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## CONFIDENTIALITY AND DISCLOSURE IN DISTRESSED INVESTING

*Noteholders Who Join a Creditors' Committee Typically Are Restricted from Trading the Debtor's Securities and May be Required to Disclose Sensitive Business Information. Trading May be Permitted under Court-approved Internal Safeguards, but "Big Boy" Letters Have Not Protected Holders from Charges of Insider Trading and May Even be Harmful.*

By Glenn E. Siegel and Davin J. Hall \*

Creditors who hold distressed debt and participate in bankruptcies or workouts are confronted with a myriad of choices and risks when they trade in the obligations of the issuer or related companies. The following article will discuss the developing law and practice in this area.

### DEALING WITH INSIDE INFORMATION

When bank debt or public debt becomes distressed, its holders must make some basic decisions. First, they need to decide whether to hold or sell the debt (a decision that must be reexamined throughout the process). Second, they need to decide whether to be a passive holder of the debt or to become actively involved in the workout process. Becoming actively involved will typically result in the receipt of confidential information, and therefore impose restrictions, if not a total ban, on the holder's ability to trade in *any* securities of the issuer.

Some ad hoc committees of holders, in order to avoid or delay this bar on trading, will delegate the receipt, analysis, and preliminary negotiation of the terms of the workout to their attorneys and/or financial advisors. Other committees will appoint a steering committee of holders, which will become restricted, while the other

holders are free to trade. In each of these instances, the assumption is that all members of the committee will become restricted and receive confidential information when the steering committee or professionals determine that a deal is close. Once that happens, holders will generally agree that the information they receive will remain confidential for a limited time (usually 30 days or less).<sup>1</sup>

The recipient of confidential information will inevitably receive a request by the company to sign a confidentiality agreement. The agreement will, of course, require the recipient not to disclose or use the information it receives without the permission of the company. The agreement should clearly specify when disclosure can be made, such as in response to a regulatory inquiry or judicial action, and should authorize the recipient to make disclosures public at the end of the confidentiality period, if the company has not already done so.

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<sup>1</sup> In some instances, it may be possible to get a company to agree that larger institutions can continue to trade so long as an ethical wall is erected between the workout people and the trading desk.

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If all goes well, holders are not restricted for very long and a successful workout is concluded. If all does not go well, holders are restricted for an unknown period of time and will have only one way out – the conclusion of a deal with the issuer.

### **“BIG BOY” LETTERS**

Holders who receive confidential information but still want to buy or sell the related debt have sometimes used “big boy” letters to complete a trade. These letters, which are only entered into between sophisticated investors (*i.e.*, “big boys”), are effectively a waiver of rights by the party to the trade who does not possess the confidential information when, notwithstanding this inequality in information, this party is still willing to make the trade.<sup>2</sup> The industry believes that such a letter adequately protects the party with superior information because the other “big boy” has waived its claim.<sup>3</sup>

Nonetheless, these letters cannot offer complete protection because they are not binding on the S.E.C. or the company providing such confidential information. In particular, a big boy letter does not insulate the trader from liability under Exchange Act Rule 10b-5(2), which provides that the duty of trust or confidence forming a predicate for insider trading liability under the “misappropriation” theory exists whenever a person agrees to maintain information in confidence.<sup>4</sup>

#### ***R<sup>2</sup> Investments v. Salomon Smith Barney and Jefferies***

The issues related to the use of “big boy” letters came to a head in a lawsuit recently brought by the Texas-based hedge fund R<sup>2</sup> Investments. In *R<sup>2</sup> Invest. LDC v.*

*Salomon Smith Barney Inc.*,<sup>5</sup> R<sup>2</sup> Investments sued Salomon Smith Barney (“SSB”) and Jefferies for violations of federal securities law and common law fraud in connection with its purchase of certain unsecured notes of World Access. R<sup>2</sup>’s complaint alleged that SSB owned \$31 million in approximate face value of World Access notes as of October 2000. Under the notes’ indenture, World Access was required to make a tender offer upon consummation of a certain asset sale; however, it was dealing with various liquidity and cash flow issues, so a protective group of the largest noteholders (including SSB) was formed to discuss a restructuring. As a member of this protective group, SSB was required to ratify an agreement to keep confidential certain non-public information. It was alleged that this information included the fact that World Access was only prepared to make a tender offer for less than half of the debt that the public thought was going to be tendered and that it was considering filing for bankruptcy.

