

**Ad Hoc Committee Disclosure Requirements —  
A Bitter Pill to Swallow for Distressed Investors**

May/June 2007

Paul D. Leake and Mark G. Douglas

An essential part of the chapter 11 process is constructive dialogue and negotiation among all stakeholders involved in the bankruptcy case with a view toward building a consensus on the terms of a confirmable chapter 11 plan. The Bankruptcy Code establishes a framework to promote such interaction by providing for the appointment of official committees of creditors and shareholders entrusted by statute with the duty to participate in the formulation of a chapter 11 plan.

Collective stakeholder participation in a chapter 11 case, however, extends beyond membership on committees officially sanctioned by the Bankruptcy Code. Unofficial, or “ad hoc” committees, have also long played prominent roles in bankruptcy cases. Like official committees of unsecured creditors, shareholders, retirees or other creditor groups, ad hoc committees commonly retain professionals and participate in a chapter 11 case by filing pleadings, appearing before the bankruptcy court and otherwise seeking to influence the outcome of the reorganization and the ultimate recovery on their claims or interests. By acting collectively, ad hoc committee members share the costs of participating in a chapter 11 case and have the ability to wield greater influence than they would if acting alone. The Bankruptcy Code itself acknowledges that unofficial committees can play an important role in a chapter 11 case by providing in sections 503(b)(3)(D) and (4) that costs, including professional fees, incurred by

such committees (and certain other parties in interest) in making a “substantial contribution” to the case will be paid by the estate as priority administrative expenses.

The members of an official committee bear fiduciary duties to both the bankruptcy estate and the committee’s constituency. Official creditors’ committees also have a duty (added to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005) to provide access to information for their creditor constituents and are obligated to solicit and receive comments from creditors concerning developments in the chapter 11 case. Any fees and expenses of their professionals must be allowed by the bankruptcy court before being paid by the estate.

Ad hoc committees, by contrast, are largely unregulated. For this reason, they are sometimes the preferred mechanism for creditors and shareholders, such as hedge funds and other “distressed” investors, who want to wield enhanced influence and bargaining power in a chapter 11 case without being subject to the statutory obligations borne by official committees and the same degree of bankruptcy court scrutiny. Even so, the conduct of unofficial committees is subject to a certain amount of scrutiny by means of information disclosure requirements contained in the Federal Rules of Bankruptcy Procedure. Rulings recently handed down by the bankruptcy court overseeing the chapter 11 case of Northwest Airlines illustrate that complying with these requirements may be seriously problematic for hedge funds and other distressed investors. As a result of these and other similar rulings, those investors, who take great pains to keep confidential information concerning the timing and pricing of their acquisition of claims or shares in a chapter 11 debtor, may no longer be inclined to sit on ad hoc committees.

## **Bankruptcy Rule 2019**

Rule 2019(a) of the Federal Rules of Bankruptcy Procedure provides that, in a case under chapter 9 or chapter 11 of the Bankruptcy Code, any entity or committee (other than an official committee) representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, must file a verified statement with the court disclosing the following information (emphasis added):

- (1) the name and address of the creditor or equity security holder;
- (2) *the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;*
- (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and
- (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, *the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.*

The consequences of noncompliance with the disclosure requirements are specified in Rule 2019(b), which authorizes the court, upon finding that any entity covered by Rule 2019(a) has failed to comply with either the rule or “any other applicable law regulating the activities and personnel” of the entity, to deny the offender any right to be heard or intervene in the bankruptcy case. The bankruptcy court may also examine any operative instrument authorizing the entity to represent its constituency, and any claim or interest acquired by any entity or committee either before or after the chapter 11 filing date, “and grant appropriate relief.” Finally, the court may

invalidate any authority given to, or votes on a chapter 11 plan procured by, any entity failing to comply with either Rule 2019(a)'s disclosure requirements or the chapter 11 vote solicitation requirements specified in section 1125 of the Bankruptcy Code.

The purpose of Rule 2019 and its predecessors in the former Bankruptcy Act and accompanying rules is to provide for disclosure of the composition and activities of groups acting in a representative capacity in order to help foster fair and equitable plans free from deception and overreaching. Its technical requirements are neither complicated nor particularly demanding. Rule 2019's profile, however, recently became much more prominent as a consequence of the bankruptcy court's ruling in *Northwest Airlines*.

