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The Rule 2019 Battle: When Hedge Funds Collide with the Bankruptcy Code

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NOTES

The Rule 2019 Battle

WHEN HEDGE FUNDS COLLIDE WITH THE BANKRUPTCY CODE

INTRODUCTION

Federal Rule of Bankruptcy Procedure 2019 imposes certain disclosure requirements on committees representing more than one creditor or equity security holder in Chapter 9 and Chapter 11 bankruptcy cases.[1] It is "part of the disclosure scheme of the Bankruptcy Code and is designed to foster the goal of reorganization plans which deal fairly with creditors and which are arrived at openly."[2] The Rule seeks to provide complete disclosure to all parties involved in bankruptcy cases, prevent conflicts of interest, and promote overall fairness in the reorganization process.[3] Although the disclosure requirements of Rule 2019 have existed in bankruptcy reorganization proceedings for nearly seventy years, they had been virtually ignored until hedge funds began to actively participate in bankruptcy cases.[4]

Hedge funds have become major participants in bankruptcy proceedings, in which they often form unofficial

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[1] FED. R. BANKR. P. 2019.

[2] 9 COLLIER ON BANKRUPTCY § 2019.01 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2007).

[3] *Id.*

[4] Menachem O. Zelmanovitz & Matthew W. Olsen, *Rule 2019: A Long Neglected Rule of Disclosure Gains Increasing Prominence in Bankruptcy*, http://www.morganlewis.com/pubs/Restructuring_Newsletter_Summer20071.pdf (last visited Mar. 23, 2008) ("Recent divergent decisions of two bankruptcy courts have catapulted a largely ignored rule of procedure into the forefront of issues concerning hedge fund participation in bankruptcy cases.").

or ad hoc committees.[5] These ad hoc committees share the expenses of participating in bankruptcy cases by hiring legal counsel and other professionals to represent them throughout the process.[6] By acting as a group, they are also able to exert greater influence and increase their leverage, since together they control a greater percentage of the company's claims.[7] While this arrangement is especially beneficial to hedge funds, it raises unique disclosure issues.[8] These disclosure issues have been the subject of two recent bankruptcy court decisions involving ad hoc committees and the application of Rule 2019.[9]

In February 2007, in *In re Northwest Airlines Corp.*, the United States Bankruptcy Court for the Southern District of New York held that an ad hoc committee failed to fulfill the disclosure requirements of Rule 2019 and ordered the committee to file a modified 2019 statement.[10] Pursuant to the Rule's requirements, the court required each member of the committee to disclose the amounts of claims and interests owned, when the claims and interests were acquired, the amounts paid for the claims and interests, and any sales of the claims and interests.[11] The committee then filed a motion requesting the court to permit the additional Rule 2019 statement to be filed under seal. The court denied the motion.[12] Conversely, in April 2007, in *In re Scotia Development LLC* ("*Scopac*"), the United States Bankruptcy Court for the Southern District of Texas denied a similar motion to compel an ad hoc committee to comply with the disclosure requirements of Rule 2019.[13] The judge in that case decided that the

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[5] Eric B. Fisher, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 AM. BANKR. INST. J. 24, 24 (2007).

[6] *Id.* at 87.

[7] *Id.* ("[S]uch committees offer similarly-situated creditors an avenue to increase their leverage within the bankruptcy case and to share legal and other expenses. *Ad hoc* committees are particularly effective when their members hold a blocking position with respect to a class of claims.").

[8] *Id.* at 88.

[9] *See generally In re* Northwest Airlines Corp. (*Northwest I*), 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re* Northwest Airlines Corp. (*Northwest II*), 363 B.R. 704 (Bankr. S.D.N.Y. 2007); *In re* Scotia Development LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. Apr. 18, 2007).

[10] *Northwest I*, 363 B.R. at 704.

[11] *Id.* at 702 ("The Rule requires disclosure of 'the amounts of claims or interests owned by the members of the committee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.' The [committee's] statement . . . fails to disclose this information and is insufficient on its face.").

[12] *Northwest II*, 363 B.R. at 705.

[13] *In re Scotia Development*, 2007 WL 2726902, at *1.

ad hoc committee was not a committee for the purposes of Rule 2019.[14]

This Note focuses on whether ad hoc committees comprised of hedge funds or private equity firms should be required to comply with the disclosure requirements of Rule 2019. It argues that Rule 2019 in its current form was enacted to address abuses by protective committees in the 1930s, and does not contemplate the types of investors or committees that exist today. Further, if required to comply with the current Rule 2019, investors like hedge funds and private equity firms will likely stop trading in distressed claims, which would be inefficient for the market for distressed securities. However, while efficiency is important to the financial markets, transparency is important to bankruptcy cases, and a proper balance must be struck to address these competing interests. Therefore, Rule 2019 should be amended to facilitate market efficiency while still allowing for disclosure of the information that is necessary to administer a bankruptcy case.

Part I of this Note explores the background of hedge funds and their role in bankruptcy proceedings, as well as the history, requirements, and purpose of Rule 2019. Part II evaluates the recent bankruptcy decisions of *Northwest* and *Scopac*. Part III discusses the importance of disclosure and transparency to bankruptcy proceedings, as well as the implications of disclosure on the liquidity in the distressed securities market. Finally, Part IV proposes an amendment to Rule 2019 that will strike a balance between the competing interests discussed in Part III. The solution will only require disclosure of the information necessary for successful reorganizations, without having the effect of shutting down claims trading and decreasing the liquidity of the distressed claims market.

I. BACKGROUND

A. Hedge Funds: Friend or Foe?

A hedge fund is "an investment vehicle that pools capital from a number of investors and invests in securities and other instruments."[15] They are customarily private investment

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[14] *Id.* at 2.

[15] THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1:1 (2007).

funds, open to only a limited number of investors.[16] This self-imposed restriction is extremely beneficial because it allows hedge funds to be lightly regulated by the Securities and Exchange Commission ("SEC") and other regulatory agencies.[17] Unlike heavily regulated mutual funds, which are subject to numerous disclosure requirements, hedge funds typically do not have to disclose their investment activities to third parties.[18] They have become notorious for their secrecy and do not want the public knowing "who their investors are, what they invest in, what they pay for their investments, or, more importantly, what their return is on their investments."[19] This secrecy is particularly important to hedge funds because it allows them to protect their investment strategies and prevent others from duplicating their trading models.[20] While hedge funds were originally designed to use their leverage and short selling strategies to *hedge* their position in equity trading markets, many funds today have a wide variety of investment strategies and techniques.[21] Of particular significance to this Note is that in recent years many hedge funds have in fact become very active in the market for distressed securities.[22]

Distressed securities are the securities of companies that are in "severe economic distress, possibly facing bankruptcy, reorganization, or otherwise involved in restructurings

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[16] *Id.*

[17] *See id.* Hedge funds are only available to accredited investors, and are not sold to the general public. As a result, hedge funds are exempt from certain registration requirements under the Investment Company Act of 1940. *Id.*; *see also* Paul F. Roye, Remarks at the Global Challenge in Investment Management Regulatory and Legal Issues, Apr. 19, 2002, http://www.sec.gov/news/speech/spch552.htm (last visited Mar. 23, 2008) (noting two major exemptions under the Investment Company Act of 1940 for funds with less than 100 investors and funds where the investors are "qualified purchasers").

[18] U.S. Sec. & Exch. Comm'n, *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, http://sec.gov/answers/hedge.htm (last visited Apr. 10, 2008).

[19] Seymour Roberts, Jr. & Joe Wielebinski, *When Worlds Collide: The Clash Between Hedge Funds and the Bankruptcy Code*, May 21, 2007, at 1, http://www.munsch.com/publication.cfm?publication_id=178 (follow "View Document" hyperlink) (last visited Mar. 23, 2008).

[20] Hedge funds "use a combination of market philosophies and analytical techniques to develop financial models that identify and evaluate market opportunities. Very often, the financial models are very sophisticated, highly quantitative and proprietary to the fund." Thomas G. Evans et al., *Hedge Fund Investing*, J. ACCOUNTANCY ONLINE, http://www.aicpa.org/pubs/jofa/feb2005/evans.htm (last visited Mar. 23, 2008).

[21] Mark Berman & Jo Ann J. Brighton, *Hedge Funds: Lessons Learned from the* Radnor *Decision*, 26 AM. BANKR. INST. J. 30, 30 (2007).

[22] *Id.*

or recapitalizations."[23] Many hedge funds buy bonds, loans, or equity of these companies at deep discounts hoping to profit from the market's lack of understanding of the value of these investments.[24] They are able to purchase these securities at a discount due to the companies' financial trouble.[25] In addition, many banks and institutional investors are forced to sell such risky securities that tend to decrease the value of their investment portfolios.[26] Hedge funds pursue these investments hoping to earn above-market returns, and, as a result, have become increasingly active in corporate bankruptcy proceedings.[27] More and more, hedge funds are purchasing distressed securities in companies only if they think they can influence the bankruptcy proceedings, and if they think they can gain high returns on their investment.[28]

Some believe that hedge funds' involvement in bankruptcy proceedings is extremely beneficial to the reorganization process because it leads to "more competitive financing terms and increased liquidity in the debt markets."[29] They are also particularly useful in the restructuring process because they can make different types of investments (debt and equity) in a single company.[30] Additionally, their exemption from traditional regulation allows them to quickly adapt their investment strategies to the situation at hand.[31]

While some investors, commentators, and companies value their participation in corporate bankruptcy, hedge funds also have their critics. As owners of debt in a company, they can influence the restructuring process and have a significant say in that company's future.[32] They are able to influence the

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[23] LEMKE ET AL., *supra* note 15, § 1:2.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] Fisher, *supra* note 5, at 24.

[28] *Id.*

[29] *See id.*; *see also* Timothy F. Geithner, *Hedge Funds and Derivatives and Their Implications for the Financial System*, Remarks at the Distinguished Lecture 2006, sponsored by the Hong Kong Monetary Authority and Hong Kong Association of Banks, Hong Kong (Sept. 15, 2006), *transcript available at* www.newyorkfed.org/newsevents/speeches/2006/gei060914.html) (last visited Mar. 23, 2008) ("In most circumstances, increased trading and participation contributes to market liquidity and makes markets less volatile. The ultimate benefit should be lower risks for all market participants.").

[30] Berman, *supra* note 21, at 30.

[31] *Id.*

[32] Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1 ("[H]edge funds have also grown prominent in corporate

bankruptcy case and protect their interests because as a committee, they have standing to be heard on any issue involved in the proceedings.[33] This is troubling to some because hedge funds tend to have short-term investment objectives and may own both debt and equity in the same company, leaving them with seemingly conflicting priorities.[34] The lack of any strict regulatory oversight over their activities also contributes to the general negative perception of hedge funds in the industry.[35]

B. The Bankruptcy Code and Rule 2019

It has been said that the "three most important words in the bankruptcy system are: disclose, disclose, disclose."[36] In fact, transparency is "one of the hallmarks of the bankruptcy process," which is illustrated by a number of provisions of the Bankruptcy Code including Rule 2019 disclosures.[37] Disclosure by the debtor allows creditors to assess the financial affairs of the company and decide whether a proposed plan of reorganization is feasible and in their best interests.[38] On the other hand, disclosure by creditor committees, like those required by Rule 2019, allows the debtor and other parties involved in the case to understand with whom they are negotiating and who will be voting on the reorganization plan.[39] Historically, bankruptcy was generally meant to be an open

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bankruptcies, where they can make a cheap bet on a company's recovery by buying its debt. By owning the debt, they can become powerful creditors and serve on committees that have a large say in the future of a company.").

[33] John D. Ayer et al., *What Every Unsecured Creditor Should Know About Chapter 11*, 23 AM. BANKR. INST. J. 16, 40 (2004).

[34] Anderson, *supra* note 32, at A1.

[35] *Id.*

[36] *In re* Sanchez, 372 B.R. 289, 305 (Bankr. S.D. Tex. 2007).

[37] Michael P. Richman & Jill L. Murch, *The Importance of Full Disclosure in Seeking Success Fees Under §328(a)*, 26 AM. BANKR. INST. J. 36, 87 (2007). (Other examples of transparency are the debtor's schedules and the 341 meeting.)

[38] Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1213, 1248 (1994); *see also* Harvey L. Tepner, *Common Sense, Nonsense and Higher Authorities: The Need for Improved Chapter 11 Financial Disclosures,* 22 AM. BANKR. INST. J. 36, 37 (2003) ("Proper financial disclosure by debtors enables creditors and other parties to make decisions based on information rather than rumor, speculation or supposition.").

