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Show and Tell: *Ad Hoc* Committees' Rule 2019 Disclosures under Examination

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Unofficial (or *ad hoc*) committees, including committees of secured (or undersecured) lenders, equity-holders, noteholders and trade creditors, have long been a feature of chapter 11 cases. Such committees are typically comprised of claimants or interest-holders that are similarly situated but believe they are not adequately represented on an official creditors' committee or hold unique claims against a debtor. Pursuant to Rule 2019 of the Federal Rules of Bankruptcy Procedure, unofficial committees in chapter 9 and chapter 11 cases[2] are required to disclose information about their claims or interests including, among other things, (1) the nature and amount of their claims or interests, (2) the date of acquisition of their claims or interests acquired in the year before filing of the bankruptcy cases, (3) the amount paid and (4) any subsequent sales of claims or interests.[3]

Historically, such disclosures were not rigorously enforced. In many cases, if any disclosure was made by an *ad hoc* committee, it would include only the names of the members of the committee and the amount of their claim. However, in recent cases debtors and others have sought to compel strict compliance with Rule 2019's required disclosures.[4] Entities that buy and trade securities—especially when purchased at a discount—are generally reluctant to share with the public the information required by Rule 2019 because, among other things, (1) they may be actively trading in the market, (2) disclosure may weaken their bargaining power and (3) disclosure may illuminate actual or perceived conflicts where members hold different types of claims against or interests in a debtor. Efforts to enforce Rule 2019's disclosure requirements have been met with fierce opposition in court, and more recently, there have been efforts to repeal the rule altogether.

The efforts to resist the effects of Rule 2019 moved beyond a case-by-case defense in November 2007 and became a concerted effort by its opponents to repeal it altogether. The Loan Syndications and Trading Association (LSTA) and Securities Industry and Financial Markets Association (SIFMA) submitted a joint letter to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States suggesting the repeal of Rule 2019. The American Bar Association's Business Bankruptcy Committee and the National Bankruptcy Conference submitted position papers in response in December 2008, arguing that Rule 2019 should be maintained, although both recommended that it be amended.[5] The fight over the scope of Rule 2019 and its very existence promises to be a hard-fought battle in the coming years.

This article will examine (1) the role and responsibilities of *ad hoc* committees in contrast to the role and responsibilities of official committees, (2) the purpose behind the enactment of Rule 2019, (3) recent decisions that have refocused scrutiny on the rule and (4) the arguments against repeal or limitation of the scope of disclosures the rule requires.

Differing Roles and Responsibilities of Ad Hoc and Vis-a-Vis Committees

An official committee of unsecured creditors is generally appointed by the U.S. Trustee in a chapter 11 case and is comprised of holders of different types of unsecured claims. As such, claimants with competing goals and objectives will often sit on the same official committee.[6] This is beneficial to the chapter 11 process because it encourages resolution of intercreditor

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Feature

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[2] *Rule 2019 does not require similar disclosures of official committees.*

[3] *Fed. R. Bankr. P. 2019(a)(4).*

[4] *These decisions have been the subject of prior articles in this publication (see n. 24, infra) and law reviews. See e.g., Sparkle L. Alexander, Note,* ***The Rule 2019 Battle—When Hedge Funds Collide with the Bankruptcy Code****, 73 Brook. L. Rev. 1411 (2008); James M. Shea Jr.,* ***Who is at the Table? Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors Under Federal Rule of Bankruptcy Procedure 2019****, 76 Fordham L. Rev. 2561 (2008); Kevin J. Coco,* ***Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases****, 2008 Colum. Bus. L. Rev. 610 (2008).*

[5] *See National Bankruptcy Conference's Letter to the Advisory Committee on Bankruptcy Rules on Sept. 22, 2008, available at www.nationalbankruptcyconference.org/other_communications.cfm (last visited on Dec. 24, 2008).* ***The Report of the Business Bankruptcy Committee Special Task Force on Bankruptcy Rule 2019****, dated Dec. 12, 2008 (ABA Report), is available from the author.*

