Great Debates

Jeffrey N. Pomerantz, Moderator
ABI Vice President-Education
Pachulski Stang Ziehl & Jones LLP; Los Angeles

Since most debtors default in chapter 13 plans before they reach completion, are modifications needed to the law's rehabilitation goals?

Pro: Hon. Pamela Pepper
U.S. Bankruptcy Court (E.D. Wis.); Milwaukee

Con: Hon. Catherine Peek McEwen
U.S. Bankruptcy Court (M.D. Fla.); Tampa

Should the U.S. Trustee's enforcement role in chapter 11 cases yield to creditor preferences?

Pro: Robert M. Fishman
Shaw Gussis Fishman Glantz Wolfson & Towbin LLC; Chicago

Con: Clifford J. White, III
U.S. Department of Justice; Washington, D.C.

Do creditors' committees serve a useful purpose in cases where the debtor's assets are overly encumbered and the amount of unsecured claims is a fraction of the amount of secured debt?

Pro: Robert J. Feinstein
Pachulski Stang Ziehl & Jones LLP; New York

Con: Jay M. Goffman
Skadden, Arps, Slate, Meagher & Flom LLP; New York

AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
February 2011 • The Essential Resource for Today's Busy Insolvency Professional • Vol. XXX, No. 1

The Potential Value of Dynamic Tension in Restructuring Negotiations

Written by:
Michelle M. Harner
University of Maryland School of Law; Baltimore
mharner@law.umaryland.edu

Jamie Marincic
University of Nebraska-Lincoln; Lincoln, Neb.
jamiemarincic@gmail.com

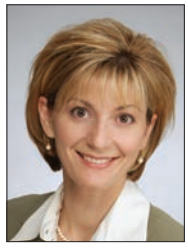
Editor's Note: *The empirical study described in this article was funded by a grant from the ABI Endowment Fund.*

The mandatory appointment of a creditors' committee was intended to provide dynamic tension with the debtor that would stimulate the reorganization process through effective and efficient oversight and negotiation.

—Harvey R. Miller[1]

Dynamic tension is often used to connote two or more conflicting priorities that may influence decision-making. In the business-restructuring context, it has been used to describe the relationship among debtors and their various stakeholders, including secured creditors, unsecured creditors and shareholders.[2] Each party potentially has a unique and competing agenda regarding the debtor's restructuring plan. Although competing agendas can lead to conflict, this can also encourage parties to reevaluate alternatives and explore different or innovative ways to create value.

This potentially productive role of dynamic tension in restructuring negotiations arguably underlies the committee structure incorporated into the U.S. Bankruptcy Code.[3] In fact, the legislative history of § 1102 of the Code suggests that Congress anticipated a multiple-committee structure in many cases.[4] Nevertheless, this structure has not emerged as a dominant or even preferred option given, among other things, concerns regarding costs, efficiency and stakeholder interest in serving on committees.


Michelle M. Harner

The committee structure, whether composed of one or multiple committees, is a core principle of chapter 11. The committee oversees the debtor's conduct during the case, investigates the debtor's conduct prior to the case and advocates the interests of the stakeholder group represented by the committee.[5] In many respects, the committee provides several of the key monitoring functions previously performed by independent trustees and the Securities and Exchange Commission under chapter X of the Bankruptcy Act. "[A] creditors' committee 'is not a perfunctory or useless body, simply appointed to satisfy a formality established by the Bankruptcy Code, but rather should be a vital and integral part of the plan formulation process.'"[6]

Despite the importance of the committee structure, relatively little empirical work regarding the role and objectives served by the structure exists. Accordingly, this empirical study was designed to fill this void and shed light on the workings of committees in chapter 11 cases. We are grateful for the funding to conduct this study provided by a grant from the ABI Endowment Fund. We also received significant support and assistance from The Bureau of Sociological Research at the University of Nebraska-Lincoln.

The study's primary data and analyses are presented in a forthcoming article for the *Vanderbilt Law Review* (herein referred to as "Committee Capture"),[7] in which we detail our methodology and the components of our database, explain the limitations of the study and then provide a thorough analysis of the data.[8] This article summarizes certain of the key data analyses and interesting descriptive data included in the study, and the "Committee Capture" article should be consulted for a complete understanding of the study and its implications.

About the Authors

Michelle Harner is an associate professor of law at the University of Maryland School of Law in Baltimore. Jamie Marincic is a doctoral candidate in Survey Research and Methodology at the University of Nebraska-Lincoln in Lincoln, Neb.

1 "The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director and Sometimes Star of the Reorganization Passion Play," 69 *Am. Bankr. L. J.* 431, 449 (1995).

2 *See, e.g.*, Thomas C. Given and Linda J. Philipps, "Equality in the Eye of the Beholder—Classification of Claims and Interests in Chapter 11 Reorganizations," 43 *Ohio St. L. J.* 735, 735-36 (1982) (explaining "dynamic tension" in context of reorganization vs. liquidation restructuring options); Donald R. Korobkin, "Bankruptcy Law, Ritual and Performance," 103 *Colum. L. Rev.* 2124, 2130 (2003) (explaining that results under bankruptcy laws often "spontaneously emerge...at a juncture of futility and loss, from the dynamic and generative tension of normative directives in unavoidable conflict"); *see also* Miller, *supra*, n.1, at 449; James E. Spiotto, "Overview of the Workout Process," *The Problems of Indenture Trustees and Bondholders*, 731, 739 (*PLI Real Estate Law & Practice*, Course Handbook Ser. No. N4–4591, 1995) ("Any discussion of marshalling of assets would be incomplete without discussing the dynamic tension between unsecured and secured creditors.").

3 *See* Miller, *supra*, n.1, at 449-50.

4 The legislative history provides, in relevant part:
> There will be at least one committee in each case. Because unsecured creditors are normally the largest body of creditors and most in need of representation, the bill requires that there be a committee of unsecured creditors...the bill also provides for additional committees, with status equal to that of the unsecured creditors' committee, when such additional committees are needed to represent various other interests in this case, including secured creditors, subordinated creditors, and equity security holders.

H.R. REP. NO. 95-595, at 235-36 (1977) (footnote omitted).

5 *See, e.g., In re ABC Auto. Prods. Corp.*, 210 B.R. 437, 441 (Bankr. E.D. Pa. 1997) ("The function of the committee is to represent and protect the interests of the unsecured creditors in the plan negotiation process and throughout the entire bankruptcy case."); *In re Diversified Capital Corp.*, 89 B.R. 826, 829 (Bankr. C.D. Cal. 1988) ("The purpose of a committee of unsecured creditors is to monitor the operations and activities of the debtor and its compliance with the requirements of the Bankruptcy Code.").

6 Miller, *supra*, n.1, at 449-50 (citing *Retail Mktg. Co v. Nw. Nat'l Bank (In re Mako Inc.)*, 120 B.R. 203, 212 (Bankr. E.D. Okla. 1990)).

7 Michelle M. Harner and Jamie Marincic, "Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations," 64 *Vand. L. Rev.* (forthcoming 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1679986.

