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Current Issues Concerning and New Dilemmas for Committees

Norman N. Kinel, Moderator
Squire Patton Boggs (US) LLP; New York

Mark D. Collins
Richards, Layton & Finger, PA; Wilmington, Del.

Hon. Kevin Gross
U.S. Bankruptcy Court (D. Del.); Wilmington

Hon. Laurel M. Isicoff
U.S. Bankruptcy Court (S.D. Fla.); Miami

Hon. Michael B. Kaplan
U.S. Bankruptcy Court (D. N.J.); Trenton

Laura Davis Jones, Facilitator
Pachulski Stang Ziehl & Jones LLP; Wilmington, Del.

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Creditors' committees certainly face dilemmas and challenges in many large Chapter 11 cases, and such dilemmas and challenges may becoming more difficult as *ad hoc* or informal committees have become more prevalent, as secured lenders or other key creditors increasingly attempt to steer and control the case, and as pressures have grown for debtors to quickly improve and restructure operations or otherwise be forced to implement expedited sales processes. Committees are confronted with potential conflicts of interest, fiduciary duty issues, concerns over appropriate compensation and carveouts, and other complications hindering a successful outcome for unsecured creditors.

I. Changing Nature of Chapter 11 Filings Affecting Committees' Agendas

Certainly, the goals, strategies, and results of creditors' committees in many cases have been significantly impacted by recent trends in the nature and outcome of larger Chapter 11 cases including, for example, the following:

- Over the last ten years, pre-negotiated bankruptcy filings have generally become more frequent. In an analysis conducted by FTI of over 300 confirmed plans in 2011-2017, nearly 66% of cases that emerged in 2016-2017 were prepackaged, prearranged or pre-negotiated filings, compared to approximately 40% over the previous five years. Further, the average duration of Chapter 11 reorganizations fell by nearly one-half in 2016-2017 compared to 2011-2015, to 235 days from 435 days.

- Generally, statistics are not on the side of successful retailer reorganizations. Between 2006 and the first half of 2015 (since the 2005 changes to the Bankruptcy Code (BAPCPA)), 55% of larger retail bankruptcies ultimately ended in liquidation, as opposed to a reorganization or going concern sale (AlixPartners Retail Bankruptcy Study).

- In the past several years, the substantial majority of retailer bankruptcy filings were "free fall" emergency filings or sale cases where a pre-filing sale process was undertaken or started (Debtwire, Restructuring Insights: Retail, p. 7). These scenarios are commonly expedited, bumpy, and especially challenging situations.

- In some cases, the Chapter 11 may start out hopefully, with a focus on different exit strategies, but end up as a liquidation. For example, Sports Authority's 2016 bankruptcy filing started with a plan to close less than half its stores and to sell the rest as a going concern, but the bankruptcy concluded with a liquidation and the closing of all 464 stores, and similarly in 2019, Shopko filed with the possibility of reorganization, but switched to a chain-wide liquidation of its 367 stores.

Such foregoing circumstances have raised and continue to raise various challenges, difficulties and uncertainties for many creditors' committees, which commonly must act expeditiously and proactively to maximize the recoveries for unsecured creditors, and which at times must use leverage to slow down the debtor's or secured lenders' favored exit strategy in order to carve out some recovery for unsecured creditors.

II. Complications in Committees Acting in Unsecured Creditors' Best Interests

A. Official Creditors' Committees and Other Statutory Committees

1. In General

Section 1102(a) of the Bankruptcy Code provides that the U.S. Trustee may appoint additional committees of creditors or of equity security holders as the U.S. Trustee deems appropriate. Since the appointment of additional committees is discretionary, such appointment will normally be made on a request from parties in interest.

If different classes of creditors are affected by the Chapter 11 case, *e.g.*, subordinated versus senior unsecured creditors, priority versus nonpriority creditors, *etc.*, the court may order the U.S. Trustee to appoint separate committees to protect the interests of each class of creditors whose rights are affected differently than the rights of other classes. The appointment of an additional committee of unsecured creditors will be ordered only if necessary to assure adequate representation of unsecured creditors.

The appointment of an additional committee is viewed by courts as an extraordinary remedy that they are reluctant to grant. Many courts considering the extraordinary appointment of an additional committee, have employed a two-step process. First, the court determines whether the appointment of an additional committee is needed to assure adequate representation. Next, if the answer to the first question is yes, the court considers whether it should exercise its discretion to appoint an additional committee. Courts have more specifically considered the following factors: (a) the cost associated with the appointment; (b) the timing of the application, whether early or late in the confirmation process; (c) the potential for added complexity; and (d) the presence of other avenues for creditor participation.

2. Equity Committees

Typically, courts treat the likelihood of a recovery to equityholders as the main factor in their analysis of whether to allow an official equity committee. If the debtor is or appears to be solvent, the concern is that a creditors' committee will negotiate a plan based on a conservative estimate of the debtor's value; however, the equityholders of an insolvent debtor have no economic interest in the case and thus, the estate should not have to bear the expenses of an equity committee over what would amount to a gift.[1]

However, even if it is not entirely clear that equityholders will receive a recovery through a Chapter 11 plan, a bankruptcy court may choose to appoint an equity committee in order to ensure that value is preserved for such parties-in-interest and if an equity committee may add something to the case.

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[1] *See, e.g., In re SunEdison Inc.*, 556 B.R. 94, 102-03 (Bankr. S.D.N.Y. 2016); *In re Williams Communications Grp. Inc.*, 281 B.R. 216, 220 (Bankr. S.D.N.Y. 2002) (factors include (i) whether debtors are likely to prove solvency, (ii) whether equity is adequately represented by stakeholders already at the table, (iii) complexity of debtors' cases, and (iv) likely cost to estates of an equity committee); *In re Kalvar Microfilm Inc.*, 195 B.R. 599 (Bankr. D. Del. 1996) (similar).

Notably, equity committees were appointed in the *Horsehead Holding* and *Energy XXI* cases where there were allegations of wrongdoing, misconduct, misrepresentation or other bad faith conduct by a debtor or its officers and directors – even though the courts ruled that they could not conclude that there was a substantial likelihood of solvency. *In re Horsehead Holding Corp.*, Case No. 16-10287 (Bankr. D. Del.); *In re Energy XXI Ltd.*, Case No. 16-31928 (Bankr. S.D. Tex.). Rather, both courts emphasized that public statements made by management regarding valuation immediately prior to bankruptcy were inconsistent with the valuation that the management advanced during the pendency of the bankruptcy. Both courts concluded that an equity committee could add value by challenging the debtors' valuations and determining whether management's pre-bankruptcy and post-bankruptcy remarks were intentionally misleading. In short, something just did not seem right to the courts and they exercised their discretion in requiring equity committees. Ultimately though, in both the *Horsehead Holding* and *Energy XXI* cases, equityholders received nothing under the confirmed plans.

Practically speaking, having status as an official committee likely improves equityholders' chances of extracting some value, even nuisance value, from a debtor. However, as the foregoing cases also demonstrate, the appointment of an equity committee does not guarantee recovery for equityholders.

B. *Ad Hoc* Committees

1. Prepetition Formation

In some situations, trade creditors, noteholders, and other creditors form themselves into informal committees to deal with the debtor before the filing of the petition. Such committees are self-appointed - and therefore unregulated. The potential benefits of acting as an unofficial committee include (i) sharing costs of counsel and other professionals, (ii) increased bargaining power, (iii) presenting a united front to the debtor and other stakeholders, and (iv) avoiding fiduciary obligations to other parties. On the other hand, *ad hoc* committee members may hold interests adverse to one another and they do not generally owe each other or any other stakeholder a fiduciary duty. Thus, there is the risk of members of an *ad hoc* committee trying to co-opt the process or act in a manner detrimental to the other members or other stakeholders.

A prepetition *ad hoc* committee often spends a great deal of time and energy with the debtor, learning about its financial problems. Notably, if a bankruptcy is thereafter filed, the prepetition committee may be converted to an official unsecured creditors' committee postpetition by the U.S. Trustee if the committee members fairly represent a reasonable cross-section of unsecured creditor claims against the debtor.

2. Postpetition Involvement

Ad hoc committees are an increasingly common feature of the Chapter 11 landscape. Based on Debtwire case data and certain assumptions, *ad hoc* committees participated or appeared in a substantial percentage of large Chapter 11 cases across the nation since 2016 (debtors with assets and liabilities over $100 million) – potentially in almost 12% or more of such recent chapter 11 cases.

An *ad hoc* committee formed postpetition can request the court to be recognized as an additional official committee under Code section 1102(a)(2); the standard for appointing additional official committees, however, is sufficiently high that such motions are not commonly granted. Not constituting an official committee, *ad hoc* committees do not have access to various statutory powers (including discovery and informational powers), and must also bear their own professional expenses, which can be burdensome relative to their often small recovery prospects. Consequently, an *ad hoc* committee presumably would carefully weigh the financial cost of advocating its interests compared to the chances of a favorable result.

It should be noted that, depending on the Chapter 11 case's circumstances, while its *de jure* powers are very limited, an *ad hoc* committee's *de facto* powers may be substantial. Without the cooperation of a key *ad hoc* committee, it is unlikely that the debtor will be able to effectively and efficiently restructure its debts. *Ad hoc* committees generally exert some influence in a Chapter 11 case because their members purport to speak for a large group of creditors and implicitly ask the court, the debtor and other parties to give their positions a higher level of credibility.

Potentially, however, there is opportunity for a member of an *ad hoc* committee to effectively take over the committee or act in a manner possibly disadvantageous to the other members and other key stakeholders in the case. Also, active involvement in the case by one or more *ad hoc* committees may incentivize more aggressive posturing or litigation among creditor groups, since an *ad hoc* committee represents only one group of claims.

C. Special Creditor/Committee Situations

1. Undersecured Creditors

An undersecured creditor holds a partially secured and partially unsecured claim. Undersecured creditors may wish to serve on a creditors' committee. An undersecured creditor may be more likely than unsecured creditors to advocate a quick liquidation of the debtor to protect its collateral. Such inclination might affect the prospects of reorganization, but it should not automatically preclude that creditor's participation on a committee. Certainly, if the subject undersecured creditor's lien or claim will be the primary issue facing the committee in the case, the creditor should not serve on the committee. The U.S. Trustee may also evaluate whether a potential dispute with such a creditor would dominate the case or undermine committee deliberations.

2. Other Official Committees

Courts have appointed additional creditors' committees to represent, among other groups, employees, priority creditors, tort claimants, subordinated note holders, retirees, and franchisees. Such committees, however, are rare and, when formed, often serve a narrow function. For example, in Enron's bankruptcy, an employee committee was formed for the limited purpose of investigating employee claims against Enron (Case No. 01-16034; Bankr. S.D.N.Y.), principally severance payments allegedly owed. Based on Debtwire data, in only about 1% of all large Chapter 11 cases (assets over $10 million) filed since 2016 was another statutory committee appointed.

D. Fiduciary Duties

1. Official Committees

A statutory committee member owes a fiduciary duty to the class the committee represents; the duty is to the class as a whole and not to individual members of the class.[2] Committee members may not take advantage of their committee membership to further their self-interest at the expense of their constituency, and their determinations are to be arrived at honestly and with care to be accurate.[3] Importantly, creditors' committee members' concern is to maximize value for general unsecured creditors of the estate.[4]

Although a member of a Chapter 11 committee has a fiduciary obligation to the class represented by the committee, that obligation does not mean that the member may not take action independent of and even contrary to the general position of the committee. For example, when the debtor seeks an extension of its plan exclusivity period, and the creditors' committee does not oppose an extension of such period, a member of the committee individually does not breach a fiduciary duty by opposing such extension.[5] However, when there is a matter before the committee which affects an individual member differently from unsecured creditors generally, that individual member should make that fact known and, depending on the circumstances, consider not participating in the discussion or the vote concerning that matter. Further,

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[2] *See, e.g., In re Johns-Manville Corp.*, 26 B.R. 919, 925 (Bankr. S.D. N.Y. 1983) (committee members are to be "honest, loyal, trustworthy and without conflicting interests, and with undivided loyalty and allegiance to their constituents"); *Official Comm. of Unsecured Creditors v. Belgravia Paper Co. (In re Great Northern Paper, Inc.)*, 299 B.R. 1, 6 (D. Me. 2003) (creditors' committee generally takes actions to further interests of its constituency – unsecured creditors; citations omitted); *Listecki v. Official Comm. of Unsecured Creditors*, 780 F.3d 731, 739 (7th Cir. 2015) ("[A] committee represents the larger interests of the unsecured private creditors, and it is to them, and not the Trustee, court, or any governmental actor, that the committee owes a fiduciary duty.... [T]he committee can, and should, oppose the Trustee if it is acting against the best interests of the unsecured creditors.").

