 1123(B)(3)(B)?*, Am. Bankr. Inst. J. 32 (May 23, 2004); (iv) Suzanne Uhland & Brian Metcalf, *Full Disclosure: The Doctrines of Equitable Estoppel, Judicial Estoppel, and Res Judicata as Applied to Causes of Action and Post-Confirmation Litigation*, (American Bankruptcy Institute, Bankruptcy Battleground West)(March 7, 2003).

professional look at every document each time they need to investigate a particular person or transaction. It is more beneficial to have a small team review all the physical documents and choose only those documents that are most relevant to the trust's investigation. Storing such documents in an electronic database makes it possible to quickly search for documents electronically as they are needed. While there are some up-front costs to consider, using an electronically searchable database for documents will prevent needless duplication of effort by professionals and is well worth the investment.

(B) Secure the Evidence You Already Have. In the hectic transition from debtor to liquidating trustee after plan confirmation, documents and electronically stored information can be lost, discarded, or destroyed. Upon confirmation of the plan, it is imperative that the trustee have the debtor's documents *immediately* moved to a secure location, out of the reach of the debtor's insiders and other potentially liable parties. To this end, the trustee should also immediately take possession of audit work papers from the debtor's accountants and client files from the debtor's pre-petition and bankruptcy counsel. If documents belonging to the trust are in the hands of a third-party, the trustee must quickly send letters demanding that such documents be turned over to the estate and warning against the destruction of evidence.

(C) Coordinate with Law Enforcement and Regulatory Agencies. Regulatory and law enforcement agencies can also be a key source of information regarding the debtor's business and financial affairs and should not be overlooked during a factual investigation. Regulatory agencies will share information pursuant to FOIA requests and law enforcement agencies may also be willing to coordinate and share information depending on the status of their investigation and the severity of the criminal activity in question. It

is worth noting, however, that where there are parallel criminal proceedings, some witnesses are likely to assert their Fifth Amendment privilege against self incrimination.

(D) *Take Advantage of Adverse Inferences.* It can be very difficult to conduct a factual investigation when the key witnesses invoke their Fifth Amendment privilege against self-incrimination and refuse to testify. But all hope is not lost. In some situations a court may find that a witness' refusal to answer questions on the grounds that the answers might incriminate him is evidence that the witness would have answered in a self-incriminating way. This is commonly known as obtaining an "adverse inference" from the refusal to answer. The use of adverse inferences will vary from circuit to circuit and it is outside the scope of this paper to survey the various jurisdictions on this issue.

By way of example, the Ninth Circuit allows an adverse inference to be drawn against a party if it is corroborated by independent and admissible evidence.² The following hypothetical example illustrates this test: (1) insider causes debtor to transfer debtor's funds to pay one of affiliate's creditors; (2) debtor's books and records reflect and corroborate that debtor owed no obligations in connection with this debt; (3) debtor's books and records reflect and corroborate that debtor received nothing in return for paying this debt; and (4) insider asserts her Fifth Amendment privilege when asked whether she intended to defraud debtor's creditors when she directed this transfer. Under these hypothetical facts, the court could infer that the insider intended to defraud debtor's creditors given the independent corroborating documentary evidence in the Debtor's own records on that point. Under that hypothetical, it is somewhat unclear whether an adverse

² See, e.g., *Rudy-Glanzer v. Glanzer*, 232 F.3d 1258, 1264 (9th Cir. 2000) (holding that adverse inferences are admissible if corroborated by independent evidence and are otherwise admissible under Federal Rule of Evidence 104(a)); see also *In re Tableware Antitrust Litig.*, No. C-04-3514 VRW, 2007 WL 781960, at *4 (N.D. Cal. Mar. 13, 2007) (same).

inference could be drawn in a case in which the insider is a non-party witness. In the Second Circuit, for example, the court would consider the following non-exhaustive list of factors to determine if an adverse inference is appropriate from a non-party witness: (1) the nature of the relationships between the witness and the party against whom the inference will be drawn; (2) the degree of control the party has vested in the witness; (3) the extent to which the interests of the party and of the witness coincide with respect to the outcome of the litigation; and (4) the extent that the non-party witness is involved in the litigation.³

(E) *Watch Out for Waiver of the Fifth Amendment Privilege.* Witnesses are not entitled to a blanket assertion of the Fifth Amendment privilege – they must first listen to each question and assert the privilege on a question by question basis. So what happens when a witness answers some questions but not others? It is possible for a witness to waive their Fifth Amendment privilege through selective and inconsistent invocation of the privilege? Whether the Fifth Amendment privilege has been waived is a fact intensive inquiry and will be considered on a case-by-case (and circuit-by-circuit) basis. As an example, the Ninth Circuit is incredibly protective of the Fifth Amendment privilege and waiver is “not lightly inferred.” Courts in the Ninth Circuit have held that, “the witness has considerable latitude in deciding when to stop responding to questions.”⁴ The

³ See, e.g., *LiButti v. United States*, 107 F.3d 110, 123 (2d Cir. 1997); Compare, *Tableware Antitrust Litig.*, 2007 WL 781960, at *5 (finding that an adverse inference could be drawn given the “identity of interests” between the third-party witness and the defendants).