[39] Mark Berman, *Will the Sunlight of Disclosure Chill Hedge Funds*, 26 AM. BANKR. INST. J. 24, 64 (May 2007) ("[I]f committee members want the benefit of collective participation [in bankruptcy cases], they must accept a fiduciary obligation to the class and disclosure rules must be complied with.").

arena where all parties could work together and come to a mutually beneficial decision.[40]

Compliance with Rule 2019 requires the filing of a verified statement containing the following information: (1) the name and address of each creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition if it was acquired within a year of the filing of the petition; (3) the facts and circumstances in connection with the employment of the representative filing the statement, and, for committees, the names of the entities who employed or organized the committees; and (4) the amounts of claims or interests owned by the representatives or committee members, the times they were acquired, the prices paid, and any subsequent sales of the claims or interests.[41] Additionally, if there are material changes to the information presented in the original disclosure statement, the Rule requires that a supplemental statement be filed to update the information.[42] If an entity or committee fails to comply with these requirements, the Rule sets out sanctions that may be imposed.[43] Among other forms of relief, a court may prohibit those entities or committees that fail to comply from further participation in the bankruptcy proceedings.[44]

Rule 2019 covers entities and committees that act in a fiduciary capacity but are not otherwise controlled by the court.[45] This specifically excludes official committees that are required to be organized under other provisions of the Bankruptcy Code.[46] Official committees are exempt from the disclosure requirements of Rule 2019 because they are otherwise "subject to direct court oversight in a variety of ways."[47]

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[40] Adam H. Kurland, *Debtors' Prism: Immunity for Bankrupts Under the Bankruptcy Reform Act of 1978 (Part I)*, 55 AM. BANKR. L.J. 177, 179 (1981) ("Full disclosure of all relevant information has always been an important policy of the bankruptcy laws . . . .").

[41] FED. R. BANKR. P. 2019.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] COLLIER ON BANKRUPTCY, *supra* note 2, § 2019.02.

[46] *Id.*

[47] Zelmanovitz & Olsen, *supra* note 4. "Among other things, official committees are appointed by the United States Trustee and must seek bankruptcy court authorization to retain professionals and court approval of their professional fees and expenses. 11 U.S.C. §§ 1102, 327, 328, 330." *Id.* at note 9.

The original purpose of Rule 2019 can be traced back almost seventy years to an influential study conducted by William O. Douglas[48] for the SEC in the 1930s.[49] Douglas held public hearings for fifteen months, calling hundreds of witnesses who testified about inside groups working with bankrupt companies to take advantage of creditors. The investigation uncovered "[i]nside arrangements, unfair committee representation, lack of oversight, and outright fraud [that] often cheated investors in financially troubled or bankrupt companies out of their investments."[50] The final report, entitled *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees* ("Douglas Report"), "centered on abuses by unofficial committees in corporate reorganizations and equity receiverships."[51] The unofficial committees addressed in the report, unlike the committees that exist today, were referred to as *protective committees*. These committees were often sponsored by the debtor and solicited deposit agreements from individual creditors that granted control over the claims to the committees.[52] Douglas viewed the members of these protective committees as fiduciaries that owed "exclusive loyalty to the class of investors they represent[ed]" because the deposit agreements were irrevocable and transferred all powers from the owner of the claim to the committee.[53] Based on his investigation, Douglas explained that many of these committees frequently violated that fiduciary duty to the depositor in two ways: (1) conflict of interests and (2) the exercise of excessive powers by committee members.[54] As will

48 William O. Douglas later served as a Supreme Court Justice from April 17, 1939 to November 12, 1975. With a term lasting thirty-six years and seven months, he is the longest-serving justice in the history of the Court.

49 *Northwest I*, 363 B.R. 701, 704 (Bankr. S.D.N.Y. 2007).

50 *Douglas and the Protective Committee Investigation: Implementing the Power of the SEC through Investigative Hearings and Legislative Recommendations*, http://www.sechistorical.org/museum/galleries/douglas/protectiveCommittee.php (last visited Mar. 23, 2008).

51 *Northwest I*, 363 B.R. at 704.

52 William O. Douglas, *Statement before Interstate and Foreign Commerce Committee of the U.S. House of Representatives*, http://www.sechistorical.org/collection/papers/1930/1937_0608_Douglas_ProtCom.pdf (last visited Mar. 3, 2008).

53 *Id.*

54 With respect to conflicts of interests, Douglas pointed to several examples, including committees dominated by management and investment bankers, bondholders serving on stockholders' committees and vice versa, and committee members serving their own individual interests. He pointed to a hypothetical case where some committee members may have acquired their securities at very low prices, and others

be discussed in this Note, while the protective committees that Douglas investigated are unlike the committees that exist today, some of these examples of abuses are still relevant today.[55]

Douglas concluded that existing laws were not sufficient and that "public investors needed protection from insiders in reorganization cases."[56] Douglas made several recommendations to Congress based on the evidence he presented. One of the recommendations was that any person who represents more than twelve creditors or stockholders (including committees) appearing in the bankruptcy cases be required to file a sworn statement that included the following: the amount of securities or claims owned by the investor being represented, the dates of acquisition, the amount paid for the securities or claims, and any subsequent sale or transfer.[57] This recommendation led to the adoption of Chapter X of the former Bankruptcy Act,[58] which became Rule 10-211 under the 1978 Bankruptcy Code and later Rule 2019.[59] Though many changes were made to the provisions affecting reorganizations, the drafters of the 1978 Bankruptcy Code retained the substance of the original Rule in the current Rule 2019.[60] In fact, in the legislative history of the Bankruptcy Reform Act of 1978, it was stated that "[t]he Commission on the Bankruptcy Laws is of

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may have acquired their securities at or near to par value. These instances would create an automatic conflict of interest since the committee members who purchased at low prices may want to agree to a settlement that would be of economic harm to those who purchased at or near to par. He said that "[o]ut of such circumstances are serious conflicts of interest born." *Id.*

With respect to the exercise of excessive powers by committee members, Douglas pointed to numerous examples, including committee members trading the securities of a corporation undergoing reorganization based on inside information, committees fixing their own fees without supervision, committees paying solicitors to use "high pressure" tactics to get investors to deposit their securities, and one-sided deposit agreements giving control of the investors' securities to the committee and immunizing the committee from responsibility. *Id.*

55 *See infra* Part IV.

56 Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 30 (1995).

57 William O. Douglas, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees* (1937), *available at* http://www.sechistorical.org/collection/papers/1930/1937_0510_SEC_003.pdf.

58 The Bankruptcy Act of 1898 was significantly amended by the 1938 Chandler Act, which added, among other things, the predecessor to the current Chapter 11 provisions that govern corporate reorganization. This was replaced by the Bankruptcy Reform Act of 1978, also known as the Bankruptcy Code.

59 *Northwest I*, 363 B.R. 701, 704 (Bankr. S.D.N.Y. 2007).

60 *Id.*

the opinion that the conclusions and recommendations of the protective committee study and the Congressional policy embodied in the Chandler Act[61] are still valid."[62] While some of the conclusions of the study are certainly relevant today, it is clear that this Rule was enacted to specifically address abuses by protective committees in the 1930s that solicited deposit agreements from investors. This Note argues that over the years, the nature of unofficial committees changed significantly and Rule 2019 was never amended to meet the needs of the changing marketplace.

Though some claim that there is relatively little case law applying Rule 2019, there have been many cases where the Rule has been applied.[63] However, there are very few cases applying the Rule to unofficial or ad hoc committees.[64] The existing case law provides some evidence that when courts have applied the Rule, it was to ensure the overall fairness and integrity of the bankruptcy process.[65] However, prior to the *Northwest* decision, no unofficial or ad hoc committees had been required to file disclosure statements in accordance with Rule 2019.[66] Typically, the legal counsel or law firms hired by committee members got away with filing a verified statement that disclosed the names of the committee members and the aggregate equity or debt holdings that the committee represented.[67]

Until *Northwest*, hedge funds in particular had participated in bankruptcy proceedings for many years without being subject to the disclosure requirements of Rule 2019. They have

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61 *See supra* note 58 (describing the Chandler Act).

62 *Report of the Commission on Bankruptcy Laws of the United States*, H.R. Doc. No. 93-137, at 247 (1973).

63 *Northwest I*, 363 B.R. at 704 ("Although the Committee argues that the Rule has been frequently ignored or watered down, there is no shortage of cases applying it.").

64 Zelmanovitz & Olsen, *supra* note 4 (noting that the majority of cases applying Rule 2019 have involved law firms representing class action plaintiffs against the debtor's estate). The court's main concern was whether the lawyer had the authority to represent the class. *Id.*

65 *See In re* Congoleum Corp, 321 B.R. 147, 167 (Bankr. D.N.J. 2005) (ordering disclosure under Rule 2019 "to prevent conflicts of interest among Creditors' counsel from undermining the fairness of the Plan, bringing to bear the values of good faith and fairness in the reorganization process that pervade the bankruptcy code"); *In re* Oklahoma P.A.C. First Limited Partnership, 122 B.R. 387 (Bankr. D. Ariz. 1990) (ordering compliance with Rule 2019 because the attorney represented conflicting interests in the case where the debtor filed for bankruptcy and the same law firm represented all creditors).

66 Zelmanovitz & Olsen, *supra* note 4.

67 *Id.*

often done so as members of ad hoc committees, since they are especially resistant to disclosing internal financial and trading information to debtors or the general public.[68]

II. *NORTHWEST* AND *SCOPAC:* RULE 2019 EMERGES

The court in *Northwest* received the attention of everyone in the bankruptcy industry when it applied Rule 2019 on its face to require ad hoc committees to disclose their trading information. It sent a strong message to industry experts, distressed companies, investors, creditors, and—most importantly—hedge funds. *Scopac* came on the heels of the *Northwest* decision, and once again drew the attention of everyone in the industry, when that court appeared to ignore the plain meaning of the Rule and refused to require disclosure because of the effects it would have on the claims-trading market. Clearly, the *Scopac* decision is at odds with *Northwest* and has added another piece to the already complicated Rule 2019 puzzle. Hedge funds celebrated a small victory, but the decision left everyone wondering how future cases would be decided. This Part explores the courts' decisions and reasoning in both cases. It argues that the *Northwest* court properly interpreted the Rule, as Rule 2019 on its face clearly applies to ad hoc committees. However, the *Scopac* court correctly recognized the tension that is created when Rule 2019 is applied on its face, which forced the court to ignore the plain meaning of the Rule. This Part therefore concludes that while Rule 2019 in its current form does apply to ad hoc committees, it is unequipped to address the needs of the financial marketplace and serve the changing dynamics of bankruptcy cases today.

A. In Re Northwest Airlines: *Debtors Win Round I*

Northwest Airlines filed a voluntary Chapter 11 bankruptcy petition in September 2005, and the trustee appointed a statutory committee of unsecured creditors.[69] In November

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[68] *See supra* Part I.A.

[69] Debtors' Objection to Motion of the Ad Hoc Equity Committee for an Order (A) Pursuant to Sections 105(a) and 107(b) of the Bankruptcy Code and Rule 9018 of the Federal Rules of Bankruptcy Procedure Granting Leave to File Its Bankruptcy Rule 2019(a) Statement Under Seal, (B) Limiting the Disclosure Required in Their Rule 2019 Statement and (C) Granting a Temporary Stay Pending Determination of

2006, news broke that U.S. Airways had made a bid to acquire Delta Air Lines out of its bankruptcy proceedings.[70] This caused speculation about consolidation in the airline industry, and within a week, Northwest's stock rose nearly 300%.[71] This prompted a group of investors who regularly invest in distressed companies to purchase some of Northwest's common stock.[72] Over the next couple of months, these investors sought the appointment of an official committee based on the contention that the increased share price was evidence of Northwest's solvency.[73] In response, the U.S. Trustee declined to appoint an official committee.[74] These investors then formed an ad hoc committee, and in January 2007, they filed a notice of appearance in the case.[75] The law firm representing the committee filed a verified statement pursuant to Rule 2019, which included the names of the eleven committee members, the aggregate amount of common stock and claims owned by the committee members, and a statement that some of the claims were acquired after the commencement of the bankruptcy case.[76]

In February 2007, Northwest filed a motion seeking, among other things, an order compelling the ad hoc committee to file an amended 2019 statement disclosing more detailed information on the amounts of claims owned by each committee member, when these claims were acquired, the amount paid for these claims, and any subsequent sale of these claims.[77] The ad

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This Motion at 4, *Northwest I.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (No. 05-17930) [hereinafter Northwest Debtors Objection].

[70] *Id.*

[71] *Id.*

[72] *Id.* at 4-5.

[73] *Id.* at 5. The investors argued that the increase in Northwest's stock price as well as general speculation about industry consolidation were evidence that Northwest was solvent and there was value for the equity holders. *Id.* The debtors opposed the motion, arguing that an increase in the trading price of their securities was not indicative of reorganization value. *Id.*

[74] *Id.* at 6. The U.S. Trustee declined the motion because the ad hoc committee "failed to demonstrate both the likelihood of a meaningful recovery for equity holders in these cases, and that a separate committee was necessary for their adequate representation." *Id.*

[75] *Northwest I*, 363 B.R. at 701.

[76] *Id.* at 701-02.

[77] Northwest Debtors Objection, *supra* note 69, at 7. Northwest argued that the ad hoc committee sought to make an impact at a late stage in the reorganization, yet the committee's true purpose remained a mystery because it did not disclose its individual holdings. Therefore, Northwest asked the court to prohibit the committee from further participating in the case unless it made proper disclosure. Posting of Bob

hoc committee opposed the motion, arguing that its 2019 statement was sufficient.[78]

1. The Court's Decision

On February 26, 2007, Judge Allan Gropper of the United States Bankruptcy Court for the Southern District of New York decided in favor of Northwest that the ad hoc committee had failed to fulfill the disclosure requirements of Rule 2019.[79] He ordered the committee to file a modified 2019 statement within three business days, concluding that "the Rule is long-standing, and there is no basis for failure to apply it as written."[80] The court's reasoning was twofold. It first addressed the committee's substantive argument against disclosure and then looked to the history and purpose of Rule 2019.

