The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 20, No. 5 May 2012

Claim Estimation: Potential Pitfall For Creditors In Chapter 11 Matters

Carren Shulman

SHEPPARD MULLIN RICHTER & HAMPTON LLP

Claim estimation is another weapon in the arsenal of a debtor seeking to push its agenda or plan through the bankruptcy court. While not new, post-*Stern v. Marshall,* estimation may allow a bankruptcy court effectively to adjudicate claims over which it has no jurisdiction. Creditors (particularly those with large unliquidated or contested claims) should plan ahead to ensure that their claims are resolved in the right forum, with sufficient due process, and that their ballots are counted despite the lodging of a claim objection.

Bankruptcy courts have the power to estimate claims of creditors in cases under §502(c), title 11, chapter 11 of the United States Code (the "Code") for purposes of allowance, and under Rule 3018 of the Federal Rules of Bankruptcy Procedure (the "Rules") for temporary allowance for purposes of voting on a plan of reorganization. The Code and Rules are silent regarding, among other things, the sufficiency of evidence and burden of proof necessary to estimate a claim; the appropriate discovery period; and whether following estimation a full litigation of the claim is appropriate to protect the due process rights of the claimant. There also is no rule limiting a bankruptcy court's authority as to the type of claim to be estimated, such that claims requiring a jury trial or class action claims, or claims for which relief from the automatic stay may have been granted, may be subject to estimation.[1]

Carren Shulman

Estimation Under Code §502(c)

Under Code §502(c), a bankruptcy court must estimate any claim for allowance purposes that is (i) contingent or unliquidated, the liquidation of which would "unduly delay" the administration of the bankruptcy case, or (ii) a right to payment based upon an equitable remedy for breach of performance. However "undue delay" is undefined in the Code. As the Fifth Circuit describes in *In re Ford,* 967 F.2d 1047, 1053 (5th Cir. 1992), §502(c) is designed to serve at least two purposes: to avoid the need to await the resolution of outside lawsuits in order to determine liability or amounts owed by anticipating the likely outcome of actions, thus permitting the debtor to quickly determine the payout to creditors; and to promote fair distribution to creditors through a realistic assessment of uncertain claims. A motion to estimate for allowance purposes is commenced by a debtor or party in interest. It is unclear whether a debtor must seek to estimate claims individually or may group them by type of claim or by debtor. In large cases in particular, creditors should look out for these types of motions, which may be contained within other motions that otherwise appear innocuous to the reader.[2]

Estimation Under Rule 3018

A bankruptcy court may estimate a claim that has been objected to for the limited purpose of voting on a plan of reorganization. Perhaps the most effective power of creditors in a bankruptcy is the ability to vote on a plan. In order to emerge from chapter 11, a debtor must confirm a plan with two-thirds in dollar amount and a majority in number of claims in each class. Code §1126. The larger the claim, the greater the effect the claim may have on confirmation. Therefore, bankruptcy courts should err on the side of ensuring that a debtor's plan offers sufficient funds to pay potential claims.[3]

Once a bankruptcy case is filed, creditors must file claims by a bar date. Code §501. While a proof of claim need not be filed in a chapter 11 case if the claim is properly identified on the debtor's schedules of claims as liquidated and undisputed, prudence dictates that a proof of claim should be filed to disclose the specific basis for the claim, among other reasons;[4] however, jurisdictional issues should be considered.[5]

Objections to claims may be filed prior to or after confirmation of a plan. If filed prior to confirmation of a plan, unless by agreement or court order, a claimant that is the recipient of an objection may be barred from voting its claim or having its vote count.[6] A creditor whose claim is objected to should confirm immediately following the filing of any objection that the debtor intends to allow the creditor to vote its claim, and should consider entering a court-approved stipulation reflecting the agreement.

