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**Representing the Committee Under the New Amendments:  
Disclosure Obligations, Conflicts and Committee Roles,  
Confidentiality and Privilege**

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On April 20, 2005, President Bush signed into law the Bankruptcy Abuse and Consumer Protection Act of 2005 (the “Act”) which made sweeping changes to the Bankruptcy Code. With limited exceptions, the Act went into effect on October 17, 2005 and applies only to bankruptcy cases filed after that date. As noted by numerous commentators and bankruptcy practitioners, the Act will significantly alter the landscape of reorganizations. One area that will be considerably impacted involves the formation and composition of creditors’ committees and the duties and responsibilities imposed on committees and their counsel. The purpose of this paper is to (i) provide an overview of issues that may arise as certain provisions of the Act affecting the Committee and its counsel are implemented; and (ii) identify critical issues that may arise in connection with the expanded duties and responsibilities of the Committee and its counsel.

## I. Introduction

The Bankruptcy Reform Act of 1978 (the “Code”) was the first comprehensive reform of the federal bankruptcy law in forty years. In the Code, Congress created a statutory committee of unsecured creditors<sup>1</sup> to undertake the task of monitoring the bankruptcy estate. Provided that there are creditors who are willing and qualified to serve on the Committee, the appointment of a Committee is mandatory in virtually all chapter 11 cases.

Aside from the debtor-in-possession, the Committee is arguably the most important player in a Chapter 11 bankruptcy case. The Committee serves a vital role in the reorganization, in part, by acting as a counterweight to the debtor-in-possession by representing the interests of its constituents, the unsecured creditors. While the debtor-in-possession is responsible for the management of the estate, the Committee performs critical functions such as investigating the assets and liabilities of the estate, negotiating the terms of a plan of reorganization or in some cases proposing its own competing plan. Furthermore, in instances where the debtor-in-possession is either unable or unwilling to perform certain of its responsibilities, the Committee often assumes those duties such as prosecuting avoidance actions and other litigation on behalf of the estate. A Committee is essential for reorganization cases to function fairly and for the interests of the unsecured creditors to be properly represented.<sup>2</sup>

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<sup>1</sup> The official committee of unsecured creditors shall be referred to as the “Committee” throughout this paper.

<sup>2</sup> The Committee is provided broad powers and authority to promote and protect its constituency. It should represent “an appropriate constituent body of parties-in-interest for the benefit of the reorganization process as it proceeds within the mechanisms of the bankruptcy court.” In re Eastern Me. Elec. Co-op, Inc., 121 B.R. 917, 933 (Bankr. D. Me. 1990). “By using creditors’ committees, the bargaining difficulties inherent in consolidating the interests of numerous unsecured creditors is simplified, and the unsecured creditors’ bargaining power enhanced, by effectively treating unsecured creditors as one bargaining entity with a single bargaining agenda.” J. Bradley Johnston, The Bankruptcy Bargain, 65 AM. BANKR. L.J. 213, 270 (Winter 1991).

II. Duties of the Committee and its Counsel Under the Code

Section 1102(a)(1) of the Code provides for the appointment of an official committee of unsecured creditors by the United States Trustee (“UST”).<sup>3</sup> The UST has administrative authority over the members of such Committee.<sup>4</sup>

A. Enumerated Responsibilities of the Committee Under § 1103 of the Code

The statutory responsibilities of the Committee are enumerated in 11 U.S.C. § 1103(c):

(1) consult with the trustee or debtor in possession concerning the administration of the case; (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan; (3) participate in the formulation of a plan, advise those represented by such committee of such committee’s determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan; (4) request the appointment of a trustee or examiner under section 1104 of this title; and (5) perform such other services as are in the interest of those represented.<sup>5</sup>

This list is not meant to be exhaustive but is instructive regarding the general duties of the Committee. While the primary function of the Committee is to represent the interests of all of the general unsecured creditors and maximize distributions, it may accomplish this through a variety of ways.<sup>6</sup> The Committee plays a critical role in the plan process. The Committee also bears the responsibility for investigating the actions and omissions of the officers and directors of the Debtor to determine if the estate holds any claims or causes of action against such parties. Likewise, courts have authorized the Committee to bring civil litigation and avoidance actions against insiders.<sup>7</sup> In many cases the Debtor is reluctant to investigate the acts of its own current

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<sup>3</sup> 11 U.S.C. § 1102(a)(1).

<sup>4</sup> In re Venturelink Holdings, Inc., 299 B.R. 420, 422 (Bankr. N.D. Tex. 2003).

<sup>5</sup> 11 U.S.C. § 1103(c).

<sup>6</sup> Walsh v. Westmoreland Human Opportunities, Inc. (In re Life Serv. Sys., Inc.), 279 B.R. 504, 510 (Bankr. W.D. Pa. 2002), rev’d on other grounds, 327 B.R. 561 (W.D. Pa. 2005).

<sup>7</sup> Official Comm. of Unsecured Creditors v. Liberty Savings Bank, FSB (In re Toy King Distrib., Inc.), 256 B.R. 1, 157 (Bankr. M.D. Fla. 2000); Official Comm. of Unsecured Creditors v. Lay (In re Enron Corp.), 295 B.R. 21, 24 (S.D.N.Y. 2003).

and former officers, directors and insiders. Moreover, the successful pursuit of claims against these insiders, especially when there is director and officer liability insurance, can generate substantial recoveries for the benefit of creditors. “An effective committee must necessarily be adversarial if it is to fulfill its role as ‘watchdog’ in a Chapter 11 case.”<sup>8</sup>

### III. Impact of the Act on the Selection of Committees and Their Members

#### A. Obligation of the UST to Select a “Representative” Committee.

The provisions of 11 U.S.C. § 1102(b)(1) provide that the Committee shall ordinarily be comprised of the persons holding the seven largest unsecured claims against the Debtor, provided that such creditors are willing to serve on the Committee.<sup>9</sup> This edict, however, is merely a guideline for the UST. The Committee may be comprised of fewer or more than seven members depending on the size and complexity of the case.<sup>10</sup> The members of the Committee need not be creditors who hold the seven largest unsecured claims, although they are usually chosen from the list of the holders of the twenty largest unsecured claims which is filed by the Debtor pursuant to Federal Rule of Bankruptcy Procedure 1007(d) at the commencement of a bankruptcy case.

