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The Price of Admission to an Ad Hoc Creditor Group in US Bankruptcy Court: Full Disclosure?

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I. Introduction

A company files for bankruptcy in the United States. You have invested in the company's debt. To save costs, you join forces with a number of other similarly situated investors, i.e., form an *ad hoc* group, and that group retains its own counsel. Do you and all the other members of the *ad hoc* group now have to file in the public record key sensitive information about your claim, such as what you paid for your investment and when? Do you now owe a fiduciary duty to similarly situated creditors who are not on your *ad hoc* committee? Have you inadvertently opened a proverbial Pandora's Box of unforeseen problems?

The murky answer to these questions is that for now it depends on which judge you ask. Some bankruptcy judges, applying the disclosure requirements of Bankruptcy Rule 2019, have answered in the affirmative. Others, applying the same Rule, have reached the opposite conclusion: no disclosure is required and no attendant fiduciary duty exists.

This article discusses recent conflicting decisions on this issue, sometimes from different judges in the same court; what this means for *ad hoc* groups; and the proposed amendments to Rule 2019 that, if they become law, will expressly require more disclosure.

II. From *Northwest Airlines* to *Philadelphia Newspapers*

A guiding principle in US bankruptcy law is that the proceedings be open and transparent. There are many Bankruptcy Code provisions and Bankruptcy Rules that are designed to achieve that goal. One of them is Rule 2019. That Rule, as currently written, requires every entity, committee or indenture trustee representing more than one creditor to file a verified statement setting forth the creditors' names and nature, amount of, and time of acquisition of each creditor's interest.

If you fail to comply with the Rule, the consequences, while discretionary, can be serious indeed. Specifically, the court may refuse to permit you to be heard or to intervene in the case at all.

In the past, the Rule was more honoured in the breach than in its observance by *ad hoc* or informal committees. And that did not seem to trouble debtors or, for that matter, the courts, unduly. That changed, however, in recent years as distressed investors and hedge funds began to play an increasingly prominent role in bankruptcy cases. Debtors perceived that the hedge funds took a short-term view, were looking for quick profits, and advanced positions in bankruptcy court, often adverse to the debtors, to realise those profits, using the leverage that came with an *ad hoc* group. Understanding that hedge funds jealously guard their trading information and would be reluctant to reveal it, debtors started to use Rule 2019 as a litigation tool to force disclosure and perhaps discourage the formation of *ad hoc* groups. This, in turn, spawned a series of bankruptcy court decisions that address whether *ad hoc* groups do or do not have to disclose 2019 information, often with surprisingly conflicting results. We turn to those decisions now.

One of the first of these more recent decisions came from the United States Bankruptcy Court in the Southern District of New York, the early 2007 case *In re: Northwest Airlines Corporation* ('*Northwest*'). There, the court, Judge Gropper, granted the debtors' motion to require an *ad hoc* group to file a Rule 2019 statement.[2] The court rejected the *ad hoc* group's argument that Rule 2019 did not apply because no member of the *ad hoc* group represented any party other than itself, that only its counsel represented more than one creditor or equity security holder, and its counsel did not have any claims or interests in the debtors or anything to

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1 The views expressed in this article are those of the authors and do not necessarily represent the views of Orrick, Herrington & Sutcliffe LLP or any of its other attorneys or clients.

2 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

disclose.[3] The court's response: '*Ad hoc* or unofficial committees play an important role in reorganisation cases. By appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings.'[4] As such, the Rule 2019 disclosure requirements applied and the committee members were required to file, in the public record, information concerning their claims, the date they bought their claims, and the price paid.

Soon thereafter, however, in April 2007, Judge Schmidt, of the United States Bankruptcy Court for the Southern District of Texas, came to an entirely different conclusion in *In re Scotia Development LLC* ('*Scotia*'), denying a motion requiring an *ad hoc* group of noteholders to comply with Rule 2019.[5] The Texas court did not elaborate on its reasoning, simply holding that the *ad hoc* group was not a 'committee' under the Rule.

