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Claims Chat II

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Practical and Ethical Considerations in Claims Resolution

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During a chapter 11 proceeding, professionals representing debtors find themselves addressing numerous critical matters, including working with key constituents to develop a reorganization plan, coordinating with clients to meet the operational challenges that inevitably arise during any bankruptcy case, and responding to statutorily or constituency-imposed reporting requirements and deadlines. In the meantime, claims against the debtor roll in, and professionals (as well as their clients) must dedicate resources to evaluating the claims that have been filed and charting a path to resolving these claims. This process has a number of steps that include the initial evaluation of the claims compared to the debtor's books and records, objections to clearly invalid claims, review of the claims that vary greatly from the debtor's records to develop a resolution plan, and litigating and negotiating claims.

While these steps seem very straightforward, there are many nuances that can pose practical and ethical questions for the professionals involved. The first challenge is often getting a debtor client to understand and buy into the necessity for a robust claims-reconciliation process. In many instances, the company's staff that remains during and after the chapter 11 process is much smaller than what was in place prior to the filing, and reconciliation of potentially thousands of claims and supporting records seems an even more daunting process to a skeleton crew. In addition, records and memories of disputes spanning years before a chapter 11 filing are often spotty and tend to become even more so over time. In many cases, the claims to be reviewed were filed by entities with which the client has an ongoing business relationship that has already suffered because of the chapter 11 filing, and which the client does not necessarily wish to further poison by filing a claim objection. Finally, the claims-reconciliation process can become time intensive and expensive, to the chagrin of company staff and management. In these cases, it is often quite helpful to establish formal standards, thresholds and guidelines to steer the process, as well to set clear rules by which all parties will guide themselves and can in turn be comfortable that the reconciliation process will be accomplished effectively, efficiently and in compliance with parties' fiduciary obligations.

Initiating and Prioritizing Claims Reconciliation

When a debtor is initially focused on claims resolution, the priorities are traditionally twofold: One is to get rid of the "low-hanging fruit" of obviously incorrect claims. This process often involves duplicative claims, claims for items that have been paid prepetition or claims that are obviously invalid. This is done through the use of omnibus objections to claims and can usually be accomplished with a cursory review of the claims and the debtor's records. Once most of these types of claims are expunged, a better picture of the range of claims can be determined.

As a first step, preliminary objections will thin the number and amount of claims, but a large number of claims with small to large variances and unliquidated claims usually remain. Developing a disclosure statement can be problematic if the range of disputed and contingent, unliquidated amounts is so large that constituencies are unable to determine with any confidence or knowledge what their ultimate recovery might be. This may not be a legal impediment to confirmation in some cases, but it may stand in the way of negotiating with key creditors that are evaluating the merits of a proposed reorganization plan. As a best practice, debtors often focus on those claims with the largest disputed amounts early in the case so that the disputes can be minimized.

If there are also large litigation or contingent claims, the resolution of those claims might impact the

amount and timing of any recoveries to creditors. It is obvious that particular attention should be paid to those claims that will significantly impact recoveries to creditors and may improperly sway voting on the plan. However, when developing an overall claims resolution plan, professionals must also evaluate the present resources that are available (both financial and human) to resolve those large disputes, and consider what resources will be available to undertake this effort after a plan is confirmed.

While the omnibus claims-objection process can still be used to initiate the process of resolving claims, these objections should only be filed after the debtor has undertaken a full review of its records. Counsel must ensure that the objection is supported by a careful review prior to the filing of any objection.[1] It is not appropriate, and might be sanctionable, for counsel to simply object to every claim that does not match the debtor's books and records without making an independent determination that the asserted liability is indeed invalid.[2]

Further, when objecting to claims in advance of the filing of a plan or disclosure statement that advises creditors of the quantum of recovery that they might receive on account of their claims, parties should be mindful of information gaps or discrepancies between the debtor and the claimants in cases where the plan and disclosure statement have not yet been filed. While there might be an inclination to assert claim objections as quickly as possible, this effort might yield more responses than would be received if the objections had been filed after the plan and disclosure statement were filed, and creditors might determine that any distributions are likely to be small. In addition, using the claims-objection process as a mechanism to deprive claimants of the ability to vote on a reorganization plan is also a questionable tactic if the underlying analysis supporting the objection is not full and supportable.