SSB then sold these notes to Jefferies pursuant to a big boy letter under which Jefferies acknowledged that SSB (as seller) was in possession of material, non-public information, but also under which such information was not to be disclosed to Jefferies (as buyer). At SSB’s request, Jefferies sold the notes to a third party, which in turn sold the notes to R<sup>2</sup>. After the transaction, the reduced scope of the tender offer was made public with predictable results in the marketplace for the World Access debt. The repercussions in the marketplace of this announcement were so severe that World Access filed for bankruptcy. As a result, on April 27, 2001, R<sup>2</sup> sued SSB and Jefferies, arguing that both had committed securities and common law fraud and, in particular, that Jefferies had a duty to disclose that it was a party to a big boy letter and was trading with inside information.

In its motion for judgment on the pleadings, Jefferies argued that its knowledge that SSB was in possession of non-public information was too general to be material for purposes of disclosure under the securities laws.<sup>6</sup>

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<sup>2</sup> Anderson, Jenny, *Buyer-Seller Agreements Not to Sue Raise Issues About Inside Information*, New York Times at C1 (May 22, 2007).

<sup>3</sup> See *e.g.*, Drain and Schwartz, *Are Bankruptcy Claims Subject To The Federal Securities Laws?*, 10 AMBKRLR 569, n.105 (Winter, 2002).

<sup>4</sup> See, *e.g.*, McTague, Rachel, *In Insider Case, Big Boy Letter Signatory Need Not Have Been Deceived*, Official Says, 39 SRLR 1893 (Dec. 10, 2007).

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<sup>5</sup> Case No. 01-03598 (S.D.N.Y. 2001).

<sup>6</sup> Jefferies argued that its acknowledgement under the big boy letter was more akin to mere rumor, as opposed to actual

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Moreover, as Jefferies argued, disclosure was not warranted since R<sup>2</sup> must have known that the ultimate seller of the notes sat on the protective committee (since there was no other noteholder that held so large an interest that was not also on that committee), and in any event, the public knew that World Access was not doing well financially and that the tender offer was not a closed deal. Furthermore, even if the underlying information was material, Jefferies argued that the very existence of the big boy letter meant that SSB's possession of material, non-public information (as opposed to the actual nature of the information) was not subject to a duty of confidentiality between SSB and World Access. Jefferies argued that R<sup>2</sup> could not recover because it did not show that the fact that SSB had material, non-public information (as opposed to the actual undisclosed information) would have affected its decision to purchase the debt.

The focus of SSB's motion to dismiss was on R<sup>2</sup>'s securities fraud allegations. Among other things, SSB interpreted R<sup>2</sup>'s complaint as making two types of insider trading claims – one based on a classical theory of insider trading and the other based on a misappropriation theory.<sup>7</sup> Essentially, SSB argued, for it to have incurred liability under a classical theory, it would have had to have been an insider of World Access, which it argued it was not, since merely possessing non-public material information did not give rise to insider status.<sup>8</sup> Jefferies argued that it had no duty to R<sup>2</sup>, because it was trading in debt securities and was not the direct seller of the securities that R<sup>2</sup> purchased. SSB also argued that it was not liable under a misappropriation theory, because only the issuer of the ultimate securities (World Access) had standing to assert such claims. In addition, SSB asserted it owed no duty of confidentiality to World Access because its mere possession of certain material, non-public information

(even if that were true) did not give rise to a confidential relationship of trust.<sup>9</sup>

In response to the arguments that neither SSB nor Jefferies breached fiduciary duties, R<sup>2</sup> argued that because SSB had superior, material, and non-public knowledge, it was a temporary insider, and because World Access was operating in a zone of insolvency, fiduciary duties were indeed owed to holders of debt claims, meaning that SSB could be liable for classical insider trading. Moreover, because, as R<sup>2</sup> alleged, SSB learned about non-public information pursuant to a restriction agreement, it owed World Access a duty of confidentiality, and it misappropriated this information by making trades. These duties were imputed to Jefferies as SSB's "tippee," which meant that Jefferies had a duty to disclose that SSB was in possession of material, non-public information or abstain from trading.<sup>10</sup>

By January of 2005, the district court held a hearing on the defendants' motions for summary judgment. The court found that the big boy letter did not insulate SSB from liability as a matter of law and that it did not provide a defense to the claims of the plaintiff under the misappropriation theory. Indeed, the court suggested that the letter might even be evidence of trading with misappropriated information.

