A Rule From a Different Era: Have in Modern-day Chapter 11

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Rule 2019 of the Federal Rules of Bankruptcy Procedure provides that unofficial "committees" participating in a Chapter 11 case disclose the claims or interests held by each member, the times acquired, the price paid and any sales thereof. For over 70 years since the original enactment of the Rule, bankruptcy courts did not enforce it to require distressed investors and hedge funds participating in ad hoc groups to disclose the trading data that such entities consider to be proprietary and highly confidential.

Instead, law firms representing such groups have routinely complied with the Rule by filing statements disclosing the aggregate face amount of the holdings of the group's members, but nothing more. It was not until the 2007 *In re Northwest Airlines Corp*. decision that a court required disclosure of the amounts of interests owned by members of an ad hoc group, the times when those interests were acquired, the amounts paid for those interests and any sales of such interests during the pendency of the bankruptcy proceedings. That decision set the stage for other courts to follow suit and for participants in Chapter 11 proceedings to attempt to use the Rule in a manner – and for a purpose – never contemplated by its drafters. Absent either amendment of the Rule itself or a ruling by a higher court reining in its use, Rule 2019 risks becoming a tool used to dissuade ad hoc bondholder and noteholder groups from participating in Chapter 11 cases.

To understand why Rule 2019, as literally read, is inappropriate to today's modern-day reorganizations, it is instructive to review its history and purpose. The predecessor to Rule 2019 was Rule 10-211 of Chapter X of the former Bankruptcy Act, which was a direct result of the belief of the Securities and Exchange Commission (SEC) belief, in the post-Depression era, that public investors needed protection from insiders in reorganization cases. When Rule 10-211 was enacted, it was common for debtors to sponsor "protective committees" that were usually comprised of large, insider creditors orchestrated by the debtors, who then sought deposit agreements from individual creditors. Through these deposit agreements, the committees gained control over the claims.

In a 1937 SEC Report, future Supreme Court Justice William O. Douglas stated that Rule 10-211 "is designed to ensure that the inside group does not manipulate a pre-petition committee to secure a dominant position in the reorganization and capture the emoluments of control." The drafters of the Bankruptcy Code imported the substance of Rule 10-211 into Rule 2019, maintaining its original purpose conceived in the wake of the Depression, one now out of sync with the reality of today's reorganization environment.

Fast forward 70 years to the United States Bankruptcy Court for the Southern District of New York, where the debtors, Northwest Airlines, filed a motion to compel the Ad Hoc Equity Committee to make certain disclosures under Rule 2019(a). The court held that the Ad Hoc Equity Committee was required to comply with the 2019(a)(4) disclosure requirements because the Ad Hoc Equity Committee 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." Further, they referred to themselves as a "committee" and actively sought the formation of an official committee of equity holders.

Two months later, the United States Bankruptcy Court for the Southern District of Texas ruled from the bench in *In re Scotia Development LLC* that Rule 2019(a)(4) did not apply to an informal group of noteholders that held more than 95 percent in principal of the aggregate amount of notes, because the informal group was not a "committee" within the meaning of the Rule. In reaching its decision, the court relied heavily on the history and purpose of Rule 2019, recognizing that "the statute went back to the old Douglas group and…the study of – of committees as they existed back then, and not committee [sic] in the sense that we talk about them now. And so [that's] why I sort of drew that line." The *Scotia* court recognized that Rule 2019 fails to take into account the realities of modern-day reorganizations and that the noteholders that were acting collectively were nothing more than a "bunch of creditors" represented by one law firm. However, because the *Scotia* decision was issued from the bench, it is of limited precedential value and has not been considered persuasive by other courts.

Two years later, in December 2009, the United States Bankruptcy Court for the District of Delaware decided that an informal noteholder group could be compelled to produce Rule 2019(a)(4) disclosure. In *Washington Mutual*, the court discounted the Scotia court's decision and its precedential value, instead relying heavily on *Northwest Airlines* and its interpretation of the history and purpose of

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Rule 2019. Analyzing the history of Rule 2019, the *Washington Mutual* court stated that the Rule was intended to "provide a routine method of advising the court and all parties in interest of the actual economic interest of all persons participating in the proceedings."