Next came the December 2009 *In re Washington Mutual, Inc.* ('*WaMu*') decision from the United States Bankruptcy for the District of Delaware, a common venue, along with the Southern District of New York, for US bankruptcy filings. There, taking an opposite tack from the *Scotia* case, the court, Judge Walrath, granted a motion to compel another group of noteholders to comply with Rule 2019.[6] The court rejected the noteholders'

loose affiliation of creditors whose goal was to save on attorney fees.[7] The court reasoned that it didn't matter what appellation the group chose, it remained the case that the group (i) consisted of multiple creditors holding similar claims, (ii) filed pleadings and appeared collectively, and (iii) was represented by the same counsel who took instructions from the group as a whole.[8] As such, Rule 2019, by its plain terms, applied.

More worrisome, however, for the *ad hoc* committee members, was what Judge Walrath had to say about potential fiduciary duties that those members owed to all creditors in the class. In that regard, the court noted: '[C]ollective action by creditors in a class implies some obligation to other members of that class.'[9] Such a sweeping imposition of fiduciary duties on similarly situated creditors makes participation in an *ad hoc* committee less attractive. Indeed, with two decisions requiring disclosure from *ad hoc* committees by the most popular venues for large bankruptcy cases, New York and Delaware, hedge funds and distressed investor groups had reason to be concerned that not only was disclosure becoming the norm but also membership in an *ad hoc* group brought with it potential liability for failure to honour fiduciary duties owed to the creditor class.

Respite, however, albeit temporary, came from an unlikely source: the Bankruptcy Court for the District of Delaware. In January 2010, Judge Sontchi of that court declined to require an *ad hoc* committee to comply with the requirements of Rule 2019 in *In re Premier International Holdings, Inc.* ('*Six Flags*').[10] Disagreeing with his colleague, Judge Walrath, Judge Sontchi reasoned that a committee is properly a small body of two or more people appointed by and out of a larger group to represent the interests of that larger group, either with their consent or by operation of law.[11] As such, the Rule, by its plain meaning, does not apply to groups that cannot be considered committees, namely groups that are self-appointed to represent only their own interests. An attentive reader will remember that this was the argument made by the *ad hoc* group, without success, in the *Northwest* case. Addressing previous case law, the court was of the view that neither Northw

tee was properly a committee at all.[12] Importantly, the court noted that 'there is nothing neither nefarious nor problematic, in and of itself, in disparate parties banding together to increase their leverage. Indeed, enabling such is one of the primary rationales for the existence of the Bankruptcy Code.'[13]

Any solace hedge funds could have drawn from *Six Flags* was short-lived. Two days later, another judge sitting in Delaware, Judge Shannon, came to the opposite conclusion in *In re Accuride Corporation*,[14] requiring, without written explanation, full Rule 2019 disclosure from an *ad hoc* group of noteholders.

But in February 2010, the tide shifted again. In the *In re Philadelphia Newspapers, LLC* case, Judge Raslavich, from the Bankruptcy Court for the Eastern District of Pennsylvania,[15] denied the debtors' motion to compel a

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3 *Ibid.*
4 *Ibid.*
5 2007 Bankr. Lexis 4731 (S.D. Tex. Apr. 18, 2007).
6 No. 08-12229 (MFW) (Bankr. D. Del. Dec. 2, 2009) (Walrath, J.).
7 *Ibid.* at 6.
8 *Ibid.* at 7.
9 *Ibid.* at 17.
10 Case No. 09-12019 (CSS), 2010 WL 198676 (Bankr. D. Del. Jan. 20, 2010) (Sontchi, J.).
11 *Ibid.* at 11.
12 *Ibid.* at 30-31.
13 *Ibid.* at 33.
14 No. 09-13449 (Bankr. D. Del. Jan. 22, 2010) (Shannon, J.)
15 No. 09-11204 (SR) (Bankr. E.D. Pa. Feb. 4, 2010) (Raslavich, J.)

group of prepetition lenders to comply with Rule 2019. The court, following the logic of the *Six Flags* decision, stated that 'the language of [Rule 2019] in its current iteration does not compel the disclosures sought.'[16] Specifically, an *ad hoc* group is not a 'committee' within the plain meaning of the term.[17] The court neatly summarised the fight between the hedge fund industry and debtors:

> 'Advocates of applying the rule to *ad hoc* committees argue that to do so is consistent 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 non-traditional lender participation in reorganization cases and thereby diminish or eliminate essential sources of capital and liquidity.'[18]

The court also noted that the body responsible for reviewing and amending the Bankruptcy Rules – the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States (the 'Standing Committee') – has proposed changing Rule 2019 so that it explicitly extends to 'a group of creditors that act in concert to advance common interests, even if the group does not call itself a committee.'[19] The court reasoned, with some logic, that if the disclosure requirements of Rule 2019 already extended to *ad hoc* groups, then the Standing Committee would not have proposed its amendment.[20] Which brings us to the amendment itself.

