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Hands Off My Creditors' Committee!

Examining the Trend of Reconstituting and Disbanding UCCs

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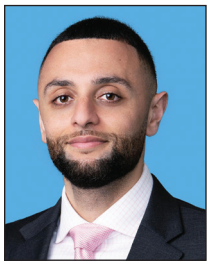

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In chapter 11 cases, the Office of the U.S. Trustee (UST) is required to appoint an official committee of unsecured creditors (UCC) to consult with the debtor; investigate the acts, conduct and financial condition of the debtor; and participate in the formulation of a reorganization plan.[1] In fact, § 1102 of the Bankruptcy Code mandates that, absent certain circumstances, the UST undertake this appointment.

Conventional wisdom suggests that the decision to form a UCC and/or determine its composition rests within the UST's exclusive purview.[2] It also has been suggested that inherent in the UST's authority under § 1102 is its exclusive authority to disband a UCC.[3] Several courts have held that the appointment and composition of a committee are the UST's exclusive powers,[4] yet certain debtors have now argued otherwise, and some courts have found those arguments persuasive.

This article highlights cases that demonstrate this growing trend away from the UST's exclusive authority. To wit, in two recent bankruptcy cases, *In re Lannett Co. Inc.* and *In re Sorrento Therapeutics Inc.*, disputes have resurfaced regarding a bankruptcy court's authority to appoint, dissolve and reconstitute a UCC — notwithstanding the UST's apparent inherent authority to do exactly that. These cases have contributed to a growing debate on a bankruptcy court's authority over creditors' committees and its review of the UST's decisions regarding those committees. This article focuses on those cases and the importance of those decisions for future chapter 11 bankruptcies.

Lannett

Lannett Co. Inc. and its debtor affiliates (together, Lannett) commenced their voluntary "prepackaged"[5] chapter 11 cases on May 2, 2023, in the U.S. Bankruptcy Court for the District of Delaware. The next day, Lannett filed its disclosure statement and plan, requesting that a combined hearing on the approval of the disclosure statement and plan confirmation be scheduled for June 8, 2023. According to milestones established in a restructuring-support agreement entered into among the company, its first-lien noteholders and second-lien term loan lenders, confirmation of the Lannett plan should have occurred no later than 40 days after the petition date, and that plan was to have gone into effect no later than 45 days after the petition date.[6] Yet,

1 "Chapter 11 Case Administration," *U.S. Trustee Program Policy and Practices Manual*, U.S. Dep't of Justice, *available at* justice.gov/ust/file/volume_3_chapter_11_case_administration.pdf/download (last visited June 28, 2023); *see* 11 U.S.C. § 1103(c).

2 As first enacted in 1978, § 1102 empowered bankruptcy courts to appoint committees, but the administrative responsibilities associated with appointment were viewed by Congress as inconsistent with courts' adjudicative authority. As a result, when the U.S. Trustee pilot program was made permanent in 1986, the power of appointment was transferred to the U.S. Trustees for each district. *See* Deborah L. Thorne, "Creditors' Committees Maximizing Creditor Recoveries," XXV *ABI Journal* 3, 20, April 2006, *available at* abi.org/abi-journal.

3 *See* 28 U.S.C. § 586(a)(3)(E) (each UST "shall ... supervise the administration of cases and trustees in cases under chapter 11 ... by, whenever the [UST] considers it to be appropriate ... monitoring creditors' committees appointed under [the Code].").

4 *See, e.g., In re New Life Fellowship Inc.*, 202 B.R. 994, 996-97 (Bankr. W.D. Okla. 1996) (holding that § 1102(a)(1) "plainly and without any ambiguity grants the [UST] the exclusive authority to appoint committees" and "is absolute in its language and deprives [a] court of any discretion concerning appointment or abolition of committees"); *In re Wheeler Tech. Inc.*, 139 B.R. 235 (B.A.P. 9th Cir. 1992) (concluding that decisions on committee composition are entrusted solely to UST and are unreviewable); *In re Gates Eng'g Co. Inc.*, 104 B.R. 653, 654 (Bankr. D. Del. 1989) ("Subsequent to 1986, subsection (c) was deleted in § 1102 so that courts no longer had any authority over the composition of committees appointed by the [UST]."); *In re Drexel Burnham Lambert Grp. Inc.*, 118 B.R. 209, 210 (Bankr. S.D.N.Y. 1990) ("Noteworthy is the absence of any indication in [§ 1102] that the court may add to or delete an unsecured creditor from a committee.").