The court did not sufficiently appreciate that the nature of a creditor's "actual economic interest" has changed significantly since the Rule's predecessor was promulgated in 1937. The purpose behind Rule 2019 – protecting retail investors in stock who might erroneously have believed that "protective committees" were representing their interests – is simply not applicable to modern-day reorganizations involving sophisticated distressed investors forming ad hoc noteholder and bondholder groups.

The *Washington Mutual* court also did not give appropriate weight the noteholder group's argument that the information being requested pursuant to Rule 2019 was "highly proprietary" and that such information would give competitors the "ability to know what's driving a particular creditor's trading strategy." The court viewed such information as "historical" and not "what you think is going to be a good buy today or tomorrow." To distressed investors, however, the dates and price of each purchase and sale of a security is information akin to the secret formula for Coca-Cola. Disclosure of such information, even if historical, would allow the sophisticated analysts of Wall Street to replicate the proprietary trading strategies that distinguish distressed investors from one another.

As noted by two of the nation's leading industry groups in the debt and equity markets, the Loan Syndication and Trading Association (LSTA) and Securities Industry and Financial Markets Association (SIFMA), forcing disclosure of the type of information sought in *Washington Mutual* "will require public dissemination of highly confidential and proprietary information from certain stakeholders." Thus, the *Washington Mutual* court not only relied on unsound authority, but also misunderstood the purpose of Rule 2019 and the consequences of its literal application. In contrast, in the *Scotia* case, where the court had the benefit of objective independent input from amicus briefs filed by the SIFMA and LSTA, the court recognized the importance of protecting the trading markets.

Soon after the *Washington Mutual* court issued its opinion, the debtors in *In re Philadelphia Newspapers, LLC* and the Official Committee of Unsecured Creditors in *In re Premier Int'l Holdings Inc*. filed motions compelling similar 2019(a)(4) disclosure from ad hoc noteholder groups participating in those Chapter 11 cases. In both of those cases, the proposed application of the Rule was for a strategic and tactical purpose by the Debtors and the Official Creditors' Committee, respectively, to gain a litigation advantage in contested plan of reorganization processes.

On January 8, 2010, Judge Sontchi in *Premier International Holdings* ruled from the bench, denying the Official Creditors' Committee motion to compel Rule 2019 (4) disclosure from an ad hoc noteholder group and indicated that he intends to issue a written opinion setting out his rationale for denying the motion. With this ruling and a pending ruling in *Philadelphia Newspapers*, there will most certainly be more reported decisions that will influence the future course of enforcement of Rule 2019, as well as deliberations concerning its possible amendment.

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Given the paucity of court decisions mandating Rule 2019 disclosure and the disparate readings of the history and purpose of Rule 2019, there has been discussion about amending Rule 2019. The LSTA and SIFMA submitted a letter to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, arguing for the repeal of Rule 2019 because of its inconsistency with the realities inherent in modern-day reorganizations. However, the Advisory Committee on Bankruptcy Rules has countered and recommended expanding disclosure pursuant to Rule 2019 to include all "disclosable economic interests."

Given these competing recommendations, distressed investors should hope that the Rules Committee amends Rule 2019 and ensures that the Rule's disclosure requirements are consistent with the prominent and positive role that ad hoc groups of distressed investors play in today's large and complex Chapter 11 reorganizations. Until such time as the Rule is amended, bankruptcy courts faced with motions for its enforcement should recognize that its application to ad hoc noteholder or lender groups in modern-day reorganizations directly conflicts with the Rule's legislative history and purpose. Acknowledging the important role that disclosure plays in the Chapter 11 process, Rule 2019 should be applied to balance the interests of disclosure against protecting confidential and proprietary trading information that is legally irrelevant to the rights of a creditor in the Chapter 11 process.