8 *See id.* (manuscript at 17-20, 34-35).

continued on page 62

The Potential Value of Dynamic Tension in Restructuring Negotiations

from cover

ets of 296 chapter 11 cases. The database contains information on 129 primary variables (*e.g.*, filing date, number of committee members, whether plan was filed, whether sale was pursued, ultimate case resolution). The cases, filed between Jan. 1, 2002, and Dec. 31, 2008, were selected from six jurisdictions using a stratified random sample.[9] All but 12 of the sampled cases had some definitive indication of case outcome at the end of the data-collection period.[10]

Recognizing that the case database reflected only public information disclosed by parties in documents filed on the docket, we supplemented the case component of the study with a survey of 300 professionals who work on chapter 11 cases and 300 individuals who have served on creditors' committees in those cases. The survey collected information about committee activities in chapter 11 cases—relations among committees, the debtor and other parties in the case—and the influence of and conflicts among committee members and professionals. Acceptable response rates were received on both surveys.[11] Some of the survey data has been summarized in this article, but a more complete report is forthcoming in a symposium issue of the *Seattle Law Review*.[12]

The overwhelming majority of cases in the database involved business debtors organized as corporations. Based on the debtors' schedules of assets and liabilities, the median amount of assets was $2,508,000 and the median amount of liabilities was $6,156,700.[13] Approximately 66 percent of the cases involved between 1-199 creditors, with the remaining cases involving 200 or more creditors.[14] As explained more fully in "Committee Capture," "143 cases (48.3 percent) involved at least one creditors' committee and 153 cases (51.7 percent) involved no creditors' committees. Of the cases with creditors' committees, 95.8 percent had one creditors' committee, 2.1 percent had two creditors' committees and 2.1 percent had three creditors' committees."[15]

Analysis of the Case Database

Based on anecdotal evidence and the legislative history of § 1102, we formulated two hypotheses to test in the study. In the first hypothesis, "creditors' committees add value to Chapter 11 cases, as determined by returns to unsecured creditors and company reorganizations."[16] In the second hypothesis, "the presence or absence of conflict or self-interest in the composition of creditors' committees impacts value in Chapter 11 cases, as determined by returns to unsecured creditors and company reorganizations."[17] We analyzed "returns to" creditors based on data regarding percentage of recoveries to unsecured creditors and "company reorganizations" based on whether debtors reorganized under a plan of reorganization or sold substantially all of their assets under either a liquidating plan or in a § 363 sale.

As noted, approximately half of the cases in the database involved one or more statutory or *ad hoc* committees. The cases were further divided into three categories, as shown in chart 1: cases with

Chart 1: Committee Structure (n=296)

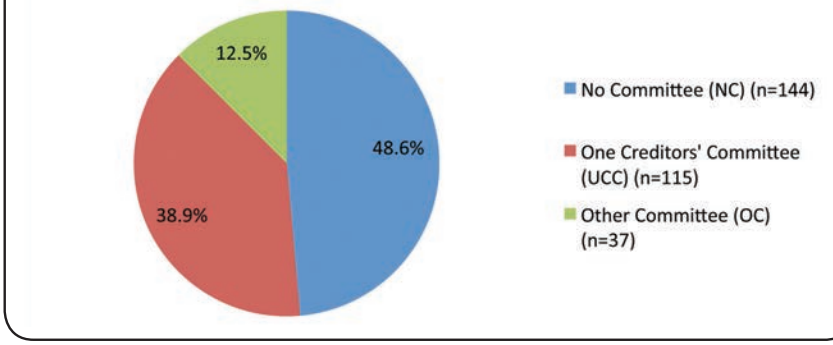
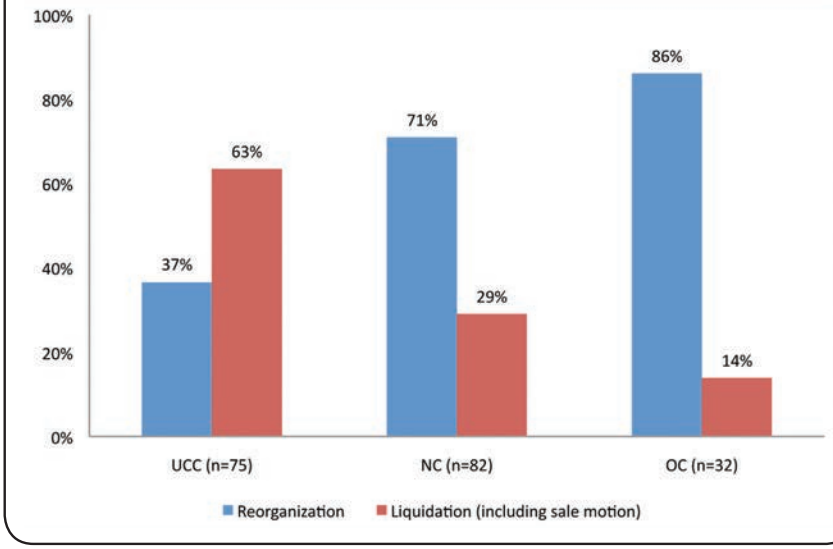


Chart 2: Percentage of Cases (Confirmed Plans Only) with Resolution by Committee Type (Controlling for Assets and DIP Financing)



9 We used the District of Delaware, Northern District of Illinois and Southern District of New York as primary jurisdictions, and the Central District of California, District of Maryland and Northern District of Ohio as additional jurisdictions. The use of and justifications for selecting these jurisdictions are explained fully in "Committee Capture." *See* Harner and Marincic, *supra*, n.7 (manuscript at 17-20).

10 For most cases in the database, we collected data from the petition date through and including the earlier of the closing of the case and June 30, 2009. For cases unresolved as of June 30, 2009, we performed additional data collection through and including June 30, 2010. *See* Harner and Marincic, *supra*, n.7 (manuscript at 17-20).

11 There were 251 professionals and 213 committee members that were contacted and met eligibility criteria. Ultimately, 70 professionals (28 percent) and 43 committee members (20 percent) completed the survey.

12 The survey data and analyses are being presented at the Annual Adolf A. Berle, Jr. Center of Corporations, Law and Society Symposium and was published in the corresponding symposium issue of the *Seattle Law Review*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1736024.

13 *See* Harner and Marincic, *supra*, n.7 (manuscript at 21).

14 *See id.* (manuscript at 22).

15 *Id.* (manuscript at 23) (footnote omitted) (as of Dec. 7, 2010). "Overall, 152 cases (51.4 percent) involved some type of committee (*i.e.*, creditors' committee, equity committee, *ad hoc* committee or some combination), leaving 144 cases (48.6 percent) with no committee involvement." *Id.*; *see also* chart 1.

16 *Id.* (manuscript at 35).

17 *Id.*

no committees (NC cases), cases with one creditors' committee (UCC cases) and cases with multiple or other committees (OC cases).[18] The OC cases included cases with more than one type of creditors' committee or some combination of a creditors' committee, an equityholders' committee or an *ad hoc* committee. These categories were then used in some of our analyses to determine the impact of a creditors' committee's activities in a particular case. We also controlled for other potentially confounding variables, such as asset size, number of creditors, liabilities, secured creditors and debtor-in-possession (DIP) financing, to try to isolate the impact of creditors' committees on chapter 11 cases.[19]

As further explained in "Committee Capture" and shown in charts 2 and 3, "[c]ases with a single creditors' committee were significantly more likely than the other two categories to result in a plan of liquidation or a motion to sell substantially all of the debtor's assets... Those cases also were significantly more likely to provide distributions to unsecured creditors in amounts less than or equal to 50 percent of their claim values."[20] These effects persisted even after controlling for potentially confounding factors. Thus, the data tend to support rejecting the first hypothesis.

