AMERICAN COLLEGE OF BANKRUPTCY

BEST PRACTICES REPORT

FORMATION, FUNCTION & OBLIGATIONS OF EQUITY COMMITTEES IN CHAPTER 11

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INTRODUCTION[*]

When the current Bankruptcy Code[1] was adopted in 1978, it included for the first time a provision to allow for the appointment of an official committee of equity security holders (an "*Equity Committee*") in a bankruptcy case filed under chapter 11.[2] Allowing

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[1] 11 U.S.C. §§ 101-1532, which title shall be referred to herein as the "*Bankruptcy Code*".

[2] 11 U.S.C. § 1102(a)(1) ("Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.").

the appointment of Equity Committees was intended to "counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors."[3] A fair and equitable reorganization was viewed as "the last clear chance to conserve for [equity security holders] values that corporate financial stress or insolvency have placed in jeopardy."[4]

Unlike official committees of unsecured creditors, however (the appointment of which is *required* by section 1102(a)(1) of the Bankruptcy Code),[5] Congress did not *mandate* the appointment of Equity Committees in chapter 11.[6] Indeed, prior to 2002, the appointment of Equity Committees had been quite rare. In all the chapter 11 bankruptcies filed between 1986 and 2002 where the debtor's assets and liabilities were in excess of $500 million, only six Equity Committees were appointed.[7] In the last decade, however, there has been a remarkable increase in the number of requests

3 S. REP. NO. 95-989, at 5796 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5796.

4 *Id.*

5 *See* note 2 *supra*. Section 1102(a)(3) of the Bankruptcy Code allows a court to order that an official committee of unsecured creditors not be appointed in a small business case on request of a party in interest and for cause.

6 *See Victor v. Edison Bros. Stores (In re Edison Bros. Stores)*, No. 95-1354, 1996 WL 534853, at *3 (D. Del. Sep. 17, 1996) ("Based on the legislative history, it is clear that Congress recognized the vulnerability of public shareholders in reorganization proceedings and intended to protect them with legislation. Despite this recognition, Congress declined to provide for the mandatory appointment of equity committees in § 1102, instead leaving the appointment decision within the discretion of bankruptcy courts based on a case-by-case determination."); *Albero v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 68 B.R. 155, 160 (S.D.N.Y. 1986) (quoting the 1978 Senate Report but noting that "Congress' desire to protect shareholders in reorganization proceedings was not strong enough, however, to mandate the creation of equity committees. The legislative history indicates only that a bankruptcy judge should be sensitive to the interests of equity holders in a reorganization proceeding.").

7 *See* David M. Feldman & Matthew J. Williams, *Appointing Equity Committees*, NEW YORK LAW JOURNAL, Aug. 9, 2004, at col. 3.

for, and appointments of, Equity Committees.[8] In the first half of the decade alone, Equity Committees were appointed in over 30 cases in 12 separate jurisdictions,[9] and the appointment of Equity Committees in so-called "mega cases" has become relatively common.[10]

8 *See. e.g., In re Washington Mut., Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Jan. 11, 2010) [Docket No. 2130]; *In re Chemtura Corp.,* Case No. 09-11233 (REG) (Bankr. S.D.N.Y. Dec. 29, 2009) [Docket No. 1676]; *In re MES Int'l, Inc.*, Case No. 09-14109 (PJW) (Bankr. D. Del. Dec. 22, 2009) [Docket No. 150]; *In re Gen. Growth Props., Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. Sep. 8, 2009) [Docket No. 2302]; *In re Pilgrims Pride Corp.*, Case No. 08-45664 (DML) (Bankr. N.D. Tex. Jun. 18, 2009) [Docket No. 2352]; *In re Tronox Inc.*, Case No. 09-10156 (ALG) (Bankr. S.D.N.Y. Mar. 13, 2009) [Docket No. 245]; *In re Dana Corp.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y. Jun. 27, 2006) [Docket No. 1581]; *In re OCA, Inc.*, Case No. 06-10179 (JAB) (Bankr. E.D. La. Jun. 13, 2006) [Docket No. 666]; *In re Oneida Ltd.*, Case No. 06-10489 (ALG) (Bankr. S.D.N.Y. May 18, 2006) [Docket No. 233]; *In re Calpine Corp.*, Case No. 05-60200 (BRL) (Bankr. S.D.N.Y. May 9, 2006) [Docket No. 1512]; *In re DPH Holdings Corp. (f/k/a Delphi Corp.)*, Case No. 05-44481 (RDD) (Bankr. S.D.N.Y. Apr. 28, 2006) [Docket No. 3503]; *In re USG Corp.*, Case No. 01-02094 (JKF) (Bankr. D. Del. Apr. 21, 2005) [Docket No. 8321]; *In re Loral Space & Commc'ns Ltd.*, Case No. 03-41710 (RDD) (Bankr. S.D.N.Y. Mar. 29, 2005) [Docket No. 1814]; *In re THCR/LP Corp.* (*In re Trump Hotels and Casino*), Case No. 04-46898 (JHW) (Bankr. D.N.J. Dec. 30, 2004) [Docket No. 292]; *In re Interstate Bakeries Corp.*, Case No. 04-45814 (JWV) (Bankr. W.D. Mo. Nov. 29, 2004) [Docket No. 781]; *In re Mirant Corp.*, Case No. 03-46590 (DML) (Bankr. N.D. Tex. Sep. 18, 2003) [Docket No. 840]; *In re Adelphia Commc'ns Corp.*, Case No. 02-41729 (REG) (Bankr. S.D.N.Y. Jul. 31, 2002) [Docket No. 250]; *In re Kmart Corp.,* Case No. 02-02474 (SPS) (Bankr. N.D. Ill. Jun. 17, 2002) [Docket No. 4051].

9 *See* Neil B. Glassman, Jeffrey M. Schlerf & Christopher A. Ward, *Equity Committees: A Consequence of the "Zone of Insolvency"*, 24-JAN AM. BANKR. INST. J. 28, 51 (2006).

10 The Administrative Office of the U.S. Courts' working definition of a "mega case" is "an extremely large case with: (1) at least 1,000 creditors; (2) $100 million or more in assets; (3) a great amount of court activity as evidenced by a large number of docket entries; (4) a large number of attorneys who have made an appearance of record; and (5) regional and/or national media attention." Laura B. Bartell & S. Elizabeth Gibson, *A Guide to the Judicial Management of Bankruptcy Mega-Cases* 5 (Federal Judicial Center, 2d ed. 2009). To provide an idea of the number of mega cases pending in the United States today,

In light of the increasing participation of Equity Committees in chapter 11 reorganizations and practice, this Report offers "best practices" guidelines with respect to various issues related to the appointment, representation, conduct, costs and duties of Equity Committees and their counsel. Specifically, this Report addresses the following issues:

- *Standards of Equity Committee Appointment*. The Report offers an overview of the standards employed (and suggests which should be employed) by bankruptcy courts in determining whether to appoint an Equity Committee. Particular attention is paid to the impact upon this determination of (i) the debtor's solvency, (ii) the ability of other constituencies (e.g., the debtor's board; creditors) to adequately represent shareholder interests, (iii) the ability of interested parties to reach consensual, negotiated solutions with respect to a debtor's reorganization without regard to the absolute priority rule, (iv) the policies of the Office of the United States Trustee for the relevant jurisdiction (the "U.S. Trustee") on appointment and (v) the standard of review regarding appointment decisions.
- *Disbanding Equity Committees Post-Appointment*. The Report addresses the ability of bankruptcy courts or the U.S. Trustee to disband Equity Committees subsequent to their appointment in light of the lack of express authorization regarding disbanding committees in the Bankruptcy Code. Assuming the courts' or the U.S. Trustee's power to disband Equity Committees, the Report further addresses the standards that govern/should govern such decisions, as well as the appropriate standard of review.
- *The Interaction of Corporate/Securities Law in the Equity Committee Context*. The Report addresses various issues arising under traditional corporate and securities law that may impact the formation and representation of Equity Committees, including (i) whether Equity Committees are "groups" for purposes of Rule 13D and Section 16(b) of the Securities Exchange Act of 1934 (the "*Exchange Act*") and (ii) shareholders' exercise of state law rights where their interests are formally represented by an Equity Committee.

consider that, as of February 23, 2011, the United States Bankruptcy Court for the Southern District of New York alone was currently hearing 120 mega cases. *See* www.nysb.uscourts.gov/megacases.html (last visited February 23, 2011).

- *Fiduciary Duties of Equity Committees*. The Report describes the fiduciary duties of Equity Committees and their members, including discussions of (i) the overlap between an Equity Committee's duties and that of the debtor's board, (ii) the potential for votes of equity holders to be designated and (iii) any obligation to disband where equity holders are to receive no recovery.

I. THE DEVELOPMENT OF CURRENT PRACTICE FROM CHAPTER X OF THE BANKRUPTCY ACT

Chapter X of the Bankruptcy Act of 1898 (the "*Bankruptcy Act*"), as amended by the 1938 Chandler Act, was designed primarily for the reorganization of large, publicly traded companies. Under Chapter X, a plan of reorganization could be confirmed only if it was found to be "fair and equitable," a term of art that led to the promulgation of the absolute priority rule by the United States Supreme Court in *Case v. Los Angeles Lumber*, 308 U.S. 106 (1939).[11] A debtor reorganizing pursuant to Chapter X could not avoid formal application of the absolute priority rule, or the necessity for a valuation hearing, by settling on the terms of a reorganization plan.[12] That is not to say that the parties in interest could not reach an agreement regarding a plan, but rather that no such agreement would eliminate the need for the court to value the reorganized debtor on a going concern basis to ensure strict compliance with the absolute priority rule.[13]

Ironically, Chapter X's rigid insistence upon compliance with the absolute priority rule (which formalism functioned in practice generally to preclude participation by equity security holders in the process of negotiating plans of reorganization) was designed to *protect* equity security holders.[14] In the years prior to the adoption of the absolute priority rule, many believed that there had been widespread abuse of the prevailing equity receivership procedures

11 *See* Richard F. Broude, *Reorganizations Under Chapter 11 of the Bankruptcy Code* 13-2 (1986).

12 *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 131 (1990).

13 *See id.*; *see also* Broude, *supra* note 11, at 13-2.

14 *See* Broude, *supra* note 11, at 13-2.

to the detriment of equity security holders.[15] The intended "remedy" for this problem was the requirement of a valuation hearing and court approval of all reorganization plans. Over the years, however, it became apparent that the absolute priority rule, in fact, injured those it was designed to protect.[16] While desirable in theory, strict application of the absolute priority rule did not work well in practice, and often served to "prevent reasonable compromises and to wipe out the interests of shareholders."[17]

Congress eventually recognized the shortcomings of the universal application of the absolute priority rule[18] and, under the current Bankruptcy Code, the rule has been abandoned entirely where the plan of reorganization is consensual.[19] Studies of reorganizations under chapter 11 of the Bankruptcy Code indicate that violations of the absolute priority rule — violations which serve to distribute value to lower priority classes such as interest holders —

15 *See id.* at 13-4; *see also* LoPucki & Whitford, *supra* note 12, at 132. Under the then-extant equity receivership procedures, parties in interest, voting by classes, could agree on a reorganization plan outside the constraints of the bankruptcy statutes. *See* LoPucki & Whitford at 132. As a result, powerful interests in the reorganization process, such as management and large banks, often obtained disproportionately large shares of the property to be distributed in the reorganization, typically at the expense of trade creditors, public debt holders and equity, which groups generally lacked the resources and sophistication to participate fully in the creation of a plan of reorganization. *Id.* Frequently, this led to recoveries for small creditors and shareholders that were far inferior to those they might have received under a strict application of the absolute priority rule. *Id.*

16 *See* H.R. Doc. No. 137, Part I, 93rd Cong., 1st Sess. 256 (1973) ("Unfortunately, the rigidity of the rule has frequently resulted in the destruction rather than the protection of interests of public investors. Public debt security holders (frequently subordinated to trade and financial institution debt) and public equity security holders are frequently eliminated from participation in a reorganization by reason of the strict application of a statute designed primarily for their protection.").

17 *Id.*

18 In addition to precluding participation by equity security holders, strict application of the absolute priority rule required a time-consuming and expensive judicial valuation proceeding in every case.

19 The absolute priority rule is still employed, of course, when a debtor seeks "cramdown" under section 1129(b) of the Bankruptcy Code.

became more the rule than the exception during the 10 to 15 year period after the enactment of the Bankruptcy Code.[20] During that period, the shift away from Chapter X proved a positive one for equity security holders, as violations of the absolute priority rule often entailed gifts or "give ups" from the debtor's secured lenders to the debtor's shareholders — gifts meant to encourage shareholders to accept plans of reorganization.[21]

Since 1990, however, the incidence of deviations from the absolute priority rule has declined dramatically, with only 22% of reorganizations during the period 1990-2005 exhibiting violations of the absolute priority rule.[22] A narrower focus reveals an even sharper decline: only 9% of chapter 11 reorganizations deviated from the absolute priority rule during the period 2000-2005.[23] Commentators

20 *See* Longhofer & Carlstrom, *Absolute Priority Rule Violations in Bankruptcy*, 31 ECON. REVIEW 21, 23 (1995) ("A growing body of empirical evidence supports the conclusion that [absolute priority rule] violations are common-place both in Chapter 11 reorganizations and in informal workouts. Using different samples of large corporations with publicly traded securities, numerous researchers have found that equity holders receive value from financially distressed firms in violation of the [absolute priority rule] in nearly 75 percent of all reorganizations."); Bharath, Panchapegesan and Werner, *The Changing Nature of Chapter 11* (November 1, 2010), Fisher College of Business Working Paper No. 2008-03-003, Charles A. Dice Center WP No. 2008-4, EFA 2008 Athens Meetings Paper, AFA 2010 Atlanta Meetings Paper, available at SSRN: http://ssrn.com/abstract=1102366, at 1 (summarizing previous research as indicating that, during the 1980s, the absolute priority rule was violated in 75% of chapter 11 reorganizations).

21 *See* Longhofer & Carlstrom, at 23 ("Under [one] view, [absolute priority rule] violations – both inside Chapter 11 and in out-of-court workouts – are a desirable consequence of renegotiation between the firm and its creditors; [absolute priority rule] violations are essentially payoffs by lenders to encourage the firm's shareholders to make good investment decisions once the firm is in financial distress."); Allan C. Eberhart, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, JOURNAL OF FINANCE, Vol. XLV, No. 5, 1457 (Dec. 1990) (noting that, at that time, the amount paid to shareholders in excess of that which they would have received under the absolute priority rule represented, on average, 7.6% of the total awarded to all claimants).

22 *See* Bharath, Panchapegesan and Werner, at 1.

23 *Id.*

have attributed the post-1990 decline in absolute priority violations in chapter 11 to, among other things, the rise in the market for debtor in possession financing and the attendant restrictions on a debtor in possession's cash (which restrictions allowed for a relatively limited set of possible reorganization outcomes and far greater control over the chapter 11 process for secured lenders) as well as the growth in popularity of key employee retention plans (which plans incentivized management to avoid protracted reorganizations that promoted deviations from the absolute priority rule).[24] These shifts in the practical facets of reorganization arguably have resulted in the reestablishment of "pervasive creditor control" over the chapter 11 process,[25] a trend that seems likely to be exacerbated by recent Circuit Court decisions disapproving of "gifting" plans of reorganization.[26]

Another distinction between Chapter X and the modern Bankruptcy Code involves the role of statutory committees. Chapter X did not provide for statutory committees of creditors or equity security holders; creditors and shareholders were entitled to act through committees,[27] but the court did not *appoint* them. By con-

24 *Id.* at 2-3; Capkun & Weiss, *Bankruptcy Resolution: Priority of Claims with the Secured Creditor in Control* (American Law & Economics Association Papers, n° 40, pp. 1-27, Feb. 15, 2007) (observing that "power over the bankruptcy process has shifted back in favor of the secured creditors," in part because the increase in debtor in possession financing and changes to the Uniform Commercial Code allowing secured creditors to take an interest in bank accounts increased the likelihood that prepetition secured lenders would provide postpetition financing and decreased the incentive for secured creditors to grant concessions to junior interests).

25 Ayotte & Morrison, *Creditor Control and Conflict in Chapter 11*, JOURNAL OF LEGAL ANALYSIS, Vol. 1, No. 2 (Summer 2010), at 511.

26 *See DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, No. 10-1175, 2011 WL 350480, at *16 (2d Cir. Feb. 7, 2011) (reversing district court affirmance of bankruptcy court order confirming "gifting" plan over the objection of creditor in intervening class; stating that "although Congress did soften the absolute priority rule in some ways, it did not create any exception for 'gifts' like the one at issue here."); *In re Armstrong World Indus., Inc.*, 432 F.3d 507, 513-15 (3d Cir. 2005) (affirming refusal of district court (sitting by designation) to confirm gifting plan where class of equal priority to gifting creditors rejected plan).

27 *See* Bankruptcy Act § 209; Chapter X Rule 10-211.

trast, the current Bankruptcy Code requires the appointment of a committee of unsecured creditors, and permits the appointment of additional committees, including Equity Committees.[28] It has been said that the official committee concept in chapter 11 was an "essential element in the Congressional redesign of the reorganization process."[29] Indeed, in no small measure, the *purpose* of replacing Chapter X with chapter 11 was the desire to encourage consensual reorganizations, at least partially through the appointment of official committees of stakeholders. The Bankruptcy Code shifted the emphasis in reorganization from the formal procedures and court supervision found in former Chapter X to a "system premised on arriving at an acceptable plan by active participation of all parties in interest through negotiation. The new Chapter 11 reflected Congress' view that public security holders could be adequately protected by … providing an opportunity to participate in the reorganization in a formal capacity through the committee process."[30]

II. THE APPOINTMENT OF EQUITY COMMITTEES, GENERALLY

A. Procedures for the Appointment of an Equity Committee

1. *Appointment by the United States Trustee*

Section 1102(a)(1) of the Bankruptcy Code vests the U.S. Trustee with the authority to appoint one or more Equity Committees in chapter 11 cases in its discretion and as it "deems appropriate."[31] Although bankruptcy courts are empowered to appoint Equity Committees prior to the U.S. Trustee's exercise of discretion to do so, the appointment decision usually is addressed by the U.S. Trustee in the first instance,[32] and section 1102(a)(1) of the Bankruptcy Code directs the U.S. Trustee to make the determination "as soon as practicable after entry of the order for relief."[33]

28 *See* 11 U.S.C. § 1102; *see also* Section II.A.1 *infra*.

29 *In re George Worthington Co.*, 921 F.2d 626, 634 (6th Cir. 1990).

30 *Id.*

31 *See* note 2 *supra*.

32 *See, e.g., In re Enron Corp.*, 279 B.R. 671, 684 (Bankr. S.D.N.Y. 2002) ("The initial determination whether to appoint an additional committee [pursuant to section 1102(a) of the Bankruptcy Code] is often a determination made by the U.S. Trustee.").

33 11 U.S.C. § 1102(a)(1).

The U.S. Trustee enjoys the discretion to appoint an Equity Committee for any appropriate reason, and its decision need not be accompanied by formal findings or adjudicatory procedures.[34] Should the U.S. Trustee decide *not* to appoint an Equity Committee at the commencement of the case, it may reconsider the decision at a later stage of the case.[35] Indeed, nothing in the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure (the "*Bankruptcy Rules*") prohibits the U.S. Trustee from appointing an Equity Committee at *any* stage of a chapter 11 case (and there may be, at times, valid reasons for deferring such decision).[36]

2. *Appointment By the Bankruptcy Court*

Alternatively, section 1102(a)(2) of the Bankruptcy Code vests the bankruptcy court with the authority, on request of a party in interest, to order the U.S. Trustee to appoint an Equity Committee. Section 1102(a)(2) of the Bankruptcy Code provides that "[o]n 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 equi-

34 *See, e.g.*, *In re Sharon Steel Corp.*, 100 B.R. 767, 786 (Bankr. W.D. Pa. 1989) ("Formal findings and adjudicatory procedures are not required of the U.S. Trustee" acting pursuant to section 1102(a)(1) of the Bankruptcy Code); *In re McLean Indus., Inc.*, 70 B.R. 852, 856 (Bankr. S.D.N.Y. 1987) ("[Section] 1102(a) [of the Bankruptcy Code] provides U.S. trustees with discretion to appoint additional committees for any appropriate reason.").

35 *See* 7 *Collier on Bankruptcy* ¶ 1102.03[1][b] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("The United States trustee may, however, determine not to appoint such a committee at the commencement of the case and may reconsider the decision at a later stage of the case.").

36 *Id.* ("There is nothing in the Code or the Federal Rules of Bankruptcy Procedure that prohibits the United States [trustee] from appointing a committee of equity security holders at a later stage of the case."); *In re Pilgrim's Pride Corp.*, 407 B.R. 211, 219 (Bankr. N.D. Tex. 2009) (unsecured creditors' committee and debtor's secured lenders urged court to defer appointment of Equity Committee until a later date, when the necessity of appointment might be more clear; although acknowledging the propriety of a later appointment, the court decided that immediate representation of shareholders by an official committee was necessary). *But see* Section II.C.3 *infra* (observing that the appointment of Equity Committees during the later stages of chapter 11 cases is generally disfavored).

ty security holders. The United States trustee shall appoint any such committee."[37] A party in interest may request that the court order the appointment of an Equity Committee pursuant to section 1102(a)(2) of the Bankruptcy Code either prior to the U.S. Trustee's initial determination with respect to appointment or after the U.S. Trustee denies or defers a request therefor.[38] The bankruptcy court is not limited to a *post hoc* review of the U.S. Trustee's determination; rather, section 1102(a)(2) of the Bankruptcy Code authorizes the bankruptcy court to determine whether an Equity Committee is necessary to assure adequate representation of shareholders in the first instance.[39] Moreover, when a bankruptcy court re-

37 11 U.S.C. § 1102(a)(2). Thus, while the court has the judicial function of determining whether the appointment of an Equity Committee is necessary to assure adequate representation, the U.S. Trustee has the administrative function of appointing the members of an Equity Committee. *See McLean Indus.*, 70 B.R. at 857-58 ("The House Report stated that the purpose of the amendment is 'to transfer the authority to appoint the chapter 11 committee[s] … from the court to the U.S. Trustee as it is an administrative task. The court still retains the authority to order the appointment of such administrative committees as are necessary, but the U.S. Trustee has the authority to actually appoint these committees once the court has ordered.'") (*quoting* H.R.Rep. No. 764, 99th Cong., 2d Sess. 28 (1986), U.S.C.C.A.N. 1986, p. 5241).

38 *In re Ampex Corp.*, No. 08-11094, 2008 WL 2051128, at *1 (Bankr. S.D.N.Y. May 14, 2008) (deciding motion for appointment of an Equity Committee filed after the U.S. Trustee had denied a prior request for appointment); *In re Texaco, Inc.*, 79 B.R. 560, 566 (Bankr. S.D.N.Y. 1987) ("There is no requirement under 11 U.S.C. § 1102(a)(2) that an interested party must first submit such a request [for the appointment of an Equity Committee] to the United States Trustee."); *McLean Indus.*, 70 B.R. at 857 ("It thus does not appear that Congress, in amending § 1102(a), had any intention of requiring a movant under § 1102(a)(2) to exhaust administrative remedies.").

39 *McLean Indus.*, 70 B.R. at 856-57 ("Noteworthy is the absence [in section 1102(a) of the Bankruptcy Code] of any indication from the statutory language that the Court's ability to determine the issue of adequate representation is fettered by any constraint other than the requirement that the appointment of one or more additional committees is necessary to achieve the designed goal…. The legislative history belies the … claim that Congress sought to limit the Court's role to a review of a determination by a U.S. trustee…. [C]ongress expressly retained in the bankruptcy courts the ability to decide *de novo* the

views the U.S. Trustee's determination to appoint an Equity Committee, it does so *de novo*.[40] Regardless of whether a request for appointment of an Equity Committee was first submitted to the U.S. Trustee, "the court must arrive at its own judgment, although the court may consider reasons advanced by the United States Trustee in the event that such a request was previously submitted to the United States Trustee."[41]

Courts consistently hold that the appointment of an Equity Committee pursuant to section 1102(a)(2) of the Bankruptcy Code should be the "rare exception" in chapter 11 cases.[42] In part, this is because section 1102(a)(2) of the Bankruptcy Code requires a bank-

question of whether additional committees are necessary to assure adequate representation.").

40 *In re Nat'l R.V. Holdings, Inc.*, 390 B.R. 690, 695 (Bankr. C.D. Cal. 2008) (rejecting U.S. Trustee's contention that its decision not to appoint an Equity Committee should be reviewed under an abuse of discretion standard and stating that "the court will review the UST's decision not to appoint an official equity security holders' committee in the … case, as requested by the Ad Hoc Committee, *de novo*"); *In re Williams Commc'ns Group, Inc.*, 281 B.R. 216, 220 (Bankr. S.D.N.Y. 2002) ("The bankruptcy court reviews the UST's decision *de novo*"); *Texaco*, 79 B.R. at 566 ("An abuse of discretion standard does not apply with respect to the United States Trustee's initial exercise of discretion because the concept of adequate representation is a legal issue which must be resolved judicially. Hence, the court's determination as to the adequacy of representation within the meaning of 11 U.S.C. § 1102(a)(2) is not an administrative review because this decision is committed to the court on a *de novo* basis.").

41 *Texaco*, 79 B.R. at 566; *see also In re Oneida Ltd.*, No. 06-10489, 2006 WL 1288576, at *1 (Bankr. S.D.N.Y. May 4, 2006) ("Moreover, although review of the U.S. Trustee's determination is *de novo*, consideration should be given to the views of the U.S. Trustee.").

