Absolute vs. Relative Priority: What Creates Equity Value?

Marcia L. Goldstein, Presiding Officer
Weil, Gotshal & Manges LLP; New York

Geoffrey T. Raicht, Moderator
Proskauer; New York

Tracy Hope Davis
Office of the U.S. Trustee, Region 17; San Francisco

Robert J. Dehney
Morris, Nichols, Arsht & Tunnell LLP; Wilmington, Del.

Adam L. Dunayer
Houlihan Lokey; Dallas

Daniel B. Kamensky
Paulson & Co. Inc.; New York

Paul D. Leake
Jones Day; New York

2015

AMERICAN BANKRUPTCY INSTITUTE

DISCOVER

interactive code&rules
law.abi.org

Start Your Research Here

Your Interactive Tool Wherever You Go!

With ABI's Code & Rules:

- **Search for a specific provision of the Bankruptcy Code and related Rules**
- **Access links to relevant case law by section (provided by site partner, LexisNexis®)**
- **Retrieve a Code section or case summary – even on your mobile device**
- **Personalize it with bookmarks and notes**
- **Receive it FREE as an ABI member**

Current, Personalized, Portable
law.abi.org

66 Canal Center Plaza • Suite 600 • Alexandria, VA 22314-1583 • phone: 703.739.0800 • abi.org

Join our networks to expand yours:

RECENT DEVELOPMENTS IN THE ROLE OF EQUITY COMMITTEES IN CHAPTER 11 CASES

VALCON 2015
PANEL
Absolute vs. Relative Priority:
What Creates Equity Value

Geoffrey T. Raicht, Proskauer, Moderator
Tracy Hope Davis, Office of the U.S. Trustee, Region 17
Robert J. Dehney, Morris Nichols Arsht & Tunnell LLP
Adam Dunayer, Houlihan Lokey, Inc.
Daniel B. Kamensky, Investor
Paul D. Leake, Jones Day*

---

* The panel thanks the authors of this article: Paul D. Leake, Daniel J. Merrett, Danielle Barav-Johnson and Genna L. Ghaul of Jones Day. Mr. Leake is global Practice Leader of Jones Day's Business Restructuring and Reorganization practice. Mr. Merrett, Ms. Barav-Johnson and Ms. Ghaul are Associates in Jones Day's Business Restructuring and Reorganization practice. The views expressed herein are those of the authors alone and do not reflect the views, positions or policies of the panel, Jones Day or its clients. The views expressed herein are not the views of the United States Trustee or the United States Trustee Program.

TABLE OF CONTENTS

Page

Introduction

The appointment of an official committee of equity security holders (an "Equity Committee") in a chapter 11 case remains the exception rather than the rule.[1] Nevertheless, Equity Committees have played an increasingly important role in chapter 11 cases in recent years.[2] The growing impact of Equity Committees in chapter 11 has been reflected by, among other things, (i) the rising number of Equity Committee appointments in several recent "mega" chapter 11 cases[3] and (ii) the increasingly common efforts by debtors and other constituencies to disband Equity Committees if they are able to formulate an argument that shareholders are out of the money.[4]

This article discusses recent developments relating to the appointment, function and occasional disbandment of Equity Committees in chapter 11 cases. This article sets forth: (1) a short introduction to the statutory basis, purpose and procedures for the appointment of Equity Committees and the duties of their members; (2) an analysis of the evolving standards for the

---

1 *See* 7 COLLIER ON BANKRUPTCY ¶ 1102.03[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) [hereinafter *Collier*].

2 *See* Heather Lennox, Dennis J. Connolly, Alan W. Kornberg, Jonathan M. Landers, Richard G. Mason, James L. Patton, Jr. & Daniel W. Sklar, *Best Practices Report: Formation, Function & Obligations of Equity Committees in Chapter 11*, AM. COLL. OF BANKR. 2-3, 2 n.8 (2011).

3 *See, e.g.*, *In re Genco Shipping and Trading Ltd.*, No. 14-11108-SHL (Bankr. S.D.N.Y. May 9, 2014) (Docket No. 139) (notice of appointment of equity committee); *In re The Dolan Company*, No. 14-10614-BLS (Bankr. D. Del. Apr. 23, 2014) (Docket No. 195) (same); *In re Overseas Shipholding Group, Inc.*, No. 12-20000-PJW (Bankr. D. Del. Mar. 17, 2014) (Docket No. 2641) (same); *In re Tuscany Int'l Holdings (U.S.A.) Ltd.*, No. 14-10193-KG (Bankr. D. Del. Mar. 13, 2014) (Docket No. 147) (same); *In re AgFeed USA, LLC*, No. 13-11761-BLS (Bankr. D. Del. Aug. 23, 2013) (Docket No. 195) (same); *In re Rotech Healthcare Inc.*, No. 13-10741-PJW (Bankr. D. Del. April 24, 2013) (Docket No. 124) (same); *In re Trident Microsystems, Inc.*, No. 12-10069-CSS (Bankr. D. Del. Feb. 14, 2012) (Docket No. 190) (same).

4 *See, e.g.*, *Dolan*, No. 14-10614 (Docket No. 210) (debtor's motion requesting order disbanding Equity Committee); *Rotech*, No. 13-10741-PJW (Docket No. 142) (same); *In re Dewey & LeBoeuf LLP*, No. 12-12321-MG, 2012 WL 5985325 (Bankr. S.D.N.Y. Oct. 30, 2012) (Docket No. 589) (debtor's reply in support of order directing the U.S. Trustee to disband an official committee of former partners); *In re Filene's Basement, LLC*, No. 11-13511-KJC (Bankr. D. Del. Nov. 23, 2011) (Docket No. 264) (motion of the creditors' committee requesting order disbanding the Equity Committee); *In re Dana Corp.*, No. 06-10354-BRL (Bankr. S.D.N.Y. Feb. 9, 2007) (Docket No. 4735) (notice of disbandment of Equity Committee); *In re Gadzooks, Inc.*, No. 04-31486-HDH-11, 2005 BL 104487, at *2 (Bankr. N.D. Tex. Jan. 13, 2005) (Docket No. 1191) (same).

appointment of Equity Committees, focusing, in particular, on the key issues of solvency and adequate representation, as addressed by bankruptcy courts in recent chapter 11 cases; and (3) a discussion of recent developments relating to the disbandment of Equity Committees and the standards for judicial review of decisions by the Office of the United States Trustee (the "U.S. Trustee") relating to Equity Committees. Despite developments in each of these areas, the standards remain ambiguous with many open questions that courts have yet to fully address.

Background Regarding the Appointment and Duties of Equity Committees

Authority for the Appointment of an Equity Committee

Equity Committees may be appointed in chapter 11 cases at the discretion of the U.S. Trustee or by order of the bankruptcy court. Although section 1102(a)(1) of title 11 of the United States Code (the "Bankruptcy Code") mandates that the U.S. Trustee appoint – or at least attempt to appoint – an official committee of unsecured creditors (a "Creditors' Committee") in every large chapter 11 case,[5] the U.S. Trustee may appoint additional official committees, including Equity Committees, as it deems appropriate.[6] Pursuant to this straightforward authorization, the U.S. Trustee has appointed an Equity Committee in a number of recent cases.[7]

Additionally, the Bankruptcy Code authorizes the bankruptcy court, upon motion by a party in interest, to order the U.S. Trustee to appoint an Equity Committee "if necessary to assure

---

[5] *See* 11 U.S.C. § 1102(a)(1) (providing in relevant part that "[e]xcept as provided in paragraph (3) [relating to small business debtors], 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 ….").

[6] *See id.* (providing that the U.S. Trustee "may appoint additional committees of creditors or of equity security holders as [it] deems appropriate").

[7] *See, e.g.*, *Genco*, No. 14-11108-SHL (Docket No. 139) (notice of appointment of an Equity Committee of three equity holders less than a month after the petition date); *Dolan*, No. 14-10614 (Docket No. 195) (notice of appointment of an Equity Committee of five equity holders about a month after the petition date); *Overseas Shipholding Group*, No. 12-20000-PJW (Docket No. 2641) (notice of appointment of an Equity Committee of three equity security holders nearly two years after the petition date); *Tuscany Int'l Holdings*, No 14-10193-KG (Docket No. 147) (notice of appointment of an Equity Committee of three equity holders about a month after the petition date); *AgFeed*, No. 13-11761-BLS (Docket No. 195) (same); *Rotech*, No. 13-10741-PJW (Docket No. 124) (same); *Trident Microsystems*, No. 12-10069-CSS (Docket No. 190) (same).

adequate representation of … equity security holders."[8] The benefits to shareholders, and the direct and indirect costs to debtors and creditors of estate-funded collective equity representation, cause such motions frequently to be hotly contested, as more fully discussed below.[9]

Although the U.S. Trustee is required to make its appointment determination "as soon as practicable" following the entry of an order for relief, there is no statutory time limitation on a party in interest's request for the appointment of an Equity Committee.[10] Nevertheless, the timing of a request for appointment of an Equity Committee may prove critical to its success. On the one hand, "[i]n many chapter 11 cases, only the passage of time and the debtor's attempt to restructure its business will determine whether a recovery will be available for equity" thereby justifying the appointment of an Equity Committee.[11] On the other hand, a request for appointment of an Equity Committee on the eve of confirmation, or especially late in the bankruptcy case, may be denied as unnecessarily disruptive of the debtor's reorganization efforts.[12]

---

8 11 U.S.C. § 1102(a)(2).

