WHAT'S YOUR POSITION? AMENDING THE BANKRUPTCY DISCLOSURE RULES TO KEEP PACE WITH FINANCIAL INNOVATION

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This Comment addresses the threat posed to the bankruptcy process by creditors whose true economic incentives are not aligned with their disclosed claims. Under current bankruptcy law, these so-called "empty creditors" may actively participate in the debtor's reorganization without ever disclosing their real economic interests. This Comment begins by exploring the extent to which empty creditors have influenced modern Chapter 11 cases. It then details the current controversy concerning the degree of position-level transparency required by Rule 2019 of the Federal Rules of Bankruptcy Procedure. Finally, it describes and critiques a proposed amendment to Rule 2019 and offers a disclosure regime that would mitigate the harms created by empty creditors.

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INTRODUCTION

A fundamental premise of the United States bankruptcy regime is that creditors will participate in Chapter 11 cases to the extent that participation maximizes their own economic interests.[1] Whether a given creditor elects to play an active or passive role in a corporate reorganization will hinge upon that creditor's analysis of the costs and benefits of active participation. Creditor participation is the primary countervailing check against the broad powers granted to debtors-in-possession[2] under Chapter 11.[3] In recent years, creditors have played an increasingly influential role in bankruptcy cases and proceedings.[4] However, the proliferation of credit default swaps (CDS) and other complex financial instruments threatens to undermine the balance of power between debtors and creditors, and to create a host of complications to which the current Bankruptcy Code is ill-equipped to respond.

Credit default swaps are frequently analogized to insurance contracts.[5] In its simplest form, a CDS represents a form of insurance against the risk of default by a corporate borrower (the reference entity). The holder of a corporate debt security may wish to purchase a CDS to minimize his economic exposure to a default by the reference entity. Under a typical CDS contract, the buyer of a CDS (the protection buyer) makes fixed premium payments to the seller of the swap (the protection seller) throughout the duration of the CDS contract. In

1. *See* Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 417–18 (2007).

2. In Chapter 11, the term "'debtor in possession' means debtor except when a person that has qualified under section 322 of [the Bankruptcy Code] is serving as trustee in the case." 11 U.S.C. § 1101(1) (2006). Chapter 11 vests the pre-petition management team with the power to operate the debtor company unless the court appoints a trustee. *See id.* §§ 1107–1108.

3. See Lubben, *supra* note 1, at 418–19 for an overview of the most important powers granted to debtors (and countervailing creditor powers) under the Bankruptcy Code.

4. *See id.* at 419; Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675 (2003) (describing modern Chapter 11 cases as "legal vehicles by which creditors in control decide which course of action—sale, prearranged deal, or a conversion of debt to a controlling equity stake—will maximize their return"); Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 840–41 (2005).

5. *See, e.g.*, *Burning Down the House*, ECONOMIST, Mar. 7, 2009, at 80 ("A [credit default swap] works like a fire-insurance policy: the holder pays a regular premium, but if the house burns down there is a big payoff."). However, unlike a standard insurance contract, the CDS pays off even if its holder is the one who "sets the fire" by forcing the underlying company to file for bankruptcy. *See id.*

return, the protection seller agrees to make a payment to the protection buyer if and when a credit event occurs. In a typical CDS contract, a credit event is triggered when the reference entity defaults under the terms of a credit agreement, completes an out-of-court restructuring, or files for bankruptcy.[6] Should a credit event occur, the protection seller is obligated to make a payment to the protection buyer that is "based on the difference between the face value of the debt instrument and its estimated market value shortly after the credit event."[7] The net result is that the holder of the CDS will be compensated for at least some portion of the diminution in value of his debt instrument that occurs as a result of a credit event.

The CDS market has grown exponentially in the past decade. In mid-2001, an International Swaps and Derivatives Association (ISDA) survey found that the total notional value[8] of outstanding credit derivatives transactions was $631.5 billion.[9] In its 2009 mid-year survey, ISDA found that the total notional value had soared to $31.22 trillion.[10]

As the credit derivatives market is a relatively recent and complex phenomenon, its potential implications in the bankruptcy context have received only limited scholarly attention.[11] Some commentators have heralded the growth of the CDS market, arguing that a large market provides "increased opportunities for hedging, increased liquidity, reduced transaction costs, and a deeper and potentially more efficient market for trading credit risk."[12] Despite

6. Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663, 680 (2008).

7. *Id.* For a complete discussion of the mechanics of credit default swaps, see *infra* Part II.

8. The notional value of a credit default swap is "a hypothetical underlying quantity upon which interest rate or other payment obligations are computed." *Product Descriptions and Frequently Asked Questions*, INT'L SWAPS & DERIVATIVES ASS'N (ISDA), http://www.isda.org/ (select "Education"; then select "Product Descriptions"; then select "6. Definition: Notional Principle") (last visited Jan. 31, 2011).

9. *2001 Mid Year Market Survey*, ISDA, http://www.isda.org/ (select "Survey & Market Statistics"; then select "Summaries of Market Survey Results"; then select "2001 Mid-Year") (last visited Jan. 31, 2011).

10. *2009 Mid Year Market Survey*, ISDA, http://www.isda.org/ (select "Survey & Market Statistics"; then select "Summaries of Market Survey Results"; then select "2009 Mid-Year") (last visited Jan. 31, 2011). According to ISDA's market surveys, the notional value of outstanding credit derivative contracts decreased by 43 percent between mid-year 2008 and mid-year 2009. *Id.* ISDA attributes this decline to "continuing efforts at portfolio compression at major dealers." *Id.*

11. *See* Hu & Black, *supra* note 6, at 679. The most significant academic discussions of the role of credit derivatives in bankruptcy can be found in Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610; Hu & Black, *supra* note 6; Lubben, *supra* note 1; Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007); and Douglas Baird & Robert Rasmussen, *Anti-Bankruptcy* (U.S. Cal. L. & Econ. Working Paper Series, Paper No. 93, 2009). Steven Schwarcz has also written extensively on CDS, although his focus is on systemic market risk rather than the interplay between CDS and bankruptcy. *See generally* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

12. Partnoy & Skeel, *supra* note 11, at 1020.

the potential benefits of a robust credit derivatives market, the rapid proliferation of these instruments presents several troubling issues for bankruptcy practitioners and judges.

As noted above, the Bankruptcy Code is premised on a delicate balance of power between debtors and creditors. The bankruptcy laws assume that creditors will act to maximize their own economic self-interest, and thus creditors with large claims are more likely to actively participate in the reorganization process.[13] Accordingly, the Bankruptcy Code affords creditors voting power in proportion to the dollar value of their claims.[14]

But the Code was not written with CDS and other modern financial instruments in mind. Consider a hypothetical bankruptcy case in which the largest bondholder has completely hedged its claim with CDS. Such a creditor will, under the current bankruptcy system, be afforded voting rights in proportion to the size of its bond position but will bear virtually no economic risk. This bifurcation of economic risk and voting rights is not unique to CDS. Creditors may also enter into so-called total return swaps in which "the owner of a loan (total return payer) exchanges the income from the loan and any appreciation for a guaranteed income stream plus protection against capital depreciation."[15] Alternatively, a creditor may reduce or eliminate its economic risk by shorting other classes of securities in the debtor's capital structure, such as equity, bonds, or secured loans.[16] Henry Hu and Bernard Black have coined the term "empty creditor" to describe "a creditor who retains formal contractual control rights and legal rights, yet has partly or fully hedged its economic risk."[17]

Empty creditors have the potential to wreak havoc on the bankruptcy process. Because they are largely indifferent to the ultimate recovery on their claims, empty creditors may play a passive role in bankruptcy proceedings, thus failing to exercise their considerable powers to check debtors-in-possession.[18] Moreover, because empty creditors have a predetermined floor on their downside risk, they may be more likely to support or propose risky and economically inefficient plans of reorganization.[19] Empty creditors may even be

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13. *See* Lubben, *supra* note 1, at 417–18.
14. *See* 11 U.S.C. § 1126(b) (2006) (providing that "[a] class of claims has accepted a plan [of reorganization] if such plan has been accepted by creditors . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors").
15. Baird & Rasmussen, *supra* note 11, at 39.
16. *See generally* Hu & Black, *supra* note 6 (explaining the various ways in which a creditor or investor may be rendered "empty").
17. *Id.* at 680.
18. *See* Lubben, *supra* note 1, at 425.
19. *Id.* at 429.

appointed to serve on official unsecured creditors' committees,[20] in which case, if they agree to serve, they would owe fiduciary duties to their constituent members,[21] despite the obvious differences in economic incentives between the empty creditors and the unhedged creditors.

Perhaps even more alarming than the prospect of empty creditors is the threat of net short creditors. A creditor is net short if the notional value of its CDS position exceeds the face value of the debt that it holds, so that the creditor stands to not only break even but *profit* if a credit event occurs. In other words, the creditor has placed a bet on the failure of the reference entity. Such a creditor would arguably have a vested interest in forcing the debtor into bankruptcy.[22] There is anecdotal evidence of net short creditors refusing to participate in out-of-court workout agreements, ostensibly because their CDS contracts would not pay out in the event of an out-of-court restructuring.[23]

This Comment elaborates on the potential harms that can occur when sophisticated investors with limited economic risk participate in the bankruptcy process and proposes a modest disclosure regime to mitigate these harms. Part I elaborates on the threat empty creditors pose and recounts several incidents in which such creditors have acted in accordance with their distorted incentives. Part II details the current controversy regarding the proper degree of disclosure of trading positions by hedge funds that participate in bankruptcy cases through ad hoc committees. Specifically, this Part explains how recent court decisions on the issue of hedge fund disclosures under Rule 2019 of the Federal Rules of Bankruptcy Procedure could impact empty creditors. Finally, Part III scrutinizes a pending proposed amendment to Rule 2019, which is the principal disclosure mechanism in the Bankruptcy Code, and offers an improved disclosure system that would alert debtors, creditors, judges, and attorneys to the presence of empty creditors without imposing unduly burdensome disclosure requirements.

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20. *See* 11 U.S.C. § 1102 (2006).

21. *See* Westmoreland Human Opportunities, Inc. v. Walsh, 246 F.3d 233, 256 (3d Cir. 2001); *In re* SPM Mfg. Corp., 984 F.2d 1305, 1315 (1st Cir. 1993).

22. This is because the filing of a bankruptcy petition is a credit event that would trigger a payout on the creditor's CDS position.

23. *See, e.g.*, Partnoy & Skeel, *supra* note 11, at 1034–35 (describing a situation in which hedge fund creditors, who were also believed to hold large short positions, were rumored to have "'triggered the [bankruptcy] filing to make their short positions worth more'" (quoting Henny Sender, *Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play*, WALL ST. J., July 18, 2005, at C3)); *see also* Shannon D. Harrington & Pierre Paulden, *YRC Has Until Yearend to Corral Bondholders, Avert Bankruptcy*, BLOOMBERG.COM, Dec. 18, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=a9kPU.MsW.xg (noting that YRC Worldwide Inc. failed to complete a debt exchange because it was "locked in a struggle with a group of bondholders who own derivatives that would profit if the company defaults"). This topic is discussed more fully in Part II, *infra*.

I. THE EMPTY CREDITOR PROBLEM

The degree to which empty and net short creditors have distorted bankruptcies and workouts is unknown. There is currently no disclosure system in place that would require such a creditor to reveal its true economic exposure, so hard evidence of foul play is necessarily scant. Scholars who have contemplated this problem have had to rely primarily on "possibilities, rumors, practitioner articles (which often don't name particular instances), and conversations with bankruptcy lawyers, bankruptcy judges, and other knowledgeable market participants."[24] Even so, the anecdotal evidence leaves little doubt that, though its magnitude is unknown, this phenomenon has made its mark in several high-profile bankruptcy and restructuring situations. At the very least, the mere possibility of empty creditors can undermine confidence in the bankruptcy system and raise suspicion about a creditor's motives.

