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Bankruptcy Trends: Sales and Restructuring

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CONCURRENT SESSION

2019

Bankruptcy Trends: Sales and Restructuring

PRE-FILING CONSIDERATIONS

I. Time Constraints: How Fast Is Too Fast?

A. Overview – Competing Interests

Parties in bankruptcy cases may seek to employ "warp speed" to obtain approval from the Bankruptcy Court for any number of reasons. This section considers several instances where speed is a factor in bankruptcy, and explores the impact of compressed timelines on the competing interests therein.

Vignette: XYZCo filed a voluntary chapter 11 petition with a restructuring support agreement with its primary lender in hand. The Debtor seeks first-day approval of an assumption of the RSA, which contains a toggled restructuring approach. Big Bank has agreed to a debt-for-equity restructuring, but first requires XYZCo to market its assets for sale in a truncated auction process. The RSA includes DIP-financing and requires the Debtor to meet an aggressive schedule of milestones designed to ensure a sale or confirmation within 30 days, with an exit from bankruptcy 15 days later.

B. Due Process/Notice - Timing of First Day Relief

Although some first day motions are designed to maintain the status quo during a restructuring, others, such as cash collateral, debtor-in-possession financing, bid procedures, and restructuring support agreement approvals, have a significant impact on case progression and treatment of creditors. Federal Rule of Bankruptcy Procedure 4001 attempts to address notice concerns for some of these motions by requiring 14 days after service before final hearings on motions to use cash collateral or to obtain credit.

Judges must balance the immediate needs of a debtor with the impairment of rights of parties with little to no notice of the relief requested. *See In re Colad Group, Inc.*, 324 B.R. 208, 224 (Bankr. WDNY 2005) ("The debtor and its secured creditor do not constitute a legislature. Thus, they have no right to implement a private agreement that effectively changes the bankruptcy law with regard to the statutory rights of third parties."). Creditors and other parties in interest must also carefully review complex motions and exhibits within a very short window. This can create questions of due process, and intersects with the post-filing considerations later discussed on this panel (necessity of an official unsecured creditors' committee, and approaches in cases where unsecured creditors are out of the money).

For an example, consider one of the motions filed with the petition in *In re Ditech Holding Corporation, et al.*, Case No. 19-10412, Bankr. SDNY (J. Garrity, Jr.). Titled "Debtors' Motion for Interim and Final Orders (A) Authorizing Debtors to Enter into Repurchase Agreement Facilities, Servicer Advance Facilities and Related Documents; (B) Authorizing Debtors to Sell Mortgage Loans and Servicer Advance Receivables in the Ordinary Course of Business; (C) Granting Back-Up Liens and Superpriority Administrative Expense Claims; (D) Authorizing Use of Cash Collateral and Granting Adequate Protection; (E) Modifying the Automatic Stay; (F) Scheduling a Final Hearing; and (G) Granting Related Relief", the motion clearly covers a lot of ground. Spanning 530 pages with exhibits, the motion itself is 89 pages. Even the summary of

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material terms of the DIP facilitates and adequate protection required by Rule 4001 runs over 26 pages. This is by no means unique, and serves to highlight the challenges faced by judges and creditors trying to evaluate the full impact of these early pleadings.

In its first day motions, XYZCo is seeking several types of relief that will steer the case going forward. Both the nature of the plan contemplated by the RSA and Big Bank's milestone requirements will affect all creditors of XYZCo. XYZCo and Big Bank will need to be prepared to present justification to the Court for all elements of the RSA and related relief to demonstrate that Big Bank is not overreaching and that XYZCo needs Big Bank's support.

C. Viability of a Going-Concern Business - Timing of Sale Procedures

A debtor's inability to continue funding its business operations is a common rationale for a quick sale process. This looming cash crisis must be balanced against concerns that a marketing campaign was not sufficiently robust or that bid procedures favoring a quick sale to a stalking horse bidder will serve to chill further bids for a debtor's assets. "The sale of assets which is not in the debtor's ordinary course of business requires proof that: (1) there is a sound business purpose for the sale; (2) the proposed sale price is fair; (3) the debtor has provided adequate and reasonable notice; and (4) the buyer has acted in good faith." *In re Exaeris, Inc.*, 380 B.R. 741, 744 (Bankr. D. Del. 2008) (denying expedited sale of debtor's assets due to lack of evidence satisfying elements for sale approval).

