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RIGHTS AND ROLES OF UNSECURED CREDITORS

Unsecured Creditors' Rights and Roles-United States

By

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MEMORANDUM

TO: International Insolvency Institute – Paris
FROM: Debra I. Grassgreen
RE: Unsecured Creditors’ Rights and Roles – United States
DATE: May 28, 2012

A. Introduction

Title 11 of the United States Code (the “Bankruptcy Code”) provides a comprehensive statutory scheme that enables a company to either restructure or liquidate. Any person, which includes individuals, partnerships, and corporations, may seek relief under the Bankruptcy Code so long as the person resides or has a domicile, a place of business, or property in the United States. 11 U.S.C. §§ 101(41) and 109(a).

Chapter 11 is a chapter of the Bankruptcy Code that permits reorganization and is available to corporations (regardless of legal structure) and to individuals, although it is predominantly used by corporate entities. 11 U.S.C. § 109(d). In contrast, chapter 7 of the Bankruptcy Code provides the statutory scheme to enable a company to liquidate, by appointing a trustee that is tasked with selling all of the debtor’s assets. 11 U.S.C. §§ 701 and 704.

Under chapter 11 of the Bankruptcy Code, the debtor remains in possession of its property and business operations and is known as a “debtor in possession,” entrusted with the duties and powers of a trustee. 11 U.S.C. §§ 1107 and 1108. Section 1107 of the Bankruptcy Code places the debtor in possession in the position of a fiduciary, with the rights, powers, and duties of a chapter 11 trustee. These duties include, among other things, filing schedules of assets and liabilities, investigating all matters relevant to the case or the formulation of a plan,

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and filing a plan under section 1121 of the Bankruptcy Code. 11 U.S.C. § 1106. The debtor in possession also has many of the other powers and duties of a trustee, including the right, with the court's approval, to employ attorneys, accountants, appraisers, auctioneers, or other professional persons to assist the debtor during its bankruptcy case. 11 U.S.C. § 327.

In contrast, under chapter 7 of the Bankruptcy Code, management is immediately displaced by an interim trustee that is appointed by the United States trustee immediately upon the filing of a voluntary chapter 7 case. 11 U.S.C. § 701(a). The interim trustee serves through the initial meeting of creditors under section 341 of the Bankruptcy Code. At the meeting of creditors held under section 341, creditors elect a permanent trustee to administer the chapter 7 case. 11 U.S.C. § 702(b). The duties of a chapter 7 trustee are enumerated in section 704 of the Bankruptcy and include, among other things, (i) investigating the financial affairs of the debtor, (ii) examining proofs of claims and objecting to the allowance of any claim that is improper, (iii) collecting and reducing to money the property of the estate and close such estate as expeditiously as possible as is compatible with the best interests of parties in interest. 11 U.S.C. § 704.

B. Formation of the Creditors' Committee¹

Pursuant to section 1102 of the Bankruptcy Code, the U.S. trustee is "required" to appoint a creditors' committee, except for cause (*e.g.*, if unsecured creditors are unwilling to participate). The requirement to form a creditors' committee demonstrates that Congress envisioned an important role for the creditors' committee in the chapter 11 process.

Shortly after the filing of a chapter 11 case (generally within 30 days), the U.S. trustee will hold a meeting to form an official committee of unsecured creditors and will usually select candidates from the list of the 20 largest unsecured creditors filed by the debtor at the outset of the case. The size of the creditors' committee is statutorily set at seven (7) members, but in practice often ranges between three (3) and seven (7) members. 11 U.S.C. § 1102(b). The fact that creditors may have different interests or views does not justify the formation of separate committees. However, if there are distinct groups within the class of creditors who cannot be adequately represented by a single committee, the U.S. trustee and/or the bankruptcy court can be petitioned for the formation of a separate committee. 11 U.S.C. § 1102(a)(2).