With respect to the second hypothesis, the data evidence showed actual and potential conflicts of interest among multiple committee members. Moreover, committees frequently are involved in litigated disputes with debtors or other creditors. Nevertheless, neither conflicts of interest nor litigation impacted value in the database cases.[21] The data show no significant increase or decrease in returns to unsecured creditors or the likelihood of reorganization based on conflicts of interest or litigation. The data tends to support rejecting the second hypothesis.

Although conflicts of interest and litigation do not appear to significantly impact value, they do tend to increase the costs associated with and duration of chapter 11 cases.[22] The amount and types of disputes resulting in litigation also are striking. Committees tend not to file formal objections to fundamental transactions in the case, such as DIP financing, motions to sell substantially all of the debtor's assets and confirmation of a plan of reorganization. However, they do frequently file or become actively involved in litigation with secured creditors and debtors. For example, committees filed an objection or other pleading opposing conduct by secured creditors or debtors in 24 percent and 67 percent, respectively, of the database cases involving creditors' committees.[23]

In addition, creditors' committees are likely to retain at least one—and perhaps multiple—professionals in chapter 11 cases. For example, committees in 135 of the 143 cases (94.4 percent) with at least one creditors' committee retained at least one lawyer or law firm. Likewise, committees in 89 of the 143 cases (62.2 percent) with at least one creditors' committee retained financial advisers.[24] Of these cases, 98 (68.5 percent) involved multiple lawyers and financial advisers.[25] The retention of a financial adviser did not significantly impact the returns to unsecured creditors or the likelihood of the debtor reorganizing.[26]

Chart 3: Percentage of Cases with Percentage Recovery to Unsecured Creditors by Committee Type (Controlling for Assets and DIP Financing)

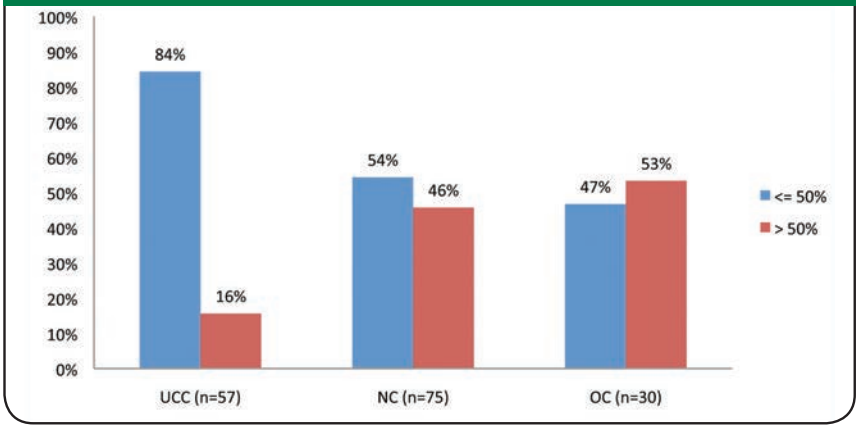
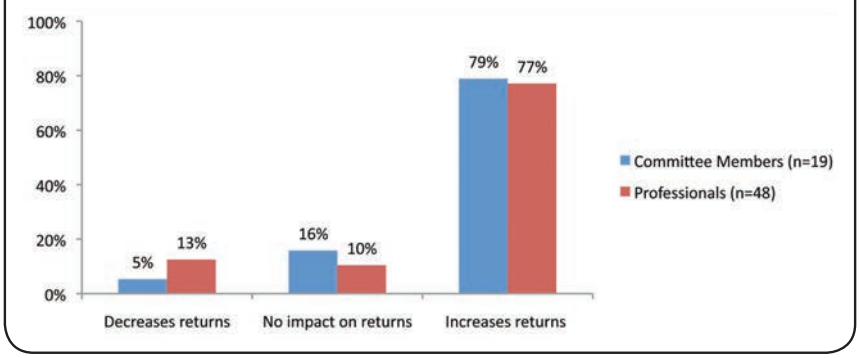


Chart 4: How Does Conflict Between the Debtor and the UCC Regarding the Restructuring Plan Typically Impact Returns to Creditors?



Analysis of Survey Data

The professionals' and committee members' surveys drew responses from a variety of individuals with extensive collective experience in chapter 11 cases. The majority of respondents to the committee members' survey served on creditors' committees, with a small percentage serving on equityholders' and *ad hoc* committees. Of these individuals, 15 have served on more than 10 creditors' committees and six have served on more than 10 *ad hoc* committees. The respondents to the professionals' survey were primarily divided among individuals representing debtors (35.7 percent), committees (17.2 percent) and some combination of parties (31.4 percent) involved in chapter 11 cases.[27] Of those individuals, approximately two-thirds (61.5 percent) reported working on more than 10 cases in any given year.

18 *Id.* (manuscript at 23). The OC Cases category captures data for cases where no single committee was appointed to represent unsecured creditors.
19 *See id.* (manuscript at 28-29).
20 *Id.* (manuscript at 6).
21 *See id.* (manuscript at 31-34).
22 *See id.* (manuscript at 33-34).
23 *See id.* (manuscript at 32).
24 Accordingly, 54 of these cases (37.8 percent) did not involve the retention of financial advisers.
25 Specifically, of the 143 cases, eight have neither a financial adviser nor a lawyer, 37 have one lawyer/law firm and the remaining 98 have some combination of lawyers and/or financial advisers.
26 The overwhelming majority of respondents (94.9 percent) were lawyers. Given the high percentage of cases appointing at least one law firm or lawyer for the committee, we did not have sufficient variability to analyze the impact of lawyers on value.
27 In addition, 2.9 percent represent DIP lenders and 4.3 percent represent individual creditors in chapter 11 cases.

continued on page 64

The Potential Value of Dynamic Tension in Restructuring Negotiations

from page 63

The survey questions focused largely on how committees interact with other parties in chapter 11 cases and consequently did not specifically address which was a more preferable structure: no committee, one creditors' committee or multiple committees. Nevertheless, both groups of respondents suggest that disputes among the creditors' committee and the debtor or among the *ad hoc* committee and the debtor regarding the debtor's plan of reorganization generate additional value for unsecured creditors, as shown in chart 4.[28] Likewise, both groups suggest that the involvement of one or more creditors trying to exert control over the chapter 11 case increases returns to unsecured creditors.[29] Although the case study did not observe any significant association between conflicts or disputes and returns to creditors, the survey data lends support to the overarching notion that greater creditor participation in the chapter 11 case—*i.e.*, dynamic tension—may enhance value.[30]

Moreover, both groups reported instances of conflict among committee members. The most frequently cited conflict involved disagreement over the debtor's plan of reorganization with at least one member being motivated by self interest.[31] The survey data suggested that most of these conflicts are resolved informally, without the need for any formal pleading with or resolution by the court.[32] In fact, the data showed that many committee objections to fundamental transactions are voiced in an informal manner and a majority of all committee objections are resolved without court intervention (see charts 5 and 6 for other responses available to respondents).[33] This data may explain the lack of formal committee objections to fundamental transactions recorded in the case database.[34]

Preliminary Observations

The rejection of the two primary hypotheses underlying the study raises interesting policy and doctrinal questions. We do not believe that the data suggest that creditors' committees are ineffective, but instead observes interesting trends that suggest potential enhancements to the use and composition of creditors' committees.[35] For example, OC and NC cases performed significantly better than UCC cases with respect to returns to creditors and the likelihood of debtor reorganization. An immediate and obvious response is to attribute the difference to factors such as the larger amount of assets and greater number of creditors typically involved in OC cases.[36] That response turns out to be incorrect, given that the significance remained even after we controlled for those and other potentially confounding factors. This suggests that something else is going on.

