Client Alert.

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Statutory Update: The Long-Awaited Debut of Amended Bankruptcy Rule 2019

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The United States Supreme Court recently approved certain amendments to the Federal Rules of Bankruptcy Procedure,[2] including significant amendments to Rule 2019, which will take effect on December 1, 2011.[3]

What does this legislative development mean for distressed debt investors and debtors? While the primary goal of the Rule 2019 amendment is to provide greater transparency to all parties-in-interest, the amended rule may have unintended effects—it could be used as a weapon by debtors who seek to limit the participation of certain parties in their bankruptcy cases.

WHILE AMENDED RULE 2019 DOES CREATE GREATER DISCLOSURE OBLIGATIONS FOR CERTAIN CREDITOR GROUPS, DEBTORS MUST BE PRUDENT IN HOW THEY UTILIZE THE RULE.

However, this use of Rule 2019 could, in turn, have the unintended effect of dissuading investor groups from actively participating in bankruptcy cases, thereby potentially hindering debtors' reorganization options. Therefore, while amended Rule 2019 does create greater disclosure obligations for certain creditor groups, debtors must be prudent in how they utilize the rule.

HISTORICAL BACKGROUND

The debut of amended Rule 2019 comes amid a four-year debate over the nature of the disclosures to be made by distressed debt investors, hedge funds, and equity owners regarding their holdings when working to advance their common interests.[4] Such parties can play a significant role in bankruptcy proceedings through acquisitions of the debtor's senior debt, with the ultimate objective of achieving a profit on those purchases (commonly referred to as "loan-to-own" strategy). Purchasers are then able to act in concert within the bankruptcy proceeding as members of unofficial or "ad hoc" committees in order to achieve their common objectives.

A recent series of *DBSD* decisions,[5] however, has given the strategic investor community pause. Courts have noted the limits of "overly-aggressive" and "egregious" creditor conduct, in one case going so far as to encourage Congress "to modify the Code to authorize bankruptcy judges to designate creditor votes for overly-aggressive and other egregious conduct even when the creditors are trying to increase returns on long positions."[6]

Debtors and other parties-in-interest have often sought to neuter the aggressive posture taken by such ad hoc committees by requiring that committee members make certain disclosures pursuant to Rule 2019, including, among other things, the dates that members acquired their interests and the price paid for such interests.[7]

CASE STUDY: LEHMAN BROTHERS

Lehman Bros. provides a recent example of how debtors are trying to use Rule 2019 to their advantage.

On March 30, 2011, the debtors in the *Lehman* cases filed a motion to compel an ad hoc group of creditors to comply with Rule 2019, notwithstanding that the group had already provided to the debtors, on a confidential basis, much of the information that the debtors requested. This information covered details regarding each member's claims against each Lehman entity, including non-debtor affiliates, whether such claims were acquired prepetition or postpetition, and, to the extent the claim is a guarantee claim, the nature of such claim and the related primary claim.[8] Notably, the debtors only raised the Rule 2019 issue after the ad hoc group submitted a competing plan of reorganization, despite the fact that the ad hoc group was an active participant in the *Lehman* cases for close to two years, having filed numerous pleadings including statements supporting certain of the debtors' requests.[9]

Notwithstanding the ad hoc group's arguments that it was being singled out by the debtors, the bankruptcy court ultimately required the ad hoc group to submit the Rule 2019 disclosures.[10]

AMENDED RULE 2019: THE DETAILS

Given the ongoing debate in a number of bankruptcy courts, it is not surprising that reported cases involving Rule 2019 provide contradictory rulings regarding the rule's requirements and applicability.[11]

Amended Rule 2019 is designed to provide greater clarity regarding which parties are required to disclose their economic interests when "tak[ing] a position before the court or [soliciting] votes regarding the confirmation of a plan on behalf of another."[12] While current Rule 2019 applies to every entity or committee representing more than one creditor or equity security holder, amended Rule 2019 will expand the disclosure requirements to include:

> every group or committee that *consists of or represents, and every entity that represents,* multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one another.[13]

AMENDED RULE 2019 IS DESIGNED TO PROVIDE GREATER CLARITY REGARDING WHICH PARTIES ARE REQUIRED TO DISCLOSE THEIR ECONOMIC INTERESTS WHEN "TAK[ING] A POSITION BEFORE THE COURT OR [SOLICITING] VOTES REGARDING THE CONFIRMATION OF A PLAN ON BEHALF OF ANOTHER."

