FIDUCIARY DUTIES OF MEMBERS OF CREDITORS' COMMITTEES

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Creditors' committees are appointed pursuant to section 1102(a)(1) of the Bankruptcy Code.[1] Section 1103(c) of the Bankruptcy Code is entitled "Powers and duties of Committees" and provides:

> (c) A committee appointed under section 1102 of this title ***may***--
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> (1) consult with the trustee or debtor-in-possession concerning the administration of the case;
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> (2) 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;
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> (3) participate in the formulation of a plan, advise those represented by the committee of such committee's determination as to any plan formulated, and collect and file with the Court acceptances or rejections of a plan;
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> (4) request the appointment of a trustee or examiner under section 1104 of Title 11; and
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> (5) perform such other services as are in the interest of those represented.

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[1] "Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate."

(emphasis added). Pertinently, section 1103(c) uses the permissive term "may" and not the obligatory term "shall." Section 1103(c) should be compared to section 704 of the Bankruptcy Code, which is entitled "Duties of trustee" and provides that "[t]he Trustee ***shall***-- . . ."

However, regardless of the use of the permissive "may" and not the obligatory "shall," courts have no hesitation in determining that committee members have affirmative fiduciary duties. *See, e.g., Westmoreland Human Opportunities, Inc. v. Walsh,* 246 F.3d 233, 256 (3d Cir. 2001) ("We have construed § 1103(c) as implying a fiduciary duty on the part of members of a creditor's committee . . . ").

A. The Fiduciary Duties Are Owed To The Class Of Creditors Represented By The Committee

Courts have generally held that committee members do not owe fiduciary duties to the estate, but instead owe their duties to the class of creditors for which the committee is appointed to represent.[2] The duty is owed to the class of creditors and not to the individual members of the

[2] *See, e.g., In re SPM Mfg. Corp.*, 984 F.2d 1305, 1315 (1st Cir. 1993) ("While a creditors' committee and its members must act in accordance with the provisions of the Bankruptcy Code and with proper regard for the bankruptcy court, the committee is a fiduciary for those whom it represents, not for the debtor or the estate generally."); *Official Committee of Asbestos Claimants of G-I Holding, Inc. v. Heyman*, 342 B.R. 416, 423 (S.D.N.Y 2006) ("[T]he Committee owes a duty only to its constituent creditors); *Official Committee Unsecured Creditors of Grand Eagle Companies, Inc. v. Asea Brown Boveri, Inc.*, 313 B.R. 219, 224 (N.D. Ohio 2004) ("A trustee acts for the benefit of the estate and owes a fiduciary duty to all creditors of the estate. [cite omitted]. In contrast, a committee of unsecured creditors is a fiduciary only to the creditors it represents and must act vigorously to pursue their interests. [cites omitted]. A creditors' committee need not consider the best interests of the estate.").

A possible exception to the general rule is *In re Iridium Operating LLC*, 478 F.3d 452 (2nd Cir. 2007). The court refused to approve a pre-confirmation settlement agreement between a secured creditor and creditors' committee that divided up certain assets in violation of the Bankruptcy Code distribution scheme. The court held that "[t]he Committee has a fiduciary duty to maximize their recovery of the Estate's assets. [cite omitted]. If in pursuit of that duty, it reaches a settlement that in some way impairs the rule of priorities, it must come before the bankruptcy court with specific and credible grounds to justify that deviation and the court must carefully articulate its reasons for approval of the agreement." *Id.* at 466.

class.[3] For instance, in *Matter of Levy*, 54 B.R. 805 (Bankr. S.D.N.Y. 1985), a creditor filed a proof of claim that if allowed would have been the largest unsecured claim in the case. The committee, through committee counsel, filed an objection to the claim. The creditor sought to disqualify committee counsel from prosecuting the objection on the theory that committee counsel owed a fiduciary duty to the creditor as a member of the class of unsecured creditors and had a duty to maximize the creditor's claim. The court rejected the argument, holding that counsel for the committee did not represent any individual creditor's interest, but the interests of the unsecured creditor class as a whole. Therefore, the counsel had no duty to the individual creditor and could object to its claim.