Among other things, the committee: consults with the debtor in possession on the administration of the case; investigates the debtor's conduct and operation of the business; and participates in formulating a plan of reorganization. A creditors' committee may, with the court's approval, hire an attorney or other professionals (*e.g.*, financial advisors) to assist in the performance of the committee's duties. 11 U.S.C. § 1103(a). Because the fees for these professionals are paid by the debtor's estate, membership on the creditors' committee is a cost-

¹ This memorandum was adopted in part from materials prepared by Debra Grassgreen and Kenneth Eckstein for a December 2011 program for the American Bankruptcy Institute.

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effective way for individual unsecured creditors to influence the outcome of a bankruptcy case and protect their interests.

A creditors' committee may also be formed under chapter 7 of the Bankruptcy Code, but it is discretionary. Pursuant to section 705 of the Bankruptcy Code, at the initial meeting of creditors, creditors "may" elect a committee comprising three (3) to seven (7) unsecured creditors. A creditors' committee formed under section 705 of the Bankruptcy Code may consult with the U.S. trustee in connection with the administration of the estate, make recommendations respecting the performance of the trustee's duties, and submit questions to the court affecting the administration of the estate. 11 U.S.C. § 705(b).

C. Structure of the Creditors' Committee

The creditors' committee has flexibility as to how formally or informally it wishes to conduct its business. Typically, however, significant decisions such as voting to oppose a proposed plan of reorganization or seeking the appointment of a chapter 11 trustee or the conversion of a case to chapter 7 is performed by formal vote.

Bylaws are a common mechanism for formalizing the rules governing the conduct of committee business. Generally, after the creditors' committee is formed, the members elect a chairman of the committee and then execute bylaws that formally appoint the chairman and address, among other things, voting procedures, confidentiality protocols, rules of procedure, schedule of meetings, and general requirements to take action.

D. Duties of an Official Committee of Unsecured Creditors

As discussed above, the appointment and maintenance of official committees in chapter 11 is governed by section 1102 of the Bankruptcy Code, which mandates the creation of an unsecured creditors' committee and any additional committees "necessary to assure adequate representation of creditors or of equity security holders." 11 U.S.C. § 1102(a)(1)-(2). Statutory committees, along with the debtor or trustee, are designed to serve as the "primary negotiating bodies" for the formulation of a plan of reorganization. H.R. REP. NO. 95-595, 95th Cong., 1st Sess. (1977). While committees' relations with the debtor may be friendly, it is important to recognize that a committee may be called upon to take adversarial positions in the pursuit of recoveries for its constituents; in addition to negotiating with the debtor and other parties, a committee "will also provide supervision of the debtor in possession and of the trustee, and will protect [its] constituents' interests," *id.* – where necessary, taking on causes of action against third parties in order to enhance estate value – with the ultimate objective of maximizing its constituents' recoveries. *See, e.g., In re Nationwide Sports Distribs., Inc.*, 227 B.R. 455, 463 (Bankr. E.D. Pa. 1995) (committees' purpose is to "strive to maximize the bankruptcy dividend paid to [the represented] class of creditors").

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Official committees must therefore strike a delicate balance, seeking both to cooperate with other parties in the interest of an efficient reorganization and to pursue maximum recoveries for their constituents in an inherently competitive environment. As one court aptly explained:

The creditors' committee is not merely a conduit through whom the debtor speaks to and negotiates with creditors generally. On the contrary, it is purposely intended to represent the necessarily different interests and concerns of the creditors it represents. It must necessarily be adversarial in a sense, though its relation with the debtor may be supportive and friendly. There is simply no other entity established by the Code to guard those interests. The committee as the sum of its members is not intended to be merely an arbiter but a partisan which will aid, assist, and monitor the debtor pursuant to its own self-interest.

In re Daig Corp., 17 B.R. 41, 43 (Bankr. D. Minn. 1981).