42 *See, e.g., In re TLC Vision Corp.*, No. 09-14473, slip op. at 3 (Bankr. D. Del. Mar. 23, 2010) (Docket No. 373) ("appointing an equity committee is 'extraordinary relief' that should be the 'rare exception'"); *In re Spansion, Inc.*, 421 B.R. 151, 156 (Bankr. D. Del. 2009) (same); *Oneida*, 2006 WL 1288576, at *1 ("The U.S. Trustee found that courts in this District have held that the appointment of an equity committee should be the 'rare exception'"); *In re Northwestern Corp.*, No. 03-12872, 2004 WL 1077913, at *2 (Bankr. D. Del. May 13, 2004) ("appointing an official equity committee 'should be the rare exception'"); *Exide Techs. v. Wisconsin Inv. Bd.*, No. 02-1572, 2002 WL 32332000, at *1 (D. Del. Dec. 23, 2002) (same).

ruptcy court to find that the appointment of an Equity Committee is "necessary" — "a high standard that is far more onerous than if the statute merely provided that a committee be 'useful.'"[43] Nonetheless, over the past decade, the appointment of Equity Committees has become increasingly frequent, and the "rare exception" much less rare, likely because of the increase in the number of mega cases filed over the past decade.[44] Indeed, Equity Committees generally have been appointed in mega cases involving large, publicly traded debtors (in which circumstance an Equity Committee would represent large numbers of shareholders).[45]

3. *Composition of Equity Committees*

Section 1102(b)(2) of the Bankruptcy Code provides that "a committee of equity security holders … shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such

43 *Oneida*, 2006 WL 1288576, at *1 (citing *In re Kasper A.S.L. Ltd.*, Oral Opinion, No. 02-10497 (ALG) (Bankr. S.D.N.Y. Jul. 15, 2003) (Tr. Hr'g on July 15, 2003 at 68)).

The *Oneida* and *Kasper* courts' focus on the "necessary" standard set forth in section 1102(a)(2) of the Bankruptcy Code evidences that courts will overlay this stricter requirement onto the U.S. Trustee's ability to appoint Equity Committees as it "deems appropriate" pursuant to section 1102(a)(1) of the Bankruptcy Code. As *Oneida* and other cases make clear, the U.S. Trustee generally also regards the appointment of Equity Committees as an extraordinary event, with the hurdle to appointment being identified as the court-created standards for appointment discussed in Section II.C *infra* rather than the ostensibly more lenient statutory language of section 1102(a)(1) of the Bankruptcy Code. *See Oneida*, 2006 WL 1288576, at *1 (noting that the U.S. Trustee had refused to appoint an Equity Committee on the grounds that appointment should be the "rare exception" and only authorized upon satisfaction of the standards articulated by the *Williams Communications* court, which addressed a request for appointment under section 1102(a)(2) of the Bankruptcy Code).

44 *See* notes 8, 10 *supra*.

45 Thomas Henry Coleman & David E. Woodruff, *Looking Out for Shareholders: The Role of the Equity Committee in Chapter 11 Reorganization Cases of Large, Publicly Held Companies*, 68 AM. BANKR. L.J. 295, 295-96 (1994).

committee."[46] In contrast to section 1102(b)(1) of the Bankruptcy Code (which section address the permissible composition of creditors' committees),[47] section 1102(b)(2) of the Bankruptcy Code does not provide the U.S. Trustee with authority to appoint an Equity Committee organized prepetition by equity security holders. The implication of this statutory omission is that, if the U.S. Trustee appoints an Equity Committee, it must actively solicit membership from equity security holders. However, because the U.S. Trustee retains considerable discretion with respect to the appointment of Equity Committees, it may still appoint the individual members of a prepetition equity committee.[48]

B. Powers, Duties and Purpose of an Equity Committee

1. *Ability to Employ Professionals*

Section 1103 of the Bankruptcy Code sets forth the powers and duties of official committees, including Equity Committees, in a chapter 11 case. Section 1103(a) of the Bankruptcy Code authorizes an official committee to select and authorize, with the court's approval, one or more professionals to represent or perform services for the committee.[49] Equity Committees may select such profes-

46 11 U.S.C. § 1102(b)(2). It has been held that the "'ordinarily' language of § 1102(b)(2) indicates that the seven largest shareholders language is merely a guideline from whence there may be variation and exception." *Bank Creditors Group v. Hamill (In re White Motor Credit Corp.)*, 27 B.R. 554, 558 (N.D. Ohio 1982).

47 Section 1102(b)(1) provides that, with respect to the appointment of a creditors' committee, the United States trustee may appoint the members of a "committee organized by creditors before the commencement of the case … , if such committee was fairly chosen and is representative of the different kinds of claims to be represented." 11 U.S.C. § 1102(b)(1).

48 7 *Collier on Bankruptcy* ¶ 1102.03[3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("Since the United States trustee retains considerable discretion concerning committee membership, the United States trustee may still appoint the individual members of a prepetition equity committee to the official equity committee."). *See also* Section II.D *infra*.

49 11 U.S.C. § 1103(a) ("At a scheduled meeting of a committee appointed under section 1102 of this title, at which a majority of the members of such committee are present, and with the court's approval, such committee may select and authorize the employment by

sionals only at meetings at which a majority of members are present[50] and, while the Bankruptcy Code authorizes the employment of multiple attorneys or other professionals, this should be considered the exception and not the rule.[51] Section 1103(b) of the Bankruptcy Code provides that professionals, while employed by an Equity Committee, may not represent any other entity having an adverse interest in connection with the chapter 11 case.[52] Crucially, section 330(a) of the Bankruptcy Code allows the bankruptcy court to award an Equity Committee's professionals reasonable compensation for their actual, necessary services and reimbursement for actual and necessary expenses from a debtor's estate.[53] As

such committee of one or more attorneys, accountants, or other agents, to represent or perform services for such committee.").

50 *Id.*

51 *See* H.R. REP. NO. 95-595, at 402 (1977) ("The subsection [§ 1103(a) of the Bankruptcy Code] provides for the employment of more than one attorney. However, this will be the exception, and not the rule; cause must be shown to depart from the normal standard.").

52 11 U.S.C. § 1103(b) ("Any attorney or accountant employed to represent a committee appointed under section 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. "). The representation of individual shareholders (or creditors) by Equity Committee counsel generally will be allowed provided the individual representation is unrelated to the debtor's chapter 11 case. *See generally* Susan M. Freeman, *Are DIP and Committee Counsel Fiduciaries for Their Clients' Constituents or the Bankruptcy Estate? What is a Fiduciary Anyway?*, 17 Am. Bankr. Inst. L. Rev. 291, 324, 352 (Winter 2009) ("Representation of one or more [constituents] of the same class represented by the Committee is not considered an adverse interest *per se*. However, Committee counsel may not actually advance the interests of a single [constituent] adversely to the interests of the class of all such [constituents].... Similarly, in a Committee context, simultaneously representing a non-Committee constituent with adverse interests is a clear conflict of interest").

53 11 U.S.C. § 330(a)(1) ("After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to … a professional person employed under section … 1103 — (A) reasonable compensation for actual, necessary services rendered by the … professional person, or attorney and by any paraprofessional person employed by any such person; and (B) reimbursement for actual, necessary expenses.").

discussed in more detail below, the ability of an Equity Committee to have its professionals' costs paid from a debtor's estate greatly impacts a U.S. Trustee's or bankruptcy court's initial decision with respect to appointment and, often, the permissible scope of the Equity Committee's participation in the debtor's reorganization.[54]

2. *Statutory Functions of Equity Committees*

Section 1103(c) of the Bankruptcy Code enumerates the functions of official committees, including Equity Committees. Specifically, section 1103(c) of the Bankruptcy Code provides that an Equity Committee may

- consult with the trustee or debtor in possession 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, and any other matter relevant to the case or to the formulation of a plan;
- participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
- request the appointment of a trustee or examiner under section 1104 of the Bankruptcy Code; and
- perform such other services as are in the interest of those represented.[55]

C. Standards Governing Appointment of an Equity Committee

Section 1102(a)(2) of the Bankruptcy Code requires the bankruptcy court to find that the appointment of an Equity Committee is "necessary to assure adequate representation of equity security holders."[56] The Bankruptcy Code does not define "adequate repre-

54 *See* Sections II.C.4, II.F.1 *infra*.

55 11 U.S.C. § 1103(c). *See also* H.R. REP. NO. 95-595, at 401 (1977) (providing that an Equity Committee will: be a primary negotiating body for the formulation of the plan of reorganization; represent the various classes of equity security holders from which it is selected; provide supervision of the debtor in possession and of the trustee; and protect its constituencies' interests).

56 11 U.S.C. § 1102(a)(2). The U.S. Trustee generally takes its cues with respect to the propriety of an Equity Committee's appointment under section 1102(a)(1) of the Bankruptcy Code from cases decided under

sentation," which leaves bankruptcy courts with discretion to examine the facts of each case to determine if appointment of an Equity Committee is warranted.[57] Equity holders need only be "adequately" represented, not "exclusively" represented,[58] and the proponents of an Equity Committee bear the burden of demonstrating the lack of such adequate representation in the absence of an Equity Committee.[59]

The most commonly considered factors addressed by bankruptcy courts in making their appointment determinations include:

- the number of shareholders/whether the stock is widely held;
- the complexity of the chapter 11 case;
- the timing of the request for appointment of an Equity Committee relative to the status of the case;
- whether the costs of the additional committee significantly outweigh the concerns for adequate representation of equity security holders;
- the solvency of the debtor; and
- whether the interests of shareholders are already represented by other parties in interest.

section 1102(a)(2) of the Bankruptcy Code, despite the facially different standards for appointment under the separate sections. *See* note 43 *supra* and accompanying text; Section II.D *infra*.

57 *See, e.g., Spansion*, 421 B.R. at 156 ("The Code does not define 'adequate representation,' and the Court has discretion to appoint an additional committee based upon the facts of the case."); *Nat'l R.V.*, 390 B.R. at 696 (stating that because adequate representation is not defined by the Bankruptcy Code, "a court's decision to order the appointment of an equity security holders' committee is discretionary and turns on the facts of each case"); *Northwestern Corp.*, 2004 WL 1077913 at *2 (stating that the adequacy of representation determination is "made on a case-by-case basis"); *Johns-Manville*, 68 B.R. at 159 (citing *In re Beker Indus. Corp.*, 55 B.R. 945, 948 (Bankr. S.D.N.Y. 1985)) ("The statute affords no test of adequate representation, leaving the bankruptcy courts with discretion to examine the facts of each case to determine if additional committees are warranted.").

58 *See Williams Commc'ns*, 281 B.R. at 222-23; *Edison Bros.*, 1996 WL 534853, at *4.

59 *See Spansion*, 421 B.R. at 156; *In re Allied Holdings, Inc.*, No. 05-12515, 2007 WL 7138349, at *1 (Bankr. N.D. Ga. Mar. 13, 2007).

These factors, however, "are simply guidelines for the courts to consider and every case must be judged on its own facts;"[60] the determination is not amenable to bright-line tests.[61] Each of these factors is discussed in further detail below, with special attention devoted to the factors of solvency (*see* Section II.C.5 *infra*) and whether the interests of shareholders are already adequately represented (*see* Section II.E *infra*)

1. *Number of Shareholders/Whether the Stock is Widely Held.*

A court's inquiry into whether a debtor's stock is sufficiently widely held to weigh in favor of the appointment of an Equity Committee generally proves non-controversial. Most publicly-held corporations have a sufficient number of shareholders to merit the appointment of an Equity Committee if this factor were considered in isolation.[62] Indeed, even under circumstances where significant

60 *Edison Bros. Stores*, 1996 WL 534853, at *3; *see also Nat'l R.V.*, 390 B.R. at 696 (quoting *In re Kalvar Microfilm, Inc.*, 195 B.R. 599, 600 (Bankr. D. Del. 1996) ("No one factor is dispositive, and the amount of weight that the court should place on each factor may depend on the circumstances of the particular Chapter 11 case.")); *In re Dana Corp.*, 344 B.R. 35, 38 (Bankr. S.D.N.Y. 2006) (same).

61 *Edison Bros. Stores*, 1996 WL 534853, at *3 ("the establishment of an equity committee pursuant to 11 U.S.C. § 1102(a) is a discretionary matter, the resolution of which is fact driven and, therefore, not amendable to any bright line tests"); *see also* note 57 *supra*.

62 Coleman & Woodruff, *supra* note 45, at 298 ("In the *Wang*, *Baldwin United* and *Beker* cases, which involved 50,000-70,000, 15,000 and 2,500 shareholders, respectively, the number of shareholders was a significant factor in the court's appointment of an equity committee. On the other hand, in Westgate General Partnership the court refused to appoint partnership equity committees in several cases involving two partners each. While these cases leave a vast middle ground, it probably is safe to say that any publicly held corporation has a sufficient number of shareholders to warrant serious consideration of appointment of an equity committee."); *see also In re Leap Wireless Int'l, Inc.*, 295 B.R. 135, 137 (Bankr. S.D. Cal. 2003) (finding 58.5 million shares outstanding to be a sufficiently large number, but denying appointment of equity committee on other grounds); *Edison Bros. Stores*, 1996 WL 534853, at *5 (finding that 22 million shares widely held by more than 4,000 record holders and a substantial number of beneficial holders warranted appointment of Equity Committee); *Kalvar Microfilm*, 195 B.R. at 601 (debtor conceded that the 46 million shares of common stock outstanding were widely held); *Beker*, 55 B.R. at 947 (12,000,000 shares of common stock held by 2,148 stockholders

percentages of shares of public corporations are concentrated in the hands of a small number of shareholders, diversity of ownership in the remaining shares generally has been held to support the appointment of an Equity Committee.[63] However, the existence of a large number of shareholders does not mandate the creation of an official Equity Committee *per se*.[64]

and 1,150,000 shares of preferred stock held by 339 entities was sufficient to satisfy number of shareholders factor). *But see Ampex Corp.*, 2008 WL 2051128, at *2 (finding that debtor's equity securities were not widely held where the debtor's 3.89 million outstanding shares of common stock were held by 393 shareholders, only one of whom formally sought the appointment of an Equity Committee); *Nat'l R.V.*, 390 B.R. at 698 (finding that debtor's equity securities not widely held or actively traded where, though there may have been "well over 100" equity holders, it was undisputed that 50% of the roughly 10.4 million outstanding shares of common stock were held by 6 individuals or entities).

63 *See, e.g.*, *In re Gen. Growth Props.*, No. 09-11977 (Bankr. S.D.N.Y. 2009) (appointment of Equity Committee approved despite approximately 51% of common stock being concentrated in the hands of four shareholders where approximately 150 million remaining shares widely held); *In re Delphi Corp.*, No. 05-44481 (Bankr. S.D.N.Y. 2005) (equity committee appointed despite approximately 31% of outstanding shares held by two sophisticated investors). *But see* discussion of *Nat'l R.V.* in note 62 *supra*.

64 *See Leap Wireless*, 295 B.R. at 140 (denying appointment of equity committee, despite 58.5 million outstanding shares, where evidence indicated that debtor was hopelessly insolvent and where request for appointment came after plan of reorganization had been filed); *Williams Commc'ns*, 281 B.R. at 223 ("while there is a large number of shareholders, not every case with such a large number will require an official equity committee"); *In re Wang Labs., Inc.*, 149 B.R. 1, 2 (Bankr. D. Mass. 1992) (finding 70,000 shareholders to be sufficient, but stating that in so finding the court "does not conclude or imply that every case with a large number of equity holders requires the appointment of an equity committee"); *In re Emons Indus., Inc.*, 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985) ("not every case with public shareholders warrants an equity committee").

2. *Complexity of the Case.*

The need for Equity Committee representation increases with the complexity of the case.[65] However, although most bankruptcy courts examine a reorganization's "complexity" as part of their appointment determination, there has not emerged a clear definition of such term. The court in *Johns-Manville*, often cited by other courts, defined a "complex" case generally as one in which "the shareholders are expected to actively participate in the case, rather than merely vote upon a plan of reorganization."[66] Other courts have defined complexity by reference to the more or less byzantine nature of the debtor's capital structure.[67] Some courts have analyzed "complexity" by assessing the relative difficulty of achieving confirmation of a plan of reorganization in light of the obstacles thereto.[68] Still other courts have collapsed an analysis of the deb-

65 Coleman & Woodruff, *supra* note 45, at 298 ("The need for equity committee representation increases with the complexity of the case. In a complex case, numerous events will occur which affect shareholders. Moreover, the formulation of a plan of reorganization likely will be a long and involved process. These are not cases where shareholders 'will be asked merely to vote on a plan.' Active and ongoing participation by shareholders, such as that provided by an equity committee, is necessary to ensure that the interests of shareholders are adequately protected.").

66 *Johns-Manville*, 68 B.R. at 159; *see also Beker*, 55 B.R. at 949 ("[T]he complex nature of this large case requires representation of Debenture holders and shareholders…. [T]his is not a case where the Debenture holders and shareholders will be asked merely to vote on a plan. This is a case requiring active participation by Debenture holders and shareholders to protect their interests.").

67 *Edison Bros. Stores*, 1996 WL 534853, at *5 (affirming bankruptcy court's determination that an Equity Committee was not needed because the debtor's capital structure was not complex, management held a 35% equity interest and there were "no facts to suggest management was not aligned with non-insider shareholders.").

68 *See, e.g., Delphi Corp.*, Transcript of Hearing, March 22, 2006, at 169-70 ("This is obviously also a large and complex bankruptcy case…. [I]t is clear to me that far more than is reflected in the docket is being done by the debtor and other parties behind the scenes in respect to resolving the key issues in this case. Those issues are complex, both in terms of the negotiating and human dynamics, as well as the qualitative and quantitative analysis in regard to the underlying documentation, the parties' rights under the Bankruptcy Code and other law, including labor law and ERISA; and they ultimately involve numer-

tor's capital structure into the inquiry into whether equity's interests are adequately represented by another person, entity or constituency (*see* Section II.E *infra*).[69] Some courts have reduced the inquiry into a reorganization's complexity to a review of the number of entries on the case docket and have reached opposite results on similar facts.[70] Finally, at least one court has addressed the complexity factor with the simple statement that "[t]he case is not complex."[71]

ous important judgment calls that … the debtor must make in consultation with key constituencies in the case…. So those factors clearly call for the appointment of an equity committee.").

69 *Pilgrim's Pride*, 407 B.R. at 220 ("The UCC would define case complexity solely in terms of capital structure. The UCC thus argues that Debtors' capital structure is so simple as not to favor creation of an equity committee. The court is not confident that Debtors' capital structure is not sufficiently complex to support the need for independent equity representation, but the court in any case considers the issue of complexity to be one that involves more than capital structure…. As the court understands the relationship between the complexity of case and the need for equity representation by a statutory fiduciary, appointment of such a representative is more appropriate when the complexities of the case make it more difficult for another – here management – to protect equity interests as well as those of creditors. In these cases, the difficulties of valuing Debtors would, in the court's view, severely complicate for any single fiduciary performance of the two tasks of determining fair treatment of creditors and advocating the entitlement of equity to participation in a reorganized enterprise. The court thus concludes the complexity factor also favors" appointing an Equity Committee).

70 *Wang Labs.*, 149 B.R. at 3 (finding that 471 docket entries in two and a half months, coupled with a general review of the docket, constituted a complex case); *Kalvar*, 195 B.R. at 601 (finding that case was "not complex from a bankruptcy perspective" where bankruptcy was preplanned, the debtors were not attempting to change the nature of their operations through the bankruptcy process and there were only 220 docket entries in the first three months of the case).

71 *Ampex*, 2008 WL 2051128, at *2. In *Ampex*, the debtors were publicly traded, with an enterprise value of approximately $80 million. The debtors' plan proposed a prearranged agreement between the debtors, their secured noteholders and the proposed owner of the reorganized entity in which the debtors would exchange their current debt for cash, new notes and/or equity. Unsecured creditors were to recover less than 10% of their claims in new common stock of the

Although no consensus on the precise contours of "complexity" exist, it seems clear that publicly-held corporate debtors will have difficulty arguing that their cases are not complex, where shareholders likely will be able to demonstrate that at least one of the foregoing factors is present.

3. *The Timing of the Request for Appointment*

Courts generally agree that a request for the appointment of an Equity Committee that is made late in the reorganization process or after a plan of reorganization has been filed should be denied.[72] The reason for the courts' bias is manifest: because "the most important aspect of a[n equity] committee's role is to negotiate the terms of a reorganization,"[73] courts are less inclined to risk the de-

reorganized entity and shareholders were to receive certain contingent payment rights. *Id.*

72 *TLC Vision*, slip op. at 4 (court denied appointment of an Equity Committee as unnecessarily costly and counter-productive where the shareholders' motion was filed after three iterations of the debtors' plan of reorganization had already been filed); *In re eToys, Inc.*, 331 B.R. 176, 186 (Bankr. D. Del. 2005) (denying request for appointment of an Equity Committee where the request came after confirmation of a plan that extinguished equity holders' interests and provided for no distribution to equity holders); *Northwestern*, 2004 WL 1077913, at *2 (denying appointment of Equity Committee in part because request came after the debtor's filing of its plan of reorganization; court reluctant to shift the cost of valuing the debtor's estate where evidence indicated that equity was $700 million out of the money); *Kalvar*, 195 B.R. at 601 (holding that timing was a primary factor in the decision to deny appointment of an Equity Committee where the request came late and the Equity Committee's sole purpose would be to object to confirmation of the pre-negotiated plan).

73 *Johns-Manville*, 68 B.R. at 161 ("As a function of its procedural role, the potential effectiveness of an official committee is, to a large degree, determined by the stage a reorganization proceeding has reached. Since one of its most important functions is to negotiate a reorganization plan, a committee will most effectively exercise its responsibilities at the beginning of a reorganization, prior to the formulation of a plan. By the time a reorganization plan has been submitted to the various classes of interest for voting, however, much of the opportunity for a committee to participate in a reorganization will have passed."); *In re Eastern Maine Elec. Coop., Inc.*, 121 B.R. 917, 933 (Bankr. D. Me. 1990) (in denying a request for the appointment of an equity committee, the court stated that the "time for meaningful participation" by an equity committee had long passed and noted that the

lay and disruption of the confirmation process attendant upon appointment after a plan has been formulated and filed.[74] Conversely, requests for the appointment of an Equity Committee in the earliest stages of a chapter 11 case may be refused as premature where reliable information as to the debtor's enterprise value — and, thus, information regarding any potential recovery for equity and the need for equity to participate in the plan process — is not yet available and the cost of acquiring such information is prohibitive.[75]

4. *Balancing the Costs of Appointment Against the Need for Adequate Representation*

Regardless of timing, the appointment of an Equity Committee can impose significant costs on the chapter 11 estate.[76] The most

purpose of the committee would be not to negotiate the formulation of a plan but rather to provide a source of information to its constituents about the plans already on file).

74 *In re Public Serv. Co. of New Hampshire*, 116 B.R. 344, 345 (Bankr. D.N.H. 1990) (denying motion for appointment of common stockholders' committee where plan of reorganization had been filed and confirmation hearing set, in part because such appointment would cause unjustified delay and disruption of the proceedings); *Johns-Manville*, 68 B.R. at 164 ("the appointment of official committees would delay the confirmation of the Manville reorganization").

75 *See Pilgrim's Pride*, 407 B.R. at 217 n.14 ("Nor at this juncture and in the context of the Motion [requesting the appoint of an equity committee] would the court be disposed to conduct a valuation of [d]ebtors on a going concern basis. Such a valuation process would be too complex and time-consuming to undertake in connection with the Motion, even if the necessary data were available to the court."). Note, however, that courts commonly render decisions regarding appointment in the absence of such information, relying on certain available information (*e.g.*, trading values of a debtor's securities) as a proxy for a comprehensive valuation. *See* section II.C.5 *infra*.

76 It is clear that the appointment of an Equity Committee should not be denied solely on account of the potential cost to the estate. *See, e.g.*, *McLean Indus.*, 70 B.R. at 852 ("Cost alone cannot, and should not, deprive public debt and security holders of representation") (citing *Beker*, 55 B.R. at 951); *Ad Hoc Bondholders Group v. Interco Inc. (In re Interco Inc.)*, 141 B.R. 422, 424 (Bankr. E.D. Mo. 1992) ("The potential added cost is not sufficient in itself to deprive the creditors of the formation of an additional committee if one is otherwise appropriate.") (quoting *In re Hills Stores Co.*, 137 B.R. 4, 6 (Bankr. S.D.N.Y. 1992)).

obvious cost of appointment is the payment of an Equity Committee's professionals' fees and expenses out of the estate pursuant to section 330(a) of the Bankruptcy Code (which fees and expenses can easily run to hundreds of thousands of dollars or more in mega cases).[77] Perhaps just as significant, however, are the indirect costs of an Equity Committee's appointment. Appointment of an Equity Committee, the attendant delay in the reorganization process and the need for the debtor and creditors' committee to negotiate with and/or respond to pleadings filed by the Equity Committee is certain to result in increased professionals' fees and expenses for the debtor and creditors' committee.[78] Moreover, the costs of a delayed reorganization are not simply administrative; an extended stay in chapter 11 may harm a debtor's operations, impose unfavorable tax consequences on the estate or erode the value of a debtor's assets.[79] Many courts have noted the potential for an Equity Committee to exploit its ability to impose costs on the chapter 11 estate in the service of maximizing the distribution to its constituents: the so-called "blackmail factor."[80]

77 *See* Section II.B.1 *supra; see also, e.g., Williams Commc'ns*, 281 B.R. at 220 (noting that "appointments [of Equity Committees] are 'closely followed by applications to retain attorneys and accountants.'") (quoting *In re Saxon Indus., Inc.*, 39 B.R. 945, 947 (Bankr. S.D.N.Y. 1984)).

78 *See Johns-Manville*, 68 B.R. at 160 ("While the court in *Beker* was concerned about the financial cost of a committee, the cost-benefit logic would seem to apply even where the 'costs' are intangible, such as the costs caused by a further delay in payment to 'innocent injured people, some of whom are survivors of deceased persons, whose recoveries have already been unduly delayed by the reorganization proceedings.'"). For example, in cases where there is some question regarding the existence of distributable value to equity, appointment of an Equity Committee may result in a relatively aggressive and protracted claims resolution process for the estate.

