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The Potential Value of Dynamic Tension in Restructuring Negotiations

Written by:

Michelle M. Harner

University of Maryland School of Law; Baltimore
mharner@law.umaryland.edu

Jamie Marincic

University of Nebraska-Lincoln; Lincoln, Neb.
jamiemarincic@gmail.com

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The mandatory appointment of a creditors' committee was intended to provide dynamic tension with the debtor that would stimulate the reorganization process through effective and efficient oversight and negotiation.

—Harvey R. Miller¹

Dynamic tension is often used to connote two or more conflicting priorities that may influence decision-making. In the business-restructuring context, it has been used to describe the relationship among debtors and their various stakeholders, including secured creditors, unsecured creditors and shareholders.² Each party potentially has a unique and competing agenda regarding the debtor's restructuring plan. Although competing agendas can lead to conflict, this can also encourage parties to reevaluate alternatives and explore different or innovative ways to create value.

This potentially productive role of dynamic tension in restructuring

About the Authors

Michelle Harner is an associate professor of law at the University of Maryland School of Law in Baltimore. Jamie Marincic is a doctoral candidate in Survey Research and Methodology at the University of Nebraska-Lincoln in Lincoln, Neb.



Michelle M. Harner

negotiations arguably underlies the committee structure incorporated into the U.S. Bankruptcy Code.³ In fact, the legislative history of § 1102 of the Code suggests that Congress anticipated a multiple-

represented by the committee.⁵ In many respects, the committee provides several of the key monitoring functions previously performed by independent trustees and the Securities and Exchange Commission under chapter X of the Bankruptcy Act. "[A] creditors' committee 'is not a perfunctory or useless body, simply appointed to satisfy a formality established by the Bankruptcy Code, but rather should be a vital and integral part of the plan formulation process.'"⁶

Despite the importance of the committee structure, relatively little empirical work regarding the role and objectives served by the structure exists. Accordingly, this empirical study was designed to fill this void and shed light on the workings of committees in chapter 11 cases. We are grateful for the funding

Cover Feature

committee structure in many cases.⁴ Nevertheless, this structure has not emerged as a dominant or even preferred option, given, among other things, concerns regarding costs, efficiency and stakeholder interest in serving on committees.

The committee structure, whether composed of one or multiple committees, is a core principle of chapter 11. The committee oversees the debtor's conduct during the case, investigates the debtor's conduct prior to the case and advocates the interests of the stakeholder group

to conduct this study provided by a grant from the ABI Endowment Fund. We also received significant support and assistance from The Bureau of Sociological Research at the University of Nebraska-Lincoln.

The study's primary data and analyses are presented in a forthcoming article for the *Vanderbilt Law Review* (herein referred to as "Committee Capture"),⁷ in which we detail our methodology and the components of our database, explain the limitations of the study and then provide

¹ "The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director and Sometimes Star of the Reorganization Passion Play," 69 *Am. Bankr. L. J.* 431, 449 (1995).

² See, e.g., Thomas C. Given and Linda J. Philipps, "Equality in the Eye of the Beholder—Classification of Claims and Interests in Chapter 11 Reorganizations," 43 *Ohio St. L. J.* 735, 735-36 (1982) (explaining "dynamic tension" in context of reorganization vs. liquidation restructuring options); Donald R. Korobkin, "Bankruptcy Law, Ritual and Performance," 103 *Colum. L. Rev.* 2124, 2130 (2003) (explaining that results under bankruptcy laws often "spontaneously emerge...at a juncture of futility and loss, from the dynamic and generative tension of normative directives in unavoidable conflict"); see also Miller, *supra*, n.1, at 449; James E. Spiotto, "Overview of the Workout Process," *The Problems of Indenture Trustees and Bondholders*, 731, 739 (PLI *Real Estate Law & Practice*, Course Handbook Ser. No. N4-4591, 1995) ("Any discussion of marshalling of assets would be incomplete without discussing the dynamic tension between unsecured and secured creditors.").

