
Michael DeMarino

Follow this and additional works at: https://repository.law.uic.edu/lawreview

Part of the Antitrust and Trade Regulation Commons, Bankruptcy Law Commons, Business Organizations Law Commons, Commercial Law Commons, Consumer Protection Law Commons, and the Securities Law Commons

Recommended Citation

https://repository.law.uic.edu/lawreview/vol42/iss1/6

This Comments is brought to you for free and open access by UIC Law Open Access Repository. It has been accepted for inclusion in UIC Law Review by an authorized administrator of UIC Law Open Access Repository. For more information, please contact repository@jmls.edu.
RULE 2019: THE DEBTOR’S NEW WEAPON

MICHAEL DEMARINO*

I. INTRODUCTION

Consider the following scenario: The owner of investment property is attempting to sell that property to a prospective buyer. Now, suppose the buyer knows how much the seller initially purchased the property for. Is this information the seller wants the buyer to possess? Probably not. Does this hurt the seller in negotiating a price? More than likely. Is this unfair? Hedge funds think so!¹

The above scenario is a simplified version of a major concern hedge funds face when participating in Chapter 11 reorganizations. In the world of bankruptcy, namely Chapter 11 reorganizations, hedge funds are major players, and their increasing involvement in reorganizations does not go unnoticed or unopposed.² A recent decision requiring hedge funds to comply with Bankruptcy Rule 2019 disclosure requirements³ may


1. The term “hedge funds” is used throughout this Comment and refers to any entity that is classified as a “distressed debt investor.” The term hedge fund, therefore, includes actual hedge funds, proprietary trading groups, venture capitalists, and investment banks.

2. See infra notes 37-39 (discussing in detail the involvement of hedge funds in bankruptcy proceedings).

3. FED. R. BANKR. P. 2019(a):
   (a) Data Required. In a Chapter 9 municipality or Chapter 11 reorganization case except with respect to a committee appointed pursuant to § 1102 or 114 of the Code, every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, the amounts of claims or interests owned by the entity, the members of the committee or indenture trustee, the times when acquired, the amounts paid therefore, and any sales or other disposition thereof. . . .
discourage hedge funds from participating in Chapter 11 reorganizations.  

Currently, hedge funds play a major role in Chapter 11 reorganizations but are viewed suspiciously by other participants in bankruptcy proceedings. In bankruptcy cases, hedge funds often form unofficial ad hoc committees, and thus become subject to Rule 2019 disclosure requirements for unofficial committees. "While no one doubts that hedge funds believe that their information is proprietary . . . the question remains, what makes them so different than anyone else?"  

This Comment will explore the clash between hedge funds' desire for secrecy and the Bankruptcy Code's requirement of openness, particularly in the context of Rule 2019 and hedge fund ad hoc committees. Part II of this Comment will lay out the origins and rationale of the Bankruptcy Code's disclosure requirements as well as the exceptions that run counter to this policy. Part III will discuss the role of hedge funds in the bankruptcy process as well as two recent cases addressing the


6. Hedge funds often form ad hoc committees when participating in Chapter 11 reorganizations. Voorhees, supra note 4, at 5. When hedge funds form ad hoc committees, they are able to defray legal costs and exert greater influence as a group. Id. Additionally, ad hoc committees are unofficial committees according to the bankruptcy code, and therefore, are not subject to restrictions under Section 1102. Id.

Ad hoc committees consist of security holders who: (1) hold the same or substantially similar types of claims; (2) discuss and collectively exchange strategies; (3) seek to negotiate in "lockstep;" and (4) retain a single law firm to minimize cost. Brief of Amici Curiae the Loan Syndications & Trading Ass'n & the Securities Industry & Financial Markets Ass'n in Opposition to Wachovia Bank's Motion to Compel the Informal Comm. of Secured Trade Vendors to File a Verified Statement Pursuant to Bankruptcy Rule 2019, at 7-8, In re Musicland Holdings Corp., (No. 06-10064) 2007 WL 748286 [hereinafter LSTA Brief].

The LSTA is the trade association for all segments of the floating rate corporate loan market. Id. at 2. Its members include broker-dealers, investment banks, commercial banks, mutual funds, and other financial institutions. Id.

unique status of hedge funds in relation to Rule 2019. Part IV
will explore the public policy arguments against subjecting hedge
fund ad hoc committees to Rule 2019 and will propose a test for
determining the applicability of Rule 2019 to these committees.
Finally, Part V of this Comment will conclude that this test
advances the public policy behind bankruptcy reorganization.

II. TRANSPARENCY AND BANKRUPTCY: THE BANKRUPTCY CODE'S
REQUIREMENT OF OPENNESS

A. A Tradition of Openness

Under common law, and throughout the American judicial
system, there has been a public policy presumption of maintaining
open and public judicial proceedings. This long-standing policy is
derived from the Constitution. More importantly, this policy
promotes public trust and ensures that justice is distributed
equally. The common law tradition of open and public judicial
proceedings is similarly reflected in the Bankruptcy Code.

The common law principle of open access is fundamental to
bankruptcy proceedings and is codified generally in Section 107(a),
the section that makes filings with the bankruptcy court public
record. The purpose of 107(a) can be gleaned from its legislative
history, which indicates Congress' intent to maintain open access
to judicial records in cases of bankruptcy.

