Disallowed Claims and Feasibility Analysis: A Precaution Worth Taking

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It has been 35 years since Lilly Gray set off from Anaheim, Calif., to meet her husband in Barstow. Her new Ford hatchback stalled unexpectedly on the freeway and quickly came to rest in the middle lane of Interstate 15. An older Ford braked quickly, but was unable to avoid Mrs. Gray's car, striking it from behind at about 30 miles per hour. Mrs. Gray's hatchback—the now-infamous 1971 Ford Pinto—burst into flames, killing Mrs. Gray and severely burning her 13-year-old passenger. The collision had caused the Pinto's fuel tank—installed behind the car's rear axle rather than over it, unprotected by any sort of reinforced bumper or housing—to be thrust forward into the Pinto's differential on the rear axle, where bolts punctured the fuel tank, igniting the gasoline.


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Had Ford anticipated and taken action in view of the possibility of a fatal fuel explosion following an unremarkable rear-end collision, it would almost surely have saved lives such as Mrs. Gray's. Reinforcing the Pinto's rear frame and bumper would have cost Ford about $3 a car. A shock absorber for the tank would have cost another $4. Placing the tank over the rear axle, another $5. A differential housing without jutting bolts would have cost another $2. The deadly conflagration that claimed Mrs. Gray's life might have been avoided had Ford simply spent a few extra dollars on the Pinto's rear axle and fuel tax assembly.

A bit further south and a quarter of a century later, the bankruptcy court in San Diego confirmed the chapter 11 plan of John Harbin, an attorney who had a few years earlier purchased a law practice from Jeffrey Sherman. The court declined an opportunity to anticipate the seemingly remote possibility of Sherman's claim being reinstated on appeal or to take an appropriate precaution by spending a few extra minutes adducing facts about the appeal and engaging in a perfunctory feasibility analysis. The Ninth Circuit decision[1] that vacated the confirmation order might have been avoided had the bankruptcy court taken an inexpensive precaution against a seemingly remote possibility.

Under the agreement which Sherman sold his practice, Harbin APC (Harbin's professional corporation) was required to pay Sherman $5,000 a month in consulting fees for 10 years. When Harbin APC stopped paying Sherman in 2000, Sherman sued the professional corporation and Harbin individually. A jury returned a verdict for Sherman in excess of half a million dollars against the professional corporation and Harbin individually. Harbin filed a voluntary chapter 7 petition in response to the verdict, but later sought to dismiss the bankruptcy case when the state trial court vacated the judgment as to Harbin, ruling that he was not personally liable under the agreement with Sherman. The bankruptcy court denied Harbin's motion to dismiss, and Harbin converted the case to chapter 11, while Sherman appealed the trial court's ruling that Harbin was not personally liable.

While Sherman's appeal in state court was pending, Sherman filed an adversary proceeding and a proof of claim for the amount of the jury verdict. The bankruptcy court granted Harbin summary judgment on the adversary proceeding, citing the collateral estoppel effect of the state trial court's ruling that Harbin was not personally liable to Sherman. The bankruptcy court also disallowed Sherman's proof of claim, but preserved Sherman's right to seek a Rule 60 reconsideration of the claim if Sherman's state appeal were later successful and specified that Sherman's claim, if ever reinstated, would not be discharged.[2] The state appellate court had not yet ruled when Harbin's plan—which provided for 100 percent recovery to all creditors—came before the bankruptcy court for confirmation. The bankruptcy court found the plan to be feasible—that is, not likely to be followed by the liquidation or the need for further financial reorganization of the debtor—under Bankruptcy Code §1129(a)(11) for the simple reason that all creditors were to be paid in full under the plan. Sherman unsuccessfully argued that the plan was not feasible as it did not include a reserve for Sherman's disallowed claim, which could later have been allowed following a reinstatement of the jury verdict by the state appellate court.

Citing the *Rooker-Feldman* doctrine—a losing state court litigant is precluded from seeking review of a state judgment in federal court[3]—the bankruptcy court believed it was precluded from even considering the possibility of Sherman's succeeding in his appeal. The Ninth Circuit regarded that as error, since "Sherman was asking the bankruptcy court only to consider the possibility that the state appellate court would reinstate the original jury verdict, not to make any substantive state law ruling or to review and reject the state trial court's judgment."[4]

This statement in the Ninth Circuit's decision—perhaps more central to the decision than any other—is almost surely wrong, and it is wrong precisely because the Ninth Circuit was correct in regarding as error the bankruptcy court's failure to perform a feasibility analysis with respect to Sherman's claim. What Sherman asked the bankruptcy court to do—consider the possibility of Sherman succeeding on appeal, discount Sherman's claim to account for the likelihood that Sherman will not succeed on appeal, then use that

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1 *Sherman v. Harbin* (*In re Harbin*), 2007 U.S. App. LEXIS 9379 (9th Cir. April 25, 2007).

2 *Id.* at *5-6.

3 *See, e.g., Exxon Mobil Corp. v. Saudi Basic Indus. Corp.*, 544 U.S. 280 (2005).

4 *Sherman v. Harbin*, 2007 U.S. App. LEXIS 9379 at *17.

discounted claim as the estimated claim for purposes a feasibility analysis under Code §1129(a)(11)—is precisely what the bankruptcy court should have done. But the statement that the bankruptcy court would not be "review[ing]...the state trial court's judgment" cannot be right; how else can the bankruptcy court assess the likelihood of a successful state court appeal if not by reviewing the state trial court's judgment? If the *Rooker-Feldman* doctrine is no impediment to the bankruptcy court's feasibility analysis—and the Ninth Circuit is clear that it is not[5]—then why would the Ninth Circuit need to pretend that the bankruptcy court won't be reviewing the state court judgment?