9 *See, e.g.*, *In re Exide Techs.*, No. 13-11482-KJC (Bankr. D. Del. Dec. 17, 2014) (Docket No. 2766) (order denying motions of three *pro se* equity security holders for appointment of an Equity Committee after a contested hearing); *In re Eastman Kodak Co.* ("Kodak II"), No. 12-10202, 2013 Bankr. LEXIS 3325; 2013 WL 4413300 (Bankr. S.D.N.Y. Aug. 15, 2013) (order denying shareholder's renewed motion to appoint an Equity Committee); *In re School Specialty*, No. 13-10125-KJC (Bankr. D. Del. May 23, 2013) (Docket No. 1153) (order denying two *pro se* equity security holders' motions for the appointment of an Equity Committee after a contested hearing); *In re Patriot Coal Corp.*, No. 12-51502-659 (Bankr. E.D. Mo. May 10, 2013) (Docket No. 3959) (order denying motion for the appointment of an Equity Committee); *In re Dynegy, Inc.*, No. 12-36728-CGM (Bankr. S.D.N.Y. Aug. 23, 2012) (Docket No. 112) (same); *In re Eastman Kodak Co.* ("Kodak I"), No. 12-10202, 2012 Bankr. LEXIS 2944, 2012 WL 2501071 (Bankr. S.D.N.Y. June 28, 2012) (same); *In re AbitibiBowater, Inc.*, No. 09-11296-KJC (Bankr. D. Del. Aug. 6, 2010) (Docket No. 2840) (same).

10 *Collier* ¶ 1102.03[2].

11 *Id*.

12 *See, e.g., Kodak II*, 2013 Bankr. LEXIS 3325, at *8 (commenting on the substantial delay that the appointment of an Equity Committee would cause, especially in light of the confirmation hearing that was only days away).

Standards Governing the Bankruptcy Court's Determination Whether to Appoint an Equity Committee

The Bankruptcy Code provides no guidance with respect to what is "necessary to assure" the "adequate representation" of equity security holders.[13] Bankruptcy courts must, therefore, examine the facts of each case and use their discretion to determine if an Equity Committee is warranted.[14] The party seeking the appointment of an Equity Committee bears the burden of persuading the Court that equity security holders are not otherwise adequately represented in the debtor's chapter 11 case.[15]

The factors that bankruptcy courts most commonly analyze in deciding whether to appoint an Equity Committee include:

- the number of shareholders and 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.[16]

Courts are free to consider some, all or none of these factors in determining whether to order the appointment of an Equity Committee.[17] As more fully discussed below, however, courts and

---

[13] *See* 11 U.S.C. § 1102.

[14] *See*, *e.g.*, *Kodak I*, 2012 Bankr. LEXIS 2944, at *4 (citing *In re Spansion, Inc*., 421 B.R. 151, 156 (Bankr. D. Del. 2009)); *In re Nat'l R.V. Holdings Inc.*, 390 B.R. 690, 696 (Bankr. C.D. Cal. 2008); *In re Northwestern Corp.*, 2004 Bankr. LEXIS 635, at *2 (Bankr. D. Del. 2004); *In re Johns-Manville Corp.*("*Johns-Manville II*"), 68 B.R. 155, 159 (Bankr. S.D.N.Y. 1986) (citing *In re Beker Indus.*, 55 B.R. 945, 948 (Bankr. S.D.N.Y. 1985)).

[15] *See In re Budd Co.*, 512 B.R. 910, 912 (Bankr. N.D. Ill. 2014); *In re Allied Holdings, Inc.*, No. 05-12515, 2007 Bankr. LEXIS 1597, at *3, 2007 WL 7138349, at *1 (Bankr. N.D. Ga. Mar. 13, 2007).

[16] *See e.g.*, *Nat'l R.V. Holdings*, 390 B.R. at 696; *Dewey & LeBoeuf*, 2012 Bankr. LEXIS 5534, at *11 (discussing that no one factor is dispositive (although in the context of whether to disband a former partners' committee)); *Dana Corp.*, 344 B.R. at 38 (discussing the same as above).

[17] *See Nat'l R.V. Holdings*, 390 B.R. at 696 (stating that "[n]o one factor is dispositive" and courts may give different weights to each factor) (citing *Kalvar Microfilm*, 195 B.R. at 600); *Dewey & LeBoeuf*, 2012 Bankr.

parties seeking, or objecting to, the appointment of Equity Committees have tended to focus first on the solvency or insolvency of the debtor and, if it appears that the debtor may be solvent, whether the interests of shareholders are nevertheless adequately represented by other parties in interest in the case.

Selection of Members of the Equity Committee

Once the decision to appoint an Equity Committee has been made – whether by the U.S. Trustee or by order of the bankruptcy court – the U.S. Trustee undertakes the process of appointing its members. 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 committee."[18] It has been held that the "'ordinarily' language of [section] 1102(b)(2) indicates that the seven largest shareholders language is merely a guideline from whence there may be variation and exception."[19] Accordingly, the U.S. Trustee retains significant discretion with

---

LEXIS 5534, at *11 (discussing the same issues when determining whether to disband a former partners' committee); *Dana Corp.*, 344 B.R. at 38 (discussing the same as above).

[18] 11 U.S.C. § 1102(b)(2). Unlike with respect to the appointment of Creditors Committees, the Bankruptcy Code does not expressly authorize the U.S. Trustee to convert an *ad hoc* shareholder committee organized prior to the commencement of the chapter 11 case into an official Equity Committee. *See* 11 U.S.C. § 1102(b)(1) (providing that the U.S. 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"). Rather, the U.S. Trustee must pay heed to the statute's guidelines and actively solicit membership from the debtor's seven largest equity security holders. *See Collier* ¶ 1102.03[3] ("In contrast to subsection 1102(b)(1), subsection 1102(b)(2) provides no authority for the United States trustee to appoint a prepetition committee organized by equity security holders. It is thus necessary for the United States trustee to solicit membership from equity security holders.").

[19] *Bank Creditors Grp. v. Hamill (In re White Motor Credit Corp.)*, 27 B.R. 554, 558 (N.D. Ohio 1982).

> While the initial presumption is that the seven largest will be chosen, there may be reasons to vary from this presumption. If there are different classes of equity, such as preferred and common stock, it would be appropriate to choose representatives from the various classes. If there are different types of holders with differing interests, or different factions among such holders, it may appropriate to choose representatives of the different groups. If there are multiple classes or factions, a committee of larger than seven may be warranted.

Id.

respect to the membership of an Equity Committee, including the discretion to appoint an Equity Committee constituted largely, if not exclusively, of the members of a prepetition *ad hoc* committee of shareholders.[20]

Duties of Equity Committee Members

Section 1103(c) of the Bankruptcy Code provides a non-exhaustive list of activities in which an official committee may engage.[21] Notwithstanding the permissive language of section 1103(c), however, an official committee may incur liability for failing to pursue an available course of action in the interest of its constituents.[22]

The members of an Equity Committee, like those of any official committee appointed under section 1102(a) of the Bankruptcy Code, are responsible for pursuing the best interests of the class they represent.[23] Members owe fiduciary duties including duties of (i) loyalty, (ii) care and (iii) honesty in communications.[24] An Equity Committee member that breaches its fiduciary

---

[20] *Collier* ¶ 1102.03[3] ("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.").

[21] *See* 11 U.S.C. § 1103(c) (providing that a committee appointed under section 1102 of the Bankruptcy Code may (i) consult with the trustee or debtor in possession, (ii) investigate the debtor, (iii) participate in the formulation of a plan, (iv) request the appointment of a trustee or examiner and (v) perform such other services as are in the interest of those the committee represents).

[22] *See Advisory Comm. of Major Funding Corp. v. Sommers (In re Advisory Comm. of Major Funding Corp.)*, 109 F.3d 219, 224 (5th Cir. 1997); *In re ABC Auto. Prods. Corp.*, 210 B.R. 437, 441 (Bankr. E.D. Pa. 1997).

[23] *ABC Auto. Prods.*, 210 B.R. at 441; *In re Johns-Manville Corp.* (*Johns-Manville I*), 26 B.R. 919, 924 (Bankr. S.D.N.Y. 1983) ("[I]t 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."); *In re Penn-Dixie Indus., Inc.*, 9 B.R. 941, 944 (Bankr. S.D.N.Y. 1981) ("An equity security holders' committee is vested with powers, duties, and functions identical to those granted to the statutorily mandated, more familiar, creditors' committees, and the fiduciary duties and responsibilities assumed by creditors' committee members, likewise apply to equity security committee members.").

