

**American Bankruptcy Institute's
2008 Mid-Atlantic Bankruptcy Workshop Program**

What's on OUST's Radar?

Friday, August 1, 2008 (9:15 - 10:30 a.m.)

Saturday, August 2, 2008 (10:45 - 12:00 p.m.)

I. Appointment of a Patient Care Ombudsman Under 11 U.S.C. § 333

Section 333 was added by the BAPCPA to ensure the safety and welfare of patients, one of the most vulnerable groups affected by bankruptcy. Section 333 requires the U.S. Trustee to appoint a disinterested patient care ombudsman ("PCO") in every health care business ("HCB") case under chapters 7, 9, or 11, unless the court finds the appointment unnecessary "for the protection of patients under the specific facts of the case." 11 U.S.C. § 333(a)(1).

- 11 U.S.C. § 101(27A) defines the term HCB as follows:

(27A) The term "health care business" – (A) means any public or private entity (without regard to whether that entity is organized for-profit or nonprofit) that is primarily engaged in offering to the general public facilities and services for –
(i) the diagnosis or treatment of injury, deformity or disease; and
(ii) surgical, drug treatment, psychiatric or obstetric care

Issues related to PCOs - The courts, the United States Trustee Program (the "Program") and other interested parties have confronted a number of issues concerning PCOs.

A. Whether the debtor is an HCB as defined in § 101(27A)

- Although the case law is in conflict, the Program favors a broad interpretation of this remedial statute. Compare *In re Banes*, 355 B.R. 532, 535 (Bankr. M.D.N.C. 2006) (HCB limited to debtors providing "facilities and services" in an institutional setting, such as hospitals or nursing homes), with *In re Saber*, 369 B.R. 631 (Bankr. D. Colo. 2007) (definition of HCB not dependant on where debtor provides its services).

B. Whether the appointment of a PCO is necessary

- Section 333 creates a statutory presumption that a PCO should be appointed, unless the court finds the appointment unnecessary under the facts of the case.
- The burden of proof is on any party (*e.g.*, debtor, creditors' committee, *etc.*) seeking to avoid the appointment to present adequate evidence to allow the court to find that a PCO is unnecessary to ensure patient safety.

- The court should consider the totality of the circumstances. *See In re Alternate Family Care*, 377 B.R. 754 (Bankr. S.D. Fla. 2007). Because patient safety is the specified statutory criteria for appointment, the cost of a PCO should not be a controlling criteria for appointment. Instead, cost is a factor that should be managed, as with other professionals in bankruptcy.

C. Considerations concerning the compensation of a PCO

- Compensation is fixed by the court following notice and hearing as provided in § 330 and Rule 2016 of the Federal Rules of Bankruptcy Procedure.
- In connection with cash collateral orders sought early in a case of an HCB, Program personnel may seek a line item in the debtor’s budget that provides for possible appointment of a PCO, or a provision in every carve out that includes a PCO, consistent with the approach followed in chapter 11 cases concerning the possible appointment of creditors’ committees.

D. Employment of Professionals by a PCO

- Although § 327 does not expressly provide that a PCO may hire professionals, consistent with the Program’s position concerning examiners, whose professionals are similarly omitted from § 327, the Program takes the position before the courts that PCOs may retain professionals on a showing of need. As an alternative, the fees and expenses of counsel could reasonably be deemed to be an “actual, necessary” expense reimbursable under § 330(a)(1)(B).

E. The extent to which exculpation of a PCO is appropriate

- The Program takes the position that a global exculpation of a PCO sought at the end of a case is not appropriate.
- When the exculpation provision is included in a plan, with its attendant notice and voting, it may be less problematic.
- Although there is currently no direct authority on exculpation of PCOs, courts have extended quasi-judicial immunity to private case trustees. *See Curry v. Castillo (In re Castillo)*, 297 F.3d 940, 947 (9th Cir. 2002) (extending quasi-judicial immunity for “actions that are functionally comparable to those of judges, *i.e.*, those that involve discretionary judgement”). Like trustees, PCOs assist the bankruptcy court by monitoring the actions of the debtor, *see* 11 U.S.C. § 333(a)(1), and filing reports with the court regarding the quality of patient care, 11 U.S.C. § 333(b)(2). The extent to which quasi-judicial immunity may be available to a PCO will likely depend on the particular facts.

F. The extent to which a PCO should be immunized from discovery

- The Program does not agree that all conceivable future discovery requests are necessarily improper, or that the court may or should enjoin discovery on a global, prospective, and permanent basis. A court may require the parties seeking discovery from the PCO first to seek court approval and explain why the information cannot be obtained from other sources. *See In re Adelpia Commc'n Corp.*, 348 B.R. 99, 110 (Bankr. S.D.N.Y. 2006) (limited protective order provided for the fee committee).

II. Appointment of a Consumer Privacy Ombudsman Under 11 U.S.C. § 332

Changes Under BAPCPA Regarding Sale or Lease of Private Consumer Information

Three changes to the Bankruptcy Code establish a new procedure for the sale or lease of customer information:

- A. Section 101(41A) defines “personally identifiable information” (PII) to include information “provided by an individual to the debtor in connection with obtaining a product or a service from the debtor primarily for personal, family, or household purposes.”
- B. Amendments to § 363 limit a debtor’s ability to sell or lease PII. Amended § 363(b) provides that if the debtor published a privacy policy regarding its collection of information which remains in effect on the date of the commencement of the case, then PII obtained under that policy cannot be sold unless the sale is consistent with that policy, or if after the appointment of a consumer privacy ombudsman, the court determines under the facts of the case that no showing was made that such a sale or lease would violate applicable non-bankruptcy law. 11 U.S.C. § 363(b)(1)(B).
- C. Section 332 controls the appointment of a consumer privacy ombudsman and defines their role in the sales process.

