

Equity Committees - Representation of Shareholders in Bankruptcy Cases ***Financier Worldwide's Restructuring and Insolvency Series 2005***

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Much has been written lately regarding directors and officers and their fiduciary duties when the company they manage enters the “zone of insolvency”. Chancellor Allen's footnote in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications*, 1991 WL 277613 (Del. Ch. 1991) heralded a general awareness that directors owe creditors a fiduciary duty under that scenario. Yet, there has been less discussion regarding equity's lack of representation in a bankruptcy setting when a company enters the “zone of insolvency.” Coincidentally (or perhaps not), in the years following *Credit Lyonnais*, an increase in bankruptcy filings by large, publicly-traded companies has been accompanied by an increase in the number of equity committees appointed. Equity committees have been appointed in a minimum of 30 cases in 12 jurisdictions in the US since 2000. For example, equity committees were appointed in the bankruptcy cases of Loral Space, Kmart, Mirant Corp., Adelphia Communications Corp., Footstar Inc., Trump Hotel and Casinos, Federal Mogul, Seitel and USG. Could this phenomenon be the logical result of *Credit Lyonnais*?

The board of directors of a solvent corporation owes fiduciary duties to its shareholders. As a fiduciary, directors have duties of loyalty, candour and care. However, under *Credit Lyonnais* and subsequent case law, once a board of directors determines that the company may not be able to pay its debts as they become due, directors cease being solely a fiduciary for the shareholders and become a watchdog for all creditors and shareholders. At this moment, equity loses its favoured position in the corporate hierarchy. Moreover, the concerns of shareholders can be easily forgotten if the directors elect to file for protection under Chapter 11 of title 11 of the US Code (the “Code”). The Code has built in protections for secured and unsecured creditors, and these creditors are actively represented in a bankruptcy. Conversely, the appointment of an official committee of equity holders remains less common in a Chapter 11 case. Consequently, the advent of fiduciary duties owing to all creditors may leave equity in the precarious position of not being zealously represented. Since in many bankruptcy cases the interests of shareholders run contrary to those of creditors, inevitably there will be disagreements regarding valuations of a company's assets and its chances of survival. The appointment of an equity committee certainly changes the dynamics of these struggles.

The appointment process

A shareholder's first step in requesting the appointment of an official equity committee is sending a letter directly or through an “ad hoc committee” to the Office of the US Trustee (the “UST”). Then, the UST will attempt to determine the level of interest among shareholders.

“Ad hoc” or informal committees often will already have been formed before such a request, so that equity's concerns may have already been brought to the attention of management or debtor's counsel (with less than satisfactory results). These committees consist of shareholders who are knowledgeable of the company's condition and typically disenchanted with the attention given to their interests or management's general intentions regarding equity. These informal committees invariably are represented by counsel. In fact, given the volume of recent equity committee solicitations, there are a growing number of law firms and financial advisory firms who actively compete to represent such committees. Like professionals for official creditors' committees,

professionals for official equity committees are compensated from assets of the bankruptcy estate.

Realising the objective of an appointment of an “official” equity committee requires immediate action by shareholders. One impediment in the process often will be a cool reception or even opposition by the debtor. One way to expedite the process is to seek support from the Securities & Exchange Commission (“SEC”). With SEC's support of an official equity committee, the UST may be more receptive to the idea. Otherwise, filing a motion with the Court may be the only other option in a fast moving case.

Applicable legal standard

Under the Code, upon request the Court may order the appointment of a committee of equity security holders if necessary to assure their “adequate representation.” Adequate representation is determined on a case-by-case basis.¹ Courts consider these factors: (1) the number of shareholders; (2) the complexity of the case; (3) the solvency of the debtor; (4) whether the cost to the estate outweighs the adequate representation interest of shareholders; and (5) whether the interests of shareholders are already represented.² No one factor is dispositive and the relative weight afforded to each depends on the circumstances.³ Since the first two factors inevitably are favourable in cases where appointment of a committee is sought, the discussion below is limited to the remaining factors.