Under Rule 3018: "Notwithstanding objection to a claim or interest, the court after notice and hearing may temporarily allow the claim or interest in an amount which the court deems proper for the purpose of accepting or rejecting a plan." It is unclear how much evidence is required to establish the basis for the creditor's claim for voting purposes. Some bankruptcy courts have held that Rule 3018(a) only requires a "summary-type hearing[.]"[7] Since a debtor may decide strategically to

***Carren Shulman** is a Partner at Sheppard Mullin LLP in the Finance and Bankruptcy practice group and regularly represents creditors in bankruptcy and contract counterparties in protecting their rights.*

Please email the author at cshulman@sheppardmullin.com with questions about this article.

object to a large claim or group of claims just before or upon the filing and distribution of its plan and ballots, there may be very little time for an estimation hearing. A bankruptcy court should take into account the timing of the objection in determining the size of the claim for voting purposes to avoid disenfranchising a claimant with a large claim.

Risks Of Estimation

The risks to the creditor whose claim may be estimated can be great. If the claim is estimated too low and the debtor begins to make payments to creditors under a confirmed plan, there may be insufficient cash to pay a higher claim following a full litigation. Additionally, although estimation may not be the ultimate adjudication on the merits, the bankruptcy court's findings of facts and conclusions of law may be adopted by another court in a future litigation. The risk to a *debtor* that puts forth a plan contemplating full payment to all unsecured creditors is that one creditor's disputed claim ultimately will be so large as to result in a subsequent insolvency, that the confirmed plan may be undone or that disgorgement of payments made to creditors may be required.

To "estimate" is "to judge tentatively or approximately the value, worth or significance of" or "to determine roughly the size, extent or nature of[.]"[8] An approximation or rough determination of the size of a claim, does not fulfill the requirements of due process. As noted in *Collier's*, "In estimating a claim, the bankruptcy court should use whatever method is best suited to the particular circumstances. Although the bankruptcy court is bound by the legal rules that govern the ultimate value of the claim[,] . . . there are no congressionally mandated limitations on the court's authority to estimate claims." 4-502 Collier on Bankruptcy ¶ 502.04[2]. Thus, the specific facts of the case dictate how estimation will apply to a particular claim.

Litigation is necessarily a long process, so the fact that litigation takes time should not be the basis alone for estimation.[9] Similarly, if a debtor causes the undue delay in litigating the claim in another forum, such delay either should not be a basis for an estimation hearing or should result in balancing the equities on estimation in the creditor's favor. Because §502(c) is intended to ensure fair and immediate distributions to creditors in situations where lengthy litigation is impractical, the bankruptcy court necessarily should err on the side of allowing for estimation purposes the largest reasonable claim. If we assume the Code was not meant to curtail the rights of litigants to due process, and was intended simply to ensure that a plan may be confirmed and claims paid quickly, then estimation (particularly under §502(c)) should be applied sparingly, to allow a bankruptcy court to make a reasonable assumption within the limited time afforded to litigate the claim, for the sole purpose of ensuring there is sufficient cash in the estate to pay all claims, including the estimated claim, until a full resolution of the claim in the proper forum or in bankruptcy court after a full hearing or trial.

Takeaways

How can a creditor plan ahead knowing that its claim may be subject to an estimation hearing before a debtor-friendly court? Go back and read the agreements that apply to the relationship. If bankruptcy is imminent and a claim exists, a creditor should consider commencing a proceeding immediately in the best and most appropriate forum. Once the bankruptcy is filed, the creditor can move for stay relief to pursue the claim. Where a contract calls for arbitration of disputes, immediately after a bankruptcy is filed, consider seeking stay relief to pursue arbitration. A creditor may also decide to affirmatively seek estimation itself early in the process to put the debtor on the defensive, particularly where a debtor has filed its bankruptcy to delay or stave off litigation.

There may be benefits to estimation for creditors. The process may be cheaper and faster than litigation in state or federal court or through arbitration. Bankruptcy judges ordinarily have low tolerance for discovery disputes and significant motion practice, because the hearing is before the judge who can parce through relevant or prejudicial evidence. Because bankruptcy court is a court of equity where fairness is as important as the law, the bankruptcy court may be more likely to award damages to a sympathetic creditor harmed by the insolvency of a contract counterparty or bad actor. Further, since the process is "estimation," the bankruptcy court should be inclined to err on the side of finding a larger claim either for allowance or voting purposes to ensure the rights of the claimant in the shortened process are not trampled upon, which may lead to a resolution of the claim without the need for further litigation.

