INSIDE THE MINDS

The Role of Creditors' Committees in Chapter 11 Bankruptcies

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The Role of a Chapter 11 Unsecured Creditors' Committee and Eligibility to Serve Thereon

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Introduction: The Importance of Creditors' Committees in the Bankruptcy Process

An individual unsecured creditor often has minimal interest in participating in the bankruptcy process because its potential losses are relatively insignificant as compared to those of the debtor's secured creditors. However, as a class, unsecured creditors often have equally as much to lose as any individual secured creditor. In an attempt to protect the interests of unsecured creditors, the Office of the United States Trustee (U.S. Trustee), a division of the Department of Justice, must appoint a committee of unsecured creditors as soon as practicable after an order for relief has been entered in a case under Chapter 11. 11 U.S.C. § 1102(a)(1) (2008). Although the U.S. Trustee may also appoint other committees of creditors or equity interest holders in a Chapter 11 case, the appointment of a committee of unsecured creditors is not a matter within the U.S. Trustee's discretion and generally must happen in every Chapter 11 case. 11 U.S.C. § 1102(a)(1) (stating that in Chapter 11 cases, "the United States trustee *shall* appoint a committee of creditors holding unsecured claims . . .") (emphasis added). There are, of course, exceptions to this rule: In some circumstances an unsecured creditors' committee need not be appointed (e.g., in cases involving small business debtors where cause is shown, 11 U.S.C. § 1102(a)(3)), and in some instances the appointment of such a committee is not feasible because of an insufficient number of eligible creditors. 15 Collier on Bankruptcy 1102.02[1][a] at 1102-6. Typically, however, unsecured creditors' committees are indispensable under Chapter 11 of the Bankruptcy Code.

Role of a Chapter 11 Creditors' Committee

Unsecured creditors' committees are to be composed of persons willing to serve who ordinarily hold the seven largest unsecured claims against the debtor. 11 U.S.C. § 1102(b)(1). Once the committee is formed, committee members are left wondering what happens next and what their role will be as a member of the committee.

Although the precise role of any specific unsecured creditors' committee varies from case to case, pursuant to the applicable sections of the Bankruptcy Code, 11 U.S.C. §§ 1102(b)(3)(A)-(C) and 1103(c)(1)-(5) (2008),

there are three main roles that any unsecured creditors' committee performs:

- The committee has a duty to represent the interests of the entire class of unsecured creditors in all of its activities. *See* 11 U.S.C. §§ 1102(a)(4) (permitting a court to change the membership of a committee *to ensure adequate representation of all creditors*) (emphasis added), and 1103(c)(5) (authorizing unsecured creditors' committees to perform services in the interest of *those the committee represents*) (emphasis added).
- The committee is responsible for investigating the debtor's financial condition and its management and consulting with the debtor about those matters. 11 U.S.C. § 1103(c)(1)-(2).
- Once armed with sufficient information about the debtor's business, the committee negotiates a plan for distributing the debtor's assets. 11 U.S.C. § 1103(c)(3).

The representation, investigation, and negotiation functions of an unsecured creditors' committee are essential to the proper resolution of a case under Chapter 11.

Representation of the Unsecured Creditor Class

Although the Bankruptcy Code itself nowhere explicitly states that the role of an unsecured creditors' committee is one of class representation for the entire class of unsecured creditors, the Bankruptcy Code strongly implies as much by permitting a court to change the membership of an unsecured creditors' committee if "the change is necessary to ensure adequate representation of creditors . . . " and by authorizing the committee to "perform such other services as are in the interest of those represented." 11 U.S.C. § 1102(a)(4); § 1103(c)(5).

The House Report issued in connection with the House version of the Bankruptcy Reform Act of 1978 said unsecured creditors' committees "are designed to deal with the debtor in a more manageable way than the entire body of creditors could. They are representative bodies that must speak for groups of creditors with similar interests." H.R. Rep. No. 95-595, at 235 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787. As one commentator remarked,

"[i]deally, by virtue of the committee, each of the members of the class is assured that its interests are adequately represented without having to participate in the proceedings personally." DeNatale, *The Creditors' Committee Under the Bankruptcy Code-A Primer*, 55 Am. Bankr. L.J. 45 (1981).

