

Credit Research Foundation Education Brief



Why Businesses Should Consider Serving on an Official Committee of Unsecured Creditors

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As well-informed credit managers know, businesses can easily become entangled in bankruptcy cases - in some circumstances even becoming one of the largest unsecured creditors of its customer who filed a Chapter 11 bankruptcy case. As a result, the business may be eligible to serve on the official committee of unsecured creditors of the debtor (the "Creditors' Committee"). But what does such service entail and why would a business want to do it? How does a business decide whether to expend time and resources serving on a Creditors' Committee or take a more passive monitoring role and file a simple proof of claim?

The Creditors' Committee can play a defining role in a debtor's bankruptcy case, influencing the direction of the case, the terms of the ultimate plan of reorganization or liquidation, or a sale of the debtor's assets and the recoveries that unsecured creditors will ultimately receive. Therefore, the Creditors' Committee's strategy and its interactions with the debtor and the bankruptcy court are important components of the bankruptcy process.

Although it does not address every aspect of committee membership (and there are many), this article addresses how a Creditors' Committee is formed, what its functions are under the Bankruptcy Code, the responsibilities of its members, the advantages of serving as a member and other considerations related to service.

Formation of the Creditors' Committee

Section 1102 of the Bankruptcy Code provides for the appointment of a Creditors' Committee by the United States Trustee. The United States Trustee forms the Creditors' Committee as soon as practicable after the debtor files its Chapter 11 petition for relief. As part of that process, the United States Trustee will distribute questionnaires to the largest unsecured creditors identified by the debtor. The United States Trustee will set a time for a Creditors' Committee formation meeting and require the questionnaires be returned to the United States Trustee prior to the meeting. The United States Trustee will then review the questionnaires and interview creditors who appear at the formation meeting. That interview can be an important opportunity for a creditor to make its case as to why it should be appointed to the Creditors' Committee. Generally, the United States Trustee will appoint three, five or seven members to a Creditors' Committee, and will try to ensure that the Committee as a whole is representative of the types of claims against the debtor.

The Creditors' Committee will then meet, select a chairperson and interview professionals. Issues are generally decided by a majority vote and in accordance with the bylaws adopted by the Creditors' Committee.

Creditors' Committee's Rights and Duties

Section 1103 of the Bankruptcy Code sets forth the powers and duties of a Creditors' Committee. Among those powers is the ability to select and retain professionals, including attorneys and financial advisors, subject to court approval. Such professionals will represent the Creditors' Committee as a whole, rather than the individual members, and will be compensated by the debtor's estate. Each Committee member's reasonable expenses may also be reimbursed by the estate, but payment of each member's own counsel is the member's individual responsibility.

The Creditors' Committee and its members act as fiduciaries to unsecured creditors of the debtor's estate. Section 1103 of the Bankruptcy Code prescribes a broad range of rights and duties for a Creditors' Committee including (i) consulting with the debtor about administration of the case, (ii) investigating acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability to continue the business, and any other matter relevant to the case or the formulation of a plan, (iii) participating in the formulation of a plan; (iv) requesting the appointment of a trustee or examiner, and (v) performing such other services that are in the interest of those represented.

To fulfill its statutory and fiduciary duties, the Creditors' Committee is able to obtain confidential information about the debtor well beyond what an ordinary creditor will receive. A Creditors' Committee's professionals and the debtor's professionals will communicate regularly about status of the debtor's business, operational planning, financial performance and other bankruptcy issues as the debtor navigates the Chapter 11 process. Because the Creditors' Committee is informed, or if the debtor is withholding information at least understands what information it may need, it is in a unique position to take a more active role in steering the

direction of the case. The Creditors' Committee role as a check on the debtor and secured creditors is an important one, particularly to the bankruptcy court who often turns to the Creditors' Committee for its views on a debtor's proposed course of action and requested relief. In instances where there are multiple organized creditor groups seeking to protect their own interests, a Creditors' Committee stands out as the only body with a fiduciary responsibility to all unsecured creditors.

