How US Trustees Can Deter Chapter 11 Proxy Abuses

By **Kenneth Rosen**

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Some problems in the Chapter 11 bankruptcy process — namely, how unsecured creditors committees and their professional advisers are being selected — have emerged in recent years. Moreover, they are only getting worse.

The problems stem from the fact that the Bankruptcy Code empowers U.S. trustees to appoint official unsecured creditors committees to represent interests of all unsecured creditors — not simply the interests of members of the committee. The committees can retain professional advisers to assist in the performance of its duties.

When the appointment of committee members becomes partly controlled by proxy solicitors, the exclusive role of the U.S. trustee in the committee selection process becomes nonexclusive — which is not what Congress intended. Further, a principal role of the U.S. trustee is to assure that the committee is representative (as much as is feasible) of all unsecured creditors. If proxy solicitors partly control who becomes a committee member, then the U.S. trustee is unable to represent to the court that the committee is representative of creditor interests without outside influence.

However, the selection process has gotten murky.

It begins with the fact that the average percentage recovery on creditors' claims is nothing to brag about. Too many Chapter 11 cases end up as bulk asset sales (followed by confirmation of a liquidating plan of reorganization) instead of true reorganizations. As a result, many creditors do not want to throw good money after bad by hiring local counsel when a debtor files hundreds, if not thousands, of miles away from the debtor's principal place of business.

Consequently, a practice akin to "ambulance chasing" has evolved. Unscrupulous individuals cold-call creditors with offers to get them appointed to the creditors committee — without the creditor having to hire local counsel or travel to where the Chapter 11 case commenced. The cold-calling begins promptly after petitions are filed — and creditors are proving quite susceptible to their sales pitches.

The callers offer to find someone to act as a proxy for the creditor but often avoid the topic of exactly how the proxy holder will exercise the creditor's right to select professionals for the committee. Creditors don't realize that they are giving up a fundamental and substantive right — and they rarely know much, if anything, about the proxy holder. They don't know have any idea that there could be an arrangement between the cold caller and the proxy holder to vote to hire a particular professional firm, which likely will handsomely reimburse the cold caller.

These professionals are supposed to be selected based on such things as a creditor's previous experience with them, the professional's industry credentials, the professional's case insights and understanding of the issues, and the professional's thoughts on how to maximize recoveries for creditors. But that's just not happening in many cases.

That brings us back to the U.S. trustees who oversee the appointment of creditors

committees and the larger role they need to take in policing the process. It’s not enough to say that the rules apply to lawyers and not to other professionals — or that the “marketplace should deal with the problem.”

The appointment of proxy holders to creditors committees has become rampant in places like Wilmington, Delaware. Unlike a proxy holder whom a creditor has contacted directly through ordinary connections to represent the creditor at the committee formation meeting, this article addresses a different sort. Rather, in some instances, committee members are increasingly nothing more than proxy holders with specific instructions to vote for certain professionals selected by the proxy solicitor.

Often, multiple proxy holders are lined up by the proxy solicitor (cold caller). The creditor giving the proxy knows nothing more than the fact that the solicitor offered to get them onto the committee free without a trip cross-country.

Without adequate oversight from a U.S. trustee, a creditor who does not want to join a committee can no longer assume that its members will be appointed fairly or that the committee will select professionals based on proper qualifications. Moreover, bankruptcy judges cannot assume that the professionals standing before them were fairly selected by the committee or that the committee was fairly appointed without undue influence.

This problem is taxing a Chapter 11 process where creditors are supposed to act as foils for the debtor. U.S. trustees do good work, but they should ask more in-depth questions about how proxies were arranged. It makes a difference whether a creditor was referred to a proxy holder by its general counsel or by a cold caller, and that information should be communicated to judges.

The entire Chapter 11 system works best when the court and creditors know that the selection of committee members as well as the professional advisers was done the right way. Better oversight of how proxies to the committees are selected would go a long way toward that outcome.

Questions that the United States trustee should ask:

1. Did anyone call you and offer to help you become appointed to the creditors committee?

2. Did the person who called you regarding this case recommend someone to hold a proxy for you, or offer to find someone to hold a proxy for you? Who first called you with the idea of finding a proxy holder?

3. Who recommended that you give a proxy to the proxy holder?

4. Did you or another representative of your company know the proxy holder prior to this case?

5. Did the proxy holder disclose to you that they would vote for committee professionals on your behalf?

6. Do you wish to be heard on the selection of professionals by the creditors committee if you are appointed to the committee?

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