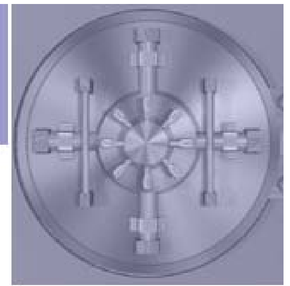

Hedge Funds in Bankruptcy Court: Rule 2019 and the Disclosure of Sensitive Claim Information

Written by:
Eric B. Fisher
Morgenstern Jacobs & Blue, LLC
efisher@mjbllc.com

Peter D. Morgenstern
Morgenstern Jacobs & Blue, LLC
pmorgenstern@mjbllc.com

Confidentiality matters in regards to hedge funds. As increasing numbers of funds compete for investment opportunities, it becomes even more critical for fund managers to keep their holdings and investment strategies close to the vest. Hedge funds that focus on distressed investments have become more active participants in bankruptcy proceedings, but remain loath to disclose sensitive information about the precise nature of their holdings. Thus, one of the side-effects of hedge fund involvement in bankruptcy proceedings has been that Bankruptcy Rule 2019 — a seemingly ministerial rule, mandating certain basic disclosure in specified circumstances — has become a source of hotly-contested litigation.[1]

Bankruptcy Rule 2019

According to Bankruptcy Rule 2019(a), except with respect to official committees, “every entity or committee representing more than one creditor or equity

[1] *See* **Fisher, Eric B**. and Buck, Andrew L., “Hedge Funds and the Changing Face of Corporate Bankruptcy Practice,” ABI Journal, Vol. XXV, No. 10 (December/January 2007) (highlighting novel disclosure issues raised by hedge fund participation in bankruptcy proceedings).

security-holder…shall file a verified statement setting forth" certain information about the creditors or equity security-holders and their claims. The information required by the rule includes "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."[2]

Bankruptcy Rule 2019 has its origins in §§210 and 211 of the Bankruptcy Act, which were combined into chapter X, Rule 10-211 – a predecessor rule that is nearly identical to the current rule. The predecessor rule resulted from an investigation of the bankruptcy process begun by SEC Chairman William O. Douglas, in 1934.[3] That investigation focused on the role of "protective committees" in equity receiverships and reorganizations. Protective committees were committees dominated by company insiders, purporting to act on behalf of the interests of groups of smaller investors. The SEC's investigation culminated in a formal report issued in 1937 that documented the abusive practices of these protective committees, and included recommended legislation to ensure that committees would live up to the fiduciary duties owed to smaller investors.[4] The disclosure requirements that ultimately found their way into Bankruptcy Rule 2019 may be traced directly to Congress' adoption of the 1937 report's recommendations.[5]

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[2] Bankruptcy Rule 2019(a)(4).

[3] *See* "William O. Douglas and the Growing Power of the SEC," (www.sechistorical.org/museum/galleries/douglas/protectivecommittee.php.)

[4] *See* Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937). Relevant excerpts from the report may be found at www.sechistorical.org/collection/papers/1930/1937_0510_SEC_003.pdf.

[5] *See* **Tabb, Charles Jordan**, "The History of the Bankruptcy Laws in the United States," 3 Am. Bankr. Inst. L. Rev. 5, 30 (1995).

The *Scotia Pacific* Decision

A recent decision in the *Scotia Pacific* bankruptcy proceedings in the Southern District of Texas demonstrates Rule 2019's newfound significance. In the *Scotia Pacific* case, the debtor sought to use Rule 2019's disclosure requirements as a sword against a group of noteholders, which included prominent hedge funds Angelo, Gordon & Co., Davidson Kempner and D.E. Shaw, among many others. According to the debtor, in order to vindicate the "rights of innocent investors who are being shut out of the process by their secretive and conflicted representatives," the debtor sought to compel full compliance by the noteholder group with Rule 2019. Specifically, the debtor asked that the court require each of the funds to disclose their precise holdings in the debtor, and the price at which each fund acquired those holdings.

The motion attracted industry attention, prompting two important trade associations — the Securities Industry and Financial Markets Association (SIFMA) and the Loan Syndications and Trading Association (LSTA) — to file a joint *amicus* brief in support of non-disclosure by the noteholder group. In their *amicus* brief, SIFMA and LSTA argued that requiring extensive disclosure under Rule 2019 from the noteholder group would "(a) prevent involvement by sophisticated parties that have frequently made positive contributions and offered valuable input in reorganizations, and (b) negatively impact the markets that create liquidity in a debtor's securities by hampering the ability of parties to manage their exposures."[6] The *amicus* brief further argued that it was the

[6] Brief of *Amici Curiae* SIFMA and LSTA in Support of Noteholder Group's Objection to Scotia Pacific Company LLC's Motion for Order Compelling Ad Hoc Committee to Fully Comply with Rule 2019(a) by Filing Complete and Proper Verified Statement Disclosing Its Membership and Their Interests dated April 9, 2007 at p.2 (*In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Texas)).

