

**Committee Formation and Reformation:
Considerations and Best Practices**

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Since the decision in *In re Universal Building Products*¹ late last year, committee formation—and the conduct of the professionals representing committees or seeking to do so—has been a topic of great interest to both bench and bar. Moreover, how and when official committees are formed or modified can be and have been the subject of various challenges. Long before the *UBP* decision, the U.S. Trustee Program (“USTP”) embarked on a review of committee formation issues to identify best practices, with an understanding that no “one-size-fits all” model can work uniformly well for the vast array of chapter 11 cases across the country.

To assist U.S. Trustees in executing their statutory duties to appoint committees and to enhance consistency and uniformity, the USTP has developed best practices for official committee formation that reflect the USTP’s collective experience. Among other issues, USTP best practices address committee size and composition, including potentially disqualifying conflicts; solicitation of creditors; timing of appointments; monitoring committee members for continued eligibility and adherence to fiduciary duties; and responding to membership challenges. This article discusses the U.S. Trustee’s statutory role and authority in committee formation and modification and identifies some best practices for fulfilling that statutory role.

¹ No. 10-12453, 2010 WL 4642046, at *1 (Bankr. D. Del. Nov. 4, 2010) (“UBP”).

Committee Formation

Section 1102(a)(1) requires U.S. Trustees to appoint a committee of creditors holding unsecured claims in all cases “as soon as practicable after the order for relief”² Because critical issues often arise early in a case, U.S. Trustees strive to contact creditors and form a committee as soon as reasonably possible. The size and exigencies of a case guide the solicitation and formation process. Although U.S. Trustees typically solicit creditors by letter and questionnaire, the number of creditors solicited and how the committee is formed vary by case size. In most cases, U.S. Trustees solicit the 20 largest creditors, while larger cases often require soliciting 30 or more creditors to obtain an adequately representative committee. Committees in smaller cases are often formed after telephone inquiries or conference calls, while formation meetings are more common in larger cases. What does not vary, however, is the U.S. Trustee’s need to gauge a creditor’s genuine willingness to serve on the committee for legitimate reasons and the committee members’ obligation to act as fiduciaries to the entire unsecured creditor constituency.

Adequate Representation

Committees must adequately represent the diverse unsecured creditors in the case, and the appointment process should result in a committee reflective of the various interests held by unsecured creditors willing to serve, such as trade creditors, tort claimants, and unsecured lenders and bondholders. “Although committees do not necessarily need to reflect the precise composition of the creditor body, committees should adequately represent the various creditor

² 11 U.S.C. § 1102(a)(1) contains one exception to the committee requirement, which authorizes courts to excuse the committee appointment in small business cases for cause. U.S. Trustees, however, often cannot appoint a committee in other cases because an insufficient number of creditors are willing to serve.

types.”³ Nor does adequate representation require “proportionate representation of distinct groups of creditors.”⁴ Committees, moreover, are not “designed to provide a speaker’s platform for a particular creditor. They are designed to enable investigation and to provide a forum for negotiation on behalf of all of the claims or interests they represent.”⁵ Thus, an adequately representative committee need only be broadly representative, not an “exact replica” or mirror image of the creditor body.⁶

Although § 1102(b)(1) provides that “a committee of creditors . . . shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee . . .,” the language is nonbinding and “affords no right of membership.”⁷ Accordingly, when determining committee composition, the size of a creditor’s claim is one factor but not dispositive. A committee composed of only those with the largest claims will not necessarily result in a representative committee. Similarly, the statute does not require a committee with seven members. Large committees can be unwieldy and expensive, but large, complex cases may sometimes warrant a committee with seven or more members. In most cases, a smaller committee is adequately representative, and its size accords with the statute’s “ordinarily” language, which recognizes the U.S. Trustee’s need for flexibility in committee formation.

³ *In re Park West Circle Realty, LLC*, No. 10-12695, 2010 WL 3219531, at *2 n.6 (Bankr. S.D.N.Y. August 11, 2010); accord *In re Hill Stores Co.*, 137 B.R. 4, 7 (Bankr. S.D.N.Y. 1992); *In re Sharon Steel Corp.*, 100 B.R. 767, 777-78 (Bankr. W.D. Pa. 1989).

⁴ *In re Garden Ridge Corp.*, No. 04-10324, 2005 WL 523129, at *3 (Bankr. D. Del. March 2, 2005).

⁵ *In re Drexel Burnham Lambert Group, Inc.*, 118 B.R. 209, 212-213 (Bankr. S.D.N.Y. 1990).

⁶ *In re Dana Corp.*, 344 B.R. 35, 39 (S.D.N.Y. 2006).

⁷ *Drexel*, 118 B.R. at 212.

