

Bankruptcy Court Decisions

WEEKLY NEWS & COMMENT

VOLUME 51, ISSUE 26

September 8, 2009

Lawyers coordinate efforts to maximize victims' returns

Massive corporate fraud schemes commonly breed both bankruptcy cases and class action lawsuits. And typically, class action lawsuits present a thorn in the side of professionals seeking to replenish the coffers of fraud-felled corporate debtors; and to be fair, the reverse is true as well.

As the class and the estate fight over who has the right to bring what claim for the benefit of roughly the same claimants, it's the victims who lose both time and money. And when the victims — creditors of the estate and members of the class alike — have already lost millions in the fraud scheme, it's time and money that can scarcely be afforded, or justified.

That's certainly true in the case of tax deferral company 1031 Tax Group LLC. Victims who lost \$126 million in the 1031 Tax Group LLC fraud, which culminated in Edward Okun's recent 100-year prison sentence, were understandably impatient by the time liquidating trustee Gerard McHale was appointed to the case in October 2007. By then, the estate was \$4 million underwater, thanks to the \$11 million in administrative claims attorneys racked up during the prior six months of the case. Okun's victims had nothing to show for it.

Parallel class action cases filed in California promised additional delay and expense. But in what may well be a first, the liquidation trustee and his counsel struck a deal with the class that instead laid the groundwork for a concerted, coordinated effort to maximize the returns to Okun's victims on both legal fronts.

The cause

The victims had, in many cases, lost their life savings to Okun's Ponzi scheme. Okun's scheme began with his purchase of a qualified intermediary, a company that facilitates the exchange of commercial property through Internal Revenue Code Section 1031. Under Section 1031, individuals wishing

to conduct a like-kind exchange of commercial real property can avoid the payment of capital gains taxes on the sale if they: deposit the proceeds from the sale of the relinquished property with a qualified intermediary; and close on the sale of a replacement property within 180 days. When the exchanger is ready to close the sale on the new property, they notify the qualified intermediary, who shows up at the closing with the exchanger's money.

That's not the way it worked for customers who entrusted one of Okun's companies to hold their money, however. Okun instead used the money held in trust for the exchangers as a personal piggy bank. He bought, among other things, a helicopter, which the trustee later sold for \$815,614; a Gulfstream jet, \$937,201; a Lear jet, \$324,176; a yacht, \$200,850; and nearly \$300,000 worth of jewelry. He also used his clients' money to fund his real estate acquisition businesses and to pay bonuses to his coconspirators. Ultimately, he bought six QI companies, and looted tens of millions of dollars out of each one.

By late 2006, the scheme was beginning to unravel. Okun was running low on cash, and U.S. Postal Inspectors opened a criminal investigation. So, with just \$19.7 million of the victims' money remaining in a Colorado bank account, Okun filed Chapter 11 for all of his QI companies.

For the victims, relief wasn't swiftly found in bankruptcy court. With Okun still at the helm, the debtor in possession and its bankruptcy counsel, now-bankrupt Dreier LLP, assured creditors that a plan of reorganization that would pay creditors in full through the sale of Okun's real estate assets was right around the corner.

But that's where the plan of reorganization stayed — right around the corner, and just out of reach. It was later discovered that the real estate assets that Okun proposed to use to fund the plan were over-leveraged to the point of being practically worthless,

said McHale's counsel, Golenbock Eiseman Assor Bell & Peskoe LLP partner Jonathan Flaxer.

"It's bad enough as a trustee when you come into a case where there isn't any money. It's worse when you start with negative \$4 million, and you have no idea if you're ever going to bring in any money," he said. "There was a lot of risk here, but we've been able to turn the ship around and send it in a positive direction."

The agreement

The trustee and his counsel swiftly shifted the focus of the case from the false hopes of a plan, to a broad investigation designed to ferret out potential claims. In the interim, of course, victims filed multiple class action suits.

"You have to view these cases with a keen eye toward casting a wide net of how the losses are going to be recompensed and how the victims are going to be compensated. It's really a matter of leaving no stone unturned," Flaxer said.

And in an effort to leave no stone unturned, the attorneys decided they needed to find a way to avoid the legal squabbles that typically accompany bankruptcy cases carried out parallel to class action suits.