"customary practice" in bankruptcy cases for stakeholders to maintain their "proprietary trading information in strict confidence," and that, notwithstanding the language of Rule 2019(a), the "consideration paid for a claim or interest is irrelevant to the treatment of the claim or interest in bankruptcy."[7] As a matter of sound policy, the *amici curiae* asserted that requiring extensive disclosure would discourage collective action by forcing stakeholders to choose between organizing efficiently into *ad hoc* groups on the one hand, and revealing highly sensitive information on the other.[8]

While the noteholder group also addressed some of the same policy arguments advanced in the *amicus* brief, its opposition papers relied chiefly on a very careful parsing of the language of the rule. The noteholder group argued simply that it was not a "committee" and that it did not "represent...more than one creditor," thus it was not subject to Rule 2019's disclosure requirements.[9] According to the noteholder group, because it had no authority to act on behalf of other noteholders that were not members of the group and never claimed to have such authority, the rule and the policy rationale behind it did not apply to the noteholder group. Even though the Noteholder group had referred to itself as an *ad hoc* committee up until the debtor's motion, the group urged the court not to read too much into that self-description, emphasizing the informality (*e.g.*, no by-laws or other procedural rules) and nonrepresentative nature of its organization.[10]

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[7] *Id.* at 4.

[8] *Id.* at 6.

[9] Noteholder Group's Objection to Scotia Pacific Company LLC's Motion for Order Compelling Ad Hoc Committee to Fully Comply with Rule 2019(a) by Filing Complete and Proper Verified Statement Disclosing Its Membership and Their Interests, dated April 6, 2007, at ¶1 (*In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Texas)).

[10] *Id.* at ¶¶11, 14.

Indeed, according to the noteholder group, decisions made by the group regarding the bankruptcy proceedings are not even binding on other group members, nor do the group members share information about their respective holdings with one another.[11] The noteholder group disclaimed any fiduciary duties to noteholders that were not members of the group, thereby distinguishing the noteholder group from the protective committees of old, which had spurred enactment of the disclosure requirements now found in Rule 2019.

In a bare-bones order that does not discuss the court's reasoning, the bankruptcy court sided with the noteholder group. The court concluded that the noteholder group was not a "committee" within the meaning of Bankruptcy Rule 2019, and thus was not required to comply with Rule 2019. Thus, the noteholder group was permitted to continue to participate actively in the proceedings without the need for any further disclosure about its members' holdings.

The *Northwest Airlines* Decision

Litigation of the Rule 2019 issue in the *Scotia Pacific* bankruptcy occurred against the backdrop of a recent decision that reached the opposite conclusion in the *Northwest Airlines* bankruptcy in the Southern District of New York. In a Feb. 26, 2007, decision, Bankruptcy Judge **Allan L. Gropper** required an *ad hoc* committee of equity security-holders to supplement its Rule 2019 disclosure by providing information about

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[11] *Id.* at ¶15.

"the amount 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."[12]

Like the noteholder group in *Scotia Pacific*, the *ad hoc* equity committee in the *Northwest Airlines* case argued that it was not a "committee representing more than one creditor or equity security-holder" within the meaning of Rule 2019 because no member of the committee represented any party other than itself. It was only counsel to the committee that represented more than one party.[13] Concluding that the Rule "cannot be so blithely avoided,"[14] the bankruptcy court highlighted the origins of the rule in the 1937 SEC Report, which "centered on perceived abuses by unofficial committees in equity receiverships and other corporate reorganizations."[15] The court noted that the *ad hoc* committee had filed a notice of appearance describing itself as a "committee," and that counsel was "retained by the committee and is compensated by the committee on the basis of work performed for the committee (and not each individual member)."[16] In summary, the bankruptcy court stated: "The Code contemplates that there will be unofficial committees. Any such unofficial committee must comply with Rule 2019 by its terms."[17]

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[12] *In re Northwest Airlines Corp.*, 05-17930 (ALG), 2007 Bankr. LEXIS 557, at *1 (Bankr. S.D.N.Y. Feb. 26, 2007).

[13] *Id.* at *5.

[14] *Id.* at *6.

[15] *Id.* at *9.

[16] *Id.* at *6.

[17] *Id.* at *10.

In a subsequent decision on March 9, 2007, the bankruptcy court denied the committee's request to file its supplemental Rule 2019 statement under seal.[18] The court reiterated that, "[b]y acting as a group, the members of this shareholders' committee subordinated to the requirements of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the debtors' securities."[19]

Conclusion

As debtors and activist creditor groups continue to do battle in bankruptcy court and rival creditor groups face off against one another, courts will undoubtedly be confronted with a proliferation of Rule 2019 motion practice similar to that seen in the *Northwest Airlines* and *Scotia Pacific* cases. Developments in this area of the law will influence the manner in which creditor groups choose to organize themselves, beginning superficially with many more *ad hoc* committees referring to themselves as "groups." Ultimately, the jurisprudential challenge for courts will lie in striking the right balance between the competing interests of confidentiality and disclosure. While there must be sufficient disclosure required to prevent *ad hoc* committees from abusing the bankruptcy system, courts must continue to protect legitimate confidentiality concerns, in order to ensure that *ad hoc* committee participation in the bankruptcy process is not chilled.

[18] Memorandum of Opinion and Order dated Mar. 9, 2007 (*In re Northwest Airlines Corp*., Case No. 05-17930 (ALG)).
[19] *Id.* at 6-7. Both the Feb. 26, 2007, and March 9, 2007, decisions are currently the subject of an appeal to the district court.