Solvency of debtor

In considering the solvency issue, the most frequently applied standard is whether the debtors are “hopelessly insolvent.”⁴ It is not a question of whether recovery to the debtors' shareholders is guaranteed.⁵ Economic indicators must demonstrate that there is value for shareholders and those shareholders are not necessarily “out of the money.”⁶ Where the debtor is even marginally solvent, shareholders have a meaningful interest in the outcome of the case, and courts find they should have the benefit of an equity committee representing their interests, regardless of the added cost.⁷

Opponents of equity committees seek application of a higher standard than “not hopelessly insolvent”, as set forth in *In re Williams Communications Group, Inc.*, 281 B.R. 216 (Bankr. S.D.N.Y. 2002). This standard requires that there is “substantial likelihood” that shareholders will receive a meaningful distribution in the Chapter 11 case under a strict application of the absolute priority rule. However, this standard in *Williams* does not appear to be supported by prior case law and few courts have followed the decision.⁸

The more prevalent view is that when equity is marginally in the money, shareholders need an equity committee. While there may be substantial debt in a given Chapter 11 case, expert financial testimony can show equity is substantially “in the money”, even if only at \$1-\$2 per share. For example, in the recent Trump Hotel and Casinos case, there was approximately \$2bn in debt, and approximately 30 million shares of common stock equivalents. The equity committee increased the recovery for shareholders from virtually nothing to tens of millions of dollars (\$2-\$3 per share). This return turned out to be inconsequential to bondholders, who received most of the new equity. One may ask what motivation do directors have to fight for such “scraps” in the absence of official representation of equity holders?

Representation of shareholders

Shareholders seeking the appointment of an equity committee must also demonstrate that their interests will not be adequately protected by any other parties. As a starting point, most

constituencies in a Chapter 11 case have divergent interests. The post-petition lender is out to assure that its post-petition financing is repaid. Pre-petition secured lenders are out to secure a full recovery on their indebtedness, or at least realise the value of their collateral. The creditors' committee wants comfort in the fact that unsecured creditors are, at a minimum, paid prior to any distribution to equity. These considerations, in turn, are the focus of the bankrupt debtor – before much attention is given to equity.

Indeed, the legislative history of the Code reflects that the purpose of an equity committee is to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business at the expense of small and scattered public investors. The other constituencies have their own interests to protect and cannot reasonably be expected to protect the interests of equity. Under the proper circumstances, the appointment of an official equity committee may be the only way to ensure a fair process and adequate representation of equity.

No undue delay or burden to the debtors' estates

The fundamental purpose for the Code's provision for equity committees is to offer a level playing field for public shareholders under the right circumstances. There will obviously be some concomitant costs and delay, but that will be weighed against that purpose. “The potential added cost is not sufficient in itself to deprive the creditors of the formation of an additional committee if one is otherwise appropriate.”⁹

Conclusion

The appointment of an official equity committee will mean equity receives a greater voice in Chapter 11 in cases where equity may be “in the money.” Delay more than anything else may negatively impact the odds for the appointment of an official equity committee. The passage of time before such appointment makes it more difficult to affect the outcome of a case. Shareholders and professionals must move quickly and convincingly in order to succeed.

1 In re Wang Laboratories, Inc., 149 B.R. 1,2 (Bankr. D. Mass 1992).

2 See In re Exide, 2002 U.S. Dist. LEXIS 27210 (D. Del. 2002).

3 In re Kalvar Microfilm, Inc., 195 B.R. 599, 600 (Bankr. Del. 1996).

4 See In re Exide, 2002 U.S. Dist. LEXIS 27210 at *4.

5 Id.

6 See In re Mansfield Ferrous Castings, Inc., 96 B.R. 779, 781 (Bankr. N.D. Ohio 1988).

7 See Wang Laboratories, 149 B.R. at 3.

8 See In re Northwestern Corporation, 2004 WL 1077913,*2 (Bankr. D. Del. May 13, 2004).

9 In re Interco, Inc., 141 B.R. 422, 424 (Bankr. E.D.Mo. 1992).