Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds

Written by:
Evan D. Flaschen
Bracewell & Giuliani, LLP; Hartford, Conn.
evan.flaschen@bgllp.com

Kurt A. Mayr
Bracewell & Giuliani, LLP; Hartford, Conn.
kurt.mayr@bgllp.com

The May 2007 issue of the *ABI Journal* featured an article entitled "Will the Sunlight of Disclosure Chill Hedge Funds?" regarding the recent *Northwest Airlines* decisions mandating that investors participating as members of *ad hoc* committees must make extensive public disclosure pursuant to Bankruptcy Rule 2019. The authors of that article assume both that the *Northwest* decision was correct and that it was directed at hedge funds. This article presents the other side of the Rule 2019 debate, which recently prevailed in two bench decisions in *In re Scotia Development*, Case No. 07-20027 (Bankr. S.D. Tex.). In addition, we take exception with the "conventional wisdom" that has been advanced to subject hedge funds to Rule 2019 disclosure.[1]

Rule 2019 Debate in a Nutshell

Evan D. Flaschen

The heart of the Rule 2019 disclosure debate involves the interpretation of the terms "committee" and "entity" as used in the rule. The customary and accepted practice has been for counsel to *ad hoc* committees to file a disclosure identifying the members of the committee and the aggregate holdings of the committee. The *Northwest* decision, however, concluded that *ad hoc* committees/groups must file much more extensive public disclosure, including a full trading history of the timing and price of all acquisitions and dispositions of each member's claims/interests relating to the debtor. This is anathema to hedge funds, as the disclosure of detailed trading histories could reveal the proprietary and highly confidential methodologies of their investment strategies.

About the Authors

Evan Flaschen and Kurt Mayr are members of the Financial Restructuring and Bankruptcy Practice of Bracewell & Giuliani LLP and represented the ad hoc noteholder group in the Scotia Development *case discussed in this article.*

Rule 2019's Origins

Kurt A. Mayr

Bankruptcy Rule 2019 was born in the 1930s in response to abuses by so-called "protective committees." These abuses were chronicled in a series of reports submitted by the Securities and Exchange Commission (SEC) 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 nonstatutory 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" which "[bound] the depositor to go along with the Committee through thick and thin." SEC Report at 586.

The SEC believed that protective committees should be considered as fiduciaries for the investors they represented and concluded that greater scrutiny and transparency were warranted. Congress adopted the SEC Report's recommendation by adopting provisions that are now contained in Bankruptcy Rule 2019, which requires "every entity or committee representing more than one creditor" to disclose, among other things, the amount of its holdings and its trading history, including timing and prices paid.

Ad Hoc Committees and Rule 2019: The Northwest Decision

Holders and purchasers of distressed securities frequently 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, where there is general agreement, to speak with one voice through common counsel. Members of the group are typically free to join and withdraw as they see fit and are not individually bound by any decision of the majority of the group. Unlike "protective committees" of the past, *ad hoc* groups cannot (and do not purport to) represent the rights of any party who is not a member of the group. Counsel to *ad hoc* groups customarily file Rule 2019 statements disclosing the identity of the group's members and their holdings in the aggregate, but not individual holdings or trading histories.

According to the *Northwest* decision, however, Rule 2019 requires each member of an *ad hoc* committee to publicly disclose its specific holdings and trading history. The *Northwest* court rejected the notion that Rule 2019 only applied to committees (like "protective committees") that act in a representative and fiduciary capacity, but rather applies to any collective action where the committee seeks to be "taken seriously" in the bankruptcy process.

The Scotia Development Decision

Within weeks of the *Northwest* decision, Scotia Pacific Co. (Scopac) asserted that the members of the "*ad hoc* group of Scopac noteholders" were "hiding behind a veil of secrecy" and should be compelled to make detailed public disclosure as to their individual holdings and trading histories. After pleadings and oral argument, the bankruptcy court denied Scopac's motion to compel (and its later motion for reconsideration), concluding that the term "committee" under Rule 2019 does not

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[1] "Hedge funds" in this context is a loosely used term to encompass more generally the universe of "distressed investors" that includes actual hedge funds, investment bank proprietary desks, alternative investment managers and other funding sources that purchase stressed or distressed debt or equity on the secondary markets.

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include informal groups that do not purport to represent anyone other than themselves.

This is the correct result for numerous reasons. To begin with, the term "committee" in Rule 2019 should be given the common meaning ascribed to it in legal and general dictionaries, which is a body that is appointed/elected to act in a representative/fiduciary capacity for a larger universe of stakeholders than the committee's members. This is clearly not true for *ad hoc* groups/committees. Similarly, the term "representing" as used in Rule 2019 should carry the legal and general dictionary connotation of a delegation of authority and acting in the capacity as an "agent" for another. *Ad hoc* groups of investors do not act for anyone other than the group's members and clearly do not serve as "agents" or "fiduciaries" to any party, even if they sometimes casually refer to themselves as a "committee." These definitions of "committee" and "representing" are consistent with the legislative history's focus on formal "protective committees," rather than on groups of two or more creditors who act solely in their own interests.

