

The Scope Of Disclosure Under Rule 2019

Thursday, Jul 05, 2007 --- Bankruptcy procedural rulings typically go unnoticed. However, in 2007 two bankruptcy court rulings regarding procedural disclosure requirements for investors participating in the bankruptcy process have caused a significant stir. Bracewell represented a group of investors in a major victory to protect the investors' confidential and proprietary information from mandatory disclosure in bankruptcy. A discussion of these rulings and some proposed measures to protect investor information follows below.

The Northwest Decision Mandated Investor Disclosure

This past February the United States Bankruptcy Court for the Southern District of New York issued a ruling mandating extensive public disclosures of sensitive trading information that sent shockwaves through the investing community. The ruling issued in the Northwest Airlines bankruptcy related to Bankruptcy Rule 2019, a 70-year-old procedural rule that requires certain disclosures by unofficial "committees" in bankruptcy cases. According to the Northwest decision—which was the first of its kind—the rule required each member of any unofficial committee to disclose its specific holdings of Northwest securities as well as the timing and amount paid to acquire such securities. Read most broadly, the Northwest decision could apply to any group of creditors who act in a coordinated manner through common counsel.

Distressed investors, who often form unofficial or ad hoc committees/groups in connection with restructurings, 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 securities market and thereby eliminate a key source of liquidity for investors seeking to exit investments in financially distressed companies. In addition, the ruling created a disincentive for creditors to act in a coordinated manner in connection with a bankruptcy because of the risk of being considered a "committee" under Rule 2019.

Bracewell Obtains Ruling Rejecting the Northwest Approach

Relying extensively on the Northwest decision, the debtor in the Scotia Development LLC chapter 11 case in the Southern District of Texas filed a motion seeking to compel detailed disclosure by the "ad hoc group of noteholders" represented by Bracewell & Giuliani. On April 18, 2007, the court sided with the noteholder group and issued an order rejecting the Northwest approach, concluding that the noteholder group was not the type

of "committee" that Rule 2019 was designed to address.

The noteholder group effectively argued that, despite having referred to itself as a committee in prior filings with the court, the group was not a "committee" within the 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 position is supported by the plain meaning of the term "committee" and Rule 2019's legislative history, which leaves no doubt that Congress promulgated Rule 2019 to protect small investors from the abuse of "protective committees" during the Great Depression.

The noteholder group also asserted several arguments that were not presented in the Northwest case; most notably, that Rule 2019 could not be applied to the noteholder group in the manner the debtor had requested because, even if the noteholder group were a "committee", such application would improperly allow a mere procedural rule to abridge the substantive rights of the noteholders to maintain the confidentiality of their proprietary information and violating several fundamental rights under the U.S. Constitution and the Bankruptcy Code.

In addition, the noteholder group argued that, even if it were a "committee" under Rule 2019, the court could and should exercise its discretion to relieve the group from the rule's disclosure requirements beyond the disclosure that the group had already provided to the court (i.e., names of group members and aggregate holdings of the group). The court agreed in its oral decision on May 22, 2007 denying the debtor's motion for reconsideration of the court's April 18, 2007 ruling. The court explicitly clarified its original ruling by stating that it also alternatively held that, even if the noteholder group were subject to Rule 2019, the court would not require any further disclosure.

The court's ruling in the Scotia Development case confirmed the long-standing practical understanding of Rule 2019's applicability to 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.

Managing Bankruptcy Rule 2019 Risk

Because the Northwest and Scotia Development decisions currently appear to be the only existing decisions on what constitutes a "committee" under Rule 2019, the application of the rule may remain uncertain in many bankruptcy cases. To reduce the risk that it may be applied, creditors seeking to coordinate their action in a restructuring should be mindful of this rule and:

Avoid using the misnomer "committee" to refer to a group of creditors acting in a coordinated manner in a restructuring.

Avoid creating the appearance that the group represents or seeks to

represent any interests other than the interests of the group's members.

Maintain as much informality of the group's activities as possible to avoid creating the impression that the group has the power to bind any non-consenting member or third party.

File "voluntary" Rule 2019 statements by the group members' common counsel even though such counsel only represents a single client—the group—in the bankruptcy case.

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