ORAL ARGUMENT – 10/19/04
03-0784
PROSTOK ET AL. V. BROWNING ET AL.

MARTIN: Notwithstanding the complex procedural history of this case, or the size of its appellate record, and no matter whether the claims that the junior bondholders have asserted against the defendants for the past 9 years of litigation are based on state or federal law, we submit that this case presents a clear and rather simple issue of resolution.

Specifically the claims as pled by the junior bondholders are based upon acts allegedly committed by the defendants during their service as officers and directors of old National Gypsum or old NGC during its bankruptcy case. Which if true, would have directly injured old NGC as a corporation and its bankruptcy estate. And thereby indirectly have injured the shareholder and creditor community of old NGC.

HECHT: I don't understand how that is. It looks to me like if you're undervalued, you come out of there great. You're in great shape. You ought to give them all a raise for getting it done.

MARTIN: Many of the junior bondholders who took warrants in this case would probably agree with you. If they did in fact breach their fiduciary duties of care and loyalty to the corporation, then that's a direct injury.

HECHT: If they did it - the allegation here is they undervalued the company. The estate in bankruptcy. How does that hurt new NGC?

MARTIN: The corporation it doesn't hurt at all. Community C wasn't even in existence at that time. What it would hurt is the estate of old NGC. Because if you take their theory literally it means that there was less value on the effective date of the plan to spread around between all of the unsecured creditors and shareholders who didn't receive 100% payment under the plan. And that is their theme as we understand it. That is that the defendants fraudulently concocted a scheme to undervalue this estate and thereby not pay everybody as much as they would have...

BRISTER: Well it's not everybody. Undervaluing hurt some, and it wouldn't have made any difference to others. Some wouldn't have gotten any regardless probably, and some got 100% as it was. So we're only talking about a few of the levels of the creditors that it hurt.

MARTIN: There were 12 classes. Two were required to be paid 100% to confirm a plan. We're talking about 10. Of those 10 classes if it had more value that value would have had to have been distributed throughout most of those classes because of subordination agreements that were in those bond indentures. So the more value that was there, the more everyone would have participated. The maximum anybody received was 86.1%. The minimum would have been in the

category such as the asbestos claimants who were relying primarily on insurance which we did not value because insurance was problematical and was being litigated. The warrants that the junior bondholders received, which we did not value because warrants typically are hard to assign a ____ value to before they are issued. And then you had all of the unsecured creditors who were getting anywhere between .32 cents on the dollar and .26. So I would say that it's a broader spectrum in the universe of that bankruptcy. Ten classes would have been affected if there was more value.

HECHT: If you had the claim and if you had sued, which it is getting to look like you are not going to do, what would your damages be?

MARTIN: That's an interesting question because right now you have a binding confirmation order that is res judicata in this case that sets the value at $350 million. And they are bound by that. So to prove their case they are going to have to prove something in excess of $350 million and I'm not sure that that's res judicata , the whole issue.

HECHT: I understand their problems. If the action belonged to old NGC or whoever, somebody other than the plaintiffs, what would the damages be?

MARTIN: We would be stuck with the same thing. I don't think we have any damages. Because I think we are bound by the $350 valuation. And if what they are just simply saying is, it should have been valued more. Then no one appealed that valuation and if the confirmation order has any validity at all, it is res judicata.

WAINWRIGHT: Assume it's not res judicata, then what are your damages?

MARTIN: If it was not res judicata - for example, we were outside of bankruptcy and we were litigating something that had damaged the overall value. It would be the difference between the value of the corporation at the time of the alleged tort and what happened to it. Usually what happens in these situations is, that you come into a situation and you have these acts that cause the value to drop by reason of the tort's value. Here they are saying that the enterprise value was really something probably over $600 million, and it was represented as being $350. So I suppose what they would be arguing or whoever would be asserting that claim would be arguing it's the difference between the real value and the stated value.

OWEN: Is there any federal common law that gives the plaintiffs remedy in this case?

MARTIN: You have federal cases that talk about duty and talk about the possibilities for suits against trustees in a bankruptcy situation when there has been a particular and personal harm to a creditor. They are not a model of clarity but I think you can discern a couple of things. One is, if you have a trustee in bankruptcy who takes it out on a particular creditor, steals their collateral or something of that nature, that's not a bankruptcy problem. That's just a tort, and I think you can do this. If you're looking for a remedy imposed by the bankruptcy code, there is none specifically for a damage remedy of this type. But there are multiple remedies that are available such as the

imposition of a trustee; the conversion of the case to a ch. 7 case; the removal of an officer and director.

OWEN: I'm talking about post confirmation.

MARTIN: You will see the case cited of San Juan Hotel, which is relied on both by the CA and by the respondents in this case. It's a 1988 case out of the 1st circuit. It basically defines the situations in which a creditor can sue a trustee directly for a direct breach of the duty, and when the injury belongs to the bankruptcy estate that can be only asserted on behalf of the estate. We think that case actually favors the position that they have not asserted a particular and personal injury.

OWEN: Is that federal common law or is that based on a state's common law?