79 *See, e.g.*, LoPucki & Whitford, *supra* note 12, at 147-48; *Williams Commc'ns*, 281 B.R. at 223 (noting that "[f]urther delay is antithetical to an overarching need to preserve or enhance asset value. This is especially so where as here, the current market place is continually devaluing the type of assets under the debtor's umbrella.").

80 *See, e.g., Delphi Corp.*, Transcript of Hearing, March 22, 2006, Comments of Judge Drain, at 164 ("Courts, I believe, because of their experience of cases where equity committees were formed, where equity committees were inordinately litigious and active in such cases and ultimately obtained for their constituents what might charitably be described as a gift, that is, an inducement to go away through a

Accordingly, a bankruptcy court must decide whether the costs of an Equity Committee significantly outweigh the concern for adequate representation of shareholders (although it is unclear which party bears the burden of proof on this issue).[81] Irrespective of which party bears the burden of proof, this factor requires the court to employ a balancing test while keeping in mind the specific facts and circumstances of the case before it. Indeed, a court's consideration of this factor often becomes indistinguishable from the appointment inquiry generally, as the cost-benefit analysis in which courts engage often weighs the costs of appointment against, *e.g.*, the debtor's solvency and the ability of other constituencies to adequately promote equity's interests.[82]

5. *The Solvency of the Debtor*

The solvency/insolvency of the debtor's chapter 11 estate — *i.e.*, the factor most likely to determine whether the debtor will ultimately be able to provide a true payout (and not merely a "gift") to equity holders — plainly is the most important factor guiding a bankruptcy court's decision whether to appoint an Equity Committee.[83] Given the relative importance of this factor to appointment of

plan, have come to emphasize the point. It's discussed in some detail and with some candor in the *Wang Laboratories* decision …, in which Judge Hillman recognized the need not to legitimize what he called the, quote, 'blackmail factor' inherent in the presence of an equity committee.").

81 *Compare Beker*, 55 B.R. at 949 ("It thus appears that once the statutory tests are met, the burden shifts to the opponent of the motion to show that the cost of the additional committee sought significantly outweighs the concern for adequate representation and cannot be alleviated in other ways."), *with Allied Holdings*, 2007 WL 7138349, at *1 ("Proponents of an equity committee have the burden of proof to show that equity holders are not adequately represented and that the costs of the equity committee do not significantly outweigh the benefit.").

82 *See, e.g.*, *Williams Commc'ns*, 281 B.R. at 220 ("Essentially, the courts employ a balancing test to weigh the cost of an equity committee versus the 'concern for adequate representation.' In this analysis, the court may consider intangible costs, such as delay, . . . as well as examining whether the equity holders' interests are already being represented by other committees.") (internal citations omitted).

83 *See, e.g.*, *Nat'l R.V. Holdings*, 390 B.R. at 696 ("The principal issue on any motion for the appointment of an equity security holders' com-

Equity Committees, this article briefly examines (1) the evolving standards for determining the impact of solvency/insolvency upon the appointment decision, (2) the sundry factors that bankruptcy courts examine when analyzing solvency and (3) a recent case study illuminating the solvency inquiry.

a. The Impact of the Evolving Standards of Solvency Upon the Appointment Decision

(1) "Hopeless Insolvency"

Prior to 2002, the established legal standard directed bankruptcy courts to inquire into whether a debtor was "hopelessly insolvent"; *i.e.*, the inquiry was framed as a measure of the debtor's insolvency rather than a determination of whether value ultimately might be distributable to equity. Courts generally held that no Equity Committee would be appointed where it appeared that the debtor was "hopelessly insolvent, because neither the debtor nor the creditors should have to bear the expense of negotiating over the terms of what is in essence a gift" to equity security holders.[84]

mittee is whether the debtor is solvent or it appears likely that there will be a substantial return for equity."); *Ampex Corp.*, 2008 WL 2051128, at *1 ("The threshold issue is solvency. Where a debtor is clearly or 'hopelessly' insolvent and there is no expected recovery for equity then the appointment of an equity committee … is unwarranted."); *Allied Holdings*, 2007 WL 7138349, at *4. *But see Oneida*, 2006 WL 1288576, at *2 (after considering testimony on the solvency of the debtor, declining to make the appointment determination on that basis; focusing instead on unique facts of the case, including the lack of a unsecured creditors' committee, in finding that an Equity Committee was warranted).

84 *Emons Indus.*, 50 B.R. at 694; *see also Edison Bros. Stores*, 1996 WL 534853, at *2 (affirming bankruptcy court's decision to appoint an Equity Committee upon finding that there were numerous public shareholders, the case was complex and the debtor was not hopelessly insolvent); *Wang Labs.*, 149 B.R. at 3 (applying principle from *Emons* that, generally, no Equity Committee should be appointed when it appears that a debtor is hopelessly insolvent). *But see In re Mansfield Ferrous Castings, Inc.*, 96 B.R. 779, 781 (Bankr. N.D. Ohio 1988) (rejecting insolvency as barring appointment of Equity Committee, stating that the court must be guided by all the facts and not look exclusively at the issue of solvency).

(2) "Substantial Likelihood of Meaningful Distribution"

In *Williams Communications Group*, however, Judge Lifland shifted the emphasis of the solvency determination from a gauge of the debtor's current level of insolvency to an analysis of the value ultimately distributable to shareholders. Although the *Williams* court analyzed the request for appointment under the "hopelessly insolvent" standard and ultimately determined that "the Debtors *appear to be hopelessly insolvent*,"[85] in its conclusion, the court recast the analysis of a debtor's relative level of solvency/insolvency as an inquiry into whether "there is a substantial likelihood that [equity] will receive a meaningful distribution in the case under a strict application of the absolute priority rule."[86] *Williams* thus proposed a materially more demanding standard upon the appointment of Equity Committees: instead of merely having to show that a debtor is not hopelessly insolvent, proponents of an Equity Committee would bear the burden of demonstrating a "substantial" likelihood of a "meaningful" distribution to equity under a "strict" application of the absolute priority rule.

The *Williams* court's "substantial likelihood" standard was *sui generis* (the court cited to no authority in support of its announced standard) and perhaps even *dicta* (although the court proposed this standard, it arguably did not apply it). Nevertheless, this "substantial likelihood" standard for determining a debtor's solvency has been adopted by a number of courts[87] (albeit not to the exclusion of

85 *Williams Commc'ns*, 281 B.R at 220 (emphasis in original).

86 *Id.* at 223. Indeed, the *Williams* court also held that Equity Committees should not be appointed "unless equity holders establish that … they are unable to represent their interests in the bankruptcy case without an official committee." *Id.*

87 *See, e.g.*, *In re Regent Commc'ns, Inc.*, No. 10-10632, slip op. (Bankr. D. Del. Apr. 12, 2010) (Docket No. 224) at 2 (stating that, in deciding whether to appoint an Equity Committee, the court must consider "whether there is a substantial likelihood that shareholder[s] will receive a meaningful distribution"); *TLC Vision*, slip op. at 3 ("courts generally should deny a motion for appointment of an equity committee unless the proponents show by a preponderance of the evidence that 'there is a substantial likelihood that they will receive meaningful distribution in the case under a strict application of the absolute priority rule.'"); *Spansion*, 421 B.R. at 156 ("the moving party must show that … there is a substantial likelihood that they will receive a meaningful distribution in the case under a strict application of the absolute priority rule"; noting that, if equity holders have no

the "hopelessly insolvent" standard).[88] Some courts cite both standards, thus confusing the issue.[89]

b. Factors Relevant to Solvency Inquiry

Generally, the appointment of an Equity Committee is considered early in a chapter 11 case, when comprehensive analyses of a debtor's enterprise value are not likely to be available, and the cost, delay and administrative burden of conducting such valuations render courts reluctant to require them.[90] Nonetheless, courts can determine the solvency of a chapter 11 estate by reference to (and

reasonable prospect of receiving a meaningful distribution, they "could serve no legitimate role in negotiating a plan."); *Nat'l R.V.*, 390 B.R. at 696 (finding, despite the fact that the debtor's schedules suggested a return for equity, that a myriad of undetermined pending costs and claims suggested that "there is a substantial likelihood that the Debtors are insolvent and that equity security holders will not receive a meaningful distribution"); *Oneida*, 2006 WL 1288576, at *2 (stating that an Equity Committee should not be appointed "unless equity holders establish that … there is a substantial likelihood that they will receive a meaningful distribution in the case under a strict application of the absolute priority rule"); *Northwestern Corp.*, 2004 WL 1077913, at *1 (finding that the "substantial likelihood that [equity] will receive a meaningful distribution" test was not satisfied).

88 *See, e.g.*, *Pilgrim's Pride*, 407 B.R. at 217 n.15 ("Much of the authority suggests — and this court agrees — that appointment of an equity committee should be denied in cases where there is no doubt about the debtor's insolvency; in cases like the one at bar [where the evidence indicates that the debtor is not 'hopelessly insolvent'], the court should not disfavor equity."); *Ampex*, 2008 WL 2051128, at *1 ("Where a debtor is clearly or 'hopelessly' insolvent and there is no expected recovery for equity, then the appointment of an equity committee (and the imposition of the costs of such committee on the debtor) is unwarranted."); *Allied*, 2007 WL 7138349, at *1 ("proponents of an equity committee must show that the debtor is not 'hopelessly insolvent'").

89 *See Leap Wireless*, 295 B.R. at 139 (court determined that equity was out of the money after applying the hopelessly insolvent standard, but concluded with substantial likelihood language in holding that the appointment of an Equity Committee was not warranted at that time); *Exide Techs.*, 2002 WL 32332000, at *1 (stating that, in determining whether there is a substantial likelihood that equity holders will receive a meaningful distribution, the court should determine whether or not the debtor appears to be hopelessly insolvent).

90 *See* discussion of *Pilgrim's Pride* at note 75 *supra*.

the proponents and opponents of appointment can cite) sundry available measures: the debtor's financial statements, operating reports, schedules and/or filings with the United States Securities and Exchange Commission (the "*SEC*"); the postpetition trading of the debtor's shares for value (and the volume of such trading); the trading range of the debtor's publicly-traded debt; the debtor's market capitalization;[91] testimony regarding valuation (*e.g.*, from

[91] Two cases decided outside the equity committee context in which solvency was actually litigated — *Statutory Committee of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007) ("*Iridium*") and *VFB, LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007) ("*Vlasic*") — suggest that trading values and market capitalization — which offer a glimpse at a debtor's reorganization value at a time when conducting a full valuation may be unwarranted — may be crucial, and perhaps even dispositive, factors in determining an enterprise's solvency.

In *Iridium*, the official committee of unsecured creditors (the "*Iridium UCC*") brought an adversary proceeding on behalf of certain of the Iridium debtors seeking to avoid as fraudulent or preferential transfers certain prepetition payments received by Motorola from the debtors, thus necessitating a determination of the debtors' solvency. *Iridium*, 373 B.R. at 290-92. The Iridium court held that the contemporaneous market data for the debtors' publicly-traded securities — which reflected trading ranges indicative of substantial market value — were both consistent with substantial enterprise value and inconsistent with insolvency. *Id.* at 293. The court rejected the Iridium UCC's arguments — supported by expert valuation testimony predicated on a discounted cash flow analysis — that the "fundamental weaknesses" of the debtor companies were not fully understood by Wall Street and that the debtors had no reportable earnings. *Id.* at 292. The court stated that:

> [a]ny reader of the Wall Street Journal knows that the markets are risky and unpredictable and that share prices frequently are influenced by a variety of factors unrelated to the fundamentals and potential of a particular company. Nonetheless, the public trading market constitutes an impartial gauge of investor confidence and remains the best and most unbiased measure of fair market val-

experts or management);[92] and the need for exit financing to enable the debtor's reorganization. A court need not determine a debtor's

> ue and, when available to the Court, is the preferred standard of valuation.

Id. at 293. In particular, the court found the following evidence regarding the debtors' solvency persuasive: the debtors' stock still reflected positive enterprise value on the date of the bankruptcy filing; market capitalization during the relevant prepetition period indicated an equity valuation between $2.3 and $10 billion; and, in the years prior to the bankruptcy filing, equity underwriters assessed the debtor companies and believed them to have a high positive equity value, allowing the debtors to close three syndicated bank loans and raise over $2 billion in the capital markets. *Id.* at 304, 332, 334, 349.

In *Vlasic*, the successor in interest to the legal claims of the debtor, Vlasic Foods International ("*VFI*"), brought a fraudulent transfer action against the Campbell Soup Company ("*Campbell*") seeking to set aside the transaction pursuant to which Campbell had sold its Vlasic and Swanson food companies to a newly-incorporated subsidiary (*i.e.*, VFI) in exchange for $500 million of borrowed cash and then spun-off VFI's stock to Campbell's shareholders. Within three years of the transaction, VFI filed for bankruptcy and sold Vlasic and Swanson for less than $500 million. *Vlasic*, 482 F.3d at 624-27. To prove its fraudulent transfer claim, the plaintiff was obliged to demonstrate that VFI was insolvent at the time of the transaction. The Third Circuit affirmed the lower court's reliance on the objective evidence of the price of VFI's stock and its market capitalization in determining the solvency of VFI and stated that earnings projections "must be tested by an objective standard anchored in [a] company's actual performance" and that market capitalization is a "classic example of such an anchored projection, as it reflects all the information that is publicly available about a company at the relevant time of valuation…. Absent some reason to distrust it, the market price is a 'more reliable measure of the stock's value than subjective estimates of one or two expert witnesses.'" *Id.* at 631-33.

92 *See, e.g.*, *Spansion*, 421 B.R. at 157 (court held that movants did not sustain their burden of demonstrating that there was a substantial likelihood that equity would receive a distribution where the debtors, in opposing the appointment of an Equity Committee, argued that their insolvency had been shown throughout the case, first in their schedules and later in their disclosure statement, which included an analysis of the debtors' reorganized value); *Regents*, slip op. at 3 (court denied appointment of Equity Committee after hearing expert testimony based on a valuation that included the "accepted consider-

reorganization value in connection with a request for the appointment of an Equity Committee; the court can reach a "practical conclusion, based on a confluence of factors" regarding a debtor's solvency in the context of a request to appoint an Equity Committee.[93]

ations, i.e., comparables, discounted cash flow and precedent transactions which [the expert] utilized in determining valuation."); *Pilgrim's Pride*, 407 B.R. at 217 (court considered testimony from the debtors' chief restructuring officer, the values provided in debtors' schedules and public filings and the debtors' operating reports; while acknowledging that such values may prove illusory, the court held that the testimony and all but the most recent operating report indicated solvency); *Nat'l R.V.*, 390 B.R. at 697 (in the context of a liquidating chapter 11 debtor, court held that there was no evidence that the debtors' collection of accounts receivable and liquidation of its inventory and other assets would put equity in the money); *Ampex*, 2008 WL 2051128, at *2 (court compared enterprise value submitted by the debtors to the amount of claims filed against the debtors' estates, plus administrative claims, priority claims, professional fees and future pension obligations, and concluded that, cumulatively, this information indicated that the debtors were insolvent); *Oneida*, 2006 WL 1288576, at *2 (after hearing extensive and conflicting testimony on value, court reserved the solvency determination for the confirmation hearing but appointed an Equity Committee nonetheless); *Leap Wireless*, 295 B.R. at 139 (court determined that debtor appeared to be hopelessly insolvent after considering expert's testimony that equity was out of the money and the fact that the debtor's bonds were trading at a steep discount); *Exide*, 2002 WL 32332000, at *2 (holding that bankruptcy court did not err in relying on credible expert evidence of equity value of the debtors on a cash flow basis); *Williams Commc'ns*, 281 B.R. at 220-21 (court determined that debtors appeared to be hopelessly insolvent after considering the debtors' balance sheet as of the petition date, the fact that the debtors' publicly-held bonds were trading at a steep discount, the fact that there was no cash distribution under the proposed plan of reorganization and the debtor's need for exit financing to fund its reorganization); *Wang Labs.*, 149 B.R. at 3 (proponents of Equity Committee pointed to the fact that the shares of the debtor had value because they were still trading at a value in excess of zero, while opponents pointed out that the publicly-traded debt was selling at a steep discount; court decided it could not determine which definition of insolvency was appropriate, but held that debtor was not hopelessly insolvent because debtor remained in operation).

93 *Williams Commc'ns*, 281 B.R. at 221 ("This court has made a determination that [the Debtors] appear to be hopelessly insolvent based on

Regardless of the exact method used to determine solvency, "the result will 'rarely, if ever, be without doubt or variation'."[94]

c. Comparison of Appointment Decisions By Circuit

Courts within more than half of the United States Courts of Appeal have considered the issue of appointing an Equity Committee. Courts within the Fourth, Sixth, Seventh, Eighth and Tenth Circuits, however, have not addressed this issue.[95] Although the inquiry is fact-intensive and within each court's discretion, consideration of the different factors upon which courts in various Circuits choose to focus promotes an understanding of what future courts will consider in making their appointment decisions.

(1) First Circuit

Two bankruptcy courts within the First Circuit have considered an application for the appointment of an Equity Committee in a chapter 11 case. In the most detailed opinion, *Wang Laboratories*,[96] the bankruptcy court considered (A) the solvency of the corporation (adopting a "hopeless insolvency" standard), (B) the number of shareholders, (C) the complexity of the case and (D) the cost of the Equity Committee as balanced against the value of its appointment.[97] The bankruptcy court ultimately determined that the appointment of an Equity Committee was warranted.[98]

By contrast, in *Public Services of New Hampshire*, the United States Bankruptcy Court for the District of New Hampshire consi-

many different factors. The Debtors' balance sheet and market value were two such factors, but so are the host of other indicia of the Debtors' financial health…. In short, this Court has not made a valuation, nor is one necessary at this stage.").

94 *Vlasic*, 482 F.3d at 633 ("Regardless of the method used [to determine whether a debtor appears to be hopelessly insolvent], the result will 'rarely, if ever, be without doubt or variation.'") (quoting *Collier* at ¶ 1129.06[3]).

95 Within the Sixth Circuit, the United States Bankruptcy Court for the Southern District of Ohio has issued an opinion appointing an Equity Committee. However, the bankruptcy court ordered the appointment without elaborating on the basis for its decision. *See In re Baldwin-United Corp.*, 45 B.R. 375, 376-77 (Bankr. S.D. Ohio 1983).

96 *Wang Labs.*, 149 B.R. at 3.

97 *Id*. at 6.

98 *Id*. at 10.

dered only the timing of the movant's application.[99] The bankruptcy court held that the application, which was filed after the approval of the disclosure statement, would delay and disrupt the confirmation process and, therefore, appointment was not warranted.[100]

(2) Second Circuit

Courts within the Second Circuit for the United States Court of Appeals have frequently considered the appointment of an Equity Committee. Specifically, the United States Bankruptcy Court and United States District Court for the Southern District of New York have issued several opinions on the topic and commonly rely heavily on the debtor's solvency/insolvency as the most significant factor impacting the appointment of Equity Committees.

In *Johns-Manville*, the district court considered (A) the number of shareholders, (B) the complexity of the case, (C) the cost of an Equity Committee as balanced against the need for adequate representation and (D) the timing of the application.[101] Ultimately, the district court held that the application was made too late in the case and that appointment of an Equity Committee would serve only to delay the confirmation of the plan.[102]

The United States Bankruptcy Court for the Southern District of New York has issued several recent opinions on the appointment of Equity Committees. Each of these recent opinions focuses heavily on the solvency of the debtor.[103] In *Williams Communications* and *Oneida*, the bankruptcy courts focused on the debtor's solvency, and denied the appointment in *Williams* and granted the appointment in *Oneida*.[104] In *Ampex*, the bankruptcy court declared the sol-

99 *Public Servs. of N.H.*, 116 B.R. at 344.

100 *Id*. at 345.

101 *Johns-Manville Corp.*, 68 B.R. at 159, 164.

102 *Id*.

103 *See Williams Commc'ns*, 281 B.R. at 221; *Oneida*, 2006 WL 1288576, at *1-2.

104 *Id*. In *Williams*, based on numerous facts, the bankruptcy court determined the debtor was hopelessly insolvent. In *Oneida*, the bankruptcy court held after lengthy consideration of the factor that it could not reach a final determination and appointed an Equity Committee in light of other, unique facts (including the lack of a creditors' committee).

vency factor to be a "threshold inquiry."[105] The court also considered the number of shareholders and the complexity of the chapter 11 case.[106] Following an analysis of the proposed payout on account of claims senior to equity and the current value of the debtor, the bankruptcy court determined that equity holders likely would not receive any distribution and, therefore, appointment was unwarranted.[107]

(3) Third Circuit

While cases decided by the United States Bankruptcy Court for the District of Delaware focus heavily on the insolvency factor, they appear more inclined than courts within the Southern District of New York to consider additional factors. For example, in *Etoys*, the bankruptcy court exclusively considered the timing of the application — made post-confirmation and, thus, much too late — in reaching its decision.[108] Similarly, in *Spansion*, while the bankruptcy court focused on the solvency of the debtor, it placed a significant amount of emphasis on the parties' relative burdens of proof.[109] After a lengthy discussion of multiple valuation theories, the bankruptcy court ultimately determined that it was uncertain of the proper valuation of the corporation.[110] In light of this uncertainty regarding valuation, the bankruptcy court held that the equity security holders had not met their burden of proving they had a substantial likelihood of a meaningful return and, thus, appointment of an Equity Committee was denied.[111]

In *Kalvar Microfilm*, while the bankruptcy court primarily focused on the debtor's insolvency, it also considered numerous additional factors, including case complexity, the extent to which the debtor's shares were widely held and whether the cost of an Equity Committee significantly outweighed the concerns for adequate re-

105 *Ampex*, 2008 WL 2051128, at *1.

106 *Id*. at *2.

107 *Id*. at *2-3.

108 *Etoys, Inc.*, 331 B.R. at 186.

109 *Spansion*, 421 B.R. at 164.

110 *Id*. at 163 (holding "the only thing certain from the record before me is the uncertainty of the proffered valuation.").

111 *Id*. ("The Ad Hoc Equity Committee has the burden of proving a substantial likelihood that equity security holders will receive a distribution from the Debtors, but this record does not support such a conclusion.").

presentation.[112] While the bankruptcy court ultimately determined that a good faith dispute existed as to the valuation of the debtor, the other factors weighed against the appointment of the Equity Committee, which was denied.[113]

In reviewing two bankruptcy court decisions — *Exide* and *Edison Brothers Stores* — addressing the appointment of Equity Committees, the United States District Court for the District of Delaware relied heavily on the abuse of discretion standard in upholding the bankruptcy courts' decisions.[114] The Court noted that, given the significant discretion allotted to courts in appointing official committees, "different judges would employ their discretion differently when faced" with similar facts of record.[115]

(4) Fifth Circuit

Only one court within the Fifth Circuit for the United States Court of Appeals has addressed the appointment of an Equity Committee. In *Pilgrim's Pride*, the United States Bankruptcy Court for the Northern District of Texas looked to recent case law and considered the following factors: (A) whether the debtors likely were solvent; (B) the complexity of the debtors' cases; and (C) the likely cost to the debtors' estates of an Equity Committee.[116] Unlike the cases from within the Second and Third Circuit Courts of Appeals, the bankruptcy court seemed to place equal weight on each factor, ultimately determining that appointment was warranted.[117]

(5) Ninth Circuit

There have been two significant opinions on Equity Committee appointments issued within the Ninth Circuit. In *National RV Holdings* and *Leap Wireless*, the bankruptcy courts placed great significance on the solvency of the corporation, with both courts adopting the "substantial likelihood of a meaningful distribution" standard.[118] However, in *Leap Wireless*, the bankruptcy court clarified that courts should also consider whether the debtors *appear* hope-

112 *Kalvar Microfilm*, 195 B.R. at 600-01.

113 *Id*. at 601.

114 *See Exide Techs.*, 2002 WL 32332000, at *1; *In re Edison Bros.*, 1996 WL 534853, at *2-3.

115 *Exide Techs.*, 2002 WL 32332000, at *2.

116 *Pilgrim's Pride*, 407 B.R. at 216.

117 *Id*. at 216-22.

118 *Nat'l R.V. Holdings*, 390 B.R. at 696; *Leap Wireless*, 295 B.R. at 139.

lessly insolvent.[119] The *Leap Wireless* court held that, despite conflicting valuation testimony, it appeared that the debtor was insolvent and denied the appointment of an Equity Committee.[120]

(6) Eleventh Circuit

There has only been one opinion issued by a court within the Eleventh Circuit that touched upon appointment. In *Allied Holdings*, the bankruptcy court essentially deemed its inquiry into adequate representation to be a threshold consideration; *i.e.*, if the Equity Committee proponents failed to demonstrate the need for adequate representation, the further consideration of other appointment factors (including solvency) would be rendered unnecessary.[121] Similar to the court in *Spansion*, the bankruptcy court emphasized that it was the equity holders' burden to prove they were not adequately represented in the bankruptcy case.[122] The bankruptcy court held that the petitioning equity holders failed to meet that burden where the movants presented no evidence that the benefits of an Equity Committee would outweigh the costs and, therefore, the court did not need to decide whether the debtor was hopelessly insolvent.[123]

d. Recent Case Study Regarding Solvency Inquiry: *In re General Growth Properties, Inc.*

In re General Growth Properties, No. 09-11977 (Bankr. S.D.N.Y. 2009) (ALG), presents a useful case study for the practical application of the legal standards discussed above. General Growth Properties, Inc. ("*GGP*") and 359 of its subsidiaries and affiliates (collectively, the "*GGP Debtors*") filed their chapter 11 cases in the Southern District of New York on April 16, 2009. At the time that the petitions were filed, GGP, a publicly-traded real estate investment trust, was the second largest operator of malls in the United States and the ultimate parent of approximately 750 wholly-owned debtor and non-debtor subsidiaries, joint venture subsidiaries and affiliates, through which it owned and managed approximately 200 shopping centers in 44 states. GGP's business model relied on a significant amount of financing and was entirely dependent upon

119 *Leap Wireless*, 295 B.R. at 139.