8. In re Nw. Airlines Corp., 363 B.R. 704 (Bankr. S.D.N.Y. 2007); In re
9. In the United States, generally, there has been a strong presumption of
public access to court documents. See Nixon v. Warner Comm., Inc., 435 U.S.
589, 597 (1978) (discussing the long-standing presumption of transparency in
court proceedings); see also Lugosch v. Pyramid Co. of Onondaga, 435 F.3d
110, 119 (2d Cir. 2006) (discussing constitutional and common law right to
examine court records). The presumption of open access to court records
recognizes the importance attached to the public's right to monitor the
N.D. Ga. 1978). This presumption of access allows the public to "keep a
watchful eye on the workings of public agencies." Nixon, 435 U.S. at 598.
10. The common law right to public access of judicial documents can be
traced to the First and Sixth Amendments. In re Inslaw, Inc., 51 B.R. 298, 299
(Bankr. D.C. 1985). The common law right to inspect judicial records is
"fundamental to a democratic state" and, like the First and Sixth
Amendments, produces an "informed and enlightened public opinion." United
11. See In re Analytical Sys., 83 Bankr. at 835 (observing that an informed
public safeguards "the "integrity, quality, and respect in our judicial system.").
12. Section 107(a) of the Bankruptcy Code provides: "Except as provided in
subsections (b) and (c) of this section and subject to Section 112, a paper filed
in a case under this title and the dockets of a bankruptcy court are public
records and open to examination by an entity at reasonable times without
Indeed, in the context of bankruptcy cases, the need for public access of documents is amplified, if not fundamental. Most of the key decisions in bankruptcy reorganizations, such as the selling of assets, cannot occur without a court filing and bankruptcy court approval. Access to such filings necessarily facilitates the exchange of information between parties in a bankruptcy case.

In addition to Section 107(a), the Bankruptcy Code’s procedural Rule 2019 addresses open access with respect to unofficial committees. Rule 2019 promotes the principal of open access by requiring disclosure from unofficial committees participating in bankruptcy. The need for a rule such as 2019 is heightened in Chapter 11 where unofficial committees significantly participate in the reorganization process and generate extreme potential for conflicts of interest between unofficial committee members and the class they represent.
Non-compliance with Rule 2019 carries grave consequences, and may result in a court refusing to hear from the ad hoc committee and denying the committee the right to speak for its members. As a disclosure rule, Rule 2019 was designed to curb the abuses of protective committees, a problem that was rampant in the 1930s. Thus, taken together, Section 107(a) and Rule 2019 are evidence of Congress' strong desire to extend the common law right of access to judicial records to bankruptcy proceedings. However, both in the Bankruptcy Code and at common law, this right has limitations.

B. Confidentiality Under the Bankruptcy Code

Notwithstanding the entrenched common law principle of maintaining public judicial fora, the presumptive right to access is not absolute. Courts recognize that under certain circumstances, public access may not be warranted. As a result, at common law, the trial court has discretionary power to protect a party by sealing court documents that could potentially harm a party.

It is important to note that Rule 2019 applies specifically to unofficial committees (committees not appointed pursuant to §§ 1102 or 1114 of the Code). See FED. R. BANKR. P. 2019(a) (stating that the Rule applies to committees representing more than one creditor and not formed under §§ 1102 or 1114). In the same vein, § 1102(b) requires official creditors' committees to disclose certain information to the creditors they represent and be subject to court orders compelling additional disclosures. 11 U.S.C. § 1102(b) (2000), amended by Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub. L. No. 109-8, § 405(b), 119 Stat. 105, 216 (2005).

It is important to note that Rule 2019 applies specifically to unofficial committees (committees not appointed pursuant to §§ 1102 or 1114 of the Code). See FED. R. BANKR. P. 2019(a) (stating that the Rule applies to committees representing more than one creditor and not formed under §§ 1102 or 1114). In the same vein, § 1102(b) requires official creditors' committees to disclose certain information to the creditors they represent and be subject to court orders compelling additional disclosures. 11 U.S.C. § 1102(b) (2000), amended by Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub. L. No. 109-8, § 405(b), 119 Stat. 105, 216 (2005).

See infra Part III (discussing the exceptions to and limitations of the presumptive right of public access in the Bankruptcy Code and common law).

See Nixon, 435 U.S. at 597 (citing In re Caswell, 18 R.I. 835, 837 (1893)) (observing that in limited circumstances, courts must deny public access to documents when used for improper purposes).

See City of Hartford v. Chase, 942 F.2d. 130, 135-36 (2d. Cir. 1991) (stating that Congress has recognized that under "compelling" circumstances, public access may be abrogated).

Id. In addition to common law, Congress has recognized that the
The Bankruptcy Code similarly recognizes that the right to public access is not absolute; however, unlike common law courts, the bankruptcy court's power is not discretionary. Although the concept of openness is heavily ingrained in the Bankruptcy Code, operating under such openness is not always in the best interest of the parties. Consequently, the Bankruptcy Code recognizes that potential problems can arise from parties having unrestricted access to documents, and therefore, Section 107(b) of the Code allows parties, under certain circumstances, to file under seal. Thus, taken together, Sections 107(a) and 107(b) provide a "framework" for the court to determine whether documents should be public or sealed.

The general policy of open access may be abrogated under certain circumstances. See, e.g., FED. R. CRIM. P. 6(e)(2) (recognizing the need for secrecy in grand jury proceedings); FED. R. CIV. P. 26(c)(1)(G) (recognizing the need for sealing trade secrets or confidential information).

26. See infra notes 30-31 and accompanying text (discussing the mandatory language in Rule 2019).

27. Companies find themselves in Chapter 11 often as the result of being the weakling of competitive industries. Erens & Neff, supra note 15, at 48. After filing a petition for Chapter 11, the debtor's reorganization may be hindered by having its business operations and strategies open to the very same competitors that drove the debtor into bankruptcy in the first place. Id.

28. Notwithstanding the Bankruptcy Code's obvious goal of maintaining an open judicial forum, Congress foresaw that bankruptcy cases might require specific court intervention to protect parties from having certain information made public. In re 50-Off Stores, Inc., 213 B.R. 646, 654 (Bankr. W.D. Tex. 1997). Consequently, 107(b) limits the scope of 107(a) by allowing a party to file under seal if the contents of the filing fall within one of the categories enumerated under Section 107(b). 11 U.S.C. § 107(a) (2006). The court, therefore, will "protect an entity with respect to a trade secret or confidential research, development, or commercial information." 11 U.S.C. § 107(b)(1) (2006).

The importance of Section 107(b) cannot be understated. Its significance is highlighted by its mandatory language that requires the Court, if requested by a party in interest, to protect such party: "On 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 ... ." Id. (emphasis added).

