AD HOC COMMITTEES IN CHAPTER 11

THIRTY-THIRD ANNUAL SOUTHEASTERN
BANKRUPTCY LAW INSTITUTE, ATLANTA, GEORGIA
APRIL 12-14, 2007

Prepared by:

Michael S. Stamer
Akin Gump Strauss Hauer & Feld LLP
590 Madison Avenue
New York, NY 10022
212.872.1000

Scott L. Alberino
Joanna F. Newdeck
Akin Gump Strauss Hauer & Feld LLP
1333 New Hampshire Avenue, N.W.
Washington, D.C. 20036
202.887.4000

I. Introduction

Stakeholders in today's chapter 11 cases are increasingly forming ad hoc or "unofficial" committees to represent collectively their interests in connection with restructuring situations. Though it is easy to understand why unaffiliated creditors would choose to act through an ad hoc committee, the functioning of an ad hoc committee raises numerous legal and practical issues which defy easy resolution. Difficult issues aside, ad hoc committee have woven themselves into the fabric of bankruptcy cases and will continue to play major roles in chapter 11 reorganizations.

A. Types of Ad Hoc Committees.

1. The organizing principle behind an ad hoc committee is the type of claim or interest held by the committee members.

    a. **Bondholders/Noteholders**. *See, e.g., In re Calpine Corp.*, Case No. 05-60200 (Bankr. S.D.N.Y. 2005); *In re Refco Inc.*, Case No. 05-60006 (Bankr. S.D.N.Y. 2005); *In re Congoleum Corp., et al.*, Case No. 03-51524 (Bankr. D.N.J. 2003); *Adelphia Commc'ns Corp.*, Case No. 02-41729 (Bankr. S.D.N.Y. 2002).

    b. **Preferred Stockholders**. *See, e.g., Adelphia Commc'ns Corp.*, Case No. 02-41729 (Bankr. S.D.N.Y. 2002).

    c. **Bank Debt**. *See, e.g., Nellson Nutraceutical, Inc., et al.*, Case No. 06-10072 (Bankr. D. Del. 2006); *Delphi Corp., et al.*, Case No. 05-44481 (Bankr. S.D.N.Y. 2005); *Meridian Automotive Systems-Composites Operations, Inc., et al.*, Case No. 05-11168 (Bankr. D. Del. 2005); *Adelphia Commc'ns Corp., et al.*, Case No. 02-41729 (Bankr. S.D.N.Y. 2002).

    d. **Equity Interests**. *See, e.g., Delphi Corp., et al.*, Case No. 05-44481 (Bankr. S.D.N.Y. 2005); *In re Loral Space & Commc'ns Ltd,. et al.*, Case No. 03-41710 (Bankr. S.D.N.Y. 2005) (official committee appointed upon motion of the ad hoc committee); *In re Mirant Corp., et al.*, Case No. 03-46590 (Bankr. N.D. Tex. 2003*); In re Interstate Bakeries Corp. et al.*, Case No. 04-45814 (Bankr. W.D. Mo. 2004) (same); *Adelphia Commc'ns Corp., et al.*, Case No. 02-41729 (Bankr. S.D.N.Y. 2002).

    e. **Landlords**. *See, e.g., In re Garden Ridge Corp.*, Case No. 04-10324 (Bankr. D. Del. 2004).

    f. **Asbestos**. *See, e.g., In re Dana Corp., et al.*, Case No. 06-10354 (Bankr. S.D.N.Y. 2006).

g. **Trade.** *See, e.g., Delphi Corp., et al.*, Case No. 05-44481 (Bankr. S.D.N.Y. 2005); *Adelphia Commc'ns Corp., et al.*, Case No. 02-41729 (Bankr. S.D.N.Y. 2002).

B. Advantages and Disadvantages.

1. *Advantages.*

a. **No Fiduciary Obligations**. The members of an ad hoc committee generally have no fiduciary duties to other creditors in the same classification. *But see Official Comm. of Equity Security Holders v. The Wilson Law Firm, P.C. (In re Mirant Corp., et al.),* 334 B.R. 787 (Bankr. N.D. Tex. 2005) (finding that ad hoc equity committee owed fiduciary duty to group as a whole and could not solicit rejection of plan with misleading statements, discussed in more detail at section VI.B, below).

b. **Influence**. Functioning through an ad hoc committee offers similarly situated stakeholders greater influence in a bankruptcy case than they likely would experience functioning on their individual behalves. Generally, the influence an ad hoc committee wields is dependant upon factors such as the voting power of the committee members and the importance of the committee members to the reorganization effort.

c. **Burden Sharing**. The formation of an ad hoc committee allows similarly situated stakeholders to share legal and other expenses incurred in connection with a restructuring situation. In addition, an ad hoc committee representing critical stakeholders in the restructuring process may be able to obtain payment of its legal and financial advisory fees by the distressed company on a voluntary basis.