These issues, however, were not ultimately adjudicated. Following years of motion practice and discovery, the parties entered into a settlement agreement in July of 2007, the terms of which are (not surprisingly) confidential.

### **Barclays Bank**

On May 30, 2007, the S.E.C. announced it had filed suit against Barclays Bank and Steven Landzberg and that the defendants had agreed to final judgments against them granting both permanent injunctions and imposing almost \$11 million in compensatory damages and penalties.<sup>11</sup>

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knowledge of insider facts, which would have triggered securities law disclosure requirements.

<sup>7</sup> SSB interpreted liability under the classical theory as a breach of a fiduciary relationship, and liability under the misappropriation theory as a breach of a duty of confidentiality in a self-serving manner.

<sup>8</sup> SSB argued that because a corporation generally does not owe fiduciary duties to its creditors (their relationship is simply contractual in nature), SSB could not have owed duties to a thrice-removed buyer of debt securities.

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<sup>9</sup> Interestingly, at a later hearing on summary judgment (following years of motion practice), the court suggested to counsel for SSB that a jury could interpret the existence of the big boy letter as an admission that SSB had a relationship of trust with World Access.

<sup>10</sup> R<sup>2</sup> further argued that the existence of the big boy letter was a material fact that needed to be disclosed.

<sup>11</sup> S.E.C. Lit. Rel. 20132, *S.E.C. v. Barclays Bank PLC and Steven J. Landzberg*, 07-CV-04427 (S.D.N.Y.), *Barclays Bank Pay*

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From July 2000 through June 2006, Landzberg was the head proprietary trader for Barclays' U.S. Distressed Debt Desk. He was responsible for supervising Barclays' analysts and other staff who worked on the Desk. As alleged in the complaint, in 2002 and 2003, the defendants joined at least six bankruptcy creditors committees, three of which were official unsecured creditors committees, and the other three were ad hoc committees. In five cases, defendants signed confidentiality agreements (and in one case endorsed committee by-laws providing for confidentiality) through which they received material, non-public information.

In particular, it was alleged that, over a period of 18 months, the defendants purchased and sold millions of dollars of securities while aware of material, non-public information received through the six committees – all in breach of fiduciary and similar duties of trust or confidence. Moreover, it was alleged that the defendants failed to disclose their illicit trading activities to the sources of the information (the creditors committees and issuers), the U.S. Trustee, the federal bankruptcy courts, or trading counterparties. The S.E.C. also alleged that Barclays and Landzberg *misappropriated* material non-public information obtained by virtue of their positions on the committees. In connection with the three official unsecured creditors committees, Barclays and Landzberg owed fiduciary duties to all of the bondholders. The Commission was unimpressed with Barclays' use of big boy letters to advise its bond trading counterparties that it may have possessed material, non-public information, since in no instance did it disclose the information it had received (which, of course, it could not do without violating the confidentiality agreements).

According to the S.E.C., Landzberg was behind this activity and Barclays failed, through its senior management and Compliance Department, to adequately supervise his course of conduct. In particular, the complaint suggests that Barclays had internal safeguard procedures in place but ignored them when it came to Landzberg's trades.

These allegations led Barclays to agree to pay approximately \$11 million in disgorgement, penalties, and interest, while Landzberg consented to an order to pay a \$750,000 penalty and agreed to an injunction precluding him from ever participating on a creditors committee in the future.

## TRADING AND MEMBERSHIP ON OFFICIAL COMMITTEES IN BANKRUPTCY

Section 1103(c) of the Bankruptcy Code sets forth the role to be played by members of official creditors committees in Chapter 11 cases. That role includes:

- (1) consult[ing] with the trustee or debtor in possession concerning the administration of the case;
- (2) investigat[ing] the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
- (3) participat[ing] in the formulation of a plan, advis[ing] those represented by such committee of such committee's determinations as to any plan formulated, and collect[ing] and filing with the court acceptances or rejections of a plan;
- (4) request[ing] the appointment of a trustee or examiner under section 1104 of this title; and
- (5) perform[ing] such other services as are in the interest of those represented.

Of necessity, performing the roles of a committee member will require access to confidential information, and accordingly an inability to trade based upon the receipt of such information.

