

# Creditors' Committee Investigations: Checklist

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A Checklist detailing how a creditors' committee should approach an investigation of a Chapter 11 debtor. This Checklist describes the types of inquiries the creditors' committee should make, including understanding the causes of the debtor's Chapter 11 case, how the debtor intends to use Chapter 11 to recover from financial distress, and how the debtor is currently operating as a postpetition entity.

In a Chapter 11 case, the creditors' committee is given broad powers to oversee and investigate the past and current business of the debtor (§ 1102, Bankruptcy Code). The committee can make document requests, speak with the debtor's employees, depose the debtor's management and board of directors, subpoena records, and generally use any appropriate form of discovery for its inquiry.

It is key for the creditors' committee to understand the true causes of the debtor's Chapter 11 filing and how or if the debtor's problems can be fixed by use of the Chapter 11 process to maximize recovery for unsecured creditors. In addition to understanding how Chapter 11 can be used to preserve, restore, or increase a company's value, creditors' committees must also investigate and understand the debtor's prepetition business and the financial issues confronting the debtor that led to the debtor's distress.

Few debtors accept blame for the mistakes, lack of vision, or failure of management or the board of directors to act in a timely manner. Therefore, committee counsel must ascertain the root cause of the debtor's financial failure and ensure that the debtor is taking the necessary steps to effectively rehabilitate itself before the company's going concern value dissipates and liquidation become inevitable.

For more information on the powers and duties of creditors' committees in Chapter 11, see Practice Note, Chapter 11 Creditors' Committees ([1-508-8252](#)).

## UNDERSTANDING THE CAUSES OF THE CHAPTER 11 FILING

Understanding the root cause behind the debtor's Chapter 11 filing is the initial objective of any creditors' committee investigation. Part of the investigation involves separating the debtor's stated cause from the debtor's real causes for filing Chapter 11. To discern the causes of a debtor's financial distress and Chapter 11 the committee should:

- Review potential management issues, including:
  - turnover; or
  - whether severance or other compensation was paid to departing executives.
- Understand why senior executives have left, such as:
  - disputes over financial reporting;
  - disputes over turnaround strategy; or
  - failure to achieve stated goals.
- Identify if, just before the bankruptcy filing, senior management received:
  - bonuses;
  - pay increases; or
  - other compensation.

(See Practice Note, Executive Compensation in Bankruptcy ([2-545-4565](#))).
- Review any adverse legal judgments against the debtor and whether the debtor has made any:
  - preparations in anticipation of the judgment;
  - begun the appellate process; or
  - analyzed likely settlement costs.
- Understand sales declines by examining:
  - the volume of purchase orders recently cancelled;
  - the volume of anticipated orders that were never placed;
  - whether the debtor failed to respond timely to changes in the marketplace (such as through a shift to e-commerce);
  - whether the debtor failed to respond timely to changes in consumer demand;

- whether the debtor lost a major customer due to product quality issues, delivery delays, or better product pricing by competitors; and
- whether the debtor failed to receive necessary raw materials, component parts, or products that caused a decline in sales.

(See Practice Note, Retail Industry Bankruptcies: Overview ([W-001-4403](#))).

- Determine whether a going concern accounting opinion was issued.
- If the debtor's company is publicly traded, determine whether there will be action by the Securities and Exchange Commission to:
  - delist the debtor's company due to failure to meet minimum financial market valuation;
  - compel the debtor to withdraw previously filed reporting;
  - report a material inaccuracy issue; or
  - report fraud or any other material issue.
- If there has been a product recall or product defect, discover whether:
  - it was a one-time event;
  - the problem requires a product redesign and what the length of time and cost of a redesign would be; or
  - there is any litigation pending as a result of the recall or defect.
- Decide whether an outside consultant should be brought in to challenge management.

### LEVERAGED BUYOUTS AND PRIOR ACQUISITIONS

One of the most common forerunners to a Chapter 11 is a leveraged buyout or acquisition. The creditors' committee must investigate whether the buyout or prior acquisition:

- Saddled the debtor with excessive debt.
- Prevented the debtor from making adequate capital investment.
- Caused inadequate working capital.
- Resulted in the withdrawal of management fees for distributions that were made to sponsors and equity holders.
- Would be the potential basis for the trustee to seek:
  - to avoid the transaction as a fraudulent conveyance (see Practice Note, Fraudulent Conveyances in Bankruptcy: Overview ([4-382-1268](#)));
  - equitable subordination (see Practice Note, The Risk of Equitable Subordination in Bankruptcy ([4-386-2555](#))); or
  - debt recharacterization (see Practice Note, The Risk of Debt Recharacterization in Bankruptcy ([3-385-6809](#))).