³ See Miller, *supra*, n.1, at 449-50.

⁴ The legislative history provides, in relevant part:

There will be at least one committee in each case. Because unsecured creditors are normally the largest body of creditors and most in need of representation, the bill requires that there be a committee of unsecured creditors...the bill also provides for additional committees, with status equal to that of the unsecured creditors' committee, when such additional committees are needed to represent various other interests in this case, including secured creditors, subordinated creditors, and equity security holders.

H.R. REP. NO. 95-595, at 235-36 (1977) (footnote omitted).

⁵ See, e.g., *In re ABC Auto. Prods. Corp.*, 210 B.R. 437, 441 (Bankr. E.D. Pa. 1997) ("The function of the committee is to represent and protect the interests of the unsecured creditors in the plan negotiation process and throughout the entire bankruptcy case."); *In re Diversified Capital Corp.*, 89 B.R. 826, 829 (Bankr. C.D. Cal. 1988) ("The purpose of a committee of unsecured creditors is to monitor the operations and activities of the debtor and its compliance with the requirements of the Bankruptcy Code.").

⁶ Miller, *supra*, n.1, at 449-50 (citing *Retail Mktg. Co v. Nw. Nat'l Bank (In re Mako Inc.)*, 120 B.R. 203, 212 (Bankr. E.D. Okla. 1990)).

⁷ Michelle M. Harner and Jamie Marincic, "Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations," 64 *Vand. L. Rev.*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1679986.

a thorough analysis of the data.⁸ This article summarizes certain of the key data analyses and interesting descriptive data included in the study, and the “Committee Capture” article should be consulted for a complete understanding of the study and its implications.

Overview of the Study

We created the study’s case database by systematically coding the court dockets of 296 chapter 11 cases. The database contains information on 129 primary variables (*e.g.*, filing date, number of committee members, whether plan was filed, whether sale was pursued, ultimate case resolution). The cases, filed between Jan. 1, 2002, and Dec. 31, 2008, were selected from six jurisdictions using a stratified random sample.⁹ All but 12 of the sampled cases had some definitive indication of case outcome at the end of the data-collection period.¹⁰

Recognizing that the case database reflected only public information disclosed by parties in documents filed on the docket, we supplemented the case component of the study with a survey of 300 professionals who work on chapter 11 cases and 300 individuals who have served on creditors’ committees in those cases. The survey collected information about committee activities in chapter 11 cases—relations among committees, the debtor and other parties in the case—and the influence of and conflicts among committee members and professionals. Acceptable response rates were received on both surveys.¹¹ Some of the survey data has been summarized in this article, but a more complete report is forthcoming in a symposium issue of the *Seattle Law Review*.¹²

The overwhelming majority of cases in the database involved business debtors organized as corporations. Based on the debtors’ schedules of assets and liabilities, the median amount of

assets was \$2,508,000 and the median amount of liabilities was \$6,156,700.¹³ Approximately 66 percent of the cases involved between 1-199 creditors, with the remaining cases involving 200 or more creditors.¹⁴ As explained more fully in “Committee Capture,” “143 cases (48.3 percent) involved at least one creditors’ committee and 153 cases (51.7 percent) involved no creditors’ committees. Of the cases with creditors’ committees, 95.8 percent had one creditors’ committee, 2.1 percent had two creditors’ committees and 2.1 percent had three creditors’ committees.”¹⁵

Analysis of the Case Database

Based on anecdotal evidence and the legislative history of § 1102, we formulated two hypotheses to test in the study. In the first hypothesis, “creditors’ com-

mittees add value to Chapter 11 cases, as determined by returns to unsecured creditors and company reorganizations.”¹⁶ In the second hypothesis, “the presence or absence of conflict or self-interest in the composition of creditors’ committees impacts value in Chapter 11 cases, as determined by returns to unsecured creditors and company reorganizations.”¹⁷ We analyzed “returns to” creditors based on data regarding percentage of recoveries to unsecured creditors and “company reorganizations” based on whether debtors reorganized under a plan of reorganization or sold substantially all of their assets under either a liquidating plan or in a § 363 sale.