Section 332 requires a consumer privacy ombudsman to assist the court in considering the sale or lease of personally identifiable information under § 332(b)(1) by filing a report that may include, but does not appear to be limited to, information concerning:

- (1) the debtor’s privacy policy;
- (2) the potential losses or gains of privacy to consumers if such sale or such lease is approved by the court;
- (3) the potential costs or benefits to consumers if such sale or such lease is approved by the court; and,

- (4) potential alternatives that would mitigate losses or potential costs to consumers.
- Section 332(c) contains an express prohibition against the disclosure by an ombudsman of any PII that comes into his/ her possession in connection with title 11 responsibilities.

Procedures Concerning the Sale or Lease of PII - Notice of a sale or lease triggers the appointment of a consumer privacy ombudsman. Program personnel will inquire at an early stage in the case, preferably at the initial debtor interview or at the § 341 meeting, whether the debtor had a privacy policy in place pre-petition. If a privacy policy was in effect on the petition date, then a copy will be requested.

- Notices for sale or lease pursuant to § 363 must contain express statements as to the applicability of § 332, including: (1) whether the intended action implicates § 332; (2) whether assets at issue implicate the privacy rights of any parties; and, (3) whether a hearing pursuant to § 363(b)(1)(B) is required.

Compensation of Consumer Privacy Ombudsman - The same issues arise as discussed previously for patient care ombudsmen. Consumer Privacy Ombudsmen may be awarded compensation pursuant to 11 U.S.C. § 330. Although nothing in § 330 addresses the issue of compensation for any professionals hired by an ombudsman, consistent with the Program's position concerning examiners, however, such professionals may be retained on a showing of need or, alternatively, their fees and expenses deemed to be an "actual, necessary" expense reimbursable under § 330(a)(1)(B).

III. Application of 11 U.S.C. § 327(e) to Professionals Other than Debtor's Counsel

Section 327(e) was enacted to avoid requiring the debtor to incur unnecessary expense and duplication of services to bring new counsel up to the level of existing counsel already handling a debtor's specific ongoing affairs, particularly in complex litigation scenarios. Section 327(e) provides:

The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.

Is § 327(e) limited to debtor's counsel, as opposed to non-debtor counsel or non-attorney professionals? - The vast majority of cases limit § 327(e) to debtor's counsel. Those few cases that have found otherwise based on facts in a particular case or reasoning by analogy have been reversed on appeal.

A. Representative Cases Limiting 327(e) to Debtor's Counsel:

- *In re AroChem Corp.*, 176 F.3d 610 (2d Cir. 1999): Relies on plain language to conclude that § 327(e) could only be used to allow retention of debtor’s, not creditor’s, attorney.
- *In re Andover Togs, Inc.*, No. 96 Civ. 7601 and 97 Civ. 6710, *3-*4 (S.D.N.Y. Mar. 15, 2001): Relies on plain language and narrow reading of § 327 espoused in two Second Circuit opinions, *In re Palm Coast*, 101 F.3d 253 (2d Cir. 1996) (reading § 327(a) and (d) narrowly to allow trustee to hire own law or accounting firm only, not real estate firm), and, *In re AroChem Corp.*, 176 F.3d 610 (2d Cir. 1999) (using plain language analysis to hold that § 327(e) applies only to debtor’s, not creditor’s, counsel), to conclude, by analogy, that bankruptcy court’s expansive reading of § 327(e) to permit debtor to retain interested accountant, even in a limited capacity, was in error.
 - *In re South Shore Golf Club Holding Co.*, 182 B.R. 94 (Bankr. W.D.N.Y. 1995): Relies on plain language to hold that § 327(e) could not be extended to include appointment of a special accountant to help prepare disclosure statement and reorganization plan.
- *In re Greenbelt CT Imaging Ctr.*, No. 07-18958, slip op at *1 (Bankr. D. Md. Jan. 3, 2008): Holds that accounting firm retained by debtor pre-petition could not be hired because accounting firm had adverse interest to bankruptcy estate because it was a “likely target” of a preference action due to pre-petition payment. Court in dicta writes that it was “unfortunate” that accounting firm could not represent debtor given prior experience, but “[u]nlike attorneys, the Debtor in Possession cannot employ [the accounting firm] for a specified special purpose under § 327(e) of the Bankruptcy Code.”
 - *In re J.S. II, L.L.C.*, 371 B.R. 31, 317-318 (Bankr. N.D. Ill. 2007): Provides excellent background on requirements, case law, and legislative history concerning § 327(e). Discusses § 327(e) solely within the context of debtor’s counsel.
 - *In re Dev. Corp. of Plymouth, Inc.*, 283 B.R. 464, 467 (Bankr. E.D. Mich. 2002): Relies on plain language to conclude that 327(e) is limited to debtor’s counsel. Cites *In re AroChem Corp.*, 176 F.3d 610, 622 (2d Cir. 1999), and five bankruptcy court cases published between 1994 and 2001 that concluded the same.

