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Bankruptcy Rule 2019

To Disclose or Not To Disclose, That Is the Question

By Kurt A. Mayr

Bankruptcy court procedural rulings typically go unnoticed. However, this year two bankruptcy court rulings regarding procedural disclosure requirements potentially applicable to investors participating in the bankruptcy process have caused quite a stir. Both rulings related to the scope of disclosure mandated by Bankruptcy Rule 2019, which applies to "committees" and "entities" that represent more than one creditor in a bankruptcy case.

After almost 70 quiet years on the books without controversy, Rule 2019 suddenly thrust itself onto bankruptcy's center stage as a result of a decision in the *Northwest Airlines* case holding that Rule 2019 mandated extensive public disclosures of sensitive trading information. *See In re Northwest Airlines*, __ B.R. __ (Bankr. S.D.N.Y. 2007). This decision sent shockwaves through the investing community because, read most broadly, it could apply to virtually any group of parties who act in a coordinated manner through common counsel in a bankruptcy case.

Another bankruptcy court has recently rejected the *Northwest* approach in an unpublished ruling in the Scotia Pacific Company LLC's ("Scopac") Chapter 11 case (jointly administered and captioned *In re Scotia Development LLC,* Case No. 07-20027 (Bankr. S.D. Tex.)). The creditors in that case successfully presented several arguments that were not presented in the *Northwest* case. This article summarizes these developments.

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Rule 2019's Origins

Rule 2019 is the current version of a procedural rule that was first enacted approximately 70 years ago in response to abuses by "protective committees" in restructurings during The Great Depression. These abuses were chronicled in a series of reports submitted by the Securities Exchange Commission to the U.S. Congress. *See e.g.*, Report on the Study And Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937) (the "SEC Report").

"Protective committees" were non-statutory committees organized by insider groups dominated by the debtor and/or its investment bank and institutional investors who would solicit smaller investors to enter into a "deposit agreement" (or other similar instrument, which were rarely arms-length) pursuant to which the smaller investors would deposit their securities and then the "committee" would negotiate with the debtor with little, if any, participation by the smaller holders that the committee represented. *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 30 (1995).

The SEC Report states that the "deposit agreement" was:

> the foundation of the control which [protective] committees dominated by the inside group have been able to obtain over the security holders. It is this agreement that has given the committees their unifying quality … [T]hese agreements bind the depositor to go along with the Committee through thick and thin.

SEC Report, at 586. And its "Conclusions and Recommendations" advised:

> It is essential that renewed emphasis be given to the fact that *representatives* of security holders in reorganization *occupy a fiduciary position* … The use of deposit agreements as means of preserving or obtaining arbitrary and exclusive control over security holders should not be permitted.
>
> *Id.* at 897 (emphasis added).

Congress adopted the SEC Report's recommendation to combat "protective committees" by adopting § 210 and § 211 of Chapter X of the Bankruptcy Act, which subsequently were combined in the form of Rule 10-211 (under Chapter X), the text of which is virtually identical to Bankruptcy Rule 2019.

Rule 2019

This provides, in relevant part:

> every entity or committee representing more than one creditor … shall file a verified statement setting forth (1) the name and address of the creditor … ; (2) the nature and amount of the claim or interest and the time of acquisition thereof … ; (3) a recital of the pertinent facts and circumstances in connection with the employment 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) with reference to the time of the employment of the entity, the organization or formation of the committee … the amounts of claims or interests owned by the entity, the members of the committee … times when acquired, the amounts paid therefore, and any sales or other disposition thereof. The statement shall include a copy of the instrument, if any, whereby the entity, committee, or indenture trustee is empowered to act on behalf of creditors or equity security holders.

Ad Hoc Committees/Groups and Rule 2019 — The Northwest *Decision*

Distressed investors often form unofficial or *ad hoc* committees/ groups in connection with Chapter 11 cases. These informal arrangements permit parties with similar interests to coordinate action and speak with one voice through common counsel in a bankruptcy case. Such an arrangement also permits the group to share the cost of such participation (*e.g.*, legal fees) where that cost might be prohibitive for any single member to bear.

The *ad hoc* nature of such groups typically means that there rarely are any formal duties relating to group membership. Members are free to join and leave the group as they see fit and are not bound by any decision of the majority of the group. *Ad hoc* groups cannot (and do not purport to) represent the rights of any party who is not a member of the group. An example would be a group of bondholders holding 60% of the principal amount of the bonds issued by a debtor, who agree to share the fees of common counsel to represent the group in the debtor's bankruptcy case, but who do not represent the remaining 40% of the bonds.

Despite the fact that bankruptcy practitioners often referred to such groups as *ad hoc* "committees," practitioners generally agreed that Rule 2019 was not intended to apply to these informal groups that do no act in a representative/fiduciary capacity. Nonetheless, counsel to *ad hoc* groups customarily filed voluntary Rule 2019 statements disclosing the existence of the group, its members' names and the group's aggregate holdings (but not the individual members' specific holdings).

Because of this well-established practice, in the years since Rule 2019's predecessor's enactment, no court had issued a published decision applying Rule 2019 to an *ad hoc* committee. Thus, it was quite a surprise when the *Northwest* decision suddenly mandated extensive public disclosures of sensitive trading information. According to the *Northwest* decision, Rule 2019 required each member of any *ad hoc* committee to disclose its specific holdings of Northwest securities as well as the timing and amount paid to acquire such securities. The *Northwest* court rejected the notion that Rule 2019 only applied to committees that acted in a representative and fiduciary capacity. Read most broadly, the decision could apply to any group of parties who act in a coordinated manner through common counsel.