The ad hoc committee argued that the Rule on its face applied only to "every entity or committee representing more than one creditor or equity security holder" and that since no committee member represented any party other than itself, Rule 2019 did not apply.[81] In addition, only the law firm represented more than one creditor, but since the firm did not have any claims in Northwest, it had nothing to disclose.[82] The court held that this interpretation of Rule 2019 by the ad hoc committee was flawed, stating succinctly that "the Rule cannot be so *blithely* avoided."[83] It pointed out that the law firm's clients appeared as a committee, filed a notice of appearance in the case as a committee, moved for the appointment of an official committee, and had been litigating discovery issues collectively.[84] Additionally, the court noted that the committee retained a firm to represent it, that it compensated the firm for the work done on its behalf, and that the firm represented the

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Eisenbach, In the (Red): The Business Bankruptcy Blog, http://bankruptcy.cooley.com/2007/03/ (Mar. 4, 2007).

[78] Eisenbach, *supra* note 77 (noting that the committee stated that the purpose of the Rule was only to ensure that reorganization plans were negotiated and voted on by those authorized to act for the real parties in interest, and that purpose was satisfied by its statement).

[79] *Northwest I*, 363 B.R. at 704.

[80] *Id.* at 704.

[81] *Id.* at 703.

[82] *Id.*

[83] *Id.*

[84] *Id.*

interests of the committee collectively, not the interests of individual committee members.[85]

After responding to the committee's substantive argument, Judge Gropper then looked to the history and purpose of Rule 2019 with regards to the role of ad hoc committees.[86] He pointed out that by appearing as a committee, the members speak as a group and "implicitly ask the court and other parties to give their positions a degree of credibility."[87] The court also cited the Douglas Report, which focused on abuses by unofficial committees, and accordingly led to the adoption of disclosure requirements under the current Rule 2019.[88]

The court therefore ordered the ad hoc committee to comply with the disclosure requirements of Rule 2019 and file an amended statement within three business days.[89] Specifically, the court required each member of the committee to provide the amounts of claims and interests owned, when the claims and interests were acquired, the amounts paid for the claims and interests, and any sales of the claims and interests.

2. A Frenzy of Filings: The Committee Seeks Privacy, Northwest Seeks Disclosure

Following Judge Gropper's ruling, both the ad hoc committee and Northwest made a series of motions and filings.[90]

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[85] *Id.* Judge Gropper also distinguished this case from others where a law firm might represent individual clients, and as such the firm would be the only party required to file a disclosure statement under Rule 2019. He pointed out that this was not the case with the ad hoc committee who, based on the facts, clearly formed a group and retained counsel to represent the collective interests of that group. Consequently, the committee fell under the plain meaning of Rule 2019, and was required to provide the information required for each of the individual committee members. *Id*.

[86] *Id.*

[87] *Id.* The court also noted that because the Bankruptcy Code provides the possibility of giving compensation to unofficial committees, disclosure is important. *Id*.

[88] *Id.* at 704.

[89] *Id.*

[90] This case drew the attention of many in the industry, and there were also motions from the Official Committee of Unsecured Creditors, the U.S. Trustee, and Bloomberg News, who wanted to weigh in on the court's decision. *See generally* Objection of the Official Committee of Unsecured Creditors to Ad Hoc Equity Committee's Motion for an Order Granting Leave to File Its Rule 2019(a) Statement Under Seal, *Northwest I*, 363 B.R. 701 [hereinafter Northwest Official Committee Objection]; Response of the United States Trustee to Motion of Ad Hoc Equity Committee for an Order Pursuant to 11 U.S.C. §§ 105(a) and 107(b) and Rule 9018 of the Federal Rules of Bankruptcy Procedure Granting Leave to File Its Bankruptcy Rule 2019(a) Statement Under Seal, *Northwest I*, 363 B.R. 701 [hereinafter U.S. Trustee Motion]; Memorandum of Law by Bloomberg News in Support of Intervention and in Opposition

Essentially, the committee sought to retain the private investment information of its members, and Northwest sought disclosure of the information that had been ordered by the court under Rule 2019.

The ad hoc committee first filed a motion for an order allowing the additional Rule 2019 statement to be filed under seal because it constituted confidential commercial information and trade secrets as contemplated by Section 107(b) of the Bankruptcy Code.[91] The committee argued that hedge funds trade using complex and proprietary strategies and maintain strict confidentiality over their trading practices.[92] Thus, the information required under Rule 2019 would prejudice the committee members if not filed with the court under seal.[93] The ad hoc committee also argued that requiring public disclosure of confidential information would have a "chilling effect" on future creditor participation in bankruptcy proceedings[94] and discourage investors such as themselves from trading in distressed securities on the secondary market.[95]

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to the Ad Hoc Committee's Request for an Order Sealing Its Rule 2019(a) Disclosures, *Northwest I*, 363 B.R. 701 [hereinafter Bloomberg Motion to Intervene].

[91] Section 107(b) provides in pertinent part that "[o]n request of a party in interest, the bankruptcy court shall, and on the bankruptcy court's own motion, the bankruptcy court may—protect an entity with respect to a trade secret or confidential research, development, or commercial information . . . ." 11 U.S.C. § 107 (2000).

[92] Motion of the Ad Hoc Equity Committee for an Order (A) Pursuant to Sections 105(a) and 107(b) of the Bankruptcy Code and Rule 9018 of the Federal Rules of Bankruptcy Procedure Granting Leave to File Its Bankruptcy Rule 2019(a) Statement Under Seal, and (B) Granting a Temporary Stay Pending Determination of This Motion at 6, *Northwest I*, 363 B.R. 701 [hereinafter Northwest Ad Hoc Committee Motion].

[93] *Id.* at 6-7. In support of this proposition, the committee relied on prior cases that held that information relating to the trading of securities was confidential, proprietary and did not have to be disclosed. *See, e.g.*, Fed. Open Market Comm. of Fed. Reserve Sys. v. Merrill, 443 U.S. 340, 363 (1978) (holding that the committee did not have to disclose commercial information including the buying and selling of securities on the open market), *cited in* Northwest Ad Hoc Committee Motion, *supra* note 92, at 6-7. The committee also argued that such relief was not discretionary, but required by the Code if the court determined that the information fell under Section 107(b). *See, e.g.*, *In re* Orion Pictures Corp., 21 F.3d 24, 28 (2d Cir. 1994); *In re* Phar-Mor, Inc., 191 B.R. 675, 679 (Bankr. N.D. Ohio 1995); *In re* Handy Andy Home Improvement Centers, Inc., 199 B.R. 376, 381 (Bankr. N.D. Ill. 1996).

[94] Northwest Ad Hoc Committee Motion, *supra* note 92, at 10-11. They noted that the information required is highly confidential and the committee members do not even share it among themselves. Only counsel has access to the information. *Id.*

[95] *Id.* at 11-12. The committee also attempted to convince the court that it should not compel the individual committee members to submit the information required by Rule 2019, but rather that the committee should be allowed to submit *aggregate* information. In support of this alternative, the committee pointed to the time and expense that would be incurred to gather this type of detailed information for a significant number of trades. The committee argued that the level of detail ordered by

Northwest quickly objected to the ad hoc committee's motion to file the information under seal. It refuted the committee's assertion that the information ordered by the court was a trade secret or proprietary information under Section 107(b).[96] Northwest maintained that the information was merely historical, factual information, not trading models or strategies.[97] In support of its argument, Northwest pointed out that current SEC regulations require disclosure of this information "as part of the fundamental premise that transparency promotes fair and efficient markets and market practices."[98] It equated this regulation to Rule 2019's purpose in a bankruptcy setting.[99] Additionally, Northwest noted that Owl Creek Asset Management, one of the leading members of the ad hoc committee, had voluntarily disclosed the information required by Rule 2019, yet there had been no contention that it had suffered any harm or prejudice as a result of its public disclosures.[100]

The Official Committee of Unsecured Creditors also objected to the ad hoc committee's motion. It argued that allowing the information to be filed under seal would defeat the underlying purpose of Rule 2019.[101] It claimed that the fact that the Code's drafters required the information to be disclosed under the Rule is evidence that the information is not a confidential trade secret that should be protected.[102] The official committee also pointed out that Section 107(b) has never been

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the court would not add anything substantive to the proceedings, and noted that the price paid for the shares had no effect on the committee members' rights. *Id.* at 14-16.

96 Northwest Debtors Objection, *supra* note 69, at 14.

97 *Id.*

98 For example, Section 13(d) of the Securities and Exchange Act of 1934 requires investors who acquire five percent or more of a class of registered equity securities to file a statement. Northwest Debtors Objection, *supra* note 69, at 15.

99 *Id.* Northwest further contended that the cases cited by the ad hoc committee all involved confidential agreements, not historical trading information like the case at hand. *Id.* at 16.

100 *Id.* at 18-19. Northwest also objected to the aggregate information solution proposed by the ad hoc committee. It argued that this was insufficient under Rule 2019, and the complete, individualized information previously ordered was essential for the reorganization proceedings to continue. *Id.* at 11. Northwest also stressed the importance of public disclosure of the information and asked the court to deny the motion to file under seal. It argued that allowing the ad hoc committee to circumvent detailed disclosure to all parties would defeat the essential purpose behind Rule 2019 of complete disclosure during the reorganization process. *Id.*

101 Northwest Official Committee Objection, *supra* note 90, at 1-2. The committee argued that "disclosure is not complete if the "disclosed" information remains under seal." *Id.* at 4.

102 *Id.* at 5.

used to allow Rule 2019 disclosures to be filed under seal.[103] Furthermore, it argued that the ad hoc committee had not proven the existence of "an extraordinary circumstance or compelling need" that is required for a seal request to be granted.[104]

Bloomberg News[105] also moved to intervene so that it could ensure that the public had access to all the information regarding the bankruptcy proceedings.[106] It also opposed the ad hoc committee's motion to seal, pointing to the importance of transparency in bankruptcy proceedings, the presumption of public access mandated by Section 107 of the Bankruptcy Code, and the constitutional right of access to judicial proceedings and court documents.[107]

The U.S. Trustee[108] also weighed in prior to the court's decision, filing a response to the ad hoc committee's motion. It argued that the committee's aggregate claims solution was insufficient to satisfy Rule 2019.[109] It also noted that public access to court documents is favored in bankruptcy cases and that the denial of public access was only appropriate in very limited circumstances, which were not met in this case.[110]

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103 *Id.*

104 *See In re* Orion Pictures Corp., 21 F.3d 24, 26 (2d Cir. 1994) (noting that "a judge must carefully and skeptically review sealing requests to insure that there really is an extraordinary circumstance of compelling need."). Like Northwest, the official committee also pointed out that Owl Creek had already publicly disclosed the same information even though it was not required to do so under any SEC regulation. Northwest Official Committee Objection, *supra* note 90, at 6-7.

105 Bloomberg is currently the largest leading financial news and data company in the world. It reports on political, legal, financial and business events worldwide.

106 Bloomberg Motion to Intervene, *supra* note 90, at 1. The motion was "an effort to ensure that the public has a full and accurate understanding of the events occurring in this Chapter 11 proceeding, including the motivations and interests of the players who seek to control an important public company." *Id.*

107 Bloomberg argued that there was a strong public interest in the role that hedge funds play in the financing of distressed companies, which could not be ignored. Bloomberg also noted that while hedge funds have become an important part of the U.S. economy, they have also been largely unregulated, and the public (including current and former employees of Northwest) had a critical interest in learning about the role that these funds would play in the reorganization of Northwest. Bloomberg ultimately stressed the importance of the disclosure, and the public harm that would result if the Rule 2019 statement were filed under seal. *Id.* at 2-3.

108 The U.S. trustee is responsible for overseeing the administration of bankruptcy cases and private trustees. 28 U.S.C. § 586 (2000).

109 U.S. Trustee Motion, *supra* note 90, at 6.

110 *Id.* at 6-9. The Trustee also concluded that before the court could order a seal, the ad hoc committee had to prove that the trading information constituted strategies that were confidential information or trade secrets, and that the public

3. The Court Decides Again: Disclosure Trumps Privacy

After consideration of the parties' motions and a hearing on the issue, Judge Gropper issued his ruling denying the ad hoc committee's motion to file the disclosure statement under seal.[111] The court rejected the argument that the committee members' trading practices constituted commercial information under Section 107(b).[112] It concluded that the committee's contention that the information would allow its competitors to determine its trading strategies was unfounded.[113] Additionally, the court pointed out that the Douglas Report considered the importance of *public* disclosure in drafting Rule 2019, which is inconsistent with filing the information under seal.[114]

The court was especially critical of the fact that the committee members chose to act as a group to gain leverage in the reorganization proceedings, while simultaneously pointing to the possibility of individual financial losses that they may incur by revealing the information.[115] Nevertheless, it concluded that even if the committee members had valid individual interests in keeping the information private, Congress had subordinated those interests to those advanced by Rule 2019.[116] For example, Rule 2019 is designed to protect equity holders who are not members of any committee and who rely on the disclosures to understand the motivations of the committee members.[117] The court concluded that even if the ad hoc committee did not accept a fiduciary responsibility to the other shareholders, the purpose of Rule 2019 was to provide those shareholders with sufficient information so that they could decipher whether that committee would advance their interests, or whether they should form their own committee.[118]

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disclosure already made by Owl Creek did not remove them from the protection of Section 107(b). *Id*.