B. Representative Cases Not Limiting 327(e) to Debtor’s Counsel or Non-Attorney Professionals: The few cases that supported the application of 327(e) to non-debtor counsel or non-attorney professionals have been either reversed or vacated on appeal. *See, e.g., In re Andover Togs, Inc.*, 199 B.R. 4, 6-7 (Bankr. S.D.N.Y. 1996) (going beyond plain language of 327(e) to apply provision to

accounting firm under “unusual situation” in case), *rev’d*, Nos. 96 Civ. 7601 and 97 Civ. 6710, *3-*4 (S.D.N.Y. Mar. 15, 2001) (reversing on plain language grounds despite the “inefficiency” that would result); *see also In re Palm Coast*, 188 B.R. 741, 743 (S.D.N.Y.1995) (affirming bankruptcy court order permitting trustee to retain his own firm as real estate broker absent “express statutory limitation”), *vacated by In re Palm Coast*, 101 F.3d 253 (2d Cir. 1996) (reading 327(a) and (d) narrowly to allow trustee to hire own law or accounting, but not real estate, firm).

What was the legislative intent behind 327(e)? - Per the legislative history, § 327(e):

[D]oes not authorize the employment of the debtor’s attorney to represent the estate generally or to represent the trustee in the conduct of the bankruptcy case. The subsection will most *likely be used when the debtor is involved in complex litigation, and changing attorneys in the middle of the case after the bankruptcy case has commenced would be detrimental* to the progress of that other litigation.

S. Rep. 95-989, at 38-39 (1978) (reprinted in 1978 U.S.C.C.A.N. 5787,5824-5825) & H.R. Rep. 95-595, at 328 (1978) (reprinted in 1978 U.S.C.C.A.N. 5963, 6285) (emphasis added).

“Section 327(e) is designed to promote economy in administration. It recognizes that continuing the retention of pre-petition counsel/creditors will avoid wasteful expense and delay that might result from having to hire disinterested counsel unfamiliar with the subject matter.” *In re S. Kitchens, Inc.*, 216 B.R. 819, 826 (Bankr. D. Minn. 1998).

Despite the legislative history, courts are split as to whether § 327(e) is limited to attorneys who previously represented the debtor. As noted in a recent bankruptcy court decision:

The majority approach imposes an express requirement of prior representation of the debtor. . . . Yet some courts have ruled otherwise, and have permitted retention of counsel under section 327(e) where such counsel had not been retained by the debtor previously. Other courts have reasoned by analogy to section 327(e) to permit attorneys who have represented creditors to be retained for special purposes. . . . These courts are persuaded that the attorneys can be retained as long as their representation of the creditor does not create a conflict with the limited purpose for which they are being retained.

In re Buffalo Coal Co., No. 06-366 (Bankr. N.D. W. Va. Apr. 30, 2008) (citing 3 *Collier on Bankruptcy* ¶ 327.04[9][b] (15th ed. rev. 2008)).

IV. Information Sharing by Creditors Committees under 11 U.S.C. § 1102(b)(3)

Section 1102(b)(3) was added by the BAPCPA in response to concerns that creditors who sat on committees had an unfair advantage over other creditors with similar claims

because they were privy to information about the debtor that was not readily available to those creditors who did not hold a position on the committee.

- 11 U.S.C. § 1102(b)(3) provides:

A committee appointed under subsection (a) shall--

(A) provide access to information for creditors who--

(i) hold claims of the kind represented by that committee;
and

(ii) are not appointed to the committee;

(B) solicit and receive comments from the creditors described in subparagraph (A); and

(C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

Issues related to § 1102(b)(3) - Courts and stakeholders have already addressed numerous issues with regard to the new requirements of § 1102(b)(3), including:

- A. How to reconcile the committee's obligation to provide access to information to non-committee members with the committee's need to protect confidential information provided to it by the debtor and privileged information of the committee.
- B. The appropriate level of exculpation of committee members obtained as part of orders entered by the court.
- C. Practical methods for achieving § 1102(b)(3)'s information-sharing objectives.
- D. The type of information contemplated by § 1102(b)(3).

The Refco Model (*In re Refco Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006) - All of the issues identified above were the source of litigation and negotiation in the *Refco* decision, and the resulting opinion and order generally struck an appropriate balance between the varying interests.

- **Protection of privileged and confidential information** - The order entered in *Refco* provided a definition of what constitutes privileged and confidential information,¹ a procedure by which creditors could seek court relief if the

¹ "Privileged and Confidential Information" is defined as follows: The Committee shall not be required to disseminate to any entity (all references to "entity" herein shall be as defined in *section 101(15) of the Bankruptcy Code*, "Entity"): (i) without further order of the Court, confidential, proprietary, or other non-public information concerning the Debtors or the Committee, including (without limitation) with respect to the acts, conduct, assets, liabilities and financial condition of the Debtors, the operation of the Debtors' business and the desirability of

committee refused to provide them with access to requested information, and a mechanism by which creditors could request additional information and provide comments on case events.