In addition, Bankruptcy Rule 1001 mandates that the Bankruptcy Rules "shall be construed to secure the just,

speedy and inexpensive determination of every case and proceeding." An overly broad interpretation of the term "committee" such as that adopted in *Northwest* would neither be "just" nor would it promote speed and efficiency. What makes the application of Rule 2019 to *ad hoc* groups particularly unreasonable is the fact that neither the integrity of the bankruptcy process nor the debtors could have any legitimate use for the information that they now seek under Rule 2019. It is well-settled that similarly situated creditors cannot be treated differently based on the price that they paid for their claims. *See* Drain, Hon. Robert D., "Are Bankruptcy Claims Subject to the Federal Securities Laws?," 10 Am. Bankr. Inst. L. Rev. 569, 578 (2002); *In re Exec. Office Ctrs*., 96 B.R. 642, 649 (Bankr. W.D. La. 1988).

Further, without a reasonable or "rational basis" for applying the rule, it cannot pass muster under 28 U.S.C. §2075 and implicates constitutional rights. To begin with, a remedy that would preclude the group's members from protecting their interests in the case would violate their participation rights under §1109(b) of the Bankruptcy Code and could affect the members' "due process" rights under the Fifth Amendment. Moreover, in the *Scotia Development* case, the noteholders held secured claims that are property interests protected against a judicial taking by the Fifth Amendment. *See In re Treco*, 240 F.3d 148, 158-60 (2d Cir. 2000) (security interests are constitutionally protected property rights). Due process and property rights are fundamental to our society, and creditors should not casually be denied equal access to the court simply because of a rule that purportedly requires disclosure of legally irrelevant information.

This is not simply a question of stubbornness. Investors who purchase debt on the secondary market have proprietary and highly confidential methodologies for determining which securities they will buy and the timing and price for the purchase of such securities. Code §107(b) protects against disclosure of such information. While speech can be compelled under certain circumstances, it should not be compelled where the rule advances no legitimate or rational governmental purpose and where no other creditor and not even the official creditors' committee is required to make such disclosure publicly. *See Int'l Dairy Foods Assoc. v. Amestoy*, 92 F.3d 67 (2d Cir. 1996) (statute compelling disclosure of commercial information infringed upon First Amendment "right not to speak").

Rule 2019 Does Not Apply to Ad Hoc Committee Counsel, Either

Bankruptcy Rule 2019 also applies to an "entity" that is "representing more than one creditor." The term "entity" has traditionally been assumed to include a law firm representing multiple creditors, but this is also incorrect except where the firm holds a power of attorney. As Rule 2019's legislative history makes clear, it targets persons with delegated authority to act on behalf of a larger group. Lawyers are attorneys-at-law, not attorneys-in-fact. They *advocate* their clients' positions, but they do not *make* their clients' decisions. The term "entity," therefore, should not be interpreted as encompassing law firms (or other professionals) that are not acting pursuant to powers of attorney. The reason "entity" is even used in Rule 2019 is to ensure that the rule encompasses those situations where a single person has representative authority, rather than a "committee" of persons. A specific example of this, which Rule 2019 identifies by name, is an indenture trustee, but other examples would include a bank agent with contractual authority, an asbestos lawyer with powers of attorney, and an industry organization with authority to bind trade creditors or employees or retirees.

There is also a fundamental misconception about the role of law firms for *ad hoc* committees. The law firm typically represents the group, not its individual members. Positions are advocated on behalf of the group only and individual group members are always free to file separate pleadings advocating different positions. From the law firm's perspective, it is also critical that its client is the group, not its members; otherwise, counsel could have a duty to advise the group members' individually, even where their interests diverge. Thus, applying Rule 2019's words, even if counsel can be an "entity," group counsel does not represent "more than one creditor," it only represents a single client—the group itself.

Rule 2019 and Official Creditors' Committees

Another way to examine Rule 2019 is to note that official creditors' committees are specifically carved out from the rule. Why should this be so,

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when official committees clearly have fiduciary duties to the class of creditors or interest-holders they represent? The reason for this is that official committees are not self-selecting—the U.S. Trustee's involvement ensures that there is not the risk that official committees will be akin to the insider-dominated "protective committees" that the SEC and Congress were concerned about. If official committees with clear fiduciary duties do not have to make Rule 2019 disclosure, then it makes no sense that *ad hoc* committees with no duties to anyone should have to make Rule 2019 disclosure.

It is also worth noting that if counsel to an *ad hoc* group is deemed a reporting "entity" under Rule 2019, the same must also be true for counsel to an *official* committee. Rule 2019 only excepts from its application the official committee itself, but there is no language that similarly excepts the "entity" that represents the official committee. The reason for this, of course, is that "entity" is used to refer to agents or representatives with the duty and binding authority to make decisions on behalf of others, not to law firms who are only advocates for others.

So What Is All the Fuss About?

"Will the Sunlight of Disclosure Chill Hedge Funds?" implicitly assumes that hedge funds are often destructive participants in the chapter 11 process and, therefore, should be resisted whenever possible. However, the common "reasons" cited for this anti-hedge fund bias are fundamentally flawed.