A. Empty Creditors Force Debtors Into Bankruptcy by Refusing to Participate in Out-of-Court Workouts

The dangers posed by net short creditors are most easily observable in the context of an out-of-court restructuring. The basic concept is that a net short creditor may impede or resist a debtor's efforts to complete an out-of-court restructuring because, should the debtor file a bankruptcy petition, the profit from the creditor's short position would outweigh the loss on its long position.

Union members of YRC Worldwide (YRC), one of the largest trucking companies in the United States, allege that creditors holding CDS positions nearly drove the company into bankruptcy last year.[25] Facing a December 30 deadline to make a $19 million interest and fee payment,[26] the company sought to complete a debt-for-equity exchange to stave off bankruptcy.[27] Throughout the month of December, with the interest payment looming, YRC granted multiple extensions to bondholders but still could not obtain the required acceptance rate to complete the exchange.[28] Approximately two weeks prior to the

24. Hu & Black, *supra* note 6, at 679; *see also* Duncan Wood, *The CDS Curse*, RISK MAG., Aug. 1, 2009, at 33, 33.

25. *See* Carey Gillam, *Trucker YRC's Debt Exchange Succeeds, Shares Fall*, REUTERS, Dec. 31, 2009, http://www.reuters.com/article/idUSTRE5BT1ZI20091231.

26. *Teamsters Seek Probe of YRC Debt Trading*, J. COM. ONLINE, Dec. 23, 2009, http://www.joc.com/trucking/teamsters-seek-probe-yrc-debt-trading.

27. *YRC Extends Offer Deadline, Claims New Support*, J. COM. ONLINE, Dec. 30, 2009, http://www.joc.com/trucking/yrc-extends-offer-deadline-claims-new-support.

28. *Id.*

deadline, Teamsters head Jimmy Hoffa wrote letters to the SEC and New York Attorney General Andrew Cuomo to draw attention to the "questionable promotion" of CDS referencing YRC.[29] Hoffa alleged that Goldman Sachs and other major Wall Street firms were promoting and making a market in which investors would purchase a package of YRC bonds and CDS contracts that would be profitable in the event of bankruptcy.[30] Hoffa described the strategy as follows:

> Certain financial firms, have been or are marketing . . . or underwriting a strategy where bonds in YRCW would be bought by investors with the intent of voting against the exchange, thereby triggering a bankruptcy that would pay the investors and possible other financial firms huge profits from the high (credit default swap) payments which would be triggered by a YRC bankruptcy or liquidation . . . The profit from the YRCW (swaps) would far outweigh losses from the failed YRCW bonds.[31]

Hoffa and the Teamsters also planned to picket outside the New York office of hedge fund Brigade Capital Management, believed to be a key bondholder participating in the CDS strategy.[32] The picketing action was scheduled for December 30, the day before the deadline to complete the exchange and make the required interest payment, and was intended to put pressure on Brigade to acquiesce to the debt-for-equity exchange.[33] However, the union postponed its rally after learning that Brigade had sold its YRC bonds.[34] It is reported that several of the Wall Street banks named in Hoffa's letter to the SEC stepped in at the last minute, bought the YRC bonds from dissenting bondholders, and agreed to the exchange.[35] YRC CEO Bill Zollars described the exchange as "a lot more difficult than we thought it would be" and cited the CDS holders who were rooting for the exchange to fail.[36]

Lear Corporation's 2009 bankruptcy filing provides further evidence of the distorted incentives a CDS can create. Lear's plan of reorganization called for

29. *See Teamsters Seek Probe*, *supra* note 26.

30. *Id.*

31. *Id.*

32. Thomas L. Gallagher, *Teamsters Postpone Protest in Support of YRC*, J. COM. ONLINE, Dec. 30, 2009, http://www.joc.com/trucking/teamsters-protest-supports-yrc.

33. *Id.*

34. *Id.*

35. William B. Cassidy, *Hoffa Says Teamsters to Build on YRC Success*, J. COM. ONLINE, Feb. 16, 2010, http://www.joc.com/trucking/hoffa-says-teamsters-build-yrc-success.

36. David Benoit & Tess Stynes, *YRC Debt Swap Helps Stave Off Bankruptcy*, WALL ST. J., Jan. 2, 2010, at B5. A similar situation is rumored to have precipitated the bankruptcy filing of Tower Automotive. *See* Sender, *supra* note 23, at C3 (describing how a group of hedge fund lenders who also held short positions in Tower allegedly pushed the company into bankruptcy by refusing to agree to a debt-for-equity exchange).

the company to convert $3.6 billion of debt into approximately $1.6 billion of new debt plus convertible preferred shares.[37] The plan, however, called for its trade creditors to be paid in full.[38] In an interview with *Risk Magazine*, Alex Yavorsky of Moody's Investors Service pointed out a peculiar aspect of this plan:

> One question to ask in this context is why, then, do you need to file for bankruptcy? The company could conceivably have exchanged its debt voluntarily. Bankruptcy is useful when you want to share the pain with other creditor groups such as trade creditors. It's impossible to know for sure, but one possible explanation for the decision to file is that the bondholders that were protected by the CDS may not have been paid if the restructuring was done on a voluntary, out-of-bankruptcy basis.[39]

This filing caught Yavorsky's attention because of the magnitude of the Lear CDS market relative to its outstanding bonds. Though the company's outstanding debt was $3.6 billion, there was reportedly more than $15 billion notional value of credit derivatives referencing this debt.[40]

Toys "R" Us's bond issuance is another recent corporate transaction that has sparked speculation that CDS concerns may be figuring prominently into corporate decisionmaking. On July 1, 2009, Toys "R" Us issued $950 million of senior unsecured notes due in 2017.[41] The notes were issued from a wholly owned subsidiary called Toys "R" Us Property Company I, LLC.[42] The implication of the rather unusual decision to issue the debt through a property subsidiary rather than the parent company is that any currently outstanding CDS will not reference the new debt issue.[43] Some have speculated that Toys "R" Us intentionally structured the deal this way to strip bondholders of any incentive

37. *See* Wood, *supra* note 24, at 34.
38. *Id.*
39. *Id.*
40. *Id.* Yavorsky has developed a framework for identifying companies that are particularly likely to be influenced by creditors holding CDS positions:

> In his own search for cases in which protected creditors have influenced bankruptcy decisions, Yavorsky has compiled a list of around 30 other companies that satisfy three criteria: they are rated Caa or lower, meaning default is a near-term possibility; they are one of the CDS market's top 1,000 reference entities; and there is a high ratio of derivatives to bonds, suggesting many creditors could be protected. "If somebody wanted to be on the lookout for firms where this particular phenomenon might actually come to the surface, those would be the ones to look at," Yavorsky says.

Id.

41. TOYS "R" US, INC., CURRENT REPORT (FORM 8-K) (2009), *available at* http://www.sec.gov/Archives/edgar/data/1005414/000119312509143556/d8k.htm.
42. *Id.*
43. *See* Wood, *supra* note 24, at 33.

to force the company into bankruptcy.[44] This type of debt issuance strategy has been dubbed a basis-buster.[45]

B. Empty Creditors Can Impede Reorganization in Bankruptcy

Even after a corporation has filed for bankruptcy protection, it may not be impervious to the threats posed by net short creditors or empty creditors. Although examples are scarce, the possibility exists that such creditors would actively sabotage the debtor's Chapter 11 reorganization in an attempt to drive up the value of their CDS positions. While this threat looms large, the extent to which creditors actually engage in activity of this nature is unknown because there is currently no mechanism in place that would force creditors to disclose any short positions in the debtor's securities.

The scent of net short creditors was detected in the recent bankruptcy case of chemical giant LyondellBasell's U.S. subsidiaries.[46] The U.S. operations filed for bankruptcy and subsequently applied for a temporary restraining order to enjoin creditors from pursuing remedies against its nondebtor foreign parent.[47] At a hearing on whether the temporary restraining order should turn into a permanent injunction, a group of creditors holding bonds issued by the European parent company appeared in court to argue against the injunction.[48] An attorney present at the hearing explained the debtor's response:

> Lyondell produced an article written in January in which a journalist wrote he had heard people had been buying up the European bonds and then buying protection, and they were seeking to trigger a default on the bonds. They showed this article to the judge and essentially said, "Gee, judge, these nasty traders are trying to destroy our company for their own financial gain."[49]

Judge Robert Gerber responded by scheduling another hearing ten days later and ordering all bondholders in opposition to the injunction to disclose any positions in credit derivatives that referenced LyondellBasell.[50] According to the

44. *Id.* at 33–34.

45. *Id.* Basis-buster refers to the so-called "negative basis" trading strategy of pairing a long position in bonds with a short position in CDS. *See* Moorad Choudhry, *The Credit Default Swap Basis: Illustrating Positive and Negative Basis Arbitrage Trades*, YIELDCURVE.COM (July 2006), http://www.yieldcurve.com/Mktresearch/files/Choudhry_BasisTrade_Jul06_Logo.pdf.

46. Lyondell Chem. Co. v. CenterPoint Energy Gas Serv., Inc. (*In re* Lyondell Chem. Co.), 402 B.R. 571 (Bankr. S.D.N.Y. 2009). For an excellent account of the proceedings that related to holders of CDS, see Wood, *supra* note 24.

47. *Lyondell*, 402 B.R. at 575–76.

48. Wood, *supra* note 24, at 34.

49. *Id.*

50. *Id.*

attorney, some bondholders dropped their opposition to the injunction, while others "returned for the final hearing and disclosed their positions under seal."[51] Judge Gerber ultimately extended the temporary restraining order for sixty days.[52]

Of course, the doomsday scenario that critics envisioned is that a net short creditor (or, more likely, an ad hoc committee[53] composed of net short creditors) would purchase a blocking position in the debtor's bonds and use that position to hinder the company's chances of a successful reorganization.[54] The Bankruptcy Code provides that in order for a class of claims to accept a plan of reorganization, the holders of "at least two-thirds in amount and more than one-half in number of the allowed [and voting] claims of such class" must vote to accept the plan.[55] Thus, a creditor or group of creditors holding more than one-third in amount or at least one-half in number of the allowed claims in a class possesses blocking power in that it can unilaterally reject a plan of reorganization. While the debtor may still be able to cram down the plan over the dissenting creditor(s),[56] the blocking stake would at least confer significant negotiating leverage upon the net short creditors rooting for the reorganization to fail.

C. Other Problems Created by the Presence of Empty Creditors

There are less nefarious, but possibly more common, problems presented by empty creditors and net short creditors. Even when such creditors are not acting deviously to subvert the debtor's reorganization, they may adversely affect the bankruptcy process. Fully hedged creditors have little, if any, incentive to act as adversaries to the debtor-in-possession throughout bankruptcy cases because they bear no economic risk. As noted above, the adversarial debtor-creditor relationship is a bedrock of the United States bankruptcy regime.[57] Stephen Lubben

51. *Id.*

52. *Id.* As Part III illustrates, Judge Gerber has been a major proponent of reforming the bankruptcy rules to provide for enhanced disclosure of credit derivative positions. *See infra* Part III.

53. An ad hoc committee is an informal group of creditors acting collectively to increase its bargaining power and reduce the costs of litigation. *See infra* Part II.B.