[3] *See, e.g., In re Gen. Homes Corp.*, 181 B.R. 870, 882 (Bankr. S.D. Tex. 1994) ("The fiduciary duty that exists between the members of the Unsecured Creditors Committee and the other unsecured creditors includes the duty to act in good faith and to insure to the greatest extent possible its actions are based on 'accurate and correct' information."); *In re Tucker Freight Lines, Inc.*, 62 B.R. 213, 216 (Bankr. W.D. Mich. 1986) ("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."); *In re Pierce,* 237 B.R. 748, 758 (Bankr. E.D. Cal. 1999) (discussing both duty of care and duty of loyalty).

[4] *See, e.g., Motorola v. Official Comm. of Unsecured Creditors (In re Iridium Operating, LLC),* 478 F.3d 452, 466 (2d Cir. 2007) (remanding to determine whether plan provision met fiduciary duty to maximize recovery of estate's assets); *In re Nationwide Sports Distribs., Inc.*, 227 B.R. 455, 463 (Bankr. E.D. Pa. 1998) ("In general, the purpose of such Committees is to represent the interests of unsecured creditors and to strive to maximize the bankruptcy dividend paid to that class of creditors.").

[5] *See, e.g., In re Am. Fed'n of Television & Radio Artists,* 30 B.R. 772, 775-76 (Bankr. S.D.N.Y. 1983) (committee member may take positions contrary to committee positions in filings on its own behalf; committee member could oppose exclusivity extension despite committee non-opposition).

committee members should not seek to use their membership on the committee to obtain (or attempt to obtain) some advantage over other unsecured creditors. Examples would include such things as utilizing information gained as a committee member to take over the debtor's business, utilizing the position to gain an advantage over other competitors, trade creditors, *etc.*

As noted, the committee member is to consider and act in the best interests of the applicable creditor (or equityholder) class as a whole. But the matter at hand may be complicated and not black-and-white where only certain subsets of the class may benefit from the committee's actions.[6] As discussed further below, the goals of the committee's constituencies may materially differ or even conflict.

Additionally, the market in general unsecured claims has gone through a substantial change with the proliferation of claims traders who are active in large, as well as many midmarket cases. While the greater liquidity in the debt markets has benefited creditors by allowing them to cash out their claims more readily, it has shifted the focus of many unsecured creditors to their immediate recovery percentage, and away from the prospect of a reorganization that might benefit the debtor and its creditors in the longer term. Those that sell their claims are replaced by traders typically focused on short term recoveries – likely resulting in a liquidation bias.

2. *Ad Hoc* Committees

Generally, *ad hoc* committee members do not owe fiduciary duties to the broader class or category of creditors (or equityholders) as a whole. Rather, *ad hoc* committee members are generally free to aggressively advocate for their own interests, whether or not they conflict with those of other similarly situated creditors.

That said, a few courts have suggested the possibility that informal committee members may have some sort of minimum fiduciary obligations; the argument being that *ad hoc* committees, by purporting to speak on behalf of a general or larger stakeholder interest, have responsibilities beyond the narrow interests of their own members.[7] Depending on the case circumstances, it may be advisable for *ad hoc* committees to try to serve to promote the interests of their stakeholder class as a whole, instead of exclusively privileging the interests of the members of the committee.

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[6] *See generally In re Bohack Corp.*, 607 F.2d 258, 262 n.4 (2d Cir. 1979) (requiring committee to safeguard minority and majority creditors because committee owes fiduciary duty to both); *In Drexel Burnham Lambert Group*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1999) ("The duty [of the committee and its counsel] extends to the class as a whole, not to its individual members."), *aff'd*, 140 B.R. 347 (S.D.N.Y. 1992).

[7] *See, e.g., In re Washington Mutual, Inc.*, 419 B.R. 271, 278-79 (Bankr. D. Del. 2009) ("The WMI Noteholders Group's argument is premised on the erroneous assumption that the Group owes no fiduciary duties to other similarly situated creditors, either in or outside the Group. The case law, however, suggest that members of a class of creditors may owe fiduciary duties to other members of the class."; however, it "is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class").

E. Difficulties in Reaching Consensus and Compromise in the Chapter 11 Case

At times, creditors with competing goals and objectives will sit on the same official committee. Conceptually, this is beneficial to the Chapter 11 process because it encourages the resolution of intercreditor disputes through compromise and negotiation in lieu of litigation.

Frequently, a dynamic occurs at the outset of the Chapter 11 case, during the time of formation of the creditors' committee, when, for instance, the unsecured financial creditors may vie with the trade creditors for control of the committee. There will often be divisions within different categories of creditors represented by committees (trade creditors, senior bondholders, subordinated bondholders, tort claimants, employees, unions, *etc.*) – each category may have its own specific agenda that is inconsistent with the agenda of another group. If such agendas are not in serious conflict, the solution to a lack of representation may be to add new members to an existing committee. If, however, the creditor groups are in too vigorous opposition, adding members of different constituencies may simply make a committee unworkable.

Multiple committees in a Chapter 11 case may also lead to significant difficulties. Multiple committees will add substantially to costs -- counsel, experts, and other committee expenses. To ameliorate the expense issue, the committees can be put on budgets, and these committees should avoid duplication of the efforts of each. Further, to a great extent, all committees will have common interest in administrative or operating matters, but not all committees need be active on these matters.

Additionally, multiple committees will likely complicate decision making. An added committee presents one more party that will take positions in a case on operating, administrative and restructuring issues. This necessarily complicates the process of arriving at a consensus on these issues and may result in more complex litigation of such matters before the court. In addition, committees make demands on a debtor and its management. The more of them, the more burdens already overextended management and staff will face.

III. Compensation Concerns

A. In General

As with the debtor's case professionals, the professionals of a creditors' committee (and any other statutory committee) generally must apply to the bankruptcy court for allowance of fees and expenses pursuant to Code sections 330 and 331 and payment thereof from the bankruptcy estate. Further, the estate will reimburse the expenses of creditors' committee members (excluding said members' own legal or other advisor fees).

In contrast, the legal and other professional fees of an *ad hoc* committee are generally not subject to reimbursement by the bankruptcy estate, unless it can be demonstrated that the applicable *ad hoc* committee members and their professionals provided a "substantial contribution" to the Chapter 11 case – typically a very difficult showing to make.

B. Carve-Out Issues

To address the risk of nonpayment or partial payment, when there are insufficient unencumbered assets and/or where superpriority claims may be asserted, it is common for statutory committees and their professionals to negotiate a carve-out from the secured creditors' collateral.

However, in some cases, in the context of a cash collateral or postpetition financing stipulation with the debtor, a debtor's secured lender may resist providing for a reasonable carve-out. Because a carve-out is a charge against its collateral, the argument of the secured lender goes that it should have the sole right and discretion to determine who, if anyone, will benefit from the subject carve-out. On the other hand, creditors' committees have reasoned and argued that the absence of an adequate carve-out for committee professionals would greatly undermine the committee's roles and functions in the case, including as a watchdog of the debtor and secured lender and the bankruptcy process. Essentially as a matter of public policy, many courts appear wary of having the bankruptcy process unreasonably skewed in favor of the debtor's secured lenders, to the detriment of the debtor, its estate and creditors.[8]

Recently, the Delaware bankruptcy court in the *Molycorp* case[9] sided with the creditors' committee and its professionals, holding that a carve-out cap of $250,000 in the DIP financing order (with respect to fees that could be incurred by the committee in investigating the DIP lender's transactions with the debtors and the debtors' adequate protection obligations) did not preclude committee counsel from being paid substantially in excess of the cap where a Chapter 11 plan was successfully confirmed. The *Molycorp* court acknowledged that "in the event that a plan was not confirmed and the estate had become insolvent, the dollar-amount cap would have resulted in … [committee counsel] not being compensated for all the work it has performed." Plan confirmation meant that counsel for the committee had to be paid regardless of the cap under the financing order, given section 1129(a)(9)(A)'s requirement that all administrative claims be paid upon plan effectiveness.

After obtaining standing, the creditors' committee brought claims against the DIP lender, alleging fraud and "loan-to-own" tactics by the DIP lender; the litigation culminated in a settlement agreement between the DIP lender and the creditors' committee. Rather than a complete bar on professional fees in excess of $ 250,000, the carve-out, according to Judge Sontchi, "capped [the DIP lender]'s exposure and liability to payment of certain administrative expenses *in case no reorganization plan had been executed*." Had a plan not been confirmed and had the debtors' estates become administratively insolvent, the $250,000 cap would have resulted in committee counsel not being compensated for the work it had performed. However, a plan was confirmed and thus, the fees incurred by the committee, to the

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[8] *See, e.g., In re Evanston Beauty Supply, Inc.*, 136 B.R. 171, 177 (Bankr. N.D. Ill. 1992) ("Negotiated 'carveouts' … are viewed as being <u>necessary</u> in order to preserve the balance of the adversary system in reorganization…. 'Carveouts' are used in order to avoid skewing the necessary balance of debtor and creditor protection needed to foster the reorganization process. Same is designed to accommodate all classes of creditors and equity interests, rather than one especially crafted for the benefit of the pre-petition lender having a perfected lien on all cash collateral ….") (emphasis added).

[9] *In re Molycorp*, 562 B.R. 67 (Bankr. D. Del. 2017).

extent such fees were allowed as administrative claims (which they were), had to be paid by the debtors pursuant to section 1129(a)(9)(A). According to the court, the operative documents "do[] not connote in any way that the dollar-amount cap would operate as a complete bar against the allowance of administrative claims following plan confirmation." The court's opinion did not provide any guidance on whether a *per se* disallowance of administrative claims in a financing order carve-out would be effective or proper under the Bankruptcy Code. *Molycorp* suggests that a standard carve-out provision (without further elaboration or explicit terms) may not necessarily deter or prohibit a creditors' committee from incurring significant professional fees. That said, it is usually in all parties' best interests to keep case professional fees within reasonable limits.

C. *Ad Hoc* Committee Fees & Expenses

1. Substantial Contribution

Ad hoc committees may seek reimbursement for their time and effort through a request for payment of an administrative expense. Section 503(b)(3)(D) provides that an *ad hoc committee* may seek reimbursement of fees and expenses if it made a "substantial contribution" to the case. Fee awards to *ad hoc* committees are unusual. Thus, parties banding together to form an unofficial committee likely do so at their own financial cost.

In determining whether an *ad hoc* committee made a "substantial contribution," courts will examine whether the committee contributed to the reorganization process, conferred a significant, direct benefit to the estate as a whole (not merely the individual committee members), and whether the committee's efforts were duplicative of services performed by others, including the creditors' committee. Providing an incidental benefit to the estate is not sufficient. Nor will the *ad hoc* committee's extensive participation in the case, without more, meet the standard.

Some of the factors courts have considered include (i) whether the services were undertaken solely for the benefit of the party itself or for the benefit of all parties in the case; (ii) whether the services were actions that would have been taken by the party on its own behalf, absent an expectation of reimbursement from the estate; (iii) whether the party can demonstrate that its actions provided a direct, significant and demonstrable benefit to the estate; (iv) whether the benefit conferred upon the estate exceeds the costs sought to obtain the benefit; and (v) whether the actions were duplicative of those being taken by other parties in the case. Demonstrating a "substantial benefit" is a high standard that *ad hoc* committees will only infrequently be able to meet.

Of note, there have been some cases of *ad hoc* committees satisfying such burden. *See, e.g., In re M&G USA Corp.*, 599 B.R. 256 (Bankr. D. Del. 2019) (Judge Shannon) (*ad hoc* committee of construction lienholders provided substantial contribution by, among other things, facilitating sale and plan settlements); *see also In re Bayou Group, LLC*, 431 B.R. 549 (Bankr. S.D. N.Y. 2010) (*ad hoc* committee made substantial contribution through prepetition services and activities).

2. Payment Through a Plan

Largely because of the difficulty of demonstrating a "substantial benefit" to creditors as a whole, *ad hoc* committees have attempted alternative methods of securing reimbursement of fees. Most commonly, *ad hoc* committees have attempted to bypass the substantial contribution standard by, usually with the debtor's assent in connection with a consensual plan of reorganization, embedding the repayment of fees into the plan itself.

Initially, some courts approved of this strategy. For example, in *In re Adelphia Communs. Corp.*, 441 B. R. 6 (Bankr. S.D.N.Y. 2010), the court concluded that an *ad hoc* committee could properly recover fees without any showing that the committee substantially benefited all creditors where the payment provision was included in the plan, which itself is subject to creditor votes and the approval of the court. In reaching this conclusion, the *Adelphia* court noted that section 503(b) "does not provide, in words or substance, that it is the *only* way by which fees of this character may be absorbed by an estate." In addition, other provisions of the Bankruptcy Code appear to contemplate that some payments, which perhaps would technically not qualify as administrative claims, might nonetheless be permissible. Section 1129(a)(4), for instance, allows payments in connection with the plan if the amount is disclosed and the court determines the payment is reasonable. Moreover, section 1123(b)(6) provides that a plan may include "any other appropriate provision not inconsistent with the applicable provisions of this title."