- **Exculpation of committee members** - The *Refco* order contained exculpation language shielding committee members from liability associated with implementation of the creditor information protocol. Such exculpation was limited, however, and the order clarified that the exculpation was coextensive with qualified immunity afforded under applicable caselaw.²
- **Method for information sharing** - The order called for the establishment by the committee of a website where a wide variety of publicly available information about the case could be easily accessed by the creditors.
- **Definition of “Information”** - The *Refco* court concluded that issues related to the type of information contemplated under § 1102(b)(3) should be resolved by reviewing analogous caselaw construing that information which a trustee is obligated to share with parties in interest in a chapter 7 case pursuant to § 704(a)(7) (“trustee shall . . . unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest.”).

The Program’s role under § 1102(b)(3) - In reviewing proposed orders under § 1102(b)(3), Program attorneys generally ensure that proposed orders include, and object to any order that does not include, the following minimum requirements:

- Acknowledgment that creditors will have access to information;
- Procedures by which creditors will be able to comment on case events and seek additional information;
- Procedures by which creditors will have a right of judicial review if they are denied information to which they believe themselves to be entitled;

the continuance of such business, or any other matter relevant to these cases or to the formulation of one or more chapter 11 plans (including any and all confidential, proprietary, or other nonpublic materials of the Committee) whether provided (voluntarily or involuntarily) by or on behalf of the Debtors or by any third party or prepared by or for the Committee (collectively, the “Confidential Information”), or (ii) any other information if the effect of such disclosure would constitute a general waiver of the attorney-client, work-product, or other applicable privilege possessed by the Committee.

² The exculpation clause included the following language stating that exculpation did “not affect the liability of any Exculpated Party protected pursuant to this paragraph 11 that otherwise would result from any such act or omission to the extent that such act or omission is determined in a final non-appealable order to have constituted a breach of fiduciary duty, gross negligence, or willful misconduct, including, without limitation, fraud and criminal misconduct, or the breach of any confidentiality agreement or Order.

- To the extent that the proposed exculpation is coextensive with the qualified immunity committee members already enjoy, this is not objectionable.³ But such clauses should be carefully scrutinized to assure that they do not expand committee members' qualified immunity or extend rights of exculpation to committee counsel and other professionals; and
- While the use of a website is clearly ideal for a large case with many creditors, alternatives exist for smaller cases. Attached is a copy of the court's order in *In re Specialtychem Prods. Corp.*, No. 06-23131 (Bankr. E.D. Wis. Aug. 17, 2006). This order authorized the maintenance of an email "listserv" by committee counsel and required that a notice of the right to subscribe to the service be transmitted to all scheduled creditors. This seems to be an ideal, lower cost approach for a smaller case that would nevertheless provide creditors with the information to which they are entitled under § 1102(b)(3).

V. Trading Orders

Members of unsecured creditor and equity committees in chapter 11 cases owe fiduciary duties to their broader constituencies.⁴ Therefore, if committee members trade in a debtor's equity or debt securities based on nonpublic information gained through committee membership, there is the valid concern that this trading may constitute self-dealing that would violate these fiduciary duties. At the same time, however, entities that trade securities or debt instruments may have significant financial interests in bankruptcy cases, as well as expertise to bear in participating in such cases. With that in mind, forcing these entities to suspend all trading in the debtor's securities or debt can be unfair to their public investors, and can discourage their participation in committees, depriving cases of expert involvement that benefits creditors and reorganization.

In light of the above dynamic, a number of bankruptcy courts have permitted committee members to trade in a debtor's securities through advance orders determining that such

³ Section 1103(c) of the Bankruptcy Code, which grants to the Committee broad authority to formulate a plan and perform "such other services as are in the interest of those represented," 11 U.S.C. § 1103(c), has been interpreted to imply both a fiduciary duty to committee constituents and a limited grant of immunity to committee members, see *In re L.F. Rothschild Holdings, Inc.*, 163 B.R. 45, 49 (S.D.N.Y. 1994); *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); *In re Tucker Freight Lines, Inc.*, 62 B.R. 213, 216, 218 (Bankr. W.D. Mich. 1986); ___ Collier on Bankruptcy ¶ 1103.05 [4], 1103-32-33 (15th ed. rev. 1996) ("[A]ctions against committee members in their capacity as such should be discouraged. If members of the committee can be sued by persons unhappy with the committee's performance during the case or unhappy with the outcome of the case, it will be extremely difficult to find members to serve on an official committee.").

⁴ A creditors' committee stands as a fiduciary to the class of creditors it represents. See, e.g., *Woods v. City Nat'l Bank and Trust Co. of Chicago*, 312 U.S. 262, 268-69 (1941).

trading will not violate committee duties. Such “trading orders” are subject to various conditions, however, including mandatory “ethical wall” procedures to prevent misuse of nonpublic information obtained by committee members. Ethical walls seek to ensure that nonpublic information obtained by a committee member can be “walled off” from those involved in trading activities.⁵

The leading trading order case is *In re Federated Dep’t Stores, Inc.*, No. 1-90-00139, 1991 WL 79143 (Bankr. S.D. Ohio Mar. 7, 1991). In that case, a committee member sought a court order permitting its trading in securities of the debtor, subject to specific ethical wall procedures filed with the court. The SEC, which regulates and oversees securities trading, filed a memorandum in support of the order. The SEC argued that it was “consistent with the requirements of the federal securities laws and the bankruptcy laws” to allow such trading, if a two-part test was met: 1) an entity trades securities as a regular part of its business, *i.e.* ordinary course; and 2) it establishes reasonable ethical walls. SEC Memo at 6. The SEC noted that investment advisers, investment banking firms, brokerage firms, pension funds, and insurance companies have “the type of expertise which is valuable to official committees.” *Id.* at 24. In addition, these entities have “considerable experience” with ethical walls. The court issued a brief order permitting the trading.