120 *Id*. at 139-40.

121 *Allied Holdings*, 2007 WL 7138349, at *2-3.

122 *Id*. at *2.

123 *Id*. at *3.

its ability to refinance its various mortgage loans. When the 2008 credit crisis spread to commercial real estate finance, GGP found itself unable to refinance a number of multi-billion dollar loans with near-term maturities. Unable to refinance and with increasing liquidity problems, GGP defaulted on several of its loans, and the GGP Debtors ultimately sought protection in bankruptcy court.

About five months into the GGP bankruptcy, the U.S. Trustee appointed, pursuant to section 1102(a)(1) of the Bankruptcy Code, an Equity Committee. A review of the factors governing appointment of Equity Committees indicates that the U.S. Trustee's appointment decision was reasonably well founded at the time. On its Petition Date, GGP had over 312 million shares of common stock outstanding, with approximately 51% of those shares held by investors with more than a 7% interest in the company.[124] The GGP Debtors' corporate and capital structures were "extraordinarily complex," with the capital structure consisting of three tranches of secured debt (conventional mortgage debt, commercial mortgage-backed securities and mezzanine debt), various forms of unsecured debt and other debt.[125] Though the Equity Committee was not appointed until approximately five months after the Petition Date, there remained plenty of negotiating left with respect to GGP's eventual plan of reorganization (the exclusivity period for which had been extended until February 26, 2010) such that an Equity Committee would be able to serve its primary function of adequately representing equity holders in the process of negotiating GGP's plan.

As of December 31, 2008, the GGP Debtors' consolidated balance sheet reported $29.6 billion in assets and $27.3 billion in liabilities, thus indicating the possibility of some recovery for equity.[126] However, following the filing of GGP's bankruptcy petition, GGP's share price declined to well under $1.00 (*e.g.*, GGP closed at $0.60 on its petition date), and there were simmering disputes regarding whether the equity holders of GGP were likely to obtain a distribu-

124 *In re Gen. Growth Props., Inc.*, No. 09-11977, slip op. at 13 (Bankr. S.D.N.Y. Aug. 11, 2009) (Docket No. 1284).

125 *Id.* at 5-13.

126 *Id.* at 6. In GGP's Form 10-Q filed with the SEC for the first quarter of 2009 (its most recent SEC filing prior to the bankruptcy filing), the GGP Debtors reported $28.9 billion in assets, approximately $27 billion in liabilities and roughly $1.77 billion in stockholders' equity.

tion in GGP's reorganization in the months preceding the U.S. Trustee's appointment.[127] As of the date of the Equity Committee's appointment, however, GGP's market capitalization had increased dramatically, rising from $189 million as of the petition date to approximately $840 million on the appointment date.

Ultimately, GGP accepted multiple, non-financing-contingent offers for substantial equity investments in the company that promised substantial recoveries for equity (*i.e.*, 32.4% of the equity in reorganized GGP and 86.1% of the equity in a spun-off company), which offers formed the basis for GGP's proposed plan of reorganization (the "*GGP Plan*").[128] The GGP Plan was confirmed by an order entered on October 21, 2010 (Docket No. 6240). The propriety of appointing GGP's Equity Committee has become progressively more obvious over time; as of the date of confirmation of the GGP Plan, the market capitalization of GGP stood at approximately $4.26 billion. As of February 15, 2011, the market capitalization had increased to approximately $4.88 billion.

D. United States Trustee's Policies on the Appointment of an Equity Committee

The Office of the U.S. Trustee briefly discusses the appointment of Equity Committees in its manual (the "*Manual*").[129] The U.S. Trustee draws from relevant cases from across the country in stating the factors it will consider with respect to appointment, including: (1) whether the debtor is hopelessly insolvent; (2) whether the debtor's stock is publicly traded and widely held; (3) whether a case is complex (financially as compared with operationally); (4) the timeliness of the request for the Equity Committee; (5) additional cost to the debtor's estate; and (6) alternative sources of adequate representation.

127 *See, e.g.*, "The battle over GGP valuation," available at http://www.notananalyst.com/2010/01/30/the-battle-over-ggp-valuation/ (noting that hedge fund Hovde Capital was highly critical of the claims made by a major shareholder of GGP regarding the ability of equity to obtain a distribution in GGP's chapter 11 case).

128 *See* Disclosure Statement for Plan Debtors' Third Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, dated August 27, 2010 (Docket No. 5865) (the "*GGP Disclosure Statement*"), at pages 1-2, 7.

129 *See* United States Trustee's Manual, Volume 3: Chapter 11 Case Administration, Section 3-4.6.

The Bankruptcy Code provides that an Equity Committee will ordinarily consist of the holders of the seven largest amounts of equity securities in the debtor.[130] In choosing a committee, the Manual provides that the U.S. Trustee should inquire whether "the holders acquired their interest before or after the commencement of the case."[131] The Manual provides that, if an equity interest is acquired postpetition, the holder may be a "'speculator' and potentially afforded different treatment under a plan."[132] Therefore, the U.S. Trustee has determined that placements of possible speculators on Equity Committees may be inappropriate and "this circumstance should be considered … in making the appointment."[133]

Interviews with individuals recently departed from the Office of the U.S. Trustee (the "*Office*") reveal that the Office does not maintain a formal written policy with respect to the appointment and creation of an Equity Committee. However, the interviewees indicate that the Office operates under several guiding principles. First, the Office attempts to determine whether the debtor's circumstances offer any meaningful opportunity for return to equity holders. Evaluating this first question, the Office starts with the debtor's schedules and statements and, if the debtor is a public company, the related SEC filings, including its Forms 10-Q and 10-K. The Office seeks to avoid wasting estate assets where there is no meaningful opportunity for returns to equity holders. Second, the Office attempts to determine whether or not equity interests are adequately represented in some fashion by parties already active in the bankruptcy case — *e.g.*, whether the debtor in possession itself provides adequate representation for the interests of equity holders. In this regard, the Office will evaluate whether the board includes the original directors from the petition date. Furthermore, the Office operates under a presumption that the debtor in possession is adequately representing the interests of equity until there are indications to the contrary. The Office will further evaluate the landscape of the case to determine whether other large equity interests are active in the case and have the wherewithal to represent the interests of equity on their own. Likewise, an *ad hoc* committee of

130 11 U.S.C. § 1102(b)(2).

131 United States Trustee's Manual, Volume 3: Chapter 11 Case Administration, Section 3-4.6, at 64.

132 *Id*.

133 *Id*.

equity that is functioning effectively may satisfy the Office that equity interests are adequately represented and the appointment of an official committee unnecessary.

Finally, if the Office determines that there is potential for value for the equity holders and that no one is adequately protecting the equity holders, the Office considers whether enough equity holders are sufficiently motivated to serve on an Equity Committee. Ultimately, if the Office determines that (1) there is the potential for a return to equity holders, (2) there are holders of equity willing to serve on a committee and (3) no other interest is adequately representing interests of equity, than the Office may proceed with the process of appointing an Equity Committee.

E. Are Shareholders' Interests Otherwise Being Adequately Represented?

1. *The Statutory Purpose of an Equity Committee*

As noted above, in the 1978 recodification of the bankruptcy laws, Congress expressed concern for the treatment of equity holders during the chapter 11 process, especially with respect to how losses were to be apportioned between creditors and stockholders when a large public company reorganized under the bankruptcy laws.[134] Equity committees were created to promote fairer, more equitable reorganizations that would give public investors a chance to conserve the value that corporate insolvency had jeopardized.[135] While Congress enacted legislation with a mandate to protect "vulnerable" investors, the courts were left to determine how best to implement such protection.

Since the enactment of the Bankruptcy Code, courts have generally appointed Equity Committees in one of two circumstances: (a) when the company is not "hopelessly" insolvent[136] and, thus, investors have some bargaining power and ability to realize some form of return on their investment; and (b) when it appears that the interests of equity holders are not being adequately represented by the debtor's board of directors (or equivalent) (the "*Board*") or the debtor's principals. The question of whether shareholders' interests are adequately represented in chapter 11 reorganizations requires

134 *See* Section I *supra*.

135 S. REP. NO. 95-989, at 10 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5796.

136 For a more detailed discussion of the issue of "hopeless" insolvency, see, *supra* Section II.C.5.

an examination of, among other things, (a) the competing loyalties of a Board when a company teeters near insolvency, (b) the propriety of a Board's conduct and (c) the potential for an Equity Committee to (1) level the negotiating playing field or (2) address potential defalcations by management without appointing a chapter 11 trustee and, thus, avoid certain negative consequences attendant upon a trustee's appointment (*e.g.*, termination of exclusivity; potential loss of attorney-client privilege; loss of valuable customer and supplier relationships).

2. *The Board's Duties Prior to and During the Bankruptcy*

a. Fiduciary Duties and Conflicting Interests

Generally, in a solvent corporation, the directors owe fiduciary duties of loyalty and care to the corporation and its shareholders.[137] Once a corporation approaches insolvency, however, the question arises whether a Board's fiduciary duties shift to creditors (*i.e.*, the residual owners of an insolvent entity) from shareholders. Recent Delaware cases hold that due to creditors' unique ability to enforce their rights directly through contractual and other claims,[138] directors and officers must continue to manage a corporation for the benefit of the corporation and its shareholders.[139] However, in addition to exercising their best business judgment in operating the business for the benefit of shareholders, directors and officers of insolvent entities may also be charged with operating the business for the benefit of additional constituencies as well.[140]

The competing interests of creditors and shareholders that arise as a corporation enters bankruptcy and becomes a "debtor in possession" or "DIP" can complicate a DIP's fulfillment of its fidu-

137 *See, e.g.*, *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A. 2d. 168, 201 (Del. Ch. 2006).

138 *See*, *e.g.*, *Gheewalla*, 930 A.2d at 99. For a more in depth discussion of *Gheewalla*, *see* Section II.E.2.b *infra* and accompanying discussion.

139 *Id.* at 101.

140 Therefore, at this juncture, the inquiry becomes who can enforce rights and remedies against the corporation's directors and officers: creditors or shareholders through a derivative action. *See generally*, *Gheewalla*, 930 A.2d at 99-101; *see also CML V, LLC v. Bax*, 6 A.3d 238, 240-41 (Del. Ch. 2010) (discussing *Gheewalla* and whether creditors of an insolvent limited liability company may pursue derivative claims, as opposed to direct claims, for breach of fiduciary duty).

ciary duties. The legislative history of the Bankruptcy Code and pronouncements of the Supreme Court of the United States make it clear that the officers and directors of a DIP bear essentially the same fiduciary obligation to creditors and shareholders as a trustee.[141] In *Commodity Futures Trading Commission v. Weintraub*, the Supreme Court said:

> Respondents also ignore that if a debtor remains in possession —that is, if a trustee is not appointed — the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession. *Wolf v. Weinstein,* 372 U.S. 633, 649-652, 83 S. Ct. 969, 979-981, 10 L. Ed. 2d 33 (1963). Indeed, the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'[142]

Thus, the officers and directors operating and managing the DIP are obligated to operate the debtor's business so as to protect and conserve property in its possession for the benefit of the entire estate — creditors and shareholders.[143]

141 In their remarks relating to section 1107(a) of the Bankruptcy Code, the sponsors stated:

> This section places a debtor in possession in the shoes of a trustee in every way. The debtor is given the rights and powers of a chapter 11 trustee. He is required to perform the functions and duties of a chapter 11 trustee (except the investigative duties). He is also subject to any limitations on a chapter 11 trustee, and to such other limitations and conditions as the court prescribes.

H.R. Rep. No. 95-595, at 367 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6360; S. Rep. No. 95-898, at 113, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5902. The Supreme Court has addressed the issue of the fiduciary obligations of the debtor in possession under old Chapter X of the Chandler Act, *Wolf v. Weinstein*, 372 U.S. 633, 644, 649-51 (1963), and the present Bankruptcy Code, *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985).

142 *Weintraub*, 471 U.S. at 355.

143 A debtor in possession has the duty to protect and conserve the property in its possession for the benefit of creditors. *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 461 (6th Cir. 1982); *In re Microwave Prods. of Am., Inc.,* 102 B.R. 666, 671 (Bankr. W.D. Tenn. 1989); *In re Sharon Steel Corp.*, 86 B.R. 455, 457 (Bankr. W.D. Pa. 1988); *In re Parker*

b. Courts' Clarifications Regarding the Board's Duties and Shareholders' Rights in Insolvency

In *Gheewalla*, the Delaware Supreme Court provided clear guidance on the question of whether officers and directors of an insolvent corporation owed fiduciary duties directly to that corporation's creditors. In *Gheewalla*, a creditor of a Delaware corporation brought direct claims for breach of fiduciary duty against three of the corporation's directors.[144] The complaint alleged that the three directors exercised their control of the company to favor an investment banking firm in violation of their fiduciary duties.[145] The directors moved to dismiss for failure to state a claim.[146]

The Delaware Supreme Court held that creditors of an insolvent company may not assert a direct claim against directors and managers for breach of fiduciary duty.[147] Rather, the Delaware Supreme Court reasoned that creditors, who are better postured to protect their interests, are protected through "contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights."[148] As a result, under Delaware law, directors continue to "owe their fiduciary obligations

Grande Dev., Inc., 64 B.R. 557, 561 (Bankr. S.D. Ind. 1986). Although section 1108 of the Bankruptcy Code is permissive ("the trustee may operate the debtor's business"), "the trustee is nevertheless under an affirmative duty to operate the business if such operation is necessary to preserve the value of the estate. Conversely, the trustee has a duty to cease operations where continued operations will deplete the debtor's estate with no reasonable prospects of rehabilitation." 5 *Collier on Bankruptcy* ¶ 1106.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010). Furthermore, the "courtroom is not a boardroom," and the court will not interfere with "a trustee's conduct of the estate where that conduct involves a business judgment made in good faith, upon a reasonable basis, and within the scope of his authority under the Code." *In re Curlew Valley Assocs.*, 14 B.R. 506, 513-14 (Bankr. D. Utah 1981); *see also In re Simasko Prods. Co.*, 47 B.R. 444, 449 (Bankr. D. Colo. 1985).

144 *Gheewalla*, 930 A.2d at 94.

145 *Id.*

146 *Id.*

147 *Id.*

148 *Id.* at 99.

to the corporation and its shareholders."[149] Therefore, "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[150]

As an analytical model, *Gheewalla* addresses the issue of a Board's fiduciary duties in the face of creditors' and shareholders' competing interests through the prism of the principles of corporate governance. A Board does not have a direct fiduciary duty to unsecured creditors; rather, a Board is required to act in a manner consistent with the interests of the corporation and to maximize the value of the enterprise.[151] Thus, the *Gheewalla* court hearkened back to Chancellor Allen's famous footnote 55 in *Credit Lyonnais*[152] in which Chancellor Allen viewed insolvency as a shield from shareholder claims rather than a sword to be wielded by creditors.

Further, the *Gheewalla* court recognized the continued vitality of the usual protections of corporate law for the Board of an insolvent corporation, including statutory exculpation protections and the business judgment rule. Indeed, the loss of such protections in the event of insolvency may well incentivize a Board to terminate a business' operations prematurely to avoid future liability. As noted by Judge Bernstein in the *Global Service Group* case,[153] the law does not require that, upon insolvency (or the entry into the so-called "zone of insolvency"), a Board shut down a business' operations to avoid personal liability. Rather, the Board may, consistent with its business judgment, continue operations in an attempt to revive the flagging financial affairs of the corporation.[154]

Courts generally preserve these corporate governance rights in bankruptcy, which can afford equity holders a chance to oust management that equity perceives as acting contrary to its interests; *i.e.*,

149 *Id.*

150 *Id.* at 101.

151 *See generally CML*, 6 A.3d at 238; *Gheewalla*, 930 A.2d at 92.

152 *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. Civ. A. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

153 *Kittay v. Atl. Bank (In re Global Service Grp., LLC)*, 316 B.R. 451, 460-61 (Bankr. S.D.N.Y. 2004).

154 *See Gheewalla*, 930 A.2d at 103.

management that does not adequately represent the interests of shareholders. For example, in *Manville Corp. v. Equity Security Holders Committee (In re Johns-Manville Corp.)*,[155] the debtor conducted intense negotiations with various constituents while formulating its plan of reorganization. Ultimately, the debtor put forth a plan that would have diluted existing equity by approximately ninety percent (90%).[156] Equity holders, through an Equity Committee, filed an action in Delaware state court to compel the debtor to hold a shareholders meeting so that they could elect a new board of directors.[157]

The debtor sought and received an injunction from the bankruptcy court prohibiting the Equity Committee from pursuing the Delaware action on the theory that it unduly obstructed the debtor's reorganization.[158] The Second Circuit remanded to the bankruptcy court with instructions that the Equity Committee's right to call a meeting should not be impaired unless the committee was guilty of "clear abuse" in attempting to call such a meeting.[159] On remand, the bankruptcy court enjoined the committee from calling a shareholder's meeting.[160]

While the Equity Committee was unsuccessful in its attempt to remove allegedly biased management in *Manville*, the Second Circuit's preservation of corporate governance rights is consistent with the Bankruptcy Code's statutory mandate of ensuring the adequate representation of shareholders and protecting equity throughout the turbulent bankruptcy process. In preserving what some may view as the "nuclear option for equity holders," *Manville* demonstrates the power of the bankruptcy court to balance — and the role of Equity Committees in balancing — the competing interests of constituencies in the context of the plan process. *Manville* also recognized, however, that, when the debtor is solvent, courts will not permit shareholders or Equity Committees to leverage their governance rights to destroy the value created through the

155 801 F.2d 60 (2d Cir. 1986).

156 *Id.* at 62.

157 *Id.*

158 *Id.*

159 *Id.* at 69.

160 *Manville Corp. v. Equity Sec. Holders Committee (In re Johns-Manville Corp.)*, 66 B.R. 517, 542 (Bankr. S.D.N.Y. 1986).

hard-fought negotiation leading to a proposed plan of reorganization.

c. Scenarios in Which Courts Have Appointed an Equity Committee Where Courts Have Determined That Management and the Board Are Not Protecting Shareholders' Interests

Courts have identified numerous circumstances under which the inability of a corporation's Board and/or officers to adequately represent shareholders warrants the appointment of an Equity Committee even though equity is clearly "out of the money." For example, where it is clear that there is no mechanism of checks and balances to evaluate the propriety of a Board's actions, the appointment of an Equity Committee is an appropriate remedy to protect investors. In *Oneida*, an *ad hoc* committee of equity security holders moved for the appointment of an Equity Committee despite having previously been denied by the United States Trustee. In *Oneida*, the bankruptcy court eschewed an inquiry into the debtor's solvency and determined as a threshold matter that the *ad hoc* committee had met its burden of demonstrating the necessity of an Equity Committee where the "unusual (perhaps unique) circumstances" prevailing in that case demonstrated the absence of adequate representation.[161]

The "unique circumstances" cited by the court involved a two stage financial restructuring of the debtors. In the first stage (effected prior to the filing of the debtors' cases), the debtors' lenders received sixty-two (62%) of the debtors' equity and the right to elect six of the debtors' nine directors (which right it exercised). In the second stage, this subsequent Board endorsed a plan of reorganization that wiped out old equity and allocated all of the equity of the reorganized company to those lenders not being paid in full.[162] Due to the unique nature of this two stage restructuring, the "usual presumption that the Board w[ould] pay due (perhaps special) regard to the interests of the shareholders [may have been]

161 *Oneida*, 2006 WL 1288576, at *2. With regard to the solvency issue, the court declined to make a ruling on the motion to appoint an Equity Committee because to do so in the face of conflicting evidence on valuation would be "unduly prejudicial to all parties." *Id.* Therefore, the court reserved the issue of solvency for a confirmation hearing. *Id.*

162 *Id.*

unrealistic."[163] While the court acknowledged that it had no reason to believe the Oneida board acted inconsistently with its fiduciary duties during either stage of the restructuring, it could not be disputed that "certain of the checks and balances" were not present.[164] Thus, *Oneida* demonstrates that, even where the evidence would suggest that a Board has acted consistently with its fiduciary duties, the absence of any systemic checks and balances upon its actions nevertheless justifies the appointment of an Equity Committee to protect investors.

Additionally, where it is clear that the financial interests of certain members of a debtor's Board are intertwined with the operations and fortunes of the debtor, an Equity Committee is an appropriate mechanism through which to protect shareholders. In *Pilgrims' Pride*, the *ad hoc* committee of equity holders moved for an order directing the appointment of an official Equity Committee. The unsecured creditors' committee and lenders of the debtors argued that equity was adequately protected by a partially-insider board. In contrast, the proponents of the Equity Committee insisted that insider directors wore "too many hats"— as creditor, guarantor of the debtors' bank debt and the debtors' contractual counterparty — to adequately represent the interests of shareholders. The court, agreeing with the Equity Committee proponents, recognized that, due to the personal interests of certain directors (which directors stood to benefit from a plan of reorganization that preserved the debtors as going concerns and, thus, were inclined to support a conservative valuation of the debtors preferred by creditors to gain their support for such a plan), the Board was not in a position to "press equity's case very hard."[165] Because the Board could not adequately represent shareholders' interests due to their insider interests, the court found value in appointing an Equity Committee that could vigorously advocate on behalf of equity.[166]

Moreover, the *Pilgrim's Pride* court viewed the fact that at least one of the insider directors was specifically named as a defendant in three actions involving the equity securities of the debtor as additional evidence that the current board could not adequately

163 *Id.*

164 *Id.*

165 *Id.* at 219-20.

166 *Id.* at 220.

represent equity.[167] While the court did not elaborate on how these actions negatively impacted management's ability to represent equity's interests, the presence of securities actions with allegations premised on corporate malfeasance or misfeasance could "taint" management in a manner that would support the appointment of an Equity Committee.

Courts have also determined that corporate inaction and failures of disclosure similarly may justify the appointment of Equity Committees. In *In re Interstate Bakeries Corporation*,[168] prior to filing for bankruptcy protection, the debtors had consistently filed public financial information that demonstrated that the companies had substantial shareholder equity. However, by the time of the filing of the debtors' schedules, that substantial equity cushion had disappeared. In a brief[169] supporting the motion[170] of an *ad hoc* equity committee for the appointment of an official Equity Committee, the SEC noted that the debtors were delinquent in filing their Form 10-K for the year 2004 (the same year in which they filed for bankruptcy protection).[171] While the SEC noted that the failure to file such report made it impossible to determine whether or not equity was "in the money," more important was that the debtors' failure to provide current financial information created substantial uncertainty as to its current financial health, which itself warranted the appointment of an Equity Committee.[172]

As the SEC noted, it was the "uncertainty surrounding the [debtor's] financial condition as a result of its public filings" that gave rise to the appointment of an Equity Committee in *Amresco,*

167 *Id.* at 218 n.18.

168 No. 04-45814 (Bankr. W.D. Mo.) (filed Sep. 22, 2004).

169 Memorandum of the U.S. Securities and Exchange Commission in Support of the Motion of Ad Hoc Committee for Appointment of Committee of Equity Security Holders, *In re Interstate Bakeries Corp*, No. 04-45814 (Bankr. W.D. Mo.) (Docket No. 549) ("*SEC Brief*").

170 Motion of Ad Hoc Committee for Appointment of Committee of Equity Security Holders Pursuant to Section 1102(a)(2) of the Bankruptcy Code for the Appointment of an Official Committee of Equity Security Holders and Memorandum In Support Thereof, *In re Interstate Bakeries Corp.*, No. 04-45814 (Bankr. W.D. Mo.) (Docket No. 486) ("*Ad Hoc Committee Motion*").

171 SEC Brief, at 10.

172 *Id.*

Inc.[173] Like the debtors in *Interstate Bakeries Corp.*, the debtor in *Amresco* had filed numerous prepetition public filings that showed substantial amounts of book equity.[174] However, a review of the debtor's schedules of assets and liabilities painted a very different picture of the debtor's finances. Although the *Amresco* court determined equity was "out of the money," it nonetheless appointed an Equity Committee to give credence to the "integrity of the bankruptcy process"[175] after it determined that shareholders were entitled to an explanation of the sudden and abrupt dissipation of equity.[176]

As demonstrated by *Interstate Bakeries Corp.* and *Amresco*, the failure of a debtor's directors and management to publish certain mandatory public information and near-term drastic swings in reported shareholders' equity can justify the appointment of an Equity Committee to preserve the integrity of the bankruptcy process, to give equity a voice during that process and to provide shareholders with an explanation as to what went wrong prior to a company's bankruptcy.

Similarly, in instances where the debtor attempts to file a pre-negotiated plan of reorganization, the appointment of an Equity Committee may be necessary to protect the interests of shareholders who are proposed to be wiped out by the pre-negotiated plan or shut out of the bargaining process.[177] Lastly, even when a court declines to appoint an official Equity Committee, in instances where *ad hoc* committees have contributed to the resolution of the bankruptcy process, some courts have allowed *ad hoc* committees to seek reimbursement for the costs of their participatory efforts on behalf of equity.[178]

173 Transcript of Bench Ruling, *In re Amresco, Inc.*, No. 01-35327 (Bankr. N.D. Tex. Sep. 7, 2001).

174 Ad Hoc Committee Motion, *supra* note 170, at 11.

175 *Id.*

176 *Id.*

177 Application for an Order Scheduling Hearing and Limiting Notice in Connection with Motion for Appointment of Official Equity Security Holders Committee, *In re Bush Industries, Inc.*, No. 04-12295 (Bankr. W.D.N.Y. Mar. 31, 2004) (Docket No. 40).

178 *See, e.g.*, *In re Energy Partners, Ltd.*, 422 B.R. 68, 79-93 (Bankr. S.D. Tex. 2009) (member of official Equity Committee sought reimbursement, pursuant to section 503(b) of the Bankruptcy Code, of fees and expenses incurred prior to formation of Equity Committee on grounds

d. Are Equity Committees Fulfilling Their Statutory Purpose?

