

Creditor Disenfranchised After Failing to Seek Temporary Allowance of its Claim

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The ability of a creditor whose claim is “impaired” under a chapter 11 plan to vote in favor of or against the plan is one of the most important rights conferred on creditors under the Bankruptcy Code. The voting process is an indispensable aspect of safeguards built into the statute designed to ensure that any plan ultimately confirmed by the bankruptcy court over the objection of a class of creditors meets certain minimum standards of fairness and does not discriminate unfairly between or among similarly situated creditors. Even so, a creditor’s right to vote its claim is not absolute and it can be forfeited. As demonstrated by a ruling recently handed down by the Fourth Circuit Court of Appeals, if an objection is filed to a creditor’s claim, the creditor will not be permitted to vote unless it takes the affirmative step of obtaining an order of the bankruptcy court either resolving the objection or temporarily allowing its claim for voting purposes. In *Jacksonville Airport, Inc. v. Michkeldel, Inc.*, the Fourth Circuit held that neither the *Rooker Feldman* doctrine nor local bankruptcy court rules excuse a creditor’s failure to obtain an order at least temporarily allowing its claim so that it can vote on a plan.

Claims Objection, Estimation and Temporary Allowance Procedures

The allowance of claims in a bankruptcy case is governed by section 502 of the Bankruptcy Code. Section 502(a) provides that a filed proof of claim is deemed allowed unless a party-in-interest objects. If an objection to a claim is filed, section 502(b) directs the bankruptcy court to

determine the allowed amount of the claim after notice and a hearing in accordance with certain restrictions and limitations specified in the statute (*e.g.*, disallowing claims for unmatured interest and capping landlord claims for future rent).

Section 502(c) of the Bankruptcy Code mandates the estimation of almost any contingent or unliquidated claim where failure to do so “would unduly delay the administration of the case.” Thus, for example, if litigation is pending against the debtor when it files for bankruptcy, but has not yet gone to trial, the bankruptcy court can estimate the debtor's liability to the plaintiffs in lieu of modifying the automatic stay to allow the action to proceed until judgment, if doing so would unduly delay the bankruptcy case.

The Bankruptcy Code does not specify the method or procedure for estimating a claim. Rather, bankruptcy courts employ whatever method is best suited to the circumstances, so long as it comports with the legal rules that govern a claim's ultimate value (*e.g.*, contract law). Estimation of a claim can be accomplished by means of arbitration, mediation, a full-blown trial or any other procedure that the court deems appropriate under the circumstances. Once a claim has been estimated, the claim becomes an allowed claim in the amount estimated on a par with all other claims of equal priority. Much is at stake in an estimation hearing. Upon confirmation of a chapter 11 plan, the estimated amount will, as a practical matter, act as a cap on the maximum amount of the debtor's obligation.

Procedural rules accompanying the Bankruptcy Code provide for the temporary estimation of a claim. Under Rule 3018(a) of the Federal Rules of Bankruptcy Procedure, a bankruptcy court

“may temporarily allow [a] claim or interest in an amount which the court deems proper for the purpose of accepting or rejecting a plan.” Temporary allowance of a claim for the limited purpose of voting on a plan is appropriate because creditors whose claims are disputed would otherwise be completely disenfranchised in chapter 11 cases where the claims resolution process cannot be completed prior to voting. Only holders of allowed claims are permitted to vote on a chapter 11 plan. A creditor’s claim must also be part of an “impaired” class (*i.e.*, the claim is not being paid in full or the plan otherwise alters the creditor’s legal rights). Creditors whose claims are unimpaired are deemed to vote in favor of a plan. Temporary allowance ensures that creditors asserting disputed claims will have an impact on the plan confirmation process that is commensurate with the court's estimate of the value of their claims, if any. As with estimation under section 502(c), there is no established procedure governing the temporary allowance of a claim under Rule 3018(a). A creditor’s failure to comply with the Bankruptcy Code’s temporary allowance requirements was the subject of the Fourth Circuit’s ruling in *Jacksonville Airport*.

Jacksonville Airport

Before filing for chapter 11 protection in 2002 in Maryland, Michkeldel, Inc. was involved in litigation against Jacksonville Airport, Inc. ("JAI") in Florida state court. The bankruptcy court granted JAI's motion for relief from the automatic stay to allow the Florida litigation to proceed to a final judgment and to permit appeal of that judgment. JAI prevailed in the trial court and filed an unsecured claim in Michkeldel's bankruptcy case based upon the judgment. Michkeldel objected to the claim, contending that it should not be allowed because Michkeldel intended to appeal the underlying judgment. JAI did not file a response to the claim objection.

As the holder of the largest unsecured claim against Michkeldel, JAI voted to reject Michkeldel's plan of reorganization. At the confirmation hearing (two days after expiration of the voting deadline), JAI learned that its vote had not been counted. According to Michkeldel, JAI was not entitled to vote because Michkeldel objected to JAI's claim.