⁴ *In re Seper*, 705 F.2d 1499, 1501 (9th Cir. 1983); see also *In re Jacques*, 115 B.R. 272, 273-274 (D. Nev. 1990) (holding that debtor had not waived his Fifth Amendment privilege by answering certain questions at meeting of creditors, but refusing to answer other questions); *Nursing Home Pension Fund v. Oracle Corp.*, No. C01-00988 MJJ, 2007 WL 1880381, at *12-13 (N.D. Cal. June 29, 2007) (finding no waiver where witness testified as to the drafting and signing of a sworn statement, but refused to testify as to its content); *Universal Trading & Inv. Co. v. Kiritchenko*, No. C-99-03073, 2007 WL 2300740, at *4-5 (N.D. Cal. August 2, 2007) (finding no waiver where the defendant answered a particular question in a deposition, but then refused to answer the same question when the deposition was re-opened).

witness “‘may pick the point beyond which he will not go,’ and refuse to answer any questions about a matter already discussed, even if the facts already revealed are incriminating, as long as the answers sought may tend to further incriminate him.”⁵ For a witness to be “‘further incriminated,” his testimony does not have to be directly incriminating, it can also be “‘further incriminating” if it might “‘possibly” supply a link in a necessary chain of evidence.⁶ In other words, all doubts and inferences will be likely be resolved in favor of the person asserting the privilege. Determining the scope of waiver is fact intensive and requires a careful review of prior testimony to determine whether waiver has occurred. The scope of the waiver (if any) will be determined by the testimony sought. If the Trust seeks testimony regarding a fact that is incriminating, the court will essentially inquire into whether the witness’ previous testimony has already fully incriminated them as to that fact. Thus, any motion to compel testimony must set forth in detail the incriminating facts that were disclosed and the specific information sought by the trust so that a court can analyze whether disclosure of such information will further incriminate the witness. The burden of proving that disclosure of information will further incriminate is on the witness asserting the privilege.

(F) *Play Nice and Make Friends*. If the debtor’s insiders have any significant exposure to civil liability or criminal sanctions, they simply will not be helpful. Indeed they are likely to resist all attempts to discover information and will invoke their Fifth Amendment privileges unfailingly. However, in most cases there is at least one person currently or formerly employed by the debtor, who is willing to reveal important

⁵ *United States v. Seifert*, 648 F.2d 557, 561 (9th Cir. 1980) (quoting *Shendal v. United States*, 312 F.2d 564, 566 (9th Cir. 1963)).

⁶ *Seper*, 705 F.2d at 1501.

information about the debtor and its insiders. Forming a relationship early with such a person can greatly reduce the trustee's ramp-up time and can help professionals undertake a more focused investigation. In addition, former employees can help the trust authenticate corporate records for use in litigation.

(G) *Use 2004 to Examine Key Witnesses and to Obtain Documents.* Federal Rule of Bankruptcy Procedure 2004 is a powerful tool for a liquidating trustee to obtain sworn testimony and to subpoena documents from witnesses with relevant information. Taking the 2004 exam of a key witness to help the trust identify and develop potential claims, does not later prevent the trust from taking the deposition of the same witness in an adversary proceeding.⁷ A witness or party seeking to prohibit the trust from taking an oral deposition bears a heavy burden and the mere fact that the witness was previously examined under Rule 2004 is unlikely to meet that heavy burden.⁸ A 2004 examination is not a substitute for a deposition and serves a distinct purpose as an investigative tool into the debtor's business and financial affairs. A 2004 examination allows a broad range of questioning and has been referred to as a "fishing expedition" with few procedural limits.⁹ Depositions, on the other hand, are strictly controlled by the Federal Rules of Civil Procedure and their purpose is to enable discovery for the purposes of trial.

⁷ See e.g. *In re Lang*, 107 B.R. 130 (Bankr. N.D. Ohio 1989).

⁸ *In re Lang*, 107 B.R. at 131 (citing 8 Wright & Miller, Federal Practice & Procedure, § 2037 (1988 Sup.); *In re McCorhill Publishing, Inc.*, 91 B.R. 223, 225 (Bankr. S.D.N.Y. 1988)).

⁹ *In re W & S Investments, Inc.*, No. 91-35830, 1993 WL 18272, at *2 (9th Cir. Jan. 28, 1993); *In re GHR Energy Corp.*, 33 B.R. 451, 453 (Bankr. D. Mass. 1983). See also *In re Bennett Funding Group, Inc.*, 203 B.R. 24, 28 (Bankr. N.D.N.Y. 1996) ("The purpose of such a broad discovery tool is to assist the trustee in revealing the nature and extent of the estate, and to discover assets of the debtor which may have been intentionally or unintentionally concealed").

