

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION**

In re:) Chapter 11
)
SENTINEL MANAGEMENT GROUP, INC.,) Case No. 07 B 14987
)
Debtor.) Hon. John H. Squires

**CORRECTED TRUSTEE'S REPLY IN SUPPORT OF MOTION
TO DISMISS OBJECTIONS TO PROOFS OF CLAIM¹**

In their Response, the Seg 1 Objectors² do not dispute two critical facts: (1) that the Trustee is the only person empowered to bring avoidance actions against the Claimants, and (2) that the Seg 1 Objectors have no basis for objecting to the Claims other than their belief that sometime in the distant future, the Claimants hypothetically could refuse to turn over to the Trustee amounts that might be awarded in avoidance actions that have not been -- and may never even be -- commenced.³ The Court should stop the Seg 1 Objectors' blatant end run around the Bankruptcy Code's exclusive grant of standing to the Trustee to pursue or settle avoidance actions and their attempt to derail Plan distributions, and should dismiss the Claim Objections.

Even if this Court were inclined to permit the Claim Objections to stand, the Court should act to prevent the grossly unjust result sought here by the Seg 1 Objectors, namely holding up all distributions to a large group of creditors who have yet to receive a penny. As explained below, no party would be even theoretically harmed by permitting the bulk of the Plan

¹ The Reply filed by the Trustee on December 15, 2008 contained mathematical errors that are corrected herein.

² Capitalized terms not otherwise defined herein have the meanings ascribed to such terms in the Motion to Dismiss Objections to Proofs of Claim (Docket No. 1163).

³ Contrary to the Seg 1 Objectors' conclusion that "preference litigation initiated by the Trustee against the Seg 3 Customers is inevitable," the Trustee has been in negotiations with members of the Creditors Committee and other major creditors concerning potential settlements of § 547 claims, and hopes to be in a position to settle many such claims within the next few weeks.

distributions to be made, and therefore if the Claim Objections are not dismissed this Court should nonetheless enter an order permitting the Trustee to proceed with an orderly distribution of estate assets to creditors, including the Claimants, in accordance with the terms of the Plan.

I. This Court Should Dismiss the Claim Objections.

A. The Claim Objections Should be Dismissed as an Improper Attempt to Seek Adjudications under Section 547 of the Bankruptcy Code.

The Seg 1 Objectors do not deny that what they really are seeking from this Court is an adjudication of the avoidability of claims arising under section 547 of the Bankruptcy Code, *see* Resp. at p. 6 (“The [Seg 1 Objectors] seek the disallowance of claims pending a determination of the avoidability of the pre-petition withdrawals made by the holders of the claims subject to the Claim Objections”), and that is entirely improper. Section 547 claims are reserved exclusively for the Trustee to pursue, and no wrangling of statutory construction can get around this fact. So while the Seg 1 Objectors are correct that section 502(d) does not on its face limit which parties in interest may bring claim objections, parties in interest cannot utilize the general provisions of section 502(d) to circumvent the express grant of standing to the Trustee to pursue section 547 litigation, particularly when section 502(d) is being used to further their own litigation goals. Section 502(d) cannot be used as a sword to force a trustee to bring avoidance actions he has not yet decided to bring, nor can it be used by creditors to hold up distributions when the sole basis for doing so is the spectre of potential avoidance actions that the trustee might bring.

The only two cases that squarely address this issue, *Prime Motor Inns* and *Magnolia Gas*, although from other circuits, are well reasoned and should be followed by this Court. As the court in *Prime Motor Inns* stated:

Thus, the issue is not whether a creditor may object to another creditor’s claim... but whether a creditor has standing to raise § 547 as a basis for such objection. The narrow issue presented here is who may assert a

claim to avoid a preference under § 547, whether offensively or defensively. It is clear that the statutory language of § 547, which specifically vests standing to bring avoidance actions in a trustee, cannot be circumvented merely by asserting § 547 defensively. The correct analysis and reading of § 502(d) suggests to this Court that [the creditor] might have standing to object under § 502(a) if there has first been a judicial determination that [claimants] have transferee liability within the meaning of § 550 of the Bankruptcy Code. . . . It is not enough for a *creditor* to establish a *prima facie* case of avoidability[.]

