

The New Wave of Equity Committees in Bankruptcy: What Are They and Are They Here to Stay?

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Introduction

In recent months, several high-profile bankruptcy cases have involved the appointment of a formal equity committee. Historically very rare, the formation of an ad hoc and/or appointment of a formal equity committee appears to have recently taken the US bankruptcy world by storm and will likely impact how future restructurings are handled.

Since 2000, equity committees have formally been appointed in several US bankruptcies, including Mirant Corporation, Loral Space & Communications Limited, Trump Hotels and Casinos, Kmart Corp., USG Corp., Interstate Bakeries Corporation, Calpine Corporation, Oneida Ltd., OCA, Inc., Dana Corporation and Delphi Corp. The formation of these equity committees has acted and may continue to act as an obstacle in any consensual restructuring plan developed by a debtor for itself and its creditors.

Generally speaking, Chapter 11 is a mechanism whereby an overleveraged debtor will utilise the US Bankruptcy Code (the 'Code') to settle or compromise its debts and emerge stronger as a healthier and hopefully viable entity. Chapter 11 allows a debtor-in-possession to obtain relief from its creditors, negotiate its past due obligations, typically in the form of cash and/or future equity of the reorganised debtor, and rehabilitate itself. Consequently, if bankruptcy is a tool that creditors use to protect their interests, should shareholders, who typically receive nothing in a restructuring, have similar rights in these proceedings?

The reason and rationale for equity committees

It is well established that the board of directors of a solvent corporation has a fiduciary duty to its share-

holders. However, when a company enters the 'zone of insolvency', it is primarily due to the fact that a company may not be able to pay its debts as they become due and accordingly, the fiduciary duty now extends to its creditors. Pursuant to the absolute priority rule in the Code, shareholders are forced to the bottom of the hierarchy and in most cases are forgotten in the process. Since the end game is for all stakeholders to obtain some value of the reorganised entity, the introduction of an equity committee has the potential to promote conflicts regarding the valuation of an enterprise and its future ownership structure. Many shareholders use this conflicting fiduciary duty of when a solvent corporation enters the zone of insolvency and the resulting change of fiduciary duty, as its first and foremost basis for the immediate appointment of an equity committee. Equity participants believe that their interests are not adequately protected upon insolvency and therefore feel it necessary to have a formal seat at the negotiating table.

Notwithstanding the above reasoning, it is unclear and somewhat confusing why equity committees were appointed in certain cases and not in others. For example, the US Bankruptcy Court declined the formation of equity committees in such mega-cases as WorldCom Inc., Enron Corp., Global Crossing Ltd., UAL Corporation and Lernout & Hauspie Speech Products N.V. Whilst it goes without saying that the appointment of formal equity committees include costs that will be borne by the debtor and, if the equity ultimately receives no distribution, by the creditors, some professionals argue that the majority of distressed equity players are large institutions and/or distressed funds who can afford their own advice and, for that reason, their associated professional fees should not be charged to the bankrupt estate at all.

Notes

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Regardless, the Code does provide for such a committee and it is very typical these days, in fact, for equity committees hoping to be formally appointed to seek backing from the Securities and Exchange Commission ('SEC'). As prescribed in section 1102(a)(1) of the Code, the Court may order the appointment of such a committee:

Except as provided in paragraph 3, as soon as practicable after the order for relief under chapter 11 under 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.

Section 1102(a)(2) goes on to state:

On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee.

Unfortunately, the Code does not define or provide any assurance of 'adequate representation' and this is more or less determined on a case-by-case basis. Historically, US courts have used five factors to make such a determination:

1. Number of shareholders;
2. Complexity of the case;
3. Solvency of Debtor;
4. Cost to Estate outweighs the adequate representation interest of shareholders; and
5. Whether the interests of shareholders are already represented.

The onus is therefore on the equity holders to convincingly prove the above factors to the US Trustee and subsequently a bankruptcy judge. Courts have stipulated that no one factor should be preferred over the others but in dealing with each of the aforementioned issues, it would appear that the third item, solvency, is the 'make-or-break' feature regarding the appointment of an equity committee, while the other four points are somewhat easier to illustrate.