111 *Northwest II*, 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007).

112 *Id.* at 706-07.

113 *Id.* at 707. In fact, the court noted that at oral argument counsel agreed that the "trading strategies" of his clients were not at issue. *Id*.

114 *Id.* at 708. The Douglas Report stated that the information required by the rule would "provide a routine method of advising the court *and all parties of interest* of the actual economic interest of all persons participating in the proceedings." *Id.*

115 *Id.* The court pointed out that by acting as a group, the committee members "subordinated to the requirements of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the Debtor's securities." *Id.*

116 *Id.* at 709.

117 *Id.*

118 *Id.*

Overall, the disclosures also would allow all parties involved in the reorganization to assess the credibility of a group that would ultimately play an important role in the case.[119]

The court pointed to two facts in the current case that emphasized the importance of Rule 2019 disclosures to the other shareholders.[120] First, the ad hoc committee had already "disclosed that committee members own[ed] a very significant amount of [Northwest's] debt, as well as stock."[121] The court concluded that shareholders had a right to know whether the debt and stock were purchased concurrently, which would raise issues about conflicts of interest.[122] Second, three committee members had already admitted that they might sell their stock at any time, which would potentially leave other similarly situated shareholders without representation.[123] The court noted that one function of Rule 2019 is to provide other members in a class "the right to know where their champions are coming from."[124]

After the court's ruling denying the seal, three hedge funds that were members of the ad hoc committee filed a motion for reconsideration of the court's initial decision.[125] The Loan Syndications and Trading Association ("LSTA"), and the Securities Industry and Financial Markets Association ("SIFMA") filed a brief in support of the motion arguing that the court's decision would discourage many sophisticated stakeholders from participating in future bankruptcy cases.[126] The court denied this motion. Nine of the thirteen members of the ad hoc committee later complied with the court's order and

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[119] *Id.*

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *Id.* Based on these facts, the court concluded that "[g]ranting the motion to seal would scuttle the Rule." *Id*.

[125] Motion of Certain Equity Holders, Pursuant to 11 U.S.C. § 105(a), FED. R. CIV. P. 59(e) and 60(b), and L.R. Bankr. P. 9023-1(a) for Reconsideration of Memorandum of Opinion and Order Granting Debtors' Motion for an Order Compelling Ad Hoc Committee to File a Verified Statement Pursuant to Bankruptcy Rule 2019(a), at 1, *Northwest I*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (No. 05-17930).

[126] Joinder of Loan Syndications and Trading Association and Securities Industry and Financial Markets Association As *Amici Curiae* to Motion of Certain Equity Holders, Pursuant to 11 U.S.C. § 105(a), FED. R. CIV. P. 59(e) and 60bB), and L.R. Bankr. P. 9023-1(a) for Reconsideration of Memorandum of Opinion and Order Granting Debtors' Motion for an Order Compelling Ad Hoc Committee to File a Verified Statement Pursuant to Bankruptcy Rule 2019(a), at 3, *Northwest I*, 363 B.R. 701.

filed an amended statement providing the amount of stock they held, when the stock was purchased, and the amounts paid.[127] The remaining four members presumably dropped out of the case.

B. In Re Scotia Development LLC: *Hedge Funds Win Round II*

In January 2007, Scotia Pacific filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code.[128] The ad hoc committee in *Scopac* (referred to as the "Noteholder Group") was present from the beginning of the bankruptcy proceedings, and in February 2007, it filed a statement pursuant to Rule 2019.[129] The equity held by the committee consisted of "timber notes," which were traded publicly, but were secured obligations of Scopac.[130] The statement filed by the committee included the names of the committee members and their aggregate note holdings, which totaled 90%.[131] Like the original Rule 2019 statement in *Northwest*, it did not include detailed information about each committee member's holdings, when they were acquired, or the price paid for the holdings.

1. Scopac and the Noteholder Group Disagree

In March 2007, not long after the final ruling in *Northwest*, Scopac filed a motion for an order compelling the ad hoc committee to disclose all the information required under Rule 2019(a).[132] Scopac argued that Rule 2019 applied to the

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[127] Verified Amended Statement of the Ad Hoc Committee of Equity Security Holders Pursuant to Bankruptcy Rule 2019(a), at 2, Exhibit A, *Northwest I*, 363 B.R. 701.

[128] Scotia Pacific Company LLC's Motion for an Order Compelling the Ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 3, *In re* Scotia Dev. LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. Apr. 18, 2007) [hereinafter Scopac Debtor's Motion].

[129] *Id.* at 3, 7.

[130] *Id.* at 4.

[131] Verified Statement of Bingham McCutchen LLP and Gardere Wynne Sewell LLP Pursuant to Bankruptcy Rule 2019 at 1-2, *In re Scotia Development*, 2007 WL 2726902.

[132] Scopac Debtor's Motion, *supra* note 128, at 1. Scopac noted in its motion that while the committee claimed to currently represent 90% of the outstanding timber notes in its initial statement, at various times it also stated that it represented 97% and 99% of the notes, but no revised statement was ever received. *Id*.

committee since it admittedly represented the majority of note holders.[133] It relied heavily on the recent *Northwest* decision, including the court's conclusion about the history and purpose of Rule 2019.[134] In addition, Scopac argued that unless the committee fully complied with the requirements of Rule 2019(a), the court should prohibit it from further participation in the proceedings.[135]

The Noteholder Group objected to Scopac's motion, arguing that Rule 2019 did not apply to it for four reasons: (1) it was not a committee; (2) it did not represent any creditors or equity security holders; (3) it did not have any instrument; and (4) it was not empowered to act on behalf of creditors.[136] The Noteholder Group then addressed the purpose of Rule 2019. It pointed to the Douglas Report[137] and argued that it was meant to apply to protective committees that were organized and controlled by the debtor and other inside groups.[138] It concluded that the term "committee" in Rule 2019 applied only to committees that were fiduciaries, and had the authority to bind the creditors they represented.[139] Furthermore, it pointed out that nothing suggested that the Rule should apply to informal groups like theirs, which sought merely to share expenses, speak collectively and only represent the interests

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133 *Id.* at 8-9.

134 *See supra* Part II.A.

135 Scopac Debtor's Motion, *supra* note 128, at 11.

136 First, the Noteholder Group examined the legal definition of a "committee" and argued that it was merely a group, not a committee, since it was self-elected and did not speak for anyone other than itself. As a group, it argued that it was not a committee within the meaning of Rule 2019. Second, the Noteholder Group argued that it did not represent more than one creditor or equity security holder as required by Rule 2019. Again it looked to the legal definition of *representative*, which means someone who represents or has the authority to act for someone else. It pointed out that the members of the group did not represent anyone other than themselves. Third, the Noteholder Group argued that there was no instrument or agreement that specified the group's authority to act on behalf of the note holders. Noteholder Group's Objection to Scotia Pacific Company LLC's Motion for an Order Compelling the ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 1-13, *In re* Scotia Development LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. Apr. 18, 2007) [hereinafter Noteholder Group Objection].

137 *See supra* notes 48-57 and accompanying text (discussing the Douglas Report).

138 The Noteholder Group noted that in the post-Depression era, these protective committees often solicited deposit agreements from small investors, who as a result gave up control in the proceedings. Thus, Congress adopted the Rule because it wanted to control abusive behavior by protective committees, who were fiduciaries to the investors they represented. Noteholder Group Objection, *supra* note 136, at 13-14.

139 *Id.* at 16.

of the members in the group.[140] The Noteholder Group also criticized *Northwest*, arguing that the court incorrectly interpreted the meaning of Rule 2019.[141]

Scopac filed a response to the Noteholder Group's objection, arguing that the plain language of the Rule applied.[142] It pointed out that the group was in fact very similar to the ad hoc committee in *Northwest* because it filed a notice of appearance as a committee, retained counsel as a committee, compensated counsel as a committee, litigated issues in the bankruptcy proceedings as a committee, and gave instructions to counsel as a committee.[143] Thus, Scopac concluded that the Noteholder Group could not argue that it was not a committee under the meaning of Rule 2019 solely to avoid disclosure.[144]

Scopac also responded to the Noteholder Group's arguments that it was not a fiduciary and no instrument existed that governed the group. It relied on *Northwest* for the proposition that a committee need not be a fiduciary to be required to comply with Rule 2019.[145] Perhaps Scopac's

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140 *Id.*

141 *Id.* at 17. The Noteholder Group also argued that the *Northwest* decision was distinguishable in the following ways: (1) the ad hoc committee in *Northwest*, unlike the Noteholder Group, initially tried to be appointed as an official committee; (2) the *Northwest* committee held only 27% of the securities, but the Noteholder Group held 95% of the timber notes; (3) some of the members of the *Northwest* committee owned both stock and debt, but the members of the Noteholder Group owned nothing but timber notes; (4) the *Northwest* committee sought to negotiate for the entire class of shareholders whereas the Noteholder Group only represented themselves; (5) Northwest was insolvent and the shareholders were fighting for recovery, but Scopac was solvent and the note holders were entitled to full recovery; and (6) the court in *Northwest* concluded that public disclosure would provide information to the other shareholders, but the members of the Noteholder Group were the substantial majority of the note holders. *Id.* at 18-20.

142 Scotia Pacific Company LLC's Response to the Noteholder Group's Objection to the Motion for an Order Compelling the Ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 1-5, *In re* Scotia Development LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. Apr. 18, 2007). Scopac pointed out that although the group had called itself a "committee" since March 2005, it changed its title to a "group" soon after the motion seeking disclosure under Rule 2019. Scopac argued that this naming convention was irrelevant since the Noteholder Group never changed anything other than its name, and continued to operate in the same way that it did since its formation. *Id*.

143 *Id.* at 1-2.

144 *Id.* at 2.

145 Scopac's brief quoted the *Northwest II* court:

> I'm not saying that these individual funds can't take action in their own interests; I'm just saying that Rule 2019 says that, if they're a group that wants to affect this case—and they certainly do—that they've got to file certain basic information that I didn't make up. I didn't create the requirement. It's on the books, it should be filed.

strongest argument for disclosure was that the timber notes held by the Noteholder Group were still publicly traded.[146] As a result, if any member of the group sought to trade the timber notes, potential purchasers should have access to the information required under Rule 2019 so that they could make relevant decisions about the group.[147]

2. Friends of the Court Point Out the Implications of Disclosure

Just as they had done in the *Northwest* case, the LSTA and the SIFMA filed an amicus curiae brief opposing Scopac's motion. They argued that Rule 2019 disclosure would have "detrimental impacts" on the trading markets for distressed companies, as well as the willingness of sophisticated stakeholders to participate in corporate bankruptcy proceedings.[148] They pointed out that the practical effect of compelling disclosure is that creditors would choose to act on their own instead of engaging in collective action, the former of which is more efficient and cost-effective for all parties involved in the reorganization proceedings.[149]

3. The Court's Decision: This Time Privacy Trumps Disclosure

On April 18, 2007, Judge Richard Schmidt of the United States Bankruptcy Court for the Southern District of Texas issued an order denying Scopac's motion to compel disclosure of the trading information that it alleged was required under Rule 2019.[150] The order was two pages long and simply stated

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Id. at 6 (quoting Transcript of Motions on March 15, 2007 at 45, *Northwest II*, 363 B.R. 704 (Bankr. S.D.N.Y. 2007) (No. 05-17930)). Scopac also argued that the absence of an instrument did not mean that the group did not fall under the Rule, which requires that "a verified [Rule 2019] statement include a copy of the [authorizing] instrument, *if any* . . . ." *Id*. at 8 (quoting FED. R. BANKR. P. 2019).

146 *Id.* at 12.

147 *Id.*

148 Motion of Securities Industry and Financial Markets Association and Loan Syndications and Trading Association for Leave of Court Pursuant to 11 U.S.C. § 1109(b) or, Alternatively, Fed. R. Bankr. P. 2018(a) and 11 U.S.C. § 105(a), to Appear as Amici Curiae, File Brief and Make Oral Argument in Support of Noteholder Group's Objection to Scotia Pacific Company LLC's Motion for Order Compelling Ad Hoc Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 2, *In re* Scotia Dev. LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007).

149 *Id.* at 12-14.