Courts across the country have consistently stated that the function of an unsecured creditors' committee is to represent the interests of the unsecured creditor class as a whole. *See e.g.*, *In re Nat'l Liquidators Inc.*, 182 B.R. 186, 191 (S.D. Ohio 1995) (describing the role of a creditors' committee as that of a "partisan representative of the different interests and concerns of the creditors"); *In re AKF Foods Inc.*, 36 B.R. 288, 289-90 (E.D. N.Y. 1984) (stating "The function of a creditors' committee is to act as a watchdog on behalf of the larger body of creditors it represents."). The court in *In re Daig Corp.* denied a debtor's request to change the membership of the unsecured creditors' committee by removing a creditor whose claim the debtor disputed, reasoning that the creditor's presence on the committee was appropriate because a fundamental concept underlying the Bankruptcy Code is that the "creditors' committee is not merely a conduit through whom the debtor speaks to and negotiates with creditors generally," but that the committee is "purposely intended to represent the necessarily different interests and concerns of the creditors it represents," and found that the challenged creditor's interests were aligned with those of other unsecured creditors. 17 B.R. 41, 43 (D. Minn. 1981).

Related to an unsecured creditors' committee's duty to represent all members of the unsecured creditor class is its duty to communicate with those class members, which the Bankruptcy Code mandates. 11 U.S.C. § 1102(a)(3)(A)-(C). The Bankruptcy Code requires that an unsecured creditors' committee provide access to information to the members of the creditor class, solicit and receive comments from those class members, and subject itself to any court order compelling additional reports or disclosures be made to those class members. *Id.*

Members of the unsecured creditors' committee must continue to represent the interests of the unsecured creditor class as a whole and communicate with class members during their investigation of the debtor, both while negotiating a reorganization plan with the debtor and throughout the entire bankruptcy process. *In re ABC Auto. Prods. Corp.*, 210 B.R. 437, 441 (E.D.

Penn. 1997) (declaring that the function of the creditors' committee is to represent and protect the interests of the unsecured creditors throughout the entire bankruptcy process).

Investigation of the Debtor's Financial Condition and Operation

Although the role of an unsecured creditors' committee as a representative of the entire unsecured creditor class is not explicitly set forth in the Bankruptcy Code, a committee's role as an investigatory body is specifically enumerated as one of its powers and duties under the Bankruptcy Code, which states that an unsecured creditors' committee may "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan." 11 U.S.C. § 1103(c)(2).

An unsecured creditors' committee's investigatory role is twofold: the committee must investigate the financial condition of the debtor, including its assets and liabilities, as a prerequisite to negotiating a plan for distributing the debtor's assets, and the committee must investigate the management and operation of the debtor's business to ensure that the debtor's available assets will be responsibly handled during the course of the bankruptcy. *Id.* (stating that an unsecured creditors' committee may investigate the "assets, liabilities, and financial condition of the debtor" and the "acts, conduct . . . and operation of the debtor's business"). An unsecured creditors' committee's fulfillment of both investigatory roles is essential if the committee is to live up to its responsibility to constituents and uphold the fiduciary duty it owes to those constituents. *See, e.g.*, *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262 (1941); *Bohack Corp. v. Gulf & W. Indus. Inc.*, 607 F.2d 258 (2d Cir. 1979); *Mirant Americas Energy Mktg. v. Official Comm. of Unsecured Creditors of Enron Corp.*, 51 Collier Bankr. Cas. 2d (MB) 903, *22 (2003).

Investigation of the Debtor's Financial Condition

An unsecured creditors' committee's investigation of a debtor's financial condition, including investigation into the assets and liabilities of the debtor, is critical if the committee is to successfully represent the entire

unsecured creditor class. This is because the investigation will assist the committee in negotiating an appropriate reorganization plan with the debtor that will protect the rights of all class members.

