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Unsecured Creditors' Committees

Who serves and how critical needs in Chapter 11 cases are met

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With bankruptcy filings on the rise, an increasing number of businesses and individuals may find themselves listed as unsecured creditors with much to lose in a bankruptcy case.

🔑 Large creditors (as defined by the amount of unsecured credit extended) may be solicited to serve on an unsecured creditors' committee formed after the commencement of a bankruptcy case. While a creditor owed significant money may consider any further time or effort to be a waste of resources, serving on a creditors' committee can present a valuable opportunity to be involved in a debtor's reorganization (or ulti-

mate liquidation), and to ensure maximum recovery for all unsecured creditors. This article provides a brief overview of what a creditors' committee is, who may serve, what service entails, and some of the pros, cons, and other considerations involved.

What is a Creditors' Committee?

🔑 The formation of an official committee of unsecured creditors is provided for under section 1102 of the U.S. Bankruptcy Code. Pursuant to section 1102, the U.S. Trustee is tasked with forming the committee (and any

others deemed necessary) after a debtor files for Chapter 11 relief. Accordingly, the process for choosing and appointing a committee will begin within days after the bankruptcy filing with solicitation letters and questionnaires sent to the largest unsecured creditors identified as part of the debtor's Chapter 11 petition.

The solicitation letters will designate a date, time, and place for an organizational meeting at which the U.S. Trustee will choose a committee that represents the general unsecured creditor body in both type and amount. An unsecured creditors' committee can be comprised of between three

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Unsecured Creditors' Committees

Key Elements

When companies file for Chapter 11 protection, the courts will create a creditors' committee to guide the process and see that the debtor's property is distributed equitably:

- 🔑 how and why certain creditors are chosen as committee members
- 🔑 the duties and responsibilities associated with serving
- 🔑 the advantages and disadvantages of committee service.

To learn more about each key element, look for the 🔑 symbols throughout the article.

and eleven members, but is usually made up of no less than five and no more than seven members.

On occasion, creditors—who were not contacted by the U.S. Trustee nor listed among the debtor's largest creditors—can garner a spot on the committee by exhibiting expertise and knowledge in the debtor's particular industry, or by demonstrating their claims may not be adequately represented by those designated for committee membership. In some cases, an additional committee representing the debtor's shareholders or bondholders may also be appointed if the U.S. Trustee and bankruptcy court see a need or if there is sufficient interest to do so.

Once formed, the committee has the right, subject only to bankruptcy court approval, to retain and consult counsel and other professionals to represent the committee as a whole (as opposed to individual members or their interests). Committees will generally retain counsel and/or financial advisors immediately after formation through an expedited interview process. As a statutorily created entity, both the "reasonable" fees and expenses of the professionals selected to represent the committee, and the "reasonable" expenses (but not the fees) incurred by members serving on the committee are paid and reimbursed out of the debtor's estate.

It should be noted, however, that fees and expenses for the attorneys and professionals retained by individual members to represent his/her own specific interests, issues, and claims in the case will not be paid by the debtor's estate and are the sole responsibility of the member as a single creditor (please also note that it is advisable to retain individual

counsel in connection with a bankruptcy case even if serving on a committee, since the committee represents all creditors and not individual interests which may, from time to time, be adverse to a specific creditor's interests).

Committee Responsibilities

Although the ordinary day-to-day operations of a Chapter 11 debtor's business are normally determined by its existing management, a committee can influence both the long-term strategy of the business and any decisions made in the administration of its assets. In so doing, the committee is fulfilling its purpose of representing the interests of all unsecured creditors and acting as a watchdog for those interests while the bankruptcy case is pending.

First, the committee and its retained professionals will investigate and become knowledgeable about the debtor's business and history, including a review of its liabilities and assets to assess and take action, unilaterally or in lieu of the debtor (where necessary) to influence the direction of the case. For example, there may be instances where a debtor will not want to challenge a certain creditor's claim or bring action against a creditor if it is dependent upon this business relationship for its post-petition and/or post-bankruptcy business, even if such creditor's claim is challengeable and negatively impacts the majority of the other creditors.

