

CONFIDENTIALITY IN CHAPTER 11*

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Chapter 11 provides companies with powerful legal tools to restructure their business operations and debts. Upon commencement of a chapter 11 bankruptcy case, a debtor is entitled to the automatic stay pursuant to § 362(a) of the U.S. Bankruptcy Code (“Bankruptcy Code”).¹ Creditor enforcement actions are immediately halted, and creditors typically must await the end of the bankruptcy proceeding to receive consideration on account of their prebankruptcy claims. Further, the debtor is given the ability to impair the state law contract rights of creditors under a plan of reorganization. Secured creditor payment schedules may be stretched out or their interest rates altered, and unsecured creditors may be required to accept less than the face amount of their claims in the form of either cash, notes, or stock of the reorganized debtor.² In addition, the debtor may reject prebankruptcy executory contracts and leases and relegate the resulting damages to unsecured claims in the bankruptcy proceeding.³

However, the sweeping power of a chapter 11 debtor to alter its creditors’ state law contract rights comes at a certain price. Most importantly, it is likely that the shareholders of the debtor will receive nothing under the debtor’s chapter 11 reorganization plan. Instead, the reorganized company likely will be owned by its pre-bankruptcy creditors or some entity that funds the reorganization plan in exchange for the post-reorganization equity. In addition, the entire bankruptcy proceeding will be conducted under the auspices of a federal bankruptcy court. Part of the tradeoff for the debtor having the unilateral power to modify the state law rights of its creditors is that such modification must occur in an open judicial forum. Bankruptcy is an “open book” process. Most key decisions, such as rejecting contracts and

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¹ 11 U.S.C. §§ 101-1330 (2000).

² *Id.* § 1129(b).

³ *Id.* § 365.

leases and selling assets, must be implemented through a filing with, and subsequent approval from, the bankruptcy court. The debtor's business plans, results of operations, and strategies will also be fully available to an official committee of creditors appointed to represent the creditors in the case. Other information about the debtor will generally be available to creditors through filings with the bankruptcy court and, therefore, available to the public at large.⁴ This open book approach to reorganization is part of the tradeoff of chapter 11. The debtor that desires to impair creditor state law rights must do so in a public forum.

Unfortunately, proceeding in such an open fashion is not always in the best interest of the reorganization for either the debtor or its creditors. In fact, companies often find themselves in chapter 11 because they are the more vulnerable players in competitive industries. With little margin for operational error and typically being fairly leveraged, a few underperforming quarters can quickly land these companies in chapter 11. Once in chapter 11, however, the debtor's reorganization may not benefit by having the results of its business operations, decisions, and strategies open to the general public. Competitors of the debtor, believing that the debtor is on the verge of collapse, may already be planning action to attempt to put the debtor permanently out of business. Having greater access to the debtor's competitive information will only make it easier for the debtor's competitors to pursue such a course of action.

For the chapter 11 reorganization to be meaningful, the major creditor constituencies of the debtor, such as its official committee of unsecured creditors and its bank group (if any), must have full access to the debtor's financial and other information. These creditors are the major stakeholders in the debtor and likely will have significant ownership and other interests in the reorganized company. They need the debtor's information to assess, among other things, its capital structure, opportunities for the restructuring of its business in chapter 11, the results of any revised operations in the bankruptcy case, and the debtor's overall prospects for reorganization under a chapter 11 plan. It is often less clear, however, why other creditors need access to the debtor's information until asked to vote on a reorganization plan. In addition, often it is not clear why the public needs access to the debtor's business information. Again, such broad access may be diametrically opposed to the

⁴ Today, most filings with a bankruptcy court are essentially publicly available because anyone with an internet browser and a password to the federal judiciary's docket system can obtain much of the information in electronic form for a very modest cost.

very purpose of the chapter 11 case—namely, the maximization of the value of the debtor’s business and its prospects for reorganization.

The proposition that a chapter 11 reorganization proceeding be an open book process, however, is heavily ingrained in bankruptcy jurisprudence. As a result, it is not likely that there will be any effort to modify the openness of such a proceeding anytime in the near future.⁵ Additionally, it is not the purpose of this Article to suggest that such an effort be made. Instead, the purpose of this Article is to explain the various confidentiality issues that arise in a chapter 11 case and to discuss how a company contemplating chapter 11 can best prepare itself to address those issues. A company that is fully informed as to how its information may become publicly available in a chapter 11 case and how it can prevent such information from being misused by competitors or others will be in a better position to maximize its prospects for a successful reorganization.

This article is divided into seven parts. Part I discusses confidentiality issues arising as a result of the existence of the Office of the United States Trustee (“OUST”). This office, which is an arm of the U.S. Justice Department, is given standing in every chapter 11 case. The mandate of OUST is to some extent self-determined and shifts from time to time. However, in a chapter 11 business case, where there is likely to be an active creditors’ committee (which is appointed by the U.S. Trustee), the office’s main function in relation to the debtor will likely be to require that certain standard business reports be filed with the bankruptcy court on a periodic basis. These reports are described in Part I.

Part II discusses confidentiality issues relevant to the public company chapter 11 debtor. Particular emphasis is placed on how a public company debtor can satisfy both its reporting requirements under the Bankruptcy Code and its obligation not to selectively disclose material non-public information under Regulation FD of the Securities Act of 1934.⁶

Part III discusses the main option available to chapter 11 debtors to avoid the public disclosure of sensitive information—filings with the bankruptcy court “under seal.” Among other things, Part III discusses the circumstances

⁵ In fact, as described in Part V, a recent amendment to the Bankruptcy Code, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), has reinforced the right of creditors to obtain information in a bankruptcy case by placing an affirmative duty on an official creditors’ committee to provide such creditors access to information in the case.

⁶ Regulation FD, 17 C.F.R. §§ 243.100-.103 (2005).

under which a debtor is entitled to make a filing under seal (so only the bankruptcy court, and likely the creditors committee and U.S. Trustee, actually see the filing).

Part IV discusses special discovery rules that exist in a chapter 11 case, and, in particular, Bankruptcy Rule 2004,⁷ which gives a party broad power to obtain discovery from a chapter 11 debtor beyond the powers typically available in civil litigation. Both the contours of Rule 2004 and the ability of a debtor to resist or limit Rule 2004 discovery are described.

Part V discusses a debtor's interactions with its official creditors' committee appointed by the U.S. Trustee. As noted above, typically the creditors' committee will be entitled to almost all information relevant to the debtor. However, the prospective debtor will need to understand how it can prevent members of a creditors' committee from potentially misusing its sensitive business information. This issue is discussed in detail.

Part VI discusses the attorney-client privilege issue in chapter 11. Upon a bankruptcy filing, the operation of the privilege becomes more complex. In addition, the bankruptcy process itself requires disclosure of certain information that arguably is privileged. These issues are explored, along with methods to avoid the disclosure of privileged information in the bankruptcy case.

Finally, Part VII discusses which business decisions a debtor must submit for approval to the bankruptcy court and which business decisions are "in the ordinary course of business," and, as such, can be implemented without court approval. The ability to implement certain business decisions without court approval allows the debtor to avoid disclosing those decisions publicly through a filing with the bankruptcy court.

I. CONFIDENTIALITY ISSUES ARISING FROM THE EXISTENCE OF THE OFFICE OF THE UNITED STATES TRUSTEE

OUST is a central feature of the bankruptcy system that Congress created in 1978 as part of a complete overhaul of the bankruptcy laws, which resulted in the enactment of the current U.S. Bankruptcy Code. The Office was created by statute⁸ in 1978 as part of the U.S. Department of Justice with the express

⁷ FED. R. BANKR. P. 2004.

⁸ 28 U.S.C. §§ 581-589(a) (2000).

purpose of overseeing the administration of bankruptcy cases. Pursuant to § 307 of the Bankruptcy Code, the U.S. Trustee “may raise and may appear and be heard on any issue in any case or proceeding” under the Bankruptcy Code, although the U.S. Trustee may not file a plan of reorganization in chapter 11.⁹ In addition, pursuant to Bankruptcy Rule 9034, the U.S. Trustee is entitled to receive most of the key filings in a bankruptcy case, and it is common practice in chapter 11 cases to serve the U.S. Trustee with all pleadings in the case.¹⁰

While the U.S. Trustee often takes an active role in bankruptcy cases for natural persons under chapters 7 and 13, its role typically becomes more limited in a chapter 11 business case. At the beginning of the case, the U.S. Trustee appoints one or more official committees of unsecured creditors.¹¹ The committee is entitled to retain legal counsel and other professionals to represent them during the chapter 11 case at the expense of the debtor’s estate. As such, the debtor’s creditors will have both a committee and professionals to safeguard their interests, and the need for the U.S. Trustee to do so will be less pronounced. Therefore, in a typical chapter 11 business case, the U.S. Trustee likely will focus on its other mandates, including ensuring the integrity of the professionals who are paid from the bankruptcy estate during the case and the overall integrity of the bankruptcy process.

The U.S. Trustee does have an additional key role in the chapter 11 case. Part of the open book legacy of the bankruptcy laws is the requirement that a debtor (i) produce a variety of financial information during the case filed with the bankruptcy court, and (ii) submit itself to an “examination” early in the case. Pursuant to § 521(1) of the Bankruptcy Code, a debtor is required to file with the bankruptcy court, among other things, “a schedule of assets and liabilities” and “a statement of the debtor’s financial affairs.”¹² Pursuant to 28 U.S.C. §§ 586(a)(3)(D) and 586(a)(3)(G), the U.S. Trustee is given the

⁹ 11 U.S.C. § 307 (2000).

¹⁰ Further, pursuant to BAPCPA, which is applicable to cases filed after October 17, 2005, “[t]he United States Trustee . . . shall have full access to all information contained in any paper filed or submitted” in a chapter 11 proceeding. The operative impact of this amendment is unclear, but it arguably could mean parties have a statutory obligation to serve all pleadings on the U.S. Trustee. 11 U.S.C.S. § 107(e)(3)(A) (2005).

¹¹ 11 U.S.C. § 1102(a)(1) (as “soon as practicable” after the bankruptcy filing, the “United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.”).

¹² *Id.* § 521(1). BAPCPA changed this section to 11 U.S.C.S. § 521(a)(1) (2005).

authority to ensure that such filings are made on a timely basis and in the proper form.¹³

The “schedule of assets and liabilities” that a debtor must file early in a chapter 11 case essentially is a detailed, non-GAAP balance sheet. For public company debtors whose balance sheet information is publicly available, the filing is somewhat of an anachronism. The filing does, however, require more than aggregate asset and liability information. The filing requires that the debtor list its assets and liabilities individually.¹⁴ For instance, each executory contract and unexpired lease of the debtor must be listed with the name of the contract counterparty and a brief statement of the type of contract or lease. While seemingly innocuous (although burdensome) to a debtor, this list of contracts may provide the marketplace with a glimpse of competitive information about the debtor. Again, the contracts and leases need only be listed; their terms need not be disclosed.¹⁵ Nonetheless, the fact that the debtor has contracts with certain vendors or customers may be valuable information to a debtor’s competitors.

The liability portion of the “schedule of assets and liabilities” also may provide the marketplace with competitive information about the debtor. For instance, each creditor of the debtor must be listed with the amount owed each creditor as of the date of the bankruptcy filing.¹⁶ Again, this listing can provide competitors with key information regarding the debtor’s customers and vendors. Literally construed, the filing also would require the debtor to list the amount owed to each of its employees as of the bankruptcy filing, even if such amounts were subsequently paid soon after the filing (as is typical in any large chapter 11 proceeding). This information could provide the debtor’s competitors, as well as the debtor’s own employees, with sensitive and personal wage and salary information. Nonetheless, a chapter 11 debtor typically will list only the aggregate amount owed to its employees as of the bankruptcy filing, with perhaps only amounts owing to executives listed individually.

The “statement of financial affairs” that the debtor must file along with its schedule of assets and liabilities provides additional information as to the

¹³ Bankruptcy Rule 1007(c) of the Federal Rules of Bankruptcy Procedure requires such filings be made within fifteen days of the debtor’s bankruptcy filing, although it is typical for a debtor to obtain an extension of such time for at least thirty to forty-five days in a large chapter 11 business case. FED. R. BANKR. P. 1007(c).

¹⁴ See 11 U.S.C. § 521(1). BAPCPA changed this section to 11 U.S.C.S. § 521(a)(1)(B) (2005).

¹⁵ See FED. R. BANKR. P. 1007(a)-(b).

¹⁶ *Id.*

debtor. For instance, this filing requires disclosure of all payments made by the debtor within ninety days of the bankruptcy filing to non-insider creditors and all payments made by the debtor within one year of the bankruptcy case to “insiders.”¹⁷ Again, this can be valuable information to a debtor’s competitors. Also, if literally applied to employees, the filing would provide sensitive wage and salary payment information with respect to the debtor’s employees, although, again, such information is almost never disclosed as to individual employees except executives.

The authors have not been involved in any situation where a debtor has attempted to file its “schedules of assets and liabilities” and its “statement of financial affairs” under seal in order to avoid the disclosure of arguably competitive information, although the issue arises frequently when debtors are planning the filing of such reports.¹⁸ In addition, essentially no case law discusses when and under what circumstances filing these documents under seal may be appropriate.¹⁹ Nonetheless, it is likely that attempting to make such filings under seal likely would meet resistance from OUST. One reason is that the United States Trustee typically uses such reports as a centerpiece for conducting what is known as a § 341 examination of the debtor.

Section 341(a) of the Bankruptcy Code provides “within a reasonable time” after the bankruptcy filing, “the United States trustee shall convene and preside at a meeting of creditors.”²⁰ Bankruptcy Rule 2003(a) provides in a chapter 11 reorganization, the meeting should be no less than twenty days, and no more than sixty days, after the date of the bankruptcy filing (depending on the location of the meeting), although the meeting can be first held and then adjourned and continued to a later time under Bankruptcy Rule 2003(e).²¹ At the meeting the “debtor shall appear and submit to examination under oath at the meeting of creditors under § 341(a) of this title.”²² Like some of the filings required under § 521(1) of the Bankruptcy Code, the section 341 meeting is

¹⁷ See Statement of Financial Affairs, Official Bankruptcy Form 7 (10/05), available at http://www.uscourts.gov/rules/Revised_Rules_and_Forms/BK_Form_B7.pdf (for cases filed after Oct. 17, 2005); Statement of Financial Affairs, Official Bankruptcy Form 7 (12/03), available at <http://www.uscourts.gov/bkforms/official/b7.pdf> (for cases filed before Oct. 17, 2005).

¹⁸ See *infra* Part III discussing making filings with a bankruptcy court under seal.