III. Proposed changes to Rule 2019

In that six highly respected bankruptcy courts could reach conclusions poles apart, relying upon the same plain text of Rule 2019, clearly demonstrates the need for clarity. To provide that clarity, the Standing Committee has proposed amending Rule 2019. The heart of the amendment is in subdivision (c)(2). If finalised, it would require disclosure of the nature, the amount, and date of acquisition of any 'disclosable economic interest' by entities, groups, committees, indenture trustees, and other parties of interest.[21] A 'disclosable economic interest' is defined as 'any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right that grants the holder an economic interest that is affected by the value, acquisitions, or disposition of a claim or interest.'[22] The Committee Note explains that this definition 'is intended to be sufficiently broad to cover any economic interest that could affect the legal and strategic positions a stakeholder takes in a chapter 9 or chapter 11 case.'[23] That is, it is intended to apply to a group of creditors that act in concert, even if they do not call themselves a committee, i.e., an *ad hoc* group.[24]

Critically, under Proposed Rule 2019, counsel representing an *ad hoc* group must disclose the following pricing information:

> 'The nature and amount of, and if directed by the court, the amount paid for, each disclosable economic interest held in relation to the debtor as of the date the entity was employed, the group or committee was formed, or the indenture trustee appeared in the case, and the date when each disclosable economic interest was acquired, unless acquired more than one year before the position was filed.'[25]

Just as with Rule 2019, parties who fail to comply with Proposed Rule 2019, may incur severe sanctions. The language in that regard is little changed.

The catalyst for the Standing Committee's efforts to amend the Rule was an 8 January, 2009 letter in which Judge Gerber of the Bankruptcy Court of the Southern District of New York urged the Advisory Committee of the Standing Committee (the 'Advisory Committee') to amend Rule 2019.[26] Echoing Judge Gerber's letter, Judge Robert D. Drain, of the same court, submitted

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16 *Ibid.* at 4.
17 *Ibid.* at 23-24.
18 *Ibid.* at 27-28.
19 *Ibid.* at 26.
20 *Ibid.*
21 The textual change of the Rule is the broadening of the type of creditor required to make disclosures and the addition of the definition of the type of disclosable interest.
22 Proposed Rule 2019(a). The text of Proposed Rule 2019 can be found at <www.uscourts.gov/rules/proposed0809/BK_Rules_Forms_Amendments.pdf> (last visited 1 Apr. 2010).
23 Proposed Rule 2019(a), Committee Note.
24 *See* Proposed Rule 2019(b), Committee Note. Significantly, such disclosures must also be made by individuals whose stake in the debtor the court has deemed would aid its evaluation of that party's arguments.
25 Proposed Rule 2019(c)(2)(B) & (C), Rule 2019(c)(3)(B) & (C).
26 Letter from Judge Robert E. Gerber, 9 Jan. 2009, available at <www.uscourts.gov/rules/BK%20Suggestions%202008/08-BK-M-Suggestion-Gerber.pdf> (last visited 1 Apr. 2010)

a 13 January, 2009 letter to the Advisory Committee supporting broadening the scope of Rule 2019.[27] Judge Drain posited that, as there are '[v]ery large sums of money' at stake, creditors may 'mislead, or selectively inform, their counsel' without the disclosure requirements.[28] Judge Drain explained: 'Clearly for some time there has been an active market in distressed debt, but it is a market that is heavily influenced by the litigation and negotiation stances taken by distressed debt holders and, therefore, the temptation to mislead the court and the other parties about one's underlying position is just as clear.'[29]

From law firms to judges to trade organisations, everyone in the bankruptcy and restructuring community seems to have something to say about Proposed Rule 2019.[30]

These opinions, and others, were the subject of witness testimony at a 5 February, 2010 hearing in New York. Various opponents and proponents of Proposed Rule 2019 attended and testified, including the Loan Syndication and Trading Association (the 'LSTA'), several law firms, and Judge Gerber himself. Many witnesses had previously submitted written comments to the Standing Committee.