As noted, approximately half of the cases in the database involved one or more statutory or *ad hoc* committees. The cases were further divided into three categories, as shown in chart 1: cases with no committees (NC cases), cases with one creditors’ committee

¹³ See Harner and Marincic, *supra*, n.7 (manuscript at 21).

¹⁴ See *id.* (manuscript at 22).

¹⁵ *Id.* (manuscript at 23) (footnote omitted) (as of Dec. 7, 2010). “Overall, 152 cases (51.4 percent) involved some type of committee (*i.e.*, creditors’ committee, equity committee, *ad hoc* committee or some combination), leaving 144 cases (48.6 percent) with no committee involvement.” *Id.*; see also chart 1.

¹⁶ *Id.* (manuscript at 35).

¹⁷ *Id.*

Chart 1: Committee Structure (n=296)

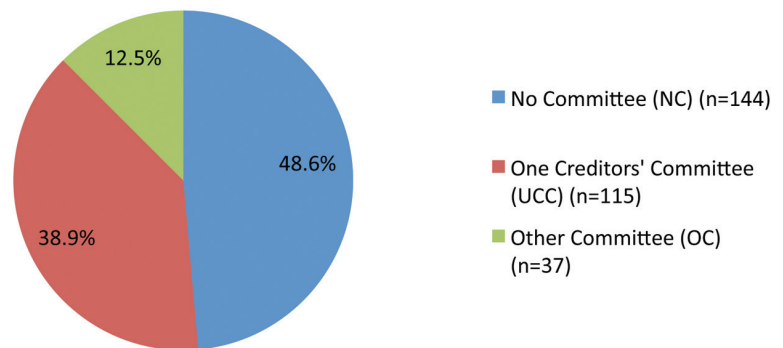
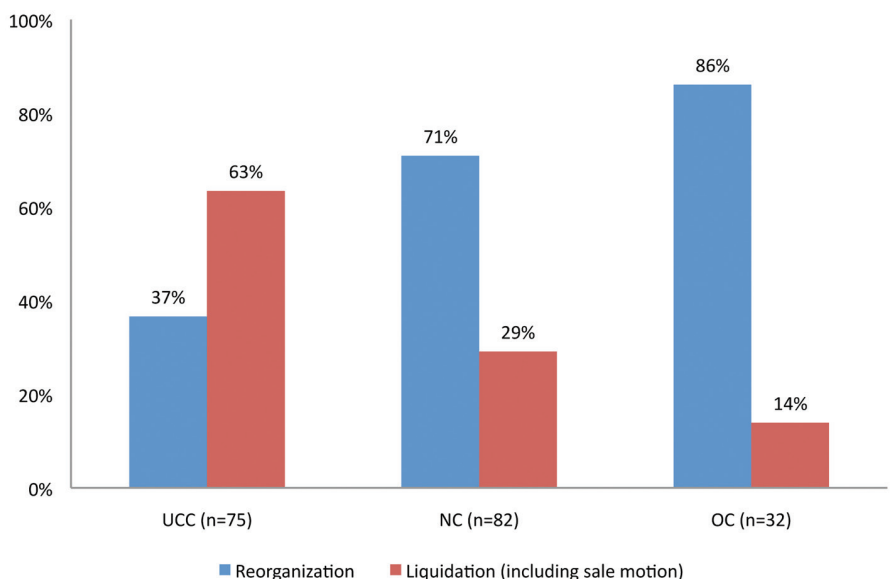


Chart 2: Percentage of Cases (Confirmed Plans Only) with Resolution by Committee Type (Controlling for Assets and DIP Financing)



⁸ See *id.* (manuscript at 17-20, 34-35).

⁹ We used the District of Delaware, Northern District of Illinois and Southern District of New York as primary jurisdictions, and the Central District of California, District of Maryland and Northern District of Ohio as additional jurisdictions. The use of and justifications for selecting these jurisdictions are explained fully in “Committee Capture.” See Harner and Marincic, *supra*, n.7 (manuscript at 17-20).

