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Continued Uncertainty Over Rule 2019 May Chill Participation of Distressed Investors

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Editor's Note: *For a related discussion regarding proposed changes to Rule 2019, please see the Straight & Narrow column on page 24, as well as the Legislative Update on page 10.*

Recent court decisions are sure to add further uncertainty in the unsettled area of Bankruptcy Rule 2019's jurisprudence, potentially chilling the involvement of hedge funds, institutional investors and other distressed investors who add much-needed liquidity to the distressed-debt marketplace. These decisions, including two issued in the two most popular venues for bankruptcy filings—New York and Delaware—require the disclosure of highly sensitive trading information about *ad hoc* committee members' claims against, and interests in, the debtor. Moreover, one recent decision issued by the U.S. Bankruptcy Court of the District of Delaware suggests that members of an *ad hoc* creditor group owe a fiduciary duty to other creditors in the same class, even if those creditors are not members of the *ad hoc* group, a result that could push an important constituent away from the negotiating table.

Rule 2019 Disclosure Requirements

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Rule 2019 of the Federal Rules of Bankruptcy Procedure requires that every entity or committee representing more than one creditor or equity security-holder other than an official committee, unless otherwise directed by the court, file a verified statement setting forth: (1) the name and address of the creditor or equity-holder; (2) the nature and amount of the claim or interest and the time it was acquired, unless it was acquired more than one year prior to the filing date of the bankruptcy petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity, and in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and (4) the amount of claims or interests owned by the entity, the members of the committee, the times when acquired, the amounts paid therefore, and any sales or dispositions thereof. *See* Rule 2019(a). Coupled with the unsettled law in this area, the waters are further muddied by the amendments to Rule 2019 proposed by the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States.

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Cover Feature

Case Law Developments

Historically, strict compliance with Rule 2019 by informal committees was lax. At most, *ad hoc* committees, or their counsel, filed statements that typically disclosed only the membership of such groups and the aggregate amount of the participating members' claims or interests. Generally, information such as the prices paid, the dates acquired and dispositions of the claims and/or interests in the debtor had not been disclosed.

However, in recent years, as the participation by hedge funds and distressed investors in the bankruptcy process has flourished, debtors and other constituents have used Rule 2019 as a litigation tactic to compel hedge funds to disclose closely guarded price and trading information. Not surprisingly, disputes over Rule 2019 disclosures have become more common.

One of the more prominent early disputes erupted in the *Northwest Airlines* bankruptcy case.[2] In *Northwest*, the debtors challenged the completeness of the Rule 2019 statement filed by the *ad hoc* committee of equity-holders who were allegedly trying to derail the airlines' reorganization plan. The court held that the *ad hoc* committee was subject to Rule 2019 and ordered strict compliance therewith, including the disclosure of each member's holdings of claims and equity interests, the dates that such claims or interest were acquired and the purchase price paid.[3] The court subsequently denied the *ad hoc* committee's request to file such information under seal.[4] About two months later, the court in *In re Scotia Development LLC* denied a similar motion and held that an *ad hoc* group of noteholders was exempt from Rule 2019 disclosures because the group was not

1 The author thanks Gina C. Virgo, an associate at Ungaretti & Harris, for her invaluable research assistance.

2 *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).
3 *Id.* at 701.
4 *In re Northwest Airlines Corp.*, 363 B.R. 704 (Bankr. S.D.N.Y. 2007).

a "committee" pursuant to Rule 2019,[5] exposing the growing rift in rulings on the subject.

