

Rule 2019 Revisited

Law360, New York (March 08, 2010) -- In 1950, Bette Davis uttered her now-famous phrase in *All About Eve*, "Fasten your seatbelts, it's going to be a bumpy night!"

By that time, argue those who would propose to abolish Rule 2019 of the Federal Rules of Bankruptcy Procedure, Rule 2019 (in its earlier form) was already obsolete. The insider-dominated reorganizations of the early 20th century, which prompted the Rule 2019 disclosure requirements, were no longer a concern after Chapter X of the Bankruptcy Act was enacted in 1938.

Today, some have come to the opposite view. Proponents of broader Rule 2019 disclosure argue that, regardless of its relevance 70 years ago, Rule 2019 remains relevant today. In fact, its disclosure requirements fall far short of what is needed to protect the integrity of the bankruptcy process.

These conflicting views and the divergent cases interpreting the rule strongly suggest that Rule 2019 will be amended in the near term.

On Feb. 5, 2010, the Advisory Committee on Bankruptcy Rules took testimony from witnesses concerning proposed changes to Rule 2019. Based on that testimony and written comment, the committee is expected to propose a final amended Rule 2019 that, if timely adopted, could take effect as early as Dec. 1, 2010.

The Rule and Proposed Amendment

Rule 2019 currently requires that every entity or committee representing more than one creditor or equity security holder file a verified statement setting forth, among other things, "the amounts of claims or interests owned by the entity, members of the committee ..., the times when acquired, the amounts paid therefor, and any sales or other disposition thereof."

The proposed amendments to Rule 2019 would broaden its scope substantially. As amended, Rule 2019 would require disclosure of "disclosable economic interests" by any party representing more than one creditor, any group of more than one creditor, any ad hoc committee, and any indenture trustee in a bankruptcy case.

Parties would be required to disclose the nature, amounts, and date of acquisition of "any ... 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."

In addition, if directed by the court, each such party could also be compelled to disclose the prices the party paid for such economic interest. Finally, upon a motion, a court could direct any party seeking or opposing relief to disclose the same information.

The Crux of the Debate

Within the last three years, debtors, committees and other parties have breathed new life into Rule 2019 by simply moving to enforce its plain terms. This new wave of enforcement has focused parties on the pros and cons of Rule 2019 in modern bankruptcy proceedings.

The abolitionists argue that Rule 2019 is outdated and unnecessary because broad discovery rules, including Bankruptcy Rule 2004, are available when the details of a party's holdings are relevant.

Accordingly, both the current Rule 2019 and the proposed amendments thereto, which require broader disclosure requirements, are unnecessary and simply function as a barrier to a sophisticated party's entry to a Chapter 11 case.

Conversely, proponents of the proposed amendments to Rule 2019 argue that broader disclosure is vital to the integrity of the bankruptcy process. They argue that current Rule 2019 is both under-inclusive and over-inclusive in scope.

On one hand, Rule 2019 fails to require disclosure of pertinent information, like short positions and derivatives. On the other hand, it requires disclosure of pricing information, which is irrelevant in most cases.

Apparently, the only things that both sides can agree on is that current Rule 2019 does not work and has been used almost exclusively to gain tactical advantage against adversaries.

Rule 2019 Decision Scorecard

Over the last three years, a handful of rulings has helped sharpen the debate over the application of the current Rule 2019. The decisions and their polarized outcomes highlight the need for reform.

Disclosure Required: Northwest Airlines, Washington Mutual, Accuride

The current debate over Rule 2019 began in February 2007, when the debtors in the Northwest Airlines (Bankr. S.D.N.Y. 2007) Chapter 11 cases moved to compel an ad hoc committee of equity security holders and creditors to comply with Rule 2019.

In that case, the bankruptcy court ruled that a plain reading of Rule 2019 required that an ad hoc committee comply with the 2019 disclosure requirements.

The court defended its decision by, among other things, observing that ad hoc committees play an important role in reorganization cases by appearing and speaking on behalf of groups, and ask the court to give them a degree of credibility based on their large collective holdings.