### ***The Federated Safe Harbor***

In 1991, confronted with its inability to sit on the official creditors committee of Federated Department Stores while simultaneously trading in Federated's securities, Fidelity Research & Management Company ("Fidelity") requested an order from the bankruptcy court allowing it to sit on the committee and trade if it agreed to maintain certain internal safeguards intended to prevent the misuse of confidential information.

The judge granted this request, allowing Fidelity to sit on the committee and trade, provided it maintained adequate safeguards.<sup>12</sup> These safeguards included: (1) requiring that all personnel with access to non-public information in the bankruptcy proceeding ("committee personnel") execute a letter acknowledging that they may receive non-public information and that they are aware of the ethical wall procedures in effect; (2) agreeing that committee personnel not share non-public

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*\$10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information, May 30, 2007.*

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<sup>12</sup> *In re Federated Department Stores, Inc.*, 1991 WL 79143 (Bankr. S.D. Ohio 1991).

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committee information with any other Fidelity employees; (3) maintaining all files containing non-public information generated from committee activities in cabinets inaccessible to other employees; (4) excluding committee personnel from receiving information regarding current securities trades in advance of such trades, except that committee personnel may receive ownership reports on the securities represented by the committee no more frequently than monthly; and (5) requiring compliance department personnel to confirm that trades are made in compliance with these procedures, and keep and maintain records of their review.<sup>13</sup>

The court reserved jurisdiction to determine the sanction to be imposed upon Fidelity if it was found to violate these procedures.

This precedent (known as a “Federated Order”) has served as a model for the circumstances under which committee members will be allowed to trade debtor securities. While useful for large operations, this safe harbor is generally not useful to smaller traders.

#### ***S.E.C. v. Sherman N. Baker***

On October 27, 1993, the S.E.C. announced that it had reached a settlement with Sherman N. Baker, the chairman of the board of J. Baker, Inc. Baker was charged with selling his company's common stock while in possession of material, negative, non-public information indirectly received about his company while sitting on the Ames Department Stores Chapter 11 Creditors Committee.<sup>14</sup>

This information was important to holders of J. Baker stock since it had shoe concessions at Ames Department Stores. The S.E.C. alleged that Baker sold over 200,000 shares of J. Baker stock after he learned, as a member of the committee, that Ames was shutting down 60-75 stores (ultimately 164 stores) where J. Baker had shoe concessions. The S.E.C. conceded that Baker had planned to sell this stock for at least six months before he learned of the closings, but charged that his

acquisition of this confidential information made his sales violative of the antifraud provisions. In particular, “Sherman Baker proceeded with his planned stock sale, despite the fiduciary duties he owed to J. Baker, Inc. and its shareholders, and to the Ames creditors' committee and the creditors of Ames not to use such information for his personal benefit.”

Baker agreed to an injunction, disgorgement and interest for violation of insider trading laws.

#### ***Van D. Greenfield and Blue River Capital LLC***

On November 7, 2005, the S.E.C. issued an order commencing and setting a case against Van D. Greenfield and Blue River Capital LLC.<sup>15</sup> Greenfield was Blue River's principal, manager and compliance officer and had discretion over Blue River's investments. John Edwin Reybold was Blue River's principal securities trader. The Commission alleged that Blue River received material, non-public information while Greenfield served as Blue River's representative on official bankruptcy committees in the Chapter 11 cases of Globalstar, L.P., Adelphia Communications Corporation (as co-chair of the equity holders' committee), WorldCom, Inc. (as co-chair of the unsecured creditors' committee), and on an informal bondholders' committee in Globalstar.

Soon after their appointments, the official committees in the WorldCom and Adelphia bankruptcy cases sought and obtained Federated Orders. Blue River never filed the affidavit required by the orders and, indeed, Adelphia's motion stated specifically that Blue River was not seeking to trade any Adelphia securities at that time. Additionally, Blue River did not have any written procedures to prevent the misuse of non-public information obtained by Greenfield.

While Blue River's supervisory and compliance procedures manual required that Greenfield, as manager, implement measures to prevent the dissemination of material, non-public information in his possession and, if necessary, restrict persons associated with Blue River from trading in the securities of issuers for which he possessed such information, Blue River did not have any written guidelines or procedures in place to prevent the misuse of such information by Reybold or Blue River and it did not restrict Blue River's trading in Globalstar, Adelphia or WorldCom securities. No person at Blue River monitored for compliance purposes any aspect of

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<sup>13</sup> Cf. Section 15(f) of the Exchange Act, which provides that “every registered broker or dealer shall establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, non-public information by such broker or dealer or any person associated with such broker or dealer.”