MARTIN: I wouldn't go as far as to say it's federal common law. I think they are just implying that there ought to be a tort remedy there on the facts of that situation.

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LAWYER: I want to address a couple of questions that have come up. With respect to the damages issue, and the damages in this case are entirely speculative, the damages aren't the difference in the value. The damages are supposedly what these plaintiffs would have gotten had there been this hypothetical, undefined plan other than the one that was actually confirmed. And one of the reasons this plan doesn't exist is because for as long as any of us have been practicing law, Texas law has prohibited claims that are based on misconduct in previous litigation. And the reason for that is to recognize the paramount importance in the finality of judgments. And so setting aside some of the issues you've discussed, the summary judgment in this case was proper because the claim does not exist under Texas law. It never has and it should not have.

WAINWRIGHT: Is it a federal or a state law claim?

LAWYER: The claim that you are adjudicating is alleged to be a state law claim. The plaintiffs in order to get out of federal court said we don't have a federal remedy. We are not suing under federal law. And so the claim that is before you is, if it exists at all, which we don't believe it does, is a state law claim. And so if you look at state law dating back decades, the court has consistently said that if a litigant loses because of allegedly perjured testimony, you can't maintain a civil action against the perjurer.

SMITH: Basically this confirmation order is a final judgment. And if you want to get out from under that, I guess there would be remedies like a bill of review or go back to bankruptcy court.
some point you have to appeal to the US DC and on up to the 5th circuit. But say if you find out about it after the appellate timetable has been run, I guess there would be some type of remedy for opening up the confirmation order on the basis of some type of fraud.

LAWYER: Congress has decided that and congress has said that to revoke a confirmation order for fraud you've got to do it within 180 days of the confirmation order regardless of when the fraud is discovered. If congress had wanted to put in some kind of discovery rule or exception to that they could have. They didn't. So under federal law that order cannot be revoked.

BRISTER: That's like a statute of limitations or statute of repose or something...

LAWYER: It is a statute of limitations in a sense that again recognizes the special importance of a final judgment in the bankruptcy context.

BRISTER: So if you can cover it up for 180 days you're off scott free?

LAWYER: Under federal law and under state law there is no private cause of action for damages based on this kind of alleged misconduct in previous litigation. There are remedies as Mr. Martin discussed and they are defined by the bankruptcy code. You can go in and you can ask that officers and directors not be compensated.

BRISTER: Post confirmation. You can get these remedies?

LAWYER: I believe that is available post confirmation. You can seek to transform a ch. 11 case into a ch. 7 case.

OWEN: Not post confirmation.

LAWYER: Yes. In some of these cases what happens is the plan gets confirmed and then the debtor does something that is not in accordance with the plan and a creditor comes in and says I was misled. Let's convert this to a ch. 7. That's one of the cases that's cited by the plaintiffs too.

BRISTER: So the bankruptcy court has some type of continuing jurisdiction over the corporation post confirmation?

LAWYER: The bankruptcy court has jurisdiction to enforce its orders. And that jurisdiction has been construed to be pretty broad.

HECHT: Why would federal law impose a fiduciary duty to the extent it does on the debtor in possession toward any of the other participants in the case, whether it's all of them together or groups of however, and whatever the duty is. Why would you do that if you weren't going to enforce it someway?

LAWYER: It is enforced. And there's a panoply of ways in which it's enforced. And you have to remember these are - the debtor in possession is both in that role, but is also a litigant and is also responsible to the shareholders...

HECHT: That's why this is so different from Trevino and Texas law because those are written in the context of litigants who don't owe anybody anything.

LAWYER: I disagree because every litigant who comes into court owes the duty not to lie and has the duty to disclose.

HECHT: But this is a fiduciary duty. This is a duty to look after somebody else's best interest.

LAWYER: It is not a fiduciary duty in the sense of what we're used to thinking of in terms of state law fiduciary duties. This is a duty that arises out of the stature of the debtor in possession under the bankruptcy code. It is not the kind of duty that gives rise to a private cause of action in favor of a particular creditor. It's a duty that is really defined by the bankruptcy code in terms of what has to be disclosed. And the remedies for it are available under the bankruptcy code. The creditors have discovery. They have their own counsel. They can object to the plan. They can propose their own plan.

OWEN: Let's say all of that was done and there was fraud. And the party allegation is there was fraud after the date the confirmation plan was confirmed, and before the 180 days ran. So that no one knew what was going on. Is there any federal relief, statutory, common law, otherwise, to get at what these directors did, or allegedly did?

LAWYER: I have to object a little bit to the hypothetical because I want to make sure the court understands that this allegation of post confirmation fraud is not something separate and independent from what allegedly happened during the bankruptcy. It's just a continuation of this alleged failure to disclose. And it's not alleged to give rise to any separate damages and the damages are measured supposedly by what happened as of the date of the confirmation order. So I think to talk about post confirmation fraud is a little inaccurate in this case.

But setting that aside. To answer you question, the federal remedies that are available do not include a private right of action against...

OWEN: What are the federal remedies that are available against these directors?