¹⁹ But see *In re MorAmerica Fin. Corp.*, 158 B.R. 135, 137 (Bankr. N.D. Iowa 1993) (rejecting a debtor’s request to file portions of its statement of financial affairs under seal, however noting “[c]ertainly the information [was] commercial matter, and under some circumstances the court could understand a debtor’s motivation for keeping the information out of the hands of competitors”).

²⁰ 11 U.S.C. § 341(a) (2000).

²¹ FED. R. BANKR. P. 2003(a), (e).

²² 11 U.S.C. § 343.

somewhat of an anachronism, especially for public company chapter 11 debtors. Nonetheless, it is required in essentially every chapter 11 case²³ and essentially constitutes an open “deposition” of the debtor by any creditor who wishes to attend.

While most § 341 meetings are sparsely attended and most of the questions come from the Trustee, and not the debtor’s creditors, a creditor has the ability to ask the debtor questions while the debtor’s representative is under oath. Therefore, it is important for the debtor to prepare adequately for the § 341 meeting and determine a course of action that permits the debtor to comply with the requirements of § 341 while preserving confidential information where appropriate. In particular, the debtor should have an understanding with OUST prior to the meeting that the debtor will not be required to answer inappropriate questions, such as questions from creditors who are competitors and who may be using the meeting simply to discover competitive information about the debtor.

The final confidentiality issue that arises regarding OUST results from its standing in the bankruptcy case. As mentioned, OUST will typically receive all filings in a bankruptcy case. As discussed in Part III, a debtor may make certain types of filings under seal to preserve the confidentiality of the information contained in the filing. However, it is likely that the sealed filing will be given to OUST, the debtor’s creditor committee(s), and certain other central parties in the case to ensure the most important creditor interests can respond to the request made in the debtor’s filing, if necessary. In those situations, the bankruptcy court may enter an order requiring that the parties who received the sealed documents maintain that information on a confidential basis. Since OUST is a governmental agency, however, it is not clear that such a bankruptcy court order will supercede the requirements placed on OUST by the federal Freedom of Information Act (“FOIA”).²⁴

Assuming the bankruptcy court order does not supercede FOIA, that statute requires federal agencies to make their records promptly available to any

²³ Pursuant to BAPCPA, however, the bankruptcy court may, upon request, decide a § 341 meeting need not be held if the debtor has filed a plan as to which the debtor solicited acceptances prior to the commencement of the case. 11 U.S.C.S. § 341(e) (2005).

²⁴ 5 U.S.C. § 552 (2000). BAPCPA perhaps clarifies this issue. The amendment, which adds § 107(c) to the Bankruptcy Code, provides in § 107(c)(3)(B), “the United States trustee . . . shall not disclose information specifically protected by the court under this title.” 11 U.S.C.S. § 107(c)(3)(B) (2005). This amendment could be interpreted to provide that bankruptcy court orders to seal filings supercede the provisions of FOIA.

person who makes a proper request.²⁵ FOIA defines “agency” to include “any executive department . . . or other establishment in the executive branch of the Government . . . or any independent regulatory agency.”²⁶ Since the Attorney General appoints the Trustee, it would appear OUST falls within the scope of FOIA. As a result, a chapter 11 debtor bears the risk that confidential information transmitted to OUST could be obtained by a third party making a FOIA request to that office. Once the Trustee properly receives a FOIA request, it has twenty business days to make a determination on the request.²⁷ Although the Trustee is not required to release the information within twenty days, access to the information should be granted promptly thereafter.²⁸

Part of the Trustee’s determination after receiving a FOIA request is whether the information sought in the request falls within any of the nine categories of information exempted from the disclosure requirements.²⁹ The key exemption for a chapter 11 debtor is that a government agency is not required to turn over “trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential.”³⁰

This exemption protects the interests of both the government and the parties who submit information. It encourages parties to voluntarily furnish useful commercial or financial information to the government and it correspondingly provides the government assurance that the information will be reliable. The exemption also affords protection to those parties who are required to furnish commercial or financial information to the government by safeguarding them from the competitive disadvantages that could result from disclosure.³¹ As a result, a chapter 11 debtor generally should feel confident that privileged or confidential commercial or financial information transmitted to OUST will not be disclosed as a result of a FOIA request.

²⁵ 5 U.S.C. § 552(a)(3)(A).

²⁶ *Id.* § 552(f)(1).

²⁷ *Id.* § 552(a)(6)(A)(i).

²⁸ *Id.* § 552(a)(6)(C)(i).

²⁹ *Id.* § 552(b)(1)-(9). The nine categories of information exempted from FOIA are: (1) information relating to national security, (2) information relating to internal agency rules, (3) information exempted by other statutes, (4) trade secrets and confidential or privileged commercial or financial information, (5) internal government memorandums, (6) private matters including medical files, (7) law enforcement investigations, (8) information relating to regulation of financial institutions, and (9) geological and geophysical information concerning oil well locations. *Id.*

³⁰ *Id.* § 552(b)(4).

³¹ OFFICE OF INFO. & PRIVACY STAFF, U.S. DEP’T OF JUSTICE, FREEDOM OF INFORMATION ACT GUIDE, May 2004: EXEMPTION 4 (2004), <http://www.usdoj.gov/oip/exemption4.htm> (last visited Nov. 19, 2005).

Of course, not all information transmitted to the Trustee by a debtor will be protected by this exemption. Most information will be considered “commercial or financial,” since courts have generally held that if information relates to business or trade, it is “commercial or financial” for purposes of FOIA.³² For information to be considered “privileged or confidential,” however, it must be “of a kind that would customarily not be released to the public by the person from whom it was obtained.”³³ As a result, where a debtor is transmitting sensitive information to OUST, it may be prudent to have some understanding with that office prior to such transmission. In particular, in some cases it may be prudent to request that the Trustee confirm it believes the information would be protected under an exemption from FOIA if the office ever received a FOIA request to disclose the information.

II. CONFIDENTIALITY ISSUES FOR PUBLIC COMPANIES, INCLUDING REGULATION FD

For public company debtors, the open book nature of bankruptcy, which involves, among other things, publicly filing pleadings with the bankruptcy court, appearing at court hearings, and interacting with creditors and creditors’ committees, can raise securities disclosure concerns. In particular, the public company debtor will need to be cognizant of potential conflicts between the disclosure requirements of a bankruptcy proceeding and the company’s obligations under Regulation FD (for “fair disclosure”) promulgated under the Securities Exchange Act of 1934.³⁴

Regulation FD became effective in October of 2000 in response to issuers disclosing nonpublic material information to securities analysts or selected institutional investors before disclosing the same information to the general public.³⁵ Selective disclosures reduced investor confidence in the fairness and

³² See, e.g., *Judicial Watch, Inc. v. U.S. Dep’t of Justice*, 306 F. Supp. 2d 58, 67–69 (D.D.C. 2004) (finding business information given by Enron to the federal government, including business plans and assessments of foreign power projects and governments, subject to the FOIA exemption); *Merit Energy Co. v. U.S. Dep’t of the Interior*, 180 F. Supp. 2d 1184, 1188 (D. Colo. 2001) (finding information regarding oil and gas leases, prices, quantities, and reserves subject to the FOIA exemption); *M/A-Com Info. Sys. Inc. v. U.S. Dep’t of Health & Human Servs.*, 656 F. Supp. 691, 692 (D.D.C. 1986) (finding settlement negotiation documents reflecting accounting and other internal procedures subject to the FOIA exemption).

³³ *Critical Mass Energy Project v. Nuclear Regulatory Commission*, 975 F.2d 871, 879 (D.C. Cir. 1992).

³⁴ 17 C.F.R. §§ 243.100-.103 (2005).

³⁵ *Selective Disclosure & Insider Trading*, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Release No. 24, 599, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) (the “Release”).

integrity of the capital markets.³⁶ In addition, when recipients of selective disclosures, or those who they advised, traded on such information, the practice of selective disclosure adversely affected market integrity in a manner similar to insider trading or tipping.³⁷

Regulation FD was promulgated to address these problems and requires that whenever

- (1) an issuer, or person acting on its behalf,
- (2) discloses material nonpublic information,
- (3) to certain enumerated persons (in general, securities market professionals or holders of the issuer's securities who may trade on the basis of the information),
- (4) the issuer must make public disclosure of that same information:
 - (a) simultaneously (for intentional disclosures), or
 - (b) promptly (for non-intentional disclosures).³⁸

Regulation FD is intended to cover only those recipients of nonpublic material information who would reasonably be expected to trade securities on the basis of selective disclosures or provide others with advice about securities trading.³⁹ Regulation FD does not interfere with communications within the ordinary course of business, such as communications to suppliers, customers, strategic partners, government regulators, rating agencies, and the press.⁴⁰

The receipt of nonpublic material information will not trigger Regulation FD if one of four exceptions applies. First, Regulation FD does not apply when a selective disclosure is made "to a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant)."⁴¹ Second, "a person who expressly agrees to maintain the disclosed information in confidence" is not covered by Regulation FD.⁴² According to the Release, an "express" confidentiality agreement need not be

³⁶ *Id.*

³⁷ *Id.* at 51,716-17.

³⁸ 17 C.F.R. § 243.100(a).

³⁹ As a result, Regulation FD generally is triggered when nonpublic material statements are made to (1) broker-dealers and associated persons, (2) investment advisors and associated persons, (3) institutional investment managers and associated persons, (4) investment companies and affiliated persons, and (5) any "holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information." *Id.* § 243.100(b)(1).

⁴⁰ Selective Disclosure & Insider Trading, 65 Fed. Reg. at 51,719.

⁴¹ 17 C.F.R. § 243.100(b)(2)(i).

⁴² *Id.* § 243.100(b)(2)(ii).

in writing and need not be obtained before making the disclosure.⁴³ Moreover, Regulation FD does not require an express confidentiality agreement contain an additional statement that the recipient agrees not to trade on the basis of the information.⁴⁴ In this regard, an acknowledgement that the recipient of material, nonpublic information will not use the information in violation of the federal securities laws does not constitute an express confidentiality agreement under Regulation FD. Rather, what is required is that the recipient expressly agree to keep the information confidential.⁴⁵ The third exception covers disclosures made to an “entity whose primary business is the issuance of credit rating, provided the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available.”⁴⁶ The fourth exception covers disclosures made in connection with securities offerings registered under the Securities Act.⁴⁷

The information disclosed by the issuer will only trigger Regulation FD if the information is both nonpublic and material.⁴⁸ Nonpublic information is information that “has not been disseminated in a manner making it available to investors generally.”⁴⁹ Information is material if (i) “there is a substantial likelihood that a reasonable shareholder would consider [the information] important” when making an investment decision, and (ii) the information “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁵⁰

Regulation FD provides two options for disseminating information to the public. The public disclosure of information may be made by filing a Form 8-K with the SEC, or by disclosing the information by any other method, or combination of methods, “that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”⁵¹ Methods “reasonably designed to provide broad, non-exclusionary distribution of the information to the public” might include “press releases distributed through a

⁴³ Selective Disclosure & Insider Trading, 65 Fed. Reg. at 51,720.

⁴⁴ *Id.*

⁴⁵ DIV. OF CORP. FIN., U.S. SEC. & EXCH. COMM’N, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS (Supp. 2001), available at <http://www.sec.gov/interps/telephone/phonesupplement4.htm>. [hereinafter TELEPHONE INTERPRETATIONS].

⁴⁶ 17 C.F.R. § 243.100(b)(2)(iii).

⁴⁷ *Id.* § 243.100(b)(2)(iv).

⁴⁸ Selective Disclosure & Insider Trading, 65 Fed. Reg. at 51,721.

⁴⁹ *Id.*

⁵⁰ *Id.* (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

⁵¹ 17 C.F.R. § 243.101(e)(1)-(2).

widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission.”⁵² The reasonableness of the disclosure may depend on whether the disclosure was made using the same method the issuer has historically used to disclose material information to the public.⁵³

A public company chapter 11 debtor may be required to disclose material, nonpublic information in a variety of circumstances. As a result, the debtor should attempt to ensure that such disclosure does not violate any obligations under Regulation FD. First, the debtor may on a regular basis during the bankruptcy case provide such information to its creditors’ committees so that the committees can properly monitor and assess the progress of the debtor’s restructuring initiatives. As such, it will be important for the debtor to ensure that the committees fall within the exception to Regulation FD for persons who “expressly agree to maintain the disclosed information in confidence.”⁵⁴ The preferred approach for the debtor will be to have express, written confidentiality agreements covering all future confidential information given by the debtor to the committees at the beginning of the case. Alternatively, a committee might simply agree to a confidentiality arrangement with respect to specific material, nonpublic information at the time it is provided by the debtor to the committee.

Court filings by the debtor and statements made in court by a debtor raise more difficult issues under Regulation FD. As noted earlier in this Article, a debtor is required by OUST to make periodic financial filings with the bankruptcy court.⁵⁵ These filings include “Monthly Operating Reports,” which provide a variety of balance sheet information regarding the debtor. Since these filings are made on a monthly basis, they provide financial information between the quarterly filings of the debtor’s Form 10-Q statements. In addition, for a variety of reasons, a debtor may be required to disclose important information in other court filings or in statements made to the bankruptcy court during court hearings. These statements could include, for instance, information relating to the overall financial health of the debtor’s business or recent trends in its operations, financial performance, restructuring efforts, or cash position.

⁵² Selective Disclosure & Insider Trading, 65 Fed. Reg. at 51,724.

⁵³ *Id.*

⁵⁴ 17 C.F.R. § 243.100(b)(2)(ii).

⁵⁵ See generally discussion *supra* Part I.

In assessing whether Regulation FD is implicated by any of these statements or filings, the public company debtor will need to assess whether the information provided is material and non-public, and whether providing the information in open court or in filings with the bankruptcy court constitutes “selective” disclosure that could violate Regulation FD. In addition, the debtor will need to determine whether any of the recipients of the information are persons who would reasonably be expected to trade securities on the basis of selective disclosure or provide others with advice about securities trading.

Even if the relevant information is material and nonpublic, the debtor may take the position that disclosing such information in a court filing or through statements made during a court hearing does not violate Regulation FD for two reasons. First, disclosing the information in such a manner has elements of public disclosure of the information. As noted earlier, in many jurisdictions, court filings are publicly available through the federal judiciary’s website for the jurisdiction at a modest cost, and often these documents become available simultaneously when filed with the court. In addition, even where such access is not available, unless the documents are filed under seal, such pleadings are accessible by the public through the clerk of the bankruptcy court or even by requesting copies from the debtor. Furthermore, statements made in court by a debtor are recorded and a transcript of the court proceeding can be ordered by any party. In fact, in many jurisdictions, these transcripts are routinely placed on the court docket, which often can be obtained via the internet from the federal judiciary’s website.