However, in the *Lehman Brothers* case (*In re Lehman Bros. Holdings, Inc.*, 508 B.R. 283 (S.D.N.Y. 2014)), the District Court for the Southern District of New York reversed the bankruptcy court holding that a reorganization plan could provide for the reimbursement of fees expended by individual official committee members, although not technically covered by section 503(b). The District Court criticized the *Adelphia* court's reasoning and concluded that the sole authority for the allowance and payment of administrative expenses was set forth in section 503(b), which does not permit compensation to counsel for individual committee members except on a substantial contribution basis. According to the *Lehman Bros.* court, reorganization plans exist to pay (i) prepetition claims and (ii) postpetition administrative claims. Inasmuch as fees incurred *after* the petition date cannot, by definition, be treated as prepetition "claims," it follows that they can only be administrative claims, which can be reimbursed, if at all, only under section 503(b). In short, the Bankruptcy Code provides no basis for a third category of payments under a plan (even if voluntarily offered by the debtor) that do not otherwise qualify as "claims" or "administrative expenses." Using a plan provision to accomplish payment would "be based on wordplay alone." The District Court remanded the matter for a determination whether the conventional substantial contribution standard under section 503(b) might, under a more expanded record, be satisfied.

The *Lehman Bros.* decision questions the viability of recovering *ad hoc* professional fees through a plan provision. On the other hand, some courts may decline to follow the *Lehman Bros.* decision on the grounds that the admittedly non-exclusive listing of administrative expenses under section 503(b) should be flexible enough to accommodate a debtor's voluntary recognition of an *ad hoc* committee's beneficial participation in a case. Nevertheless, professionals for an *ad hoc* committee should not readily expect to be able to sidestep section 503(b)'s substantial contribution requirement.

D. **Litigation Financing**

Related to the compensation of committee professionals is the emerging issue of third party litigation funding (TPLF) in bankruptcy cases. Commonly, the bankruptcy estate has limited resources to prosecute causes of action for the benefit of the estate's creditors, and in such situations, the estate and its representatives (like the DIP or a creditors' committee) may have to forego pursuing some potentially beneficial actions or must find some alternative funding mechanism like contingency fee arrangements with counsel. Some debtors, trustees, and other estate representatives have also obtained TPLF – where investors finance the litigation for a percentage of the recovery (or a similar arrangement is implemented like the investor buying the estate's specific cause of action).[10] Players in the TPLF market include, for example, Burford Capital, Therium Group Holdings, Icahn Capital, and Longford Capital Management.

TPLF may arise in various bankruptcy contexts. An investor may be a prepetition creditor (secured or unsecured) that agrees to fund estate litigation and has an interest in the litigation proceeds (or other asset); the debtor in possession may obtain TPLF to finance case-critical postpetition litigation; a postconfirmation trust under a confirmed Chapter 11 plan may obtain TPLF to pursue estate claims for the creditor trust beneficiaries; *etc.* A recent case example is *In re Magnesium Corp. of America (MagCorp)*, Case No. 01-14312-MKV (Bankr. S.D. N.Y.), wherein, in 2016, the MagCorp Chapter 7 trustee auctioned off and sold the rights to receive $50 million of a $213 million judgment in favor of the estate (obtained after many years of litigation and then on appeal) against MagCorp's former majority shareholder based on fraudulent transfers and other theories, to a predecessor of Burford Capital in exchange for $26.2 million (Docket No. 745). The judgment was ultimately upheld on appeal in 2017, resulting in a 92% return on a 7-month investment by the Burford predecessor. The estate (which prior to the sale had less than $1 million in cash and no other material non-litigation assets) certainly benefitted, obtaining cash to pay administrative expenses and guaranteeing there would be funds for general unsecured creditors irrespective of the outcome of the appeal.

In some cases however, TPLF may raise, in addition to possible legal hurdles,[11] ethical concerns such as whether the involvement of third party financing could create conflicts of interest (for instance, where the interests of the financier diverge from those of the litigant/client) or could, through communications with the financier, compromise the attorney client privilege. More generally, third party funding in the bankruptcy context may raise fiduciary duty concerns. Debtors in possession and trustees, as well as statutory committees, have fiduciary obligations, which may be hampered or undermined by TPLF agreements that may give substantial control to the TPLF provider.

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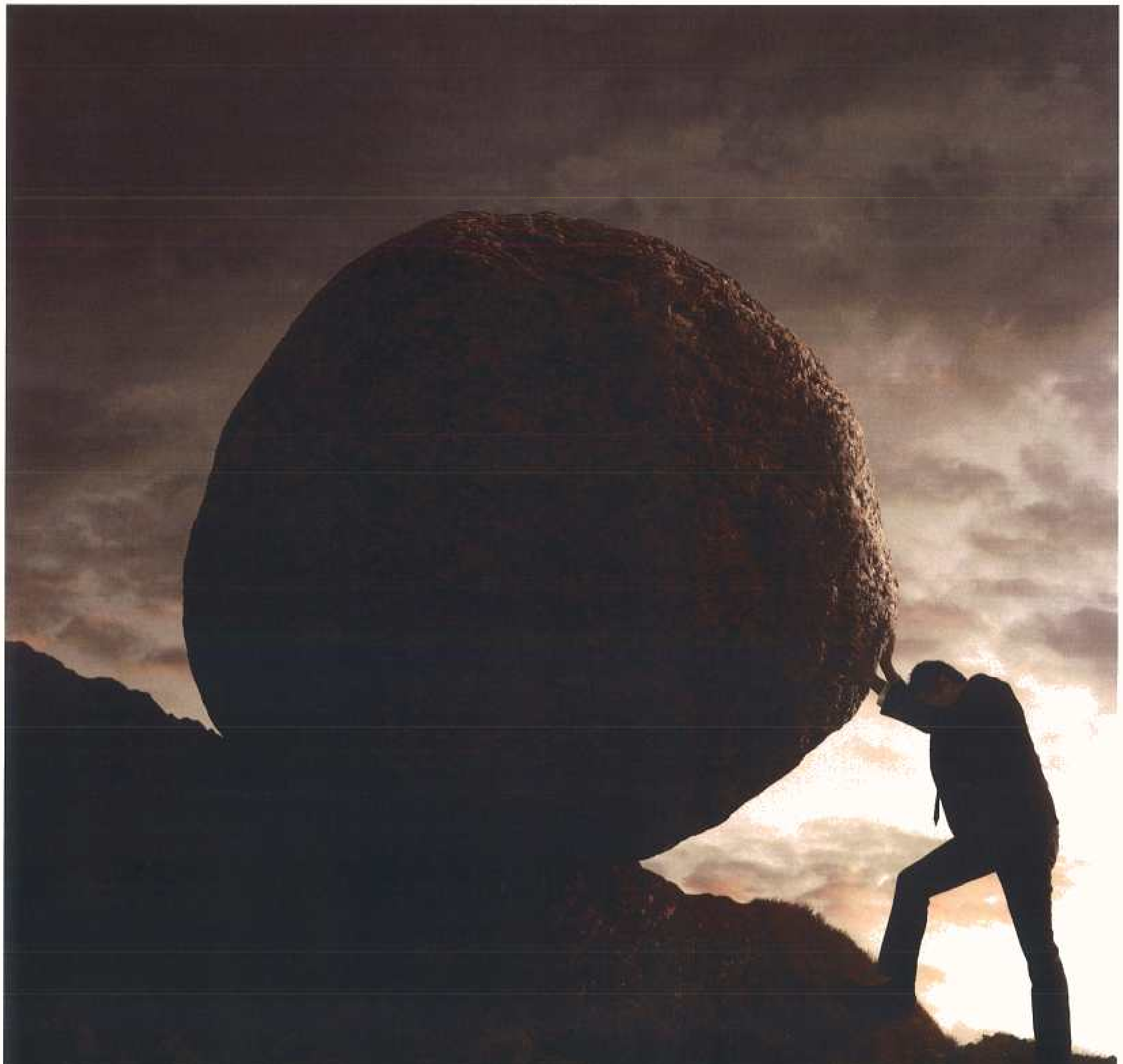
[10] Indeed, there are various possible permutations including portfolio deals (involving multiple certain types of cases) and post-judgment deals (where the value of a successful judgment can be realized while appeals or other proceedings continue).

[11] A Delaware state court has found a litigation funding agreement to be proper as a matter of Delaware law; said arrangement did not violate the state prohibition against "champerty and maintenance" (common law doctrines intended to prevent frivolous litigation). *See Charge Injection Technologies, Inc. v. E.I. DuPont de Nemours & Co.*, 2016 Del. Super. LEXIS 118 (Del. Super. Ct. March 9, 2016). The legal analysis will vary, however, depending on the applicable jurisdiction.



Did *Jevic* Doom Future Chapter 11 Recovery Efforts by Unsecured Creditors?

BY NORMAN N. KINEL & NAVA HAZAN, PARTNERS, SQUIRE PATTON BOGGS (US) LLP

A majority of today's large Chapter 11 cases are structured as quick Section 363 sales of all the debtor's assets followed by confirmation of a plan of liquidation, dismissal of the case, or a conversion to a Chapter 7. The purchaser in the sale is often one of the debtor's prepetition secured or undersecured lenders, which may also act as the debtor-in-possession (DIP) lender and purchase the debtor's assets through a credit bid, with no cash consideration.

In these cases, general unsecured creditors have little chance of a

meaningful recovery absent a viable and recoverable claim against the prepetition lenders, the DIP lender, or some other third party, assuming that such claim has not already been encumbered by the liens of more senior creditors or released in connection with the DIP financing.

To obtain a recovery for their constituency in these types of cases, official unsecured creditors' committees vigorously assert all of their rights under the U.S. Bankruptcy Code to seek to leverage their position. For example, the committee may raise good faith objections to, among other things, (i) the DIP financing (especially if it is being provided by the lender/credit bid purchaser), (ii) the sale procedures—including what is often a highly expedited sale timeline—which the committee may believe were not designed to maximize value for unsecured creditors, and/or (iii) whether the credit bid itself should be allowed under the particular circumstances of the case.

The committee may then negotiate a settlement of these objections, which may include the lender/credit bid purchaser agreeing to "gift" certain non-estate assets to a liquidating or litigation trust established for the benefit of general unsecured creditors. In many of these cases, confirmation of a plan is not possible due to the estate being close to, or in fact, administratively insolvent. As such, claims with a higher priority than those of general unsecured creditors may not be included in the settlement for a variety of reasons, such as (a) because such creditors are unwilling to agree to a settlement that will not pay them in full or are seeking a higher percentage recovery on their claims than the recovery provided to general unsecured creditors, or (b) because the "gift" would be severely diluted by what are often the vastly larger deficiency claims of undersecured creditors.

Although these types of settlements have been successfully implemented in many cases over the years, a recent decision by the U.S. Bankruptcy Court for the District of Delaware—if it is followed by other courts—may preclude this strategy from being used and significantly limit the leverage that a committee may have against a lender/credit bid purchaser in circumstances similar to those described.

Constellation Settlement Agreement

In the Chapter 11 cases of *Constellation Enterprises LLC, et al.*,[1] the official committee of unsecured creditors and the debtors jointly filed a motion with the Bankruptcy Court seeking approval of a settlement agreement, which was entered into by the debtors, the committee, and an *ad hoc* group of noteholders.[2] A subset of those noteholders were both the lenders that provided the DIP financing to the debtors and the successful credit bidders in a sale of substantially all of the assets of certain of the debtors' subsidiaries.

The settlement agreement resolved the committee's pending objections to both the DIP financing and the sale, in return for which the noteholders agreed (through an affiliate) to contribute to a trust to be established for the benefit of the debtors' unsecured creditors (the GUC trust) the following assets: (1) $1.25 million, for a direct *pro rata* cash recovery to unsecured creditors; (2) certain potentially valuable causes of action, which the noteholders either acquired through the sale or which

continued on page 16

continued from page 15

were strictly their own; and (3) $1 million in funding to administer the GUC trust and pursue the causes of action.

However, under the settlement agreement, the distributions to the GUC trust would skip certain priority claimants, such as the Internal Revenue Service (IRS)—which held a large claim against the debtors—and treat the deficiency claim of a group of "delayed-draw term loan lenders" (DDTL) and their agent less favorably than the claims of the other unsecured creditors. Objections to the settlement motion were filed by the DDTL parties, the United States Trustee, the IRS, and certain WARN Act claimants.

