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Res Judicata: The Preclusive Effect of the Confirmation Order

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The preclusive effect of a prior judgment in a subsequent case is a powerful weapon in the litigator's arsenal, prohibiting the plaintiff from reaching the merits of the case — no matter how strong the facts and the law are in his/her favor. The result is no different in the bankruptcy context. A chapter 11 confirmation order may constitute a final judgment on the merits entitled to *res judicata*.

After briefly discussing the law of *res judicata*, this article will focus on the facts of three bankruptcy cases that held that the confirmation order constituted *res judicata*, preventing the nondebtor party from challenging the confirmation order. These cases illustrate the dangers that lurk post-confirmation if a party does not raise outstanding issues at the chapter 11 plan confirmation stage.

Res Judicata

Res judicata prohibits parties from relitigating issues that have previously been decided by a court of competent jurisdiction.[2] This means that "any attempt by the parties or those in privity with them to relitigate any of the matters that were raised or *could have been* raised ... is barred."[3] Courts routinely conclude that a confirmation order is comparable to the entry of a final judgment in nonbankruptcy litigation.[4] Section 1141 of the Bankruptcy Code provides that the provisions of a confirmed plan bind the debtor and any creditor, among others, as to all of the plan's provisions and vests all of the property of the estate in the debtor. If a party had adequate information about claims before the petition date or during the chapter 11 plan process, courts conclude that the existence of such information is evidence that the claims *could have been* raised during confirmation.[5]

Notwithstanding the foregoing, *res judicata* does not apply if the claim has been expressly reserved for later adjudication.[6] *Res judicata* only prohibits parties from raising claims that they could have raised but failed to raise before confirmation of the chapter 11 plan.

To determine whether *res judicata* applies, courts consistently look at the following four factors: whether (1) the prior judgment was a final judgment on the merits; (2) the parties were the same; (3) the prior court had competent jurisdiction; and (4) the causes of action were the same. In addition, bankruptcy courts have asked whether a judgment in a subsequent action would "'impair, destroy, challenge, or invalidate the enforceability or effectiveness' of the reorganization plan."[7] If so, *res judicata* can be raised as an affirmative defense or in a motion to dismiss under Rule 12(b)(6).[8] In the three cases discussed herein, it is the first factor (whether the prior judgment was a final judgment on the merits) and the fourth factor (whether the causes of action were the same) that were at issue.

In re Optical Technologies Inc.

In *In re Optical Technologies Inc.*,[9] the bankruptcy court confirmed a chapter 11 plan that purported to modify certain leases with nondebtor lessees that were assigned to finance companies (the "lessors") by one of the debtors.[10] The subject of the leases involved electronic billboards and kiosks that the lessees would place in their medical offices for advertising by the lessors.[11] Although the lessees were not served with the fourth amended plan, the lessees were served with the third amended plan and later with a summary of the fourth amended plan, which highlighted the differences between the third and the fourth plans.[12] The lessees were also served with the scheduling order for the confirmation hearing, but they did not file an objection to confirmation or appear at the hearing.[13] The bankruptcy court confirmed the fourth amended plan, under which the leases were modified.[14]

After the confirmation order became final and nonappealable, one of the lessors sent the lessees a statement of revised lease terms and options under the fourth amended plan, reflecting the lessor's understanding of the new lease terms.[15] During the course of an adversary proceeding brought by the lessor for declaratory judgment that the leases had

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2 *In re Arcapita Bank B.S.C.(c)*, Adv. Pro. No. 13-01677(SHL), 2014 WL 6435522, at *4 (Bankr. S.D.N.Y. Nov. 14, 2014).
3 *Id.* (quoting *Sure-Snap Corp. v. State St. Bank & Trust Co.*, 948 F.2d 869, 873 (2d Cir. 1991) (emphasis in original)).
4 *Id.*
5 *Id.* (citing *Sure-Snap Corp.*, 948 F.2d at 873).
6 *Id.*
7 *Id.* (citing *Sure-Snap Corp.*, 948 F.2d at 875-76).
8 *Id.* at *5.
9 425 F.3d 1294 (11th Cir. 2005).
10 *Id.* at 1296-97.
11 *Id.*
12 *Id.* at 1298.
13 *Id.*
14 *Id.* at 1297.
15 *Id.* at 1298.

been modified by the terms of the debtors' plan, some of the lessees argued that their leases had expired prior to the petition date, and therefore the fourth amended plan could not have modified a lease that was no longer in effect.[16] The bankruptcy court agreed, explaining that since there was no live lease, there was nothing to be modified.[17]