5 Lannett described its case as a "pre-pack," but unsecured noteholders were not part of the restructuring transactions contemplated among Lannett and its other creditor constituencies. In fact, unsecured noteholders were projected to receive no distribution under the proposed chapter 11 plan. *See In re Lannett Co. Inc., et al.*, Case No. 23-10559 (JKS), Motion of Debtors for Entry of an Order (I) Scheduling a Combined Disclosure Statement Approval and Plan Confirmation Hearing; (II) Approving Related Dates, Deadlines, Notices, and Procedures; (III) Approving the Solicitation Procedures and Related Dates, Deadlines, and Notices; and (IV) Conditionally Waiving the Requirements that (A) the U.S. Trustee Convene a Meeting of Creditors, and (B) the Debtors File Schedules of Assets and Liabilities, Statements of Financial Affairs, and Rule 2015.3 Statements, Dkt. No. 18 ("Lannett files these prepackaged chapter 11 cases with broad support of its secured creditors."; "Holders of Convertible Notes will receive no distribution.").

6 *See In re Lannett Co. Inc., et al.*, Case No. 23-10559 (JKS), Restructuring Support Agreement, Dkt. No. 17 at 178 (describing case milestones agreed to pursuant to restructuring-support agreement).

notwithstanding these milestones, the UST distributed committee questionnaires to Lannett's unsecured creditors, some of whom expressed interest in sitting on a creditors' committee. Thus, on May 19, 2023, the UST filed its notice of appointment of a committee of unsecured creditors.[7]

The following business day, Lannett filed an emergency motion pursuant to § 105(a) and (d) of the Bankruptcy Code to disband the UCC, arguing that there was no justification for the UST's formation of the UCC (and payment of UCC professionals) given that holders of general unsecured claims (*excluding* unsecured holders of convertible notes claims) were unimpaired.[8] Holders of general unsecured claims would be paid in full or have their claims reinstated by virtue of a gift from the debtors' first-lien noteholders and second-lien term loan lenders (collectively, the "crossover group").[9]

This group joined in the motion to disband, emphasizing that holders of general unsecured claims were already adequately represented *because they were receiving the maximum recovery possible under the plan*, and the bankruptcy court undoubtedly had the authority to disband the UCC.[10] The UCC disagreed with the debtors' and the crossover group's characterization of the alleged factual circumstances, arguing that unsecured creditors were *not* being paid in full and thus were not receiving the maximum possible recovery under the plan.[11] According to the UCC, its members and their constituents consisted of (among others) the indenture trustee for $86.25 million in unsecured convertible notes, whose noteholders would receive no recovery under the plan.[12] Discovery disputes related to the motion to disband ensued, with certain UCC members supporting the UCC's opposition to the motion to disband and arguing that bankruptcy courts altogether lacked the statutory authority to disband a creditors' committee.[13]

After a flurry of litigation and the bankruptcy court's initial refusal to hear the motion on an expedited basis, the parties ultimately settled the motion to disband without the bankruptcy court having the opportunity to rule on the merits of such motion. The global settlement included the debtors agreeing to provide limited recoveries to unsecured convertible noteholders in exchange for the UCC's agreement to limit its future role in the *Lannett* bankruptcy case.

Sorrento

Unlike *Lannett*, *Sorrento* did not involve the proposed disbandment of a creditors' committee. Rather, it involved a debtor's request to reconstitute a creditors' committee by removing one of the UCC's members.

Sorrento Therapeutics Inc. and one debtor affiliate (together, Sorrento) commenced their voluntary chapter 11 cases on Feb. 13, 2023, in the U.S. Bankruptcy Court for the Southern District of Texas. The primary reason cited in support of Sorrento's bankruptcy was the longstanding and ongoing litigation (the "Nant litigation") with an alleged competitor and a number of his companies, including NantCell Inc., Sorrento's largest unsecured creditor.[14] According to Sorrento, the Nant litigation gave rise to multiple eight-digit arbitration awards (one in favor of and one against Sorrento) and was "caused by the ill intentions of an opportunistic competitor who wants to destroy Sorrento for his own gain."[15] After solicitation from the UST, two weeks post-petition the UST appointed a five-member UCC consisting of, among others, NantCell.

NantCell's appointment as a member of the UCC prompted Sorrento to file an emergency motion to reconstitute the UCC by removing NantCell from the UCC altogether.[16] Sorrento posited that NantCell's interests were fundamentally misaligned with Sorrento's general unsecured creditors, including its fellow committee members, which consisted of a landlord and miscellaneous trade creditors.[17] Further, Sorrento argued that NantCell's membership in the UCC would "inhibit the [UCC's] ability to effectively represent the interests of unsecured creditors" without inevitable conflicts within the UCC.[18]