d. **Access to Information**. Serving on an ad hoc committee may give a member access to up to the minute information concerning a company's restructuring efforts as well as access to legal and financial advice from the ad hoc committee's advisors.

e. **Facilitates Restructuring Efforts**. The presence of an ad hoc committee can facilitate reorganization discussions when the committee represents a critical constituency in the reorganization efforts and has the appropriate professionals in place to advise committee members.

f. **No United States Trustee Imposed Restrictions on Trading.** In certain jurisdictions, the United States Trustee (the "U.S. Trustee") in connection with the formation of an official committee, requires the prospective committee members to agree in writing not to trade

in the debtor's securities while sitting on the official committee, except pursuant to court approved trading procedures. This U.S. Trustee restriction does not apply to ad hoc committees.

g. **Ability to Remain Unrestricted.** Members of ad hoc committees often choose not to obtain material, nonpublic information and instead remain able to continue to trade in the debtor's securities.

2. *Disadvantages.*

a. **Replacement by Statutory Committee**. The influence and role of an ad hoc committee of unsecured creditors will wane following appointment of the statutory creditors' committee.

b. **Professional Fees**. Ad hoc committees of undersecured or unsecured creditors are generally not entitled as a matter of law to receive current reimbursement of fees and expenses incurred in connection with a chapter 11 case. Rather, such an ad hoc committee may seek reimbursement of its fees and expenses as part of a consensual plan of reorganization, as a "substantial contribution" to the bankruptcy case pursuant to section 503(b)(3)(D) and (4) of the Bankruptcy Code, or for undersecured creditors, as part of an adequate protection package (discussed in more detail at section V, below).

c. **Membership Changes**. Ad hoc committees must deal with the issue of members constantly joining and leaving the committee due to claims trading activities. Changes to the composition of an ad hoc committee's membership ranks can be disruptive to the functioning and effectiveness of a committee, and lessen the committee's influence in the reorganization process.

d. **Limited Powers**. Ad hoc committees do not enjoy many of the rights conferred upon statutory committees pursuant to section 1103 of the Bankruptcy Code, including, without limitation, the right to consult with the trustee and debtor in possession concerning the administration of the case and the right to investigate the acts and financial condition of the debtor.

II. Formation and Governance: Official Committees versus Ad Hoc Committees

A. Official Committee Formation. Section 1102 of the Bankruptcy Code provides authority for the appointment of an official unsecured creditors' committee as soon as practicable after the order for relief.

1. Additional official committees of either creditors or equity security holders may be formed pursuant to 1102 by one of two ways:

a. In the discretion of the U.S. Trustee, if it determines that the appointment of additional committees of creditors or of equity security holders is appropriate; or

b. On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders. Such a request will only be granted if the court determines that the appointment of another committee is necessary to assure adequate representation.

2. Pursuant to section 1102 of the Bankruptcy Code, the U.S. Trustee is vested with the authority to appoint members of any official committee. However, upon request of a party in interest and upon notice and hearing, the court may order the U.S. Trustee to change the composition of the committee if necessary to ensure adequate representation of creditors or equity security holders.

B. Ad Hoc Committee Formation. Ad hoc committees are formed through the collaboration of stakeholders, or through action encouraged by a distressed company.

1. *Company Led.* Ad hoc committees are often formed in connection with out of court restructurings. The distressed company may attempt to create an informal creditors' committee by invitation to certain creditors or the company may be approached by an organized creditor group. The company's goals here are two-fold: (i) to negotiate a settlement and (ii) to solicit the support of other creditors.

2. *Stakeholder Led.* Other times, an ad hoc committee will form pre-petition through the collective action of unaffiliated stakeholders. In most distressed company situations, the debtor's largest stakeholders are aware of the debtor's financial troubles for some period of time prior to the petition date. Stakeholders may form an ad hoc committee to streamline communications with the distressed company in connection with a potential restructuring.

C. Ad Hoc Committee Governance. Committee governance gives rises to some of the most difficult issues facing an ad hoc committee. There is no "one size fits all" strategy for addressing the internal workings of an ad hoc committee. Generally, the degree of formality under which an ad hoc committee operates is addressed on a case by case basis and is driven by the desires of its members.

1. *Bylaws.* Official committees often function pursuant to official bylaws that may govern, among other things, voting, attorney-client privilege and confidentiality issues. Ad hoc committees typically function without the use of bylaws and to address voting and confidentiality issues on a case by case basis.

2. *First Refusal Rights.* The members of an ad hoc committee may agree to provide each of its fellow committee members with formal or informal first refusal rights in the event the member wishes to sell its claim. This type of agreement may be necessary to ensure that an ad hoc committee maintains its voting bloc.

3. *Deference to Significant Stakeholders.* Ad hoc committee members may eschew a high degree of formality in favor of deference to the largest stakeholders on the committee.