¹⁰ For most cases in the database, we collected data from the petition date through and including the earlier of the closing of the case and June 30, 2009. For cases unresolved as of June 30, 2009, we performed additional data collection through and including June 30, 2010. See Harner and Marincic, *supra*, n.7 (manuscript at 17-20).

¹¹ There were 251 professionals and 213 committee members that were contacted and met eligibility criteria. Ultimately, 70 professionals (28 percent) and 43 committee members (20 percent) completed the survey.

¹² The survey data and analyses are being presented at the Annual Adolf A. Berle, Jr. Center of Corporations, Law and Society Symposium and was published in the corresponding symposium issue of the *Seattle Law Review*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1736024.

(UCC cases) and cases with multiple or other committees (OC cases).¹⁸ The OC cases included cases with more than one type of creditors' committee or some combination of a creditors' committee, an equityholders' committee or an *ad hoc* committee. These categories were then used in some of our analyses to determine the impact of a creditors' committee's activities in a particular case. We also controlled for other potentially confounding variables, such as asset size, number of creditors, liabilities, secured creditors and debtor-in-possession (DIP) financing, to try to isolate the impact of creditors' committees on chapter 11 cases.¹⁹

As further explained in "Committee Capture" and shown in charts 2 and 3, "[c]ases with a single creditors' committee were significantly more likely than the other two categories to result in a plan of liquidation or a motion to sell substantially all of the debtor's assets... Those cases also were significantly more likely to provide distributions to unse-

cured creditors in amounts less than or equal to 50 percent of their claim values."²⁰ These effects persisted even after controlling for potentially confounding factors. Thus, the data tend to support rejecting the first hypothesis.

With respect to the second hypothesis, the data evidence showed actual and potential conflicts of interest among multiple committee members. Moreover, committees frequently are involved in litigated disputes with debtors or other creditors. Nevertheless, neither conflicts of interest nor litigation impacted value in the database cases.²¹ The data show no significant increase or decrease in returns to unsecured creditors or the likelihood of reorganization based on conflicts of interest or litigation. The data tends to support rejecting the second hypothesis.

Although conflicts of interest and litigation do not appear to significantly impact value, they do tend to increase the costs associated with and duration of chapter 11 cases.²² The amount and types of disputes resulting in litigation also are striking. Committees tend not to file

formal objections to fundamental transactions in the case, such as DIP financing, motions to sell substantially all of the debtor's assets and confirmation of a plan of reorganization. However, they do frequently file or become actively involved in litigation with secured creditors and debtors. For example, committees filed an objection or other pleading opposing conduct by secured creditors or debtors in 24 percent and 67 percent, respectively, of the database cases involving creditors' committees.²³

In addition, creditors' committees are likely to retain at least one—and perhaps multiple—professionals in chapter 11 cases. For example, committees in 135 of the 143 cases (94.4 percent) with at least one creditors' committee retained at least one lawyer or law firm. Likewise, committees in 89 of the 143 cases (62.2 percent) with at least one creditors' committee retained financial advisers.²⁴ Of these cases, 98 (68.5 percent) involved multiple lawyers and financial advisers.²⁵ The retention of a financial adviser did not significantly impact the returns to unsecured creditors or the likelihood of the debtor reorganizing.²⁶

¹⁸ *Id.* (manuscript at 23). The OC Cases category captures data for cases where no single committee was appointed to represent unsecured creditors.

¹⁹ *See id.* (manuscript at 28-29).

²⁰ *Id.* (manuscript at 6).

²¹ *See id.* (manuscript at 31-34).

²² *See id.* (manuscript at 33-34).