Other lessees (those whose leases had not expired) argued that they did not have sufficient notice that their leases would be modified by the fourth amended plan and that the bankruptcy court lacked jurisdiction to modify leases between two nondebtor parties.[18] The bankruptcy court held for these lessees, explaining that the parties to the leases were nondebtor entities and that the lessees were not given a meaningful opportunity to participate in the bankruptcy case.[19]

The district court reversed the bankruptcy court, explaining that the confirmation order, which was final and nonappealable, was *res judicata* rendering the lessees' defenses a collateral attack on the confirmation order.[20] The district court held that "[w]hile arguably the bankruptcy court should not have confirmed a Plan that purported to modify leases that expired prior to [the debtor] filing for bankruptcy, the fact of the matter is that ... the Plan applies to leases that expired before [the debtor] filed for bankruptcy."[21] The Eleventh Circuit Court of Appeals agreed, explaining that the terms of the fourth amended plan were plain on their face and any objection to them *could have been* raised by the lessees at the time of confirmation.[22]

The district court also reversed the bankruptcy court's order as it related to the unexpired leases, explaining that the terms of the fourth amended plan were sufficient to put the lessees on notice. Once again, the Eleventh Circuit agreed with the district court.[23] In affirming the district court, the Eleventh Circuit concluded that the lessees were barred from collaterally attacking the confirmation order, and that the bankruptcy court was bound to enforce the terms of the plan as written and as reflected in the statements.[24]

In re FFS Data Inc.

In a more recent case, *In re FFS Data Inc.*,[25] the U.S. Bankruptcy Court for the Southern District of Florida determined whether "an explicit general release in favor of the debtor's principal on behalf of all parties with claims against the debtor, contained in a plan of reorganization confirmed long ago and never appealed, was binding on a creditor that had actual notice of the general release."[26] The bankruptcy court answered in the affirmative, based on the U.S. Supreme Court's opinion in *Travelers Indemnity Co. v. Bailey*[27] and the plain language of the confirmed chapter 11 plan.[28]

The debtor filed its amended reorganization plan, which was served on Iberiabank via CM/ECF.[29] The court conditionally approved the disclosure statement, and the order, plan and related disclosure statement were served on counsel for Iberiabank.[30] The plan provided an "unequivocal general release in favor of Bradford Geisen, the Debtor's principal, binding on all holders of claims against the Debtor with adequate notice of the Plan."[31] Iberiabank did not dispute that it had actual notice of the plan and that it had an opportunity to object to the release provisions.[32]

The bankruptcy court stated that the Supreme Court in *Bailey* provided clear guidance, explaining that "[w]here, as here, a confirmation order is final and no longer subject to appeal, it and the plan incorporated into it are entitled to *res judicata* effect."[33] The court further explained that it had two questions to answer: (1) whether Iberiabank had adequate notice of the plan terms and the opportunity to object; and (2) whether the language of the plan and confirmation order covered Iberiabank's claim.[34] Finding that Iberiabank conceded that it had notice and had a reasonable opportunity to object, and that the plan and confirmation order were clear and unequivocal, Geisen was released of the claim brought by Iberiabank.[35] Thus, the confirmation order was given *res judicata* effect.

In re Arcapita Bank B.S.C.(c)

In *In re Arcapita Bank B.S.C.(c)*,[36] the reorganized debtors filed a motion to dismiss a complaint, which alleged that certain funds in the debtors' possession were not property of the estate.[37] The bankruptcy court held that the plaintiffs' complaint was precluded under the doctrine of *res judicata* because "the classification and treatment of the Plaintiffs' monetary claims against the Debtors were conclusively determined in the confirmation order."[38]

Before the petition date, the plaintiffs entered into an investment account agreement with Arcapita, placing more than $10 million for investment purposes in four different accounts.[39] Out of the $10 million, a little over $3 million was never invested and remained in the accounts,[40] which were governed by two agreements between the plaintiffs and Arcapita.[41] Pursuant to their terms, Arcapita was appointed as the plaintiffs' investment manager, and the investor (the plaintiffs) retained the title to its investments unless and until the funds were invested in or with third parties.[42]

In addition, Arcapita commenced a rights offering to its shareholders, including the plaintiffs, which offered each investor the opportunity to purchase up to 1,666,667 shares in Arcapita.[43] If the rights offering failed, the shareholders would be notified and their investment, together with profits,

16 *Id.*
17 *Id.*
18 *Id.*
19 *Id.*
20 *Id.* at 1299.
21 *Id.* at 1303-04.
22 *Id.*
23 *Id.*
24 *Id.* at 1308.
25 509 B.R. 403 (Bankr. S.D. Fla. 2014).
26 *Id.* at 404.
27 557 U.S. 137, 151, 129 S. Ct. 2195, 174 L. Ed. 2d 99 (2009).
28 *FFS Data Inc.*, 509 B.R. 403, 404.
29 *Id.* at 405.
30 *Id.*
31 *Id.* at 407.
32 *Id.* at 405.
33 *Id.* at 414.
34 *Id.*
35 *Id.*
36 Adv. Pro. No. 13-01677(SHL), 2014 WL 6435522 (Bankr. S.D.N.Y. Nov. 17, 2014).
37 *Id.* at *1.
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.*
42 *Id.*
43 *Id.* at *2.