The Bankruptcy Court initially deferred hearing the settlement motion until the U.S. Supreme Court issued its ruling in *Czyzewski v. Jevic Holding Corp.*, which was pending at the time.[3] When the Supreme Court issued its opinion and ruling in *Jevic*, it reversed a decision by the 3rd U.S. Circuit Court of Appeals, which had affirmed a Bankruptcy Court order approving the distribution of proceeds from the settlement of certain *bankruptcy estate causes of action* to general unsecured creditors in connection with a structured dismissal, which skipped distributions to certain higher priority claims. The Supreme Court framed the question before it and its ruling as follows:

> The question before us is whether a bankruptcy court has the legal power to order this priority-skipping kind of distribution scheme in connection with a Chapter 11 *dismissal*.
>
> In our view, a bankruptcy court does not have such a power. A distribution scheme ordered in connection with the dismissal of a Chapter 11 case cannot, without the consent of the affected parties, deviate from the basic priority rules that apply under the primary mechanisms the Code establishes for final distributions of estate value in business bankruptcies.[4]

The Supreme Court provided a second iteration of the question presented, and its answer, as follow:

> Can a bankruptcy court approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent? Our simple answer to this complicated question is "no."[5]

In additional briefing in *Constellation* requested by the Bankruptcy Court following the Supreme Court's ruling, the committee argued that *Jevic* was either inapplicable to the settlement motion or distinguishable because it only addressed distributions of property of a debtor's estate, whereas the contributions to be made to the GUC trust by the noteholders were either assets they had purchased from the debtors in the sale and now owned or assets that had always belonged exclusively to the noteholders.

In support of its argument, the committee relied in part on the 3rd Circuit's decision in *In re ICL Company, Inc.*,[6] for the proposition that the Bankruptcy Code's "distribution rules don't apply to non-estate property." The committee pointed out that, notably, *ICL Holding* was not addressed or even cited in the Supreme Court's *Jevic* decision.

In opposing the settlement motion, the principal argument advanced by the objectors was that approval of the settlement agreement was precluded by the ruling in *Jevic*. Specifically, the objectors argued that: (a) the prohibition against class-skipping in *Jevic* did not specifically focus on the distinction between property of the estate and non-estate property and hence, that distinction was irrelevant; (b) *Jevic* reflected a broad policy against all class-skipping; (c) *ICL Holding*, which permitted class-skipping, was either effectively overruled by *Jevic* or should be narrowly read to mean that if there was a distribution of non-estate assets that were at one time property of the estate, then a class-skipping distribution was not permitted; (d) the causes of action were "laundered" through the sale to the noteholders to make it appear that they were not estate assets; and (e) the settlement agreement included other forms of estate property or involvement, such as the payment of legal fees, releases, and assistance by the debtors in the claims reconciliation process.

Following an evidentiary hearing, the Bankruptcy Court declined to approve the settlement agreement on the basis that it was impermissible under *Jevic*. The Bankruptcy Court, in an oral ruling, held that (a) *Jevic* did not necessarily focus on whether estate assets were involved; (b) *ICL Holding*, which the committee contended supported approval of the settlement agreement, may have been overruled or significantly narrowed by *Jevic*; and (c) in any event, *ICL Holding* did not apply to the facts of the *Constellation* cases because some of the assets to be contributed by the noteholders were "at one time" property of the debtors' estates.

The committee appealed the Bankruptcy Court's denial of the settlement motion to the U.S. District Court for the District of Delaware. The DDTL parties, the U.S. Trustee, and the IRS opposed the appeal.

The Committee's Arguments on Appeal

In the settlement appeal, the committee argued that in *Jevic*, the Supreme Court specifically focused on the distinction between estate assets and non-estate assets and that its holding pertained only to a distribution of estate assets. According to the committee, the Bankruptcy Court erred by failing to recognize this important distinction, and the only material assets involved in the settlement agreement were non-estate assets.

The committee also argued that *ICL Holding* correctly held that the distribution scheme under the Bankruptcy Code does not apply to distributions of non-estate property pursuant to a settlement and that the Bankruptcy Court incorrectly disregarded that ruling, which, according to the committee, remained binding precedent in the 3rd Circuit. Further, citing to a then recent decision by the District Court in another case,[7] the committee submitted that a settlement that involves the distribution of non-estate property does not require compliance with the Bankruptcy Code's priority scheme, even if such property was "at one time" property of the estate. In addition, those causes of action that did not already belong to the noteholders were legally transferred to them pursuant to the order approving the sale, which was final in all respects before the Bankruptcy Court considered the settlement motion, such that they were non-estate assets and, therefore, not subject to the Bankruptcy Code's priority scheme. Finally, the committee maintained that the payment of legal fees, the proposed releases, and the debtors' nominal assistance in the claims reconciliation process did not constitute an impermissible distribution of estate assets.

Appeal Thwarted

While the settlement appeal was pending, the *Constellation* debtors moved to convert their Chapter 11 cases to Chapter 7 on the basis that their estates were administratively insolvent. The committee objected to the conversion motion on the basis that, among other things, conversion would jeopardize the viability of the settlement appeal. The Bankruptcy Court nevertheless approved the motion, a ruling the committee also appealed to the District Court.

The appellees then moved to dismiss both the settlement and conversion appeals, arguing that, immediately upon conversion of the debtors' Chapter 11 cases to Chapter 7, the committee was automatically dissolved. Because the committee was the only appellant, both appeals had to be dismissed, they contended. In a reported decision, the District Court agreed and dismissed both appeals.[8]

As a result, the settlement appeal was never heard or decided on the merits. Thus, the Bankruptcy Court's ruling in *Constellation* was never subject to appellate review. All of the consideration they were to contribute to the GUC trust remained with the noteholders, who thereby received a multimillion-dollar windfall, since they were under no obligation to, nor did they ever, contribute those assets to the debtors' estates.

Conclusion

The Bankruptcy Court's ruling in *Constellation*, if followed by other courts, may serve to significantly impair a creditors' committee's options and leverage when seeking to obtain a recovery from the debtor's secured or undersecured lenders. Secured and/or undersecured creditors generally already dominate these types of cases and, just like in *Constellation*, often acquire all of the estate's assets by credit-bidding their debt and leave the estate either close to or, in fact, administratively insolvent. In these cases, the only hope for unsecured creditors is for a committee to use whatever leverage it can muster to try to obtain some recovery for its constituency from the only available source—the debtor's senior secured (or undersecured) creditors.

Committees will undoubtedly continue to advocate for the position advanced by the committee in *Constellation*, such that when a secured creditor has obtained title to former estate assets free and clear of liens and encumbrances, it should be permissible for that creditor to contribute what are now its own assets—or its own funds or causes of action that were never estate assets—to unsecured creditors, even if doing so involves class-skipping. Committees will continue to argue that, where there is no transfer of estate assets but rather a gift of non-estate assets to unsecured creditors, there is no requirement that such gifting must comply with the priority scheme imposed by the Bankruptcy Code.

It remains to be seen whether other courts will follow the ruling in *Constellation* or distinguish it from the ruling in *Jevic*. Like the committee argued in *Constellation*, courts may conclude that *Jevic* does not prohibit the gifting of non-estate property from a secured lender and/or purchaser of estate assets to unsecured creditors, even if in doing so, certain creditors who would be entitled to a higher priority in the context of a plan of reorganization or liquidation will not be similarly treated.

If, on the other hand, courts decide to follow the *Constellation* ruling and prohibit priority-skipping settlements and gifting in all circumstances, Chapter 11 may largely become nothing more than a federal foreclosure statute, for the sole benefit of secured creditors.

Norman N. Kinel is a partner at Squire Patton Boggs (US) LLP based in New York and a member of the firm's Reorganization & Insolvency Practice Group. He is also national chair of the firm's Creditors' Committee Practice. He represents debtors, creditors, bondholders, and committees of creditors and equityholders in complex Chapter 11 cases nationwide.

Nava Hazan is a partner at Squire Patton Boggs (US) LLP based in New York and a member of the firm's Reorganization & Insolvency Practice Group. She is also co-chair of the firm's Cross Border Restructuring Practice. She represents debtors and official committees in complex Chapter 11 cases, as well as foreign liquidators and companies in Chapter 15 and other cross-border matters.

[1] *In re Constellation Enterprises LLC*, Case Number 1:16-bk-11213.

[2] Squire Patton Boggs (US) LLP was lead counsel for the committee in the *Constellation* bankruptcy cases.

[3] 137 S. Ct. 973 (2017).

[4] *Id.* at 978 (emphasis in original).

[5] *Id.* at 983.

[6] 802 F.3d 547, 555 (3d Cir. 2015).

[7] See *Hargreaves v. Nuverra Environmental Solutions, Inc. (In re Nuverra Environmental Solutions, Inc.)*, No. 17-1024, 2017 U.S. Dist. LEXIS 122317 (D. Del. Aug. 3, 2017).

[8] *Official Comm. of Unsecured Creditors v. Constellation Enters. LLC (In re Constellation Enters. LLC)*, No. 17-757-RGA, 2018 U.S. Dist. LEXIS 47153 (D. Del. March 22, 2018). The District Court summarized its ruling as follows:

> A creditors' committee exists only under the statutory framework of the Bankruptcy Code. When these cases converted, the Chapter 11 order for relief became an order for relief under Chapter 7, the statutory predicate for the existence of Committee no longer applied, and the Committee automatically dissolved. As the Committee has dissolved, it has no capacity or authority to appear before this Court, including filing the notice of appeal of the Conversion Order and any filings made in further prosecution of the appeal of the Settlement Denial Order. Because the Committee has no capacity to pursue these appeals, and there is no co-appellant to pursue these appeals, the appeals must be dismissed.

Id. at *286-87.

Feature

By Norman N. Kinel

Conversion Equals Death for a Creditors' Committee and Its Appeal

Norman N. Kinel
Squire Patton Boggs (US) LLP; New York

Norman Kinel is a partner in Squire Patton Boggs (US) LLP's Reorganization and Insolvency Practice Group in New York and national chair of the firm's Creditors' Committee Practice. He represents debtors, creditors, bondholders and committees of creditors and equityholders in complex chapter 11 cases nationwide.

If asked what happens to a creditors' committee appointed in a chapter 11 case if the case is converted to chapter 7, most bankruptcy practitioners would likely opine that the committee is dissolved. However, what if the committee is a party to one or more appeals at the time of the conversion? In addition, what if one of those appeals is of the conversion order itself?

These questions were recently examined and answered by the U.S. District Court for the District of Delaware in the *Constellation Enterprises* cases. The court ruled, in an appeal from the bankruptcy court's decision, that immediately upon conversion of a chapter 11 case to one under chapter 7, a creditors committee is automatically dissolved, and any pending appeal to which such committee is the only appellant must automatically be dismissed because, upon conversion, the committee ceases to exist.[1]

In *Constellation*, the unsecured creditors' committee (the "committee") appointed in the chapter 11 cases of Constellation Enterprises LLC and its affiliates (the "debtors") had appealed the bankruptcy court's denial of a motion seeking approval of a settlement (the "Settlement Motion"). The Settlement Motion sought approval of a settlement agreement entered into by the debtors, the committee and an *ad hoc* group of noteholders, which provided for an affiliate of the noteholders to contribute to a trust, to be established for the benefit of the debtors' general unsecured creditors (the "GUC Trust"), the following: (1) $1.25 million, for a direct, *pro rata* cash recovery to unsecured creditors; (2) certain potentially valuable causes of action; and (3) $1 million in funding to administer the GUC Trust and pursue such causes of action. A subset of the noteholders were both the lenders who provided debtor-in-possession (DIP) financing and the successful bidders in the bankruptcy court-approved sale of substantially all of the assets of certain of the debtors' subsidiaries (the "sale"); the settlement agreement resolved the committee's objections to both the DIP financing and the sale.

Following a hearing, the bankruptcy court issued an oral ruling that the settlement agreement could not be approved because the distributions to be made to the GUC Trust would skip certain priority claimants and treat the deficiency claim of a group of delayed-draw term loan lenders and their agent (the "DDTL Parties") less favorably than the claims of other unsecured creditors and was therefore impermissible under the U.S. Supreme Court's decision in *Czyzewski v. Jevic Holding Corp.*[2] The committee sought to distinguish *Jevic* as only being applicable to distributions of property of a debtor's estate and argued that the contributions to the GUC Trust from the noteholders were either assets they had purchased from the debtors in the noteholder sale, or assets that had always belonged exclusively to the noteholders.

The committee primarily relied on the Third Circuit's decision in *In re ICL Holding Co. Inc.*, which held that the Bankruptcy Code's "distribution rules don't apply to nonestate property."[3] However, the bankruptcy court disagreed and refused to approve the settlement agreement, finding that (1) *Jevic* did not necessarily focus on whether estate assets were involved; (2) *ICL Holding*, which otherwise might have allowed the settlement agreement to be approved, was overruled or narrowed by *Jevic*; and (3) in any event, *ICL Holding* did not apply because some of the assets to be contributed by the noteholders were "at one time" property of the debtors' estates.

