NEW BANKRUPTCY RULE 2019: BOON OR BANE FOR DISTRESSED INVESTORS?

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Recent changes to Federal Rule of Bankruptcy Procedure 2019 clarify and significantly alter disclosure requirements for creditors and equity holders that act in concert in Chapter 11 bankruptcy proceedings. These changes, which took effect on December 1, 2011, primarily impact hedge funds and other distressed investors who regularly choose to participate in Chapter 11 proceedings via membership in an official or ad hoc committee. New Rule 2019 requires every member of an official or ad hoc committee to publicly disclose each economic interest it holds "in relation to the debtor." As a result, those distressed investors who elect to participate in Chapter 11 cases via committee membership are now required to disclose short and derivative positions in claims against, and securities of, the debtor. This Note describes the factors that spurred reform of Rule 2019, explains recent changes to Rule 2019, and describes how these changes will affect members of ad hoc committees. Additionally, this Note analyzes the potential impact the recent changes on distressed investors, with particular attention to how these changes will affect distressed investors' return on investment. The Note concludes that distressed investors' broad-based support for New Rule 2019 is explained by the fact that distressed investors, as a class, stand to realize several important benefits from the recent changes to Rule 2019, without any significant corresponding costs.

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I. INTRODUCTION

Recent changes to Federal Rule of Bankruptcy Procedure 2019 ("Rule 2019") clarify and significantly alter the disclosure requirements for creditors and equity holders that elect to band together to participate in Chapter 11 bankruptcy proceedings as a group. These new disclosure rules, which took effect on December 1, 2011, primarily impact hedge funds and other distressed investors,[1] who now hold the majority of claims in most Chapter 11 cases.[2]

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[1] The term "distressed investor," as used throughout this Note, means an investor that seeks to amass claims and securities in distressed and defaulted companies when the market value of the claim or equity interest falls below the investor's estimate of its "true" or fair value. *See infra* Part II.A.

[2] *See Hearing on Proposed Amendments to the Federal Rules of Bankruptcy and Criminal Procedure Before the Advisory Committee on*

Distressed investors, who generally take an active role in the Chapter 11 bankruptcy process, regularly choose to participate via membership in an official or ad hoc committee,[3] due to the often prohibitive cost of individual participation.[4] Rule 2019, as amended ("New Rule 2019"), requires each member of an official or ad hoc committee to disclose publicly any economic interests it holds in the debtor or the debtor's claims or securities.[5] Importantly, the broad

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Bankruptcy Rules, Judicial Comm. of the U.S. 23 (Feb. 5, 2010) [hereinafter *Hearing*] (statement of Hon. Robert E. Gerber), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Hearing_Feb_5_2010.pdf (noting that in the Chapter 11 cases over which he presides, most of the creditors are distressed investors).

[3] The term "ad hoc committee" as used throughout this Note, means a loose affiliation of creditors or equity holders acting in concert, through common counsel, to advance their common interests. *See infra* Part II.A.2.

[4] *See* Kurt A. Mayr, *Bankruptcy Rule 2019: To Disclose or Not to Disclose, That is the Question*, 24 BANKR. STRATEGIST 11 (2007).

[5] New Rule 2019 states, in relevant part:

> (a) DEFINITIONS. In this rule the following terms have the meanings indicated:
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> (1) "Disclosable economic interest" means any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest.
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> (2) "Represent" or "represents" means to take a position before the court or to solicit votes regarding the confirmation of a plan on behalf of another.
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> (b) DISCLOSURE BY GROUPS, COMMITTEES, AND ENTITIES.
>
> (1) In a chapter 9 or 11 case, a verified statement setting forth the information specified in subdivision (c) of this rule shall be filed by every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one another.
>
> . . .
>
> (c) INFORMATION REQUIRED.The verified statement shall include:

definition of "disclosable economic interest" adopted by New Rule 2019 means that those distressed investors who elect to participate in Chapter 11 cases via committee membership will now be required to disclose short and derivative positions in claims against, and securities of, the debtor.[6]

> . . .
>
> (2) . . . with respect to an entity, and with respect to each member of a group or committee:
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> (A) name and address;
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> (B) the nature and amount of each disclosable economic interest held in relation to the debtor as of the date the entity was employed or the group or committee was formed; and
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> (C) with respect to each member of a group or committee that claims to represent any entity in addition to the members of the group or committee, other than a committee appointed under § 1102 or § 1114 of the Code, the date of acquisition by quarter and year of each disclosable economic interest, unless acquired more than one year before the petition was filed.

FED. R. BANKR. P. 2019.

[6] *See Id.* 2019(a)(1). A short position is a negative economic interest in a security. An investor creates a short position by borrowing a security, such as a share of stock, from another investor and then selling the borrowed security to a third party. Since the short seller will eventually need to buy the security in the open market, so that it can return the borrowed security to its owner, the value of the short position increases in value as the value of the security declines. Derivative positions are indirect economic interests in a security. The value of a derivative position may be either positively or negatively related to the value of the underlying security. Because most distressed investors are hedge funds, they do not face any regulatory restrictions on holding short or derivative positions in a debtor's claims or securities. Some legal scholars and practitioners have argued that the rise in distressed investor participation in Chapter 11 proceedings creates a potential hazard, because the interests of a hedge fund or group of hedge funds holding both long and short (or derivative) positions in the debtor may differ significantly from the interests of other parties to the reorganization. In an extreme case, a distressed debt investor holding both long and short positions in the claims and securities of a single debtor might have a net short position in the debtor, such that the value of the investor's overall investment in the debtor increases as the debtor's enterprise value decreases.

During the Rule 2019 revision process, many industry groups charged with representing the interests of distressed investors ultimately voiced support for enhanced disclosure rules that require each member of an official or ad hoc committee to disclose all economic interests held in the claims or interests of the debtor, including short positions, derivative instruments, and participations.[7] Since hedge funds and other distressed investment firms generally regard their holdings and investment strategies as sacrosanct, the industry's nearly universal support for New Rule 2019's enhanced disclosure requirements appears a bit puzzling at first glance.

This Note argues that, contrary to conventional wisdom, distressed investors will prove to be the primary beneficiaries of New Rule 2019. Part II examines the rise of distressed investor involvement in Chapter 11 cases and traces the significant controversy over the application of the version of Rule 2019 in effect prior to December 1, 2011 ("Prior Rule 2019") to ad hoc committees.[8] Part III provides an overview of the recent changes to Rule 2019, paying particular attention to how these changes affect members of ad hoc committees. Part IV analyzes the potential impact of recent changes to Rule 2019 on distressed investors, focusing on how these changes will modify return on investment. This Note concludes that distressed investors' broad-based support for New Rule 2019 can be explained by the fact that distressed investors, as a class, stand to realize several important benefits from the recent changes to Rule 2019, without any significant corresponding costs.

Commentators worry that a net short distressed investor holding a blocking position within a particular class could exploit its control strategically to stall the Chapter 11 proceeding or manipulate the structure of the reorganized entity to maximize total returns on its overall investment. *See infra,* Part II.B.

[7] *See Hearing*, *supra* note 2.

[8] FED. R. BANKR. P. 2019(a).

II. CONTROVERSY SPURRING REFORM OF RULE 2019

A. Increasing Participation of Distressed Investors in Chapter 11 Bankruptcy Proceedings

Over the past twenty years, distressed debt investors, including hedge funds and private equity firms, have played an increasingly important role in Chapter 11 bankruptcies.[9] Distressed debt investors seek to amass claims and securities in distressed and defaulted companies when the market value of the claim or security falls below the distressed investor's estimate of the claim or security's "true" or fair value. These investors are often able to purchase claims at a significant discount to fair value from sellers who wish to avoid the time, expense, and uncertainty of the bankruptcy proceeding and those who face regulatory or contractual restrictions that prohibit the seller from holding defaulted securities.[10] Furthermore, the seller may wish to realize a tax loss on the investment or may face accounting rules, such as asset write-off or mark-to-market requirements, that make the sale attractive, even at a steep discount to fair value.[11]

The number of investors and amount of capital pursuing distressed debt investment strategies has grown exponentially over the past two decades. Professor Edward Altman estimates that approximately $300 billion of capital was dedicated to distressed debt investment strategies in

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[9] One study analyzed a comprehensive sample of 474 Chapter 11 reorganizations from 1996 to 2007 and found observable hedge fund involvement in approximately ninety percent of the cases. Wei Jiang et al., *Hedge Funds and Chapter 11*, J. OF FIN. (forthcoming) (manuscript at ii), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1493966.

[10] Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 4 (1990).

