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Problems in the Code

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Official Equity Committees in Chapter 11 Cases

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Official equity committees are a rarity in chapter 11 cases and certainly are not necessary in most nonpublic medium and smaller-size chapter 11 cases where the company's managers are the predominant equityholders. As the predominant equityholders, these managers often hire counsel separate from debtor's counsel to represent their interests as distinct from those of the corporate entity.

However, in large public company cases, the circumstances are vastly different for several reasons. First, a shareholder who owns a small percentage of stock in a large publicly held company can hardly afford to retain counsel who can competently contest a plan that proposes to eliminate all the old equity. Moreover, if one shareholder or even an *ad hoc* group of shareholders did this and succeeded, they would be benefiting other shareholders who will not be required to pay their fair share of the costs. In this circumstance, most public shareholders will simply acquiesce to the proceedings and write off their investments.

Second, the reorganization plans in these large public company cases often provide broad general releases to officers and directors of both direct and derivative claims, with these same officers and directors at the helm of the plan-negotiation process, preventing the shareholders from even voting on the plan. This should give rise to serious concerns regarding the conflict of interest for the officers and directors, since it is *per se* self-dealing, especially when equity interests are being terminated or impaired. A small shareholder or a small group of shareholders simply cannot afford to fight against these potentially improper third-party releases.

In the spirit of flexibility, and to keep within the concept of having a single reorganization chapter, the Bankruptcy Code deals with the issue of equity committees in 11 U.S.C. § 1102(a)(1) by stating that the U.S. Trustee "*may*" appoint a committee of equity security-holders, as opposed to requiring the appointment of an unsecured creditors' committee, whenever possible. Under subsection (a)(2), if the U.S. Trustee refuses to appoint an equity committee, a party-in-interest can request the court to order the U.S. Trustee to appoint an equity committee. The standard set out in the statute for such an appointment is that such appointment must be "*necessary to assure adequate representation ... of equity security holders*."

The overarching problem is that if the court appoints an official equity committee, the bankruptcy estate must pay for its professional fees and expenses, thereby removing this burden from the individual shareholders. It appears that many courts do not want debtors to have to bear the expense of an additional committee or the potential additional litigation. Therefore, over the years, courts have imputed a series of "factors" to determine whether equity is "*adequately represented*." Some of these factors include the following: (1) whether the debtor is hopelessly insolvent; (2) whether equityholders are adequately represented by stakeholders already at the table; (3) the likely cost of an equity committee; (4) whether the shares are widely held and actively traded; and (5) whether it is practical to appoint an equity committee, among others.[1]

These factors, which go far beyond the statutory standard, appear to be practical in nature. Stated another way, if the debtor is hopelessly insolvent, why burden the estate with another layer of administrative cost? Or perhaps one can avoid this additional cost because the interests of the equityholders are already represented by bondholder groups that also own equity? These rationales place public shareholders in an absurd box.

1 *In re Pilgrim's Pride Corp.*, 407 B.R. 211, 216 (Bankr. N.D. Tex. 2009).

In its ruling in the *Equity XXI* case appointing the official equity committee, the court commented that the unsecured creditors' committee's valuation certainly would not benefit the shareholders, as the incentive of that class is to provide a value $1 less than solvency so that the unsecured creditors can own the entire company and wipe out equity.[2] Moreover, none of these factors have anything to do with either the granting of improper third-party releases or discrimination among existing management who are promoting a plan releasing themselves. These plans generally also provide that members of management who own old equity will receive equity in the reorganized debtor under a management-incentive plan while wiping out all the other old equityholders.

In the face of experts hired by the debtor to show hopeless insolvency, and by creditors to show value sufficient to only pay their claims, how is an individual public shareholder by himself/herself or in a small *ad hoc* committee going to bear the cost burden to retain experts and lawyers to rebut the claim of hopeless insolvency of a large publicly held company? The cost of the debtor's appraisal could be in the millions of dollars, with the debtor spending additional millions in legal fees. In a case where the debtor argues that there is no equity and therefore should be terminated, the equity interests are at this stage the most vulnerable.

Any delay in the confirmation process, or letting the debtor strike out three times, further prejudices equity by increasing the litigation costs with the risk that equity could still be zeroed out. This is especially so when the debtor files the plan based on a restructuring-support agreement without first consulting with all stakeholders and files a pre-packaged plan with onerous terms, knowing that it will lead to a confirmation battle if the other stakeholders organize to fight for their interests.

The equity interests are often compromised in the prebankruptcy negotiations between the debtor and secured creditors, where the debtor crafts the position that the equity is worthless only weeks before the bankruptcy filing. In several cases, equity has argued that the pre-petition investor presentations and the Securities and Exchange Commission reports conflict with the debtor's position in the bankruptcy that it is hopelessly insolvent.[3] The resulting conflicts lead to shareholder anger, distrust and lack of confidence in public markets and, if disregarded by stakeholders and the courts, a deeper mistrust in the financial markets and justice system.

Further complicating the problem is the retention by the company of experts who are paid huge "completion fees," which are tantamount to success fees. These fees are only paid if the experts come up with valuations low enough to wipe out equity and most of the unsecured debt.[4]

An uncompensated *ad hoc* equity committee simply cannot compete with the compensation structures approved for the financial advisors and lawyers in these big cases, unless it is formed by institutional investors with deep pockets. A trend has been developing with retail investors getting organized to try to have official equity committees appointed. One of the first large "activist" movements by retail investors seeking an official equity committee was in *Horsehead*,[5] where the committee's fees were capped, but the cap was exceeded after confirmation. Ultimately, it was found that the official equity committee made a substantial contribution to the case, but was unable to prove a valuation sufficient to recover anything for equity.