These tensions were on display in *In re Central Grocers, Inc., et al.*, Case No. 17-10993, Bankr. D. Del. (J. Selber Silverstein). Here the Debtors sought approval of a sale of assets. They had a stalking horse bidder for 19 supermarket stores, but no stalking horse bidder for their distribution center and other real estate. The Creditors' Committee objected to the sale procedures [Dkt. No. 274], arguing that the distribution center and other real estate should not be sold on the same quick schedule as the stores. The Debtors agreed to extend the bid deadline for all assets, and the bid procedures were approved [Dkt. No. 338].

XYZCo is an operating business, and a going concern sale of its assets would in all likelihood provide a significantly better return to creditors. However, Big Bank is eager to see some stability in its troubled investment, and is willing to give XYZCo only a short window to see if it can find a purchaser willing to offer a better deal for the Debtor's assets than Big Bank's debt-for-equity proposal. Like the Debtors in *Central Grocers*, XYZCo would be better positioned for approval of a quick sale if it could show that it began marketing it assets prior to the bankruptcy filing.

D. The Solicitation Process - Timing of Plan Confirmation

Compressed timelines for confirmation may be trendy, but they are not new. For example, shortly after passage of BAPCPA there was speculation that the 2005 changes to the Bankruptcy Code would spur parties towards a more streamlined confirmation process. The Bankruptcy Rules only permit a combined disclosure statement and confirmation hearing for small business debtors. As

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a result of these notice requirements, most whirlwind confirmations are proposed for pre-packaged plans where the debtor has completed most of the solicitation process prior to filing the bankruptcy case. Another instance when a confirmation process may be sped up is in the event that a plan requires no solicitation because all classes of creditors are deemed to accept the plan under § 1126 of the Bankruptcy Code. Without a need for plan solicitation, a disclosure statement need not be approved by the Court prior to confirmation.

Two cases confirmed in February 2019 highlighted the role of speed in plan confirmation. Most famously, FULLBEAUTY Brands Holdings Corp., *et al.*, Case No. 19-22185, Bankr. SDNY (J. Drain), set a record by obtaining a confirmation of its pre-packaged plan in less than 24 hours over the objection of the U.S. Trustee. The case was filed on February 3, 2019 and the plan was confirmed orally on February 4, 2019, with the confirmation order entered on February 5, 2019. The Debtors' memorandum of law in support of confirmation [Dkt. No. 19] illustrates the significant efforts necessary prior to the filing to ensure that the bankruptcy itself could progress at light speed, including providing notice through publication and establishing a claims agent website pre-petition, soliciting plan approvals, and opening a dialogue with the U.S. Trustee. In Delaware, Arsenal Energy Holdings, LLC, Case No. 19-10226, Bankr. D. Del. (J. Shannon) obtained a confirmed plan in less than 10 days over the objection of the U.S. Trustee. Arsenal Energy involved another pre-packaged plan providing for the conversion of debt to equity. The case was filed on February 4, 2019, and the plan was confirmed on February 13, 2019. Like FULLBEAUTY Brands, Arsenal Energy addressed bankruptcy notice requirements by serving notices of anticipated filings and a combined hearing prior to the filing date. Final decrees were entered in both cases on March 22, 2019.

XYZCo and Big Bank are likely to run into problems with the aggressive timeline required under the RSA. Unless they can show that they somehow complied with notice requirements or have a plan that needs no solicitation (i.e., all classes are unimpaired), they can expect pushback from the U.S. Trustee and Committee, and the proposed timeline likely will be denied.

E. Costs of Staying in Bankruptcy – Timing of Bankruptcy Exit

The 2018 increases in U.S. Trustee quarterly fees have created an incentive for companies to speed up their exit from bankruptcy as lingering can be costly, and especially worrisome for entities with large disbursements and narrow profit margins. Section 350(a) of the Bankruptcy Code provides that "after an estate is fully administered and the court has discharged the trustee, the court shall close the case." 11 U.S.C. § 350(a). Section 350(a) is implemented by Bankruptcy Rules 3022, which provides that "[a]fter an estate is fully administered in a chapter 11 reorganization case, the court, on its own motion or on motion of a party in interest, shall enter a final decree closing the case." Fed. R. Bankr. P. 3022. To help avoid later questions as to when full administration has occurred, XYZCo should add language to its plan that provides when the plan is deemed fully administered and governs when a motion for final decree will be filed.