[6] ***See, e.g., Mirant Americas Energy Marketing LP v. Official Comm. of Unsecured Creditors of Enron Corp. (In re Enron Corp.)****, 2003 WL 22327118*7 (S.D.N.Y. Oct. 10, 2003) ("Often single committees represent what can be characterized as different 'classes' of unsecured creditors.").*

disputes through compromise and negotiation rather than through litigation.[7] In addition, official committees have a fiduciary duty to their constituencies and cannot use the forum of the creditors' committee to advance their own parochial interests.[8] Finally, official committees are selected by the U.S. Trustee—often after filling out a questionnaire disclosing conflicts. The U.S. Trustee also has protocols in place to monitor potential conflicts when appointing committee members and can reconstitute committees where necessary.[9]

Ad hoc committees are self-appointed—and therefore unregulated—groups that generally represent a single type of claim against a debtor even though members of the group may hold various types of claims. For example, an *ad hoc* committee may represent the interests of senior unsecured noteholders, but some or all of the committee members may hold secured debt, subordinated notes or equity interests in the debtor. Typically, *ad hoc* committees will appear in cases where similarly-situated claimants believe that they have unique rights that will not be adequately advocated by an official committee or where parties (such as secured creditors or equity-holders) cannot sit on an official committee of unsecured creditors. The benefits of acting as an unofficial committee include (a) sharing costs of counsel and other professionals, (b) increased bargaining power, (c) presenting a united front to the debtor and other stakeholders and (d) avoiding fiduciary obligations to other parties.

On the other hand, *ad hoc* committee members may hold interests adverse to one another and they do not generally owe each other or any other stakeholder a fiduciary duty. As such, there is considerable room for members of an *ad hoc* committee to co-opt the process or act in a manner detrimental to the other members or other stakeholders in the bankruptcy estate. In addition, committee members are often, but not always, entities that purchased securities at a discount. As such, their interests are not necessarily aligned with other creditors, such as trade creditors or par purchasers of securities. In fact, the economic interests of par purchasers and discount purchasers sitting on the same committee may diverge. Finally, participation by one or more *ad hoc* committees in a case may encourage more aggressive bargaining or litigation among creditor groups, because a committee only represents one group of claims and is not as compelled to reach negotiated settlements among creditors as a member of an official committee holding a spectrum of claims.

Rule 2019 Was Implemented to Prevent Abuses by Unofficial Committees

The Bankruptcy Code recognizes the importance of *ad hoc* committees, and Rule 2019 provides a means of mitigating the risks of their participation in the reorganization process. Rule 2019 is derived from Rule 10-211 of chapter X of the old Bankruptcy Act, which was adopted largely as a result of a Securities and Exchange Commission (SEC) report on the "Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees" (1937),[10] and "is part of the disclosure scheme of the Bankruptcy Code and is designed to foster the goal of reorganization and plans which deal fairly with creditors and which are arrived at openly."[11] The SEC report examined perceived abuses by unofficial committees in corporate reorganizations,[12] and focused on the practice of formation of "protective committees." These unofficial committees were formed ostensibly to protect the interests of security holders, but in practice were often dominated by insiders, financial advisors or other parties with potential or actual conflicts. According to the SEC report, dominant members of the protective committees often acquired their claims or interests at "default prices" and sought either to "capitalize on their nuisance value or endeavor to effectuate settlements or plans favorable to those who bought at depressed prices but disadvantageous to those who purchased at predefault prices."[13] The report noted that other security holders may be misled by such groups' participation in a reorganization by the mistaken belief "that in the hands of these self-styled independents their cause will be honestly and rigorously served."[14] As such, the report recommended "that persons who represent more than 12 stockholders...be required to file with the court a sworn statement containing the information now required by Rule 2019"[15] in order to "provide a routine method of advising the court and all interested parties in interest of the actual economic interest of all persons participating in the proceedings."[16] This recommendation was embodied in what is now Rule 2019.

Rule 2019 Has Recently Been the Subject of Renewed Enforcement Efforts

Although adherence to Rule 2019's disclosures by *ad hoc* committees has historically been lax, as hedge funds, private equity firms and other purchasers of distressed securities have increased their role in chapter 11 cases—often through *ad hoc* committees—and the debtors' capital structures have increased in complexity, there have been renewed efforts to strictly enforce Rule 2019's disclosure requirements with respect to members of *ad hoc* committees.