Section 1102(b)(1) requires that the Committee be “representative of the different kinds of claims to be represented.” There is no determinative standard for whether the Committee is in fact representative of its constituency; such determination has been made on a case-by-case basis.<sup>11</sup> The standard for adequate representation “lies not in the uniqueness of a single claim but ‘in the nature of the case and the composition of the committee.’”<sup>12</sup> “Adequate representation” does not require that the Committee membership exactly reproduce the precise make-up of the creditor body.<sup>13</sup> “What is required is adequate representation of various creditor types.”<sup>14</sup> One of the chief concerns of adequacy of representation is “whether it appears that different classes of debt and equity holders may be treated differently under a plan and need representation through appointment of additional committees.”<sup>15</sup> In large, complex cases, the

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<sup>8</sup> In re Seascapes Cruises, Ltd., 131 B.R. 241, 243 (Bankr. S.D. Fla. 1991).

<sup>9</sup> 11 U.S.C. § 1102(b)(1).

<sup>10</sup> See Van Arsdale v. Clemo (In re A.H. Robins Co.), 65 B.R. 160, 163 (E.D. Va. 1986) (approving Committee consisting of five members).

<sup>11</sup> In re Dow Corning, Corp., 194 B.R. 121, 141 (Bankr. E.D. Mich. 1996), rev'd on other grounds, 212 B.R. 258 (E.D. Mich. 1997).

<sup>12</sup> In re Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 212 (Bankr. S.D.N.Y. 1990).

<sup>13</sup> In re Hills Stores Co., 137 B.R. 4, 7 (Bankr. S.D.N.Y. 1992).

<sup>14</sup> Id. (a disparity between bondholders' claims constituting 35% of the debtor's total liabilities while only comprising 27% of the Committee representation does not establish inadequate representation).

<sup>15</sup> In re Drexel Burnham Lambert, 118 B.R. at 212.

UST will scrutinize the nature of the claims of the proposed Committee members to ensure that the Committee as a whole is representative of the different categories of creditors.

B. Ability of the Court to Order the Change of the Composition of the Committee

One of the significant changes in the Act is the grant of authority to the bankruptcy court to alter the composition of the Committee. Congress included section 1102(a)(4) in the Act to provide bankruptcy courts with the authority to order the UST to change the membership of the Committee upon request of a party in interest and after notice and a hearing if “the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders.”<sup>16</sup>

Prior to the 1986 amendments to the Bankruptcy Code, bankruptcy courts were responsible for appointing the Committee and its members and upon motion could alter the composition of the Committee. Bankruptcy courts were formally authorized to change the membership or size of the Committee if the existing membership did not adequately represent the claims or interests of the creditors.<sup>17</sup> “In 1986, section 1102(a) was amended to shift responsibility for committee appointments from bankruptcy courts to the United States Trustees. At the same time, Congress deleted section 1102(c), which had read: ‘On request of a party in interest and after notice and a hearing, the court may change the membership or the size of a committee appointed under subsection (a) of this section if the membership of such committee is not representative of the kinds of claims or interests to be represented.’”<sup>18</sup> Accordingly, the bankruptcy courts were stripped of the power to change the membership of the Committee upon motion.<sup>19</sup>

Congress’ apparent intent behind this shift in responsibility was to ease the administrative burden on the courts that in some cases led to lengthy delays in the appointment of creditors’ committees. Moreover, delegating responsibility to the court for appointing members to a committee also raised questions regarding the future neutrality of the court if it were called upon to adjudicate disputes between committee members selected by the court and other interested third parties. “By revising Section 1102, Congress purposely removed administrative responsibility from the bankruptcy courts and placed it in the hands of the United States Trustee to allow the courts to make decisions ‘untainted by knowledge of administrative matters unnecessary and perhaps prejudicial to an impartial judicial determination.’”<sup>20</sup>

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<sup>16</sup> 11 U.S.C. § 1102(a)(4).

<sup>17</sup> In re Barney’s, Inc., 197 B.R. 431, 438 (Bankr. S.D.N.Y. 1996).

<sup>18</sup> In re Pierce, 237 B.R. 748, 752 (Bankr. E.D. Cal. 1999).

<sup>19</sup> See In re Columbia Gas Sys., Inc., 133 B.R. 174, 175 (Bankr. D. Del. 1991).

<sup>20</sup> In re Mission Health, Inc., 242 B.R. 527, 530 (Bankr. M.D. Fla. 1999) (quoting H.R. Rep. No. 99-764, 99<sup>th</sup> Cong., 2d Sess. 18 (1986), reprinted in 1986 U.S.C.A.N. 5227, 5230)).

Unfortunately, the 1986 amendments to section 1102 resulted in inconsistencies regarding the impact of the deletion of section 1102(c) on bankruptcy courts' authority, or lack thereof, to review the UST's committee appointments.<sup>21</sup> Some courts held that the membership of the Committee could be reviewed by bankruptcy courts only under an abuse of discretion standard or if the UST's actions were arbitrary and capricious.<sup>22</sup> Other courts held that bankruptcy courts had no authority to alter the membership of the Committee even if the UST acted arbitrarily and capriciously.<sup>23</sup> Yet another group of courts held that bankruptcy courts still had the power to exercise plenary review of the UST's appointment of committee members.<sup>24</sup> Even if bankruptcy courts lost the power to appoint additional members to the Committee, they still retained the ability to appoint additional committees to resolve the issue of adequate representation.<sup>25</sup>

In an apparent response to the inconsistent positions taken by bankruptcy courts throughout the United States, Congress amended section 1102 to mimic the pre-1986 amendment language, by allowing the court to order the UST to change the membership of a committee appointed, if the court determines that the change is necessary to ensure the adequate representation of creditors or equity security holders. As creditors may bring this issue to the court's attention without initially approaching the UST, and without having to satisfy the abuse of discretion standard, there may be substantially more activity in this area.

