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Northwest Airlines and *Pacific Lumber* — Recent Sparring May Impact the Willingness of Hedge Funds and Distressed Investors to Serve on *Ad Hoc* Debt or Equity Committees

This is to advise you of a recent decision from a leading bankruptcy court that has the potential to alter the manner in which hedge funds and other distressed investors seek to influence the direction of Chapter 11 cases. In *Northwest Airlines*, Judge Gropper of the United States Bankruptcy Court for the Southern District of New York ordered an unofficial or "*ad hoc*" committee of equity holders, comprised of hedge funds, to disclose in a public filing each member's debt and equity holdings, the dates of each acquisition and the price paid. Separately, he also denied a request that the members be allowed to file their information under seal.

Investors serving on *ad hoc* committees fight vigorously to avoid making these disclosures. Hedge funds argue that they trade based on proprietary systems that could be reconstructed from such data by competitors. Distressed investors argue that if they disclose the price at which they acquired their positions they will be seriously disadvantaged in plan negotiations. Both say that requiring the disclosure of trading data will have a "chilling effect" on sophisticated debt and equity investors who participate actively in, and bring value and liquidity to, Chapter 11 cases.

The decision in *Northwest Airlines* dealt with an unofficial committee of equity holders, but the Court's reasoning may apply equally to unofficial committees of bondholders or lenders. By its terms, Bankruptcy Rule 2019 requires every entity representing more than one creditor or equity holder (other than official committees) to file a statement disclosing the identities of each party represented, each party's holdings, the dates of each acquisition and the price paid. In practice, however, unofficial committees have generally avoided the requirement. The statement typically filed by an unofficial committee identifies the group's counsel, counsel's interest in the case, the group's members, and the aggregate amount of the group's debt and equity holdings, without any disclosure of the dates of acquisition, the price paid, or any individual member's stake.

Forming or participating on an unofficial committee is one important way that hedge funds and other stakeholders seek to assert leverage in a Chapter 11 case. By consolidating, members may attain greater influence than they have standing alone, and will in many cases "secure a seat at the table" with the company, its lenders and other major players. Consolidating also allows members of the group to pool expenses and resources. The end result may be a greater recovery for those investors than if left to their own devices. Often, at the end of the case, unofficial committees also ask the court to compel the company to pay their attorneys' fees for making a "substantial contribution" to the reorganization. Such requests for reimbursement are often met with mixed results.

From a strategic standpoint, these disclosure challenges may be a new arrow in the quiver of debtors, lenders, official committees and other parties in interest seeking to restrict the influence of assertive or difficult *ad hoc* committees. The dispute in *Northwest Airlines* arose in the context of the *ad hoc* committee's request for an

official equity committee. In response, the debtors challenged the adequacy of the group's disclosures. Some say the debtors applied the rule selectively to rein in a particularly aggressive group of stakeholders; the *ad hoc* committee is contending that the airline is undervaluing its stock and hiding or delaying a planned merger with Delta until the two carriers emerge from bankruptcy in the next year or so. Whether the ploy will be successful remains an open question. The group withdrew its request for an official equity committee but is now seeking the appointment of an examiner to investigate its charges.

As further proof that these challenges are susceptible to strategic use, there is a similar fight brewing in Pacific Lumber's Chapter 11 case. The highly contentious case was filed in Corpus Christi, Texas in January 2007, but the company's fighting with bondholders, environmentalists and the State of California dates back several years. Last week, on the heels of the ruling in *Northwest Airlines*, the company asked the court to order a group of hedge funds organized as an *ad hoc* committee of noteholders to disclose their individual holdings and the prices paid for their bonds. The company asserts that the hedge funds have engaged in "overly aggressive behavior" that threatens its reorganization prospects while "hiding behind a veil of secrecy."

The debate over what disclosures are required, and how public they should be, is still very much alive. In *Pacific Lumber*, the fight over what disclosures will be required is scheduled for hearing on April 10, 2007. In *Northwest Airlines*, the *ad hoc* committee filed an appeal from the denial of its request to file the disclosures under seal. Several committee members also filed a motion for reconsideration and, in an unusual move, the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association asked to be heard in support of the motion because of its potential impact on the debt and equity markets. The motion was denied, but the efforts of the two trading associations to weigh in illustrates its potential magnitude.

For the time being, then, the disputes in *Northwest Airlines* and *Pacific Lumber* between the companies and hedge funds should make investors think carefully about forming or participating on an *ad hoc* committee of debt or equity holders if they are concerned at all about the risk of being required to disclose their individual holdings, the dates they bought in or the price they paid.

We will keep you updated of any further developments.

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