<sup>14</sup> *S.E.C. v. Sherman N. Baker*, S.E.C. Lit. Rel. No. 13850, 1993 WL 441385 (October 27, 1993).

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<sup>15</sup> Order Pursuant to Sections 15(B) and 21c of the Securities Exchange Act of 1934 in the Matter of *Van D. Greenfield and Blue River Capital LLC*. Rel. No. 52744; Rel. No. 34-52744, 86 S.E.C. Docket 1623, 2005 WL 2978438.

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Blue River's trading in those securities or reviewed Reybold's trade tickets for such transactions. Reybold continued to trade actively in Globalstar, Adelphia, and WorldCom securities in Blue River's proprietary accounts while Greenfield, who was Blue River's compliance officer and principal owner, served on the committees.

The only measures Blue River took occurred when Greenfield became Blue River's representative on the committees. Those measures were: (1) Greenfield told Reybold to take over the trading in the securities of those issuers; (2) Greenfield told the Blue River staff that he would have no role in trading decisions while he was serving on the committees; and (3) in the case of WorldCom only, Greenfield also circulated a one-page memorandum to his staff advising them that he would not be involved in trading decisions and that due to the small size of the firm there should be no discussion or mention of WorldCom in the office. Nevertheless, Greenfield also requested that his staff inform him of all public information they became aware of regarding Globalstar, Adelphia, and WorldCom.

Blue River was located in the same building as Greenfield's residence, a townhouse in New York City. Greenfield maintained a small office adjacent to Blue River's trading room. Communication between Greenfield and Blue River's traders was generally informal, and face-to-face or by telephone. Greenfield frequently walked through the trading room and asked Reybold or other employees for the current market quotes for Adelphia and WorldCom securities. Greenfield and Reybold together met personally with a securities analyst who covered Globalstar securities and talked to the analyst about his evaluation of Globalstar's technology. Greenfield also received daily Blue River profit and loss reports prepared by Reybold that reflected Blue River's trading activity in Globalstar, Adelphia, and WorldCom securities.

These actions, when taken together, in the S.E.C.'s view, represented violations of numerous securities laws, including those prohibiting the trading of securities based upon material, non-public information.<sup>16</sup>

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<sup>16</sup> To make matters worse, Blue River also lied about the size of its position in WorldCom debt in order to persuade the Office of the U.S. Trustee to appoint it to the WorldCom creditors committee. In reality, Blue River owned only \$6 million in face value of WorldCom unsecured 7.5% notes due 2011 and \$500,000 in face amount of WorldCom 6.25% Notes due 2003. However, Blue River advised the U.S. Trustee that it owned \$400 million of WorldCom debt without disclosing that simultaneously with the purchase of its \$400 million position in Adelphia's debt it had executed a short sale of \$400 million in

## AD HOC COMMITTEES: DISCLOSING THE MEMBERS' HOLDINGS

Federal Rule of Bankruptcy Procedure 2019(a) requires non-official committees of creditors or equity holders to disclose certain information about their holdings when they appear in court through an attorney, including the following:

In a ... chapter 11 reorganization case, except with respect to a[n] [official] committee ..., every entity or committee representing more than one creditor or equity security holder ..., shall file a verified statement setting forth ... the amounts of claims or interests owned by the entity, [or] the members of the committee ..., the times when acquired, the amounts paid therefor, and any sales or other disposition thereof....

Recent decisions from the Bankruptcy Courts for the Southern District of New York and the Southern District of Texas highlight differences in textual interpretation of this rule and, more importantly, differing views as to what exactly it means for an ad hoc group to disclose the nature and amount of its claim or interest, the time when such claim or interest was acquired, and the amount paid therefor.

### **Northwest Airlines**

In *In re Northwest Airlines Corp.*,<sup>17</sup> the United States Bankruptcy Court for the Southern District of New York, per Judge Gropper, strictly construed the text of Bankruptcy Rule 2019 to hold that members of an ad hoc group of equity security holders (who were also holders of general unsecured claims) of debtor Northwest Airlines were required to disclose when the individual members acquired each of their own claims and interests and the consideration paid therefor.