While committees generally do not have a duty to the estate, it is unclear if a duty to the estate arises if the committee chooses to prosecute litigation on behalf of the estate. In *Official Committee Unsecured Creditors of Grand Eagle Companies, Inc. v. Asea Brown Boveri, Inc.*, 313 B.R. 219, 224 (N.D. Ohio 2004), the court recognized the issue and held:

> Courts must carefully consider the Gibson factors before granting derivative authority to an creditors' [sic] committee because the committee's role is different from the trustee's. A trustee acts for the benefit of the estate and owes a fiduciary duty to all creditors of the estate. *See, e.g., In re Troy Dodson Construction Company*, 993 F.2d 1211, 1216 (5th Cir.1993). In contrast, a committee of unsecured creditors is a fiduciary only to the creditors it represents and must act vigorously to pursue their interests. *See, e.g., In re SPM Mfg. Corp.*, 984 F.2d 1305, 1315-16 (1st Cir.1993); *In re Great Northern Paper, Inc.*, 299 B.R. 1 (D.Me.2003). A creditors' committee need not consider the best interests of the estate. *In re SPM Mfg. Corp.*, 984 F.2d at 1315-16. As the bankruptcy court notes, the interests of a creditors' committee and the trustee may sometimes align. Yet the interests of a creditor's committee and the trustee are not identical. Outside the context of being granted derivative standing, the committee represents the unsecured creditors, not the estate. Consequently, the Court finds it imperative that bankruptcy

[3] *See, e.g., In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992) ("The duty extends to the class as a whole, not to its individual members.").

courts give sufficient attention to the Gibson factors before granting derivative standing to a creditors' committee.

B. The Duties Owed By Committee Members

Corporate fiduciaries normally have two duties: (1) the duty of loyalty, and (2) the duty of due care. While the case law concerning committee members do not usually use those terms in describing the duties owed, the concepts are helpful in defining the duties owed by committee members.

1. Duty of Loyalty

The duty of loyalty can be summarized as the obligation of fiduciaries to not engage in self-dealing or usurpation of corporate opportunities.[4] Courts have recognized that because committee members are not corporate insiders, the traditional concept of "duty of loyalty" to the corporation is not practically applicable and committee members are generally fee to pursue their own interests.[5]

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[4] *See, e.g., Unified Western Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1113 (9th Cir. 2006) ("As a fiduciary, [the director's] duties to the corporation include undivided, unselfish and unqualified loyalty, unceasing effort never to profit personally at corporate expense, and unbending disavowal of any opportunity which would permit the director's private interests to clash with those of his corporation."); *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345, 363 (Del. Supr. 1993) ("to establish a breach of duty of loyalty, [plaintiff] must present evidence that the director either was on both sides of the transaction or 'derive[d] any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.'")

[5] *See, e.g., In re El Paso Refinery, L.P.*, 196 B.R. 58 (Bankr. W.D. Tex. 1996) ("A corporate insider's principal and overriding responsibility is to the shareholders of the corporation, and such insider is not permitted to allow personal interests to conflict with that overriding duty. The insider is expected to subordinate his own interests to that paramount responsibility. The same expectation is not appropriately placed on the members of creditors' committees in a bankruptcy case."); *In re Rickel & Associates, Inc.*, 272 B.R. 74, 100 (Bankr. S.D.N.Y. 2002) ("Although Committee members owe fiduciary duties, they are hybrids who serve more than one master. Every member of the Committee is, by definition, a creditor. Thus, he is competition with every other creditor for a piece of a shrinking pie. He may assert his rights as a creditor to the detriment of the creditor body as a whole without running afoul of his fiduciary obligations."); *In re Fas*

However, notwithstanding the recognition that the "duty of loyalty" concept is not directly applicable, courts have held that committee members are "required to be honest, loyal, trustworthy and without conflicts of interest"[6] and may not use their position as a committee member to advance their interests at the expense of the unsecured creditor class.[7]

The tension between the right of a committee member to pursue its own interest, and the obligation not to use its committee position to the detriment of the unsecured creditor class, is obvious and the line is not always easy to define. However, a general guideline is whether the corporate opportunity came to the attention of the committee member as a result of the member's normal business activity (actions not within the scope of the fiduciary duty), or as a result of the member's role on the committee (actions within the scope of the fiduciary duty).[8]

The scope of the duty of loyalty was extensively analyzed in a series of published decisions arising in *In re Life Service Systems, Inc.*, a case pending in the Western District of

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Mart Convenience Stores, Inc., 265 B.R. at 432 ("Membership on a committee does not preclude members from pursuing their own interests so long as this can be done without running afoul of their fiduciary duties to all unsecured creditors.").

[6] *In re Rickel & Associates, Inc.*, 272 B.R. 74, 99 (Bankr. S.D.N.Y. 2002). A creditor may serve on a committee as long as there is no actual conflict of interest even if there is a potential conflict of interest. *See, e.g., Matter of Enduro Stainless, Inc.*, 59 B.R. 603 (Bankr. N.D. Ohio 1986) (union was not disqualified from serving on the committee based upon speculation that union would use committee to advance union interest).