Trading orders are certain to remain a closely watched issue, with the rise of distressed debt trading and the increased role of hedge funds as creditors in large chapter 11 cases.

United States Trustee Program Position:

- The Program generally requires that a committee member not trade in a debtor’s equity or debt securities and agree to this prohibition in seeking to serve on a committee, unless the member obtains a trading order that meets the SEC test in *Federated*: the entity trades as a regular part of its business and the member can establish reasonable ethical walls.⁶ Moreover, because the trading in *Federated* was subject to securities laws and the oversight of the SEC, a trading order is only appropriate if there are similar laws and regulatory oversight over the proposed trading. This position has been articulated by a number of our offices, including the Southern District of New York, the District of Delaware, and the Central District of California.

⁵ Individual natural persons who serve on committees in their individual capacity should not be permitted to trade. In such cases, no ethical wall is possible.

⁶ *In re Spiegel*, a Southern District of New York bankruptcy court decision that has been cited favorably by the Program in opposition to a trading order, rejected a securities trading order and expressed concern about such orders in general. *In re Spiegel*, 292 B.R. 748, 751 (Bankr. S.D.N.Y. 2003). Trading in securities of the debtor by committee members, regardless of how the creditor internally divides its office, creates “an appearance of impropriety.” *Id.* In *Spiegel*, the court could not determine that committee members met the *Federated* standards absent further development of the factual record regarding, *inter alia*, the nature of the members’ business and their relationships with their clients.

- In forming an unsecured creditors' committee, the United States Trustee will seek to include all interests represented within the unsecured creditor body, will question whether an entity trades as a regular part of its business, and if so, whether it has established reasonable ethical walls. The inquiry will include whether the SEC or another agency has effective oversight of the trading at issue.⁷ If these inquiries are not answered in the affirmative, the United States Trustee will consider whether there are other suitable creditors available to serve on the committee.
- A committee member's motion for a trading order must provide adequate notice to all parties in interest. Different approaches have been encountered by United States Trustee offices in Southern District of New York and Delaware. In *Delta Airlines*, each individual committee member who sought to trade was required to seek a trading order. The Program believes that this approach is preferable.
- Members who seek trading orders should demonstrate familiarity with ethical walls. In affidavits, it is advisable that members make the following declarations consistent with the *Federated* decision and similar subsequent orders:
 - (1) That the individual performing committee duties will comply with the terms and procedures of the ethical wall and will designate a person responsible for monitoring compliance;
 - (2) That committee personnel will not share non-public committee member information with other employees of their company;
 - (3) That committee personnel will receive no information regarding the company's current securities trades in advance of such trades;
 - (4) That committee personnel will maintain all files containing non-public information generated from committee activities in cabinets inaccessible to other employees;
 - (5) That committee personnel will work in physically separated office space, and will use separate phone and fax lines.
- The Program has started to implement a procedure that requires a committee member to file quarterly statements with the United States Trustee confirming that it has reviewed its procedures to ensure that the ethical walls continue to be effective.⁸

⁷ Inadequate ethical walls recently prompted SEC enforcement actions against Blue River, a member of several bankruptcy creditors' committees. *See* attached summary.

⁸ The committee member should be responsible for reviewing the procedures itself, whether or not it reports its review to the United States Trustee. *See Federated*, 1991 WL 79143 at *1 (order does not require reporting but requires committee member's compliance department

- In addition, in the wake of the SEC’s investigation of Blue River Capital LLC,⁹ the U.S. Trustee in the Southern District of New York developed a procedure for certification with quarterly updates, which we seek to implement nationally. A committee member must file an initial certification of the amount and types of its claims and holdings in the debtor, and update this information through quarterly reports submitted to the United States Trustee.
- A trading order should clearly and appropriately state the limitations of its “comfort” to the particular creditor. *See Federated; Calpine Order* (copy attached).
- It is advisable that an order also include the following protections to the jurisdiction of the court and the United States Trustee:
 - (1) The bankruptcy court is not precluded from taking any action in the event that it determines that an actual breach of fiduciary duty has occurred. *See Calpine Order* at 2; and
 - (2) The United States Trustee is not precluded from removing a committee member pursuant to § 1102 if it determines that such a breach has occurred. *See Calpine Order* at 2.
- U.S. Trustees have encountered the issue whether fees associated with a motion for a trading order are properly payable from the estate. Generally, it would appear that these expenditures would inure solely to the benefit of the particular creditor. The creditor is required to demonstrate an affirmative showing that the order benefits the estate and thereby justifies payment of fees from the estate.

VI. Ad Hoc Committees

Nature and Activities of Ad Hoc Committees

personnel to review trades to confirm that such trades were made in compliance with ethical walls and to keep records of such review); *Note: Fiduciary Responsibilities of Creditors’ Committee Members With Respect to Securities and Commodities Transactions*, 10 Am. Bankr. Inst. L. Rev. 493, 508 (Spring 2002) (stating that oversight of ethical walls is the most controversial issue with trading orders, and that the “courts are not the appropriate venue for this responsibility,” as oversight should be provided by either the affected parties or outside counsel).