As a result of these competing concerns, much ink has been spilled concerning the duties imposed upon committee members and their counsel. Unsurprisingly, the presence of these duties can create conflicts for committee members, who, as creditors themselves, have their own interests at stake.

a. Powers of the Committee

Section 1103 of the Bankruptcy Code enumerates the specific powers and duties of the creditors' committee. Accordingly, the creditors' committee may:

- i. consult with the debtor in possession, concerning the administration of the case;
- ii. investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, the desirability of the continuance of such business, and any other matters relevant to the case or to the formulation of a plan;
- iii. participate in the formulation of a plan and advise the members of the class which it represents of the committee's position as to any plan formulated;
- iv. request the appointment of a chapter 11 trustee or examiner, or if the committee determines that it is in the creditors' best interest to have a trustee liquidate the business, seek the conversion of the case to chapter 7; and
- v. perform such other services as are in the interest of the creditors.

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In addition, the creditors' committee may: (i) review and advise the court of the creditors' committee's position on motions or other legal actions; (ii) investigate the debtor's prepetition conduct for possible causes of action against insiders that would benefit the estate (*e.g.*, preferential transfers); (iii) determine the viability of the company as a going concern; (iv) advise other unsecured creditors on whether to accept or reject a particular plan of reorganization; (v) appear at various hearings as a party in interest; and (vi) prepare and file its own plan of reorganization when the debtor ceases to have the exclusive right to do so.

b. Duties of the Committee and its Members

It is well established that a creditor's membership on an official committee gives rise to fiduciary duties to other creditors whose interests the committee represents. *In re Refco Inc.*, 336 B.R. 187, 195 (Bankr. S.D.N.Y. 2006) ("It is well recognized that . . . the members of an official committee owe a fiduciary duty to their constituents – in the case of an official creditors committee, to all of the debtor's unsecured creditors."). These duties extend *only* to constituent creditors, and not to the estate or to creditors in other classes. *Official Comm. of Asbestos Claimants of G-I Holding, Inc. v. Heyman*, 342 B.R. 416, 423 (S.D.N.Y. 2006).

These duties divide into three broad categories: (i) the duty of care; (ii) the duties of loyalty and impartiality; and, increasingly, (iii) the duty to communicate with non-member constituents whose interests the committee represents regarding developments in the case. *See generally* Susan M. Freeman, *Are DIP and Committee Counsel Fiduciaries for their Clients' Constituents or the Bankruptcy Estate? What is a Fiduciary, Anyway?*, 17 AM. BANKR. INST. L. REV. 291 (2009); *Refco*, 336 B.R. at 197.

i. Duty of Care

The duty of care applies to creditors' committees as it does in agency law generally: put simply, a committee must take care to obtain maximum value for its constituents. This means, among other things, that a committee must engage experts when appropriate to ensure competent representation of constituents' interests, and preserve the confidentiality of sensitive information obtained in the course of representation. Freeman at 311. *See also In re Mesta Machine Co.*, 67 B.R. 151, 163 (Bankr. D. Pa. 1986) (committee has a duty to retain professionals where necessary to advance the interests of constituents); *In re Refco Inc.*, 336 B.R. 187, 196-97 (Bankr. S.D.N.Y. 2006) ("[C]ommittee members should and will receive commercially sensitive or proprietary information from the debtor and other parties (including each other, because plan negotiations are as often conducted between unsecured creditor groups as between the unsecured creditors and the debtor), often in the context of settlement discussions. It has frequently been held that committee members' fiduciary duties of loyalty and care to the unsecured creditor body require such information to be held in confidence.")