#### C. Impact the Act May Have on the Committee Selection Process (Appointment of Multiple Committees)

Section 1102 provides that the UST may appoint additional committees of creditors as deemed appropriate. Additionally, on request of a party in interest, the court may order the appointment of additional committees of creditors to ensure that the creditors are adequately represented. Multiple committees place an additional layer of expense on the estate. Although cost is an important factor when analyzing whether the appointment of additional committees is

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<sup>21</sup> See In re Pierce, 237 B.R. at 752; The legislative history to the 1986 amendments did not offer any guidance in resolving the split between the courts as there were no hearings conducted on this particular issue. 7 Collier on Bankruptcy § 1102.07(2) (15<sup>th</sup> Ed. Rev. 2005).

<sup>22</sup> E.g. In re Venturelink Holdings, Inc., 299 B.R. 420, 423 (Bankr. N.D. Tex. 2003); In re Pierce, 237 B.R. at 754; In re Columbia Gas, 237 B.R. at 176.

<sup>23</sup> See, e.g. Masters, Mates & Pilots Plans v. Lykes Bros. S.S. Co. (In re Lykes Bros. S.S. Co.), 200 B.R. 933, 939 (M.D. Fla. 1996) (discussing split among courts); In re New Life Fellowship, Inc., 202 B.R. 994, 996-97 (Bankr. W.D. Okla. 1996).

<sup>24</sup> In re Pub. Serv. Co. of N.H., 89 B.R. 1014, 1021 (Bankr. D. N.H. 1988); In re Texaco, Inc., 79 B.R. 560, 566 (Bankr. S.D.N.Y. 1987)

<sup>25</sup> In re Mission Health, 242 B.R. at 529; In re Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 211 (Bankr. S.D.N.Y. 1990).

warranted, added cost alone is an insufficient basis to deny creditors the formation of an additional committee if one is otherwise appropriate.<sup>26</sup>

Courts have upheld the UST's decision to decline to appoint additional committees if the creditors are adequately represented by a single committee.<sup>27</sup> Generally, multiple committees will be the exception to the rule.<sup>28</sup> The burden is on the party requesting the additional committee to prove that the existing committee(s) do not adequately represent the interests of the creditors.<sup>29</sup> In the past, “[b]ankruptcy Courts generally have been reluctant to appoint separate committees of unsecured creditors notwithstanding the diverse and sometimes conflicting interest of such creditors in the context of a chapter 11 proceeding.”<sup>30</sup> However, “a case which is sufficiently large and complex may strongly indicate the need for additional committees representing different interests.”<sup>31</sup>

It is unclear what impact the enhancement in the courts' authority to alter the membership of the Committee to resolve the adequate representation issue will have on the frequency of requests for and the appointment of multiple committees. On one hand, the courts' ability to alter the membership of the Committee could decrease the frequency of requests for, and appointment of, multiple committees because the courts will now clearly have the ability to address the issue of adequate representation by altering the membership of the Committee, even if the UST has not abused its discretion. On the other hand, the increased involvement by the courts in Committee membership issues may lead to the increased appointment of additional committees if courts remove members from the Committee who then lobby for the creation of a separate committee on the basis that such creation is necessary for their interests to be adequately represented.

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<sup>26</sup> In re Hills Stores Co., 137 B.R. 4, 6 (Bankr. S.D.N.Y. 1992); Some of the factors considered by courts when determining whether creation of an additional committee is appropriate include: (i) the existing committee structure; (ii) the context of the particular bankruptcy case; (iii) the various creditor constituencies and their respective claims; (iv) the composition of the committee; and (v) the ability of the Committee to function properly. See In re Dow Corning, 194 B.R. 121, 141 (Bankr. E.D. Mich. 1996), rev'd on other grounds, 212 B.R. 258 (E.D. Mich. 1997); In re Enron Corp., 279 B.R. 671, 685 (Bankr. S.D.N.Y. 2002). Additional “[d]iscretionary considerations include: (1) [t]he cost associated with the appointment; (2) [t]he time of the application; (3) [t]he potential for added complexity; and (4) [t]he presence of other avenues for creditor participation.” In re Enron, 279 B.R. at 685.

<sup>27</sup> In re Enron, 279 B.R. at 688-89 (declining to appoint additional committees noting that the size of a case alone is not determinative of the issue of whether additional committees are necessary to assure adequate representation); In re Agway, Inc., 297 B.R. 371, 376 (Bankr. N.D.N.Y. 2003) (court refused to appoint separate committee of retired employees); In re Gates Eng'g Co., 104 B.R. 653, 654-55 (Bankr. D. Del. 1989) (declining to appoint a governmental units committee when that category of claimant was already adequately represented by another committee in the case).

<sup>28</sup> In re Sharon Steel Corp., 100 B.R. 767, 778 (Bankr. W.D. Pa. 1989).

<sup>29</sup> In re Dow Corning, 194 B.R. at 144.

<sup>30</sup> In re Pub. Serv. Co. of N.H., 89 B.R. 1014, 1020 (Bankr. D. N.H. 1988).

<sup>31</sup> In re Hills Stores, 137 B.R. at 6.