D. Transition from an Ad Hoc Committee to an Official Committee.

1. *Committees formed prior to the petition date.*

a. The U.S. Trustee is obligated to appoint a committee of unsecured creditors "as soon as is practicable" after the petition date. If, prior to the petition date, an ad hoc group of unsecured creditors has been formed, the U.S. Trustee may appoint this committee as the official committee, provided those members were fairly chosen and represent different kinds of claims that exist against the debtor. *See, e.g., Tri-State Outdoor Media Group, Inc. v. Official Comm. of Unsecured Creditors (In re Tri-State Outdoor Media Group, Inc.)*, 283 B.R. 358, 361 (Bankr. M.D. Ga. 2002) (noting that the U.S. Trustee appointed an official unsecured creditors' committee that consisted primarily of former ad hoc committee members).

b. Bankruptcy Rule 2007 allows a party in interest to challenge the U.S. Trustee's appointment of a pre-petition ad hoc committee as the official committee by motion with the court. However, the motion for review must be timely. *See Van Arsdale v. Clemo (In re A.H. Robins Co.)*, 65 B.R. 160, 162 (E.D. Va. 1986) (finding that the motion was untimely where the parties in interest delayed two months before challenging the appointment).

2. *Committees formed after the petition date.* Ad hoc committees commonly are formed during an ongoing bankruptcy case when a certain group of creditors feel that their interests are not being adequately represented by the official committee(s). Sometimes, these ad hoc committees will seek to transition to official committees.

a. Section 1102(a)(2) addresses the appointment of additional official committees and provides, in pertinent part,

> On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee.

11 U.S.C. § 1102(a)(2).

b. However, "[m]any courts are reluctant to appoint an additional committee of creditors because it is an extraordinary remedy." *In re Sharon Steel Corp.*, 100 B.R. 767, 777-78 (Bankr. W.D. Pa. 1989).

c. The case of *In re Enron Corp.*, 279 B.R. 671 (Bankr. S.D.N.Y. 2002) provides a comprehensive list of the various factors courts might consider in determining whether to appoint an additional committee under section 1102(a)(2), such as:

(1) The ability of the committee to function;

(2) The nature of the case; and

(3) The standing and desires of various constituencies.

Id. at 685 (citing *In re McLean Indus., Inc.*, 70 B.R. 852, 860 (Bankr. S.D.N.Y. 1987)).

Other considerations may include:

(1) The cost associated with the appointment;

(2) The motivation of the movant;

(3) The time of the application;

(4) The potential for added complexity; and

(5) The presence of other avenues for creditor participation.

Id. (listing these factors with case citations).

Case Studies – Request for Additional Committee Denied.

d. **An additional official committee will not be appointed to represent a subset of unsecured creditors where the official committee already adequately represents the creditor group as a whole.** *In re Garden Ridge Corp.*, 2005 WL 523129 (Bankr. D. Del. March 2, 2005):

(1) The official committee of unsecured creditors was composed of four vendors, one advertising company and two landlords with rejected leases. Two months after the commencement of the bankruptcy case, an informal committee of landlords formed, consisting of 19 members. The ad hoc committee filed a motion with the court

requesting an appointment of an additional committee, asserting that due to the make up of the committee they did not have a meaningful voice on the official committee. This was especially true, they argued, since the vendors' interests were adverse to the landlords' interests (as evidenced by the voting record on certain issues).

(2) The court reiterated the principal that the "chief purpose of the Official Committee is to represent all general unsecured creditors" rather than be a platform for on which each member could advance its own interests; this, the court noted, would be a breach of each members' fiduciary duties to the unsecured creditors as a whole. *See id.* at *3.

(3) Accordingly, the court denied the ad hoc committee's request for an additional official committee, noting that "[t]hose landlords who are members of the Informal Committee may continue to work collectively that designation, and, should it choose to do so, the Informal Committee will continue to be heard as a party of interest in this case." *Id.* at *4.

e. **Request for additional official committee must be timely.** *Ad Hoc Bondholders Group v. Interco Inc. (In re Interco Inc.*), 141 B.R. 422 (Bankr. E.D. Mo. 1992).

(1) An ad hoc committee of bondholders moved for the appointment of a separate committee to represent those debenture holders who were rejecting the proposed chapter 11 plan.

(2) The court found that a separate committee to represent those debenture holders who were rejecting the plan was not warranted under section 1102 where the motion was not filed until more than one month after the official committee announced its decision to support debtors' plan, balloting on proposed plan had commenced, and the confirmation hearing was scheduled to commence soon.

(3) Further, the court found that the creation of a new committee would be disruptive and would not reasonably ensure that any additional benefit would result to the debtors' estates. Lastly, the court found that the ad hoc group would still be able to participate in the process as a party in interest under section 1109.