In *Energy XXI*, the official equity committee also argued that the pre-petition restructuring support agreement and plan violated the company's bylaws by stipulating to a termination of equity without a vote of the shareholders. In other words, the very negotiations involved in the plan were the result of management breaching its fiduciary duty to the shareholders by taking an action that arguably would not be allowed under applicable corporate law.[6]

In some recent cases where the debtors seem to be more sensitive to bankruptcy litigation costs, the restructuring support agreements are providing a small percentage of new equity to original shareholders while terminating the original equity.[7] In these large cases, there can be tens of millions spent on litigation that could be avoided with better prebankruptcy planning, especially if the intent is to try to limit unnecessary litigation expenses and exit bankruptcy quickly. The cost savings can be better dedicated to provide a "tip" to equity or compensation for the actual value of their equity interests at the time of filing for bankruptcy.

The multi-factor tests utilized by the courts have strayed far from the statutory standard, as well as the legislative intent behind the standards. A plan that calls for the elimination of all public equity without the opportunity for public equity to be represented is simply a "taking of property" without any real due process. The risk to equityholders has been further exacerbated by the increased control of secured creditors in the plan process, where the plan is often just a thinly disguised effort to foreclose on the assets.

In these large bankruptcies, all the shareholders may receive is an overly complicated notice hidden inside of hundreds of pages of a disclosure statement and plan that many lawyers — much less lay shareholders — could not come close to understanding. These highly complicated documents, in addition to eliminating equity, might also provide releases of both direct and derivative claims that shareholders might have against officers and directors that are covered by director and officer liability insurance. It would be virtually impossible for any single shareholder to ferret out what claims might exist and precisely what is being released, given that most of the records of a public company are not publicly available, and the disclosure of pertinent information for shareholders to assess any such claims is complicated by Regulation FD. None of the factors mentioned by the courts consider any of these issues. These concerns for equityholders were directly addressed in the legislative history behind the Bankruptcy Reform Act of 1978, where it was stated:

2 *Energy XXI Ltd., et al.*, Case No. 16-31928 (S.D. Tex.), Transcript of Hearing held on June 15, 2016, Doc. No. 532.
3 *See, e.g., id.*
4 *Id.*
5 *Horsehead Holding Corp.*, No. 16-10287 (Bankr. D. Del. 2016).
6 *See* n.2.
7 *See, e.g., Key Energy Servs. LLC*, No. 16-12307 (Bankr. D. Del. 2016); *In re Stone Energy Corp.*, No. 16-36390 (Bankr. S.D. Tex. 2016).

> Reorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the values of the estate should be apportioned among creditors and stockholders. *In a large public company, whose interest[s] are diverse and complex, the most vulnerable today are public investors who own subordinated debt or equity securities. The bill, like chapter X, is designed to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors.*
>
> The Committee believes that it should be emphasized that investor protection is most critical when the company in which the public invested is in financial difficulties and is forced to seek relief under the bankruptcy laws.... *As public investors are likely to be junior or subordinated creditors or stockholders, it is essential for them to have legislative assurance that their interests will be protected. Such assurance should not be left to a plan negotiated by a debtor in distress and senior or institutional creditors who will have their own best interest[s] to look after.*[8]

Finally, absent some form of protection for the public investor in the bankruptcy process, faith in the public-capital markets could be undermined. Why should a small public investor risk invested money if the interest can easily be eliminated in a bankruptcy case without the benefit of joint representation by an independent committee funded by the estate? The answer is simple: Retail investors might not want to risk their life savings, while large banks and investors can take their investments away without any form of due process or adequate representation. Thus, a major source of capital could be removed from the markets.

The Solution

The solution is a simple one: The Bankruptcy Code should be amended to require the appointment of an equity committee by the U.S. Trustee in every bankruptcy involving publicly traded companies where equityholders are willing to serve. The equity committee should be funded by the bankruptcy estate as a cost of doing business. Currently, the courts are reluctant to grant establishment of equity committees because they do not want the creditors of an insolvent estate to effectively subsidize the representation of equity. However, this requires the court to make a solvency determination at the beginning of the case without any evidence, or with it being difficult to provide unbiased valuations considering the interests of the equityholders.

If the Bankruptcy Code is amended to require the appointment of equity committees, creditors will simply have to take this into account in making their credit decisions. Of course, the bankruptcy court will still have the power to control fees if the equity committee is duplicating the fees and expenses incurred by other estate professionals. Another suggestion is that the U.S. Trustee should also appoint an examiner in each public company case for the purposes of presenting an independent valuation and monitoring the attorneys' fees of all estate professionals.

Finally, any plan that contemplates the termination of equity in a public company should allow for the following: (1) an auction procedure to prevent secured creditors from taking the equity at a bargain price or bargain valuation; and (2) the preservation of both direct and derivative claims for the benefit of creditors and equityholders. This is especially a risk in cases that are driven by commodities that are known to be cyclical, such as oil and gas. Debtors should give to others the ability to bid for the reorganized debtor's equity or propose their own competing reorganization plan. **abi**

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8 Sen. Rep. 95-989 at p. 10 (emphasis supplied).