54. While there are no known examples of this phenomenon, Jason Kilborn of the John Marshall Law School has noted the potential for such activity to occur. *See* Jason Kilborn, *Hoping for Failure!?*, CREDIT SLIPS: A DISCUSSION ON CREDIT AND BANKRUPTCY (Mar. 11, 2009, 4:14 PM), http://www.creditslips.org/creditslips/2009/03/hoping-for-failure.html.

55. 11 U.S.C. § 1126(c) (2006).

56. *See id.* § 1129(b) (providing that the debtor may cram down a plan on dissenting creditors if certain requirements are met, most notably that the plan is "fair and equitable" with respect to each impaired class).

57. *See* Lubben, *supra* note 1.

describes how this relationship might be altered by the existence of a creditor whose economic risk is eliminated or mitigated by a CDS position:

> The Bankruptcy Code gives creditors a variety of tools that check the tools given to debtors, but there is no affirmative requirement that creditors use these tools. And the court generally has no obligation or power to assert the rights or powers of creditors if no creditor deems it wise to appear before the court. Likewise, a theory of creditor control in chapter 11 only works if the creditor who has bargained for certain levers of control also decides to use those levers.[58]

Lubben provides a table (reproduced in part below) that offers an excellent summary of the various powers granted to debtors under the Bankruptcy Code and the concomitant checks on those powers granted to creditors.[59]

Debtors' Powers	***General Creditors' Powers***
Initiation/Choice of Procedure (§ 301, § 1112(a))	Involuntary Petition (§ 303); Conversion Or Dismissal (§ 1112(b))
Automatic Stay (§ 362)	Lift Stay (§ 362(d)); Adequate Protection (§ 361)
Assumption/Rejection [of Executory Contracts] (§ 365)	Lift Stay (§ 362(d))
Exclusivity (§ 1121)	Terminate Exclusivity (§ 1121(d)); Trustee (§ 1104); Conversion Or Dismissal (§ 1112(b))
Cramdown (§ 1129(b))	Classification (§ 1122); Good Faith (§ 1129(a)(3)); One Class Rule (§ 1129(a)(10)); Two Part Majority Rule (§ 1126(c)); Best Interests Test (§ 1129(a)(7))

58. *Id.* at 419–20. Lubben's assertion that "the court generally has no obligation or power to assert the rights or powers of creditors if no creditor deems it wise to appear before the court" is debatable. *Id.* Section 105(a) of the Bankruptcy Code grants the court broad power to act even in the absence of creditor action:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a).

59. Lubben, *supra* note 1, at 419.

The Code was crafted with the delicate balance of power between creditors and debtors in mind. However, this balance is disrupted when a large creditor has hedged its position and thus has no incentive to exercise its considerable rights in bankruptcy. As a result, the traditional (i.e., unhedged) creditors in the case may suffer from the large creditor's failure to vigilantly fight for maximum recovery value. On the other hand, empty creditors may pose an entirely different type of problem: excessive risk tolerance. Such creditors may be inclined to propose or vote in favor of highly risky plans of reorganization because "the risks they face are low relative to the size of their claims."[60] In other words, their downside is subject to a floor because of their CDS hedge, but they have unlimited upside potential. The incentive to champion a risky plan of reorganization is clear.

Thus far, this Comment has focused on the potential harms stemming from CDS. This is because CDS contracts represent the most direct way for a devious creditor to gain short exposure that matches its long position. However, there are myriad combinations of other financial instruments that could render a creditor empty or net short. For example, a creditor who owned a small position in the debtor's bonds and took a much larger short position in the debtor's equity securities would be similarly incentivized to encourage the debtor's failure. It is even possible for a traditional long-only creditor to be conflicted if it holds long positions in multiple classes of the debtor's capital structure.[61]

Although no one can be sure of the prevalence or magnitude of the harms caused by empty creditors in bankruptcy cases, the anecdotal evidence suggests that short positions are skewing creditors' incentives in a way that hinders reorganization and runs contrary to the purpose of the Bankruptcy Code. There is no denying that, at the very least, these instruments create the potential for abuse. Without any mechanisms in place to provide for disclosure of conflicts of interest created by derivatives and short positions, we may never know the extent to which this abuse is occurring. Part II explores a recent controversy concerning the scope of Rule 2019 of the Federal Rules of Bankruptcy Procedure, which governs disclosure in bankruptcy,[62] and discusses the issue's potential impact on the empty creditor problem. Before that, however, a brief overview of Rule 2019 illuminates the discussion.

60. *Id.* at 429.

61. *See, e.g.*, Aladdin Hotel Co. v. Bloom, 200 F.2d 627 (8th Cir. 1953) (describing how a controlling stockholder, who also held 72 percent of the debtor's outstanding bonds, extended the maturity date of the bonds for the benefit of the equity class).

62. *See* FED. R. BANKR. P. 2019(a).

II. RULE 2019 AND THE HEDGE FUND CONTROVERSY

A. An Overview of Rule 2019

Rule 2019 of the Federal Rules of Bankruptcy Procedure[63] is "part of the disclosure scheme of the Bankruptcy Code and is designed to foster the goal of reorganization plans which deal fairly with creditors and which are arrived at openly."[64] Rule 2019 requires "every entity or committee representing more than one creditor or equity security holder" to file a verified statement containing certain disclosures.[65] Each member of the entity or committee must disclose:

(1) the member's name and address;

(2) the nature and amount of the member's claim or interest and the time of acquisition unless it was alleged to have been acquired more than one year prior to the filing of the petition;

(3) the facts and circumstances in connection with the representative entity and, in the case of a committee, the name of the entity or entities who arranged or organized the committee; and

(4) the amounts of the claims or interests owned by the entity or the members of the committee and the time(s) on which such claims or interests were acquired, the amounts paid to acquire them, and any sales or disposition thereof.[66]

If the court determines that the disclosure requirements of Rule 2019(a) have not been complied with, the court may refuse to permit the committee to be heard further or to intervene in the case, or it will hold invalid any authority, acceptance, rejection, or objection given, procured, or received by a committee who has not complied with Rule 2019 or with section 1125(b) of the Code.[67]

Rule 2019 was enacted as the successor to Rule 10-211 under Chapter 10 of the Bankruptcy Act.[68] Congress passed Rule 10-211 "as a result of an extensive SEC Report regarding abuses by unofficial committees in corporate reorganizations."[69] Several commentators have argued that adopters of Rule

63. FED. R. BANKR. P. 2019.

64. 9 COLLIER ON BANKRUPTCY § 2019.01 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2010). Collier also notes that Rule 2019 "has been used as a control device to provide to stakeholders complete disclosure of material facts in the solicitation and voting process and to prevent conflicts of interest among creditors' counsel from undermining the fairness of the plan process." *Id.*

65. FED. R. BANKR. P. 2019(a).

66. *Id.* Note that the Advisory Committee on Bankruptcy Rules is currently considering a proposed amendment to Rule 2019. This development is discussed in detail in Part III, *infra*.

67. FED. R. BANKR. P. 2019(b).

68. *See* Coco, *supra* note 11, at 625.

69. *Id.*; *see also* SECURITIES & EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937) [hereinafter SEC REPORT].

10-211 were motivated by a desire to stem the abuse of deposit agreements by "protective committees."[70] These were agreements in which "creditors deposited their securities with a designated institution and gave up control of their rights in the reorganization to the committee."[71] The rule was intended to create a fiduciary relationship between the committee and the depositors.[72]

It is important to note that Rule 2019 governs only unofficial or ad hoc committees—it explicitly exempts official committees from its coverage.[73] Official creditors' committees, unlike ad hoc committees, are appointed by the U.S. Trustee pursuant to Bankruptcy Code section 1102(a)(1). The U.S. Trustee is required to appoint an official creditors' committee "as soon as practicable after the order for relief under chapter 11 of this title."[74] In cases in which the debtor remains in possession of the estate, the official committee is "capable of assuming many of the watchdog functions that would otherwise be performed by a trustee."[75] Appointed creditors need not serve on the official creditors' committee if they are not "willing to serve."[76] The U.S. Trustee may also appoint an official committee of equity security holders as it deems appropriate.[77]

B. Hedge Funds and Ad Hoc Committees

Although there is no universally accepted definition of the term "hedge fund," one scholar has aptly described hedge funds as "actively managed investment pools which invest in market opportunities to produce risk-adjusted positive returns."[78] Hedge funds are not registered as investment companies under the Investment Company Act.[79] Hedge funds engage in a vast array of

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70. *See* Coco, *supra* note 11, at 625 ("The rule was adopted to prevent exploitation by 'protective committees' in bankruptcy proceedings."); Evan D. Flaschen & Kurt A. Mayr, *Ad Hoc Committees and the Misuse of Bankruptcy Rule 2019*, 16 NORTON J. BANKR. L. & PRAC. 983, 984–86 (2007) (arguing that Rule 10-211 was implemented solely to remedy the abuse of deposit agreements); Sparkle L. Alexander, Note, *The Rule 2019 Battle: When Hedge Funds Collide With the Bankruptcy Code*, 73 BROOK. L. REV. 1411, 1420 (2008) ("[I]t is clear that [Rule 2019] was enacted to specifically address abuses by protective committees in the 1930s that solicited deposit agreements from investors.").

71. *In re* Wash. Mut. Inc., 419 B.R. 271, 277 (Bankr. D. Del. 2009) (granting a motion to compel disclosure under Rule 2019).

72. *See* Coco, *supra* note 11, at 625–26 (citing Kurt A. Mayr, *Bankruptcy Rule 2019: To Disclose or Not to Disclose, That Is the Question*, 24 BANKR. STRATEGIST 11 (2007)).

73. FED. R. BANKR. P. 2019(a) (explicitly stating that the rule does not apply to "a committee appointed pursuant to § 1102 or 1114 of the Code").

74. 11 U.S.C. § 1102(a)(1) (2006).

75. Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1004 (1993).

76. 11 U.S.C. § 1102(b)(1).

77. *Id.* § 1102(a)(1).

78. Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 192.

79. *Id.* at 205.

investing activities, but the relevant strategy for the purpose of this Comment is distressed debt investing. "Distressed debt trading occurs when investors purchase claims and interests in distressed entities."[80] Distressed debt investors seek to acquire claims "when the market value of debtors' claims falls below what these investors consider to be the 'true' value."[81]

Distressed debt investors may be able to acquire claims or interests at a price below "true value" for a variety of reasons. Claimants may be eager to "sell low" to avoid a lengthy and expensive reorganization process.[82] The seller may wish to sell in order to take advantage of a capital loss on his investment for tax purposes.[83] The seller may be an investment fund whose investment covenants do not permit it to invest in defaulted bonds.[84] Moreover, the claim might be laden with legal disputes that the seller cannot accurately assess. Because of these and other circumstances that put pressure on claimants to sell their claims, "[d]istressed investors offer liquidity, albeit often at a steep discount, for owners of nearly every kind of claim, including publicly traded debt, bank loans, trade claims, tort claims, and rejected executory contract claims."[85]

Hedge funds, including distressed funds, are known to fiercely protect the secrecy of their portfolio holdings. Hedge funds are reluctant to release information about their current holdings or historical purchases, out of fear that their competitors may be able to use this information to "reverse engineer" their trading strategies.[86] Most distressed debt hedge funds do not even disclose their positions to their investors, as they fear that this information could be leaked to the market.[87]

In 2003, Edward Altman, a leading expert on distressed debt investing, described the strategy as the "hottest alternative investment area."[88] Altman's research revealed the dramatic growth of the distressed trading strategy: At least $65 billion was allocated to distressed debt investing in 2003, while the

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80. Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2015 (2002).

81. Paul M. Goldschmid, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 206.

82. *Id.*

83. *Id.*

84. *Id.* at 207.

85. *Id.* at 206.