The fundamental role of an unsecured creditors' committee is to maximize recovery for the entire class of unsecured creditors. *ABC Auto. Prods. Corp.*, 210 B.R. at 441 (quoting Michael S. Lurey et al., *The Role of the Chapter 11 Creditors' Committee*, 546 P.L.I./Comm. 171, 176 (1990)). Accordingly, the potential scope of the committee's investigation is very broad and includes delving into all aspects of the debtor and its business affairs. *See, e.g.*, *In re Wilson Foods Corp.*, 31 B.R. 272, 272 (Bankr. W.D. Okla. 1983). As a part of its investigatory function, an unsecured creditors' committee must meet and consult with the debtor, as required under the Bankruptcy Code, which states that a committee may "consult with the trustee or debtor in possession concerning the administration of the case." 11 U.S.C. § 1103(c)(1). The nature of consultation that the Bankruptcy Code contemplates in this context includes discussions between the committee and the debtor about things such as the ongoing operation of the business, whether the business is profitable, the conservation of assets, the maintenance of insurance, and prosecution of causes of action by the debtor against others. Irving Sulmeyer & Israel Saperstein, Collier Handbook for Creditors' Committees 14-9 (Lawrence P. King ed., Matthew Bender & Company Inc. 1998).

However, in carrying out its mission, there are limits upon an unsecured creditors' committee's powers to investigate and consult with the debtor. A committee may not go so far as to prepare for or prosecute an adversary proceeding on behalf of the debtor against others, as this generally is not within the duties of the unsecured creditors' committee unless specifically authorized by the court. *In re Gulf USA Corp.*, 171 B.R. 379, 382 (Bankr. D. Idaho 1994). For example, the Second Circuit Court of Appeals has stated that a creditors' committee may sue on behalf of a debtor "with the approval and supervision of a bankruptcy court" where the debtor unreasonably fails to bring suit or the debtor consents to the creditors' committee bringing of a lawsuit. *In re Commodore Int'l Ltd.*, 262 F.3d 96 (2nd Cir. 2001). Additionally, although the Bankruptcy Code contemplates the unsecured creditors' committee's role as one of consultation with the debtor about the debtor's financial affairs, 11 U.S.C. § 1103(c)(1), that role

does not extend so far as to authorize the committee to be involved in the debtor's day-to-day operations or require that the debtor obtain the committee's approval prior to making financial decisions while the Chapter 11 case is pending. *In re UNR Indus. Inc.*, 30 B.R. 609, 611-12 (Bankr. N.D. Ill. 1983). As the court in *In re UNR Indus. Inc.* stated, there is a "clear intent on the part of Congress to allow debtors in possession…to conduct business as usual after the filing of Chapter 11, which does not encompass day-to-day input from creditors." *Id.* at 612.

Investigation of the Debtor's Operation

An unsecured creditors' committee's investigation of a debtor's financial affairs is critical if the committee is to succeed in protecting the interests of the entire class of unsecured creditors, but it alone is not sufficient in achieving that goal; the committee must also investigate and consult with the debtor about the debtor's management and business operation to ensure that the debtor's assets will be responsibly handled while the Chapter 11 case is pending. 11 U.S.C. § 1103(c)(1)-(2).

Although the obligation of an unsecured creditors' committee to investigate a debtor's management and operation, like its duty to investigate the debtor's financial affairs, is to "dig deep into all aspects of the debtor and its business affairs," *Wilson Foods Corp.*, 31 B.R. at 273, there are limits upon what the committee can do in carrying out this function as well. Although the committee is free to, and should, consult with the debtor regarding its business operation and management, 11 U.S.C. § 1103(c)(1), the committee may not go so far as to involve itself in the day-to-day management of the debtor's business, because as one court explained, the Bankruptcy Code does not authorize the committee to operate the debtor's business. *See UNR Indus. Inc.*, 30 B.R. at 612. Committees appointed under [the Bankruptcy Code] may make recommendations concerning the debtor's business but a committee should not attempt to displace the persons who are legally responsible for management of the debtor's financial affairs . . . . [I]n making recommendations to management of the debtor corporations concerning operation, the committee does not assume management responsibility for the affairs of the debtor." *In re Structurlite Plastics Corp.*, 91 B.R. 813, 819 (Bankr. S.D. Ohio 1988) (quoting 5 *Collier on Bankruptcy* ¶ 1103.07 at 1103-21 (15th ed. 1988)).

