

U.S. SECURITIES AND BANKING NEWS AND ANALYSIS**Hedge funds: further privacy considerations in bankruptcy proceedings**

May 23 2007 Eric Sleeper

Recently, an earlier article published by *Complinet* discussed two recent decisions of the bankruptcy court in the Northwest Airlines Chapter 11 case jarring to the hedge fund and general investment community. Specifically, those cases addressed the scope of public disclosures required by that court of an ad hoc committee of such investors. In the more than half a century that the Bankruptcy Rule (and its predecessor) underlying the Northwest Airlines court had been in existence, there had been no prior published decision ordering a creditor group (especially acting in a non-fiduciary capacity) to disclose publicly significant proprietary and confidential information. An even more recent dispute before a bankruptcy court in Texas and its corresponding decision, however, provides investors with some newfound hope against broad-based disclosures of previous confidential and highly private trading information, and a potential roadmap for the avoidance of such unusual — and possibly damaging — disclosures.

Northwest Airlines revisited

Our March 28 article discussed the Northwest Airlines opinions at length. In short, the bankruptcy court in that case determined that the relatively obscure Bankruptcy rule 2019 required the members of an ad hoc shareholders committee, including several hedge funds, to (i) make fairly extensive disclosures of trading information previously guarded as trade secret and confidential commercial information and (ii) without the protection of a seal.

"Don't mess with Texas"

In January 2007, the particularly combative Chapter 11 case of Scotia Pacific Company (or Scopac) was filed in Texas. Disputes were long-running even before the case began between the debtor-timber company on the one side and investors, environmentalists and government entities on the other. In the midst of this, and before the ink had barely dried on the Northwest Airlines decisions, the debtor in Scopac attempted to use the decisions against a group of its noteholders ("Noteholder Group"), comprised mainly of hedge funds who hold more than 95 percent of the principal amount of the notes at issue ("Notes"). The debtor impugned the funds for exercising what it claimed were overly aggressive tactics, allegedly threatening its prospects for reorganization, while being cloaked in secrecy. Scopac urged the bankruptcy court to apply rule 2019 and the Northwest Airlines precedent to bar the Noteholder Group from further participation in the case until they made extensive disclosures related to their investment. This time, however, the bankruptcy court in Texas refused to cause the funds to disclose anything further.

Northwest Airlines distinguished

Unlike the multipage Northwest Airlines decisions, the Scopac court's determination was short and to the point. In its brief order, the Scopac court ruled that the Noteholder Group (i) was not a committee within the meaning of rule 2019 and (ii) was, therefore, not subject to its disclosure requirements. While the basis for the Scopac decision is not apparent from the face of the court's order, its underlying logic can be gleaned from a review of the Noteholder Group's objections to the debtor's motion.

The Scopac roadmap

The Noteholder Group's objections opened by challenging the separate components of rule 2019. They noted that the Rule required (i) a "committee," (ii) "representing more than one creditor" to make certain disclosures and to provide a copy of (iii) "the instrument" (iv) "whereby the ... committee ... is empowered to act on behalf of creditors." The Noteholder Group's retort was that it (i) was not a "committee," (ii) did not represent "any creditors," (iii) had no "instrument" and (iv) was not "empowered to act" on behalf of any creditor group.

The Scopac court was convinced the Group was not a committee as the rule envisioned. In that regard, the Noteholder Group began by pointing to definitions of a "committee" in both a legal and non-legal context and submitted that it fell well short under either definition. Instead, they argued that, at most, they were a group of individual members who represented and spoke for no one other than themselves. In short, the Group was composed of individual creditors who (i) were free to join in or drop off as they chose, (ii) did not participate in any fiduciary capacity nor sought to speak on behalf of anyone else and (iii) shunned such committee formalities as being bound by a set of by-laws.

While it is impossible from its order to know exactly what factors lead to the Scopac court's decision that the Noteholder Group was not a "committee" for purposes of rule 2019 disclosures, the Group's objections highlight a number of distinctions from the circumstances found in Northwest Airlines that provide something of a roadmap around the harsher result of the earlier New York court's ruling.

First, the Scopac Noteholder Group pointed to several public filings and statements made earlier by the debtor that suggested it understood (and had complained) it could not negotiate with the Group because it did not represent the noteholders as a whole. Second, the Group never had or operated pursuant to any by-laws, procedural rules, agreements or any other "instruments." Third, it was understood that any "consensus decision" of the Group members was not binding on any individual member and members were free to drop out of or rejoin the Group at any time. Fourth, the ad hoc committee in Northwest Airlines, unlike the Group in Scopac, was comprised of shareholder members holding only 27 percent of the airline's stock but sought nonetheless to act and negotiate for the airline's shareholders as a whole, in a representative or fiduciary capacity. The Northwest Airlines ad hoc committee actively sought to be an official committee.

Moreover, the Northwest case involved a more complex capital structure, where members of the ad hoc committee held a "significant amount of debt" in addition to their stock interests that the court there found might "raise questions of divided loyalties." Finally, while the Northwest court believed disclosure would serve an important public purpose of providing information to the substantial majority of shareholders who were not actually members of the ad hoc committee that sought to speak on their behalf, the Scopac Noteholder Group members were already a substantial majority of the noteholders, and they indicated they did not want to know the details of the individual members holdings.

The Scopac decision significance

The Scopac decision has, at the very least, provided hedge funds (an ever-more prevalent player in Chapter 11 cases), and the investment community in general, a counter position to the broad based ruling of Northwest Airlines. This does not mean the issue of disclosure is resolved. The debate is clearly very much alive and courts are free to adopt either the Northwest or Scopac case decision in other cases, if they so chose. The distinctions highlighted by the Scopac Noteholder Group objections from the Northwest Airlines ad hoc committee, however, provide something of a roadmap for other distressed investors to think carefully about when contemplating organizing as a group or more formal ad hoc or official committee, especially if concerned about the risk of compelled public disclosures of previously private trading information.

On another front

What about those funds and investors that choose to go so far as to become a member of an officially appointed Chapter 11 case creditors committee? Circumstances surrounding recent allegations about a unit of Britain's Barclays PLC provide a note of caution about committee participation and corresponding fiduciary responsibility. A lawsuit filed in New York in late March by a former investment analyst for Barclays' US distressed-debt trading desk highlighted allegations that have been the subject of a three-year investigation by the Securities and Exchange Commission. The allegations suggest Barclays gained and used non-public information by actively joining Chapter 11 creditor committees that were a source of information with the potential to be used for debt trading, thereby breaking insider-trading rules.

The lawsuit allegations suggest purposeful committee participation resulting in insider-trading potentials contrary to, among other things, fiduciary obligations. It also discloses the practice, even in the bankruptcy arena, of utilizing "Big Boy" letters (with financially sophisticated buyers of distressed debt or equity therein acknowledging that the insider seller they are buying from may have access to material non-public information but they are waiving any claims against the insider arising out of the sale). In this instance, however, it is alleged that the claimed use of such letters to insulate the Barclays trade simply never occurred.

Most recently, Barclays moved to dismiss the former analyst's lawsuit challenging various of his allegations and his own role at Barclays. However, it has brought to light some of the potential perils for investors who on the one hand have loaned money to distressed companies while also trading their debt or equity — these days a much more common practice than in the past.