There is no specific guidance as to whether information provided in a court filing or at a bankruptcy court hearing constitutes public disclosure of such information for purposes of Regulation FD. Certain guidance provided by the SEC under Regulation FD currently provides that disclosing information on a company’s website is not, by itself, a sufficient method of public disclosure on the basis that investors may have limited access to the internet.⁵⁶ Similarly, simply having the press in attendance at a company meeting that the public is not invited to or otherwise present at, might not, by itself, satisfy the requirements of public disclosure. Whether the requirements are satisfied depends on “when, what and how widely the press reports on the meeting.”⁵⁷ As such, depending on the circumstances, disclosing material, nonpublic

⁵⁶ Selective Disclosure & Insider Trading, 65 Fed. Reg. at 51,724. In the future, however, disclosures on the company’s website may be sufficient. *Id.*

⁵⁷ TELEPHONE INTERPRETATIONS, *supra* note 45.

information in a court filing might not constitute public disclosure for purposes of Regulation FD even though the filing may be accessible via the internet or otherwise available from the bankruptcy court. In addition, since the public generally does not attend bankruptcy court hearings even though it has the right to, disclosure of information in such a court hearing may not constitute public disclosure.

The second reason a company might assert that disclosing material, nonpublic information in a court filing or in open court does not implicate Regulation FD is that the information is not being transmitted to persons who would reasonably be expected to trade securities on the basis of selective disclosure or provide others with advice about securities trading. Instead, the information is transmitted to the bankruptcy court and to other recipients of the relevant pleadings or other attendees at the court hearing. Recipients of pleadings and attendees at a court hearing include, for instance, the debtor's creditors' committees, who ideally will have executed confidentiality agreements with the debtor so that receipt by the committees of information will fall within the confidentiality exception to Regulation FD described above. However, recipients of pleadings and attendees at court hearings are not limited to the committees. Often, the debtor will serve pleadings on a long list of parties in interest who have requested copies, and the list could include parties who are monitoring the case for purposes of buying or selling the company's securities or advising others about securities trading. In addition, while not necessarily common, interested investors sometimes attend court hearings either in person or telephonically. As a result, it is difficult for the debtor to know whether the persons who receive information from the company through a court filing or statements made in court include the types of recipients of the information covered by Regulation FD.

Thus, the most conservative course of action by the debtor simply may be to avoid the public disclosure of material, nonpublic information in any court filing or statement made in court unless (i) the filing is made under seal (and provided only to those parties who have executed confidentiality agreements) or (ii) the court hearing is held *in camera*. Alternatively, if open disclosure of material, nonpublic information cannot be avoided, in certain cases the debtor may need to be ready to make an 8-K filing and possibly a press release contemporaneously with the disclosure.

III. FILINGS WITH THE BANKRUPTCY COURT UNDER SEAL

Once in chapter 11, a debtor will need bankruptcy court approval for many key actions in the chapter 11 case, such as rejecting contracts, selling assets, entering into settlements with creditors or other parties, retaining professionals, and a myriad of other activities if they are outside of the ordinary course of the debtor's business.⁵⁸ To obtain court approval, the debtor will need to make a filing with the bankruptcy court explaining the justification for the action, thereby making its business decision public.⁵⁹ Sometimes, however, the nature of its actions are sufficiently confidential from a competitive standpoint that the debtor will want to avoid its application to the bankruptcy court from becoming public. The typical manner to effectuate this result is to make the filing "under seal" under § 107(b) of the Bankruptcy Code.⁶⁰ This section overviews how the language of § 107(b) has been interpreted and applied.

The open and public nature of judicial proceedings is heavily ingrained in the American judicial system.⁶¹ This long-standing policy reflects a belief that judicial proceedings should be fully open to the public so that the workings of the judicial system are at all times capable of being monitored by a democratic society.⁶² In fact, the preference for public access is founded upon the First Amendment right to be informed about the administration of justice and has been called "fundamental to a democratic state."⁶³ Through § 107(a) of the Bankruptcy Code, Congress codified the public's right to access filings in bankruptcy proceedings and the presumption in favor of public access to court records. Section 107(a) states that all papers filed in a bankruptcy case "are public records and open to examination by an entity at reasonable times without charge."⁶⁴

Such an open book judicial policy, without limitation, could reveal information that an entity, for strategic or other purposes, has a reasonable

⁵⁸ See, e.g., 11 U.S.C. § 327 (2000) (retention of professionals); *id.* § 363 (use, sale, or lease of property); *id.* § 365 (rejecting executory contracts); FED. R. BANKR. P. 9019 (settlements).

⁵⁹ See, e.g., 11 U.S.C. § 327 (retention of professionals); *id.* § 363 (use, sale, or lease of property); *id.* § 365 (rejecting executory contracts); FED. R. BANKR. P. 9019 (settlements).

⁶⁰ 11 U.S.C. § 107(b).

⁶¹ See *Nixon v. Warner Commc'ns, Inc.*, 435 U.S. 589, 597 (1978).

⁶² *Id.* at 597-98.

⁶³ *In re Inslaw, Inc.*, 51 B.R. 298, 299 (Bankr. D.C. 1985) (citations omitted) (noting such right is "analogous to the First Amendment right to freedom of speech and of the press and to the Sixth Amendment guarantee of public trials").

⁶⁴ 11 U.S.C. § 107(a).

expectation of maintaining confidential. Thus, notwithstanding the strong general presumption favoring public access to court records, “[i]t is uncontested . . . that the right to inspect and copy judicial records is not absolute.”⁶⁵ Section 107(b)(1) of the Bankruptcy Code codifies this exception to public access to court documents for purposes of bankruptcy proceedings. The policy behind this section is “Congress’ anticipation that the administration of bankruptcy cases might, by their very nature, require special intervention to protect some kinds of information from dissemination to the world.”⁶⁶ Section 107(b) provides that “On request of a party in interest, the bankruptcy court shall, and on the bankruptcy court’s own motion, the bankruptcy court may – (1) protect an entity with respect to a trade secret or confidential research, development, or commercial information.”⁶⁷

Congress left it to the courts to define the key terms used in § 107(b)(1), although the meaning of these terms has been litigated in surprisingly few reported cases. While there does not appear to be any case law or secondary authority that speaks directly to the issue, it can be inferred from case law that the term “confidential” modifies each of the terms “research, development, and commercial information.”⁶⁸ Moreover, unlike the discovery requirements for Rule 26 of the Federal Rules of Civil Procedure, confidential information does not need to be the equivalent of a trade secret to qualify for protection of § 107(b)(1).⁶⁹ The plain language of the Bankruptcy Code states that protection is afforded for trade secrets *or* confidential information.⁷⁰

The phrase “commercial information” has been interpreted somewhat diversely by the courts. For instance, the Ninth Circuit Bankruptcy Appellate Panel has defined commercial information as information that would bestow “an unfair advantage to competitors by providing them information as to the commercial operations of the debtor.”⁷¹ In general, however, courts have

⁶⁵ *Nixon*, 435 U.S. at 598.

⁶⁶ *In re 50-Off Stores, Inc.*, 213 B.R. 646, 654 (Bankr. W.D. Tex. 1997).

⁶⁷ 11 U.S.C. § 107(b). Bankruptcy Rule 9018 provides procedures for the application of § 107(b). Interestingly, the language of Bankruptcy Rule 9018(1) protects *all* types and forms of confidential material, filed or not. See *In re Handy Andy Home Improvement Ctrs., Inc.*, 199 B.R. 376, 381 (Bankr. N.D. Ill. 1996).

⁶⁸ See, e.g., *Video Software Dealers Ass’n v. Orion Pictures Corp.* (*In re Orion Pictures Corp.*), 21 F.3d 24, 27–28 (2d Cir. 1994) (requiring an interested party to show that the information which it desired to be sealed was both “confidential” and “commercial” in nature).

⁶⁹ *Id.* at 28.

⁷⁰ *Id.* (noting the “clear and unambiguous usage of ‘or’ [in § 107] neither equate[d] ‘trade secret’ with ‘commercial information’ nor require[d] the latter to reflect the same level of confidentiality as the former”).

⁷¹ *Ad Hoc Protective Comm. for 10-1/2% Debenture Holders v. Intel Corp.* (*In re Intel Corp.*), 17 B.R. 942, 944 (B.A.P. 9th Cir. 1982).

applied § 107(b)(1) in situations where “open inspection may be used as a vehicle for improper purposes.”⁷² Thus, pursuant to § 107(b)(1), courts have maintained the confidentiality of, among other things, a licensing agreement where disclosure would cause “an unfair advantage to competitors by providing them information as to the commercial operation of the debtor,”⁷³ a hearing involving matters related to the Committee of Foreign Investment in the United States,⁷⁴ customer lists,⁷⁵ marketing strategies,⁷⁶ and portions of a proposed plan of reorganization.⁷⁷ Further, in determining whether an agreement can be filed under seal, a court often will review whether the parties to the contract believed that the agreement was confidential.⁷⁸

If the protection pursuant to § 107(b)(1) is requested by a party in interest, courts differ on the standard to be applied for overcoming the presumption of the public’s right of access under § 107(a).⁷⁹ According to some courts, if the information contained in the document falls within the scope of any of the specified categories in the statute, the court *must* apply the protections of the Bankruptcy Code.⁸⁰ The mandatory application is required by the language of § 107(b)(1) itself, which states, “[o]n the request of a party in interest, the bankruptcy court *shall* . . .”⁸¹ These courts have ruled that the mandatory plain language of the Bankruptcy Code negates the need for “compelling reasons, balancing of interests or ‘good cause’” to justify sealing the information.⁸²

⁷² *In re Orion Pictures Corp.*, 21 F.3d at 27.

⁷³ *Id.* (citation omitted).

⁷⁴ *In re Global Crossing Ltd.*, 295 B.R. 720, 725 (Bankr. S.D.N.Y. 2003) (finding the hearing should be sealed due to national security reasons and to the commercial damage that was likely to result to the debtor and its creditors if the hearing was released).

⁷⁵ *In re Nunn*, 49 B.R. 963, 965 (Bankr. E.D. Va. 1985) (discussing why a customer list may be “commercial information” requiring § 107(b)(1) protection).

⁷⁶ *In re Farmland Indus., Inc.*, 290 B.R. 364, 368 (Bankr. W.D. Mo. 2003) (“‘[C]onfidential commercial information’ may include short and long term marketing strategies.”).

⁷⁷ *In re Lomas Fin. Corp.*, No. 90-7827, Bankr. L. Rep. (CCH) ¶ 73,823 (S.D.N.Y. Feb. 11, 1991) (approving the sealing of four sentences of a plan of reorganization where such sentences might, among other things, have a chilling effect on the debtor’s negotiations).

⁷⁸ *In re Muma Servs., Inc.*, 279 B.R. 478, 485 (Bankr. D. Del. 2002) (noting “there is no basis to keep the information [in a certain lease] confidential in the absence of a written confidentiality provision,” in the agreement, although even the existence of such a provision “would not be determinative”).

⁷⁹ Mark D. Bloom et al., *Reorganizing in a Fish Bowl: Public Access vs. Protecting Confidential Information*, 73 AM. BANKR. L.J. 775, 782 (1999).

⁸⁰ *See, e.g.*, *Video Software Dealers Ass’n v. Orion Pictures Corp.* (*In re Orion Pictures Corp.*), 21 F.3d 24, 27 (2d Cir. 1994).

⁸¹ 11 U.S.C. § 107 (2000) (emphasis added).

⁸² *See Bloom, supra* note 79, at 782. These courts reason when Congress added § 107(b)(1) it did not impose a good cause requirement despite the fact the section appears to have been drawn from Rule 26(c) of

In the alternative, other courts have held even if the information appears to fall within the protections of § 107(b)(1), the court need not unquestionably seal the document. Instead, these courts assess all of the facts and circumstances of each case, conduct a balancing of the parties' interests based upon those facts, and then decide whether the document should be sealed.⁸³ Courts that have required a balancing test have held that to justify sealing a document they must "specifically find that the interest of secrecy outweighs the presumption in favor of access."⁸⁴ For example, in *In re Nunn*,⁸⁵ the court asserted that the decision whether to seal fell within the discretion of the bankruptcy court and sealing was a proper remedy only when it was shown to be the least restrictive alternative.⁸⁶

In any case, a debtor seeking to make a filing under seal often will suggest procedures with respect to the sealing of the documents, rather than the simple relief that the document be sealed. For instance, the debtor may propose that any recipient of the information (such as a creditors' committee) must maintain its confidentiality and that any hearing which might involve the information not be open to the public. As a result, determining the applicability of § 107(b)(1) often is a two step process which requires the court to (i) determine whether the information at issue falls within the purview of the seal protections of the Bankruptcy Code, and (ii) decide the appropriate degree of protections warranted, if any.⁸⁷

Although there is a strong presumption of open access to court documents and, therefore, a correspondingly heavy burden for the proponent of a motion to seal, in practice, large chapter 11 debtors typically have little trouble obtaining court approval to seal documents. In large part, this is because it is common practice to give copies of the relevant documents to the Trustee, the debtor's creditors' committee, and its bank group, if any, which typically are the key parties in interest. As a result, often there is no party with a sufficient interest in the matter to object to the sealing of the document. If an objection is made to the motion to file under seal, however, the debtor will have to show a need for confidentiality.

the Federal Rules of Civil Procedure, which requires "good cause" be established before a protective order in discovery can be granted. See, e.g., *In re Orion Pictures Corp.*, 21 F.3d at 28.

⁸³ See *In re Epic Assocs.*, 54 B.R. 445, 450 (Bankr. E.D. Va. 1985).

⁸⁴ *In re Gen. Homes Corp.*, 181 B.R. 898, 903 (Bankr. S.D. Tex. 1995).

⁸⁵ *In re Nunn*, 49 B.R. 963, 964 (Bankr. E.D. Va. 1985).