However, if in the course of its investigation, an unsecured creditors' committee comes to believe that the debtor is incapable of properly managing its business during the course of the Chapter 11 case, the Bankruptcy Code contains a vehicle through which the committee can request the appointment of a trustee or examiner to assume or examine the operations of the business. 11 U.S.C. §§ 1104 (2008), 1103(c)(4). Courts have consistently denied unsecured creditors' committees' requests to be involved in the daily operation of a debtor's business, routinely relying on the committee's ability to request the appointment of a trustee or examiner if it believes the debtor's continued management of the business is not in the best interest of the creditors. *See e.g. UNR Indus., Inc.*, 30 B.R. at 612. Although appointment of a trustee is reserved for situations in which, among other things, there is fraud, dishonesty, incompetence, or gross mismanagement of the debtor's affairs by current management, 11 U.S.C. § 1104(a)(1), it is the principal remedy available to unsecured creditors' committees if their investigation of the debtor's business operation reveals that the debtor's continued management of the company is not in the best interests of the unsecured creditor class.

Negotiation

Perhaps the most important role of an unsecured creditors' committee is its role in negotiating with the debtor on behalf of the unsecured creditor class in the creation of a reorganization plan. *See, e.g.*, *In re Marin Motor Oil Inc.*, 689 F.2d 445, 455-56 (3d Cir. 1982) (quoting H.R. Rep. No. 95-595, 401, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6357); *In re Refco Inc.*, 336 B.R. at 195. The House Report issued in connection with the House version of the Bankruptcy Reform Act of 1978 declared that creditors' committees would "be the primary negotiating bodies for the formulation of the plan of reorganization," and that they would "represent the various classes of creditors . . . from which they are selected." H.R. Rep. No. 95-595, 401, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6537. Courts have long observed that the primary function of unsecured creditors' committees is to negotiate a reorganization plan with the debtor that will serve the best interests of the class of unsecured creditors. *See, e.g.*, *Refco Inc.*, 336 B.R. at 195; *ABC Auto. Prods. Corp.*, 210 B.R. at 440-41. Unsecured creditors' committees ordinarily do not construct their own reorganization plans, although they have the power to do so, but more often negotiate with the debtor such that the

debtor is able to propose a plan that is acceptable to the committee and is fair to its constituents. Irving Sulmeyer & Israel Saperstein, Collier Handbook for Creditors' Committees 14-4 n. 44, 13-5 (Lawrence P. King ed., Matthew Bender & Company Inc. 1998). Having said that, in those cases where the debtor proposes a plan that is unacceptable to the committee, the committee, working in conjunction with its counsel, may be able to propose a competing plan.

An unsecured creditors' committee is more than an objective third party helping the debtor negotiate with the members of the unsecured creditor class. Rather, as one court stated, the committee is "not merely a conduit through whom the debtor speaks to and negotiates with creditors generally," but rather "it must necessarily be adversarial in a sense . . . . The committee as the sum of its members is not intended to be merely an arbiter but a partisan . . . ." *Daig Corp.*, 17 B.R. at 43. In negotiation with the debtor about a reorganization plan, an unsecured creditors' committee is not only a negotiating partner with the debtor, but also the debtor's opposition. Sulmeyer & Saperstein, *supra*, at 14-4.

As a corollary to an unsecured creditors' committee's role as an adversarial negotiator between the debtor and the class of unsecured creditors in formulating a reorganization plan, the committee also must advise the unsecured creditor class about the results of its negotiation with the debtor and its determinations regarding the plan that is eventually formulated. *Id.* at 13-6. An unsecured creditors' committee's recommendation regarding a debtor's proposed reorganization plan can be extremely impactful on whether the proposed plan is eventually accepted or rejected by the unsecured creditors. *Id.* at 14-4. However, although the determinations of the unsecured creditors' committee about the proposed reorganization plan are extremely powerful, committees are not vested with the power to bind their constituent creditors, and the individual unsecured creditors themselves must eventually cast a vote accepting or rejecting the plan. *See In re Donlevy's Inc.*, 111 B.R. 1, 2 (Bankr. D. Mass. 1990). To this end, each unsecured creditor entitled to vote on the plan must take care to carefully review the plan of reorganization and accompanying disclosure statement as it determines whether to cast its ballot for or against the plan.