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II. Communication, Communication, Communication!!

A. Overview

The success of a corporate reorganization, whether it is a restructuring or a sale transaction, will be affected by many factors; but one factor that perhaps does not get enough attention is the Company's communication plan leading into a filing with the various stakeholders. Developing an effective communication plan in advance of a filing is critical not only in satisfying notice requirements under applicable non-bankruptcy law and avoiding additional claims against the company that is already in distress, but in sending the right messaging to critical constituencies whose support will be necessary to a successful reorganization. Here is a somewhat common vignette to set the stage:

Vignette: Family-owned, mid-cap Company has been in financial distress for a couple of years. Company has a significant local presence. It has been operating under a series of 30-60 day forbearance agreements with its lender, which is owed $20 million; and the lender is showing signs of fatigue. The prior forbearance included a demand to engage a CRO to assist with the restructuring effort, as well as an investment banker to shop for a new lender and/or a buyer. IBanker has located a buyer, and the buyer has signed an LOI. Buyer wishes to retain existing management, which includes certain members of ownership. The purchase price is sufficient to pay off the lender and cover the freight of the anticipated 363 sale process, but there would be nothing for other creditors. A 60-day marketing period has yielded no other offers. The Company is a manufacturing company with over 1,000 employees, and over $30 million of unsecured claims, including pension debt, trade claims, landlord claims, deposit claims of customers, and some tax debt, including sales taxes. Same vignette, but scenario "B" - Buyer is not satisfied with due diligence and decides to walk from the LOI, the forbearance has expired, and with no other buyer prospect the lender freezes the debtor's accounts and sweeps the cash.

B. Communication with Various Constituencies

Discuss communication issues/protocols that counsel and the CRO should consider in these alternative settings vis-a-vis the following constituencies:

- **The Board** (the zone of insolvency speech, the need for an independent director, and the need for separate counsel);
- **Employees** (when to alert management and whether/when to alert rank and file of an imminent filing, is there a need for a Keip/Kerp, when/ whether to issue a WARN notice- can a conditional WARN notice be issued);
- **Customers/Sales Reps** (if made to order business, do you continue to take orders when delivery date on orders will be after anticipated filing date, and when to advise independent sales reps);

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- **Unsecured Creditors** (whether/when to advise key vendors / landlords, whether to continue to accept goods and services on credit terms extending beyond anticipated filing date - does 503(b)(9) status come into play);
- **Secured Creditors** (whether/when to advise various secured creditors, need to discuss possible DIP financing, use of cash collateral);
- **Potential Bidders** (if seeking accelerated sale or plan process, soliciting proposals from broad spectrum of suitors in advance of filing will maximize value and the chances of an accelerated process); and
- **Others/General Public** (if public company 8k requirement, if private then consider press release, when to issue and how to tell the story, when to advise parties to pending litigation - suggestion of bankruptcy requirement, whether to advise shareholders).

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III. Bankruptcies for the Benefit of Secured Creditors

Vignette: Your client is a family-owned regional retailer with ten stores which has been in business for 30 years. The client owns its flagship store, which is older but in an area that is experiencing significant growth and redevelopment activity. The flagship store has 10,000 square feet of retail and office space, as well as a significant amount of surface parking and some green space. All the other stores are leased. The stores are located in multiple states. The client also has a small on-line presence.

The client's assets consist of its real property, leasehold rights, inventory, FF&E, website, trademark, and goodwill. The client employs about 300 people.

Many of the stores are underperforming, and the client is behind on both payments to critical vendors and lease payments. The client has a revolving line of credit, secured by substantially all its assets. The flagship store is encumbered by a mortgage in favor of the secured lender. The credit line is maxed out, and the secured lender has declined to increase the line of credit unless the client files for chapter 11 bankruptcy.

If the client files for chapter 11 bankruptcy, the lender has agreed to provide DIP financing for the sole purpose of liquidating the assets. The sale of the assets is not expected to generate sufficient funds to pay the secured debt in full, but the lender has agreed to a carve-out for the costs of sale and the administrative expenses of the bankruptcy case.