[7] *See, e.g., In re Haskell-Dawes, Inc.*, 188 B.R. 515, 522 (Bankr. E.D. Pa. 1995) ("This duty prohibits members of the creditors' committee from using their position to advance their own individual interests."); *Matter of Enduro Stainless, Inc.*, 59 B.R. 603, 605 (Bankr. N.D. Ohio 1986) ("A member of the creditors' committee undertakes to act in a fiduciary capacity and may not act through the committee in such a manner to promote that creditor's interest.").

[8] *Compare, In re El Paso Refinery, L.P.*, 196 B.R. 58 (Bankr.W.D.Tex.1996) (no breach of duty because business opportunity did not come to the committee member as a result of the member's participation on the committee), *with, In re Rickel & Associates, Inc.*, 272 B.R. 74 (Bankr. S.D.N.Y. 2002) (where committee member was a former insider of the debtor and requested by committee to value certain assets, and member then offered to purchase the assets, member breached fiduciary duty by misrepresenting value of assets in the sale negotiations).

Pennsylvania.[9] The debtor, a provider of social services, obtained a grant from the Department of Housing and Urban Development ("HUD") for the development of a housing project. Shortly after the bankruptcy filing, HUD declared the debtor in default and gave 30 days to cure or lose the grant. The debtor's controlling insider did not inform the creditors' committee of the default letter, but instead informed one of the committee member, "WHO," which was also a provider of social services. With the cooperation of the debtor's controlling insider, WHO was selected by HUD to step into the shoes of the debtor with respect to the grant.

Thereafter, a chapter 11 trustee was appointed and became aware of the transaction. The trustee alleged that the grant was property of the estate and sued WHO for violating its fiduciary duties. The bankruptcy and district courts determined that the grant was property of the estate and, therefore, the trustee properly alleged a breach of fiduciary claim against WHO. On appeal, the Third Circuit reversed the determination that the grant was property of the estate, but remanded for a determination of whether a breach of a fiduciary duty by a committee member "can arise in connection with a transaction that falls outside of the debtor's bankruptcy estate."

On remand, both the bankruptcy and district courts concluded that the fiduciary duty does extend to transactions which do not involve property of the estate. The district court then went on to use very expansive language that could be interpreted to mean that the fiduciary duty is applicable whenever a corporate opportunity is presented that could affect the estate, even if the corporate opportunity presented itself to the committee member in the ordinary course of the member's business:

> In the absence of prior disclosure to the members of the unsecured creditors committee and where their consent is not obtained, then when the actions of a member of the unsecured creditors committee in dealing with

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[9] *See,* 246 F.3d 233 (3rd Cir. 2001); 279 B.R. 504 (Bankr. W.D. Pa. 2002); 327 B.R. 561 (W.D. Pa. 2005).

> nonestate property cause a loss of income to the debtor or debtor in possession, a lower amount of recovery for its fellow general unsecured creditors, an increase in the size of the class of general unsecured creditors, or otherwise adversely affect the orderly and efficient resolution of the bankruptcy petition or satisfaction of claims that is not in accord with the interests and duties of the committee of general unsecured creditors, this Court finds that a breach of the fiduciary duty which that member owes to the committee of general unsecured creditors has been committed.

327 B.R. at 571. In analyzing the duty, the court concluded that in order to satisfy the fiduciary duty that arises when a corporate opportunity is presented, the committee member must not only disclose the opportunity to the committee and obtain the committee's consent, but must also obtain approval of the bankruptcy court:

> [N]otice and the opportunity to object to WHO's intentions were required to be given to the unsecured creditors committee, and to the debtor, due to its interest in the nonestate property, and that the approval of the Bankruptcy Court was required to be obtained prior to WHO's succession to the grant because of the impact of that action upon the interests of creditors in the Bankruptcy litigation. The Court's reasoning for this conclusion is the effect that WHO's succession to the nonestate property had upon the recovery by the creditors in bankruptcy and the debtor's ability to rehabilitate itself. The fact that the property involved was nonestate property does not obviate the adverse impact and the creditors.

327 B.R. at 574. The court then repeated its requirement of court approval whenever a corporate opportunity is presented that could affect the estate:

> Therefore, the Court concludes that the requirements of notice and opportunity to object must be given by a committee member to all of its fellow committee members when it seeks to deal with nonestate property of the debtor where the dealings with such property could impact in any manner, negatively or positively, upon the recovery of the creditors in Bankruptcy. If the disinterested committee members approve the interested committee member's proposal for the nonestate property, approval of the bankruptcy court must be sought and obtained before the interested committee member may deal in the nonestate property. Should dealings with the nonestate property clearly have no potentiality to affect the recovery of creditors, approval of the committee and the court may be unnecessary while notice to the committee would appear to still be required in order for the disinterested committee members to conduct their

> own analysis of the effect of the interested member's actions; such is not an issue before the Court, so this matter need not be addressed further.