Eligibility to Serve

There are only a few requirements for membership on the unsecured creditors' committee. Essentially, a member must be a "person" as defined by the Bankruptcy Code, be willing to serve, and have an unsecured claim. 11 U.S.C. § 1102(b)(1). Generally, a court will restrict membership to the top seven unsecured claims holders, but it is not unusual for a court to approve of a higher or lower number. *See id.* ("A committee of creditors . . . shall *ordinarily* consist of the persons, willing to serve that hold the seven largest claims against the debtor") (emphasis added); *see also, e.g.*, *In re Enron Corp.* 279 B.R. 671, 677 (Bankr. S.D.N.Y. 2002) (approving of thirteen-member committee). A common problem is that a creditor will qualify to serve on the committee but may be prevented from serving due to a conflict of interest. For example, a competitor engaged in the same business as the debtor may be eligible to serve on the committee, but could potentially obtain sensitive information about the debtor. *In re Plant Specialties Inc.*, 59 B.R. 1, 1 (Bankr. W.D. La. 1986) (holding that competitor is not per se ineligible from serving on creditor committee); *In re Wilson Foods Corp.*, 31 B.R. 272, 272 (Bankr. W.D. Okla. 1983) (holding competitor unable to serve on creditors' committee because of confidentiality concerns). While this chapter does not specifically address the complexities of conflict of interest, it will discuss where such an issue is likely to be raised.

The Counterintuitive Definition of a "Person:" Individuals, Partnerships, Corporations, and Certain Governmental Units

Often, legal terms do not have the same meaning as the corresponding term in the vernacular; lawyers call this legalese—jargon. The definition of a "person" under the Bankruptcy Code is one such example. According to the definition section, a "person" includes an individual, partnership, corporation, or certain branches of the government. 11 U.S.C. § 101(41) (2007). The government agencies that are able to appoint a representative to serve on a creditors' committee are the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Company (RTC), and the Pension Benefit Guarantee Corporation (as well as individual states' equivalent). 7 Collier on Bankruptcy ¶ 1102.02[2][a][viii] (Matthew Bender 15th Ed. Revised) (2008). A layperson would not generally consider the

government a "person." Additionally, it is not intuitive that some agencies of the government are considered a person, while others are not. Thus, the following discussion requires stepping out of the normal English language and wading through the foreign language of the Bankruptcy Code. As discussed below, determining eligibility requires cross-referencing several provisions within the definition section of the Bankruptcy Code. 11 U.S.C. § 101. The following sections will address whether certain private entities qualify as an "individual, partnership, and corporation" and thus are eligible to serve on the creditors' committee.

Probate Estate: Not Eligible to Serve

A probate estate is not a "person" within the definition of the Bankruptcy Code and by extension, the executor or administrator of the estate could not serve on the creditors' committee. The term person has been determined in two different contexts—with regard to creditors' committee and with regard to debtors (i.e., those who can file for bankruptcy). 11 U.S.C. §§ 101(41) and (13). Though outside the scope of this chapter, in order to file for bankruptcy, a debtor must fit within the definition of a person or a "municipality." 11 U.S.C. § 101(13). Courts have only interpreted the definition of person in the context of debtors, but these decisions provide strong guidance on how a future court should construe the term in the context of a creditors' committee. *See, e.g.*, *In re Goerg*, 844 F.2d 1562, 1566 (11th Cir. 1988) *cert. denied*, 488 U.S. 1034 (1989); *In re Walters*, 113 B.R. 602, 604 (Bankr. D.S.D. 1990).

A common situation is that a person dies with a financially insolvent estate and then the executor of the estate attempts to gain access to the bankruptcy courts. This situation occurred in *In re Georg*, but the court foreclosed access to the bankruptcy courts because the probate system has "comprehensive and specialized machinery for the administration of such estates." *Goerg*, 844 F.2d at 1566. Thus, it appears that courts are hesitant to mix and match jurisdiction of the probate courts with jurisdiction of the bankruptcy courts. The *Georg* court noted that, "the legislative history expressly states that 'the definition [of person] does not include an estate or a trust.'" *Id.* Even though a court has not specifically addressed whether a probate estate can serve on a creditors' committee, it is unlikely that a court would adopt a separate definition of a person.