The controversy in the *Northwest* Chapter 11 bankruptcy case began when a certain ad hoc group of

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face value of the same notes. The stated \$400 million unsecured claim put Blue River among the top 20 unsecured creditors of WorldCom as disclosed in WorldCom's schedule of the 50 largest unsecured claims against it that was filed on the Petition Date. The actual \$6.5 million face value claim was much smaller than the smallest unsecured claim listed by WorldCom in the schedule of the 50 largest unsecured claims against it, which exceeded \$100 million.

<sup>17</sup> 363 B.R. 701 (Bankr. S.D.N.Y. 2007) ("Northwest I"); 363 B.R. 704 (Bankr. S.D.N.Y. 2007) ("Northwest II").

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equity security holders filed a motion to compel the Office of the United States Trustee to appoint an official committee of equity security holders, arguing that holders of equity interest were in the money and the shareholder interest could not be adequately represented without an official committee to voice their interests. Naturally, the debtor and official committee of unsecured creditors, as well as the U.S. Trustee, objected by responding that the ad hoc group had overvalued the debtor's equity interest, that the creditors' committee could adequately represent equity interests, and that the appointment of the committee would cause undue delay and attendant expense, among other things. In connection with their motion, the ad hoc committee sought discovery on various issues; however, the Bankruptcy Court subsequently stayed all discovery pending the filing of the debtor's disclosure statement. Thereafter, according to the debtor, the ad hoc committee sought additional discovery from the debtors and various third parties of information that would not otherwise be found in the disclosure statement.

Counsel for the ad hoc committee had filed a 2019 statement, as supplemented, simply identifying the members of the ad hoc committee and the number of common stock shares and the value of the claims that the group held in the aggregate.<sup>18</sup> The debtors argued that the text of Rule 2019 explicitly requires that any "committee" (which, in the debtors' view, the ad hoc group held itself out to be) comply with its disclosure requirements and that the ad hoc committee could not continue to fail to do so while, at the same time, seeking recognition and discovery by holding itself out as an important and necessary constituent group. The debtors argued that each individual committee member should be required to state the amount and nature of its holdings and the dates that it acquired its claims and interests and, importantly, the amounts paid therefor.<sup>19</sup>

In response, the ad hoc committee argued that the explicit language of the rule did not require counsel to an ad hoc committee to identify the amount paid by the members for their interest or claims, or when these were acquired. Since counsel for the ad hoc committee was the only relevant "entity" for purposes of Rule 2019, and did not hold any claims against, or interests in, the debtor, there was nothing further to disclose.<sup>20</sup>

The Bankruptcy Court, however, held that the plain terms of the rule required the disclosure of each

individual shareholder's acquisition information and holdings, and that counsel's position circumvented the purpose and intent of the rule. Moreover, since the committee had held itself out to be an important constituent group that sought to avail itself of various discovery procedures, the Bankruptcy Court reasoned that it should not be exempt from disclosing information that the rule otherwise requires.<sup>21</sup> In particular, the court noted that committees historically were required to make rigorous disclosures.<sup>22</sup>

Thereafter, the ad hoc committee moved to file the supplemental information under seal pursuant to section 107 of the Bankruptcy Code.<sup>23</sup> The Bankruptcy Court rejected this argument, pointing out that the legislative history of Rule 2019 indicated that public dissemination of the individual member's information was favored, especially since the ad hoc group sought credibility as a public constituency.<sup>24</sup> The court was also unmoved by subsequent arguments that the dissemination of such information would cause irreparable harm to committee members, reasoning that potential loss in negotiating leverage through disclosure did not amount to irreparable harm to their rights, especially when considering the countervailing interests of the debtors and the public in disclosure.

### **Scotia Development**

In *In re Scotia Development LLC*,<sup>25</sup> however, the United States Bankruptcy Court for the Southern District of Texas held that an ad hoc group of certain noteholders was not required to make individualized disclosures

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<sup>21</sup> *Id.* at 703-04. In other pleadings, certain members of the ad hoc committee argued that their group was not a "committee" for purposes of Rule 2019, since it was not an estate fiduciary, but rather simply a "consortium"; but this apparently did not persuade the Bankruptcy Court.

<sup>22</sup> This included relying on a certain 1937 S.E.C. report that later served as a foundation for Rule 10-211 of Chapter X of the Bankruptcy Act, itself a precursor to current Bankruptcy Rule 2019. *Id.*

<sup>23</sup> *Northwest II*, 363 B.R. at 705.