Under the following scenarios, should the bankruptcy case be allowed to go forward?

i. The lender demands that the client file a 363 sale motion along with its chapter 11 petition and first day motions. The strategy is to close the stores as soon as possible, liquidate the assets, and dismiss the case (notwithstanding the Supreme Court's decision in *Czyzewski v. Jevic Holding Corp.*).

ii. The lender demands that the client file a plan of liquidation along with its chapter 11 petition and first day motions. The plan provides for a sale of all the assets and a wind down of the business.

iii. Does the analysis of scenario i and ii change if the secured lender agrees not only to a carve out for the costs of sale and administrative expenses but also a gift for the benefit of unsecured creditors? As a percent of total recoveries, how large would the gift have to be to change the analysis? Does your analysis change if priority claims do not receive any recovery?

iv. Assume that during the one-year period prior to the bankruptcy, the client's principals made loans to the client to provide operating cash and keep the doors open through the lucrative holiday shopping period. The loans are secured by a properly-perfected junior lien on the assets. However, due to the amount of the

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senior secured debt, the junior lien is wholly unsecured and nearly doubles the pool of general unsecured claims. Does the analysis change?

v. What if the client is backed by a financial sponsor who (i) acquired the business in a leveraged buy-out and encumbered the business with additional debt to fund a dividend to the sponsor and (ii) provided additional junior secured debt that is un- or under-secured?

A. Overview - The Case for and against

With the rise of "fast track" bankruptcies, the debate over whether a chapter 11 case filed solely or primarily for the benefit of secured creditors is improper has once again come to the forefront. Some practitioners have taken the position that such bankruptcies are essentially an abuse of the process and should be dismissed. Other practitioners have taken the position that secured creditors are no different than any other creditor and that, so long as the secured creditor's collateral bears the expense of the chapter 11 process, bankruptcy filings solely or primarily for the benefit of secured creditors are consistent with the principles and legislative history of the Bankruptcy Code.

B. The Case against Bankruptcies for the Benefit of Secured Creditors

1. Those who oppose chapter 11 bankruptcies filed solely or primarily for the benefit of secured creditors find support for their position in the fundamental principles underlying the Bankruptcy Code and the bankruptcy process:

- **"Fresh Start"** – The basic intent of chapter 11 is to rehabilitate the debtor for the benefit of all its creditors and provide the debtor with a "fresh start." *See Pioneer Inv. Svcs. Co. v. Brunswick Assoc. Ltd. P'ship,* 507 U.S. 380, 389 (1993) ("Whereas the aim of a chapter 7 liquidation is the prompt closure and distribution of the debtor's estate, chapter 11 provides for reorganization with the aim of rehabilitating and avoiding forfeitures by creditors.")

- **Preservation of Going Concern Value** – The goals of chapter 11 include the preservation of going-concern value to enhance recoveries for all creditors, not just secured creditors. *See In re Timbers of Inwood Forest Assoc., Ltd.*, 808 F.2d 363 (5th Cir. 1987), aff'd, 484 U.S. 365 (1988).

- **Role of the Creditors' Committee** – Chapter 11 was intended for situations in which a meaningful surplus to unsecured creditors is likely. Section 1102(a)(1) mandates the appointment of an unsecured creditors' committee in chapter 11 business cases other than small business cases: " [. . .] 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 . . ." (emphasis added).

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- **No Support for *Sub Rosa* Plans** – Section 1123(b)(4) contemplates liquidating plans. However, the Bankruptcy Code does not contemplate the disposition of all or substantially all the assets of the estate outside of a confirmed plan, solely for the benefit of secured creditors.

2. In addition to finding support in the fundamental principles underlying the Bankruptcy Code and the bankruptcy process, those who come out against chapter 11 bankruptcies filed solely or primarily for the benefit of secured creditors also point to several complications of using the bankruptcy process in a way which was neither intended nor contemplated by Congress.

- **The *Lionel* Standard** - The seminal case addressing the legal standard for sales under section 363 is *In re Lionel Corp.*, 722 F.2d 1063 (2d. Cir. 1983). In *Lionel*, the Second Circuit rejected a proposed sale of shares owned by the debtor in a third-party company where such shares were not diminishing in value and were in fact expected to retain their value through plan confirmation. The Second Circuit held that section 363(b) does provide a statutory basis for the sale of a debtor's assets outside of a chapter 11 plan for articulated business reasons, but that a court must consider the sale in the context of the protective provisions included in chapter 11 for the benefit of creditors ("The history surrounding the enactment in 1978 of current chapter 11 and the logic underlying it buttress our conclusion that there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b)."). *Id.* at 1069. A chapter 11 bankruptcy case premised on a 363 sale filed solely or primarily for the benefit of secured creditors would not satisfy the *Lionel* standard.