See id. at 424-25.

f. *See also, e.g.*, *In re Enron Corp.*, 279 B.R. at 685 (denying motion of ad hoc committee of energy merchants to appoint additional official committee); *In re Dana Corp.*, 344 B.R. 35 (Bankr. S.D.N.Y. 2006) (refusing ad hoc committee's request to appoint an official committee to represent interests of asbestos personal injury claimants where ad hoc committee failed to show that additional committee was necessary for adequate representation); *In re Pub. Serv. Co. of New Hampshire*, 116 B.R. 344 (Bankr. D.N.H. 1990) (denying ad hoc committee's request to appoint an official common stockholders' committee on grounds that that appointment of an additional committee so late in the reorganization process would result in unwarranted delay and expense).

III. Standing: Official Committees versus Ad Hoc Committees

A. In General.

1. *Official committees.* Official committees are formed pursuant to section 1102 of the Bankruptcy Code; their duties, among others, are enumerated in section 1103 and include the power to: (i) consult with the trustee or debtor in possession concerning the administration of the case; (ii) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuances of such business; (iii) participate in the formulation of a plan; (iv) request the appointment of a trustee of examiner; and (v) perform such other services as are in the interests of those represented.

2. *Ad hoc committees*. Ad hoc committees, on the other hand, derive their standing to be heard in court as creditor "parties in interest" under section 1109 of the Bankruptcy Code.

a. Section 1109 provides, in pertinent part:

> A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.
>
> 11 U.S.C. § 1109(b).

b. "Section 1109 of the Bankruptcy Code enables all creditors to be heard on any issue." *In re Drexel Burnham*, 118 B.R. 209, 212 (Bankr. S.D.N.Y. 1990).

B. Derivative Standing.

1. The concept of derivative standing allows an official creditors' committee (under certain narrow conditions) to file an action in bankruptcy court in place of the debtor-in-possession or trustee. Thus, derivative standing is an implicit exception to the "general rule" whereby the Bankruptcy Code assigns to the trustee or debtor-in-possession "the privilege of prosecuting" various actions on behalf of the estate. 7 *Collier on Bankruptcy* ¶ 1109.05 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2006).

2. *Official committees.* Most circuits (with the exception of the Tenth Circuit) have adopted the principal that an official creditors' committee may obtain derivative standing to commence an action on behalf of the bankruptcy estate when the debtor or trustee cannot or will not bring the action. *See, e.g., Official Comm. of Unsecured Creditors of Cybergenics Corp v. Chinery*, 330 F.3d 548 (3d Cir. 2003) (seminal case for the proposition that bankruptcy courts may authorize creditors' committees to sue derivatively to recover property for the benefit of the estate), *Commodore Int'l, Ltd. v. Gould (In re Commodore Int'l, Ltd.)*, 262 F.3d 96 (2d Cir. 2001) (creditors' committee may bring suit with consent of debtor); *Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (In re STN Enters.)*, 779 F.2d 901, 904 (2d Cir. 1985) (creditors' committee may initiate adversary proceeding if debtor-in-possession refuses to do so). *But see In re Fox*, 305 B.R. 912, 914 (10th Cir. 2004) (disagreeing with the idea that a committee can obtain derivative standing).

3. *Individual creditors.* Courts have expanded the concept of derivative standing to allow individual creditors to bring actions on behalf of a debtor or trustee provided the interests of the individual creditors do no conflict with those of the estate. *See, e.g., Infinity Investors Ltd. v. Kingsborough (In re Yes! Entertainment Corp.)*, 316 B.R. 141, 145 (Bankr. D. Del. 2004) (finding that although *Cybergenics* addressed derivative standing for creditors' committees its holding nonetheless was applicable in determining whether an individual creditor could obtain derivative standing); *Glinka v. Murad (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64 (2d Cir. 2002) (finding that secured creditor had standing to bring fraudulent transfer claims on behalf of the estate); *Canadian Pac. Forest Prods., Ltd. v. J.D. Irving Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436 (6th Cir. 1995) (permitting creditor to prosecute avoidance action).

4. *Ad hoc committees.* It also appears that ad hoc committees may have a similar ability to obtain derivative standing. For example, in *In re Adelphia Commc'ns Corp.*, 336 B.R. 610, 634-35 (Bankr. S.D.N.Y. 2006), it appears that the court expanded the scope of a creditor's derivative standing by approving a process whereby ad hoc creditor committees

would litigate a number of inter-debtor disputes on behalf of their representative debtor estates.

C. Right to Intervene. There is nothing in the Bankruptcy Code that would prevent members of an ad hoc committee from intervening pursuant to Rule 7024 in an adversary proceeding brought by the debtor or trustee where the interests of the informal committee members and the trustee/debtor do not coincide. *See, e.g., In re Adelphia Commc'ns Corp.*, 327 B.R. 143 (Bankr. S.D.N.Y. 2005) (noting that the court allowed the unofficial committee of trade claim holders to intervene in adversary proceeding filed by the official creditors' committee); *Metro Commc'ns Inc. v. Comm. of Unsecured Creditors (In re Metro Commc'ns, Inc.)*, 135 B.R. 15 (W.D. Pa. 1991) (noting that unofficial unsecured creditor's committee intervened in adversary proceeding filed by creditor bank seeking to avoid alleged preferences and fraudulent conveyances); *In re Fleck Indus., Inc.*, 16 B.R. 802 (Bankr. E.D. Pa. 1982) (group of creditors permitted to intervene in adversary proceeding).