The UCC took no position with respect to the reconstitution motion.[19] Instead, the UCC noted the substantial protocols and safeguards that were in effect to alleviate potential conflicts that might exist or later arise in Sorrento's chapter 11 cases (which are commonly implemented in creditors' committee practice).[20] The UST objected to the reconstitution motion, arguing that while it was sensitive to Sorrento's concerns, it was "aware of no information [at the time of the UCC's appointment] that would indicate that NantCell is unable or unwilling to perform its fiduciary role" as a member of the UCC.[21] In addition, the UST argued that NantCell was capable of performing its fiduciary role because committee members need not be disinterested and are not expected to abandon their personal economic interests, as long as they do not take unfair advantage of their committee membership.[22]

Lastly, the UST expressly emphasized that it would continue to monitor NantCell's role on the UCC in accordance with its statutory duties and expected that NantCell would later resign or be removed from the UCC should it assume a role that was incompatible with its duties as a committee

7 *See id.* at Dkt. No. 92.
8 *Id.* at Dkt. No. 98.
9 *Id.* at 3.
10 *Id.* at Dkt. No. 102; *see, e.g., In re City of Detroit*, 519 B.R. 673 (Bankr. E.D. Mich. 2014) (disbanding official creditors' committee upon finding that committee "would add little value to the case, if any," thus enormous costs could not be justified); *In re JNL Funding Corp.*, 438 B.R. 356, 360 (Bankr. E.D.N.Y. 2010) ("Despite limited case law on this issue, the majority of courts [have held] that the bankruptcy court has the inherent power, as well as the statutory authority under Section 105(a), to review acts of the UST, under an 'arbitrary and capricious' or 'abuse of discretion' standard of review."); *In re Pac. Ave. LLC*, 467 B.R. 868, 870 (Bankr. W.D.N.C. 2012) (ordering disbandment of committee under § 105(d) because, among other things, committee's fees were paid out of secured lender's cash collateral, which was "free ride for one group of creditors at the expense of another and the committee was not necessary to protect the interests of its constituency").
11 *Id.* at Dkt. No. 109.
12 *Id.*
13 *See In re Caesars Entm't Operating Co. Inc.*, 526 B.R. 265 (Bankr. N.D. Ill. 2015) (holding that Bankruptcy Code did not authorize court to disband committee once appointed by UST); *In re Lannett Co. Inc., et al.*, Case No. 23-10559 (JKS), Computershare Trust Co. NA's Statement and Reservation of Rights with Respect to Discovery Requests, Dkt. No. 163.
14 *See In re Sorrento Therapeutics Inc., et al.*, Case No. 23-90085 (DRJ), Declaration of Mohsin Meghji, Chief Restructuring Officer of the Debtors, in Support of Chapter 11 Petitions, Dkt. No. 5 at 8-19.
15 *Id.* at 8.
16 *Id.* at Dkt. No. 219.
17 *Id.* at 2.
18 *Id.* at 4.
19 *See id.* at Dkt. No. 240.
20 *Id.* at 2.
21 *Id.* at Dkt. No. 237.
22 *Id.* at 5 (citing *In re El Paso Refinery LP*, 196 B.R. 58, 75 (Bankr. W.D. Tex. 1996)). A competitor of the debtor is not automatically disqualified from serving on a committee. *See In re Map Int'l Inc.*, 105 B.R. 5, 6 (Bankr. E.D. Pa. 1989) (citing *In re Plant Specialties Inc.*, 59 B.R. 1 (Bankr. W.D. La. 1986)); 5 *Collier on Bankruptcy* § 1102.01(6) (15th ed. 1988)); *but see In re Wilson Foods Corp.*, 31 B.R. 272 (Bankr. W.D. Okla. 1983). Until a committee member takes action, which indicates a breach of fiduciary duty, a court should not alter a committee's composition. *See In re Map Int'l Inc.* at 6 (citing *In re Richmond Tank Car Co.*, 93 B.R. 504, 507-09 (Bankr. S.D. Tex. 1988)).

member.[23] NantCell also opposed the motion, arguing that the debtors offered no evidence that NantCell's membership on the UCC did not adequately represent the interests of the unsecured creditors, and the remaining UCC members (without NantCell's participation) voted unanimously in favor of NantCell's continuing to serve on the UCC.[24] In NantCell's view, the issue before the bankruptcy court was whether to impose the bright-line rule requested by the debtors — that "judgment creditors or creditors with ongoing litigation ... can never serve on a creditors' committee."[25]

The bankruptcy court ultimately granted the reconstitution motion, finding that the harms — both actual and anticipated, stemming from NantCell's continued presence on the UCC — warranted its removal. The court did not find that NantCell, at any time, breached its fiduciary duties or otherwise engaged in any wrongdoing. Rather, the court justified its decision by emphasizing the need for transparency and a smooth bankruptcy process. In the court's view, the *Sorrento* bankruptcy cases would not exist but for NantCell's prepetition disputes with the debtors, and NantCell nonetheless had enough capital to maintain a significant presence in the bankruptcy cases and remain adequately represented without being a member of the UCC.