[11] *Id.*

2010,[12] up from $65 billion in 2003,[13] and just $6 billion in 1991.[14] This growth in distressed debt investing is most likely linked to dramatic growth in the issuance of high-yield bonds and high-leverage bank loans in the past two decades,[15] coupled with increased liquidity in the secondary market for distressed loans over the same period.[16] Because of this dramatic growth, today, distressed debt investors often are among the largest claimholders in major bankruptcies.[17]

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[12] Xiang Ji, *Encouraging Signs of Distress*, INSTITUTIONAL INVESTOR, Sept. 2010, at 62, 64, *available at* http://www.iimagazine.com/Article.aspx?ArticleID=2673738.

[13] Matt Miller, *Disciple of Doom*, DAILY DEAL, June 5, 2003, at 2.

[14] Edward Altman et al., *The Link Between Default and Recovery Rates: Theory, Empirical Evidence and Implications* (Int'l Swaps & Derivates' Dealers Ass'n, Working Paper, Apr. 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=314719.

[15] Issuance of high-yield debt peaked at approximately $330 billion in 2010, up from just $10.5 billion in 1991. E-mail from Loan Syndications & Trading Ass'n to author (Oct. 11, 2011, 16:23 EST) (on file with author). Similarly, issuance of leveraged loans has increased significantly over the past twenty years, peaking at $689 billion in 2007, up from less than $200 billion in 1997. *See* Meredith Coffey, Senior Vice President, Loan Syndications & Trading Ass'n, State of the U.S. Corporate Loan Market, Address to the Phila. Council for Bus. Econ. (Jan. 7, 2009) (PowerPoint presentation, *available at* http://www.pcbe.org/pcbe.nsf/0/032c37afb934a03a85257537005962f2/$file/COFFEY_PCBE_2009_01_07.pdf).

[16] In the past two decades, secondary markets for high-yield debt and senior bank loans have experienced significant growth. Most dramatically, secondary market volume for distressed bank loans experienced staggering growth in recent years, peaking at $139.5 billion in 2009, up from just $24 billion in 2000. *See* E-mail from Loan Syndications & Trading Ass'n to author, *supra* note 15.

[17] *See Hearing*, *supra* note 2, at 23 (statement of Hon. Robert E. Gerber) (stating that as a bankruptcy judge in the Southern District of New York, most of the creditors in the cases tried before him are distressed investors). *See also* Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 200–09 (2005).

1. Distressed Investor Participation on Official Committees

As significant claimholders, distressed investors have played an increasingly active role in the bankruptcy process. With a large stake in the outcome of the bankruptcy proceeding, distressed debt investors holding the largest claims often seek appointment by the trustee to the official committee of unsecured creditors ("official committee") under section 1102 of the Bankruptcy Code.[18] As a member of the official committee, a distressed investor has authority to consult with the debtor's management team on administration of the case; investigate the management team's conduct and operation of the business; and participate in formulation of the debtor's plan of reorganization.[19] Such authority often provides the distressed investor with significant sway over the debtor's management team and influence over the structure of the reorganized company.

However, this influence comes at a price. First, official committee members owe a fiduciary duty to represent the interests of all similarly situated parties in interest.[20] As a result, official committee members often face significant restrictions on transactions in the debtor's securities. For example, a member of an official committee of unsecured creditors may not pursue any transaction that might create a conflict of interest between the committee member and the unsecured creditors it represents, such as trading in the equity securities of the debtor.[21] Further, members of the

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[18] The official committee is composed of seven members appointed by the trustee. 11 U.S.C. § 1102 (2011). These members are ordinarily those unsecured creditors holding the seven largest unsecured claims against the debtor. *Id.* However, the trustee may also consider whether the interest of a potential committee member is "representative of the interests of other creditors." *See* 7 COLLIER ON BANKRUPTCY ¶ 1102.02[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

[19] 11 U.S.C. § 1103.

[20] COLLIER, *supra* note 18, at ¶ 1103.05[2] (stating that members of the official committee "owe[] a fiduciary duty to the class the committee represents").

[21] *Id.*

official committee of creditors will almost always be in possession of material nonpublic information about the debtor, placing significant limitations on an official committee member's ability to trade in claims against, and securities of, the debtor.[22]

2. Distressed Investor Participation Through Ad Hoc Committees

Alternatively, a distressed debt investor may decide to join forces with similarly situated claimholders (usually other distressed debt investors) by forming an unofficial or ad hoc committee ("ad hoc committee").[23] Ad hoc committees are generally "loose affiliation[s]" of creditors, which are formed to represent the interests of their members.[24] Importantly, ad hoc committees do not purport to represent the interests of any other parties in interest.[25] For example, "a group of bondholders holding [sixty percent] of the principal amount of bonds issued by the debtor" may agree to retain common counsel to represent the group in the debtor's bankruptcy proceedings, but would not (and would not seek to) represent the interests of holders of the remaining forty percent of the bonds.[26] Formation of an ad hoc committee allows members to share costs, coordinate efforts, and form a united front in the bankruptcy proceeding by acting through common counsel, thereby enhancing members' ability to influence the debtor's management team and the structure of the debtor's plan of reorganization.[27]

Ad hoc committees are often made up of parties whose claims are too small to warrant appointment to the official committee. However, in some circumstances, a creditor which qualifies for appointment to the official committee

[22] *Id.*

[23] 11 U.S.C. § 1109(b) (permitting creditors and equity holders to form unofficial or ad hoc committees).

[24] *In re* Wash. Mut., Inc., 419 B.R. 271, 274 (Bankr. D. Del. 2009).

[25] *See* Mayr, *supra* note 4.

[26] *See id.*

[27] *See id.*

may elect to join an ad hoc committee instead. This is because many distressed investors believe that membership in an ad hoc committee offers several key advantages over official committee membership.[28] For example, unlike official committees, ad hoc committees choose their own members.[29] Additionally, in most instances, members are free to join or leave the group at will, and as a result, are not bound by majority decisions of the group.[30] Perhaps most importantly, members of ad hoc committees are not subject to the same fiduciary duties imposed on members of official committees and therefore face significantly fewer restrictions on trading of claims against the debtor.[31]

While the ad hoc committee's professional expenses (unlike those incurred by the official committee) are not paid directly by the debtor's estate, formation of the ad hoc committee allows members to share costs, such as legal and financial advisory fees.[32] Accordingly, ad hoc committees serve an important function in the Chapter 11 process by making participation feasible for parties that view individual participation as prohibitively costly.[33] Additionally, ad hoc committees may seek reimbursement for professional expenses incurred during the proceeding.[34] However, such reimbursement may only be awarded in cases where the court determines that the committee and its counsel made a "substantial contribution" to the case.[35]

Although the ad hoc committee does not enjoy any explicit statutory authority to influence or investigate decisions of the debtor's management or the development of the debtor's plan of reorganization, in practice, ad hoc committees often hold significant influence over the debtor's behavior. For example, where the members of an ad hoc committee hold a

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[28] *See id.*

[29] COLLIER, *supra* note 18, at ¶ 1102.06.

[30] *See* Mayr, *supra* note 4.

[31] *See* COLLIER, *supra* note 18, at ¶ 1102.06.

[32] *Id.*

[33] *See* Mayr, *supra* note 4.

[34] 11 U.S.C. § 503(b)(4) (2011).

[35] *Id.* § 503(b)(3)(D).

large or blocking position (i.e. a position that, in aggregate, controls thirty-three percent of the value or fifty percent in number of claims of a particular class), the debtor will need to secure approval of its reorganization plan from the ad hoc committee in order to exit Chapter 11.[36] Likewise, an ad hoc committee may have significant influence over the decisions of management if the committee's members are likely to hold significant equity positions in the company post-bankruptcy.

B. Growing Concerns Regarding Distressed Investor Influence Over Chapter 11 Proceedings

The increasingly active presence of distressed investors—particularly hedge funds and private equity firms—combined with the high-degree of direct and indirect control these investors have over the reorganization process as members of official or ad hoc committees has generated significant concern in recent years from debtors, academics, and bankruptcy judges. This concern stems from the fact that hedge funds, unlike mutual funds, do not face any regulatory restrictions preventing them from holding short or derivative positions in a debtor's claims or securities. As such, legal scholars and practitioners have argued that the interests of a hedge fund holding claims against, or securities issued by, a particular debtor may conflict with the interests of other parties in interest in the Chapter 11 proceeding, where the hedge fund also holds a short position (or derivative position) in other claims against, or securities issued by, the debtor.[37] In an extreme case, a distressed debt investor holding both long and short positions in the claims and securities of a single debtor might have a net short position in the debtor, such that the value of the investor's overall investment in the debtor increases as the debtor's enterprise value decreases. Commentators worry that a net short distressed

[36] *Id.* § 1126(c) (setting forth the rights of creditors to accept or reject the debtor's plan).