29. The mandatory language of Section 107(b) is a key distinction between common law analysis of when sealing is proper and the Bankruptcy Code's framework for determining when sealing is proper. See In re OrionPictures Corp., 21 F.3d 24, 27 (1994) (observing that, unlike most cases, the bankruptcy court does not exercise its discretion in finding "extraordinary" or "compelling" circumstances; rather, the bankruptcy court is required to protect trade secrets, confidential research, development, or commercial information); see also In re Gitto, 422 F.3d at 8 (stating that Section 107 "speaks directly to the question of public access," and therefore, supplants common law analysis of this issue); In re Food Mgmt., 359 B.R. at 553 (recognizing that Section 107(b) is a departure from the common law analysis of balancing the public and private interests in determining whether to allow parties to file under seal). Although Section 107(b) employs mandatory language, the court still must make a determination whether the information involved fits into the
In addition to Section 107(b), limitations to the policy of open access to bankruptcy filings are accomplished through the safeguards of bankruptcy's procedural rules, in particular Rule 9018, the procedural counterpart for Section 107. The authority given to the court under Section 107 and Rule 9018 is by no means foreign to bankruptcy proceedings. Not surprisingly, Rule 9018 bears a strong relationship to Federal Rule of Civil Procedure 26(c)(1)(G). In fact, the first classification of protective orders in Rule 9018 is the same kind authorized under Rule 26(c)(1)(G).

Although the rules are undoubtedly similar, Rule 9018 is slightly broader. Furthermore, its application does not require a showing of good cause. Rule 9018 provides the procedure for invoking the court's power under Section 107 of the Code, and is therefore, very familiar to hedge funds.

categories of 107(b). 2 COLLIER ON BANKRUPTCY, supra note 18, ¶ 107.03. This determination is a question of fact to be determined by judicial guidelines of that particular jurisdiction. Id. ¶ 107.03(2).

30. Bankruptcy Rule 9018 implements the powers given to the court by Bankruptcy Code Section 107, and when taken together, codify the Supreme Court' decision in Nixon. Mark D. Bloom et al., Reorganizing in a Fish Bowl: Public Access vs. Protecting Confidential Information, 73 AM. BANKR. L.J. 775, 781 (1999).

31. Collier points out that the Advisory Committee Note to former Bankruptcy Rule 918, a rule containing similar provisions to Section 107, indicates that prior to the formulation of either Bankruptcy Rule 9018 or Section 107, bankruptcy judges had the inherent power to issue protective orders, which are now addressed by Rule 9018 and Section 107. 10 COLLIER ON BANKRUPTCY, supra note 18, ¶ 9018.04.

32. Id. ¶ 9018.04. Federal Rule of Civil Procedure 26(c)(7) provides: "A party... may move for a protective order... and the court may, for good cause, issue an order... requiring that a trade secret or other confidential research, development, or commercial information not be revealed...." FED. R. CIV. P. 26(c)(1)(G).

33. Both Rule 9018 and Rule 26(c)(1)(G) protect trade secrets, confidential research, development, or commercial information. 10 COLLIER ON BANKRUPTCY, supra note 18, ¶ 9018.04.

34. The civil rule applies only to discovery, whereas Rule 9018 takes into account that a need for a protective order may arise in the context of a non-dispute. Id. ¶ 9018.04. Thus, Rule 9018 is a broader-based authorization that reflects a greater need for protection in the arena of bankruptcy. Id.

35. A court's power to issue a protective order under Rule 26(c) is limited to situations where "good cause" has been shown. Jepson v. Makita, 30 F.3d 854, 858 (7th Cir. 1994). Generally, good cause requires a showing that if the information is disclosed, serious and clearly defined injury will occur. In re Handy Andy Home Improvement Ctrs., Inc., 199 B.R. 376, 380 (Bankr. N.D. Ill. 1996).

Under Rule 9018, however, there is no requirement to show "good cause." Id. at 382. While Rule 26(c) expressly requires "good cause" even when the material protected is a "trade secret or other confidential research, development, or commercial information," the Bankruptcy Code does not impose such requirement. In re Orion, 21 F.3d at 28.

36. Bloom, supra note 30, at 781.
C. Hedge Funds and Bankruptcy

Hedge funds are widespread in the world of bankruptcy, often finding financial opportunity in Chapter 11 reorganizations. Traditionally, hedge funds have played a significant role in the stock market, but recently have become heavily involved in the debt market. More specifically, hedge funds have plunged into the distressed debt market, one of the fastest growing investment categories.

As credit markets tighten in the wake of the current subprime crisis, so-called "vulture funds," named for their emphasis on distressed-debt investing, are preparing to feast. Distressed-debt investors, such as hedge funds, buy this typically unattractive debt...
in the secondary market because of its potential for higher returns.\textsuperscript{42} Given the regulatory scheme governing hedge funds, they are extremely flexible entities capable of capitalizing on the substantial opportunities available in distressed investing and Chapter 11 reorganizations.\textsuperscript{43}

Within the financial community, however, hedge funds are viewed suspiciously, especially with regard to their lending activity.\textsuperscript{44} Part of this suspicion arises from hedge funds' reputation for being aggressive creditors that exert influence over their highly leveraged borrowers.\textsuperscript{45} Moreover, hedge funds often emerge from reorganizations as the owners of the companies to which they lend, and hence, hedge funds have become a target of the trustee and other creditor committees in bankruptcy reorganizations.\textsuperscript{46}

While participating in a Chapter 11 reorganization, hedge funds often form ad hoc committees in order to defray attorney fees and speak with one voice.\textsuperscript{47} This raises two important issues that have been side-stepped by the courts. First, the threshold issue of whether ad hoc committees are subject to Rule 2019.\textsuperscript{48} In

\textsuperscript{42} Vultures Take Wing, supra note 39. In the second-lien loan market, the primary lender gets repaid before the secondary lender in the event of a default. Anderson, supra note 38, at A1. In exchange for this greater risk, the secondary lender earns a higher interest rate. Id.