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The imposition of a duty of care regarding confidentiality of information serves to encourage open communication among creditors and between committees and debtors and to prevent harm to a debtor's estate that may result in diminished creditor recoveries. *Refco* at 196; *In re Swolsky*, 55 B.R. 144, 146 (Bankr. N.D. Ohio 1985) (removing insider from creditors' committee on the basis of confidentiality concerns arising from insider's close relationship with debtor).

ii. Duty of Loyalty

Committee members individually may not use their status to obtain or take advantage of opportunities unavailable to the constituents represented by the committee. *In re Refco Inc.*, 336 B.R. 187, 196 (Bankr. S.D.N.Y. 2006) (committee members prohibited from "profiting from, or enabling selected creditors to profit from, non-public information obtained as a result of committee membership"). This duty has long been tied to committee membership. *See, e.g., Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 265-66 (U.S. 1941) (a committee member, as fiduciary to both majority and minority constituents, must ensure "that his primary loyalty was not weakened by the pull of his secondary one"); *In re Realty Assocs. Sec. Corp.*, 56 F. Supp. 1008, 1009 (D.N.Y. 1944) (committee "owes undivided loyalty and allegiance" to its constituents).

Moreover, the committee as a whole may not favor the interests of individual constituents as against other constituents' interests. *In re Continental Airlines, Inc.*, 57 B.R. 839, 841 (Bankr. S.D. Tex. 1985) (A committee must avoid "the untenable position of a clear conflict of interest between one individual creditor/employee and another, maximizing some claims, some at the potential expense of others."); *Pension Ben. Guaranty Corp. v. Pincus, Verlin, Hahn, Reich & Goldstein Professional Corp.*, 42 B.R. 960, 964 (E.D. Pa. 1984) (committee may not advocate individual creditors' interests over others). This does not mean, of course, that a committee may not vote to take actions over the objection of individual constituents; only that such actions must be justified as serving the interests of the constituents generally, and not be tainted by a preference for one creditor's individual interests over another's.

In practice, this means that official committee members should be removed where their interests interfere with the committee's ability to represent its constituents without favoring individual creditors – or where such interests create the *appearance* of favoritism. *In re Venturelink Holdings, Inc.*, 299 B.R. 420, 423 (Bankr. N.D. Tex. 2003); *In re First RepublicBank Corp.*, 95 B.R. 58, 61 (Bankr. N.D. Tex. 1988); *In re Johns-Manville Corp.*, 26 B.R. 919, 925 (Bankr. S.D.N.Y. 1983). However, "not all conflicts mandate removal." For example, "a creditor disagreement over strategy or objectives," common in bankruptcy, does not create grounds for removal. *Id.*; *see also In re Altair*, 727 F.2d 88, 90 (3d Cir. 1984). Committee members are not expected to be disinterested, and even debtor-insiders may serve under certain circumstances. *Id.* Since the applicable statutes do not provide specific guidelines

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governing the removal of a committee member, the interpretation of what constitutes a qualifying “conflict” tends to be subjective and fact-specific. And, because the U.S. Trustee is delegated the authority to appoint and remove official committee members, Courts typically avoid making such determinations themselves except where the U.S. Trustee’s actions were arbitrary and capricious. *See, e.g., First RepublicBank*, 95 B.R. at 60 (Bankr. N.D. Tex. 1988).

iii. Duty to Communicate and Inform

Congress codified the duty of communication by adding section 1102(b)(3) to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).² This section provides that:

- (3) A committee appointed under subsection (a) shall
- (A) provide access to information for creditors who –
 - (i) hold claims of the kind represented by that committee; and
 - (ii) are not appointed to the committee;
 - (B) solicit and receive comments from the creditors described in subparagraph (A); and
 - (C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

The purpose of requiring such disclosure and communication is to protect smaller, less involved creditors – according to Congress, small businesses – from being “caught off guard” by the actions of more powerful institutional creditors who serve on the committee. Cong. Rec. H. 2655, 2709 (May 5, 1999) (citing the “way the bankruptcy process leaves small businesses who are creditors on the outside looking in” and the need to ensure that those “small businesses not included on the committee but who will nonetheless be affected by the outcome” have access to “critical information regarding the credit [sic] committee’s actions”); *see also In re Refco Inc.*, 336 B.R. 187, 197 (Bankr. S.D.N.Y. 2006) (describing “the right of unsecured creditors to be informed of material developments in the case before they are presented with what in practical terms may be a *fait accompli*”).