[37] *See* Kevin J. Coco, Note, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 619 (2008).

investor holding a blocking position within a particular class could exploit its control strategically to stall the Chapter 11 proceeding or manipulate the structure of the reorganized entity to maximize total returns on its overall investment.[38] Interestingly, these fears appear to be grossly disproportionate to the actual threat, as commentators have failed to produce any empirical or anecdotal evidence demonstrating that distressed investors have ever used such a strategy to benefit a short position.[39]

C. Application of Prior Rule 2019 to Ad Hoc Committees

Growing concern that distressed investors might exercise control strategically to manipulate a Chapter 11 proceeding and cause a decline in the debtor's value led commentators and debtors to seek new strategies to compel distressed investors that were actively involved in Chapter 11 proceedings to fully disclose their true economic exposure to the debtor.[40] For example, in the seminal case *In re Northwest Airlines Corp.*, the debtor moved to require the ad hoc committee of equity holders to disclose "the amounts of claims or interests owned by [each member] of the

[38] *Id.* at 620.

[39] *See, e.g.*, *id.* at 640. In fact, Coco provides only one definitive example of "bad behavior" by a hedge fund in a Chapter 11 proceeding, which involved a hedge fund "purchasing claims constituting a blocking position" within a class in order to use its blocking position as leverage to take control of the debtor. *Id.* at 639. However, this action was motivated by the hedge fund's desire to maximize the value of its *long* position in the debtor. Coco provides no evidence that the fund held any short positions in claims against the debtor. Therefore, *any* creditor could have pursued a similar strategy.

[40] Importantly, anecdotal evidence suggests that these fears are likely disproportionate to the actual threat. *See Hearing*, *supra* note 2, at 60–61 (testimony of Tom Lauria, Global Chairman, Financial Restructuring & Insolvency Practice, White & Case) (stating that in his twenty-four years of experience in Chapter 11 cases he had been involved in only one case where he believes a bank (notably, not a distressed investor) *may* have held a position that impacted its desire to maximize recovery of the estate).

committee, the times when acquired, the amounts paid therefor and any sales or other disposition thereof" pursuant to Prior Rule 2019.[41]

Prior Rule 2019 required entities and committees "*representing more than one creditor or equity security holder*" in Chapter 11 cases to file a verified statement disclosing: "(1) the name and address of the creditor or equity security holder; and (2) the nature and amount of the claim or interest and the time of acquisition thereof" unless acquired more than one year prior to filing of the petition.[42] Additionally, Prior Rule 2019 required committees "*representing more than one creditor or equity security holder*" to disclose (1) the amounts of claims and interests owned by the members of the committee; (2) the date such claims or interests were acquired; (3) the amounts paid for such claims or interests; and (4) "any sales or other disposition thereof."[43]

The predecessor to Rule 2019 (Rule 10-211 of the Bankruptcy Act) was adopted to combat bad behavior by "protective committees," which acted as fiduciaries to smaller investors in equity receivership proceedings during the 1930s.[44] The disclosure requirements of the predecessor rule were aimed at limiting this bad behavior by providing the court with sufficient information to assess whether the

[41] 363 B.R. 701, 702 (Bankr. S.D.N.Y. 2007).

[42] FED. R. BANKR. P. 2019(a) (2011) (amended Dec. 1, 2011) (emphasis added).

[43] FED. R. BANKR. P. 2019(a)(4).

[44] *See* Brian S. Herman & James M. Millerman, *Ad Hoc Attack*, DAILY DEAL, May 29, 2007, at 12–13. The "protective committees" were often organized by insider groups and "dominated by the debtor or its investment bank and institutional investors." *Id.* Once organized, the committee solicited "smaller investors to enter a deposit agreement whereby the smaller investors would deposit their securities" and grant authority to the committee to negotiate with the debtor on their behalf. *Id.* After gaining control over the securities of other investors, members of the "protective committee" often abused their position by using the deposited securities to advance their own interests, rather than the interests of those who actually owned the securities under their control. *Id.*

positions adopted by a protective committee were consistent with the protective committee's fiduciary duties to the investors it represented.[45]

Since the predecessor to Rule 2019 applied to protective committees based on their fiduciary relationships to the investors they represented,[46] ad hoc committees, which do not purport to represent interests of nonmembers, seemingly fell beyond the predecessor rule's intended scope of coverage.

1. Application of Prior Rule 2019 to Ad Hoc Committees Prior to 2007

Prior to 2007, there is no record of any court holding the disclosure requirements of Prior Rule 2019 (or its predecessor) applicable to an ad hoc committee.[47] Generally, the verified statements required under Prior Rule 2019 were filed only by law firms representing groups of multiple creditors or equity holders and simply identified the group's members and disclosed the aggregate amount of their holdings.[48] Since ad hoc committees (unlike the "protective committees" targeted by Rule 2019's predecessor) do not serve in a representative or fiduciary capacity, the general consensus among bankruptcy practitioners was that Prior Rule 2019 was inapplicable to ad hoc committees.[49] However, this consensus view was upended by Judge Gropper's decision in *Northwest Airlines*.

2. Bankruptcy Courts Split Over Application of Prior Rule 2019 to Ad Hoc Committees

In *Northwest Airlines*, Judge Gropper held that, by its plain terms, Prior Rule 2019 required ad hoc committees to file verified statements disclosing "the amounts of claims or interests owned by members of the committee, the times

[45] *Id.*
[46] *Id.*
[47] *See* Mayr, *supra* note 4.
[48] *Id.*
[49] *Id.*

when acquired, the amounts paid therefor, and any sales or disposition thereof."[50] Further, Judge Gropper held that Prior Rule 2019 required that the ad hoc committee disclose such information on a member-by-member, rather than aggregate, basis.[51] In a subsequent ruling, Judge Gropper refused to grant the ad hoc committee's request, pursuant to section 107(b) of the Bankruptcy Code, that the court place under seal the information disclosed in the Rule 2019 verified statement that related to each committee member's trading history in the debtor's securities (including dates, amounts, and prices of all purchases and sales).[52]

Ultimately, the seven courts that faced this issue split over the question of whether the disclosure requirements set out in Prior Rule 2019 applied to ad hoc committees of creditors acting in concert to advance their common interests.[53] Five of these courts explicitly based their

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[50] *In re* Nw. Airlines Corp., 363 B.R. 701, 702–03 (Bankr. S.D.N.Y. 2007).

[51] *Id.* at 703.

[52] *In re* Nw. Airlines Corp., 363 B.R. 704 (Bankr. S.D.N.Y. 2007). Judge Gropper held that the application of disclosure requirements under Prior Rule 2019 to ad hoc committees was premised on the idea that other members of the class have a right to be informed of purchases and sales by committee members, in order to make an informed decision as to whether the ad hoc committee adequately represents their interests, or whether they should consider forming their own committee. *Id.* at 709. Another court explicitly based its decision holding Prior Rule 2019(a) applicable to ad hoc committees on its determination that ad hoc committees owed a fiduciary duty to other members of their class, finding that collective action by members of a class implied an obligation to other similarly situated parties. *See In re* Wash. Mut., Inc., 419 B.R. 279, 279 (Bankr. D. Del. 2009).

[53] Following the *Northwest Airlines* decisions, three other courts held the disclosure requirements set out in Prior Rule 2019(a) applicable to members of ad hoc committees. *See In re* Milacron, Inc., 436 B.R. 515 (Bankr. S.D. Ohio 2010); *In re* Accuride Corp., No. 09-13449, 2010 WL 4285004 (Bankr. D. Del. Jan. 22, 2010); *Wash. Mut.*, 419 B.R. at 271. Conversely, the other three courts that weighed the issue during the same period deemed Prior Rule 2019(a) inapplicable to ad hoc committees. *See In re* Phila. Newspapers LLC, 422 B.R. 553 (Bankr. E.D. Pa. 2010); *In re* Premier Int'l Holdings, Inc., 423 B.R. 58 (Bankr. D. Del. 2010); *In re* Scotia

determinations on the "plain meaning" of the text of Prior Rule 2019. This inconsistent application of Prior Rule 2019 among bankruptcy courts resulted in frequent litigation of the issue in Chapter 11 proceedings.[54]

D. Fallout from *Northwest Airlines* and Subsequent Split Over Applicability of Prior Rule 2019 to Ad Hoc Committees

As discussed above, Prior Rule 2019, as applied in *Northwest Airlines*, required each distressed investor who chose to participate as a member of an ad hoc committee to *publicly* disclose: (1) its investments in claims against, and securities issued by, the debtor; (2) its trading history in such claims and securities; (3) the amount paid for such claims and securities; and (4) any sales or dispositions of such claims or securities during the course of the bankruptcy proceeding.