Reason 1: Rule 2019 Will Curb the "Influence" of Hedge Funds in the Bankruptcy Process. Firmly embedded in this rationale is the assumption that hedge funds are somehow a corrosive influence on the bankruptcy process, typically due to their purported short-term trading philosophy. To be sure, some hedge funds are short-term investors looking for a quick recovery, but others are medium-term investors looking for a recovery over time, and still others are long-term investors looking to convert their debt into equity. And regardless of their investment strategy, hedge funds all look to maximize recovery just as other investors and creditors do, and the issue is not what they paid for their claim but what they can get for it, whether that means a 10 percent return or a 200 percent return (or 90 percent loss). The truth is, debtors often resent hedge funds because the funds are true economic creatures that focus on maximizing the value of the business *as it exists today,* rather than seeking to protect the "sacred cows" of the past, to preserve credit relationships going forward, or to maintain management's employment in the future. In addition, the secondary market provides an essential source of liquidity for investors seeking to exit investments in financially distressed companies and ensures that participants in the chapter 11 process consist of those persons who desire to participate, rather than legacy creditors who often want to exit as quickly as possible and will remain silent in the meantime.

Reason # 2: Rule 2019 Protects Other Creditors in the Same Class. Inherent in this rationale is an assumption that *ad hoc* groups somehow have a duty to other creditors in the same class, even though they do not purport to represent those creditors. Indeed, the authors of "Will the Sunlight of Disclosure Chill Hedge Funds" (at 62) interpret *Northwest* as meaning that "if committee members want the benefit of collective participation, *they must accept a fiduciary obligation to the class* and disclosure rules must be complied with." There is simply no precedent in the law for the proposition that two creditors with separate lawyers can act solely in their own self interests, but two creditors sharing a lawyer must accept a fiduciary duty to all others with similar claims.

Reason # 3: Rule 2019 Holds Hedge Funds to the Same Rules as Other Bankruptcy Participants. This is also just plain wrong. No other creditor or shareholder in a bankruptcy proceeding is required to make the kind of detailed disclosures that is now suddenly being demanded of *ad hoc* investor groups under Rule 2019. Indeed, even members of official committees are not expected to disclose publicly the amount of their holdings (other than to the U.S.. Trustee at the time of committee formation), let alone their trading histories.

Reason # 4: Disclosure Is Necessary to Understand Hedge Fund Motivations. Hedge funds, like all other creditors, desire to maximize the return on their investment. For some creditors, this return focuses purely on the maximum current economic recovery. For others, this return focuses on the maximum long-term economic recovery. For others still, the focus is on a combination of value and liquidity. And the foregoing do not include the other non-monetary return considerations relevant to many trade creditors, landlords, employees, etc. In sum, hedge funds are just like other bankruptcy-process participants: They are individual creditors who have individual needs and individual motivations based on wide-ranging factors that may or may not coincide with the needs and motivations of any other stakeholder.

Reason # 5: Ad Hoc *Groups Seek to Be Taken Seriously.* The *Northwest* decision states that *ad hoc* groups use their ability to speak as a collective voice in order "to be taken seriously" and, therefore, they should be required to make Rule 2019 disclosures. Respectfully, this is a *non sequitur.* Every party in a bankruptcy proceeding seeks to be taken seriously. This simply cannot be the basis for imposing extensive disclosure obligations regarding confidential and proprietary information. Further, *ad hoc* groups seek a voice proportionate to the amount of claims in the group, not the number of group members. Stated differently, it is not particularly relevant whether a "voice" consists of one holder of a debt issue or 100 holders. What is vitally relevant, however, is whether that one holder (or those 100 holders) collectively have the dollars needed either to satisfy the statutory percentage in amount of those voting in order to consent to the treatment of a class or the dollars needed to block the consent by others to a particular treatment. In other words, it is "might that makes right," not noise, and whether that "might" is concentrated in a single large creditor or in a group of smaller creditors should make no difference as to how seriously that creditor or that group should be taken, nor is it a rational basis for imposing extensive disclosure obligations not

imposed on other bankruptcy process participants.

Conclusion

Bankruptcy Rule 2019 exists for a reason. If an entity or a committee asserts that it has the legal power to bind others, then that entity or committee has a fiduciary duty to those others and ought to make appropriate disclosure to those others to ensure that they are being fairly represented. The rule simply has nothing to do with creditors who desire to speak for themselves, and only for themselves, in a collective manner (nor does it have anything to do with group counsel). In truth, the battle is not really about Rule 2019 at all: The rule is simply the latest weapon in the arsenal that debtors seek to employ against the owners of their debt, particularly those owners who tend to be more assertive about their economic views. However, secondary market investors, including hedge funds, are here to stay, and their votes will often be determinative as to whether a particular class consents to a particular reorganization plan. Consequently, debtors can choose to fight with hedge funds all they want, and hedge funds can choose to fight back. In the end, however, debtors should welcome the participation of a sophisticated group of creditors that collectively has substantial voting power, rather than seeking to fight those creditors at every turn. ■

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