In particular, cases contemplating the formation of an equity committee typically are public companies whereby the common stock is widely held and actively traded both before and after the petition date. As a general note, it is vastly agreed that these types of ownership structures inevitably lead to complex restructurings and thus factors #1 and #2 are typically satisfied. In addition, equity holders in almost all cases are easily able to state and prove that the other constituencies, including the creditors' committee, do not represent the interest of shareholders, thereby

advocating the need to adequately protect the interests of shareholders; this relates to factor #5.

Depending on the stage of the case and with respect to factor #4, it is sometimes difficult to prove the cost-benefit advantage of appointing an equity committee but at times it can be best to appoint a formal committee and later disband it if it can be proven that no meaningful recoveries exist for equity security holders. As stated above, no one factor should outweigh another and 'costs alone cannot and should not deprive public debt and security holders of representation' as set out *In re McLean Indus., Inc.*, 70 B.R. 852, 860 (Bankr. S.D.N.Y. 1987).

Although the solvency test is one of the most difficult to apply, it is one of the most commonly used reasons referred to when determining whether or not to appoint a formal equity committee.

The concept of solvency

Solvency is the most-used applicable legal standard when deciding whether or not to appoint an equity committee. In many cases, it is imperative for the shareholders to prove to the courts that the debtor was not or is not 'hopelessly insolvent', as opposed to simply proving solvency. It is a very common technique for shareholders to analyse (and use to their advantage) the pre- and post-petition trading data of the common equity along with positive press releases from company management to prove the point of not being hopelessly insolvent.

If a debtor is hopelessly insolvent, justification can be made that there is no need for shareholder opinion, as shareholders are out-of-the-money and the cost required and charged to the bankrupt estate for the professionals representing the shareholders outweigh the adequate representation interest of the shareholders and would, therefore, be unduly burdensome to the bankrupt estate.

Other stakeholders not in favour of an equity committee will attempt to illustrate that equity holders are out-of-the-money and there is no substantial likelihood or potential for a meaningful distribution of value as set out *In re Williams Communications Group, Inc.*, 281 B.R. 216 (Bankr. S.D.N.Y. 2002). Since the *Williams* ruling in 2002, this higher standard has rarely been used as a precedent for future cases and is supported by minimal prior case law (*In re Northwestern Corporation 2004*, WL 1077913, *2 (Bankr. D. Del. 13 May 2004)). However, in the bankruptcy of the grocery chain Winn-Dixie Stores, Inc., the five-month-old shareholder committee was disbanded because it was disclosed that there was in fact, no meaningful recovery to shareholders.

This higher standard highlights the 'chicken-and-egg' game involved in restructuring negotiations. In order for equity holders to bring their position to the

forefront, they are preliminarily forced to produce a valuation with limited information from the debtor and minimal resources in order to illustrate their cause prior to being able to execute their rights under section 1102.

Not surprisingly, the solvency issue surfaces when the debtor appears to be superficially solvent on some level, and it can therefore be proven that shareholders have some meaningful interest in the outcome of the case. The shareholders therefore take the position that they should be entitled to 'voice' their opinions meaningfully via section 1102. Bankruptcy cases involving debtors substantially leveraged with minimal (but not zero) equity value have the dangerous ability to pose problems in trying to obtain a consensual reorganisation.

Role of the equity committee

Similar to the formation and role of a creditors' committee in US Bankruptcy, a formal equity committee should participate and be very interactive with the debtor and its advisors, and in some cases will need to communicate with other stakeholders. Effective and frequent communication amongst all parties reduces the risk and extent of litigation in any reorganisation. Specifically, section 1103(c) of the Code allows the equity committee to participate in the plan process which may include an investigation into the financial affairs and operations of the debtor, negotiate specific terms and conditions relating to the debtor's Plan of Reorganisation ('POR') and participate in the confirmation of the POR. Also, analogous to the rights of a creditors' committee, it is technically possible for an equity committee to file its own POR, should the debtor's exclusivity period expire and just cause be shown.

