Bankruptcy Rule 2019: A new battleground

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Until recently, Federal Rule of Bankruptcy Procedure 2019 occupied a quiet backwater of the restructuring world. That changed with **Northwest Airlines**' motion to compel an ad hoc committee of its equity security holders to disclose a myriad of information regarding each committee member's equity and debt holdings, including sensitive pricing data. Judge **Allan L. Gropper**'s decision in *In re Northwest Airlines Corporation* to require Northwest's ad hoc committee to make the disclosures demanded by the debtor and a similar, but unsuccessful, motion that was filed in *In re Scotia Development LLC*, have opened up a new battlefront between debtors and their creditors and equity holders, the contours of which are largely undefined, but which will undoubtedly be hotly contested in the next cycle of restructurings.

Rule 2019 is best known as the rule that requires attorneys who represent multiple clients in a bankruptcy case to file a verified statement with the court that includes the identity of each of the clients represented and the amount of their claims or interests. But Rule 2019 also imposes disclosure requirements on certain types of committees — namely those committees that are not appointed pursuant to Section 1102 of the Bankruptcy Code. Under Rule 2019, such committees must file a verified statement with the court that includes the following information:

(a) The name and address of each creditor or equity security holder.

(b) The nature and amount of the claim or interest held.

(c) The date of acquisition of such claim or interest, unless it was acquired more than one year prepetition.

(d) The name or names of the entity or entities at whose instance, directly or indirectly, the committee was organized or agreed to act.

(e) The amounts of claims or interests owned by the members of the committee, the times acquired, the amounts paid for such claims and interests, and any sales or other dispositions thereof.

In addition, the committee must attach to its verified statement, a copy of any instrument whereby the committee is empowered to act on behalf of creditors or equity security holders. Failure to comply with Rule 2019 may result in the bankruptcy court's refusal to allow a creditor or an equity holder to participate in a debtor's bankruptcy case. F.R. Bankr. Pro. 2019(b); *In re Oklahoma P.A.C. First LP*, 122 B.R. 387 (Bankr. D. Az. 1990).

The *Northwest Airlines* decision

In *Northwest Airlines*, a group of hedge funds and other distressed investors that held approximately 19 million shares of Northwest common stock and approximately $265 million of claims, formed an ad hoc committee of equity holders. The ad hoc committee requested the appointment of an official equity committee pursuant to Section 1102 of the Bankruptcy Code, and in the course of related discovery disputes, Northwest sought to compel the ad hoc committee to comply with Bankruptcy Rule 2019.

The ad hoc committee eventually abandoned its effort to have an official equityholders' committee appointed, but that did not dispose of Northwest's motion to compel its compliance with Rule 2019. In response to the motion, the ad hoc committee argued that it was a committee in name only and that because it did not represent anyone other than its members, it was not the type of committee covered by Rule 2019. Judge Gropper disagreed, ordering the ad hoc committee to file a verified Rule 2019 statement. The judge explained that, "By appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings." *Northwest Airlines Corp., et al., In re,* 47 BCD 248 (Bankr. S.D.N.Y. 2006).

The ad hoc committee responded initially with a request that it be permitted to file its Rule 2019 statement under seal on the basis that it contained confidential and proprietary trading information. Judge Gropper denied the motion. Next, the ad hoc committee moved for reconsideration of the court's Rule 2019 ruling supported by amicus curiae briefs filed by the **Loan Syndications and Trading Association** and the **Securities Industry and Financial Markets Association**, that argued that the court's decision could have substantial negative impact on the willingness of distressed debt and equity traders to participate in Chapter 11 cases. The court denied the ad hoc committee's motion to reconsider, after which the committee appealed both of Judge Gropper's orders without seeking a stay pending appeal. Instead, the ad hoc committee filed the 2019 statement required by the court. Both appeals are pending.