86. *See* Letter From Loan Syndications & Trading Ass'n & Sec. Indus. & Fin. Mkts. Ass'n to Comm. on Rules of Practice and Procedure of the Judicial Conference of the United States at 12 (Feb. 1, 2010) [hereinafter LSTA/SIFMA 2010 Letter], *available at* http://staging.sifma.org/Issues/item.aspx?id=876 (follow "SIFMA and Other Association Submit Comments to the Committee on Rules of the Judicial Conference of the U.S. on Bankruptcy Procedures" hyperlink).

87. *Id.* at 13.

88. Goldschmid, *supra* note 81, at 202 (citing Matt Miller, *Disciple of Doom*, DAILY DEAL, June 5, 2003).

comparable figure for 1991 was just $6 billion.[89] Commentators are sharply divided with respect to the value added by distressed debt hedge funds in bankruptcy proceedings,[90] but, for better or worse, distressed debt investors appear to be here to stay.[91]

When distressed debt hedge funds participate in bankruptcy reorganizations, they frequently find it advantageous to organize ad hoc committees.[92] The nature and purpose of ad hoc committees are as follows:

> *Ad hoc*, or unofficial, committees provide a mechanism by which creditors or equity interest holders with a common agenda can join together on an informal basis to advance their interests in the reorganization process. To put it simply: any group of creditors or equity holders who gets together and hires counsel to advance a common agenda in a bankruptcy case can be an *ad hoc* committee, whether or not it so labels itself. The theory behind *ad hoc* committees is that multiple creditors or equity holders singing together in chorus is better than a cacophony of individual creditors or equity holders each singing its own tune.[93]

The primary advantage of an ad hoc committee is that its constituents are able to "increase their leverage within the bankruptcy case and to share legal and other expenses."[94] A further advantage for hedge funds is that members of ad hoc committees, unlike members of official committees, have not traditionally been held to owe fiduciary duties to similarly situated creditors outside the committee; thus, they are able to trade their positions freely and "pursue their parochial interests."[95]

89. *Id.*

90. *Compare id.* at 193 (arguing that distressed debt investors "expedit[e] business reorganizations and protect . . . going-concern enterprise values") *with* Miller, *supra* note 80, at 2014–16 (arguing that distressed debt investors are partially responsible for the increased rate of recidivism in Chapter 11).

91. *See generally* Jonathan Henes, *Henes: The Boys Are Back in Town: Hedge Funds Are Trading Distressed Debt Again*, CNBC GUEST BLOG (Aug. 18, 2009, 10:20 AM), http://www.cnbc.com/id/32460428 (noting that, after a brief lull in hedge fund activity due to the so-called Great Recession and other market factors, "hedge funds are reentering the chapter 11 arena").

92. *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, AM. BANKR. INST. J., Dec.–Jan. 2007, at 24, 87.

93. Robert J. Rosenberg et al., Ad Hoc *Committees and Other (Unofficial) Creditor Groups: Management, Disclosure and Ethical Issues*, ABI BUS. REORGANIZATION COMMITTEE NEWSL., June 2008, at 261, 263, *available at* http://www.abiworld.org/committees/newsletters/busreorg/vol7num2/AdHoc.pdf.

94. Fisher & Buck, *supra* note 92, at 87.

95. *Id.*

C. The Rule 2019 Controversy Arises: Northwest and Scopac

Traditionally, hedge fund members of ad hoc committees enjoyed the benefit of maintaining a shroud of secrecy around their trading positions. According to one commentator, prior to 2007, no ad hoc or unofficial committee had ever been required to file a disclosure statement pursuant to Rule 2019.[96] However, the court's holding in *In re Northwest Airlines Corp.*[97] sent shock waves throughout the distressed debt community. Shortly after the *Northwest* decision was handed down, a conflicting decision in *In re Scotia Development LLC*[98] left the bankruptcy community in a state of utter confusion.

1. Northwest

Northwest Airlines filed a Chapter 11 petition on September 14, 2005.[99] While Northwest's bankruptcy case was in progress, U.S. Airways announced its unsolicited offer to purchase Delta Airlines, which was also in bankruptcy at the time.[100] This news "sparked widespread speculation in the trading markets about consolidation in the airline industry" and led to rapid price appreciation in airline stocks; Northwest's stock, in particular, increased nearly 300 percent on the news.[101]

These developments in the airline industry prompted a group of sophisticated distressed investors to purchase Northwest's stock.[102] This group, which consisted of thirteen members[103] who collectively owned approximately 27 percent of the debtor's stock,[104] became active in Northwest's bankruptcy proceedings. On January 11, 2007, the group of hedge funds made its first appearance in the case, calling itself the "*Ad Hoc* Committee of Equity Security

96. *See* Alexander, *supra* note 70, at 1420.

97. *In re* Nw. Airlines Corp. (*Northwest I*), 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re* Nw. Airlines Corp. (*Northwest II*), 363 B.R. 704 (Bankr. S.D.N.Y. 2007).

98. *In re* Scotia Dev., LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. May 29, 2007).

99. Debtors' Objection to Motion of the Ad Hoc Equity Comm. for an Order (A) Pursuant to §§ 105(a) & 107(b) of the Bankr. Code and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File Its Bankr. Rule 2019(a) Statement Under Seal, (B) Limiting the Disclosure Required in Their Rule 2019 Statement and (C) Granting a Temp. Stay Pending Determination of This Motion at 4, *Northwest II*, 363 B.R. 704 (Bankr. S.D.N.Y. 2007) (No. 05-17930) [hereinafter Northwest's Objection to Motion to File Under Seal].

100. *Id.*

101. *Id.*

102. *Id.* at 4–5.

103. *In re* Nw. Airlines Corp. (*Northwest I*), 363 B.R. 701, 702 (Bankr. S.D.N.Y. 2007).

104. *Northwest II*, 363 B.R. at 708.

Holders."[105] On January 16, the law firm representing the ad hoc committee filed a Rule 2019 statement that disclosed the *aggregate* claims and interests held by the group members.[106] Shortly thereafter, Northwest filed a motion for an order compelling the ad hoc committee to comply with Rule 2019 and disclose the required information for each member of the committee.[107]

In Judge Gropper's decision to compel disclosure under Rule 2019 (*Northwest I*), he emphatically rejected the ad hoc committee's argument that each committee member represented itself and only itself, and therefore the only "entity or committee representing more than one . . . equity security holder" was the attorney representing the group.[108] Judge Gropper chastised the committee for its attempt to "blithely avoid[ ]" what he felt was the plain language of Rule 2019.[109] He then enumerated a list of facts demonstrating that the committee was in fact a committee for the purposes of Rule 2019:

> [The members of the committee] appeared in these Chapter 11 cases as a "Committee." Their notice of appearance was as a committee, and it is the "Ad Hoc Committee" that has moved for the appointment of an official shareholders' committee and has been actively litigating discovery issues in numerous hearings and conferences before the Court. Counsel was retained by the "Committee" and is compensated by the "Committee" on the basis of work performed for the Committee (and not each individual member). The law firm does not purport to represent the separate interests of any Committee member; it takes its instructions from the Committee as a whole and represents one entity for purposes of the Rule.[110]

The opinion then moved on to briefly address some of the larger policy concerns presented by the issue. Judge Gropper noted that unofficial committees "play an important role" in bankruptcy.[111] He stated that "[b]y appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings."[112] Judge Gropper then touched on the history of Rule 2019, noting that its predecessor, Rule 10-211, was adopted in light of "perceived abuses by unofficial committees in

105. *Northwest I*, 363 B.R. at 701.
106. *Id.* at 701–02.
107. Northwest's Objection to Motion to File Under Seal, *supra* note 99, at 7.
108. *Northwest I*, 363 B.R. at 703.
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*

equity receiverships and other corporate reorganizations."[113] In light of this background and the "plain terms"[114] of Rule 2019, Judge Gropper granted the debtors' motion and ordered the committee to amend its statement so as to comply with Rule 2019's requirements within three business days.[115]

The hedge funds involved in the case vociferously objected to public disclosure of their trading information. The ad hoc equity committee filed a motion for an order allowing the amended Rule 2019 statement to be filed under seal, as permitted by Rule 9018.[116] Specifically, the committee sought "non-disclosure protection to seal the purchase prices, dates of purchase, and the dates of sales of claims and interests."[117] The committee's argument was based on the highly confidential and sensitive nature of the trading information to be disclosed. The committee relied on section 107(b) of the Bankruptcy Code, which provides that "[o]n request of a party in interest, the bankruptcy court shall . . . protect an entity with respect to a trade secret or confidential research, development, or commercial information . . . ."[118] The committee pointed out that its members "maintain strict confidentiality of trading information, do not disclose the amounts of their positions, their purchase prices, their trading timing, or other indications of trading strategy and would be severely prejudiced if such information is disclosed."[119] The committee also noted that its members did not even disclose this information to one another; only the committee's counsel was aware of each individual member's trading information.[120] The committee stressed that disclosure of purchase price information (either directly or indirectly through disclosure of purchase date information) would put the committee members at an "extreme disadvantage in plan negotiations" due to the

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113. *Id.* at 704.

114. *Id.* at 702.

115. *Id.* at 704.

116. *See* Motion of the Ad Hoc Equity Comm. for an Order (A) Pursuant to §§ 105(a) & 107(b) of the Bankr. Code and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File Its Bankr. Rule 2019(a) Statement Under Seal, and (B) Granting a Temp. Stay Pending Determination of This Motion at 6, *Northwest II*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (No. 05-17930) [hereinafter Northwest Ad Hoc Committee Motion to File Under Seal].

117. Reply of the Ad Hoc Equity Comm. in Further Support of its Motion for an Order (A) Pursuant to §§ 105(a) & 107(b) of the Bankr. Code and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File Its Bankr. Rule 2019(a) Statement Under Seal, and (B) Granting a Temp. Stay Pending Determination of This Motion at 3, *Northwest I*, 363 B.R. 701 (No. 05-17930) [hereinafter Northwest Ad Hoc Committee Reply].

118. Northwest Ad Hoc Committee Motion to File Under Seal, *supra* note 116, at 7 (emphasis omitted) (quoting 11 U.S.C. § 107(b) (2006)).