Chart 3: Percentage of Cases with Percentage Recovery to Unsecured Creditors by Committee Type (Controlling for Assets and DIP Financing)

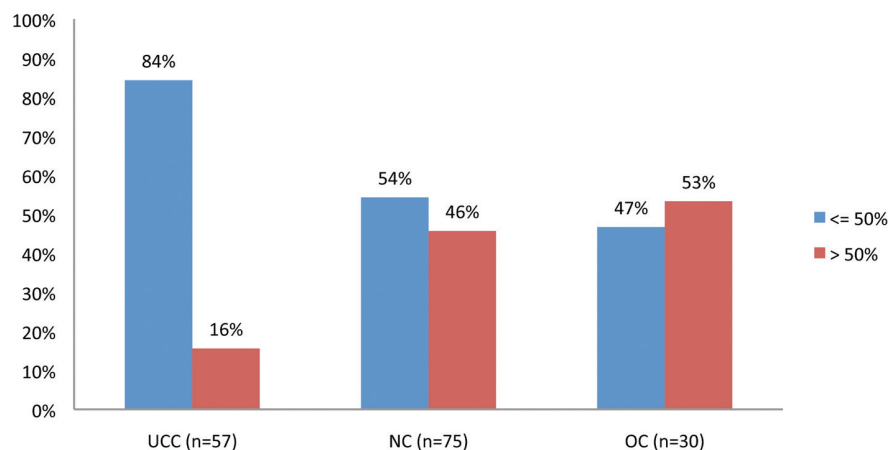
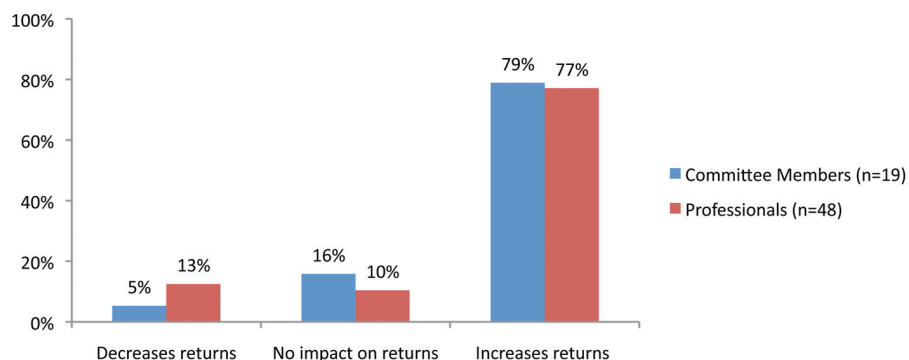


Chart 4: How Does Conflict Between the Debtor and the UCC Regarding the Restructuring Plan Typically Impact Returns to Creditors?



Analysis of Survey Data

The professionals' and committee members' surveys drew responses from a variety of individuals with extensive collective experience in chapter 11 cases. The majority of respondents to the committee members' survey served on creditors' committees, with a small percentage serving on equityholders' and *ad hoc* committees. Of these individuals, 15 have served on more than 10 creditors' committees and six have served on more than 10 *ad hoc* committees. The respondents to the professionals' survey were primarily divided among individuals representing debtors (35.7 percent), committees (17.2 percent) and some combination of parties (31.4 percent) involved in chapter 11 cases.²⁷ Of those individuals, approximately two-thirds (61.5 percent) reported working on more than 10 cases in any given year.

The survey questions focused largely on how committees interact with other parties in chapter 11 cases

²³ *See id.* (manuscript at 32).

²⁴ Accordingly, 54 of these cases (37.8 percent) did not involve the retention of financial advisers.

²⁵ Specifically, of the 143 cases, eight have neither a financial adviser nor a lawyer, 37 have one lawyer/law firm and the remaining 98 have some combination of lawyers and/or financial advisers.

²⁶ The overwhelming majority of respondents (94.9 percent) were lawyers. Given the high percentage of cases appointing at least one law firm or lawyer for the committee, we did not have sufficient variability to analyze the impact of lawyers on value.