In these situations, the committee may be the only party willing and able to make such challenges or bring such actions for the benefit of all creditors. Having the ability to defer such responsibilities to a committee allows the debtor to maintain its relationship with the target creditor and, in the long run, benefit all other creditors by enriching the estate and supporting the survival of the reorganized entity after bankruptcy.

Most importantly, however, the committee will have a significant role in advising the court during the bankruptcy process. Specifically, bankruptcy courts will often look to the committee whenever a debtor seeks court approval to enter into an agreement outside the ordinary course of business, including the disposal of assets or the

assumption of any post-petition debt, with respect to a debtor's plan of reorganization or liquidation, or to take other action that affects the estate and creditors as a whole. For example, a debtor will often seek to enter into an agreement to take on "debtor-in-possession" (DIP) financing at the commencement of a case in order to fund its operations and pay administrative costs.

It is common for the lender of DIP financing to require a 'first priority' lien on substantially all of a debtor's assets, a comparatively high interest rate and short maturity date, in addition to other quite burdensome requirements on the debtor and its estate, in exchange for the loan. A court will, as a matter of course, put off final approval of such an arrangement until a committee has been appointed and given ample time to review and weigh in on the DIP financing arrangement and will also take the committee's suggestions on any changes to such an arrangement.

Accordingly, through the discharge of its duties and actions, the committee is an integral part of the bankruptcy process in both the direction and success of a debtor's case. The committee ultimately influences how and whether the debtor reorganizes or liquidates, as well as the amount of distributions made to unsecured creditors in either scenario, accomplishing these goals through investigation and negotiation with the debtor, its lenders, and other large creditors in the case.

Advantages & Disadvantages

🔑 Serving on a bankruptcy committee is a somewhat significant responsibility:

Time commitment. Serving on a committee may require a considerable amount of time depending on the complexity of the case; however, the typical committee may meet several times a month, usually via phone conference for minimum disruption. In any event, time spent on the committee will take away from other business activities, which ordinarily would not have been spent on an insolvent party likely to pay only a fraction of what is owed to the creditor. In addition, since service is voluntary, committee members are not directly compensated for their time (although they do receive reimbursement for expenses by court order).

Acting as a fiduciary. The committee and

its members also have a fiduciary duty to act in the best interests of the unsecured creditors as a whole. As such, committee members must discharge the duties for which they are accountable. Specifically, as a fiduciary, committee members are prohibited from using confidential information for their own advantage or from trading on claims (or any securities held in the debtor) based on such information.

There are, however, significant advantages to serving on a committee:

Providing your opinion. The committee has a fiduciary responsibility to represent the interests of all similarly situated parties, i.e., all unsecured creditors. As such, a bankruptcy judge relies heavily on the committee's opinions and recommendations, as opposed to the self-interested view of one creditor. Being a committee member enables a creditor to influence the treatment and recovery of its own claims, in conjunction with the claims of all creditors.

Sharing and cutting costs. Because the committee will hire its own attorneys and financial advisors, a creditor serving on the committee may find its interests are, necessarily, aligned with the entire committee in taking or objecting to an action. Asserting those positions through the singular voice of the committee and its professionals saves costs to individual creditors taking or opposing actions on their own. Moreover, while payment from the debtor's assets will decrease the estate assets available to pay creditors in the long run, the cost of those professionals is disbursed evenly among all the creditors the committee is formed to benefit.

Networking Opportunities. Participating on a committee also provides a unique opportunity to work with other individuals involved in the same industry. Due to the committee's access to confidential information and heightened knowledge of case developments, many members view committee service as a way to sustain or strengthen existing business rela-

tionships with the debtor or other committee members, who may provide vital business to the creditor.

Conclusion

Although committee service requires a major time commitment and extensive responsibility, a creditor may find it has excerpted more control in an environment where creditors often find themselves feeling somewhat helpless. Ultimately, committee service should always be considered in consultation with counsel to discuss the advantages and disadvantages of service in a particular situation. 

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