119. Northwest Ad Hoc Committee Reply, *supra* note 117, at 4–5.

120. *Id.* at 5.

fact that "other constituencies . . . will be able to determine the Ad Hoc Committee's basis and use that information against the Ad Hoc Committee."[121]

The second prong of the ad hoc committee's argument was policy-based. The committee cited the benefits that ad hoc committees (and, implicitly, hedge funds) bring to the bankruptcy process:

> There also is no doubt . . . that collective action by shareholders and creditors in ad hoc committees benefits bankruptcies, whether by providing liquidity, funding, alternative restructuring, or simply organizing groups with whom plans may be negotiated. Accordingly, secondary market participants are critical both to the efficiency of the capital markets and to the proper functioning and proper reorganization of debtors.[122]

The committee argued that forced disclosure of confidential trading information would have a "chilling effect" on future creditor involvement in bankruptcy cases and proceedings, to the detriment of all parties involved in the reorganization process.[123]

The ad hoc committee's motion to file its Rule 2019 statement under seal was met with a flurry of objections. Northwest filed an objection on the grounds that the trading information was neither a trade secret nor commercially sensitive information as contemplated by section 107(b).[124] Northwest pointed out that it merely sought to compel disclosure of current stock ownership and historical pricing data, as opposed to "disclosure of trading strategies, models, analytics or other information that may be characterized as 'proprietary' to an institution's investment strategy or philosophy."[125] The debtors' objection noted that, if certain conditions are met, federal securities law routinely compels investors to disclose the dates and prices of securities purchases (for example, Schedule 13D filings).[126] In fact, Owl Creek Asset Management, the "leading member of the [committee]" and the committee member holding the greatest amount of Northwest securities,[127] had already *voluntarily* filed two 13D schedules with the SEC, in which it disclosed "precisely the type of information" that Northwest

121. *Id.*
122. *Id.* at 7.
123. Northwest Ad Hoc Committee Motion to File Under Seal, *supra* note 116, at 10–13.
124. *See* Debtors' Objection to Motion of the Ad Hoc Equity Comm. for an Order (A) Pursuant to §§ 105(a) & 107(b) of the Bankr. Code and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File Its Bankr. Rule 2019(a) Statement Under Seal, (B) Limiting the Disclosure Required in Their Rule 2019 Statement and (C) Granting a Temp. Stay Pending Determination of This Motion at 3, *In re* Nw. Airlines Corp. (*Northwest II*), 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (No. 05-17930) [hereinafter Northwest Debtors' Objection].
125. *Id.* at 14.
126. *See id.* at 15 ("Schedule 13D must disclose the background and identity of the persons filing, the source and amount of funds for any purchase and the number of shares owned.").
127. *Id.* at 18.

sought to compel disclosure of via Rule 2019.[128] Owl Creek provided no evidence of prejudice or harm resulting from disclosure of the information.[129] Northwest cited this fact as strong evidence that "public disclosure of the [committee's] purchases and sales of Northwest common stock would not cause them to suffer any harm or prejudice."[130]

In addition to Northwest's objection, both the Official Committee of Unsecured Creditors and the U.S. Trustee filed objections to the ad hoc committee's motion, raising arguments similar to those made in the debtors' objection.[131] Interestingly, Bloomberg News also made a motion to intervene in the interest of ensuring that "the public has a full and accurate understanding of the events occurring in this Chapter 11 proceeding."[132] Bloomberg argued that the role of distressed hedge funds was "an issue of intense public interest and debate" and that "[t]he nature of the positions being taken by these key financial players, and the potentially conflicting interests they may hold in any given situation, raise the potential for precisely the types of abuse that led to the adoption of Rule 2019."[133] Bloomberg even raised a First Amendment argument, claiming that the public has a right of access to judicial documents in civil proceedings.[134]

In *Northwest II*, Judge Gropper considered the ad hoc committee's motion to file its Rule 2019 statement under seal and the accompanying objections.[135] In a succinct five-page decision, Judge Gropper denied the ad hoc committee's motion.[136] Skeptical of the committee's "trade secret" argument under section 107(b), Judge Gropper said it was "improbable" and "unsupported" that

128. *Id.*

129. *See id.*

130. *Id.*

131. *See* Objection of the Official Comm. of Unsecured Creditors to Ad Hoc Equity Comm.'s Motion for an Order Granting Leave to File Its Rule 2019(a) Statement Under Seal, *Northwest I*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (No. 05-17930) [hereinafter Northwest Official Committee Objection]; Response of the United States Trustee to Motion of Ad Hoc Equity Comm. for an Order Pursuant to 11 U.S.C. §§ 105(a) & 107(b) and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File Its Rule 2019(a) Statement Under Seal, *Northwest I*, 363 B.R. 701 (No. 05-17930) [hereinafter U.S. Trustee Response].

132. Memorandum of Law by Bloomberg News in Support of Intervention and in Opposition to the Ad Hoc Equity Comm.'s Request for an Order Sealing Its Rule 2019(a) Disclosures at 1, *Northwest I*, 363 B.R. 701 (No. 05-17930) [hereinafter Bloomberg Motion].

133. *Id.* at 2–3.

134. *Id.* at 9–10 (citing Lugosch v. Pyramid Co. of Onandaga, 435 F.3d 110, 119–20 & n.4 (2d Cir. 2006)); Video Software Dealers Ass'n v. Orion Pictures Corp. (*In re* Orion Pictures Corp.), 21 F.3d 24, 26 (2d Cir. 1994); United States v. Suarez, 880 F.2d 626, 631 (2d Cir. 1989); United States v. Haller, 837 F.2d 84, 87 (2d Cir. 1988)).

135. *In re* Nw. Airlines Corp. (*Northwest II*), 363 B.R. 704 (Bankr. S.D.N.Y. 2007).

136. *Id.* at 709.

competitors would be able to discern the committee members' "investment strategies" on the basis of the information to be disclosed under Rule 2019.[137]

Judge Gropper then moved on to a brief examination of Rule 2019's legislative history. He noted that the SEC Report,[138] upon which Rule 2019's direct antecedent was based, warned of possible conflicts of interests stemming from outsiders as well as insiders.[139] Partially motivated by a desire to curb abuses by outside interests, the SEC recommended the disclosure requirements that are now found in Rule 2019.[140] The court placed a great deal of emphasis on the SEC's stated belief that disclosure of this information would "provide a routine method of advising the court *and all parties in interest* of the actual economic interest of all persons participating in the proceedings."[141] Gropper viewed this statement as evidence of the importance of the policy of *public* disclosure of the Rule 2019 information; a policy that clearly would be frustrated if the ad hoc committee were permitted to file its statement under seal.[142]

Gropper then engaged in an interesting, albeit brief, analysis of the role of ad hoc committees in bankruptcy cases and proceedings. The opinion notes that the ad hoc committee was prominently involved in the case and that its members collectively controlled 27 percent of the debtor's outstanding common stock.[143] Judge Gropper was skeptical of the fact that the committee attempted to gain credibility on the basis of its members' large stock positions, yet it refused to divulge detailed information about those positions.[144] In light of the strong policy favoring public disclosure, Gropper stated that even if the hedge funds did have a valid interest in keeping their trading information confidential, that interest became "subordinated to the requirements of Rule 2019" when the funds elected to act as a group.[145] Gropper declined to decide whether an ad hoc committee owes a fiduciary duty to nonmembers in the same class, but he did lean that way in suggesting that the purpose of Rule 2019 is to "protect[ ] other members of the group."[146] More specifically, Gropper offered the following

137. *Id.* at 707.
138. *See* SEC REPORT, *supra* note 69.
139. *Northwest II*, 363 B.R. at 707 (citing SEC REPORT, *supra* note 69, at 880).
140. *Id.*
141. *Id.* at 707–08.
142. *See id.*
143. *Id.* at 708.
144. *Id.*
145. *Id.*
146. *Id.* at 709 (concluding that even if there was no fiduciary duty, Rule 2019 still applies for credibility reasons).

commentary on the relationship between ad hoc committees and other non-member holders of securities in the same class:

> Rule 2019 is based on the premise that the other shareholders have a right to information as to committee member purchases and sales so that they make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own. It also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy case and play a major role.[147]

Finally, Judge Gropper found that two facts unique to this case weighed in favor of compelling public disclosure. First, certain committee members had already disclosed that, in addition to their common stock holdings, they held significant positions in Northwest's debt securities.[148] Given the obvious potential for "divided loyalties" when a creditor owns positions in multiple classes of the debtor's capital structure, Judge Gropper felt it appropriate for each committee member to provide the detailed Rule 2019 information so that parties in interest could determine whether the purchases of debt and stock had been made simultaneously.[149] Second, each of the three committee members who had submitted declarations in support of the committee's motion had admitted that they might sell their positions at any time.[150] Concerned that members of the ad hoc committee might sell their holdings and leave the remaining shareholders without a "representative," Judge Gropper stated that "Rule 2019 gives other members of the class the right to know where their champions are coming from."[151]

After Judge Gropper denied the ad hoc committee's motion to file the amended Rule 2019 statement under seal, three hedge fund members of the committee filed a motion for reconsideration of the initial decision to compel the committee to amend its Rule 2019 statement.[152] Two prominent industry groups, the Loan Syndications and Trading Association (LSTA) and the Securities Industry and Financial Markets Association (SIFMA) filed a supporting brief.[153]

147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. Motion of Certain Equity Holders, Pursuant to 11 U.S.C. § 105(a), Fed. R. Civ. P. 59(e) & 60(b), and L.R. Bankr. P. 9023-1(a) for Reconsideration of Memorandum of Opinion and Order Granting Debtors' Motion for an Order Compelling Ad Hoc Comm. to File a Verified Statement Pursuant to Bankr. Rule 2019(a) at 1, *In re* Nw. Airlines Corp. (*Northwest I*), 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (No. 05-17930).
153. Joinder of Loan Syndications and Trading Ass'n and Sec. Indus. and Fin. Mkts. Ass'n as Amici Curiae to Motion of Certain Equity Holders, Pursuant to 11 U.S.C. § 105(a), Fed. R. Civ. P. 59(e) &

The amicus brief argued that the court's decision would have a chilling effect on distressed investing and thus would preclude many sophisticated investors from participating in reorganizations.[154] Judge Gropper denied the motion for reconsideration. As a result, nine of the thirteen committee members filed an amended statement that disclosed the amount of stock they held, the dates of purchase, and the amounts paid for the stock. The other four hedge funds presumably dropped out of the case.[155]

Judge Gropper's ruling in *Northwest* severely rattled the distressed debt community. Several law firms immediately sent memos to their hedge fund clients, alerting their clients to the decision and its potential implications.[156] One law firm went so far as to predict that "this seemingly innocuous opinion on a mundane Bankruptcy Rule by Judge Gropper may change the current dynamics of Chapter 11 cases."[157]

2. Scopac

Shortly after the *Northwest* decision whipped the hedge fund community into a frenzy, a decision out of the Bankruptcy Court for the Southern District of Texas took the opposite stance on virtually the same issue. Scotia Pacific Company (Scopac) filed a bankruptcy petition in January 2007.[158] In *In re Scotia* (*Scopac*),[159] a group of noteholders initially referred to itself as an ad hoc committee in its motions to the court. However, in an apparent attempt to escape the disclosure requirements imposed on ad hoc committees in *Northwest*, the noteholders began calling themselves a mere "group."[160] The debtor filed a

60(b), and L.R. Bankr. P. 9023-1(a) for Reconsideration of Memorandum of Opinion and Order Granting Debtors' Motion for an Order Compelling Ad Hoc Comm. to File a Verified Statement Pursuant to Bankr. Rule 2019(a), *Northwest I*, 363 B.R. 701 (No. 05-17930).

154. *Id.* at 3.

155. *See* Alexander, *supra* note 70, at 1429–30.

156. *See* Coco, *supra* note 11, at 630 (citing *Court Denies Hedge Funds' Motion to Seal Confidential Trading Information*, SCHULTE ROTH & ZABLE LLP CLIENT ALERT (Mar. 12, 2007), http://www.srz.com/Court-Denies-Hedge-Funds-Motion-To-Seal-Confidential-Trading-Information-03-12-2007/ (click "View Full Publication")).

157. *Id.*

158. *See* Scotia Pac. Co.'s Motion for an Order Compelling the Ad Hoc Comm. to Fully Comply with Bankr. Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 3, *In re* Scotia Dev. LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. 2007).

159. *In re Scotia*, 2007 WL 2726902.

160. *See* Noteholder Grp.'s Objection to Scotia Pac. Co. LLC's Motion for an Order Compelling the Ad Hoc Comm. to Fully Comply With Bankr. Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests at 1, *In re* Scotia Dev., LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. 2007) (linking prior references to the "Ad Hoc Committee" with the "Noteholder Group" and explicitly arguing that it "[was] not a 'committee'").

motion to compel the noteholders to comply with the Rule 2019 disclosure requirements, which the court rejected in a two-page order that simply stated that the noteholders were not a "committee" and thus were not subject to Rule 2019.[161] Unfortunately, the decision came in the form of a bench ruling that failed to elucidate the rationale supporting the conclusion, so scholars and practitioners were left with little guidance on how to interpret *Scopac* in light of the conflicting decision in *Northwest*.[162]

D. The Debate Is Rekindled: Washington Mutual and Six Flags

The conflicting rulings in *Northwest* and *Scopac* left practitioners, scholars, and distressed investors in a state of confusion about the applicability of Rule 2019 to unofficial committees. For more than two years, there were no reported opinions on the issue. Then, in late 2009 and early 2010, two cases shed more light on the Rule 2019 issue.