Emphasizing Flexibility and Efficiency

Determining how to structure the claims-resolution process in a particular case cannot be done in a vacuum. An efficient claims-resolution process might be different for each case, depending on projected recoveries to creditors, availability of resources with institutional knowledge to evaluate the claims, make-up of the creditor base, time constraints, cost of resolution and the direction provided by the court overseeing the case. As a fiduciary to the estate and its creditors, it is not necessarily the mandate of the debtor and its professionals to reduce the claims pool to the lowest possible value, but rather to maximize returns to all valid claimholders.[3]

> **In many cases, once the claims-reconciliation process is complete, the reorganized company or plan administrator is left holding residual funds that would cost more to distribute than the value of the available funds themselves.... [I]n some cases, chapter 11 plans direct the distribution agent to donate such *de minimis* funds to the ABI Endowment Fund....**

The costs to resolve claims involve both the time and effort of debtor employees and professionals, but also the cost to notice claimants (both before and after the hearing), the review and input from creditor professionals, and the administrative costs, including noticing and court time. In fact, it can be a significant burden on the court to hear claims objections with larger cases, which may take up precious court time that debtors would like to have for more pressing issues. One overlooked cost is the price to the estate of claims that are objected to for which the hearing is often only partially concluded and continually extended. It is with these costs in mind that out-of-court settlements are often preferred by both the debtors and the court.

During a case, various interested parties will also be involved in the settlement of claims (either negotiations or authorizations of settlements) due to their interests in the ultimate outcome of the case. This provides additional oversight to ensure that settlements are appropriate and monitored. For example, in cases with a large number of unliquidated claims due to outstanding litigation, it might be helpful to construct a resolution mechanism, such as an alternative dispute resolution process, in order to resolve claims without costly litigation. A third-party mediator is often more successful in helping claimants recognize the realities of plan recoveries and litigation costs, as well as reach a fair resolution. Again, however, practitioners should consider whether the mediation process, and their clients' participation in such process, is truly geared toward an efficient resolution of liabilities for the benefit of all creditors or whether enforcing more tasks into the claims reconciliation process is merely meant as a method of delaying a final resolution of claims in hopes of grinding creditors into submission.[4]

1 The Federal Rules of Bankruptcy Procedure require that certain claim objections include detailed information from the debtor's records. *See* Fed. R. Bankr. P. 3007(e) (providing that "[a]n omnibus [claim] objection shall: (1) state in a conspicuous place that claimants receiving the objection should locate their names and claims in the objection; (2) list claimants alphabetically, provide a cross-reference to claim numbers, and, if appropriate, list claimants by category of claims; (3) state the grounds of the objection to each claim and provide a cross-reference to the pages in the omnibus objection pertinent to the stated grounds; (4) state in the title the identity of the objector and the grounds for the objections; (5) be numbered consecutively with other omnibus objections filed by the same objector; and (6) contain objections to no more than 100 claims"). An objecting party "must adduce facts tending to defeat the claim [and] [i]f the objector succeeds in overcoming the *prima facie* effect of the proof of claim, then the burden remains on the creditor to prove the validity of the claim by a preponderance of the evidence." *In re All-Am. Auxiliary Ass'n*, 95 B.R. 540, 545 (Bankr. S.D. Ohio 1989).