[24] *Comm. of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 60 B.R. 842, 853 (S.D.N.Y. 1986) (quoting *Johns-Manville I.*, 26 B.R. at 925) ("[T]he individuals constituting a committee should be honest, loyal, trustworthy and without conflicting interest and with undivided loyalty and allegiance to their constituents."), *rev'd on other grounds*, *Manville Corp. v. Equity Sec. Holders Comm. (In re. Johns-Manville Corp.)*, 801 F.2d 60 (2d Cir. N.Y. 1986). Although these duties are not expressly provided for under the Bankruptcy Code, case law consistently interprets them as inherent in the authority to represent others during the reorganization process. *E.g.*, *Johns-Manville I*, 26 B.R. at 924 ("[I]t is well-

duty may face various consequences, including removal from the committee, the designation of any vote held by the member or, least commonly, a lawsuit for damages.[25] Removal from the Equity Committee is the easiest accomplished and most common remedy.[26] In contrast, the designation of votes is considered a drastic remedy[27] and a lawsuit may be unavailable as a result of the limited immunity afforded members of official committees for activities that fall short of "willful misconduct."[28]

Equity Committee members owe their duty of loyalty only to the shareholder body at large.[29] As such, an Equity Committee may seek to advance the interests of shareholders at the expense of the estate – for example, by negotiating a recovery for shareholders in the form of a gift in exchange for voting in favor of a chapter 11 plan even where shareholders would not

---

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."); *see also In re Drexel Burnham Lambert Group*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992); *Comm. of Asbestos-Related Litigants*, 60 B.R. at 853 n.23 ("No doubt, a committee and its members are fiduciaries for each of the parties that it represents."); *In re Tucker Freight Lines, Inc.*, 62 B.R. 213, 216 (Bankr. W.D. Mich. 1986).

25 Generally, the party seeking the remedy has a heavy burden of showing an actual breach. *See In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (addressing a motion to designate votes); *In re Kovalchick*, 175 B.R. 863, 875 (Bankr. E.D. Pa. 1994) (same); *Tucker Freight Lines*, 62 B.R. 213 (addressing a lawsuit for breach of duty); *Penn-Dixie*, 9 B.R. at 943-44 (removing a committee member for conflict of interest).

26 *See*, *e.g.*, *Penn-Dixie*, 9 B.R. at 943-44 (holding that a creditor could not serve on an Equity Committee because of its "abyssal entanglement" with, and inescapable influence on, the debtor where the creditor's managing director was closely connected to the debtor's operations throughout the bankruptcy). *But see In re Shorebank Corp.*, 467 B.R. 156, 163 (Bankr. N.D. Ill. 2012) (indicating that the court would not reconstitute the membership of a Creditors' Committee, despite acknowledging a conflict of interest, without evidence that the members have breached, or likely would breach, their fiduciary duties).

27 *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995) (confirming that "[d]esignation is the exception rather than the rule" in relation to the vote of a secured creditor). *See also Adelphia Commc'ns*, 359 B.R. at 56 (addressing a motion to designate the votes of three special committee creditors).

28 *Drexel*, 138 B.R. at 722 (determining that the Bankruptcy Code grants committee members limited immunity, but that it did not necessarily protect them against willful misconduct).

29 *Id.*; *Comm. of Asbestos-Related Litigants*, 60 B.R. at 853 n.23 (disagreeing with the bankruptcy judge's finding that an Equity Committee member had fiduciary duties to the estate because "neither a committee nor its members has any underlying duty to the debtor or to the estate").

otherwise have been entitled to any disbursement.[30] Additionally, Equity Committee members may not pursue favorable treatment for individual shareholders (or each other) unless doing so is in the interests of their constituency as a whole.[31]

Equity Committee members also owe their constituents a duty of care, meaning that they must act competently.[32] Committees must communicate honestly with constituents and must make all efforts to represent information accurately.[33] These duties are violated by, for example, reckless decision making, the misrepresentation of the risks or consequences of a course of action or the unjustified prediction of specific outcomes.[34] Conflicts between members over strategy or outcome, however, do not constitute a breach of any duty nor adequate justification for the removal of a committee member.[35]

---

30 *See Rotech*, No. 13-10741-PJW (Docket No. 142) (debtor's motion requesting dissolution of an Equity Committee; alleging that the Equity Committee planned to "launch extensive and costly investigations, not for the benefit of Rotech's estate, but for the personal benefit of the shareholders"); *Genco*, No. 14-11108-SHL (Docket No. 154) (joinder in debtor's motion to dissolve an Equity Committee; describing a settlement that would give equity holders a distribution of over $30 million even though they would otherwise not recover under the absolute priority rule, and seeking disbandment of the Equity Committee to prevent a further "windfall" to equity holders); *Comm. of Asbestos-Related Litigants*, 60 B.R. at 853 n.23.

31 *In re Park West Circle Realty, LLC*, No. 10-12965 (AJG), 2010 Bankr. LEXIS 2463, at *17 (Bankr. S.D.N.Y. Aug. 11, 2010) (discussing the potential conflict of interest of a prospective committee member); *Drexel*, 138 B.R. at 721-22 ("[C]ounsel for the creditors' committee do not owe a duty to [one creditor] to maximize its interest at the expense of the remaining creditors in the represented class.").

32 *Tucker Freight Lines*, 62 B.R. at 216 ("At a minimum, this fiduciary duty requires that the committee's determinations must be honestly arrived at, and, to the greatest degree possible, also accurate and correct.").

33 *See id.* at 213-216.

34 *See id.*

35 ROBERTA A. DEANGELIS & NAN ROBERTS EITEL, COMMITTEE FORMATION AND REFORMATION 6 (2011), *available at* http://www.justice.gov/ust/eo/public_affairs/articles/docs/2011/abi_201110.pdf.

The Evolving Standard for Appointment of an Equity Committee

The Role of Solvency in Appointing an Equity Committee

The solvency or insolvency of the debtor's chapter 11 estate is often the primary factor influencing a bankruptcy court's decision whether to appoint an Equity Committee.[36] Simply put, if the debtor lacks sufficient assets to satisfy its liabilities then there should be no recovery for holders of equity interests – at least under the priority scheme prescribed by the Bankruptcy Code.[37] In that scenario, it would, therefore, be a waste of valuable resources to require the debtor to fund an Equity Committee with no hope of recovery for equity. Conversely, if the debtor is solvent, or may be solvent, then there is a stronger argument for providing equity security holders with estate-funded representation.

Although courts generally agree that the debtor's solvency or insolvency is a central issue, two distinct standards have emerged to evaluate solvency for purposes of determining whether to appoint an Equity Committee. These standards are (i) whether the debtor is "hopelessly insolvent" and (ii) whether there is a "substantial likelihood of a meaningful distribution" to equity security holders.[38]

---

[36] *See, e.g.*, Hr'g Tr. 30:8-12; 39:6-19, *Dynegy*, No. 12-36728-CGM (Docket No. 102) (the U.S. Trustee, with whom the court later agreed, argued that the equity holder failed to meet "the very first threshold issue . . . . They haven't shown that there would be a substantial likelihood that they'd receive a meaningful distribution in the case."); *Nat'l R.V. Holdings*, 390 B.R. at 696 ("The principal issue on any motion for the appointment of an equity security holders' committee is whether the debtor is solvent or it appears likely that there will be a substantial return for equity."); *In re Ampex Corp.*, No. 08-11094 (AJG), 2008 Bankr. LEXIS 1536, at *3, 2008 WL 2051128, at *1 ("The threshold inquiry 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."); *In re Williams Commc'ns Grp., Inc.,* 281 B.R. 216, 220 (Bankr. S.D.N.Y. 2002) ("the debtor's solvency is a major factor when considering the cost of appointing an equity committee").

[37] Section 1129(b)(2)(B)(ii) of the Bankruptcy Code – the codification of the so-called "absolute priority rule" – provides that a chapter 11 plan may be confirmed over the objection of impaired classes only if: (i) all classes of unsecured claims are paid in full; or (ii) if a class of unsecured claims is not paid in full, then no junior class of claims or interests receives any recovery under the plan. *See* 11 U.S.C. § 1129(b)(2)(B)(ii).

[38] *Compare In re Emons Industries, Inc.*, 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985) ("this court is of the view that generally no equity committee should be appointed when it appears that a debtor is hopelessly insolvent") *with Williams Commc'ns*, 281 B.R. at 220 (adopting a solvency test of whether "there is a

The "hopelessly insolvent" standard generally involves an inquiry into the solvency of a debtor's estate as of the present moment, as opposed to an analysis of whether value ultimately may be distributable to equity.[39] Thus, if a debtor appears to be "hopelessly insolvent," an Equity Committee will not be appointed under the rationale that "neither the debtor nor the creditors should have to bear the expense of negotiating over terms of what is in essence a gift" to equity security holders.[40]

A shift of the solvency determination from a gauge of the debtor's current level of insolvency to an analysis of the future value likely distributable to shareholders occurred in the *Williams Communications Group* case – a 2002 decision by the United States Bankruptcy Court for the Southern District of New York.[41] The *Williams* court analyzed the request for appointment of an Equity Committee under the "hopelessly insolvent" standard and ultimately denied the shareholders' motion for appointment of an Equity Committee on the grounds that "the Debtors appear to be hopelessly insolvent."[42] Nevertheless, the court set forth in its conclusion a two-factor test for appointing an Equity Committee: that an Equity Committee

---

substantial likelihood that [equity] will receive a meaningful distribution in the case under a strict application of the absolute priority rule").