150 *In re Scotia Development*, 2007 WL 2726902, at *1-2.

that the Noteholder Group was not a committee within the meaning of Rule 2019 and therefore the disclosure requirements of the Rule did not apply.[151]

During the hearing on the Rule 2019 motion, Judge Schmidt elaborated a little more on his rationale. He reasoned that the Noteholder Group was not a committee but was merely a group of creditors represented by a single law firm.[152] He did point out, however, that there was an opportunity for conflicts of interest to arise among the group. As such, he noted that counsel for the Noteholder Group should ensure that everyone understood the potential conflicts and waived them accordingly.[153]

Scopac filed a motion for reconsideration shortly after the initial denial; however, the court also denied this motion. During the hearings held on the reconsideration motion, Judge Schmidt noted that he made a "practical" decision: while the information that Scopac requested was important, it was far more important that such disclosure might negatively affect the trading market for distressed securities.[154] He also concluded that the *Northwest* court's interpretation of Rule

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[151] *Id.*

[152] Transcript of Hearing on April 17, 2007 at 4-5, *In re* Scotia Dev. LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. Apr. 18, 2007). Judge Schmidt stated, "I'm going to take an approach, a practical approach, and find that is not a committee, that this is—at this point that this is just one law firm representing a bunch of creditors."

[153] Judge Schmidt stated:

> I think that he [counsel] needs to be also careful that his, and this is just, this is not a ruling, but I suspect that there could well be situations where his representation of this group of people could have some conflicts of interest. And thereby, it would be important that all of the parties that he represents understands those conflicts in order to waive them . . . . I'm not suggesting there are any at the present time. I'm just saying, obviously, if one of the claimants happen to have a large unsecured claim as well as a secured claim, there could be a conflict in the position taken with respect to—to all of his representation.

Id. at 5.

[154] Judge Schmidt stated:

> I suspect technically you should file the specific amounts of the claims of each of the—of your people you represent . . . . I know that this is one of those things that everybody finds important. I think it's far more important in the sense of the impact it might have on the trading of claims and the distressed claims market. And that's the reason I—I made sort of a practical decision when I made the decision.

Transcript of Hearing on May 22, 2007 at 19, *In re Scotia Development*, 2007 WL 2726902.

2019 was not what the drafters intended.[155] In support of this conclusion, he noted that the Rule was enacted as a result of the Douglas Report, and the committees that existed then were not the same as the committees that exist today.[156]

This decision appears to be inconsistent with Rule 2019. However, Judge Schmidt chose to ignore the plain meaning of the Rule in favor of a results-oriented decision that emphasized the effects on disclosure. Specifically, Judge Schmidt seemed especially concerned about the implications of disclosure on future claims trading. The next Part explores this tension between the transparency required under the Bankruptcy Code and the secrecy that is purportedly necessary for a functioning marketplace.

III. THE RULE 2019 TENSION: TRANSPARENCY V. LIQUIDITY

As the *Northwest* court held, Rule 2019 on its face applies to ad hoc committees. In addition, certain disclosures are necessary to achieve successful results in bankruptcy cases. However, applying the Rule in its current form to require disclosure of the complete trading history of committee members has implications on claims trading of distressed securities. This Part discusses the implications of the *Northwest* and *Scopac* decisions and concludes that they create a tension between transparency and liquidity. Additionally, it discusses and analyzes two Delaware cases that present a "middle ground" to help resolve this tension. This discussion will help to develop a framework for a proposed amendment to Rule 2019 in Part IV of this Note.[157]

A. *The Northwest Approach: The Implications of Disclosure*

The *Northwest* decision requires that each member of an ad hoc committee disclose the information specified in Rule 2019. While disclosure is one of the hallmarks of the Bankruptcy Code, and is important to successful corporate

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155 *Id.* at 19 ("In any event, I also understand that—that this is one of those things that—that, I mean, you can't fault the reasoning of the New York Court. I just don't think that was what was intended by the statute originally.").

156 *Id.* ("I think the statute went back to the old Douglass group and whatever that—those—that group, the study of—of committees as they existed bank then, and not committee in the sense that we talk about them now. And so what's [sic] why I sort of drew that line.").

157 *See infra* Part IV.

reorganization,[158] there are two other major implications to be considered. One is the effect that disclosure will have on liquidity in the trading markets for distressed claims and securities. The second is the effect that disclosure will have on the participation of experienced stakeholders, like hedge funds, in future bankruptcy litigation. These two implications were discussed in amici curiae briefs filed by the LSTA and the SIFMA in the *Northwest* and *Scopac* cases.[159] Additionally, in *Scopac*, Judge Schmidt noted that while the committee was technically required to file individual disclosures, he made his decision because of the potential impact that disclosure would have on claims trading in the market for distressed securities.[160]

1. Liquidity

One of the major arguments against requiring disclosure is that it will decrease the liquidity of the trading markets for distressed claims. Liquidity refers to the ability to convert claims and securities by buying and selling.[161] The trading of distressed claims is often beneficial to both the buyer and the seller.

Buyers of distressed claims and equity seek to acquire securities in reorganizing debtors for various reasons. Unlike sellers, buyers view these claims as being undervalued and seek to gain by taking a risk on the investment.[162] They are willing to purchase these claims and accept the risk because they feel that they understand the true value and can gain above-average returns. Many distressed investors sometimes hold debt in the company and seek to bundle these claims with the debt that they hold.[163] Specifically, in our marketplace today, many hedge funds have begun making direct "second-lien" loans to struggling companies and want to *hedge* their investment by acquiring equity in the company.[164] They may

158 *See supra* Part I.B.

159 *See supra* note 126 and accompanying text; *supra* Part II.B.2.

160 *See supra* note 154.

161 Forbes Media, *Investopedia*, http://www.investopedia.com/terms/l/liquidity.asp (last visited Mar. 23, 2008).

162 Presentation by the Loan Syndications and Trading Association Continuing Legal Education Seminar, *Legal Issues and Trends Related to Claims Trading*, at 6, June 14, 2007 [hereinafter LSTA Presentation] (on file with author).

163 *Id.*

164 LEMKE ET AL., *supra* note 15, § 1:2.

want to influence the reorganization process by taking an active role in the repayment plan or even by taking over the company.[165] Since sellers are eager to get rid of their claims in light of the financial performance of the company, buyers can often obtain the debtor's securities at significantly discounted prices.[166] Despite the discounted prices at which they acquire distressed claims, investors like hedge funds can offer sellers much needed liquidity.

On the other hand, sellers of distressed claims usually need cash immediately and cannot wait for the company to reorganize before receiving some kind of payment.[167] The reorganization process is typically long, and it may take holders of claims some time before they receive consideration for their equity holdings. In fact, equity holders are unlikely to receive anything because they are the residual claimants. Additionally, sellers may not want to participate in the restructuring proceedings themselves, which are expensive and timely.[168] Specifically, active participation in restructuring cases sometimes requires significant expenses such as counsel and litigation fees. Sellers may value liquidity when they need money to meet their own debt obligations or to pay current creditors or employees. The financial affairs of the company may also lead sellers to believe that the claims they hold are overvalued, and thus they may want to "cash out" before the value of their investment decreases even more.[169]

In particular, many institutional investors like insurance companies and pension plans are forced to quickly dispose of distressed securities because their portfolio holdings are often subject to credit quality and rating limitations.[170] Alternatively, the seller may also be a customer or supplier who has a valuable relationship with the debtor and does not want to jeopardize that long-term relationship by participating in what might turn out to be an antagonistic bankruptcy case.[171] Overall, for a variety of reasons, sellers of distressed claims want out, and they want out relatively quickly. Though

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165 LSTA Presentation, *supra* note 162, at 6.

166 LEMKE ET AL., *supra* note 15, § 1:2.

167 LSTA Presentation, *supra* note 162, at 6.

168 *Id.*

169 *Id.*

170 LEMKE ET AL., *supra* note 15, § 1:2.

171 Paul M. Goldschmid, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 207 (2005).

this generally leads to a discounted selling price, sellers are willing to accept this in light of their motivations. They value the liquidity that distressed investors provide to the market because it allows them to accomplish their goals.

Disclosure under the *Northwest* approach threatens this liquidity because the majority of distressed investors are hedge funds that rely on secrecy for their success.[172] Hedge funds are specifically formed in such a way as to avoid regulations that require them to disclose how they conduct their business.[173] More than anything, they seek to keep their trading information private. If forced to disclose this information, including the price and date that they acquired their claims, it is highly possible that hedge funds will no longer invest in distressed claims and securities. This decrease in the trading markets will in turn prevent holders of distressed claims from liquidating their claims prior to the conclusion of the bankruptcy case.

2. Participation in Bankruptcy Proceedings

The second implication of disclosure is that it will provide a disincentive for hedge funds to actively participate in bankruptcy cases. It is important to note that hedge funds may continue to participate but simply choose not to join ad hoc committees. However, this may very well mean that small hedge funds will refrain from participating altogether for fear that they would not be able to afford the litigation costs. The implication of disclosure on participation is therefore twofold.

First, disclosure under Rule 2019 discourages hedge funds from forming ad hoc committees and participating collectively in bankruptcy cases since individual creditors are not required to comply with the Rule.[174] This will lead to inefficiencies and cause delays in the resolution of cases since debtors will be forced to negotiate with individual creditors, rather than with all of them as a group.[175] It may seem that individual creditors are the only ones who benefit from the

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[172] *See supra* Part I.A.

[173] *See supra* Part I.A.

[174] *See* FED. R. BANKR. P. 2019 (specifying that only "committees" or "entities" are required to comply with the rule).

[175] Evan D. Flaschen & Kurt A. Mayr, *Ad Hoc Committees and the Misuse of Rule 2019*, 16 J. BANKR. L. & PRAC. 6 (2007). ("[T]he quickest and most effective reorganizations are typically accomplished on a consensual basis, and 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.").

formation of ad hoc committees because they can share litigation costs and exert greater influence on the case. However, collective participation benefits both creditors and debtors because it prevents delays and duplication of efforts.[176] In addition, because ad hoc committees can pool their resources to cover litigation expenses, they can retain experienced, sophisticated professionals to negotiate with debtors. If certain creditors are discouraged from participating in ad hoc committees and forced to act individually, they may no longer have the financial resources to retain these professionals, who arguably bring more expertise to the cases and help negotiate more effective reorganization plans for both parties.

Second, disclosure discourages participation by smaller hedge funds because of the time and expense required. One of the reasons that creditors form ad hoc committees is in an effort to share the litigation expenses.[177] Some small investors may not have the resources to retain counsel and incur the litigation expenses, whereas others may simply choose not to do so because the expense outweighs the benefit based on their stake in the company. As a result, these creditors will essentially have their interests restructured by larger creditors who can afford to participate in the case. The LSTA and SIFMA argue that this result is contrary to the broader intent of enacting Rule 2019, which was to prevent the investors from having their claims restructured on terms that were negotiated by larger stakeholders, who did not adequately represent their interests.[178]

B. The Scopac *Approach: The Implications of Non-Disclosure*

The *Scopac* decision does not require that each member of an ad hoc committee disclose the information required by

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[176] Whereas debtors only had to negotiate with representatives acting on behalf of a group of creditors, if hedge funds choose not to form ad hoc committees to avoid disclosure, debtors will be forced to negotiate with counsel for each individual creditor. Coordination is extremely beneficial in reorganization cases. As the Seventh Circuit stated in another context, "coordination is especially common in bankruptcy, which often is described as a collective proceeding among lenders." United Airlines v. U.S. Bank, 406 F.3d 918 (7th Cir. 2005).

[177] Eisenbach, *supra* note 77.

[178] Brief of Amici Curiae of Securities Industry and Financial Markets Association and Loan Syndications and Trading Association at 8, *In re* Scotia Dev. LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. Apr. 18, 2007).

Rule 2019.[179] Instead, it allows ad hoc committees to simply file a statement identifying the members of the committee and stating the aggregate claims held by its members.[180] Prior to the recent Rule 2019 litigation, ad hoc committees usually provided this information on a voluntary basis.[181] As discussed in Part II.B.3, *supra*, the *Scopac* court's decision was motivated by the potential impact that disclosure would have on claims trading. The LSTA and SIFMA also filed amici curiae briefs in that case and testified during the hearings that the two main implications of disclosure are the effects on liquidity in the distressed securities market and participation in bankruptcy cases. However, while these implications are important, the *Scopac* decision has implications of its own. Specifically, while liquidity is important, transparency is equally important in bankruptcy cases in order to ensure an effective reorganization. This Part argues that the *Scopac* decision does not adequately consider the importance of transparency in bankruptcy cases. There are two main implications of not requiring disclosure from individual committee members. First, non-disclosure has the potential to result in an uneven playing field for the parties of interest in a bankruptcy case. Second, it prevents the debtor, and other parties involved in the case, from understanding the motivations of the ad hoc committee, exposing the debtor and others to potential harms.

1. An Even Playing Field

An "even playing field" is where all parties involved in bankruptcy litigation are held to the same standards. The first potential consequence of non-disclosure is that it can create an uneven playing field because it allows members of the ad hoc committee to participate without meeting disclosure requirements. Transparency is the very essence of bankruptcy proceedings, and by not holding hedge funds to this standard, the scales are tipped in their favor. Regular participants in bankruptcy cases have borne this burden of full disclosure in order to reap the benefits of participation. For example, if debtors want to reap the benefits of the automatic stay as well as the ability to discharge their debts, they must disclose all

179 *See supra* Part II.B.

180 *See supra* Part II.B.