JAI petitioned the bankruptcy court to allow its vote, but the court ruled that JAI's request was untimely because the voting deadline had passed. The court confirmed Michkeldel's chapter 11 plan, ruling in the confirmation order that it could not consider JAI's claim as an allowed claim because JAI failed to respond to Michkeldel's claim objection. JAI appealed the decision to the district court, which affirmed.

JAI fared no better before the Fourth Circuit. The Court of Appeals began its analysis by observing that section 1126(a) of the Bankruptcy Code permits only the holder of a "claim or interest allowed under section 502" to vote to accept or reject a plan. Explaining that section 502(a) of the Bankruptcy Code provides that a claim or interest is deemed allowed, unless a party in interest objects, the Fourth Circuit emphasized that "[t]hese provisions allow only holders of claims to which no party has objected to vote on Chapter 11 plans."

The court stated that JAI's claim was not allowed under section 502 of the Bankruptcy Code because it was undisputed that Michkeldel filed an objection to the claim. Therefore, it was proper for the bankruptcy court and district court to conclude that JAI was precluded from voting on the plan.

JAI offered several reasons as to why its vote should have been counted. First, JAI contended that Michkeldel's objection to its claim was without merit because it was premised upon a potential appeal of the Florida state court judgment. According to JAI, the bankruptcy court would have to examine the merits of the state court judgment to rule upon the objection — an examination barred by the *Rooker Feldman* doctrine. The *Rooker Feldman* doctrine provides that a federal court (other than the Supreme Court) lacks jurisdiction to adjudicate a dispute that would require it to review a state court judgment. Application of the doctrine, JAI insisted, should invalidate Michkeldel's objection, such that JAI should be deemed to have an allowed claim for voting purposes.

The Fourth Circuit rejected this argument. Acknowledging that JAI might ultimately prevail on the merits of the claim dispute by operation of a *Rooker Feldman* defense, the Court of Appeals ruled that JAI could not circumvent the plain meaning of section 502(a). Section 502(a), the Fourth Circuit observed, is not limited to valid claims objections. Rather, so long as a party in interest objects to a claim, “regardless of the objection's validity or merit,” the claim cannot be deemed an allowed claim. JAI, the Court emphasized, could and should have filed a motion to temporarily allow its claim for voting purposes under Bankruptcy Rule 3018. Moreover, it explained, the facts indicated that the bankruptcy court could have fully adjudicated any opposition filed by JAI on the merits prior to the voting deadline, thereby making temporary allowance unnecessary. Because JAI failed to do anything before expiration of the plan's voting deadline, the Fourth Circuit ruled that JAI's vote could not be counted.

JAI also argued that its reliance on a local procedural rule excused it from opposing Michkeldel's objection. The rule in question dispensed with any requirement to file a written response to a claim objection if the claimant wished to rely solely upon the proof of claim. The Court of Appeals rejected this argument, stating that although the local rule may have excused JAI from offering papers in opposition, the rule could not grant a claimant the right to vote on a plan where the Bankruptcy Code expressly provides to the contrary. The Fourth Circuit affirmed the decisions below.

Analysis

Jacksonville Airport is emblematic of what can happen when a creditor fails to exercise due vigilance in protecting its rights by complying with the Bankruptcy Code's procedural requirements governing the claims resolution process. The penalty in this case was severe — the creditor having not only the largest unsecured claim against the debtor, but also potentially the means to block confirmation of its chapter 11 plan, was stripped of its vote and, because the bankruptcy court found that the plan otherwise met the requirements for confirmation, the creditor was forced to accept whatever treatment of its claims (and the claims of other similarly situated unsecured creditors) was provided under the debtor's confirmed plan of reorganization.

We can only speculate concerning the ramifications of JAI's disenfranchisement as it pertains to the ultimate recovery on its claims — the Fourth Circuit's ruling does not describe the terms of the debtor's plan of reorganization. If nothing more, its inability to vote very likely deprived JAI of crucial bargaining power, and the debtor effectively denied JAI any meaningful say concerning the outcome of the chapter 11 case simply by interposing a possibly meritless

objection to JAI's claim. This is precisely what temporary allowance under Rule 3018(a) was designed to prevent. Having failed to protect its rights by seeking temporary allowance for voting purposes, the strong likelihood that JAI would have prevailed on the underlying merits was of no consequence whatsoever.

JAI never obtained a stay of the confirmation order pending its appeal of the bankruptcy court's rulings in the confirmation order itself and in JAI's subsequent motion to reconsider that order. Given the time that elapsed between confirmation and issuance of the Fourth Circuits' ruling, substantial consummation of Michkeldel's chapter 11 plan almost certainly should have mooted any appeal.

Jacksonville Airport, Inc. v. Michkeldel, Inc., 434 F.3d 729 (4th Cir. 2006).