1. Industry Groups Lobby for Repeal of Prior Rule 2019

In the wake of the *Northwest Airlines* ruling, industry groups lobbied the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States for repeal of Rule 2019. These groups argued that Prior Rule 2019, as applied in *Northwest Airlines*, created significant disincentives for distressed investors to participate in Chapter 11 bankruptcy proceedings by effectively forcing distressed investors to choose between several unattractive alternatives: (1) bear the substantial costs of participation on their own; (2) join an ad hoc committee, disclose detailed trading information, and risk revealing proprietary analyses and trading strategies;[55] or (3) watch the Chapter 11 proceedings from the sidelines.[56]

Dev. LLC, No. 07-20027-C-11, 2007 Bankr. LEXIS 4731 (Bankr. S.D. Tex. Apr. 18, 2007).

[54] *Hearing*, *supra* note 2, at 19 (statement of Hon. Robert E. Gerber).

[55] Distressed investors conduct extensive research and analysis on potential investments to detect trends, inefficiencies, and valuations that

The Securities Industry and Financial Markets Association ("SIFMA") and the Loan Syndications and Trading Association ("LSTA") reasoned that investors, faced with such disincentives, would most likely reduce their exposure to the securities of distressed companies, resulting in decreased liquidity for such securities.[57] They contended that the resulting illiquidity would significantly hamper opportunities for pre-petition/pre-insolvency creditors and shareholders to cash out their positions prior to reorganization.[58]

Further, industry groups argued that those distressed investors who—despite the significant disincentives—continued to purchase claims in bankrupt companies would be less likely to participate in Chapter 11 proceedings.[59]

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they believe "*have not been recognized* by other investors" and, therefore, have a high probability of earning above-average rates of return. *See* Letter from the Sec. Indus. & Fin. Mkts. Ass'n and the Loan Syndications & Trading Ass'n to Peter McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. 23 (Nov. 30, 2007), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202007/07-BK-G-.pdf [hereinafter Letter, SIFMA/LSTA I] (emphasis in original). Further, many distressed investors employ unique proprietary trading strategies to exploit these opportunities. *See Hearing*, *supra* note 2, at 43 (statement of Forest Wolfe, Deputy General Counsel, Angelo, Gordon & Co.). Public disclosure of the timing and price of each trade in which a distressed investor acquired or disposed of a security representing a claim or interest in the debtor would allow competing firms to reconstruct that distressed investor's proprietary trading strategies. *Id.*

[56] *See* Letter, SIFMA/LSTA I, *supra* note 55, at 24–25.

[57] *Id.*

[58] *Id.* For example, the industry groups argued that due to reduced demand for distressed securities, those pre-insolvency security holders forced to sell their positions in the debtor (due to prohibitions on holding defaulted securities imposed by regulatory accounting requirements or fund by-laws) would most likely be required to accept much lower prices for these securities. *See id.*

[59] Letter from the Sec. Indus. & Fin. Mkts. Ass'n and the Loan Syndications & Trading Ass'n to Peter McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. 13 (Feb. 1, 2010), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/2009%20Comments%20Committee%20Folders/BK%20Comments%202009/

SIFMA and LSTA argued that, when faced with the choice between (1) publicly disclosing trading information that would reveal the investor's proprietary trading strategy and (2) foregoing membership in an ad hoc committee, most distressed investors would choose to forego ad hoc committee participation.[60] As a result, large claimholders would likely choose to participate in the reorganization process individually,[61] while small claimholders, unable to bear the substantial cost of legal and financial advisors on their own, would most likely be entirely excluded from the reorganization process.[62]

Additionally, SIFMA and LSTA argued that, with less participation by organized groups of claimholders united by similar interests, the debtor would be forced to go through the "time-consuming and expensive" process of negotiating with large claimholders on an individual basis.[63] In addition to prolonging the reorganization process, industry groups argued that "splintering" of claimholders would lead to longer and more complicated bankruptcy court proceedings.[64]

Industry groups therefore believed that Prior Rule 2019 would eventually: (1) cause decreased liquidity for the securities of distressed and bankrupt companies; (2) result in

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09-BK-026-Comment-Ganz%20and%20Davy.pdf [hereinafter Letter, SIFMA/LSTA II].

[60] *Id.*; *see also Hearing*, *supra* note 2, at 44–45 (statement of Forest Wolfe, Deputy General Counsel, Angelo, Gordon & Co.) (stating that Angelo, Gordon would most likely stop participating in ad hoc committees if it became common practice for bankruptcy courts to require ad hoc committees to disclose the price and date of all trades related to the debtor's securities).

[61] *See Hearing*, *supra* note 2, at 45 (statement of Forest Wolfe, Deputy General Counsel, Angelo, Gordon & Co.) (testifying that requiring disclosure of price and trade data by ad hoc committees under Rule 2019 would likely cause Angelo, Gordon to pursue individual representation in Chapter 11 proceedings).

[62] Letter, SIFMA/LSTA II, *supra* note 59, at 13–14.

[63] *Id.* at 15.

[64] *Id.* (arguing that because the parties would no longer be pursuing a coordinated legal strategy, courts could quickly become inundated with motions and arguments made on behalf of each of the individual claimholders).

effective exclusion of small claimholders from the reorganization process; and (3) increase the length, complexity, and expense of Chapter 11 reorganizations. Consequently, industry groups argued that these negative side-effects far outweighed any potential benefits resulting from the application of Prior Rule 2019 to ad hoc committees.

2. Bankruptcy Judges and Others Recommend Amendment of Prior Rule 2019

In response to the SIFMA and LSTA calls for the repeal of Prior Rule 2019, a handful of bankruptcy judges and groups composed of bankruptcy scholars and practitioners—including the National Bankruptcy Conference and the ABA's Business Bankruptcy Committee—submitted letters to the Judicial Conference opposing the repeal of Rule 2019, but recommending significant amendments to the rule's scope of coverage and corresponding disclosure requirements.[65]

At a threshold level, these groups argued that reform was necessary to settle the substantial ambiguity related to the applicability of Prior Rule 2019 to ad hoc committees.[66] First,

[65] *See* MICHAEL ST. PATRICK BAXTER, REPORT OF THE BUSINESS BANKRUPTCY COMMITTEE SPECIAL TASK FORCE ON BANKRUPTCY RULE 2019 (Dec. 12, 2008), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202008/08-BK-P-Suggestion-ABA%20Section%20of%20Business%20Law%20%28Baxter%29.pdf; Letter from Hon. Robert D. Drain to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. (Jan. 13, 2009), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202008/08-BK-N-Suggestion-Drain.pdf; Letter from Hon. Robert E. Gerber to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. (Jan. 9, 2009), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202008/08-BK-M-Suggestion-Gerber.pdf; Letter from Nat'l Bankr. Conf. to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. (Dec. 10, 2008), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK%20Suggestions%202008/08-BK-O-Suggestion-National%20 Bankruptcy%20Conference%20(Katz).pdf.

[66] *See Hearing*, *supra* note 2, at 19 (statement of Hon. Robert E. Gerber) (noting that the ambiguity of Prior Rule 2019 was clearly demonstrated by the fact that the four most recent judges tasked with

they argued that with no clear consensus among bankruptcy judges as to Prior Rule 2019's applicability to ad hoc committees, the rule wasted judicial resources by generating a significant amount of recurring litigation in Chapter 11 proceedings.[67] Additionally, Judge Robert E. Gerber, a bankruptcy judge in the Southern District of New York, argued that the inconsistent application of the rule among bankruptcy courts created a substantial risk that the parties would exploit Prior Rule 2019's ambiguity for purely tactical purposes.[68] In order to remove any ambiguity concerning the scope of Rule 2019's coverage, reformers argued that Prior Rule 2019 should be amended to identify clearly (1) the types of parties required to make disclosures under the rule, and (2) the types of claims and interests that these parties must disclose.[69]

Further, many of those in favor of reform pointed out that Prior Rule 2019 was under-inclusive, as it did not apply to members of official committees established under section 1102 or section 1114 of the Bankruptcy Code or to any party in interest filing a pleading on its own.[70] The reformers also

interpreting its application to ad hoc committees had evenly split between two opposite interpretations of the rule's meaning).

[67] *Id.*

[68] *Id.* at 19–20 (highlighting the actions of the Official Committee of Unsecured Creditors in a recent case in which the Official Committee filed a motion to compel the ad hoc committee of noteholders, which supported the debtor's proposed reorganization plan, to comply with Prior Rule 2019, but *did not* file a similar motion to compel compliance of another ad hoc committee of noteholders, which—like the Official Committee—opposed the plan). *See In re* Premier Int'l Holdings, 423 B.R. 58 (Bankr. D. Del. 2010).

[69] *Hearing*, *supra* note 2, at 20 (statement of Hon. Robert E. Gerber) (stating that he would like to see the committee develop a rule that is so clear that "compliance becomes routine," and, in those cases where a party fails to comply, judges are able to grant curative action without the need for extended proceedings).