The committee appealed the bankruptcy court's denial of the settlement agreement (the "Settlement Appeal"). However, while the Settlement Appeal was pending, the debtors moved to convert their chapter 11 cases to chapter 7 pursuant to § 1112(a) of the Bankruptcy Code (the "Conversion Motion"), citing, *inter alia*, the administrative insolvency of the chapter 11 cases. The Conversion Motion was supported by the DDTL Parties and U.S. Trustee, but the committee objected and asked the bankruptcy court to deny the conversion motion based on an "equitable analysis of the facts,"[4] including that (1) the debtors did not have the absolute right to convert their cases to chapter 7, (2) the debtors had agreed to support the Settlement Motion, (3) conversion would jeopardize the Settlement Appeal, and (4) absent success in the Settlement Appeal, the debtors' unsecured creditors stood no chance of recovery on their claims, and the noteholders would receive a multi-million-dollar windfall.

1 *Official Comm. of Unsecured Creditors v. Constellation Enters. LLC (In re Constellation Enters. LLC)*, No. 17-757-RGA, 2018 U.S. Dist. LEXIS 47153; 2018 WL 1419886 (D. Del. March 22, 2018). The author served as lead counsel for the unsecured creditors' committee in the *Constellation* bankruptcy cases.

2 137 S. Ct. 973 (2017).

3 802 F.3d 547, 555 (3d Cir. 2015).

4 *Constellation*, 2018 U.S. Dist. LEXIS 47153, at *5.

Following a hearing on the Conversion Motion, the bankruptcy court concluded *that a debtor has the absolute right to convert its chapter 11 case to chapter 7*. The court also held that no evidentiary showing was required in order to convert the cases, even though the debtors were prepared to present evidence at the hearing. The court found that it was undisputed that the debtors were eligible to be debtors under chapter 7 and that "the 'record [had] been established over months of this case' regarding [the] administrative insolvency of the cases."[5]

Accordingly, the bankruptcy court entered an order converting the cases from chapter 11 to chapter 7 (the "Conversion Order"), which became effective several days after the hearing. However, just prior to the Conversion Order becoming effective, the committee amended its bylaws in order to purportedly continue to exist as an "*ad hoc*" committee for purposes of the Settlement Appeal in the event the district court determined that the committee was dissolved upon conversion.[6]

After the Conversion Order became effective, the DDTL Parties and U.S. Trustee filed motions to dismiss the Settlement Appeal (collectively, the "Settlement Appeal Dismissal Motions"), arguing that the Conversion Order had triggered the immediate dissolution of the committee. The committee then appealed the Conversion Order (the "Conversion Appeal," and, together with the Settlement Appeal, the "appeals") and moved for a stay pending appeal in the district court (the "stay motion"). The DDTL Parties and U.S. Trustee then moved to dismiss the Conversion Appeal (collectively, the "Conversion Appeal Dismissal Motions" and, together with the Settlement Appeal Dismissal Motions, the "motions to dismiss").

The committee filed objections to the motions to dismiss, contending that the Conversion Order was entered in error, as a matter of law, because the bankruptcy court granted the conversion based on its determination that a chapter 11 debtor has an absolute right to convert its case to chapter 7 and need not present any evidence in order to do so. The committee argued that case law holds to the contrary, including a case decided by the Supreme Court, *Marrama v. Citizens Bank of Mass*.[7] Therefore, the committee maintained that the motions to dismiss must be denied because they were solely premised upon the Conversion Order. In addition, the committee argued that even if a debtor ordinarily has a right to convert, such a right is not without limits, and it is improper for a bankruptcy court to order the conversion of a chapter case if it would interfere with, or require dismissal of, a pending appeal.

The committee also contended that even if the conversion caused its dissolution, the consequences of dissolution are not the same as "extinction" and did not result in the loss of all "vested rights of the Committee." The committee relied on *In re SPM Mfg. Corp*.[8] in support of its position, wherein the First Circuit resolved an appeal pursued by a chapter 11 committee post-conversion. Finally, the committee argued that even if it was found to have been dissolved, the motions to dismiss should still be denied because the committee granted its individual members the collective right to pursue the appeals as an *ad hoc* committee, as successor or assignee to the committee.

The district court in *Constellation* rejected each of these arguments. First, the court agreed with the DDTL Parties and U.S. Trustee (collectively, the "appellees") that "the legal entity that was the Committee automatically dissolved and ceased to exist as of the conversion of the chapter 11 cases to chapter 7."[9] According to the court:

> An official committee of unsecured creditors is created when appointed by the Trustee under § 1102 of the Bankruptcy Code, and it exists only under the framework of chapter 11. Section 103(g) of the Bankruptcy Code provides that, subject to an exception not applicable here, §§ 1101 through 1146 — which include the creditors' committee formation provision in § 1102 and the creditors' committee's powers and duties in § 1103 — "apply only in a case under such chapter" — *i.e.*, chapter 11. Section 1102 does not apply to a case under chapter 7.[10]

The court also found that "numerous courts have agreed that upon conversion to chapter 7, the chapter 11 committee of unsecured creditors is terminated"[11] and concluded that it could "see no other result under the structure of the Bankruptcy Code. Once the case is converted to a different chapter, the relevant provisions of the new chapter must govern." The court then held that case law did not support the post-conversion existence of the committee, even while an appeal is pending:

> The Court is persuaded by *Great Northern Paper*, a case [that] directly addressed the same question at issue here: "What happens to a pending appeal by the Official Committee of Unsecured Creditors when the bankruptcy court converts a chapter 11 proceeding to a chapter 7 proceeding during the appeal?"... The court held, "When the statutory basis of the case is changed, either through dismissal or, as in this case, conversion, 'the statute under which the Committee was created no longer applies and the committee is automatically dissolved.'"[12]

The court also rejected the committee's reliance upon *SPM*, noting that no party had moved to dismiss the appeal in

5 *Id.* at *6 (quoting bankruptcy court's opinion).

6 The bylaw's amendment provided as follows:

> In the event any court of competent jurisdiction determines that the Committee has ceased to exist, has dissolved or has been divested of its powers or of its ability to pursue the appeal of the decision and order issued on May 16, 2017, by the [bankruptcy court] which denied the Joint Motion of the Debtors and Creditors' Committee for an Order Approving Settlement by and among the *Ad Hoc* Noteholder Group [Doc. No. 560] (the "Appeal"), the Members hereby elect to continue to function as an "*ad hoc*" committee of unsecured creditors ("*Ad Hoc* Committee"), in order to protect the interest of the Committee and/or its Members in the Cases and the Appeal and to prosecute the Appeal.
>
> Upon entry of (a) any order converting the Cases to cases under Chapter 7 of the Bankruptcy Code (a "Conversion Order"), and (b) a binding, judicial determination that the Committee has been dissolved, terminated or otherwise rendered incapable of proceeding with (i) the prosecution of the Appeal, (ii) approval of the settlement subject to the Appeal, or (iii) any matter related thereto, the Committee shall automatically be deemed reconstituted as the *Ad Hoc* Committee, which reconstitution shall be deemed to have occurred prior to the effective date and time of entry of a Conversion Order, without further action on the part of the Committee.

Id. at *22-24 (quoting Article XIV.A-.B of the Committee's Amended and Restated Bylaws).

7 549 U.S. 365 (2007).

8 984 F.2d 1305 (1st Cir. 1993).

9 *Constellation*, 2018 U.S. Dist. LEXIS 47153, at *12.

10 *Id.* at *12-13 (internal citations omitted).

11 *Id.* at *15 (citing *In re World Health Alts.*, 344 B.R. 291, 295 (Bankr. D. Del. 2006); *Creditors' Comm. v. Parks Jaggers (In re Parks Jaggers Aerospace Co.)*, 129 B.R. 265, 268 (M.D. Fla. 1991); *In re Freedlander Inc., The Mortg. People*, 103 B.R. 752, 758 (Bankr. E.D. Va. 1989); *In re Kel-Wood Timber Prods. Co.*, 88 B.R. 93, 94 (Bankr. E.D. Va. 1988)).

12 *Id.* at *19 (citations omitted).

continued on page 72

Conversion Equals Death for a Creditors' Committee and Its Appeal

from page 35

SPM based on the conversion and that "the issue of whether the creditors' committee in that case had survived the conversion was not raised, argued, or discussed."[13] Therefore, "[a]s the *SPM* court never considered the issue of the committee's post-conversion existence, this drive-by ruling offers no guidance here."[14]

Next, the court refused to accept what it termed the committee's "parade of horribles" arguments as to the dangerous precedent that would be set if the appeals were dismissed. The committee had argued:

> Taken together, the Conversion Order and the relief sought in the Motions to Dismiss would mean that a bankruptcy court can grant a debtor's motion to convert without any opportunity for an opposing party — even an estate fiduciary such as an official committee of unsecured creditors — to be heard or afforded due process. Instead, debtors would have the unilateral ability to divest an official committee of its statutory rights, and all related rights and powers arising under law, including vested appeal rights. Permitting conversion to operate as a dissolution of a committee and the forfeiture of all of its vested rights runs afoul of basic due process and should not be permitted.[15]

However, the court found that because the committee did not suggest any "limiting principle," were it to "adopt the Committee's position, and hold that a case may never be converted where to do so would interfere with ... a pending appeal," it would be introducing "another avenue for potential gamesmanship and abuse in the proceedings."[16] The court rejected the committee's contention that the *ad hoc* committee comprised of its former members was vested with the right of the committee to prosecute the Settlement Appeal as a result of the committee's bylaw amendment. According to the court:

> There is no provision in the Bankruptcy Code that permits the Committee to hold or transfer rights or interests, nor is there any provision that permits the Committee to transfer its statutory duties to another entity. And there could be no "transfer" here, because the nature of any interests the Committee, as a statutory body and fiduciary, asserted in the appeal of the Settlement Denial Order are of wholly different cloth than personal interests held post-conversion by individual creditors. Only Congress may determine whether there is a successor-in-interest to a dissolved federal entity. The entity may not on its own name a successor to which it transfers its interests.[17]

The court also noted that no other creditor had appealed the settlement or Conversion Orders, nor had any creditor sought to intervene, and would by then be time-barred from doing so.[18] Accordingly, the court concluded that *no "party" had appealed the conversion order*, since the committee ceased to exist upon conversion.[19] In sum, the court held as follows:

> A creditors' committee exists only under the statutory framework of the Bankruptcy Code. When these cases converted, the chapter 11 order for relief became an order for relief under chapter 7, the statutory predicate for the existence of [the] Committee no longer applied, and the Committee automatically dissolved. As the Committee has dissolved, it has no capacity or authority to appear before this Court, including filing the notice of appeal of the Conversion Order and any filings made in further prosecution of the appeal of the Settlement Denial Order. Because the Committee has no capacity to pursue these appeals, and there is no co-appellant to pursue these appeals, the appeals must be dismissed. Accordingly, the Court dismisses the Motion for Stay Pending Appeal as moot.[20]

As a result of the district court's ruling, the Settlement Appeal was never heard on the merits, leaving the important *Jevic*-related issues that it raised unanswered at the appellate level. The unfortunate net result of the *Constellation* decision was that the noteholders received a multi-million-dollar windfall, and there will almost certainly be no distribution to unsecured creditors.

Although the district court seemed to suggest that the Settlement Appeal might have been saved if an individual creditor had also appealed, it is unclear whether any such non-objecting creditor — even if it possessed the financial incentive and wherewithal to do so — would have standing to prosecute the appeal of an order denying a settlement that resolved *the committee's objections* to the DIP and noteholder sale, which was entered into between debtors who were no longer DIPs and a committee that no longer existed.[21]

The result in *Constellation* highlights how a committee's efforts to obtain recoveries for its constituents were completely thwarted once the debtors determined to convert their cases to chapter 7. Unfortunately, the decision may have broader —and perhaps unintended — consequences, since it may serve to invite "gamesmanship" by an unscrupulous chapter 11 debtor who wishes to rid itself of a committee's appeal based on its right to obtain "conversion on demand." abi

13 *Id.* at *15.
14 *Id.* at *16.
15 *Id.* at *20-21 (quoting committee's objection to motions to dismiss).
16 *Id.* at *22 (quoting U.S. Trustee's motion to dismiss).
17 *Id.* at *24-25.
18 *Id.* at *21.
19 *Id.* at *20-22.
20 *Id.* at *25-26.
21 *See In re Combustion Eng'g Inc.*, 391 F.3d 190, 214 (3d Cir. 2004) ("Standing to appeal in a bankruptcy case is limited to 'persons aggrieved' by an order of the bankruptcy court ... the 'persons aggrieved' test ... limits bankruptcy appeals to persons 'whose rights or interests are "directly and adversely affected pecuniarily" by an order or decree of the bankruptcy court....' '[P]erson[s] aggrieved' must show the order of the bankruptcy court 'diminishes their property, increases their burdens, or impairs their rights.' Whether someone is a person aggrieved is normally a question of fact.") (internal citations omitted).

Creditors' committees certainly face dilemmas and challenges in many large Chapter 11 cases, and such dilemmas and challenges may becoming more difficult as *ad hoc* or informal committees have become more prevalent, as secured lenders or other key creditors increasingly attempt to steer and control the case, and as pressures have grown for debtors to quickly improve and restructure operations or otherwise be forced to implement expedited sales processes. Committees are confronted with potential conflicts of interest, fiduciary duty issues, concerns over appropriate compensation and carveouts, and other complications hindering a successful outcome for unsecured creditors.