The *Scotia Development* decision

Shortly after Judge Gropper's *Northwest* decisions, **Scotia Pacific**, the debtor in the *Scotia Development LLC* Chapter 11 case, which is pending in the **U.S. Bankruptcy Court, Southern District of Texas**, filed

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a motion seeking to compel an ad hoc committee of its noteholders to file a Rule 2019 statement regarding the debt holdings of its members. Relying on the *Northwest* decision and accusing the noteholders of "hiding behind a veil of secrecy," the debtor asked the court to refuse to hear from the noteholder group until it complied with Rule 2019. Coming closely on the heels of the *Northwest* decision, Scotia Pacific's strategy drew immediate interest from the distressed investing community, and the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association again filed amicus curiae briefs.

Scotia Pacific's noteholders argued that Rule 2019 is designed to protect only those entities represented by a committee, but that are not members of the committee themselves. Because they did not represent anyone other than their own members, and any noteholder was free to join the committee, the ad hoc noteholders' committee argued that its members should not be required to comply with Rule 2019.

The bankruptcy court agreed, and in a ruling from the bench issued on April 18, declined to follow Judge Gropper's lead. The court's order noted simply that the ad hoc committee was not a "committee" for purposes of Rule 2019. Consequently, the Rule 2019 disclosure already made by the ad hoc committee's attorneys was sufficient to satisfy Rule 2019.

Unanswered questions, future battles

Ad hoc committees are popular with distressed investors as a vehicle for participation in Chapter 11 cases because they permit their members to share costs and to exert greater influence as a group without the statutory duties and some of the trading restrictions and disclosure obligations imposed on an official Section 1102 committee. For instance, in *In re Spiegel*, 292 B.R. 748 (Bankr. S.D.N.Y. 2003), the court expressed serious reservations concerning whether the members of an official committee could ever be permitted to trade the debtor's claims, regardless of internal ethical walls that committee members imposed, in light of the committee members' fiduciary duties to their constituents. By forming an ad hoc committee that is not subject to Section 1102, creditors and equity holders can sidestep many of the kinds of issues raised by *Spiegel*.

The Rule 2019 decisions in *Northwest* and *Scotia* are the product of a head-on collision between distressed investors' desire to simultaneously participate in the Chapter 11 process while protecting their proprietary trading methods and strategies, and the underlying policies of the Bankruptcy Code and Rules that generally favor disclosure and the transparency of the bankruptcy process. To date, *Northwest* stands alone — no other reported case has imposed Rule 2019 obligations on an ad hoc committee. However, issued from the **U.S. Bankruptcy Court, Southern District of New York**, an epicenter of large Chapter 11 filings, its significance cannot be understated. And while *Scotia* is notable for declining to follow the court in *Northwest*, the lack of any substantial analysis by the court renders its precedential value somewhat suspect.

The importance of the decisions in *Northwest* and *Scotia* is unmistakable, but they nonetheless leave substantial questions unanswered. For example, what is a committee that is not appointed pursuant to Section 1102 of the Bankruptcy Code? Rule 2019 does not define this sort of committee. In *Northwest*, Judge Gropper seemed to be influenced by the ad hoc committee's implication that its views were entitled to greater weight in the case because of the magnitude of the constituency that it represented, notwithstanding the ad hoc committee's statements that it represented its members only. By contrast, the court's analysis in *Scotia* is completely opaque concluding, without explanation, that the ad hoc committee of noteholders was not a committee for Rule 2019 purposes. Was it enough in *Scotia* that the ad hoc committee simply refrained from calling itself a "committee" after the debtor filed its Rule 2019 motion?

Also, to what other groups will debtors or other parties in interest seek to extend Rule 2019? Does it apply to the members of groups of trade creditors with common counsel or to lenders in lender groups that participate in a bankruptcy case under a common credit agreement?

It remains to be seen whether *Northwest* or subsequent decisions will create the barriers to participation in the Chapter 11 process that the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association have predicted, but the use of Rule 2019 as a new offensive weapon certainly has the potential to influence the dynamics of cases considerably, and particularly in light of the uncertainty created by the questions that *Northwest* and *Scotia* raise. ▯

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