#### IV. New Disclosure Requirements Imposed on the Committee by the Act

The Act expands the responsibilities and duties of the Committee and its counsel by the inclusion of subsection 1102(b)(3) which provides as follows:

- (3) A committee appointed under subsection (a) shall—
  - (A) provide access to information for creditors who—
    - (i) hold claims of the kind represented by that committee; and
    - (ii) are not appointed to the committee;
  - (B) solicit and receive comments from the creditors described in subparagraph (A); and
  - (C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

While the intent behind this new subsection, to increase communication and the flow of information between the Committee and its constituents, is admirable, the general language of the subsection opens a Pandora's box of issues. Dictating that access to information must be provided to creditors without further guidance regarding how such information must be disseminated and what type of information is required to be disclosed opens a host of issues in connection with the Committee's execution of its duties and responsibilities under the Act. Clearly, one of the Committee's responsibilities is to consult with the debtor-in-possession as to the administration of the bankruptcy case. However, if the Debtor fears that all of the information it provides to the Committee will be disseminated to the entire creditor body, the Debtor will be reluctant to provide that information to the Committee if it contains certain confidential or sensitive financial information. The inability of the Committee to receive all pertinent financial information will impair the Committee's ability to function if it is then unable to make fully informed decisions on critical issues.

Further, this provision also impacts the Committee's obligation to investigate the acts, conduct, assets, liabilities and financial condition of the Debtor. Such an investigation can create a sensitive and, at times, adversarial relationship with the Debtor. Accordingly, the results of these investigations are generally kept confidential until the Committee has concluded its investigation and determined whether further action should be taken. If the Committee is compelled to share information with its constituents while still in the investigative stage, it could cause the Debtor to be less forthcoming with information and will increase the inherent tension between the debtor-in-possession and the Committee.

Yet another responsibility of the Committee is to participate in the formulation of the plan. Plan negotiations can be a long and painstaking process. If the Committee is now required

to update its constituency every time a new plan proposal is discussed and solicit input, it could hamper the Committee's ability to ultimately negotiate the best result for the creditor constituency. These pressures may be exacerbated by the new provisions in the Act that require the Debtor to formulate its plan earlier in the process. All of these issues impact the duties of Committee counsel as well since counsel "is responsible for ensuring that the committee advances the collective interests of the entire creditor class."<sup>32</sup>

The lack of guidance on how to accomplish the directives set forth in section 1102(b)(3)(A) creates a host of problems. For example, is the Committee required to provide access to information only upon individual inquiry by a creditor or is the Committee required to file or otherwise make generally available periodic reports to its creditor constituency through press releases, websites or the like? Both approaches carry with them their own set of problems and issues. Additionally, is the Committee now obligated to disseminate confidential and/or sensitive information to its constituents, or bound to disclose information protected by the attorney-client privilege in order to comply with the new provisions of the Act?

Section 1102(b)(3)(B) provides that the Committee shall solicit and receive comments from its constituency without giving guidance on the frequency of such solicitation or the procedure by which such solicitation should be made. However, does the Committee have an obligation to act or consider those constituent comments before it takes a position on the issue; further, can the Committee simply ignore the comments of its constituency? A process of soliciting comments before taking action could present a logistical nightmare for the Committee and its counsel and could hamper the effectiveness of the Committee if it is unable to make critical decisions quickly because it is compelled to solicit and obtain comments from its constituents.

Not surprisingly, these issues implicate the fiduciary duties owed by the Committee to its constituency. The Committee owes a duty of undivided loyalty and impartial service to its constituency.<sup>33</sup> However, the Committee and its members do not owe a fiduciary duty to any particular creditor or the Debtor.<sup>34</sup> If the Committee must consider comments from its constituency, has it then delegated its fiduciary responsibilities? Do creditors who provide comments undertake a fiduciary obligation?

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<sup>32</sup> Carl A. Eklund et al., The Problem With Creditors' Committees in Chapter 11: How to Manage the Inherent Conflicts Without Loss of Function, 5 AM. BANKR. INST. L. REV. 129, 144 (Spring 1997).

<sup>33</sup> In re Pierce, 237 B.R. 748, 758 (Bankr. E.D. Cal. 1999).

<sup>34</sup> See ABF Capital Mgmt. v. Kidder Peabody & Co., 210 B.R. 508, 516 (S.D.N.Y. 1997); Official Comm. of Unsecured Creditors v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1315 (1<sup>st</sup> Cir. 1993); In re Microboard Processing, Inc., 95 B.R. 283, 285 (Bankr. D. Conn. 1989).

A. Procedure for Dissemination of Information

1. Must Information Be Provided Only Upon Inquiry of Individual Creditors or Must it Be Disseminated to the Entire Creditor Constituency

Section 1103(a) of the Act authorizes the Committee, with bankruptcy court approval, to employ its own attorneys, accountants or other agents to represent or perform services for the Committee. Committee counsel will most likely be tasked with the responsibility of disseminating information to the creditor constituency. Disseminating information to multitudes of creditors will impose a large administrative cost on the bankruptcy estate which will ultimately deplete funds that could have been available to fund a plan of reorganization and make distributions to the unsecured creditors. As a result, although creditors will have been privy to information they might not otherwise have received, they may ultimately be in a worse position because funds that would have been distributed to them may be utilized to pay the administrative costs incurred as a result of providing them with information pertinent to the bankruptcy case. There is also a significant question of who “fronts” the cost of disseminating this information – the Debtor, the Committee or its counsel.