Over thirty years after the enactment of the Bankruptcy Code, the question remains as to whether Equity Committees are fulfilling their intended statutory purpose of protecting "vulnerable" investors. However one quantifies the protection of investors, it is clear that, at least by some measures, equity now enjoys increasing awareness and recognition of their interests. For example, from 2000 to 2006, courts appointed Equity Committees in at least thirty cases across the United States.[179] Further, since the enactment of the Bankruptcy Code, courts show a tendency to preserve pre-bankruptcy structures of corporate governance, which allow equity interests to replace "tainted" management by means of compelling a shareholders' meeting.[180]

Moreover, while the adequacy of representation is difficult to quantify (and deviations from the absolute priority rule are becoming progressively more rare),[181] empirical data shows that the appointment of Equity Committees can result in dramatically improved recoveries for equity.[182] By way of example, in *In re GSI*

that it made substantial contribution; court granted reimbursement but reduced fees); *Spansion*, 421 B.R. at 164 (*ad hoc* equity committee could seek relief under section 503(b)(3)(D) of the Bankruptcy Code if it made a substantial contribution to case); *Nat'l R.V. Holdings*, 390 B.R. at 700 (*ad hoc* equity committee could seek reimbursement under section 503(b) of the Bankruptcy Code for substantial contribution).

179 *See* Glassman, Schlerf & Ward, *supra* note 9, at 28, n.1.

180 *See generally Johns-Manville*, 801 F.2d at 69 (denying motion for summary judgment in action by debtor to enjoin equity committee's state court action to compel shareholders' meeting); *Official Comm. of Equity Sec. Holders of Lonestar Indus., Inc. (In re New York Trap Rock Corp.)*, 138 B.R. 420, 422-24 (Bankr. S.D.N.Y. 1992) (granting standing to the Equity Committee to compel the debtor to hold a shareholders meeting).

181 *See* Section I *supra*.

182 LoPucki & Whitford, *supra* note 12, at 159 ("One way equity interests may be 'present at the bargaining table' is through an official committee of equity holders…. [W]ith the single exception of the *Evans Products* case, when an equity committee organized and retained counsel, equity shared in the distribution."). While the LoPucki and Whitford study is twenty years old, analysis of recent cases reveals, by way of anecdote, the negotiating leverage equity can assert when it organizes and retains counsel.

Group, Inc,[183] the Equity Committee was able to negotiate a plan that provided for value of approximately $1.60 a share, an increase from $0.60 a share under the debtor's original plan. Likewise, in *In re Trump Hotels and Casino*,[184] the debtor entered bankruptcy with approximately $2 billion in debt and 30 million shares of outstanding common stock equivalents. The Equity Committee increased the recovery of shareholders from virtually nothing to a cash distribution of $40 million, plus a right to certain warrants at a value of approximately $2-$3 share. Lastly, in *Mirant*,[185] instead of receiving no value, shareholders were able to negotiate a plan that provided them with 3.75% of the reorganized company and warrants for an additional ten percent (10%).

While courts and officers and directors continue to grapple with the challenges that bankruptcy brings with respect to the protection of equity interests, there appears an ever-increasing willingness to protect investors and to ensure that they are adequately represented during the bankruptcy process. Formal representation appears to afford, among other things, a higher recovery on account of pre-bankruptcy interests and enhanced access to information regarding events that preceded a company's downfall.

F. "Best Practices" with Respect to Appointment Standards

The following discussion attempts to suggest certain "best practices" regarding, and the potential for revision of, the articulated standards governing the decision by a bankruptcy court or the U.S. Trustee with respect to the appointment of an Equity Committee.

1. *A "Benefit of the Doubt" Standard Regarding Solvency*

As described herein, the 1978 revisions to the Bankruptcy Code — which (a) generally encourage consensual reorganizations freed from the shackles of an indiscriminately applied absolute priority rule and (b) specifically provide for the appointment of Equity Committees to represent the interests of equity holders where appropriate — arguably support the argument that the appointment of Equity Committees should be something more than the "rare exception" to the general rule. Where the appointment of an Equity Committee is a close call, the U.S. Trustee and bankruptcy courts should be mindful of (a) the state and purpose of the laws, which

183 No. 09-14110 (Bankr. D. Del. Nov. 20, 2009).

184 No. 04-46898 (Bankr. D.N.J. Nov. 21, 2004).

185 No. 03-46590 (Bankr. N.D. Tex. Jul. 14, 2003).

encourage negotiation and recognize the importance of providing a vehicle through which equity can meaningfully participate in the reorganization and (b) the current trend towards the elimination of deviations from the absolute priority rule and the reestablishment of creditor control over reorganizations.[186] On the other hand, the U.S. Trustee and bankruptcy courts should be loathe to impose the substantial costs of an improvident appointment — *i.e.*, the appointment of an Equity Committee in circumstances where no value ultimately is distributed to equity — upon the debtor's creditors,[187] who clearly bear the risk of such mistakes (especially where "gifted" recoveries may be available to equity).[188]

Neither of the dueling standards for the relative levels of solvency/insolvency that a movant must demonstrate to justify the appointment of an Equity Committee — *i.e.*, the absence of "hopeless insolvency" vs. the substantial likelihood of a meaningful distribution to equity under a strict application of the absolute priority rule — appear to strike the appropriate balance between the need to ensure adequate representation of equity holders in the reorganization process and the desire to avoid imposing the substantial costs of appointment upon the chapter 11 estate. Each standard appears to pay too little heed to either the costs attendant upon appointment (the lenient "hopeless insolvency" standard) or Congress' clearly expressed desire to provide equity with a seat at the table where appropriate (the "substantial likelihood" standard). A middle ground — a "reasonable prospect of solvency/potential for distribution" standard that errs on the side of appointment in close cases — appears far better suited to striking the appropriate balance between these two goals, especially in light of the ability of bankruptcy courts to monitor and limit the role, activities and spending of Equity Committees in chapter 11.

As set forth in Section II.C.4 *supra*, the direct and indirect costs of appointing an Equity Committee can be substantial. Too little attention, however, is generally paid to the ability of bankruptcy

186 *See* Section I *supra*.

187 Where the question of who bears the costs of an ill-considered appointment of an Equity Committee is at issue, the anodyne formulation of "the estate" ought to be avoided. Plainly, it is the estate's residual stakeholders — *i.e.*, the creditors — that bear such costs where there is insufficient value to provide a recovery to equity.

188 Note, however, the recent disapproval by the Second and Third Circuits of "gifting" plans in various contexts. *See* note 26 *supra*.

courts to control these costs and the implications of this power on the threshold appointment decision. The methods by which a bankruptcy court can cabin the costs attendant on an Equity Committee's appointment are sundry. For example, a court can:

- place formal limitations on the role of the Equity Committee;[189]
- limit the ability of an Equity Committee to retain professionals and/or require that the Equity Committee share financial advisors, accountants, actuaries and other non-legal professionals with the official committee of unsecured creditors;[190]
- periodically reconsider the initial appointment decision (whether made by the U.S. Trustee or the bankruptcy court) and disband the Equity Committee if it later appears that no value will become distributable to equity or the Equity Committee has become dysfunctional or harmful to the debtor's estate or reorganization (*e.g.*, if it appears that an Equity Committee is engaging in purely dilatory action designed to maximize the "blackmail factor" or if equity is engaging in

189 *See In re DPH Holdings Corp. (f/k/a Delphi Corp.)*, No. 05-44481, Order at ¶ 4 (Bankr. S.D.N.Y. Mar. 30, 2006) (court order appointing Equity Committee stated that Equity Committee should not inject itself into negotiations between or among the debtors, the unions and General Motors Corporation).

190 *Pilgrim's Pride*, 407 B.R. at 221-22 (court requested, without imposing the formal limitations that it felt it had the power to impose, that the Equity Committee limit its involvement to those matters where its interests were at odds with those of the creditors' committee, and court set quarterly budget for the Equity Committee for all purposes, including the fees of its counsel and financial advisor); *DPH Holdings Corp.*, No. 05-44481, Order at 3 (order appointing Equity Committee stated that it could not, without prior leave of the court, retain or seek the retention of any professionals other than a law firm); *Beker*, 55 B.R. at 951 (stating that the Equity Committee, creditors' committee and debenture committee needed to determine their joint interests and address them jointly and take steps to minimize duplication of efforts, while the court would closely monitor the fees and expenses of committee members). Consider, however, whether the selective restriction of access to advisors is consistent with the Congressional purpose behind section 1103(a)(1) of the Bankruptcy Code, despite the section's requirement that professionals may only be appointed "with the court's approval."

manipulative trading designed to artificially inflate the value of equity);[191]

- exercise vigilance with respect to the fee applications submitted by an Equity Committee's professionals, especially in circumstances where equity ultimately does not recover value; and[192]
- refuse the appointment of Equity Committee professionals pursuant to section 328 of the Bankruptcy Code in order to ensure the application of section 330 of the Bankruptcy Code to the review of fee applications.[193]

This ability of the bankruptcy courts to control costs incurred by, and review the appointment of, Equity Committees strongly (a) argues in favor of a standard that, unlike the "substantial likelihood" standard, does not sacrifice legitimate concerns over the adequate representation of equity's interests at the altar of cost control and (b) counsels in favor of providing equity with the benefit

191 *See* Section III *infra*. The ability of bankruptcy courts to review periodically the need for, and disband, Equity Committees is perhaps the most compelling reason to err on the side of appointment of Equity Committees in close cases.

192 *See In re Heck's Props., Inc.*, 151 B.R. 739, 748-49 (S.D.W. Va. 1992), *aff'd* in part, *rev'd* in part on other grounds, 151 B.R. 739 (S.D.W. Va. 1992) (reducing the compensation of an Equity Committee's professionals where, among other things, committee unnecessarily interfered with debtor's litigation); *Emons*, 50 B.R. at 64 (stating that, where no value is to be distributed to equity, "it may well be that no fees and disbursements would be awarded" to the Equity Committee's professionals "because in light of the outcome the amounts were not reasonable nor reflective of actual, necessary services."). The *Wang Laboratories* court adopted an especially stringent approach to the compensation of Equity Committee professionals by requiring that such professionals demonstrate their having made a substantial contribution to the case in the first instance, essentially making a professional's right to compensation dependent upon a return achieved for equity. *See Wang Labs.*, 149 B.R. at 3.

193 *See*, *e.g.*, *In re Mirant Corp.*, 354 B.R. 113, 128 (Bankr. N.D. Tex. 2006) (court criticized itself for the authorization of professionals' "success fees" pursuant to section 328 of the Bankruptcy Code; "[t]he court erred seriously in entering orders which left it so little discretion in assessing the work of the financial advisors."); *compare In re Northwest Airlines Corp.*, 382 B.R. 632, 635 (Bankr. S.D.N.Y. 2008) (denying success and completion fees of professionals under section 330 of the Bankruptcy Code).

of the doubt in circumstances where there is a reasonable possibility that equity may recover value in the debtor's reorganization.

A standard that allows for the appointment of Equity Committees in cases where there is a reasonable possibility of solvency moreover mitigates some of the prejudice to equity inherent in having to demonstrate a debtor's solvency/insolvency (much less the "substantial likelihood of a meaningful recovery") at the very outset of a chapter 11 case, when (a) comprehensive valuations of a debtor's estate are either unavailable, prohibitively expensive and time-consuming or (certainly from a debtor's perspective) ill-advised; (b) the plan process may not have begun in earnest or at all, meaning that issues crucial to the determination of whether equity will recover value from the debtor's estate (*e.g.*, resolution of labor and pension issues; significant contractual issues with major suppliers/customers) have not yet been determined; (c) the relative success of the debtor's operations while in chapter 11 are unknown; and (d) estimations of the debtor's solvency are inherently speculative and equity likely suffers from asymmetries of information vis-à-vis the debtor.[194] Likewise, favoring appointment in close cases mitigates against what Congress and the courts have identified as the natural tendency of management to favor their suppliers/customers at the expense of shareholders.[195] Finally, a disposi-

194 *See* Bob Rajan & Brett Harrison, *The New Wave of Equity Committees in Bankruptcy: What Are They and Are They Here to Stay?*, INTERNAT'L CORPORATE RESCUE, Vol. X, Issue X (2006) ("This higher [substantial likelihood] standard highlights the 'chicken-and-egg' game involved in restructuring negotiations. In order for equity holders to bring their position to the forefront, they are preliminarily forced to produce a valuation with limited information from the debtor and minimal resources in order to illustrate their cause prior to being able to execute their rights under section 1102" of the Bankruptcy Code); *see also* Glassman, Schlerf & Ward, *supra* note 9, at 52 (stating that under the substantial likelihood standard, "equity-holders would have to put forth a valuation case, at their own expense, relying on questionable information that they have limited access to in order to persuade the U.S. Trustee and/or the court that the debtors' enterprise value exceeds the total amount of potential claims against the estates").

195 *See*, *e.g.*, *Johns Manville*, 68 B.R. at 160 (noting that the purpose of enacting section 1102(a) of the Bankruptcy Code was "to counteract the natural tendency of a debtor in distress to pacify large creditors with whom the debtor would expect to do business at the expense of

tion towards the appointment of Equity Committees where a reasonable prospect of solvency exists serves to counteract the trend towards increasing creditor control of chapter 11 reorganizations and the renewed marginalization of equity holders (which trend is arguably at odds with the desire for flexibility and increased ability for equity to negotiate favorable outcomes which animated the 1978 amendments to title 11).[196]

2. *Adjustment/Elimination of "Complexity" and "Balancing of Costs Against the Need for Adequate Representation" Factors*

As noted in Section II.C.2 *supra*, the "complexity" factor has become opaque to the point of uselessness. To the extent a reorganization's supposed complexity should factor into the appointment decision, the emphasis should be on the expected obstacles to reorganization and the issues to be faced by the debtor in restructuring and *not* on the relatively complicated nature of the debtor's governance or capital structure (to say nothing of the number of docket entries in the chapter 11 case), with which courts, investors and the debtor's and creditors' committee's professionals are likely very familiar. A thousand-foot level overview of the relative difficulty of the debtor's reorganization illuminates the need for equity to participate in the plan process in a far more practical manner than a granular recitation of the various tranches of the debtor's debt.

Similarly, the factor requiring courts to balance the costs attendant upon appointment against the need for adequate representation could profitably be eliminated and replaced with the instruction that courts consider the costs of appointment shorn of any balancing test. To the extent that courts conceive of this factor as a balancing test within the larger balancing test already undertaken, it appears redundant; indeed, in many cases, the discussion of this factor serves as a proxy for the appointment inquiry generally. A straightforward consideration of the costs of appointment appropriately streamlines the court's and U.S. Trustee's inquiry and eliminates unnecessary duplication and confusion.

III. DISBANDING AN EQUITY COMMITTEE

There is very little law, either statutory or case law, on issues involved in disbanding or possibly disbanding appointed commit-

small and scattered public investors.") (quoting S. Rep. No. 989, 95th Cong. 2d Sess., at 10 (1978)).

196 *See* Section I *supra*.

tees. Accordingly, an analysis of this topic proceeds in three parts: First, can an Equity Committee be disbanded and, if so, what are the proper procedures for doing so? Second, assuming an Equity Committee can be disbanded, what standards should be applied? Third, assuming the U.S. Trustee disbands the Equity Committee, what standard should be applied to judicial review of the decision? In answering these questions, it is noted that both statutory and decisional law are much more comprehensive in connection with issues connected with creditors' committees; we, therefore, assume that decisions on disbanding an Equity Committee will draw upon such law.

A. The Ability of Bankruptcy Courts and the U.S. Trustee to Disband Equity Committees

Section 1102(a) of the Bankruptcy Code provides for the mandatory appointment of a creditors' committee and the discretionary appointment of an Equity Committee, and section 1102(b) of the Bankruptcy Code prescribes general rules regarding the composition of committees (including the possible appointment of members of a prepetition committee). Section 1102(a)(4) of the Bankruptcy Code also provides for the bankruptcy court to order the appointment of additional members of both creditors' and Equity Committees and to change the membership if "necessary to ensure adequate representation," but this provision is limited to representation issues and, on its face, does not authorize the bankruptcy court (as opposed to the U.S. Trustee) to order the appointment of new members based upon any factors other than the need to assure adequate representation.[197] Bankruptcy Rule 2007 provides for judicial review of the membership of a creditors' committee appointed by the U.S. Trustee consisting of members of a prepetition committee, a standard for determining whether the prepetition committee was fairly chosen and for the bankruptcy court to direct the U.S. Trustee to vacate the appointment of the committee and other appropriate action if the appointment failed to satisfy the standards of section 1102(b)(1) of the Bankruptcy Code.[198]

197 It can be argued that "adequate representation" includes all issues involved in deciding whether to appoint an Equity Committee, but this seems to assume the conclusion.

198 There is no comparable provision for Equity Committees.

These provisions are far from a comprehensive regulation of committee appointment and composition issues. [199] They do not elucidate the appointment procedures the U.S. Trustee can or should follow in deciding whether to appoint an Equity Committee or change the membership of an existing Equity Committee. They do not contemplate possible changes in composition for reasons other than adequate representation, and they do not address standards and procedures for removal of Equity Committee members. They do not provide recourse or remedies for creditors or Equity Committee members who believe an existing Equity Committee is not functioning properly or may be violating legal or ethical requirements. In fact, it is not even clear whether, in such situations, recourse is first to the U.S. Trustee or to the bankruptcy court. In short, there are many issues relating to Equity Committees that are not regulated by either the Bankruptcy Code or the Bankruptcy Rules, and for which there are no clear guidelines as to procedures and remedies. In particular, there are no statutes or rules addressing the disbanding of Equity Committees.[200]

From this, one may surmise that both the U.S. Trustee and the bankruptcy courts have power to fill in the substantive gaps and to provide procedures for disbanding Equity Committees.[201] Several sources for such power exist. First, there is the broad power of the U.S. Trustee to supervise the administration of chapter 11 cases pursuant to 28 U.S.C. § 586(a)(3), and the specific duty to monitor creditors' committees and the progress of cases under 28 U.S.C.

[199] Indeed, section 1102 of the Bankruptcy Code does not have a clear delineation of the respective roles of the U.S. Trustee and bankruptcy court on a number of areas relating to official committees (*e.g.*, do the U.S. Trustee and the bankruptcy court have the power in the first instance to appoint additional committees? Compare sections 1102(a)(1) and 1102(a)(2) of the Bankruptcy Code).

[200] There is likewise no provision for disbanding a creditors' committee but, since the appointment of a creditors' committee is *required* under section 1102(a) of the Bankruptcy Code in all but small business cases, there is a strong argument that a creditors' committee cannot be disbanded prior to the conclusion of the case.

[201] Certainly, the power to disband has been exercised (at least by the U.S. Trustee). *See In re Dana Corp.*, No. 06-10354 (Docket No. 4735), "Notice of Disbandment of Official Committee of Equity Security Holders," filed by U.S. Trustee (providing notice of the disbanding of Equity Committee where two of three appointed members had resigned).

§§ 586(a)(3)(E) and (G).[202] Second, there is the broad administrative power of the bankruptcy court under section 105(a) of the Bankruptcy Code[203] exercised in conjunction with the powers granted to the bankruptcy court under section 1102 of the Bankruptcy Code; indeed, section 1102 of the Bankruptcy Code itself may imply a power to take actions necessary and proper to assure a properly functioning, fair and efficient committee system.[204] Third, both the U.S. Trustee and the bankruptcy court have the power to reconstitute an official committee, to replace members and to remove committee members notwithstanding a member's objection.[205] Fourth, in case law developed under the predecessor provisions of section 1102 of the Bankruptcy Code, which did not have a specific provision for judicial review of initial committee appointments, the majority of courts held that the power to reconstitute official committees existed largely on the basis that an orderly functioning committee system necessarily assumed such power, although the

202 28 U.S.C. § 586(a)(3) generally provides (a) that "[e]ach United States trustee … shall … supervise the administration of cases and trustees in cases under chapter … 11" and (b) various examples of circumstances in which the U.S. Trustee may exercise its supervisory role (*e.g.*, reviewing fee applications; reviewing plans of reorganization and disclosure statements; ensuring that all reports, schedules and fees are filed and paid). Subsections (a)(3)(E) and (a)(3)(G) provide that the U.S. Trustee shall supervise the administration of bankruptcy cases by "monitoring creditors' committees appointed under title 11" and "monitoring the progress of cases under title 11 and taking such actions as the United States trustee deems to be appropriate to prevent undue delay in such progress," respectively.

203 Section 105(a) of the Bankruptcy Code provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a).

204 A bankruptcy court can limit the activities of an Equity Committee and its counsel to matters affecting the Equity Committee, and avoid duplication of effort with the creditors' committee. *See Pilgrim's Pride*, 407 B.R. at 211.

205 *See In re Penn-Dixie Indus., Inc.*, 9 B.R. 936, 940 (S.D.N.Y. 1981) (affirming bankruptcy court's refusal to remove stockholder who wanted to acquire the debtor from Equity Committee); *In re Penn-Dixie Indus., Inc.*, 9 B.R. 941, 944-45 (Bankr. S.D.N.Y. 1981) (disqualifying stockholder with management role from serving on an Equity Committee).

cases were not uniform.[206] Fifth, there is the widespread practice of including provisions for the disbanding of both Creditors' and Equity Committees upon confirmation of a plan of reorganization (or providing for the continued existence of such committees to be limited to specifically defined tasks). Sixth, since the U.S. Trustee has the power to appoint an Equity Committee, change its membership and delay the appointment of an Equity Committee pending further developments, such powers logically should also include the power to disband the Equity Committee (although there are differences, disbanding an Equity Committee is not materially different than simply terminating all of its members). Finally, bankruptcy courts are historically descended from courts of equity and have long been held to have equitable jurisdiction, which includes the power to devise interstitial rules for administering equitable proceedings and supervising entities that are acting in connection with such proceedings.[207]

For these reasons, it is reasonable to conclude that the ability to disband an Equity Committee is inherent in the bankruptcy process. Indeed, it would make little sense for both the U.S. Trustee and the bankruptcy court to have the power to appoint an Equity Committee but to lack the power to disband one upon a proper showing. Such a conclusion finds support in the Second Circuit's decision in *In re Adelphia Communications Corp*.[208] In *Adelphia*, the bankruptcy court had granted an Equity Committee derivative standing to prosecute certain litigation, but the confirmed plan provided that the Equity Committee's appointment would terminate and prosecution of the litigation would be transferred to a creditors' committee. The Equity Committee's objection to the plan was overruled by the bankruptcy court, and the district court affirmed. On appeal, the Second Circuit held that the grant of derivative standing to prosecute the litigation did not give the Equity Committee ownership of the litigation, and standing could be withdrawn if "in the best interests of the bankruptcy estate."[209] The Second Circuit found that the bankruptcy court had conducted a

[206] *See* Kenneth Klee & K. John Shaffer, "Creditors' Committees Under Chapter 11 of the Bankruptcy Code," 44 S.C.L. Rev. 995, 1035-37 (Summer 1993) (reviewing authorities).

[207] *See* 28 U.S.C. § 1334 (granting district courts jurisdiction over all bankruptcy cases).

[208] 544 F.3d 420 (2d Cir. 2008).

[209] *Id.* at 423.

"reasonable analysis of the costs and benefits" of allowing the Equity Committee to continue to manage the litigation and had based its decision to withdraw standing on the facts that (a) equity was substantially out of the money and was unlikely to realize any recovery and (b) future expense would increase because the Equity Committee had previously cooperated with the creditors' committee in prosecuting parallel claims and this was unlikely to continue.[210] While *Adelphia* does not expressly address disbanding Equity Committees, in that case, the Second Circuit countenanced (a) plan provisions that disbanded the Equity Committee and removed derivative standing and (b) the bankruptcy court's power to review those provisions pursuant to a "best interests of the estate" standard and the exercise of considered discretion.

Another case that lends support to the theory of broad judicial power to disband Equity Committees is *In re Finova*.[211] In *Finova*, an Equity Committee was appointed and, pursuant to the plan, was disbanded upon confirmation. The debtor's plan had provided for equity to receive 5% of any distribution on unsecured debt issued as part of the plan, but also provided that such 5% distributions to equity would be impermissible if such distributions would violate applicable law, render the debtor insolvent or constitute a fraudulent transfer. However, the plan did not anticipate a situation where the debtor might be forever insolvent and, thus, prevented from ever making any distributions to equity under the plan (which situation came to pass in *Finova*).

In light of its permanent insolvency and its resulting inability to make any distribution to equity under the plan, the debtor sought an order authorizing it to use funds that had been held in a separate account for potential distribution to equity for corporate purposes and payment of debts. In response, the members of the disbanded Equity Committee moved to reconstitute the committee in order to object to the motion, arguing that equity interests were entitled to representation under such circumstances. The bankruptcy court granted equity's motion for reconstitution and, although there was no written opinion, the court's decision seems to recognize its inherent power to address issues arising in connection with official committees for which there was no statutory precedent. As in *Adelphia*, the *Finova* decision reflects the willingness of bankrupt-

210 *Id.* at 425-26.

211 Case No. 01-698 (Bankr. D. Del. Jun. 17, 2005).

cy courts to act with respect to committee issues that are not explicitly contemplated by the Bankruptcy Code or Bankruptcy Rules when necessary and in the best interests of the debtor's estate.

Based on the foregoing, we conclude that bankruptcy courts and the U.S. Trustee possess the power to disband an Equity Committee, and next move to the question of the proper procedures governing disbanding.

B. Procedures Governing Disbanding Equity Committees.

An implicit power to disband Equity Committees raises several issues with respect to the proper procedure for effecting such a disbanding. Does the U.S. Trustee have the power to disband the equity committee and what procedures must be followed? If the U.S. Trustee has the power, does the court have concurrent power to disband and, if not, does the court have the power to review a decision to disband? If the U.S. Trustee has the power can s/he act on his or her own, or is some form of request from a party in interest required? Published cases do not address these issues.