Estimation continues to be used by debtors as a tool to dictate the administration of a case and the resolution of claims for strategic purposes and not simply because claims are numerous and may take too long to litigate. As such, creditors need to fully understand the potential implications of estimation in order to protect their rights.

---

1 C.f. 28 U.S.C. §157(b)(2)(B) (other than contingent or unliquidated personal injury tort or wrongful death claims).

2 In *In re Enron Corp.,* Case No. 01-16034-agl (Bankr. S.D.N.Y. 2001), the court granted debtors' motion [Dkt. No. 23903] to "establish reserves" for thousands of claims in order to begin making distributions under the confirmed plan. Though the underlying motion generally referenced §502(c), there is no authority to lump claims together to establish "reserves."

3 *See In re Harbin,* 486 F.3d 510 (9th Cir. 2007) (appellate court vacated bankruptcy court's confirmation of debtor's plan, finding that debtor's plan was infeasible and the bankruptcy court failed to evaluate the effect a future judgment may have on implementation of the plan).

4 A proof of claim is *prima facie* evidence of the existence and amount of a claim that must be rebutted through the filing of an objection. Code §502(a), Rule 3001. Rather than objecting to a scheduled claim, the debtor may simply amend its schedules during its bankruptcy to change the amount or designation of a claim, which amendment may be missed by the creditor, particularly in a case with a large number of pleadings filed. Furthermore, if the creditor needs to update or amend its claim, it may file an amended claim after the bar date referring to the original filed claim – there is no box on the claim form referring to an amendment to a scheduled claim.

5 Filing a proof of claim subjects the filer to the jurisdiction of the bankruptcy court for purposes of resolving the claim. Thus, where bankruptcy court is not the preferred forum for resolution of a claim, a claimant should consider filing an appropriate motion in advance of the bar date to address the jurisdictional issue, e.g., seek stay relief to continue or commence a dispute in another jurisdiction, removal to another court or withdrawal of the reference.

6 *In re Frascella Enters, Inc. (In re Frascella)*, 360 B.R. 435, 457 (Bankr. E.D. Pa. 2007); *Jacksonville Airport, Inc. v. Michkeldel, Inc.*, 434 F.3d 729 (4th Cir. 2006); *Armstrong v. Rushton (In re Armstrong)*, 294 B.R. 344, 354 (B.A.P. 10th Cir. 2003).

7 *In re Zolner*, 173 B.R. 629, 633 (Bankr. N.D. Ill. 1994). Other courts have found the allocations of the burden of proof to be the same as for claim objections. *In re FRG, Inc.*, 121 B.R. 451, 456 (Bankr. E.D. Pa. 1990); *see also In re Easterly Constr. Co.*, 2009 Bankr. LEXIS 3481, at *2, n.1 (Bankr. M.D. La. 2009).

8 Merriam-Webster's Dictionary (11th ed. 2008).

9 In *MSR Resort Golf,* Case No. 11-10372-shl (Bankr. S.D.N.Y. 2011), debtors received court approval for a negotiated settlement with its mezzanine lenders that included forbearance from objecting to extensions of exclusivity for twelve months. Using the arbitrary deadline of the forbearance agreement, debtors moved for an emergency sale of assets, followed by a motion to estimate a large potential rejection claim. No rejection had occurred, so no rejection claim was filed; thus, no basis for estimation existed. Nor was any threat to asset value asserted if a sale did not occur within the stated period. Rather, the emergency was based entirely on debtors' strategy to emerge before the expiration of its forbearance agreement with a group of lenders. Nonetheless, the bankruptcy court granted debtors' motion to estimate an unfiled, unobjected to claim on short notice. The entire process was in the nature of an advisory proceeding, the cost of which the creditor was required to bear.