United Jersey Bank v. Morgan Guar. Trust Co. of N.Y. (In re Prime Motor Inns, Inc.), 135 B.R. 917, 921 (Bankr. S.D. Fla. 1992) (emphasis in original); *see also Energy Income Fund, L.P. v. Compression Solutions Co., L.L.C. (In re Magnolia Gas Co., L.L.C.)*, 225 B.R. 900, 915 (Bankr. W.D. Okla. 2000) (relying on *Prime Motor Inns* to find that creditor did not have standing to object to another creditor's claims under § 502(d)). Both the *Prime Motor Inns* and *Magnolia Gas* courts were concerned about precisely the situation the Court faces here -- attempts by creditors to do indirectly through section 502(d) what they are expressly prohibited from doing under section 547. As such, those courts correctly concluded that, notwithstanding the "party in interest" language of section 502(a), *creditors* are not permitted to bring objections to claims of other creditors solely under section 502(d) unless and until there has been a judicial determination of liability under section 547. *Magnolia Gas*, 225 B.R. at 915; *Prime Motor Inns*, 135 B.R. at 921. Here, there has been no judicial determination of liability under section 547, and therefore creditors such as the Seg 1 Objectors cannot utilize section 502(d) to indirectly force such an adjudication.

B. After the Effective Date, the Liquidation Trustee Will Have Exclusive Authority to Prosecute All Claim Objections.

The Seg 1 Objectors also argue in their Response (without citation) that notwithstanding the plain terms of the Plan, the Seg 1 Objectors will retain standing to pursue the Claim Objections after the Effective Date because their objections already are pending. The Plan,

however, unambiguously provides that the Liquidation Trustee, in consultation with the Committee, will have exclusive authority to object to claims after the effective date of the Plan. *See* Plan § 7.7. The Plan contains no carve-out whatsoever for claim objections filed prior to confirmation.

Section 1123(b)(3)(B) of the Bankruptcy Code explicitly provides that a plan may provide for the retention and enforcement of a claim by an estate representative. 11 U.S.C. § 1123(b)(3)(B). That is exactly what was done here, and there is nothing improper about such a provision.

The Seg 1 Objectors had every opportunity to object to this Plan provision during the plan objection and confirmation process, but did not do so. Had the Seg 1 Objectors wanted to protect their right to pursue claim objections, they could have attempted to do so in the same way that they objected to numerous other Plan provisions. *See Ernst & Young LLP v. Baker O'Neal Holdings, Inc.*, 304 F.3d 753, 756 (7th Cir. 2002) (holding that the defendant's right to arbitrate was superseded by the terms of the confirmed plan, and noting that the defendant could have sought to protect its arbitration rights prior to confirmation like it did other rights). Now that the Plan has been confirmed (Docket No. 1257), however, the Seg 1 Objectors are bound by it and "its terms are not subject to collateral attack." *See Adair v. Sherman*, 230 F.3d 890, 894 (7th Cir. 2000). Because the Court's confirmation of the Plan "constitutes a final judgment on the merits with *res judicata* effect," the Seg 1 Objectors are precluded from asserting arguments pertaining to the Plan that could have been asserted prior to its confirmation. *See Apex Mgmt. Corp. v. WSR Corp.*, 225 B.R. 640, 645 (N.D. Ill. 1998).

The Seg 1 Objectors assert that the notice sent to creditors violated Bankruptcy Rule 2002(c)(3) because it failed to state in bold and conspicuous language that the Liquidation

Trustee would have exclusive post-confirmation authority to object to claims. Bankruptcy Rule 2002(c)(3), however, does not apply to a plan provision granting a liquidation trustee exclusive authority to object to claims, because such a provision in fact is not an injunction. Rather, it merely reserves certain rights for the liquidation trustee to exercise in accordance with section 1123(b)(3)(B) of the Bankruptcy Code. Utilizing the Seg 1 Objectors' proposed expansive definition of "injunction" would coin virtually every provision in a plan an injunction. *See Moglia v. Pac. Employers Ins. Co.*, --- F.3d ----, 2008 WL 4810080 (7th Cir. November 6, 2008) ("The order to sign the hold-harmless promise is no more an 'injunction' than the order to arbitrate itself. Judges routinely direct parties to do things . . . without thereby entering injunctions . . ."); *In re City of Springfield, Illinois*, 818 F.2d 565, 567 (7th Cir. 1987) (stating that because too broad a definition of the term "injunction" would include too many court orders, the definition must be limited).