\textsuperscript{43} Hedge funds generally do not have to comply with the stringent disclosure and registration requirements of the Securities Exchange Act of 1933 because they fit into a registration exemption available to funds that only engage in private placement of securities; if a fund does not engage in public offerings, the fund is not required to register with the SEC. Securities Act of 1933, ch. 38, tit. I § 4, 48 Stat. 77 (codified as amended at 15 U.S.C. § 77d (2000).

\textsuperscript{44} Lending, once dominated by highly regulated banks, is an attractive investment vehicle for hedge funds. See Anderson, supra note 38, at A1. The lending practices of hedge funds raise suspicions because unlike banks, they are not required to separate their various lines of business and as a result, trading on inside information is possible. Id.

\textsuperscript{45} See id. (stating that hedge funds are powerful creditors, often serving on committees and boards of the borrowing company).

\textsuperscript{46} An illustration of the type of hedge fund activity that creates ill will in bankruptcies is found in In re Radnor, 353 B.R. 820 (Bankr. Del. 2006). In Radnor, the hedge fund provided loans to Radnor to refinance its existing debt. Id. at 828-29. Subsequently, the hedge fund acquired equity in Radnor and obtained a seat on its board. Id. at 829. When the company filed for Chapter 11, the hedge fund became a bidder of the company's assets. Id. The committee of unsecured creditors opposed this sale, arguing that the hedge fund engaged in a "loan to own" strategy that increased the company's insolvency. Id. at 830.

\textsuperscript{47} See supra note 6 and accompanying text (discussing the advantages of forming an ad hoc committee).

\textsuperscript{48} This issue turns on whether the court classifies the ad hoc committee as a committee under Rule 2019. See Voorhees, supra note 4, at 5 (commenting that courts have not successfully answered the question of "what is a
other words, are they a committee within the meaning of Rule 2019? Second, if they are a committee under Rule 2019, is their information protectable under Section 107(b)? These issues were addressed by the court in two important cases.

D. In re Northwest Airlines

A recent decision in the Bankruptcy Court for the Southern District of New York is a source of angst and consternation for hedge funds that participate in Chapter 11 reorganizations. In re Northwest Airlines addressed the challenge by a debtor to the Rule 2019 statement of an ad hoc committee of equity holders. The debtor argued that the ad hoc committee's statement only listed the aggregate holdings of the group and not the required individual holdings of its members; consequently the debtor argued that the filed statement was deficient. The court agreed with the debtor and ordered the ad hoc committee to comply with Rule 2019.

In response to the order to comply with Rule 2019, the ad hoc committee sought to file its amended Rule 2019 motion under seal based on Section 107(b) and Rule 9018. The court denied this motion on the basis that it frustrates the principle of Rule 2019, and that the information to be disclosed did not constitute "commercial information."

committees not appointed pursuant to Section 1102?")


51. Id.

52. Id. In determining that the ad hoc committee must comply with Rule 2019, the court found that the members of the shareholders' committee formed an ad hoc committee, and that "by acting as a group... this [ad hoc] committee subordinated to the requirements of Rule 2019." Id. at 708.

53. Filing the Rule 2019 statement under seal would only make the statement available to the Court and the U.S. Trustee. Id. at 705-06. The ad hoc committee argued that filing under seal was necessary to protect its members' investment strategies. Id. at 708. In particular the ad hoc committee argued that exposure of their basis would give their counterparties an unfair advantage. Id. In other words, the ad hoc committee's bargaining position would be seriously damaged if their competitors were to know their actual acquisition cost. Id.

54. See id. at 709 (stating that any interest individual members may have in keeping the statement confidential is outweighed by the interests that Rule 2019 seeks to protect, namely that the other shareholders need to be informed of "where a committee is coming from").

55. Id. at 707; see also id. at 708 n.8 (stating that preserving leverage is usually not an interest that would justify sealing court records).
E. In re Scotia Development

In stark contrast to the Northwest Airlines decision is the In re Scotia Development decision. The Scotia court denied the debtor’s motion to compel the ad hoc note holder committee to fully comply with Rule 2019.66 The Scotia decision, however, failed to provide an explanation for why the ad hoc committee of note holders was not a committee contemplated by Rule 2019.67

The Northwest Airlines and Scotia decisions bring uncertainty to the applicability of Rule 2019 to ad hoc committees and raises the question of whether Rule 2019 will extend to other groups that form committees or share counsel. Moreover, the Northwest Airlines decision has been criticized for the potential chilling effect on the participation by hedge funds in Chapter 11 reorganizations. Part III of this Comment will examine the definition of “committee,” as contemplated by Rule 2019, and as argued by the parties and amici to Northwest Airlines. Additionally, Part III will discuss the protected categories under 107(b), and whether ad hoc committees’ information is entitled to be filed under seal.

III. Analysis

A. Scope of Rule 2019

Analysis of the requirements under Rule 2019 and to whom the rule applies is a difficult task because there is limited case law dealing with the subject.68 A review of the little case law that does exist, however, reveals that courts have applied the requirements of Rule 2019 quite broadly,69 as is within their discretion under Section 105(a) of the Bankruptcy Code.70

One example of such discretion is where a court held that Rule 2019 encompassed potential conflicts arising from fee sharing

57. See Voorhees, supra note 4, at 5 (mentioning the lack of analysis and “opaque” decision of In re Scotia).
58. 9 COLLIER ON BANKRUPTCY, supra note 18, ¶ 2019.04[4].
59. Id. Some courts have required strict compliance with the rule, often resulting in harsh consequences. See, e.g., In re Baldwin-United Corp., 52 B.R. 146, 148 (Bankr. S.D. Ohio 1985) (holding that the 2019 statement was deficient because it did not list the names and addresses of class members); In re Ionosphere Clubs, Inc., 101 B.R. 844, 852 (Bankr. S.D.N.Y. 1989) (requiring a consumer union representing ticket holders to show that every ticket holder had authorized the consumer union to act as his or her representative). But see In re Trebol Motors Distrib. Corp., 220 B.R. 500, 503 (B.A.P. 1st Cir. 1998) (holding that a class certified prepetition is a single claimant and does not need to comply with Rule 2019).
60. The court has broad power to “issue any order... necessary or appropriate to carry out the provisions of this title... or appropriate to enforce or implement court orders or rules...” 11 U.S.C § 105(a) (2000) (emphasis added).
and referral relationships. While these disclosures are not specifically or explicitly required under Rule 2019, the court found that the precise nature of these relationships fell within the "literal language of the rule as well as the Judge's discretion to apply... [R]ule [2019]."