2. Administrative Costs of Providing En Masse Updates When the Debtor is a Large Public Company

The administrative cost of providing information is compounded when the Debtor is a public company with tens of thousands of creditors and shareholders. One possible solution may be for the Committee to simply create a website that constituents may access to obtain periodic updates on the activity in the bankruptcy case. In the past, websites have been used by Debtors to disseminate information in a bankruptcy case and to provide copies of certain critical documents such as disclosure statements and plans of reorganization when the cost of disseminating such voluminous documents by mail is prohibitive. Of course, creating and running a website has its own costs but it may ultimately be more cost-effective in larger cases. As discussed below, additional issues arise if confidential or sensitive information is required to be disseminated.<sup>35</sup>

3. Possible Securities Law Implications from Dissemination of Non-Public Information to the Committee

When the Debtor is a publicly traded company, the Committee and its counsel must be cognizant of the additional issues that arise as a result of securities law regulations. One issue that may arise involves the concept of “selective disclosure.” The Securities and Exchange Commission (“SEC”) has adopted Regulation FD (Fair Disclosure) regarding the issue of selective disclosure. In essence, this regulation provides that when an issuer [the debtor] discloses material, non-public information to certain persons (including holders of its securities

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<sup>35</sup> One way to handle such a scenario, if information is being disseminated through a website, may be to provide secure passwords to creditors to allow them to access sensitive or confidential information if they have executed confidentiality agreements.

who may trade on the basis of such information) then the issuer must make public disclosure of the information as well.<sup>36</sup>

Therefore, it is possible that if the Debtor discloses certain non-public information to the Committee, and certain members of the Committee also hold securities in the Debtor, then the Debtor must make such information available to the general public. However, Rule 100(b)(2) of Regulation FD excepts communications made to any person who expressly agrees to maintain the information in confidence. Accordingly, obtaining confidentiality agreements from the members of the Committee and Committee counsel (and policing those agreements) will be critical. Absent a confidentiality agreement, the Debtor will most likely resist any request to disclose confidential information to the Committee in order to avoid violating securities regulations.

## B. Protecting Confidential/Sensitive Information

### 1. Confidentiality Agreements/Committee Bylaws

The language of the Act mandates that the Committee provide access to information to its constituents without providing exceptions for confidential or proprietary information. By virtue of its role and duties in a bankruptcy case, the Committee is entitled to obtain from the Debtor certain confidential information and/or information, that while not rising to the level of confidentiality, may be extremely sensitive. For example, in almost all cases the Debtor provides the Committee with data concerning the Debtor's financial status, its future business plans as well as data concerning proposed distributions to creditors under the plan. The Committee also typically receives confidential information about the Debtor's operations, budget projections, salaries of officers, potential asset sales and sources of financing. If the Committee is required to disclose such information to the unsecured creditor body as a whole, or to certain individual creditors who specifically request it, it could create scenarios where such disclosure could seriously harm the creditor body as a whole and the Debtor's ability to reorganize.

The fiduciary duty owed by the members of the Committee to their constituency imposes a duty of care with regard to safeguarding confidential information. In the past, Committee members have normally executed confidentiality agreements in connection with receiving confidential information from the Debtor.<sup>37</sup> Confidentiality agreements have been and are important tools because they promote the free flow of information between the Debtor and the Committee by enabling the Debtor to securely provide information to the Committee with an assurance that it will be kept confidential. They also serve to enhance the Committee's awareness of the significance of certain proprietary information. Absent the presence of a confidentiality agreement and the attendant threat of some form of sanction for breaching such agreement, there is no independent check and balance upon one member of the Committee acting in its own self-interest to the detriment of the broader creditor constituency. An unsophisticated

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<sup>36</sup> 17 C.F.R. § 243.100.

<sup>37</sup> See e.g. In re Northwestern Corp., 326 B.R. 519, 522 (Bankr. D. Del. 2005).

creditor, not represented by counsel, may not fully grasp the implications of a confidentiality agreement. While this would not be a valid defense to the breach of such an agreement, it is something the Debtor must consider in providing confidential information to the Committee.

Committee counsel also have often addressed the protection of confidential information through the Committee bylaws. For example, bylaws normally provide that information shall be treated as “confidential” by the Committee if: (i) the Debtor requests that the Committee keep the information confidential and the Committee consents to such request; (ii) the Committee is advised by Committee counsel that the information should be treated as confidential; or (iii) the Committee determines that the information in question is confidential. While such provisions in Committee bylaws have provided some comfort to Committee counsel to protect the disclosure of confidential information, they may now run afoul of the provisions of the Act since they limit constituent access to information in the Committee’s possession.

## 2. Balancing the Debtor’s Concern for Protecting Confidential Information With the Committee’s Disclosure Obligations

One of the fundamental duties of the Committee is to consult with the Debtor regarding the administration of the bankruptcy case. The Committee must have access to the Debtor’s financial records in order to perform its duties.<sup>38</sup> “[I]n order to properly foster negotiations over reorganization plans, the Debtor must be able to provide information to the Committee free of the risk that the Committee may be forced to disgorge such records and information to adverse third parties without the opportunity of the Debtor to preserve, if appropriate, any objections it may have to such disclosures.”<sup>39</sup> Absent entry of an order by the court providing protection for confidential information, it is likely that Debtors and their professionals will refuse to provide certain critical confidential/proprietary financial information to the Committee. Absent receipt of such information, the Committee may be unable to accurately assess the pros and cons of a plan of reorganization proposed by a Debtor and, therefore, be unable to adequately promote and protect the interests of its constituency.

If the Committee does not seek an order from the court providing guidelines for the dissemination of information to its constituents and restrictions on the dissemination of confidential information, it is likely that a Debtor may seek entry of a protective order to maintain the confidentiality of this information. Section 107(b)(1) provides, “[o]n request of a party in interest, the bankruptcy court shall, and on the bankruptcy court’s own motion, the bankruptcy court may – (1) protect an entity with respect to a trade secret or confidential research, development, or commercial information; . . .” “Commercial information” has been defined as that “information which would cause an unfair advantage to competitors by providing them information as to the commercial operations of the debtor.”<sup>40</sup> “A bankruptcy court is

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<sup>38</sup> Kaiser Steel Corp. v. Frates (In re Kaiser Steel Corp.), 84 B.R. 202, 206 (Bankr. D. Colo. 1988).

<sup>39</sup> Id.