327 B.R. at 575-76.

2. Duty of Due Care

The duty of due care can be summarized as the requirement that fiduciaries exercise that degree of care that an ordinarily prudent person would exercise under the same or similar circumstances. The duty has been interpreted to require the fiduciary to act rationally, in good faith and based upon a reasonable investigation of the available information relating to the decision.[10]

Where the duty of loyalty is not at issue, corporate fiduciaries normally have the protection of the "business judgment rule." In summary, courts will not review or second guess the substantive decision of an officer or director, regardless of the consequences of the decision, if the process by which the fiduciary reached the decision satisfied the following general elements: (1) the fiduciary was not interested in the subject of the decision, (2) the fiduciary was informed with respect to the subject of the decision, and (3) the fiduciary rationally believed that the decision was in the best interests of the corporation.[11]

While courts have not used the "duty of care" and "business judgment rule" terminology in discussing the duties of committee members, they are in agreement that committee members

[10] *See, e.g., In re General Motors Class E Stock Buyout Securities Litigation*, 694 F. Supp. 1119, 1133 (D. Del. 1988) (to state a claim for breach of the duty of due care, "plaintiffs must allege facts to support the conclusion that the Board acted with so little information that their decision was 'unintelligent and unadvised,' or outside of the 'bounds of reason and reckless.'").

[11] *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Supr. 1984) (the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."); *Gaillard v. Natomas Co.*, 208 Cal.App.3d 1250, 256 Cal. Rptr. 702 (1989) ("Under this rule, a director is not liable for a mistake in business judgment which is made in good faith and in what he or she believes to be the best interests of the corporation, where no conflict of interest exists.").

have immunity from suit so long as the acts are (1) undertaken in performance of the member's duties as a committee member and (2) not the result of willful misconduct.[12]

The decision in *In re Tucker Freight Lines, Inc.*, 62 B.R. 213 (Bankr. W.D. Mich. 1986), provides an example of conduct outside the scope of the immunity. The committee included a letter in the plan solicitation package opposing the plan because of alleged tax consequences. The creditors voted against the plan and the case was converted. The debtor's sole shareholder, which was also a creditor, then sued the committee members alleging that the tax analysis contained in the letter was factually and legally wrong and that the committee members knew or should have known the letter was misleading. The committee members asserted immunity. For purposes of summary judgment, the court assumed that the letter contained "intentionally and tortiously false and misleading statements." The court held that the committee's fiduciary duty "requires that the committee's determinations must be honestly arrived at, and, to the greatest degree possible, also accurate and correct." The court then held that "[f]or a Creditors' Committee to urge rejection of a plan for reasons they knew, or would have known but for their recklessness, to be false would violate this duty and deprive them of any limited immunity they might otherwise hold under § 1103(c)(3)." *Id.* at 216.

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[12] *See, e.g., In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000) ("§ 1103(c) ... limits liability of a committee to willful misconduct or ultra vires acts"); *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992), *aff'd*, 140 B.R. 347 (S.D.N.Y. 1992) (a "'willful misconduct' standard strikes the proper balance between breach of duty and limited immunity."); *In re WCI Cable, Inc.*, 282 B.R. 457, 476 (Bankr. D. Or. 2002) (limiting liability to "willful misconduct or ultra vires acts").

3. Duty To Third Parties

Committee members have been sued by third parties for actions taken as committee members. Courts have generally held that committee members are entitled to immunity from such suits as long as the members did not engage in willful misconduct or ultra vires acts.[13]

For instance, in *Prince v. Zazove*, 959 F.2d 1395 (7th Cir. 1992), an individual debtor acquired a new business without making any disclosure to his creditors' committee and then entered into an agreement to sell the business. After the committee discovered the transaction, committee counsel wrote a letter to the buyer asserting that the estate, and not the debtor, had the right to sell the business. After the court determined that the debtor, and not the estate, owned the business, the debtor sued committee counsel and the committee members for tortious interference. The court held that the counsel and members were entitled to immunity because they reasonably (albeit erroneously) believed that the assets were property of the estate.