Although courts have generally applied Rule 2019 broadly, it may be inappropriate to require strict compliance given that the Bankruptcy Code favors unofficial committees' participation in bankruptcy cases. Moreover, broadly or strictly applying Rule 2019 often results in courts refusing to hear from the parties, a result that runs counter to Bankruptcy Code policy.

B. The History and Purpose of Rule 2019

Any analysis regarding Rule 2019's applicability to ad hoc committees participating in Chapter 11 reorganizations must begin by exploring the history and purpose of Rule 2019. As previously stated, Rule 2019 is part of a general disclosure scheme designed to curtail the abuses of protective committees. Protective committees were formed to protect the interests of constituents holding similar classes of securities. However, protective committees were largely criticized because of abuses resulting from conflicts of interest between security holders and...

61. The appellants challenged the bankruptcy judge's Rule 2019 order requiring appellants to include a detailed explanation of any type of co-counsel, consultant or fee sharing arrangements. Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm., 321 B.R. 147, 166 (D.N.J. 2005).
62. See FED. R. BANKR. P. 2019(a) (making no mention of disclosure requirements regarding fee sharing or referral arrangements).
63. Baron & Budd, 321 B.R. at 167. One of the main reasons the appellate court upheld the judge's Rule 2019 order is that the order promoted the underlying goals of Rule 2019; preventing conflicts among creditors and increasing fairness in reorganization. Id.
64. The Bankruptcy Code recognizes the importance of unofficial committees by treating the costs of unofficial committees as administrative expenses with priority of payment over other unsecured creditors. 11 U.S.C. § 503(b)(3)(D) (2000).
65. See 9 COLLIER ON BANKRUPTCY, supra note 18, at ¶ 2019.04[4] (stating that strict compliance with the rule is impractical because it silences parties intended to be heard, namely, unofficial committees). For further analysis of 2019 consequences for non-compliance, see supra note 20 and the accompanying text.
66. See supra note 21 and accompanying text (presenting a brief background on protective committees).
67. Protective committees were non-statutory committees organized by insider groups who would solicit smaller investors to enter into a deposit agreement that binds the depositor to go along with the protective committee. Evan D. Flaschen & Kurt A. Mayr, Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds, ABI J., Sept. 2007, at 16.
68. Gwynne, supra note 19, at 110.
the protective committee.\textsuperscript{69}

In particular, Rule 2019 was designed to ensure that the inside group of the committee does not manipulate the committee to "secure a dominant position in the reorganization" at the expense of minority constituents.\textsuperscript{70} In other words, Rule 2019 assures that distribution of assets is made in the proper amount, to the proper creditor.\textsuperscript{71} Moreover, without such a rule, there is a danger that a party allegedly acting on another's behalf may not be authorized to do so, or may have opposing interests.\textsuperscript{72} Due to these potential abuses, the belief emerged that protective committees should be considered as fiduciaries to the investors they represent.\textsuperscript{73} Accordingly, the Bankruptcy Code enacted Rule 10-211, the direct antecedent of Rule 2019.\textsuperscript{74}

\textbf{C. To Whom Rule 2019 Applies}

It would seem, from the legislative history, Rule 2019 specifically applies to entities that act in a fiduciary capacity, but that are not official committees under other sections of the Bankruptcy Code.\textsuperscript{75} Thus, Rule 2019 applies to attorneys, law firms, or committees representing more than one creditor or equity shareholder.\textsuperscript{76} As a result, Rule 2019 ensures that lawyers or those who act in a representative capacity adhere to certain

\textsuperscript{69} Congress found that protective committees gave rise to abuses because the committees were plagued by conflicts of financial interest and often securities holders were induced into believing that their cause was championed by the protective committee when it actually was not. SECURITIES AND EXCHANGE COMMISSION STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATIONS COMMITTEES, 880 (1937) [hereinafter SEC Report]. Protective committees were also criticized because they offered little protection for small groups of dissenting creditors. Gwynne, supra note 19, at 110. For example, instances arose where the competing interests of the committee members resulted in a situation where the committee did not adequately represent the interest of a particular creditor group. Id.

\textsuperscript{70} Baron & Budd, 321 B.R. at 166.


\textsuperscript{72} Id.

\textsuperscript{73} Flaschen & Mayr, supra note 67, at 16.

\textsuperscript{74} As a result of protective committees' abuses, namely the conflicts of interest, the SEC report recommended that persons (including committees) who represent more than twelve creditors or shareholders make disclosures to the court consisting of the information now found in Rule 2019. SEC REPORT, supra note 69, at 880.

\textsuperscript{75} Rule 2019 specifically exempts from its inclusion official committees organized under Sections 1102 and 1114 of the code, and therefore, applies to entities behaving as fiduciaries not subject to the control of the court. 9 COLLIER ON BANKRUPTCY, supra note 18, ¶ 2019.02.

ethical standards by bringing potential conflicts of interest out into the open and under the scrutiny of the court. 77 It is helpful to briefly examine a few of the typical conflicts of interest that arise when forming committees to better understand Rule 2019's purpose. Although some of these conflicts arise in the context of Section 1102's official committees, they are also illustrative of conflicts of interest relating to the formation of committees in general.

