Equity Committees: A Consequence of the "Zone of Insolvency"

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A good deal has been written lately regarding directors and officers and their fiduciary duties when a company 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), heightened awareness that directors owe all creditors a fiduciary duty under that scenario, yet what has not been discussed is equity's need for representation after a company enters the "zone of insolvency." There has been a surprising number of official committee of equity security-holders appointed in recent years.1 This phenomenon may be attributed, at least in part, to *Credit Lyonnais* and the subsequent decisions.

By definition, the board of directors is a warrior for shareholders. However, since *Credit Lyonnais*, once a board determines that the company may not be able to pay its debts as they come due, the board ceases being a warrior for the shareholders and becomes a watchdog for all creditors. At this moment shareholders lose their favored position in the corporate structure. For all intents and purposes, any lingering concerns of shareholders can be easily forgotten if the board elects to file for protection under chapter 11. The Bankruptcy Code has built-in protections for secured and unsecured creditors, and these creditors are actively represented in a bankruptcy case. However, prior to *Credit Lyonnais*, shareholders were typically left out of the equation. The creation of a quasifiduciary duty to all creditors in the "zone of insolvency" left shareholders in the precarious position of not being zealously represented upon the filing of a bankruptcy petition. As a result, official equity committees can become the warrior the board once was. Since in many bankruptcy cases the interests of shareholders run contrary to those of other 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.

Process for Appointment of Equity Committee

A shareholder's first step in requesting the appointment of an official equity committee is sending a letter to the Office of the U.S. Trustee petitioning the Trustee to solicit interest among shareholders to serve on an official equity committee. "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 (usually with less-thansatisfactory results). These committees consist of shareholders who are knowledgeable about 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.

Time is not necessarily on the share-holder's side when seeking the appointment of an official equity committee. One impediment in the process will be a cool reception or even opposition by the debtor. One way to expedite the process is to seek support from counsel to the Securities & Exchange Commission (SEC). With SEC support of an official equity committee, the U.S. Trustee may be more receptive to the idea. Otherwise, filing a motion with the court may be the only other option in a fastmoving case.

Applicable Legal Standard

Under §1102(a)(2) of the Code, upon request of a party in interest, the court may order the appointment of a committee of equity security-holders if necessary to assure "adequate

representation" of equity securityholders. 11 U.S.C. §1102. Section 1102 does not define what constitutes "adequate representation."

To make that determination, courts have considered the following 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. *In re Exide*, 2002 U.S. Dist. LEXIS 27210 (D. Del. 2002). No one factor is dispositive, and the relative weight that should be afforded to the various factors depends on the circumstances of the particular reorganization case. *In re Kalvar Microfilm Inc.*, 195 B.R. 599, 600 (Bankr. D. Del. 1996).

Not Hopelessly Insolvent

In considering the solvency issue, the most frequently applied legal standard is whether the debtors are "hopelessly insolvent." *In re Exide* at *4 (determining that appointment of an official committee of equity security-holders was necessary to assure adequate representation where the debtor was not hopelessly insolvent).

It is not a question of whether recovery to the debtors' shareholders is guaranteed. *Id*. Economic indicators must demonstrate that there is value for shareholders and that those shareholders are not necessarily "out of the money." *In re Mansfield Ferrous Castings Inc.*, 96 B.R. 779, 781 (Bankr. N.D. Ohio 1988) (rejecting insolvency as barring appointment of an equity committee and stating that the court will be guided by all the facts and not just the issue of solvency). Where the debtor is even marginally solvent, shareholders have a meaningful interest in the outcome of the case and should have the benefit of an equity committee representing their interests, regardless of the cost. *In re Wang Laboratories Inc.*, 149 B.R. 1, 3. This can be established through various means, including the volume of shares trading postpetition (in the bankruptcy context, this will most likely be in over-the-counter trading or on "pink slips"), the post-petition volatility in share price or through the market capitalization of the debtors. The more difficult arguments to allege are that substantial room for improvement exists with respect to the debtors' business operations, or that regardless of the fact that unsecured creditors are not being paid in full, a restructuring will provide a more viable deleveraged company that may in the future provide value to equity.