IV. Disclosure Issues

A. Rule 2019 Disclosure.

1. Bankruptcy Rule 2019 requires that:

> [E]very entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement setting forth (1) the name and address of the creditor or equity security holder; [and] (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition. . . .
>
> Fed. R. Bankr. P. 2019(a).

2. The purpose of Rule 2019 is "to further the Bankruptcy Code's goal of complete disclosure during the business reorganization process," and "to cover entities which, during the bankruptcy case, act in a fiduciary capacity to those they represent, but are not otherwise subject to control of the court." *Matter of CF Holding Corp.*, 145 B.R. 124, 126 (Bankr. D. Conn.1992).

B. Official Committees versus Ad Hoc Committees.

1. *Official committees.* The requirements of Rule 2019 do not apply to official committees appointed under section 1102 of the Bankruptcy Code.

2. *Ad hoc committees.*

a. Unlike official committees, Rule 2019 applies to all ad hoc or informal committees. *See In re Oklahoma P.A.C. First Ltd. P'ship*, 122 B.R. 387, 390 (Bankr.D.Ariz.1990) (noting that Rule 2019 require informal committees to make disclosures pursuant to this rule).

b. If an ad hoc committee fails to file a Rule 2019 statement, a court may, in its discretion, refuse to permit the entity acting on behalf of the ad hoc committee to be heard further in the bankruptcy case or may impose others sanctions or remedies. *See* Rule 2019(b) (setting forth the possible consequences of failing to comply with Rule 2019); *In re Oklahoma P.A.C. First Ltd. P'ship*, 122 B.R. at 390 (noting that if there is a failure to comply with Rule 2019 a court may refuse to permit the entity acting on behalf of the parties from being heard in the bankruptcy case).

V. Reimbursement/Payment of Ad Hoc Committee Professional Fees and Expenses

Professionals employed by statutory committees are compensated by the bankruptcy estate pursuant to section 330 of the Bankruptcy Code. Ad hoc committee professionals are not. The general rule is that unsecured creditors in a chapter 11 case must pay their own professional fees. Section 503(b)(4) provides a mechanism whereby ad hoc committee members may seek reimbursement of such fees and expenses. *See In re Mirant Corp., et al.*, -- B.R. ---, 2006 WL 3735610, * 9 (Bankr. N.D. Tex. Nov., 21, 2006) (noting this concept).

A. Administrative Expenses.

1. "*Substantial Contribution*"

a. Section 503 deals with the allowance of administrative expenses. It is under this provision that ad hoc committees and their professionals may receive compensation for fees and expenses incurred during the administration of a bankruptcy case.

b. In order to qualify for payment by the bankruptcy estate, each applicant must fall within section 503(b)(4), which provides, in pertinent part:

> (b) After notice and a hearing, there shall be allowed administrative expenses. . . including –
>
> (4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph (A), (B), (C), (D), or (E) of paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the

cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant.

11 U.S.C. 503(b)(4).

c. Subsection (3)(D), in turn, establishes that an ad hoc committee is entitled to administrative expense claims if it has made a "substantial contribution" to the bankruptcy case and provides, in pertinent part:

> (b) After notice and a hearing, there shall be allowed administrative expenses. . . including –
>
> (3)(D) the actual, necessary costs and expenses . . . incurred by. . . a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, *in making a substantial contributio*n in a case under chapter 9 or 11 of this title.

11 U.S.C. 503(b)(3)(D) (emphasis added).

d. Courts may consider the following factors to determine whether a party's efforts constitute "substantial contribution":

(1) Whether there is a showing of benefit to the estate; *see, e.g., In re Cellular 101, Inc.*, 377 F.3d 1092, 1096 (9th Cir. 2004) ("the principal test of substantial contribution is 'extent of benefit to the estate'");

(2) Whether the services involved in the contribution were undertaken just for the ad hoc committee or for the benefit of all parties in the case; *see, e.g., In re Am. Plumbing & Mech. In.*, 327 B.R. 273, 283-84 (Bankr. W.D. Tex. 2005);

(3) Whether the applying party would have done the same thing absent expectation of compensation from the bankruptcy estate;

(4) Whether the benefit conferred through the party's "substantial contribution" exceeds the cost the party seeks to assess against the estate; *see, e.g., In re Lease-A-Fleet, Inc.*, 148 B.R. 419, 429 (Bankr. E.D. Pa. 1992);

(5) Whether the efforts of those seeking compensation or reimbursement under section 503(b) were duplicative of

those undertaken by statutory fiduciaries; *see, e.g., Am. Plumbing*, 327 B.R. at 279; and

(6) The effect of the applicant's activities on the bankruptcy case, *i.e.*, whether negative or positive.