LAWYER: If it's after 180 days, then the confirmation order cannot be disturbed.

OWEN: What is the federal remedy?

LAWYER: I don't believe that there is a federal remedy in terms of this kind of private right of action. As I said, there are cases in which creditors have gone back and sought to convert to ch. 7, or have gone back and asked the bankruptcy court to take certain action with respect to certain assets. But in the sense of conduct occurring during the bankruptcy litigation, just like in Texas, Cayle v. Palmer and Trevino, we don't have private right of action to go back and look at

what happened in the context of the litigation.

WAINWRIGHT: Can the bankruptcy proceeding be reopened more than 180 days after the confirmation order?

LAWYER: I believe that is possible in certain circumstances.

WAINWRIGHT: There's some federal authority particularly from the 7th circuit citing 11 USC 350(b). It's a few years old and I don't know if the statute has been modified. But it talks about a bankruptcy proceeding that can be opened based upon the alleged misconduct during the bankruptcy and it can be reopened by the debtor or other party in interest, which presumably includes trustees and debtors in possession.

LAWYER: And I think that's part of the bankruptcy court's continuing jurisdiction.

WAINWRIGHT: But your position is the confirmation order cannot be changed?

LAWYER: The confirmation order cannot be revoked more than 180 days under sec. 11.44. But there are other ways to go about it. It's just in the cases that have been cited, none of them even hint at this kind of claim for a private damages action. And if you think about it it makes sense. Because what you are allowing is, you are allowing one self selected group of creditors to get more than they got in the confirmation order while other creditors who are similarly situated are not part of the process.

HECHT: But your argument would be that even if all of the impaired creditor class is joined together they still wouldn't have a cause of action. You're not just singling this out.

LAWYER: That's true. The nature of it is if there were a private right of action for damages it would undermine the whole principle of the bankruptcy code which would have everybody in one place and to adjudicate. If you think about it there is always going to be a creditor who comes out of the bankruptcy court saying I didn't get as much as I should have. Because that's the whole idea. There's not enough to go around and you have this order of priority and senior creditors are going to get treated better then junior creditors every time.

OWEN: They cite on page 27 of the brief, ANR Ltd. out of Utah and some other cases in footnote 6. Have you distinguished those cases?

LAWYER: I believe we've addressed all of the cases that are even remotely similar to this one in our briefing.

WAINWRIGHT: Talking about fiduciary duty. Back a couple of steps. You said that the debtor in possession's fiduciary duty is not the same of a general state law concept of fiduciary duty. Is a trustee in bankruptcy fiduciary duty more consistent with in your opinion the state law of general

concept or the bankruptcy concept of a debtor in possession?

LAWYER: Bankruptcy.

WAINWRIGHT: And you're aware of course that in Winetraub the US SC said the trustee and the debtor in possession have the same fiduciary duties. It was dicta but the US SC said that.

LAWYER: They used the term fiduciary duty. But if you look at it and you think about it - for example. An attorney prohibited from representing conflicting interests. Trustee, has to represent conflicting interests: shareholders; creditors; competing creditors. That's just one example. It's not the same concept.

WAINWRIGHT: Whether it's the trustee or the debtor in possession you think it's a more limited bankruptcy code fiduciary duty rather than the general concept of fiduciary duty under state law?

LAWYER: Yes. The debtor in possession stands in the same shoes as a bankruptcy trustee.

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LYNN: I would like to speak to two issues. The first is the statute of limitations issue, the one that the CA abstained; and also the issues that they did not reach, which would be the collateral estoppel, res judicata and 1144 issues that they did not reach with respect to our argument.

There were questions though about 1144 and whether or not the fraud could be discovered after the 180 days? And the answer is no. You can't do anything about it after the 180 days. After the 180 days the order can not be revoked. And that's been the law in the 5th circuit since the South Mark case. Colliers at page 32 of our brief, we cite a passage from Colliers under 1144.04. It says, 180 day deadline applies even if fraud is not discovered until after the expiration of the 180 days. This deadline can sometimes be harsh and that fraud by its very nature is difficult to discover and may not be discovered or even discoverable until the 180 days period has elapsed.

Well there's a strong bankruptcy policy against allowing ch. 11 plan procured by fraud. There is an equally strong policy in favor of finality of the confirmation order.

HECHT: But it seems to me that that statement can be true and still not exclude the possibility of liability by the defrauder.

LYNN: I think it can because you have to couple the fact that it's a final order with the fact that it is an ____ judgment, and, therefore, res judicata attaches. It could have been litigated. We are to look at whether there's a common nucleus of operative facts between what might be alleged afterwards and what was decided during the course of the bankruptcy. And here that common

nucleus was the value of the entity. That was litigated for 32 days. During the course of that, these very allegations came up: manipulation of the financials; of the idea that there was $100 million of additional expenses that were pumped on to the financial sheet that should not have been pumped on to the financial sheet. The federal court heard that, and at the end of the day found that there was good faith on the part of TCW, good faith on the part of the others, and found that the value was $350 million. What's going on here is a collateral attack of that.

