PART V – OUTLOOK FOR THE DISTRESSED MARKET IN 2004

Vulture Investors Heed Caution: Creditors Committees and Trading May Be a Dangerous Combination

BY JAMES H.M. SPRAYREGEN, JONATHAN S. HENES, LISA G. LAUKITIS AND JAVIER SCHIFFRIN

The two recognised purposes of Chapter 11 are preserving companies as going concerns and maximising the value of distributions to a company's creditors. In the past, debtors, with the support of their creditors – especially prepetition lenders – utilised the protections of Chapter 11 to fix their operations and emerge from bankruptcy with a viable business. However, over the past several years, the practice of Chapter 11 has undergone a transformation. Scholars and practitioners are observing increased hurdles that debtors need to overcome to accomplish a successful reorganisation. In particular, the creation of an active secondary market for the trading of distressed debt – and the new opportunities for profit-taking created thereby – has fundamentally altered the traditional dynamic between the Chapter 11 debtor and its creditors. Specifically, sophisticated investment funds (so-called "vulture investors") – which specialise in buying and selling the debt of distressed companies and may be willing to "sacrifice the long-term viability of a debtor for the ability to realise substantial and quick returns of their investments"[1] – are becoming the dominant creditor constituency in Chapter 11 cases.

Creditors Committees

At the outset of a Chapter 11 case, a statutory committee of unsecured creditors is appointed. The intended purpose of a creditors committee is to represent the interests of all unsecured creditors through oversight of and negotiations with a debtor. As a result, the members of a creditors committee owe a fiduciary duty to all unsecured creditors and are empowered to maximise the distributable value to this constituency. In this role, the members of a creditors committee are provided with confidential, non-public information regarding a debtor's financial condition, operations and business plan.

With the emergence of the vulture investor as a major player in a company's restructuring efforts, it is not surprising that vulture investors are joining creditors committees. To both the practitioner and the lay person, the issues concerning fiduciary obligations and, potentially, the federal securities laws would seem to impede or eliminate a vulture investor's ability to trade. In recognition of these concerns, certain creditors committees have petitioned bankruptcy courts for orders establishing procedures to enable their members to trade throughout a Chapter 11 case. Generally, these "trading orders" require screens to prevent a vulture fund's traders from receiving non-public information as a result of such fund's membership on a committee. Despite the availability of trading orders, many creditors committees do not seek them in Chapter 11 cases. Yet, it is not unusual for members of creditors committees to trade nonetheless.

Legal and Practical Concerns

The trading activity by members of a creditors committee raises a number of legal and practical issues and is garnering significant attention. In a recent law review article, Greg M. Zipes and Lisa L. Lambert, both trial attorneys for the office of the United States Trustee, observe:

> "In large cases, a claim trader, such as a hedge fund, may wish to serve on a committee while reserving the right to trade in debt or securities. *The appointment of such a creditor for a committee is, at first blush, exceedingly problematic, both for the proposed committee member, and other creditors.*"[2]

Moreover, a former chief executive officer of a large Chapter 11 debtor explained:

> "They [the vulture investors] were telling the U.S. Trustee they were willing to serve [on the creditors committee] and getting inside information. You would think the restricted nature of their [confidentiality] agreement would suggest they couldn't sell their claims. A couple of times I've asked: What does it mean to be restricted? I'm told, 'that whole area hasn't been tested yet.' Why not? ... [The trading] can be so distracting to a company to have a bunch of new people around the table every time they try to negotiate a plan."[3]

The potential conflict of interest created by the trading activities of committee members – i.e., the desire for personal gain versus the maximisation of value for all creditors - and the resulting impact on Chapter 11 cases – i.e., more complex negotiations and the potential sacrifice of the long-term viability of a debtor for short-term profit – is increasing the focus on the role of the vulture investor in Chapter 11 cases. To date, the focus has been academic in nature, however, a recent adversary proceeding commenced by a creditors committee against one of its former members warrants careful review by vulture investors as it may be a sign of a changing tide.

Galey & Lord

On November 6, 2003, in the Chapter 11 case of Galey & Lord, Inc., the creditors committee commenced an adversary proceeding against Barclays Bank Plc. and Barclays Capital (collectively "Barclays"), former members of the committee. The complaint alleged that Barclays engaged in inequitable conduct and violated its fiduciary duties by exploiting insider information to purchase and sell secured bank debt for profit at the expense of the unsecured creditors. Specifically, the complaint alleged:

- Barclays was a member of the creditors committee from March 1, 2002 to March 18, 2003.
- To join the creditors committee, Barclays had executed a "no-trading form," that provided: "[n]oteholders wishing to serve as fiduciaries on any statutory committee are advised that they may not trade while they are committee members."
- Barclays acknowledged on the "no-trading form" that it did not possess any debt instruments representing secured obligations of Galey & Lord.
- Barclays executed by-laws, which stated that each member of the creditors committee was a fiduciary and confidential information received by members "may not be used for any purpose that is inconsistent with the majority decision or intent of the" creditors committee.
- Barclays received "insider" information.
- Barclays purchased up to $20 million of secured bank debt without the knowledge or consent of the creditors committee.
- After receiving a business plan revising financial projections downward from those presented to the creditors committee six months earlier, Barclays withdrew from the creditors committee and joined an ad hoc committee of secured creditors.
- Barclays continued to be a member of the ad hoc committee through the effective date of Galey & Lord's plan of reorganisation.

Based on these allegations, the creditors committee asserted that Barclays' claims should be equitably subordinated to the claims of all general unsecured creditors and sought damages and/or disgorgement of all profits realised by Barclays.

The United States Trustee filed a motion to intervene in the adversary proceeding, seeking injunctive relief to require Barclays to:

- Institute internal protective measures to prevent the misuse of confidential [c]ommittee information;
- Certify to the United States Trustee that it is in compliance with its internal protective measures;
- Use internal protective measures in all cases in which it serves on a creditors committee; and
- Refrain from the future use of any confidential committee information for its own pecuniary interest.

Barclays, in response to the complaint and motion, filed an answer disputing all of the allegations made by the creditors committee and the United States Trustee.

With the allegations and answer on record, but before the bankruptcy court made any rulings, the Committee and Barclays settled the adversary proceeding. The settlement provided, among other things, that Barclays would pay $2,079,000, which represented the approximate market value of Barclays' secured claim in the Galey & Lord Chapter 11 case.

Conclusion

While the legitimacy of the trading activities of committee members remains relatively untested, the change in dynamics of Chapter 11 cases has focused the spotlight on vulture investors. Enhanced scrutiny of the actions of these investors will continue. The Galey & Lord litigation is a warning shot to vulture investors that the future may bring increased litigation or regulation by committees, debtors, the office of the United States Trustee or the Securities and Exchange Commission. ■

1 Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 Vand. L. Rev. 1987, 2016 (2002).

2 Greg M. Zipes & Lisa L. Lambert, *Creditors' Committee Formation Dynamics: Issues in the Real World*, 77 Am. Bankr. L.J. 229, 245 (2003)(emphasis supplied).

3 *Chapter 22: Are Vulture Investors to Blame?*, 38 No. 4 Bankr. Ct. Dec. (LRP) 1 (August 21, 2001).

James H.M. Sprayregen and Jonathan S. Henes are partners in the Restructuring, Workout and Bankruptcy Group at Kirkland & Ellis LLP. Lisa G. Laukitis and Javier Schiffrin are associates in the group.