See In re Mirant Corp., et al., 2006 WL 3735610 at *10-11 (listing these factors with case citations).

2. *Case Study. In re Mirant Corp., et al.*, -- B.R. ---, 2006 WL 3735610 (Bankr. N.D. Tex. November 21, 2006).

a. Two ad hoc committees that organized and were actively involved in the Mirant chapter 11 cases (the "MAG Ad Hoc Committee" and the "Corp Ad Hoc Committee") applied for reimbursement of expenses under section 503 of the Bankruptcy Code.

b. **The Corp Ad Hoc Committee – Application Granted Based on Substantial Contribution.**

The Corp Ad Hoc Committee was an unofficial committee of bondholders that was organized at the request of the official equity committee, a debt holder and the examiner to help facilitate negotiations towards a consensual plan. The court found that the participation of the Corp Ad Hoc Committee in plan negotiations was critical in obtaining consensus with the Official Corp Committee. Accordingly, the court found that the committee's efforts constituted a "substantial contribution" and its application for payment was granted. *See id.* at *12-13.

c. **The MAG Ad Hoc Committee – Application Denied Based on Duplicative Efforts.**

The MAG Ad Hoc Committee represented a group of noteholders. There was also an Official MAG Committee appointed in this bankruptcy case. The court found that the MAG Ad Hoc Committee took an active role in the bankruptcy case, but found that active participation was not akin to "substantial contribution." Rather, the court noted that many of the actions taken by the MAG Ad Hoc Committee were duplicative of the actions taken by the Official MAG Committee. Further, the court found that the MAG Ad Hoc Committee was formed to provide its members a voice in the bankruptcy case without subjecting them to trading restrictions that applied to the members of the Official MAG Committee. The court held that section 503 was "not meant to provide large trading institutions an

opportunity to organize to play a central role in a chapter 11 case while avoiding the circumscriptions necessarily applicable to membership on a statutory committee." For these reasons, the court denied the administrative expense application of the MAG Ad Hoc Committee. *See id.* at *13-14.

B. Payments in the "ordinary course of business".

1. *Pre-petition payments.*

a. Companies heading into bankruptcy may agree to pay the pre-petition fees and expenses of ad hoc committee professionals. *See, e.g., In re Tri-State Outdoor Media Group, Inc.*, 283 B.R. at 361 (debtor paid pre-petition fees of the ad hoc committee's financial advisor since the possible restructuring would benefit the company).

b. Be warned, however, that such payments made by the debtor prior to the petition date may be subject to challenge as avoidable transfers, but such challenges have historically had little success.

(1) *See, e.g., Argus Management Group as Trustee for the Creditors Reserve Trust v. Chanin Capital Partners LLC (In re CVEO Corp.),* 320 B.R. 258 (Bankr. D. Del. 2005) (trustee brought an avoidance action to recover payments debtor made to the ad hoc committee's financial advisors prior to the petition date, arguing that those payments were preference payments outside the ordinary course of debtor's business or, in the alternative, fraudulent transfers).

(2) *See, also Pummill v. Greensfelder, Hemker & Gale (In re Richards & Conover Steel Co.),* 267 B.R. 602 (B.A.P. 8th Cir. 2001) (finding no fraudulent transfer where debtor made pre-petition payments to the ad hoc committee's counsel for services performed pre-petition).

2. *Post-petition payments.*

Payment by the debtor of an ad hoc committee's professional fees post-petition may be complicated by Bankruptcy Code restrictions and cash collateral use limitations.

a. Oversecured Creditors. Pursuant to section 506 of the Bankruptcy Code, oversecured creditors are entitled to payment or reimbursement of professional fees if such a right exists under the applicable credit documentation. Accordingly, ad hoc committees

of oversecured creditors typically receive current payment of professional fees.

b. Unsecured Creditors. Ad hoc committee members holding unsecured claims rarely receive current payment of their post-petition professional fees and are forced to rely on either (a) a retainer provided by the debtor prior to the petition date and/or (b) allowance (through agreement or litigation) of a "substantial contribution" claim in order to be reimbursed for their professional fees and out-of-pocket expenses incurred during the bankruptcy case.

c. Undersecured Creditors. Although not technically entitled to current payment or reimbursement of post-petition professional fees, an ad hoc committee of undersecured creditors will usually attempt, either before the petition date or shortly thereafter, to negotiate an adequate protection stipulation that provides current pay for the committee's professionals, with the characterization of such payments to be subject to a determination at a later date.