Unions: Eligible to Serve

As previously discussed, the Bankruptcy Code requires an unsecured creditor to be a person, which is defined in part as "individual, partnership, and corporation." 11 U.S.C. § 101(41). Courts have further construed the term "corporation" to include labor unions, which enables them to sit on creditors' committees. *In re Plabell Rubber Prods.*, 140 B.R. 179 (Bankr. N.D. Ohio 1992); *In re Enduro Stainless Inc.*, 59 B.R. 603 (Bankr. N.D. Ohio 1986). In one reported case, a labor union requested the court for permission to serve on the unsecured creditors' committee because its members had contributed wages to a collectively bargained pension plan. *In re Schatz Federal Bearings Co.*, 5 B.R. 543, 547 (Bankr. S.D.N.Y. 1980). The court concluded that labor unions operate under the terms of national and local charters and are unincorporated associations eligible to serve on the unsecured creditors' committee. *See id.* at 546; *see also In re Altair Airlines*, 727 F.2d 88, 90 (3d Cir. 1984). Even though the Bankruptcy Code has undergone some amendments since that time, a labor union is eligible under the definition section. 11 U.S.C. § 101(9)(A)(iv) ("The term corporation includes [an] unincorporated company or association").

Trusts: Business Trusts Are Eligible But Non-Business Trusts Are Not

In short, a non-business trust is not considered a person and therefore, it cannot serve on the creditors' committee. *In re Hunt*, 160 B.R. 131 (B.A.P. 9th Cir. 1994); *In re Betty L. Hays Trust*, 65 B.R. 665 (Bankr. D. Neb. 1986). Like probate estates, whether a trust is considered a person has been determined in the context of whether a debtor can file for bankruptcy. The authority on this issue is directly applicable to whether a trust can serve on a creditor's committee.

A business trust, on the other hand, falls within the definition of a corporation, 11 U.S.C. § 101(9)(A)(v), and thus it is a person for the purposes of the Bankruptcy Code. The distinction between a non-business trust and a business trust was a key issue in *In re Treasure Island Land Trust*, 2 B.R. 332 (Bankr. M.D. Fla. 1980). There, a debtor land trust filed for bankruptcy on the grounds that it was a business trust. *Id.* at 334. The court rejected that argument because the trust instrument prohibited the trustee from conducting business and the debtor could not point to any evidence

that the trust had in fact transacted business. *Id.* at 334-35. Thus, the distinction between business and non-business trust depends on both the nature of the trust instrument as well as the trustee's actual management. *Id.*

Willingness to Serve and Holding an Unsecured Claim

Creditors frequently view service on a committee as an unwanted burden and fail to recognize the opportunities committee membership presents. Peter C. Blain, *Creditors' Committees under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers and Duties*, 73 MARQ. L. REV. 581, 618 (1990). The benefits of serving on the creditors' committee are multifold, including maintaining the debtor as a valued customer, influencing the reorganization plan, creating new business contacts through serving on the committee, and educating members about risk exposure. *Id.* Most issues regarding willingness to serve are resolved informally when United States Trustee is selecting a committee. Few, if any, cases have disqualified members based on their willingness to serve. At the very least, an unsecured creditor may appoint a lawyer or third-party representative to avoid being derelict in its duties. *See In re A.H. Robins Co.*, 65 B.R. 160 (E.D. Va. 1986), *aff'd* 825 F.2d 794 (4th Cir. 1987); *see also In re First Republicbank Corp.*, 95 B.R. 58, 60 (Bankr. N.D. Tex. 1988).

The final criterion for serving on an unsecured creditors' committee is holding an unsecured claim. § 1102(a)(1). As discussed below, many legal issues have surfaced about what constitutes holding a legal claim. The overarching theme is that the courts tend to be inclusive as long as it is a claim within the context of the Bankruptcy Code.

Undersecured Creditors – A Mix between Secured and Unsecured

Creditors do not always fall neatly into the category of either secured creditor or unsecured creditor. Oftentimes, creditors possess a partially or undersecured loan, i.e., whether the value of the collateral is insufficient to cover the indebtedness. In these cases, the question arises as to whether a creditor is eligible to serve on the unsecured creditors' committee. The answer will depend on a number of factors. The most important factor in determining the ability to serve is the proportion of the unsecured debt to the secured debt. Although there is no "magic" dividing line, the higher the

unsecured debt relative to the secured debt, the more likely a court will permit an undersecured creditor to serve on the committee.