1. *Role of the U.S. Trustee*

Given the construct of the committee appointment structure, it appears consistent with the provisions of section 1102 of the Bankruptcy Code and 28 U.S.C. § 586(a)(3), which provisions, respectively, (a) give the U.S. Trustee authority over Equity Committee appointment issues in the first instance and (b) delegate administrative power over official committees to the U.S. Trustee, for the U.S. Trustee to exercise power to disband Equity Committees. Moreover, the power to disband seems implicit in the power to appoint and change membership, and it would be incongruous for the U.S. Trustee to have the authority to do one and not the other.[212] Indeed, as noted above, the removal power overlaps considerably with the power to disband.

The informal procedures that have settled into place with respect to the appointment of creditors' committees over the past three decades may offer useful precedent with respect to establishing practical and fair procedures governing the disbanding of Equity Committees. Although section 1102(a)(1) of the Bankruptcy Code empowers the U.S. Trustee to appoint creditors' committees as a threshold matter, neither the Bankruptcy Code nor the Bankruptcy Rules set forth procedures for doing so. Instead, an informal

212 *See* Section II.A.1 *supra*.

practice has arisen by which, at least for creditors' committees, the U.S. Trustee sends questionnaires to the largest creditors, receives completed forms (and/or other indications of interest from attorneys and creditors) and, if there is considerable creditor interest, holds an information and selection session at which the U.S. Trustee considers the candidates and forms a creditors' committee. In some cases, attorneys for parties in interest may lobby the U.S. Trustee and/or send letters or other communications reflecting their views on member selection. Of course, in smaller cases, there may not be much competition for committee slots, and the U.S. Trustee may use even less formal procedures (or simply appoint those willing to serve).[213] A similar informal procedure generally has been followed in cases where there is a need to replace a resigning member of a creditors' committee. In that process, the precise role of the U.S. Trustee is more ambiguous. The U.S. Trustee clearly has administrative powers (including decision-making power), but s/he is also a party in interest in the bankruptcy case who works with the parties on issues far removed from appointment and membership. As a consequence, the appointment process also may involve a process of negotiation among the U.S. Trustee and various constituencies jockeying for position.

The same informal procedure appears to be followed in cases where parties are seeking an Equity Committee and, if a committee is appointed, in selecting members. However, it appears that Equity Committees are sought most often in cases where there is a functioning unofficial, *ad hoc* committee of equity security holders, and it is this group that seeks both the appointment of the Equity Committee as well as the selection of the ad hoc committee's members as the members of the to-be-appointed Equity Committee. Once the decisions on appointment and membership are made, the U.S. Trustee may provide some explanation for his or her decision, but there is no requirement to do so; whether there is an explanation and, if so, how extensive it is depends more on the individual

213 Section 1102(b)(1) of the Bankruptcy Code states that "ordinarily" the creditors holding the seven largest claims against a debtor, and who are willing to serve, shall be appointed to the creditors' committee, which may be read to imply that no appointment process is necessarily required. Similarly, section 1102(b)(2) of the Bankruptcy Code suggests that the persons willing to serve and holding the seven largest amounts of equity securities shall constitute an Equity Committee.

in the U.S. Trustee's office making the decision rather than an overall set of policies and procedures.[214]

Based on this precedent, as in the case of appointment, parallelism would dictate that the U.S. Trustee may follow informal procedures in connection with disbanding an Equity Committee. The nature of the U.S. Trustee's responsibilities is such that the initial impetus for disbanding the committee may come from either a party in interest or the U.S. Trustee itself. Initially, some form of notice to the existing Equity Committee and the major parties in interest would seem appropriate. Disbanding an Equity Committee may be painless (as in the *Dana* case, where two of the three Equity Committee members resigned, and the decision to disband did not appear to be contested),[215] but when it is contested or likely to be contested, considerations of due process suggest that an opportunity to present views in open court should be provided, and that the U.S. Trustee should offer some explanation for its decision.[216] On the other hand, there is no authority for the proposition that some form of briefing and/or a hearing — and a subsequent formal opinion or ruling — are required. Moreover, the situation is sufficiently uncommon that the U.S. Trustee apparently has not adopted more formal procedures. Finally, although we have found no cases on point, the general power of the U.S. Trustee to administer cases probably is sufficient to permit disbanding an Equity Committee appointed either by the court or with the approval of the court (in the event of an objection). Further, one would expect the U.S. Trus-

214 It is not common for the U.S. Trustee to prepare a letter or statement explaining his rationale for deciding to appoint or not to appoint an Equity Committee. When there is a bankruptcy court review, however, the U.S. Trustee may offer such an explanation. *See Nat'l R. V. Holdings*, 390 B.R. at 693 n.5 (quoting U.S. Trustee's declaration explaining reasons for denying appointment). In one case, the U.S. Trustee said he generally agreed with the creditors' committee in opposing the appointment of an Equity Committee, but would not actively participate in the trial of the appointment motion. Such a position seems somewhat at variance with the role of the U.S. Trustee in administering cases. *Pilgrim's Pride Corp.*, 407 B.R. at 213.

215 *See* note 201 *supra*.

216 In *Dana*, the U.S. Trustee disbanded the Equity Committee on its own volition based on certain actions of a large shareholder serving as a member of the Equity Committee, but it is questionable whether such unilateral action would be appropriate absent a court hearing in a case where there are potential disagreements with that decision.

tee to hesitate to order the disbanding of an Equity Committee absent circumstances unrelated to the initial facts giving rise to the appointment or approval.[217]

2. *Role of the Court.*

The role of the bankruptcy court is complicated by the fact that there is no clear delineation of the respective roles of the court and the U.S. Trustee in the appointment process and other matters relating to committees.[218] This is true with respect to decisions to disband as well. As with appointments of the committees, it would be consistent with the overall scheme of the Bankruptcy Code for addressing issues related to officially appointed committees that the U.S. Trustee should initially consider any requests for disbanding an Equity Committee and the Bankruptcy Court's role should be in reviewing such decisions. One could argue that allowing the U.S. Trustee to take the lead on determinations to disband as well may make sense even if the Court had initially directed the committee's initial appointment under section 1102(a)(2) of the Bankruptcy Code because such provision passes authority to the U.S. Trustee to populate the committee once the appointment is made.[219] Given the U.S. Trustee's role in the official committee process, his or her familiarity with the situation "on the ground" and the Congressional policy to take the bankruptcy judge out of administrative matters, the better practice on disbanding an Equity Committee would

217 There is also a question whether a bankruptcy court, as part of a contested appointment process, can deny the U.S. Trustee the power to alter committee membership or, at least, require that the U.S. Trustee make a motion to do so. We have found no cases addressing this issue.

218 *Compare* 11 U.S.C. § 1102(a)(1) and § 1102(a)(2).

219 Since the U.S. Trustee makes the initial appointment once the bankruptcy court directs formation of an Equity Committee under section 1102(a)(2) of the Bankruptcy Code, a strong argument can be made that this authority includes the power to change membership of the Equity Committee. We have suggested that there are certain common elements between the power to change membership and the power to disband the Equity Committee. However, we would expect the U.S. Trustee to be very circumspect in such situations not to interfere with or appear to undermine the authority of the bankruptcy court (*i.e.*, not to disband the Equity Committee in cases where the situation has not changed materially from the time of the bankruptcy court's decision to form the Equity Committee).

seem to be that such relief initially be sought from the U.S. Trustee. This certainly makes sense in some instances where, for instance, a committee member simply is not participating or has developed a conflict.

On the other hand, the court clearly has specific authority over initial appointment decisions in some instances. Thus, in connection with membership issues (*e.g.*, parties seeking membership on, or changes in membership of, an Equity Committee) or the appointment of an additional Equity Committee, parties in interest are not required to make an initial request to the U.S. Trustee,[220] but, instead, may seek redress directly from the bankruptcy court, suggesting that a party in interest ought to have similar power to seek redress from the court to disband an Equity Committee. Given the general lack of clear lines of authority and clear allocation of decision-making responsibility between the bankruptcy court and the U.S. Trustee in the present statute, it appears that multiple avenues for seeking the disbanding of an Equity Committee currently exist under existing law.

C. Standards for Disbanding the Committee.

Because there are no statutes or reported cases addressing the standards for disbanding Equity Committees, the best reference for such standards are the standards for appointing an Equity Committee in the first instance, although some standards can be gleaned from motions seeking judicial remedies in connection with creditors' committees.

The standards for appointing an Equity Committee are addressed in detail in Section II *supra*. As discussed above, section 1102(a)(2) of the Bankruptcy Code authorizes the appointment of Equity Committees by a bankruptcy court when "necessary to assure adequate representation of . . . equity security holders." In interpreting this "adequate representation" standard, courts consider the questions of the debtor's insolvency, the likelihood of a substantial return for equity under the strict absolute priority test, the ability of shareholders to represent their own interests, the number of shareholders, cost/benefit factors and the size and complexity of the case.[221]

220 *See* 11 U.S.C. § 1102(a)(2), (4). The rationale for treating initial appointments and subsequent changes differently is not clear.

221 *See* Section II.C *supra*.

Based on the foregoing, it would seem logical that, in deciding a motion or a request seeking to disband an Equity Committee, a bankruptcy court or the U.S. Trustee ordinarily should (a) focus on the "best interests of the debtor and the estate" standard similar to that propounded in *Adelphia* and (b) in making its determination, consider the same factors as are relevant to the initial appointment decision, with two important caveats.[222] The first of these caveats is that, if the Equity Committee was appointed and is functioning, the burden should be on the party seeking the relief to justify disbanding that committee. The second caveat is that the appointment of an Equity Committee may have come at the outset of a case when there are uncertainties about a number of factors, which uncertainties may have been fully or partially resolved as the case has developed. When a motion to disband is considered, the Bankruptcy Court can appraise a number of the appointment factors with the benefit of hindsight, as well as assess the actions and actual contribution of the Equity Committee (in light of the costs) during the chapter 11 case.

As in appointment, the most significant factor impacting the decision to disband would be the question of insolvency/likelihood of a meaningful distribution to equity. On this issue, developments in the case since the decision to appoint may provide important information. For example, there may have been a sale of the debtor's assets that removed valuation uncertainties (or sales efforts that resulted in offers suggesting insolvency). Alternatively, the debtor may have proposed a plan of reorganization supported by the creditors' committee that provides a significant haircut to creditors (who would have every incentive to reject such a plan if valuations of the debtor's estate were high enough to justify a return for equity). Of course, an Equity Committee may seek to argue valuation or the existence of litigation claims as a basis not to disband, and the movants will likely argue that they should not be required to effectively finance a valuation fight and/or litigation which has little probability for success but which gives the shareholders great nuisance value. Nevertheless, the existence of a plan providing for a significant creditor haircut would be given strong

222 We would expect the U.S. Trustee to apply such standards on a more informal basis than a bankruptcy court, but are reluctant to suggest that the U.S. Trustee apply the standards so informally that a bankruptcy court feels compelled to review the disbanding question *de novo*.

weight in the balancing process, especially since the costs of the Equity Committee will be substantially borne by creditors. In addition, there is almost always going to be better evidence regarding the amount and validity of claims that take precedence over equity at the time of a determination to disband than existed at the outset of the case.

At the end of the day, the issues with respect to disbanding Equity Committees are similar to those at formation. Is there a likelihood of a meaningful distribution to equity? How much will the committee cost? Will it delay the process and, if so, by how much? To what extent do shareholders need continued representation in the form of an Equity Committee, and are the members of such committee providing appropriate representation? However, as contrasted with the situation upon appointment, by the time of a motion to disband, both the U.S. Trustee and the bankruptcy court are likely to have a much greater familiarity with the debtor's circumstances and a far more informed view with respect to, *e.g.*, insolvency, adequate representation and whether the costs of the Equity Committee are justified.[223]

D. Standards for Review.

The basic issue with respect to the standard governing a bankruptcy court's review of the U.S. Trustee's decision to disband an Equity Committee is whether *any* deference should be given to the U.S. Trustee's prior determination. Perhaps, the most useful analogy is to a bankruptcy court's review of the U.S. Trustee's appointment decisions. On appointment decisions, the prevailing authority suggests that the standard of review should be *de novo* rather than an abuse of discretion standard. In *Texaco*, the bankruptcy court explained that the question of adequate representation was primarily a legal issue and noted that a party seeking committee membership was not required to submit a request to the U.S. Trustee in the

[223] One court, in deciding whether to appoint an Equity Committee, noted that the professionals might be denied compensation if there was ultimately no return for equity. *Pilgrim's Pride*, 407 B.R. at 217. Arguably, this approach effectively puts counsel and the other Equity Committee professionals on notice that reimbursement for the costs of an Equity Committee is uncertain and should deter parties from seeking appointment or opposing disbanding if such a recovery is unlikely.

first instance, thus supporting the court's *de novo* review. [224] Moreover, a *de novo* standard dovetails with the fact that the U.S. Trustee typically employs informal procedures, where review for "abuse of discretion" becomes difficult absent a prior process encompassing formal pleadings, notice, a hearing and a written or oral opinion.

IV. CORPORATE AND SECURITIES LAW ISSUES

A. Is an Equity Committee a "Group" Under the Exchange Act?

As noted above, Equity Committees, historically, were rarely appointed under section 1102(a) of the Bankruptcy Code, but have been increasingly appointed in high-profile chapter 11 cases.[225] As discussed throughout, the activities of an Equity Committee may include: (1) investigating the financial affairs and operations of the debtor, (2) consulting with other constituents regarding the administration of the case, (3) negotiating terms and conditions of a proposed plan to maximize the recovery of equity, (4) participating in the plan confirmation process and making recommendations to other shareholders to accept or reject the plan, (5) litigating matters related to the above,[226] (6) compelling the debtor to hold shareholders' meetings,[227] and (7) filing its own plan where the debtor's exclusivity period has expired or has been terminated.

As Equity Committees become increasingly active, they have sponsored restructuring proposals and spearheaded rights offerings.[228] In such situations, members of an Equity Committee should

224 *See Texaco*, 79 B.R. at 566; *see also Nat'l R.V. Holdings*, 390 B.R. at 694-95 (reviewing authorities).

225 *See* note 8 *supra*.

226 *See Heck's Properties*, 112 B.R. at 790.

227 *See Johns-Manville,* 801 F.2d at 65-66 (shareholders' meeting may be called unless purpose is to derail debtor's reorganization); *New York Trap Rock,* 138 B.R. at 422-23 (an Equity Committee has standing to compel debtors' directors to hold annual shareholder's meeting).

228 *See, e.g., In re MES Int'l, Inc.,* Case No. 09-14109 (Bankr. D. Del.). In *MES International*, the Equity Committee submitted its proposal for a plan of reorganization to the debtor and later entered into a plan support agreement with the debtor. Pursuant to the debtor's plan, existing shareholders would receive a *pro rata* share of new common shares and participate in a rights offering, paying cash in exchange for a *pro rata* share of additional common shares. *See* Final Fourth Modified Joint Chapter 11 Plan of Reorganization, *In re MES Int'l, Inc.,* Case

be mindful about their collective participation in the plan process, including their purchases or sales of plan securities (including the reorganized debtor's new common stock or rights to purchase additional common stock or warrants), not to (1) violate securities laws, (2) inadvertently become subject to beneficial ownership reporting requirements and short-swing profits reporting and disgorgement provisions or (3) trigger "change of control" provisions often found in debt documents.

The discussion below primarily focuses on sections 13(d) and 16(b) of the Exchange Act. Under section 13(d) of the Exchange Act, any *person* becoming the beneficial owner of more than 5% of any class of a company's voting equity securities that is registered under section 12 of the Exchange Act must generally file a Statement on Schedule 13D with the SEC via the SEC's EDGAR electronic filing system within 10 days of reaching such ownership level.[229]

No. 09-14109 (Bankr. D. Del. May 27, 2010) (Docket No. 768). According to the company, as of July 23, 2010, existing shareholders would retain an 86.1% ownership in the company's post-reorganization common stock subject to the distribution of shares placed in reserve pending resolution of certain litigation matters.

See also In re Visteon Corp., Case No. 09-11786 (CSS) (Bankr. D. Del. Jun. 30, 2010). In *Visteon*, members of an *ad hoc* equity committee negotiated with the debtor regarding their treatment under the plan with the result that the debtor offered shareholders two percent of the post-reorganization equity and warrants for additional new equity if they supported the plan. *See* Amended Chapter 11 Plan/Notice of Filing of Revised Fifth Amended Joint Plan of Reorganization of Visteon Corporation and Its Debtor Affiliates Pursuant to Chapter 11 of the United States Bankruptcy Code, *In re Visteon Corp.,* Case No. 09-11786 (Bankr. D. Del. Aug. 30, 2010) (Docket No. 4083).

229 Section 13(d)(1) of the Exchange Act provides in relevant part:

> Any person who, after acquiring directly or indirectly the *beneficial ownership* of any equity security of a class *which is registered pursuant to section 12 of this title* … , is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing such of

Schedule 13D requires disclosure of, among other things, information about the reporting person, the reporting person's stock holdings in the issuer, all transactions by the reporting person in the relevant class of the issuer's equity securities during the past 60 days and the reporting person's plans for control of the issuer.[230]

Section 13(d)(3) of the Exchange Act addresses group membership and provides that "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or *group* shall be deemed a *person* for the purposes of this subsection."[231] The related regulation further provides that "[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an

> the following information, and such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78m(d)(1) (emphasis added).

Rule 13d-1(i) provides in relevant part:

> For the purpose of this regulation, the term "equity security" means any equity security of a class which is registered pursuant to Section 12 of [the Exchange Act]…: provided, such term shall not include securities of a class of non-voting securities.

17 C.F.R. 240.13d-1(i).

We note that short-form filings on Schedule 13G are available for certain institutional holders such as banks, insurance companies, trust companies, brokerage houses and pension funds if they become 5% stockholders in the ordinary course of their business and not with the purpose or effect of changing or influencing the control of the issuer (a "disqualifying purpose"), but that an Equity Committee, if found to be a "group" for purposes of section 13(d) of the Exchange Act, will generally not be eligible to file Schedule 13G. *See* 17 C.F.R. 13d-102.

230 *See* 17 C.F.R. § 240.13d-101, Item 5.

231 15 U.S.C. § 78m(d)(3) (emphasis added).

issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of Sections 13(d) and (g) of the Exchange Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons."[232]

Under section 16(a)(1) of the Exchange Act, every person who is directly or indirectly the beneficial owner (as calculated for purposes of section 13(d) of the Exchange Act) of more than 10% of any class of any equity security that is registered pursuant to section 12 of the Exchange Act (other than an exempted security), or who is a director or an officer of the issuer of such security (each, a "*Section 16 Person*") will be subject to beneficial ownership reporting requirements.[233] A Section 16 Person is required to file a Form 3, which reports its initial beneficial ownership of all equity securities of the issuer (not just the section 12-registered classes) within 10 calendar days after it becomes a Section 16 Person, and then to disclose changes in its beneficial ownership of such securities by filing a Form 4 by the end of the second business day after a transaction has been executed.[234] A small number of types of transactions in the issuer's equity securities may be reported on Form 5, which must be filed no later than 45 days after the close of the issuer's fiscal year.[235] Under section 16(b) of the Exchange Act,[236] any Sec-

232 17 C.F.R. § 240.13d-5(b)(1).

233 *See* 15 U.S.C. § 78p(a)(1).

234 *See* 17 C.F.R. § 240.16a-3(a). All reportable transactions need to be reported electronically and posted on the issuer's website not later than the end of the business day following the filing. *See* 17 C.F.R. § 240.16a-3(k).

235 *See* 17 C.F.R. § 240.16a-3(f).

236 Section 16(b) of the Exchange Act provides, in pertinent part, as follows:

> (b) **Profits from purchase and sale of security within six months**. For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer *(other than an exempted security)* … within any period of less than six months, … shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security … purchased

tion 16 Person can be required to disgorge to the issuer all profits realized from purchases and sales of equity securities of the issuer within a six-month period, "without proof of actual abuse of insider information and without proof of intent to profit on the basis of such information."[237] This section applies to any "beneficial owner," defined as any *person* under section 13(d) of the Exchange Act and the rules thereunder.[238]

As such, if members of an Equity Committee constitute a "group" under section 13(d) of the Exchange Act, they would be treated as a single person, and each individual member in the group would be deemed to be the beneficial owner of all equity securities of that issuer beneficially owned by any member of the group.[239] Consequently, (1) when their collective equity holdings in a debtor exceed 5% as a "group," each member of an Equity Committee would be required to make section 13(d) filings, including disclosure of any intention to file a plan of reorganization and the terms of any such plan;[240] (2) when their collective equity holdings

> or of not repurchasing the security … sold for a period exceeding six months…. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security ….

15 U.S.C. § 78p(b) (emphasis added).

237 *Kern Cnty. Land Co.* v. *Occidental Petroleum Corp.,* 411 U.S. 582, 595 (1973).

238 Rule 16a-1(a)(1) provides that, "[s]olely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities *registered pursuant to Section 12 of the [Exchange] Act*," the term "beneficial owner" means, with exceptions not pertinent here, "any person who is deemed a *beneficial owner pursuant to section 13(d)* of the [Exchange] Act and the rules thereunder." 17 C.F.R. § 240.16a-1(a)(1) (emphasis added).

239 *See* 17 C.F.R. § 240.13d-5(b)(1).

240 *See* 17 C.F.R. § 240.13d-101. Among other things, Schedule 13D requires disclosure with respect to the identity of the acquirer, the source and amount of its funds, the purpose of the investment, the aggregate number of shares and percentage of its investment in the issuer and any plans or proposals the acquirer may have to acquire additional securities or to seek to effect an extraordinary transaction with respect to the issuer. *Id*. Significantly, postpetition acquirers are required to disclose any intention to file a plan of reorganization and

in the debtor exceed 10% as a "group," each member would become subject to the reporting requirements of section 16(a) of the Exchange Act and the short-swing profit disgorgement provisions of section 16(b) of the Exchange Act with respect to transactions in any equity securities of the issuer unless safe harbors under sections 1125(e) and 1145 of the Bankruptcy Code apply;[241] and (3) if either an Equity Committee or an ad hoc committee of equity security holders constitutes a "group," a "change of control" covenant contained in one or more of the issuer's debt documents may be triggered and thereby impose challenges to reinstatement of debt contemplated by a proposed plan of reorganization or even cause a company to be forced into bankruptcy because of change of control defaults or repurchase requirements that are triggered by a change of control. Therefore, an analysis is warranted to explore whether a committee of equity security holders (whether officially appointed or organized on an *ad hoc* basis) constitutes a section 13(d) "group" both during the process of developing an out-of-court restructuring proposal or a consensual chapter 11 plan of reorganization and following implementation of such arrangements.

1. *The Charter Decision*

The recent decision in *Charter Communications, Inc*.[242] dealt with a number of issues related to allegations of section 13(d) group membership by members of a bondholder committee and, therefore, is of interest. In *Charter*, the debtor, the country's fourth largest cable operator, proposed "perhaps the largest and most complex prearranged bankruptc[y] ever attempted, and in all likelih-

the terms of any such plan. *Id.* (Item 4 of Schedule 13D requires acquirers to "[s]tate the purpose or purposes of the acquisition of securities of the issuer [and d]escribe any plans or proposals which they may have which relate to or would result in . . . (b) . . . [a] reorganization or liquidation, involving the issuer or any of its subsidiaries").

241 It should be noted that the combination of section 13(d) reporting and section 16(b) liability can pose very significant issues for persons who are subject to such requirements in light of the very active section 16(b) plaintiffs' bar. A number of such firms use sophisticated automated tools to analyze the Schedule 13D, Schedule G and Form 3/4/5 filings of persons subject to section 16 of the Exchange Act to bring disgorgement lawsuits. In particular, entities that are engaged regularly in trading activities may be particularly vulnerable once subject to section 16 liability unless safeguards are put in place.

242 *In re Charter Commc'ns Inc.*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009).

ood … among the most ambitious and contentious as well."[243] Key aspects of the pre-arranged plan of reorganization included the reinstatement of $11.8 billion of senior debt issued by certain subsidiaries and the exchange by certain bondholders of their debt for the new equity of the reorganized company. As a result of the debt-for-equity exchange and backstopping of a rights offering, certain members of an *ad hoc* bondholder committee (collectively, the "*Bondholders*") would in the aggregate hold more than 35% of the reorganized company's equity.

Certain senior lenders alleged that their debt could not be reinstated because confirmation of the proposed plan would result in a "change of control" that would either (a) constitute an event of default under their loan documents or (b) trigger a requirement for the relevant issuer to repurchase their debt at or above par upon consummation of the plan. Specifically, a "change of control" would be triggered if a "group" (as defined by section 13(d) of the Exchange Act) were to hold more than 35% of the voting power of the borrower (on a fully diluted basis) unless the majority shareholders of the pre-reorganized Charter held a greater percentage of such voting power.[244]

The *Charter* court concluded that the Bondholders never formed or constituted a "group" for purposes of section 13(d) of the Exchange Act, although the Bondholders worked collectively and in a coordinated fashion to secure control of Charter for common economic motivations.[245] Specifically, the *Charter* court pointed to the following: (a) the Bondholders did not enter into any binding agreements that tied them together as a group for purposes of dealing with Charter's equity securities; and (b) each of the Bondholders made an independent decision to purchase Charter debt prior to restructuring negotiations and did not take the initiative to form an *ad hoc* committee (rather, each was invited by Charter's financial advisor to do so).[246] As such, because the Bondholders were found not to be a section 13(d) "group," the "change of control" covenant was not violated.

Charter raises two key issues for prospective members of official Equity Committees or *ad hoc* equity committees. The first is wheth-

243 *Id.* at 230.

244 *Id.* at 248.

245 *Id.* at 249.

246 *Id.*

er an explicit agreement with respect to acquiring, holding, voting or disposing of securities of an issuer is required to make the members of an equity committee a "group" for purposes of section 13(d)(3) of the Exchange Act, or whether general allegations of co-operative activity are sufficient. The second is whether actual beneficial *ownership* of a registered class of voting equity security is required for "group" status, or whether an *agreement to acquire* securities of an issuer that will replace an existing class of voting security registered under section 12 of the Exchange Act, or that will eventually be registered under section 12 of the Exchange Act, is sufficient to establish group status under section 13(d)(3) of the Exchange Act.

