Delaware Judges Can't Agree on Disclosures to Require from Investors in Ad Hoc Groups

A trio of recent decisions from the Bankruptcy Court in Delaware has stoked the flames of the fight over how much investors that band together as an unofficial or "ad hoc" group in a chapter 11 case must disclose about their investments in a troubled company in order to act together as a group — including what each member holds, when it invested and what it paid.

Hedge funds, distressed funds, private equity firms and other investors often decline to serve on "official" committees to avoid trading restrictions imposed on members. As a popular alternative, these investors may form an unofficial group to speak with a unified voice and pool legal costs. These groups face heavy scrutiny, however, due to a split among the courts as to whether their members must follow the letter of the disclosure rule, Bankruptcy Rule 2019.

The rule is under fire for the lack of certainty it gives investors, who strongly oppose disclosing the specifics of their investments and are rethinking whether to form these unofficial groups. The rule is also susceptible to strategic use by parties who wait to object to a group's disclosures until an important juncture in a case, in an effort to deny the group a voice.

The issue is a timely one, and there is a proposed amendment to expand the rule's scope that will be considered at a public hearing on February 5, 2010, with public comments due by February 16, 2010. For now, however, it is unclear whether the amendment will survive, and in what shape. Moreover, if passed, it appears unlikely that the change would take effect for a year or more.

In lieu of an amendment, the controversy could be resolved by the appellate courts, and the three recent Delaware decisions are in the early stages of appeals. However, there is no guarantee that the appellate courts will alleviate the confusion and so, until there is a satisfactory resolution, investors may have no choice but to live with the present uncertainty.

Bankruptcy Rule 2019

Reasonable people can differ over whether the rule is a good one or bad one from a policy standpoint. However, on its face, the rule does not appear susceptible to varying interpretations as to who must comply with its terms. The text says that every "entity or committee representing more than one creditor or equity holder [excluding any official committee]" must file a statement disclosing the identity of each party represented, each party's respective holdings, the dates of each acquisition and the price paid in each instance.

In practice, ad hoc groups rarely follow the rule. Most argue that they are not "committees" *per se*, because they are self-appointed and not authorized to "represent" other investors. Some investors contend that disclosing trading histories would enable competitors to reverse-engineer their proprietary investment

strategies. Others argue that disclosing the discounted price at which they acquired their debt or equity would compromise their bargaining position.

Of course, it is generally accepted that a group's counsel must adhere to the rule as an "entity … representing more than one creditor or equity holder." However, in most instances, counsel will file a "bare bones" statement that identifies each group member and the group's aggregate holdings, without making the more sensitive disclosures regarding each member's holdings. These groups contend that even if the rule did apply to them, which they dispute, their lawyer's statement would satisfy any independent disclosure obligation the group might have. It is clear from a plain reading that the partial disclosures fall short of what the rule contemplates but, until a few years ago, an ad hoc group's disclosures were seldom, if ever, challenged.

Split Among the Courts

Over the last three years, litigation over the disclosure requirements applicable to ad hoc groups has become increasingly prominent. The following are the major cases:

- *Northwest Airlines*: In March 2007, in the case that sparked the current fight, Judge Gropper of the Bankruptcy Court in Manhattan ordered an unofficial equity committee, which included hedge funds, to comply with the rule and make full disclosures. The court also denied the group's request for permission to make its disclosures under seal.
- *Scotia Pacific*: One month later, in April 2007, Judge Schmidt of the Bankruptcy Court in Corpus Christi, Texas, declined to follow *Northwest Airlines*, concluding that partial disclosures by counsel for an ad hoc group of noteholders satisfied the group's requirements.
- *Sea Containers*: In May 2008, Judge Carey of the Delaware Bankruptcy Court ordered a group of investment managers to disclose aggregate holdings and the dates holdings were acquired, but excused them from identifying noteholders or pricing data.
- *LyondellBasell*: In February 2009, Judge Gerber of the Bankruptcy Court in Manhattan ordered an ad hoc group to disclose members' bond and credit default swap positions.
- *Washington Mutual*: In December 2009, Judge Walrath of the Delaware Bankruptcy Court ordered an ad hoc group of noteholders to make the full disclosures.
- *Six Flags*: In early January 2010, Judge Sontchi of the Delaware Bankruptcy Court held that an ad hoc group was beyond the scope of the rule, reasoning from the rule's text and legislative history that ad hoc groups are not true "committees."
- *Accuride*: In late January 2010, Judge Shannon of the Delaware Bankruptcy Court compelled an ad hoc group of noteholders to make detailed disclosures, but denied a request to ignore the group as a sanction until its full disclosures were made.

The lack of certainty in how courts are applying the rule begs for a resolution. Nowhere is that uncertainty more obvious than Delaware, one of the nation's most influential courts, where four judges have applied the rule three different ways in a span of less than two years.

Conclusion

Given the split among the courts and the likely delay before an amendment could resolve the dispute, investors would be wise to consider the following before joining an ad hoc group:

- whether the court or judge has considered the disclosure issue previously;

- the advantages of participating as an ad hoc group (principally, obtaining a larger voice and sharing one set of professionals); and
- the impact if the investor has to choose between making full disclosures or ceasing its participation in the group.

Until the rule is amended or the appellate courts weigh in, the investors who form ad hoc groups will continue to be at the mercy of bankruptcy judges over how much they may need to disclose in order to continue acting together as a group.

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