Several bankruptcy courts have addressed this issue and have uniformly found that nothing in the Bankruptcy Code precludes a creditor who holds both secured and unsecured claims from serving on the Committee. *See, e.g.*, *In re Seascape Cruises Ltd.*, 131 B.R. 241, 243 (Bankr. S.D. Fla. 1991); *In re Walat Farms Inc.*, 64 Bankr. 65, 68-69 (Bankr. E.D. Mich. 1986). A good illustration of this principle is in the bankruptcy of *Seascape Cruises Ltd.* Several creditors appointed to the unsecured creditors' committee possessed maritime liens on Seascape's vessels that covered only some of the debt. *Seascape Cruises Ltd.* 131 B.R. at 241-43. The Court did not disqualify the members who possessed partial security from serving on the committee. *Id.* at 243.

Possessing both secured and unsecured debtor could raise a potential conflict of interest, however. *In re Glendale Woods Apts. Ltd.*, 25 B.R. 414 (Bankr. D. Md. 1982). Creditors' committees have members with a variety of viewpoints: some members may favor liquidation, others may favor continuation of the business. *In re Hills Stores Co.*, 137 B.R. 4, 6 (Bankr. S.D.N.Y. 1992). The danger with undersecured creditors is that they might favor a position that is beneficial to the secured creditors and detrimental to unsecured creditors. *Glendale Woods Apts.*, 25 B.R. at 415 (noting in the dicta "even if Associates is not fully secured, its interests may be in conflict with other members of the Creditors' Committee"). This danger, nevertheless, "is tempered . . . by the fundamental notion that a committee represents all unsecured creditors whether or not a member of a particular group is included in its membership." *In re McLean Indus. Inc.*, 70 B.R. 852, 862 (Bankr. S.D.N.Y. 1987). Thus, undersecured creditors are able to serve on creditors' committees, but they should be wary about potential conflicts of interest. The risk of conflict of interest increases if the unsecured debt is relatively small compared to the secured debt.

Holders of Disputed Claims and Purchasers of Claims

Ongoing litigation between an unsecured creditor and a debtor will not preclude that creditor from serving on the committee. *See In re Grynberg*, 10 B.R. 256 (Bankr. D. Colo. 1981); *see also* Irving Sulmeyer, Israel Saperstein

& Lawrence P. King, *Collier Handbook for Creditor's Committees* 3-17 to 3-20 (1998). Additionally, the purchaser of a claim, such as a company that buys a claimant's unsecured debt, may serve on the creditor's committee. *In re Beugan*, 99 B.R. 961 (B.A.P. 9th Cir. 1989). Taken together, these principles indicate that the courts do not require that disputes be settled or that creditors halt the transaction of unsecured debt in order to be eligible for service on a committee.

In re Grynberg was one of the first cases to address whether creditors with disputed claims could serve on a creditors' committee. In that case, the United States Trustee had omitted creditors from membership on the committee because they held disputed claims. According to the court, the trustee had acted erroneously because the holding of a "claim," broadly encompassed the "[r]ight to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, *disputed,* undisputed, legal, secured, or unsecured." *Grynberg*, 10 B.R. at 257 (referring to 11 U.S.C. § 101(5)(A) (formerly codified as 11 U.S.C. § 101(4)(A)) (emphasis in the original). Therefore, a creditor engaged in litigation with the debtor may still serve on the creditor's committee. As a further point, it makes no difference who has initiated the dispute, whether it is the creditor or debtor. For example, even if the debtor has alleged fraud against the creditor, that creditor may still be eligible to serve in the reorganization. *In re Bennett*, 17 B.R. 819 (Bankr. D.N.M. 1982).