[70] *See* Letter, Nat'l Bankr. Conf., *supra* note 65, at 1–2; *see also* Letter, Hon. Robert E. Gerber, *supra* note 65, at 4 ("[Prior] Rule 2019 is insufficiently broad in covering the classes of stakeholders who should be making disclosure before they are heard on discretionary matters involving the future of the estate."). In essence, reformers argued that,

argued that Prior Rule 2019 disclosure requirements were not sufficient to provide a clear picture of a stakeholder's true economic exposure to the debtor.[71] For example, Judge Gerber contended that Prior Rule 2019 did not clearly require disclosure of short positions held in securities of the debtor, making it impossible to determine the extent of a party's true net exposure to the debtor.[72] To combat this deficiency, those lobbying for reform of Rule 2019 argued that the rule should be amended to require every active participant in a Chapter 11 proceeding to disclose each economic interest (including long and short positions, derivative instruments, options, and participations) that affects the stakeholder's net economic interest in or exposure to the debtor.[73]

While several of the recommendations set forth by the reformers favored expanding the reach of Rule 2019, many of these proponents also recognized that application of Prior Rule 2019 to ad hoc committees required members of those committees to disclose information, such as the date or price of acquisition, that was "not essential" to achieve sufficient transparency in the Chapter 11 proceeding.[74] Further, they foresaw that requiring disclosure of this non-essential information might "chill legitimate distressed debt investing."[75] Recognizing that the participation of distressed investors is usually constructive, and that ad hoc committees

because members of the official committee and claimants participating in the Chapter 11 process on an individual basis were explicitly exempted from its disclosure requirements, Prior Rule 2019 did not prevent these parties from actively manipulating the Chapter 11 process.

[71] The reformers specifically argued that Prior Rule 2019 did not adequately address the growth of complex financial instruments (such as derivative instruments, options, and participations), which provide the opportunity for Chapter 11 stakeholders to create economic exposure to "claims and equity securities without directly owning or acquiring them." Letter, Nat'l Bankr. Conf., *supra* note 65, at 1.

[72] *See* Letter, Hon. Robert E. Gerber, *supra* note 65, at 7–8.

[73] *See* Letter, Nat'l Bankr. Conf., *supra* note 65, at 1–2; *see also* Letter, Hon. Robert E. Gerber, *supra* note 65, at 7–8, 10–11.

[74] *See* Letter, Hon. Robert E. Gerber, *supra* note 65, at 4.

[75] *Id.*

serve a very important role in the Chapter 11 reorganization process,[76] most reformers argued that Rule 2019 should not require parties to disclose the time of acquisition or the price paid, unless the individual party or ad hoc committee purported to represent the interests of others.[77]

III. OVERVIEW OF NEW RULE 2019

In response to the significant controversy surrounding Prior Rule 2019, the Judicial Conference's Committee on the Rules of Practice and Procedure set out to draft a revision. In the drafting process, the Committee initially sought to improve the rule's clarity and "expand the scope of its coverage and the content of its disclosure requirements."[78] Additionally, the committee sought to minimize the rule's impact on distressed investor participation by eliminating required disclosure of information that was not essential to a bankruptcy court's application of the law.[79] By responding to the concerns of both constituencies, New Rule 2019 strikes an appropriate balance, as it improves transparency without sacrificing the benefits that flow from participation of distressed investors in the Chapter 11 reorganization process via ad hoc committee membership. At the same time, the

[76] *See Hearing*, *supra* note 2, at 27–28 (statement of Hon. Robert E. Gerber).

[77] *See* Letter, Nat'l Bankr. Conf., *supra* note 65, at 1–2; *see also* Letter, Hon. Robert E. Gerber, *supra* note 65, at 7. Still, the reformers stressed that the amended rule should not be written in a way that would diminish the judge's power to require disclosure of date and price information in the discovery process upon a showing of relevance, pursuant to Federal Rule of Bankruptcy Procedure 2004, or *sua sponte*. *See Hearing*, *supra* note 2, at 25 (statement of Hon. Robert E. Gerber). Bankruptcy Rule 2004 allows the court, upon the "motion of any party in interest," to order examination of an entity with respect "to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge." FED. R. BANKR. P. 2004(a), (b).

[78] *See* JUDICIAL CONFERENCE COMM. ON RULES OF PRACTICE AND PROCEDURE, REPORT TO THE CHIEF JUSTICE OF THE UNITED STATES AND MEMBERS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES app. B at 30 (Sept. 2010) [hereinafter JUDICIAL CONFERENCE REPORT].

[79] *See id.* app. B at 3–7.

improved clarity of New Rule 2019 should improve judicial efficiency by decreasing litigation related to the rule, while also neutralizing the risk that parties in Chapter 11 proceedings will use the rule as a tactical device against their opponents.

A. New Rule 2019 Clarifies and Expands the Scope of Applicability

New Rule 2019 clarifies and expands the scope of Rule 2019's coverage and alters the information covered parties are required to disclose. The disclosure requirements of Prior Rule 2019 applied only to groups and committees "representing more than one creditor or equity security holder."[80] As discussed above, this language resulted in inconsistent determinations by bankruptcy courts as to whether disclosure requirements of Prior Rule 2019 were applicable to ad hoc committees of creditors.[81] By contrast, New Rule 2019 applies to every unofficial group or committee that "*consists of or represents* ... multiple creditors or equity security holders" acting in concert to promote their common interests.[82] The Committee Note submitted to the Judicial Conference makes clear that "[t]he rule applies to a group of creditors or equity security holders that acts in concert to advance common interests . . . , even if the group does not call itself a committee."[83] Further, under

[80] FED. R. BANKR. P. 2019(a) (2011) (amended Dec. 1, 2011).

[81] *See In re* Nw. Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re* Wash. Mut., Inc., 419 B.R. 271 (Bankr. D. Del. 2009); *In re* Accuride Corp., No. 09-13449, 2010 WL 4285004 (Bankr. D. Del. Jan. 22, 2010) (holding that the plain language of Prior Rule 2019 required ad hoc committees to disclose the information required under Prior Rule 2019(a) for each of its members on an individual basis). *But cf. In re* Scotia Dev. LLC, No. 07-20027-C-11, 2007 Bankr. LEXIS 4731 (Bankr. S.D. Tex. Apr. 18, 2007); *In re* Premier Int'l Holdings, Inc., 423 B.R. 58 (Bankr. D. Del. 2010); *In re* Phila. Newspapers LLC, 422 B.R. 553 (Bankr. E.D. Pa. 2010) (holding the disclosure requirements of Prior Rule 2019(a) inapplicable to any group of creditors that does not purport to represent the interests of parties other than the group's members).

[82] FED. R. BANKR. P. 2019(b)(1).

[83] JUDICIAL CONFERENCE REPORT, *supra* note 78, app. B at 31.

New Rule 2019, official committees appointed under section 1102 or section 1114 of the Bankruptcy Code are no longer wholly exempted from Rule 2019's disclosure requirements.[84] This means that under the new rule, *all* creditors and equity security holders acting as a group must file verified statements disclosing information required by New Rule 2019(c). Importantly, like the prior rule, New Rule 2019 does not apply to a single party in interest that appears on its own behalf.[85]

B. New Rule 2019 Requires Covered Parties to Disclose Any Economic Interest Affected by the Value of the Debtor

In addition to clarifying and expanding the scope of coverage to include *all* creditors or equity security holders acting as a group, New Rule 2019 significantly expands the types of interests and claims that each of these parties must disclose. Covered parties are required to disclose the nature and amount of each "disclosable economic interest" in the

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[84] *See* FED. R. BANKR. P. 2019(b)(1), (c)(1)(A). Although New Rule 2019 requires that official committees file verified statements, the disclosure requirements for official committees are far less onerous than those imposed on unofficial or ad hoc committees. While the verified statement filed by an official committee must disclose the nature and amount of each disclosable economic interest held by each committee member *at the time the committee was formed*, New Rule 2019 specifically exempts official committees from many other disclosure requirements. For example, although official committees represent the interests of entities that are not members of the committee, official committees are not required to disclose the quarter and year of acquisition of each disclosable economic interest that was acquired less than one year before the filing of the bankruptcy petition. *See* FED. R. BANKR. P. 2019(c)(2).