⁹ In November 2005, the SEC announced an enforcement action against Blue River Capital LLC, an SEC-registered broker-dealer, which it found had fraudulently backdated trades to give the firm an apparently large enough stake in WorldCom to gain a seat on WorldCom’s chapter 11 bankruptcy creditors’ committee. The SEC also alleged that Blue River violated securities laws by misusing nonpublic information.

Ad hoc committees enable members who are not on official committees to pool information and resources and act collectively, such as sharing the expenses of counsel and other professionals and speaking with a single voice, both in court and in negotiations with the debtor and other parties. Such arrangements offer the promise of efficiency for members and for others by avoiding duplicative appearances, filings and arguments.

Ad hoc committees may engage in the same activities and appear and be heard in the same capacity and right as their members. But there may be limitations, such as submitting a joint claim or joint ballot.

Unlike official committees, ad hoc committees:

- Lack a statutory basis in Bankruptcy Code. They are not an expressly defined entity under the Code and have no role provided under the Code. An ad hoc committee's authority to appear and be heard in a bankruptcy case derives from the status of its members. Ad hoc committees may exist before a case is commenced and may continue after a plan is confirmed.
- Are not constituted by the United States Trustee. Membership is not determined by United States Trustee, the Code, or the bankruptcy court. For instance, the Code authorizes official committees of creditors and interest holders, but ad hoc committees may include those and other parties, such as secured creditors or administrative claimants. In addition, membership is at will and the composition of the committee may change frequently and substantially during the course of the case.
- Lack the same duties as official committees. Official committee members owe fiduciary duties to those with claims or interests of the type represented by the committee, and accordingly may not act solely in their own interest when acting as committee members. Because ad hoc committees do not purport to represent interests beyond those of their members, and because they are not creatures of the Code, they lack duties to non-members.
- Lack the rights of an official committee to information, including those rights set forth in 11 U.S.C. § 1103(c) to: (1) consult with the trustee or debtor in possession concerning the administration of the case; (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; (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan; (4) request the appointment of a trustee or examiner under § 1104 of the Bankruptcy Code; and (5) perform such other services as are in the interest of those represented.

- If the debtor chooses to disclose information to the ad hoc committee, typically members are not subject to trading restrictions applicable to members of an official committee, unless they seek to receive material nonpublic information about the debtor.
- Are not obligated, under 11 U.S.C. § 1102(b)(3), to share information with and solicit the opinion of other creditors or interest holders of the type represented by the committee.
- Are not entitled under the Code to reimbursement from the bankruptcy estate for professional fees and expenses, unless the ad hoc committee members can demonstrate that they have made a “substantial contribution” to the debtor’s bankruptcy case within the meaning of 11 U.S.C. §§ 503(b)(3)(D) and (b)(4), or as oversecured creditors under 11 U.S.C. § 506(b).
- May retain professionals that do not comply with the requirements for disinterestedness and restrictions on representation of adverse interests under 11 U.S.C. §§ 328(c) and 1103(b) applicable to official committees. However, state law ethical guidelines for professionals do apply.

Is disclosure required under Rule 2019(a)?

Federal Rule of Bankruptcy Procedure 2019(a) requires any “entity or committee” that represents more than one creditor or equity security holder in connection with a chapter 9 or chapter 11 bankruptcy case, other than official committees appointed under § 1102 or retiree committees appointed under § 1114(d), to file a verified statement identifying each client and the nature of their claims or interests, together with certain facts about the professional’s employment.

The rule requires the filing of a verified statement that sets forth:

- (1) the name and address of the creditor or equity security holder;
- (2) the nature and amount of the claim or interest and the time of acquisition unless it is alleged to have been acquired more than one year prior to the filing of the petition;
- (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and
- (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the

entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.

The rule requires the prompt filing of a supplemental statement setting forth any material changes in the facts contained in the verified statement.

Although historically there has been very little case law under Rule 2019(a), two decisions early last year attracted significant attention by addressing whether the Rule applies to ad hoc committees in chapter 11 cases. Members of these committees may be hedge funds and other distressed-debt investors that are playing an increasingly active role in corporate reorganizations, and some of them may hold debt at various levels of the debtor's debt structure.

The two decisions, *Northwest Airlines* and *Pacific Lumber*, split on the issue of whether more detailed Rule 2019(a) disclosure is required for ad hoc committees.

- In February 2007, Judge Allan Gropper of the U.S. Bankruptcy Court for the Southern District of New York ordered that members of an ad hoc committee of equity security holders disclose the amounts of their claims or interests, the times when they acquired this property, the amounts paid, and any sale or other disposition of this property. *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).
- Following the court's decision, the ad hoc committee argued that § 107 of the Bankruptcy Code required that the court keep the Rule 2019(a) statement confidential in order to protect the members' investment strategies. The United States Trustee responded that public policy favors open access to documents filed in bankruptcy cases and that the committee members had not demonstrated that their trading data was confidential information or trade secrets. In March 2007, Judge Gropper denied the committee's motion to file the Rule 2019(a) statement under seal. *In re Northwest Airlines Corp.*, 363 B.R. 704 (Bankr. S.D.N.Y. 2007). The judge held that any interest that an individual committee member had in keeping information confidential was overridden by the interest in public disclosure that Rule 2019(a) seeks to protect.
- In *Pacific Lumber*, Rule 2019(a) was interpreted in a much different manner. *In re Scotia Dev., LLC*, 07-20027 (Bankr. S.D. Tex. Apr. 20, 2007). In that case, Judge Richard Schmidt of the U.S. Bankruptcy Court for the Southern District of Texas rejected a motion by the debtor to require full Rule 2019(a) disclosure from members of an ad hoc committee of timber note holders. The debtor argued that the note holders actively participated in the case, but hid "behind a veil of secrecy" that was contrary to the open disclosure policies in bankruptcy. The committee did not disclose its composition, the interests each member held, and the price at which its interests were acquired. The committee argued that it was not a "committee" under Rule 2019 because it did not purport to represent any

others who were not on the committee. In a unpublished April 2007 decision, Judge Schmidt held that the committee was not a “committee” under Rule 2019 and, therefore, did not need to make disclosures in compliance with the Rule.

