

# Distressed Investor Alert: Revisions to Bankruptcy Rule 2019 Will Discourage Active Involvement in U.S. Bankruptcy Cases

By Jon Kibbe, Michael Friedman and Keith N. Sambur

Bankruptcy Rule 2019, an often ignored procedural rule in U.S. bankruptcies, has returned to the public eye with a vengeance in light of a recent ruling by the influential Bankruptcy Court for the District of Delaware<sup>1</sup> and controversial pending amendments to Rule 2019 proposed by the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States (the “Rules Committee”). The amendments will be the subject of a public hearing held in New York City on February 5, 2010.<sup>2</sup>

The outcome of current cases and proposed revisions to Rule 2019 will likely change the landscape of distressed investing. If courts adopt recent judicial interpretations of current Rule 2019 and the proposed revisions become effective, distressed investors may be less willing to participate in “*ad hoc* committees” -- increasingly important informal groups or committees that retain common counsel and financial advisors to advocate a restructuring strategy, but which do not act in a fiduciary or representative capacity to a class of claimants.

Currently, Rule 2019 provides that any “committee” representing creditors in a bankruptcy proceeding must publicly disclose information about (i) the members represented, (ii) the amount and nature of each member’s claims, (iii) the dates the members acquired their claims, and (iv) the amounts paid for the claims.

“*Ad hoc* committees” or “*ad hoc* groups” typically have not disclosed detailed information about their members or the investments of their members. In an effort to curtail the power of *ad hoc* committees, debtors or other parties in interest have pressed judges to require Rule 2019 disclosures by *ad hoc* groups. For example, in the *Northwestern Airlines Corporation*<sup>3</sup> bankruptcy proceedings, the Bankruptcy Court for the Southern District of New York held that Rule 2019 required *ad hoc* committee members to disclose, among other things, the dates of all claim and equity acquisitions and the amounts paid for such acquisitions and refused a request by the members to file the 2019 statement under seal. In *Scotia Development LLC*<sup>4</sup> however, the court did not follow the rationale of the *Northwestern* court and ruled that an *ad hoc* group was not a committee and therefore Rule 2019 did not apply.

Rule 2019 recently returned to the spotlight in the *Washington Mutual* bankruptcy proceedings, where Judge Walrath followed the reasoning of *Northwestern* and held that because an *ad hoc* “group” of noteholders was in reality an “*ad hoc* committee,” Rule 2019 required disclosure by each committee member. Even more disturbing was Judge Walrath’s conclusion that “collective action by creditors in a class implies some obligation to other members of that class.”<sup>5</sup> The ruling suggests that even though members of an *ad*

<sup>1</sup> See *In re Washington Mutual, Inc.*, Case No. 08-12229 (Bankr. D. Del. Dec. 2, 2009).

<sup>2</sup> Comment letters must be delivered before February 16, 2010 to Peter McCabe, the Secretary for the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Secretary of the Committee on Rules of Practice and Procedure, Administrative Office of the United States Courts, Washington D.C. 20544; or electronically to <Rules\_Comments@ao.uscourts.gov>. Parties desiring to testify at that hearing must give notice to the Committee on or before January 8, 2010. After the public comment period, the Committee will decide whether to submit the proposed amendments to the Standing Committee on Rules of Practice and Procedure. Ultimately, the Judicial Conference and the Supreme Court must adopt any amendment to Rule 2019.

<sup>3</sup> *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

<sup>4</sup> See *Scotia Development LLC*, 2007 Bankr. Lexis 4731 (Bankr. S.D. Tex. 2007).

<sup>5</sup> See *In re Washington Mutual, Inc.*, Case No. 08-12229.

## Memorandum

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“Bankruptcy Rule 2019...has returned to the public eye with a vengeance in light of a recent ruling by the influential Bankruptcy Court for the District of Delaware and controversial pending amendments to Rule 2019”

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*hoc* committee or group act only for themselves, by virtue of their collective action, the committee members may undertake obligations to other similarly situated creditors.

Running in parallel with recent judicial interpretations of Rule 2019, the Rules Committee has drafted and published for public comment proposed revisions to Rule 2019 (“Revised Rule 2019”).<sup>6</sup>

As currently proposed, Revised Rule 2019 would broaden the disclosure requirement to apply to (i) every “entity, group, or committee” that represents or *consists of* more than one creditor and (ii) upon a motion of a party in interest or on the Court’s own motion, to *any entity* that seeks or opposes the granting of any relief. In addition, Revised Rule 2019 broadly defines the “disclosable economic interests” that would be required to be disclosed to include a “participation, derivative instrument, or any other right or derivative right that grants the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest.”<sup>7</sup> Finally, Revised Rule 2019 requires parties to disclose the date a member acquired each economic interest and, if required by a court, the price paid for such interest.