1. Washington Mutual

Judge Mary Walrath of the Bankruptcy Court for the District of Delaware issued a decision on the Rule 2019 issue in the *Washington Mutual*[163] case; it was the first time a Delaware bankruptcy court had published an opinion on the disclosure issue.

In *Washington Mutual*, the debtor, Washington Mutual, Inc. (WMI) was a savings and loan holding company that, prior to filing for bankruptcy, owned Washington Mutual Bank (WMB), formerly the largest savings and loan association in the country.[164] After WMB's infamous collapse, the Office of Thrift Supervision seized WMB and appointed the FDIC as receiver on September 25, 2008.[165] The FDIC immediately sold substantially all of WMB's assets to J.P.

161. For an excellent analysis of the *Scopac* case, see Alexander, *supra* note 70, at 1430–35 (analyzing the hearing transcripts and motions filed with respect to the Rule 2019 issue and concluding that "Judge Schmidt chose to ignore the plain meaning of the Rule in favor of a results-oriented decision that emphasized the effects on disclosure," and "[s]pecifically, Judge Schmidt seemed especially concerned about the implications of disclosure on future claims trading").

162. *See* Order Denying Scotia Pac. Co. LLC's Motion for an Order Compelling the Ad Hoc Noteholder Grp. to Fully Comply With Bankr. R. 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests, *In re* Scotia Dev., LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. 2007).

163. *In re* Wash. Mut., Inc., 419 B.R. 271 (Bankr. D. Del. 2009).

164. *Id.* at 272.

165. *Id.*

Morgan Chase Bank (JPM). On September 26, WMI filed a Chapter 11 petition in the District of Delaware.[166]

The WMI Noteholders group consisted of twenty-three entities and "collectively held over $1.1 billion in principal amount of notes issued by WMI."[167] Like the unofficial committee in *Scopac*, the WMI Noteholders referred to themselves as a "group" rather than a "committee." The WMI Noteholders submitted a statement representing that each entity "makes its own decisions as to how it wishes to proceed and does not speak for, or on behalf of, any other creditor, including the other participants participating in the WMI Noteholders Group in their individual capacities."[168] The WMI Noteholders were quite active, as they "filed responsive pleadings relating to several contested matters and appeared at numerous hearings."[169]

JPM moved to compel the WMI Noteholders to provide the trading information required by Rule 2019.[170] The WMI Noteholders responded by arguing that they were not an ad hoc committee but "simply a loose affiliation of WMI creditors who, in the interest of efficiency, are sharing the cost of advisory services in this case."[171]

Judge Walrath rejected the WMI Noteholders's argument and adopted much of the *Northwest* reasoning in granting the motion to compel disclosure:

> Here, the WMI Noteholders Group possesses virtually all the characteristics typically found in an *ad hoc* committee, save the name. The WMI Noteholders Group consists of multiple creditors holding similar claims. The members of the WMI Noteholders Group filed pleadings and appeared in these chapter 11 cases collectively, not individually. The WMI Noteholders Group retained counsel, which takes its instructions from the Group as a whole. While counsel contends that it speaks only for the members of the WMI Noteholders Group that agree with the filing of each pleading or position taken in each appearance, counsel for the Group has never advised this Court that it is representing less than all the Group. Rather the pleadings and appearances by counsel demonstrate that the Group and counsel represent not each individual member in its individual capacity, but rather the Group as a whole. In fact, it is the collective $1.1 billion in holdings of the members of the Group that counsel uses to argue in favor of the Group's position, not each individual's separate holding.

166. *Id.* at 273.
167. *Id.*
168. *Id.* (internal quotation marks omitted).
169. *Id.* (footnote omitted).
170. Motion of JPMorgan Chase Bank, Nat'l Ass'n to Compel the Wash. Mut., Inc. Noteholders Grp. to Comply With Fed. Rule of Bankr. P. 2019 at 3, *Wash. Mut.*, 419 B.R. 271 (No. 08-12229).
171. *Wash. Mut.*, 419 B.R. at 274.

> Under the plain language of Rule 2019, therefore, the Court finds that although the WMI Noteholders Group call themselves a Group, they are in fact acting as an *ad hoc* committee or entity representing more than one creditor. The WMI Noteholders Group, therefore, must comply with Rule 2019.[172]

Judge Walrath not only adopted Judge Gropper's reasoning with respect to the disclosure issue but took it a step further by strongly suggesting (in dictum) that unofficial creditor groups may owe fiduciary duties to other creditors in the same class who are not members of the group:

> The WMI Noteholders Group contends, however, that the Rule [2019] was only intended to apply to "a body that purports to speak on behalf of an entire class or broader group of stakeholders in a fiduciary capacity with the power to bind the stakeholders that are members of such a committee." The WMI Noteholders Group's argument is premised on the erroneous assumption that the Group owes no fiduciary duties to other similarly situated creditors, either in or outside the Group. The case law, however, suggests that members of a class of creditors may, in fact, owe fiduciary duties to other members of the class.[173]

After the release of the *Washington Mutual* decision, it appeared that a majority view had developed with respect to the Rule 2019 debate. The *Northwest* and *Washington Mutual* decisions came from courts in the Southern District of New York and Delaware, respectively, which are by far the two most active bankruptcy courts in the country for large Chapter 11 cases.[174] The one contrary opinion, *Scopac*, came from the Southern District of Texas and was in the form of a two-page order completely devoid of reasoning. Just as a consensus appeared to be building, Delaware Bankruptcy Judge Christopher Sontchi issued an opinion in *In re Premier International Holdings, Inc.*[175] (*Six Flags*) that emphatically conflicted with *Northwest* and *Washington Mutual*.

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172. *Id.* at 275 (footnotes omitted).

173. *Id.* at 278 (finding that stockholders, "by appealing from a judgment which affected a whole class of stockholders owed an obligation to them, the full extent of which we need not now delineate" and "[c]ertainly, at the very least they owed them an obligation to act in good faith" (citing Young v. Higbee Co., 324 U.S. 204, 210 (1945))); Official Comm. of Equity Sec. Holders of Mirant Corp. v. Wilson Law Firm, P.C. (*In re* Mirant Corp.), 334 B.R. 787, 793 (Bankr. N.D. Tex. 2005) ("It is a well established principle of bankruptcy law that when a party purports to act for the benefit of a class, the party assumes a fiduciary role as to the class.").

174. *See generally* Lynn LoPucki, *Bankruptcy Research Database*, http://lopucki.law.ucla.edu/bankruptcy_research.asp (last visited Jan. 31, 2011).

175. *In re* Premier Int'l. Holdings, Inc. (*Six Flags*), 423 B.R. 58 (Bankr. D. Del. 2010).

2. Six Flags

The relevant facts of *Six Flags* mirror those of the previously discussed cases. Six Flags, Inc. (SFI) was the corporate parent of Six Flags Operations Inc. (SFO), which, in turn, owned Six Flags Theme Parks, Inc. (SFTP). Substantially all of the debtors' operations were conducted through SFO.[176] SFO and SFI issued approximately $400 million and $870 million in notes, respectively. SFI was a guarantor of the SFO notes.[177] The *Six Flags* case involved three committees: the Official Committee of Unsecured Creditors (Official Committee), the Informal Committee of SFO Noteholders (Informal SFO Committee), and the Ad Hoc Committee of SFI Noteholders (Informal SFI Committee).[178]

The Rule 2019 controversy reared its head when the Official Committee moved to compel the Informal SFO Committee to file a verified statement pursuant to Rule 2019.[179] The Official Committee further requested that the court bar the Informal SFO Committee from participating in the case until it had complied with Rule 2019's disclosure requirements.[180] Notably, the Official Committee did *not* make a similar motion to compel disclosure by the other informal committee in the case, the Informal SFI Committee.[181] Judge Sontchi acknowledged that the *Northwest* and *Washington Mutual* courts had confronted "virtually the identical issue."[182] However, on the basis of a rigorous analysis of Rule 2019's plain language and legislative history, he respectfully disagreed with the conclusion reached in those two cases.

Judge Sontchi's plain language analysis began with an examination of the dictionary definition of the word "committee":

> A "committee" is a "body of two or more people *appointed* for some special function by, and usu. out of a (usu. larger) body." The use of the word "appointed" clearly contemplates some action be taken by the larger body. Thus, a *self-appointed* subset of a larger group—whether it calls itself an informal committee, an *ad hoc* committee, or by some other name—simply does not constitute a committee under the plain meaning of the word. In order for a group to constitute a committee under Rule 2019 it would need to be formed by a larger group either by consent, contract or applicable law—not by "self-help." This construct is supported by the rule's applicability to indenture trustees, which are delegated with certain

176. *Id.* at 60.
177. *Id.*
178. *Id.* at 61.
179. *Id.* at 62.
180. *Id.*
181. *Id.*
182. *Id.* at 73–74.

> rights and obligations on behalf of all holders of the debt *by operation of contract, i.e., the indenture*. Similarly, official committees under section 1102 of the Bankruptcy Code (although exempted from Rule 2019) receive their authority *from federal law, i.e., the Bankruptcy Code*.[183]

The opinion then progressed to an analysis of the word "representing" and concluded:

> Thus, under the plain meaning of the phrase "a committee representing more than one creditor," a committee must consist of a group representing the interests of a larger group with that larger group's consent or by operation of law. As the SFO Noteholders Informal Committee does not represent any persons other than its members either by consent or operation of law, it is not a "committee" under Rule 2019 and, thus, its members need not make the disclosures required under the rule.[184]

Although the court found that Rule 2019's meaning was plain on its face, it nevertheless engaged in an extensive analysis of the rule's legislative history. Much of the history of Rule 2019, which is detailed exhaustively in the *Six Flags* opinion,[185] is beyond the scope of this Comment. The most salient component of *Six Flags*'s legislative history analysis is its contrast of modern-day ad hoc committees to the "protective committees" to which the rule's direct antecedent, Rule 10-211, was targeted. Judge Sontchi noted that the protective committees "were able to control completely the entire reorganization—from inception to formulation to solicitation to implementation."[186] The protective committees were authorized to negotiate on behalf of creditors and enter binding agreements on their behalf.[187] They were "so intimately involved with management so as to be virtually in control of the business."[188] Protective committees had the ability to "steal[ ]" the debtor company by credit bidding an inadequate "upset price" at a foreclosure sale.[189]

Judge Sontchi reasoned that the "*ad hoc* committees of [modern bankruptcy practice] have none of these expansive powers."[190] In fact, Judge Sontchi concluded, Rule 10-211 "so effectively curbed the power of protective

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183. *Id.* at 65 (footnotes omitted) (quoting 1 SHORTER OXFORD ENGLISH DICTIONARY 104, 464 (6th ed. 2007)).

184. *Id.* (footnotes omitted) (quoting 2 SHORTER OXFORD ENGLISH DICTIONARY, *supra* note 183, at 2537) (citing RESTATEMENT (THIRD) OF AGENCY §§ 1.01, 1.02, 3.01, 3.03, 4.01 & 6.11 (2006)).

185. *See id.* at 65–73.

186. *Id.* at 72–73.

187. *Id.* at 73.

