Hedge funds: privacy considerations in bankruptcy proceedings

Mar 28 2007 Eric Sleeper

Hedge funds and other investors in the debt and equity securities of troubled companies may want to rethink the wisdom of joining unofficial committees or similar representative entities in bankruptcy cases.

Background

The Bankruptcy Code provides for the formation of one or more official committees of creditors and equity security holders. These committees, which speak for entire constituencies rather than for individual creditors or shareholders, play significant roles in Chapter 11 cases. Recently, hedge funds and other traders of debt and equities of distressed companies have become highly involved in large Chapter 11 cases. Some have purchased control of companies under plans of reorganization, while others have extended first or second lien loans to highly leveraged companies. Additionally, in efforts to exert greater influence, groups of such investors have organized ad hoc or unofficial committees, taking more active and vocal roles in bankruptcies pending throughout the country.

The case

In Northwest Airlines' Chapter 11 proceeding, more than a dozen shareholders, including various hedge funds holding collectively 27 percent of the common stock and over $260m in claims, formed an ad hoc committee. This committee, which sought to be appointed as an official committee (a request it has since withdrawn), had significant disagreements with the debtors regarding valuation issues. The debtors asked the court to require the members of this committee to disclose information about the claims and shares that they owned, including when they acquired them, how much they paid for them and the amounts of claims and shares subsequently sold.

The court held that the committee members (i) must make such disclosure, despite their vociferous contentions that this trading information constitutes trade secret and confidential commercial information, and (ii) could not file the information under the protection of a seal. The court then denied a motion for reconsideration joined by the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association. The court held that "public interest" considerations overrode any confidentiality or investment strategy concerns. In acting as a group, the court determined, the members of the ad hoc committee had subordinated any privacy interests they have in their trading information to the applicable bankruptcy rule.

Old rule, new application

The court's rulings are based on a relatively old and obscure rule of bankruptcy procedure that requires committees (except officially appointed ones) in Chapter 11 cases representing one or more creditors or equity security holders, to make public disclosure of a variety of trading information. The rule requires committee members to disclose (i) names and addresses, (ii) the nature and amount of their claims or equity interests and when they were acquired, unless acquired more than a year before the bankruptcy filing, (iii) the names of those causing the committee to form and (iv) as of the time of the committee's formation, who its members are, when they acquired their claims or equity interests, what they paid for them and any sale or disposition of their claims and interests.

The purpose of the rule is to give the courts greater oversight of unofficial committees or other representative entities. One argument made in favor of such disclosure is that those who are not members of the group should know whether those who serve on an ad hoc committee appearing to be similarly situated to non-members (i) actually own both debt and equity and may therefore have "divided loyalties," or (ii) have sold large positions during the case and thus no longer have the significant interest in the outcome that they once had.

An appeal of the bankruptcy court's ruling has been filed, but at least some members of the ad hoc committee have disclosed their trading information to comply with the court's rulings.

What the decision means

While the bankruptcy court's holding is based on a straightforward reading of the applicable rule, we are not aware of any other Chapter 11 case in which an unofficial committee of debt or equity traders was directed to file publicly such extensive trading information. Notably, a debtor in another case, Pacific Lumber Company, has asked a Texas bankruptcy judge to follow the lead of the Northwest Airlines court and require an ad hoc committee of noteholders,

which includes over two dozen hedge funds, to disclose their pricing information. Purchasers of debt or stock in distressed companies zealously guard, in particular, the secrecy of such information. If the decisions in Northwest Airlines stand, or if other courts adopt the same position, group action by hedge funds and other institutional investors as unofficial committees in Chapter 11 may entail a loss of confidentiality and privacy that may be too high a price to pay for seeking collective influence in bankruptcy cases.

Similarly, debtors and other interested parties may use the court's decisions to exert bargaining leverage against groups of such investors, or to obtain evidence to buttress their argument that trading by hedge funds caused spikes in prices and temporarily distorted debtors' market value. As a result, hedge funds may choose to go it alone, or if their positions are relatively small, curtail their involvement and act only as passive investors.

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