VI. Fiduciary Obligations

A. Official Committees. Members of an official committee are bound by fiduciary duties to a broader creditor constituency and may not use information gained while sitting on the committee for their personal benefit. *See, e.g., Westmoreland Human Opportunities, Inc. v. Walsh (In re Life Services Systems, Inc.*), 327 B.R. 561 (D. Del. 2005) (committee member owed fiduciary duty not to use confidential information for personal gain in purchasing non-estate assets); *Official Comm. Of Unsecured Creditors v. Sea Brown Boveri, Inc. (In re Grand Eagle Companies, Inc.)*, 313 B.R. 219 (N.D. Ohio 2004) (committee owes duty to the creditors it represents); *In re Barney's, Inc.*, 197 B.R. 431, 442 (Bankr. S.D.N.Y. 1996) ("[T]he committee and its members have a fiduciary duty to all creditors represented by the committee.").

B. Ad Hoc Committees.

1. In contrast, ad hoc committee members generally owe no fiduciary duties to a broader group of creditors and are free to pursue their individual self-interests.

2. Be aware, however, that in certain situations, courts may find that members of an ad hoc committee are fiduciaries of the constituency of which they are a part.

a. For example, in the recent case of *Official Comm. of Equity Security Holders v. The Wilson Law Firm, P.C. (In re Mirant Corp., et al.)*, 334 B.R. 787 (Bankr. N.D. Tex. 2005), the court found that an ad hoc equity committee owed a fiduciary duty to the

equity interests as a whole and could not solicit rejection of a plan of reorganization with misleading statements. The court noted that while it might not be able to exercise control over the expressions of opinion of alleged statements of fact by a shareholder acting in his or her own right, it could insist that an attorney, as a fiduciary representing an ad hoc committee of equity holders, deal fairly and honestly with the class as a whole. Accordingly, the court found it was able to examine the attorney's solicitation materials for accuracy. The solicitation of rejections, which contained misleading information, did not constitute good faith. Accordingly, the court enjoined the attorney from further disseminating or using the material. *Id.* at 93-94.

b. *See also Young v. Higbee*, 342 U.S. 204 (1945) (establishing the principle that "when a party purports to act for the benefit of a class, the party assumes a fiduciary role as to the class").

VII. Attorney-Client Privilege

A. Privilege. Generally, courts have found that members of either an official or ad hoc committee are entitled to assert attorney-client privilege with respect to communications with the committee's lawyers. *See, e.g., In re Subpoenas Duces Tecum Dated March 16, 2992*, 978 F.2d 1159 (9th Cir. 1992) (recognizing the existence of attorney-client privilege between official committee members and their attorney); *In re Refco Inc.*, 336 B.R. 187, 197 (Bankr. S.D.N.Y. 2006) (recognizing "[t]hat privilege clearly can be enforced against those who are not represented by the [official] committee or who are standing in an adversarial relationship to the unsecured creditors as a group."); In *re Baldwin-United*, 38 B.R. 802 (Bankr. S.D. Ohio 1984) (recognizing attorney client privilege between committee and attorney).

B. *Tri-State Outdoor Media Group, Inc. v. Official Comm. of Unsecured Creditors (In re Tri-State Outdoor Media Group, Inc.)*, 283 B.R. 358 (Bankr. M.D. Ga. 2002) addresses the specific issue of whether ad hoc committees are entitled to the attorney-client privilege. In holding that advice provided by the ad hoc committee's financial advisor was protected by the attorney/client privilege the court implicitly affirms that attorney/client privilege exists between ad hoc committees and their attorneys.

1. Background**.** The ad hoc committee hired Orrick, Herrington & Sutcliffe "Orrick") to represent it in pre-bankruptcy negotiations with the debtor. Orrick, in turn, hired Houlihan Lokey Howard & Zukin ("Houlihan") as the ad hoc committee's financial advisor.

2. Issue**.** Whether the advice that Houlihan provided to the ad hoc committee was protected by the attorney/client privilege.

3. Holding**.** The court found that Houlihan's advice was protected by the attorney/client privilege. The court noted that when Houlihan was retained by Orrick, "[t]he attorney-client relationship between Orrick and the Ad Hoc Committee had already been established at that time, so Houlihan was Orrick's agent for the purpose of rendering legal advice to the Ad Hoc Committee." *Id.* at 363.

C. No Privilege. At least one court has found that no attorney-client privilege exists between members of a creditors' committee and their attorney. *See In re Christian Life Center, First Assembly of God of Santa Rosa, Cal.*, 16 B.R. 35 (Bankr. N.D. Cal. 1981) (finding no privilege between committee members and their attorney). *Christina Life Center*, however, clearly represents the minority view and has been rejected by the Ninth Circuit in *Subpoenas Duces Tecum*, 978 F.2d at 1161. *See also In re Baldwin-United Corp., D.H.*, 38 B.R. 802, 805 (Bankr. Ohio 1984) (declining to follow *Christian Life Center* to the extent it "forecloses the assertion of the privilege by a creditors' committee under all circumstances").