⁸⁶ *Id.*

⁸⁷ *Id.*

In addition, once the debtor makes the filing under seal, it may not be possible to “undo” this action, even if, upon a challenge to its seal motion, the debtor decides either not to pursue the underlying matter for which the sealed document is filed or simply not to use the sealed document in support of the matter. This point recently was made evident by proceedings in the District Court for the District of Delaware in *Copley Press, Inc. v. Peregrine Systems, Inc. (In re Peregrine Systems, Inc.)*.⁸⁸ In that case, an audit committee of the debtors’ board of directors commissioned an internal accounting investigation and retained a law firm, which produced a 250 page report concerning accounting irregularities (the “Audit Report”) prior to the bankruptcy.⁸⁹ As a result of the investigation, the debtors restated earnings for fiscal years 2000, 2001, and 2002.⁹⁰ In response, the SEC launched an investigation, and a copy of the Audit Report was given to the SEC.⁹¹ The debtors subsequently filed for chapter 11.⁹²

After the filing, the debtors and their creditors’ committee agreed that certain materials provided by the debtors to the committee would be treated as confidential, and the debtors provided confidential documents, including the Audit Report, to the committee.⁹³ Further, the bankruptcy court entered an order (the “Sealing Order”) authorizing the committee “to file under seal confidential documents that it obtained from [the debtors] pursuant to a confidentiality agreement.”⁹⁴ Subsequently, the committee filed a motion under seal for the appointment of a chapter 11 trustee and included the Audit Report as a sealed exhibit in support of its motion.⁹⁵ *Copley Press, Inc. (“Copley”)* then filed a motion to unseal the Audit Report.⁹⁶ The debtors stated that the Audit Report contained information that ““would be harmful to potentially innocent third parties”” and ““confidential business information, such as the identities of Peregrine’s customers and reseller/partners, and detailed information regarding certain business transactions.””⁹⁷

⁸⁸ 311 B.R. 679 (D. Del. 2004).

⁸⁹ *Id.* at 682.

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* at 682–83.

⁹⁶ *Id.* at 683.

⁹⁷ *Id.* at 682 n.3 (citations omitted).

At the hearing upon Copley's motion, the bankruptcy court "expressed doubt that the Committee's filing of the full [Audit] Report was proper"⁹⁸ and "decided [] to strike the [Audit] Report from the record."⁹⁹

Copley appealed the bankruptcy court's order and argued that once filed, the Audit Report was potentially subject to public access and the bankruptcy court could not strike the Audit Report as a way to avoid having to decide whether it was proper to seal the report.¹⁰⁰ In response, the debtors made several arguments as to why the Audit Report should not be unsealed. First, Peregrine argued Copley's motion was moot because the motion to appoint a trustee had been withdrawn and the Audit Report was no longer in the custody of the bankruptcy court.¹⁰¹ The district court rejected these arguments and noted that

[b]ecause the public right of access, while not unfettered, did attach to the [Audit Report] when [it was filed with] the bankruptcy court . . . and the irrelevancy of the contents of the documents is not alone a basis for denying public access . . . and because the

⁹⁸ *Id.* at 683. The judge stated at the hearing

I'm not sure that the parties . . . who filed these documents had a right to file them in the first place. That's my concern. I have looked at the [Audit] Report. The [Audit] [R]eport I think has some contentions in it that really could be disruptive and very harmful to certain individuals who are not before this Court, may have no idea that this would be happening to them, have not had any notice that there might be some document that they don't even know about that's now filed and public record in a bankruptcy court. At best it seems to me that some of that report may very well be relevant to the motion to appoint a trustee or other matters that are pending. But that entire document is not relevant and should not have been filed without being redacted.

Id. (citations omitted).

⁹⁹ *Id.* In so doing, the court noted that it was

permitted to strike irrelevant, harassing and other types of evidence that cause potential problems to individuals particularly who are not before the [c]ourt. The [Audit] Report contains information that I believe falls well within my prerogative in striking the document The information with respect to the [Audit] Report, I think I'm going to handle differently. I believe it was improperly filed. I do not think at this point it's relevant to anything. If it is relevant to something it will be admitted into evidence in relevant parts on the motion to appoint the trustee. I see no reason to have that document on this Court's record at this time. It's before the SEC. If you want it, file a [Freedom of Information Act] request and deal with it there. I'm going to strike . . . the [Audit Report] because I see no basis for it

Id. at 683–84.

¹⁰⁰ *Id.* at 684.

¹⁰¹ *Id.* at 686–87.

bankruptcy court still has control over the [Audit] Report, Copley's appeal is not moot.¹⁰²

Therefore, the district court reversed and ordered the bankruptcy court to place the Audit Report back into public record, subject to the Sealing Order, and stated the party seeking the continued sealing of the Audit Report should show justification for it to remain under seal.¹⁰³

IV. CONFIDENTIALITY ISSUES ASSOCIATED WITH DISCOVERY IN CHAPTER 11

Discovery is another area where confidentiality issues arise in a bankruptcy proceeding. Often the discovery powers in a chapter 11 case are broader than in typical civil discovery, thereby creating a risk for a debtor that its confidential information could be obtained in a manner not available outside of chapter 11. In particular, Bankruptcy Rule 2004 permits, upon motion of "any party in interest," a bankruptcy court to order an "examination of any entity."¹⁰⁴ Rule 2004(b) provides the examination can relate to the "acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge."¹⁰⁵ In a proceeding under chapter 11, the inquiry may also extend to

the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration

¹⁰² *Id.* (citations omitted) (noting the bankruptcy court had indicated that the Audit Report "exists in lots of . . . places where the [Bankruptcy] Court can acquire it if need be").

¹⁰³ *Id.* at 692. The debtors subsequently appealed the district court's decision to the Third Circuit. *Copley Press Inc. v. Peregrine Sys., Inc. (In re Peregrine Sys., Inc.)*, 312 B.R. 755, 756 (D. Del. 2004). Their appeal was denied in December of 2004. *See Copley Press, Inc. v. Peregrine Sys., Inc. (In re Peregrine Sys., Inc.)*, No. 03-00815 (D. Del.), D.I. 45. While that appeal was pending, the debtors filed an expedited motion to stay the District Court's order pending appeal of that decision. *In re Peregrine Sys., Inc.*, 312 B.R. at 756. The district court held the debtor's decision to appeal deprived it of jurisdiction to enter a stay. *Id.* The court clarified, however, that its decision reversing the bankruptcy court with respect to the Audit Report was "limited to the specific context of [that] case" and in no means meant the contents of the Audit Report should be publicly available. *Id.* at 758-59. Rather, the court reiterated the Audit Report remained subject to the Sealing Order while the parties that sought to maintain the Audit Report under seal bore the burden of justifying the continued sealing of the document. *Id.* at 759.

¹⁰⁴ FED. R. BANKR. P. 2004(a).

¹⁰⁵ FED. R. BANKR. P. 2004(b).

given or offered therefor, and any other matter relevant to the case or to the formulation of a plan.¹⁰⁶

Rule 2004 is intentionally broad, and courts have referred to the scope of examinations under this rule as “unfettered” and in the nature of a “quick ‘fishing expedition.’”¹⁰⁷ The result of this broad discovery device is that discovery in bankruptcy lacks some of the procedural safeguards provided to discovery in civil proceedings by Rule 26 of the Federal Rules of Civil Procedure.¹⁰⁸

Because of the broad language used in Rule 2004, there is potential for the rule to be abused. For example, if a party in interest begins a Rule 2004 inquiry before it files a proceeding in the debtor’s case, it could obtain information otherwise unavailable under the Federal Rules of Civil Procedure and use that information against the debtor during a later proceeding between the parties. Although courts acknowledge that the Rule 2004 device could be used to circumvent the Federal Rules of Civil Procedure, many have consciously chosen to weigh creditors’ interests in maximizing a bankruptcy estate more heavily than debtors’ interests in shielding themselves from the possibility of subsequent litigation.¹⁰⁹

Similarly, courts have weighed creditors’ interest in maximizing the bankruptcy estate over third parties’ interests in shielding themselves from collateral litigation. For example, in *In re Mittco*, the court allowed a creditor to conduct a Rule 2004 examination, even though that creditor was pursuing a separate, non-bankruptcy action against the debtor’s accountant.¹¹⁰ The court stated the fact that the inquiry could lead to collateral litigation for the third-party accountant was not a sufficient reason to restrict the broad Rule 2004 examination.¹¹¹ Rule 2004 can lead to other adverse consequences in civil litigation, as well. For example, the rule could force a debtor to release

¹⁰⁶ *Id.*

¹⁰⁷ *In re Dinubilo*, 177 B.R. 932, 939 (E.D. Cal. 1993); *In re Enron Corp.*, 281 B.R. 836, 840 (Bankr. S.D.N.Y. 2002); *Moore v. Eason (In re Bazemore)*, 216 B.R. 1020, 1023 (Bankr. S.D. Ga. 1998); *In re Kreiss*, 46 B.R. 164, 165 (Bankr. E.D.N.Y. 1985); *In re GHR Cos.*, 41 B.R. 655, 660 (Bankr. D. Mass. 1984).

¹⁰⁸ *See In re Dinubilo*, 177 B.R. at 939–40 (“[I]n a Rule 2004 examination: the witness has no right to be represented by counsel . . . ; there is only a limited right to object to immaterial or improper questions; there is no general right to cross-examine witnesses; and no right to have issues defined beforehand.”).

¹⁰⁹ *In re Table Talk, Inc.*, 51 B.R. 143, 145–46 (Bankr. D. Mass. 1985) (rejecting argument that Rule 2004 discovery should be denied because of the possibility of subsequent litigation and noting the discovery could potentially aid in maximizing the estate).

¹¹⁰ *In re Mittco, Inc.*, 44 B.R. 35, 37 (E.D. Wis. 1984).

¹¹¹ *Id.* at 38.

information to creditors, even if that information might aid the IRS in proving increased tax liability for the debtor.¹¹²

Although Rule 2004 discovery has the potential to reveal damaging information which later can be used against the debtor or a third party during ensuing litigation or proceedings, courts have developed some safeguards to prevent abuses of the rule. The three most often used tools to protect debtors from potentially improper Rule 2004 requests involve (i) requiring the party seeking discovery to abide by the Federal Rules of Civil Procedure if such parties are already engaged in a lawsuit surrounding the subject of the Rule 2004 examination, (ii) granting motions to quash a subpoena issued pursuant to a Rule 2004 request, and (iii) granting protective orders that limit the scope of a Rule 2004 inquiry.

Bankruptcy courts have recognized the potential for parties to use Rule 2004 to circumvent the discovery process outlined by the Federal Rules of Civil Procedure. Although bankruptcy courts generally are not unwilling to allow the *possibility* of a lawsuit to limit the scope of a creditor's Rule 2004 examination, a line of case law suggests the balance of interests shifts once a suit has actually been filed. This line of cases holds that if a party seeks to depose another party or witness on an issue that is the subject of a pending adversary proceeding, examination cannot be conducted pursuant to Rule 2004, but must instead be conducted pursuant to the Federal Rules of Civil Procedure.¹¹³

Although this line of cases does help to prevent the most aggressive use of Rule 2004 as a device to expand the scope of discovery against a party in civil litigation, it is not a complete protection. For instance, this line of case law easily can be sidestepped by merely waiting to officially file suit until after a Rule 2004 examination is completed. Therefore, courts have devised some limited protections even before a suit is filed. Although the scope of Rule 2004 is very broad, it is not limitless, and courts have drawn some lines to prevent Rule 2004 from being used for purposes other than uncovering a debtor's assets. For instance, courts have refused to allow questioning under

¹¹² See *In re GHR Cos.*, 41 B.R. at 664 (rejecting a debtor's argument that production of certain documents to an unsecured creditor may "provide the IRS with information that would cause it to harden its settlement position, to increase or amend its claim, or aid the IRS in the pending litigation").

¹¹³ See *2435 Plainfield Ave., Inc. v. Twp. of Scotch Plains (In re 2435 Plainfield Ave., Inc.)*, 223 B.R. 440, 455-57 (Bankr. D.N.J. 1998); *Sweetland v. Szadkowski (In re Szadkowski)*, 198 B.R. 140, 142 (Bankr. D. Md. 1996) (stating it would "not allow litigants to utilize Rule 2004 as a substitute for discovery under the Federal Rules of Civil Procedure").

the guise of Rule 2004 that was not primarily intended to further the goal of maximizing the value of the estate.¹¹⁴ Additionally, judges are free to decline a motion for a Rule 2004 examination if the examination is for the purpose of abuse or harassment.¹¹⁵

Another procedural safeguard against abuses of Rule 2004 is the ability of debtors or other third-party examinees to file a motion to “quash” a subpoena and thereby avoid the Rule 2004 examination. In motions to quash, the examiner bears the initial burden of proof and must show some reasonable basis to examine the material sought to be discovered or that denial of production would cause undue hardship or injustice.¹¹⁶ This is an affirmative duty and “is not satisfied merely by a showing that justice would not be impeded by production of the requested documents.”¹¹⁷ As discussed before, however, Rule 2004 intentionally allows for “fishing expeditions,” and thus this showing usually is not difficult.

The protective order is probably the most commonly used device to protect examinees against potential abuses of Rule 2004. Through a protective order, a judge can restrict the scope of a Rule 2004 examination to those issues that are appropriately tailored to the bankruptcy proceeding, thereby protecting examinees from revealing certain confidential information.¹¹⁸ The protective order is issued under Rule 26(c) of the Federal Rules of Civil Procedure and is

¹¹⁴ See, e.g., *Keene Corp. v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 42 B.R. 362, 365 (S.D.N.Y. 1984) (holding the examination of a third party witness as to matters having no relationship to the debtor’s affairs or to the administration of the debtor’s estate was improper); *In re Bd. of Dirs. of Hopewell Int’l Ins. Ltd.*, 258 B.R. 580, 584 (Bankr. S.D.N.Y. 2001) (holding the representatives of the debtor in a foreign proceeding were not entitled to use Rule 2004 in a case ancillary to that foreign proceeding where disclosure was sought in connection with separate arbitration proceeding in which debtor was a litigant and not in connection with general efforts to determine liabilities); *Snyder v. Soc’y Bank*, 181 B.R. 40, 41–42 (Bankr. S.D. Tex. 1994) (holding an examination set only to oppress the witness or to further state court litigation should not be permitted); *In re Wilcher*, 56 B.R. 428, 434 (Bankr. N.D. Ill. 1985) (holding Rule 2004 may not be used as a device to launch into a wholesale investigation of a non-debtor’s private business affairs).

¹¹⁵ *In re Lufkin*, 255 B.R. 204, 209 (Bankr. E.D. Tenn. 2000) (noting Rule 2004 cannot be used to harass, abuse, or inquire into irrelevant issues); *In re Fearn*, 96 B.R. 135, 138 (Bankr. S.D. Ohio 1989) (noting the “examination should not be so broad as to be more disruptive and costly to the party sought to be examined than beneficial to the party seeking discovery”).

¹¹⁶ *In re Wilcher*, 56 B.R. at 434.

¹¹⁷ *Id.* at 435 (holding the examiner had not met its initial burden of proof where, among other things, the examiner failed to allege that the discovery was necessary to establish a claim or that the denial of the discovery would result in undue hardship); *In re Drexel Burnham Lambert Group*, 123 B.R. 702, 712 (Bankr. S.D.N.Y. 1991) (stating the same standard and finding there was “no doubt [that the examiner] need[ed] a large amount of discovery to buttress its claims”).