### PREPETITION LENDERS, AMENDMENTS, AND MODIFICATIONS

The creditors' committee must review all the debtor's prepetition financing documents.

- Newly entered forbearance agreements should be examined for:
  - fees paid; or
  - increased interest rates.

(See Practice Note, Forbearance Agreements: Key Issues and Provisions ([3-523-5129](#)) and Standard Document, Forbearance Agreement ([1-524-1560](#))).

- Amendments or modifications to existing financing facilities should be examined for:
  - a reduced advance rate;
  - modified covenants;
  - additional collateral given to the lenders, and at what value;
  - required milestones for a sale process or restructuring; and
  - requirement by the lender that the debtor engage a chief restructuring officer (see Practice Note, Role of the Chief Restructuring Officer in Bankruptcy: Overview ([W-001-1449](#))).

All the modifications to the debtor's financing agreements should be compared to the value of the relief received by the debtor.

### PREPETITION TURNAROUND EFFORTS

Bankruptcy is not a first resort for a struggling company. It is important to understand the debtor's prepetition efforts to steer the debtor out of distress and into profitability. Such actions include:

- Executive compensation reductions.
- Employee headcount reductions.
- Reductions or renegotiation of equipment lease costs.
- Reductions or renegotiation of real estate rental costs (see Practice Note, Borrower Defaults and Lender Remedies in Commercial Real Estate Loans ([9-535-5345](#))).
- Reductions in permitted travel, entertainment, and conference expenses.
- Analysis of current suppliers for better pricing.
- Consolidation of operating facilities.
- Sale of unnecessary or unprofitable assets or business lines.
- Exit from unprofitable markets.
- Renegotiation of debt obligations.

### UTILIZATION OF CHAPTER 11

The creditors' committee must investigate the debtor's plans to use the tools given to debtors under Chapter 11 to fix the business. Initially, it is crucial for the creditors' committee to understand the debtor's case strategy, such as:

- If the debtors intend to implement a simple balance sheet restructuring, and whether this will adequately address the debtor's business problems.
- Whether Chapter 11 will help fix the business or if it will simply facilitate a sale or liquidation.
- Whether Chapter 11 can fix the business or it is simply a bandage and the debtor will emerge from Chapter 11 still in trouble.
- If a party in interest has undue control over the debtor's use of Chapter 11.

Beyond a global Chapter 11 blueprint, it is important for the creditors' committee to understand how to use the primary tools of Chapter 11, such as the debtor's ability to:

- Reject burdensome leases and contracts (see Practice Note, Executory Contracts and Leases: Overview ([8-381-2672](#))).
- Convert debt to equity (see Practice Note, Debt Exchange Offers: Purpose and Process ([0-384-4790](#))).

- Cram down a plan on a dissenting creditor (see Practice Note, Chapter 11 Plan Process: Overview: Confirmation of a Plan: Cramdown Plans ([0-502-7396](#))).
- Reinstate, reduce, or restructure indebtedness (see Reorganization and Restructuring).
- Dispose of underperforming or non-core assets through a sale (see Section 363 Sales).

### REORGANIZATION AND RESTRUCTURING

The debtor's chosen form of restructuring or reorganization guides the committee in understanding:

- The debtor's profitability and cash flow.
- How the debtor's customers will respond to business changes.
- How the debtor's customers previously responded to business operations.
- Which product lines, divisions, and segments are essential to a feasible reorganization.
- Which product lines, divisions, and segments are impeding profitability and cash flow, and whether they can be turned around.
- Current management, and whether new management is necessary with a restructured corporate entity.
- Whether a combination with a competitor or strategic player could be beneficial to the debtor.
- Whether management should dispose of any business units.

### Restructuring Strategies

Not every restructuring strategy equally serves the debtor.

- Considerations for downsizing or consolidation include:
  - whether it is a path to viability;
  - costs versus results;
  - time necessary to achieve; and
  - potential economic returns.
- Considerations for a modified business model include:
  - product redesign;
  - changed product selection;
  - lower price points;
  - focus on the target customer;
  - hone methods of distribution;
  - outsourcing to lower costs;
  - expense reductions; and
  - examine relationships with work force relations including collective bargaining agreements.
- Considerations and options for a balance sheet restructuring include:
  - refinancing;
  - deferral or reduction of debt;
  - additional equity; and
  - conversion of debt to equity.