39 *See In re Wang Lab., Inc.*, 149 B.R. 1, 4 (Bankr. D. Mass. 1992) (looking to the debtor's *present* operations to determine whether it was hopelessly insolvent); *cf. Ampex Corp.*, 2008 Bankr. LEXIS 1536, at *3, (recognizing that whether a debtor is hopelessly insolvent and whether there is an expected recovery for equity are two different inquiries).

40 *Emons*, 50 B.R. at 694 ("[T]his court is of the view that generally no equity committee should be appointed when it appears that a debtor is 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."); *see also Williams Commc'ns*, 281 B.R. at 220 (applying *Emons* and explaining that "[a]s a result of the absolute priority rule, equity security holders of a hopelessly insolvent debtor will receive no distribution. As such, the shareholders have no economic interest left to protect, and any contribution would amount to a gift."); *Wang Labs.*, 149 B.R. at 3 (applying the 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).

41 *Williams Commc'ns*, 281 B.R 216. *See also* Lennox et al., *supra* note 2, at 27-28.

42 *Williams Commc'ns*, 281 B.R at 220.

should not be appointed unless equity holders establish that "(i) there is a substantial likelihood that they will receive a meaningful distribution in the case under a strict application of the absolute priority rule, and (ii) they are unable to represent their interests in the bankruptcy case without an official committee."[43] With respect to the solvency inquiry, therefore, the *Williams* court appeared to move away from the "hopelessly insolvent" inquiry in favor of a prospective evaluation of the potential that equity will be entitled to a meaningful distribution in the case.[44] Although the *Williams* court cited no authority in support of its approach, the "substantial likelihood" standard has been adopted by a number of courts in place of, or in addition to, the "hopelessly insolvent" test.[45]

Recent Decisions on the Role of Solvency in Appointing an Equity Committee

In recent years, the majority of disputes and decisions regarding the appointment of Equity Committees have occurred in the bankruptcy courts of the Second and Third Circuits. The discussion below summarizes certain themes that can be taken from these recent decisions. Characteristic of their past decisions,[46] bankruptcy courts in the Second Circuit have continued to focus on the debtor's solvency in deciding whether to direct the appointment of an Equity Committee, with one notable exception. Bankruptcy courts in the Third Circuit, while also

---

43 *Id.*

44 *Williams Commc'ns*, 281 B.R at 223.

45 *See, e.g.*, *Kodak II*, 2013 Bankr. LEXIS 3325, at *8 (following the precedent of *Williams Commc'ns* and adopting the "substantial likelihood" test for solvency); Hr'g Tr. 33:21-24; 39:6-19, *Dynegy*, No. 12-36728-CGM (Docket No. 102) (noting court agreement with the U.S. Trustee that "a substantial likelihood that equity will receive a meaningful distribution is not met," before also referencing the "hopelessly insolvent" metric); *In re Commlinications, Inc.*, No. 10-10632, 2010 Bankr. LEXIS 5792, at *2-3 (Bankr. D. Del. April 12, 2010) (ruling that its decision not to order the appointment of an Equity Committee turned primarily on the finding that there was not a "'substantial likelihood' of a meaningful distribution from Debtors' estates"); *Patriot Coal*, No. 12-51502-SCC (Docket No. 3959) (order denying a motion for appointment of an Equity Committee and adopting the *Williams* "substantial likelihood" test).

46 *See, e.g.*, *Ampex Corp.*, 2008 WL 2051128, at *2 (finding solvency factor to be the "threshold inquiry"); *Oneida*, 2006 Bankr. LEXIS 780, at *3; *Williams Commc'ns*, 281 B.R. at 221.

focusing on solvency, have occasionally emphasized other considerations, such as the adequacy of the evidence submitted before the courts.[47]

(i) The Receipt of a Gift under a Chapter 11 Plan Likely Does Not Constitute a "Meaningful Distribution"

Perhaps unsurprisingly, courts have held that the anticipated receipt of a gift does not constitute a substantial likelihood of a meaningful distribution justifying the appointment of an Equity Committee. In *Dynegy*, for example, out-of-the-money equity security holders stood to receive a distribution in connection with a settlement agreement in exchange for supporting confirmation of the debtors' chapter 11 plan.[48] Despite this potential recovery, the court agreed with the U.S. Trustee and other parties in interest that the equity security holders were "out of the money" under the absolute priority rule and, therefore, possessed no substantial likelihood of receiving a "meaningful distribution" under the plan.[49] Disagreeing with the equity holders' other solvency arguments, the court, therefore, denied their motion to appoint an Equity Committee.[50] However, in *Rotech Healthcare, Inc.*, the opposite result was reached. Rotech's pre-packaged plan provided out-of-the-money equity with a distribution equal to up to ten cents

---

47 *See, e.g.*, *In re eToys, Inc.*, 331 B.R. 176, 186 (Bankr. D. Del. 2005) (exclusively considering the timing of the application); *Spansion*, 421 B.R. at 164 (emphasizing the parties' relevant burdens of proof); *Kalvar Microfilm*, 195 B.R. at 600-01 (discussing factors other than solvency – the complexity of the case, whether the debtors' shares were widely held and adequate representation).

48 Hr'g Tr. 25:19-22, *Dynegy*, No. 12-36728-CGM (Docket No. 102) (debtors' counsel describes equity's distribution under the plan as a "contingent right of payment" or a "gift").

49 *Id.* at 33:21-24; 39:11–13 (agreeing with the U.S. Trustee, who asked the Court to look to whether there was a substantial likelihood that equity would receive a meaningful distribution, and ultimately finding that equity would not obtain any recovery under the absolute priority rule).

50 *See also Commlinications*, 2010 Bankr. LEXIS 5792, at *4 (receiving a gift pursuant to a plan does not necessarily constitute a meaningful distribution from the debtors' estates); *Ampex Corp.*, 2008 WL 2051128, at *2-3 (denying motion for appointment of an Equity Committee on grounds that*, inter alia*, appointment is not proper where equity is out of the money and any recovery by equity would come only in the form of a gift).

per share. The U.S. Trustee determined to form an official committee of equity security holders because, among other reasons, the initial plan provided for a distribution to equity.[51]

(ii) Reliable Valuation Testimony is Essential to the Success of a Motion for Appointment of an Equity Committee

In several recent cases where courts have denied motions to appoint Equity Committees, the courts have noted the moving parties' failure to meet their burden of proof, especially with respect to the determination of the debtors' solvency. In *AbitibiBowater*, equity security holders did not present their valuation expert, who had submitted a valuation report, for cross-examination at an evidentiary hearing.[52] Nevertheless, the equity security holders sought, and ultimately were permitted, to cross-examine the debtors' witness.[53] Nonetheless, the court stated at the hearing that it couldn't "remember a lighter evidentiary record made in support of an Equity Committee motion in its career" and ultimately denied the equity holders' motion.[54]

Similarly, in *Commlinications*, equity holders cross-examined the debtors' valuation expert without presenting their own valuation report or any witnesses.[55] Despite what the court described to be an "effective and skilled cross examination [of the debtors' valuation expert]," the equity security holders "did not establish a substantial likelihood that equity would obtain a significant recovery."[56] In other recent cases, equity security holders made an expert available for cross-examination but the proffered experts had other shortcomings. In *Patriot Coal*, for example, the court found the valuation performed by the equity holders' expert to be

---

51 *See Rotech*, No. 13-10741-PJW (Docket No. 189) (U.S. Trustee's objection to debtors' motion requesting order disbanding Equity Committee).

52 *See* Hr'g Tr. 32:1-21, *AbitibiBowater*, No. 09-11296-KJC (Docket No. 2840).

53 *See id.* at 34:8-12.

54 *Id.* at 67:12-14.

55 *See Commlinications*, 2010 Bankr. LEXIS 5792, at *3.

56 *See id.* at *4.

"speculative, at best."[57] Likewise, in *Kodak II*, the court questioned the reliability of an expert who spent a mere five hours valuing Kodak's patent portfolio.[58]

These cases demonstrate that, to prevail, motions for the appointment of an Equity Committee must do more than raise mere suspicions of solvency. Rather, such motions must establish a clear and comprehensive evidentiary record on the issue of solvency, supported by professional and defensible valuation reports and expert testimony.

(iii) A Potential Shift Away from Reliance on the Solvency Factor

Despite the general continued emphasis on the solvency determination, the court in *Kodak I* expressly declined to consider preliminary evidence of the debtor's insolvency in denying the shareholders' motion for the appointment of an Equity Committee.[59] Instead, the court was primarily concerned with the damage to the debtor's restructuring negotiations that would be caused by forcing the debtor to establish its insolvency through a valuation trial. "Nothing could be more harmful to Kodak's restructuring efforts than a hearing at which it would be required to adduce evidence of its insolvency at a time when its efforts should be focused on maximizing the value of its enterprise for all stakeholders."[60] The court maintained that it was not required to evaluate "exhaustive evidence on solvency before [deciding] a motion to appoint an Equity Committee."[61] Although a cursory review of the debtors' assets ($4.678 billion) and liabilities ($7.028 billion), as well as other financial information taken from the debtors' public

---

57 *Patriot Coal*, No. 12-51502 (Docket No. 3959) (order denying a motion for appointment of an Equity Committee).