### ***Northwest Airlines: Rule 2019 Emerges from Obscurity***

Sixteen months after Northwest Airlines and three affiliates filed for chapter 11 protection in September of 2005, and the day before the debtors filed a plan of reorganization, an ad hoc committee of equity security holders filed a notice of appearance in the case. Its January 16, 2007 verified statement under Rule 2019(a) identified 11 committee members, including hedge funds and other investment entities, that collectively owned 16,195,200 shares of Northwest's common stock and \$164.7 million in claims against the debtors, some of which were acquired after the bankruptcy petition date. The statement was later supplemented to disclose the addition of two members, so that the committee's aggregate holdings consisted of over 19 million shares of stock (of approximately 87 million shares outstanding) and over \$264 million in claims. The Rule 2019(a) statement did not disclose the amount of claims or interests owned by individual committee members, the specific dates on which such claims or interests were acquired, the amounts paid for them, or any post-acquisition sales or dispositions.

The ad hoc committee immediately filed a motion with the bankruptcy court for an order directing the appointment of an official committee of equity security holders (since withdrawn), and sought certain discovery in connection with the motion. Northwest responded on February 9, 2007 by filing a motion for a protective order, the imposition of civil contempt sanctions, and an order directing the ad hoc committee to supplement its 2019(a) statement with more detailed information concerning individual committee members' stock and claim holdings, including the dates of acquisition, the acquisition prices and the details of any post-acquisition divestitures. The ad hoc committee opposed the motion, contending that Rule 2019(a), which by its express terms covers "every entity or committee representing more than one creditor or equity security holder," may apply to the committee's lawyers, who "represent" all committee members, but may not apply to each individual member, which "represents" no one but itself, even though it sits on a committee. Moreover, the committee contended, the information already contained in its Rule 2019(a) statement was adequate to satisfy the rule's purpose in promoting the formulation of a fair chapter 11 plan through an above-board negotiation process.

### **The Bankruptcy Court's 2019(a) Ruling**

On February 26, 2007, Bankruptcy Judge Allan Gropper issued a memorandum decision requiring the ad hoc committee to provide the detailed information requested by Northwest. Judge Gropper rejected the committee's interpretation of Rule 2019(a), explaining that the members of the ad hoc committee were clearly acting collectively in seeking the appointment of an official equity committee and in litigating discovery issues, so that the ad hoc committee as well as its lawyers can fairly be characterized as "representing" the interests of multiple shareholders within the strictures of the rule. Observing that "[a]d hoc or unofficial committees

play an important role in reorganization cases,” the Judge traced the history of Rule 2019(a) and its predecessors back to the 1930s, when disclosure requirements were first promulgated to remedy perceived abuses by unofficial committees in equity receiverships and other corporate reorganizations. “The Rule is long standing,” Judge Gropper wrote, “and there is no basis for failure to apply it as written.”

### **Subsequent Events**

The ruling sent shock waves through the distressed investment community, whose players have increasingly included hedge funds, private equity investors and other distressed investors. The decision represents one of the first tests of the extent to which hedge funds must reveal trading information to the public when they act collectively in a chapter 11 case.

On March 1, 2007, the ad hoc committee sought a stay of Judge Gropper’s order and court authority to file the required information under seal, contending that the trading information represents trade secrets and confidential commercial information which no other committee or party has previously been required to file publicly in any other chapter 11 case. According to the committee, public disclosure of such information would cause irreparable harm to its members because other investors need not make the same disclosure and can use the information to gain an unfair advantage in the market for distressed securities. Judge Gropper granted the stay pending resolution of the appeal.

### **Public Access to Documents in Bankruptcy**

The ad hoc committee’s motion to file the requested information under seal implicated section 107(a) of the Bankruptcy Code, which recognizes the right of public access to documents in a

bankruptcy case. It provides that “[e]xcept as provided in subsection (b) of this section, a paper filed in a case under this title and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge.” The scope of the provision extends to nearly all documents filed with the court, with certain exceptions.

The right of access to public documents is not absolute — confidentiality may be justified in certain designated circumstances. Thus, section 107(b)(2) of the Bankruptcy Code provides in relevant part that, if an interested party so requests, “the bankruptcy court shall . . . protect an entity with respect to a trade secret or confidential research, development, or commercial information.” Rule 9018 of the Federal Rules of Bankruptcy Procedure similarly authorizes the court to issue any order necessary “to protect the estate or any entity in respect of a trade secret or other confidential research, development, or commercial information.”

On March 9, 2007, Judge Gropper denied the ad hoc committee’s request to seal the trading information. In his ruling, the Judge was critical of the committee’s characterization of trading positions as “commercial information,” explaining that “any interest that the individual Committee members may have in keeping this information confidential is overridden by the interests that Rule 2019 seeks to protect.” Moreover, Judge Gropper emphasized, whether or not the ad hoc committee is acting as a fiduciary to Northwest’s other stockholders, “Rule 2019 is based on the premise that the other shareholders have a right to information as to Committee member purchases and sales so that they [can] make an informed decision whether this Committee will represent their interests or whether they should consider forming a more

broadly-based committee of their own.” The Judge directed the ad hoc committee to file an amended Rule 2019(a) statement containing the trading information within three business days.

