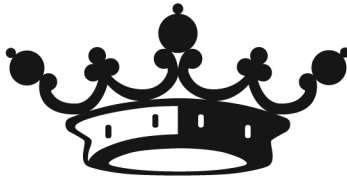


I N S I D E   T H E   M I N D S

# Creditors' Rights in Chapter 11 Cases

*Leading Lawyers on Navigating the Reorganization  
Process, Exercising Creditors' Rights, and  
Understanding the Impact of Current Developments*



ASPATORE

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Chapter 11 Strategy and the  
Creditors' Committee:  
Achieving Success for All  
Creditors

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## **The Role of the Creditors' Committee in Chapter 11 Cases**

The creditors' committee plays an essential role in Chapter 11 cases. In understanding that role, one must first consider the positions of the two key parties in a Chapter 11 proceeding: the debtor and the lender. The debtor and its professionals are charged with administering the bankruptcy estate for the benefit of all of the debtor's creditor constituencies and the debtor's shareholders. The focus of the post-petition lender (often, but not always, the same entity who served as the pre-petition lender) is to maximize value for the lender or lending group. Since the Chapter 11 case cannot be administered without post-petition financing, or at least an agreement to use the lender's cash collateral, it is often difficult for a debtor to negotiate favorable lending terms from its post-petition lender and maintain control of its own affairs. The terms of the debtor in possession financing facility (DIP facility), therefore, are routinely onerous for a debtor.

### *The Creditors' Committee and the DIP Facility*

Given the Chapter 11 financing challenges, the official committee of unsecured creditors must undertake the role of negotiating more favorable terms in the DIP facility than those previously negotiated by the debtor and presented to the court at the outset of the case. DIP facilities are routinely approved on an interim basis on the first day of a Chapter 11 case. In some jurisdictions (such as Delaware), especially controversial terms of a DIP facility (e.g., 506(c) waiver, liens on avoidance actions, cross-collateralization, disparate carve-outs, and a rollup of the pre-petition loan into the post-petition loan) are approved, if at all, only on an interim basis and are subject to review by the committee after its formation. The committee, in the above instance, then negotiates with the DIP lender in order to obtain better financing terms for the debtor, which in turn benefits all of the debtor's creditors in the form of a less expensive DIP facility.

The creditors' committee plays a vital role in reviewing the validity of a lender's pre-petition liens. As part of a DIP facility, a post-petition lender is routinely given liens that prime the pre-petition liens on a debtor's assets. In addition, given the debtor's inability to secure the more favorable financing terms from the DIP lender, the debtor must acknowledge the extent and validity of the lender's liens at the outset of the case. The

committee is charged with reviewing the lender's liens to determine their scope and if they are properly perfected. If a committee is able to determine that a lender's pre-petition liens, or a portion thereof, are not perfected, the committee then possesses an amount of leverage over a lender and may be able to obtain a return for its constituency. Even if a committee determines that the lender's liens are valid and properly perfected, the committee and professionals may nonetheless find that the lender was subject to the receipt of preferential payments, fraudulent transfers, or otherwise received more favorable treatment from the debtor than the rest of the debtor's creditors. Under these circumstances, a committee can threaten to challenge the lender's liens or the perfection thereof, or seek to equitably subordinate the lender's claim, which, again, garners the committee negotiating leverage with the lender in order to secure a return to general unsecured creditors of the Chapter 11 debtor.

*Avenues of Challenge Available to the Creditors' Committee*

Another avenue of challenge for a committee with respect to a post-petition lender is if the Chapter 11 case is filed for the sole benefit of the pre-petition lender; in this instance, the debtor may be administratively insolvent or may be funded by the post-petition lender for the sole purpose of conducting an orderly liquidation of the lender's collateral in Chapter 11 that will only benefit the pre-petition lender. Arguably, such an orderly liquidation should occur pursuant to Chapter 7 of the Bankruptcy Code and the oversight of a Chapter 7 trustee. Chapter 7, however, involves a separate body of rules and costs that may not be beneficial to the lender, the debtor, or, in many instances, the creditors. Accordingly, a lender may require a debtor to liquidate in a Chapter 11 proceeding; if there is, however, no likelihood of recovery for general unsecured creditors, then a committee can argue that the case should be converted to a Chapter 7 filing. The risk of conversion again places the committee in a better position to negotiate with a lender for a carve-out of the lender's collateral for the benefit of unsecured creditors.