- **DIP Financing** – In a chapter 11 case filed solely or primarily for the benefit of secured creditors, the senior secured creditor will often agree to provide DIP financing or allow the use of cash collateral for the limited purpose of financing going-out-of-business sales or an expedited sales process. The terms of the DIP financing are often onerous and can have the effect of increasing administrative insolvency:
    - Significant DIP fees and high interest rates;
    - New liens on previously unencumbered assets, such as proceeds of leasehold interests, intellectual property, and avoidance actions;
    - Covenants requiring adherence to a short-term budget through the sale, with limited variance allowed;
    - Aggressive sale and procedural milestones;
    - Roll-ups of pre-petition debt;
    - Section 506 (c) waivers; and
    - Insufficient budget to pay all administrative expenses of the case, such as professional fees, administrative rent and 503(b)(9) claims

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- **Absolute Priority Rule** – The absolute priority rule is a fundamental principle of bankruptcy. It is set forth in section 1129(b)(2) of the Bankruptcy Code, which provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if, among other things, the creditors in the class are paid in full, or absent payment in full, so long as no creditor of lesser priority, or shareholder, receives any distribution under the plan. In chapter 11 cases where the secured lender agrees to "gift" funds to the general unsecured creditors, the absolute priority rule is violated.

C. The Case for Bankruptcies for the Benefit of Secured Creditors

1. Those who do not oppose chapter 11 bankruptcies filed solely or primarily for the benefit of secured creditors find support for their position in the fundamental principles underlying the Bankruptcy Code and the bankruptcy process:

- **"Best Interest of Creditors"** – Section 1112 requires that the "best interest of creditors" be considered when determining whether a case should be converted or dismissed for cause based on substantial loss or diminution of the estate and absence of the reasonable likelihood of rehabilitation. Secured creditors are creditors under the definition in section 101(10). Where unsecured creditors will have no recovery under any scenario, the best interests of the secured creditors should be considered. *See United States Trustee v. GPA Tech. Consultants, Inc.*, 106 B.R. 139, 142-143 (Bankr. S.D. Ohio 1989) ("Even if the only reason for the chapter 11 in the instant case is to maximize the return to the secured creditor through the retention of the debtor-in-possession to collect and liquidate assets and to avoid pre-petition transfers of the debtor, the interests of the secured creditor are legitimate interests to be taken into account . . . . In fact, there need not be any unsecured creditors in a bona fide reorganization, and thus the only creditor interests to be taken into account may sometimes be secured creditors.").

- **No Requirement of Distributions to Unsecureds** – The Bankruptcy Code does not mandate a return to unsecured creditors. Section 363 does not require that a sale generate a return for unsecured creditors. Similarly, sections 1123(b)(4), 1123(a)(5) and 1129(a)(11) contemplate both liquidating and reorganization plans, with no requirement that distributions be made to any class of creditors.

- **Diminution of the Estate** – Section 1121(b) allows for conversion or dismissal of a bankruptcy case for "cause." Section 1121(b)(4) provides a list of examples constituting "cause" for dismissal or conversion, including "substantial or continuing loss to or diminution of the estate and the unlikelihood of rehabilitation." In cases which solely or primarily benefit the secured creditor, rehabilitation is clearly not the goal. However, where the debtor's assets are wasting assets (see "Melting Ice Cube," below), diminution is a risk. In such cases, the secured creditor can provide DIP

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financing and other support to minimize diminution and allow the debtor adequate time to maximize value through a 363 sale process.

- **Good Faith** – The lack of good faith is another ground for dismissal of a chapter 11 case. In assessing the lack of good faith, courts generally focus on whether there was an abuse of the chapter 11 process or some form of misconduct. *See, e.g., Carolin Corp. v. Miller*, 886 F.2d 693, 702 (4th Cir. 1989). It is not, however, "bad faith" for a debtor to file a bankruptcy petition in order to take advantage of a particular provision of the Bankruptcy Code (*In re PPI Enters. (U.S.), Inc.*, 228 B.R. 339, 345 (Bankr. D.Del. 1998) (internal citation omitted)) or to obtain a "breathing spell" from creditors (*Baker v. Latham Sparrowbush Assoc. (In re Cohoes Indus. Terminal, Inc.)*, 931 F.2d 222, 228 (2d. Cir. 1991).