Revised Rule 2019 generally follows the recommendations of Judge Robert E. Gerber, of the Bankruptcy Court for the Southern District of New York, to the Rules Committee to “update” Rule 2019.<sup>8</sup> Judge Gerber recommended changes to Rule 2019 that would add necessary transparency to allow judges to understand the underlying motivations of creditors active in a case. In his letter, Judge Gerber noted:

“[W]hen anyone in the case – *ad hoc* committee or not, distressed debt investor or not – professes to speak on what is best for the estate (and/or for its creditors, equity security holders, employees, and the communities in which our debtors operate),

and/or to influence the outcome of the case, its private agenda can matter. If it does not want to reveal basic information as to its holdings in the case (which are an important indicator of ‘where it is coming from’ in connection with the position it advocates), it should not be trying to influence the court.”<sup>9</sup>

The broader goals of disclosure and transparency promoted by Revised Rule 2019 are not controversial -- they are legitimate tools to protect against incomplete disclosures that do not disclose “short” or “synthetic” positions that can significantly offset a “long” position disclosed by a committee member. What is problematic, however, is that Revised Rule 2019 requires each entity, group or committee member to disclose the dates of purchase, and, if required by Court, the price paid for its claims or interests. In addition, it is important to note that Revised Rule 2019 may also apply to an agent bank that has filed a proof of claim on behalf of a syndicate of lenders and may require the agent to disclose the amount, price and acquisition date of its claims as well as the claims of each lender in the syndicate.

The requirement to disclose proprietary and confidential information relating to the acquisition date and price paid will have a significant impact on the willingness of hedge funds, institutional investors and other distressed investors to participate (or even appear) in a bankruptcy proceeding. Although on its face, Revised Rule 2019 does not require disclosure of prices paid absent court order, requiring a party to disclose dates of purchase is tantamount to requiring a party to disclose the price, given the ease of determining the market price of bonds, syndicated loans or securities on any given day.

The bedrock principles of distressed investing are (i) a claim in the hands of a secondary market purchaser has the same rights and disabilities as it did in the

<sup>6</sup> A copy of Revised Rule 2019 is available at <http://www.uscourts.gov/rules/>.

<sup>7</sup> See Revised Rule 2019.

<sup>8</sup> See Letter from Judge Gerber to Advisory Committee on Bankruptcy Rules (Jan. 9, 2009).

<sup>9</sup> *Id.*

hands of the original claimant, and (ii) “the price paid for a claim does not affect the amount of the creditor’s claim, or the creditor’s voting power.”<sup>10</sup> Distressed investors jealously guard pricing information and investment strategies, as well they should. By requiring disclosure of such information, debtors may attempt to use pricing information when negotiating claim recoveries with secondary market debt purchasers, despite the legal principle that a claim purchased in the secondary market is the legal equivalent of an original claim. This would result in unearned, undeserved profit for the debtor and destroy or impair the sales value of securities by abolishing the profit motive, which inspires purchasers.<sup>11</sup>

While arguably increasing the “transparency” of the bankruptcy process, the requirement to disclose dates of purchase and, in effect, pricing information is not likely to further any public policy goals and will only serve to discourage distressed investors from participating in bankruptcy proceedings or in *ad hoc* committee groups. As Judge Gerber noted, “disclosure of what investors paid for their claims or for the bonds they hold is rarely relevant when making determinations as the future of a chapter 11 case ...”<sup>12</sup> Indeed, the overwhelming evidence to date demonstrates that Rule 2019 is not being used for its intended purpose of providing transparency and disclosure, but rather is being used as a sword to gain leverage in disputes among different classes of creditors or between debtors and certain of its creditors.<sup>13</sup>

Distressed investors and *ad hoc* groups play an increasingly large role in many of the most significant bankruptcy proceedings. Revised Rule 2019, if adopted as currently proposed, is likely to have a direct impact on future reorganizations. Because Revised Rule 2019 is subject to comment and adoption during a politically charged financial climate, hedge funds and distressed investors may be hesitant to object or comment on even the onerous disclosure requirements of proprietary price information and by implication investment strategies proposed by Revised Rule 2019.

Nonetheless, measured comment and input by the distressed investing community to Revised Rule 2019 would seem reasonable to balance the goal of promoting the efficiency of the modern reorganization process (and recognizing the importance of *ad hoc* committees and other creditor groups play in today’s process), with the equally worthy goal of transparency between the debtor and creditor constituencies.

The end-result should be a Revised Rule 2019 that (i) respects the bedrock principle of distressed investing – that a claim in the hands of a secondary purchaser is just as good as it was in the hands of the original claimant, (ii) does not provide debtors with unfair negotiating leverage by directly or indirectly disclosing the price paid for a distressed claim, (iii) encourages formation of *ad hoc* committees as an efficient driver in the modern bankruptcy process, and (iv) encourages stakeholders (including distressed investors) to participate in the process.

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<sup>10</sup> *Fairfield Executive Associates*, 161 B.R.595, 602-603 (D.N.J. 1993).

<sup>11</sup> *Lorraine Castle Apts. Bldg. Corp. v. Machiewich (In re Lorraine Castle Apts. Bldg. Corp.)*, 149 F.2d 55, 57-58 (7th Cir. 1945).

<sup>12</sup> See Letter from Judge Gerber to Advisory Committee on Bankruptcy Rules (Jan. 9, 2009). Judge Gerber did note, however, that when investors bought claims may in certain instances prove relevant.

<sup>13</sup> See *In re Philadelphia Newspapers, LLC*, Case No. 09-11204 (Bankr. E. Dist. Penn. Dec. 21, 2009); *In re Washington Mutual, Inc.*, Case No. 08-12229; *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *Scotia Development LLC*, 2007 Bankr. Lexis 4731 (Bankr. S.D. Tex. 2007).

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