58 *Kodak II*, 2013 LEXIS 3325, at *12-13.

59 *Kodak I,* 2012 Bankr. LEXIS 2944, at *12 ("Although the Court does not reach the question of solvency in this opinion, the Court *notes* that there is no evidence in the record that equity is likely to receive a meaningful distribution.") (emphasis added).

60 *Kodak I,* 2012 Bankr. LEXIS 2944, at *9-10.

61 *Id.*

filings, weighed against appointment of an Equity Committee, the court chose not to "hang its hat" on this evidence.[62]

The Role of Adequate Representation in Appointing an Equity Committee

In addition to the threshold issue of solvency, the question of whether equity security holders' interests are being adequately represented by other parties in interest in a chapter 11 case is central to a determination of whether to appoint an Equity Committee. In this regard, recent cases have considered whether and to what extent: (i) the members of the debtor's board of directors represent equity holders through their own holdings in the debtor; (ii) other constituencies in the chapter 11 case have the same or substantially similar goals to those of equity holders; and (iii) equity holders have otherwise demonstrated an ability to fend for themselves.

(i) Equity Ownership by the Debtor's Board of Directors May Weigh Against Appointment of an Equity Committee

Two recent cases have found that equity ownership by the debtor's management and board of directors is relevant to the determination of whether equity already is adequately represented. In *Kodak I*, the United States Bankruptcy Court for the Southern District of New York found that "there [was] no reason to think that the interests of shareholders [would] be ignored in the debtors' cases, particularly where Kodak's directors and officers own[ed] over 10 million shares of Kodak stock themselves."[63] Similarly, in *U.S. Concrete*, a Delaware bankruptcy court found that, "based on the board of directors' and management's fiduciary duties

---

[62] The court chose not to rely on solvency, perhaps, in part, due to the unknown value of the debtor's patent portfolio, which the shareholders argued may have been valuable enough to render the debtors solvent. *Id.* at *10-11. Thirteen months later in *Kodak II*, the court, having already approved a disclosure statement that estimated a 4-5% recovery for unsecured creditors, placed more of an emphasis on solvency in denying certain shareholders' renewed request for the appointment of an Equity Committee. *See generally Kodak II*, 2013 LEXIS 3325. Timing also played a key role in *Kodak II*, as the court was to hold a confirmation hearing only a few days after it issued its opinion. *Id.* at *10.

to equity holders and their holdings of existing equity" – which holdings exceeded those of the *ad hoc* committee of equity holders – "the board and management adequately represent the interests of equity holders."[64]

Notably, the courts in *Kodak I* and *U.S. Concrete* also found that the interests of the various constituencies were relatively aligned. Where the interests of a company's board diverge from those of general shareholders "the usual presumption that the Board will pay due (perhaps special) regard to the interests of shareholders" in bankruptcy may prove unrealistic.[65]

(ii) Alignment of Interests with the Creditors Committee May Weigh Against the Appointment of an Equity Committee

In several recent cases, bankruptcy courts have denied appointment of Equity Committees in part on the grounds that the interests of equity holders were aligned with those of the Creditors Committee. In *Kodak I*, for example, the court found that "Kodak's unsecured creditors' committee has a duty to maximize the value of the Kodak estates which would inhere to the benefit of shareholders," and the shareholders' position that the Creditors' Committee would cease to maximize value once it reached the point at which unsecured creditors were paid in full was unrealistic.[66] Similarly, in *Patriot Coal*, the court found that there was "no basis for concluding that the Unsecured Creditors Committee [would] not adequately represent the

---

63 *Kodak I*, 2012 Bankr. LEXIS 2944, at *7.

64 *In re U.S. Concrete, Inc.*, No. 10-11407 (PJW), 2010 Bankr. LEXIS 3332, at *3-4 (Bankr. D. Del. June 21, 2010).

65 *Oneida*, 2006 Bankr. LEXIS 780, at *7. In *Oneida*, the court was faced with an unusual situation in which lenders, through a two-stage financial restructuring, not only nearly wiped out equity, but also took control of a substantial portion of the Board. *Id.*

66 *Kodak I*, 2012 Bankr. LEXIS 2944, at *7-8.

shareholders, because the Committee has a duty to maximize the value of the Debtors' estates, which [would] trickle down to the benefit of the shareholders."[67]

(iii) Equity Holders' Competent Representation of Their Own Interests May Weigh Against Appointment of an Equity Committee

In several recent cases, courts and parties opposing the appointment of an Equity Committee have reasoned that equity holders' effective assertion of their own interests weighs against appointment of an Equity Committee. In *Dynegy*, for example, the court stated, in response to an equity holder's motion for the appointment of an Equity Committee, "You'll be here [contesting valuation at the confirmation hearing]. You're not going anywhere. You'll be here whether you're [the equity holder] or the Equity Committee."[68] Similarly, in *Kodak I*, the court concluded that "given the quality of legal talent hired by the Shareholders, there is no reason to conclude that the Shareholders cannot be represented ably through an unofficial committee."[69] That any such unofficial committee or equity holder theoretically may be entitled to recover its expenses for any substantial contribution it makes to the debtor's reorganization under section 503(b)(3) of the Bankruptcy Code likely would prove cold comfort to affected shareholders.[70]

---

67 *See Patriot Coal*, No. 12-12900-SCC (Docket No. 3959) (order denying motion for appointment of an Equity Committee).

68 Hr'g Tr. 14:7–9, *Dynegy*, No. 12-36728-CGM (Docket No. 102) (ultimately denying the motion to appoint an Equity Committee despite the equity holders' allegations of a substantially conflicted board).

69 *Kodak I*, 2012 Bankr. LEXIS 2944, at *8-9.

70 Section 503(b)(3) of the Bankruptcy Code accords administrative expense status to, among other things:

> the actual, necessary expenses … incurred by (D) … an equity security holder, or a committee representing … equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case under chapter 9 or 11 of this title . . . .

11 U.S.C. § 503(b)(3); *see also Exide*, No. 13-11482-KJC (Docket No. 2700) (response of Creditors' Committee arguing that "if the movants proceed and make a substantial contribution to the Chapter 11 Case, they can seek relief under Bankruptcy Code § 503(b)(3)(D), which provides parties with a mechanism for reimbursement of certain costs and expenses if they can demonstrate that they made a 'substantial contribution' to a chapter 11 case."); *Davis v. Elliot Management Corp.(In re Lehman Bros. Holdings, Inc.)*, 508 B.R. 283, 291- (S.D.N.Y. 2014) (holding that members of official committees are not entitled to

A tension has, therefore, developed between the dual requirements that movants seeking the appointment of an Equity Committee: (i) thoroughly substantiate their position as to the debtor's solvency with, among other things, valuation reports, expert testimony and cross-examination by sophisticated counsel; and (ii) demonstrate that, notwithstanding any such comprehensive presentation of evidence, the appointment of an Equity Committee is necessary to provide for the effective representation of their interests. In *Exide*, for example, the Creditors' Committee argued that the equity holders' valuation report was flawed and that their expert failed to provide support for the conclusion that there was a "substantial likelihood" that equity holders would receive a "meaningful distribution" in the case.[71] The Creditors' Committee continued, however, that the equity holders' mere retention of their expert and production of the valuation report demonstrated that no Equity Committee was necessary because the equity holders already were adequately represented.[72] The court denied the equity holders' motion without further comment.[73] Nevertheless, the arguments raised in *Exide* highlight the fine line that equity holders must draw to effectively establish insolvency without simultaneously demonstrating that they already are adequately represented.

---

receive payment of their own professional expenses solely on the basis of their committee membership but that they may seek payment on the ground that they made a "substantial contribution" to the case).

71 *See id.*

72 *Id.* at ¶ 14.

73 *Exide*, No. 13-11482-KJC (Docket No. 2766) (order denying motions to appoint an Equity Committee).

Modifying and Disbanding Equity Committees

Both the U.S. Trustee and the Courts Are Authorized to Modify the Membership of an Equity Committee

After the U.S. Trustee appoints an official committee, it has a continuing duty to ensure that members continue to be qualified to serve on the committee.[74] The U.S. Trustee therefore has the power and responsibility to change committee membership where necessary by appointing new members or removing members that were previously appointed.[75] The U.S. Trustee generally removes or changes members as a result of conflicts of interest, breaches of fiduciary duty or changes in status that make parties no longer eligible to represent the committee class.[76]

Although the U.S. Trustee generally is responsible for appointing and managing the members of an Equity Committee, courts also retain the authority to order the U.S. Trustee to make modifications to committee membership, on request of a party in interest and where "necessary to ensure adequate representation."[77] Just as with respect to a bankruptcy court's original appointment of an official committee, however, the Bankruptcy Code provides no standard for determining when membership modification is necessary for the committee to continue to provide adequate representation of the applicable class.[78] Instead, courts have considered a variety of similar factors – including "the ability of the committee to function, the

---

74 *See, e.g.*, DEANGELIS & EITEL, *supra* note 35, at 6; *see also In re Texaco, Inc.*, 79 B.R. 560, 563-564 (Bankr. S.D.N.Y. 1987) (citing the U.S. Trustee's response to the debtor's letter requesting disbandment of a special creditor committee, which promised continued monitoring of the special committee to see if it should be dissolved in the future).