In Washington Mutual (Bankr. D. Del. 2009), the bankruptcy court relied on similar reasoning and reached the same conclusion.

Further, the court observed that the proliferation of short-selling and advent of myriad derivative products now allow creditors to take multiple stakes in a debtor's capital structure and that such holdings have the potential to create complex, conflicting incentives for large creditors.

Accordingly, the disclosure of total economic interests of all creditors was crucial. About a month after the Washington Mutual decision, the bankruptcy court in *Accuride* (Bankr. D. Del. 2010) reached the same outcome on substantially similar facts.

Disclosure Not Required: Scotia Development, Six Flags, Philadelphia Newspapers

Conversely, the courts in *Scotia Development*, *Six Flags* and *Philadelphia Newspapers* each determined that, on substantially similar facts, disclosure under Rule 2019 was not required.

In *Scotia* (a decision rendered just two months after *Northwest*), the court was asked to decide if a noteholders group was a “committee” as that term is contemplated under Rule 2019. There, the court also heard from various amici, including Securities Industry and Financial Markets Association and the Loan Syndications and Trading Association.

The *Scotia* court succinctly concluded, without explaining its reasoning, that the noteholders group was not a “‘committee’ within the meaning of ... Rule 2019[.]”

More recently, the court in *Six Flags* (D. Del. 2010) faced “the virtually identical question” addressed in *Northwest Airlines* and *Washington Mutual* cases.

The *Six Flags* court first observed that the plain meaning of “committee” and “represent” denote the concepts of appointment, consent and contract with or by other creditors.

Accordingly, the court reasoned that because the ad hoc committee did not represent any persons other than its members, it was not a “committee” under Rule 2019 and need not make the required disclosures.

The *Six Flags* court checked its reasoning against Rule 2019’s legislative history. It looked specifically at the “protective committees” that dominated railroad restructurings in the early part of the 20th century.

The court noted that the predecessor to Rule 2019 and Chapter X of the Bankruptcy Act (as amended by the Chandler Act of 1938) were designed to limit a protective committee’s influence in a reorganization.

The court noted that although there are similarities between modern ad hoc committees and protective committees, the differences between the two “far outweigh the similarities.”

In general, modern debtors have far more control over the bankruptcy process and modern committees have far less influence than protective committees did.

Finally, the court observed that abuses by protective committees virtually ceased to exist within a few years of the Chandler Act’s passage, rendering the predecessor of Rule 2019 superfluous almost immediately after its passage.

The *Philadelphia Newspapers* (Bankr. E.D.Pa. 2010) decision largely adopted *Six Flag’s* reasoning and reached the same conclusion.

Advisory Committee Hearing on Amending Rule 2019

On Feb. 5, 2010, approximately a half dozen witnesses testified at the Advisory Committee’s hearing concerning the proposed amendment to Rule 2019. As set forth below, several clear themes emerged from the testimony.

Bankruptcy Courts Need to Understand the True Interests of Parties Seeking or Opposing Relief

Most witnesses acknowledged that the bankruptcy court needs to understand the positions held by parties appearing before it. Some testified that, while rare, certain parties to bankruptcy proceedings were less than clear, or worse, intentionally evasive, about their client's true stake in the proceedings, who they actually represented, upon who's authority they spoke, and who would be bound by the arguments they advanced or relief they sought.

For example, more than one witness testified that in some instances, parties seeking to be heard by the bankruptcy court actually had an interest in the debtor's failure because such party held "short positions" or otherwise had credit default swaps that could have precipitated a payment event if a certain bond was accelerated or the debtor's reorganization failed.

Accordingly, it was generally acknowledged that there was an ever-present possibility of misrepresentation and the court should not find itself in a position where it is being asked to rule on relief without knowing a party's true economic stake in a reorganization. Therefore, broader disclosures under an amended Rule 2019 would be beneficial.

Disclosure of Price Paid and/or Acquisition Date is Not Generally Necessary or Desirable

The vast majority of the witnesses agreed that, in most instances, disclosure of the price paid for a claim was not necessary or desirable.