HECHT: That's the part I don't understand, because it looks to me like if J. ____ thought it was a collateral attack why would he remand it to state court?

LYNN: Because there's quite a bit of difference between a situation where it's in bankruptcy and he can deal with it, and a situation where it's over with, it's gone, it's out of his, there's no bankruptcy and he can't deal with it. I believe that the passage is...

HECHT: What if the allegation in this case in state court before it was removed was we want to collaterally attack. We just fess up. We want to collaterally attack the bankruptcy judgment. We think we can do that. We think we have a right to do that. And you get to the federal court - it's removed to federal court and the federal judge who remands it, it looks like he's say well yes you can go ahead with that.

LYNN: I don't believe that's what he was saying. There were a number hearings. There were a number of quotes that have been cited in the brief. You've been cited snippets by the appellant. You've been cited snippets by ours. I think what you will end up seeing, if you read the entire transcript, the gist of what he is saying is, I no longer have - this is a classic case of res judicata. It's an affirmative defense that there has been a judgment reached. My jurisdiction at this point in time that you now have it on appeal to me, I no longer have jurisdiction of this case with respect to that point. You go back to state court and search your affirmative defenses.

With respect to the statute of limitations, the parties largely agree on the law. I don't think that there is much difference in how they approach the case. Essentially everyone agrees that something like the following equation would apply. If you have facts or circumstances that are presented to a reasonable person, it would put them on some sort of inquiry of a wrongful act or an injury, even if they don't know the full extent of that injury, it triggers the running of the statute of limitations.

WAINWRIGHT: And the question in this case is who has to be put on notice and how?

LYNN: I think that the issue here is an objective standard. It is would the facts that we have and circumstances give a reasonable person notice? So we're looking at a reasonable person and then we're looking back to see whether or not under the circumstances we have conclusively shown that through summary judgment proof. That's the way I understand the way that this is _____ up before your honor.

Now here are the facts. We have given you three different dates that we believe conclusively show this. If you look back at the record, you will see that the issue of valuation was litigated quite extensively throughout the entire period.

BRISTER: But not the issue of how much cost can we cut.

LYNN: That was absolutely litigated.

BRISTER: This plan was not disclosed. I mean that's the whole ____ of their complaint that the plan was not disclosed and didn't take place till months after _____.

LYNN: March 19, 1992 in the record 11794 to 11798, we're talking about a concocted, orchestrated effort to manipulate down evaluation of the business. At 11726, management knowingly gave the ____ committee a statement of projected expenditures with nearly $100 million unnecessary expenses. What they are saying is, we had a collection of facts. We had a mosaic of facts from which we were arguing. Throughout 1992, 32 days of hearings, there is one fact that we didn't know about, but we knew about all the rest of this. Now the suggestion is that they somehow didn't know about the wrongful conduct because of this one fact, which is not true. It is demonstratively not true based upon the record. They knew about all of this. They put experts on. They tried to prove this up. And at the end of the day a federal judge did not accept it.

Now they are suggesting that the discovery of one fact after 180 days somehow would permit them to reopen the case, or that the statute shouldn't run. In this circumstance, the two questions: Did they know of facts that would put a reasonable person on notice of the alleged wrongful acts? It's difficult to read the entire record without coming to the conclusion that they knew precisely what they were talking about. Now there is a March 23, 2000 letter that Marvin ____, Carrington Coleman firm wrote and was filed at the CA. And it contains a chart that has all of the different assertions of wrongdoing by all of the folks that are now before you that were litigated during the entire year of 1992.

So they did know of facts. They did now of circumstances that a reasonable person would think would have resulted in discovery of the fraud, and discovery of the alleged injury. So under those circumstances we think that the CA was perfectly correct in saying that the statute of limitations began running on March 1993. And therefore the 4 years, if we were to accept the longest statute of limitations we have, certainly the statute of limitations would have run.

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RESPONDENT

TOWNSEND: This case has been around for a very long time. It was under submission in the CA for a very long time. And I think as with any human endeavor, when you look back in hindsight, you find things that you wish you would have done differently. And there is something I wish I would have done differently in my briefing to the court. And that is to use more pages and

belabor the facts of fraud in this case. Because the standard of review favored us on the granting of summary judgment, I, and the CA, relied much more conclusively than we would normally have done because we didn't think it was really relevant to the legal issues before the court.

But given the arguments that I've heard today, it would be nice to walk the court through in detail the fraudulent conduct that was going on in this case. But rather than do that, I will simply refer you to where it is spelled out in the record in great detail, which is the combined response of the asbestos plaintiffs to the motions for summary judgment, which my parties joined in in the TC and incorporated. It's in vol. 41 of the clerk's record beginning at page 13,210. It is quite extensive. It has cites to exhibits, quotations, and reveals a shocking course of conduct.

OWEN: Let me make sure I understand what you're asking us, what your theory is. It seems to me you're saying we should take the fiduciary obligation that's under federal law and fashion a state common law remedy for you.

TOWNSEND: That is exactly correct.