Prior to the *Charter* decision, courts found that general allegations of parallel investments and cooperative activity by investors were insufficient to prove existence of a "group";[247] rather, proof of an agreement or arrangement among such investors to act in concert is required to form a "group."[248] The plain language of section 13(d)(3) of the Exchange Act demands only an agreement for the purposes of "acquiring, holding, or disposing of securities;" it does not require an agreement to gain corporate control or to influence corporate affairs.[249] The *Charter* court reaffirms these principles by holding that the existence of a "group" must be evidenced by an actual agreement with respect to plan securities. This conclusion is also consistent with the position of the SEC, as articulated in its no-action letters, providing that collaborative activity by investors itself does not give rise to a section 13(d) "group" within the meaning of the Exchange Act.[250] Based upon *Charter*, therefore, to

247 *See, e.g., Litzler* v. *CC Inv., L.D.C.*, 411 F. Supp. 2d 411, 415 (S.D.N.Y. 2006) (such allegations do not suffice to establish a "group" for purposes of section 13(d) of the Exchange Act within the meaning of section 16(b) of the Exchange Act).

248 *See, e.g., Quigley Corp.* v. *Karkus*, No. 09-1725, 2009 WL 1383280, at *3 (E.D. Pa. May 15, 2009) ("There must be agreement to act in concert."). No written agreement is needed to find that a group exists, so courts will look to circumstantial evidence to determine whether a group exists. *See, e.g., Hallwood Realty Partners, L.P.* v. *Gotham Partners, L.P.*, 286 F.3d 613, 617 (2d Cir. 2002).

249 *Morales v. Quintel Entm't, Inc.*, 249 F.3d 115, 125-26 (2d Cir. 2001).

250 *See, e.g., Reading and Bates Corp.*, SEC No-Action Letter, 1989 WL 246329, at *4 (Aug. 21, 1989) (the SEC agreed not to recommend enforcement against a group of banks holding debt of a company that was proposing a restructuring transaction whereby the banks would

constitute a section 13(d) "group," a binding agreement among members of an Equity Committee with respect to acquiring, holding, voting or disposing of securities is required.

The *Charter* decision does not, however, discuss whether individuals or entities without a current beneficial ownership interest in the debtor's securities can nonetheless become members of a "group" within the meaning of section 13(d)(3) of the Exchange Act. Outside of the bankruptcy context, courts have held that there can be no "group" unless each member actually beneficially owns the relevant securities at the time the purported group is formed.[251] To be a "beneficial owner" under sections 13(d) and 16(b) of the Exchange Act, such an owner must have an interest in the *outstanding*

receive, in part, common stock of the company in exchange for the debt obligations owed to them).

251 *See Hemispherx Biopharma, Inc. v. Johannesburg Consol. Inv.,* 553 F.3d 1351, 1366 (11th Cir. 2008) ("[A] beneficial ownership interest in securities is necessary to become a member of a group within the meaning of section 13(d)(3) of the Exchange Act."); *Rosenberg v. Xm Ventures,* 274 F.3d 137, 147-48 (3d Cir. 2001) ("[E]ach member of a section 13(d) group must hold beneficial ownership of the shares of the issuing entity prior to becoming a section 13(d) group member."); *Transcon Lines v. A.G. Becker Inc.,* 470 F.Supp. 356, 372-74 (S.D.N.Y. 1979) (same).

The SEC appears to agree that a current beneficial ownership interest in securities is necessary to become a member of a group within the meaning of section 13(d) of the Exchange Act. *See Great Sw. Overseas Fin. Corp. N.V.*, SEC No-Action Letter, 1972 WL 8199, at *4 (Apr. 17, 1972) (noteholders agreed to a refinancing plan and to receive new warrants in connection therewith; the SEC found that "[a]lthough the common stock of the company is registered under Section 12 of the [Exchange] Act, the [warrants] to purchase shares of such stock are not, and such warrants may not be exercised until [a later date]. Therefore, the receipt of the [warrants] by the [noteholders] in the refinancing transaction did not involve a present acquisition of the underlying common stock of [the issuer] …. The holders of the [warrants] would not be considered to be acting as a group with respect to the common stock of [the issuer] either at the time the [warrants] first became exercisable or thereafter, solely because they were acting as a group at the time of the receipt of the [warrants] in the refinancing").

securities of "any class of equity security of the debtor *registered* pursuant to section 12 of the Exchange Act."[252]

Therefore, two or more members of an Equity Committee would likely be deemed to have formed a "group" for purposes of section 13(d) of the Exchange Act if they enter into a binding agreement (unrelated to the debtor's reorganization or its plan) to acquire, hold or dispose of a debtor's pre-reorganization stock, if such stock is a voting security and is registered under section 12 of the Exchange Act. Such would be the case because such members already were beneficial owners of the debtor's pre-reorganization stock when they agreed to acquire, hold or dispose of more shares of such stock. If such beneficial owners were to sign a plan support agreement that required them to vote their shares of existing registered stock in favor of a plan, such beneficial owners would be members of a section 13(d)(3) group.

The situation is different where members of an Equity Committee participate in a debtor's rights offering or plan of reorganization by exchanging their existing securities that are *not* registered under section 12 of the Exchange Act for plan securities. When members collectively negotiate with the debtor over the terms of a proposed plan and agree to the terms of a related transaction with the debtor, plan securities have not yet been issued by the debtor and have, therefore, not been registered under section 12 of the Exchange Act. Under such an agreement, the receipt of plan securities by members of an Equity Committee does not involve a purchase of the debtor's existing common stock already registered pursuant to section 12 of the Exchange Act.[253] Therefore, plan securities in such instance cannot be considered to be *outstanding* securities of "any class of equity security of the issuer *registered* pursuant to section 12 of the Exchange Act." Accordingly, members of an Equity Committee, which merely own beneficial interests in the debtor's pre-reorganization common stock, are not "beneficial

[252] *See* 15 U.S.C. § 78m(d)(1); 17 C.F.R. § 240.16a-1(a)(1). Section 12 of the Exchange Act sets forth registration requirements for any member, broker or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange. *See* 15 U.S.C. § 78l.

[253] A similar interpretation was made by the SEC in *Great Sw. Overseas Fin. Corp. See supra* note 251 and accompanying text.

owners" of, and do not have beneficial interests in, plan securities at the time when the purported "group" forms.[254]

Consequently, a section 13(d) "group" within the meanings of sections 13(d) and 16(b) of the Exchange Act does not exist unless members of the Equity Committee actually beneficially own section 12 registered securities at the time the purported group is formed. In addition, based upon Charter, even where members of an Equity Committee act cooperatively with each other to participate in the debtor's plan or a related rights offering, they do not form a section 13(d) "group" within the meanings of sections 13(d) and 16(b) of the Exchange Act in the absence of an agreement with the purpose of acquiring, holding, voting or disposing of plan securities of the debtor.

2. *Safe Harbors of the Bankruptcy Code*

As discussed below, sections 1125(e) and 1145 of the Bankruptcy Code protect Equity Committee members from liability based upon non-compliance with the requirements of relevant securities laws with respect to disclosure, solicitation, registration, sales or purchases of securities. An obligation of a person that becomes the beneficial owner of more than 5% of any class of a company's voting equity securities to make section 13(d) filings, however, does not fall into the purview of such safe harbor protections. Therefore, if members of an Equity Committee are found to be a section 13(d) "group" within the meanings of sections 13(d) and 16(b) of the Exchange Act, sections 1125(e) and 1145 of the Bankruptcy Code would only shield members from liability based upon non-compliance with sections 16(a) and 16(b) in certain circumstances.

a. Section 1125(e) of the Bankruptcy Code

Section 1125(e) of the Bankruptcy Code protects Equity Committee members from risks associated with soliciting acceptances or rejections of a plan and participating in the offer, issuance, sale or purchase of a security of the debtor offered or sold under the plan, provided that such members act in good faith and comply with the applicable provisions of the Bankruptcy Code.[255] Case law

[254] This is similar to the situation in *Charter* where the Bondholders did not hold beneficial interests in plan securities when they cooperatively negotiated the pre-arranged chapter 11 plan with Charter and other parties.

[255] Section 1125(e) of the Bankruptcy Code provides that:

and SEC no-action letters have addressed the disclosure and solicitation process under section 1125(e) of the Bankruptcy Code. For example, as a general matter, the term "solicitation" in the chapter 11 context should be interpreted narrowly to facilitate negotiations between creditors or shareholders to reach a compromise over the terms of a proposed plan.[256] At least one court has found "no principled, predictable difference between negotiation and solicitation" with respect to acceptance or rejection of a proposed plan.[257] Accordingly, negotiations among parties in interest over the proposed plan are encouraged. Moreover, section 1125(e) of the Bankruptcy Code provides that the adequacy of the disclosure and solicitation process related to a chapter 11 plan is not governed by federal or state securities laws.[258] Therefore, members of an Equity Committee that rely on a bankruptcy court-approved disclosure statement and comply with other applicable requirements of chapter 11 should not be liable for soliciting acceptances or rejections under the disclosure rules of the securities laws. The antifraud provisions of such laws, however, still apply to other activities.[259]

> A person that solicits acceptance or rejection of a plan, in good faith and in compliance with the applicable provisions of this title, or that participates, in good faith and in compliance with the applicable provisions of this title, in the offer, issuance, sale or purchase of a security, offered or sold under the plan, of the debtor, of an affiliate participating in a joint plan with the debtor, or a newly organized successor of the debtor under the plan, is not liable, on account of such solicitation or participation, for violation of any applicable law, rule or regulation governing solicitation of acceptance or rejection of a plan or the offer, issuance, sale or purchase of securities.

§ 11 U.S.C. 1125(e).

256 *See, e.g., Century Glove, Inc.* v. *First Am. Bank*, 860 F.2d 94, 101 (3d. Cir. 1988) ("A broad reading of § 1125 can seriously inhibit free creditor negotiations.").

257 *Id.*

258 *See Jacobson* v. *AEG Capital Corp.*, 50 F.3d 1493, 1496 (9th Cir. 1995).

259 *Bennett Petroleum Corp.*, SEC No-Action Letter, 1983 WL 28907, at*1 (Dec. 27, 1983); *see also Jacobson*, 50 F.3d at 1496 ("Section 1125(e) only provides a safe harbor for the disclosure and solicitation process of a bankruptcy. In other words, if the securities fraud alleged came from some other source or procedure than disclosure and solicitation, then section 1125(e) would not provide immunity.").

There appears to be no decision or SEC no-action letter addressing an Equity Committee's participation in the offer, issuance, sale or purchase of a security of the debtor offered or sold under a chapter 11 plan. Under the plain language of section 1145(e) of the Bankruptcy Code (discussed below), such activities should be protected from liability arising out of non-compliance with securities law as long as the committee member's participation is in good faith and complies with applicable bankruptcy law. Without such an exemption from liability, uncertainty would exist as to whether purchases or sales of plan securities by members of an Equity Committee would be subject to section 16(b) of the Exchange Act regarding the recapture of short-swing profits. This would be of particular concern if members of an Equity Committee were found to constitute a section 13(d) "group" within the meaning of section 16(b) of the Exchange Act. Accordingly, activities of members of an Equity Committee related to the disclosure and solicitation process as well as participation in the debtor's plan should be outside the SEC's concern, although careful analysis of the applicability of section 16(b) of the Exchange Act with respect to any particular purchases and sales of equity securities of the debtor may still be warranted based on the particular facts and circumstances.

b. Section 1145 of the Bankruptcy Code

Section 1145(a) of the Bankruptcy Code exempts certain offers and sales of securities issued by a debtor (or an affiliate of the debtor) under a plan of reorganization from the registration and prospectus delivery requirements of the Securities Act of 1933 (the "*Securities Act*") and from any other federal or state laws requiring registration of securities or registration or licensing of an issuer or underwriter of, or broker or dealer in, such securities.[260] Sec-

[260] Section 1145(a) provides, in relevant part, that:

> (a) Except with respect to an entity that is an underwriter as defined in subsection (b) of this section, section 5 of the Securities Act of 1933 and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security do not apply to –
>
> (1) the offer or sale under a plan of a security of the debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to the debtor under the plan;

tion 1145(c) of the Bankruptcy Code deems an offer or sale of securities in conformity with section 1145(a)(1) of the Bankruptcy Code to be a "public offering" for Securities Act purposes and, as a result, plan securities that an Equity Committee member receives in a section 1145(a)(1) offering are unrestricted provided such member is not an "underwriter" of plan securities.[261] Therefore, members of an Equity Committee must have received plan securities from the debtor (or its affiliates) in a plan transaction that itself satisfied section 1145 of the Bankruptcy Code in order to resell such securities.[262] Thus, in cases such as *MES Int'l*, debtors have relied on section 1145 of the Bankruptcy Code to exempt the issuance of new equity to prepetition shareholders from the registration requirements of the Securities Act and any state securities or "blue sky" laws.[263] Nonetheless, independent confirmation of the applicability of section 1145 of the Bankruptcy Code is advisable.

> > (A) in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor or such affiliate; or
> >
> > (B) principally in such exchange and partly for cash or property;
>
> (2) the offer of a security through any warrant, option, right to subscribe, or conversion privilege that was sold in the manner specified in paragraph (1) of this subsection, or the sale of a security upon the exercise of such a warrant, option, right, or privilege; ….

11 U.S.C. § 1145(a).

261 *See* 8 *Collier on Bankruptcy* ¶ 1145.04 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

262 A debtor also can rely, without registration, on the private placement exemption of section 4(2) of the Securities Act, which provides that registration is not required for transactions by an issuer not involved in any public offering. Members of an Equity Committee can rely on Rule 144 or a privately negotiated "§4(1-1/2)" transaction to resell their shares of common stock received in exchange for their holdings in the debtor's pre-reorganization common stock. However, these exemptions may not be available to the issuance of plan securities by the debtor (or the resale by members of an Equity Committee) to a large class of existing shareholders.

263 In their proposed plans, debtors have routinely concluded that any issuance of plan securities is being made in accordance with the safe harbor of section 1145(a)(1) of the Bankruptcy Code. *See, e.g.,* Final Fourth Modified Joint Chapter 11 Plan of Reorganization, *In re MES Int'l,*

Section 1145(a)(1) of the Bankruptcy Code applies to plan securities offered and sold in exchange for existing equity interests in the debtor, or "*principally in … exchange*" for such equity interests and "*partly for cash*."[264] (emphasis added) When a rights offering is proposed, satisfying the requirement of "principally in … exchange" can be a challenge. The SEC has taken the position that, to qualify for the exemption, the debtor must demonstrate that the value of interests being exchanged exceeds the value of the other consideration (whether new cash or property or a combination of both) to be contributed in exchange for such new common stock.[265]

For example, in *Bennett Petroleum Corp*., the SEC concluded that the offer or sale of Class B Preferred Stock under the plan fell within the exemption of section 1145(a)(1) of the Bankruptcy Code.[266] The proposed exchange involved one share of the company's outstanding common stock and a cash payment equal to 75% of the average bid price for the company's common stock in exchange for one share of Class B Preferred Stock.[267] The debtor asserted that because the cash payment was 75% of the average bid price for the debtor's common stock, the value of the debtor's common stock was greater than the cash payment and therefore the proposed exchange would be "principally" for an interest in the debtor, and "partly" for cash.[268] The SEC in *Bennett Petroleum Corp.* provided no-action relief to permit the debtor to issue the Class B Preferred Stock without registration.

The SEC reached the opposite result in *Marvel Holdings Inc.* In *Marvel*, the SEC objected to the applicability of section 1145(a)(1)(B) of the Bankruptcy Code because the debtor failed to demonstrate that the value of the old common stock to be exchanged under the plan exceeded the amount of the new cash to be contributed pursuant to the rights offering.[269] In that case, the debtor's plan pro-

Inc., et al., Case No. 09-14109 (Bankr. D. Del. May 27, 2010) (Docket No. 768). There is no suggestion that the SEC believes otherwise.

264 *See supra* note 260 and accompanying text.

265 *See, e.g., In Jet Florida Sys., Inc.*, SEC No-Action Letter, 1987 WL 107448, at *7-8, 18 (Jan. 12, 1987); *Bennett Petroleum Corp.*, 1983 WL 28907, at *3.

266 *Bennett Petroleum Corp.*, 1983 WL 28907, at *1.

267 *Id.* at *3.

268 *Id.*

269 Michael Berman, *The SEC Speaks in 1998*, 1038 PLI/CORP 51, at 229; see also Objection of the SEC to the First Amended Disclosure State-

posed to issue to the holders of its old common stock for each share of such old common stock, one-half of one share of new common stock and one right to purchase 1.93 shares of new common stock at a purchase price of $1.857576 per share. The implied value of the old common stock was between $1 and $1.25 per share, and the reorganization value of new common stock was between $2 to $2.50 per share. Therefore, the value of the old common stock to be exchanged under the plan was less than the amount of the new cash to be contributed pursuant to the rights offering.

Further, members of an Equity Committee may participate in an oversubscription offering and backstop arrangement to purchase any shares of common stock unclaimed or not subscribed for by other shareholders.[270] As a result, such members may receive new common stock at a rate disproportionate to their holdings of original interests in the debtor. Thus, although no decision or no-action letter addresses this point, section 1145 of the Bankruptcy Code may also have implications for an oversubscription or backstop feature of a rights offering. To avoid a potential violation of section 1145(a)(1) of the Bankruptcy Code pursuant to the SEC no-action letter in *Bennett Petroleum Corp.*, when members of an Equity Committee exercise their full backstop rights beyond their *pro rata* rights the value of interests being exchanged should exceed the value of the consideration to be contributed (such as new cash to pay for backstop rights and pro rata rights) in exchange for such new common stock.

As mentioned above, plan securities issued to members of an Equity Committee may be resold without registration by members who are neither an "underwriter" within the meaning of section

ment relating to First Amended Joint Chapter 11 Plan of Reorganization and First Amended Joint Plan, *In re Marvel Holdings Inc.*, Case Nos. 96-2066 to 96-2068 (Bankr. D. Del. Jun. 13, 1997).

270 For example, in *MES Int'l*, the Equity Committee proposed to raise $70 million through a rights offering to the equity holders of the pre-reorganized debtor fully backstopped by certain members of the Equity Committee. *In re MES Int'l, Inc.*, Case No. 09-14109 (Bankr. D. Del. Apr. 29, 2010) (Docket No. 650). Later, the Equity Committee reached an agreement with the debtor and the debtor's noteholders that the existing shareholders could participate in the rights offering, but such offering was fully backstopped by certain noteholders as opposed to by certain members of the Equity Committee. *In re MES Int'l, Inc.*, Case No. 09-14109 (Bankr. D. Del. May 27, 2010) (Docket No. 768).

1145(b)(1) of the Bankruptcy Code nor an affiliate of the reorganized debtor.[271] For example, in *Barry's Jewelers, Inc.,* existing shareholders of the debtor received *pro rata* distributions of new warrants to purchase up to 5% of the reorganized debtor's new common stock under the plan.[272] The SEC took no action against the resale of the new warrants and new common stock issuable upon exercise of such new warrants.[273]

Where the requirements of section 1145 of the Bankruptcy Code are met, plan securities should be "exempted securities" under section 16 of the Exchange Act, which explicitly provides that an exempted security is not covered by that provision.[274] Accordingly, coupled with the safe harbor provision of section 1125(e) of the Bankruptcy Code, the reporting requirements of section 16(a) of the Exchange Act and strict short-swing liability under section 16(b) of the Exchange Act should not apply to members of an Equity Committee with respect to purchases and sales (or sales and purchases) of plan securities.

However, as discussed above, safe harbor protections do not excuse the obligation to make section 13(d) filings. Accordingly, members of an Equity Committee should take care not to permit their collective participation in the plan process to cause the formation of a section 13(d) "group" that would trigger unexpected filing obligations under section 13(d) of the Exchange Act.

B. *Intersection of Bankruptcy and Traditional Corporate Law*

1. *Can an Equity Committee Call a Shareholders' Meeting to Replace the Board?*

Shareholders enjoy the fundamental right to select the stewards of the corporation whose shares they own. Reflecting this right, state corporation laws typically require corporations to hold periodic meetings for the shareholders' election of the board of di-

[271] Members of an Equity Committee are assumed not to be an "underwriter" under section 1145(b)(1) of the Bankruptcy Code, and thus any discussion related to qualification as an "underwriter" under section 1145(b)(1) of the Bankruptcy Code is not within the scope of this paper.

[272] *Barry's Jewelers, Inc.*, SEC No-Action Letter, 1998 WL 425887, at *1-5 (Jul. 20, 1998).

[273] *Id.*

[274] *See* 15 U.S.C. §§ 78p(a)(1) and 78p(b).

rectors and consideration of other important matters. For example, in Delaware, corporations must hold a shareholders meeting at least once every thirteen months.[275] If the corporation fails to hold the meeting, a shareholder can apply to the Chancery Court to compel one to be held.[276] Also, the charter or by-laws of Delaware corporations typically enable holders of more than a specified percentage of the outstanding common stock to call for a special meeting. Although shareholders do not actually oversee the operation of the corporation, state law and the corporation's organic documents give them the power to appoint, remove and replace those who do.

If the corporation is bankrupt, the question becomes whether shareholders retain their power over corporate governance and, if so, who exercises that power: the individual shareholders or an Equity Committee. Very few reported cases address these issues. As discussed above,[277] in the seminal case, *In re Johns-Manville Corporation*, the Second Circuit considered whether the bankruptcy court could enjoin an Equity Committee from prosecuting a Delaware action to compel the debtor to hold a shareholders' meeting. After the debtor and its creditor constituencies had reached agreement on a plan of reorganization that, if implemented, would dilute existing equity by 90%, the Equity Committee filed the Delaware action, for the stated purpose of replacing the board with new directors who would consider withdrawing the objectionable plan. The bankruptcy court enjoined the lawsuit under section 105(a) of the Bankruptcy Code[278] on the grounds that the lawsuit "has the potential to derail the entire Manville reorganization," which had taken years to bring to the point of consensus among the debtor and its creditors. The district court affirmed and held that the Equity Committee intended either to "torpedo" the reorganization or to acquire a bargaining chip in further plan negotiations.[279]

On appeal, the Second Circuit reversed and remanded. Relying on the pre-Code decision in *In re Bush Terminal Co.*,[280] the court

275 Del. Gen. Corp. Law § 211(c).

276 *Id.*

277 *See* Section II.E.2.b *supra.*

278 *See* note 203 *supra*.

279 *Id.* at 64.

280 78 F.2d 662, 665 (2d Cir. 1935) (holding that, since shareholders are entitled to be represented by directors of their choice, court may en-

held that shareholders of a bankrupt corporation are entitled to exercise their governance rights, unless doing so would give rise to "clear abuse." Merely seeking to acquire leverage in plan negotiations would not constitute clear abuse, nor would the possibility that replacing the board might lead to delay or outright stalemate with other constituencies. The Second Circuit applied a higher standard: did the Equity Committee's actions seriously threaten or jeopardize the debtor's prospects of reorganization? In other words, whether an Equity Committee desires to defeat a particular plan, even one that took the debtor and creditors years to negotiate, is not determinative; to issue an injunction, the bankruptcy court must find that the Equity Committee's actions put the entire case at risk of failure.[281] Further, the court must find that the debtor would suffer irreparable injury if the Equity Committee were allowed to proceed.[282] Lastly, in *dicta*, the Second Circuit said that, if a debtor is insolvent, then denial of an Equity Committee's effort to call a shareholder meeting might be proper even without a showing of clear abuse by the Equity Committee, since the shareholders of insolvent debtors are not the "real parties in interest."[283] Thus, *Manville* stands for the proposition that an Equity

join shareholders' meeting only in extraordinary circumstances where the harm is "disproportionate to the good obtainable").

281 *See also Heck's Properties*, 151 B.R. at 760 ("clear abuse" standard means that committee must be "motivated by a bad faith desire to risk rehabilitation altogether").

282 *See Manville*, 801 F.2d at 68 (stating that a finding of "clear abuse" would not necessarily lead to one of "irreparable injury"). It is difficult to envision circumstances under which the former threshold is met and the latter is not.

283 *Id.* at 65, n.6. Unfortunately, the Second Circuit provided no guidance as to how litigation with respect to solvency should proceed at the stage of the bankruptcy case in which a *Manville* issue might typically arise (*i.e.*, after the debtor has proposed a plan to which the Equity Committee objects, but before the confirmation hearing on that plan). To force an Equity Committee to wait until the confirmation hearing would arguably deprive the Equity Committee of its right under *Manville* to install a board to withdraw that very same plan. On the other hand, litigating the issue of the debtor's solvency prior

Committee of a solvent debtor (or at least of a debtor not yet proven to be insolvent) may proceed with the replacement of the debtor's board, unless the bankruptcy case would collapse as a result.

However, *Manville* does not address, much less resolve, the threshold question of whether an Equity Committee has the power under the Bankruptcy Code to bring a state court lawsuit at all. Section 1103(c) of the Bankruptcy Code[284] enumerates four specific categories of actions in which an Equity Committee (or a creditors' committee) may engage, none of which expressly authorizes the filing of non-bankruptcy court lawsuits. Moreover, several courts have held that the fifth catch-all category (*i.e.*, performing "such other services as are in the interest of those represented") does not give a statutory committee the authority to engage in activities outside of bankruptcy court.

For example, in *In re Dow Corning Corporation*,[285] the tort claimants' committee requested court approval to expand the services of its counsel to include lobbying activities. The committee argued that the debtor was lobbying the Food and Drug Administration to lift a moratorium on the debtor's products (*i.e.*, silicone implants)

to the confirmation hearing would promote the type of piecemeal litigation that courts typically endeavor to avoid, since solvency might be an important issue raised by the plan. The Second Circuit also left unaddressed other important issues, such as who would have the burden of proof on solvency.