Further, the witnesses made clear that even where the purchase price is not disclosed, the mandatory disclosure of the acquisition date would often reveal the necessary date point for sophisticated parties to derive the purchase price paid through publicly available information.

More importantly, for the reasons that follow, witnesses testified that disclosure of the price paid would actually be harmful to the claimholder and the debtor's estate.

First, the secondary markets function efficiently in reliance on established case law that provides that regardless of the amount paid for a claim, acquired claims are enforceable at their full face value. Injecting doubt into the validity of purchased claims would impair the liquidity of the claims trading market, which would hurt the debtor, its estate and all creditors.

For example, all parties would be harmed if the claims trading market contracted, forcing unwilling creditors to stay involved with a debtor's case and possibly even receive unwanted equity in the reorganized company.

Second, in addition to being legally irrelevant in most cases, the amount paid for a claim is sensitive, proprietary business information to the trader. Its nondisclosure is central to a trader's value-added and competitive advantage in the distressed trading field.

Accordingly, disclosure could harm the claim trader's business. As a natural consequence of compulsory disclosure, sophisticated parties would be dissuaded from getting involved in bankruptcy cases. These parties often form the basis for the success of DIP lending, exit financing, and rights offerings. These parties increase the efficiency of the bankruptcy proceeding because, among other things, they result in fewer parties with which the debtor must negotiate.

Third, pricing information could be used to a specific trader's disadvantage.

For example, where a debtor seeks to sell assets pursuant to Bankruptcy Code section 363, it is feared that a bankruptcy court could, upon learning the actual amount paid for a claim, consider that price in determining

whether a sale price for assets is fair and reasonable to holders of claims against the debtor. Accordingly, legally irrelevant information could creep into the court's decision making process to the detriment of claims traders.

All that said, witnesses generally agreed that the purchase price paid is relevant under certain circumstances. For example, pricing information or date acquired could be relevant where there has been an allegation that a fiduciary wrongly traded a claim to the detriment of the estates, or where a claim was acquired solely to thwart a plan of reorganization or otherwise to capitalize on a timing issue.

In such cases, however, discovery of that information should not be a concern because the parties and the court already possess the ability to require, for cause, disclosure of any relevant information pursuant to the existing broad discovery rules, including Rule 2004.

Rule 2019 Has Wrongly Been Used as a Tactical Device

Finally, virtually all witnesses agreed that current Rule 2019 is being enforced solely to gain a tactical advantage in bankruptcy proceedings. One witness specifically addressed the Six Flags decision where the court observed that the movant selectively sought to enforce the rule against its adversary but was willing to look the other way when its ally failed to comply.

Any revision to Rule 2019 should eliminate the incentive to use its compliance tactically.

Conclusion

Rule 2019 is headed for change. Its current applicability to ad hoc committees and other groups, for now, varies from court to court and sometimes from judge to judge within the same court.

Any amendment to Rule 2019 may not be known for months, but in the meantime, parties will presumably continue to move for ad hoc and other unofficial committees or groups to comply with Rule 2019's current disclosure requirements. Except in those courts that have already made rulings, the outcome of these motions will be unpredictable in many cases.

The final form of amended Rule 2019 is equally unpredictable. For example, will the amended rule completely dispose of any requirement to provide information on pricing and date of acquisition? Will it require a showing of cause for such information? Will it specifically acknowledge that Rule 2019 does not impair the authority that courts and parties already have under the discovery rules to require disclosure of claim information when relevant?

Will it continue to require the disclosure of date of acquisition, but in a more generalized form, such as whether positions were acquired within 60 days of a certain point in time, whether the positions were acquired pre- or post-petition, or whether the positions were acquired pre- or post-confirmation? Will Rule 2019 clarify who is subject to its provisions, thereby making enforcement routine and eliminating selective enforcement against adversaries, while giving allies a pass?

Pending adoption of an amended and clarified Rule 2019, the current rule remains in effect and its applicability to certain groups remains an open question. The form of a proposed rule is still a matter of debate. Given the uncertainties, for the foreseeable future, debt traders should fasten their seatbelts and prepare themselves for a bumpy night!

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