U.S. Trustee Program’s Position - Full disclosure of the identities of ad hoc committee members and their claims, in accordance with Fed. R. Bankr. P. 2019(a), should be the general rule in light of the compelling policy reasons for requiring full disclosure from unofficial committees.¹⁰ These reasons include guarding against abuse and helping to foster fair and equitable plans free from deception and overreaching.

Other Issues of Interest to the United States Trustee Program

- A. Substantial Contribution Claims.** The Program closely scrutinizes substantial contribution claims brought by ad hoc committees and their professionals under 11 U.S.C. §§ 503(b)(3)(D) and (b)(4), and settlements that effect the payment of substantial contribution claims, to ensure compliance with applicable standards for reimbursement. Among other things, the Program looks at whether the ad hoc committee was motivated and acted solely in its members’ self interest and whether the activity duplicated the activity of an official committee. In such cases, reimbursement is not appropriate.
- B. Trading Orders.** Once a member obtains material nonpublic information about the debtor, it is restricted from trading in the debtor’s securities. Ethical walls between individuals who receive the information and those that trade the debtor’s securities may be impractical for smaller investors.

VII. KERPs and the Application of 11 U.S.C. § 503(c)

Prior to BAPCPA, debtors-in-possession typically requested approval of employment compensation under 11 U.S.C. §§ 363(b) or 365. Debtors’ requests for approval of management compensation proposals, including “key employee retention programs” (“KERPs”), were considered under the “sound business purpose” test, which was essentially a “business judgment” rule.

BAPCPA amended the Bankruptcy Code to add 11 U.S.C. § 503(c), which restricts the allowance and payment of administrative expenses to a debtor’s officers, managers, and consultants. In drafting the BAPCPA, Congress sought to substantially limit a chapter 11 debtor’s use of KERPs and severance packages to enhance the compensation of the debtor’s top managers and insiders.

¹⁰ Recognizing the importance of full disclosure by candidates for membership on official committees of unsecured creditors formed pursuant to 11 U.S.C. § 1102(a) in large, public companies, the Program has begun to require quarterly reporting of the members’ debt and securities holdings.

1. Section 503(c) establishes basic evidentiary standards that must be met before a bankruptcy court may authorize payments made to an “insider” for the following purposes:

- **Retention Payments** - Must show that (1) the individual has a bona fide offer from another business at the same or greater rate of compensation; (2) the continued service of the person is essential to the survival of the business; and (3) *either* transfer not greater than 10 times the amount of the mean payment of a similar kind given to non-management during the calendar year in which transfer is made *or*, if no similar transfers, the amount of the transfer cannot be greater than 25 percent of any similar transfer made to the insider during the calendar year before the year in which the proposed transfer is made.
- **Severance Payment** - Must show that (1) the payment is part of a program generally available to all full-time employees; and (2) the payment not greater than 10 times the average amount of severance pay given to non-management employees during the calendar year in which payment is made.

Section 503(c)(3) prohibits transfers outside the ordinary course of business that are “not justified by the facts and circumstances of case.” While the statute applies to all such transfers for compensation, it specifically lists transfers to or for the benefit of officers, managers, or consultants hired after the date of the filing as being within its scope.

2. **Issues Arising Under 11 U.S.C. § 503(c)** - Motions filed by debtors in possession seeking authority to make payments or incur obligations subject to 11 U.S.C. § 503(c) often raise more questions than they answer. Such motions omit critical information necessary to evaluate whether the plan complies with § 503(c), such as: (a) who is covered by the plan; (b) whether any of the covered persons are “insiders;” (c) if the plan purports to be an incentive plan, the performance goals an employee must meet to receive a bonus; and (c) the specific amounts proposed to be paid to each employee.

- **Who is an “insider”?** Debtors frequently seek the approval of retention or severance plans that cover persons with titles such as “Vice President” or “Secretary.” Because “insider” is defined in § 101(31) to include an officer or director of a corporation, proposed bonus payments to persons with such titles raise red flags. The United States Trustee will inquire into whether persons with such titles were given them pursuant to applicable non-bankruptcy law; *i.e.*, by resolution of the board of directors. If so, those persons are insiders and may not be paid retention or severance bonuses that do not fit the constraints of §§ 503(c)(1) and (2). Debtors frequently assert that such officers are not “real officers,” because they do not have control over the debtor’s affairs. The definition in §101(31) does not, however, differentiate between officers in control and officers not in

control. While the title does not govern insider status, the debtor must establish that persons with officer titles are not true officers of the corporate debtor.