The goal of not only the equity committee (along with the creditors' committee) is to maximise value; the nuance is determining an optimal valuation and how to divide that value (if at all possible) in order to satisfy all stakeholders. However, an equity committee must not only maximise the overall value of the reorganised debtor but also the specific consideration received, whether it is purely common stock of the reorganised debtor or in the form of hybrid instruments such as preferred shares and/or warrants that may or may not be conditional on the debtor achieving certain financial milestones after exiting bankruptcy. In several cases, these equity-like securities can turn out to be in-the-money in the future.

To accomplish their goals, equity committees typically try:

a. To be involved as early as possible in the case. The earlier the concerns are voiced and recognised, the better the chance of obtaining a seat at the table to negotiate a more efficient confirmation process;

- b. To ensure open communication with all stakeholders but especially the debtor and its advisors to minimise litigation costs;
- c. To ensure the debtor is obtaining optimal value by achieving maximum profitability and obtaining maximum value related to the disposal of assets (i.e. no improvident realisation);
- d. To monitor an efficient claims management process to minimise value of claims and the optimal level of assets is used to satisfy creditor claims and minimise litigation costs; and
- e. To provide a supportable enterprise valuation.

Valuation concerns – pre- and post-petition

Determining whether or not meaningful equity value exists can be a challenge and in some cases may give new meaning to the expression, 'optical illusion'. Take for example, the case of Interstate Bakeries Corporation ('IBC').

A motion filed by the ad hoc committee of equity security holders on 2 November 2004 disclosed that IBC filed for Chapter 11 bankruptcy protection on or about 12 August 2004 but just 40 days prior, finalised a USD 100 million private placement of senior subordinated convertible notes. Court documents filed by legal counsel of the ad hoc committee of equity security holders on 2 November 2004 indicate the notes were priced with a 34.7% conversion premium and approximately three months after bankruptcy (i.e. post-petition) only traded at a slight discount. This financing would have been approved by its board of directors and management would have had to illustrate to investors meaningful equity value in order to consummate the financing. So, regardless that market share price may be driven by such extraneous factors as vulture funds, market manipulation, option value and global political events, from a capital markets basis, it would appear that the market perceived IBC equity to be 'in-the-money' at the time of the fund raising.

From an accounting convention, IBC filed its petition and other first-day motions indicating its book value of assets to be USD 305 million greater than its book value of liabilities – once again, indicating meaningful equity value. Although it is a fairly consistent theme that when companies become more and more distressed, it becomes more difficult to understand their financial statements, as they are typically not up-to-date, it is plausible that a significant write-down in assets (i.e., market value) as of the petition date may yield some potential equity value.

Furthermore, management stated in the press prior to the petition date comments indicating shareholder value. The sudden disappearance of this 'value' may in itself merit an investigation. In fact, the SEC did

support the formation of an equity committee with respect to IBC and all factors stated above strongly conquer this holistic notion of IBC being 'hopelessly insolvent' and accordingly the potential for meaningful equity value.

The aforementioned facts may have justified the need for an equity committee (which it did) or possibly an investigation of management or a thorough examination of the world's supposedly efficient capital markets.

The example above illustrates the concept of solvency and the potential establishment for an equity committee before and right after the petition date. During bankruptcy and prior to emergence, it is necessary to determine and support an enterprise valuation where it can be shown that all liabilities subject to compromise can be satisfied and any residual value should flow to equity holders. However, it is a well-known fact that enterprise value is subjective to a point. The choice of discount rates, terminal values, comparable companies and financial projections five years beyond, let alone three years, is based on so many assumptions and factors, one has to question how realistic some of these hypothetical estimates are, under dynamic circumstances.

By example, Foamex International Inc. ('Foamex') filed for bankruptcy on 19 September 2005 listing assets of USD 620 million and debts of USD 744 million, thereby implying no equity value from an accounting book value basis. However, Foamex's stocks and bonds continued to trade, and since May of this year, institutional shareholders kept implying that a formal committee should be appointed because equity was in-the-money due to improved and extraordinary financial performance of the debtor and consequently a higher valuation and potential distribution and/or recovery for equity holders. It is only recently, that the shareholders have withdrawn their bid for the creation of an official equity committee, and its reasons are unknown at this juncture.

