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AD HOC ATTACK

UNOFFICIAL SHAREHOLDER COMMITTEES MAY BE AN ENDANGERED SPECIES IN CHAPTER 11 CASES

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Ad hoc or unofficial committees play an important role in many large Chapter 11 cases.

However, in view of Judge Allan Gropper's recent decision in In re Northwest Airlines Inc., in which the members of an ad hoc shareholder committee were ordered, pursuant to Bankruptcy Rule 2019, to disclose information pertaining to their holdings in **Northwest Airlines Inc.**'s securities, including the amount of their holdings and the price(s) they paid, those considering participating in such committees will now need to weigh the harm to them of making such disclosures against the benefit of serving on an ad hoc committee and enjoying a greater voice in the bankruptcy case. Or will they?

In In re Scotia Pacific Company LLC, at least one court to have considered Bankruptcy Rule 2019's disclosure requirements in the wake of the Northwest decision reached the opposite conclusion, and it refused to require ad hoc committee members to make the disclosures required in Northwest. Why did the Bankruptcy Court for the Southern District of Texas decline to follow Northwest?

In the **Scotia Pacific Co. LLC** case, the debtor, relying on Northwest and what it viewed as Bankruptcy Rule 2019's plain language, moved to compel the individual members of an ad hoc noteholder committee that had formed prior to the bankruptcy case to comply fully with Rule 2019 by, among other things, disclosing the amount of their holdings and the price(s) paid. The ad hoc committee's counsel had previously filed a 2019 statement identifying the committee members by name and the aggregate amount of their holdings (approximately 95% of the total notes outstanding) but, as has been the common practice, it did not identify specific holdings or the prices paid by committee members.

> Anyone considering participation in an ad hoc panel must be wary of having to provide additional disclosures about their holdings.

The ad hoc committee and amici curiae the Securities Industry and Financial Markets Association and the Loan Syndications and Trading Association opposed the debtor's motion on various grounds. First, despite having referred to itself as a "committee" in its pleadings, the ad hoc committee argued that it in fact was not a "committee" in the legal or colloquial sense of the word because its members were neither elected nor appointed, no powers were delegated to it, and it did not act in a representative capacity. Rather, the ad hoc committee proclaimed that it was merely a "group" of creditors that banded together to share the costs of their retained professionals.

Second, the ad hoc committee argued that Rule 2019's legislative history demonstrates that the rule only applies to committees that act as fiduciaries on behalf of others. Specifically, Rule 2019 was enacted to deal with harms caused by so-called protective committees that formed in the old equity receiverships in the 1930s.

"Protective committees," the ad hoc committee asserted, were privately formed committees that were often organized by insider groups dominated by the debtor or its investment bank and institutional investors who would solicit smaller investors to enter into a deposit agreement whereby the smaller investors would deposit their securities and delegate to the committee the responsibility of negotiating with the debtor. This arrangement was rife

with opportunities for insider dealing and created a need for public investors to be protected from insiders in reorganization cases.

A report by the Securities and Exchange Commission advocating correction of this problem stated that the members of the protective committees were fiduciaries of the other creditors. Congress adopted the SEC report's recommendation for legislation to combat the problems of protective committees by enacting the requirements now embodied in Rule 2019. Unlike these "protective committees," the ad hoc committee did not act for anyone else, not even, according to it, its own members.

In support of the ad hoc committee's position, the Securities Industry and Financial Markets Association and the Loan Syndications and Trading Association argued in a joint pleading that forcing disclosure of the prices individual members paid would decrease the liquidity in the secondary market for distressed securities because many parties that buy such securities with a view to participating in a case through an ad hoc committee no longer would do so. This, in turn, would diminish active participation in Chapter 11 cases by sophisticated parties that often make significant contributions toward reorganizations. Finally, these trade associations noted that requiring members of an ad hoc committee to disclose price would inevitably mean that, during plan negotiations, debtors and other constituents in the case would seek to tie the price a particular member paid to that member's recovery under a plan, a concept long since rejected by bankruptcy courts across the country.

In an oral ruling, of which the debtor subsequently sought but was denied reconsideration, the court opted for what it termed "a practical approach" and refused to apply Rule 2019 to the committee members themselves. The court instead concluded that the ad hoc group was not a committee, but rather was simply a group of creditors represented by a single law firm, and, as a result, only the law firm was required to comply with Rule 2019. As a result, disclosure of individual committee member holdings and the prices paid was not required.

Unfortunately, the court did not elaborate on its reasoning. However, we suspect that a critical distinction from Northwest that contributed to the court's "practical" approach was the fact that the ad hoc group in Scotia Pacific, unlike the group in Northwest, collectively held virtually all of the securities in its class. Thus, it was easier to make the case in Scotia Pacific that nobody that was not already a committee member stood to gain from the additional disclosure.

It remains to be seen which of the two rulings—Northwest or Scotia Pacific—will have more vitality. Suffice it to say for now that anyone considering participating in an ad hoc group must be wary of having to provide the additional disclosures required in Northwest as debtors and other constituents in Chapter 11 cases across the country, including, we suspect, the U.S. Trustees' offices, will seek to apply Bankruptcy Rule 2019 to unofficial creditor and shareholder groups. Only time will tell whether that ultimately chills group formation and what consequences flow from it. ■

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