188. *Id.*

189. *Id.*

190. *Id.*

committees that they virtually ceased to exist within a few years of the [Chandler] Act's passage. Rule 10-211 was, for all intents and purposes, superfluous almost immediately after its passage. There was nothing left to regulate."[191] Judge Sontchi then reached the conclusion that, in light of the relatively limited powers of today's informal committees in comparison to the protective committees of yesteryear, "Rule 2019 is also, for all intents and purposes, superfluous—the problem it was designed to address by requiring certain disclosures simply no longer exists."[192]

To bolster his conclusion that the Informal SFO Committee was not required to file a verified Rule 2019 statement, Sontchi framed the Official Committee's motion to compel disclosure as nothing more than a harassment tactic.[193] Recall that there were two informal committees involved in the case: the Informal SFO Committee and the Informal SFI Committee. The debtor and the Informal SFI Committee were, at the time of the Rule 2019 motion, allies with respect to a proposed plan of reorganization. The debtor and the Informal SFO Committee, on the other hand, were at odds with each other.[194] Judge Sontchi noted that the Official Committee was "clearly engaged in a litigation tactic to apply pressure on it [sic] current adversary, the Informal Committee of SFO Noteholders, as well as attempting to make an 'end run' around a previous ruling denying the Official Committee's request for discovery seeking virtually the same information."[195]

In the wake of the conflicting *Washington Mutual* and *Six Flags* decisions, the distressed debt community once again found itself in a state of utter confusion about the scope of Rule 2019. Law firms again rushed to issue cautionary memos to clients advising them of the conflicting rulings and the resulting lack of predictability surrounding Rule 2019 disclosures.[196] Further obfuscating the issue, two additional cases since *Six Flags* have addressed essentially the same issue and, not surprisingly, have come out in opposite directions. Just two days after *Six Flags* was decided, Judge Brendan Shannon, who also sits in Delaware, held that an ad hoc committee *was* required to comply with Rule 2019's

191. *Id.*
192. *Id.*
193. *Id.* at 75.
194. *See id.* at 61–62.
195. *Id.* at 75.
196. *See, e.g.*, Alan W. Kornberg, Stephen J. Shimshak & Karen R. Zeituni, *Bankruptcy Rule 2019* Redux—*Delaware Bankruptcy Court Holds That Informal Committee Is* Not *Subject to Rule 2019*, PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP ALERTS AND MEMORANDA (Jan. 22, 2010), http://www.paulweiss.com/resources/pubs/detail.aspx?publication=2581; Fred S. Hodara & Abid Qureshi, *Rule 2019 Does Not Apply to Steering Groups*, AKIN GUMP STRAUSS HAUER & FELD LLP NEWSLETTERS & ALERTS (Feb. 5, 2010), http://www.akingump.com/communicationcenter/podcastdetail. aspx?pub=2360 [hereinafter Akin Gump Newsletter].

requirements in *In re Accuride Corp*.[197] In contrast, two weeks later, on February 4, 2010, in *In re Philadelphia Newspapers*, Chief Judge Stephen Raslavich of the Bankruptcy Court for the Eastern District of Pennsylvania sided with the *Six Flags* court and held that a "Steering Group of Prepetition Lenders" was *not* subject to the disclosure requirements of Rule 2019.[198] So, as of the date of this writing, the scorecard shows three courts (*Northwest*, *Washington Mutual*, and *Accuride*) compelling informal committees or groups to make disclosures under Rule 2019 and three courts (*Scopac*, *Six Flags*, and *Philadelphia Newspapers*) holding that Rule 2019 does not apply to informal groups or committees. The *Philadelphia Newspapers* decision was appealed the day after it was handed down, and appeals are also pending in *Washington Mutual* and *Six Flags*.[199]

III. AMENDING RULE 2019 TO ADDRESS THE EMPTY CREDITOR PROBLEM

After the recent spate of conflicting decisions on the applicability of Rule 2019 to informal groups of creditors and equity holders, it is difficult for hedge funds, debtors, and other participants in the bankruptcy process to predict the level of disclosure that will be required in any given case. However, this controversy may be mooted if a proposed amendment to Rule 2019 (the Proposed Rule), recently submitted to the Judicial Conference's Standing Committee on Rules of Practice and Procedure (Standing Committee) by the Advisory Committee on Bankruptcy Rules (Rules Committee), is adopted.[200]

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197. *See* Order (A) Compelling the Ad Hoc Noteholder Grp. to Comply with Fed. R. Bankr. P. 2019; (B) Prohibiting Further Participation in These Cases by the Ad Hoc Noteholder Grp. Pending Compliance With Fed. R. Bankr. P. 2019; and (C) Directing the Debtors to Withhold Further Payments to or on Behalf of Such Grp. Pending Compliance With Fed. R. Bankr. P. 2019 at 2, *In re* Accuride Corp., No. 09-13449, 2010 WL 5093173 (Bankr. D. Del. Feb. 18, 2010).

198. *In re* Phila. Newspapers, LLC, 422 B.R. 553, 567–69 (Bankr. E.D. Pa. 2010).

199. Akin Gump Newsletter, *supra* note 196.

200. *See* Memorandum From Judge Laura Taylor Swain, Chair, Advisory Comm. on Bankr. Rules to Hon. Lee H. Rosenthal, Chair, Standing Comm. on Rules of Prac. and Proc. (June 14, 2010), http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/jc09-2010/2010-09-Appendix-B.pdf [hereinafter Proposed Rule]. Under the Rules Enabling Act, the Advisory Committee was required to submit its recommendation to the Standing Committee, which must then recommend the Proposed Rule to the Supreme Court. Finally, after the Supreme Court approves of the rule, it must be sent to Congress; it will become effective unless Congress acts to block it.

A. The Initial Proposal to Amend Rule 2019

After the *Northwest*[201] and *Scopac*[202] decisions, the Rules Committee received several letters calling for an amendment of Rule 2019 in order to clarify the rule's scope and bring it up to date with current economic realities.[203] Of these letters, the most notable came from Judge Robert E. Gerber of the Bankruptcy Court for the Southern District of New York. On January 9, 2009 Judge Gerber sent a letter to the Rules Committee advocating for revisions to Rule 2019.[204] Judge Gerber's letter, which predated *Six Flags*[205] and *Washington Mutual*,[206] noted the conflicting decisions in *Northwest* and *Scopac* and the need for clarification of Rule 2019.[207] Judge Gerber called for an amendment that would, among other things, "[c]larify Rule 2019 to make clear that it requires disclosure of short positions, or derivatives with the same economic substance" and "[c]larify Rule 2019 to make clear that . . . it covers any instance in which multiple creditors are represented by the same counsel, whether or not they call themselves a 'committee.'"[208]

On August 12, 2009, the Rules Committee released an initial version of the Proposed Rule (the Initial Proposal) and solicited public comments.[209] The salient features of the Initial Proposal are discussed immediately below.

First, the Initial Proposal would have expanded Rule 2019's coverage so that "every entity, *group*, or committee *that consists of or* represents more than one creditor or equity security holder" would be subject to its disclosure requirements.[210] The addition of the word "group" clarifies that informal or ad hoc

201. *In re* Nw. Airlines Corp. (*Northwest I*), 363 B.R. 701 (Bankr. S.D.N.Y. 2007); *In re* Nw. Airlines Corp. (*Northwest II*), 363 B.R. 704 (Bankr. S.D.N.Y. 2007).

202. *In re* Scotia Dev., LLC, No. 07-20027-C-11, 2007 WL 2726902 (Bankr. S.D. Tex. May 29, 2007).

203. *See, e.g.*, Letter From Ira D. Hammerman, Senior Managing Dir. and Gen. Counsel, SIFMA, and Elliot Ganz, Exec. V.P. and Gen. Counsel, LSTA to Peter G. McCabe, Sec'y, Advisory Comm. on Bankr. Rules (Nov. 30, 2007), *available at* http://www.sifma.org/regulatory/pdf/BankruptcyRule2019Letter.pdf (calling for the repeal of Rule 2019).

204. Letter From Judge Gerber, U.S. Bankr. Court of the S. Dist. of N.Y., to Advisory Comm. on Bankr. Rules (Jan. 9, 2009), *available at* http://www.uscourts.gov/rules/BK%20Suggestions%202008/08-BK-M-Suggestion-Gerber.pdf [hereinafter Judge Gerber Letter]. See Part II, *supra*, for a discussion of Judge Gerber's treatment of the allegedly net short creditors in the *Lyondell* case.

205. *In re* Premier Int'l. Holdings, Inc. (*Six Flags*), 423 B.R. 58 (Bankr. D. Del. 2010).

206. *In re* Wash. Mut., Inc., 419 B.R. 271 (Bankr. D. Del. 2009).

207. *See* Judge Gerber Letter, *supra* note 204, at 1.

208. *Id.* at 10.

209. *See* ADVISORY COMM. ON BANKR. RULES, JUDICIAL CONF. OF THE U.S., PROPOSED AMENDMENTS TO THE FEDERAL RULES ON BANKRUPTCY PROCEDURE (2009), http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/proposed0809/BK_Rules_Forms_Amendments.pdf [hereinafter Initial Proposal].

210. *Id.* at 7 (emphasis added).

committees are subject to Rule 2019. Likewise, the addition of the words "consists of" would obviate the plain language debate over whether informal groups "represent" anyone other than their own members.

Second, the proposed changes would have (partially) addressed the empty creditor problem by requiring each member of a group or committee to disclose any "disclosable economic interests."[211] This term, which is a new addition to the bankruptcy lexicon, is defined as follows:

> In this rule, "disclosable economic interest" means any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right that grants the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest.[212]

According to the Committee Notes, the definition of disclosable economic interest is "intended to be sufficiently broad to cover any economic interest that could affect the legal and strategic positions a stakeholder takes in a chapter 9 or chapter 11 case."[213] Under the Initial Proposal, each member of a group or committee would have been required to make an initial disclosure of the "nature and amount" of its disclosable economic interests as well as the date such interests were acquired.[214] The Initial Proposal also would have granted the court discretion to require disclosure of the amount paid for such interests.[215] Even creditors who were not members of informal groups or committees might have been required to disclose their disclosable economic interests on motion of a party in interest or upon the court's own motion.[216] Parties subject to the Initial Proposal would have been required to update their disclosures on a monthly basis.[217]

Publication of the Initial Proposal "attracted much attention."[218] In response to the Initial Proposal, the Rules Committee received a flurry of letters and comments.[219] The letters came from a wide range of attorneys, judges, industry groups, and scholars.[220] On February 5, 2010, the Rules Committee heard testimony on the Proposed Rule. Seven witnesses testified at the

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211. *Id.*
212. Proposed Rule, *supra* note 200, at B-25.
213. *Id.* at B-30.
214. *See* Initial Proposal, *supra* note 209, at 9.
215. *Id.* (requiring disclosure of purchase price "if directed by the court").
216. *Id.* at 8.
217. *Id.* at 10–11.
218. Proposed Rule, *supra* note 200, at B-3.
219. *Id.*
220. There are twenty-two letters regarding Rule 2019 posted on the U.S. Courts website. *See* *2009 Bankruptcy Rules Comments Chart*, UNITED STATES COURTS, http://www.uscourts.gov/RulesAndPolicies/FederalRulemaking/ResearchingRules/Comments/Proposed0809Comments/2009BKCommentsChart.aspx (last visited Feb. 13, 2011).

hearing.[221] Those witnesses consisted of attorneys who regularly represent hedge funds in Chapter 11 cases, the general counsel of LSTA, the deputy general counsel of a large distressed debt hedge fund, and Judge Gerber.[222]