One potential explanation is dynamic tension. In OC cases, more creditors are taking a more active role in the chapter 11 process. Accordingly, rather than having just one priority voiced to the debtor through a single creditors' committee, multiple parties voice potentially competing priorities, which may cause all parties to evaluate valuations, restructuring options and the like more closely.[37] It also may suggest an underutilization of,

28 About 77 percent of professionals and 78 percent of committee members indicated that conflict between the debtor and the creditors' committee regarding the restructuring plan typically results in increased returns to creditors. Nearly 40 percent of professionals and 63 percent of committee members indicated that such conflict between the debtor and *ad hoc* committee typically results in increased returns to creditors. Respondents also could select that the conflict decreased or had no impact on returns to creditors.

29 About 33 percent of professionals and 45 percent of committee members indicated that the activities of individual creditors or small groups of creditors trying to assert influence in chapter 11 cases typically result in increased returns to creditors. Respondents also could select that such influence decreased or had no impact on returns to creditors.

30 In addition to the limitations inherent in this type of survey study (*e.g.*, self-selection bias), the difference between the survey study and case study data regarding conflicts of interest or disputes and value impact may relate to the off-docket nature of many conflicts of interest and disputes among parties in a chapter 11 case. *See* Harner and Marincic, *supra*, n.7 (manuscript at 31). The survey data confirms that many conflicts of interest and disputes are resolved without the filing of a formal pleading with or intervention by the bankruptcy court.

31 Approximately 57 percent of professionals and 45 percent of committee members selected this option among six other options, including disagreement over restructuring plan with no members motivated by self-interest, disagreement over a significant event in the chapter 11 case with at least one member motivated by self-interest, disagreement over a significant event in the chapter 11 case with no members motivated by self-interest, disagreement over selection of professionals, other and not applicable.

32 In the survey, 90 percent of professionals and 88 percent of committee members indicated that disputes among committee members are most commonly resolved in this way.

33 Almost 32 percent of professionals and 23 percent of committee members indicated that objections raised by the creditors' committees are most commonly informal, with 95 percent of professionals and 76 percent of committee members indicated that the majority of creditors' committees' objections are resolved without court intervention. Of these, nearly 28 percent of professionals and 41 percent of committee members indicated that objections raised by the *ad hoc* committee are most commonly informal. Approximately 71 percent of professionals and 81 percent of committee members indicated that the majority of *ad hoc* committees' objections are resolved without court intervention.

34 The key analyses underlying the case database component of the study do not rely on committee objections to fundamental transactions. Nevertheless, this off-docket information is an example of a limitation of observational studies.

35 *See* Harner and Marincic, *supra*, n.7 (manuscript at 35-41).

36 *See id.* app. B (manuscript at 44).

37 *See id.* (manuscript at 35-41).

Chart 5: Based on Past Experiences, Are the Most Common Objections Raised by the UCC Chapter 11 Cases Formal or Informal Objections?

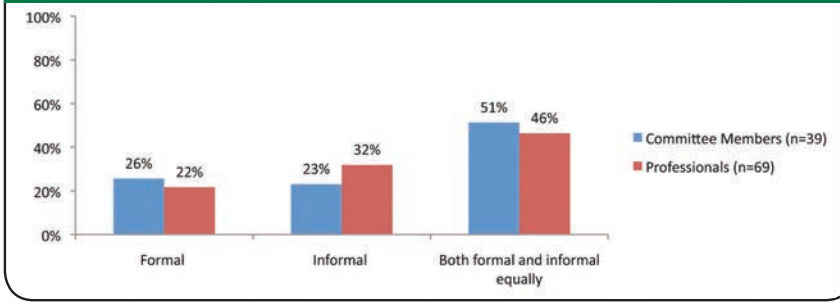
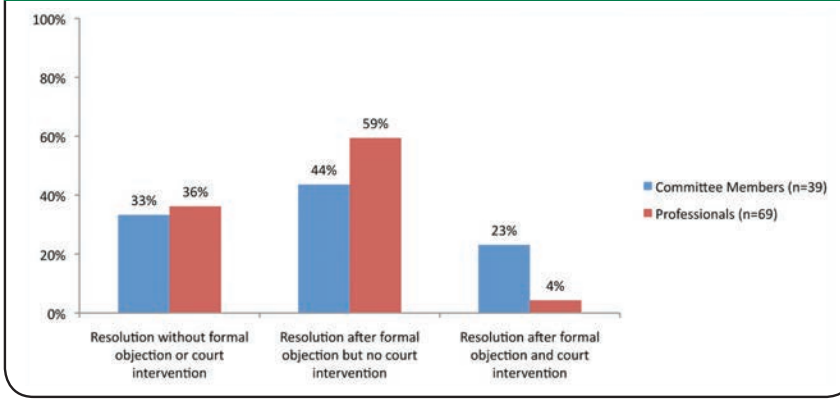


Chart 6: Based on Past Experiences, Which of the Following Best Describes How the Majority of Objections Raised by the UCC Are Resolved?



or passivity by, creditors' committees when no other major constituency is organized or active in the case.

We explore these and other potential explanations in "Committee Capture," and we hope to continue this evaluation in our analysis of the survey data and future studies. Our ultimate goal is to help judges, practitioners and policymakers better understand the role of committees in chapter 11 and how they might utilize the committee structure more effectively and efficiently going forward. As often suggested by courts and commentators, "the very nature of a chapter 11 case (the attempt to continue the debtor's business, generally the continuation of a DIP and the need to address both the determination of assets available for secured and unsecured creditors and equity security holders and the determination of the allocation of said assets among creditors and equity security holders) dictates a much more active role for committees in chapter 11 cases."[38] ■

[38] *In re Marin Motor Oil Inc.*, 689 F.2d 445, 455 (3d Cir. 1982) (citation omitted).

Tasks and Duties of Unsecured Creditors' Committees

by Bill Lenhart, BDO Consulting

Basis for Unsecured Creditors' Committees

Section 1102 of the Bankruptcy Code:

...as soon as practicable...the United States trustee shall appoint a committee of creditors holding unsecured claims...

A committee of creditors appointed...shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee...