<sup>24</sup> *See id.* at 707-08. The court further reasoned that "[b]y acting as a group, the members of th[e] shareholders' Committee subordinated to the requirements of Rule 2019 their interest in keeping private the prices at which they individually purchased or sold the Debtors' securities. This is not unfair because their negotiating decisions as a Committee should be based on the interest of the entire shareholders' group, not their individual financial advantage." *Id.* at 708.

<sup>25</sup> Bankr. Case No. 07-20027 (RSS) (Bankr. S.D. Tex. 20007).

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<sup>18</sup> *Northwest I*, 363 B.R. at 702.

<sup>19</sup> *Id.*

<sup>20</sup> *See Northwest I*, 363 B.R. at 702-03.

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under Rule 2019, because they were not members of an official committee.

In *Scotia*, a certain ad hoc group of senior secured noteholders had engaged in an aggressive litigation strategy, contesting approximately 20 of the debtors' pleadings within two months of the petition date. In addition, this group, through its counsel, filed a Rule 2019 statement simply identifying the group's membership and the fact that the members held, in the aggregate, approximately 90% of the principal amount of the debtor's senior secured notes.

In response, and specifically taking a cue from the developments in the *Northwest* case, the debtors filed a motion to compel the ad hoc group to disclose the individual holdings of each member, as well as the time of acquisition and the consideration given therefor.

The group objected to the debtor's motion, making a number of statutory and constitutional arguments against disclosure. Its most salient arguments were that it was not a "committee" (as the term is understood under the Code), that legislative history and practice did not support disclosure, and that the *Northwest* decisions were wrongly decided and, in any event, were distinguishable.

In support of its position that it was not a "committee," the group looked to legal and non-legal definitions of that word, and argued that a "committee" was a group that acts in a representative or official capacity. Since the ad hoc group was not appointed, had fluid membership, specifically disclaimed acting in a fiduciary capacity, was comprised of 90-95% of all the noteholders (*i.e.*, the group was not a *representative*, but the noteholders themselves), it was not a committee of the holder, but rather simply a group that shared costs and had a common consensus of views.

Additionally, the ad hoc group sought to show that the basis for the precursor to modern Bankruptcy Rule 2019, a certain S.E.C. report overseen by former Justice Douglas, identified situations that were materially different from those presented in *Scotia*. In particular, the historical rules in favor of disclosure were enacted to address perceived harms caused by equity "protective committees." The S.E.C. report stated that these committees would solicit small investors to deposit their securities with the committee, and the committee would then collusively negotiate with the debtor without any input of the smaller constituents. The ad hoc group suggested that the policy behind these rules did not apply to it, because it was not representing any noteholders in any fiduciary capacity (and the group itself was comprised of substantially all noteholders).

Since virtually all of the holders were part of the group, there was no need to disclose individual holdings.

The group also argued that Judge Gropper's decision in *Northwest* was incorrect. Preliminarily, the group claimed that the decision could be said to stand for the proposition that any collective creditor group that seeks standing and credibility would be a committee for Rule 2019 purposes, and therefore, conversely, a creditor who is not a member of a group does not deserve to be taken seriously. The group also tried to distinguish the facts in *Scotia*, pointing out that the ad hoc group in *Northwest* had previously (and unsuccessfully) tried to have it itself appointed as an official committee and that the group only held about 27% of the relevant securities in question, both of which suggested that it was acting in a representative capacity.

The ad hoc group's objection was also supported by the Securities Industry and Financial Markets Association ("SIFMA") and the Loan Syndications and Trading Association ("LSTA"). These lobbying interests not only echoed some of the group's positions, but (more importantly) also stressed the macro effects of the *Northwest* decision and the *Scotia* debtors' position. Specifically, the associations argued that stringent individual disclosure requirements would discourage group cooperation amongst the creditor body and debtors, thereby threatening the reorganization process in many cases. Moreover, according to the associations, creditors would be disincentivized to enter into the distressed debt marketplace out of fear of forced disclosure and the prospect of increased costs (as they would be less willing or able to share advisors).

After considering both the ad hoc group's and the association's respective objections, the Bankruptcy Court entered an order denying the debtors' motion and found that the group was not a "committee" within the meaning of Bankruptcy Rule 2019. Although the court did not draft an opinion on the matter, it did seem to imply that a committee would exist if an ad hoc group was acting in a fiduciary or representative capacity.

