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No More *Ad Lib*: The Nuts & Bolts of *Ad Hoc* Bankruptcy Committees

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The Bankruptcy Code is purposefully designed to foster the development of consensual Chapter 11 plans of reorganization. Indeed, one of the principal statutory tasks of an official creditors' committee is to directly participate in crafting the debtor's plan. Recently, unofficial, or ad hoc, committees have also started to play a prominent role in Chapter 11 bankruptcy cases. Unlike their official committee counterparts, however, ad hoc committees are comparatively unregulated. This lack of a comprehensive regulatory framework has led to considerable uncertainty – and spirited debate – regarding the purpose, structure, rights, duties, and influence of ad hoc committees.

In recent years, however, the role of ad hoc committees has been significantly clarified. Several decisions and rule changes have helped to fill the regulatory gap created by the limited guidance under the Bankruptcy Code and Bankruptcy Rules regarding ad hoc committees, leading to the emergence of a basic legal framework governing unofficial committees.

This article surveys the basic nuts and bolts of ad hoc committees. First, it describes the characteristics of ad hoc committees, including their nature, creation, advantages, and potential costs. Second, it examines recent legal developments that have tentatively resolved some of the most-contested questions involving ad hoc committees, including their disclosure obligations, fiduciary duties (or lack thereof), right to claim the attorney-client privilege, and entitlement to fees and expenses.

With the emergence of a basic legal framework governing ad hoc committees, bankruptcy practitioners can now more confidently advise their clients on the power and obligations of ad hoc committees. Their advice need no longer be ad lib.

What Are Ad Hoc Committees?

The term "ad hoc committee" refers to any group of stakeholders who wish to collaborate in the pursuit of similar claims or interests. Bondholders, equity security interests (e.g., shareholders), unions, lessors, tort claimants, secured loan syndicates, other groups of investors or financial institutions (including hedge funds), and virtually any other stakeholders may choose to form an ad hoc committee to pursue their collective interests. Committees formed on an ad hoc basis are, as the name suggests, free from many of the constraints governing official committees. As a result, an ad hoc committee is able to organize itself in almost any way it sees fit, and may be as fluid or as organized as their members and interests require. While official committees are frequently administered in a formal, corporate style – adopting bylaws, subcommittees, chairpersons, and regular meetings – ad hoc committees are typically more informally managed.

How Are Ad Hoc Committees Created?

While official unsecured creditor committees are appointed by the U.S. Trustee, ad hoc committees are created through unofficial channels – namely the voluntary collaboration of like-minded stakeholders. The formation of an ad hoc committee is sometimes actively encouraged by the debtor, especially in connection with out of court restructurings. The debtor may informally approach several important stakeholders pre-petition and encourage them to form a voluntary creditors' committee in an attempt to quickly facilitate settlement.

More frequently, however, ad hoc committees are formed by the independent, collective action of stakeholders, with or without the support of the debtor, who come together for the purpose of better pursuing their particular interests. An ad hoc committee may last for the duration of the case,

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or may persist only temporarily, disbanding upon achieving its limited purpose (e.g., settlement or plan support agreement).

Notably, an ad hoc committee formed pre-petition may be converted to an official unsecured creditors' committee post-petition by the U.S. Trustee if the committee members fairly represent a reasonable cross-section of unsecured creditor claims against the debtor. *See* Bankruptcy Rule 2007. An ad hoc committee formed post-petition can also timely request the court to be recognized as an additional official committee. *See* Bankruptcy Code § 1102(a)(2). The standard for appointing additional official committees, however, is sufficiently high that such motions are infrequently granted.

Why Form an Ad Hoc Committee?

Ad hoc committees present several advantages. An ad hoc committee provides a unified, more powerful voice for the particular stakeholders it represents. Although the influence of any ad hoc committee depends upon the voting power of the committee members and their relative importance to the reorganization effort, organizing a committee to represent and advocate for a specific stakeholder interest can maximize the influence of that interest. In addition, ad hoc committees, free of some of the fiduciary shackles binding official committees, may zealously and aggressively advocate on behalf of their members despite potential conflicts with the interests of unsecured creditors as a whole.