In bankruptcy cases there is tremendous potential for conflicts of interest to arise when multiple parties are represented by the same entity. 78 First, a committee possessing competing fiduciary or contractual duties may not adequately represent the creditor group. 79 Second, there is potential for conflicts of interest between committee members themselves. 80 Finally, there is potential for under representation of a particular creditor group. 81

Another potential conflict of interest can arise from law firms representing more than one creditor group. In re Oklahoma P.A.C. illustrates effectively this very type of conflict of interest in a Chapter 11 reorganization. 82 Based on a Rule 2019 disclosure, the court in In re Oklahoma P.A.C. determined that a conflict of interest existed because one law firm represented two creditors

77. See id. at 127 (noting that the court would not make a determination of whether a law firm representing both secured and unsecured creditors gave rise to conflicts of interest until the law firm complied completely with Rule 2019).

78. At the heart of every bankruptcy case is a limited pool of assets available for distribution to creditors; hence competing interests will result. See In re Hills Stores Co., 137 B.R. 4, 6 (Bankr. S.D.N.Y. 1992) (discussing how conflicts between creditors occur regularly in bankruptcy, should be anticipated, and are not foreign).

79. Competing duties may arise where a committee member owes a fiduciary duty or contractual duty to an entity other than the class of creditors represented by the committee or where a single committee is appointed to represent creditors of estates with competing interests. Gwynne, supra note 19, at 120-21.


81. The following example illustrates the issue of under-representation: One group of creditors holds a majority of the seats on the committee and its claim is valued at ten cents on the dollar. Another creditor group holds a minority of seats on the committee and its claim is valued at eighty cents on the dollar. Assume further that the debtor proposes a plan that will yield a recovery of twenty-five cents on the dollar. The creditor group holding the majority of seats will certainly vote in favor of this plan, much to the dissatisfaction of the minority group.

holding liens on the same property.83 The Rule 2019 disclosure requirement is an effective method of discovering the distinct and adverse interests of creditors participating in Chapter 11 reorganization.84

D. The Language of Rule 2019

The determination of what constitutes a “committee” for purposes of Rule 2019 is the issue addressed in both Northwest Airlines and Scotia. To properly analyze this issue, it is necessary to explore the precise terminology of Rule 2019 in light of its plain meaning, and according to its usage in other sections of the Bankruptcy Code.

1. Entity

Rule 2019 requires every entity that represents more than one creditor to file a disclosure statement comporting with the rule.85 “Entity” is broadly defined and is evidence of Congress’ intent to increase the scope of Rule 2019.86 The Bankruptcy Code defines entity to include “person, estate, trust, governmental unit, and United States trustee.”87 Additionally, Merriam Webster’s dictionary defines an entity as “an organization that has an identity separate from those of its members.”88 These definitions both imply that a group of creditors having a distinct identity from its members is an entity.

2. Committee

The term “committee” is not defined in Rule 2019 or in Section 101 of the Bankruptcy Code.89 As a result, the term “committee” should be given its everyday meaning and the
common meaning ascribed to it in legal and general dictionaries. Under a colloquial definition, a “committee” constitutes a group of people that act on behalf of or for the sake of others. Similarly, a legal definition of “committee” is an individual or body to whom others have given the authority to act or delegated a particular duty. These definitions are consistent with the purpose and history of Rule 2019, which tend to show that “committee” implies a representative relationship between parties.

The only cases to date that address the definition of a “committee” and when a committee is subject to Rule 2019 are Northwest Airlines and Scotia. The Scotia court declined to follow Northwest Airlines and offered virtually no guidance for resolving these issues. This leaves only the reasoning of the Northwest court to analyze.

In Northwest Airlines, the court held that the hedge fund ad hoc committee was a “committee” for purposes of Rule 2019. Notably, the court found irrelevant the ad hoc committee’s contention that they did not act in a fiduciary capacity. The court reasoned that even if the committee does not act as a fiduciary, Rule 2019 still applies because the other shareholders have a right to the information that will be helpful in deciding whether the committee represents their interests.

Thus, it is apparent in Northwest Airlines that Rule 2019 was designed to protect both the class represented by the committee

---

90. See Edwards v. Aguillard, 482 U.S. 578, 594-95 (1987) (stating that “[t]he “plain meaning” of the statute’s words . . . can control the determination of legislative purpose.”).
91. See WEBSTER’S, supra note 88, at 458 (defining a committee as “a body of persons delegated to consider, investigate, or take action”).
93. See 9 COLLIER ON BANKRUPTCY, supra note 18, ¶ 2019.02 (mentioning that Rule 2019 applies to entities behaving as fiduciaries not subject to the control of the court) (emphasis added); see also In re CF Holding Corp., 145 B.R. at 126 (mentioning that Rule 2019 is targeted at entities which act in a fiduciary capacity to those they represent) (emphasis added).
94. See supra note 57 and accompanying text (discussing the lack of analysis in In re Scotia).
95. The ad hoc committee argued that given the legislative history of Rule 2019, namely the fact that the rule was designed to apply to entities acting in a fiduciary capacity, the rule does not apply to them because the committee does not act for anyone other than the group’s members and does not serve as a fiduciary to any party, not even other members of the committee. In re Nw., 363 B.R. at 709.
96. See id. (stating that shareholders have a right to full disclosure of the committee members’ purchases and sales, and that this information is necessary to make an informed decision on whether to form a committee of their own that will more adequately represent their interests). The Northwest court also stated that it does not need to find that a committee is a fiduciary to fall within the scope of Rule 2019. Transcript of Record at 45, In re Northwest Airlines Corp., 363 B.R. 704 (Bankr. S.D.N.Y. 2007) (No. 05-17930).
Rule 2019: The Debtor’s New Weapon

and all parties to the bankruptcy case. Importantly, the court determined that Rule 2019 applied to the ad hoc committee because the ad hoc committee appeared as a group and sought relief as a group. Accordingly, the behavior of an entity as a fiduciary is not the sine qua non for determining whether Rule 2019 applies. The applicability of Rule 2019, rather, turns on whether the ad hoc committee has acted collectively and whether either the class represented, or any other party to the case, would benefit from disclosure.