### SECTION 363 SALES

If the debtor intends to sell a portion or substantially all the debtor's assets under section 363, the creditors committee must:

- Evaluate every aspect of the sale process, including:
  - when the sale process began;
  - whether the marketing process was sufficiently thorough;
  - the timing of the sales process and whether it was conducted during a slow season for the business; and
  - which investment banker, if any, conducted the sale process.
- Review with the selected investment banker:
  - copies of all pitch materials;
  - all parties solicited for a potential purchase;
  - all potential strategic parties solicited;
  - all financial suitors solicited;
  - any competitors solicited;
  - any signatories to non-disclosure agreements;
  - any parties that obtained a management presentation;
  - any parties that conducted due diligence reviews;
  - whether management impeded the due diligence or efforts of any potential buyer;
  - what materials the debtor provided to potential buyers and ensure all necessary documents and information were made available to all potential buyers;
  - any offers received;
  - any offers declined;
  - postpetition marketing strategies;
  - any new potential suitors for solicitation postpetition; and
  - postpetition plans for resolicitation of previously solicited potential suitors.

For more information on sales of assets under section 363 of the Bankruptcy Code, see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview ([1-385-0115](#)) and Timeline of a Section 363 Sale ([3-385-0751](#)).

### POSTPETITION FINANCIAL ANALYSES

To understand the debtor's postpetition financial status, the creditors' committee must normalize the debtor's postpetition financial projections to see results without bankruptcy costs. This allows the committee to:

- Understand the debtor's cash flow without Chapter 11 related costs.
- Understand the share of postpetition losses or negative cash flow attributable to Chapter 11 related costs.
- Review the debtor's accrual basis postpetition projections.
- Review the debtor's accrual basis postpetition operating results.
- Compare the debtor's projected and actual postpetition results to prepetition actual results by:
  - product line;
  - division; and
  - segment.

- See how the debtor's current backlog compares to year-over-year results to:
  - determine whether the backlog is seasonal;
  - determine the trends for backlogged orders;
  - compare current aggregate dollar amounts to prior years; and
  - compare year-over-year backlog for individual product sales and product lines.

### ACCOUNTS RECEIVABLE AND COLLECTIONS

The creditors' committee's review of the debtor's postpetition financials must include a review of postpetition accounts receivable and collections.

- Review accounts receivable aging to see:
  - the percentage of accounts receivable that are 30, 60, 90, or over 90 days due;
  - the aggregate dollar amounts that are at 30, 60, 90, or over 90 days due;
  - the percentage of receivables that are ineligible for collection;
  - the amounts of otherwise eligible receivables that have aged into ineligible collection; and
  - if receivables are excessively aged out, why.
- Review the debtor's efforts to generate more cash from accounts receivable, such as:
  - use of a collection agency;
  - starting litigation;
  - conversion to cash on delivery or cash in advance payment terms with delinquent customers; and
  - termination of sales to delinquent customers pending pay down from customer.

(See Collecting Customer Debts for Small Businesses Checklist ([W-019-2398](#)).

### PEER COMPARISON

A comparison of the debtor's business to its peers helps the creditors' committee determine whether the debtor's competitors are in similar distress.

- The committee must examine potential reasons why the debtor's competitors may be more financially secure, such as that they:
  - are less leveraged;
  - discerned economic problems sooner, and reacted faster, to avoid distress;
  - spent less on capital expenditures; or
  - had more efficient business operations.

### COMPARATIVE FINANCIAL ANALYSIS

The creditors' committee should also perform a comparison of the debtor's current financial performance with previous periods. A comparative financial analysis should include:

- A review of prior period financial statements and notes.
- Identification of major changes in assets and liabilities from previous periods compared to current period.
- A review of documented payments to officers, directors, and insiders.

- A comparison of the debtor's operating and financial results to industry peers.
- A comparison of the debtor's prepetition results to postpetition financial projections.
- A comparison of the debtor's prepetition financial ratios to projected postpetition financial ratios.
- A review whether ratios are consistent over time. If the ratios are not consistent, examine:
  - what caused the variation; and
  - whether credibility is an issue.
- A determination of whether there was an increase in secured debt.
- A review any additional unencumbered collateral pledged to the lender.

### SPECIAL TREATMENT

Creditors' committees must be sure to scrutinize the debtor's relationships to determine:

- Whether the debtor loaded up on additional or excess merchandise prepetition in anticipation of bankruptcy.
- Any major creditors who were paid down in anticipation of bankruptcy.
- The relationships of major creditors to management.
- Outstanding personal guarantees.
- Whether the holders of guarantees received any special treatment prepetition.
- The connection of independent board members, specifically:
  - who selected the board member;
  - when was the board member appointed;
  - the reason the independent board member was appointed;
  - to whom the independent board member may be indebted;
  - whether there are relationships between any independent board member and debtor's counsel;
  - whether there are relationships between any independent board member and the debtor's equity sponsor;
  - whether there are potential insider or related party claims; and
  - if there are potential insider claims, whether they should be investigated by an independent board member or another party and who should serve as legal counsel to the independent board member.

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