Disqualifying Conflicts or Limitations

When soliciting creditors, U.S. Trustees seek to elicit information sufficient to evaluate a creditor's eligibility to serve while avoiding appointments of those unsuited or unqualified for service. In addition to considering the size and nature of the creditor's claim, U.S. Trustees seek to determine whether a candidate for committee membership has a *potentially* disqualifying conflict or status. Although it is difficult to define precisely what may be disqualifying outside the confines of a particular case, U.S. Trustees consider whether the creditor has executed any agreement limiting its ability to act as a fiduciary or to consider more than one plan, such as an inter-creditor agreement or "lock-up" agreement with the debtor. Other considerations include whether the creditor will be paid as a critical vendor, has an executory contract or lease that will be assumed (and defaults cured), holds claims among multiple levels of the company's debt structure, or has insurance or other hedges that may limit its exposure or affect the identity of the true beneficial holder of the claim. Holders of disputed, unliquidated and contingent claims, however, may serve on a committee,⁸ as may those in litigation with the debtor or those hostile to reorganization.⁹

Determining the legitimacy of the creditor's motives is critical but difficult. Two scenarios in particular can obscure a creditor's true motives and affect the integrity of the committee formation process: the creditor's undisclosed intention to trade in claims against, or securities of, the debtor, and the use of proxies by creditors seeking to influence the selection

⁸ *In re Barney's, Inc.*, 197 B.R. 400, 431 (S.D.N.Y. 1996). Any rule otherwise could allow the debtor to control committee membership by simply labeling a claim as disputed.

⁹ *In re Altair Airlines, Inc.*, 727 F.2d 88, 91 (3d Cir. 1984).

of committee counsel, sometimes for an undisclosed *quid pro quo* arrangement. These hidden agendas are anathema to a process dependent upon disclosure, transparency and integrity.

Trading

U.S. Trustees inquire whether the creditor intends to trade in claims against the debtor or the debtor's securities because committee members typically receive confidential, "inside" information. Trading while having non-public, confidential information breaches a member's fiduciary duty to all unsecured creditors. For this reason, committee members are treated as "insiders" for purposes of the securities trading laws.¹⁰ Even though U.S. Trustees may require committee members to certify they will not trade absent bankruptcy court authorization—and to re-certify periodically—some still trade.¹¹ Committee members who seek a trading order must meet the standards enunciated in *Federated Department Stores*.

Proxies

U.S. Trustees increasingly encounter creditors who do not attend the committee formation meeting but give their proxy to someone with whom they do not have a long-standing relationship. The proxy holder's singular goal may be to have its preferred counsel retained as committee counsel. This was precisely the scenario faced in *UBP*, where law firms used a non-lawyer to contact overseas creditors and solicit their proxies so the firms would be retained as committee counsel.

¹⁰ See *In re Federated Dep't Stores, Inc.*, No. 1-90-00130, 1991 Bankr. LEXIS 288, at *1 (Bankr. S.D. Ohio Mar. 7, 1991) (order entered to prevent committee member from misusing non-public information while trading in debtor's securities).

¹¹ *E.g., United States Secs. & Exch. Comm'n v. Barclays Bank, PLC, et al.*, 07-CV-4427 (S.D.N.Y. May 30, 2007).

Rule 9010 specifically permits the use of proxies. Thus, there is no *per se* prohibition on a proxy holder appearing at a creditors' committee formation meeting. But the circumstances surrounding the proxy's execution, including whether it was solicited by the proxy holder rather than sought by the creditor, require further inquiry to ensure the integrity of the committee formation process. Consistent with Judge Walrath's suggestion in *UBP*, the U.S. Trustees have amended the questionnaire for prospective committee members to inquire whether they were solicited by anyone in connection with the case.

Committee Modification and Judicial Review

A U.S. Trustee's oversight of the committee does not end at appointment.¹² Rather, U.S. Trustees periodically monitor whether a member remains qualified to serve or has acted in breach of its fiduciary duty. In fulfilling this responsibility, U.S. Trustees have the authority to appoint, remove and substitute members. Removal may result from a member's change in status as a creditor or apparent breach of fiduciary duty, but removal should not be based on mere conflict within the committee over objectives or strategy.¹³

Judicial Review Before BAPCPA

Between 1978 and 1986, the power to appoint and modify a committee rested with the bankruptcy court, except in those districts participating in the U.S. Trustee pilot program established in 1978.¹⁴ But the 1986 amendments—which established the U.S. Trustee system on a permanent, nationwide basis (except in Alabama and North Carolina)—repealed § 1102(c), withdrew the bankruptcy court's authority to appoint or modify committees, and vested that

¹² 28 U.S.C. § 586(a)(3)(E).

¹³ *Barney's*, 197 B.R. at 444.