Substantial Likelihood of Recovery

Opponents of equity committees seek application of a higher standard than "not hopelessly insolvent," as advocated in *In re Williams Communications Group Inc.*, 281 B.R. 216 (Bankr. S.D.N.Y. 2002). This standard requires that there is a substantial likelihood that shareholders will receive a meaningful distribution in the chapter 11 case under a strict application of the absolute priority rule. The "substantial likelihood" standard established in *Williams* does not appear to be supported by prior case law. In fact, since the *Williams Communication* ruling in 2002, courts have been reluctant to apply the "substantial likelihood" standard. *In re Northwestern Corp.*, 2004 WL 1077913, *2 (Bankr. D. Del. May 13, 2004).

The party seeking the formation of an official equity committee will no doubt assert that the court should not impose the "substantial likelihood of a meaningful distribution" standard on shareholders as a condition to official recognition. If this were the standard, then it would require the U.S. Trustee (or the court) to rely on a valuation of the debtors in every case prior to exercising their discretion under §1102 to appoint an official equity committee. In most chapter 11 cases, there is some uncertainty surrounding the debtors' performance and financial

information. Thus, equity-holders would have to put forth a valuation case, at their own expense, relying on questionable information that they have limited access to in order to persuade the U.S. Trustee and/or the court that the debtors' enterprise value exceeds the total amount of potential claims against the estates. This would unfairly alter shareholders from having their voice heard in already tenuous negotiations with the core constituencies in the case.

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 $1-2 per share. For example, in the recent *Trump Hotels and Casino* case, there was approximately $2 billion in debt, and approximately 30 million shares of common stock equivalents. The equity committee increased the recovery for shareholders from virtually nothing to a cash distribution of approximately $40 million in addition to warrants (or $2-3 per share). This return turned out to be inconsequential to the bondholders, who received most of the reorganized equity. One may ask what motivation do directors have to fight for such "scraps" in the absence of official representation of equity-holders?

Shareholders Interests Are Not Adequately Represented

Shareholders seeking the appointment of an equity committee must also demonstrate that their interests will not be adequately protected by any other party. 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. The creditors' committee wants assurance that unsecured creditors are, at a minimum, being made whole prior to any distribution to equity. These considerations, in turn, are the focus of the bankrupt debtor—before much attention is given to equity.

The legislative history of §1102 confirms 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." S.Rep.No. 989, 95th Cong., 2d Sess. 10 (1978). The other creditor constituencies that are represented in the chapter 11 case have their own interests to protect and cannot reasonably be expected to protect the interests of shareholders. Under the proper circumstances, the appointment of an official equity committee may be the only way to ensure the fairness of the process and provide adequate representation to equity.

Cases Are Clearly Large and Complex

For the most part, debtors will have difficulty arguing that their cases are not large and complex. In most instances, one need go no further than the affidavit in support of the "first-day pleadings" where debtors routinely argue that their cases are large and complex and therefore must be jointly administered. The size and complexity of a debtor's case can further be highlighted by considering their corporate structure and workforce. Another avenue to support this position would be to review the amount of professionals retained in the case, as well as the applications to retain such professionals, as most will include resounding admissions regarding the intricacies of the debtor's cases and the need for seasoned professionals.

No Undue Delay or Burden to the Debtors' Estates

The fundamental purpose of §1102(a)(2) is to provide a level playing field for public shareholders, but there will obviously be some costs and concomitant delay. However, the additional cost must be weighed against the need for adequate representation of shareholders.

Wang Laboratories, 149 B.R. 4. The oversight of professional fees already provided by the U.S. Trustee and the court operates as a check against any official committee undertaking unreasonable activities. "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." *In re Interco Inc.*, 141 B.R. 422, 424 (Bankr. E.D. Mo. 1992). *See, also, In re McLean Indus. Inc.*, 70 B.R. 852, 860 (Bankr. S.D.N.Y. 1987) ("costs alone cannot, and should not, deprive public debt and security-holders of representation"). Allowing the board to once again hear from shareholders should not always be considered a negative consequence; rather, the board should realize that it will be fulfilling its duty to *all* creditors, which should be a fair and equitable plan that treats *all* parties fairly.