2 *See* Fed. R. Bankr. P. 9011(b), noting that by presenting to the court any paper, such as a claim objection, the attorney signing such an objection is making a certification to the court that, among other things, the objection "is not being presented for any improper purposes, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation," that the "legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification or reversal of existing law or the establishment of new law," and that "the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery." This sentiment is bolstered in the Model Rules for Professional Conduct, which states that a "lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law." Model Rules of Prof'l. Conduct R. 3.1 (2013). Cases sanctioning practitioners in chapter 11 cases are uncommon, but bankruptcy courts have sanctioned counsel for debtors in chapter 13 matters in a number of cases for abusive claims objection tactics. *See, e.g., In re MacFarland*, 462 B.R. 857, 882-83 (Bankr. S.D. Fla. 2011) ("So long as the proof of claim contains sufficient information to match it with a scheduled debt, the debt is undisputed, no other creditor has filed a proof of claim for the debt, and the debtor doesn't present any evidence to dispute the debt or ownership of the debt, the objection to claim is specious. Such claims objections — whether isolated Rule 9011(b) violations or concerted frauds — interfere with the just, speedy, and inexpensive determination of whether claims should be allowed.") (internal citation omitted).

3 *See In re Moody Nat'l SHS Houston H LLC*, 426 B.R. 667, 675 (Bankr. S.D. Tex. 2010) ("At its most fundamental level, a business bankruptcy case is designed to maximize the returns to creditors holding claims against the estate, while allowing a debtor to reorganize." (citing *Fla. Dept. of Revenue v. Piccadilly Cafeterias Inc.*, 554 U.S. 33, 51 (2008))).

Key Ethical Considerations

- What is the impact on the recoveries to creditors?
- Who is benefiting from the process: the creditors or the professionals?
- The process should lead to recording the appropriate liability and not the lowest number possible.
- Fairness to all creditors is paramount.

One best practice is to have settlement-process procedures approved by the court, including identifying settlement authority for the debtor and appropriate input or authorities for other interested parties such as creditors' committees.[5] With settlement parameters approved for each of these potentially large-dollar claims, debtors can often efficiently resolve the claims in a reasonable timeframe while avoiding the management time, expense and extensive timeline that is inherent in most litigation. In other cases, it may make sense to establish a convenience class if there are a large number of claims for low-dollar amounts, the threshold for which would vary by case. A bankruptcy professional's obligation as an advisor to the debtor is to establish a process that treats the creditor body fairly and uses the debtor's limited resources wisely.

Winding Down the Process

Upon emergence from chapter 11 in larger cases, the work of claims resolution is typically not complete, but professionals often find themselves working with interested parties with minimal patience to participate in a robust reconciliation process. Especially in cases where the distributions are a *pro rata* allocation of a fixed number of shares or dollars, interested parties often suggest a blanket allowance of all remaining unresolved claims, or an underresearched placeholder omnibus objection to all remaining unresolved claims, on the basis that whether claims are allowed or disallowed does not impact the amount that the estate will distribute. It is fairly easy to explain that, at a minimum, the reorganization plan and the obligations therein to prosecute any objections to claims that are not allowable constitutes a contractual duty owed to creditors;[6] that violation of the terms and obligations of a plan might be seen as sanctionable violations of a court order (*i.e.*, the confirmation order); and that some courts have determined that post-confirmation, parties still have fiduciary duties to the creditors of the estate.[7] It is also fairly easy to explain the notion that the bankruptcy court considers a completed proof of claim as *prima facie* evidence of a claim's validity[8] and requires the same standards of proof, regardless of the value of distribution a claimant might receive, if it is required to rule on a claims objection. However, a more challenging discussion arises when evaluating claims that present good-faith factual or legal disputes that will require judgment, negotiation or litigation and for which an emerged entity might have to expend time and resources to resolve.

For example, a proof of claim may raise a dispute that could cost significant amounts to litigate, but the actual distribution value, if the claim were to be allowed or compromised, might not be as significant. In this case, a party in interest (seeking to simply cut off administrative costs of the claim reconciliation) might have little interest in mounting any considerable challenge to such claim, but in other instances, the party in interest (seeking to avoid the negative precedent of allowing a claim in any significant amount based on a set of asserted facts) may wish to mandate full-blown litigation over such claim, despite the fact that the actual cost of litigation would exceed the value of consideration that would be distributed if the claim were simply allowed. From an overall process evaluation, while it is absolutely appropriate to advance the position that all claims should be resolved at the appropriate liability due to the creditor, this position is sometimes at odds with the effect that such a process will have on the value of distributions to the entire creditor base. While there is no cut-and-dried answer to these questions, the ultimate goal should always be to provide net value to the unsecured creditors.