OWEN: This is bankruptcy and we've got congress involved and we've got a real overlay of federal law. Is there a federal common law that gives you remedy and if not shouldn't this be decided - should it or not be a uniform federal common law and not piecemeal state by state?

TOWNSEND: No. To my knowledge there is no federal common law that deals with this. All the cases that have discussed this, and we've cited them in the brief, have all referred to the presence of a tort remedy usually in terms of it being a state tort remedy. Colliers on Bankruptcy has a separate section that talks about while you can't open the plan again if the fraud is concealed for more than 180 days, you certainly can have a tort damages remedy against the people who committed the fraud.

OWEN: The tort remedy on pages 26, 27, and 28, you go through at least some cases and maybe other places in all the briefing seems to say yes you can have tort damages, but in certain circumstances they may have to be constrained because it would impact on the bankruptcy. So a state court would have to weave through and say yes you can get damages for this but not for this. We would really have to be fashioning a specific fraud remedy based totally in a bankruptcy context wouldn't we?

TOWNSEND: I don't think so. The cases on pages 26 and 27 are dealing with our standing to bring a claim against a trustee. And they established that when a creditor suffers individual injury, separate from an injury to the corporation as a whole, that it has a right of action against a trustee or a debtor in possession.

OWEN: Are they applying federal law or state law to decide if there is standing?

TOWNSEND: Those are again I believe state tort claims. The cases allowing us to go back

against them after the 180 day period are discussed in the earlier part of our brief, beginning on pages 11 to 13. And those cases talk about common law theories and that's where we also have a Collier citation allowing a tort damages action.

OWEN: Are they actually applying state common law or federal common law? Do they talk about a need for uniformity?

TOWNSEND: There is no discussion of federal common law, and to the best of my knowledge there is not a federal common law on this subject. I don't think the uniformity problem is that great because the duty is established fairly clearly as J. Wainwright's question about the SC case revealed. It spells out the fiduciary duty requirements and they included full disclosure of financial information, which did not happen here. They include maximizing the assets for the benefit of all creditors, which is not particularly at issue in this case since it was particularized to some creditors and not others, and also avoiding self dealing, which certainly is a problem in this case. Because the evidence I referred you to earlier documents financial kickbacks they were getting in exchange for concealing this plan.

If that is the duty -full disclosure, avoiding self dealing, maximizing total assets, then the question after that becomes just merely did they breach those duties?

OWEN: Do we look at anything that occurred within the bankruptcy itself, or do we just look at post-confirmation?

TOWNSEND: I think you look during the bankruptcy and post-confirmation both. Because the breach of fiduciary duty occurred...

OWEN: It seems like you do have federal remedies while the bankruptcy is ongoing. You can ask for removal of these people. You've got lots of...

TOWNSEND: If we learn of it, I agree with you. And that's the problem in the case that we didn't learn of it. And they went to great lengths to conceal it. In the record are memos telling each other let's be sure not to divulge this. People are erasing it from their computers, denying that events, meetings occurred, and then we happen to get it off the memory of the hard drive of somebody's computer.

OWEN: What if this were a state law case and you had all this going on, and a final judgment was entered. It's beyond the time for appeal. You would have a bill of review. Is that what you're asking for essentially is a bill of review?

TOWNSEND: In analysis it's probably the most similar thing. In the federal context there's not really a bill of review from the bankruptcy once you get past the 180 days.

OWEN: You wouldn't be able to sue under state common law for something that went

on in litigation where you claimed everybody was defrauded, the judge was defrauded. It harmed everybody. You wouldn't have a fraud cause of action. You would have the bill of review. So what do we call this?

TOWNSEND: It's complicated to be honest. Because the people who committed the fraud and breach of fiduciary duty were not actually parties in the bankruptcy proceeding. We have not sued National Gypsum Company. We've sued officers and directors. And they were not parties in the bankruptcy. And that's why the bankruptcy court said I can't really do anything to help you because this is not really connected with the bankruptcy court. They were not parties, and that's also why it's not res judicata...

OWEN: Again if this were a Texas corporation and you sued to collect a debt, and then you find after the fact that they hid assets, they did all this - the directors did, did all this bad stuff, what would your remedy under state law be?

TOWNSEND: We probably would not have a remedy as spoliation in that. What makes it different here is the presence of a fiduciary duty because they owed us the duty of full disclosure. If this were your normal adversary litigation and they perjured themselves and do all those types of things...

OWEN: Well it's a husband and wife. It's a divorce. It's a closely held corporation. A year after the divorce you find out that the husband was a real scoundrel and he hid a bunch of assets from the wife. Now would you have a breach of fiduciary suit or would you have a bill of review?

TOWNSEND: You certainly could have a breach of fiduciary suit. The only hesitancy I have about the bill of review is the requirement of extrinsic verses intrinsic fraud that the court sometimes talks about.

OWEN: I'm trying to fit all of this into state law claims because you're asking us to fashion a state law.

TOWNSEND: I think it is a typical state law breach of fiduciary duty case. It's just that the source of the duty happens to be created by federal law.

OWEN: You see that it does have other implications in terms of...