Actions the Equity Committee Can Undertake

The most compelling argument in support of the formation of an official equity committee is that it will provide an oversight to the chapter 11 process that is not already in place. Illustrations of what activities an official equity committee can undertake to add this value include:

1. Analyze the debtors' business plan, which will likely form the basis of the debtors' ultimate restructuring strategy (be it a stand-alone reorganization plan, going-concern sale or otherwise);
2. Work with the other constituencies and their professionals to provide a determination, valuation and accounting—for the benefit of all creditors and equityholders—of the debtors' assets and liabilities, the extent to which the debtors' equity-holders are "in the money," the debtors' ability to confirm a feasible plan and the treatment of equity-holders through any such plan;
3. Analyze and/or seek approval to commence potential causes of action against insiders and/or the current or former directors or any other possible breaches of fiduciary duty;
4. Analyze whether the debtors' estates have any other claims or causes of action including, but not limited to, causes of action under chapter 5 of the Code;
5. Analyze whether any of the debtors should proceed under a distinct and separate reorganization plan, or if consolidation (substantive or otherwise) of two or more of the debtors is appropriate;
6. Analyze whether insider shareholders should be afforded separate voting classes and treatment through any reorganization plan;
7. Analyze whether there has been any mismanagement, self-dealing or other improprieties in the debtors' operations; and
8. Perform such other and further analyses as is deemed necessary and proper after notice and opportunity of interested parties to be heard.

Conclusion

The appointment of an official equity committee will mean shareholders receive a greater voice in a chapter 11 case where equity may be "in the money." More than anything, delay can negatively affect a request for the appointment of an official equity committee as the passage of time will render the equity's voice silent and allow the debtor to gain momentum. If a request for the solicitation of an equity committee goes unanswered by the U.S. Trustee, an informal committee must be prepared to attack in order to salvage equity's voice in the chapter 11 process. Shareholders and professionals must move quickly and convincingly in order to succeed.

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1: Equity committees have been appointed in at least 30 cases in 12 separate jurisdictions across the nation since 2000. Some examples include: USG Corp. (01-2094 D. Del.); Loral Space & Communications Ltd. (03-41710 S.D.N.Y); THCR/LP Corp. (Trump Hotels & Casinos) (04-46898 D. N.J.); Interstate Bakeries Corp. (0445814 W.D. Mo.); Intermet Corp. (04-67597 E.D. Mich.); Bush Industries (04-12295 W.D.N.Y); Footstar (04-22350 S.D.N.Y.); Gadzooks (04-31806 N.D. Texas); Seitel (03-12227 D. Del.); Mirant Corp. (03-46590 N.D. Texas); Impath (03-16113 S.D.N.Y.); Solutia (03-17949 S.D.N.Y.); Peregrine Systems Inc. (02-12740 D. Del.); Cone Mills (03-12944 D. Del.); Exide Technologies (02-11125 D. Del.); MSCP Holdings Inc. (02-10253 D. Del.); Kmart Corp. (0202474 N.D. Ill.); Adelphia Communications Corp. (02-41729 S.D.N.Y.); Pathmark Stores Inc. (02-2963 D. Del.); Federal Mogul Corp. (01-10578, D. Del.); W.R. Grace (01-01139 D. Del.); Quintus Corp. (01-501 D. Del.); Imperial Distributing (01-00140 D. Del.); Amresco Inc. (01-35327 N.D. Texas); Finova Corp. (01-00697 D. Del.); Comdisco (01-24795 N.D. Ill.); Heilig-Meyers (00- 34533 E.D. Va.); Coram Healthcare Corp. (00-03299 D. Del.); Stone & Webster Inc. (00-2142, D. Del.); and LTV Steel Co. (00-43866 N.D. Ohio). Equity Committees were also appointed in at least the following cases across the nation prior to 2000: American Banknote (S.D.N.Y.); Harnischfeger Industries (D. Del.); Continental Airlines Holdings Inc. (D. Del.); El Paso Electric Co. (N.D. Texas); America West Airlines (D. Ariz.); Roses Stores Inc. (D. N.C.); Sizzler International (C.D. Calif.); Caldor Corp. (S.D.N.Y.); Leslie Fay Cos. (S.D.N.Y.); JohnsManville (S.D.N.Y.); Wang Laboratories (D. Mass.); Beker Industries (S.D.N.Y.); Evans Products (S.D. Fla.); and Columbia Gas (D. Del.). In addition, the appointment of an equity committee was sought, but not obtained, in several other cases. See, e.g., GB Holdings Inc. (0543736 D.N.J.); Ultimate Electronics (05-10104 D. Del.); Touch America (03-11195 D. Del.); Resorts International Inc. (94-259 D. N.J.); Edisto Resources Corp. (92-1345 D. Del.).