75 DEANGELIS & EITEL, *supra* note 35, at 6. Even after the 1986 amendments to the Bankruptcy Code threw into question the court's ability to reconstitute committee membership, courts readily recognized the U.S. Trustee's authority to change committee members. *See Texaco*, 79 B.R. at 565.

76 DEANGELIS & EITEL, *supra* note 35, at 6.

77 11 U.S.C. § 1102(a)(4).

78 *See, e.g.*, *Shorebank*, 467 B.R. at 160 (noting that the Bankruptcy Code "nowhere defines 'adequate representation'" in the context of changing committee membership); *Park West*, 2010 Bankr. LEXIS 2463, at *7 (noting that the Bankruptcy Code does not define adequate representation).

nature of the case, and the standing and desires of the various constituencies," as well as whether a committee member breached a fiduciary duty to arrive at a case-by-case determination.[79]

Neither the Courts Nor the U.S. Trustee Possess Clear Authority to Disband an Equity Committee

The Bankruptcy Code does not address the disbanding of Equity Committees. Accordingly, issues such as what entity may disband them, pursuant to what authority and for what reasons are open questions.[80] Although the Bankruptcy Code is silent on the U.S. Trustee's authority to disband committees, the U.S. Trustee has assumed that it possesses this authority based on its broad statutory power to "supervise the administration of cases," monitor official committees and review the progress of bankruptcy cases.[81] The argument is that the power to disband an Equity Committee is inherent in the power to appoint, change membership of and supervise Equity Committees and consistent with the need for effective management of the bankruptcy process.[82] Otherwise, the dissolution of Equity Committees may be impossible even where they are no longer necessary or effective, and such an inefficient result would undermine the U.S. Trustee's role.

Chapter 11 debtors also have assumed that the U.S. Trustee has the authority to disband committees. In *Texaco*, the debtor wrote to the U.S. Trustee seeking to disband a special

---

79 *See Shorebank*, 467 B.R. at 160-61 (describing factors courts consider when determining adequate representation for the purposes of appointing a committee and noting that they are the same factors courts have analyzed in the few cases that address reconstituting membership of an existing committee); *Park West*, 2010 Bankr. LEXIS 2463, at *7-17 (analyzing the factors listed above when deciding to add a member to a Creditors' Committee).

80 *See, e.g.*, *Dewey & LeBoeuf*, 2012 WL 5985325, at *3 (acknowledging that it is unclear whether the court has the authority to order the U.S. Trustee to disband an Equity Committee); *Texaco*, 79 B.R. at 565 ("The Bankruptcy Code is silent as to the elimination or merger of creditors' committees that were previously appointed by the United States Trustee.").

81 28 U.S.C. § 586(a)(3); *see also Dana Corp.*, No. 06-10354 (Docket No. 4735) (U.S. Trustee's notice of dissolution of an Equity Committee where only one member remained on the committee); *Gadzooks*, 2005 BL 104487 (Docket No. 1191) (same).

82 *See* 28 U.S.C. § 586(a)(3), 11 U.S.C. § 1102 (a).

committee appointed under section 1102(a)(1).[83] The U.S. Trustee considered the request but ultimately decided to retain the committee, although the U.S. Trustee agreed to monitor the committee and potentially reconsider its decision in the future.[84] Neither party questioned the U.S. Trustee's authority to disband the committee.

Other chapter 11 debtors have sought the disbandment of an Equity Committee directly from the bankruptcy court.[85] Courts also lack clear authority to disband Equity Committees.[86] A number of courts have, nonetheless, explored what inherent or implied authority they may have, and they have found the necessary authority in a variety of sources.[87]

Courts predominantly find the power to disband committees to be inherent in their powers under sections 105(a)[88] and/or 1102[89] of the Bankruptcy Code. In *Dewey & LeBoeuf*, for example, the debtor argued that the power to appoint additional committees and modify their

---

83 *Texaco*, 79 B.R. at 563.

84 *Id.* at 563-64.

85 *Rotech*, No. 13-10741-PJW (Docket No. 142) (debtor's motion requesting order disbanding Equity Committee); *Filene's Basement*, No. 11-13511-KJC (Docket No. 264) (Creditors' Committee's motion requesting dissolution of the Equity Committee appointed in the case); *Dolan*, No. 14-10614-BLS (Docket No. 210) (debtor's motion requesting order disbanding Equity Committee); *Dewey & LeBoeuf*, 2012 WL 5985325 (Docket No. 589) (debtor's reply in support of order directing the U.S. Trustee to disband the official committee of former partners appointed in the case).

86 *See, e.g.*, *In re JNL Funding Corp.*, 438 B.R. 356, 361 (Bankr. E.D.N.Y. 2010) (acknowledging that section 1102 of the Bankruptcy Code is silent on the issue of disbanding a committee).

87 *See, e.g.*, *Dewey & LeBoeuf*, 2012 WL 5985325, at *3 (noting that it is unclear whether the court has the authority to disband an Equity Committee and, if it does have the authority, what standards it would apply in making the determination to disband).

88 11 USC § 105(a); *see also Bodenstein v. Lentz (In re Mercury Fin., Corp.*), 240 B.R. 270, 274 (N.D. Ill. 1999) (reviewing the bankruptcy court's decision to dissolve a special committee based on its authority under section 105(a) of the Bankruptcy Code to review the U.S. Trustee's actions). *But see Rotech*, No. 13-10741-PJW (Docket No. 187) (objection to motion to dissolve Equity Committee; arguing that section 105(a) of the Bankruptcy Code should not be used to override U.S. Trustee actions or expand the court's powers beyond that granted in the Bankruptcy Code). Even before the 2005 amendments granted express authority to the courts to modify committee membership, courts inferred such authority, as well as the power to disband committees, from the intersection of sections 105(a) and 1102 of the Bankruptcy Code. *See, e.g.*, *Shorebank*, 467 B.R. at 160 (describing the history of courts using judicial review under section 105(a) to "inject themselves into the committee process"); *Bodenstein*, 240 B.R. at 276.

89 *Bodenstein*, 240 B.R. at 276 (citing several similar rulings); *In re Mercury Fin. Co.*, 224 B.R. 380 (Bankr. N.D. Ill. 1998).

membership under section 1102 of the Bankruptcy Code must imply the corresponding power to disband an additional committee.[90] Although the court never reached the merits of that argument, the debtor was not alone in arguing this theory.[91] Debtors and other interested parties have argued that, in many respects, disbanding an Equity Committee is essentially the same as terminating all of the committee's members and, therefore, the power to terminate the committee is inherent in the power to remove its members.[92]

Recently, courts have also looked toward their broad power to make bankruptcy cases more efficient and economical under section 105(d) of the Bankruptcy Code[93] as a source of authority for disbanding Equity Committees.[94] As courts address more requests to disband committees, many have merely assumed the power to dissolve (or reconstitute) a committee, either upon the motion of a party in interest or *sua sponte*, without clarifying the source of that authority.[95] These rulings suggest perhaps that bankruptcy courts have grown more comfortable with the management of Equity Committees as they become more prevalent.

The Standards for Appointment May Influence the Standards for Disbanding an Equity Committee

As the Bankruptcy Code is silent on the authority to disband an Equity Committee, it is also predictably silent on what standard the court or U.S. Trustee should apply when determining

---

90 *In re Dewey & LeBoeuf LLP*, 2012 WL 5985325, at *2.

91 *Dewey & LeBoeuf*, 2012 WL 5985325, at *5.

92 Lennox et al., *supra* note 2, at 60.

93 *See* 11 U.S.C. § 105(d) (providing that bankruptcy courts may hold status conferences and issue such orders as "the court deems appropriate to ensure that the case is handled expeditiously and economically").

94 *See Rotech*, No. 13-10741-PJW (Docket No. 597) (debtor's motion requesting valuation of security and dissolution of Equity Committee); *see also In re Pac. Ave., LLC*, 467 B.R. 868, 870 (Bankr. W.D.N.C. 2012) (drawing on § 105(d) to disband a creditor's committee).