Purpose of Unsecured Creditors' Committees

- Members of the Committee are fiduciaries and represent the entire unsecured creditor body.
- The Committee attempts to maximize recovery for all unsecured creditors.
- Opportunity to shape progress and outcome of case
  - Evaluate Debtor's decisions and direction
  - Object to actions not in the unsecured creditors' best interests

Selecting Members of the Unsecured Creditors' Committee

- The U.S. Trustee selection process is based on:
  - Value
    - The Code provides even a creditor with a small claim who is suffering disproportionately by the Debtor's filing may be appointed
  - U.S. Trustee considers unique skills and knowledge of industry
  - Diversified Interests
    - Representative of all unsecured creditors

The Role of the Unsecured Creditors' Committee

The Committee's involvement and role varies on a case by case basis. Deliberations and investigations will depend on whether the case will result in a sale or in reorganization.

- ***Immediate priority – First Day Motions***
  - DIP Financing
  - Use of cash collateral
  - Sale process and timing
  - Critical vendor motions
  - Employee wages and benefits
  - Lease rejections

This paper was presented at ABI's 2011 Annual Spring Meeting at National Harbor, Md.

THE ROLE OF THE UNSECURED CREDITORS' COMMITTEE

- ***Sale***
  - Evaluate proposed sale process and timing
  - Assist in finding going concern potential buyers
  - Participate in evaluation of offers from interested parties
  - Attend and participate in auctions
- ***Reorganization***
  - Review business projections to determine viability
  - Assist in formulating plan of reorganization with debtor and its advisors
    - Focus on core business
    - Shed non-core assets
  - File own plan of reorganization
- ***Investigation***
  - The extent of the Committee's investigation will often depend on the assets available and likelihood of recovery to unsecured creditors
  - Fraudulent transfers
  - Insider transactions
  - Secured lender transactions
  - Solvency analysis

POWERS AND DUTIES OF THE UNSECURED CREDITORS' COMMITTEE

- Section 1103 of the Bankruptcy Code outlines specific powers and duties of the UCC:

  ...consult with the trustee or debtor concerning the administration of the case
  ...investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business
  ...participate in the formulation of a plan
  ...request the appointment of a trustee or examiner
- Review the progress and status of the case and discuss it with the debtor.
- Participate in the formulation of a viable plan of reorganization or liquidation.
- Apply for appointment of a trustee to assume control.
- Apply for the appointment of an examiner.
- Apply to dismiss the case or convert it to a Chapter 7 liquidation case.
- Provide information to the general creditor body.

Recent Cases Regarding Creditors' Committees

by Scott L. Hazan, Esq. and Enid Nagler Stuart, Esq., Otterbourg, Steindler, Houston & Rosen, P.C.

At the outset of a chapter 11 case, an official committee of unsecured creditors (the "Committee") is appointed to represent the interests of all unsecured creditors through oversight and negotiations with the debtor. The Committee is a fiduciary for all unsecured creditors charged with maximizing value. The Committee is provided confidential information in order to do its job. This model has worked well in most cases. However, in cases with extreme facts, issues arise which result in extreme consequences.

1. The Dysfunctional Committee - Improper Functioning

The FiberMark chapter 11 case, Case No. 04-10463 (Bankr. D. Vt.), raises issues of significant concern for Committee members and Committee counsel. The case is a lesson as to what can happen when a Committee and its counsel lose sight of their fiduciary obligation to the entire Committee and the class of creditors the Committee represents.

In the FiberMark case, based upon a series of pleadings and the Debtor's inability to confirm a Chapter 11 Plan in what was viewed as an uncomplicated case, the Court sua sponte, appointed Harvey Miller as examiner (the "Examiner"). The Court directed the Examiner to investigate, inter alia, whether any Committee member breached its fiduciary duty to act in the best interests of unsecured creditors. After an extensive investigation, the Examiner submitted a 322 page Report (the "Report"),[1] in which he concluded that the Committee should be disbanded, and that two Committee members, AIG Global Investment Corp. ("AIG"), the Committee Chair, and Post

[1] Report of Harvey R. Miller, As Examiner (August 16, 2005 version) - Docket No. 1805. The Report is available as part of the CD-Rom material or upon request to the authors.

Advisory Group, LLC ("Post"), had breached their fiduciary duties by usurping the role of the Committee for their own interests "in one of the worst examples of chapter 11 reorganization gone awry to the prejudice of all parties and particularly, the entire unsecured creditor constituency."[2] In addition, the Examiner found that Committee counsel had, during certain periods of the case, failed to objectively represent the entire Committee and its constituency of all general unsecured creditors by aligning itself with AIG and Post.

In FiberMark, there was a battle of wills between AIG and management which began before the Chapter 11 case was commenced. AIG, was the holder of 19% of the Debtor's public notes and served as Chair of the Committee. According to the Report, AIG's representative believed that "the debtor should be totally subservient and responsive to the directions of its substantial creditors or its creditors' committee."[3] His hostility towards the Debtor and other members of the Committee "caused disharmony among the members of the Committee" and his "desire for control and disrespect for the views of others resulted in a dysfunctional Committee and a perplexed FiberMark."[4] Post, another substantial noteholder, supported AIG. The Examiner also found that Committee counsel, by aligning with AIG and Post "failed to discharge its duties in an independent, objective and disinterested manner."[5]

Based upon the evidence, the Examiner recommended that with respect to the breach of fiduciary duty by AIG and Post and the resultant loss of value to the FiberMark estate and creditors because of the delay and extension of the Chapter 11 case caused by AIG and Post, inter alia:

---

2 Report at p. 295.

3 Report at p. 3.

4 Report at p. 3.

5 Report at 315 - 321.

- Disallowance of AIG's and Post's claims for voting purposes as to any plan of reorganization proposed in the case.

- That the Committee be disbanded as dysfunctional and unable to discharge its duties to unsecured creditors.

- Any cash distributions to be made to AIG and Post pursuant to a confirmed Plan be reduced in the sum of $8,378,000,[6] allocated 2/3 to AIG and 1/3 to Post, representing the loss of value to unsecured creditors other than Silver Point Capital, L.P. ("Silver Point") (the largest noteholder and another Committee member), because of the delay caused by AIG and Post, and that such amount be reallocated to the unsecured creditors (other than Silver Point).

- That any plan or reorganization not provide for releases for AIG, Post or Silver Point.[7]

With respect to Committee counsel, the Examiner recommended that some significant portion of its fees be disallowed.[8] Subsequently, Committee counsel entered into a Settlement Agreement with respect to its Final Fee Application, without admitting any liability. Counsel agreed to relinquish $1.2 million in unpaid fees, to pay $400,000 to the Reorganized Debtors, and to abide by a *Protocol for Procedures to Ensure Compliance with Bankruptcy Rule 2014 Disclosure Obligations* Docket No. 2127.

2. The Tainted Committee - Formation and Professional Selection Issues

The recent decision by Judge Walrath in the Universal Building Products case ("Universal"), highlights the pitfalls of the use of intermediaries and proxies by law firms in connection with their effort to be retained as Committee counsel. *2010 Bankr. LEXIS 3828* (Bankr. D. Del. 2010) After an extensive review of the evidence, Judge Walrath found that two law firms seeking retention as Committee counsel violated Rules 7.3 and 8.4 of the Model Rules of Professional Conduct and of Delaware's Rules of Professional Responsibility in connection with their prepetition solicitation

---

[6] Exhibit D to the Report shows the calculation of the loss of distributable value to unsecured creditors based on the original version of the plan of reorganization and the later version of the plan.