Witnesses may also attempt to contest the trust's ability to take a Rule 2004 examination after confirmation of the bankruptcy plan. In the context of a litigation trust designed to investigate and pursue pre-petition claims for the benefit of creditors, post-confirmation Rule 2004 examinations absolutely are proper. After plan confirmation, the bankruptcy court's jurisdiction covers matters "pertaining to the implementation or execution of the plan."¹⁰ Thus, if the trust is acting within the scope of its duties under the confirmed plan, the bankruptcy court has post-confirmation jurisdiction to order the 2004 examination.¹¹

III. Identify and Lock Down Estate Assets

(A) Coordination Between Professionals is Key. When assets of the debtor have been fraudulently or improperly transferred, time is of the essence to identify and prevent those assets from moving further out of the trust's reach. In many instances, the trust's lawyers and forensic accountants must run parallel tracks to identify and locate these assets. The trust's lawyers can obtain information regarding estate assets from virtually any person or entity through 2004 examinations (discussed above) with assistance from the forensic accountants who should be tracing transfers of the debtor's cash and other assets through the debtor's financial records. Accordingly, the lawyers, forensic accountants and (occasionally) private investigators must maintain constant communication and share information seamlessly in order to prevent unnecessary delays in the recovery of estate assets.

¹⁰ See e.g., *In re Daisytek, Inc.*, 323 B.R. 180 (N.D. Tex. 2005).

¹¹ *Id.*

(B) Attempt Less Costly Alternatives to Recover Assets. It may be appropriate under certain circumstances to send notice letters to potential targets advising that they are in possession of estate property and demanding immediate turnover. This approach can be a cost-effective way to recover estate assets without incurring substantial fees and expenses. It is far more likely, however, that the trust will have to initiate adversary proceedings in order to recover the bulk of the estate's improperly transferred assets.

(C) Aggressively Protect Assets If Necessary. In more extreme cases, it may be possible for a trustee to obtain an injunction to prevent the depletion of estate assets while an adversary proceeding is pending. In certain jurisdictions, the trust may also take advantage of state law remedies, such as a pre-judgment writ of attachment or *lis pendens*, to prevent further dissipation of estate assets. Finally, it may be possible to gain control over estate assets by initiating involuntary bankruptcy proceedings (or seeking a receivership) against a person or entity who has improperly received the estate's assets. Before attempting to enjoin or freeze assets, the trust's counsel should determine the specific remedies available in their respective jurisdiction, whether there are bonding requirements in order to take advantage of such remedies, and whether there is any potential liability to the trust for taking such action.

IV. Conduct a Cost-Benefit Analysis and Develop a Strategic Action Plan After Identifying Potential Targets and Claims

(A) Eliminate the "Underbrush". In many cases a liquidating trust is on a very tight budget and thus it is difficult to prosecute every available cause of action. After completing the investigation phase, the trustee and counsel should evaluate all potential claims and conduct a cost-benefit analysis so that the trust prosecutes only its strongest claims with the greatest chance of recovery. Eliminating the "underbrush" is something

the trustee should do to ensure that the trust's already scarce resources are not wasted with little relative benefit to the estate. Counsel with experience representing liquidation trusts can provide invaluable insight to the trustee regarding realistic litigation budgets and the viability of the parties' respective claims and defenses. Accordingly, the trustee and counsel should work together to develop a strategic action plan to pursue litigation that will ensure that the trust's resources are used judiciously.

(B) Identify Problem Areas. Every case presents a different set of facts and unique legal issues, but the following is a list of several of the more common issues a trustee should consider when identifying the trust's most viable claims:

- (i) What is the right forum for the litigation? Does the trust prefer a bench trial in bankruptcy court? Will the opposing party consent to a jury trial in bankruptcy court? Does the federal district court have jurisdiction to hear the case? Will there be motions to withdraw the reference? Is state court an option?
- (ii) Is the doctrine of *in pari delicto* a problem for the trust? *In pari delicto* is an equitable defense to claims against third parties where insider wrongdoing is imputed to the debtor. So, is it applicable to a liquidation trust? Does the adverse interest exception apply? Does it help if there was an innocent director?
- (iii) Directors and officers will likely only be liable for acts that: (a) are a breach of fiduciary duty; and (b) involve intentional misconduct, fraud, or knowing violations of law. The catch-22 is that pleading such facts may trigger insurance policy exclusions for intentional acts, which would

prevent recovery under such policies. If pleading intentional misconduct is unavoidable, consider whether there is potential for recovery from other sources. Also consider whether the trust is competing with other claimants to recover under an insurance policy?

- (iv) Do “Limitation-of-Liability Provisions” in the engagement letters of debtor’s accountants/auditors prevent recovery from them? Even for gross negligence / intentional torts?
- (v) Is early mediation an option? And if certain parties reach a settlement, how will comparative responsibility affect recovery from non-settling defendants? The answer to this question is largely dependent on applicable state law.

CONCLUSION

Ultimately every case is different and will present its own unique set of circumstances and issues. However, the primary goal of a liquidating trustee should always be the same – to efficiently and effectively manage the trust in order to maximize recoveries for creditors. The foregoing discussion provides a few examples and practical strategies to consider in order to accomplish that objective.