A committee will also review the pre-petition management of the debtor and the control that a lender asserted over such management prior to the bankruptcy filing. It is becoming more common to find that the DIP lender in a given case is also the pre-petition lender, the largest equity security

holder, and, in some instances, the largest unsecured creditor of the debtor. In this scenario, a committee would investigate how much leverage the lender asserted over the debtor while wearing its various hats: did the lender assert too much control over the debtor as both secured creditor and equity holder? Did the secured lender control the debtor's board of directors? Did the secured lender control the management team running the debtor's business? Were payments made to the lender in any of its capacities to the detriment of other parties in interest? These questions are all legitimate avenues for the creditors' committee to investigate and analyze. Should the committee find that a lender's interests in a case were inextricably intertwined with the debtor's operations prior to the bankruptcy filing, a committee may then request that the court appoint a Chapter 11 trustee to administer the debtor's estate. A Chapter 11 trustee would then supplant the debtor's management and professionals and take control of the debtor's case with its own professionals.

Alternatively, a committee may seek the appointment of an examiner, who would undertake an independent investigation of the debtor's pre-petition activities. Both Chapter 11 trustees and examiners present tremendous difficulties for a lender, as both typically retain separate counsel and financial advisers to assist them in their duties and both will scrutinize the lender and its position in the case vis-à-vis the debtor. Of all the alternatives available to a committee, the appointment of a Chapter 11 trustee may be the option least compelling to the committee's best interest. Typically, a Chapter 11 trustee will administer the estate under the Code and without consulting with the committee as the Chapter 11 trustee itself is an independent fiduciary charged with overseeing the interests of all creditors. A committee, however, does have its own fiduciary duty to all unsecured creditors in a Chapter 11 case, and there may be instances where the appointment of a Chapter 11 trustee is the only way to fulfill this duty.

### *The Creditors' Committee and the 363 Sale*

In addition to reviewing the validity of the lender's security interest and pre-petition interaction with the debtor, the creditors' committee plays an essential role in the sales process pursuant to section 363 of the Bankruptcy Code. There are circumstances where a debtor will determine that there is little likelihood of reorganization and that a sale of substantially all of its

assets is the best way to maximize value for all creditors. In the above situation, a DIP lender's primary focus will be to assure that its DIP loan is paid in full. Additionally, if the DIP lender is also the pre-petition lender, its focus will be to have both the DIP and the pre-petition loan made whole prior to any distribution to other constituencies. The lender, however, is not bound by a fiduciary duty to all creditors. The debtor, who is relying on the lender to finance its existence, will often acquiesce to the lender when it comes to a 363 sale; a creditors' committee, therefore, represents the principal party left to review the sales process. The committee may independently value the debtor's assets, conduct an investigation to determine if the debtor has unencumbered assets, discuss the debtor's business and enterprise value with potential purchasers, review any bids submitted for the debtor's assets, and evaluate what is the highest and best offer to obtain substantially all of the debtor's assets. It is common for a lender and a committee to differ on what constitutes the highest and best offer for disposing of the debtor's assets; from the lender's perspective, any offer that makes them whole and gets them out of the case is a sufficient offer, but from the committee's perspective, a suitable offer will provide at least a minimal recovery for unsecured creditors above and beyond the value being received is able to assert by the lender.

### *The Ultimate Goal of the Creditors' Committee*

A committee is able to attempt to assert its influence over a lender or debtor either in or out of court, and it is done with the ultimate goal being to maximize value for unsecured creditors. Upon its formation, and after the selection of counsel and any financial advisers or other professionals, a committee will typically meet with the debtor in order to better understand the debtor's background, its corporate and financial structure, and the events leading up to the Chapter 11 filing. A meeting with the lender and its counsel usually follows close behind, and, as part of the initial meetings, a committee will attempt to negotiate global resolutions of any potential issues with the debtor, the lender and any other parties in interest that may have contributed to the debtor's demise. If a settlement with all parties in interest can be negotiated, such a settlement could be on a cash basis (i.e., the lender agrees to carve out or gift a portion of its collateral in order to make a distribution to unsecured creditors) and/or via the assignment of potential causes of action and the proceeds thereof (i.e., Chapter 5 causes of