¹¹⁸ See *In re Mittco, Inc.*, 44 B.R. 35, 38 (E.D. Wis. 1984).

available only for “good cause shown.”¹¹⁹ Case law instructs judges should strive for the goal of “full disclosure of relevant information and at the same time afford the participants maximum protection” from the harmful consequences of a Rule 2004 examination.¹²⁰ Protective orders can limit the use of confidential information or restrict the scope of examinations so that confidential information is not an acceptable subject of questioning.¹²¹ Therefore, a debtor that finds itself subject to a Rule 2004 request should carefully consider whether confidential information may become a topic of questioning. If such possibility exists, the debtor should consider the availability of a protective order.

V. CONFIDENTIALITY ISSUES ASSOCIATED WITH A DEBTOR’S CREDITORS’ COMMITTEES

In a bankruptcy proceeding, various official and unofficial committees may be formed or appointed to represent the interests of different parties interested in the proceeding. A debtor engages in substantial interactions with these various committees. In particular, it is expected the debtor will share confidential information with its official committee of unsecured creditors to permit the committee to fully evaluate the debtor’s activities during the bankruptcy case and its prospects for reorganization. The debtor, of course, should be concerned that the information be used only for those purposes and not be disclosed to third parties outside of the creditors’ committee.

There is nothing in the Bankruptcy Code that states a member of a creditors’ committee must keep the information it receives from a debtor as confidential. In addition, there does not appear to be any case law squarely creating such a duty. Case law does provide, however, that the Bankruptcy Code imposes fiduciary duties on committee members to their constituencies (but not to the debtor or its estate generally).¹²² Accordingly, as several

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ See *In re Summit Corp.*, 891 F.2d 1, 5 (1st Cir. 1989) (stating the district court had properly “tailored the discovery so as to achieve a balance between the confidentiality of” the affairs of the subject of the discovery and the need for the requested information); *In re Jewelers Shipping Ass’n*, 97 B.R. 149 (Bankr. D.R.I. 1989) (upholding its decision to not allow Rule 2004 discovery of a confidential membership list); *In re Cont’l Forge Co.*, 73 B.R. 1005, 1006 (Bankr. W.D. Pa. 1987) (stating “Rule 2004 is not intended to be used as a vehicle for gathering confidential information for which no reasonable need is shown” and denying discovery of confidential documents related to the design and manufacture of a product).

¹²² See, e.g., *Westmoreland Human Opportunities, Inc. v. Walsh*, 246 F.3d 233, 256 (3d Cir. 2001) (“We have construed § 1103(c) as implying a fiduciary duty on the part of members of a creditor’s committee, such

commentators have recognized, committee members may violate the fiduciary duties owed to their constituency by disclosing the debtor's confidential information, if such disclosure would harm their constituency's interests.¹²³ In addition, courts have held a committee member's fiduciary duty can be breached if the committee member uses its position to pursue its self-interest to the detriment of the constituency at large.¹²⁴ Presumably, this would apply if a committee member sought to use the debtor's confidential information solely for its own self-interest and to the potential detriment of the debtor's unsecured creditors.

For a debtor, however, the fact that a committee member may be breaching its fiduciary duties by disclosing the debtor's confidential information may not be sufficient comfort. If the confidential information were disclosed, it is not clear that the debtor would have standing to assert the breach of fiduciary duty claim, since the duty does not run to the debtor. In addition, there could be situations where the disclosure of the debtor's confidential information by a creditors' committee would not necessarily be harmful to the creditor constituency, although the debtor still would not want the information to be publicly disclosed. As a result, it will be in the best interest of the debtor to require that the committee execute express confidentiality agreements to ensure that the debtor has the contractual right to prevent the disclosure of its confidential information. As noted earlier, the debtor may require a

as the present Unsecured Creditors Committee, toward their constituent members."); *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000) ("Section 1103(c) of the Bankruptcy Code, which grants to the Committee broad authority to formulate a plan and perform 'such other services as are in the interest of those represented,' . . . has been interpreted to imply both a fiduciary duty to committee constituents and a limited grant of immunity to committee members."); *In re ABC Auto. Prods. Corp.*, 210 B.R. 437, 441 (Bankr. E.D. Pa. 1997) ("Creditors who serve on the committee owe a fiduciary duty to the constituents whom they represent.").

¹²³ See 7 COLLIER ON BANKRUPTCY ¶1103.05[2][a] (Alan N. Resnick et al. eds., 15th ed. rev. 2005) ("Members of an official committee will routinely receive sensitive information about the debtor that is not generally known to the public. If confidential information is disseminated to persons not entitled to receive it, the debtor's operations could be potentially damaged to the detriment of the constituency represented by the committee."); Carl A. Eklund & Lynn W. Roberts, *Bankruptcy Ethics: The Problem with Creditors' Committees in Chapter 11: How to Manage the Inherent Conflicts Without Loss of Function*, 5 AM. BANKR. INST. L. REV. 129, 146 (1997) ("The information provided to the committee either from non-public sources or from analyses by the committee professionals, as well as the deliberations of the committee, must be kept in strict confidence."); see also *In re Johns-Manville Corp.*, 26 B.R. 919, 926 (Bankr. S.D.N.Y. 1983) (attorney member of committee criticized for breaching fiduciary duty where information concerning reorganization was used to foster rights of private litigant).

¹²⁴ See *In re PWS Holding Corp.*, 228 F.3d at 246; *In re Map Int'l, Inc.*, 105 B.R. 5, 6 (Bankr. E.D. Pa. 1989) ("[M]embers of a creditors' committee are obligated to act in a fiduciary capacity and may not use their positions as committee members to advance only their individual interests.").

confidentiality agreement from the committee in any case to ensure the disclosure of confidential material and nonpublic information to the committee does not violate Regulation FD.

While the specific provisions a debtor may seek in a confidentiality agreement are too numerous to discuss at length, a few are worth noting. First, it will be prudent for the debtor to make clear that confidential information includes both written and oral communication, since confidential information is often disclosed to a committee in the course of meetings between the committee and the debtor or in separate conversations among the debtor, committee members, or their respective professionals. Second, procedures should be established in case the committee ever wants to use confidential information in a court filing or as part of an argument in court. Typically, the committee would be asked to make the filing under seal or to make the argument *in camera*. Finally, the term of the confidentiality agreement must be negotiated. The debtor may take the position that the agreement should be indefinite since there is no reason for committee members ever to disclose the debtor's confidential information to third parties. However, committees usually become concerned about these types of indefinite obligations. As a result, usually the parties negotiate a period of time after disclosure of the information or after confirmation of the debtor's chapter 11 plan after which the confidentiality restrictions will lapse. As part of this negotiation, the debtor should ensure the confidentiality period expressly applies not only to existing committee members, but also to any members who resign from, or are appointed to, the committee after the delivery of the confidential information.

BAPCPA complicates the otherwise fairly straightforward approach of a debtor seeking to protect its confidential information by obtaining confidentiality agreements from its creditors' committees. The amendment, which applies to bankruptcy cases filed after October 17, 2005, provides that a creditors' committee shall:

- (A) provide access to information for creditors who - (i) hold claims of the kind represented by that committee; and (ii) are not appointed to the committee;
- (B) solicit and receive comments from the creditors described in subparagraph (A); and

- (C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).¹²⁵

As a result, creditors' committees now have certain express statutory obligations to share information with the creditors they represent.

Currently, it is not clear how this obligation will affect the ability or willingness of a creditors' committee to enter into a confidentiality agreement with a debtor. Clearly, the debtor will not want, and will not permit, its confidential information to be shared indiscriminately with its general creditor body. On the other hand, a creditors' committee may want to carve out from any confidentiality agreement its new statutory obligations under the Bankruptcy Code. Ultimately, then, the debtor may be put in a position of not disclosing confidential information to its creditors' committee until a court order is obtained confirming that the new Bankruptcy Code provision does not require the committee to disclose to general creditors confidential information obtained from the debtor, or some other mutually acceptable arrangement is put in place that is acceptable to both the debtor and the committee.

While properly drafted confidentiality agreements or other arrangements should help ensure that a debtor's confidential information is not disclosed by a committee to third parties, these agreements or arrangements will not address a separate confidentiality concern of a debtor—the appointment to the committee of a competitor to the debtor. Such a competitor does not need to disclose the debtor's confidential information to third parties to misuse the information. Instead, it can use the information for its own purposes as a competitor of the debtor. While the debtor's confidentiality agreement may state that no committee member can use confidential information except for purposes of evaluating the debtor's reorganization, as a practical matter, it may be impossible to determine whether a competitor is making decisions in its own business based on the knowledge it has obtained from confidential information of the debtor.

As noted earlier, upon the inception of a chapter 11 case, the Trustee appoints the members of a debtor's creditors' committee.¹²⁶ To solicit interest in serving on the committee, the Trustee sends solicitation forms to the

¹²⁵ See Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub. L. No. 109-8, § 405(b), 119 Stat. 105, 216 (2005) (amending § 1102(b) of the Bankruptcy Code).

¹²⁶ See 11 U.S.C. § 1102(a)(1) (2000).

debtor's largest creditors as indicated in the first day filings made by the debtor. The solicitation forms often ask any party interested in serving whether it is a competitor of the debtor. As a matter of policy, OUST generally will not appoint creditors who are also competitors of a debtor to a committee.¹²⁷ Once in a while, however, a competitor is appointed.

Such an appointment raises the issue of whether the debtor can seek judicial review of the appointment in an attempt to have the competitor removed from the committee. The majority rule is that a bankruptcy court does have the authority to review the committee appointments of the Trustee.¹²⁸ The majority rule also is that the standard for review with respect to the Trustee's appointments is "abuse of discretion."¹²⁹ In addition, BAPCA provides that a bankruptcy court may order the Trustee to change the membership of a committee if the court determines that the change is necessary to ensure adequate representation of creditors.¹³⁰ While the amendment codifies the ability of a court to review committee appointments, it will have to be seen whether courts view this amendment as limiting the ability of a court to conduct such review to situations involving questions of adequate representation. If this were the case, arguably a court could not review the appointment of a committee member simply because the member is a competitor of the debtor, unless that fact itself raised adequate representation issues.

Assuming courts will be able to review the appointment of a committee member on the grounds that it is a competitor of the debtor, the case law is sparse as to whether the fact is sufficient to disqualify the member from serving on the committee. The case law that does exist generally states the mere fact the creditor is a competitor will not itself bar its appointment to a

¹²⁷ The *United States Trustee Manual* states "[t]he fact that a creditor is a competitor of the debtor does not disqualify the creditor from membership on the creditors' committee, *but the better part of wisdom may be not to make such an appointment.*" U.S. DEP'T OF JUSTICE, UNITED STATES TRUSTEE MANUAL, ch.3-4.4.1.4 (Oct. 1998) (emphasis added), available at http://www.usdoj.gov/ust/ustp_manual/manual/vol3toc.htm.

¹²⁸ See, e.g., *Mercury Fin. Co. v. Lentz* (*In re Mercury Fin. Co.*), 240 B.R. 270, 276 (N.D. Ill. 1999) (citations omitted); *In re Fas Mart Convenience Stores, Inc.*, 265 B.R. 427, 433 (Bankr. E.D. Va. 2001); *In re Sharon Steel Corp.*, 100 B.R. 767, 772-73 (Bankr. W.D. Pa. 1989). *But see In re Dow Corning Corp.*, 212 B.R. 258, 263-64 (E.D. Mich. 1997) (holding the bankruptcy court has no authority to review decisions of the Trustee regarding committee membership, which represents the minority position).

¹²⁹ See, e.g., *In re Fas Mart Convenience Stores*, 265 B.R. at 433; *In re Columbia Gas Sys., Inc.*, 133 B.R. 174, 175 (Bankr. D. Del. 1991); *In re Doehler-Jarvis Inc.*, No. 97-953, 1997 WL 827396, at *3 (D. Del. Oct. 7, 1997).

¹³⁰ See Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub. L. No. 109-8, § 405(b), 119 Stat. 105, 216 (amending § 1102(a)(4) of the Bankruptcy Code).

creditors' committee.¹³¹ Rather, the party seeking to exclude a creditor from a committee generally bears the burden of showing the creditor's appointment will be detrimental to the debtor's reorganization efforts.¹³² As a result, a debtor should be very proactive at the beginning of the case to help ensure that no competitor is placed on its creditors' committee. If a competitor does become a member of the committee, it may be difficult to obtain a court order removing a member merely because the member is a competitor.

VI. CONFIDENTIALITY ISSUES ASSOCIATED WITH THE ATTORNEY-CLIENT PRIVILEGE IN CHAPTER 11

Another confidentiality issue that arises in chapter 11 relates to the debtor's attorney-client privilege. Attorneys have an ethical obligation to safeguard information relating to the representation of a client.¹³³ This obligation is incorporated into the attorney-client privilege¹³⁴—"the oldest of the privileges

¹³¹ See *In re Map Int'l, Inc.*, 105 B.R. 5, 6 (Bankr. E.D. Pa. 1989); *In re Plant Specialties, Inc.*, 59 B.R. 1, 1–2 (Bankr. W.D. La. 1986). But see *In re Wilson Foods Corp.*, 31 B.R. 272 (Bankr. W.D. Okla. 1983) (refusing to appoint a competitor of the debtor to the creditors' committee).

¹³² See, e.g., *In re Barney's, Inc.*, 197 B.R. 431, 442 (Bankr. S.D.N.Y. 1996); *In re Map Int'l*, 105 B.R. at 6.

¹³³ MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2004) states

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

- (1) to prevent reasonably certain death or substantial bodily harm;
- (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
- (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
- (4) to secure legal advice about the lawyer's compliance with these Rules;
- (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
- (6) to comply with other law or a court order.

¹³⁴ The privilege does not apply to all communications with an attorney, and it only guards against disclosure of communications, "not the underlying facts communicated to an attorney." WILLIAM L. NORTON, JR., *NORTON BANKR. L. & PRAC.* 2d, § 141:73 (2005) [hereinafter *NORTON BANKR. L. & PRAC.*]. There are five elements of attorney-client privilege that must exist for it to cover a communication:

[T]he person asserting the privilege is or seeks to become a client[;]

for confidential communications known to the common law.”¹³⁵ The underlying purpose of the attorney-client privilege is “to encourage full and frank communication between attorneys and their clients.”¹³⁶ In chapter 11, however, there can be disputes as to how the debtor may use the attorney-client privilege relating to prepetition activities. In addition, the Bankruptcy Code and related rules and guidelines generally require that a debtor’s attorneys publicly submit detailed time records for work performed during the chapter 11 case in order to be paid for such work. These disclosures tend to run contrary to the attorney-client privilege, because the debtor’s attorneys must publicly disclose in some detail the nature of their services for the debtor. These issues are discussed in more detail below.