- **Incentive Bonus Plans.** Many debtors have sought to adopt incentive bonus plans that would pay insiders and others substantial bonuses if the debtor reached prescribed benchmarks or payment “triggers.” Any such program is subject to the constraints of § 503(c)(3) – the debtor must establish that the payments are justified by the facts and circumstances of the case. If, however, the incentive triggers are so easily attained that all an insider need do is stay employed by the debtor until a date certain, the plan is in reality a disguised retention plan subject to the constraints of § 503(c)(1). United States Trustees carefully scrutinize “incentive plans” to assure to the greatest extent possible that they are not proscribed KERPs. *See* discussion of *Dana* cases below.
- **Assumption of executory contracts.** Some debtors have sought to circumvent §§ 503(c)(1) and (2) by moving under § 365 to assume employment contracts calling for the payment of retention or severance bonuses to insiders. But § 503(c) states that such payments shall neither be allowed *nor paid*. The payment of a retention bonus to an insider, whether pursuant to a contract assumed under § 365 or a post-petition agreement, therefore runs afoul of § 503(c)(1) unless it meets the stringent requirements of that provision. United States Trustees will therefore object to attempts to circumvent § 503(c) through the use of § 365.
- **Unreasonably narrow definitions of “severance.”** Some debtors argue that post-termination payments are being given as consideration for actions or forbearance on the part of the terminated employee which are unrelated to the termination event itself. Because non-compete clauses and releases are standard terms of severance agreements, United States Trustee will carefully scrutinize any such proposed payments.
- **Calculation of severance benefits.** Under § 503(c)(2)(B), the maximum severance pay for an insider cannot exceed 10 times the average severance pay given to non-management employees during the calendar year in which the payment to the insider is made. It is impossible for a court to approve a prospective severance payment for an insider, because the calculation of the average non-management severance pay cannot be made until the time when the payment is to be made to the insider. This problem can best be alleviated by building the statutory limitation into the plan itself.
- **Standard of Proof under § 503(c)(3).** Parties routinely assert that the debtor need meet only the “business judgment” standard under § 363 to obtain approval for payments subject to § 503(c)(3). The *Dana* court so

held. Nevertheless, the statutory language requires that the court find that such payments are “justified by the facts and circumstances of the case.” If this standard is identical to the “business judgment” standard, then § 503(c)(3) means nothing. All transfers of estate assets outside the ordinary course of business must meet the business judgment standard under § 363. Congress, by enacting § 503(c)(3), clearly intended that unusual compensation arrangements be subjected to higher scrutiny. At a minimum, debtors should be required to put on real evidence showing why such payments are an appropriate use of estate property; the mere invocation of the words “business judgment” should not suffice to satisfy this burden of proof.

3. Case law in this area is still developing.

- ***In re Malden Mills Indus., Inc.*, Case No. 07-40124 (Bankr. D. Mass. 2007)** - Debtors filed chapter 11 petitions in the District of Delaware and filed a motion for an order authorizing payment of sale-related incentive pay to senior management, most of whom were insiders. Under the motion, if certain executive employees remained employed in their current jobs until the sale of the debtors’ businesses – a date projected to be only 57 days from the commencement of the cases – they would receive close to \$1 million in “incentive” payments from the sale proceeds. Unsecured creditors would receive no sale proceeds. The cases were later transferred to the District of Massachusetts.

The Unsecured Creditors Committee and the U.S. Trustee filed objections to the incentive pay plan, arguing that it was nothing more than a disguised KERP that would improperly pay insider executives large sums for remaining a short time and doing what they are already employed to do in any event.

Subsequently, the U.S. Trustee was informed that Malden Mills was withdrawing its motion. According to the firm’s local counsel, the firm had assessed their likelihood of success on the motion as poor and adverse publicity generated by the motion was a factor in the decision to withdraw.

- ***In re Dana Corp.*, 351 B.R. 96 (Bankr. S.D.N.Y. 2006)** - Debtor sought approval of its compensation plan for certain of its executives. As part of the plan, the debtor proposed that (i) if the chief executive officer’s (“CEO”) employment is involuntarily terminated without “cause,” (ii) if the CEO resigns for “good reason,” or (iii) if the CEO fails to complete a replacement employment agreement with the reorganized company following good-faith negotiations, the CEO would execute a non-compete agreement in exchange for payments of approximately \$167K/month for the 18-month term of the agreement. Additionally, the CEO would be eligible to receive a pro rata payout of a “completion bonus” if the business plan had been completed, but the effective

date of a confirmed plan had not occurred. If the effective date of a confirmed plan occurred, the CEO would receive full payment of the completion bonus.

The debtor argued that the aforementioned payments linked to the CEO's termination were not "severance" payments for 11 U.S.C. § 503(c)(2) purposes. Rather, the payments were "payments in exchange for non-compete agreements." *Dana I*, 351 B.R. at 102. The bankruptcy court refused to adopt the debtor's construction of the "severance" term in 11 U.S.C. § 503(c)(2), and noted that "[s]everance pay is a form of compensation to alleviate the consequent need for economic readjustment but also to recompense him for certain losses attributable to the dismissal." The court also rejected the characterization of the "completion bonus" as an incentive bonus, saying instead that the "compensation scheme walks, talks and is a retention bonus" that was subject to evidentiary standards of § 503(c).

In *In re Dana Corp.*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006) ("*Dana II*"), the bankruptcy court approved the debtor's revised bonus plan, finding that the incentive goals were legitimate and would not be so easily met that the bonus plan was in reality a retention plan.