action for preferential payments or fraudulent transfers, general business or contract litigation, LBO litigation). If a global settlement is not reached at the outset of the case, then a committee may choose to become a thorn in the debtor's (and lender's) side via an extensive lien review, exhaustive investigation of the pre-petition relationship between the debtor and lender, or by appearing in court and objecting to the debtor's proposed course of action in the Chapter 11 case, including opposing the DIP financing, opposing any incentive or retention plans, and opposing any 363 sale process proposed by the debtor. When a committee takes a more aggressive course of action such as that outlined above, it can become an expensive proposition for the debtor and its estate, as the fees of the committee and its professionals are an administrative expense of the debtor's estate that must be paid by the debtor (via any post-petition financing facility) in order to confirm a Chapter 11 plan.

#### *The Post-Confirmation Role of the Creditors' Committee*

The debtor's strategy for the Chapter 11 case will dictate exactly how the creditors' committee factors into the final proceedings of a case. If the debtor is truly reorganizing as intended under Chapter 11, then a committee's role may be limited, nonexistent, or relegated to merely oversight. Pursuant to a Plan of Reorganization, the committee may have the right to appoint a member to the debtor's board of directors, or it may inherit some sort of supervisory control of the debtor on a going forward basis as a result of unsecured creditors receiving equity in the reorganized debtor.

In the normal course of a Chapter 11 Plan, the committee's role is complete upon confirmation and the Plan becoming effective, although there are many instances where the committee disbands pursuant to the Plan, but not before appointing a Litigation Trustee or a Plan Administrator to conduct the activities that will lead to a distribution to unsecured creditors. For instance, a committee may have negotiated a pot of money to be distributed to unsecured creditors pursuant to a confirmed plan. After the confirmation of a plan, the committee will be charged with overseeing the distribution of these funds. Moreover, the committee will want to conduct a review of the claims that have been filed in the case and scheduled by the debtor; the committee, therefore, will maintain its existence to undertake the claims administration process and oversee the distribution to unsecured creditors. Alternatively, or

in addition to the claims administration process, the committee may be charged with prosecuting avoidance actions for the benefit of unsecured creditors.

What is becoming more common for a committee in the Chapter 11 context is its role in appointing a liquidating trustee. In many instances, liquidation is the only alternative available to the debtor. Under this scenario, the debtor will conduct an orderly liquidation of its assets in the Chapter 11 case. In exchange for permitting the lender to conduct this orderly liquidation in Chapter 11, rather than Chapter 7, the lender may, in turn, agree to set money aside to fund a Chapter 11 liquidating plan. In these instances, a committee may play an active role in wrapping up a debtor's estate, including prosecuting avoidance actions, administering claims, and selling any assets that may remain in the estate. In addition to an agreement to fund the plan, the lender may also agree to a carve-out of its recoveries in the liquidating Chapter 11 for the benefit of unsecured creditors.

#### *The End Game for the Creditors' Committee*

As demonstrated by the many and varied means to recovery by unsecured creditors via the actions of a committee, negotiation is the keystone to maximizing value for creditors. Whether through negotiating with the lender, the debtor, or both, the committee must assert its position in such a way that is beneficial for unsecured creditors, using a calculated, reasonable approach to obtaining sufficient leverage to convince the debtor (or the lender) to carve out recoveries for unsecured creditors. In some jurisdictions, a carve-out of the lender's collateral for the benefit of unsecured creditors is the cost of doing business in Chapter 11. The amount of such recoveries will vary on a case-by-case basis, but the ability of a committee to conduct an efficient investigation of the liens, a reasonable investigation into the conduct of the debtor's business, and a comprehensive analysis of the debtor's assets and liabilities, will result in the committee being able to obtain a reasonable outcome for both the debtor and committee by securing an amount of funds made available for unsecured creditors that otherwise was not attainable. Regardless of the approach, a committee undoubtedly plays an integral role in every Chapter 11 case.