In a chapter 11 case, it is important to identify who maintains control of the attorney-client privilege relating to prebankruptcy activities, and, as a result, who is able to waive that privilege and disclose communications between the prebankruptcy company and its attorneys. In *Commodity Futures Trading Commission v. Weintraub*, the Supreme Court held, in the case of a corporate debtor who filed for relief under chapter 7 of the Bankruptcy Code, control of the attorney-client privilege passed from the old management of the corporation to the trustee in the bankruptcy case.¹³⁷ The Supreme Court reasoned the trustee’s duties most closely resembled those of management.¹³⁸ Furthermore, providing control of the privilege to the trustee enabled the trustee to fulfill its fiduciary and management duties toward the company, whereas leaving control of the privilege with the displaced corporate debtor could prevent creditors from obtaining access to necessary financial information, thus thwarting the purposes of bankruptcy laws.¹³⁹

[T]he communication was made to an attorney or his subordinate, acting in his capacity as an attorney with respect to the communication[;]

[T]he communication relates to a fact which the attorney was informed of by his client in confidence[;]

[T]he communication related to the seeking of legal advice or assistance and not for the purpose of committing a crime or tort[; and]

[T]he privilege has been claimed and not waived.

Id.

¹³⁵ *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

¹³⁶ *Id.*

¹³⁷ *Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 353 (1985).

¹³⁸ *Id.* at 353–54, 358.

¹³⁹ *Id.* at 353–54.

Where no trustee has been appointed, courts have stated the chapter 11 debtor-in-possession (“DIP”) maintains control of the attorney-client privilege.¹⁴⁰ For instance, the Bankruptcy Court for the District of Delaware quoted language from *Weintraub* indicating that “the actor whose duties most closely resemble those of management should control the privilege in bankruptcy”¹⁴¹ and held the DIP “control[led] the attorney-client privilege with respect to both its pre- and post-petition communications.”¹⁴² Moreover, the court stated that the DIP was the “sole holder of the attorney-client privilege in bankruptcy.”¹⁴³ Similarly, the Bankruptcy Court for the Eastern District of New York noted the attorney-client privilege “pass[ed] by operation of law to the trustee in bankruptcy, or . . . to the debtor-in-possession” upon the filing of a bankruptcy case.¹⁴⁴ Therefore, in a chapter 11 proceeding where no trustee or examiner has been appointed, a court likely will hold the DIP is the holder of the attorney-client privilege and is the only entity capable of waiving such privilege.¹⁴⁵

Nonetheless, there can be questions as to how the debtor should use the attorney-client privilege once it has filed for chapter 11. A DIP in a bankruptcy case is essentially a stakeholder for all parties in interest, and, as such, has fiduciary duties to its creditors.¹⁴⁶ Therefore, in certain circumstances and where the debtor is clearly insolvent, there can be questions as to whether a debtor should waive the attorney-client privilege if doing so will maximize the value of the debtor’s estate. This issue typically has not

¹⁴⁰ See, e.g., *In re Eddy*, 304 B.R. 591, 599 (Bankr. D. Mass. 2004) (stating “the debtor in possession retains control over the attorney-client privilege during his/her stewardship.”); *In re Cenargo Int’l, PLC*, 294 B.R. 571, 601 n.37 (Bankr. S.D.N.Y. 2003) (“[T]he attorney-client privilege for a debtor corporation belongs to the debtor in possession, not the estate . . .”); *Ramette v. Bame* (*In re Bame*), 251 B.R. 367, 373 (Bankr. D. Minn. 2000) (“A corporate DIP, just like a solvent corporation outside of bankruptcy, is an inanimate entity that must act through [its] agents. While the corporation remains in possession, its management controls the attorney-client privilege.”).

¹⁴¹ *Am. Metrocomm Corp. v. Duane Morris & Heckscher L.L.P.* (*In re Am. Metrocomm Corp.*), 274 B.R. 641, 654 (Bankr. D. Del. 2002) (quoting *Weintraub*, 471 U.S. at 351–52).

¹⁴² *Id.* (citing *Weintraub*, 471 U.S. at 358).

¹⁴³ *Id.* (emphasis added).

¹⁴⁴ *In re Featherworks Corp.*, 25 B.R. 634, 643 (Bankr. E.D.N.Y. 1982) (holding a change in control of the corporation did not terminate the attorney-client privilege because “[t]hat privilege belongs to the corporate client and not to the individual officers or directors”).

¹⁴⁵ Of course, if a trustee were appointed in a chapter 11 case, then the privilege likely would transfer to that trustee. See, e.g., *Hechinger Inv. Co. v. Fleet Retail Fin. Group*, 285 B.R. 601, 610–11 (D. Del. 2002) (stating the corporate debtor’s former officers and directors lost the right to assert the attorney-client privilege with respect to the corporate debtor’s documents because the right passed to a liquidating trust).

¹⁴⁶ See *Ford Motor Credit v. Weaver*, 680 F.2d 451, 462 n.8 (6th Cir. 1982) (“[A] debtor in possession, as a fiduciary, represents both the secured and unsecured creditors of the debtor.”).

arisen in case law, but in such a scenario, failure to waive the attorney-client privilege could lead to the assertion by creditors that the DIP is breaching its fiduciary duties.

Furthermore, a company in chapter 11 may lose some control over the attorney-client privilege by virtue of the procedures that must be followed by the company's bankruptcy attorneys to be paid in the bankruptcy case. Section 330 of the Bankruptcy Code authorizes compensation for services and reimbursement of expenses of professionals for the chapter 11 estate and describes the standards to be used by courts in determining the amount of compensation.¹⁴⁷ Pursuant to this Bankruptcy Code provision and various related rules and guidelines, an attorney's time records must be sufficiently detailed so that parties in interest may assess whether such fees are reasonable, and because the bankruptcy court has a duty to examine the reasonableness of the compensation requested.¹⁴⁸ Because of the obligation to submit detailed billing records to the bankruptcy court, the debtor and its attorney should consider whether the billing records might have the effect of waiving or breaching the attorney-client privilege.

Outside of bankruptcy, a law firm's billing records are privileged when they "reveal the nature of the services . . . rendered" by the firm for the client.¹⁴⁹ Therefore, such records are not privileged when they only contain billing rates and hours information, but courts generally consider them to be privileged if they contain "substantive communications or descriptions of trial strategy."¹⁵⁰ The "attorney-client privilege embraces attorney time, records and statements to the extent that they reveal litigation strategy and the nature of the services provided," but "simply the number of hours billed, the parties' fee arrangement, costs and total fees paid do not constitute privileged information."¹⁵¹ Disclosure of information related to hours worked, billing

¹⁴⁷ 11 U.S.C. § 330 (2000).

¹⁴⁸ See 3 COLLIER ON BANKRUPTCY ¶ 330.04[4][c] (Alan N. Resnick et al. eds., 15th ed. rev. 2005) ("The court has an independent obligation to review all fee applications and evaluate the propriety of the compensation requested.")

¹⁴⁹ *Montgomery County v. Microvote Corp.*, 175 F.3d 296, 304 (3d Cir. 1999).

¹⁵⁰ *Dunlap v. Sunbeam Corp.*, No. 17048, 1999 Del. Ch. LEXIS 132, at *3 (Del. Ch. June 7, 1999); see also *In re Witnesses Before the Special March 1980 Grand Jury*, 729 F.2d 489, 491, 495 (7th Cir. 1984) (noting client fee information generally is not covered by the privilege unless there are "exceptional circumstances" in which disclosure of such information would "reveal confidential communications").

¹⁵¹ *Coal. to Save Our Children v. State Bd. of Educ.*, 143 F.R.D. 61, 66 n.4 (D. Del. 1992) (citation omitted); see also *Ulrich v. Stukel*, 689 N.E.2d 319, 325 (Ill. App. Ct. 1997) (noting some billing records "may contain explanations for legal fees and may indicate the type of work done or matters discussed between the attorney and client [and thus] could reveal the substance of confidential attorney-client discussions, and be

rates, and the amount of time spent on each issue related to the case may be required because such information does not discourage “full and frank communication between attorneys and their clients.”¹⁵²

The filing of a bankruptcy case by a debtor with the recognition that its attorneys will be required to submit detailed billing records to the bankruptcy court is not, in and of itself, a waiver of the attorney-client privilege. For example, in *Danning v. Donovan (In re Carter)*, several bankruptcy trustees asserted that “by filing for [c]hapter 11 relief, [the debtor] waived his attorney-client privilege regarding his financial dealings with his bankruptcy attorneys” and noted “if the attorney-client privilege is allowed to prevail, this [would] ‘emasculate the prophylactic benefit of [section] 329,’” a provision similar to § 330 of the Bankruptcy Code.¹⁵³ The court was not persuaded, and stated while it “recognize[d] its duty to evaluate the reasonableness of fees paid to bankruptcy counsel pursuant to section 329[,] this statutory requirement does not, per se, result in an automatic waiver of the attorney-client privilege.”¹⁵⁴

In fact, a debtor’s attorneys may assert that the attorney-client privilege still applies to their detailed billing records in bankruptcy proceedings. For instance, in *In re Computer Learning Centers, Inc.*, counsel for the bankruptcy trustee filed its entire first interim fee application under seal based on the trustee’s assertion that the time records were subject to the attorney-client privilege.¹⁵⁵ The court stated that “filing it under seal deprived interested creditors from any meaningful review of the fee application.”¹⁵⁶ This was inappropriate as the creditors “[were] the very ones who [were], effectively, paying [the counsel].”¹⁵⁷ The court noted

subject to valid claims of attorney-client privilege”); *Licensing Corp. v. Nat’l Hockey League Players Ass’n*, 580 N.Y.S.2d 128, 129 (N.Y. Sup. Ct. 1992) (billing statements “detailed in showing services, conversations, and conferences between counsel and others” are “clearly privileged”).

¹⁵² *Coal. to Save Our Children*, 143 F.R.D. at 66. Of course, descriptive time records might be required to be disclosed upon a discovery request where the reasonableness of any expense is being questioned because the time spent on a case is the heart of the issue. *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 825 (Del. 1992). However, “[t]he mental processes or other work product of the attorneys who billed the time is not subject to disclosure.” *Id.* at 825 n.8.

¹⁵³ 62 B.R. 1007, 1014 (Bankr. C.D. Cal. 1986). Section 329 requires an attorney for the debtor to disclose to the court, among other things, compensation paid during the year prior to the bankruptcy filing, whereas § 330 requires the filing of fee applications with the bankruptcy court so that the debtor’s attorney may be paid for services rendered during the bankruptcy case. *Id.*

¹⁵⁴ *Id.* at 1014–15 (noting the movants did not cite and the court did not find “any reported decisions holding that merely filing a bankruptcy results in a waiver of the attorney-client privilege”).

¹⁵⁵ 272 B.R. 897, 907 n.8 (Bankr. E.D. Va. 2001).

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

While time records may contain privileged material, they must nonetheless provide the basis for the requested fees. *Chaudry v. Gallerizzo*, 174 F.3d 394, 402 (4th Cir. 1999); *In re Grand Jury Proceedings, Thursday Special Grand Jury September Term, 1991*, 33 F.3d 342, 354 (4th Cir. 1994). They should reflect the attorney who performed the services, the date of the services, the amount of time expended and a description of the services. *It is not required that the actual communication between the attorney and the client be revealed in the time records.* Privileged material is not usually included in original time records; however, if it is included in the firm's copy of the time records, *it may be redacted from the filed document.* Nonetheless, sufficient, non-privileged information must be provided so that the court can evaluate the application.¹⁵⁸

Ultimately, however, the court ordered the time records be unsealed.¹⁵⁹ Therefore, a debtor and its bankruptcy attorneys should discuss the process by which the attorney's time records should be reviewed prior to submission to the bankruptcy court to ensure no privileged communications are revealed. Careful preparation and communication between the debtor and its professionals will ensure the privilege is neither unintentionally waived nor violated. An unintentional waiver of the privilege by disclosing certain information in a debtor's fee application to the court likely results in the loss of protection for the communication at issue. Further, once the privilege is waived with respect to the communication, the privilege likely is relinquished for all purposes and circumstances thereafter.

VII. ACTIONS OF A DEBTOR THAT ARE IN THE ORDINARY COURSE SO NO COURT DISCLOSURE IS REQUIRED

Finally, a debtor should understand the rules governing when a particular action requires bankruptcy court approval. If court approval is not required, the action will not face public scrutiny and will remain to some degree confidential. By contrast, if court approval is required, subject to the debtor's ability to file its request to the court under seal, the proposed action will become public even before court approval is considered.

¹⁵⁸ *Id.* (emphasis added).

¹⁵⁹ *Id.*

A. *The Concept of “Ordinary Course” Transactions*

Section 363(c)(1) of the Bankruptcy Code provides that a debtor may enter into transactions in the ordinary course of business without court approval.¹⁶⁰ This section was intended to provide a debtor with flexibility in operating its business by allowing the debtor to enter into transactions in the ordinary course without being subject to substantial judicial oversight and scrutiny.¹⁶¹ Likewise, § 363(b)(1) provides that transactions outside of the ordinary course of business require court approval.¹⁶² Section 363(b)(1) protects creditors by giving them a right to object to transactions that are not typical in a debtor’s business.¹⁶³ Requiring court approval of such transactions, however, has the effect of making such transactions public, where the debtor or a third party may desire that they remain confidential.

Therefore, it is critical for a debtor to identify whether a contemplated transaction is in the “ordinary course of business.” Unfortunately, the phrase is neither defined in the Bankruptcy Code nor significantly discussed in the relevant legislative history.¹⁶⁴ Therefore, courts have developed two related tests for determining whether a transaction is within the ordinary course of business.¹⁶⁵ The first test is the horizontal dimension test, where a court reviews the transaction from an industry-wide perspective and determines whether the transaction is one commonly undertaken by companies in the debtor’s industry.¹⁶⁶ Factors establishing similarity typically include size, resources, expertise, history, current situation, and anticipated future business activities. Typically, a debtor will be able to satisfy the horizontal test except for fairly unusual transactions, since the debtor will likely be able to show that a transaction is of a type undertaken in its industry.¹⁶⁷

¹⁶⁰ 11 U.S.C. § 363(c)(1) (2000).

¹⁶¹ See *In re Roth Am., Inc.*, 975 F.2d 949, 952 (3d Cir. 1992). See generally 7 COLLIER ON BANKRUPTCY, *supra* note 123, ¶ 363.03.

¹⁶² 11 U.S.C. § 363(b)(1).

¹⁶³ Failure to seek court approval of a transaction accompanied with a later determination by the court that the transaction was outside of the ordinary course of business runs the risk that, among other things, the transaction later may be undone.

¹⁶⁴ See *Burlington N. R.R. Co. v. Dant & Russell, Inc. (In re Dant & Russell)*, 853 F.2d 700, 704 (9th Cir. 1988).