<sup>40</sup> In re Northstar Energy, Inc., 315 B.R. 425, 429-30 (Bankr. E.D. Tex. 2004).

required to seal ‘documentary information filed in court that does not rise to the level of a trade secret but that is so critical to the operations of the entity seeking the protective order that its disclosure will unfairly benefit that entity’s competitors.’”<sup>41</sup> Pursuant to section 107, courts have precluded disclosure of timelines for sale of the Debtor’s assets and have sealed financial projections and proposed distribution allocations to creditors.<sup>42</sup> Accordingly, absent the Committee obtaining such an order, it would be prudent for a Debtor to proactively seek entry of an order protecting disclosure of confidential/sensitive information provided to the Committee.

### 3. Court Intervention to Protect Confidential Information

Immediately after the Committee is formed and retains counsel, it may be prudent for the Committee to file a motion with the court requesting entry of an order outlining specific procedures for disseminating information to creditors and excepting out certain confidential or proprietary information from disclosure. This serves the dual purpose of notifying creditors of the proposed procedures regarding dissemination of information and the non-disclosure of certain confidential information while also providing them with an opportunity to object. It protects the Committee and its counsel from allegations that the requirements of section 1102(b)(3) have been violated. It also addresses concerns that the Debtor may have that may prompt it to withhold certain confidential/sensitive information absent a court order that provides for protection of such information. Since Committees may receive confidential information almost immediately after appointment, Committee counsel should consider seeking this relief from the court *nunc pro tunc* and on an expedited basis.

#### C. The Committee and the Attorney-Client Privilege

##### 1. Duties of Committee Counsel

Attorneys retained by the Committee to represent its interests enjoy the attorney-client privilege with the Committee and its members in their official capacity.<sup>43</sup> This privilege is important to facilitate full and frank communications between the Committee and its counsel. Such privilege, however, does not extend to the Committee’s constituency. Accordingly, Committee members and counsel for the Committee must exercise caution when communicating with the Committee constituency to ensure that privileged matters are not revealed to non-Committee members, thereby potentially waiving the privilege.

While attorneys retained by the Committee owe a fiduciary duty to the Committee, such duty does not extend to the creditor constituency as a whole. As a result, certain situations may arise where the Committee’s fiduciary relationship is in tension with the attorney-client

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<sup>41</sup> *Id.* at 430 (quoting In re Global Crossing, Ltd., 295 B.R. 720, 725 (Bankr. S.D.N.Y. 2003)).

<sup>42</sup> See In re Farmland Indus., Inc., 290 B.R. 364, 370 (Bankr. W.D. Mo. 2003); In re Lomas Fin. Corp., No. 90 Civ. 7827 (LLS), 1991 WL 21231 at \*1 (S.D.N.Y. Feb. 11, 1991).

<sup>43</sup> See In re Baldwin-United Corp., 38 B.R. 802, 805 (Bankr. S.D. Ohio 1984).

privilege. “The fiduciary relationship between the committee and those it represents requires a balancing of the injury resulting from disclosure with the interest of those whom the committee represents in obtaining information.”<sup>44</sup> The requirements imposed under the Act put the fiduciary responsibility of counsel to the Committee at odds with its obligation to maintain the confidentiality of privileged communication. How can counsel prepare confidential and protected work product if it is then required to share it with the creditor constituency, thereby waiving the privilege?

## 2. Waiver of the Privilege

The essence of the attorney-client privilege is to maintain confidentiality among counsel and the client. Generally, the privilege is waived if an otherwise privileged communication is made in the presence of a third party. The Act does not exclude attorney-client privileged communications from those matters that must be disclosed to Committee constituents. Mandatory disclosure of privileged communications could constitute a waiver of the privilege which could ultimately cause more damage to the creditor constituency than the non-disclosure of such information. Because the Act does not specifically exclude attorney-client privileged communications from the information that the Committee is now required to provide, the Committee may be obligated to share such privileged information as a confidential and privileged assessment of claims the estate may have against officers and directors of the Debtor and other third parties.

## 3. Common Interest / Joint Defense Agreements

Joint defense agreements may provide a method to protect privileged information. The joint defense or common interest privilege underlying such agreements is an extension of the attorney-client privilege and the work product doctrine.<sup>45</sup> Generally, the attorney-client privilege is waived when an otherwise privileged communication takes place in the presence of a third party. An exception to this rule is when the communication occurs in furtherance of a “common interest” or “joint defense.”<sup>46</sup>

The common interest privilege does not create a separate privilege, rather it is an exception to the general rule that the attorney-client privilege or the work product doctrine are waived when information protected by such privileges is disclosed to a third party.<sup>47</sup> “Courts

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<sup>44</sup> Id.

<sup>45</sup> Durkin v. Shields (In re Imperial Corp. of America), 179 F.R.D. 286, 289 (S.D. Cal. 1998).

<sup>46</sup> Peter N. Levenberg, Can a Committee Keep a Secret? Protecting Work Product and the Attorney-Client Privilege in Creditors’ Committee Representations, 23 CAL. BANKR. J. 65, 75 (1996).

<sup>47</sup> See United States v. Schwimmer, 892 F.2d 237, 243 (2<sup>nd</sup> Cir. 1989), aff’d 924 F.2d 443 (2<sup>nd</sup> Cir. 1991); In re Six Grand Jury Witnesses, 979 F.2d 939, 943-44 (2<sup>nd</sup> Cir. 1992); Supreme Court Standard 503, which has been adopted by some states, recognizes the existence of a common interest privilege:

have recognized that the common interest privilege applies to communications between debtors-in-possession and creditors committees in bankruptcy cases.”<sup>48</sup>

The parameters of the common interest privilege, however, are not altogether clear. “[C]ourts differ on whether the parties sharing the privilege actually have to be parties on the same side of a pending or existing piece of litigation, whether the common interest privilege can apply between parties with interests which are diverse on certain issues, and whether formal agreements are required in order to invoke the privilege.”<sup>49</sup>

Consequently, in connection with seeking a court order setting parameters for the protection of confidential/sensitive information, the most prudent course for Committee counsel is to also request that the Court exclude its privileged communications and work product, including those protected by a joint defense agreement, from dissemination to the Committee’s constituents.