On the same day that Judge Gropper issued that ruling, certain members of the ad hoc committee filed a motion asking the court to reconsider its original ruling directing the committee members to disclose trading information. According to the committee members, an examination of the history and purpose of the Rule 2019’s disclosure requirements indicates that the term “committee” in Rule 2019 was not intended to encompass an informal creditor group “more appropriately described as a ‘consortium’ — financial institutions combining to undertake an operation beyond the resources of any member.” The Loan Syndications and Trading Association (“LSTA”) and Securities Industry and Financial Markets Association (“SIFMA”), two of the nation’s leading industry groups in the debt and equity markets, joined in the motion on March 15, 2007. In their joinder motion, LSTA and SIFMA expressed concern “that the Rule 2019 Decision will have a serious detrimental impact on the willingness and ability of many stakeholders to participate in future chapter 11 cases.” Moreover, they noted, there are “countless examples” in chapter 11 cases where “groups of stakeholders have cooperated, many times in the guise of ‘ad hoc’ committees, to create imaginative and strikingly successful solutions” — a positive contribution by sophisticated stakeholders that may be forfeited by requiring the disclosure of proprietary and highly confidential information.

Judge Gropper denied the motion on March 15, 2007, ruling that the individual committee members lacked standing to move for reconsideration of an order directed at the ad hoc committee and characterizing the reconsideration motion as “totally frivolous.”

### **Where Do We Go From Here?**

The ad hoc committee appealed Judge Gropper's ruling denying its motion to file members' trading information under seal. However, the nine remaining members of the committee, which once consisted of as many as 17 shareholders claiming to own 27% of Northwest's common stock, filed the required information with the court on March 21, 2007.

The ad hoc committee also filed a notice of appeal from Judge Gropper's initial February 26, 2007 disclosure ruling on March 26, 2007. At a March 15, 2007 hearing, Judge Gropper denied the ad hoc committee's request for a stay pending the resolution of its section 107(b) appeal. However, the court gave the committee until March 25, 2007 to seek a stay from the district court. The committee elected not to seek a stay pending the resolution of either appeal.

Hedge funds and other distressed investors closely guard trading information, such as the acquisition price of stock or claims, public disclosure of which would compromise their ability to maximize investment returns. If Judge Gropper's disclosure ruling is upheld on appeal, there may well be a chilling effect on who agrees to serve on ad hoc committees going forward.

Hedge funds and other distressed investors have made and continue to make enormous investments in all levels of the capital structures of distressed companies. As a consequence, these funds and investors have regularly assumed prominent roles in major chapter 11 cases.

The level of this involvement, at least in the ad hoc committee context, could change significantly if such investors are discouraged from participating due to disclosure requirements in the federal bankruptcy laws.

## Epilogue

*Northwest Airlines* is not the only chapter 11 case in which ad hoc committee's have battled against disclosure of trading information under Rule 2019(a). Unlike in *Northwest Airlines*, some committees have succeeded in resisting the disclosure requirements. Barely three weeks after Judge Gropper issued his latest ruling on committee disclosure requirements under Rule 2019(a), Judge Richard S. Schmidt of the U.S. Bankruptcy Court for the Southern District of Texas denied a motion filed by chapter 11 debtor Scotia Pacific Company LLC ("Scopac") to compel an ad hoc noteholders group consisting principally of hedge and private equity funds to file an amended Rule 2019(a) statement disclosing information concerning the composition of the committee and its members' trading positions. In denying Scopac's motion at a hearing held on April 10, 2007, the Judge observed that the noteholder group was "not a committee" within the meaning of Rule 2019(a), but merely a "bunch of creditors" represented by a single law firm.

SFMA and LSTA filed an amicus brief in opposition to the disclosure motion, citing the same concerns articulated in *Northwest Airlines*, and indicating that this controversial issue is far from resolved. On April 27, 2007, Scopac filed a motion asking Judge Schmidt to reconsider his ruling, based upon previous representations by the noteholder group in the chapter 11 cases that they were indeed functioning as an ad hoc committee. Judge Schmidt denied Scopac's motion on May 22, 2007. It is anticipated that the company will appeal Judge Schmidt's original ruling.

---

*In re Northwest Airlines Corp.*, 2007 WL 609214 (Bankr. S.D.N.Y. Feb. 26, 2007).

*In re Northwest Airlines, Inc.*, 2007 WL 724977 (Bankr. S.D.N.Y. Mar. 9, 2007).

*In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007)

(unpublished order entered eight days following denial of motion at April 10, 2007 hearing).