¹⁶⁵ See *Roth*, 975 F.2d at 952.

¹⁶⁶ *Id.* at 953.

¹⁶⁷ See *Dant*, 853 F.2d at 704.

The second test is the vertical dimension test, also known as the creditor expectation test.¹⁶⁸ Here, the court reviews the transaction from the perspective of a hypothetical creditor and inquires whether the transaction exposes the creditor to economic risks of a nature different from those it accepted by extending credit.¹⁶⁹ Thus, the vertical test focuses on whether a debtor's creditors would reasonably expect the debtor to enter into the transaction at issue.¹⁷⁰ The rationale behind the vertical test is the notion each creditor consented to a certain level of risk when it extended credit to the debtor and a transaction altering the risks faced by the creditor unilaterally impairs the creditor's interests.¹⁷¹ Despite this rationale, courts neither examine particular creditors' expectations nor consider the impact of a transaction on creditors with varied interests. Instead, the vertical test focuses on a hypothetical creditor of the debtor and the proposed transaction's likely impact on the general mix of risks faced by the debtor.

When applying the vertical test, courts are interested in the business of the debtor before and after the commencement of the case.¹⁷² If the transaction at issue is of a type the debtor routinely engaged in before filing for bankruptcy, the transaction probably will be deemed ordinary course.¹⁷³ As such, courts have allowed debtors to continue to lease property for operations, to lobby governmental bodies, and to continue selling goods, all in accordance with the prepetition activities of the debtor.¹⁷⁴ This is not to say new transactions, or transactions on a larger scale than in the past, cannot qualify as ordinary course transactions under the vertical test. As long as the transaction at issue does not materially increase the risks faced by creditors, it may pass the vertical test.¹⁷⁵

By contrast, transactions not typical of a debtor's previous activities may be found to be outside of the ordinary course of business. For example, in *In*

¹⁶⁸ See *Roth*, 975 F.2d at 952.

¹⁶⁹ *Id.*

¹⁷⁰ See *Roth*, 975 F.2d at 953; *Dant*, 853 F.2d at 704.

¹⁷¹ See 7 COLLIER ON BANKRUPTCY, *supra* note 123, ¶ 363.03 ("This test measures the types of risks that creditors impliedly agreed to when they extended credit to the debtor, and determines whether the transaction at issue is within the range of risks reasonably expected by creditors.").

¹⁷² See, e.g., *Dant*, 853 F.2d at 705 (stating under the vertical test, "the debtor-in-possession's prepetition business activities are compared to its postpetition transactions").

¹⁷³ See *id.* at 705–06 (holding the vertical test was met where the DIP engaged in similar leasing transactions prepetition and postpetition).

¹⁷⁴ See, e.g., *id.* at 700; *Comm. of Asbestos-Related Litigants v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 60 B.R. 612 (Bankr. S.D.N.Y. 1986) (continued lobbying activities); *In re County Line Homes*, 43 B.R. 440 (Bankr. E.D. Mo. 1984) (continued sales activity permitted).

¹⁷⁵ See *Dant*, 853 F.2d at 705.

re Roth American, Inc.,¹⁷⁶ the Third Circuit addressed whether a debtor's execution of collective bargaining agreements was in the ordinary course. The court first found other industry players entered collective bargaining agreements, and, as a result, the horizontal test was satisfied.¹⁷⁷ The agreement at issue, however, contained unusual terms binding the corporation to refrain from halting operations within two years.¹⁷⁸ The court thus indicated the agreement failed the vertical test because the creditors would not expect the debtor to enter such a collective bargaining agreement.¹⁷⁹ Classic examples of non-ordinary course transactions include changing lines of business or selling all assets of the debtor or some central, important asset.¹⁸⁰ Similarly, transactions that are considered unprecedented will also require court approval.¹⁸¹

The consequences of failing to obtain court approval for a transaction outside the ordinary course of business can be serious. The most common remedy for transactions undertaken without court approval has been to set the transaction aside or treat the transaction as voidable, typically at the option of creditors. For example, in *In re Lavigne*,¹⁸² the debtor's cancellation of an insurance policy was void under § 363(b)(1) of the Bankruptcy Code because the cancellation was beyond the ordinary course of business and therefore required notice and a hearing.¹⁸³ Similarly, courts have declared sales invalid if not authorized by court order.¹⁸⁴ Some courts have suggested a "balancing

¹⁷⁶ 975 F.2d 949 (3d Cir. 1992).

¹⁷⁷ *Id.* at 953 (noting "several courts have ruled that [postpetition] collective bargaining agreements were in the ordinary course of business").

¹⁷⁸ *Id.* at 951.

¹⁷⁹ *Id.* at 954 (noting the agreement "sought to bind the hands of a Chapter 11 debtor to maintain its then existing operations for two years[.] . . . [therefore,] the nature of the agreement here ventures beyond the domain of transactions that a hypothetical creditor would reasonably expect to be undertaken in the circumstances").

¹⁸⁰ See *In re O'Brien Env't Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999) (selling substantially all assets); *Watford v. S. Cent. Farm Credit (In re Watford)*, 159 B.R. 597 (M.D. Ga. 1993) (farmer must obtain approval before selling soil).

¹⁸¹ See, e.g., *Med. Malpractice Ins. Ass'n v. Hirsch (In re Lavigne)*, 114 F.3d 379 (2d Cir. 1997) (holding action of the DIP failed both tests where the DIP cancelled various insurance policies that would have increased the value of the estate); *In re Century Brass Prods.*, 107 B.R. 8 (Bankr. D. Conn. 1989) (finding unusually large severance payments to officers were not in the ordinary course of business).

¹⁸² 114 F.3d 379.

¹⁸³ *Id.* at 389.

¹⁸⁴ See, e.g., *In re F.A. Potts & Co.*, 86 B.R. 853, 859, 863 (Bankr. E.D. Pa. 1988), *order aff'd*, 93 B.R. 62, 73 (Bankr. E.D. Pa. 1988) (stating sales held without proper notice are unequivocally invalid; the court determined that the notice to creditors of a judicial sale was defective and thus the sale should be declared violative of the creditor's rights to due process and voidable at the option of the creditor); *Esposito v. Title Ins. Co. (In re Fernwood Mkts.)*, 73 B.R. 616 (Bankr. E.D. Pa. 1987) (finding a sale in violation of the notice

test,” however, to see if the estate has benefited by the transaction in dispute to determine if the transaction should be rendered invalid.¹⁸⁵

In addition to canceling the transaction, the bankruptcy court has, in theory, other means to sanction a debtor’s failure to seek court approval of a transaction. For instance, § 105 of the Bankruptcy Code has been interpreted to grant bankruptcy courts contempt power.¹⁸⁶ Moreover, § 1104 allows the court to appoint either an examiner to monitor management’s conduct or a trustee to replace management where a court believes there has been adequate misconduct or breach of a debtor’s fiduciary or other duties as a DIP.¹⁸⁷ In practice, however, a bankruptcy court is unlikely to resort to any of these more extreme “punishments” unless extraordinary circumstances are present.

Given the elusiveness of the ordinary course operating concept, transactions will arise that are not clearly in or out of the ordinary course. A conservative approach for dealing with such situations would be to treat a transaction as outside the ordinary course of business and seek court approval of the transaction. Indeed, parties on the other side of transactions with a DIP often will insist on obtaining court approval of “close” transactions. If the time, expense, and publicity involved in a judicial proceeding make this treatment unappealing, the debtor might consider obtaining the assurance of any official committee appointed in the case that the transaction is favorable and arguably is a transaction within the ordinary course of the debtor’s business. If the committee believes no court approval may be required and agrees with the transaction, the debtor can proceed knowing that it is less likely the transaction will be challenged or scrutinized in the future.

B. Settlements

Whether a debtor is required to seek court approval of settlements involves some additional considerations. Federal Rule of Bankruptcy Procedure 9019(a) provides “after notice and a hearing, the court may approve a

provisions of section 363(b)(1) to be voidable at the option of the creditor); *see also* Dalton Dev. Project v. Unsecured Creditors Comm. (*In re Unioil*), 948 F.2d 678 (10th Cir. 1991) (affirming the bankruptcy court order rendering null and void a chapter 11 debtor’s vice president’s assignments of debtor’s interests in oil and gas properties, where assignments were in violation of § 363(c)(1) allowing transactions of estate property without notice and hearing only if transactions are in the ordinary course of business).

¹⁸⁵ *See, e.g., In re Cavalieri*, 142 B.R. 710 (Bankr. E.D. Pa. 1992).

¹⁸⁶ *See, e.g., Midwest Props. No. Two v. Big Hill Inv. Co.*, 93 B.R. 357 (Bankr. N.D. Tex. 1988) (sanctioning CEO and attorney of a close corporation for improper cash collateral expenditures, but not actually finding them in contempt).

¹⁸⁷ 11 U.S.C. § 1104 (2000).

compromise or settlement” proposed by a debtor.¹⁸⁸ By negative implication, Rule 9019(a) could be read as requiring court approval of all settlements of a debtor, without distinguishing “ordinary course” and “outside of the ordinary course” settlements. Unfortunately, current case law remains unclear as to whether there exists a concept of an “ordinary course settlement” that does not require court approval.

The present uncertainty concerning the necessity of court approval of settlements may stem from differences in the statutes historically governing bankruptcy. The Bankruptcy Act of 1898,¹⁸⁹ the Bankruptcy Code’s predecessor, contained a specific provision on settlements that could be read as requiring a debtor to obtain court approval to settle any controversy related to the bankrupt’s estate.¹⁹⁰ By contrast, the Bankruptcy Code does not have any section expressly dealing with court approval of settlements, suggesting that at least some settlements may not require court approval. Nevertheless, with such a significant body of pre-Bankruptcy Code precedent requiring court approval for settlements,¹⁹¹ courts have been hesitant to find otherwise under the Bankruptcy Code. Some courts have held court approval is necessary without explicitly referring to any statutory provision.¹⁹² However, Rule 9019(a) is the source primarily cited as evidence that court approval of a settlement is mandatory.¹⁹³

¹⁸⁸ FED. R. BANKR. P. 9019(a).

¹⁸⁹ Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544 (repealed 1978) [hereinafter “Bankruptcy Act” or “Act”].

¹⁹⁰ Section 27 of the Act provided, “The [receiver or] trustee may, with the approval of the court, compromise any controversy arising in the administration of the estate upon such terms as he may deem for the best interests of the estate.” Bankruptcy Act § 27; 11 U.S.C. § 50 (1978).

¹⁹¹ See, e.g., *Lincoln Nat’l Life Ins. Co. v. Scales*, 62 F.2d 582 (5th Cir. 1933); *Wheeling Structural Steel Co. v. Moss*, 62 F.2d 37 (4th Cir. 1932); *In re Med. Sterile Prods.*, 310 F. Supp. 262 (D.P.R. 1970); *Parker v. Balt. Paint & Chem. Corp.*, 273 F. Supp. 651 (D. Colo. 1967); cf. *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968); *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106 (1939).

¹⁹² See *Reynolds v. Comm’r*, 861 F.2d 469, 473 (6th Cir. 1988) (“In bankruptcy proceedings, as distinguished from ordinary civil cases, any compromise between the debtor and his creditors must be approved by the court as fair and equitable.” (citing *TMT Trailer Ferry*, 390 U.S. at 424)); *United States v. City of Miami*, 614 F.2d 1322, 1330 (5th Cir. 1980) (“[T]here are certain special situations in which the trial court is required by statute or rule to approve a settlement to which the parties to the litigation have agreed. The three most prevalent examples of this are proposed class action settlements, proposed shareholder derivative suit settlements, and proposed compromises of claims in bankruptcy court.” (citing *TMT Trailer Ferry*, 390 U.S. 414)).

¹⁹³ See *Travelers Ins. Co. v. Am. Agcredit Corp. (In re Blehm Land & Cattle Co.)*, 859 F.2d 137 (10th Cir. 1988); *N.J. Dep’t of Env’t Prot. & Energy v. Helder Indus., Inc. (In re Helder Indus., Inc.)*, 139 B.R. 290 (D.N.J. 1992), *rev’d on other grounds*, 989 F.2d 702 (3d Cir. 1993); *Saccurato v. Masters, Inc. (In re Masters Inc.)*, 149 B.R. 289 (E.D.N.Y. 1992); *In re Git-N-Go, Inc.*, 322 B.R. 164 (Bankr. N.D. Okla. 2004); SGE

Nonetheless, given that Rule 9019(a), unlike its predecessor Rule 919,¹⁹⁴ does not correspond to a substantive statutory provision, some courts instead have held Rule 9019(a) only serves a procedural function.¹⁹⁵ Rather than challenge the necessity of court approval, some of these courts have found the required approval for settlements in § 363 of the Bankruptcy Code.¹⁹⁶ While that provision ostensibly governs only the “use, sale or lease” of “property of the estate,” courts have interpreted it in certain circumstances to mandate court approval for a settlement of a cause of action belonging to the estate because “[t]he underlying rationale behind Section 363’s notice and hearing requirements is identical to that of Rule 9019’s notice and hearing requirements, to prevent secret dealings and provide interested creditors with the opportunity to be heard.”¹⁹⁷

Mortgage Funding Corp. v. Accent Mortgage Servs., Inc. (*In re* SGE Mortgage Funding Corp.), 298 B.R. 854 (Bankr. M.D. Ga. 2003); *In re* Texaco, Inc., 84 B.R. 893, 901 (Bankr. S.D.N.Y. 1988) (“The decision of whether to approve a particular compromise lies within the discretion of the Bankruptcy judge and pursuant to Bankruptcy Rule 9019(a).”); *see also* COLLIER ON BANKRUPTCY, *supra* note 123, ¶ 9019.01 (“It is an unusual case of any size in which there is not some litigation between the representative of the estate and an adverse party. Much of that litigation is settled. In such situations, the settlement must be approved by the court.”); NORTON BANKR. L. & PRAC., *supra* note 134, § 145:1 (“In bankruptcy cases, Bankruptcy Court approval of all compromises and settlements should be obtained. The procedure set forth in Bankruptcy Rule 9019 must be followed in settlements of adversary proceedings and contested matters, even where no lawsuit has been filed by the parties.”).

¹⁹⁴ Rule 919 stated, “On application by the trustee or receiver and after hearing on notice to the creditors as provided in Rule 203(a) and to such persons as the court may designate, the court may approve a compromise or settlement.” 11 U.S.C. § 919(a) (1982). The Advisory Committee Note to Rule 919 explained that prior to the Bankruptcy Code’s enactment, Rule 919 was derived from § 27 of the Bankruptcy Act. *See* COLLIER ON BANKRUPTCY, *supra* note 123, at ¶ 9019.1 (citing Advisory Committee Note to former Bankruptcy Rule 919). *See* United States v. Aweco, Inc. (*In re* Aweco, Inc.), 725 F.2d 293, 297 (5th Cir. 1984) (“The bankruptcy court derives its authority to approve settlements from Bankruptcy Rule 919(a).”).