[7] Report at 25.

[8] Report at 26.

efforts and were disqualified from serving as counsel to the Committee. The Court also found that the law firms failed to provide complete disclosure pursuant to Bankruptcy Rule 2014 at the *outset* of the engagement warranting denial of the retention applications.

In Universal, the law firms used a translator, Dr. Liu, who had connections to (or for purposes of the case, made contact with) Asian based clients, to obtain proxies which would be used by Dr. Liu to vote for the two law firms as Committee counsel. In return, Dr. Liu would be retained by the Committee as a translator. The Court found that the law firms and Dr. Liu "were acting in concert to cold call creditors that Dr. Liu did not represent for the purpose of being retained by them to attend the Committee formation meeting and to cast a proxy in favor of AF and EG for counsel." Universal, *2010 Bankr. LEXIS 3828, at *23*. The Court predicated its decision to disqualify the law firms on, inter alia, the following facts:

- As a result of communications between Dr. Liu and counsel, it was clear Dr. Liu did not represent any of the creditors at the time he first tried to contact them.
- Dr. Liu kept counsel apprised at least on a daily basis of his efforts to locate and obtain proxies from creditors and would act "as usual".
- Dr. Liu asked for assistance in locating creditors and received assistance from counsel.
- Dr. Liu understood that counsel wanted him to get support from the creditors.
- To persuade creditors to provide proxies, Dr. Liu was provided with legal advice from counsel relevant to the creditors' rights.
- Both law firms were on the phone with one of the creditors to discuss the case and help persuade the creditor to provide a proxy.
- Dr. Liu voted his proxy (one of the two proxy givers was appointed to the Committee) in favor of the two law firms at the formation meeting.
- Counsel immediately recommended the retention of Dr. Liu as a translator and Dr. Liu stepped down as a creditor representative.

This decision will likely impact (and to some extent has already impacted) the way Committees are formed and how professionals pursue such engagements in the future. Although Court's generally do not give advisory opinions, Judge Walrath made it clear that Bankruptcy Rule 2014 requires all professionals to disclose any direct calls they made (or calls made on their behalf) to creditors who were not their clients in an effort to be employed in a bankruptcy case. Universal, *2010 Bankr. LEXIS 3828,* footnote 16 at *38. The Court also urged the United States Trustee to consider implementing procedures to reduce the likelihood of undue influence on the decision of a Committee to hire professionals. Judge Walrath's suggestions included keeping creditors in a separate room from prospective counsel and amending the Questionnaire the United States Trustee sends out to prospective Committee members to include questions regarding whether they were solicited by any professional.

3. The Damaged Committee - Committees and Trading

The creation of an active market for trading in distressed debt and the active participation of investment funds or "vulture investors" in Committees has changed the traditional dynamic of chapter 11 cases. The participation of "vulture investors," whose business depends on the ability to continue trading, raises issues regarding the fiduciary obligations of a Committee member and federal and state securities laws. In order to address these concerns, certain Committees have obtained "trading orders" which allow an investment fund's traders to continue trading during the bankruptcy case. The 'trading orders" generally require "ethical walls" or other procedures to prevent a fund's traders from receiving non-public information as a result of the fund's membership on a Committee. However, Committees do not always seek the protection of a "trading order" or if there is one, the funds on the Committee do not always implement the requisite procedures.

In the Galey & Lord chapter 11 case, Case No 02-40445 (Bankr. S.D.N.Y.), the Committee commenced an adversary proceeding in the Bankruptcy Court against Barclays Bank Plc. and Barclays Capital (collectively "Barclays"), a former Committee member. Adv. No. 03-92683. The Complaint alleged that Barclays engaged in inequitable conduct and breached its fiduciary duty by engaging in trading transactions while serving as a member of the Committee. The Complaint sought equitable subordination of Barclays' claims and damages, alleging:

- Barclays was a member of the Committee from March 1, 2002 to March 18, 2003.
- To join the Committee, Barclays had executed a Committee Acceptance that provided: "[n]oteholders wishing to serve as fiduciaries on any statutory committee are advised that they may not trade while they are Committee members."
- Barclays executed by-laws, which stated that each member of the Committee was fiduciary and confidential information received by members "may not be used for any purpose that is inconsistent with the majority decision or intent of the Committee."
- Barclays received "insider" information.
- While serving on the Committee, Barclays purchased up to $20 million of secured bank debt without the knowledge or consent of the other members of the Committee.
- After receiving a business plan revising financial projections downward from those previously presented to the Committee, Barclays withdrew from the Committee and joined an Ad Hoc Committee of secured creditors and disseminated Committee confidential information to the Ad Hoc Committee.
- Barclays continued to be a member of the Ad Hoc Committee through the effective date of Galey & Lord's plan of reorganization.

Barclay's filed an Answer denying all liability. Thereafter, the Committee and Barclays settled the Adversary Proceeding. Without admitting any liability, Barclays agreed to pay $2,079,000 to be distributed to unsecured creditors pursuant to the Debtor's chapter 11 plan.

However, this was not the end for Barclays. On May 30, 2007, the Securities and Exchange Commission filed a Complaint against Barclays and a former head proprietary trader for Barclays'

United States distressed debt desk, who was the Barclays representative on the Galey & Lord Committee. United States Securities and Exchange Commission v. Barclays Bank PLC and Steven J. Landzberg, 07-CV- 04427 (S.D.N.Y.). The Complaint alleged that Barclays and the trader served on at least six Committees (including Galey & Lord and two other Official Committees) and misappropriated material nonpublic information and engaged in securities fraud through a pattern of insider trading. Barclays and the trader consented, without admitting or denying the allegations, to entry of final judgments permanently enjoining them from violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5. Barclays also consented to the entry of an Order requiring payment of $10.94 million, and the trader consented to be permanently enjoined from the participation in any Committee in any bankruptcy case involving the issuer of securities and payment of a civil penalty of $750,000.

The WorldCom chapter 11 case, 02-13533 (Bankr. S.D.N.Y.), is another example of the impact the trading activities of one Committee member may have on the Committee as a whole. In WorldCom, the plan of reorganization became effective on April 20, 2004 and the Committee was dissolved (except for very limited purposes). In July 2004, the SEC served subpoenas on the then eleven current Committee members (the Committee at that time, as noted, existed only for limited purposes) in connection with an investigation of one Committee member seeking "thousands if not millions of pages of documents" relating to the Committee and the WorldCom case. The Committee members retained Committee counsel to represent them for purposes of responding to the SEC and Committee counsel filed a Motion with the Bankruptcy Court for an Order compelling WorldCom to pay attorneys' fees in connection with the SEC investigation. Docket No. 12299. The Committee cited, inter alia, to the following in support of the Motion:

- That an order granting the relief would be in furtherance of consummation of the Plan under Section 1142 (b) of the Bankruptcy Code.

- The Plan provided for defense costs for all Covered Parties including the Committee and its members for any action by a third party with respect to the plan of reorganization.

- Payment of the fees is consistent with the legislative goal of encouraging creditors to take an active role in complex chapter 11 cases.