Comparatively, in *Luedke v. Delta Air Lines, Inc.*, 159 B.R. 385 (S.D.N.Y. 1993), former Pan Am employees sued Delta Airlines for various claims arising from Delta's failed efforts to acquire Pan Am during Pan Am's bankruptcy case. Delta then impleaded, among other parties, the members of the creditors' committee. According to Delta's third-party complaint, "the Committee and its members intentionally acted improperly and beyond [the Committee's] statutory duties." In particular, Delta alleged that the committee and its members "took over negotiations for the sale of Pan Am's assets, often excluding Pan Am, and thereby usurped the roles of Pan Am as the debtor-in-possession." Delta also charged that the committee and its

[13] *See, e.g., In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000) ("§ 1103(c) ... limits liability of a committee to willful misconduct or ultra vires acts"); *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992), *aff'd*, 140 B.R. 347 (S.D.N.Y. 1992) (a "'willful misconduct' standard strikes the proper balance between breach of duty and limited immunity."); *In re WCI Cable, Inc.*, 282 B.R. 457, 476 (Bankr. D. Or. 2002) (limiting liability to "willful misconduct or ultra vires acts").

members "attempted to force Delta to provide additional financing to Pan Am by threatening to support a motion by the United States Air Force to foreclose on Pan Am's receivables in which the Air Force had a security interest despite the negative impact which foreclosure would have had upon the interests of general unsecured creditors, whom the Committee represents." Delta further accused one or more of the committee members of "intentionally leak[ing] to the press a November 4, 1991, letter from the Committee's counsel to Delta and Delta's counsel which predicted that the reorganization plan for Pan Am 'cannot or will not be confirmed' and blamed Delta for the probable failure of the proposed reorganization." *Id.* at 3893-94.

Based upon the allegations, the court held that the complaint survived the motion to dismiss because the allegations against the Committee and its members described "willful misconduct and other ultra vires actions and therefore suffice to lift any qualified immunity from suit which the Committee and its members may enjoy." *Id.*

C. Standing To Sue A Committee Member For Breach Of A Fiduciary Duty.

If the duties of a committee member run to the class of unsecured creditors and not the estate or any individual creditor, who has standing to sue the committee member for breach of the fiduciary duty? This rather difficult conceptual issue has rarely been the subject of analysis in a published decision.

1. The Creditors' Committee

The committee itself is probably the entity best positioned to commence litigation against a committee member for breach of a fiduciary duty, but there is no case law discussing the issue. Section 1103(c)(5) authorizes the committee to "perform such other services as are in the interest of those represented." In *In re Fas Mart Convenience Stores, Inc.*, 265 B.R. 427 (Bankr. E.D. Va. 2001), the court granted the motion of a committee to remove a member for a conflict of interest.

2. The Debtor in Possession

The debtor in possession has the right to request that the bankruptcy court remove a member of the committee for cause, and evidence of a breach of a fiduciary duty is cause.[14] However, no published case has analyzed whether a debtor in possession has standing to sue a committee member based upon a breach of fiduciary duty. In *Prince v. Zazove*, 959 F.2d 1395 (7th Cir. 1992), the debtor sued the committee counsel and members, but the case was resolved based upon an analysis of immunity and not standing. Furthermore, the allegation was tortious interference and not breach of fiduciary duty.

3. Trustees

There are several examples of cases where trustees have successfully sued committee members for breach of fiduciary duties. *See, e.g., Westmoreland Human Opportunities, Inc. v. Walsh*, 246 F.3d 233, 256 (3d Cir. 2001) (chapter 11 trustee); *Matter of REA Holding Corp.*, 8 B.R. 75 (Bankr. S.D.N.Y.1980) (chapter 11 trustee under Bankruptcy Act). Unfortunately, in none of the cases was standing discussed by the court.

4. Individual Members Of The Class

In *In re Rickel & Associates, Inc.*, 272 B.R. 74, 99 (Bankr. S.D.N.Y. 2002), after acknowledging that committee members do not owe duties to individual unsecured creditors, the court permitted a member of the general unsecured class to sue a committee member for breach of fiduciary duty, became the plaintiff was the only remaining creditor in the class and "[i]t would exalt form over substance to prohibit their prosecution of the claim, and let a possible wrongdoer escape in the process."

[14] *See, e.g., In re Haskell-Dawes, Inc.*, 188 B.R. 515, 522 (Bankr. E.D. Pa. 1995); *In re Map Intern., Inc.*, 105 B.R. 5 (Bankr. E.D. Pa. 1989).

In *In re Tucker Freight Lines, Inc.*, 62 B.R. 213 (Bankr. W.D. Mich. 1986), the committee members were sued by the sole shareholder of the debtor who was also a creditor. The issue of standing was not discussed in the published opinion.