Because 1102(b)(3) is relatively new – and imposes an unprecedented duty – courts that have addressed it have been forced to look beyond the statutory language itself. In *Refco*, the first chapter 11 case to implement the requirements of 1102(b)(3) and by far the most authoritative on the subject, Judge Drain of the Southern District of New York adapted prior courts’ interpretations of section 704(a)(7), which governs a chapter 7 trustee’s duties of

² It bears noting that this is the *only* section in the Bankruptcy Code that imposes affirmative duties on a committee, as opposed to simply describing a committee’s powers, as in section 1103.

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disclosure to parties in interest. Judge Drain found that these duties, while “extensive,” are not unlimited. For example, a trustee is not necessarily obligated to share information where disclosure would result in a waiver of attorney-client privilege, or where such information is “proprietary and confidential.” *Id.* at 193-94. Judge Drain ultimately ruled that “each of these aspects of section 704” should apply to a committee’s obligations under 1102(b)(3). *Id.* at 194. The very few courts to have addressed this issue subsequently have generally followed Judge Drain’s approach. *See, e.g., In re S&B Surgery Ctr., Inc.*, 421 B.R. 546 (Bankr. C.D. Cal. 2009).

In spite of the helpful precedent relating to 704(a)(7), however, the duty of disclosure imposed by section 1102(b)(3) remains murky and nebulous. The legislative history is minimal and opaque, providing courts with virtually no guidance as to how the duty should be met and enforced as a practical matter. *See* H.R. REP. NO. 109-31, at 87 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 153 (“Section [1102(b)(3)] requires the committee to give creditors having claims of the kind represented by the committee access to information. In addition, the committee must solicit and receive comments from these creditors and, pursuant to court order, make additional reports or disclosures available to them.”); *S&B Surgery* at 548 (The legislative history “does not provide any meaningful guidance regarding the type of information to which access must be given or the manner in which it should be communicated.”). Moreover it is unclear what, if any, sanctions could be imposed upon a committee for failure to meet its disclosure requirements. *S&B Surgery* at 548.

E. Ad Hoc Committees

While no one appears to question the existence of fiduciary duties imposed on members of *official* committees (even if the nuances remain somewhat unsettled), recent case law has given rise to the question of whether these duties may be imputed to members of *ad hoc or unofficial* creditor groups. If so, this could cause a sea change in the way such informal committees organize and conduct themselves.

Membership on an ad hoc committee can confer a number of benefits on creditors or interest holders seeking to maximize their recoveries.³ Commonly cited is the fact that, by combining creditors with aligned interests can realize an enormous efficiency in obtaining (and paying for) common legal representation. Also frequently invoked is the “strength in numbers rationale” – the formation of an ad hoc group allows relatively small individual creditors to speak and be heard through the voice of a single larger entity. Finally, membership in an ad hoc

³ Of course, there are liabilities as well. First and foremost, ad hoc committees typically pay their own legal fees. Moreover, membership on such an informal committee – unlike membership on an official committee – does not guarantee a creditor’s right to participate in settlement negotiations or obtain standing to pursue its interests before the court beyond its role as a “party in interest” under section 1109.

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committee was assumed not to carry the sorts of trading restrictions that typically accompany a creditor's membership on an official committee.

This last benefit depends upon a recognized difference between the fiduciary duties applicable to official versus ad hoc committee members. Because members of official committees have an obligation not to use their role as members to obtain a benefit not available to non-member constituents, and because of the broad-ranging obligations members face in relation to their receipt and maintenance of confidential information, it has become generally recognized that trading in a debtor's securities while serving on an official committee can lead to a breach of fiduciary duties. Moreover, by accepting an appointment to an official committee, a committee member certifies that they will not trade in claims against the debtor or the debtor's securities absent an appropriate trading order. As such, members of official committees have generally governed themselves by stringent trading restrictions.⁴

Absent such fiduciary duties, however, an *unofficial* committee member needed only restrict its trading in light of traditionally understood securities laws and the general requirements governing creditor behavior under the Bankruptcy Code, without worrying whether it would breach an obligation to other creditors in the course of pursuing its own good faith self-interest. The notion that fiduciary duties could attach to ad hoc committee membership has not historically been considered a serious risk, as has been reflected by established practice.

