



Scott E. Schuster, Esquire

412.456.8119 telephone

412.456.8273 fax

sschuster@bernsteinlaw.com

Scott concentrates in bankruptcy and restructuring. Prior to joining Bernstein Law Firm, he clerked for two civil litigators in the area of bankruptcy. In addition to his firm work, Scott also completed an externship with the honorable Judge Arthur J. Schwab, United States District Court, Western District of Pennsylvania.

THE UNSECURED CREDITORS COMMITTEE: WHAT IT IS, WHAT IT DOES, AND WHY YOU SHOULD BE INVOLVED

By Scott E. Schuster, Esquire

OVERVIEW

Unless you demand C.O.D. payments from all of your customers, chances are you've worried about a customer that has entered Chapter 11 bankruptcy. Of course, your first thought is: "Am I going to get paid?" Depending on the type of business you are in, you probably don't have a lien on any of the debtor's property, in which case, under the Bankruptcy Code you are known as an unsecured creditor. Fortunately, the Bankruptcy Code provides for an alliance of unsecured creditors, known as the Official Committee of Unsecured Creditors (the "Committee"), whose duty is to represent the interests of all of the debtor's unsecured creditors. The Committee typically consists of the debtor's largest unsecured creditors, but if there are many small creditors, the Committee should have some small creditor representatives.

If your company is one of the debtor's largest unsecured creditors, the U.S. Trustee might send a letter asking if you would like to participate on the Committee. Many companies disregard this request; assuming that there is nothing anyone can do to change the outcome of the bankruptcy case. This article explores the various tools at a Committee's disposal to benefit the class of general unsecured creditors, i.e. increase the payout to unsecured creditors, as well as the advantages of serving on the Committee.

TYPICAL CHAPTER 11 BANKRUPTCY

There are three primary parties in the typical chapter 11 bankruptcy case: 1) the "Debtor" (the one in bankruptcy); 2) the Debtor's primary secured creditor; and 3) the official Committee of Unsecured Creditors.

In a chapter 11, the Debtor operates as a "debtor-in-possession," which means that the Debtor remains in possession of its assets and should operate its business for the benefit of its creditors and shareholders. As you might imagine, debtors often operate with little or no regard to the welfare of creditors. Even if the Debtor's intentions are sincere, the same management that drove the company to bankruptcy is usually charged with rescuing it. Obviously, certain checks and balances are necessary for a successful reorganization.

The secured creditor is most often a bank and is usually represented by very skilled legal counsel. The secured creditor usually has a lien on substantially all of the



A BUSINESS APPROACH
TO LEGAL SERVICE

continued on page 2

THE UNSECURED CREDITORS COMMITTEE

continued from page 1

Debtor's assets, including its equipment, inventory and even the cash in its bank accounts. The secured creditors often wield significant influence on whether a Debtor can successfully reorganize or is forced to liquidate and close its doors. Often, secured creditors are paid the value of their secured claims before the unsecured creditors can receive any distribution.

Last, but certainly not least, the Unsecured Creditors Committee represents the interests of the Debtor's unsecured creditor body. The Bankruptcy Code authorizes the Committee to hire professionals such as lawyers and financial advisers to assist the Committee in executing its duties. Further, the Bankruptcy Code mandates that the Debtor pay the fees and expenses of the Committee's professionals (yes, that means attorneys' fees), so long as those fees and expenses are reasonable and necessary. The professionals assist the Committee in several key areas:

- Review and analyze the Debtor's financial records, determining if the Debtor can successfully reorganize.
- Assess how much the Debtor can afford to pay to unsecured creditors through a plan of reorganization.
- Protect the Committee's interest throughout the process, including representation before the court.

The debtor, the secured creditors and the unsecured creditors are sometimes at odds with each other, but depending on the facts of the case, they may become allies. The Debtor wants to successfully reorganize and emerge from bankruptcy, but often attempts to do so by paying the unsecured creditors as little as possible. As you would expect, the bank wants to maximize its recovery, with little concern about how much the unsecured creditors receive. Accordingly, the Committee usually acts as a check on the otherwise unobstructed power of these two groups.

THE COMMITTEE'S ROLE

• Drive the Case – Reorganization or Liquidation?

From the standpoint of unsecured creditors, every bankruptcy case is different. In a small percentage of bankruptcy cases, the Debtor has enough assets to pay its secured creditors in full and still make a substantial distribution to unsecured creditors. When it is clear that the Debtor is losing money (often due to some unavoidable economic condition), the Committee may want to force the Debtor to liquidate, which the Committee often has the power to do. Liquidation maximizes the return to creditors because it prevents the Debtor from dissipating the assets present at the onset of the bankruptcy case.

continued on page 3

THE UNSECURED CREDITORS COMMITTEE

continued from page 2

Many times, a bank is owed much more money than the Debtor's assets are worth. Consequently, unsecured creditors usually get paid only if the Debtor successfully reorganizes and makes a distribution to creditors through future cash flow. In these cases, the Committee wants to "drive" the case toward reorganization and influence and/or control the Debtor's business decisions with an eye toward eventual payments to unsecured creditors.

• **Police the Debtor**

As one of its most important duties, the Committee polices the Debtor, making sure the Debtor operates its business to maximize a return to creditors, which is a fiduciary "duty" for businesses in Chapter 11. Unfortunately, in many small- and medium-sized businesses, either the Debtor management ignores its fiduciary duty or is not competent to successfully navigate a company in bankruptcy.