In recent cases, *ad hoc* committees have argued that Rule 2019 does not apply to them because (a) they are merely groups of creditors that are represented by one counsel, rather than committees acting in a representative capacity on behalf of a larger group, and (b) Rule 2019 only applies to *fiduciary* committees.[17] Rule 2019 in its plain language applies to committees other than official committees.[18] Clearly, in the era of claims trading and shifting interests in chapter 11 cases, the question of what types of entities qualify as a "committee"

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7 *See, e.g., In re Enron Corp., 279 B.R. 671, 688-89 (Bankr. S.D.N.Y. 2002) (quoting In re Sharon Steel Corp., 100 B.R. 767, 779 (Bankr. W.D. Pa. 1989) ("this case will succeed or fail to the extent members of the Official Committee can adjust their differences within the framework of the existing Official Committee.").*

8 *See, e.g., Westmoreland Human Opportunities Inc. v. Walsh (In re Life Service Sys. Inc.), 246 F.3d 233, 256 (3d Cir. 2001) (remanding case for determination of whether creditor committee member breached its fiduciary duty) (citing In re PWS Holding Corp., 228 F.3d 224, 246 (2d Cir. 2000)). See also Official, Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1315 (1st Cir. 1993) (creditors' committees owe fiduciary duty to their constituency).*

9 *See generally United States Trustee Manual at chapters 3-4 (available at www.usdoj.gov/ust/eo/ust_org/ustp_manual/volume3/vol3ch04.htm#3-4.2.4.4 (last viewed on Dec. 23, 2008)). Parties in interest can also seek to reconstitute the membership of a committee. 11 U.S.C. §1102(a)(4).*

10 *A copy of the SEC report is available at www.sechistorical.org/collection/papers/1930/1937_0514_DefaultedForeign.pdf (last viewed on Dec. 30, 2008).*

11 *Alan N. Resnick and Henry J. Sommer, 9 Collier on Bankruptcy, ¶2019.01 at 2019-3 (15th ed. rev. 2008).*

12 *See generally, In re Northwest Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (Northwest I); In re Northwest Airlines Corp., 363 B.R. 704 (Northwest II).*

13 *SEC Report at 897.*

14 *Northwest II, 363 B.R. at 708 n. 6 (quoting SEC Report at 880).*

15 *Id. at 704.*

16 *SEC Report at 702.*

17 *See, e.g., Objection of the Ad Hoc Lenders' Committee to Motion of Wachovia Bank, National Association for Order Compelling Ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019. In re Le-Nature's Inc., Case No. 06-25454-MBM (Bankr. W.D. Pa. May 25, 2007) (Le-Nature's Objection) (arguing that ad hoc committee in that case was "fee sharing consortia" of "like-minded stakeholders").*

18 *See, e.g., Barron & Budd PC v. Unsecured Asbestos Claimants Comm., 321 B.R. 147, 166 (D. N.J. 2005).*

pursuant to Rule 2019 is an important issue to resolve.

The bankruptcy court in *In re Northwest Airlines Corporation (Northwest)* answered that question when it held that members of an *ad hoc* committee of equity security-holders must disclose the amount of their interests, price paid, dates purchased and any subsequent sales thereof.[19] The *Northwest* court noted that "*[a]d hoc* or unofficial committees play an important role in reorganization 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 position a degree of credibility appropriate to a unified group with large holdings."[20] In *Northwest,* the bankruptcy court applied the following factors in support of its holding that the *ad hoc* committee of equityholders in that case was required to file Rule 2019 disclosures: (1) the *ad hoc* committee filed a single notice of appearance; (2) the members appeared as a "committee"; (3) the *ad hoc* committee moved for appointment of an official committee of equity securityholders; (4) the *ad hoc* committee actively litigated discovery issues and other matters; (5) the *ad hoc* committee's counsel was paid for its action on behalf of the committee and not individual members; and, (6) the *ad hoc* committee's counsel took instructions from the ad hoc committee as a whole and did not represent the interests of any individual member.[21]

Thereafter, parties in other cases sought to compel similar disclosures from members of *ad hoc* committees. For example, in the *Pacific Lumber* case,[22] the court declined to compel strict enforcement of Rule 2019.[23] The court ruled in an oral decision that the *ad hoc* group of noteholders was not a committee but rather "just one law firm representing a bunch of creditors."[24]

To the extent any conclusions can be drawn from these two cases, it appears that the *Northwest* court was swayed by the *common purpose* of the *ad hoc* committee before it, and that the retention of a single law firm was one piece of evidence of that common purpose. In contrast, the court in *Pacific Lumber* did not address whether members of the group before it had a common purpose.