If a person were barred from serving on a creditors' committee because of a disputed claim, then the debtor could exploit this rule and file frivolous lawsuits against unfavorable creditors to prevent them from participating in the reorganization. The same policy concern underlies the eligibility of purchasers of claims, but the courts have not prohibited claims purchasers from serving on the committee. Sulmeyer, Saperstein & King, *supra*, at 3-12. Even though it is possible that a person could purchase enough claims to become a member on the creditors' committee, the United States Trustee has the ability not to appoint that creditor if they perceive foul play. *Id.*; 11 U.S.C. § 1102(a)(1). Additionally, the committee could establish bylaws to freeze the transfer of unsecured debt. Sulmeyer, Saperstein & King, *supra* note 38, at 3-12.

Equity Partners and General Partners

The courts have excluded equity partners and general partners from unsecured creditors' committees because they are not holders of a "claim." *See In re AVN Corp.*, 235 B.R. 417, 422 (Bankr. W.D. Tenn. 1999); *see also In re Charter Co.*, 44 B.R. 256, 258 (Bankr. M.D. Fla. 1984). Equity partners can request the United States Trustee or Court to appoint a separate committee, but general partners have no such recourse. 11 U.S.C. § 1102(a)(1)-(2); *In re Finley*, 85 B.R. 13 (Bankr. S.D.N.Y. 1988).

Bankruptcy courts have uniformly held that a preferred shareholder or an equity security holder "fails to possess that which symbolizes creditor status, i.e., a claim against the estate." *AVN Corp.*, 235 B.R. at 422; *see Charter Co.*, 44 B.R. at 258. Certainly, equity partners have an *interest* in the outcome of the Chapter 11 reorganization, but this interest does not amount to an unsecured claim that enables them to sit on the creditors' committee. *See* § 501(a). The reasoning behind this principle is that the language of the Bankruptcy Code draws a distinction between unsecured creditors and equity partners. *Charter Co.*, 44 B.R. at 257 ("a reading of [§ 1102], along with other sections . . . , convinces [this] Court that the Code views creditors and equity holders as entirely different categories of entities"). Based on this authority, general partners with even less of an interest at stake have not attempted to claim that they deserve membership on the unsecured creditors' committee.

Equity partners, however, are not left without the option of organizing a committee to represent their collective interests. The Bankruptcy Code allows the United States Trustee discretion to appoint an additional committee of equity security holders. 11 U.S.C. § 1102(a)(1). Additionally, equity security holders can request a separate committee upon a showing that it is necessary to ensure adequate representation. 11 U.S.C. § 1102(a)(2). In practice, communication and cooperation with the United States Trustee helps to achieve the appointment of an additional committee and saves the expense of having to petition a court. General partners are not considered "equity security holders," and thus are at a greater disadvantage because the court or United States Trustee cannot appoint an additional committee. *Finley*, 85 B.R. at 18. It is possible, however, for general partners to establish an informal committee to pool their resources,

but this committee will not necessarily have the privileges of a formally recognized committee under the Bankruptcy Code. *See Id.*

Diversity of Interests — Creditors Opposed to Reorganization, Insiders, and Competitors Are Eligible to Serve

As a general policy, parties with an adverse relationship to the debtor are not excluded from serving on unsecured creditors' committee. Creditors opposed to reorganization, insiders, and competitors all have interests that are potentially divergent from those of debtor company, yet an adverse interest alone is not sufficient make those members ineligible. *See, e.g.*, *In re M.H. Corp.*, 30 B.R. 266 (Bankr. S.D. Ohio 1983) (involving creditors opposed to reorganization); *In re Vt. Real Estate Inv. Trust*, 20 B.R. 33 (Bankr. D. Vt. 1982) (involving insiders); *In re Plant Specialties Inc.*, 59 B.R. 1 (Bankr. W.D. La 1986) (involving competitors). The Bankruptcy Code does place any requirements on the nature of the unsecured interest, but a court can provide relief if the committee does not "assure adequate representation." 11 U.S.C. § 1102(a)(2). Raising concerns about a conflict of interest or confidentiality is the debtor's best method for challenging certain members of the unsecured creditors' committee with an adverse interest. *See, e.g.*, *In re Wilson Foods Corp.*, 31 B.R. 272 (Bankr. W.D. Okla. 1983); *In re MAP Int'l Inc.* 105 B.R. 5 (Bankr. E.D. Pa. 1989).

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