95 *See, e.g.*, *In re Pilgrim's Pride Corp.*, 407 B.R. 211, 222 (Bankr. N.D. Tex. 2009); *In re Delphi Corp.*, No. 05-44481 (RDD), (Bankr. S.D.N.Y. Apr. 23, 2009) (order directing U.S. Trustee to disband Equity Committee); *Official Comm. of Equity Sec. Holders of FINOVA Group, Inc. v. FINOVA Group, Inc. (In re FINOVA Group, Inc.)*, 393 B.R. 64, 69 (D. Del. 2008) (discussing the bankruptcy court reconstituting an Equity Committee).

whether to disband the Committee. Although no formal framework has been established by statute, rule or controlling case law, courts and the U.S. Trustee have developed their own standards when considering the dissolution of Equity Committees. In *Rotech*, for example, the court analyzed the solvency of the estate given updated evidence and estimates, and determined that, because the estate was insolvent, equity holders no longer required estate-funded representation and maintaining the Equity Committee was not in the best interests of the debtors and their estates.[96] Therefore, the court dissolved the committee.[97]

Equity Committees can be expensive to the debtor's estate, both in terms of costs directly incurred by the committee and incremental costs and delays incurred by the debtor and any other official committees negotiating or litigating with the Equity Committee. Nevertheless, bankruptcy courts have been reluctant to disband committees based solely on their price tag.[98] Some courts and the U.S. Trustee have declined to allow the cost of an Equity Committee to govern where they find the committee provides adequate representation for its constituents.[99] For example, in *Dewey & LeBoeuf*, the court decided to maintain an Equity Committee despite "substantial expense to the estate" because the committee "continue[d] to serve an important purpose, the most obvious function being to prosecute [a pending] appeal."[100] Similarly, in *Texaco*, the U.S. Trustee refused to disband an Equity Committee solely on the basis of its substantial annual professional fee expenses because the U.S. Trustee deemed the committee

---

96 *Rotech*, No. 13-10741-PJW (Docket No. 977) (order determining debtors are insolvent and disbanding Equity Committee).

97 *Id.*

98 *See Texaco*, 79 B.R. at 564 (describing that that the U.S. Trustee refused to consider the significant cost of professionals hired by the Equity Committee when determining whether to disband the committee, although the court did consider the redundancy of those costs in its decision).

99 *See, e.g.*, *Dewey & LeBoeuf*, 2012 WL 5985325, at *5; *Texaco*, 79 B.R. at 563 (noting that the U.S. Trustee did not consider the costs of the committee when analyzing whether to disband it).

100 *Dewey & LeBoeuf*, 2012 WL 5985325, at *5.

necessary to provide adequate representation for its members.[101] Instead, the U.S. Trustee imposed a variety of controls to curb committee expenses.[102]

Most courts consider the costs of a committee within a broader framework of a cost-benefit analysis to claimholders and the estate.[103] For example, the debtor in *Rotech* maintained that the estate was insolvent and, therefore, the debtor and creditors should no longer be required to bear the costs of maintaining and negotiating with the Equity Committee.[104] The court ultimately agreed and disbanded the Committee in the best interests of the debtors.[105] Similarly, in *Adelphia*, the court extinguished an Equity Committee having concluded that "the benefits of the Equity Committee's continued litigation [to gain a disbursement] were questionable, [and] the costs risked [were] considerable."[106]

The Procedure for Disbanding an Equity Committee Is Unsettled

As may be anticipated given the lack of express authority for the dissolution of Equity Committees generally, there is also no formal procedure for this process. Bankruptcy courts, the U.S. Trustee and parties in interest, however, have developed informal procedures to initiate the disbanding of Equity Committees.[107] Parties may petition the U.S. Trustee, formally or informally, to disband an Equity Committee, or the U.S. Trustee may undertake to disband the

---

101 *Texaco*, 79 B.R. at 563 (quoting the U.S. Trustee's assertion that it did not "believe that a price tag should be placed on adequate representation").

102 *Id.* (suggesting, among other things, coordinating efforts with the Creditors' Committee).

103 *Official Comm. of Equity Sec. Holders v. Official Comm. of Unsecured Creditors (In re Adelphia Commc'ns Corp.)*, 544 F.3d 420, 423 (2d Cir. N.Y. 2008); *Texaco*, 79 B.R. at 566.

104 *Rotech*, No. 13-10741-PJW (Docket No. 142) (debtor's motion requesting an order disbanding an Equity Committee).

105 *Rotech*, No. 13-10741-PJW (Docket No. 977) (order determining debtors are insolvent and disbanding Equity Committee); *see also Adelphia*, 544 F.3d at 423 (upholding the bankruptcy court's decision to withdraw the standing of the Equity Committee, thus ending its opportunity to pursue litigation that could lead to a potential recovery, because doing so was in the "best interests of the bankruptcy estate").

106 *Adelphia*, 544 F.3d at 426.

107 *See, e.g.*, *Texaco*, 79 B.R. at 566-67.

committee on its own initiative.[108] The U.S. Trustee in *Texaco*, for example, entertained a request to disband a committee based on a letter the debtor wrote to the U.S. Trustee, and the U.S. Trustee responded with a letter of its own setting forth its decision to maintain the committee.[109] In certain cases, the U.S. Trustee may request that the court, or the court may elect to, conduct a hearing on the record and issue a reasoned opinion to satisfy due process concerns or facilitate further judicial review.[110]

Courts have likewise employed a variety of procedures to disband Equity Committees and other additional committees. Commonly, the court approves a plan that would disband the Equity Committee upon the effective date.[111] Additionally, the court may issue an order calling on the U.S. Trustee to dissolve the committee.[112] At least one bankruptcy court has revoked the standing of an Equity Committee, thus effectively eliminating its role in the bankruptcy process and dissolving the committee.[113]

---

108 *Dana Corp.*, No. 06-10354 (Docket No. 4735) (U.S. Trustee's notice of dissolution of an Equity Committee); *Gadzooks*, 2005 BL 104487 (Docket No. 1191) (same).

109 *Texaco*, 79 B.R. at 563-64, 568. Informal communications with the U.S. Trustee regarding a debtor's solvency are not uncommon. *See, e.g.,* David McLaughlin, *AMR Sees 'Reasonable Possibility' of Shareholder Value*, BLOOMBERG (Jan. 9, 2013), http://www.bloomberg.com/news/print/2013-0 1-08/amr-sees-reasonable-possibility-of-shareholder-value.html (reporting that the debtors' counsel communicated the debtors' potential solvency with the U.S. Trustee by letter).

110 *See Shorebank*, 467 B.R. at 162 (noting that judicial review of the U.S. Trustee's decisions is only possible where the "the decision is accompanied by a stated rationale and a record of some kind on which the decision was based").

111 *See, e.g.*, *In re Tronox Inc.*, No. 09-10156 (ALG), 2010 BL 318842 (Bankr. S.D.N.Y. Nov. 30, 2010) (dissolving the Equity Committee on the Effective Date of the reorganization plan); *In re Simmons Bedding Co.*, No. 09-14037 (MFW), 2010 BL 318827, at *60 (Bankr. D. Del. Jan. 05, 2010) (same). *But see In re Chemtura Corp.*, No. 09-11233 (REG), 2010 BL 249386, at *38 (Bankr. S.D.N.Y. 2010) (severing the term of a reorganization plan that would have dissolved the Equity Committee upon confirmation to allow the Committee to retain standing for an appeal).

112 *See, e.g.*, *Delphi*, 2009 BL 48479 (Order directing the U.S. Trustee to disband an Equity Committee).

113 *Adelphia*, 544 F.3d at 420.

Significant procedural questions remain, however, that may be exacerbated by the overlapping roles of the court and the U.S. Trustee in the appointment process.[114] It is unclear, for example, whether the party seeking dissolution of an Equity Committee is required to petition the U.S. Trustee before requesting relief directly from the bankruptcy court. Although there is no such express requirement in the Bankruptcy Code of the Federal Rules of Bankruptcy Procedure, parties will likely continue to petition the U.S. Trustee to: (i) achieve the potentially efficient dissolution of Equity Committees, taking advantage of the U.S. Trustee's perceived authority to disband the Equity Committee and familiarity with the relevant facts and circumstances; and (ii) maintain positive relations with the U.S. Trustee's office. Nevertheless, it is consistent with parties' rights to petition the bankruptcy court directly for appointment or modification of an Equity Committee that they may also seek dissolution by this same procedure.[115]

Standard of Review of U.S. Trustee Appointments

Another open question exists regarding the proper deference that bankruptcy courts should give the U.S. Trustee when reviewing its appointment of an Equity Committee under section 1102 of the Bankruptcy Code. In this regard, courts commonly characterize the modification or disbandment of an official committee as judicial review of the U.S. Trustee's prior decision to appoint the committee or the committee member.[116]

---

114 *See* 11 U.S.C. § 1102(a)(1), (2), (4).

115 The *Texaco* court, for example, interpreted section 1102 of the Bankruptcy Code to allow a party to petition the court for dissolution first if it chooses to do so, although it recommended that the party submit the request to the U.S. Trustee before approaching the court. The court would review dissolution decisions *de novo* regardless of whether the request was first submitted to the U.S. Trustee or the court. *Texaco*, 79 B.R. at 565-66.