²⁷ In addition, 2.9 percent represent DIP lenders and 4.3 percent represent individual creditors in chapter 11 cases.

and consequently did not specifically address which was a more preferable structure: no committee, one creditors' committee or multiple committees. Nevertheless, both groups of respondents suggest that disputes among the creditors' committee and the debtor or among the *ad hoc* committee and the debtor regarding the debtor's plan of reorganization generate additional value for unsecured creditors, as shown in chart 4.²⁸ Likewise, both groups suggest that the involvement of one or more creditors trying to exert control over the chapter 11 case increases returns to unsecured creditors.²⁹ Although the case study did not observe any significant association between conflicts or disputes and returns to creditors, the survey data lends support to the overarching notion that greater creditor participation in the chapter 11 case—*i.e.*, dynamic tension—may enhance value.³⁰

Moreover, both groups reported instances of conflict among committee members. The most frequently cited conflict involved disagreement over the debtor's plan of reorganization with at least one member being motivated by self interest.³¹ The survey data suggested that most of these conflicts are resolved informally, without the need for any formal pleading with or resolution by the court.³² In fact, the data showed that many committee objections to fundamental transactions are voiced in an informal manner and a majority of all committee objections are resolved without court intervention (see charts 5 and 6 for other responses available to respondents).³³ This data may explain

the lack of formal committee objections to fundamental transactions recorded in the case database.³⁴

Preliminary Observations

The rejection of the two primary hypotheses underlying the study raises interesting policy and doctrinal questions. We do not believe that the data suggest that creditors' committees are ineffective, but instead observes interesting trends that suggest potential enhancements to the use and composition of creditors' committees.³⁵

For example, OC and NC cases performed significantly better than UCC cases with respect to returns to creditors and the likelihood of debtor reorganization. An immediate and obvious response is to attribute the difference to factors such as the larger amount of

assets and greater number of creditors typically involved in OC cases.³⁶ That response turns out to be incorrect, given that the significance remained even after we controlled for those and other potentially confounding factors. This suggests that something else is going on.

One potential explanation is dynamic tension. In OC cases, more creditors are taking a more active role in the chapter 11 process. Accordingly, rather than having just one priority voiced to the debtor through a single creditors' committee, multiple parties voice potentially competing priorities, which may cause all parties to evaluate valuations, restructuring options and the like more closely.³⁷ It also may suggest an underutilization of, or passivity by, creditors' committees when no other major constituency is organized or active in the case.

We explore these and other potential explanations in "Committee Capture," and we hope to continue this evaluation in our analysis of the survey data and future studies. Our ultimate goal is to help judges, practitioners and policymakers better understand the role of committees in chapter 11 and how they

³³ Almost 32 percent of professionals and 23 percent of committee members indicated that objections raised by the creditors' committees are most commonly informal, with 95 percent of professionals and 76 percent of committee members indicated that the majority of creditors' committees' objections are resolved without court intervention. Of these, nearly 28 percent of professionals and 41 percent of committee members indicated that objections raised by the *ad hoc* committee are most commonly informal. Approximately 71 percent of professionals and 81 percent of committee members indicated that the majority of *ad hoc* committees' objections are resolved without court intervention.

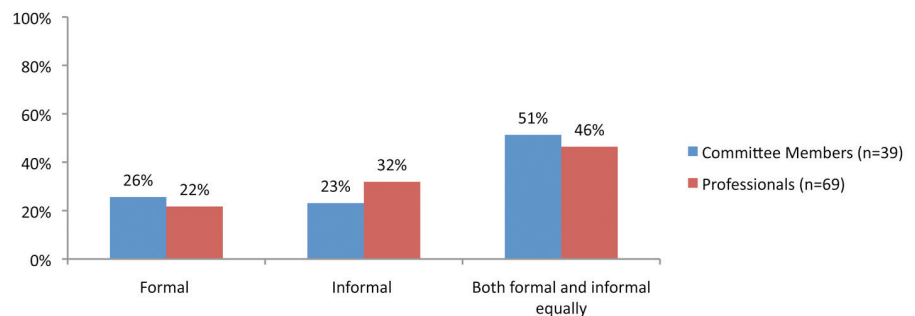
³⁴ The key analyses underlying the case database component of the study do not rely on committee objections to fundamental transactions. Nevertheless, this off-docket information is an example of a limitation of observational studies.