This is probably a small quibble that doesn't undermine what is otherwise a sound and an uncontroversial ruling. The bankruptcy court should have undertaken a feasibility analysis, even a perfunctory one, with respect to Sherman's claim. The bankruptcy court could have noted the state trial court's stated bases for vacating the jury's finding of liability against Harbin individually, could have considered the general unlikelihood of any judgment being reversed on appeal, could have read Sherman's and Harbin's appellate briefs, and could then have estimated Sherman's claim at zero. That the state trial court had already vacated the judgment against Harbin individually and the bankruptcy court had already disallowed Sherman's proof of claim (while preserving Sherman's rights if circumstances changed in the future) also would have militated heavily in favor of a claim estimate of zero. Even the Ninth Circuit, in basing its opinion on the bankruptcy court's failure to engage in this exercise, intimated that an appropriate claim estimation process would likely have resulted in the claim being estimated at zero.[6]

Considering how easy a claim estimation and nearly certain its outcome would have been, it is hard to understand why the bankruptcy court was so reluctant to do it and, more fundamentally, why Harbin himself didn't simply urge the court to do it in a selfish effort to avoid creating a good issue for appeal of the confirmation order. Harbin's creditors, ready to receive full payment under Harbin's plan, would certainly have been well-served to urge the bankruptcy court to undertake a claim estimation and feasibility process as well in order to ensure that the confirmation order (and their 100 percent recovery) would withstand any appeal. When Sherman requested such a feasibility analysis, Harbin and his creditors should have gladly joined in that request, confident in its outcome and aware that Sherman's appeal of the confirmation order that followed would have been markedly weaker than if the bankruptcy court had not even asked the feasibility question. Harbin's response to the bankruptcy court's concerns regarding the *Rooker-Feldman* doctrine should have been simple: Remind the bankruptcy court that, following an estimate of Sherman's claim at zero, no party would have been harmed had the bankruptcy court erroneously disregarded some theoretical limit placed on it by the *Rooker-Feldman* doctrine.

Instead, the bankruptcy court overruled Sherman's objections to confirmation, found the plan feasible without considering Sherman's claim or Sherman's state court appeal, and

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5 *Id.* at *16-17 ("The bankruptcy court's conclusion...reflects a misunderstanding of the scope of the Rooker-Feldman doctrine.... The bankruptcy court thus erred in concluding that the Rooker-Feldman doctrine prevented it from considering the consequences of Sherman's appeal").

6 "While our decision would not have prevented the bankruptcy court from valuing Sherman's claim at zero, the bankruptcy court had the duty to exercise its own judgment in reaching such a conclusion, taking into account the possibility that the state appellate court would reinstate the jury's original verdict." *Id.* at *19, n.7.

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confirmed the plan. Then the Pinto exploded: Sherman won his appeal. His judgment against Harbin individually was reinstated and Sherman's now-allowable claim, exceeding $700,000, rendered Harbin unable to pay all creditors in full and rendered the plan infeasible. The Ninth Circuit remanded the case to the bankruptcy court, technically so that the bankruptcy court could conduct a feasibility analysis, but noted that the remand would, practically speaking, result in consideration of a new plan that would pay less than 100 percent to creditors.[7]

This result demonstrates why Harbin's creditors would have been better served by convincing the bankruptcy court to estimate Sherman's claim at zero and enter feasibility findings before confirming the plan. If the bankruptcy court had done that, the plan could have been consummated and all of Harbin's creditors could have received their 100 percent distributions before Sherman's state appeal had concluded. Under those circumstances, Sherman would still have been able to obtain a reconsideration and allowance of his claim in the bankruptcy court following his state appellate victory, but that reinstated claim would never have been able to preclude Harbin's other creditors from receiving their 100 percent recovery under the confirmed plan. Sherman's reinstated claim would simply not have been discharged—the bankruptcy court had already ruled that the claim would not be discharged were it ever reinstated—and Sherman would have been free to pursue satisfaction of his state judgment after confirmation, outside of the bankruptcy case.

Doing this type of analysis—involving a claim estimation for purposes of confirmation under §502(c)—could have been done quickly and easily during the course of the confirmation hearing.

Comparing Ford and its Pinto with the bankruptcy court's order confirming Harbin's chapter 11 plan is grossly unfair to the bankruptcy court for obvious reasons (no one died), but it's not all that unfair to Ford. After all, Ford did precisely what the bankruptcy court did—it declined to take an inexpensive and easy precaution against a possible problem of which it was aware. Ford performed a dispassionate cost comparison—it considered the possibility and likely costs of deaths and injuries from exploding Pintos and compared those costs with those associated with spending an additional $10-$15 per car to retrofit the 11 million Pintos then on the road to prevent those Pintos from exploding. Ford estimated the costs of retrofitting all Pintos at $121 million, and estimated the costs of tort damages and settlements at $50 million.[8]

In Harbin's bankruptcy case, what could a claim estimation and feasibility hearing have possibly cost? Whatever that amount, it was surely dwarfed by what the bankruptcy court's failure to conduct that hearing cost Harbin and his creditors. The costs of the bankruptcy appeals, the costs of proceedings on remand, the costs of drafting and soliciting a new plan—all these costs, and more, further reduced recoveries to Harbin's creditors whose 100 percent payout had already been lost. This cost comparison is no closer a call than the one Ford made, but with precisely the opposite result. Isn't a 30-minute feasibility hearing a precaution worth taking? ■

7 *See id.* at *20 n.8.

8 As it turned out, Ford wrongly estimated the number of deaths and injuries attributable to the Pinto's fuel tank assembly. The difference between what Ford paid in tort damages and what Ford would have had to pay to retrofit all Pintos was even greater than Ford had estimated.