Ad hoc committee members also possess significantly more latitude than their official committee counterparts in directly reaching and communicating with debtors. Moreover, ad hoc committee members, unlike their official counterparts, can continue to trade in the debtors' securities while serving on the ad hoc committee, as long as they agree not to obtain or use material, non-public information. Moreover, teaming up in a single committee potentially saves costs as stakeholders can share legal, accounting, and other expenses typically incurred in the bankruptcy process, a savings that can be substantial.

On the other hand, ad hoc committees also have some limitations. While ad hoc committees have more freedom to maneuver than official committees, they also have less power. Indeed, with the appointment of a statutory unsecured creditors committee, the influence of the ad hoc committee may diminish considerably. Notably, ad hoc committees lack the formal statutory powers bestowed by Section 1103 of the Bankruptcy Code, such as the right to investigate the financial condition of the debtor or the right to consult with the trustee concerning the administration of the estate.

In addition, ad hoc committees may suffer the instability that comes with frequent membership changes and differing levels of commitment (and possible conflicts) among committee members. Finally, unlike the fees and expenses incurred by the official committee, the recovery of ad hoc committee fees and expenses may prove to be an uphill battle, as described in further detail below.

Disclosure Obligations

Ad hoc committee members have significant disclosure obligations under Bankruptcy Rule 2019, as was amended on December 1, 2011. The amended rule now requires that any group that consists of, or any entity that represents (e.g., an attorney) more than one creditor or equity security holder in connection with a bankruptcy case, must file a verified statement identifying each client and the nature of its claims or interests, together with certain facts about the attorney's employment. The rule does not apply, however, to an official statutory committee appointed by the U.S. Trustee.

Such disclosures must include: (1) the name and address of the creditor or equity security holder; (2) the nature, amount, and acquisition date of all recently-acquired claims and interests; (3) details relating to the organization of the committee and those responsible for its creation; and (4) the amount of claims or interests owned by the members of the committee.

The 2011 amendments to Rule 2019 significantly expanded the scope of its coverage and the content of its disclosure requirements. The amendments specify that the financial interests of committee members must be disclosed on a member-by-member basis, *not* simply in the aggregate. Moreover, ad hoc committees must disclose the quarter and year of every "disclosable economic interest" acquired by each member within a year prior to the filing of the bankruptcy petition. These disclosure duties are continuing in nature, i.e., subject to supplementation upon the material change of any fact previously disclosed before the committee takes a position in court or solicits votes on the confirmation of a plan.

Crucially, these disclosure obligations have teeth. Among other penalties, a court may refuse to hear the committee, invalidate any authority, acceptance, rejection, or objection given by the committee, or grant other appropriate relief. For example, the court could order the rehearing of motions, resolicitation of votes, correction of improper disclosures, or award attorneys' fees and costs to any parties damaged by delays due to the ad hoc committee's failure to comply with its disclosure obligations.

Fiduciary Duties of Committee Members

It is generally accepted that an official unsecured creditors committee owes a fiduciary duty to its constituents, i.e., the class of unsecured creditors. In accordance with these fiduciary obligations, official committee members are required to place the collective interests of unsecured creditors above their own personal financial interests in the restructuring.

Ad hoc committee members, by contrast, do not possess fiduciary obligations to the class of unsecured creditors as a whole. Rather, ad hoc committee members are generally free to aggressively advocate for their own interests, whether or not they conflict with those of other similarly situated creditors.

This view that ad hoc committees lack fiduciary duties to other stakeholders has waned in recent years, however, with several recent decisions suggesting that ad hoc committee members have certain minimal fiduciary responsibilities. Consider, for ex-

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ample, *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007). Here, the court found that a group which filed an appearance as "the Ad Hoc Committee of Equity Security Holders" was subject to the (pre-2011 amended) disclosure requirements of Rule 2019(a), implying that the ad hoc committee might be representing a larger group than its formal members. "By appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings." In this regard, *Northwest Airlines* broached the possibility that ad hoc committees, by purporting to speak on behalf of a general stakeholder interest, have responsibilities beyond the narrow interests of their own members.