2. In addition to finding support in the fundamental principles underlying the Bankruptcy Code and the bankruptcy process, those who do not oppose chapter 11 bankruptcies filed solely or primarily for the benefit of secured creditors also point to several benefits of the chapter 11 process for all parties in interest.

- **Maximizing Value** – The chapter 11 process often yields better results than a chapter 7 liquidation or state court foreclosure proceedings. In contrast to a chapter 7 liquidation or a state court foreclosure, the people most familiar with a Debtor's business remain in possession and continue to operate the business in a way that will maximize value upon sale as a going concern or a liquidation of highly specialized assets. While a chapter 11 bankruptcy may not result in a return to unsecured creditors, other constituents, such as officers and directors, employees, landlords, etc., will likely benefit from this process. In addition, the protection offered to a good faith purchaser under section 363 has its own value and will generally yield a higher sale price than a state court foreclosure or other out-of-court remedy.

- **The "Melting Ice Cube" Theory** - Where the debtor's assets (and presumably the secured creditor's collateral) are "wasting" and diminishing in value with the passage of time, a sale under section 363 is the best option to preserve value and maximize recovery. *See Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 113-117 (2d Cir. 2009), *vacated as moot*, 558 U.S. 1087 (2009) ("Resort to section 363(b) has been driven by efficiency, from the perspective of sellers and buyers alike. The speed of the process can maximize asset value by sale of the debtor's business as a going concern."). The secured creditor often provides DIP financing or other support to allow the Debtor to maintain business operations while the assets are sold.

- **Gifting and Carve Outs** – In many cases where the secured creditor is the sole or primary beneficiary of the chapter 11 process, the secured creditor will provide a carve

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out for the expenses of sale and other administrative costs associated with the chapter 11 case. The secured creditor may also provide a "gift" to junior secured creditors and/or unsecured creditors, in order to gain consent for the process. While gifting and carve outs raise issues with respect to the absolute priority rule (see Section B.2.), they allow the secured creditor to ensure that no party is worse off having participated in the chapter 11 process.

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IV. Shall or May: The Court's Authority Regarding Statutory Committees

You just filed a chapter 11 bankruptcy petition for a mid-size corporation which is a service provider. It has minimal hard assets, other than some FF&E. Its primary assets are an aging patent portfolio, receivables, and the value of its contract assets.

The corporation has $5 million is allegedly secured debt, in three tranches. The second tranche of debt is partially secured, while the third tranche of debt is likely wholly unsecured.

The corporation also has unsecured debt which roughly equals the debt alleged to be secured.

Under the following circumstances, should a creditors' committee be formed?

1. The debtor filed a pre-pack. It intends to sell substantially all its assets within 6 weeks of filing. The proposed purchase price is not enough to pay the secured debt.
2. Because of the nature of its business, the debtor's general unsecured debt consists largely of (a) amounts due to the lawyers who obtained and monitored the patent portfolio; (b) lawyers who litigated a contract dispute with a larger corporation,; (c) the large corporation which obtained a significant judgement against the debtor in that litigation; and (d) equity holders who allegedly made unsecured loans to the debtor in the lead-up to bankruptcy.
3. The U.S. Trustee has received positive responses to committee formation from just two creditors.

A. Overview

Bankruptcy Code Section 1102(a) provides

> (1) Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.
>
> (2) On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee.
>
> (3) On request of a party in interest in a case in which the debtor is a small business debtor and for cause, the court may order that a committee of creditors not be appointed.

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> (4) On request of a party in interest and after notice and a hearing, the court may order the United States trustee to change the membership of a committee appointed under this subsection, if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders. The court may order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern (as described in section 3(a)(1) of the Small Business Act), if the court determines that the creditor holds claims (of the kind represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.

The plain language of section 1102(a) of the Bankruptcy Code would seem to imply that the appointment of an unsecured creditors committee by the U.S. Trustee is mandatory in all cases other than small business cases. In small business cases, the court may order that a committee not be appointed. For the appointment of other committees (such as a bondholders committee or equity security holders committee), the court may, in its discretion, order the U.S. Trustee to form such a committee.

Should an amendment focus on making the U.S. Trustee's authority discretionary? If so, should the amendment specify factors to consider when appointing a creditors' committee.