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would be applied to their investment accounts.[44] The plaintiffs participated in the amount of $462,568.[45] The rights offering failed, however, so no shares were issued to subscribing shareholders.[46]

Arcapita and its affiliates filed for chapter 11, and the plaintiffs filed four proofs of claim totaling $10,262,597.36, which constituted the amounts in the four accounts and the amounts placed with Arcapita pursuant to the rights offering. The debtors' first disclosure statement explained that third-party investors as of the petition date would be treated as general unsecured creditors.[47] The plaintiffs' share of this class was the uninvested amount of approximately $3 million.[48] Thus, under the debtors' first amended plan, $3,012,223.55 of the plaintiffs' claims was classified as a general unsecured claim.[49]

As for the rights offering investments, the disclosure statement stated that the rights offering participants would receive subordinated claims against Arcapita Bank.[50] Thus, under the plan, the plaintiffs would have a subordinated claim in the amount of $452,568.[51] Although the debtors filed a second amended reorganization plan and second amended disclosure statement, the treatment afforded to the plaintiffs' claims remained the same.[52]

Almost five months after confirmation of the chapter 11 plan and two months after the plan became effective, the plaintiffs filed a complaint asserting that $3,464,791.66 being held by the debtors was never property of the bankruptcy estate and therefore requested the court to compel turnover of the funds.[53] The debtors filed a motion to dismiss for failing to state a claim asserting that *res judicata* prohibited the plaintiffs from collaterally attacking the confirmation order's treatment of the plaintiffs' claims.[54] First, in contesting the debtors' motion, the plaintiffs argued that the confirmation order was not a final judgment on the merits because a plan-confirmation order "cannot confer upon a debtor [the] title to another's property."[55] The bankruptcy court explained that "[w]hile it is true that a party has the right to contest what constitutes property of the estate, this issue was resolved in the plan of reorganization that was approved by the Confirmation Order."[56] The bankruptcy court further explained:

> The lack of authority supporting the Plaintiffs' position is not surprising given the real world consequences of permitting the Plaintiffs' legal challenge. In short, it would wreak havoc. The Plaintiffs' Complaint challenges a central premise of the Debtors' confirmed plan: that approximately $320 million ... [is] available for distribution to claimants on a *pro rata* basis under the classification scheme set forth in the Plan.
>
> Indeed, given concerns about finality of a confirmed plan, it is well established that a confirmation order may be revoked only if it was procured by fraud. 11 U.S.C. § 1144. But the Plaintiffs do not allege any claim of fraud. Rather, the facts demonstrate that the Plaintiffs were aware [of] the treatment that the Funds would receive under the Plan.... [T]he Plan made [it] clear how these claims were to be addressed. Thus, the Plaintiffs' Complaint is an improper attempt to "redivide the pie," because granting the requested relief would dramatically increase the Plaintiffs' payout under the Plan and significantly lessen the sum available for all other claimants.[57]

Based on the foregoing, and since the issue regarding whether the funds were property of the estate was addressed in the chapter 11 plan and confirmation order, the plaintiffs' claims were barred by the doctrine of *res judicata*.[58]

Conclusion

As you can see from just these three case examples, *res judicata* is a powerful tool, and if the claim was *or could have been* raised in the chapter 11 plan process, creditors and other parties in interest are at risk of having their claims or causes of action barred by the doctrine. Thus, if there is any doubt as to whether a chapter 11 plan would constitute *res judicata* over any causes of action or claims, the better practice would be to raise it at the confirmation stage, and even if not resolved, have the claims or causes of action explicitly reserved for later adjudication. Otherwise, issues relating to whether property is actually property of the estate, whether a release is appropriate, or whether an expired lease can be revived by an order confirming the plan may be barred by the doctrine of *res judicata*. abi

44 *Id.*
45 *Id.*
46 *Id.*
47 *Id.*
48 *Id.*
49 *Id.*
50 *Id.* at *3.
51 *Id.*
52 *Id.*
53 *Id.*
54 *Id.*
55 *Id.*
56 *Id.* at *5.
57 *Id.* at *7.
58 *Id.*