#### D. Policing the Disclosure of Information to Certain Creditors

The obligations under the Act also raise the concern of whether the Committee should preclude certain creditors from obtaining access to information that would give them an unfair advantage over other creditors. General unsecured creditors do not owe a fiduciary duty to one another, which is problematic if they become privy to confidential/sensitive information and use it for their own self interest. Because the Committee and its members owe a fiduciary duty to all members of its constituency, it may find itself at risk if it discloses certain proprietary information to creditors that it suspects will use that information for their own self interest. Alternatively, if the Committee is required to disclose information to the entire creditor body, may it carve out certain portions of its constituency? The Act provides no guidance on these troubling concerns.

##### 1. Disclosure of Information to Claims Purchasers/Traders

Typically, parties engaging in claims purchasing/trading are attempting to improve their position in a bankruptcy case by trying to make a profit on the margin between the price they

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General Rule of Privilege. A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client, (1) between himself or his representative and his lawyer or his lawyer’s representative, or (2) between his lawyer and the lawyer’s representative, or (3) by him or his lawyer to a lawyer representing another in a matter of common interest, or (4) between representatives of the client or between the client and a representative of the client, or (5) between lawyers representing the client. “The critical inquiry is whether a ‘sufficient commonality of interests’ exists between the parties such that the privilege may be asserted. Supreme Court Standard 503.

<sup>48</sup> In re Imperial Corp., 179 F.R.D. at 289.

<sup>49</sup> Levenberg, 23 CAL. BANKR. J. at 75.

paid to purchase the claims and the ultimate distribution(s) on such claims. Generally, until a Disclosure Statement is filed with the bankruptcy court and served on the creditors, claimants have little idea what the distribution on their claim(s) will be. As a result, claims purchasers/traders generally have to estimate what distribution they believe will be made and gamble that they did not overestimate the proposed distribution. If such entities are now able to access certain confidential financial data of the Debtor not generally available in the public arena or obtain information during plan negotiations concerning proposed percentages of distribution to creditors, it could create tremendous opportunities for these parties.

The ability of Committee members who wish to engage in claims trading has been addressed by the courts and provides some guidance on what level of information may be appropriate. In some cases, a claim trader (such as a hedge fund) may wish to serve on a Committee while continuing to trade in the Debtor's debt or securities. The inclusion of such a creditor on a Committee can be problematic from the standpoint of creating the appearance of impropriety, i.e. non-committee members may assume that such a creditor is utilizing inside information in making its decisions regarding claims trading. Creditors who sell their claims to such a creditor may accuse such a creditor of impropriety if the plan ultimately provides for a higher distribution than the percentage such creditors received for the purchase of their claim.

Although there is no per se rule barring a party who purchased pre-petition claims post-petition from serving on a Committee, such entities pose a risk to the other Committee members (for unauthorized use of confidential information) and may expose themselves to liability. This risk can be managed by imposing appropriate limitations on claims trading.<sup>50</sup> The SEC has approved the use of so-called "Chinese" walls to allow members of a Committee to engage in trading in the securities of a Debtor. The bankruptcy court in In re Federated Dept. Stores, Inc. permitted a committee member to continue trading under certain limitations:

Fidelity will not be violating its fiduciary duties as a committee member and accordingly, will not be subjecting its claims to possible disallowance, subordination, or other adverse treatment, by trading in securities of the Debtors ... during the pendency of these Cases, provided that Fidelity employs an appropriate information blocking device or "Chinese Wall" which is reasonably designed to prevent Fidelity trading personnel from receiving any nonpublic committee information through Fidelity committee personnel and to prevent Fidelity committee personnel from receiving information regarding Fidelity's trading in securities of the Debtors . . .<sup>51</sup>

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<sup>50</sup> 7 Collier on Bankruptcy, § 1102.02(2)(a)(iv) (15<sup>th</sup> Ed. Rev. 2005).

<sup>51</sup> No. 1-90-00130, 1991 WL 79143 at \*1 (Bankr. S.D. Ohio Mar. 7, 1991).

In Federated Dept. Stores, the Court approved the following screening procedures: (i) written acknowledgement by personnel performing committee work that they could receive non-public information and were aware of the screening wall procedures in effect; (ii) a prohibition on the sharing of non-public committee information with other employees; (iii) separate file space for committee work which is inaccessible to other employees; (iv) restrictions on committee personnel's access to trading information; and (v) a compliance review process.<sup>52</sup>

While these type of ethical walls may work well in practice when the claims trader in question is a member of the Committee, trying to impose them on non-Committee members will be difficult.

## 2. Disclosure of Information to Competitors of Debtor

An additional concern relates to competitors of the Debtor serving on the Committee. These parties may have a potential interest in purchasing assets of the Debtor or gaining market share at the Debtor's expense. In the past, competitors of Debtors who are otherwise qualified to serve on the Committee have been allowed to serve on committees and have not been subject to disqualification solely on the basis of their competitor status.<sup>53</sup> "[T]he party seeking to exclude a creditor bears the burden of proving that the creditor's appointment will be detrimental to the debtor's reorganization efforts."<sup>54</sup> The check and balance on competitors who serve on the Committee is the fiduciary duty of the members of the Committee which precludes them from using their position on the Committee to advance their individual self interest. Prior to the Act, the Committee and its counsel could take preventative steps to limit confidential information to a competitor. The mandatory obligation to provide that information to all creditors may complicate the process. Most likely, the Debtor will utilize this concern as a justification to limit the Committee's access to confidential information.

## 3. Conflicts of Interest

When the UST initially forms the Committee, he/she should exclude parties which have actual conflicts of interest with other unsecured creditors. Furthermore, a Committee member cannot fulfill its fiduciary responsibility if it holds an actual conflict of interest. Not all conflicts of interest, however, rise to the level of prohibiting appointment to or requiring removal from the Committee.<sup>55</sup> "The Bankruptcy Code does not expressly prohibit a person from serving on a

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<sup>52</sup> Id.