In many cases, once the claims-reconciliation process is complete, the reorganized company or plan administrator is left holding residual funds that would cost more to distribute than the value of the available funds themselves. Determining what constitutes a *de minimis* distribution will depend on the case, the number of creditors and the costs to distribute. While there is no case law on this point (as it is unlikely that anyone is going to spend money to litigate over these small amounts), there is anecdotal evidence of courts instructing professionals to use their best judgment in these cases. A best practice, however, is to consider this issue during the plan-negotiation process so that there is clear direction that can be relied upon when the time comes to make the final distributions. In addition, in some cases, chapter 11 plans direct the distribution agent to donate such *de minimis* funds to the ABI Endowment Fund or other worthy charities.[9]

Conclusion

The claims-reconciliation process in a chapter 11 case can be costly, time-consuming and frustrating to clients. Claims-management strategies can vary from case to case, and professionals and fiduciaries can have differing views as to how their obligations to creditors are best fulfilled. The key is to be mindful that the process should be geared toward providing the maximum value to all valid claimholders in a timely manner. abi

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4 To the extent that a court finds that the established procedures were simply employed as a delaying tactic, there is precedent for the court refusing to award the payment of fees related to such process. *See In re Fleming Cos. Inc.*, 304 B.R. 85, 97-98 (Bankr. D. Del. 2003) (finding that motions to establish additional procedures related to submission of reclamation claims, where debtors ultimately asserted that secured lenders' liens on all inventory were superior to reclamation claimants' liens, constituted "nothing more than a delaying tactic, wasting the Debtors' and this Court's precious time," and denying fees sought by counsel in relation to prosecution of motions and analyzing reclamation claims).

5 *See, e.g.*, Order Establishing Omnibus Procedures for Settling and Allowing Certain Claims and Causes of Action, *In re Eastman Kodak Co.*, Case No. 12-10202, Dkt. No. 3361 (Bankr. S.D.N.Y. March 20, 2013).

6 *See, e.g., Ernst & Young LLP v. Baker O'Neal Holdings Inc.*, 304 F.3d 753, 755 (7th Cir. 2002) ("A confirmed plan of reorganization is ... a contract between the parties and the terms of the plan describe their rights and obligations.").

7 *See, e.g., In re B. Cohen & Sons Caterers Inc.*, 147 B.R. 369, 378 (Bankr. E.D. Pa. 1992) (noting that post-confirmation, debtor has "a fiduciary duty to its creditors to make the distribution as promptly as possible").

8 *See* Fed. R. Bankr. P. 3001(f) ("A proof of claim executed and filed in accordance with these rules shall constitute *prima facie* evidence of the validity and amount of the claim."); *In re Lampe*, 665 F.3d 506, 514 (3d Cir. 2011) (noting that "a proof of claim that alleges sufficient facts to support liability satisfies the claimant's initial obligation to proceed, after which the burden shifts to the objector to produce sufficient evidence to negate the *prima facie* validity of the filed claim" (citing *In re Allegheny Int'l Inc.*, 954 F.2d 167, 173 (3d Cir. 1992))).

9 *See, e.g.*, Second Amended Joint Chapter 11 Plan of Liquidation Proposed by the Debtors and the Official Committee of Unsecured Creditors, *In re Allen Family Foods Inc.*, Case No. 11-11764, Dkt. No. 834 (Bankr. D. Del. Dec. 19, 2012) (providing in section 7.19 of plan that "[a]fter final distributions have been made in accordance with the terms of the Plan, if there is any remaining cash, the Liquidating Trustee shall donate such amount to the [ABI] Endowment Fund."). Learn more about contributing to the ABI Anthony H.N. Schnelling Endowment Fund at endowment.abi.org/unclaimed.