Amended Rule 2019(c) requires that each verified statement include not only the nature and amount of each "disclosable economic interest"[14] as of the date the entity was employed or the group or committee was formed, but also the date of acquisition by quarter and year of each disclosable economic interest, unless acquired more than one year before the petition was filed. If any previously disclosed fact changes materially, then the entity, group or committee must file a verified supplemental statement when it takes a position before the court or solicits votes on confirmation of a plan.

Amended Rule 2019 also expands the scope of a "disclosable economic interest" to specifically include short positions, swaps, and other derivatives,[15] as well as the extent of such disclosures.

CONCLUSION

Will the additional disclosures required by amended Rule 2019 result in reduced participation in bankruptcy cases from distressed debt investors, hedge funds, and equity committees going forward? Or will these investors instead choose to deal individually with debtors, rather than as a group, thus making the bankruptcy process more inefficient? Can anything short of a repeal of Rule 2019 avoid the potential "weaponization" of the rule by debtors?[16] How will these dynamics ultimately affect the range of exit financing options for debtors in the long run? And will reorganizations become even

more complex to achieve if similarly situated creditors are less willing to act in concert through ad hoc or unofficial groups?

At a minimum, investors will be forced to evaluate carefully, in each instance, the benefits and burdens associated with participating in ad hoc or unofficial groups in a bankruptcy case. Moreover, notwithstanding amended Rule 2019's efforts to foster greater transparency amongst the participants in a bankruptcy proceeding, debtors must carefully consider the ramifications of using this rule as a sword, rather than as a mechanism to ensure that a level playing field is maintained by the parties-in-interest.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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[2] *See, e.g.,* amendments to Rule 1004 (requiring a statement by a Chapter 15 debtor indicating where the debtor has its center of main interests and each country in whichh a foreign proceeding is pending, and permitting parties-in-interest to file a motion to challenge the designation of the debtor's center of main interests) and Rule 6003 (clarifying that the court shall not, within 21 days after the filing of a petition, issue an order granting an application under Rule 2014; a motion to use, sell, lease or otherwise incur an obligation regarding property of the estate; or a motion to assume or assign and executory contract or lease).

[3] For the full text of the Supreme Court order, see http://www.supremecourt.gov/orders/courtorders/frbk11.pdf.

[4] For a complete discussion of this split in judicial authority, see our Bankruptcy + Restructuring Current Developments Newsletter, June/July 2010 at http://www.mofo.com/files/Uploads/Images/100713Bankruptcy.pdf.

[5] *See Dish Network Corp. v. Ad Hoc Comm. of Senior Noteholders* (In re DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011).

[6] *In re DBSD N. Am., Inc.,* 421 B.R. 133, 142 (Bankr. S.D.N.Y. 2009), aff'd sub nom. Sprint Nextel Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), No. 09-CIV-10156, 2010 U.S. Dist. LEXIS 33253 (S.D.N.Y. Mar. 24, 2010).

[7] *See infra* note iii.

[8] *See In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (JMP) (Dkt. Nos. 15461, 15746, 15814). The parties also acknowledged that the ad hoc

group had already filed certain Rule 2019 disclosures, but the debtors asserted that the prior disclosures were inadequate.

[9] *See In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (JMP) (Dkt. No. 15746).

[10] *See In re Lehman Brothers Holdings, Inc*., Case No. 08-13555 (JMP) (Dkt. No. 16107). Recognizing the limitations of the current version of Rule 2019 and to prevent selective enforcement of the rule, the ad hoc group filed a motion on May 23, 2011 requesting that the bankruptcy court implement uniform procedures for purposes of the Lehman case to specify which parties are required to make disclosures and the specific disclosures required. The ad hoc group asserted that several parties had attempted to circumvent the Rule 2019 disclosure requirements by retaining separate counsel but filing joint pleadings, including a joint plan of reorganization. The ad hoc group further noted that, notwithstanding these concerted actions, (i) no other ad hoc committee or other collection of creditors had filed similar Rule 2019 disclosures; and (ii) the Debtors had not sought to require additional disclosures from any other collection of creditors. The motion is currently scheduled to be heard in August 2011.

[11] *See infra* note iv.

[12] *See* Amended Rule 2019(a)(2).

[13] *See* Amended Rule 2019(b)(1)(emphasis added).

[14] *See* Amended Rule 2019(a)(1).

[15] *See* Amended Rule 2019(a)(1).

[16] See http://online.wsj.com/article/SB10001424052748703367004576289412179433004.html ("In a hearing on the matter this month, U.S. Bankruptcy Judge James Peck noted that the disclosure rule had been 'weaponized' as a litigation tactic in certain instances. Still, he ruled the creditors … must reveal trading details given their organized attempt to influence the case.").