When the same ad hoc committee attempted to file its Rule 2019 disclosure under seal, the court denied the motion and noted that, "Rule 2019 protects other members of the [ad hoc] group – here, the shareholders – and informs them where [the ad hoc] committee is coming from…." The ad hoc committee's "negotiating decisions as a Committee *should be based on the interests of the entire shareholders' group,* not their individual financial advantage." (Emphasis added). The court's statement that the ad hoc committee must negotiate on behalf of the entire stakeholder group comes exceedingly close to the explicit recognition of fiduciary duties towards the class as a whole.

In the recent Washington Mutual Chapter 11 case, a group of noteholders calling itself the "WMI Noteholders Group" objected when a party sought the ad hoc group's Rule 2019 disclosures. *In re Washington Mutual, Inc.*, 419 B.R. 271, 273 (Bankr. D. Del. 2009). In requiring the ad hoc committee to provide the disclosures, the *Washington Mutual* court remarked that "[t]he WMI Noteholders Group's argument is premised on the erroneous assumption that the Group owes no fiduciary duties to other similarly situated creditors, either in or outside the Group. The case law, however, suggest that members of a class of creditors may owe fiduciary duties to other members of the class." The court added that it "is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class."

These recent decisions affirm that ad hoc committees must promote the interests of their stakeholder class as a whole, instead of exclusively privileging the interests of the members of the committee. Bankruptcy practitioners should be careful to thoroughly consider these recent decisions. This is especially important because there can be serious repercussions for an ad hoc committee's failure to abide by court-sanctioned fiduciary duties.

Attorney-Client Privilege

Courts have generally recognized an attorney-client privilege involving confidential legal communications between the ad hoc committee's lawyers and committee members. There has been some dispute, however, regarding whether the individual committee members or the committee as a whole qualifies as the client. If the client is deemed to be the committee as a whole, the application of the privilege is relatively straightforward, following attorney-client privilege principles applicable in the corporate context.

By contrast, complications may arise if the individual committee members, rather than the committee as a whole, are deemed to be the "clients." While the privilege should still apply under state "joint client doctrines," as long as the individual committee members can show that they intended to jointly consult one law firm intending to keep their communications confidential, it would not apply in subsequent litigation between two or more committee members. Many ad hoc committees will adopt written joint defense agreements to ensure that communications among committee members with counsel will not lose the protection of the attorney-client privilege.

Moreover, the attorney will need to be alert for possible conflicts of interest between two or more of the member-clients. Irreconcilable conflicts may force the ad hoc committee attorney to withdraw from representing one or more committee members. Such potential for conflicts of interest may be lessened, however, by recent case law recognizing that an ad hoc committee has a fiduciary duty to represent the interests of the particular stakeholder class as a whole, not the individual interests of any committee member.

Entitlement to Fees and Costs

Ad hoc committees may seek reimbursement for their time and effort through a request for payment of an administrative expense. Under the Bankruptcy Code, administrative expenses incurred by a debtor after the commencement of the bankruptcy case are entitled to special payment priority in order to encourage parties to continue to assist with the debtor's rehabilitation. Section 503 of the Bankruptcy Code contains a non-exclusive list of administrative expenses and Section 507 establishes the special payment priority for these charges. Section 503(b)(3)(D) provides that an ad hoc committee may seek reimbursement of fees and expenses if it made a "substantial contribution" to the case.

In determining whether an ad hoc committee made a "substantial contribution," courts will examine whether the committee contributed to the reorganization process, conferred a significant, direct benefit to the estate as a whole (not merely the individual committee members), and whether the committee's efforts were duplicative of services performed by others, including the official unsecured creditors committee. Providing an incidental benefit to the estate is not sufficient. Nor will the ad hoc committee's extensive participation in the case, without more, meet the standard. Demonstrating a "substantial benefit" is a high standard that ad hoc committees will only infrequently be able to meet.