I. <u>Changing Nature of Chapter 11 Filings Affecting Committees' Agendas</u>

Certainly, the goals, strategies, and results of creditors' committees in many cases have been significantly impacted by recent trends in the nature and outcome of larger Chapter 11 cases including, for example, the following:

- Over the last ten years, pre-negotiated bankruptcy filings have generally become more frequent. In an analysis conducted by FTI of over 300 confirmed plans in 2011-2017, nearly 66% of cases that emerged in 2016-2017 were prepackaged, prearranged or pre-negotiated filings, compared to approximately 40% over the previous five years. Further, the average duration of Chapter 11 reorganizations fell by nearly one-half in 2016-2017 compared to 2011-2015, to 235 days from 435 days.

- Generally, statistics are not on the side of successful retailer reorganizations. Between 2006 and the first half of 2015 (since the 2005 changes to the Bankruptcy Code (BAPCPA)), 55% of larger retail bankruptcies ultimately ended in liquidation, as opposed to a reorganization or going concern sale (AlixPartners Retail Bankruptcy Study).

- In the past several years, the substantial majority of retailer bankruptcy filings were "free fall" emergency filings or sale cases where a pre-filing sale process was undertaken or started (Debtwire, Restructuring Insights: Retail, p. 7). These scenarios are commonly expedited, bumpy, and especially challenging situations.

- In some cases, the Chapter 11 may start out hopefully, with a focus on different exit strategies, but end up as a liquidation. For example, Sports Authority's 2016 bankruptcy filing started with a plan to close less than half its stores and to sell the rest as a going concern, but the bankruptcy concluded with a liquidation and the closing of all 464 stores, and similarly in 2019, Shopko filed with the possibility of reorganization, but switched to a chain-wide liquidation of its 367 stores.

Such foregoing circumstances have raised and continue to raise various challenges, difficulties and uncertainties for many creditors' committees, which commonly must act expeditiously and proactively to maximize the recoveries for unsecured creditors, and which at times must use leverage to slow down the debtor's or secured lenders' favored exit strategy in order to carve out some recovery for unsecured creditors.

II. Complications in Committees Acting in Unsecured Creditors' Best Interests

A. Official Creditors' Committees and Other Statutory Committees

1. In General

Section 1102(a) of the Bankruptcy Code provides that the U.S. Trustee may appoint additional committees of creditors or of equity security holders as the U.S. Trustee deems appropriate. Since the appointment of additional committees is discretionary, such appointment will normally be made on a request from parties in interest.

If different classes of creditors are affected by the Chapter 11 case, *e.g.,* subordinated versus senior unsecured creditors, priority versus nonpriority creditors, *etc*., the court may order the U.S. Trustee to appoint separate committees to protect the interests of each class of creditors whose rights are affected differently than the rights of other classes. The appointment of an additional committee of unsecured creditors will be ordered only if necessary to assure adequate representation of unsecured creditors.

The appointment of an additional committee is viewed by courts as an extraordinary remedy that they are reluctant to grant. Many courts considering the extraordinary appointment of an additional committee, have employed a two-step process. First, the court determines whether the appointment of an additional committee is needed to assure adequate representation. Next, if the answer to the first question is yes, the court considers whether it should exercise its discretion to appoint an additional committee. Courts have more specifically considered the following factors: (a) the cost associated with the appointment; (b) the timing of the application, whether early or late in the confirmation process; (c) the potential for added complexity; and (d) the presence of other avenues for creditor participation.

2. Equity Committees

Typically, courts treat the likelihood of a recovery to equityholders as the main factor in their analysis of whether to allow an official equity committee. If the debtor is or appears to be solvent, the concern is that a creditors' committee will negotiate a plan based on a conservative estimate of the debtor's value; however, the equityholders of an insolvent debtor have no economic interest in the case and thus, the estate should not have to bear the expenses of an equity committee over what would amount to a gift.[1]

However, even if it is not entirely clear that equityholders will receive a recovery through a Chapter 11 plan, a bankruptcy court may choose to appoint an equity committee in order to ensure that value is preserved for such parties-in-interest and if an equity committee may add something to the case.

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[1] *See, e.g., In re SunEdison Inc*., 556 B.R. 94, 102-03 (Bankr. S.D.N.Y. 2016); *In re Williams Communications Grp. Inc*., 281 B.R. 216, 220 (Bankr. S.D.N.Y. 2002) (factors include (i) whether debtors are likely to prove solvency, (ii) whether equity is adequately represented by stakeholders already at the table, (iii) complexity of debtors' cases, and (iv) likely cost to estates of an equity committee); *In re Kalvar Microfilm Inc*., 195 B.R. 599 (Bankr. D. Del. 1996) (similar).

Notably, equity committees were appointed in the *Horsehead Holding* and *Energy XXI* cases where there were allegations of wrongdoing, misconduct, misrepresentation or other bad faith conduct by a debtor or its officers and directors – even though the courts ruled that they could not conclude that there was a substantial likelihood of solvency. *In re Horsehead Holding Corp.*, Case No. 16-10287 (Bankr. D. Del.); *In re Energy XXI Ltd.*, Case No. 16-31928 (Bankr. S.D. Tex.). Rather, both courts emphasized that public statements made by management regarding valuation immediately prior to bankruptcy were inconsistent with the valuation that the management advanced during the pendency of the bankruptcy. Both courts concluded that an equity committee could add value by challenging the debtors' valuations and determining whether management's pre-bankruptcy and post-bankruptcy remarks were intentionally misleading. In short, something just did not seem right to the courts and they exercised their discretion in requiring equity committees. Ultimately though, in both the *Horsehead Holding* and *Energy XXI* cases, equityholders received nothing under the confirmed plans.

Practically speaking, having status as an official committee likely improves equityholders' chances of extracting some value, even nuisance value, from a debtor. However, as the foregoing cases also demonstrate, the appointment of an equity committee does not guarantee recovery for equityholders.

B. *Ad Hoc* Committees

1. Prepetition Formation

In some situations, trade creditors, noteholders, and other creditors form themselves into informal committees to deal with the debtor before the filing of the petition. Such committees are self-appointed - and therefore unregulated. The potential benefits of acting as an unofficial committee include (i) sharing costs of counsel and other professionals, (ii) increased bargaining power, (iii) presenting a united front to the debtor and other stakeholders, and (iv) avoiding fiduciary obligations to other parties. On the other hand, *ad hoc* committee members may hold interests adverse to one another and they do not generally owe each other or any other stakeholder a fiduciary duty. Thus, there is the risk of members of an *ad hoc* committee trying to co-opt the process or act in a manner detrimental to the other members or other stakeholders.

A prepetition *ad hoc* committee often spends a great deal of time and energy with the debtor, learning about its financial problems. Notably, if a bankruptcy is thereafter filed, the prepetition committee may be converted to an official unsecured creditors' committee postpetition by the U.S. Trustee if the committee members fairly represent a reasonable cross-section of unsecured creditor claims against the debtor.

2. Postpetition Involvement

Ad hoc committees are an increasingly common feature of the Chapter 11 landscape. Based on Debtwire case data and certain assumptions, *ad hoc* committees participated or appeared in a substantial percentage of large Chapter 11 cases across the nation since 2016 (debtors with assets and liabilities over $100 million) – potentially in almost 12% or more of such recent chapter 11 cases.

An *ad hoc* committee formed postpetition can request the court to be recognized as an additional official committee under Code section 1102(a)(2); the standard for appointing additional official committees, however, is sufficiently high that such motions are not commonly granted. Not constituting an official committee, *ad hoc* committees do not have access to various statutory powers (including discovery and informational powers), and must also bear their own professional expenses, which can be burdensome relative to their often small recovery prospects. Consequently, an *ad hoc* committee presumably would carefully weigh the financial cost of advocating its interests compared to the chances of a favorable result.

It should be noted that, depending on the Chapter 11 case's circumstances, while its *de jure* powers are very limited, an *ad hoc* committee's *de facto* powers may be substantial. Without the cooperation of a key *ad hoc* committee, it is unlikely that the debtor will be able to effectively and efficiently restructure its debts. *Ad hoc* committees generally exert some influence in a Chapter 11 case because their members purport to speak for a large group of creditors and implicitly ask the court, the debtor and other parties to give their positions a higher level of credibility.

Potentially, however, there is opportunity for a member of an *ad hoc* committee to effectively take over the committee or act in a manner possibly disadvantageous to the other members and other key stakeholders in the case. Also, active involvement in the case by one or more *ad hoc* committees may incentivize more aggressive posturing or litigation among creditor groups, since an *ad hoc* committee represents only one group of claims.

C. Special Creditor/Committee Situations

1. Undersecured Creditors

An undersecured creditor holds a partially secured and partially unsecured claim. Undersecured creditors may wish to serve on a creditors' committee. An undersecured creditor may be more likely than unsecured creditors to advocate a quick liquidation of the debtor to protect its collateral. Such inclination might affect the prospects of reorganization, but it should not automatically preclude that creditor's participation on a committee. Certainly, if the subject undersecured creditor's lien or claim will be the primary issue facing the committee in the case, the creditor should not serve on the committee. The U.S. Trustee may also evaluate whether a potential dispute with such a creditor would dominate the case or undermine committee deliberations.

2. Other Official Committees

Courts have appointed additional creditors' committees to represent, among other groups, employees, priority creditors, tort claimants, subordinated note holders, retirees, and franchisees. Such committees, however, are rare and, when formed, often serve a narrow function. For example, in Enron's bankruptcy, an employee committee was formed for the limited purpose of investigating employee claims against Enron (Case No. 01-16034; Bankr. S.D.N.Y.), principally severance payments allegedly owed. Based on Debtwire data, in only about 1% of all large Chapter 11 cases (assets over $10 million) filed since 2016 was another statutory committee appointed.

D. Fiduciary Duties

1. Official Committees

A statutory committee member owes a fiduciary duty to the class the committee represents; the duty is to the class as a whole and not to individual members of the class.[2] Committee members may not take advantage of their committee membership to further their self-interest at the expense of their constituency, and their determinations are to be arrived at honestly and with care to be accurate.[3] Importantly, creditors' committee members' concern is to maximize value for general unsecured creditors of the estate.[4]

Although a member of a Chapter 11 committee has a fiduciary obligation to the class represented by the committee, that obligation does not mean that the member may not take action independent of and even contrary to the general position of the committee. For example, when the debtor seeks an extension of its plan exclusivity period, and the creditors' committee does not oppose an extension of such period, a member of the committee individually does not breach a fiduciary duty by opposing such extension.[5] However, when there is a matter before the committee which affects an individual member differently from unsecured creditors generally, that individual member should make that fact known and, depending on the circumstances, consider not participating in the discussion or the vote concerning that matter. Further,

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[2] *See, e.g., In re Johns-Manville Corp.*, 26 B.R. 919, 925 (Bankr. S.D. N.Y. 1983) (committee members are to be "honest, loyal, trustworthy and without conflicting interests, and with undivided loyalty and allegiance to their constituents"); *Official Comm. of Unsecured Creditors v. Belgravia Paper Co. (In re Great Northern Paper, Inc.)*, 299 B.R. 1, 6 (D. Me. 2003) (creditors' committee generally takes actions to further interests of its constituency – unsecured creditors; citations omitted); *Listecki v. Official Comm. of Unsecured Creditors*, 780 F.3d 731, 739 (7th Cir. 2015) ("[A] committee represents the larger interests of the unsecured private creditors, and it is to them, and not the Trustee, court, or any governmental actor, that the committee owes a fiduciary duty…. [T]he committee can, and should, oppose the Trustee if it is acting against the best interests of the unsecured creditors.").

[3] *See, e.g., In re Gen. Homes Corp.*, 181 B.R. 870, 882 (Bankr. S.D. Tex. 1994) ("The fiduciary duty that exists between the members of the Unsecured Creditors Committee and the other unsecured creditors includes the duty to act in good faith and to insure to the greatest extent possible its actions are based on 'accurate and correct' information."); *In re Tucker Freight Lines, Inc.*, 62 B.R. 213, 216 (Bankr. W.D. Mich. 1986) ("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."); *In re Pierce,* 237 B.R. 748, 758 (Bankr. E.D. Cal. 1999) (discussing both duty of care and duty of loyalty).

[4] *See, e.g., Motorola v. Official Comm. of Unsecured Creditors (In re Iridium Operating, LLC),* 478 F.3d 452, 466 (2d Cir. 2007) (remanding to determine whether plan provision met fiduciary duty to maximize recovery of estate's assets); *In re Nationwide Sports Distribs., Inc.,* 227 B.R. 455, 463 (Bankr. E.D. Pa. 1998) ("In general, the purpose of such Committees is to represent the interests of unsecured creditors and to strive to maximize the bankruptcy dividend paid to that class of creditors.").