¹⁹⁵ *See, e.g.,* Northview Motors, Inc. v. Chrysler Motors Corp., 186 F.3d 346, 351 n.4 (3d Cir. 1999) (“[Defendant] is correct that, as a matter of law, Bankruptcy Rule 9019(a), a rule of procedure, cannot, by itself, create a substantive requirement of judicial approval of [a settlement].”); LeCompte v. Sparks, No. 96 C 1373, 1997 WL 156488, at *11 (N.D. Ill. April 1, 1997) (“The bankruptcy judge noted that Bankruptcy Rule 9019 creates no substantive right to a hearing, and it has not been shown that this conclusion [is] erroneous.”); *In re* Dow Corning Corp., 198 B.R. 214, 246 (Bankr. E.D. Mich. 1996) (“Rule 9019, being merely a rule, can do no more than establish a procedural mechanism for exercising a statutory power.”).

¹⁹⁶ *See* Myers v. Martin (*In re* Martin), 91 F.3d 389, 395 n.2 (3d Cir. 1996) (“Section 363 of the Code is the substantive provision requiring a hearing and court approval; Bankruptcy Rule 9019 sets forth the procedure for approving an agreement to settle or compromise a controversy.”); *cf. In re Dow Corning Corp.*, 198 B.R. at 245 (“Equating compromises/settlements of lawsuits to sales of a debtor’s property is appropriate because there is so little to distinguish them.”). *But see* Hicks, Muse & Co. v. Brandt (*In re* Healthco Int’l, Inc.), 136 F.3d 45, 50 n.4 (1st Cir. 1998) (questioning whether Congress intended § 363 as the clear source for the substantive power to approve settlements or whether that power is simply inherent to the judicial forum).

¹⁹⁷ Reynaldo Anaya Valencia, *The Sanctity of Settlements & the Significance of Court Approval: Discerning Clarity from Bankruptcy Rule 9019*, 78 OR. L. REV. 425, 478 (1999).

If § 363 of the Bankruptcy Code is the substantive provision that requires court approval of settlements, then it can be asserted that § 363(c)(1), which allows a debtor to enter into transactions in the ordinary course of business without court approval, also authorizes a debtor to enter into settlements in the ordinary course of business without court approval. Indeed, while several courts have found settlements require court approval if they are outside the ordinary course of business,¹⁹⁸ certain courts, mostly in the Sixth Circuit, also have found that not all settlements necessarily require bankruptcy court approval. This trend commenced with the Sixth Circuit case of *Bostick Foundry Co. v. Lindberg*¹⁹⁹ and continued in *Cashflow Design, Inc. v. Foster (In re Comprehensive Business Systems, Inc.)*.²⁰⁰ Most instructive, however, is *In re Dalen*.²⁰¹ There, a creditor with a \$1.9 million judgment against the debtor agreed to release its claim in exchange for two payments totaling \$390,200.²⁰² After the debtor failed to make the second payment, a chapter 7 trustee reached a second agreement with the creditor, but the bankruptcy court denied a motion to approve the settlement because it believed the agreement did not serve the best interests of the estate.²⁰³ Upon a motion by the creditor to reconsider its decision, the bankruptcy court initially noted the absence of any provision in the Bankruptcy Code requiring court approval of a

¹⁹⁸ See *Northview Motors, Inc.*, 186 F.3d 346 (stating the bankruptcy court approval was necessary for a settlement to be enforceable); *Darwin v. Beck (In re Fid. Standard Mortgage Corp.)*, 839 F.2d 1517, 1522 (11th Cir. 1988) (“We hold that the transfer of property of the estate [mortgage interests] for purposes of settling a dispute is not within the ordinary course of business of the debtor, and that it requires the approval of the court pursuant to section 363.”); *LeCompte*, 1997 WL 156488, at *5 (holding settlement of \$105,000 administrative expense claim not in ordinary course of business); *Peltz v. Gulfcoast Workstation Group (In re Bridge Info. Sys., Inc.)*, 293 B.R. 479 (Bankr. E.D. Mo. 2003) (finding the settlement of a \$2,100,000 preference claim and significant fraud, negligent misrepresentation, and unjust enrichment claims was outside of ordinary course of business); *In re Telesphere Commc’ns, Inc.*, 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) (“The settlement presented by the pending motion is subject to court review, since the trustee is seeking to liquidate assets of the estate—certain avoidance claims—and notice and a hearing is required, under Section 363(b) of the Code, for any use or sale of estate assets out of the ordinary course.”).

¹⁹⁹ 797 F.2d 280 (6th Cir. 1986).

²⁰⁰ 119 B.R. 573 (Bankr. S.D. Ohio 1990). The creditor in that case tentatively agreed to pay \$67,000 for a software system and to release all of its claims in regard to debtor’s bankruptcy. *Id.* at 575–79. When the creditor subsequently refused to purchase the system because a third party did not perform certain actions it considered conditions precedent, the trustee moved the bankruptcy court to enforce the settlement agreement. *Id.* After determining insufficient evidence existed to establish whether conditions precedent existed, the bankruptcy court found the point was moot because of the creditor’s repudiation. *Id.* at 580. Consequently, the bankruptcy court held the trustee was entitled to the creditor’s specific performance of the settlement agreement’s terms. *Id.* at 583.

²⁰¹ 259 B.R. 586 (Bankr. W.D. Mich. 2001).

²⁰² *Id.* at 591.

²⁰³ *Id.* at 590–91.

settlement.²⁰⁴ The bankruptcy court then observed that “[n]othing within Rule 9019(a) actually prohibits a trustee from settling a claim for or against the estate outside the purview of the bankruptcy court.”²⁰⁵ Lastly, the bankruptcy court determined that the cases frequently cited for the general proposition that court approval of settlements is mandatory actually only recognize that court approval may be necessary in some situations because of specific Bankruptcy Code provisions.²⁰⁶ Therefore, the bankruptcy court concluded:

As for settlements to which the trustee (or the debtor-in-possession) is a party, the Bankruptcy Code may require court intervention in some instances (e.g., a settlement which will materially affect a Chapter 11 plan of reorganization . . . or which contemplates the transfer of estate property outside the ordinary course . . .) and the Bankruptcy Rules offer the trustee the option to seek court approval in all other instances Whether the trustee actually elects to exercise this option is exclusively the trustee’s prerogative.²⁰⁷

Hence, although it could examine whether the trustee had met his fiduciary duties in making the settlement once he voluntarily sought approval, the bankruptcy court ruled the settlement was enforceable upon its signing even without court approval.²⁰⁸

Cases such as *In re Dalen* suggest a debtor can enter into settlements without court authority if those settlements are in the ordinary course of business.²⁰⁹ This result makes sense to the extent that settlements are viewed as simply a subset of transactions of a debtor pursuant to § 363 of the Bankruptcy Code. The approach also will permit a debtor to avoid having to publicly disclose and seek approval for all of its settlements, which can be costly and burdensome, as well as intrusive into the operations of a debtor’s business.

²⁰⁴ *Id.* at 594.

²⁰⁵ *Id.* at 595.

²⁰⁶ *Id.* at 599–601.

²⁰⁷ *Id.* at 609 (citations omitted).

²⁰⁸ *Id.* at 602–05.

²⁰⁹ See also *Vision Metals, Inc. v. SMS Demag, Inc. (In re Vision Metals, Inc.)*, 325 B.R. 138 (Bankr. D. Del. 2005) (holding a second agreement between a debtor and a creditor settling various claims between the parties did not require court approval because the agreement was typical to those executed in the industry and because the debtor’s creditors, having had notice of the first original agreement, would have expected the debtor, in the ordinary course, to enter into the second agreement).

C. Professional Retentions

One final confidentiality issue involves the debtor's retention of professionals. Section 327(a) of the Bankruptcy Code provides

[T]he [debtor], with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the [debtor] in carrying out the [debtor]'s duties under this title.²¹⁰

Thus, many professionals hired by the debtor need to be court-approved. Consequently, through this judicial process, certain information pertaining to the retentions and, of course, the very existence of the retentions will be made publicly available.²¹¹ In various situations, however, a debtor may desire that its retention of a professional remain out of the public eye, for example, when a debtor needs to retain a professional to conduct an internal criminal investigation or to assist with confidential litigation planning. In such cases, the debtor may wish to hire the professional without following the procedures set forth in § 327 of the Bankruptcy Code.

Not all persons or entities employed by the debtor require the court's approval. Section 327 sets forth only professional persons employed by the debtor "to represent or assist the [debtor] in carrying out the [debtor's] duties" need to be court approved.²¹² In addition, there exist a variety of court opinions regarding who exactly constitutes a professional under § 327.²¹³ Some courts have characterized the major cases interpreting § 327 as falling within two camps—"those adopting a quantitative analysis and those adopting

²¹⁰ 11 U.S.C. § 327(a) (2000).

²¹¹ The manner in which the debtor requests court employment of a professional person is set forth in Rule 2014 of the Federal Rules of Bankruptcy Procedure. Pursuant to Bankruptcy Rule 2014, the debtor must indicate, among other things, the name of the professional person, the facts indicating the necessity for employment, the professional services to be rendered, the reasons for selection of this professional person and any connections that the professional person has with the debtor, the debtor's professionals or other parties in interest.

²¹² 11 U.S.C. § 327(a).

²¹³ A definition for a "professional" is not set out in the Bankruptcy Code. The Bankruptcy Court for the Eastern District of Pennsylvania noted a professional is "[c]learly . . . not simply 'personnel,' hired by the debtor in possession, as that standard was rejected by Congress." *In re Metro. Hosp.*, 119 B.R. 910, 916 (Bankr. E.D. Pa. 1990). Besides the specific occupations listed in § 327(a), the court noted that courts have found airplane brokers, secretaries to creditors' committees, media brokers, financial consultants, public relations firms, oil and gas consultants, lobbyists, and property managers can be "other professionals" under this section. *Id.*

a qualitative analysis.”²¹⁴ Under the quantitative analysis, § 327 is limited “to those occupations which play a central role in the administration of the debtor proceeding, and not those occupations which are involved in the day-to-day mechanics of the debtor’s business.”²¹⁵ The quantitative analysis, therefore, “focuses on the significance of the individual’s role to the debtor proceeding.”²¹⁶ On the other hand, “the qualitative test focuses on the amount of discretion the individual has in accomplishing that role.”²¹⁷ As noted by the Bankruptcy Court for the District of Delaware, however, “both tests involve [] an examination of the types of duties to be undertaken by the individual.”²¹⁸ The court also noted “both tests are somewhat vague and difficult to apply.”²¹⁹

The Bankruptcy Court for the District of Delaware consolidated these two tests into a separate, nonexclusive six factor test to determine whether a person is a “professional” within § 327.²²⁰ In its view, courts should consider:

- (1) whether the employee controls, manages, administers, invests, purchases or sells assets that are significant to the debtor’s reorganization,
- (2) whether the employee is involved in negotiating the terms of a Plan of Reorganization,
- (3) whether the employment is directly related to the type of work carried out by the debtor or to the routine maintenance of the debtor’s business operations[.]

²¹⁴ See, e.g., *In re First Merchants Acceptance Corp.*, No. 97-1500, 1997 Bankr. LEXIS 2245, at *6 (Bankr. D. Del. Dec. 15, 1997).

²¹⁵ *Id.* For example, in *In re Seatrain Lines, Inc.*, 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981), the court noted a “professional person” under § 327 is limited to those persons that “play a central role in the administration of the debtor proceeding.” Therefore, “[c]ourt approval is required for the retention of attorneys, accountants, appraisers, auctioneers and persons in other professions intimately involved in the administration of the debtor’s estate.” *Id.* The court then found, although the maritime engineers would play an important part in the mechanics of the debtor’s operations, their retention would not affect the administration of the debtor’s reorganization. *Id.* As such, the court held the retention of the maritime engineers did not need to be court approved. *Id.*

²¹⁶ *In re First Merchants Acceptance Corp.*, 1997 Bankr. LEXIS 2245, at *7.

²¹⁷ *Id.* For example, in *In re Fretheim*, the court held § 327(a) applies where the person’s function is related to the administration of the estate and where it is determined that the employee is given some degree of “discretion or autonomy in some part of the administration of the debtor’s estate.” 102 B.R. 298, 299 (Bankr. D. Conn. 1989). As such, the court held that a surveyor, who in its opinion had “an essentially mechanical, nondiscretionary task,” need not be court approved pursuant to § 327(a). *Id.*

²¹⁸ *In re First Merchants Acceptance Corp.*, 1997 Bankr. LEXIS 2245, at *7 (citing a case for its observations that the tests only slightly differ from each other).

²¹⁹ *Id.* at *8 (rejecting these tests for the six factor analysis, described below).

²²⁰ *Id.* at *8-9.

- (4) whether the employee is given discretion or autonomy to exercise his or her own professional judgment in some part of the administration of the debtor's estate, . . .
- (5) the extent of the employee's involvement in the administration of the debtor's estate, . . . and
- (6) whether the employee's services involve some degree of special knowledge or skill, such that the employee can be considered a "professional" within the ordinary meaning of the term.²²¹

The court stated no one factor was determinative and "that the factors should be weighed against each other and considered in toto."²²² In applying the factors, the court found the receivables collection firm at issue played a substantial role in the estate and was crucial to the debtor's ability to continue operations and reorganization.²²³ Further, the court looked to the skill involved in its work, the discretion afforded to the entity, and the importance of the services provided in determining whether the entity was a professional whose retention was subject to § 327.²²⁴

Ultimately, while it is typical to seek court approval of many different types of firms that will provide services to the debtor in chapter 11, where a firm's role is to assist with confidential matters the debtor wishes not to disclose, the debtor and its counsel should weigh whether a court approval clearly is necessary. The answer will depend on the degree to which the firm is involved in the chapter 11 restructuring, as well as whether, arguably, the firm will assist the debtor in "carrying out its duties" under chapter 11. While it is always prudent to err on the side of court retention, if there is a way to avoid such process, the debtor may be able to avoid public disclosure of the fact that it intends to use the services of a firm that it seeks to keep confidential.

²²¹ *Id.* (citations omitted); see also *In re ACandS, Inc.*, 297 B.R. 395 (Bankr. D. Del. 2003) (adopting and applying the six factor test set out in *First Merchants*).

²²² *In re First Merchants Acceptance Corp.*, 1997 Bankr. LEXIS 2245, at *9.

²²³ *Id.* at *15.

²²⁴ *Id.* (ultimately denying approval based on the disinterestedness prong of § 327).

