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Allowance of Class Claims in Bankruptcy Starts with Discretion

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Bankruptcy courts long have been a forum to resolve *pending* class action litigation on topics including asbestos liability, plastic surgery injury and other consumer protection and mass tort law. It was not until the Seventh Circuit Court of Appeals' decision in *In re American Reserve Corp.* that class action adversary proceedings and class proofs-of-claim could be filed on behalf of *potential* claimants.[1]


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Today, if not certified prepetition, a putative class may ask a bankruptcy court to file a class proof-of-claim and grant class certification. Only a few circuits expressly allow class claims,[2] but bankruptcy courts continually face how and when claims within a bankruptcy proceeding may be granted class action status. In 2009, for example, bankruptcy courts considered certifying classes relating to employment law[3] and fax machine spam.[4] These recent case examples illustrate how courts approach the question of class claim treatment and explain various procedures when addressing class claims.

Courts Have Strict Procedures, Broad Discretion over Whether to Apply Fed. R. Civ. P. 23

Class actions concentrate litigation in a single forum, and their procedures are designed to avoid "multiplicity of activity."[5] Similar benefits can be found in bankruptcy law, where "many of the perceived advantages of class treatment drop away."[6] Some question whether class actions have a place in bankruptcy cases because resolution of the class claim may complicate and delay the bankruptcy case. As one court explained:

> Bankruptcy provides the same procedural advantages as a class action. In fact, it provides more advantages. Creditors, even corporate creditors, don't have to hire a lawyer, and can participate in the distribution for the price of a stamp. They need only fill out and return a proof of claim sent with the Bar Date Notice. Furthermore, claims are "deemed allowed" under [11 U.S.C.] §502(a) in the absence of an objection, in which case discovery and fact-finding are avoided altogether.[7]


Gil Hopenstand

Bankruptcy law still has its own procedures, and a proof of claim executed and filed in accordance with the bankruptcy rules constitutes *prima facie* evidence of the validity and amount of the claim.[8] A filed proof of claim is "deemed allowed" until objected to,[9] and many courts extend that presumption to class claims.[10] Maybe the debtor will accept the class claim, decide not to litigate it or seek to compromise the class claim without an objection.[11] If a party objects to the class claim, that objection elevates the claim dispute to a "contested matter."

Absent a claim objection, a claimant must affirmatively move to invoke contested matter procedures and, by extension, Fed. R. Civ. P. 23. "[T]he proponent is the one who wants the court to enter an order. Without that

Claims Chat

1 *In re American Reserve Corp.*, 840 F.2d 487 (7th Cir. 1988).
2 Sixth, Seventh, Ninth and Eleventh Circuits. Respectively, *see Reid v. White Motor Corp.*, 886 F.2d 1462 (6th Cir. 1989), *cert. denied*, 494 U.S. 1080 (1990); *In re American Reserve Corp., supra*; *Birting Fisheries v. Lane (In re Birting Fisheries Inc.)*, 92 F.3d 939 (9th Cir. 1996); *In re Charter Co.*, 876 F.2d 866 (11th Cir. 1989), *cert. dismissed*, 496 U.S. 944 (1990).
3 *In re Bally Total Fitness of Greater New York Inc., et al.*, 402 B.R. 616 (Bankr. S.D.N.Y. 2009), *aff'd*, 411 B.R. 142 (S.D.N.Y. 2009) (claims include failure to provide meal and rest periods); *Kettell v. Bill Heard Enterprises Inc. (In re Bill Heard Enterprises Inc.)*, 400 B.R. 795 (Bankr. N.D. Ala. 2009) (alleged WARN Act violations).
4 *Hacienda Heating & Cooling Inc. v. United Artists Theatre Circuit Inc. (In re United Artists Theatre Company, et al.)*, 410 B.R. 385 (Bankr. D. Del. 2009).
5 *American Pipe & Constr. Co. v. Utah*, 414 U.S. 538 (1974).
6 *Bally Total Fitness of Greater New York Inc.*, 411 B.R. at 145.
7 *In re Musicland Holding Corp.*, 362 B.R. 644, 651 (Bankr. S.D.N.Y. 2007) (citations omitted).
8 Fed. R. Bankr. P. 3001(f).
9 11 U.S.C. §502(a).
10 *But see Musicland Holding Corp.*, 362 B.R. at 652 ("Until certification, the [class] claim is in limbo... The proof of claim, improperly filed or improperly signed, is not *prima facie* evidence of the debt, and until class certification, may not even be a 'filed' claim within the meaning of 11 U.S.C. §502(a). In that case, no objection would be necessary, and it would be incumbent on the putative class representative to raise the issue [to extend the application of Rule 23].").
11 *Charter Co.*, 876 F.2d at 875; *cf, In re W.R. Grace & Co.*, 389 B.R. 373, 377, n.10 (Bankr. D. Del. 2008).

order, [Rule 23] is not applicable to the proof of claim and a class proof of claim is improper."[12] Class certification should be sought early in the bankruptcy process before the class action hampers the administration of the case.