However, this view has been subjected to a radical reassessment as a result of the September 13, 2011 opinion of Judge Mary Walrath of the Bankruptcy Court for the District of Delaware, in which Judge Walrath ruled that an ad hoc group of four private equity management companies known as the "Settlement Noteholders" may have acquired fiduciary duties to other creditors as constructive "insiders" of the debtors.⁵ *In re Wash. Mut., Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011). Judge Walrath found that such status could have accrued to the Settlement Noteholders under either of two concepts, commonly known as "temporary insider" status,

⁴ In some instances official committee members have obtained court approval to establish internal screening mechanisms and continue trading. *See, e.g.*, Order Approving Specified Information Blocking Procedures and Permitting Trading in the Securities of and Claims against the Debtors upon Establishment of a Screening Wall, *In re Dana Corp.*, Case No. 06-10354 (Bankr. S.D.N.Y. 2006) (Docket No. 1013) (granting motion of Official Committee of Unsecured Creditors member P. Schoenfeld Asset Management to erect ethical wall and trade in debtors' securities).

⁵ Judge Walrath made this finding in the context of allegations of insider trading leveled against the Settlement Noteholders by the Official Committee of Equity Security Holders, which had sought standing to pursue claims against the group for equitable subordination and disallowance. As such, the September 13 ruling was limited to whether these claims were "colorable" as a matter of surviving preliminary dismissal thresholds.

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which is rooted in securities law, and “non-statutory insider” status, which finds its basis, albeit limited, in bankruptcy jurisprudence.

a. Temporary Insider Status

“Temporary insider” status is a securities law concept that has traditionally been applied outside the bankruptcy context to non-employee professionals engaged by a corporation to assist that corporation with its business (*e.g.*, bankers, accountants and lawyers assisting with a merger transaction). Under the doctrine, “insider” status – and the fiduciary duties imposed on corporate insiders – may be imputed where such a professional obtains confidential information in the course of her involvement with the corporation’s affairs. The U.S. Supreme Court explained this concept in *Dirks v. S.E.C.*:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

Dirks v. SEC, 463 U.S. 646, 655 n.14 (U.S. 1983).

Judge Walrath, relying principally on *Dirks*, found that the Settlement Noteholders may have become such temporary insiders, and thus incurred fiduciary duties to other creditors and shareholders, “when the Debtors gave them confidential information and allowed them to participate in negotiations . . . for the shared goal of reaching a settlement that would form the basis of a consensual plan of reorganization.” *In re Wash. Mut., Inc.* at 263. This point is critical because a breach of fiduciary duty to a corporation’s shareholders is a necessary element to a finding of liability under the so-called “classical theory” of insider trading. *Id.* at 144; *U.S. v. O’Hagan*, 521 U.S. 642, 651-52 (1997).

b. Non-Statutory Insider Status

Judge Walrath alternatively found colorable the allegation that the Settlement Noteholders had incurred “non-statutory insider” status by their obtaining, collectively, a blocking position in two classes of the debtors’ securities. In support of this finding Judge Walrath invoked case law suggesting that, where a party purports to act for the benefit of a given creditor class in a bankruptcy proceeding, that party may acquire a fiduciary duty to the class. *Id.* (citing *Official Comm. of Equity Sec. Holders of Mirant Corp. v. Wilson Law Firm, P.C. (In re Mirant Corp.)*, 334 B.R. 787, 793 (Bankr. N.D. Tex. 2005)).