The next high-profile ruling—out of the influential District of Delaware—added a further twist to Rule 2019 jurisprudence. On Dec. 2, 2009, Hon. **Mary F. Walrath** in the *Washington Mutual* bankruptcy case ruled that not only was an *ad hoc* noteholder committee subject to Rule 2019, but that such a group owes a fiduciary duty to other members of the same class of creditors, even though the *ad hoc* group was not purporting to act on those other creditors' behalf.[6]

In *Washington Mutual*, a secured lender filed a motion for an order to force the *ad hoc* noteholders group to comply with Rule 2019. The noteholders—calling themselves a "loose affiliation of creditors"—objected, stating that they were banding together to help defray the cost of retained professionals.[7] The court held that regardless of what the group called itself, Rule 2019 applied to the noteholders because the group shared all the characteristics of an *ad hoc* committee: (1) it was comprised of multiple creditors with similar claims; (2) the group filed pleadings as a group, rather than individually; and (3) the group retained professionals collectively, who takes their direction from the group, not individual members.[8] Thus, the group of noteholders fell within the plain language of Rule 2019.

Potentially more concerning to *ad hoc* committee members, however, was the court's statement, albeit *dicta*, which suggests that members of an informal group of creditors may owe fiduciary duties to nonmember creditors of the same class. The court wrote: "It is not necessary, at this stage, to determine the precise extent of fiduciary duties owed but only to recognize that collective action by creditors in a class implies some obligation to other members of that class."[9]

On Jan. 20, 2010, in the chapter 11 case of *Premier International Holdings Inc.*,[10] an affiliate of Six Flags Inc. (the theme park operator), Hon. **Christopher S. Sontchi** of the U.S. Bankruptcy Court for the District of Delaware ruled that Rule 2019 does not apply to an informal committee of noteholders. In *Six Flags*, Judge Sontchi disagreed with the reasoning of his colleague, Judge Walrath in *Washington Mutual*, and held that under the plain meaning of Rule 2019, an informal committee of noteholders was not a "committee representing more than one creditor" subject to Rule 2019.[11] Like Judge Walrath, Judge Sontchi relied on a plain-meaning analysis, but arrived at a different conclusion.

Judge Sontchi reasoned that a self-appointed subset of a larger group does not comport with the plain meaning of the word "committee," which is a "body of two or more people appointed for some special function by and [usually] out of a [usually larger] body."[12] Further, Judge Sontchi noted that a committee must represent the interests of the larger group with the larger group's consent or by operation of law.[13] The informal noteholders did not represent anyone other than its own members, and thus was not a committee under Rule 2019.

The *Six Flags* court also considered the legislative history of Rule 2019 and concluded that the "protective committees" contemplated under Rule 2019's predecessor, and the informal committees of today, are far more different than they are similar, mainly in that the protective committees had far greater influence and control over the reorganization process than informal committees do today.[14] The court concluded that the abuses that the rule was intended to curb simply do not exist under the modern U.S. Bankruptcy Code.[15]

Finally, Judge Sontchi considered the *Northwest* and *Washington Mutual* cases, but did not find their reasoning persuasive. He wrote that the *Northwest* court did not focus enough on the plain meaning of the word "committee."[16] Judge Sontchi distinguished *Washington Mutual* on the basis that the *Washington Mutual* court did not analyze whether an *ad hoc* committee satisfies the definitional requirement of "committee" under Rule 2019—it assumed that it did.[17] Further, Judge Sontchi disagreed with the *Washington Mutual* court's interpretation of the legislative history of Rule 2019 and concluded that Rule 2019 is a prophylactic rule to be applied objectively at the beginning of the case, not a "litigation tactic to apply pressure on [an] adversary."[18]

On Jan. 22, 2010, yet another judge for the U.S. Bankruptcy Court for the District of Delaware, Hon. **Brendan L. Shannon**, entered an order granting a motion by the Official Committee of Equity Security Holders in the *Accuride Corp.* bankruptcy case, compelling an *ad hoc* group of noteholders to file a "full and complete Rule 2019 Statement."[19] To date, there is no transcript of the proceedings or opinion available.