Controversy: Should Rule 2019 Be Amended or Repealed?

In light of the renewed efforts to enforce the disclosure requirements of Rule 2019, there have been calls to repeal or limit the scope of the disclosures by industry groups such as LTSA and SIFMA[25] because, in their opinion, among other things: (1) Rule 2019 disclosures are unlikely to provide information that assists parties in reaching successful resolution of a case; (2) the information required by Rule 2019 is available through existing discovery methods; (3) Rule 2019 is improperly limited to *ad hoc* committee members and does not apply to members of official committees; and (4) Rule 2019 discourages active participation in the chapter 11 process. On the other hand, groups including the American Bar Association and the National Bankruptcy Conference have argued that Rule 2019 should not be repealed or amended to limit the scope of disclosures currently required of members of unofficial committees.

These arguments must be considered in light of Rule 2019's goal of illuminating the chapter 11 process through disclosure of potential conflicts and the actual economic interests of participants in the process. The purpose of Rule 2019 is to "further the Bankruptcy Code's goal of complete disclosure during the business reorganization process."[26] The Rule fulfills that purpose by assuring that all participants in the reorganization process are aware of the actual economic stake of members of an *ad hoc* committee. This awareness fosters a more open negotiation process, mitigates certain gamesmanship aspects of negotiation and allows parties to obtain at the outset of negotiations information that is not necessarily available without seeking discovery. In addition, the role and responsibilities of official committees, as well as the process of selecting members, serve to mitigate the concerns that led to enactment of the disclosure requirements for unofficial committees.

Rule 2019 levels the playing field because it assures that parties will not mistakenly rely on *ad hoc* committees appearing to represent their interests and all stakeholders know with whom they are negotiating or litigating. This helps resolve cases because it prevents the gamesmanship attendant to any process in which certain stakeholders are not aware of the type and scope of the actual economic interest of negotiating counterparties. In other words, limiting the scope of disclosures would in effect cause aspects of the chapter 11 process to resemble a poker game where other players have to guess which cards the *ad hoc* committee members actually hold. That will not further the goal of a successful reorganization; instead, it will lead to increased guesswork and in turn delay as parties try to figure out with whom they are negotiating.

Rule 2019 disclosures also allow creditors who may be similarly situated with an *ad hoc* committee to determine whether the committee truly represents the interests of one creditor group or is acting to pursue the parochial interests of the *ad hoc* committee members (which can be comprised of as few as two members). Such disclosure fits squarely within the concerns that Rule 2019 was designed to address. The disclosures foster, rather than impede, negotiations because the other stakeholders (typically other creditors and the debtor) know with whom they are negotiating (*e.g.*, secured, undersecured or unsecured creditors or equityholders).

At first blush, it appears that Rule 2019 may be "underinclusive" because it does not require similar disclosure from members of official committees. However, because official committees have a fiduciary obligation to all similarly

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19 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

20 **Id.** at 703.

21 **Id.** In a subsequent decision, the **Northwest** court held that Rule 2019 disclosures could not be filed under seal. **Northwest II**, 363 B.R. at 706 (Bankr. S.D.N.Y. 2007). Subsequently, the **ad hoc** committee of equity securityholders in the **Northwest** case filed an amended statement pursuant to Rule 2019 disclosing, among other things, that five of the nine **ad hoc** committee members held claims against the debtor in addition to their equity holdings. Verified Amended Statement of the **ad hoc** committee of equity securityholders pursuant to Bankruptcy Rule 2019(a), **In re Northwest Airlines Corp.**, Case No. 05-17930 (ALG) (Bankr. S.D.N.Y., Mar. 21, 2007) [Docket No. 5446].