In this scenario, the Committee can and should use its statutory powers to force the Debtor to operate its business properly. The Committee can hire financial advisors to gauge whether the Debtor is running its business efficiently and can prod the Debtor to reduce expenses by, say, forcing it to cut payroll, freeze capital expenditures, lower excessive salaries of its officers and directors, or sell excess equipment. Through these actions, the Committee can ensure that the Debtor's business decisions are benefiting the creditors, rather than the Debtor's management or owners.

• **Balance the Secured Creditor(s)' power**

The Committee also acts as an aggressive opponent of the Debtor's secured creditor(s). The secured creditors, often, are represented by counsel adept in using the Bankruptcy Code to maximize the return to their clients. As such, the Committee tries to prevent the secured creditors from taking advantage of the Debtor. This is one reason why the Committee should select legal counsel experienced in representing unsecured creditors' committees as soon as possible. Among the issues arising in a chapter 11 case, are situations where the Debtor is unable to stand up to its bank because of loan covenants, politics or simply maintaining relationships. In such cases, the Committee can protect the interest of unsecured creditors (and sometimes the Debtor's interest) by raising issues and challenging the bank when the Debtor cannot. The Committee, as the representative of the entire unsecured creditor body, can appear and be heard on almost every issue in a case, giving the Committee significant power to negotiate with the various parties in the case.

• **Negotiate the terms of a Plan of Reorganization**

Perhaps the single most important function of the Committee occurs toward the end of the bankruptcy case. In order to emerge from bankruptcy, the Debtor must have a

continued on page 4



A BUSINESS APPROACH
TO LEGAL SERVICE

THE UNSECURED CREDITORS COMMITTEE

continued from page 3

court approve a Plan of Reorganization. This Plan is a new agreement that determines how the reorganized entity will treat the creditors, including how much money they will receive. Typically, in order for a Plan to be confirmed, each “class” of creditors (secured creditors, priority creditors such as taxing authorities, and unsecured creditors) must vote to accept the Plan.

The Committee should make a recommendation to the creditor body to vote to accept or reject the Debtor’s Plan. As you would imagine, such a recommendation greatly influences the unsecured creditors’ votes. Since the Committee spends the bulk of its time analyzing the Debtor’s business and determining the viability of the Debtor’s Plan, the Debtor should negotiate the Plan’s terms with the Committee before the Plan is filed. Thus, the Committee can negotiate terms such as the total percentage of the unsecured claims to be paid, how frequently payments are made and for how long. Remember, the Committee’s attorneys and financial advisors review the Debtor’s financial statements, so the Committee knows how much the Debtor can afford to pay and over what period of time.

The Committee can often be creative in negotiation. Perhaps the Debtor makes one lump sum payment immediately after it emerges from bankruptcy. Perhaps the Debtor makes some minimum payment for a number of years. There are many options available to the Committee and it literally “pays” to be creative.

• **When and why you should volunteer to be on the Committee**

As you can see, the Committee often has a significant impact on what the unsecured creditors receive from a bankruptcy. Obviously, if the Debtor does not owe you much money, it may not be worth your time to get involved. However, that is not always the case. What if the Debtor is one of your most important customers? Do you really want other people determining whether the Debtor survives or goes into liquidation and closes its doors? Very often, a large number of unsecured creditors want the Debtor to survive because they depend on the Debtor as a customer. These creditors are more interested in keeping a company alive as a customer and hopefully recoup their losses through future sales. The Committee should be aware that not all creditors are concerned with the survival of the debtor – they want their money and many of them might not benefit from future business.

Serving on a Committee usually takes far less time than most people think. As discussed above, the Committee hires professionals to review the Debtor’s books, monitor the Debtor’s legal filings, and recommend a course of action. Committee counsel then implements that strategy, i.e. drafts and files the necessary motions, negotiates with the Debtor’s lawyers, etc.



A BUSINESS APPROACH
TO LEGAL SERVICE

continued on page 5

THE UNSECURED CREDITORS COMMITTEE

continued from page 4

Another important question: How much money will Committee membership cost you? The answer is nothing. The Debtor pays all of the Committee's reasonable and necessary fees and expenses.

GET INVOLVED – EARLY!

Timing is very important. Since the first days of a Chapter 11 can set the stage for the future of the reorganization, and since the Debtor (and the Banks) often rush in with "First Day" Motions and Orders, any word you get about your customer filing Chapter 11 should trigger a call to your bankruptcy counsel. Bernstein Law Firm routinely receives those calls from creditors asking if there is something that can be done because their customer just filed. In fact, if you even think they've filed, we can help you quickly determine the truth and create a strategy to help you make the right moves during the first few days of the case. Fast action on your part could make the difference between a reasonable recovery and a complete write-off.

CONCLUSION – BE AWARE

Someday you may find yourself caught up in a bankruptcy filing. It may be a situation where your company has a lot of money at stake or the future of one of your top customers hangs in the balance. The decisions made by the Committee may dramatically alter the outcome of the Debtor's case. You can get involved by committing yourself (or someone from your company) to a conference call once a week or once every two weeks on the Debtor's dime. The next time you receive a letter from the U.S. Trustee's Office asking you to join a Committee, perhaps you'll give it a try.



A BUSINESS APPROACH
TO LEGAL SERVICE

Suite 2200 Gulf Tower
707 Grant St.
Pittsburgh, PA 15219

412.456.8100

www.BernsteinLaw.com