TOWNSEND: Well it does and it doesn't. It does not affect the bankruptcy proceeding because we're not trying to reopen that.

OWEN: That would be the same argument in the divorce. It doesn't affect the divorce. Now we're suing the...

TOWNSEND: It's like also we recognize a lawsuit for legal malpractice. And as recently as King Ranch v. Chapman, you reiterated the rule that just because your lawyer commits malpractice we don't open up the underlying judgment. Your remedy for that breach of fiduciary duty is a tort suit against your lawyer. I think that's the closest analogy.

WAINWRIGHT: There's an important difference here. We have a comprehensive federal scheme to resolve creditor complaints, shareholder issues, various duties and distribute assets that the US congress has put in place to take care of those issues. Folks get a number and get in line at different levels of priority. Why are we not, or do you have the concern that your position could undermine this comprehensive bankruptcy scheme? Respond to this quote. This is in re Levy, 7th circuit 1998: if debtors, creditors, defendants in adversary proceedings and other parties to a bankruptcy proceeding can sue the trustee or lets say debtor in possession and directors in state court for damages arising out of the proceeding, the state court, that court, would have the practical power to turn bankruptcy losers into bankruptcy winner and vise versa. Do you have a concern in that regard?

TOWNSEND: I don't think that argument really fits here for several reasons. The simple answer is that you have, at least in Texas, rule 13 sanctions for frivolous suits, admittedly not a perfect remedy but it's there. You have no evidence motions for summary judgment. We survived that on our allegations of fraud in this case. They did not get a summary judgment, that we lacked evidence of fraud. You also have in our case and I don't think it's unique in that regard, fee shifting language that says if we lose, we have to pay their fees if they were acting in good faith.

WAINWRIGHT: What you're talking about are essentially precautions to ensure that only substantive claims are brought and won. I'm talking more about the systemic issue of having a state court remedy for complaint following the conclusion of a federal bankruptcy for conduct that occurred admittedly during the bankruptcy.

TOWNSEND: The difference I would say to the 7th circuit is that this conduct was concealed during the bankruptcy proceeding. You have heard counsel for the other side say no they knew and they contested this and all those sorts of things. I don't think that's caught an accurate portrayal of the evidence in this case. Yes, we contested the valuation of the corporation. That happens in any contested bankruptcy hearing. And we fought hard on that issue because we thought that they ought to be able to do a better job than they were doing in streamlining costs. A lot of creditors do that in bankruptcy proceedings all the time. What we did not know and in fact the reason we did not appeal that order, and the reason we did not challenge it within 180 days is we did not know that they were breaching fiduciary duties and simply lying to us and to the court about what they were doing.

WAINWRIGHT: Do you think that congress may have made some judgments as similar judgments are made in setting up any statute of limitations, that some good claims may fall by the wayside. There may be some concealment that happens, but just to fit within the limitations period. Could they have decided that to maintain their comprehensive scheme we have to draw a line, good, bad or neutral. And the question you're asking, which I agree is a good one, should there be a state

law followup when that happens?

TOWNSEND: I think congress did draw that line when it came to revocation of the confirmation order. If they get past 180 days, as they did here, we cannot go back and reopen that confirmation order. Because it affects too many other parties. There has to be a settlement to life and you go on down the road with the business reorganizing. But I don't think congress foreclosed the right to bring a damages remedy when you can actually prove a breach of fiduciary duty and fraud by the directors in that case that damage a particular group of creditors, not a generalized damage, but a particular gaining up for kickbacks to favor one group over another.

SMITH: I read the specifics of this conduct. You say it's pretty bad. In your view does it rise to the level of criminal conduct? Has there been any movement in that regard?

TOWNSEND: The record does not reflect anything about the criminal proceedings...

TAPE A, SIDE 1 runs out

SMITH: If you wrote yourself a check for $1 million during a bankruptcy that would be against some law in the bankruptcy code subject to criminal prosecution. So if there is other massive fraud, I know that it would be subject to federal criminal prosecution. So that would maybe wouldn't be adequate, but it would certainly be a backstop to fraud.

TOWNSEND: It could be. I've litigated in civil courts now for 25 years and I've seen a lot of things that to me ought to be remedied by the criminal law that just don't seem to happen. For example, here, a witness - the man who was writing the secret plan was served a subpoena duces tecum to bring documents to his deposition. He shows up and says there are no such documents, never happened, don't have any of these papers. You are just imagining these things. And we basically say well look what our private investigator pulled out of your trash can last night after you got the subpoena duces tecum Whoops. And here are all of the documents he just denied existed. That's one example of fraud that went on throughout this case.

BRISTER: What are your damages and how are they going to be allocated if you're successful?

TOWNSEND: I think our damages will be the difference between what we would have received if the proper valuation of the company had been made and the false valuation that was made.

BRISTER: If there had been an extra $300 under valuation, how would that have been allocated among the 12 classes?