22 The cases were jointly administered under the lead case captioned **In re Scotia Development LLC**, chapter 11 Case No. 07-20027 (Bankr. S.D. Tex.) **(Pacific Lumber)**. For more information on these cases, visit the Web site established by the creditors' committee in the case, at www.pszjlaw.com/creditor-4.html.

23 Tr. of April 17, 2007, Hearing at 4-5, Docket No. 696, **In re Scotia Devel. LLC**, No. 07-20027, 2007 WL 2726902 (Bankr. S.D. Tex.).

24 **Id.** at 5:1-2. The **Northwest** and **Pacific Lumber** decisions have been the subject of prior articles in this publication that were written shortly after the decisions were issued. In the first article, the authors provided a detailed recital of the actions taken by members of the **ad hoc** committee in **Northwest** and appear to assume that the decision was correct. The article also raised the question of whether the decision would chill distressed-purchasers' participation in chapter 11 cases. **See** Mark Berman & Jo Ann J. Brighton, "Will the Sunlight of Disclosure Chill Hedge Funds?," **Am. Bankr. Inst. J.**, May 2007. In a subsequent article, different authors (who represented the **ad hoc** committee in the **Pacific Lumber** case) presented distressed investors' point of view of these issues. They make the same arguments later raised by SIFMA and LTSA and also argued that requiring full disclosures (as the **Northwest** court did) would limit **ad hoc** committee members' access to the courthouse and infringe on their property rights in the process. **See** Evan D. Flaschen & Kurt A. Mayr, "Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds," **Am. Bankr. Inst. J.**, Sept. 2007. This article endeavors to pick up where these articles left off by focusing on the objective of Rule 2019 and the role of **ad hoc** committees **vis-à-vis** official committees and the more strategic efforts by SIFMA and LTSA to repeal the rule in an effort to avoid piecemeal litigation of the issue.

25 **See, e.g.**, Minutes of the March 27-28, 2008 Meeting of the Advisory Committee on Bankruptcy Rules at p21-22, available at www.uscourts.gov/rules/Minutes/BK03-2008-min.pdf (last visited Dec. 24, 2008).

26 **In re CF Holding Corp.**, 145 B.R. 124, 126 (Bankr. D. Conn. 1992).

situated creditors, parties relying on official committees are afforded some measure of protection from abuses. Moreover, official committees are regulated by the court in other ways: the court can change the membership of official committees,[27] review an application of counsel for employment, including counsel's conflicts disclosures,[28] and can review a counsel's requests for compensation.[29] In addition, members of official committees, by design, often have claims that conflict with other members' claims. As such, official committees do not lend themselves to the abuse perceived by the drafters of the SEC report with respect to unofficial committees. Nevertheless, the ABA report recommends that Rule 2019 be *expanded* to require disclosure by official committees, as well as unofficial committees.

Rule 2019 also prevents drawn-out discovery and unnecessary delay by requiring disclosures from the outset. While Rule 2019 disclosures can probably be obtained through available discovery methods, compelling discovery of the information required by Rule 2019 would likely only add a layer of confusion in chapter 11 cases because any discovery requests would undoubtedly cause delay that is attendant to any discovery process. Clearly, delay could ensue as parties seek protective orders, produce reams of trading data or litigate over the scope of discovery. Rule 2019 short-circuits any delay by requiring disclosure at the start of the process, thereby minimizing the likelihood of delay while the scope of claims-trading data is produced and analyzed.

Conclusion

Although *ad hoc* committees may be justified in their hesitancy to provide some or all of the disclosures required by Rule 2019, the rationale underpinning the rule—concern about unofficial committees without checks and balances attendant to official committees—is still valid. As such, while there has been renewed focus on Rule 2019 in the wake of the *Northwest* decision, unofficial groups acting in concert and represented by one set of attorneys should continue to disclose their economic stake in the process as a check against actual or perceived abuses. ■

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[27] *See* 11 U.S.C. §1102(a)(4).
[28] *See* 11 U.S.C. §§328 and 1103; Fed R. Bankr. P. 2014.
[29] *See* 11 U.S.C §328.