181 *See supra* Part I.B for discussion of Rule 2019 litigation prior to the *Northwest* and *Scopac* cases.

pertinent information, including assets, liabilities, and business affairs.[182] Their management is also subject to scrutiny so that creditors can make an informed decision about their plan of reorganization.[183] If secured lenders want to reap the benefits of debtor-in-possession lending or exit financing, court approval is required and other creditors have an opportunity to object.[184] Similarly, ad hoc committees who want to reap the benefits of collective participation should bear the burden of complying with the disclosure rules and accepting a fiduciary obligation to the class that they represent.[185] Under the *Scopac* approach, ad hoc committees are allowed to ignore their burden of disclosure under Rule 2019, while still reaping the benefits of participation.

2. Potential Harms to Other Parties

One party that may be harmed by non-disclosure is the group of other creditors or equity holders in the class. For example, in *Northwest*, the ad hoc committee only held about 27% of the shares in the company. The other outstanding shareholders represented other equity holders in the class. As discussed in Part II.A, *supra*, the court in *Northwest* was concerned about harm to these shareholders if the ad hoc committee was not forced to comply with Rule 2019.

Non-disclosure can harm the other shareholders in a number of ways. First, it prevents them from being able to assess the motivations of the committee. The dates that the committee members purchased their claims and the price at which they acquired them will allow the other creditors to understand their goals in the bankruptcy case. For example, in *Northwest*, it was disclosed that some of the committee members held both debt and equity in the company.[186] Rule 2019 disclosure allows shareholders to determine whether such debt and equity claims are purchased at around the same time, which may be evidence of a conflict of interest.[187]

Second, non-disclosure prevents other creditors from making informed decisions as to whether an ad hoc committee

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[182] 11 U.S.C. § 541 (2000); *see also* Berman, *supra* note 39, at 64.
[183] Berman, *supra* note 39, at 64.
[184] *Id.*
[185] *Id.*
[186] *Northwest II*, 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007).
[187] *See supra* text accompanying notes 121-122.

will adequately represent their interests or if they should form a committee of their own. For example, if the *Northwest* shareholders were not aware that some of the committee members owned both debt and equity, they may have mistakenly believed that the ad hoc committee represented their interests since they were in the same class.

Third, non-disclosure of subsequent sales of claims prevents the other creditors from knowing when a committee member is no longer involved in the case. If the committee members are allowed to sell their claims without disclosure, this may leave other creditors who thought that the committee was representing their interests without representation. For example, in *Northwest* it was disclosed that several members of the committee intended to sell their claims.[188] Rule 2019 would force the committee members to disclose subsequent sales of the claims and keep everyone informed. Non-disclosure of this information would have allowed committee members to sell their claims and leave the bankruptcy negotiations, which could leave other shareholders without representation.

Another party that may be harmed by non-disclosure is the debtor. The debtor, like other parties in a bankruptcy case, needs to know with whom they are negotiating. The debtor cannot effectively negotiate with the committee unless it understands its individual members and their holdings in the company. For example, in the *Northwest* case, the ad hoc committee filed a notice of appearance and immediately began serving document subpoenas and notices of depositions to parties involved in the case.[189] The ad hoc committee sought specific information regarding the debtor, including valuations, potential mergers, consolidations, and other sales involving the debtor.[190] The debtor, however, had no information about the committee members or their holdings, which led the debtor to file the motion requesting disclosure under Rule 2019.[191]

C. The Owens Corning *Approach: A Middle Ground*

While the option of allowing creditors to file their Rule 2019 disclosures under seal was rejected by the *Northwest* court, the United States Bankruptcy Court for the District of

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[188] *Northwest II*, 363 B.R. 704, 708 (Bankr. S.D.N.Y. 2007).

[189] Northwest Debtors Objection, *supra* note 69, at 7.

[190] *Id.*

[191] *Id.*

Delaware was more receptive to this approach. In *In re Owens Corning*, Judge Judith K. Fitzgerald was the first to institute a procedure designed to require disclosure while still protecting creditors' privacy rights.[192] She allowed parties to file their Rule 2019 disclosure statements privately. Information submitted to the court was unavailable on the public docket, and a party seeking to obtain the information had to receive the court's permission.[193] Several parties challenged the order, arguing that they were entitled to the information under Rule 2019, that it should have been made public, and that it was inappropriate to require court permission for access to Rule 2019 statements.[194] Judge Fitzgerald defended her order on the ground that it adequately balanced the privacy rights of creditors with the public's competing interest in full disclosure.[195]

This identical approach was followed by the bankruptcy court in *In re Kaiser Aluminum Corp.* and later upheld by the Delaware district court.[196] The parties challenging the bankruptcy court's decision argued that the procedure unfairly restricted their rights to access the information.[197] They also argued that it required them to incur additional expenses to access the information disclosed under Rule 2019 since they had to file a motion before the bankruptcy court.[198] The district court disagreed stating that the purpose of Rule 2019 was "to ensure that plans of reorganization are negotiated and voted upon by people who are authorized to act on behalf of the real parties in interest."[199] Therefore, it concluded that the bankruptcy court had struck an appropriate balance between complying with the requirements of the Rule and considering the complexities of the case.[200]

These Delaware court decisions present another alternative for the current Rule 2019 conflict: filing the Rule 2019

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192 *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in Northwest Airlines and Owens Corning*, ABI COMMITTEE NEWS, Apr. 2007 (citing *In re Owens Corning*, No. 00-3837 (Bankr. D. Del.)).

193 *Id.*

194 *Id.*

195 *Id.* Judge Fitzgerald explained her ruling as follows: "This order, in my view, does everything and probably more than it needs to do. *It provides for protection of the parties' rights to ask us [for] this information by simply filing a motion with this Court telling me why you want it* . . . ." *Id.* (emphasis added).

196 *See In re* Kaiser Aluminum Corp., 327 B.R. 554 (D. Del. 2005).

197 *Id.* at 557.

198 *Id.*

199 *Id.* at 559.

200 *Id.*

disclosures with the court under seal. It is noteworthy that these cases did not specifically allow filing under seal. The information was removed from the electronic docket, but parties could still obtain access by filing a motion with the court and obtaining an order.[201] However, the reasoning employed by the court in devising this procedure is similar to the arguments that were presented by the ad hoc committee in the *Northwest* case when it sought to make its Rule 2019 disclosures under seal.[202]

At first glance, the approach seems to be a compromise or a "middle ground"—the committee would be required to comply with the disclosure requirements of Rule 2019, but it could avoid having its confidential trading information made public. However, allowing hedge funds to file their trading information with courts under seal is an ineffective approach for the following three reasons. First, as discussed above, one of the aims of the disclosure Rule is to ensure that everyone involved in the case has access to the information. Second, the argument that trading information constitutes "confidential trade secrets" is unconvincing. As the debtor in *Northwest* pointed out, the information required under the Rule is historical information that is currently required under existing SEC regulations.[203] Finally, there is a valid concern that this information should be available not only to the parties involved in the case, but also to the public.

1. Access to the Information

The seal would allow the committee members to submit the information required under Rule 2019 to the court, but keep it from other parties involved in the litigation. In *Northwest*, the ad hoc committee sought to make its trading information available only to the court and the U.S. Trustee.[204] The committee members wanted to keep the information from the public, from the debtor, and from all other creditors and equity holders.[205] This simply overlooks the fact that Rule 2019 is an integral part of the disclosure scheme of the Bankruptcy

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201 *Id.* at 560.

202 *See supra* notes 91-95 and accompanying text.

203 *See supra* notes 96-100 and accompanying text.

204 Northwest Ad Hoc Committee Motion, *supra* note 92, at 14.

205 *Id.*

Code.[206] One of the purposes of the Rule is to ensure that reorganization plans are negotiated both openly and fairly among all creditors.[207] By not allowing all parties that are participating in the case to have access to the information, filing under seal seems to run contrary to this purpose of the Rule. Disclosure is important to both the debtors so that they can effectively negotiate with the committee, and to the other creditors to prevent them from being harmed by conflicts of interest. While Rule 2019(b) provides courts with discretion as to what sanctions they can impose for noncompliance, the requirements with respect to the information to be provided and filing procedures under Rule 2019(a) do not allow for discretion.[208] There are no exceptions that would allow a committee to file its information with the court under seal.

2. Trade Secrets

The ad hoc committee in *Northwest* argued that a sealed 2019 statement was justified because the trading information required under Rule 2019 constituted trade secrets protected by Section 107(b) of the Code.[209] It argued that its members trade their securities using complex strategies that comprise proprietary, confidential, and commercial information.[210] This Note argues that the court made the correct decision in rejecting this argument. The information to be reported under Rule 2019 is far from complex trading strategies. It is factual, historical trading data, including the prices and dates on which claims were purchased and subsequently traded by the hedge funds.[211] The Rule does not seek disclosure of any hedge fund policies, models, investment strategies, or practices. In fact, the information required is usually available publicly for companies that are subject to SEC regulations.[212] While hedge

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[206] *See supra* Part I.B for background information about Rule 2019 and its purpose in the Bankruptcy Code.

[207] COLLIER ON BANKRUPTCY, *supra* note 2, at §2019.01.

[208] *See* FED. R. BANKR. P. 2019.

[209] Northwest Ad Hoc Committee Motion, *supra* note 92, at 5-6.

[210] *Id.*

[211] Northwest Debtors Objection, *supra* note 69, at 14.

[212] For example, Section 13(d) of the Securities and Exchange Act of 1934 requires certain disclosure for investors who obtain more than 5% of a class of publicly traded securities. 15 U.S.C. § 78m (2006). This and other federal securities rules and regulations require full disclosure based on the premise that "transparency promotes fair and efficient markets and market practices." Northwest Debtors Objection, *supra* note 69, at 15.

funds seek to maintain their privacy and ensure they do not fall under these regulations, these efforts do not turn this routine trading information into proprietary trade secrets. Additionally, bankruptcy rules, if they plainly apply, should not be ignored to cater to a hedge fund's preferred business practices.

3. Public Access

Allowing an ad hoc committee to file its disclosure statement under seal would prevent public access to the information. When a public company files for Chapter 11 bankruptcy, other parties are affected, including employees and pensioners. For example, in the *Northwest* case, the bankruptcy proceeding affected 30,000 employees, as well as potentially tens of thousands of other pensioners.[213] Allowing disclosure under seal would prevent these stakeholders from understanding the motivations of a committee that could play an important role in the restructuring of the company. In addition, Northwest was a large, well-known airline serving nearly 250 cities and 50 million passengers annually, and thus what happened to the company was a matter of general public interest.[214]

IV. THE SOLUTION: A PROPOSED AMENDMENT TO RULE 2019

This Part proposes that Congress should amend Rule 2019 to strike a better balance between requiring adequate disclosures in bankruptcy proceedings and maintaining hedge fund investment in distressed claims. First, this Part argues that while there is a need for greater consistency in Rule 2019 litigation, judges should also have some discretion to evaluate committees based on the circumstances presented in a given case. This can be accomplished through a combination of outcome-determinative rules and standards.[215] This Part will use the "rules versus standards" approach in constructing a change to Rule 2019, which will be presented in three parts: the factors that should be considered when determining

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[213] Bloomberg Motion to Intervene, *supra* note 90, at 1-2.

[214] *Id.*

[215] *See* Jack F. Williams, *Distrust: The Rhetoric and Reality of Means-Testing*, 7 AM. BANKR. INST. L. REV. 105, 119 (1999) (discussing the "rules" versus "standards" approaches as limits on judicial discretion).

whether or not the Rule applies, the information that must be disclosed under the Rule, and the sanctions that should be imposed for noncompliance.

A. *A Delicate Balance: The Need for Consistency and the Need for Discretion*

There is a general need for "consistency and certainty" in bankruptcy litigation.[216] The *Northwest* and *Scopac* decisions were clearly divergent and thus created uncertainty about the future of Rule 2019 litigation. Both courts had to decide whether or not the Rule should apply to the respective ad hoc committees based on factors that they considered important. This divergence is partly attributable to the fact that the current Rule does not contemplate the nature of committees today and partly because it does not adequately address the various factors that should be considered in determining who should disclose. In crafting a rule that achieves consistency, it is necessary to allow judges some discretion. Bankruptcy reorganization practices are constantly evolving; the recent emergence of hedge funds as active participants in these proceedings is an example of this. As new controversial issues emerge, Rule 2019 must allow bankruptcy judges to exercise discretion to give them the flexibility necessary to effectively adapt to new circumstances.

This Note advocates an approach that both promotes consistency and allows judges to react to developments in the financial markets through a careful application of the "rules versus standards approach." Rules and standards are two techniques that are often used to channel judicial discretion.[217] The proposed solution to the Rule 2019 conflict employs a combination of rules and standards for judges to follow when deciding cases.

A *rule* mandates or guides conduct or action in a given type of situation.[218] Rules are outcome determinative and require the decision-maker to categorize or classify issues.[219]

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[216] John W. Myers II, *Bankruptcy*—Associates Commercial Corp. v. Rash: *The Valuation Controversy Is Over—Almost*, 28 U. MEM. L. REV. 1025, 1039 (1998) (stating that the Supreme Court accepted a case "because of the need for consistency and certainty in the bankruptcy process").

[217] Williams, *supra* note 215, at 119 ("Rules and standards are tools for channeling the discretion of a decision-maker.").

[218] BLACK'S LAW DICTIONARY 1331 (6th ed. 1990).