284 Section 1103(c) of the Bankruptcy Code provides that "[a] committee appointed under section 1102 of this title may — (1) consult with the trustee or debtor in possession concerning the administration of the case; (2) 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, and any other matter relevant to the case or to the formulation of a plan; (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan; (4) request the appointment of a trustee or examiner under section 1104 of [the Bankruptcy Code]; and (5) perform such other services as are in the interest of those represented." 11 U.S.C. § 1103(c).

285 199 B.R. 896 (Bankr. E.D. Mich. 1996).

and was seeking federal legislation to protect implant manufacturers from liability. Without the ability to lobby against the debtor, the committee would be unable to counteract the detrimental effect that the debtor's efforts, if successful, would have on the committee's constituency.

The *Dow Corning* court held that section 1103(c)(5) of the Bankruptcy Code must be read in harmony with subsections (c)(1) through (c)(4). The common factor in subsections (c)(1) through (c)(4) is that the enumerated actions, such as formulating a reorganization plan or requesting a trustee, all take place within the reorganization itself, not outside of it. Thus, the court construed section 1103(c)(5) of the Bankruptcy Code as authorizing a statutory committee only to engage in ancillary actions inside of the case and denied the lobbying request.[286] Under *Dow Corning*'s logic, an Equity Committee would have no power to sue the debtor in state court to compel a shareholders' meeting.

If Equity Committees are restricted from suing debtors outside of bankruptcy court, the question then arises as to whether an Equity Committee can sue the debtor for the same purpose *in* bankruptcy court. At least one court has said yes. In *New York Trap Rock*, the Equity Committee sought court approval to retain Delaware counsel to prosecute a Chancery Court action compelling the debtor to call an annual meeting for the purpose of electing new directors. The court denied this request and stayed further prosecution of the Delaware action. However, the court held that the Equity Committee did have the power under section 1103(c)(5) of the Bankruptcy Code to come before the bankruptcy court and seek enforcement of a by-law provision requiring the calling of a meeting.[287] The court also stated in *dicta* that the debtor's individual

286 *Id.* at 903; *cf. In re Eagle-Picher Indus., Inc.,* 167 B.R. 102, 103 (Bankr. S.D. Ohio 1994) (denying request of Equity Committee for the reimbursement of fees incurred in attempting to prevent a de-listing of the debtor's common stock; stating that "[a] distinction must be made between services which benefit shareholders, and services which benefit shareholders for which the bankruptcy estate should pay.").

287 *New York Trap Rock*, 138 B.R. at 423 ("Clearly, an official Equity Committee has standing as a party in interest to apply to the bankruptcy court for an order compelling the debtor's directors to comply with ... the debtor's own by-laws."). The court side-stepped the question of whether the Equity Committee was a "stockholder" within

shareholders clearly have standing to bring an action in the Delaware courts to compel an annual meeting.[288]

The theme of *Manville* and the other cases described above is this: normal corporate governance does not stop completely at the door of bankruptcy. Shareholders or their representatives are entitled to replace the debtor's board, but they cannot do so if their purpose, or the likely effect of their action, is to jeopardize the debtor's emergence from chapter 11. Moreover, at least according to the later cases, Equity Committees can only sue in the bankruptcy court itself to enforce the debtor's by-laws, and not in state court. Inasmuch as Equity Committees are creatures of the Bankruptcy Code, this latter restriction makes sense. An Equity Committee should arguably be able to pursue the corporate governance rights of shareholders in appropriate circumstances (*i.e.*, where the debtor is solvent and there is no "clear abuse"), but only before the court which generally has supervisory authority over it and is familiar with the reorganization.

The analogous question is whether courts should impose a similar venue restriction on individual shareholders. It would seem logical that all litigation over an issue as fundamental as the debtor's corporate governance should be brought before the bankruptcy court, regardless of the identity of the plaintiff. This is particularly true when the litigation is brought late in the case, as a tactic to enhance the shareholders' bargaining power against other constituencies. However, exercising control over individual shareholders in this manner would not have an explicit basis in the Bankruptcy Code (beyond, perhaps, section 105(a), and unlike section 1103 as applied to Equity Committees) and might run contrary to the disinclination of at least some bankruptcy courts to "interfere with corporate democracy."[289]

the meaning of DGCL § 211(c) and therefore had standing to bring an action under that section, since the Equity Committee abandoned its section 211(c) action and was instead suing to enforce the debtor's by-laws. *Cf. Prickett v. Am. Steel and Pump Corp.*, 251 A.2d 576, 578 (Del. Ch. 1969) (receiver appointed by federal court to take action as a shareholder of defendant may bring Delaware action to compel shareholders' meeting).

288 *Id.* at 423 (citing *In re Mid-America Petroleum, Inc.*, 71 B.R. 140, 142 (N.D. Tex. 1987)) (individual shareholder may seek to replace entire board of debtor).

289 *Id.*

Ironically, an Equity Committee's success in pursing the shareholders' corporate governance rights might call into question the need for the continued existence of the Equity Committee itself. For example, if as a result of an Equity Committee's efforts, a new board of directors is elected by the shareholders, other parties might argue that the shareholders are now "adequately represented" and that a statutory committee, paid for by the estate, is no longer necessary to represent their interests.

V. FIDUCIARY DUTIES OF AN EQUITY COMMITTEE

A. *Duties of the Board vs. The Equity Committee*

It is universally held that directors stand in a fiduciary relationship to the corporation they serve and its shareholders. Inasmuch as corporate directors occupy a fiduciary capacity, they must exercise the utmost good faith in all transactions touching their duties to the corporation and its property. In other words, a director of a corporation owes the corporation complete loyalty, honesty and good faith.[290] Thus, it has been expressly held that a director's primary duty is to act totally for the benefit of the corporation with the objective of maximizing its enterprise value.[291] Accordingly, as fiduciary, a director may not pursue a private advantage at the expense, or to the detriment, of the corporation.

Although the Bankruptcy Code does not expressly provide that members of official committees are fiduciaries, it has been clearly established by case law that an Equity Committee and its members owe a fiduciary duty to the debtor's shareholders (and, in contrast to the debtor's board, *not* to the corporation or the debtor-in-possession).[292] In *In re Johns-Manville Corporation*,[293] Judge Lifland

290 Fletcher Cyclopedia Corporations, § 837.50 Directors, Other Officers and Agents (2009); *see also Gully v. Nat'l Credit Union*, 341 F.3d 155, 165 (2d Cir. 2003) (applying New York law; stating that "[a] corporate officer's fiduciary duty includes discharging corporate responsibilities 'in good faith and with conscientious fairness, morality and honesty in purpose' and displaying 'good and prudent management of the corporation.'") (quoting *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 569 (1984)).

291 *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 887 (6th Cir. 1986).

292 *See In re Drexel Burnham Lambert Group*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992), *aff'd*, 140 B.R. 347 (S.D.N.Y. 1992); *Johns-Manville,* 60 B.R. at 853-54 n.23; *Penn-Dixie Indus.*, 9 B.R. at 944; *see also* Section II.E *supra*.

held that "it is well-established that a holder of a claim or an equity interest who serves on a committee undertakes to act in a fiduciary capacity on behalf of the members of the class he represents."[294] Subsequently, in *In re Microboard Processing, Inc.*,[295] the court expressly stated that "[a] creditors committee and its members owe no duty to the debtor or the estate…. A committee and the holders of claims who serve on it only have a fiduciary duty to the parties or class represented."[296] The same rule applies to Equity Committees and their members.[297] Likewise, members of an Equity Committee, serving as fiduciaries, are not permitted to act in their own interest as a group to acquire, hold or dispose of plan securities.[298]

In *Johns-Manville*, Judge Lifland explained the policy reasons behind the foregoing rule: "In the case of reorganization committees, these fiduciary duties are crucial because of the importance of committees. Reorganization committees are the primary negotiating bodies for the plan of reorganization. They represent those classes from which they are selected. They also provide supervision of the debtor and execute an oversight function in protecting their constituent's interest."[299]

293 26 B.R. 919 (Bankr. S.D.N.Y. 1983)

294 *Id.* at 924 (citations omitted).

295 95 B.R. 283 (Bankr. D. Conn. 1989).

296 *Id.* at 285 (citations omitted).

297 H. Miller & M. Cook, *A Practical Guide to the Bankruptcy Reform Act*, at 527, n. 78 (declaring that the members of an Equity Committee are presumed to have undertaken fiduciary responsibilities identical to those assumed by the members of a creditors' committee). *But see Drexel*, 138 B.R. at 722 (stating that the fiduciary duties of Equity Committees and their members extend to the class of shareholders as a whole and *not* to individual members of the class).

298 Whether such a limitation might also apply to members of an *ad hoc* equity committee is an issue of keen interest to the investing community. *Compare In re Washington Mut., Inc.*, 419 B.R. 271, 279 (Bankr. D. Del. 2009) (suggesting, without deciding, that members of an *ad hoc* committee may owe fiduciary duties to other members of the relevant class) *with Charter Commc'ns*, 419 B.R. at 249 (holding that bondholders who functioned as an *ad hoc* committee were able to act in their own interests in the formulation and negotiation of a plan). *See* Section IV.A *supra* regarding treatment of Equity Committee members as a "group" for securities law purposes.

299 *Johns-Manville*, 26 B.R. at 925.

This fiduciary duty prohibits members of an Equity Committee from maximizing their own interests at the expense of other shareholders. The breach of an Equity Committee member's fiduciary duty to shareholders has the following consequences: (1) the member can be removed from the Equity Committee; (2) the member's vote on the plan can be designated under section 1126(e) of the Bankruptcy Code; (3) the member's claim or interest can be equitably subordinated under section 510(c) of the Bankruptcy Code; or (4) an action may be brought by "an aggrieved party for damages or to force disgorgement of benefits improperly received by the committee member." [300] Although limited immunity may be granted to members of an Equity Committee with respect to their fiduciary duties and to release them from liability absent willful misconduct,[301] the existence of such duties would still create potential risks for members of an Equity Committee who do not act in the best interests of all shareholders.

Given the differences between the duties of a debtor's directors and Equity Committee members set forth above, a strong argument can be made that a debtor's board of directors are not "adequately representing" the interests of equity holders.[302] To be sure, the efforts of the directors to maximize enterprise value and create a rising tide, if successful, may inure to the economic benefit of the stockholders. An Equity Committee and its constituents, on the other hand, could conceivably benefit from conduct that might adversely affect the debtor's value if, as Judge Abram noted, they were successful in "negotiating over the terms of what is in essence a gift,"[303] conduct that would be consistent with the committee's exclusive fiduciary duty to its constituents to maximize their recovery.[304] Moreover, in *Advisory Committee of Major Funding Corp. v. Sommers*,[305] the Court of Appeals for the Fifth Circuit stated that an

300 *See* 7 *Collier on Bankruptcy* ¶ 1103.05[4][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

301 *Drexel,* 138 B.R. at 722 (finding that "[t]he Plan's 'willful misconduct' standard strikes the proper balance between breach of duty and limited immunity").

302 *See* Section II.E *supra.*

303 *Emons,* 50 B.R. at 694.

304 Michael S. Lurey, *et al.*, *The Role of the Chapter 11 Creditors' Committee*, 546 P.L.I./Comm. 171 (1990).

305 109 F.3d 219 (5th Cir. 1997).

official committee has a "duty" rather than just the "power" to "use any tool available under Section 1103 to accomplish its goal of acting in the best interests of [its constituency]."[306]

Clearly, the foregoing standard could not apply to Equity Committee members were they burdened with a duty to the corporation and all of its competing constituencies. Based upon the foregoing, it is fairly evident that the existence of an active board of directors does not constitute a basis for denying a motion to appoint an Equity Committee pursuant to section 1102(a)(2) of the Bankruptcy Code.

B. What Behavior Results in Vote Designation?

Assuming that equity interests are permitted to vote on a plan of reorganization,[307] the voting rules present in the Bankruptcy Code and the Bankruptcy Rules will apply to holders of equity interests, including members of an Equity Committee. In particular, section 1126(e) of the Bankruptcy Code provides that "[o]n request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title."[308] This provision is permissive, not mandatory, and a bankruptcy judge has discretion in designating votes.[309] The Bankruptcy Code does not define the phrase "good faith." As such, the definition of "good faith" must be found in case law.

In *In re Dune Deck Owners Corp.*,[310] the court noted that bad faith may be found where a claim holder attempts to extract or extort a

306 *Id.* at 224.

307 Often, holders of equity interests receive no value on account of such interests under a debtor's chapter 11 plan and, thus, are deemed to have rejected such plan. *See* 11 U.S.C. § 1126(g) (providing that "a class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class do not entitle the holders of such claims or interests to receive or retain any property under the plan on account of such claims or interests").

308 11 U.S.C. § 1126(e).

309 *See Century Glove*, 860 F.2d at 97 (stating that section 1126(e) of the Bankruptcy Code "grants the bankruptcy court discretion to sanction any conduct that taints the voting process, whether it violates a specific provision or is in 'bad faith.'").

310 175 B.R. 839 (Bankr. S.D.N.Y. 1995).

personal advantage not available to other creditors or equity holders in the class, or where a creditor or equity holder acts in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor. The *Dune Deck Owners* court went on to cite several "badges of bad faith," including efforts to: (1) assume control of the debtor; (2) put the debtor out of business or otherwise gain a competitive advantage; (3) destroy the debtor out of pure malice; or (4) obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize.[311] Some courts have held that some type of wrongdoing must be present to evidence bad faith.[312] The burden on a party seeking to have a ballot disallowed is heavy.[313] Designation of a creditor's or an equity holder's vote is a drastic remedy, and as a result, designation of votes is the exception, not the rule.[314]

The leading case on the first badge of fraud – an attempt to assume control of the debtor – is *In re Allegheny Int'l, Inc.*,[315] albeit in the creditor context. In *Allegheny*, a plan proponent, Japonica Partners, purchased claims against the debtor at increasing prices (even after the debtor had filed a plan of reorganization) in order to gain control of the reorganized debtor and block confirmation of an alternative plan that would have denied Japonica Partners the opportunity to acquire such control. The *Allegheny* court ruled that, pursuant to section 1126(e) of the Bankruptcy Code, the purchase of claims was not executed in good faith, and the court disqualified Japonica Partners' vote against the debtor's plan. The court noted that "[t]he particular claims that Japonica purchased, and the manner in which they were purchased, can be used to determine their intent" (the claims were acquired at a price as high as 95 cents on the dollar).[316] Japonica was determined to be acting with a purpose to take over and control the reorganized debtor, a purpose fundamentally different than the normal desire of any creditor to maximize recovery on its claim against the debtor. Such acts were "in aid

311 *Id.* at 844-45; *see also In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 60 (Bankr. S.D.N.Y. 2006).

312 *Adelphia*, 359 B.R. at 60.

313 *Id.* at 61.

314 *Id.*

315 118 B.R. 282 (Bankr. W.D. Pa. 1990).

316 *Id.* at 289.

of an interest other than an interest as a creditor."[317] The court determined that votes must be designated where a creditor has cast his vote with an ulterior purpose aimed at gaining some advantage to which it would not otherwise be entitled in its position.

In what was deemed "a classic case for application of the *Allegheny* doctrine," the bankruptcy court for the Southern District of New York designated the vote of DISH Network Corporation ("*DISH*") in *In re DBSD North America, Inc.*[318] DISH had purchased all claims within a certain class at par, knowing that the plan proposed replacing the debt in this class with an amended financing facility that DISH did not want.[319] A senior officer at DISH admitted that "there was no determination made that it made financial sense to buy this debt."[320] The court noted that "[w]hen an entity becomes a creditor late in the game paying 95 [cents] on the dollar (as in Japonica), or 100 [cents] on the dollar, as here, the inference is compelling that it has done so not to maximize the return on its claim, acquired only a few weeks earlier, but to advance an 'ulterior motive' condemned in the caselaw."[321] Further, DISH had acquired claims after the debtor proposed its plan of reorganization.[322] DISH's own documents revealed that DISH desired "to obtain a blocking position" and "control the bankruptcy process for this potentially strategic asset."[323]

Ultimately, DISH's true purpose of acquiring debt and using it to vote to advance DISH's effort to take control of the debtor was found to be as plain as in *Allegheny*. In closing, the *DBSD* court encouraged Congress "to modify the Code to authorize Bankruptcy Judges to designate creditor votes for overly-aggressive and other egregious conduct even when the creditors are trying to increase

317 *Id.* (quoting *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945)).

318 421 B.R. 133 (Bankr. S.D.N.Y. 2009), *aff'd*, *Sprint Nextel Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, No. 09-10156, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in relevant part and rev'd in part*, *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, No. 10-1175, 2011 WL 350480 (2d Cir. Feb. 7, 2011).

319 *Id.* at 140.

320 *Id.*

321 *Id.*

322 *Id.*

323 *Id.* at 140-41.

returns on long positions."[324] The Second Circuit, finding that DISH had impermissibly "purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring DBSD's spectrum rights, not toward protecting its claim …. [but to] divert[ ] the progress of the proceedings to achieve an outside benefit," affirmed the bankruptcy court's designation of DISH's vote.[325]

By contrast, the same court elected not to designate the votes of a class of creditors in *In re Adelphia Communications Corporation*. In *Adelphia*, Judge Gerber noted that "[t]he ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case. And in my view, it should not be denied except for highly egregious conduct – principally, seeking to advance interests apart from recovery under the Plan, or seeking to extract plan treatment that is not available for others in the same class."[326] The targeted creditors in *Adelphia* had entered into a settlement with the debtor and thereby allegedly extracted special consideration for themselves in the form of releases, exculpation and fee awards (which consideration was not awarded to other members of their voting classes who had voted against the settlement). The targeted creditors were also accused of voting their claims for the ulterior purpose of benefiting other claims they held against the debtor. The court determined that such matters may warrant confirmation objections, but they did not warrant designation of the targeted creditors' votes. The court went on to express its "distaste" for the activities of the targeted creditors, but refused to "disenfranchise creditors from their statutory rights" on account of "activities that, while distasteful and heavy handed, are sufficiently within what the law permits, and sufficiently tied to maximize creditor recoveries."[327]

The same standard of review should apply to equity holders in situations where the debtor's value reaches equity. In cases where the equity class or classes recover no value, they are "deemed" to have rejected the plan pursuant to section 1126(g) of the Bankruptcy Code (and, thus, do not vote on a plan of reorganization). Equity

[324] *Id.* at 142.

[325] *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, No. 10-1175, 2011 WL 350480, at *17-20 (2d Cir. Feb. 7, 2011)

[326] *Adelphia*, 359 B.R. at 56-57.

[327] *Id.* at 63.

holders in such cases could pursue some "bad faith" objective through their various corporate governance rights, which efforts courts would probably address under section 105(a) of the Code, as opposed to section 1126(e) of the Bankruptcy Code.[328] Conversely, in those cases where equity is the fulcrum class in the capital structure, interest holders could be guilty of violating any one of the enumerated "badges of bad faith," resulting in the designation of their votes. Congress actually anticipated this outcome when it drafted section 1126(d) of the Bankruptcy Code, which provides that "[a] class of interests has accepted a plan if such plan has been accepted by holders of such interests, *other than any entity designated under subsection (e) of this section*" (emphasis added).

C. What If Some/All Members of an Equity Committee Wish to Backstop a Rights Offering?

It is not unheard of for the members of an Equity Committee to take an active role in a rights offering, or even to draft a rights offering and assemble a group of investors to backstop the same.[329] It is conceivable that the members of an Equity Committee could themselves backstop a rights offering, in which case, they would still be bound by their fiduciary duties to the class of equity holders.[330] The members' motives in backstopping the rights offering would play a central role in determining whether those fiduciary duties were being met in the event the question was raised.

Take, for example, a situation in which members of an Equity Committee decide to backstop a rights offering for the specific reason that they desire to obtain control of the debtor. The members of these Equity Committee then structure the rights offering in such a way to virtually guarantee that they will become the majority interest holders at the offering's completion. In such a case, are the Equity Committee members running a serious risk of being removed from the committee for breach of their fiduciary duty to

328 *See In re Johns-Manville Corp.*, 52 B.R. 879, 889-90 (Bankr. S.D.N.Y. 1985), *aff'd* 60 B.R. 842 (S.D.N.Y. 1986), *rev'd on other grounds*, 801 F.2d 60 (2d. Cir. 1986) (affirming ability of bankruptcy court to police abuses of corporate governance rights through resort to section 105(a) of the Bankruptcy Code).

329 *See, e.g., In re Gadzooks, Inc.*, 352 B.R. 796, 800 (Bankr. N.D. Tex. 2006), *rev'd on other grounds*, *Kaye v. Hughes & Luce LLP*, No. 3:06-CV-01863-B, 2007 WL 2059724 (N.D.Tex. Jul. 13, 2007).

330 *See* Section V.A *supra*.

their constituents and/or vote designation based on the first of the badges of bad faith outlined above and as seen in the *Allegheny* decision?

Taking control of the debtor by equity is not problematic in every situation. Pursuant to section 1103(c)(2) of the Bankruptcy Code, an Equity Committee may "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*, and any other matter relevant to the case or to the formulation of a plan."[331] If the members determine that it is not desirable that the debtor's business continue, and if the members further determine that the most efficient way to see that the debtor does not continue in business is to wrest control of the organization by way of exercising their rights as stockholders,[332] so long as the members of the Equity Committee hold the belief in good faith and based on sound reasoning, it would seem that their action is expressly permitted by section 1103(c)(2) of the Bankruptcy Code, and they will not suffer the designation of their votes or removal from the committee.

By way of contrast, if the members of an Equity Committee are acting in furtherance of their own personal interests, and not on behalf of their constituency, and specifically so as to secure benefits for themselves which will not also be made available to other equity holders, such members would run afoul of both the first and the fourth badges of bad faith outlined above, and would surely also violate their fiduciary duties.

Lastly, there is the issue of the underwriting fee to be paid to the members who have agreed to backstop the offering. Normally the amount of this up-front fee is negotiated between the plan proponent and the brokerage house that has agreed to underwrite the offering (making it an arm's length process). When committee members are involved, their fiduciary duties to the class they represent may make it somewhat difficult to demand a certain fee. Counsel should be especially mindful of this potential conflict. Additionally, one might consider retaining an expert in the area to advise the Equity Committee as to the reasonableness of the proposed fee arrangement.

331 11 U.S.C. § 1103(c)(2).

332 *See* Sections II.E and IV.B.1 *supra*.

D. Duties of a Committee "Out of the Money"

It is fairly well established that no Equity Committee should be appointed when it appears that a debtor is hopelessly insolvent.[333] Assume that an Equity Committee has been appointed before everyone realizes that the debtor is, in fact, hopelessly insolvent or that equity will not receive a meaningful distribution. What should the Equity Committee and its counsel do? As a matter of prudent practice, the Equity Committee should not choose simply to do nothing. The potential liability of an inactive Equity Committee to its constituents mandates that it must either continue to exercise its powers and observe its duties as prescribed by section 1103 of the Bankruptcy Code or it should seek to disband.

In *In re ABC Automotive Products Corporation*,[334] the bankruptcy court was confronted with an unusual situation arising from the actions of a law firm that held proxies from a majority of Equity Committee members. In the court's discussion of the committee's fiduciary duties to its constituents, it noted that "[w]hile Section 1103(c) is framed in discretionary language, exercise of certain of the enumerated functions has been found to be not necessarily permissive."[335] Subsequently, the court observed that

> [t]his view raises an interesting issue regarding the potential liability of an inactive and ineffective committee for failing to exercise its statutory powers. Addressing this issue, one law review article comments: "Few decisions under the Code impose liability on committees or their members for failing to exercise the statutory powers that enable committees to participate actively in the reorganization process. Perhaps the same apathy and sense of hopelessness which often results in inactive committees also produces creditors who fail to consider whether the committee properly represented their interests…. However, heightened awareness among creditors and their counsel about the committee's responsibilities to those it represents may result in the emergence of claims against inactive committees and committee members. Such claims might prompt the committee … to carry out more fully and effectively the role Congress intended them to play in the reorganization process.336

333 *See* Section II.C.5 *supra*.

334 210 B.R. 437 (Bankr. E.D. Pa. 1997).

335 *Id.* at 441.

336 *Id.* at n.7 (quoting Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers and Duties*, 73 Marq. L. Rev. 581, 615 (1990)).

In light of the foregoing, it would seem that no Equity Committee member who understands the nature and ramifications of its fiduciary duties would want to put herself at personal risk in a case where the debtor is hopelessly insolvent or where it appears that equity will not be entitled to a distribution. Consequently, when members find themselves in such a situation, the Equity Committee should either continue to exercise its powers and duties under section 1103 of the Bankruptcy Code or direct its counsel to petition either the court or the U.S. Trustee to disband. In sum, the onus appears to be on the Equity Committee to formally disband even when it is otherwise apparent to everyone involved that the prepetition equity will not be entitled to a distribution under the plan of reorganization.[337]

VI. CONCLUSION

Since the enactment of the Bankruptcy Code (which abandoned the rigid application of the absolute priority rule in consensual reorganizations), and particularly over the last ten years in mega cases, bankruptcy courts and the U.S. Trustee have been receptive to requests for the appointment of Equity Committees. Despite their recent prevalence, however, the standards governing Equity Committees (*e.g.*, standards governing appointment, disbanding, fiduciary duties and status under securities law) remain relatively ambiguous. Likewise, the respective roles of bankruptcy courts and the U.S. Trustee in applying and enforcing these standards are not clearly delineated. As the reorganization landscape grows more unfriendly to equity holders (*i.e.*, with deviations from the absolute priority rule becoming relatively scarce and, moreover, being reversed by some courts when they do occur), clarification of these standards and roles might serve to further encourage the consensual reorganizations — negotiated by all parties in interest — promised by the adoption of the Bankruptcy Code. When Congress next turns its attention to a review of the Bankruptcy Code, clarification of the formation, function and obligations of official Equity Committees would prove helpful.

[337] *See* Section III *supra* regarding disbanding Equity Committees.