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In *Mirant*, the court ascribed fiduciary duties to an attorney-stakeholder who became actively involved in the debtors' chapter 11 cases, filing disclosure statement objections and a Rule 2019 statement certifying his "incremental" retention by roughly a dozen other shareholders, which his firm's website referred to as an "ad hoc committee." 334 B.R. at 791. While conducting his representation, this attorney had also begun e-mailing additional shareholders and posting information about the case – including his analyses as to why shareholders should, and were likely to, vote against confirmation – on internet message boards, along with links to his firm's website. *Id.* The Debtors and an appointed examiner sought to enjoin the attorney from making further solicitations on the grounds that he had made materially misleading factual and legal statements in his e-mails and message-board postings, in violation of section 1125(e) of the Bankruptcy Code. *Id.* The court agreed, finding that the attorney had "donned the mantle of fiduciary" by "participating in these cases as a representative of shareholders, by assuming the role on the Firm's website of counsel to an 'ad hoc committee,' [and] by seeking compensation for the Firm from the estate." *Id.* at 793. As such, the court reasoned, the attorney had acquired a duty to "the constituency he purports to represent - here the common stockholders - to present only truthful and accurate information in the Solicitation Materials." *Id.* On this basis, the court enjoined him from publishing any further materials without the court's prior approval. *Id.* at 800.

The *Mirant* court, like Judge Walrath, relied on the "well established principle" that "when a party purports to act for the benefit of a class, the party assumes a fiduciary role as to the class." *Id.* at 793 (citing *Young v. Higbee Co.*, 324 U.S. 204 (1945)). As with the "temporary insider" question, the presence of a fiduciary duty is important as an element of insider-trading liability. What is less clear in the context of "non-statutory insider" status, however, is whether a fiduciary duty incurred thereunder by a *creditor* – and thus owed to that creditor's class – could give rise to classical insider trading liability, which requires a breach of duty owed to a corporation's *shareholders*. *In re Wash. Mut., Inc.* at 264. Judge Walrath's opinion does not address this question.

Judge Walrath had foreshadowed her findings as to the possibility that the Settlement Noteholders had acquired fiduciary duties to other creditors in an earlier opinion discussing the application of Rule 2019 disclosure requirements to ad hoc committees. *In re Wash. Mut., Inc.*, 419 B.R. 271, 278 (Bankr. D. Del. 2009). In rejecting an unrelated ad hoc group's contention that Rule 2019 is only applicable to an entity "that purports to speak on behalf of an entire class or broader group of stakeholders *in a fiduciary capacity*," *id.* (emphasis added), Judge Walrath concluded that the ad hoc group's argument was premised on "the erroneous assumption that the Group owes no fiduciary duties to other similarly situated creditors, either in or outside the Group." *Id.* Judge Walrath recited the words of Judge Gropper in *In re Northwest Airlines* (which did not find that an ad hoc group bears fiduciary duties to other creditors) to highlight "the importance of the relationship between the [ad hoc shareholders'] committee and other similarly situated shareholders":

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By acting as a group, the members of the shareholders' Committee subordinated to the requirement of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the Debtors' securities. This is not unfair because their negotiating decisions as a Committee should be based on the interest of the entire shareholders' group, not their individual financial advantage.

Id. at 279 (quoting *In re Northwest Airlines Corp.*, 363 B.R. 701, 708 (Bankr. S.D.N.Y. 2007). Judge Walrath stopped short of elucidating the specifics of such duties (if any), however, finding it necessary only "to recognize that collective action by creditors in a class implies some obligation to other members of that class." *Id.*

By raising the possibility that ad hoc groups may now be deprived of one of the principal grounds for their existence – the right to continue trading – Judge Walrath's ruling has already sent shockwaves through the distressed investing community. This is evidenced by the multitude of law firms that have issued client alerts advising clients that entry into limited or short term confidentiality agreements and adoption of temporary restrictions while engaged in settlement negotiations may no longer protect them. Given the absence of case law directly addressing the propriety of such established practices, ad hoc groups of investors may well be deterred from entering into settlement negotiations – or even joining together in the first place – for fear of incurring a previously unimagined duty to other creditors or shareholders.