For example, the LSTA, the trade organisation for the secondary loan market and distressed debt trading, urged the Standing Committee at the hearing to eliminate the requirement for pricing disclosures, including the requirement to disclose trade dates. The LSTA argued that a requirement to disclose trade dates is tantamount to requiring disclosure of prices themselves. This is because, with the trade dates, prices can be easily obtained using tools like Bloomberg, Thomson Reuters, and/or Markit.

Several witnesses argued that the price of a disclosable economic interest is irrelevant, particularly in light of the basic bankruptcy law principle that price is irrelevant to the treatment of a claim. To the extent that price is relevant, witnesses testified that the discovery process sufficiently enables litigants to obtain the price of a disclosable economic interest. Witnesses who argued for the elimination of pricing disclosures in Proposed Rule 2019 also believed that pricing information is proprietary. Such witnesses testified that pricing disclosures would reveal strategies and investment models, amounting to a disclosure of trade secrets.

Judge Gerber, who has continued to be a strong proponent of the expansion of Rule 2019, testified that a bankruptcy judge should be able to decide when price is relevant and when it is an unnecessary burden on the distressed debt investor. Judge Gerber suggested adding language to the Comment clarifying that nothing in Proposed Rule 2019 would impair the court's inherent power to request disclosure when he or she thinks it is necessary.

Based on questions posed to the witnesses from its members, the Standing Committee appears to be wrangling with potential compromises to the pricing requirements of Proposed Rule 2019. One such potential compromise would require disclosure of the price of the disclosable economic interest at a time other than the time of purchase.

Pricing disclosure was not the only issue raised in testimony. Judge Gerber and others urged the Standing Committee to eliminate the vagueness of current Rule 2019. 'The new rule should be so clear that compliance is routine,' Judge Gerber observed. Judge Gerber further suggested that, to eliminate debate, Proposed Rule 2019 refer specifically to short positions and credit default swaps.

In the wake of the public comment period, the Advisory Committee is revisiting Proposed Rule 2019. Once the Advisory Committee approves the proposed rule in its final form, it will transmit it to the Standing Committee. This process usually takes one to two months after the close of the public comment period. The Standing Committee, normally in its June meeting, approves the amendment, with or without revisions, and recommends approval by the Judicial Conference. In its September session, the Judicial Conference will approve the amendment and transmit it to the Supreme Court. By 1 May of the following year, the Supreme Court prescribes the amendment. 1 May to 1 December is a statutory time period during which Congress may enact legislation to reject, modify, or defer the amendment. On 1 December, absent Congressional action, the amendment becomes law. Provided that Proposed Rule 2019 continues to progress, it will become law on 1 December 2011.

One hypothesised consequence of Proposed Rule 2019, if it stays as written, is inefficiency in the bankruptcy process. Rather than risk disclosure of sensitive pricing information, some creditors may choose not to participate in the bankruptcy process as *ad hoc* groups, but as individuals. This will result in multiple creditors with similar interests advancing duplicative arguments, consuming creditor, debtor, and court resources. For many entities, however, participating in a

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27 Letter from Judge Robert D. Drain, 13 Jan. 2009, available at <www.uscourts.gov/rules/BK%20Suggestions%202008/08-BK-N-Suggestion-Drain.pdf>.

28 *Ibid.*

29 *Ibid.*

30 Comments submitted to the Standing Committee and transcripts of public hearings are available at <www.uscourts.gov/rules/comments0808.html> (last visited 1 Apr. 2010).

bankruptcy proceeding individually rather than as an *as hoc* group is not economically efficient or practical. Thus, such entities simply will not participate in the process at all. Another possible consequence is that it will reduce liquidity for distressed companies. If forced to disclose pricing and timing of their purchases, prospective buyers of distressed debt may be less likely to take on the risk of investing, because they would be forced to choose either to remain silent in any bankruptcy proceeding of the debtor or reveal trade secrets.

The counterpoint of this is that disclosures will uncover economic motives of creditors who, for strategic financial reasons, may not want what is in the best interest of the debtor.[31] It also protects efficiencies of settlement negotiations when the parties are well known rather than cloaked behind an *ad hoc* committee.[32]

We will know soon enough the final format of the proposed rule. In the interim, creditors who join in an *ad hoc* group will have to look closely at the rulings of the court and, in Delaware, the particular judge, to determine how to proceed.

Notes

31 *See* letter by Judge Gerber, note 26, *supra*.
32 *See* letter by Judge Drain, note 27, *supra*.