## **The Anatomy of the Creditors' Committee in Chapter 11 Cases**

### *The Formation of the Creditors' Committee*

When a creditor is listed on the debtor's Chapter 11 petition as one of the largest creditors in the case, that creditor will be solicited by the Office of the United States Trustee to serve on an official committee of unsecured creditors. In each Chapter 11 filing, the United States Trustee will seek to form an official committee pursuant to 11 U.S.C. § 1102. Notice of the committee formation meeting is given to the top creditors listed in the debtor's petition for relief. The solicitation is made by way of a letter and questionnaire sent by the United States Trustee to the top creditors. A sample of a committee questionnaire is included herewith. In order to serve on the committee, the creditor must appear, either in person or by proxy, at the formation meeting. If a creditor is unable to attend a formation meeting in person, that creditor may obtain a proxy to act on their behalf at the meeting. While most trustees favor live participation at the formation meeting, in some jurisdictions, a creditor is permitted to act by way of a properly held proxy. A sample proxy is also included herewith. Typically, the formation meeting is held in the jurisdiction of the debtor. At the formation meeting, the United States Trustee interviews creditors interested in serving on the committee. The United States Trustee will then evaluate the amount of the creditor's claim, whether the debtor contests the validity of the creditor's claim, if a portion of the creditor's claim is secured, whether the creditor is subject to a critical vendor motion or other motion that seeks to pay pre-petition claims on a post-petition basis, and the characterization of the creditor's claim (i.e., a claim based on a bond or a note, a trade claim). After considering all parties interested in serving on the committee, the United States Trustee will form a committee, typically of at least three members, hopefully representative of various types of creditors; these creditors, as members of the committee, will then owe a fiduciary duty to *all* creditors of the debtor.

After the committee is formed, pursuant to section 1103 of the Bankruptcy Code, the committee will have the right to retain professionals to represent its interests in the bankruptcy case. Professionals interested in representing the committee, which are classically attorneys and financial advisers, appear at the formation meeting seeking to "pitch" the committee to accept their

representation. One of the benefits of serving on the committee is that the fees expended by the committee's professionals are paid by the debtor's estate as an administrative expense rather than from the pocket of the committee members themselves.

*Variations in the Creditors' Committee: Alternative Committees*

In addition to an official committee of unsecured creditors, the United States Trustee may opt to form a committee to represent other creditors aside from general unsecured creditors. For example, on occasion, committees of equity security holders, bondholders, employees, landlords or retirees have been formed. Alternative forms of committees can be formed *sua sponte* by the United States Trustee or upon request by a party in interest pursuant to section 1102(a)(2). The typical process in forming an alternative committee appointment involves first a request for the formation of such a committee made to the United States Trustee. To the extent that the United States Trustee refuses to appoint an alternative committee, or does not act quickly enough for the movant, a party in interest may request, by way of motion, that the court order the appointment of an alternative committee to represent the interests of all similarly situated parties who are covered by this additional committee. To the extent an alternative committee is formed by either the United States Trustee or the court, the United States Trustee will solicit membership on the committee. In addition, such a committee will be afforded the opportunity to retain its own counsel and financial advisers, the cost of which will also be borne by the debtor's estate.

*Variations in the Creditors' Committee: The Ad Hoc Committee*

When representing creditors doing business with an entity experiencing financial difficulty, one option available to creditors to protect their interests is the formation of an ad hoc committee to represent their interests and the interests of all similarly situated creditors well in advance of a bankruptcy filing. An ad hoc committee is fashioned to share costs associated with retaining professionals, which professionals may then approach the troubled company about a more global solution to its problems rather than individual stopgap remedies that may only exacerbate the situation. An additional advantage to forming an ad hoc committee is

the leverage an ad hoc committee will have if a bankruptcy petition is filed. The existence of an ad hoc committee typically means that the debtor will not obtain emergent relief at the first day hearing in the bankruptcy case without a party in interest taking part in the negotiation or objection process. An ad hoc committee will be in a position to react quickly to any extraordinary relief that a debtor may seek upon the filing of a Chapter 11 petition. Thereafter, members of the ad hoc committee will have an advantage over other creditors in being asked to serve on any official committee. Moreover, the professionals that represented the ad hoc committee will be in a better position to represent the interests of the official committee given their prior knowledge of the case and familiarity with the debtor and its creditor constituencies.

*Relevant Statutes to a Discussion of the Chapter 11 Creditors' Committee*

As a reference, the particular United States statutes most relevant to the consideration of the creditors' committee and the Chapter 11 case are listed below:

- 11 U.S.C. § 1102 – Creditors' and equity security holders' committees
- 11 U.S.C. § 1103 – Powers and duties of committees
- 11 U.S.C. § 1109 – Right to be heard
- 11 U.S.C. § 1104 – Appointment of trustee or examiner
- 11 U.S.C. § 1106 – Duties of trustee or examiner

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