TOWNSEND: I think we would have a minimum claim of $70 million because using the same percentage applied to the greater valuation that we were awarded. I think we would have an

argument that the judge would have given us a larger percentage had he known the pies of whole were bigger. Because that's another flaw in their argument in my view. They try to say - if the pie grew, everybody would grow at the same rate. And I don't think that's necessarily true because senior bondholders, junior bondholders, the seniors get taken care of first. If there is more there then there is some more room for the juniors to gain. It's a balancing act.

WAINWRIGHT: The state court judge would have to make that determination. Correct?

TOWNSEND: After expert testimony. That's correct.

HECHT: And that seems to me to - maybe this was part of the complication that you didn't quite get to. But this seems to be the focus of the concern in that case. I can see that the fraud action itself may not disturb the bankruptcy proceeding after it's done. We're going to leave the plan in place. The company is ongoing. That's not going to be undone. In fact this is an action against individuals and others. But you would have to in the damage phase of the trial go back and try to establish what the bankruptcy court would have done if there had been a different valuation and does that inject a state court too much into this kind of traditional, federal area?

TOWNSEND: I don't think so certainly if you take the lesser number I gave J. Brister, where you simply take the bigger value and use the same percentage that the bankruptcy court already gave. That seems pretty mathematical at that level.

Another possibility of course would be, because this is a breach of fiduciary duty, would be a disgorgement of the ill-gained profits by the trustees.

BRISTER: But there again, unless you all took 100% of it, you are going to have your share of it but then there's just all this money left with other classes of creditors that aren't in court.

TOWNSEND: Well the other classes either got what they wanted or they've been satisfied or the asbestos people settled out. So at this point we are the ones who remain dissatisfied.

BRISTER: So you get everybody else's money by default?

TOWNSEND: If that's awarded. But I think if you just did the straight percentage mathematics, then that's not a problem.

BRISTER: Does this give creditors who see the handwriting on the wall an incentive not to complain during the bankruptcy proceeding but to come flood our courts later on with fraud claims and breach of fiduciary duty claims?

TOWNSEND: I think they would be running a terrible risk at that point.

BRISTER: No more risk than the motions that have been filed against you.

TOWNSEND: It would seem to me there would be a defense if the fraud were discovered during the 180 day period and you kept quiet about it. I don't see how you have much reasonable reliance. Our reliance in the case as I understand it is the fact that we did not avail ourselves of the option to appeal or challenge the order within the 180 day period.

OWEN: I'm trying to see how this applies in another context. Let's say you have some sort of regulatory proceeding, maybe in oil and gas, two operators sue each other and one operator says I want to drill a well right next to the property line. And you go to the commission and the commission says no. And the losing party later finds out that the officers and directors of the defendant in the regulatory proceedings committed fraud and falsified evidence to the commission and did all this stuff. Do they then come into a state court and say okay, they defrauded everybody in the RR Commission proceeding, and had they not done that the RRC would have let us drill and the well would have done this. And here's the kind of order the RRC would have put out and so give us damages based on that. Are you asking the court to basically be a shadow regulator in these proceedings?

TOWNSEND: I think the fiduciary duty makes the difference. I don't think for just a ordinary garden variety fraud case, as distasteful as it is to have people lying and cheat to a court, to get the case over with and move on with life we accept some tolerance for that. We try to find what we can through discovery, but when you have a fiduciary duty that's breached like that, I think you may just have to make an exception.

OWEN: Why didn't you sue in court and ask them to impose some sort of federal remedy? You didn't seem like you tried very hard to get a federal remedy.

TOWNSEND: We didn't think there was one. Generally there is not a federal common law. There's nothing in the bankruptcy code that says you have this damages remedy available by bankruptcy law.

OWEN: I just remember we were looking at the Quatro(?) orders for example. There's been a suggestion by a number of circuit courts that when you've got fraud in those kinds of proceedings that there should be a federal common law as opposed to different states adjudicating it in different ways. There ought to be uniformity. So it seems like the federal courts might be inclined to have some sort of uniform common law of fraud cause of action in this situation.

TOWNSEND: We really just looked at it differently. It was basically a breach of fiduciary duty case. As always duty is created by contract, by statute, occasionally by common law. And so we felt like we had the duty created there and that made it a fiduciary duty claim we can pursue in Texas. Since the conduct occurred in Texas we had jurisdiction here.

WAINWRIGHT: In your state law claim in that case, would all the parties in the bankruptcy proceeding have standing to now make their arguments about the additional $300 million?

TOWNSEND: No. The statute of limitations has run for one thing on that. If they had filed suit timely and could show that they were victims of this, yes they could. But it was basically the junior bondholders and the asbestos plaintiffs who were the victims of this. And what the record actually shows on that, the management of Old National Gypsum and the people at Golden Sacs and the people at TCW kind of know each other. They've been at other groups together. They've worked together on other deals and it's kind of a network; whereas the junior bondholders are small investors, typically under $10,000 and they just don't run in the same circles and they don't each other, and they don't stand to benefit each other and future deals down the road.

WAINWRIGHT: Was there a request made to the bankruptcy court for leave to pursue a state law action?

TOWNSEND: No. There was not because we were out of the bankruptcy court before we realized what was really happening here.