[219] Williams, *supra* note 215, at 119.

They "promote consistency, predictability, and judicial restraint in decision making."[220] They effectively provide future litigants with notice of how an issue is to be decided.[221] However, rules do not allow the decision-maker to adapt the law to special circumstances that may arise.[222] They simply require application of the law to a set of facts to produce a result.

On the other hand, *standards* are indeterminate and require the decision-maker to weigh competing interests.[223] They are more flexible than rules and allow a judge more discretion in deciding an issue.[224] Allowing more discretion, though, increases the risk of error due to bias or incompetence.[225] While rules and standards each have advantages and limitations, one or the other may be preferable in setting up a statutory scheme, depending on the purpose of the legislative action and the degree of decision-maker discretion that is desirable.

In the context of Rule 2019 litigation, the best approach would use a combination of rules and standards to promote consistency but still allow judges to weigh different factors on a case-by-case basis. With respect to disclosure, the current Rule 2019 takes a purely rule-based approach without the use of any standards. The single question is whether or not Rule 2019 applies, but there are no guidelines to help a court answer this question. This is likely because when the Rule was enacted, it applied to protective committees, which were the only type of committee that existed at the time.[226] Currently, there are so many participants in bankruptcy cases that committees come in many shapes and sizes. In response, judges who believe that a committee should not have to disclose all the information required under the Rule simply conclude that the committee is not covered under Rule 2019.[227] How they arrive at this

220 *Id.* at 120.

221 *Id.*

222 *Id.* at 121 ("A rule is perceived as the death of thought.").

223 *Id.* at 119.

224 *Id.* at 121.

225 *Id.*

226 *See supra* Part I.B (discussing the Douglas Report). Protective committees solicited deposit agreements from individual creditors and controlled their claims during a reorganization. *Id.* Because of the nature of these committees and because they were the only unofficial committees that existed at the time, there was no need for judges to decide whether or not the Rule applied.

227 For example, in *Scopac*, Judge Schmidt was concerned about the impact of disclosure on the trading markets. *See supra* note 154. He therefore concluded that the

decision, however, is left to their discretion. While the nature of bankruptcy cases requires judges to have some discretion to decide the Rule 2019 issue, there is also a need to have clear rules for certain aspects of the decision to promote fairness and prevent uncertainty. As such, the solution presented is a combination of rules and standards.

B. The Structure of the Rule

There are essentially three questions to be answered in applying the proposed rule. First, is the particular committee in question required to disclose under the rule? If the answer is no, then the inquiry ends. If the answer is yes, then the second question is: what information is that committee required to disclose? And finally, what are the consequences or sanctions for failure to disclose the required information?

Under this framework, the first question suggests a "standards" approach. Since the participants and stakeholders in bankruptcy proceedings can change at any time, the nature of committees can also change. As such, a pure rule-based approach would not be able to adapt to new scenarios or complications that may arise. However, the standard will not give judges complete discretion. Rather, it will provide several factors that the court should consider and weigh in deciding whether or not the committee is required to disclose.

The second and third questions are rule-based approaches. Once the court has decided that the committee falls under the rule and must disclose, the question of what should be disclosed is not open for interpretation or discretion by the court. The rule will provide for specific disclosures that must be made. Similarly, the sanctions that should be imposed for noncompliance are clearly stated to prevent courts from using it as an "out." As long as a committee is required to disclose, and chooses not to, the court cannot excuse it from sanctions for any reason. This is to ensure consistency and fairness in the application of the rule, and to preserve its integrity.

Noteholder Group was not a "committee" within the meaning of the Rule. *In re* Scotia Dev. LLC, No. 07-20027-C-11, 2007 WL 2726902, at *1-2 (Bankr. S.D. Tex. Apr. 18, 2007).

C. *Question 1: Is Disclosure Necessary?*

The first—and arguably most important—question is whether or not disclosure is required by a particular committee. This decision should not be left to the complete discretion of the judge. Instead, certain factors relating to the circumstances of the case and the members of the committee should be considered. The following three factors are perhaps the most important: the aggregate holdings of the committee members, whether the committee members hold both debt and equity in the debtor company, and whether the claims were acquired pre-bankruptcy or post-bankruptcy. These factors provide judges with a roadmap to guide their inquiry into whether the committee should be required to disclose.

Though the factors are independent of each other, they do not all have to line up for a court to decide a certain way. The court can use its discretion to weigh each factor depending on the circumstances of the case.[228] For example, a court can find that a committee holds 100% of a company's stock and acquired all of its claims pre-bankruptcy but still require disclosure because the committee holds significant debt in the company in addition to the stock. Similarly, a committee does not have to meet all three factors to escape disclosure under the rule. These factors merely guide the court through issues that should be considered, but allows them to weigh one or two factors more strongly when making their decision.[229] While this may lead to some inconsistency, the nature of bankruptcy litigation calls for some flexibility in the rules.[230] Without

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[228] This discretionary weighing can be analogized to the "Delaware Block Approach" that is used in the corporate context to value businesses. Under this method, the court uses three different values: values for net assets, earnings, and market price. It gives a weight to each, and then adds them together. The weight given to each element varies from case to case and is discretionary depending on the business being valued. This weighing process may be outcome determinative. *See* Piemonte v. New Boston Garden Corp., 387 N.E.2d 1145, 1148 (Mass. 1979).

[229] This weighing technique is currently used in the "Delaware Block Approach" where the court assigns a weight to each of the valuation techniques based on the case before them. *Id.* In the Rule 2019 context, the courts would decide which factors should be weighed more prominently based on the committee before them. For example, if a committee held a majority of the class of claims, this would favor non-disclosure. However, this factor may be weighed less than the other two factors if the committee purchased all their claims post-bankruptcy and owned both debt and equity in the company.

[230] The recent emergence of hedge funds as active participants in bankruptcy litigation is an example of why flexibility is required. Rule 2019 was drafted to apply primarily to protective committees, which are now a thing of the past. *See supra* Part

allowing this discretion, the rule may end up being over-inclusive or under-inclusive, and thus ineffective.[231] At the very least, this approach provides a framework for judges so that they are all considering the same types of factors in making their decisions. It also provides notice to investors, including hedge funds, of what types of inquiries will be made by the court when a Rule 2019 motion is being decided.

1. Aggregate Holdings

One of the factors that should be considered is the aggregate holdings of the committee.[232] This information would allow the court to figure out what percentage of the total holdings is held by the committee. If a committee holds a vast majority of a particular class of securities, the potential for harm to other similarly situated creditors is minimal. For example, the ad hoc committee in *Northwest* held only 27% of the outstanding stock in the debtor company, whereas in *Scopac* the ad hoc committee held 95% of the timber notes.[233] Comparing these two particular cases tends to oversimplify the inquiry because 27% versus 95% is a big difference. However, if a court had a committee that represented 60%, for example, the inquiry is not as easy.

To provide a structure for evaluating committees based on their investment in the debtor, this Note suggests the following categorization. First, if a committee represents less than 50% of the total outstanding claims or securities, the

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I.B. As such, bankruptcy rules should be drafted with an appropriate balance of achieving consistency and allowing for flexibility.

[231] Without allowing judges some discretion and a clear framework for deciding whether a particular committee should be subject to the rule, judges will either require disclosure or ignore the rule altogether, depending on what they think the outcome of the case should be. Judges would be in the best position to apply the rule effectively if there were specific factors to consider and they had the discretion to weigh each factor depending on the facts of a case.

[232] This was one of the factors discussed by the *Northwest* court in Part II.A, *supra*. This Part argues that the court was correct in considering this factor when deciding whether or not disclosure was required.

[233] *See Northwest II*, 363 B.R. 704, 708 (Bankr. S.D.N.Y. 2007); Noteholder Group Objection, *supra* note 136, at 1. This difference in holdings is significant for the following reason. In *Northwest*, 73% of the stockholders were potentially unrepresented in the bankruptcy case. *Northwest II*, 363 B.R. at 708. Allowing the ad hoc committee to proceed without disclosure could therefore harm an extremely large percentage of stockholders. However, in *Scopac*, only five percent of the note holders were not represented by the committee. Noteholder Group Objection, *supra* note 136, at 1. In that case, allowing the committee to proceed without disclosure could only potentially harm a small percentage of the note holders.

assumption is that they should be required to disclose. Such a committee's overall holdings are not a majority, and the interests of other creditors, which represent a substantial percentage of the outstanding claims, should be protected. Second, if a committee represents more than 90% of the total outstanding claims or securities, the assumption is that they are not required to disclose. Such a committee represents an overwhelming majority of that class of investments, and there is a very small percentage of other creditors who may be harmed by the committee's actions. Finally, if a committee represents between 50% and 90% of the outstanding claims or securities, the court may not make any assumptions about disclosure using this factor alone. The court should consider the aggregate holdings in light of the other factors under this part of the rule in making its decision. Aggregate holdings alone will not be sufficient to either require disclosure or avoid disclosure.

2. Debt and Equity Investments

Another factor that should be considered by the court is whether the committee members participate in more than one level of the debtor's capital structure. When committee members own both debt and equity in a company, serious conflicts of interest issues are implicated.[234] For example, if the debt and equity were purchased around the same time, this raises an issue about the motivations of the committee member and warns other stakeholders accordingly. Purchasing debt and equity concurrently suggests that the investor is solely interested in maximizing profits. The committee may make decisions that minimize or reduce its recovery for one type of investment while balancing this loss by maximizing its recovery on the other investment. This strategy will allow it to gain overall, but will potentially harm other creditors whose sole recovery depends on the first investment.[235] The general

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[234] *See supra* Part II.A where the *Northwest* court also considered this factor when making its decision. Several of the committee members admitted to owning a significant amount of debt in the company in addition to the shares. The court concluded that this created a conflict of interest, and the Rule 2019 disclosures were necessary for the other creditors in the class to make decisions.

[235] The Douglas Report discussed in Part I.B, *supra*, identified this problem, which already existed in the 1930s. Although contemporary committees are unlike protective committees of that era, Douglas identified problems that have implications today. Parties that hold both debt and equity in the same company have inherent

idea is that inherent conflicts exist when committee members have alternate interests or motivations that can affect the other members of the class.

Unlike the aggregate holdings factor, this factor is a bright-line issue and does not require a judge's discretion. The inquiry is a simple one: committee members either own both debt and equity or they do not. If they own both debt and equity, the court should favor disclosure, but if they do not own both debt and equity, the court should favor non-disclosure. As discussed previously, this factor is only one in a series that will be considered collectively. It does not operate independently in the overall question of whether disclosure is required. For instance, a committee may own both debt and equity, but own 95% of either the debt or the equity. Though the debt and equity factor on its own favors disclosure, the court should balance all the factors in making its decision.[236]

3. Pre-Bankruptcy or Post-Bankruptcy

The final factor to be considered is whether the claims were acquired pre-bankruptcy or post-bankruptcy. The goal of this factor is to uncover the motivations and intentions of the committee in the bankruptcy proceedings. For example, claims that are acquired while a company is in bankruptcy will likely be acquired at a discounted price, whereas claims that have been previously acquired may have been purchased at or around face value. A committee member who has purchased a claim for less than face value may be motivated to accept recovery that will not fully compensate someone who has purchased at face value.[237] Understanding the timeline would

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conflicts of interest, just like the bondholders who served on stockholder committees in the 1930s.

[236] For example, consider a committee that owns 95% of the outstanding stock in a debtor company and the committee members own both debt and equity. Under the first factor, the potential for harm to other similarly situated creditors is small. This factor favors non-disclosure since only 5% of the class of creditors is unrepresented. On the other hand, the second factor would favor disclosure because of the potential for conflicts of interest among the committee members. The court would weigh these two factors (along with the third factor discussed in the next part) to decide whether or not disclosure is warranted. In a case like this, the court may decide that disclosure is not warranted because although the committee members own both debt and equity, they own 95% of the outstanding stock and there is little potential for harm to other parties.

[237] *See supra* Part I.B. This factor was also derived from the results of the Douglas Report. As discussed in Part I.B, Douglas was concerned about the hypothetical case where some committee members had acquired their interests at low prices, and others had acquired it at par value. The pre-versus-post bankruptcy purchase will identify whether this conflict may exist and factor it into the decision.

expose the motivations of committee members and allow other creditors who may be harmed to protect themselves. This is another bright-line factor. If the claims were acquired before the case was filed, it would favor non-disclosure. However, if the claims were acquired during the bankruptcy case, it would favor disclosure.

4. Summary of Factors

These three factors all seek to divulge different categories of information that will play a role in the court's ultimate decision: position, conflicts, and motivations. The aggregate holdings of the committee indicate the overall percentage of the class that it represents, and therefore its position among the other creditors. The debt and equity investments implicate potential conflicts of interest based on investments in more than one tier of the debtor's capital structure. Finally, the pre-bankruptcy versus post-bankruptcy issue exposes the motivations of the committee or committee members. If taken together, these three factors should provide the court with sufficient information to help it decide whether disclosure is warranted.[238] As stated previously, the court should exercise its discretion in weighing these factors to reach its decision. If the court decides that a committee should not be subject to the disclosure rules, the inquiry ends. If the court decides that disclosure is warranted, it moves to the second part of the analysis.