[5] *See, e.g., In re Am. Fed'n of Television & Radio Artists,* 30 B.R. 772, 775-76 (Bankr. S.D.N.Y. 1983) (committee member may take positions contrary to committee positions in filings on its own behalf; committee member could oppose exclusivity extension despite committee non-opposition).

committee members should not seek to use their membership on the committee to obtain (or attempt to obtain) some advantage over other unsecured creditors. Examples would include such things as utilizing information gained as a committee member to take over the debtor's business, utilizing the position to gain an advantage over other competitors, trade creditors, *etc*.

As noted, the committee member is to consider and act in the best interests of the applicable creditor (or equityholder) class as a whole. But the matter at hand may be complicated and not black-and-white where only certain subsets of the class may benefit from the committee's actions.[6] As discussed further below, the goals of the committee's constituencies may materially differ or even conflict.

Additionally, the market in general unsecured claims has gone through a substantial change with the proliferation of claims traders who are active in large, as well as many midmarket cases. While the greater liquidity in the debt markets has benefited creditors by allowing them to cash out their claims more readily, it has shifted the focus of many unsecured creditors to their immediate recovery percentage, and away from the prospect of a reorganization that might benefit the debtor and its creditors in the longer term. Those that sell their claims are replaced by traders typically focused on short term recoveries – likely resulting in a liquidation bias.

2. ***Ad Hoc* Committees**

Generally, *ad hoc* committee members do not owe fiduciary duties to the broader class or category of creditors (or equityholders) as a whole. Rather, *ad hoc* committee members are generally free to aggressively advocate for their own interests, whether or not they conflict with those of other similarly situated creditors.

That said, a few courts have suggested the possibility that informal committee members may have some sort of minimum fiduciary obligations; the argument being that *ad hoc* committees, by purporting to speak on behalf of a general or larger stakeholder interest, have responsibilities beyond the narrow interests of their own members.[7] Depending on the case circumstances, it may be advisable for *ad hoc* committees to try to serve to promote the interests of their stakeholder class as a whole, instead of exclusively privileging the interests of the members of the committee.

[6] *See generally In re Bohack Corp.,* 607 F.2d 258, 262 n.4 (2d Cir. 1979) (requiring committee to safeguard minority and majority creditors because committee owes fiduciary duty to both); *In Drexel Burnham Lambert Group*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1999) ("The duty [of the committee and its counsel] extends to the class as a whole, not to its individual members."), *aff'd*, 140 B.R. 347 (S.D.N.Y. 1992).

[7] *See, e.g., In re Washington Mutual, Inc.*, 419 B.R. 271, 278-79 (Bankr. D. Del. 2009) ("The WMI Noteholders Group's argument is premised on the erroneous assumption that the Group owes no fiduciary duties to other similarly situated creditors, either in or outside the Group. The case law, however, suggest that members of a class of creditors may owe fiduciary duties to other members of the class."; however, it "is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class").

E. Difficulties in Reaching Consensus and Compromise in the Chapter 11 Case

At times, creditors with competing goals and objectives will sit on the same official committee. Conceptually, this is beneficial to the Chapter 11 process because it encourages the resolution of intercreditor disputes through compromise and negotiation in lieu of litigation.

Frequently, a dynamic occurs at the outset of the Chapter 11 case, during the time of formation of the creditors' committee, when, for instance, the unsecured financial creditors may vie with the trade creditors for control of the committee. There will often be divisions within different categories of creditors represented by committees (trade creditors, senior bondholders, subordinated bondholders, tort claimants, employees, unions, *etc*.) – each category may have its own specific agenda that is inconsistent with the agenda of another group. If such agendas are not in serious conflict, the solution to a lack of representation may be to add new members to an existing committee. If, however, the creditor groups are in too vigorous opposition, adding members of different constituencies may simply make a committee unworkable.

Multiple committees in a Chapter 11 case may also lead to significant difficulties. Multiple committees will add substantially to costs -- counsel, experts, and other committee expenses. To ameliorate the expense issue, the committees can be put on budgets, and these committees should avoid duplication of the efforts of each. Further, to a great extent, all committees will have common interest in administrative or operating matters, but not all committees need be active on these matters.

Additionally, multiple committees will likely complicate decision making. An added committee presents one more party that will take positions in a case on operating, administrative and restructuring issues. This necessarily complicates the process of arriving at a consensus on these issues and may result in more complex litigation of such matters before the court. In addition, committees make demands on a debtor and its management. The more of them, the more burdens already overextended management and staff will face.

III. Compensation Concerns

A. In General

As with the debtor's case professionals, the professionals of a creditors' committee (and any other statutory committee) generally must apply to the bankruptcy court for allowance of fees and expenses pursuant to Code sections 330 and 331 and payment thereof from the bankruptcy estate. Further, the estate will reimburse the expenses of creditors' committee members (excluding said members' own legal or other advisor fees).

In contrast, the legal and other professional fees of an *ad hoc* committee are generally not subject to reimbursement by the bankruptcy estate, unless it can be demonstrated that the applicable *ad hoc* committee members and their professionals provided a "substantial contribution" to the Chapter 11 case – typically a very difficult showing to make.

B. Carve-Out Issues

To address the risk of nonpayment or partial payment, when there are insufficient unencumbered assets and/or where superpriority claims may be asserted, it is common for statutory committees and their professionals to negotiate a carve-out from the secured creditors' collateral.

However, in some cases, in the context of a cash collateral or postpetition financing stipulation with the debtor, a debtor's secured lender may resist providing for a reasonable carve-out. Because a carve-out is a charge against its collateral, the argument of the secured lender goes that it should have the sole right and discretion to determine who, if anyone, will benefit from the subject carve-out. On the other hand, creditors' committees have reasoned and argued that the absence of an adequate carve-out for committee professionals would greatly undermine the committee's roles and functions in the case, including as a watchdog of the debtor and secured lender and the bankruptcy process. Essentially as a matter of public policy, many courts appear wary of having the bankruptcy process unreasonably skewed in favor of the debtor's secured lenders, to the detriment of the debtor, its estate and creditors.[8]

Recently, the Delaware bankruptcy court in the *Molycorp* case[9] sided with the creditors' committee and its professionals, holding that a carve-out cap of $250,000 in the DIP financing order (with respect to fees that could be incurred by the committee in investigating the DIP lender's transactions with the debtors and the debtors' adequate protection obligations) did not preclude committee counsel from being paid substantially in excess of the cap where a Chapter 11 plan was successfully confirmed. The *Molycorp* court acknowledged that "in the event that a plan was not confirmed and the estate had become insolvent, the dollar-amount cap would have resulted in … [committee counsel] not being compensated for all the work it has performed." Plan confirmation meant that counsel for the committee had to be paid regardless of the cap under the financing order, given section 1129(a)(9)(A)'s requirement that all administrative claims be paid upon plan effectiveness.

After obtaining standing, the creditors' committee brought claims against the DIP lender, alleging fraud and "loan-to-own" tactics by the DIP lender; the litigation culminated in a settlement agreement between the DIP lender and the creditors' committee. Rather than a complete bar on professional fees in excess of $ 250,000, the carve-out, according to Judge Sontchi, "capped [the DIP lender]'s exposure and liability to payment of certain administrative expenses *in case no reorganization plan had been executed*." Had a plan not been confirmed and had the debtors' estates become administratively insolvent, the $250,000 cap would have resulted in committee counsel not being compensated for the work it had performed. However, a plan was confirmed and thus, the fees incurred by the committee, to the

[8] *See, e.g., In re Evanston Beauty Supply, Inc.,* 136 B.R. 171, 177 (Bankr. N.D. Ill. 1992) ("Negotiated 'carveouts' … are viewed as being <u>necessary</u> in order to preserve the balance of the adversary system in reorganization…. 'Carveouts' are used in order to avoid skewing the necessary balance of debtor and creditor protection needed to foster the reorganization process. Same is designed to accommodate all classes of creditors and equity interests, rather than one especially crafted for the benefit of the pre-petition lender having a perfected lien on all cash collateral ….") (emphasis added).

[9] *In re Molycorp*, 562 B.R. 67 (Bankr. D. Del. 2017).

extent such fees were allowed as administrative claims (which they were), had to be paid by the debtors pursuant to section 1129(a)(9)(A). According to the court, the operative documents "do[] not connote in any way that the dollar-amount cap would operate as a complete bar against the allowance of administrative claims following plan confirmation." The court's opinion did not provide any guidance on whether a *per se* disallowance of administrative claims in a financing order carve-out would be effective or proper under the Bankruptcy Code. *Molycorp* suggests that a standard carve-out provision (without further elaboration or explicit terms) may not necessarily deter or prohibit a creditors' committee from incurring significant professional fees. That said, it is usually in all parties' best interests to keep case professional fees within reasonable limits.

C. *Ad Hoc* Committee Fees & Expenses

1. Substantial Contribution

Ad hoc committees may seek reimbursement for their time and effort through a request for payment of an administrative expense. Section 503(b)(3)(D) provides that an *ad hoc committee* may seek reimbursement of fees and expenses if it made a "substantial contribution" to the case. Fee awards to *ad hoc* committees are unusual. Thus, parties banding together to form an unofficial committee likely do so at their own financial cost.

In determining whether an *ad hoc* committee made a "substantial contribution," courts will examine whether the committee contributed to the reorganization process, conferred a significant, direct benefit to the estate as a whole (not merely the individual committee members), and whether the committee's efforts were duplicative of services performed by others, including the creditors' committee. Providing an incidental benefit to the estate is not sufficient. Nor will the *ad hoc* committee's extensive participation in the case, without more, meet the standard.

Some of the factors courts have considered include (i) whether the services were undertaken solely for the benefit of the party itself or for the benefit of all parties in the case; (ii) whether the services were actions that would have been taken by the party on its own behalf, absent an expectation of reimbursement from the estate; (iii) whether the party can demonstrate that its actions provided a direct, significant and demonstrable benefit to the estate; (iv) whether the benefit conferred upon the estate exceeds the costs sought to obtain the benefit; and (v) whether the actions were duplicative of those being taken by other parties in the case. Demonstrating a "substantial benefit" is a high standard that *ad hoc* committees will only infrequently be able to meet.

Of note, there have been some cases of *ad hoc* committees satisfying such burden. *See, e.g., In re M&G USA Corp*., 599 B.R. 256 (Bankr. D. Del. 2019) (Judge Shannon) (*ad hoc* committee of construction lienholders provided substantial contribution by, among other things, facilitating sale and plan settlements); *see also In re Bayou Group, LLC*, 431 B.R. 549 (Bankr. S.D. N.Y. 2010) (*ad hoc* committee made substantial contribution through prepetition services and activities).

2. Payment Through a Plan

Largely because of the difficulty of demonstrating a "substantial benefit" to creditors as a whole, *ad hoc* committees have attempted alternative methods of securing reimbursement of fees. Most commonly, *ad hoc* committees have attempted to bypass the substantial contribution standard by, usually with the debtor's assent in connection with a consensual plan of reorganization, embedding the repayment of fees into the plan itself.

Initially, some courts approved of this strategy. For example, in *In re Adelphia Communs. Corp.*, 441 B. R. 6 (Bankr. S.D.N.Y. 2010), the court concluded that an *ad hoc* committee could properly recover fees without any showing that the committee substantially benefited all creditors where the payment provision was included in the plan, which itself is subject to creditor votes and the approval of the court. In reaching this conclusion, the *Adelphia* court noted that section 503(b) "does not provide, in words or substance, that it is the *only* way by which fees of this character may be absorbed by an estate." In addition, other provisions of the Bankruptcy Code appear to contemplate that some payments, which perhaps would technically not qualify as administrative claims, might nonetheless be permissible. Section 1129(a)(4), for instance, allows payments in connection with the plan if the amount is disclosed and the court determines the payment is reasonable. Moreover, section 1123(b)(6) provides that a plan may include "any other appropriate provision not inconsistent with the applicable provisions of this title."

However, in the *Lehman Brothers* case (*In re Lehman Bros. Holdings, Inc.*, 508 B.R. 283 (S.D.N.Y. 2014)), the District Court for the Southern District of New York reversed the bankruptcy court holding that a reorganization plan could provide for the reimbursement of fees expended by individual official committee members, although not technically covered by section 503(b). The District Court criticized the *Adelphia* court's reasoning and concluded that the sole authority for the allowance and payment of administrative expenses was set forth in section 503(b), which does not permit compensation to counsel for individual committee members except on a substantial contribution basis. According to the *Lehman Bros.* court, reorganization plans exist to pay (i) prepetition claims and (ii) postpetition administrative claims. Inasmuch as fees incurred *after* the petition date cannot, by definition, be treated as prepetition "claims," it follows that they can only be administrative claims, which can be reimbursed, if at all, only under section 503(b). In short, the Bankruptcy Code provides no basis for a third category of payments under a plan (even if voluntarily offered by the debtor) that do not otherwise qualify as "claims" or "administrative expenses." Using a plan provision to accomplish payment would "be based on wordplay alone." The District Court remanded the matter for a determination whether the conventional substantial contribution standard under section 503(b) might, under a more expanded record, be satisfied.