Several major objections to the Initial Proposal were repeatedly raised in the public comments and testimony.[223] First, the most vociferous objections pertained to the Initial Proposal's purchase price and purchase date disclosure requirements.[224] Critics of the Initial Proposal argued that disclosure of purchase price and purchase date was inappropriate because, among other things:

> The price paid for a claim or interest is generally irrelevant to any issue in a chapter 11 case[;] If this information should ever be relevant, it could be obtained through discovery or pursuant to the court's inherent authority to order its disclosure[;] Pricing information is highly guarded by distressed debt purchasers[;] Requiring its disclosure will allow competing firms to determine the disclosing party's trading strategy[;] Parties in interest engage in the strategic use of the authority to compel the disclosure of this confidential information.[225]

Second, several comments contended that filing supplemental monthly disclosures would be overly burdensome.[226] Third, two commenters expressed concern about 2019(b)'s provision authorizing the court, on motion of a party in interest or on its own motion, to require disclosure of some or all of the information specified in subdivision (c)(2) by any entity seeking or opposing the granting of relief.[227] Because this provision could potentially compel disclosure by individual entities not representing others, the commenters argued that "the provision was inconsistent with the original purpose of the rule."[228]

B. The Rules Committee Responds to Criticism of the Initial Proposal

On May 27, 2010, the Rules Committee submitted the Proposed Rule. The Proposed Rule includes the Initial Proposal's innovative use of the term "disclosable economic interest." It also retains the "group . . . that consists of" language in subdivision (b) that makes clear that the rule applies to ad hoc

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221. Proposed Rule, *supra* note 200, at B-3.
222. *See List of Witnesses for February 5 Bankruptcy Rules Committee Meeting*, U.S. COURTS (2010), http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/2010-02-BK_Hearing_Witness_List.pdf.
223. This Comment discusses only those objections and comments that are relevant to the empty creditor problem. Certain individuals and organizations raised concerns about Rule 2019 that do not have any bearing on the empty creditor problem, and those objections are not addressed here.
224. *See* Proposed Rule, *supra* note 200, at B-3.
225. *Id.* at B-4.
226. *Id.* at B-5.
227. *Id.* at B-6.
228. *Id.*

committees.[229] The Proposed Rule incorporates many of the criticisms and suggestions raised in the comments to the Initial Proposal.[230] Most importantly, the Proposed Rule eliminates the purchase price and purchase date disclosure requirements. The Proposed Rule also eliminates "the provision in subdivision (b) of the [Initial Proposal] that authorized the court to require disclosure by an entity that does not represent anyone else."[231] Furthermore, the Proposed Rule drops the monthly supplemental disclosure requirement and adopts a more lenient standard, requiring "the filing of supplemental statements only when a covered entity, group, or committee is taking a position before the court or solicits votes on a plan, and any fact disclosed in its most recently filed statement has changed materially."[232]

C. A Critique of the Proposed Rule

The Proposed Rule is certainly a step in the right direction in terms of rectifying the empty creditor problem. The introduction of the term "disclosable economic interest" signals that the Rules Committee is attuned to the realities of modern Chapter 11 practice and understands the unique threat posed by credit derivatives, short positions, and a host of other financial innovations. However, the Proposed Rule is vulnerable to criticism on several levels. Most importantly, the rule is grossly underinclusive.

The Proposed Rule is underinclusive in the sense that it only requires—in fact, it only *permits*—disclosure from parties who are members of groups or committees. Individual creditors and equity holders who elect not to join informal groups are not subject to its disclosure requirements. The Initial Proposal was superior to the Proposed Rule in that it did authorize the court to compel disclosure by individual parties seeking or opposing relief on motion of a party in interest or on the court's own motion. However, the Proposed Rule eliminates even this permissive power to compel disclosure of individual entities.

Because there is no disclosure requirement for all parties involved in the case, it is entirely possible that a large and influential creditor acting on its own behalf could possess a massive short position that would go undetected throughout the duration of the case. Consider a hypothetical hedge fund creditor holding a $1 million claim (its long position) and a $5 million short position (this could take the form of stock, CDS, a total return swap, or a combination of these and other instruments). Assume that this hedge fund is not a member of

229. *Id.* at B-25, B-31.
230. *Id.* at B-6, B-7.
231. *Id.*
232. *Id.*

an ad hoc committee or informal group. Under the Proposed Rule as currently drafted, the hedge fund could aggressively participate in the bankruptcy proceedings without ever having to disclose its true economic interests.

Of course, some other party in interest could attempt to discern the empty creditor's true economic position via traditional discovery measures. The comments to the Proposed Rule explicitly state that "[t]he Proposed Rule does not affect the right to obtain [position-level] information by means of discovery . . . under authority outside of the rule."[233] But the problem is that other creditors might not have any reason to suspect foul play, and thus would not think to commence discovery. Unless the hedge fund's behavior before the court is suspicious, other parties in interest will have no cues triggering them to investigate its position. So as long as it acts in a way that does not egregiously broadcast its true economic interests, the hedge fund would be likely to escape disclosure, and the rest of the participants in the proceedings would be ignorant of the true motivations of this large, powerful creditor. In short, empty creditors can easily circumvent the Proposed Rule's disclosure requirements by choosing not to join groups and committees and by abstaining from acting in a manner that alerts other parties in interest to their true incentives.

D. Modifying the Proposed Rule

The Proposed Rule is a strong start. Its definition of "disclosable economic interest" is sufficiently broad to cover CDS, total return swaps, short positions in stock, and any of the myriad other financial instruments that might render a creditor empty. However, the Proposed Rule is underinclusive. This Subpart recommends modest reforms to better effectuate the goal of discerning parties' true economic interests without chilling the distressed debt market.

First, to address the Proposed Rule's underinclusiveness, the court's power to compel disclosure under Proposed Rule 2019(b) must be strengthened. This could easily be achieved by reintroducing and slightly altering the final sentence of subdivision (b) found in the Initial Proposal.[234] For instance, the sentence could be modified to read as follows:

> *The court shall also require disclosure of all of the information specified in subdivision (c)(2) by an entity that seeks or opposes the granting of relief.*

233. *Id.* at B-7, B-32.

234. As originally drafted in the Initial Proposal, *supra* note 209, at B-8, this sentence read: "On motion of a party in interest, or on its own motion, the court may also require disclosure of some or all of the information specified in subdivision (c)(2) by an entity that seeks or opposes the granting of relief."

This simple modification would have significant consequences. It would require *any* party seeking to be heard in the case to file an accompanying verified statement setting forth its disclosable economic interests. Thus, empty creditors would not be able to escape detection merely by choosing not to join ad hoc committees.

In conjunction with this change, subpart (d), which governs supplemental disclosures, should also be amended. This provision, as currently drafted, reads:

> If any fact disclosed in its most recently filed statement has changed materially, an entity, group, or committee shall file a verified supplemental statement whenever it takes a position before the court or solicits votes on the confirmation of a plan. The supplemental statement shall set forth the material changes in the facts required by subdivision (c) to be disclosed.[235]

Although supplemental disclosures are necessary, this provision is fraught with an obvious loophole. If creditors know in advance that they will have to file supplemental disclosures in conjunction with any vote solicitation or appearance before the court, they can simply close out any outstanding short positions in advance of the relevant deadline. Thus, the creditor could represent that it was not empty as of the date the disclosure statement was filed. The creditor could then reestablish its short position immediately after filing its disclosure statement, and no other party to the case would have any idea of its true economic interests. It could participate in all proceedings under the guise of a long creditor despite its actual emptiness. Because of such possibilities for abuse, a real-time supplemental disclosure system is necessary. After an entity, group, or committee files its initial verified statement, it should be required to file a supplemental disclosure upon the occurrence of "any material change in facts in a statement previously filed under this rule, including information about any acquisition, sale, or other disposition of a disclosable economic interest."[236]

One final loophole must be closed. In an attempt to circumvent Rule 2019, devious creditors might allocate some or all of their short positions to affiliates. By parking some of their disclosable economic interests with affiliates, empty creditors could remain empty in an economic sense while appearing full to the other parties to the bankruptcy case. To curb this potential and seemingly

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235. Proposed Rule, *supra* note 200, at B-28–29.

236. It is worth considering that such a rule might be overly burdensome for creditors with large, actively traded portfolios. For example, a creditor with a $10 million short position in the debtor's securities might decide to increase or reduce this short position by a few thousand dollars as a matter of portfolio rebalancing. In such a case, it would not seem necessary for the creditor to incur the time and expense required to file an updated Rule 2019 statement. For this reason, the supplemental disclosure requirements of Rule 2019(d) should be subject to some sort of exception for de minimis trading activity. The exact details of this exception are beyond the scope of this Comment.

inevitable abuse, the drafters of Rule 2019 should insert a provision that makes clear that all required disclosures must also be made with respect to any and all affiliates of the creditor making the disclosure.[237]

If these suggestions are adopted, all parties in interest will have up-to-date information about the economic incentives of any party seeking or opposing relief. At a minimum, parties will be able to use this information to gauge the credibility of an empty creditor's arguments. Moreover, in especially egregious cases, the court might be able to use this information to designate an empty or net short creditor, effectively stripping it of its voting power. Section 1126(e) of the Bankruptcy Code provides:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.[238]

"Good faith" is not defined in the Code. For the purposes of section 1126(e), courts have found "bad faith"—an absence of good faith—when "a creditor acts in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor."[239] In the recent case, *In re DBSD North America, Inc.*, the court designated the vote of a creditor who purchased first lien notes at par after the disclosure statement had been filed in an attempt to vote down the debtor's proposed plan of reorganization and propose an alternative plan that would enable the creditor to take control of the debtor's business.[240] Quoting from his opinion in *In re Adelphia*, Judge Gerber noted that the court should exercise its power to designate votes only when faced with "'highly egregious conduct—principally, seeking to advance interests apart from recovery under the Plan, or seeking to extract plan treatment that is not available for others in the same class.'"[241] This language would seem to lend strong support to courts seeking to designate the votes of empty and net short creditors who vote against the best interests of the estate for the purpose of profiting on their short positions. However, the court must actually be aware of a creditor's true economic interests before it can designate the creditor's votes on that basis; the expansive disclosure

237. The Bankruptcy Code provides a robust definition of "affiliate" in section 101(2). However, this definition describes only affiliates of the debtor. Substantially the same language could be used to define an "affiliate" of a creditor or equity interest holder for the purposes of Rule 2019.

238. 11 U.S.C. § 1126(e) (2006).

239. *In re* DBSD N. Am., Inc., 421 B.R. 133, 138 (Bankr. S.D.N.Y. 2009), *aff'd*, No. 09 Civ. 10156, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010).

240. *Id.* at 134.

241. *Id.* at 142 (quoting *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 56–57 (Bankr. S.D.N.Y. 2006)).

requirement suggested above is the best way to bring such information to the court's attention.

CONCLUSION

Innovation is inevitable in both finance and law. Financial evolution tends to occur at a more rapid pace and leave the legal world struggling to catch up. This is exactly the scenario that has unfolded with respect to Rule 2019 and the parties and financial instruments it governs. In recent years, hedge funds have become a pervasive, dominant force in bankruptcy cases and proceedings. They use myriad complex financial instruments to take positions that are more nuanced than those envisioned by the drafters of the Bankruptcy Rules. Hedge funds in and of themselves are not a hazard to the bankruptcy system; in fact, they arguably add value to the process. However, when hedge funds and other sophisticated creditors engage in trading strategies that render their economic risk disproportionately small in relation to their contractual rights, they pose a threat to the stability of the corporate reorganization process. To address this threat, Rule 2019 must be amended to ensure that all parties involved in a bankruptcy case are aware of creditors' true economic incentives.