Advantages

Strategic Impact. The Creditors' Committee's goal is to maximize value for all unsecured creditors. To do so, it will develop a case strategy that provides it the best opportunity to impact the administration and direction of the case. This may involve balancing the interests of various creditors. Some may prefer a faster cash distribution while others may value preserving an ongoing relationship with the debtor upon its emergence from Chapter 11. Creating a cohesive strategy and reconciling these differences is one of the Creditors' Committee's and its professionals' important responsibilities. A member of the Creditors' Committee thus has access to the pertinent information and the unique ability to provide direct input in formulating the strategy.

In addition, the Creditors' Committee directly participates in the negotiation of the plan for emergence from Chapter 11. This may involve determining the kinds of consideration unsecured creditors receive from the debtor, the amounts of the distributions and what the debtor's capital and operational structure looks like post-emergence. A Creditors' Committee's strategy will differ depending on the facts and circumstances of the case. In some circumstances, the Creditors' Committee will align itself with the debtor against a group of other stakeholders who want to move the case in a certain direction. In other circumstances, the Creditors' Committee may cooperate with a potential acquirer of the debtor's business. Sometimes a Creditors' Committee will need to pursue litigation where a debtor has refused and leverage its negotiating power.

The court relies on the Creditors' Committee's opinion and recommendations when considering requests from the debtor or any other party in interest. Any number of constituents are involved in a Chapter 11 case, including secured creditors, vendors, insiders, public debtholders, and others. Those constituents may act individually or as part of a group, but generally always seek to protect their self-interest. The Creditors' Committee on the other hand, is an independent fiduciary body that is involved in every major decision in the case. Thus, its views and strategy will greatly impact the court's decision and the direction of the case.

Information. Serving on the Creditors' Committee is one of the most effective ways to stay informed of real-time developments in the case. During the case, the Creditors' Committee will receive regular summaries about the debtor's business performance and anticipated next steps in the case. The Creditors' Committee's professionals present the materials to the Creditors' Committee after reviewing the information with the debtor's professionals and explain the reasoning behind the debtor's performance. This insight into the debtor's business can be

extremely valuable to members and will allow them to understand the likelihood of reorganization versus liquidation, as well as the debtor's strategic view of the company going forward.

Additionally, access to the debtor's assets and liabilities and prepetition transactions gives the Creditors' Committee a better understanding of kinds of claims that may be against the debtor or other stakeholders, and whether such claims and causes of action are worth pursuing on behalf of the estate. In circumstances where the debtor refuses to pursue such actions, the Creditors' Committee can request court approval to bring those actions on behalf of the debtor's estate.

Sharing Administrative Costs. The Creditors' Committee professionals are paid by the Debtor's estate rather than individual members. A member of the Creditors' Committee can access their professionals and provide their direct input. Further, the Creditors' Committee's positions may often overlap with a member's own individual position, and it is both efficient and economical for the Creditors' Committee to speak with a singular voice.

Industry Relationships and Bankruptcy Knowledge. Membership on a Creditors' Committee is a unique opportunity to develop relationships, learn more about the industry and understand the bankruptcy process. The members interact with one another and hear the various perspectives of other creditors on a particular industry, whether they are vendors of the debtor or even competitors. This membership can help shape the framework for developing and strengthening relationships, including a creditor's relationship with the debtor. It also can be helpful for a creditor who will inevitably encounter another bankruptcy case. The creditor will be more prepared to protect its interests and navigate through the case.

Time and Resources. Serving on a Creditors' Committee requires the creditor to expend time and resources on the case. While the level of activity varies based on the cases, generally Creditors' Committees meet telephonically at agreed upon intervals. There may also be meetings with the debtor's management team giving a presentation of their view of the case which can be invaluable.

Conclusion

In sum, there are significant advantages to serving on a Creditors' Committee. A creditor can have an influential voice and play an important role in the Chapter 11 process through its service on the Creditors' Committee. Also, the experience will help the creditor to be more knowledgeable about the bankruptcy process in general, and how to specifically recognize and protect against evidence of financial distress among its customers.

Arent Fox's Bankruptcy & Financial Restructuring group focuses on the representation of Creditor Committees and creditor rights. If you have any questions, please contact George Angelich (George.Angelich@ArentFox.com), Rob Hirsh (Robert.Hirsh@ArentFox.com), or Beth Brownstein (Beth.Brownstein@ArentFox.com).