VIII. Lock-Up Agreements

A. "[A] "lock-up" refers to an agreement between a creditor and a debtor (or prospective debtor) in which the creditor becomes legally bound to vote for a plan of reorganization so long as certain key plan provisions are included." *Official Comm. of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co.*, 332 B.R. 560, 569 (M.D. Pa. 2006). Lock-up agreements may be entered into pre-petition or post-petition.

B. As lock-up agreements have increased in popularity, they have become the subject of increased scrutiny.

C. Post-Petition Lock-Up Agreements.

1. *Section 1125 of the Bankruptcy Code*.

a. Post-petition lock-up agreements are often analyzed in the context of the solicitation requirements of section 1125 of the Bankruptcy Code. This section prohibits the post-petition solicitation of votes from a holder of a claim or interest before a summary of the plan and a court-approved disclosure statement is transmitted to such holder of a claim or interest. *See* 11 U.S.C. § 1125(b).

b. If a vote is obtained in violation of section 1125 due to, among other things, a post-petition lock-up agreement, the court may "designate" the votes obtained in violation of section 1125.

2. Case law regarding the propriety of post-petition lock-up agreements is not uniform.

a. Post-Petition Lock-Up Agreements Permitted.

See, e.g.,

(1) *Zentek GPV Fund IV LLC v. Vesper*, 2001 WL 1042217 (6th Cir. 2001) (finding that trustee's settlement agreement with the IRS about plan treatment, under which the IRS voted in favor of the trustee's plan, was not improper solicitation);

(2) *In re Kellogg Square P'ship*, 160 B.R. 336, 340 (Bankr. D. Minn. 1993) (debtor's post-petition agreement with other creditor for acceptance of plan before disclosure statement had been filed with the court for approval did not violate the disclosure requirements of section 1125);

(3) *In re Texaco Inc.*, 81 B.R. 813, 815 (Bankr. S.D.N.Y. 1988) (finding that the solicitation of a ***plan support agreement*** whereby the creditor agreed not to vote for, support or participate in the formulation of another plan did not violate section 1125(b) of the Bankruptcy Code).

b. Post-Petition Lock-Up Agreements Not Permitted (Votes Cast Pursuant to Post-Petition Lock-Up Agreements Were Designated).

See, e.g.,

(1) *In re Stations Holdings Co., Inc.*, 2002 WL 31947022, *3 (Bankr. D. Del. Sept. 30, 2002). Here, the holders of certain claims and equity interests executed a lock-up agreement after the petition date but before the Bankruptcy Court approved the debtors' disclosure statement. The Bankruptcy Court held that the lock-up agreement violated the disclosure requirements of section 1125 of the Bankruptcy Code because it did not give parties the benefit of a court-approved disclosure statement before being asked to vote. Accordingly, for purposes of determining if the plan satisfied section 1129, the court excluded the votes of those holders who were signatories to the post-petition lock-up agreement.

(2) *In re NII Holdings, Inc.*, 288 B.R. 356, 362 (Bankr. D. Del. 2002). The court designated votes cast by parties to a lock-up agreement that was negotiated pre-petition but executed post-petition. The court's comments at the hearing reflect

its feelings toward post-petition lock-ups: "if you want a lock-up agreement to be effective, you make darn sure you get the signature before you file the petition." *See NII Holdings, Inc.*, Transcript of October 22, 2002 Hearing, Case No. 02-11505 (Bankr. D. Del. Oct. 22, 2002).

D. Pre-Petition Lock-Up Agreements.

1. Section 1125(b) only governs the solicitation of plans after the bankruptcy case has commenced. Therefore, by its terms, section 1125(b) is not applicable to pre-petition solicitation of plan terms (that is, pre-petition lock-up agreements).

2. Despite the apparent acceptance of pre-petition lock-up agreements, however, pre-petition ad hoc committee members should be aware that signing onto a pre-petition lock-up agreement may disqualify them from serving on an official committee of creditors in cases pending in certain jurisdictions.

See, e.g.,

In re NII Holdings, Inc. and NII Holdings (Delaware), Inc., Case. No. 02-11505 (MFW) (Order Dated June 25, 2002).

a. Prior to the petition date, certain bondholders formed an ad hoc bondholders committee to negotiate a prepackaged plan of reorganization involving a pre-petition workout agreement. The U.S. Trustee refused to appoint any member of the ad hoc committee to the official committee of unsecured creditors, claiming that the ad hoc members could not adequately represent the official committee's interests as fiduciaries because they had signed the pre-petition lockup agreement.

b. The ad hoc bondholders' committee subsequently filed an emergency motion with the court pursuant to section 1102(a)(2) of the Bankruptcy Code, challenging the U.S. Trustee's refusal to include a bondholder on the official creditors' committee. The court, in reviewing the U.S. Trustee's decision under an abuse of discretion standard, denied the motion, finding that it was not "unreasonable for the U.S. Trustee to believe that having signed a lock-up agreement. . . would make those members unable or potentially unable to fulfill their fiduciary duty." *In re NII Holdings*, Transcript of June 18, 2002 Hearing at 63: 11-20.