Notwithstanding the language from the code section, bankruptcy courts have faced the question of whether they have the authority to disband an official committee appointed by the U.S. Trustee. In these instances, the bankruptcy court must determine whether sections 105 and 1102 grant such authority, and more importantly, which factors should be evaluated when determining whether to disband the appointed creditors' committee.

B. The Case for and against Mandatory Appointment

1. The Case Against Mandatory Appointment

Notwithstanding the apparent mandate in section 1102(a), the U.S. Trustee does not appoint an unsecured creditors committee in every case. The reasons for this vary from case to case but may include one or more of the following:

- **Lack of Appropriate Creditors** – If the pool of unsecured creditors is comprised of professionals, deficiency claimants, or equity holders which have made unsecured loans to the debtor, the U.S. Trustee may decline to appoint a committee.

- **Lack of Interest Among Creditors** – Even if there are enough "traditional unsecured creditors" among the creditor body, there may not be enough interest. Serving on a creditors' committee is a time-consuming task and may not ultimately result in a better outcome for the general unsecured

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creditors. For those reasons, creditors may not be inclined to serve on a committee.

- **Case Cannot Support a Committee** – If a case is thinly-capitalized or surviving on life support from a pre-petition secured lender, there simply may not be enough resources to support a committee.

2. The Case For Mandatory Appointment

Section 1102(a) mandates the appointment of a committee. It does not allow the U.S. Trustee to use its discretion; it simply says that the U.S Trustee shall appoint a creditors committee. The reasons in favor of mandatory appointment include many of the issues already discussed in these materials

- **Due Process** – Unsecured creditors can get cast aside in larger cases or in cases on an accelerated timetable. Committees are essential to preserving the due process rights of general unsecured creditors.

- **Cases Can't Benefit Only Secured Creditors** – Using the bankruptcy courts to protect the interests of secured creditors is an abuse of the system. Secured creditors have state court remedies available to them. Committees must be appointed to protect the interest of the general unsecured creditors.

C. Whether a Court Has the Authority to Disband a Committee

1. *Law v. Siegel,* 134 S.Ct. 1188 (2014)

Law filed a chapter 7 proceeding, indicating that he was claiming Californians homestead exemption on his primary residence and that this residence was subject to two mortgages. Siegel, the chapter 7 trustee, did not object to the homestead exemption, but did initiate an adversary proceeding asserting that one of the mortgages amounted to a fraudulent transfer. Two defendants claimed to be the name defendant; one defendant entered a stipulated judgement disavowing the mortgage, the other defendant contested the adversary proceeding. Upon the conclusion of the adversary proceeding, and the bankruptcy court's determination that the mortgage was a fraudulent conveyance, the bankruptcy court sanctioned the Debtor. The BAP and Court of Appeals affirmed the ruling; and the Supreme Court reversed.

The Supreme Court held that "[a] bankruptcy court has statutory authority to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of' the Bankruptcy Code . . . And it may also possess 'inherent power . . . to sanction 'abusive litigation practices.'' . . . But in exercising those statutory and inherent powers, a *bankruptcy court may not contravene specific statutory provisions*." 134 S.Ct. at 1194 (emphasis added; internal citations omitted). As

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to the specific facts of law, the Supreme Court concluded that the imposition of a surcharge that included the value of the California homestead exemption was contrary to Bankruptcy Code section 522 (which provides that an excepted amount cannot serve as a basis for an administrative expense). While the Supreme Court conceded that this would reward the malfeasance of the debtor and put a heavy financial burden on the chapter 7 trustee (who failed to make a timely objection to the exemption), the better interpretation was to not allow section 105 to be used in a manner inconsistent with the expressed provisions of the Bankruptcy Code.

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The question is raised, however, whether the holding of *Law* would apply to Bankruptcy Code section 1102, which while requiring the U.S. Trustee to appoint a committee, is silent as to whether a bankruptcy court may subsequently disband that committee. The two schools of thought are described in *In re City of Detroit* and *In re Caesars Entertainment Operating Co., Ltd.*:

2. Analysis of *In re City of Detroit, Michigan,* 519 B.R. 673 (Bankr E.D. Mich. 2014)

City of Detroit, involved a Chapter 9 municipal bankruptcy and the U.S. Trustee's appointment of a creditors' committee under section 901, which specifically incorporated section 1102. As an initial matter, the court concluded that section 1102(a)(1) was not applicable in a chapter 9 bankruptcy, because the more specific provisions of section 1102 should be given deference over the general incorporation provisions of section 901.