<sup>53</sup> See e.g. In re Map Int'l, Inc., 105 B.R. 5, 6 (E.D. Pa. 1989); In re Plant Specialties, Inc., 59 B.R. 1, 2 (W.D. La. 1986).

<sup>54</sup> In re Map Int'l, 105 B.R. at 6 (refusing to disqualify a competitor serving on the Committee absent establishment that such competitor has had access to confidential information of the debtor or that it has violated its fiduciary duties).

<sup>55</sup> In re Venturelink Holdings, Inc., 299 B.R. 420, 423 (Bankr. N.D. Tex. 2003).

committee because of a lack of disinterestedness.”<sup>56</sup> Membership on a Committee does not preclude a creditor from pursuing and protecting its own interests so long as such pursuit does not cause a breach of the member’s fiduciary duty to the Committee’s constituency.<sup>57</sup> A conflict of interest that rises to the level of breaching the Committee member’s fiduciary duty mandates removal of the creditor from the Committee.

The Committee is obligated to strive to maximize the value of the bankruptcy estate for the benefit of its constituency. As a result, Committee members may not use their position on the Committee to advance their own self-interest.<sup>58</sup> Pursuing a course of action that is detrimental to the Committee’s constituents and benefits the Committee member pursuing the action constitutes a violation of the Committee member’s fiduciary duty.<sup>59</sup> Violations by the Committee as a whole, or its members individually in their capacity as members of the Committee, can give rise to the imposition of numerous penalties, including the disallowance or subordination of the Committee member’s claim, exposure to civil lawsuits by parties harmed by such breach and other sanctions.

#### 4. Remedies for Breach of Confidentiality

There are several potential remedies if confidentiality is breached by a member of the Committee, including: (i) the disallowance of the creditor’s vote pursuant to 11 U.S.C. § 1126(e); (ii) equitable subordination, pursuant to 11 U.S.C. § 510(c); and (iii) pursuit of an action for money damages or disgorgement of benefits improperly received.

Section 1126(e) provides, “[o]n request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, . . .” The court may disallow a creditor’s vote if it was not cast in good faith. If a creditor breaches a confidentiality agreement by utilizing confidential information improperly, the Committee or Debtor may seek disallowance of the creditor’s vote.

A showing of three elements is required before equitable subordination of a claim will be ordered: “(1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code.”<sup>60</sup> Equitable subordination has been determined to be an

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<sup>56</sup> Id.

<sup>57</sup> In re Fas Mart Convenience Stores, Inc., 265 B.R. 427, 432 (Bankr. E.D. Va. 2001).

<sup>58</sup> Walsh v. Westmoreland Human Opportunities, Inc. (In re Life Serv. Sys., Inc.), 279 B.R. 504, 510 (Bankr. W.D. Pa. 2002), rev’d on other grounds, 327 B.R. 561 (W.D. Pa. 2005).

<sup>59</sup> Id. at 513.

<sup>60</sup> Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 986-87 (3<sup>rd</sup> Cir. 1998) (citing U.S. v. Noland, 517 U.S. 535 (1996)).

appropriate remedy when an insider of a Debtor purchased claims at a discount with the benefit of non-public information acquired as a fiduciary of the Debtor.<sup>61</sup>

Further, a creditor who breaches a confidentiality agreement may be held liable for damages suffered by the estate or subject to disgorgement of funds that it received as a result of its breach.

E. Potential Claims by Creditors or the Debtor Against Committee Members Associated With the Disclosure/Non-Disclosure of Information

The lack of guidance provided by the Act concerning what information must be disclosed to creditors may result in creditors asserting claims against Committee members and Committee counsel if they believe they have suffered damages as a result of the Committee's failure to disseminate certain information. Additionally, the Debtor might assert claims against the Committee and its counsel based on the Committee's dissemination of confidential/sensitive information that allegedly should have been withheld.

Members of the Committee have the right to limited immunity from lawsuits.<sup>62</sup> Courts have determined that the broad scope of authority granted to the Committee pursuant to section 1103(c)(3) carries with it a grant of limited immunity for Committee members.<sup>63</sup> Such immunity is limited "to actions taken within the scope of the Committee's authority as conferred by statute or the court and may not be extended to 'willful misconduct' of the Committee or its members."<sup>64</sup> Committee members do remain liable, however, for willful misconduct or ultra vires acts.<sup>65</sup> This limited immunity has also been recognized in release language contained in plans of reorganization.<sup>66</sup> The purpose of this limited immunity is to encourage entities to serve on the Committee by reducing the risk that they will become embroiled in litigation if a creditor is not pleased with the outcome of a case.<sup>67</sup>

It seems logical that since dissemination of information is now clearly a part of the Committee's duties, the limited immunity enjoyed by Committee members should protect them from litigation by disgruntled creditors, absent proof that the withholding of certain information

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<sup>61</sup> Citicorp Venture Capital, 160 F.3d at 990-91.

<sup>62</sup> Philip v. L.F. Rothschild Holdings, Inc. (In re L.F. Rothschild Holdings, Inc.), 163 B.R. 45, 49 (S.D.N.Y. 1994).

<sup>63</sup> Id.

<sup>64</sup> Luedke v. Delta Airlines, Inc., 159 B.R. 385, 392-93 (S.D.N.Y. 1993).

<sup>65</sup> In re PWS Holding Corp., 228 F.3d 224, 246 (3rd Cir. 2000).

<sup>66</sup> In re Drexel Burnham Lambert Group, Inc., 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992) (plan provided for release of claims against the Committee and its counsel but not those claims based on willful misconduct).

<sup>67</sup> See PWS Holding, 228 F.3d at 246.

or the dissemination of confidential/privileged information rises to the level of willful misconduct. Obtaining a court order immediately upon the Committee's appointment articulating guidelines for what information must be disseminated, by what means it must be disseminated and how often it must be disseminated may provide additional protection.