¹⁴ *In re Victory Markets, Inc.*, 196 B.R. 1, 3 (Bankr. N.D.N.Y. 1995).

authority exclusively in the U.S. Trustee.¹⁵ Part of the impetus for the comprehensive revamping of the bankruptcy system in 1986 was Congress's desire to bifurcate judicial from administrative functions and screen courts from administrative functions that could raise conflict of interest issues:

Congress recognized that requiring courts to appoint creditors' committees was an administrative burden which should be shifted entirely to the U.S. Trustee. [citation omitted]. It also became apparent that by shifting the responsibility of appointing creditors' committees to the U.S. Trustee, Congress could avoid any questions as to the court's neutrality in the bankruptcy process when deciding disputes between its hand-picked committee and other parties in interest.¹⁶

The 1986 amendments, however, "created considerable confusion regarding a court's authority to alter (reconstitute) a committee's composition or size."¹⁷ Some courts held they had no authority to review committee appointments while others invoked their equitable power to review under § 105.¹⁸ Courts reviewing appointments also applied inconsistent standards of review. Some reviewed for an abuse of discretion, some reviewed for arbitrary and capricious decision making, while others afforded the U.S. Trustee no deference and engaged in *de novo* review.¹⁹

¹⁵ *Id.* at 3-4 [citations omitted]. Section 1102(c) had expressly granted courts authority to add members to and remove members from creditors' committees. In reviewing committee appointment jurisprudence, it is important to understand which version of the statute was at issue.

¹⁶ *Id.* at 3-4.

¹⁷ *In re Mercury Finance Co.*, 240 B.R. 270, 276 (N.D. Ill. 1999) (collecting cases).

¹⁸ *Victory Markets*, 196 B.R. at 6 (no authority to review); *Mercury Finance*, 240 B.R. at 277 (equitable power under § 105 authorizes review).

¹⁹ *Mercury Finance*, 240 B.R. at 277 (abuse of discretion); *Barney's*, 197 B.R. at 439 (arbitrary and capricious); *Sharon Steel*, 100 B.R. at 772 (*de novo*).

Limited Judicial Review Post-BAPCPA

Section 1102(a)(4), added in 2005 by BAPCPA, granted bankruptcy courts express authority for the first time since the 1986 repeal of § 1102(c) to review a committee's membership and order its modification upon the "request of a party in interest and after notice and a hearing." But the scope of a court's authority is not unfettered: a court is confined to acting only upon a party in interest's request and then to determining whether the committee is adequately representative. If the committee is not, the court may only order a change in composition "necessary to ensure adequate representation" ²⁰

Those parties challenging committee composition post-BAPCPA may still allege that the U.S. Trustee abused his or her discretion or acted arbitrarily and capriciously. Although U.S. Trustees take such allegations seriously, the *process* of committee formation is not and should not be a basis for relief under § 1102(a)(4). Rather, § 1102(a)(4) focuses on the *result* of the appointment process—adequate representation. Given that § 1102 now provides a standard and a mechanism for challenging committee composition, the analysis should follow the statute and not the *ad hoc* formulations used between 1986 and 2005, when courts struggled with the "considerable confusion" left by the statutory gap. ²¹

²⁰ 11 U.S.C. § 1102(a)(4). Adequate representation for modification is the same standard governing requests for additional committees under § 1102(a)(2). *Park West*, 2010 WL 3219531, at *2 n.6. Indeed, most "adequate representation" jurisprudence addresses requests for additional committees.

²¹ See fn. 18, *supra*.

Remedies

If a committee is not adequately representative, § 1102(a)(4) does not authorize the court to direct the appointment of any particular member or to make the appointment itself.²² A court may, instead, only order the U.S. Trustee to make appointments in accordance with judicial findings on adequate representation. Indeed, the statutory language—“order the U.S. Trustee to change the membership”—would be unnecessary if courts were to perform both the judicial function of determining what classes of creditors ensure a committee’s adequate representation and the administrative function of appointing specific creditors.

This interpretation is consistent with the origins of § 1102(a)(4). In considering predecessor legislation to BAPCPA, the National Bankruptcy Review Commission (“NBRC”) proposed amending § 1102 to allow judicial review of committee structure. The NBRC responded to concerns about a renewed court role in committee selection with a statement that “the U.S. Trustee would remain responsible for the actual appointment of committee members. . . . Although courts would have the power to review, they would remain removed from the actual appointment process.”²³ As a result, if a party objects to committee composition, courts should only determine whether the committee is adequately representative and leave to the U.S. Trustee modification of committee membership in accordance with the court’s findings.

²² 11 U.S.C. § 1102(a)(4).

²³ NBRC, Final Report, p. 500-501 (October 20, 1997) available at <http://gov.info.library.unt.edu/nbrc/reporttitlepg.html>.

Conclusion

Committees play a critical role in many chapter 11 cases. In the process of appointing official committees, U.S. Trustees consider an array of issues, some of which can be quite challenging. With its focus on best practices, the USTP seeks consistency and brings transparency and integrity to the process.