[85] *See* FED. R. BANKR. P. 2019(b)(1). This creates a loophole, as an individual claimant can avoid Rule 2019's disclosure requirements simply by acting on its own behalf. While the rule leaves open the possibility that a claimant intent on manipulating the Chapter 11 process for its own benefit could do so by participating on an individual basis, as a practical matter, this possibility is likely foreclosed in the vast majority of cases, as the high costs of individual participation are likely to exceed any benefit the claimant could reasonably expect to realize from any such attempt.

debtor as of the date the group or committee was formed.[86] New Rule 2019(a)(1) broadly defines "disclosable economic interest" to include any direct economic interest affected by the value of the debtor or the value of claims or interests in the debtor.[87] By requiring each member of a group or committee of creditors or equity holders to disclose all short positions, derivative positions (including credit default swaps and total return swaps), and participation interests in securities of the debtor, the information disclosed pursuant to New Rule 2019 will provide a snapshot of each covered participant's true economic exposure to the debtor.[88] Armed with this additional information, the bankruptcy court, the debtor, and other claimants will be able to better evaluate the motivations for the legal and strategic positions taken by each committee or committee member during the Chapter 11 proceeding.

C. New Rule 2019 Significantly Narrows Applicability of Disclosure Requirements Regarding Price and Timing of Acquisition

While New Rule 2019 significantly expands disclosure of the types of interests that each committee member must disclose, it significantly narrows disclosure requirements regarding the price and timing of acquisition. Prior Rule 2019 required covered parties to disclose the date of acquisition and price paid for each claim or interest.[89] By

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[86] FED. R. BANKR. P. 2019(c)(2)(B).

[87] FED. R. BANKR. P. 2019(a)(1) (defining "disclosable economic interest" as "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest").

[88] *See* JUDICIAL CONFERENCE REPORT, *supra* note 78, app. B at 30 (stating that the definition of "disclosable economic interest" was "intended to be sufficiently broad to cover any economic interest that could affect the legal and strategic positions a stakeholder takes in a . . . chapter 11 case" and includes "short positions, credit default swaps, and total return swaps").

[89] FED. R. BANKR. P. 2019(a).

contrast, New Rule 2019 does not require covered parties to disclose the price at which any "disclosable economic interest" was acquired or sold.[90] Further, disclosure requirements related to the timing of acquisition are significantly narrower. Under New Rule 2019, only members of an unofficial group or committee that *claims to represent the interests of non-members* are required to disclose information regarding the timing of the acquisition of each "disclosable economic interest."[91] Importantly, the definition of "represent" explicitly adopted in subsection (a)(2) clarifies that New Rule 2019 does not require traditional ad hoc committees to make any disclosure regarding the timing of their acquisitions of any economic interests held in the debtor's securities.[92]

D. New Rule 2019 Limits Events Triggering Requirement to File Supplemental Statements

Under Prior Rule 2019, covered parties were required to promptly file supplemental statements disclosing any material change to the information disclosed in a previous

[90] *See* JUDICIAL CONFERENCE REPORT, *supra* note 78, app. B at 32. While disclosure of the acquisition price of each "disclosable economic interest" held by a covered party is not required by New Rule 2019, the Committee on Rules of Practice and Procedure, which was responsible for drafting the amendments to Rule 2019, states that nothing in New Rule 2019 precludes discovery of acquisition price or its disclosure when ordered by the bankruptcy court pursuant to another authority. *Id.*

[91] FED. R. BANKR. P. 2019(c)(2)(C). *See also* JUDICIAL CONFERENCE REPORT, *supra* note 78, app. B at 31–32.

[92] New Rule 2019 states that "[r]epresent" or "represents" means to take a position before the court or to solicit votes regarding the confirmation of a plan *on behalf of another.*" FED. R. BANKR. P. 2019(a)(2) (emphasis added). Additionally, under the new rule, those deemed to "represent" other parties in interest face far less onerous disclosure requirements than those imposed by the prior rule. Under New Rule 2019, these entities need only disclose the quarter and year of each acquisition and need not make any disclosure regarding the timing of any acquisitions that occurred more than one year prior to filing of the bankruptcy petition. FED. R. BANKR. P. 2019(c)(2)(C).

Rule 2019 filing.[93] Because this requirement could be interpreted to require covered parties to file a supplemental statement immediately, any time they traded in the claims or securities of the debtor, such filings, like filings disclosing the price and timing of trades opposed by industry groups, could be used by competitors to reconstruct a distressed investor's proprietary trading strategy. By contrast, New Rule 2019 only requires covered parties to file supplemental statements disclosing material changes at the time the covered party "takes a position before the court or solicits votes on the confirmation of a plan."[94] This change balances the interest of the parties by allowing the court to evaluate each of the covered party's actions in light of its true economic interest in the debtor, while protecting the proprietary strategies of distressed investors.

IV. DISTRESSED INVESTORS AS PRIMARY BENEFICIARIES OF NEW RULE 2019

Despite their initial call for repeal of Rule 2019, distressed investors and industry groups ultimately came out in support of New Rule 2019.[95] Perhaps the most puzzling aspect of the Rule 2019 revision process is the fact that distressed investors and industry groups widely supported the expanded disclosure of economic interests held by parties involved in Chapter 11 reorganization cases.[96] In fact, even

[93] FED. R. BANKR. P. 2019(a).

[94] FED. R. BANKR. P. 2019(d).

[95] *See* JUDICIAL CONFERENCE REPORT, *supra* note 78, app. B at 6.

[96] *See* Letter from Managed Funds Ass'n to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. (Feb. 16, 2010), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/2009%20Comments%20Committee%20Folders/BK%20Comments%202009/09-BK-131-Comment-Kaswell.pdf (stating that the Managed Funds Association ("MFA") appreciated "the Committee's efforts to update and modernize Rule 2019 to provide a bankruptcy court with greater transparency with respect to a group's economic interests, including short and 'synthetic' positions, in a debtor"); Letter from Regiment Capital Advisors to Peter G. McCabe, Sec'y, Comm. on Rules of Practice & Procedure of the Judicial Conf. of the U.S. (Feb. 9, 2010), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/2009%20Comments%

the LSTA, the first group to lobby the Judicial Committee for repeal of Prior Rule 2019, publicly announced its support for the broad definition of "disclosable economic interest" employed by New Rule 2019.[97]

However, the distressed investment industry's widespread support for New Rule 2019 and its enhanced position disclosure requirements seems logical once one realizes that: (1) disclosure of position data is unlikely to result in any significant negative effects for the vast majority of distressed investors; (2) the clear disclosure rules set out in New Rule 2019 should allow distressed investors to realize lower investment costs and to forecast expected returns on investment with improved accuracy; and (3) distressed investors, as a class, stand to realize the greatest benefit from the enhanced position disclosure requirements of New Rule 2019, to the extent these requirements successfully

20Committee%20Folders/BK%20Comments%202009/09-BK-036-Comment-Meisner.pdf (explaining that Regiment Capital Advisors is an active participant in various Chapter 11 bankruptcy restructurings and stating that it supported expansion of disclosure requirement related to position reporting).

[97] *Hearing*, *supra* note 2, at 34 (statement of Elliot Ganz, General Counsel, Loan Syndications and Trading Association). Mr Ganz said:

> The LSTA supports the salutary objective of mandatory disclosure that will allow the court to understand the true economic stakes of the participants in the bankruptcy process.
>
> The LSTA believes that [New Rule 2019] satisfies these legitimate disclosure concerns by requiring each holder in a group . . . publicly to disclose the nature and extent of its economic interest in the debtor, including short and synthetic positions such as credit default swaps.
>
> The LSTA supports the amendment to the extent it would require those disclosure[s] that will enable the bankruptcy court[,] the debtor[,] and other parties in interest to not only appreciate how large the group's collective voice looms in the restructuring process, but also to understand how long the committee members truly are on a net basis in their holdings.

Id.

prevent other parties from manipulating the Chapter 11 reorganization process.[98]

A. The Ramifications of Public Disclosure: Price vs. Position Data

At first glance, the industry's overarching support for New Rule 2019, which requires expanded disclosure of economic interests held by members of ad hoc committees, seems at odds with its staunch opposition to required disclosure of information regarding the price and timing of acquisitions. However, there *are* several reasons why disclosure of pricing and timing information is far more problematic for a distressed investor than simple disclosure of the economic interests it holds (even when those economic interests may include short positions or derivative instruments).

1. Disclosure of Acquisition Price Data Poses a Threat to Distressed Investors

In stark contrast to a distressed investor's disclosure of position data, disclosure of the price (and trade date, to the extent it could be used to discern price) at which the distressed investor acquired each economic interest in the debtor directly threatens the distressed investor's profits by hampering the investor's ability to maximize returns from its proprietary analyses.