The Seg 1 Objectors' reliance on *Manchester Gas* for the proposition that a plan provision granting a liquidating trustee exclusive standing to pursue claim objections constitutes an injunction is unavailing. In *Manchester Gas*, the Court held that the plan provision at issue did not preclude other parties in interest from objecting to claims because it did not grant exclusive authority to the plan agent. *In re Manchester Gas Storage, Inc.*, 309 B.R. 354, 370 (Bankr. N.D. Okla. 2004). The Seg 1 Objectors rely upon *dicta* buried in a footnote for the additional proposition that such a plan provision actually is an injunction. *See id.* at n.10. No court has directly so held, and plans routinely contain similar provisions granting exclusive authority to an estate representative to object to claims post-confirmation. This *dicta* from a single case should not have an impact on the enforceability of the express terms of the now-confirmed Plan, the terms of which the Seg 1 Objectors had ample opportunity to contest.

In any event, even if this provision were interpreted to be an injunction which technically did not meet the terms of Bankruptcy Rule 2002(c)(3), such a minor procedural violation would not warrant a finding that the terms of the Plan are no longer enforceable or binding on the Seg 1 Objectors. In order for due process to be satisfied, the notice must be “reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.” *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950). Here due process has been satisfied, and the mere fact that the Plan or a notice failed to state in bold, italic, or underlined text that the Liquidation Trustee will have exclusive authority to object to claims hardly justifies a finding that the Seg 1 Objectors are no longer bound by the Plan’s express terms. The Seg 1 Objectors’ “due process argument is especially hollow in this case” because of the ample opportunity afforded to them to object to this provision prior to confirmation of the Plan. *See Educ. Credit Mgmt. Corp. v. Mersmann*, 318 B.R. 537, 544 (D. Kan. 2004). They should not now be permitted to complain given their “complete failure to properly protect [their] interest” during the course of the Plan confirmation process. *Id.*

C. The Orderly Administration of the Estate Dictates that the Claim Objections Be Dismissed.

Finally, although the Seg 1 Objectors are correct that creditors generally may have a right to object to claims, it also is indisputably within this Court’s discretion to dismiss or stay the Claim Objections in the interests of orderly administration of the estate. “While the debtor’s other creditors may make objections to the allowance of a claim, *the demands of orderly and expeditious administration* have led to a recognition that the *right to object is generally exercised*

by the trustee.” FED. R. BANKR. P. 3007 advisory committee notes (emphasis added).⁴ Accordingly, this Court should not permit creditor claim objections to proceed where (i) a trustee already has undertaken this obligation, and (ii) the claim objections are being presented for the improper purpose of attempting to prevent distributions that have no impact on the Seg 1 Objectors. See *Kowal v. Malkemus (In re Thompson)*, 965 F.2d 1136, 1147 (1st Cir. 1992) (“As a general rule, absent leave of court, the chapter 7 trustee alone may interpose objections to proofs of claim. Leave to object is not generally accorded an individual creditor unless the chapter 7 trustee refuses to object, notwithstanding a request to do so, and the bankruptcy court permits the creditor to object in the trustee’s stead.”); *Werth v. First Interstate Bank of Denver, N.A. (In re Werth)*, 54 B.R. 619, 622 (D. Colo. 1985) (finding that for purposes of *res judicata* debtor did not have a full and fair opportunity to litigate because “when a trustee has been appointed, the debtor and his creditors may not object to the allowability of another creditor’s claim.”).

The Trustee’s reliance on *Thompson*, a chapter 7 case, and section 704(5) is not misplaced as suggested by the Seg 1 Objectors. Section 1106(a)(1) of the Bankruptcy Code makes section 704(5) applicable to chapter 11 cases and requires a trustee to examine and object to proof of claims. 11 U.S.C. § 1106(a)(1). Like *Thompson*, where the trustee already had undertaken objections to claims, here the Trustee already has filed objections to numerous claims, is in discussions with various additional creditors regarding resolution of disputes involving their claims, and is investigating other claims and potential preference litigation. The

⁴ The Trustee’s reliance on the advisory committee notes is not “misplaced.” Courts and practitioners often turn to such notes for guidance in interpreting statutes and rules. *Accord Mississippi Publishing Corp. v. Murphree*, 326 U.S. 438, 444, 66 S.Ct. 242, 245, 90 L.Ed. 185 (1946) (construction given to rules by Advisory Committee is to be considered); see also *Lisk Elec., Inc. v. Brandt (In re Fesco Plastics Corp., Inc.)*, 908 F.2d 240, 242-43 (7th Cir. 1990) (relying on advisory committee notes in interpreting Bankruptcy Rule 1019(4)).