The Debtors opposed the Motion arguing that the Plan did not provide for payment of the particular fees in question, Section 1142 of the Bankruptcy Code was not relevant since the plan of reorganization had already been consummated, and that the Committee was wrong in suggesting that the Debtors' refusal to pay the fees impacts the integrity of the chapter 11 case. Docket No. 12489. The Court denied the Motion after a hearing. Docket No. 12603.

The SEC investigation resulted in a settled enforcement action against Van D. Greenfield ("Greenfield") and Blue River Capital LLC ("Blue River") which included suspension of Mr. Greenfield from association with any broker-dealer for six months and payment by Greenfield and Blue River of $150,000 as a fine. Exchange Act Release No 52744 (November 7, 2005). Blue River was a member of the WorldCom Committee and Greenfield was its representative and co-chair of the Committee.[9]

The SEC found that Blue River obtained membership on the WorldCom Committee by backdating a $400 million short sale and purchase of Notes which was not disclosed to the United States Trustee. The SEC found that Blue River actually held only $6.5 million in Notes and would not have been appointed to the Committee based upon those holdings. In addition, while a "trading order" was obtained in the *WorldCom* case, which allowed Committee members to continue trading in the debtor's securities, the SEC found that Blue River failed to establish an effective information

[9] Blue River, represented by Mr. Greenfield, also served on the Creditors' Committee in the Globalstar, L.P. chapter 11 case and the Equity Committee in the Adelphia Communications Corp. case, which was chaired by Mr. Greenfield. The SEC enforcement action also encompassed Blue River's trading activity in those cases.

barrier or to file an Affidavit attesting to compliance with the "trading order" as was required. The SEC found numerous deficiencies in Blue River's practices including the following:

- Blue River's trading room consisted of four tables in the dining room of the ground floor of Greenfield's townhouse next to Greenfield's office. Mr. Greenfield would frequently walk through the trading room and ask for market quotes for *WorldCom* securities and he received daily reports on Blue River's trading activity in *WorldCom* securities

- Blue River did not have written guidelines or procedures to prevent the misuse of confidential information while Greenfield served on Committees; no person monitored Blue River's trading practices, while Greenfield, who was Blue River's principal owner and compliance officer, served on the *WorldCom* and other Committees.

Conclusion

The Creditors' Committee plays a vital role in representing unsecured creditors to maximize distributable value. As the cases illustrate, if the Committee members or the attorney's for the Committee run afoul of their fiduciary duty to the unsecured creditor class, bankruptcy disclosure requirements or federal securities law, the consequences can be significant.

Overview of Committee Activities

by Professor Michelle M. Harner, University of Maryland School of Law & Jamie Marincic[**]

This empirical study collected and analyzed a wealth of information concerning the activities of committees—particularly, official committees of unsecured creditors appointed pursuant to section 1102 of the U.S. Bankruptcy Code—in chapter 11 business bankruptcy cases. Specifically, the investigators identified 296 chapter 11 cases through a stratified random selection process. The sample pool included cases filed during 2002-2008 in six different jurisdictions. The investigators' article, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations* (forthcoming in the *Vanderbilt Law Review* (*Committee Capture*)[1]), further explains the case selection process and the methodology underlying the study. *Committee Capture* also presents the study's primary hypotheses and key data results. A separate article, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations* (forthcoming in the *Seattle University Law Review)*[2] presents the results of a related survey of professionals and creditors' committee members involved in chapter 11 cases. The content of both articles is summarized in *The Potential Value of Dynamic Tension in Restructuring Negotiations: An Overview of Empirical Data Concerning Creditors' Committee*, which appeared in the *American Bankruptcy Institute Journal* and is reprinted with permission in these meeting materials.

In addition, the attached "Committee Activity Chart" presents some key descriptive data from the empirical study. These data are intended to provide additional information about the activities of committees in chapter 11 cases. They are presented according to committee type and, unlike the committee comparisons made in the study, are not based on whether a particular case involved a single creditors' committee or multiple committees. The chart focuses on what different types of committees are doing in chapter 11 cases and what other parties are doing in cases involving those committees.

[**] Doctoral Candidate in Survey Research and Methodology, Concentration in Statistics, University of Nebraska-Lincoln.

[1] Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1679986.

[2] Michelle M. Harner & Jamie Marincic, *Closed Doors: The Influence of Creditors in Business Reorganizations*, SEATTLE U. L. REV. (forthcoming) (with Jamie Marincic) (symposium piece), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1736024.

Committee Activity Chart

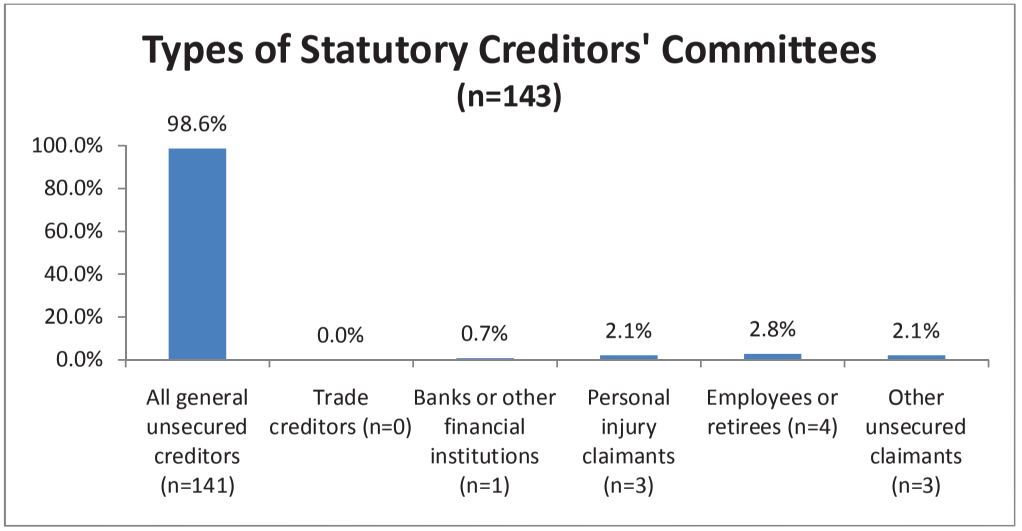
	Cases with at least one Creditors' Committee (n=143)	Cases with at least one Equity Committee (n=8)	Cases with at least one Ad Hoc Committee (n=33)
DEBTOR IN POSSESSION (DIP) MOTION			
% of Cases with Filed DIP Motion	67.8% (n=97)	87.5% (n=7)	75.8% (n=25)
Among Cases with a Filed DIP Motion			
% of Cases with Committee* Objections to DIP Motion	52.6% (n=51)	0% (n=0)	24.0% (n=6)
% of Cases with Non-Committee Objections to DIP Motion	56.7% (n=55)	57.1% (n=4)	72.0% (n=18)
SALE MOTION			
% of Cases with Filed Sale Motion	49.7% (n=71)	0% (n=0)	15.2% (n=5)
Among Cases with Filed Sale Motion			
% of Cases with Committee* Objections to Sale Motion	26.8% (n=19)	--	60.0% (n=3)
% of Cases with Non-Committee Objections to Sale Motion	77.5% (n=55)	--	60.0% (n=3)