## DISCLOSURE OF INFORMATION PROVIDED TO LENDERS AND COMMITTEES

### *Dura Automotive Systems*

On June 28, 2007, the United States Bankruptcy Court for the District of Delaware, in *In re Dura Automotive Systems, Inc.*,<sup>26</sup> denied a request of the Official Committee of Unsecured Creditors to require

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<sup>26</sup> Case No. 06-11202 (KJC) (Bankr. D. Del. 2006).

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that certain portions of the debtors' business plan be filed publicly.

In early 2007, the debtors had sought court authority to make certain incentive bonus payments to management, which the court had approved in part and denied in part, reasoning that various interested parties would need to review the debtors' business plan and other financial information as evidence in support of the proposed payments (that the court had denied authority to pay). Accordingly, the debtors shared the information with the committee and other parties in interest on a confidential basis, and sought to file the information under seal, pursuant to section 107 of the Bankruptcy Code, as confidential commercial information.<sup>27</sup>

The committee, however, objected, essentially arguing that the debtors' EBITDA projections, which were contained in the business plan, were about to be publicly disclosed in the months following the sealing motion, and more importantly, it suspected that the numbers had been leaked and that some creditors and investors were trading on that information, to the detriment of other creditors who were not in the know.

The debtors subsequently withdrew their motion to file their business plan under seal. As a result, the committee filed a motion seeking to publicly file the business plan (in particular, the EBITDA numbers) themselves. Even though the committee reasoned that it had a statutory duty to disclose under section 1102 of the Bankruptcy Code, the committee needed to request authority from the Bankruptcy Court to publicly file the information, because a previous information-sharing and disclosure order required the committee to seek court relief if it wished to disseminate any information marked by the debtors as confidential. The committee believed that cause existed to disclose the business plan in order to "prevent creditors from potentially being preyed upon by other creditors with more information."

Not surprisingly, the debtors objected to committee's motion, making a number of legal and factual arguments. For example, the debtors argued that the committee's point about improper trading was moot, since the alleged suspicious trading had ended by the time the committee filed its motion, and in any event, it was unclear to what extent information had been leaked and to whom. Full public disclosure of the debtors' numbers could likely harm the debtors' estates without

providing any corresponding benefit to unsecured creditors. Furthermore, the debtors argued that (i) the business plan was defined as "confidential information" under the previous section 1102 order, (ii) the financial projections were subject to protection under section 107, (iii) dissemination could potentially rob the debtors of the good faith safe harbor solicitation provisions in section 1125 of the Code (out of the fear that the business plan could be deemed to be misleading for securities laws purposes, and be outside of the solicitation process), and that (iv) public disclosure of the numbers could possibly violate securities laws (because the draft projections were non-GAAP financial measures, among other things).

At oral argument, the judge indicated that his primary concern was with the administration of the debtor's Chapter 11 estate, rather than leveling the playing field among creditors, especially when there was nothing in the record to indicate that the alleged insider trading would affect the estate. In particular, the judge noted that trading had corrected itself by the time of oral argument, the data sought to be disclosed (the projected EBITDA numbers) were only one piece of information that was meaningless without the context of how those numbers were arrived at, and public trading of a debtor's debt was ancillary to the Chapter 11 process (which meant that the court should interfere with trading only to the extent it could affect the administration of the estate).<sup>28</sup> As such, the judge denied the committee's request.

## CONCLUSION

As the foregoing illustrates, becoming actively involved in a workout or restructuring can both limit the holder's options if it receives confidential information and require it disclose sensitive information to the public if the holder decides to get actively involved as a member of an ad hoc group in a bankruptcy case. Moreover, recent developments in the R<sup>2</sup> litigation and the Barclays consent judgment draw the effectiveness of "big boy" letters into question.

Nonetheless, maximizing the value of their investments may require that holders become involved in the workout and the legal restrictions placed on them can assure that no one obtains an unfair advantage. ■

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<sup>27</sup> Bankruptcy Code § 107(b)(1) provides that "on request of a party in interest . . . the bankruptcy court may protect an entity with respect to a trade secret or confidential research, development, or commercial information."

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<sup>28</sup> Transcript of Hearing at 40-41, in *In re Dura Automotive Sys., Inc.*, Case No. 06-11202 (KJC) (Bankr. D. Del. Jun. 28, 2007).

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