³⁵ See Harner and Marincic, *supra*, n.7 (manuscript at 35-41).

³⁶ See *id.* app. B (manuscript at 44).

³⁷ See *id.* (manuscript at 35-41).

Chart 5: Based on Past Experiences, Are the Most Common Objections Raised by the UCC Chapter 11 Cases Formal or Informal Objections?



²⁸ About 77 percent of professionals and 78 percent of committee members indicated that conflict between the debtor and the creditors' committee regarding the restructuring plan typically results in increased returns to creditors. Nearly 40 percent of professionals and 63 percent of committee members indicated that such conflict between the debtor and *ad hoc* committee typically results in increased returns to creditors. Respondents also could select that the conflict decreased or had no impact on returns to creditors.

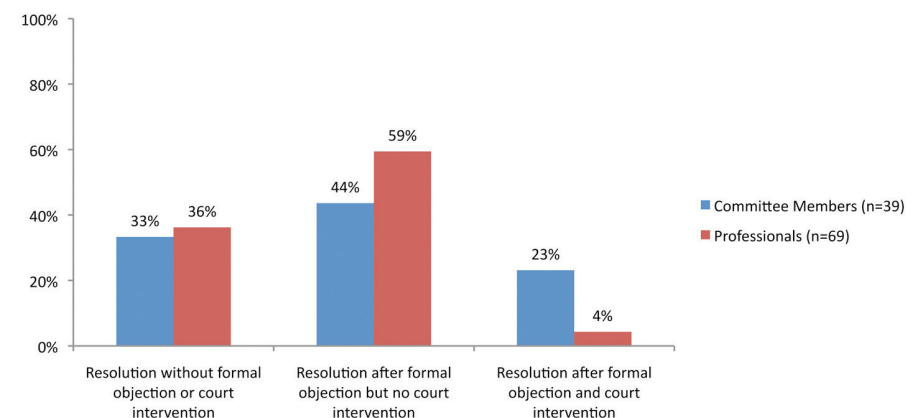
²⁹ About 33 percent of professionals and 45 percent of committee members indicated that the activities of individual creditors or small groups of creditors trying to assert influence in chapter 11 cases typically result in increased returns to creditors. Respondents also could select that such influence decreased or had no impact on returns to creditors.

³⁰ In addition to the limitations inherent in this type of survey study (*e.g.*, self-selection bias), the difference between the survey study and case study data regarding conflicts of interest or disputes and value impact may relate to the off-docket nature of many conflicts of interest and disputes among parties in a chapter 11 case. See Harner and Marincic, *supra*, n.7 (manuscript at 31). The survey data confirms that many conflicts of interest and disputes are resolved without the filing of a formal pleading with or intervention by the bankruptcy court.

³¹ Approximately 57 percent of professionals and 45 percent of committee members selected this option among six other options, including disagreement over restructuring plan with no members motivated by self-interest, disagreement over a significant event in the chapter 11 case with at least one member motivated by self-interest, disagreement over a significant event in the chapter 11 case with no members motivated by self-interest, disagreement over selection of professionals, other and not applicable.

³² In the survey, 90 percent of professionals and 88 percent of committee members indicated that disputes among committee members are most commonly resolved in this way.

Chart 6: Based on Past Experiences, Which of the Following Best Describes How the Majority of Objections Raised by the UCC Are Resolved?



might utilize the committee structure more effectively and efficiently going forward. As often suggested by courts and commentators, “the very nature of a chapter 11 case (the attempt to continue the debtor’s business, generally the continuation of a DIP and the need to address both the determination of assets available for secured and unsecured creditors and equity security holders and the determination of the allocation of said assets among creditors and equity security holders) dictates a much more active role for committees in chapter 11 cases.”³⁸ ■

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³⁸ *In re Marin Motor Oil Inc.*, 689 F.2d 445, 455 (3d Cir. 1982) (citation omitted).