Largely because of the difficulty of demonstrating a "substantial benefit" to creditors as a whole, ad hoc committees have attempted alternative methods of securing reimbursement of fees. Most commonly, ad hoc committees have attempted to bypass the "substantial contribution" standard by,

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usually with the debtor's assent in connection with a consensual plan of reorganization, embedding the repayment of fees into the plan itself.

Initially, courts approved of this strategy. For example, in *In re Adelphia Communs. Corp.*, 441 B. R. 6 (Bankr. S.D.N.Y. 2010), the court concluded that an ad hoc committee could properly recover fees without any showing that the committee substantially benefited all creditors where the payment provision was included in the plan, which itself is subject to creditor votes and the approval of the court. In reaching this conclusion, the *Adelphia* court noted that Section 503(b) "does not provide, in words or substance, that it is the *only* way by which fees of this character may be absorbed by an estate."

In addition, other provisions of the Bankruptcy Code appear to contemplate that some payments, which perhaps would technically not qualify as administrative expenses, might nonetheless be permissible. Section 1129(a)(4), for instance, allows payments in connection with the plan if the amount is disclosed and the court determines the payment is reasonable. Moreover, Section 1123(b)(6) provides that a plan may include "any other appropriate provision not inconsistent with the applicable provisions of this title."

The bankruptcy courts in the American Airlines and Lehman Brothers Chapter 11 cases followed this reasoning. In the Lehman Brothers case, for example, the bankruptcy court held that a reorganization plan providing for the reimbursement of fees expended by individual official committee members, although not technically covered by Section 503(b), was legitimate.

This ruling, however, was recently reversed by the District Court for the Southern District of New York, calling into question the continuing viability of recovering ad hoc committee fees without demonstrating a "substantial contribution" to creditors as a whole. The court criticized the *Adelphia* bankruptcy court's reasoning and concluded that the sole authority for the allowance and payment of administrative expenses was set forth in Section 503(b), which does not permit compensation to counsel for individual committee members except on a substantial contribution basis. *See In re Lehman Bros. Holdings, Inc.*, 508 B.R. 283 (S.D.N.Y. 2014). According to the *Lehman Bros.* court, reorganization plans exist to pay (1) pre-petition claims and (2) post-petition administrative expenses. Inasmuch as fees incurred *after* the petition date cannot, by definition, be treated as pre-petition "claims," it follows that they can only be administrative expenses, which can be reimbursed, if at all, only under Section 503(b).

In short, the Bankruptcy Code provides no basis for a third category of payments under a plan (even if voluntarily offered by the debtor) that do not otherwise qualify as "claims" or "administrative expenses." Using a plan provision to accomplish payment would "be based on wordplay alone." "A plan provision cannot short-circuit the process by deeming an entity to have made a substantial contribution." The court then remanded the matter to the bankruptcy court to determine whether the conventional substantial contribution standard under Section 503(b) might, under a more expanded record, be satisfied.

The *Lehman Bros.* decision jeopardizes the continuing viability of recovering ad hoc professional fees through a plan provision. Courts following *Lehman Bros.* are likely to query whether such provisions improperly circumvent the "substantial contribution" standard of Section 503(b). On the other hand, some courts may decline to follow the *Lehman Bros*. decision on the grounds that the admittedly non-exclusive listing of administrative expenses under Section 503(b) should be flexible enough to accommodate a debtor's voluntary recognition of an ad hoc committee's constructive participation in a case.

Nevertheless, professionals for an ad hoc committee should not readily expect to be able to circumvent Section 503(b)'s "substantial contribution" requirement by including a fee repayment provision in the plan itself, as such a strategy is now likely to be challenged.

Conclusion

Ad hoc committees are now a generally accepted feature of the Chapter 11 landscape. Moreover, a basic legal framework governing ad hoc committees has emerged in recent years, and previously debated questions such as an ad hoc committee's disclosure obligations, fiduciary duties and entitlement to fees have recently received at least tentative answers. As a result, the governance of ad hoc committees is no longer purely ad lib and bankruptcy practitioners can now more confidently advise their clients on the mechanics of ad hoc committees.

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