F. Creditor Participation Outside Committees

a. A Creditor has Standing as a "Party in Interest"

If a creditor is unable to participate in a bankruptcy case through an official committee of unsecured creditors or an *ad hoc* committee, his or her voice has not been silenced. Each creditor is a "party in interest," defined by Black's Law Dictionary as including "one whose pecuniary interest is directly affected by the bankruptcy proceeding." Specific provisions of the Bankruptcy Code often extend the right to be heard to "parties in interest"⁶ and, unless otherwise specified,⁷ section 1109(a) authorizes parties in interest to participate in the bankruptcy case:

⁶ 11 U.S.C. § 330(a)(2) (professional compensation); 11 U.S.C. § 362(d) (lift automatic stay); 11 U.S.C. § 502(a) (claim objections); 11 U.S.C. § 554(b) (abandon property); 11 U.S.C. § 1112(b) (dismiss case); 11 U.S.C. § 1128(b) (object to plan confirmation).

⁷ See *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 8 (2000) ("[W]e do not read § 1109(b)'s general provision of a right to be heard as broadly allowing a creditor to pursue substantive remedies that other code provisions make available only to other specific parties.")

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A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.

11 U.S.C. § 1109(a). Although section 1109(a) expressly notes that “party in interest” includes the parties listed, the term is not limited to those parties and is not otherwise defined in the Bankruptcy Code.

b. Creditor Participation in Plan of Reorganization

In addition to generally participating in a chapter 11 bankruptcy case as a “party in interest” with general standing to be heard, a creditor may also influence a chapter 11 bankruptcy case by actively participating and voting in the plan process.

Only the debtor may file a plan of reorganization during the first 120-day period after the petition is filed. 11 U.S.C. § 1121(b). The court may grant an extension of this exclusive period up to 18 months after the petition date. 11 U.S.C. § 1121(d). In addition, the debtor has 180 days after the petition date or entry of the order for relief to obtain acceptances of its plan. 11 U.S.C. § 1121(c). The court may extend (up to 20 months) or reduce this acceptance exclusive period for cause. 11 U.S.C. § 1121(d).

If the exclusive period expires before the debtor has filed and obtained acceptance of a plan, other parties in interest in a case, such as the creditors' committee or a creditor, may file a plan. 11 U.S.C. § 1121(c). Such a plan may compete with a plan filed by another party in interest or by the debtor. Thus, one way – although rare – a creditor may participate in a bankruptcy case is to introduce a competing plan. Generally, a debtor will extend its exclusivity period, preventing parties in interest from soliciting competing plans.

Section 1123(a) of the Bankruptcy Code lists the mandatory provisions of a chapter 11 plan. Section 1123(a)(1) provides that a chapter 11 plan must designate classes of claims and interests for treatment under the reorganization. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders.

Under section 1126(c) of the Bankruptcy Code, an entire class of claims is deemed to accept a plan if the plan is accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims in the class. Under section 1129(a)(10), if there are impaired classes of claims, the court cannot confirm a plan unless it has been accepted by at least one class of non-insiders who hold impaired claims (*i.e.*, claims that are not going to be paid completely or in which some legal, equitable, or contractual right is altered). Accordingly,

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TO: International Insolvency Institute - Paris
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DATE: May 28, 2012

a creditor's vote to accept or reject a plan is a principal way the creditor is able to participate in a chapter 11 bankruptcy case. Because it is often difficult to solicit unsecured creditor votes, a single creditor can determine whether a class votes to accept or reject a plan. If the class votes to accept the plan, the debtor must resort to "cram down" procedures, which require at least one impaired accepting class.

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