The *Lehman Bros.* decision questions the viability of recovering *ad hoc* professional fees through a plan provision. On the other hand, some courts may decline to follow the *Lehman Bros*. decision on the grounds that the admittedly non-exclusive listing of administrative expenses under section 503(b) should be flexible enough to accommodate a debtor's voluntary recognition of an *ad hoc* committee's beneficial participation in a case. Nevertheless, professionals for an *ad hoc* committee should not readily expect to be able to sidestep section 503(b)'s substantial contribution requirement.

D. Litigation Financing

Related to the compensation of committee professionals is the emerging issue of third party litigation funding (TPLF) in bankruptcy cases. Commonly, the bankruptcy estate has limited resources to prosecute causes of action for the benefit of the estate's creditors, and in such situations, the estate and its representatives (like the DIP or a creditors' committee) may have to forego pursuing some potentially beneficial actions or must find some alternative funding mechanism like contingency fee arrangements with counsel. Some debtors, trustees, and other estate representatives have also obtained TPLF – where investors finance the litigation for a percentage of the recovery (or a similar arrangement is implemented like the investor buying the estate's specific cause of action).[10] Players in the TPLF market include, for example, Burford Capital, Therium Group Holdings, Icahn Capital, and Longford Capital Management.

TPLF may arise in various bankruptcy contexts. An investor may be a prepetition creditor (secured or unsecured) that agrees to fund estate litigation and has an interest in the litigation proceeds (or other asset); the debtor in possession may obtain TPLF to finance case-critical postpetition litigation; a postconfirmation trust under a confirmed Chapter 11 plan may obtain TPLF to pursue estate claims for the creditor trust beneficiaries; *etc*. A recent case example is *In re Magnesium Corp. of America (MagCorp)*, Case No. 01-14312-MKV (Bankr. S.D. N.Y.), wherein, in 2016, the MagCorp Chapter 7 trustee auctioned off and sold the rights to receive $50 million of a $213 million judgment in favor of the estate (obtained after many years of litigation and then on appeal) against MagCorp's former majority shareholder based on fraudulent transfers and other theories, to a predecessor of Burford Capital in exchange for $26.2 million (Docket No. 745). The judgment was ultimately upheld on appeal in 2017, resulting in a 92% return on a 7-month investment by the Burford predecessor. The estate (which prior to the sale had less than $1 million in cash and no other material non-litigation assets) certainly benefitted, obtaining cash to pay administrative expenses and guaranteeing there would be funds for general unsecured creditors irrespective of the outcome of the appeal.

In some cases however, TPLF may raise, in addition to possible legal hurdles,[11] ethical concerns such as whether the involvement of third party financing could create conflicts of interest (for instance, where the interests of the financier diverge from those of the litigant/client) or could, through communications with the financier, compromise the attorney client privilege. More generally, third party funding in the bankruptcy context may raise fiduciary duty concerns. Debtors in possession and trustees, as well as statutory committees, have fiduciary obligations, which may be hampered or undermined by TPLF agreements that may give substantial control to the TPLF provider.

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[10] Indeed, there are various possible permutations including portfolio deals (involving multiple certain types of cases) and post-judgment deals (where the value of a successful judgment can be realized while appeals or other proceedings continue).

[11] A Delaware state court has found a litigation funding agreement to be proper as a matter of Delaware law; said arrangement did not violate the state prohibition against "champerty and maintenance" (common law doctrines intended to prevent frivolous litigation). *See Charge Injection Technologies, Inc. v. E.I. DuPont de Nemours & Co*., 2016 Del. Super. LEXIS 118 (Del. Super. Ct. March 9, 2016). The legal analysis will vary, however, depending on the applicable jurisdiction.

Faculty Biographies

Mark D. Collins is a director of Richards, Layton & Finger in Wilmington, Del., and is recognized as a leading bankruptcy lawyer in both the U.S. and internationally. He has been involved in hundreds of significant bankruptcy cases in Delaware since 1991, and has received top ranking from every major legal directory. Mr. Collins has served as counsel to hundreds of large troubled companies, secured creditors, debtor-in-possession lenders, creditors' committees, boards of directors (including special or independent committees), and acquirers of businesses and assets in large corporate chapter 11 cases, pre-packaged chapter 11 cases, chapter 15 cases and out-of-court restructurings. He also is a frequent lecturer at national corporate restructuring and bankruptcy seminars and a Fellow in the American College of Bankruptcy. Rated AV-Preeminent by Martindale-Hubbell, Mr. Collins received his B.A. from Rutgers College and his J.D. *summa cum laude* in 1991 from American University Washington College of Law.

Hon. Kevin Gross is a Bankruptcy Judge with the U.S. Bankruptcy Court for the District of Delaware in Wilmington, appointed on March 13, 2006. He served as Chief Judge from July 1, 2011, to June 30, 2014. Previously, he practiced general litigation, representing shareholders, and was a director for Rosenthal, Monhait & Goddess PA in Wilmington, Del., which he joined in 1985. He most recently served as an ombudsman for the U.S. District Court from 1977-2006 and was a member of the Board of Professional Responsibility of the Delaware Supreme Court from 2005-06. He was also the chair of the Advisory Committee for the U.S. District Court of Delaware from 1995-2005. Judge Gross has been listed several times in *The Best Lawyers in America* and was awarded the first annual Caleb R. Layton III Service Award by the district court in 1996. Judge Gross's recent cases include *Nortel Networks Corp., Los Angeles Dodgers, NewPage Corp., Friendly's Ice Cream Corp., Boscov's, Pierre Foods, Mervyn's Holdings, Sharper Image, Cadence Industries, Dynamerica Manufacturing, Intermet Corp., Aventine Renewable Energy, Fisker, Tuscany Holdings, Greenfield Energy*, *Trump Entertainment*, *Magnum Hunter*, *Emerald Oil* and *DexMedia*, and more recently *Insys, Hahnemann Hospital* and *PES Holdings.* A former clerk for the Delaware Court of Chancery, he received his bachelor's degree in psychology from the University of Delaware in 1974 and his J.D. in 1977 from American University Washington College of Law, where he served on its law review.

Hon. Laurel M. Isicoff is Chief Judge for the U.S. Bankruptcy Court for the Southern District of Florida in Miami, initially appointed on Feb. 13, 2006, and named chief judge on Oct. 1, 2016. She also serves on ABI's Board of Directors. Judge Isicoff is president-elect of the National Conference of Bankruptcy Judges and an ABI Board member. She also is a member of the Pro Bono Committee of the American College of Bankruptcy, as well as chair of its Judicial Outreach Committee. Judge Isicoff currently serves as judicial chair of the Pro Bono Committee of the Business Law Section of the Florida Bar and is a member of the Florida Bar Standing Committee on Pro Bono. Prior to becoming a judge, she specialized in commercial bankruptcy, foreclosure and workout matters, both as a transactional attorney and litigator, for 14 years with the law firm of Kozyak Tropin & Throckmorton after practicing for eight years with Squire, Sanders & Dempsey, now known as Squire Patton Boggs. In private practice, she also developed a specialty in SEC receiverships involving Ponzi schemes. After graduating from law school, Judge Isicoff clerked for Hon. Daniel S. Pearson at the Florida Third District Court of Appeal before entering private practice. She is a past president of the Bankruptcy Bar Association (BBA) of the Southern District of Florida and, until she took the bench, served as the chair of the Pro Bono Task Force for the BBA. Judge Isicoff speaks extensively on bankruptcy around the country, and is committed to increasing pro bono service, diversity in the bankruptcy community and financial literacy. She received her J.D. from the University of Miami School of Law in 1982.

Laura Davis Jones is a name partner and management committee member of Pachulski Stang Ziehl & Jones LLP and is the managing partner of the firm's Wilmington, Del., office. She gained national recognition as debtor's counsel in the *Continental Airlines* bankruptcy case, and has represented numerous debtors, creditors' committees, bank groups, acquirers and other significant constituencies in chapter 11 cases and workout proceedings. Her recent clients include Deb Stores Holding LLC, Cache, Inc., Revstone Industries, LLC, Exide Technologies, EveryWare Global, AFA Investment and SS Body Armor, Inc., and her recent creditor representations include the creditors' committees of LCI Holding Company, Inc. ("LifeCare") and NE Opco, Inc., and she was co-counsel to the second-lien notes indenture trustee of Energy Future Holdings Corp., *et al.* A frequent speaker and writer, Ms. Jones was named "Deal Maker of the Year" by *The American Lawyer* and has been continuously named in *The Best Lawyers in America* and as one of the "Best Lawyers in Delaware," and she was selected as one of the top 10 lawyers in Delaware by *Delaware Super Lawyers*. She is also included among *Chambers USA America*'s "Leading Lawyers for Business," and is ranked among the top-tier bankruptcy/restructuring lawyers in Delaware. Ms. Jones has been recognized in the *K&A Restructuring Register* and *LawDragon 500* since their inception, has been repeatedly named to the *International Who's Who of Insolvency and Restructuring Lawyers*, and holds an AV rating from Martindale-Hubbell. She is admitted to practice in Delaware and the District of Columbia. Ms. Jones received her undergraduate degree from the University of Delaware and her J.D. from Dickinson School of Law, where she was on the board of editors and business manager for the *Dickinson Law Review*, as well as served on the Appellate Moot Court Board.

Hon. Michael B. Kaplan is a U.S. Bankruptcy Judge for the District of New Jersey in Trenton, appointed on Oct. 3, 2006. Prior to taking the bench, he served as a standing chapter 13 bankruptcy trustee, as well as an appointed trustee in chapter 7, 11 and 12 cases. Judge Kaplan has spoken to numerous bar associations and business organizations over the last 30 years, including the New Jersey Judicial College, National Association of Chapter 13 Trustees, National Association of Bankruptcy Trustees, Turnaround Management Association, New York Institute of Credit, Bloomberg, L.P., Federal Reserve Bank of Philadelphia, ABI, Pennsylvania Bar Institute and the New Jersey Institute for Continuing Legal Education. He is also an adjunct professor at Rutgers University School of Law, has authored several articles relating to bankruptcy issues and is a co-author of West's *Consumer Bankruptcy Manual* and *Consumer Bankruptcy Handbook.* He also serves as on the editorial board and as business manager of the *American Bankruptcy Law Journal*. Judge Kaplan is the recipient of the National Association of Chapter 13 Trustees' 2006 Distinguished Service Award and the New Jersey State Bar Association's 1999 Legislative Recognition Award. He has been appointed by the director of the Administrative Office of the U.S. Courts to a term as the Third Circuit representative to the Bankruptcy Judges Advisory Group, in addition to appointments as the bankruptcy judge representative on both the Human Resources Advisory Council and Budget & Finance Advisory Council to the AOUSC. Prior to taking the bench, Judge Kaplan served as mayor and councilman for the Borough of Norwood, N.J., and as a member of the Norwood Planning Board. He received his A.B. from Georgetown University in 1984 and his J.D. from Fordham University School of Law in 1987.

Norman N. Kinel is a partner with Squire Patton Boggs's Restructuring & Insolvency Practice in New York and the national chair of the firm's Creditors' Committee Practice. He has more than 30 years of experience as a bankruptcy practitioner and regularly represents debtors, creditors, bondholders, trustees and committees of creditors, equityholders and retirees. Mr. Kinel's experience includes litigation and appeals in connection with contested confirmations of plans, DIP financing, cash collateral and adequate protection, relief from the automatic stay, assumption and rejection of executory contracts and leases, exclusivity, substantive consolidation, and also director and officer liability, breach of fiduciary duty, fraudulent conveyance and preferential transfer actions. He also advises clients in out-of-court default, workout and restructuring matters and has extensive experience in bankruptcy asset sales and cross-border insolvency proceedings. Mr. Kinel is listed on the Register of Mediators of the U.S. Bankruptcy Courts for the Southern District of New York and the District of Delaware. He has been recognized numerous times by *Super Lawyers* as one of the top bankruptcy attorneys in New York City and recently accepted the Turnaround Atlas Award for Chapter 11 Restructuring of the Year ($500 million to $1 billion) in connection with his representation of the Official Committee of Unsecured Creditors in the *Optima Specialty Steel* chapter 11 cases, where unsecured creditors received a 100 percent recovery on their claims. He also recently completed the representation of the unsecured creditors' committee in the *LBI Media* cases, where unsecured creditors are projected to receive a nearly 100 percent recovery. Mr. Kinel has been recognized in *Super Lawyers* and received the Turnaround Atlas Award for both Energy Restructuring of the Year (for Midstates Petroleum in 2016) and Industrials Restructuring of the Year (for Constellation Enterprises in 2016). He received his undergraduate degree in 1980 from Yeshiva University and his J.D. in 1983 from American University Washington College of Law.