Trustee is not sitting on his laurels and, as such, the orderly administration of this estate requires that the Trustee be the sole party to pursue claim objections.

Because (1) the Seg 1 Objectors really are seeking an adjudication under section 547 that they are barred from seeking directly, (2) the Plan gives exclusive authority to the Liquidation Trustee to pursue claim objections, and (3) the orderly administration of the estate dictates that the Trustee should handle claim objections, this Court should dismiss the Claim Objections.

II. Even if the Claim Objections Are Not Dismissed, the Court Should Authorize Interim Distributions to Holders of Certain Disputed Claims.

The Seg 1 Objectors appear to be under the impression that simply by filing the Claim Objections, they will be able to hold up all distributions to Claimants impacted by their Claim Objections for years, thereby undermining implementation of the Plan and blocking distributions to a large number of customers who have yet to receive a penny on account of their claims. Even if this Court were to permit the Seg 1 Objectors' Claim Objections to stand, however, the Plan provides a mechanism to avoid such a grossly unjust result.

Under the Plan, for “purposes of the Initial Distribution, as of the Effective Date, Class 3 Customer Claims, other than those which the Liquidation Trustee, after consultation with the Liquidation Trust Committee, has considered Disputed shall be deemed Allowed in the amount as calculated under Section 4.4 of the Plan. For the avoidance of doubt, (i) no distributions shall be made on account of Disputed⁵ Claims, including Claims considered Disputed by the

⁵ Under section 1.1 of the Plan, Disputed means “a Claim or Equity Interest, or any portion thereof, that is not an Allowed Claim, an Allowed Equity Interest, a Disallowed Claim, or a Disallowed Equity Interest, including, but not limited to, Claims or Equity Interests (I) (a) that have not been scheduled by the Debtor or the Chapter 11 Trustee, or have been scheduled by the Debtor or the Chapter 11 Trustee at zero (\$0) or as contingent, unliquidated, or disputed, (b) that are the subject of a proof of claim or interest that differs in nature, amount or priority from the Schedules, or (c) as to which an objection has been interposed as of the Claims Objection Deadline, and (II) the allowance or disallowance of which is not the subject of a Final Order. A Claim or Equity Interest may be considered “Disputed” by the Liquidation Trustee, in his

Liquidation Trustee, in his sole discretion, prior to the expiration of the deadline to object to, or seek subordination of, such Claim under the Plan, **unless otherwise ordered by the Court**, and (ii) no Initial Distribution or subsequent distributions shall impair or impact the Liquidating Trustee's ability to bring any Causes of Action against any Creditor or Customer." Plan, § 7.6 (emphasis added). Thus, the Plan expressly contemplates that the Court may enter an order permitting distributions to be made even on account of Disputed Claims.

No legitimate purpose would be served by blocking distributions to most Claimants. The avoidance of potential preferential transfers would result in higher (not lower) distributions to those Claimants, and, even assuming all preferential transfers are avoided, there is no scenario under which most Claimants would receive any less than the amount now proposed to be distributed by the Trustee. For example, the Seg 1 Objectors have lodged an objection to the claims of the largest NonCitadel-Beneficiary Customer, Discus Master Limited, which by the Trustee's calculations is the holder of an otherwise undisputed claim of roughly \$407 million. Without taking into account preference recoveries, Discus's claim constitutes approximately 53% of the total customer claims pool of roughly \$770 million in claims presently entitled to initial distributions under the Plan. Therefore, assuming a \$257 million initial distribution,⁶ Discus would be entitled to an initial distribution of roughly \$136 million on account of its claim.

sole discretion if the time to object to, or seek subordination of, such Claim or Equity Interest under the Plan has not yet expired, unless otherwise ordered by the Court."