Distressed investors were understandably alarmed by this ruling because it would force disclosure of proprietary and highly sensitive trade information that could impair their ability to compete in the market. Some even questioned whether the ruling could cause hedge funds to withdraw from the distressed markets and thereby eliminate a key source of liquidity for investors seeking to exit investments in financially distressed companies. In addition, the ruling deters creditors from coordinated action in a bankruptcy because of the risk of being considered a "committee" under Rule 2019.

Compounding the troubling nature of the ruling is the fact that the party seeking to enforce Rule 2019, the debtor, has no legitimate use for the information that it seeks to compel. It is well settled that a Chapter 11 debtor cannot treat its similarly situated creditors differently based upon the price that they paid for their claims. *See* Hon. Robert D. Drain, *Are Bankruptcy Claims Subject to the Federal Securities Laws*, 10 Am. Bankr. Inst. L. Rev. 569,

578 (2002); *In re Executive Office Ctrs.*, 96 B.R. 642, 649 (Bankr. W.D. La. 1988).

The *Scotia Development* Decision

The *Northwest* decision was quickly tested by Scopac in *In re Scotia Development LLC*. Scopac is a special purpose entity that was created to own and operate approximately 210,500 acres of timberland, which it acquired with $876 million raised from the issuance of timber notes to investors. When Scopac encountered financial difficulty, Scopac requested holders of the timber notes to organize an *ad hoc* committee to negotiate with Scopac. At the time of Scopac's bankruptcy filing, this group of timber noteholders held approximately 95% of the timber notes.

Relying exclusively on the *Northwest* decision, Scopac filed a motion seeking to compel detailed public disclosure by the noteholder group regarding each members' trading history of the timber notes. Absent such disclosure, Scopac requested the court to order that the noteholder groups' members could no longer participate in Scopac's bankruptcy.

Ultimately, the bankruptcy court agreed with the noteholder group, which asserted numerous arguments not presented in the *Northwest,* that Rule 2019 was not designed to apply to *ad hoc* groups. The noteholder group asserted four primary arguments.

First, the group argued that it was not a "committee" within the plain meaning of Rule 2019 because the group did not purport to act in a representative capacity for any person other than the group members, who individually approve all action taken by the group's counsel. This argument centered around the legal definition of the term "committee" and the other provisions of Rule 2019 which clearly indicate that a true "committees" act in a fiduciary/representative capacity for parties other than their own members.

Second, the group argued that, even if there was ambiguity, Rule 2019's legislative history leaves no doubt that Rule 2019 was promulgated to protect small investors from "protective committees" that acted in a fiduciary/representative capacity during the Great Depression.

Third, the noteholder group asserted that, even if the term "committee" applied to the noteholder group, the rule could not be applied to *ad hoc* groups in the manner requested because such application would improperly allow a mere procedural rule to abridge the numerous substantive rights of the noteholders. *See* 28 U.S.C. § 2075 (Bankruptcy Rules "shall not abridge, enlarge, or modify any substantive right."). To begin with, Scopac sought to use Rule 2019 to preclude the noteholder group from further protecting its members interests in the case in violation of their participation rights under § 1109(b) of the Bankruptcy Code and the due process clause of the Fifth Amendment.

Moreover, the noteholder group's substantive rights included: 1) their property interests in their collateral protected against judicial taking under the Fifth Amendment, *see In re Treco*, 240 F.3d 148, 158-60 (2d Cir. 2000) ("security interests have been recognized as property rights protected by our Constitution's prohibition against takings without just compensation.") and 2) their First Amendment right not to speak and disclose their confidential and proprietary information for no legitimate purpose. *See Int'l Dairy Foods Assoc. v. Amestoy*, 92 F.3d 67, 71-72 (2d Cir. 1996) (statute compelling disclosure of commercial information infringed upon defendants companies' First Amendment "right not to speak"); 11 U.S.C 107(b).

And Scopac's discriminatory use of Rule 2019 as a tool to extract disclosure that was not required of any other creditor for no legitimate purpose also violated the basic tenet of equal treatment that underlies bankruptcy law and the U.S. Constitution. *See Board of Directors of Multicanal*, 314 B.R. 486, 518-19 (Bankr. S.D.N.Y. 2004) ("The principle of equality between identically situated creditors is fundamental under U.S. insolvency law."); U.S. Const. amend. V & XIV.

Finally, the noteholder group emphasized that Bankruptcy Rule 2019's enforcement is discretionary (by its terms and pursuant to § 105) and should not be enforced even if applicable. *See* Fed. R. Bankr. P. 2019(b) (providing that the court "may" order various remedies for a failure to comply with Rule 2019); *Kaiser Aluminum Corp.*, 327 B.R. at 559.

The court agreed that the noteholder group was not a "committee" and further, after argument on Scopac's motion for reconsideration, observed that even if the group was a "committee," the court would exercise its discretion to relieve the group from having to comply with Rule 2019. These rulings confirm the long-standing practical understanding of Rule 2019's applicability to *ad hoc* creditor groups in bankruptcy proceedings and protects the legitimate interests of the holders of distressed securities to maintain the confidentiality of their portfolios and trading strategies.

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