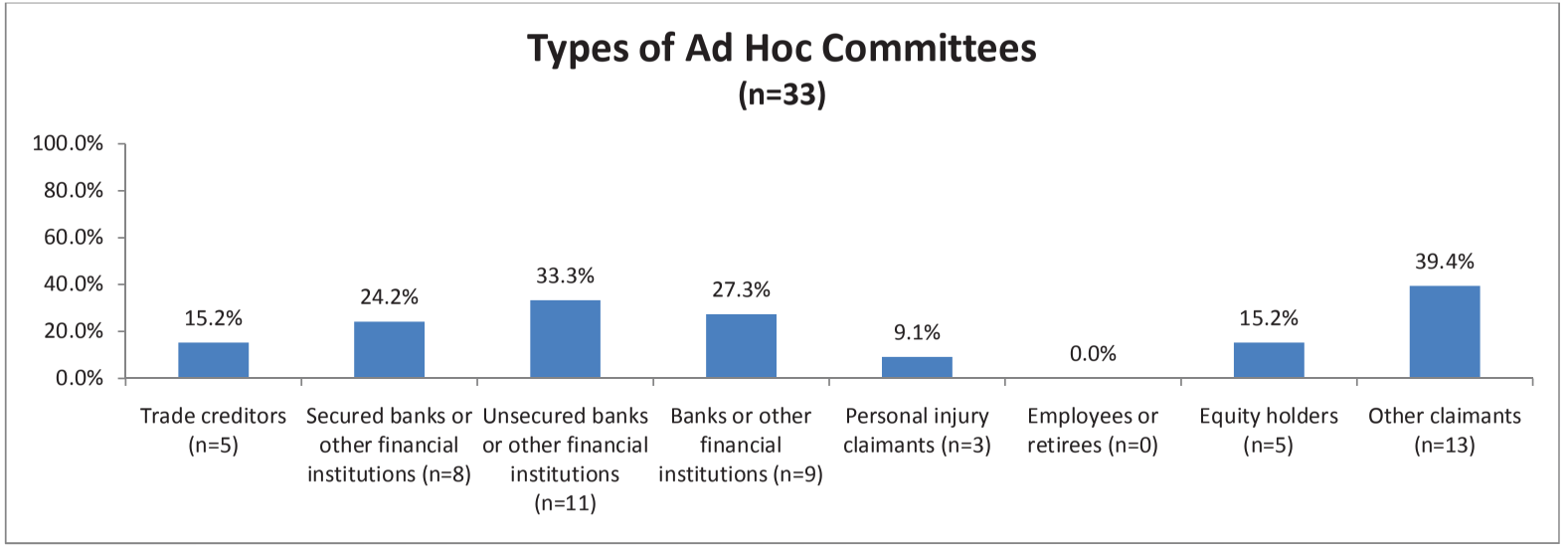
* Refers to objections made by the identified committee type under study (e.g., 52.6% of cases with at least one creditors' committee and a filed DIP motion had a creditors' committee objection to the DIP motion; 0% of cases with at least one equity committee and a filed DIP motion had an equity committee objection to the DIP motion; 24.0% of cases with at least one ad hoc committee and a filed DIP motion had an ad hoc committee objection to the DIP motion).

	Cases with at least one Creditors' Committee (n=143)	Cases with at least one Equity Committee (n=8)	Cases with at least one Ad Hoc Committee (n=33)
DISCLOSURE STATEMENT			
% of Cases with Filed Disclosure Statement	80.4% (n=115)	100.0% (n=8)	100.0% (n=33)
Among Cases with Filed Disclosure Statement			
% of Cases with Committee* Objections to Disclosure Statement	20.0% (n=23)	50.0% (n=4)	42.4% (n=14)
% of Cases with Non-Committee Objections to Disclosure Statement	63.5% (n=73)	87.5% (n=7)	75.8% (n=25)
PLAN			
% of Cases with Filed Plan	82.5% (n=118)	100.0% (n=8)	100.0% (n=33)
Among Cases with Filed Plan			
% of Cases with Pre-packaged, Pre-arranged, or Pre-negotiated Plan	5.1% (n=6)	0% (n=0)	24.2% (n=8)
% of Cases with Committee* Objections to Plan	11.9% (n=14)	50.0% (n=4)	36.4% (n=12)
% of Cases with Non-Committee Objections to Plan	65.3% (n=77)	100.0% (n=8)	87.9% (n=29)

	Cases with at least one Creditors' Committee (n=143)	Cases with at least one Equity Committee (n=8)	Cases with at least one Ad Hoc Committee (n=33)
OBJECTIONS AND LITIGATION			
% of Cases with Objections Filed by Individual Committee* Members	31.5% (n=45)	--	18.2% (n=6)
% of Cases with Litigation by/against Individual Committee* Members	72.0% (n=103)	--	36.4% (n=12)
% of Cases with Any Committee Dispute/Litigation with Another Committee	14.0% (n=20)	87.5% (n=7)	51.5% (n=17)
% of Cases with Any Committee Dispute/Litigation with Secured Lenders	43.4% (n=62)	62.5% (n=5)	42.4% (n=14)
% of Cases with Any Committee Dispute/Litigation with Debtor	66.4% (n=95)	100.0% (n=8)	72.7% (n=24)
TRADING ORDERS			
% of Cases with Entered Trading Order	8.4% (n=12)	--	--
SECTION 1102(b)(3) DUTY ORDERS			
% of Cases with Entered Duty Order	15.4% (n=22)	--	--
CHAPTER 11 TRUSTEE			
% of Cases with Order Appointing Trustee	3.5% (n=5)	0.0% (n=0)	0.0% (n=0)
% of Cases with Order Denying Trustee or Withdrawn or Unresolved Motion Regarding Trustee	14.7% (n=21)	37.5% (n=3)	18.2% (n=6)

	Cases with at least one Creditors' Committee (n=143)	Cases with at least one Equity Committee (n=8)	Cases with at least one Ad Hoc Committee (n=33)
CHAPTER 11 EXAMINER			
% of Cases with Order Appointing Examiner	3.5% (n=5)	37.5% (n=3)	6.1% (n=2)
% of Cases with Order Denying Examiner or Withdrawn or Unresolved Motion Regarding Examiner	6.3% (n=9)	12.5% (n=1)	9.1% (n=3)


Types of Statutory Creditors' Committees
(n=143)
100.0%
80.0%
60.0%
40.0%
20.0%
0.0%
98.6%
0.0%
0.7%
2.1%
2.8%
2.1%
All general unsecured creditors (n=141)
Trade creditors (n=0)
Banks or other financial institutions (n=1)
Personal injury claimants (n=3)
Employees or retirees (n=4)
Other unsecured claimants (n=3)


Types of Ad Hoc Committees
(n=33)
100.0%
80.0%
60.0%
40.0%
20.0%
0.0%
15.2%
24.2%
33.3%
27.3%
9.1%
0.0%
15.2%
39.4%
Trade creditors (n=5)
Secured banks or other financial institutions (n=8)
Unsecured banks or other financial institutions (n=11)
Banks or other financial institutions (n=9)
Personal injury claimants (n=3)
Employees or retirees (n=0)
Equity holders (n=5)
Other claimants (n=13)