On Feb. 4, 2010, Hon. **Stephen Raslavich** of the U.S. Bankruptcy Court for the Eastern District of Pennslyvania issued a decision in the *Philadelphia Newspapers* case[20] on the debtors' motion for an order compelling the steering group of prepetition lenders to comply with Rule 2019. In its motion, the debtors sought to compel the steering group's full compliance with Rule 2019, which, according to the debtors, is "critically important to the Court and parties in interest in assessing: (a) the true value of their claims; (b) the level and nature of their interest in these Chapter 11 Cases; (c) the bias and motivation behind the positions that they are taking before this Court; and (d) their credibility."[21]

Like four of the earlier decisions, the *Philadelphia Newspapers* court based its ruling, in part, on a plain-meaning analysis of Rule 2019. The court held that "the plain meaning of the rule's text renders it inapplicable to the Steering Group." In support of its decision, the court reasoned that Rule 2019 does not apply to the group of prepetition lenders because "it is not an organization that has a legal identity apart from its individual members."

The court adopted the *Six Flags* court's rationale and found that the steering group is not a committee within the meaning of Rule 2019 because "it has not been appointed by any larger deliberative body, either by consent, contract or applicable nonbankruptcy law." Judge Raslavich found a "'reality check' of a different sort to exist by reason of the amendments to Rule 2019 proposed by the Judicial Conference's Committee

5 *In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Tex. April 18, 2007) [Dkt. No. 659].
6 *In re Washington Mutual*, 419 B.R. 271, 278-279, (Bankr. D. Del. 2009) (noted in *dicta*).
7 *Id.* at 274.
8 *Id.* at 274-75.
9 *Id.* at 279.
10 *In re Premier International Holdings Inc.*, Case No. 09-12019 (CSS) (Bankr. D. Del. Jan. 20, 2010) *(Six Flags)* [Dkt. No. 1423].
11 *Id.*
12 *Id.*
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.*
19 *In re Accuride Corp.*, Case No. 09-13449 (BLS) (Bankr. D. Del. Jan 22, 2010) [Dkt. No. 633].
20 *In re Philadelphia Newspapers LLC, et al.*, Case No. 09-11204 (SR) (Bankr. E.D. Pa.).
21 *In re Philadelphia Newspapers LLC, et al.*, Case No. 09-11204 (SR) (Bankr. E.D. Pa.), Motion of Debtors for Entry of an Order Compelling the Steering Group of Prepetition Lenders to Comply with Federal Rule of Bankruptcy Procedure 2019, ¶16 [Dkt. No. 1507].

on Rules of Practice and Procedure." Using inductive reasoning, the court concluded that "it is logical to infer that if the rule already covered the Steering Group, there would be no need to expand the Rule to do so [by virtue of the proposed amendment]." The court concluded by acknowledging the "vigorous" debate between chapter 11 debtors and the hedge fund industry over the scope and application of Rule 2019 but deferred to Congress to settle the controversy:

> Advocates of applying the rule to *ad hoc* committees argue that to do so is inconsistent with long standing common law principles of openness and transparency in court proceedings in general and the reorganization process in particular. Hedge funds, however, have historically guarded their trading secrets fiercely. They argue, in fact, that compelling disclosure of such data may effect the deprivation of substantive rights. Those that argue that trading information should be protected from disclosure also maintain that compulsory disclosure of such data may deter nontraditional lender participation in reorganization cases and thereby diminish or eliminate essential sources of capital and liquidity. The Court will refrain from casting a vote on this issue, but merely notes that it lies at the root of the controversy.

Conclusion

Seeing that the uncertain, if not adverse, environment that recent court decisions have created in the two most popular bankruptcy forums, hedge funds, institutional investors and other distressed investors may pause at forming *ad hoc* committees or "groups" to advance and protect their interests in a bankruptcy case. Threatened by the requirement of full disclosure of highly sensitive trading information, coupled with the possibility of owing a fiduciary duty to noncommittee members, these active and constructive sources of capital and liquidity may take a less active role in the reorganization process. Without a group of significant noteholders or equity security-holders sitting at the negotiating table, debtors may find it more costly and burdensome to have a constructive dialogue with such constituent members when such members are diffused among the general creditor ranks. ■

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