Determinations to Be Drawn, and the Import for Future Cases

Prior to a UCC's appointment, the UST typically vets any of the debtor's unsecured creditors that have expressed interest in serving on a UCC in an effort to identify potentially disqualifying conflicts of interest. Specifically, each creditor, *prior to* a UCC's appointment, presents to the UST the nature and amount of its economic interest. Moreover, the UST also informs potential committee members of their fiduciary duties and obligations, including (but not limited to) the duty to notify the UST of any changed circumstances that arise during a bankruptcy case that might affect their ability to serve.

Traditionally, the UST's decisions surrounding UCC formation and composition are not regularly challenged by bankruptcy courts, especially when a UCC's existence and composition are at stake. Notwithstanding the outcome in *Sorrento*, courts have held the following: (1) Conflicts of interest are inherent in committee members, and the mere presence of conflicts is insufficient to show lack of adequate representation;[26] (2) there "must be some overt, specific act to indicate a conflict of interest" justifying removal from a committee;[27] (3) there "must be specific evidence that the committee member or members with the [alleged] conflict have breached or are likely to breach their fiduciary duties";[28] and (4) "until actions are taken [that] indicate some breach or conflict, 'the court should not deny a creditor a position on a creditors' committee based upon speculation.'"[29] The *Sorrento* decision appears to justify a creditor's expulsion from the UCC based on the creditor's particular role and status in the bankruptcy case for facts and circumstances far less severe than those delineated in other chapter 11 proceedings.

Although not ultimately adjudicated on the merits by the bankruptcy court, *Lannett* demonstrates a debtor's increased willingness to seek relief to disband a UCC altogether. While the internal deliberations of and factors considered by the UST with respect to UCC appointments are generally not the subject of public fodder, the *Lannett* debtors sought to second-guess the UST's decisions concerning appointment and asked the bankruptcy court to follow suit.

Conclusion

It is not the authors' intent to argue for a complete lack of authority of bankruptcy courts in connection with the appointment, dissolution or composition of a committee. However, both *Lannett* and *Sorrento* appear to indicate, at a minimum, that the standards by which courts should intervene should require some heightened standard of review.

The Bankruptcy Code, in its current form, does not appear to expressly provide bankruptcy courts with any power to reconstitute or disband committees, absent reconstitution for the purposes of ensuring the adequacy of representation of a particular subset of creditors. Congress already took action at least once before — transferring authority over the appointment and composition of UCCs to the UST — without any express reservations of bankruptcy courts. Since then, nearly every decision that purports to provide for bankruptcy court authority to reconstitute or disband a UCC has relied on § 105. However, § 105 should not serve as an independent source of jurisdiction over matters concerning a UCC's existence and composition.[30] Instead, further changes in decision-making power regarding the appointment and composition of UCCs can — and should — come from future congressional amendments to the Code. abi

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23 *In re Sorrento Therapeutics Inc., et al.*, Case No. 23-90085 (DRJ), Objection of the U.S. Trustee to Debtors' Emergency Motion for Entry of an Order to Reconstitute the Committee of Unsecured Creditors, Dkt. No. 237 at 6.
24 *Id.* at Dkt. No. 247.
25 *Id.* at 2-3.
26 *In re Shorebank Corp.*, 467 B.R. 156 (Bankr. N.D. Ill. 2012).
27 *In re Cont'l Cast Stone LLC*, 625 B.R. 203, 208 (Bankr. D. Kan. 2020).
28 *In re Shorebank Corp.*, 467 B.R. at 161.
29 *In re Richmond Tank Car Co.*, 93 B.R. at 507-08.
30 *See Law v. Siegel*, 571 U.S. 415, 417 (2014) (holding that § 105 is limited in scope and does not "create substantive rights that would otherwise be available under the Bankruptcy Code"); *In re Hoffman Bros. Packing Co. Inc.*, 173 B.R. 177 (B.A.P. 9th Cir. 1994) ("Section 105 must, in all cases, be carefully construed so as to implement and fit the specific provisions of the Bankruptcy Code."); *In re Barney's Inc.*, 197 B.R. 431, 438 (Bankr. S.D.N.Y. 1996) (§ 105(a) "cannot create substantive rights not otherwise found in the Bankruptcy Code"); *In re First Republic Bank Corp.*, 95 B.R. 58, 60 (Bankr. N.D. Tex. 1988) ("[A] court may not invoke § 105(a) to create substantive rights that are not provided by the Code."); *In re Gates Eng'g Co.*, 104 B.R. at 653 ("However, the court cannot under the provisions of § 105 circumvent the unambiguous language of [§ 1102] in light of the deletion of subsection (c) in 1986.").