E. Analysis of Public Policy Arguments

Northwest Airlines has sparked much criticism in the arena of bankruptcy, particularly by groups who participate in the secondary debt market and their corresponding trade associations. These organizations argue that applying Rule 2019 to informal committees will discourage sophisticated financial institutions from participating in Chapter 11 reorganizations. In particular, these groups maintain that participants in the Chapter 11 reorganizations buy and sell claims (debt) based on confidential and proprietary strategies. Importantly, these participants implement an investment strategy that requires continual adjustment of its position. Disclosure under Rule 2019 would give competitors insight into its unique trading strategy. Part IV of this Comment will address the public policy arguments against subjecting hedge funds to Rule 2019. In addition, Part IV will propose a test to determine under what circumstances an entity should be subject to Rule 2019’s requirements.

IV. BALANCING INTERESTS

The lack of relevant case law regarding whether an ad hoc committee is subject to Rule 2019’s disclosure requirements, coupled with the little precedential value of the case law that does exist, provides little guidance in resolving the issue. In the

97. See In re Nw., 363 B.R. at 709 (maintaining that Rule 2019 “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”).

98. See id. at 708 (stating that when the members of the ad hoc committee decided to act as a group, the ad hoc committee fell under the scope of Rule 2019).

99. See LSTA Brief, supra note 6, at 1 (pointing out that requiring the informal committee of secured trade vendors to file a statement pursuant to Rule 2019 produces a result antithetical to the goals of bankruptcy).

100. Id. at 3.

101. Id.

102. Id. A competitor that understands a participant’s trade strategy has an advantage over that participant because it can identify the participant’s upside and downside potential, and more importantly, its risk tolerance. Id.

103. 9 COLLIER ON BANKRUPTCY, supra note 18, ¶ 2019.04[4]. See also
absence of relative case law, the issue is best approached by relying on bankruptcy principles and balancing competing interests.

A. Addressing the Public Policy Arguments

Proponents of Rule 2019’s applicability to hedge funds argue that hedge funds are a disruptive force in bankruptcy cases, in particular Chapter 11 reorganizations. In contrast, opponents of Rule 2019’s applicability to ad hoc committees (hedge funds and similar entities) argue that subjecting an ad hoc committee to Rule 2019’s disclosure requirements will have a chilling effect on hedge fund participation in Chapter 11 reorganizations. This, opponents argue, will hinder reorganization because hedge funds bring sophisticated solutions to problems in bankruptcies.

First, if a hedge fund is forced to comply with Rule 2019, it will be subject to a definite disadvantage. Compliance with Rule 2019 will expose a hedge fund’s cost basis because Rule 2019 requires the disclosure of both the amount of the claim and the time of acquisition. Disclosing this data essentially discloses purchase price information (directly or inferentially through time of purchase) that is proprietary information in the view of hedge funds.

It is difficult to argue that exposing the price paid for an investment intended to be sold is advantageous to a hedge fund. Hedge funds, consequently, may be at an inherent disadvantage when negotiating a Chapter 11 reorganization plan, or attempting

Voorhees, supra note 4, at 5 (noting the lack of an explanation and the court’s conclusory analysis in Scotia).

104. See Flaschen & Mayr, supra note 67, at 48 (noting that Rule 2019, according to opponents of hedge funds, will curb hedge funds’ influence in bankruptcy). Thus, according to hedge fund adversaries, hedge funds have a destructive and corrosive influence on the bankruptcy process. Id. See also supra notes 44-46 and accompanying text (discussing the general distrust associated with hedge funds in bankruptcy).

105. See Flaschen & Mayr, supra note 67, at 48 (discussing how necessitating compliance with Rule 2019 will discourage hedge funds and distressed debt investors from participating in Chapter 11 proceedings).

106. See id. at 49 (mentioning that hedge funds are sophisticated creditors that should be welcomed in bankruptcy rather than opposed at every instance).

107. See supra note 3 and accompanying text (stating the specific requirements under Rule 2019).

108. Reply of the Ad Hoc Equity Committee in Order (A) Pursuant to Sections 105(a) and 107(b) of the Bankruptcy Code and Rule 9018 of the Federal Rules of Bankruptcy Procedure Granting Leave to File Its Bankruptcy Rule 2019(a) Statement Under Seal, and (B) Granting a Temporary Stay Pending Determination of this Motion, In re Nw. Airline Corp., 363 B.R. 704, No. 05-17930, 2007 WL 748286 [hereinafter Reply of the Ad Hoc Committee].
to sell their claims to a third party.\textsuperscript{109} What is uncertain, however, is whether such a disadvantage will ultimately lead to hedge funds retreating from the bankruptcy arena. Taking the opponents of Rule 2019's argument at face value, and assuming \textit{arguendo} that subjecting ad hoc committees to Rule 2019 will curtail hedge funds' participation in Chapter 11, it becomes apparent that such a result is not desirable and runs counter to the goals of bankruptcy.

The additional costs incurred as a result of disclosing under Rule 2019 may prove to be a significant barrier to entry in Chapter 11 reorganizations.\textsuperscript{110} The secondary debt market, specifically in the context of Chapter 11 reorganizations, is a true market with significant market participants: buyers and sellers of debt instruments, specifically second lien loans.\textsuperscript{111}

The secondary debt market is valuable in Chapter 11 proceedings because it promotes reorganization and workout agreements by providing an essential source of liquidity to investors that buy and sell secondary debt.\textsuperscript{112} This in turn increases the efficiency of the secondary debt market.\textsuperscript{113} Hedge funds are major participants within this market, and they, like any other investor in a market, look to maximize their investment. As a result, hedge funds increase secondary debt liquidity by offering complex and sophisticated solutions to the workout and reorganization process, and therefore, facilitate the goal of collective reorganization. Consequently, if Rule 2019 discourages hedge fund involvement in bankruptcy, liquidity and efficiency in the secondary debt market will diminish, hampering the overall reorganization process.

The argument that hedge funds frustrate the bankruptcy process because they participate short term or opportunistically

\textsuperscript{109} See supra note 105 and accompanying text (discussing that compliance with Rule 2019 will discourage hedge funds and distressed debt investors from participating in Chapter 11 proceedings).