Distressed investors employ skilled investment analysts, who conduct in-depth research and use the information they obtain to construct detailed financial models to estimate the value of the debtor's estate and various components of the

[98] By completely eliminating position disclosure requirements, it is likely that repeal of Rule 2019 would have also allowed distressed investors to realize lower investment costs and more accurately forecast expected returns on investment. However, under New Rule 2019, distressed investors should realize higher recoveries than could have been achieved by repeal of the rule, at least to the extent that its disclosure requirements prevent manipulation of the Chapter 11 reorganization process.

debtor's capital structure. Public disclosure of data that reveals the prices that the distressed investor paid for claims and securities at each level of the debtor's capital structure would allow competitors to reconstruct, and make trades based on, the firm's proprietary valuation models, thereby piggybacking off the skill and hard work of the firm's investment analysts.[99] With additional firms chasing the same trading strategy, the distressed investor's opportunity to exploit these proprietary valuation analyses by engaging in future trades in claims against, and securities of, the debtor would be frustrated.

Further, the debtor's pre-insolvency creditors and shareholders would be able to engage in a similar exercise. By sifting through the publicly disclosed trading histories, potential sellers of claims against, and securities of, the debtor would be able to determine the range of prices at which a particular distressed investor has purchased the claim or security it wishes to sell. Such information would significantly improve the seller's bargaining power, by revealing (or at least providing a good idea of) the highest price the distressed investor would be willing to pay for that claim or security. This information would provide the seller with the potential to capture the entire spread between the lowest price at which it would be willing to sell the claim or security and the highest price the distressed investor would be willing to pay for it. As a result, the distressed investor would end up paying higher average prices for claims and securities and would therefore realize lower average returns.

Finally, disclosure of distressed investors' acquisition prices would allow the debtor to determine the investor's return on investment under various contemplated reorganization plans. Since valuation is both an art and a science, distressed investors are likely to accept a debtor's reorganization plan, so long as the compensation it receives under the proposed plan falls close enough to the investor's

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[99] *See* Nicholas F. Kajon, Northwest *Rulings May Chill Hedge Fund Participations in Chapter 11 Cases*, STEVENS & LEE BANKR. CLIENT ALERT, Mar. 16, 2007, *available at* http://www.stevenslee.com/news/bankruptcy/Northwest_Ruling_0307.pdf.

target price that it is within the range of values the investor views as fair. Armed with the information necessary to calculate each distressed investor's return on investment, the debtor will be able to more accurately estimate the stakeholder's acceptable range of values for its claim. Since distressed investors hold the majority of creditor claims in most Chapter 11 cases, providing the debtor with this capability would increase the risk of the debtor proposing a reorganization plan that values creditor claims at the low end of the acceptable valuation range. The result would be to shift value from creditors to equity holders.[100] Because further negotiations would extend the proceedings, causing the investor and the estate to incur additional advisory fees and negatively impacting the investor's annualized return on investment, the distressed investor would likely vote in favor of the plan in many cases where it believed a higher value for its claim could be achieved with further negotiation. As such, the disclosure of pricing data could effectively coerce approval of a plan that is far less favorable to creditors than a plan based only on an analysis of the fair value of the various claims against the estate.

In summary, requiring disclosure of the acquisition price (and trade date, to the extent it can be used to determine price) would pose a significant threat to distressed investor profits by empowering: (1) competing investors to trade on the investor's proprietary valuation analyses, thereby hampering the firm's ability to make future profitable trades based on its investment strategy; (2) sellers to exact a higher price on future trades; and (3) debtors to coerce approval of reorganization plans at or near the bottom of the investor's projected valuation range.

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[100] Since management teams often hold significant equity positions in the pre-petition company, they are incentivized to maximize the value of equity in a Chapter 11 reorganization. *See* Christopher W. Frost, *Are You Really Disinterested? Chapter 11 Presents Real Problems in Ethics*, BUS. LAW TODAY, Nov.–Dec. 1998, at 24, 27, *available at* http://apps.americanbar.org/buslaw/blt/8-2chapter11.html.

2. Disclosure of Position Data Not Problematic for Most Distressed Investors

While the public disclosure of acquisition price and trading data poses serious threats to a distressed investor's profits, public disclosure of position data raises far fewer concerns. First and foremost, in most instances such disclosure will not affect the distressed investor's relative bargaining power in negotiations with claim sellers or the debtor.[101] Additionally, mere position data is unlikely to provide competitors with enough information to reconstruct and trade on the distressed investor's strategy. Although competitors will be able to see where the distressed investor has placed its bets within the firm's capital structure, this information alone is insufficient to determine the firm's trading strategy.[102] Furthermore, even if competitors could

[101] It is possible that a distressed investor's bargaining power vis-à-vis the debtor might be diminished if it discloses that it holds economic interests which decrease its net exposure to the debtor. However, such a result is unlikely in all but the most extreme cases, because in most cases the debtor would still need to obtain the distressed investor's approval of its proposed reorganization plan.

[102] As one prominent bankruptcy scholar and practitioner pointed out, disclosure of the economic interests held by a single distressed investor is insufficient to determine that investor's underlying investment strategy:

> Example 1: Creditor A discloses it holds: (a) $1 million face amount of the debtor's senior bonds, and (b) a short sale of $400,000 of the debtors senior bonds.
>
> What does the disclosure mean? It can mean many different things. Creditor A may simply want the value of the debtor's estate to increase, because Creditor A will earn more from the appreciation of its $1 million of senior bonds, than it will lose from its short sale of $400,000 of senior bonds. Conversely, Creditor A may want the value of the debtor's estate to decline initially from bad news or a bad litigation outcome so that Creditor A can take a profit on its short sale, and then Creditor A may hope good things will happen to the debtor's estate so that it can profit on its long position in the senior bonds.

Letter from Martin J. Bienstock to Peter G. McCabe, Sec'y, Comm. on Rules of Practice and Procedure of the Judicial Conf. of the U.S. 2 (Feb. 11, discern the distressed investor's underlying motivation for investing in the economic interests it holds, without information regarding the price at which the distressed investor acquired each economic interest, competitors will not have sufficient data to reconstruct the firm's proprietary valuation model.[103]

Of course, New Rule 2019 will require distressed investors who choose to participate in the Chapter 11 reorganization process via membership in an ad hoc committee to disclose short positions and other negative economic interests which will increase in value as the value of the debtor's estate declines.[104] While disclosure of a significant short position would almost certainly limit a distressed investor's ability to influence the debtor's reorganization, this is unlikely to factor into the typical distressed investor's decision to join an ad hoc committee. Because "the vast majority of distressed investors [participating in Chapter 11 proceedings] act entirely appropriately,"[105] most investors would not face any serious negative consequences to their reputation or influence over the Chapter 11 proceedings, because they either: (a) do not hold any short or derivative positions that would increase in value as the value of the debtor's estate decreased; or (b) hold such positions only as legitimate hedges and maintain significant net long exposure to the debtor. Therefore, it follows that the "vast majority" of distressed investors could

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2010), *available at* http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/2009%20Comments%20Committee%20Folders/BK%20Comments%202009/09-BK-104-Comment-Bienenstock.pdf.

[103] For example, a competitor may be able to discern that an investor holding both secured and unsecured claims against the debtor believes that there will be sufficient assets to allow unsecured creditors to realize some level of recovery. However, the value of this information is limited, because without knowing the prices at which the distressed investor has acquired its unsecured claims, the competitor will not have any idea what value the distressed investor's internal valuation model places on the unsecured debt.

[104] FED. R. BANKR. P. 2019.

[105] *Hearing*, *supra* note 2, at 27–28 (statement of Hon. Robert E. Gerber).

elect to join an ad hoc committee and fully comply with the expanded disclosure requirements without experiencing any significant decrease in influence over the reorganization or negative impact to their reputations.

Those who argue that New Rule 2019 will lead to decreased distressed investor participation in Chapter 11 proceedings likely fail to appreciate that, unlike detailed disclosure of historical acquisition price and date information, full disclosure of a distressed investor's economic interest in a debtor's claims or securities is unlikely to reveal proprietary trading strategies. Furthermore, they likely discount evidence which suggests that, for the vast majority of distressed investors, such disclosure would not significantly compromise the investor's reputation or its degree of influence over the Chapter 11 reorganization process. Full consideration of these factors compels the conclusion that, for most distressed investors, New Rule 2019's expanded disclosure requirements are unlikely to decrease their propensity to join an ad hoc committee.

B. Improved Clarity of New Rule 2019 Should Lead to Improved Forecasting and Lower Investment Costs

In addition to the fact that disclosure of position data, under New Rule 2019 enhanced disclosure requirements, is unlikely to result in any significant negative effects for the vast majority of distressed investors, distressed investors also stand to realize substantial economic benefits under New Rule 2019, including improved forecasting of expected returns and lower investment costs.