It is the opinion of certain professionals that equity committees do not make sense at all because debtholders are entitled to the assets of a corporation and if the market value of the assets exceeds the market value of liabilities, the company should not have entered bankruptcy in the first instance. In other instances, it is often thought that liabilities might be overstated thereby drowning out any equity value. Or in fact, certain liabilities may be transferred to other entities or ultimately removed (e.g. pensions), reducing the net asset deficiency and possibly creating some level of equity value, even superficially.

International implications

The concept of a formal equity committee has not made any material impact internationally as it has in

the United States. It may take time to do so, if at all. The traditional thought of 'equity receives nothing' is still strictly followed in most developed countries and even with developing and refined bankruptcy legislation may be difficult to implement in not only creditor-friendly jurisdictions but in debtor-friendly courts.

Because of the extensive cross-border interconnectivity of businesses between Canada and the US, the concept of 'shareholder opinion' during a restructuring may start to be given a voice at the table during large Canadian restructurings. Although the statute under which most large Canadian restructurings occur, the *Companies Creditors' Arrangement Act* does not provide for the recognition of committees in the way that section 1102 of the Code does, the Canadian courts have historically followed US jurisprudence on the use of committees in restructurings.

A good example of the effect of an active shareholder group in Canada can be seen from the restructuring of Stelco Inc. ('Stelco'). Stelco highlights the importance of valuation evidence in establishing that shareholders' interests should be considered in a restructuring.

Although the shareholders were never granted official 'committee' status in that case, a group of shareholders joined together as an informal committee. To many observers, Stelco appeared solvent at the time that it sought protection, however, it claimed to be insolvent on the ground that if it were to be immediately wound up, it would have an approximately CAD 1.2 billion unfunded pension liability. Stelco's union challenged the finding that Stelco qualified for court protection as it was not insolvent, but this challenge was denied by the supervising judge who found that Stelco had negative equity.

Shortly after Stelco's filing, the price of steel rose dramatically and Stelco had one of its best quarters ever, financially speaking. This gave the shareholders hopes that they would have a voice in the development of the POR. Although Stelco had originally signalled that it would involve its shareholders by appointing two significant shareholders to its board of directors, the POR that Stelco eventually developed provided no value for the shareholders. This caused the shareholders to fight the sanctioning of the POR. They brought a motion to be formally recognised, but this motion was never heard, likely in recognition that Canadian courts have not generally granted shareholders committee status. As is typical in these cases, the key issue in the battle between the shareholders and Stelco was whether there was any value for the shareholders.

The dispute became a classic valuation fight with each side filing valuations supporting its position. The debtor filed three valuations while the shareholders relied on one. It is not clear, but it appears that, as a result of the fact that they were an informal committee, the shareholders were having funding issues and did not have the same resources as the debtor to fight

the dispute. The final determination of the court that the shareholders were out-of-the-money was pivotal in the court holding that the POR was fair and reasonable and in denying the request of the shareholders for a further sale process.

Although the shareholders eventually lost, they did voice their concern and manage to delay the sanction process by several months and dramatically increase the costs of the sanctioning of the POR. In another case, this amount of leverage could easily have led to a negotiated resolution, particularly where the shareholders formed a formal committee which would have been funded by the debtor. That is all to say that it would not be surprising to see an increase in the use of equity committees in Canadian cases where there is an argument that there remains some value for shareholders.

Conclusion

At the beginning of this article, the question was asked whether or not shareholders should receive similar rights as creditors in US bankruptcy proceedings. It goes without saying that the sudden emergence of equity committees in US bankruptcy is most likely not an anomaly and is here to stay. Regardless of how equity value is derived both pre- and post-petition either due to capital markets behaviour or from an enterprise valuation perspective and regardless of whether or not they should be granted such protection in a bankruptcy or can protect itself by continuing to actively trade, bankruptcy courts are not likely to reject the formal appointment of an equity committee if it appears that there is any level of equity value, even superficially, or if it can be proven that the debtor is not hopelessly insolvent.

This type of 'new age' thinking will take time to be adopted internationally and may never actually be accepted but, with the growing integration of capital markets and extensive cross-border growth activity, anything is possible.

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