In courts that follow *American Reserve*, consideration of a class action motion in bankruptcy or an objection to a class-action claim will trigger a two-step process. First, the court must exercise its discretion as to whether to apply Fed. R. Civ. P. 23 to the contested proceeding. Courts' decisions vary because, while Fed. R. Civ. P. 23 automatically applies to bankruptcy adversary proceedings by Federal Rule of Bankruptcy Procedure 7023, its applicability to contested matters is left broadly to a court's discretion by Federal Rule of Bankruptcy Procedure 9014. If a court decides to apply Fed. R. Civ. P. 23, the second step is for a court to determine whether the proposed class action/proceeding and class representative satisfy the class certification requirements of Fed. R. Civ. P. 23(a) and (b) for numerosity,[13] commonality,[14] typicality[15] and adequate representation,[16] and subsequently maintainability.[17]

First, in deciding whether to apply Fed. R. Civ. P. 23, a court will consider a variety of factors relating to the bankruptcy case. Such factors include (1) whether the class was certified prepetition, (2) whether the members of the putative class received notice of the bankruptcy case bar date and (3) whether class certification will adversely affect the administration of the case.[18] Other courts additionally consider prejudice to the debtor or its creditors, prejudice to the putative class members, whether the class representative satisfied its burden to move for class certification and the status of proceedings in other courts.[19] Allowing a class claim effectively extends the bar date for class members, but not for others, so "putative members of an uncertified class who received actual notice of the bar date but did not file timely claims are the least favored candidates for class action treatment."[20]

Also relevant to whether class certification will affect the bankruptcy case are the timing of the certification motion and whether a plan has been negotiated, submitted, voted on or confirmed.[21] For example, when allowance of class claims did not arise until after a disclosure statement was approved and ballots were sent to creditors to vote on a plan, expunging the class claims "at this late juncture" was affirmed because the class claims otherwise "would wholly disrupt and undercut the expeditious execution of the Plan of Reorganization."[22]

If a bankruptcy court applies Fed. R. Civ. P. 23 to the contested matter, it next considers whether the class claim meets the Fed. R. Civ. P. 23(a) requirements of numerosity, commonality, typicality and adequate representation, and one of the three maintainability elements of Fed. R. Civ. P. 23(b). The case law here is well-developed, and bankruptcy courts are guided by their respective circuit's binding authorities.

Recent Examples

The factors in applying Fed. R. Civ. P. 23 are discretionary, and courts do not always exercise their discretion. When Bally Total Fitness filed a voluntary bankruptcy petition in the Southern District of New York in 2008, two different class action suits had been pending in California—one for nearly three years and the other for two months—alleging various employment law violations. One case involved between 3,180 and 5,000 present and former employees in California. The other case was brought only on behalf of personal trainers and group fitness instructors. Prior to Bally's bankruptcy petition, neither putative classes had sought class certification.

A bar date was set in Bally's bankruptcy case, and notice of the bar date was sent to all current employees and former employees whose employment had terminated after Jan. 1, 2004. Notice of the bar date was also published in newspapers nationwide. When the putative class members sought class certification in bankruptcy court or permission to file a class claim, the requests were denied, and the denials were affirmed on appeal due to the following factors:

- Classes were not certified prepetition;
- Putative class members received actual or constructive notice of the bar date, and notably only few such claims were filed;
- Expanding the bar date to include class members who did not file timely claims would prejudice claimants who met the claim deadline;
- "[C]lass certification would adversely affect the administration of these cases, adding layers of procedural and factual complexity that accompany class-based claims, siphoning the Debtors' resources and interfering with the orderly progression of the reorganization;"[23]
- Class status is unnecessary to protect the rights of putative class members, for their rights are protected by the bankruptcy claim process; and
- Resolving each class member's factual and legal issues in "mini-trials" would "mak[e] class treatment untenable and implausible."[24]

The district court concluded that, in this context, "bankruptcy provides the most expeditious and efficient path for the resolution of all creditors' claims."[25]

Analyses by other bankruptcy courts yielded different results. In *In re Bill Heard Enterprises*, about 2,300 terminated employees in seven states each filed an adversary proceeding in the Northern District of Alabama against the debtor—their former employer—alleging violations of the Worker Adjustment and Retraining Notification Act (WARN Act). Plaintiffs also filed

12 *In re Computer Learning Centers Inc.*, 344 B.R. 79, 87 (Bankr. E.D. Va. 2006).

13 The class must be "so numerous that joinder of all members is impractical." Fed. R. Civ. P. 23(a)(1). What constitutes a sufficient number is a question of fact to be determined on a case-by-case basis, and numbers have varied. However, "impracticality" does not mean "impossibility," and a court has denied certification for 33 potential class members, but has certified a potential class of 390 members. For example, the Third Circuit has indicated that this numerosity requirement generally is met "if the named plaintiff demonstrates that the potential number of plaintiffs exceeds 40." *United Artists Theatre Company*, 410 B.R. at 392, citing *Stewart v. Abraham*, 275 F.3d 220, 226-27 (3d Cir. 2001).