\textsuperscript{110} There are two generally accepted definitions of entry barriers. Daniel E. Lazaroff, \textit{Entry Barriers and Contemporary Antitrust Litigation}, 7 U.C. DAVIS BUS. L.J. 1, 2-3 (2006). The first definition of an entry barrier is limited to costs that a prospective market entrant will have to incur that an existing market participant did not have to incur when they entered the relevant market. \textit{Id.} The second definition deems any cost that deters entry of a potential entrant to be an entry barrier. \textit{Id.}

\textsuperscript{111} See supra note 43 and accompanying text (discussing the secondary debt market and its role in chapter 11).

\textsuperscript{112} See Flaschen & Mayr, supra note 67, at 48 (noting that hedge funds are "true economic creatures" that maximize and bring efficiency to businesses and markets).

\textsuperscript{113} See Reply of the Ad Hoc Committee, supra note 108, at 5 (mentioning that secondary market participants such as hedge funds are "critical to both the efficiency of the capital markets and to the proper functioning and proper reorganizations of debtors.").
engage in strategies designed to own or acquire the debtor company,\textsuperscript{114} simply ignores a fundamental principle of bankruptcy: placing the property of a business in the hands of parties who will use it the most efficiently. Hedge funds that acquire a business as a result of bankruptcy reorganization advances this objective.

\textbf{B. A Presumption of Non-Applicability}

The public policy goal of bankruptcy, namely the placement of property in the hands of parties who will use it most effectively, is promoted by granting hedge funds favored status in bankruptcy cases. Rule 2019 potentially discourages participation by hedge funds in the bankruptcy process and should only be employed in instances that require the balancing of competing interests. This favored status would contain a rebuttable presumption that an ad hoc committee is not subject to Rule 2019 unless a court finds the committee acts \textit{de facto} as a fiduciary, or other circumstances are present which may give rise to potential conflicts of interest.

\textbf{C. When to Apply Rule 2019 to an Ad Hoc Committee}

Granting hedge funds' ad hoc committees a favored status under the Bankruptcy Code and creating a presumption against subjecting them to Rule 2019 is the first necessary step to advance the public policy goals of bankruptcy reorganization. Under what circumstances, however, should an ad hoc committee be subject to Rule 2019? To answer this question, it is necessary to revisit the purpose and significance of Rule 2019.

First, the legislative history of Rule 2019 strongly indicates the Rule was created as an attempt to combat conflicting interests arising between bankruptcy committee members and those they represent.\textsuperscript{115} The legislative history also indicates that Rule 2019, when originally drafted, was intended to apply to entities that act in a representative or fiduciary capacity.\textsuperscript{116} Accordingly, ad hoc committees and hedge funds argue that because their committee does not act in a fiduciary capacity, they should not be subject to Rule 2019.\textsuperscript{117}

The ad hoc committee's argument however, is a \textit{non sequiter}. Simply because Rule 2019 was intended to apply to entities acting as fiduciaries, it does not necessarily follow that Rule 2019 should not apply to entities not acting as fiduciaries. The fact that a

\textsuperscript{114} See, e.g., \textit{In re Radnor}, 353 B.R. at 823 (involving a Chapter 11 case that resulted in a hedge fund acquiring the debtor's business).

\textsuperscript{115} For a thorough discussion on the legislative purpose of Rule 2019, see supra Part III(B): "The History and Purpose of Rule 2019."

\textsuperscript{116} See supra Part III(C) (discussing the various conflicts of interest that arise when entities act in a fiduciary capacity).

\textsuperscript{117} See id. (discussing the ad hoc committee's contention that Rule 2019 only applies to committees that are fiduciaries).
committee does not act in a fiduciary capacity should not exempt it 
from Rule 2019. If a committee acts in a fiduciary capacity, it 
should be subject to Rule 2019 because this is consistent with the 
legislative purpose behind Rule 2019.118 If, however, a committee 
does not act as a fiduciary, there should be a presumption that the 
committee is not subject to Rule 2019 unless other circumstances 
are present, namely potential conflicts of interests. This policy is 
consistent with the history and purpose behind Rule 2019.119 

Applying Rule 2019 to entities behaving as fiduciaries 
comports with the legislative history behind Rule 2019 and also 
addresses conflicts of interest between committee members and 
their constituents, committee members themselves, and all parties 
to a bankruptcy case.120 This is consistent with the Northwest 
Airlines decision to the extent that they held that there does not 
need to be a fiduciary relationship present in order to hold a 
committee subject to Rule 2019.121 

V. THE COMPLETE TEST 

Hedge funds and their ad hoc committees enhance the 
bankruptcy reorganization process. In recognition of this benefit, 
Rule 2019 should not be used as a sword against hedge fund 
participation in the bankruptcy process. Discouraging hedge 

funds from participating in bankruptcy cases, particularly Chapter 

11. reorganizations, is detrimental to the reorganization process as 

a whole. To encourage hedge fund participation in the 

reorganization process, there should be a rebuttable presumption 

that Rule 2019 does not apply to hedge funds’ ad hoc committees. 
The burden should be placed on the opposing party to demonstrate 

that a hedge fund ad hoc committee either acts as a fiduciary or a 

conflict of interest exists, triggering Rule 2019. These sensible 

changes to the application of Rule 2019 promotes the underlying 

public policy behind bankruptcy reorganization and encourages 

the vital participation of hedge funds in the reorganization 

process.

118. The legislative history clearly indicates that Rule 2019 was intended to apply to entities that act in a fiduciary capacity. See supra note 75 and accompanying text (mentioning Collier’s view that Rule 2019 applies to committees that act as fiduciaries). 
119. See supra Part III, Section C (discussing the various conflicts of interest that arise when entities act in fiduciary capacity). 
120. This is the view of the Northwest Airlines court. See In re Nw. Airlines, 363 B.R. at 709 (holding that it is not necessary to find that a committee is a fiduciary to fall within the scope of Rule 2019); see also supra note 97 and accompanying text (discussing that Rule 2019 is designed for all parties to a bankruptcy case). 
121. Id.