116 *See, e.g.*, *Rotech*, No. 13-10741-PJW (Docket No. 187) (objection to debtor's motion to disband Equity Committee; framing the court's decision to disband as a judicial review of the U.S. Trustee's decision to appoint the Equity Committee); *Rotech*, No. 13-10741-PJW (Docket No. 597) (debtor's motion for valuation of security and dissolution of Equity Committee; detailing that the court ruled not to disband the Equity Committee because the U.S. Trustee had not acted arbitrarily or capriciously in appointing it);

The majority view among courts is that the U.S. Trustee's actions should be reviewed *de novo* because the appointment of members to an Equity Committee is a legal issue.[117] Before the 2005 amendments to the Bankruptcy Code clearly set forth the court's authority to adjust committee membership, however, many courts reviewed appointments under an arbitrary and capricious or abuse of discretion standard because they reasoned that the U.S. Trustee's appointment activities were (i) administrative in nature or (ii) entitled to greater deference because they are subject to review solely under the bankruptcy court's equitable powers where bankruptcy courts lacked express authority under the Bankruptcy Code to act.[118] Even after the 2005 amendments, however, some courts continued to apply the arbitrary and capricious or abuse of discretion standards.[119] Yet other courts have held that the Bankruptcy Code does not grant the court any power to review the U.S. Trustee's appointments at all.[120]

Mercury Fin. Co., 224 B.R. at 383-85 (approaching a motion to change membership of an Equity Committee as a review of the U.S. Trustee's appointment decisions). *But see Shorebank*, 467 B.R. at 161 (emphasizing that the court has no authority to review the U.S. Trustee's appointment decisions and any change in membership of a committee must be based on the court's independent assessment that the committee does not provide adequate representation, rather than on judicial review of U.S. Trustee actions).

117 *See, e.g., Park West*, 2010 Bankr. LEXIS 2463, at *7; *Nat'l R.V. Holdings*, 390 B.R. at 695; *In re Enron Corp.*, 279 B.R. 671, 684 (Bankr. S.D.N.Y. 2002); *Texaco*, 79 B.R. at 566.

118 *JNL Funding*, 438 B.R. at 361 (applying an arbitrary and capricious standard); *In re Venturelink Holdings, Inc.*, 299 B.R. 420, 423 (Bankr. N.D. Tex. 2003) (same); *Bodenstein*, 240 B.R. at 276 (applying an abuse of discretion standard).

119 *See Rotech*, No. 13-10741-PJW (Docket No. 597) (debtor's motion for valuation of security and dissolution of Equity Committee; describing that the court refused to disband the Equity Committee in a prior hearing because the U.S. Trustee had not abused its discretion in appointing it); *Filene's Basement*, No. 11-13511-KJC (Docket No. 319) (U.S. Trustee's objection to motion requesting dissolution of Equity Committee; arguing that the court should apply the abuse of discretion standard when reviewing whether to disband an Equity Committee because the U.S. Trustee acted within the discretion granted by the Bankruptcy Code when appointing the committee). *Cf Filene's Basement*, No. 11-13511-KJC (Docket No. 264) (Creditors' Committee's motion for dissolution of Equity Committee; arguing that Delaware Bankruptcy Courts apply the abuse of discretion standard when reviewing the U.S. Trustee's decision to appoint particular members to a committee, but not necessarily when reviewing the decision to create the committee itself).

120 *Dewey & LeBoeuf*, 2012 WL 5985325, at *3 (holding that the court has no role in reviewing appointment decisions); *Shorebank*, 467 B.R. at 161 (describing that section 1102(a)(4) of the Bankruptcy Code does not authorize the court to review the U.S. Trustee's appointment decisions); *Rotech*, No. 13-10741-PJW (Docket No. 187) (objection to debtor's motion for dissolution of Equity Committee; arguing that the court has no authority to review the U.S. Trustee's appointment of an Equity Committee).

Conclusion

Equity Committees have traditionally been a rarity in chapter 11 cases. The frequency of appointment of Equity Committees has increased in recent years, however, and there are no signs of this trend slowing. Nevertheless, equity holders retain the burden of establishing the necessity for appointment of an Equity Committee and, in particular, the potentially conflicting requirements of solvency and inadequate representation. Many rules and procedures surrounding the appointment, management and potential dissolution of Equity Committees remain undeveloped or unclear. As the U.S. Trustee's office and bankruptcy courts continue to encounter requests to appoint, reconstitute or disband Equity Committees, particularly in large bankruptcy cases, it is possible that they will develop controlling or more uniform standards and procedures for their administration. For the moment, however, a number of open questions remain with respect to this developing area of bankruptcy law.

Hypothetical: Appointment of an Equity Committee

Company and Situation Overview

- Company is a supplier in a cyclical industry at its all-time low, but is expected to rebound in 1-2 years.
- Corporate structure includes a holding company (incorporated in Delaware) and 15 subsidiaries (various states of incorporation, including foreign jurisdictions).
- The holding company is publicly traded:
  - 30 million issued and outstanding shares of common stock.
  - The stock is trading at $0.08 (it was once as high as $20).
  - The majority shareholder owns 30% of the common stock.
  - The board of directors has 9 members, of which 5 are independent.
  - The majority shareholder has two board seats.
  - Each director holds equity interests in the company (collectively less than 1%).
- LTM EBITDA is $130 million and has been declining historically, but the peak EBITDA was $200 million 3 yrs ago.
- The company is highly leveraged (5X) and pressed by the global and regional economic recession and is running out of cash.
- Secured notes are currently trading at 98.
- Unsecured notes recently settled at 75, but have traded between 60 and 80 over the past 6 months.

Chapter 11 Case

- A pre-negotiated chapter 11 plan was filed on the petition date, and seeks to:
  - Reinstate $300 million of secured notes
  - Turn $350 million unsecured notes into 100% of equity
  - Pay $5 million of outstanding trade debt in full in cash
  - Wipe out existing equity holders
- On the petition date, two institutional investors (who held the stock for over a year) and a distressed fund (who acquired the stock days before the filing and after the prepackaged deal was publicly announced) requested the appointment of an equity committee.

Valuation

Market Trading Price Valuation

	Amt$	Price	Value	EBITDA Mult
Secured	300	98	294	2.26
Notes	350	75	263	2.02
Trade	5	100	5	0.04
Total	**655**		**562**	**4.32**

Company Valuation @$570m Valuation (low end)

	Amt$	Recovery	Value	EBITDA Mult
Secured	300	100	300	2.31
Notes	350	76	265	2.04
Trade	5	76	4	0.03
Total	**655**		**569**	**4.38**

Company Valuation @$610m Valuation (high end)

	Amt$	Recovery	Value	EBITDA Mult
Secured	300	100	300	2.31
Notes	350	87	305	2.35
Trade	5	87	4	0.03
Total	**655**		**609**	**4.69**

Equity Holders' Valuation

$750 m - $865 m

Primarily based on a discounted cash flow methodology.

Hypothetical: Appointment of Equity Committee in a Chapter 11 Case

Arguments For and Against Appointment of Equity Committee		
Fact	**Argument FOR Appointment of an Equity Committee**	**Argument AGAINST Appointment of an Equity Committee**
Company operates in an industry that is expected to rebound in 1-2 years	The expected rebound may indicate that there is future value for shareholders.	Speculative nature of business cycle is not a basis to appoint an equity committee.
Corporate structure includes a holding company and 15 subsidiaries (some are foreign companies)	The corporate structure with many subsidiaries, including foreign subsidiaries, could support an argument for the complexity of the case.	
Publicly-traded company	A large number of shareholders supports the appointment of an equity committee.	A large number of equity security holders does not **alone** warrant appointment of an equity committee.
Stock is trading at $0.08, was once as high as $20	Shares are trading and the historic price may indicate equity has value.	Shares are trading at option value (mostly to distressed investors) and not a true indicator of equity value
The majority shareholder owns 30%	The majority shareholder interest may not be aligned with the remaining 70%	The majority shareholder may be able to adequately represent all shareholders.
The board of directors has 9 members, of which 5 are independent; each director holds equity interests in the company (collectively less than 1%)	The board cannot represent equity's interest because old equity may look into its past conduct.	The board's interests are aligned with the equity security holders and may be able to adequately represent all shareholders.
The shareholders requested the appointment of an equity committee on the filing date	The timing of the request is appropriate.	
Enterprise value is estimated between $570 – $610 million based primarily on a comparable company methodology; the company has secured debt in the amount of $300 million; the total debt (including unsecured claims) is estimated at $655 million	The debtor is under-valuing its true value in order to benefit its debt holders and a different valuation will show solvency.	The company is insolvent by at least $40 million demonstrating that equity has no stake in the company in an absolute priority basis.
The shareholders claim the enterprise value of the company	The equity holders' valuation shows substantial likelihood of	The Court may not deem the equity holders' valuation reliable

Arguments For and Against Appointment of Equity Committee		
is $750 - $865 million primarily based on a discounted cash flows analysis	meaningful distribution to shareholders.	because the discounted cash flow analysis may be too speculative in a cyclical business.
Two institutional investors (who held the stock for over a year) and a distressed fund (who acquired the stock days before the filing and after the prepackaged deal was publicly announced) made the request to the UST for the appointment of the equity committee.		The shareholders are sophisticated and able to represent themselves without an official equity committee.