D. Question 2: What Information Is Required?

The second part of the analysis is a rule-based approach. If the court decides that disclosure is warranted for a particular committee, this section applies and the committee members must disclose *all* the information required under the rule. The court does not have the discretion to tailor the requirements on a case-by-case basis. Thus, if a court decides

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Though the dynamics of bankruptcy cases are different today, the main concern that Douglas had was that ulterior motives, conflicts of interest and self-serving actions would cause committees to take advantage of others. This concern is still valid today and should be considered by the court.

[238] Under the appropriate circumstances, the court may consider other factors, not mentioned here, that are unique to a particular case. If this occurs, the court should try to classify the additional factors into one of the three categories: position, conflicts, or motivations.

that disclosure is required, its discretion ends, and the Rule controls. A committee that is required to disclose should not be excused from disclosure regardless of any special circumstances. This is necessary for several reasons. First, Rule 2019 is the only provision in the Bankruptcy Code that courts can use to regulate ad hoc committees.[239] It is important that the Rule be followed in its entirety to promote fairness, equality, and integrity. Second, it will provide adequate notice to committees that all information listed under this part of the Rule is required, and they should be prepared to provide it if necessary.

In presenting the information that should be required under the proposed rule, this Part evaluates the information that is currently required under Rule 2019 and concludes whether or not it should remain in the rule. The first three requirements listed below have been generally undisputed by parties involved in bankruptcy litigation. The last four requirements, however, have been the subject of much controversy and debate. As will be explained in greater detail below, this Note advocates that all information currently required under the Rule should remain the same, except for the price at which the claim was acquired. Under the proposed approach, the *price acquired* would be removed from the current Rule 2019 disclosure requirements.

1. Names and Addresses of Creditors

The names and addresses of the creditor or equity security holder should continue to be required under the rule. This information informs everyone who the parties of interest are and their contact information. In the past, this information has been voluntarily provided by committees participating in bankruptcy cases and thus should not be an issue in future litigation.

2. Nature and Amount of Each Claim

Under the current Rule, the nature and amount of the claim must be disclosed, as well as the time of acquisition, unless the claim was acquired more than one year prior to the filing of the bankruptcy petition. Again, this part of the Rule

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[239] *See supra* Part I.B (discussing how Rule 2019 fits into the Bankruptcy Code's overall disclosure scheme).

has not been controversial or challenged by committees involved in bankruptcy cases. Thus, it should remain in the rule since it serves a valid purpose of informing the debtor and other parties about the nature of the claims that are represented in the case.

3. Information About the Committee

The third requirement involves disclosure of the facts and circumstances related to the formation of the committee, including the names of all parties that arranged formation. This requirement has also been generally complied with in bankruptcy cases. It should remain a part of the Rule since it has been uncontested by committees in the past and provides all interested parties with the important basic information of who organized the committee and whom the committee represents.

4. Amount of Claims Owned by Committee Members

Disclosure of the amount of claims owned by committee members has been met with resistance from ad hoc committees. The current Rule requires each individual committee member to disclose the amount of claims they own. Members of ad hoc committees prefer to, and often voluntarily, disclose the aggregate amount of claims owned by the committee. However, despite the opposition, this requirement should remain a part of the Rule. While disclosure of the aggregate amount is helpful, disclosure on an individual basis is essential so that everyone knows who is involved and what his stake is in the bankruptcy case.

5. The Dates Claims Were Acquired by Committee Members

The date that the claims were acquired by the individual committee members is the second most contested piece of information that is currently required under the Rule. Hedge funds in particular have argued that this information is confidential and proprietary. They are very reluctant to make this information public because of a fear that it will result in loss of leverage and that it will reveal their trading models or strategies.[240]

This information should remain a part of the disclosure requirements for the following reasons. First, the dates that claims were acquired are not trade secrets or proprietary information that exposes business strategies or policies. Although hedge funds are secretive and seek to keep their trading information private, this information is not of such a nature that it will impact their business going forward. Hedge funds are primarily concerned about others being able to replicate their trading strategies.[241] However, the dates on which they acquire their claims will not likely shed any light to outsiders about their strategy for investing. Second, this information is helpful in bankruptcy cases so that other parties can determine the motivations of the committee members and identify any potential conflicts of interest. Particularly when a committee member owns both debt and equity, the dates that these purchases were made could expose potential conflicts.[242] When the committee member's interest in keeping the information private is balanced against the importance of the information in bankruptcy, the disclosure interest trumps the privacy interest. Therefore, the dates that the claims were acquired should remain a part of the Rule.

6. The Price Paid for the Claims by Committee Members

The price paid by committee members for the claims and interests they hold is undoubtedly the most controversial disclosure requirement under Rule 2019. Hedge funds have repeatedly objected to this requirement for the same reasons they do not want to disclose the dates they acquired the claims. In fact, the price and date combined is what they refer to as confidential trading information. For example, in *Northwest*, the committee specifically requested that this information be

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[240] *See supra* Part II.A.2. The ad hoc committee in *Northwest* argued that even if they were required to disclose this information, they should be allowed to file it under seal because it constituted trade secrets under § 107(b).

[241] *See supra* Part I.A.

[242] As noted in Part IV.C.2, *supra*, if debt and equity were purchased around the same dates, there may be an inherent conflict of interest that other stakeholders should be aware of.

filed under seal because they claimed it constituted trade secrets.[243]

Though this Note rejects that argument, it advocates that the price paid should not be a disclosure requirement under a revised Rule 2019. This is the only piece of required information that should be removed from the current Rule. In arriving at this conclusion, this Note balances the hedge fund's interest in keeping the information private against the need for disclosure in bankruptcy. Presumably, the main reason that hedge funds do not want to disclose the price paid for their holdings is a loss of leverage in future trades. Since the original purchase price would be public knowledge under the current Rule, any potential purchasers would recognize the profit that hedge funds stand to gain as a result of the transaction. Hedge funds are most secretive when it comes to this pricing information, and requiring them to disclose it publicly in order to participate in bankruptcy proceedings will have a detrimental effect on liquidity in the distressed claims market.

On the other hand, this Note also considers the importance of the purchase price in bankruptcy cases. The one benefit of disclosure is that the price may reveal ulterior motivations of hedge funds. For example, if they acquired their claims at a very low purchase price, they may be content with a lower recovery than others who purchased at face value. However, this information can also be easily discerned based on the purchase date. If the claim was acquired just before or during bankruptcy, it was likely purchased at a discount.

More importantly, the purchase price of a claim is not relevant in determining recovery or participation in bankruptcy cases. Courts have consistently held that the price paid for a claim does not have any bearing on recovery.[244] A

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[243] *See supra* Part II.A.

[244] The Seventh Circuit has held:

> The debtor's obligation is to pay his debts . . . . In the absence of some equitable reason, taking the case out of the ordinary rule, the prices which security holders pay for their securities in no wise affects the measure of their participation in reorganization or their voting power . . . . *To reduce the participation to the amount paid for securities, in the absence of exceptional circumstances which are not present here, would reduce the value of such bonds to those who have them and want to sell them. This would result in unearned, undeserved profit for the debtor, destroy or impair the sales value of securities by abolishing the profit motive, which inspires purchasers.*

In re Lorraine Castle Apartments Bldg. Corp., 149 F.2d 55, 57-58 (7th Cir. 1945) (emphasis added). The Ninth Circuit has also held:

successful reorganization is not contingent on this information, and thus the market need to keep this information private outweighs the bankruptcy need to disclose it.

This Note aims to strike a balance in revising the current Rule 2019. The goal is to ensure that the information required in bankruptcy proceedings is disclosed without discouraging future hedge fund investment in distressed securities. The purchase price of the claim presents a critical opportunity to apply this idea. The purchase price is not something that is absolutely necessary in bankruptcy. On the other hand, it is probably a "deal-breaker" when it comes to hedge fund participation, since hedge funds guard this information more closely than anything else. If forced to disclose the purchase price, it is highly probable that they will no longer invest in distressed claims, and the liquidity in the market would decrease significantly.[245] Therefore, this Note proposes that the purchase price no longer be required under the Rule. Moreover, the purchase price is likely to be used aggressively by the debtor to discourage hedge fund participation in bankruptcy proceedings. Since it is well known by all parties that hedge funds are extremely reluctant to provide the purchase price, debtors may bring Rule 2019 motions requiring disclosure as a weapon to force hedge funds out of the bankruptcy case altogether.

7. Any Subsequent Sales of Claims

Under the current Rule, any subsequent sale of claims by individual committee members must also be disclosed. This information is essential to bankruptcy cases and should remain in the Rule. One of the concerns in bankruptcy is whether other creditors may be harmed by actions of the committee. If

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> Analysis shows the application of such a principle would be grossly inequitable to the holder of the secured debt. It would destroy or impair its sales value. *Buyers purchase bonds or other secured indebtedness primarily from the profit motive* . . . .He expects to realize out of the purchase more than the purchase price, at the same time running the risk of recovering less. Under the proposed equity, buyer, confined to the maximum of his purchase price, buys nothing but the chance to "break even" or make a loss.

Security-First Nat'l Bank of L.A. v. Rindge Land & Navigation Co., 85 F.2d 557, 563 (9th Cir. 1936) (emphasis added).

[245] For a discussion of the arguments made by the LSTA and SIFMA that disclosure will negatively affect the claims trading markets, see *supra* note 126 and Part II.B.2, *supra*.

committee members were allowed to sell their claims without disclosing the sale, creditors depending on that committee to represent their interests would potentially be harmed. Because there is no countervailing reason to keep this information private, it should remain a part of the Rule.

E. Questions 3: What Are the Sanctions for Noncompliance?

The sanctions under this section should follow a strict rule-based approach as well. The sanctions are a key part of Rule 2019 because they serve as a deterrent to parties who are considering withholding information that they have been ordered to disclose. The Rule should be clear—if a party deliberately ignores a court's order to disclose, it will not be permitted to participate in the bankruptcy proceedings. The judge must impose this sanction unless noncompliance was in error or accidental. While this may seem harsh, it puts all parties on notice of the consequences. If judges had more discretion, parties may opt not to disclose and then hope to convince the judge to impose a lesser sanction. However, this would defeat the Rule's purpose and defeat the purpose of having sanctions that seek to deter noncompliance.

CONCLUSION

Rule 2019 is an important disclosure rule that had essentially been overlooked until the *Northwest* and *Scopac* decisions in 2007. The divergence between those decisions raised the question of whether Rule 2019 should be applied to ad hoc committees comprised primarily of hedge funds and other private equity firms.

Although Rule 2019 on its face applies to ad hoc committees, the legislative history indicates that its primary purpose was to address abuses by protective committees in 1930s.[246] Protective committees, however, are now a thing of the past. The committees that exist today, like ad hoc committees, are organized by creditors who seek to collectively participate in bankruptcy cases to share costs and increase their leverage.[247] The Rule has not been changed in seventy years and does not contemplate the types of committees or investors that exist today. Furthermore, if required to comply with the

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[246] *See supra* Part I.B.

[247] *See supra* Part I.A.

Rule, hedge funds and similar investors will likely stop trading in distressed claims and securities, which could decrease the liquidity in the market.

While liquidity is an important consideration, this Note also recognizes the importance of transparency to bankruptcy proceedings, which the Rule seeks to preserve through its disclosure requirements.[248] This creates a tension between liquidity and transparency—while disclosure implicates a liquidity problem, non-disclosure implicates a transparency problem.[249] Therefore, this Note concludes that Rule 2019 should be amended to address the current dynamics of Chapter 11 bankruptcy proceedings.[250]

Finally, this Note presents a revised Rule 2019, which attempts to balance these competing interests.[251] The goal in crafting this revision is twofold. First, it provides a framework for courts to use in determining whether or not a particular committee was required to disclose. Second, it changes the disclosure requirements to only require information that is essential to bankruptcy and removes unnecessary disclosures that discourage hedge fund investment in distressed securities.

Although this Note mainly addressed the issue of whether Rule 2019 should apply to ad hoc committees comprised of hedge funds, the proposed rule can be applied to any ad hoc committee, regardless of whether it is made up of hedge funds. This Note thus exposes a larger problem with Rule 2019 and its inadequacy given the nature of bankruptcy cases today. This may be a lesson that other bankruptcy rules and procedures also need to be evaluated given the changing dynamics of Chapter 11 cases.

Sparkle L. Alexander[†]

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[248] *See supra* Part III.

[249] *See supra* Part III.

[250] *See supra* Part IV.

[251] *See supra* Part IV.

[†] J.D. Candidate, Brooklyn Law School, 2010; M.B.A., Hofstra University, 2003; B.S., Saint Francis College, 2002. First and foremost, I give thanks to my Lord and Savior Jesus Christ, who makes all things in my life possible. I would especially like to thank my husband, Andres Alexander, and my parents, Deo and Shafina Sooknanan, for their unwavering love and support. I would also like to thank Michael and Geeta Edwards, June Hutchinson, and all my family and friends for their prayers, support, and encouragement throughout law school. Last but certainly not least, I would like to thank Shannon M. Sneed for introducing me to this topic, Professor Edward Janger for his advice and guidance, and the editors and staff at the *Brooklyn Law Review* for their assistance with this Note.