14 There must be "questions of law or fact common to the class." Fed. R. Civ. P. 23(a)(2). It is not necessary to demonstrate that there is an absolute identity of facts among the class members. Common issues need not "predominate," but there need be only a single issue common to the class members. *In re Coggin*, 155 B.R. 934 (Bankr. E.D.N.C. 1993); *In re First Alliance*, 269 B.R. 428, 447 (C.D. Cal. 2001).

15 "[T]he claims or defenses of the representative parties [must be] typical of the claims or defenses of the class." Fed. R. Civ. P. 23(a)(3). While courts often overlap this analysis with the question of commonality, typicality focuses on the relation between the representative parties and the class as a whole.

16 Courts analyze adequate representation and whether "the representative parties will fairly and adequately protect the interests of the class." Fed. R. Civ. P. 23(a)(4). Specifically, "courts consider the adequacy of both the named representative and class counsel. Thus, adequate representation requires two elements: (1) the class representative must not have interests antagonistic to those of the class, and (2) class counsel must be qualified, experienced and generally able to conduct the proposed litigation." 5 *Moore's Federal Practice* §23.25[3][a].

17 The claimant must show that (1) prosecution of separate actions by or against individual class members would create a risk of inconsistent adjudications that would establish incompatible standards of conduct for the opposing party or that would be dispositive of the interests of nonparties or would impair or impede the nonparties' ability to protect their interests, (2) the party opposing the class has acted or refused to act in a way "generally applicable to the class" so that final relief with respect to the class as a whole is appropriate, or (3) the court finds that questions of law predominate over questions affecting only individual members, and that a class action is a superior method for the "fair and efficient adjudication of the controversy." *W.R. Grace & Co.*, 389 B.R. at 378.

18 *Musicland Holding Corp.*, 362 B.R. at 654-55 (internal citations omitted); *Bally Total Fitness of Greater New York Inc.*, 411 B.R. at 145.

19 *In re Craft*, 321 B.R. 189, 199 (Bankr. N.D. Tex. 2005).

20 *Musicland Holding Corp.*, 362 B.R. at 654-55. *See also Scoggin v. Adam Aircraft Industries Inc. (In re Adam Aircraft Industries Inc.)*, 2009 Bankr. Lexis 1747 at *9-10 (in such instances, "[a] class proof of claim or a class action certification may actually impede the normal bankruptcy process...").

21 *Id.*

22 *In re Ephedra Prods. Liab. Lit.*, 329 B.R. 1, 4 (S.D.N.Y. 2005).

23 *Bally Total Fitness of Greater New York Inc.*, 402 B.R. 616, 621 (Bankr. S.D.N.Y. 2009).

24 *Id.* at 622.

25 *Bally Total Fitness of Greater New York Inc.*, 411 B.R. at 148.

a class claim, and the debtor sought to have the adversary proceedings dismissed and handled by each plaintiff filing a proof of claim. Given the class size and that the debtor would vigorously oppose the WARN Act allegations however presented, the court held that resolution of the employment issues as a class claim would be more efficient than piecemealed into the claim-objection process, particularly given "the geographical hardship it would create on [putative class members] to defend their claims" in Alabama.[26]

The court held that class treatment was appropriate because joining 2,300 adversary proceedings was impractical, there would be several common questions to be addressed for each plaintiff, the proposed class representative suffered the same types of injuries as the class employees, no substantial or fundamental conflicts of interest existed between the proposed class representatives and the class as a whole, and the class was maintainable.[27]

In *In re Protected Vehicles Inc.*, the debtor terminated more than 300 employees, nearly 180 of whom filed proofs of claim alleging, *inter alia*, WARN Act violations.[28] Two former employees also filed similar adversary proceedings, and the court held that the issues could best be resolved as a class adversary proceeding. The court found relevant that the debtor would incur greater litigation costs in responding to each proof of claim individually rather than in one class adjudication, and the former employees' "disadvantage of individually litigating complicated legal issues for relatively small recoveries."[29] The class adversary proceeding met all of the requirements of Fed. R. Civ. P. 23(a) and (b)(3), however, the class would only be comprised of terminated employees who filed *timely* proofs of claim because opening the class to *all* employees "would render proof of claim deadlines in bankruptcy cases meaningless."[30]

Conclusion

Courts following *American Reserve* have broad discretion to allow class claims, when done correctly. Fed. R. Civ. P. 23 must be made applicable to the class claim by an objection, through an adversary proceeding or by class claim proponents affirmatively seeking such an order. Recent cases suggest that class claim consideration must come early enough in the bankruptcy proceeding so as not to hinder the case. Further, if a bankruptcy court decides that these initial hurdles are overcome, the class claim must meet the established requirements of Fed. R. Civ. P. 23(a) and (b). In the end, each bankruptcy court's determination will depend on the specific facts and on whether these procedures were met. ■

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26 *Bill Heard Enterprises Inc.*, 400 B.R. at 801.
27 *Id.* at 802-3.
28 *Burgio v. Protected Vehicles Inc. (In re Protected Vehicles Inc.)*, 397 B.R. 339 (Bankr. D. S.C. 2008).
29 *Id.* at 345-46.
30 *Id.* at 347.