"What can happen in these cases is that the class action and the bankruptcy estate are at loggerheads. The trustee seeks to enjoin the class action from pursuing claims he asserts belong to the bankruptcy estate, and that's where the battles begin. They wind up fighting over who owns this claim and who has jurisdiction, who has the right to go after this party, and who's violating the automatic stay. We decided to try to work with the class action lawyers so we could avoid expending our limited resources fighting with the class action, and try to maximize returns by working with them."

Both the bankruptcy trustee and the class were asserting similar claims, with similar underlying facts, against the same parties. The only real difference was the legal basis for the claims.

As far as the attorneys are aware, it was the first time such an agreement had been forged, and it took some time to work out the details. Ultimately, however, the cooperation agreement won the approval of Judge Martin Glenn in the U.S. Bankruptcy Court, Southern District of New York, and received preliminary approval from the class action Judge James Ware in the U.S. District Court, Northern District of California.

The basis for the cooperation agreement is simple, Flaxer said. Through negotiations, both parties agreed that the class owns certain claims, and the trustee owns certain other claims.

Under the agreement, the estate and the class agreed to coordinate discovery, so that, rather than the trustee taking his depositions, and then the class taking depositions of the very same people, depositions were conducted only once and were shared. The agreement also dictated that the parties coordinate settlement discussions, which, Flaxer said, likely worked to minimize the kind of posturing common during such settlement negotiations. When a potential or actual defendant entered the settlement negotiations, it was with the knowledge that the people sitting across the table owned all of the claims asserted.

"What we did is take away their ability to try to tell either the bankruptcy estate or the class that they didn't own the claim they were asserting. The defendants can't hide behind that defense when both parties are at the table," Flaxer said.

While the coordinated settlement discussions took away some of the defendants' leverage, at the same time, it allowed the defendants to buy complete peace with the class and the estate during the same negotiations.

The cooperation agreement also dictated how recoveries procured through the coordinated effort would be split between the class and the estate. In some cases, the distribution tilted toward the estate, in others it tilted toward the class, and in the majority of claims going forward, recoveries will be split equally, depending on whom the attorneys agreed owned each claim, and whether or not the settlement had been reached prior to the cooperation agreement.

While all that might have sounded good to the attorneys, it would raise the ire of class action and bankruptcy claimants concerned that they'd be responsible for paying two sets of legal fees. But the attorneys worked that out too. The class action attorneys agreed that when they sought approval of the settlements, they could only take credit for that portion of the settlement allocated to the class. In the recently reached Wachovia settlement for example, the attorneys agreed that the class would receive 40 percent of the \$45 million settlement. Their fees, then, would be based on \$18 million. Further, the agreement caps the attorney's fees.

The agreement also allowed the trustee, if need be, to rely on the class action court to deliver in-

junction relief to settling parties. That's particularly important in light of the 2d U.S. Circuit Court of Appeals opinion in *In re Metromedia Fiber Network, Inc.*, 44 BCD 276 (2d Cir. 2005), which set standards for permitting third-party releases. "*Metromedia* set up a series of tests that create some hurdles that are not so easy to jump over and that have effectively cut back, or at least muddied the power of bankruptcy courts to issue such injunctions. While it may not be cut and dry whether the New York bankruptcy court can approve such injunctions, it is clear that the class action court can."

The agreement provides then, that before any settlement goes into effect, either the class action court or the bankruptcy court must approve an injunction to protect the settling parties.

The cross-country joint hearing

All in all, Flaxer said, the cooperation agreement "seems to be working out very well" — something of an understatement considering that the par-

ties just reached a \$45 million settlement with Wachovia.

While the bankruptcy case moves toward gaining approval for its recently filed liquidation plan, the class action case is, meanwhile, moving toward obtaining class action approval. In yet another unusual move, the attorneys have teed up both the class action and the liquidation plan for one final, multicourt approval hearing on Oct. 7. Live video will connect the bankruptcy court in New York with the class action court in San Jose, Calif., "with the goal being — if we can pull this off — that once the 10-day bankruptcy appeal period expires and the 30-day federal District Court appeal period expires, we can hopefully cut the checks and make distributions before the end of the year," Flaxer said.

Today, between the class action and the bankruptcy case, victims would receive 44 cents on the dollar. Potential future settlements with defendants Citigroup and Boulder Capital LLC could significantly increase that amount. ■