⁶ Depending on certain recoveries and the size of reserves, the Trustee is expecting that an amount somewhat in excess of \$200 million will be available for initial distribution. For ease of comparison only, however, the Trustee is using the same assumptions used by the Seg 1 Objectors in their Response (p. 10, n.4), namely (a) an initial distribution of \$257 million (\$1,315.7 million after recovered avoidable transfers are included), and (b) \$1,981.8 in total customer claims (\$923.1 million in base customer claims, \$211.8 million in § 502(h) claims on account of § 549 avoided post-petition transfers, and \$846.9 million in § 502(h) claims on account of § 547 avoided pre-petition transfers).

If potential preferential transfers are taken into account, Discus would receive an even greater distribution. Indeed, it is for that reason, and not the sinister motives ascribed to the Trustee by the Seg 1 Objectors, that the Trustee has not commenced any litigation against Discus or the other Claimants. As explained in the chart below, even using the radical assumptions utilized by the Seg 1 Objectors in their Response, Discus never will receive a distribution that is less than the amount proposed to be distributed to it now. To the contrary, Discus would receive a far greater distribution under the hypothetical scenario described in the Response, in which all parties return 100% of all avoidable transfers (including a return by Discus of roughly \$60 million in potentially avoidable preferential transfers):

<u>Base Distribution</u>		<u>Distribution With Avoidance Recoveries</u>	
Discus Claim:	\$407,000,000	Discus Base Claim + §502(h) Claim:	\$467,000,000
Claims receiving initial distributions under Plan:	\$770,000,000	Total Claims:	\$1,981,800,000
Distribution amt. assumed by Seg 1 Objectors:	\$257,000,000	Distribution (\$257 million + avoidance recoveries)	\$1,315,700,000
<i>Discus Distribution:</i>	<i>\$135,842,856</i>	<i>Discus Distribution:</i>	<i>\$310,037,289</i>
		<i>Less Returned Preference:</i>	<i>\$(60,000,000)</i>
		<i>Net Discus Recovery:</i>	<i>\$250,037,289</i>

Even in a most ludicrous scenario -- one in which only Discus (and no other creditor) returns avoidable transfers, and all customer claims are nonetheless allowed in their full amounts -- Discus still would receive a distribution close to the amount now proposed to be distributed to it.⁷ Therefore, there is no need to withhold any amounts from Discus's distribution in order to protect IFX and other similarly-situated Seg 1 Objectors.

⁷ Assuming \$317 million is available for distribution (\$257 million assumed distribution amount + \$60 million preference returned by Discus) and a \$467 million claim by Discus (\$407 million base claim +

A similar analysis holds true for many other Claimants. For example, the second largest unpaid creditor, Trading LSIII (one of the Lake Shore funds), holds a \$67,321,292 claim and received, at most, \$231,849 in preferential transfers. But the Seg 1 Objectors would have the Trustee withhold Trading LSIII's entire \$22.4 million distribution (calculated using the Seg 1 Objector's \$257 million in cash assumed available for distribution) to protect against the hypothetical possibility that the Trustee may be entitled to recover a tiny fraction of that amount, \$231,839, from Trading LSIII sometime in the future. The third largest unpaid creditor, Lake Shore Alt. Financial Fund IV, is in the same position. It holds a \$45,264,937 claim and received, at most, \$151,947 in preferential transfers.

All of these Claimants would do far better (not worse) in a scenario under which preferential transfers were avoided and redistributed, and thus there is no legitimate basis for withholding any distributions to them. If anything, the foregoing exercise using the Seg 1 Objectors' own assumptions shows why the Seg 1 Objectors, who are advancing solely their own agenda and are not exercising any independent judgment whatsoever concerning which claims can and should legitimately be paid, must not be permitted to misuse the claim objection process to thwart Plan distributions.

For the reasons set forth above, even if the Court were to determine that the Claim Objections should not be dismissed at this time, at a minimum the Court should enter an order authorizing the Trustee to make interim distributions to holders of otherwise uncontested claims, and to withhold from those distributions only the amounts the Trustee determines, using his independent judgment, are necessary to actually protect the estate from potential losses in the event preferential transfers are avoided sometime in the future.

\$60 million § 502(h) claim), Discus would be entitled to a Plan distribution of \$178,360,240, and net of the returned \$60 million preference would recover \$118,360,240.

Dated: Chicago, Illinois
December 17, 2008

Respectfully submitted,

**FREDERICK J. GREDE, chapter 11 trustee
for the estate of SENTINEL MANAGEMENT
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By: /s/ Vincent E. Lazar
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