The bankruptcy court also went through an analysis of whether section 105 allowed the Court to disband the creditors' committee notwithstanding the mandatory language found in section 1102(a)(1). The U.S. Trustee's and the appointed creditors' committee's objection both argued that section 1102 identified the limit of the bankruptcy court's authority over a creditors' committee; specifically that the court could order that a committee of creditors not be appointed in cases involving a small business debtor, 11 U.S.C. § 1102(a)(3), and that it could question the composition of the committee. 11 U.S.C. § 1102(a)(4). The bankruptcy court noted, however, that no provision of the bankruptcy code specifically identified these provisions—or any other provisions—as the limits of the court's authority regarding committee appointments.

The bankruptcy court, having determined that using section 105 to disband the committee was not inconsistent with the bankruptcy code, then analyzed whether disbanding the creditors' committee was a "necessary and appropriate" act under section 105. The bankruptcy court focused on two factors:

1. The committee's value to the case; and
2. The costs that would be incurred by the committee.

The bankruptcy court determined that the committee would not provide any value in the case, because it had already disavowed and refused to participate in mediation and because the U.S.

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Trustee had already appointed a retiree committee. The court considered it to be a binary selection between mediation (a potentially cheaper option) and litigation (the more expensive option), and the committee's decision to pursue litigation demonstrated value destruction rather than value creation. Finally, using the professional fees of the retiree committee and the Debtor as a guide, the Bankruptcy court concluded that the committee's potential professional fees would cost the estate millions of dollars and would not be justified in light of the small value to the estate the creditors' committee would provide.

3. The Contrary View of In re Caesars Entertainment Operating Co., Ltd., 526 B.R. 265 (Bankr. N.D. Ill. 2015)

In *Caesars Entertainment*, the Debtor sought to disband one of the two committee's appointed by the U.S. Trustee pursuant to section 1102(a)(1): the noteholders committee. The bankruptcy court reached an opposite conclusion as *City of Detroit*, finding that the only powers a bankruptcy court had with respect to a U.S. Trustee appointed committee were found in section 1102(a)(2) (the court "may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation...."); section 1102(a)(3) (in a small business case, the court "may order that a committee of creditors not be appointed"); and section 1102(a)(4) (permitting court to order a "change [to] the membership of a committee" if a change is "necessary to ensure adequate representation of creditors or equity security holders"). Therefore, because Congress did not expressly provide the bankruptcy court with the authority to disband an appointed committee, the bankruptcy court could not disband the noteholders committee.

Turning to the section 105 argument raised by Caesars Entertainment, the bankruptcy found that utilizing section 105 to disband the committee would be inconsistent with the provisions of section 1102 and the remainder of the bankruptcy code. The court held that section 105 "gives bankruptcy courts the power only to implement existing Code provisions . . . [and] is neither an independent source of rights, . . . nor a source of substantive authority. . . . [Section 105] does not allow bankruptcy courts to contradict the Code . . .by exercising powers the Code does not confer." 526 B.R. at 269 (internal citations omitted). The bankruptcy court denied the Debtors' motion to disband by concluding that "[s]ection 105(a) thus is not a vehicle for reading into section 1102(a)(1) a power to do away with statutory committees when section 1102(a)(1) itself grants no such power — and especially when section 1102(a) grants other powers but not that one." *Id.*

4. Discussion on *Law v. Siegel*, *City of Detroit*, and *In re Caesars Entertainment*: what is the impact on section 1102?

What thoughts does the panel have regarding the bankruptcy court's authority to disband a statutory committee?

Is it appropriate for the bankruptcy court to disband a statutory committee when the Bankruptcy Code provides that a U.S. Trustee shall appoint a creditors' committee? Is *Detroit* or *Caesars Entertainment* the better interpretation of section 105 and its applicability to section 1102?

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Assume *City of Detroit* applies. The court considered only two factors when disbanding the committee: value to the estate and cost of professionals fees. Are there other factors or scenarios that a bankruptcy court should consider when faced with a motion to disband an appointed committee?

Regardless of the current position of the Courts, should an amendment to Bankruptcy Code section 1102 be taken up by Congress that specifically addresses whether the bankruptcy courts have authority to override the U.S. Trustee and disband a committee? What does this provision look like—what test or set of factors would the bankruptcy court consider?

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