HECHT: Looking for some analogue. If in an ordinary state court proceeding a corporate officer or someone, a partner, or someone who owed an entity a fiduciary duty took a bribe or some money to testify against that entity during the court of the trial. A chief financial officer gives damaging testimony. And it turns out he's being paid by somebody to breach his fiduciary duties. And the corporation loses as a result. Then it may be that the judgment can't be set aside. Would the corporation have a cause of action against the default ____ witness under those circumstances or not?

TOWNSEND: I think for the fiduciary duty yes. If it were not probably no.

All I have to say about limitations is that I don't think the CA really followed the standard of review. It seems to me rather harsh to say as a matter of law that a reasonable investor in these circumstances had to be on notice of the claim because of three different articles around the country at a certain time.

BRISTER: When the newspaper hits the press, that's when your limitations run whether you got the paper that day or not.

TOWNSEND: But I would think at that point it's really when the injury is being suffered to the reputational damage. And if you're really harmed then you are going to hear about it fairly soon. It seems to me that we could lose this issue to a jury on limitations. And if we do, I probably can't really have a good appeal challenging it. But to actually just cut it off as a matter of law seems too harsh to say objectively as a matter of law all of these investors were supposed to know what the Charlotte Business Journal had reported on a certain day or what Forbes Magazine had said on a certain date.

WAINWRIGHT: Jeff Prostock's claim individually, I understand he's a lawyer, a lawyer talked to him about a potential claim more than 4 years before TCW was brought into the case.

Individually his claim is in trouble would you say?

TOWNSEND: He has a tougher position than the class members as a whole.

WAINWRIGHT: Is he the class rep?

TOWNSEND: He is one of three class reps, but he is not a member of the class because of the way the class was defined and when he bought his bonds. So we have two other class reps. There is no doubt that he was made aware of the injury on a certain date from his lawyer. And that led to the filing of the lawsuit against all the parties accept TCW. For TCW, what I believe happened is that it took discovery to get some of these documents, and to uncover them because of the hiding and the disposal things that I've talked about and the evidence reflects. When you're asking fiduciaries for documents, they say they don't exist, and you're sending out subpoenas and they are getting thrown in trash cans. It just takes awhile to find how everybody is connected together. So even for Mr. Prostock that's why I think he should still be within the discovery rule on that. But he has a tougher time I admit for the class because he was represented by that lawyer and the class was not at the time.

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REBUTTAL

HECHT: What's your answer to that question: if a witness with a fiduciary duty to a partner testified a different way, would the losing entity have a cause of action for breach of fiduciary against the witness?

MARTIN: I think any cause of action on the part of the employer would be based on the contractual relationship between the employer and the employee not on the fiduciary duty. If the guy is up there lying, then he's breaching a duty to the court, and he's breaching a duty to every litigant who is there. But the relationship between the employer and the employee is some different and separate.

HECHT: That's what I mean. Maybe under Trevino and that sort of part of our jurisprudence you can't sue him for perjury, even though he shouldn't have said what he said, but could you still sue him for breach of a fiduciary duty because he had a duty to get up there and look out for the corporation's best interest, and he was officer of record, and he abandoned it for a promise of a better job after the trial was over. It seems like you could sue under those circumstances.

MARTIN: Under Trevino, I don't think you could bring a claim that said I lost this litigation because you lied. I think you could bring a claim for breach of some contractual obligation to do your job and serve the interest of the company. I don't know how you would measure the damages but I don't see that as analogous to this case at all.

I want to talk about what actually happened in the bankruptcy. I'm going to quote for you from the plaintiff's bankruptcy court papers and arguments. It wasn't just that valuation was an issue. They argued "debtor management has manipulated the projections and performance of the company in such a manner as to diminish its value. Debtor was intentionally manipulating its financial data and projections to make it appear as if the value of NGC was much lower than it actually is. Management deceived NGC's creditors with a misrepresentation of the value of the company to coax a small creditor faction into supporting its plan and opposing the BT plan."

The things we are talking about here are not new. What they are saying is, heah, we've got a new piece of paper and we want to make those arguments again. And we want to make it to a state court jury and we want to have this jury get in the mind of the bankruptcy judge and decide what the bankruptcy judge would have done had he had this piece of paper before him.

OWEN: Why did the bankruptcy court and DC and 5th circuit all allow a fee shifting agreement for litigation to continue against officers and directors if they didn't think there was going to be some possible claim?

MARTIN: The intent of that paragraph was to foreclose frivolous litigation. So I don't think you can view it now as some sort of sanction for it. That was the intent of it, was to foreclose litigation.

J. Brister you asked about damages. I lost my train of thought.

BRISTER: He said they were going to just take their share according to the bankruptcy plan of the difference over valuation.

MARTIN: Of course the problem with that is, think of the next case down the road when there are 100 creditors. You know, I'm representing 5 individuals and in the next case the officers and directors would be subject to 100 individual lawsuits, all that might have inconsistent results. If every creditor has its own claim, then you're never going to be able to get an individual to serve as a manager of a debtor in possession if everything can be judged in hindsight and give rise to some private right of action on the part of creditors, any creditor.