1. Improved Ability to Forecast Expected Returns Prior to Investment

Perhaps most importantly, under New Rule 2019, a distressed investor considering an investment in the claims or securities of a Chapter 11 debtor has full information about what disclosures will be required under a variety of potential scenarios. Armed with this knowledge, the distressed investor will be able to fully weigh the pros (greater bargaining power and lower costs) and cons (public disclosure of its positions in the debtor) of joining an ad hoc committee prior to making an investment decision. The ability to make such an evaluation prior to investment is important, because it allows the distressed investor to more accurately project the costs it is likely to incur related to the investment, and therefore impact the expected return on investment. Because the costs of participation in the Chapter 11 reorganization process via membership in an ad hoc committee (which divides the cost of legal and financial advisors among members) is significantly lower than individual participation, the expected return on an investment is nearly certain to be substantially higher where the distressed investor determines that it will most likely participate as a member of an ad hoc committee.

Since it appears that full disclosure of economic interests in a debtor is likely to result in few, if any, negative consequences for the vast majority of distressed investors, it seems that many, if not most, distressed investors will choose to join an ad hoc committee and disclose their holdings. Faced with lower investment costs, distressed investors are likely to uncover many attractive distressed investment opportunities that would have appeared far less attractive under Prior Rule 2019.[106] In the aggregate, this dynamic is likely to result in increased demand for the claims and securities of Chapter 11 debtors and other distressed companies under New Rule 2019.

[106] Under Prior Rule 2019, faced with the risk that participation in an ad hoc committee might result in disclosure of price and timing trade data, a distressed investor forecasting projected investment costs would likely choose to either: (1) factor in the full cost of individual participation; or (2) since ad hoc committee membership is at-will, calculate the expected value of participation based on the probability that it would be required to comply with the disclosure requirements of the rule and the projected costs of individual and group participation. Given the substantially higher costs of individual participation, under either method, the distressed investor's expected investment costs would likely be substantially higher than the expected investment cost of participation via ad hoc committee.

2. Clear Disclosure Rules Should Lower Litigation Costs and Speed Exit

By providing significantly improved clarity as to whether a party is required to file a verified statement and, if so, the precise information they must disclose, New Rule 2019 will most likely increase efficiency in most Chapter 11 cases by reducing litigation. Given ad hoc committees' widespread non-compliance with Prior Rule 2019, as interpreted in *Northwest Airlines*, debtors and other creditors routinely filed motions to compel disclosure by ad hoc committees in Chapter 11 cases.[107] Furthermore, because of significant ambiguities regarding the applicability of Prior Rule 2019 to ad hoc committees, these motions were fiercely litigated, stalling reorganization efforts and generating significant legal fees.

However, with no interpretational ambiguities to exploit, distressed investor compliance with the New Rule 2019's disclosure requirements will most likely become routine.[108] Furthermore, even where an ad hoc committee fails to make disclosures required by New Rule 2019, the judge should be able to order disclosure without the need for extensive litigation between the parties.[109] This is likely to result in a steep decline in Rule 2019 litigation in Chapter 11 cases, thereby reducing litigation costs and allowing debtors to exit the bankruptcy process more quickly. As a result of lower costs and shorter proceedings, investors in claims against Chapter 11 debtors stand to realize superior returns on investment under New Rule 2019.

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[107] *See* Letter, Hon. Robert E. Gerber, *supra* note 65, at 5.

[108] *See Hearing*, *supra* note 2, at 20 (statement of Hon. Robert E. Gerber).

[109] *See id.*

C. Distressed Investors Realize the Greatest Benefit from Any Reduction in Manipulation by Parties Seeking to Decrease Value of Estate

Finally, contrary to conventional wisdom, distressed investors, as a class, should be the greatest beneficiary of New Rule 2019's enhanced position disclosure requirements to the extent these requirements successfully prevent other parties from manipulating the Chapter 11 reorganization process to benefit a short economic interest.[110]

Several academic articles focus on the possibility that a distressed investor could engage in manipulative tactics to the detriment of other claimholders in order to benefit a net short position.[111] These articles have generally divided Chapter 11 claimants into two groups—distressed investors and other claimants—portraying the distressed investors as pirates seeking only to maximize the value of their short positions and the other claimants as their unwitting victims.[112] However, this analytical framework fails to recognize that distressed investors as a class generally bear the brunt of any nefarious behavior because (1) the majority of creditors in Chapter 11 cases are distressed investors[113]

[110] In fact, some distressed investors lobbied for position disclosure by ad hoc committee members, even under Prior Rule 2019. For example, in *Adelphia Communications Corp.*, the Official Committee of Unsecured Creditors (composed solely of distressed investors) argued that "[i]t is appropriate to know when somebody stands up in court, somebody takes a position, somebody files pleadings, it's appropriate to know who their clients are and what their positions are." Letter, Hon. Robert E. Gerber, *supra* note 65, at 8–9 n.18.

[111] *See* Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. 648 (2010); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609 (2009); Coco, *supra* note 37.

[112] *See* Lipson, *supra* note 111; Coco, *supra* note 37; Baird & Rasmussen, *supra* note 111.

[113] *Hearing*, *supra* note 2, at 23 (statement of Hon. Robert E. Gerber) (noting that in Chapter 11 cases over which he presides, most of the creditors are distressed investors). Importantly, this fact compels the conclusion that the vast majority of distressed investors who are claimants in a Chapter 11 proceeding must have net long economic exposure to the value of the debtor's estate.

and (2) "the vast majority of distressed investors [participating in Chapter 11 proceedings] act entirely appropriately."[114] These facts compel the conclusion that, in the aggregate, distressed investors are likely to be the primary beneficiaries of New Rule 2019's expanded disclosure requirements, to the extent that these requirements effectively prevent parties in interest from manipulating the Chapter 11 reorganization process.

While New Rule 2019 may not completely eliminate the opportunity for net-short investors to manipulate the Chapter 11 reorganization process, it should significantly limit such behavior. By requiring each member of an official or ad hoc committee to disclose fully each claim, security, or instrument that impacts its net economic exposure to the debtor, New Rule 2019 arms distressed investors with the information necessary to police the actions of their peers. For example, with full information of the economic interests held by each member, ad hoc committees can effectively terminate the membership of any members they suspect of attempting to manipulate the Chapter 11 process. The likely result is that net short distressed investors will refrain from participation via official or ad hoc committee in order to avoid disclosure.

Furthermore, although an entity intent on manipulating the reorganization process could choose to participate in Chapter 11 proceedings on an individual basis,[115] such action is likely to be foreclosed in the vast majority of cases due to the high cost of individual participation. Because in most cases individual participation in the Chapter 11 reorganization process will be economically infeasible and

[114] *Id.* at 27–28. Judge Gerber notes that in a case involving disclosure of a credit default swap held by a distressed investor, in deciding whether or not to compel disclosure, he was effectively weighing the interests of one distressed investor against those of other distressed investors, who likely was representative of the majority of other creditors in the case. *See id.* at 23.

[115] New Rule 2019 and its disclosure requirements apply only to groups or committees that consist of or represent, and entities that represent, multiple creditors or equity security holders acting in concert to advance their common interests. FED. R. BANKR. P. 2019(b)(1).

the disclosure requirements of New Rule 2019 foreclose participation via official or ad hoc committee, a distressed investor pursuing a net-short strategy in a Chapter 11 case is likely to find itself blocked from participation, and thus unable to manipulate the outcome of the reorganization. Of course, this result will benefit all creditors and equity holders. However, because they hold a majority of claims in Chapter 11 cases, distressed investors will realize the greatest benefit.

V. CONCLUSION

Distressed investors as a class are likely to emerge as the primary beneficiaries of recent amendments to Rule 2019. While New Rule 2019 will require many distressed investors to disclose publicly their claims and economic interests in the debtor (including short and derivative positions), such disclosure is unlikely to reveal their proprietary investment strategies or threaten profits. Additionally, because "the vast majority of distressed investors [participating in Chapter 11 proceedings] act entirely appropriately,"[116] most distressed investors stand to realize several substantial benefits under New Rule 2019. These benefits include: (1) improved ability to forecast expected returns at the time of investment due to increased certainty regarding future legal and financial advisory costs related to the investment; (2) lower investment costs and higher annualized returns on investment stemming from speedier and less litigious Chapter 11 proceedings; and (3) heightened protection from parties seeking to manipulate the Chapter 11 process to decrease the value of the debtor's estate. By lowering investment costs, New Rule 2019 should result in improved returns for distressed investors holding claims against Chapter 11 debtors. Furthermore, faced with these lower investment costs, distressed investors are likely to uncover many attractive distressed investment opportunities that would have appeared far less attractive under Prior Rule

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[116] *Hearing*, *supra* note 2, at 27–28 (statement of Hon. Robert E. Gerber).

2019. As a result, New Rule 2019 should increase distressed investors' demand for claims and securities of Chapter 11 debtors, thereby ensuring the vitality of the secondary market for distressed debt.