

**OUTLINE OF TOPICS/ISSUES TO BE ADDRESSED AT
9TH ANNUAL NYC BANKRUPTCY CONFERENCE BY PANELISTS ON:
BANKRUPTCY/SECURITIES LAW INTERSECTION¹**

I. Disclosure Issues

A. Pre-Bankruptcy

1. Rights and Obligations of Creditor Equity “Groups”

(a) Can beneficial owners² of convertible (into common stock, registered or to be registered) debt (or members of a bank group that holds options/warrants to purchase such stock) of a public company take “group” action without complying with Regulation/Schedules 13D, 13G and Section 16 of the Securities Exchange Act of 1934?

The answer depends on the type of security owned and the type of action to be taken. The disclosure requirements of Regulation 13D-G apply only when a person or group acquires more than 5% of a class of equity securities that are registered pursuant to Section 12 of the Exchange Act and that have voting rights. (17 C.F.R. § 240.13d-1(a) & (i); Release No. 34-39538, n.43, 63 FR 2854 (January 1998)). The definition of “equity security” also includes a security convertible into an equity security, but only if the conversion right will occur within 60 days of acquisition of the underlying security. (17 C.F.R. § 240.13d-3(d)(1)(i); Release No. 34-39538, n.3(a), 63 FR 2854 (January 1998)). The definition would not cover a debt security that might be exchanged for an equity security pursuant to a confirmed reorganization plan. The same Regulation 13D analysis applies when considering the disclosure requirements in Section 16, except that the trigger for disclosure is ownership of more than 10% of the class of securities at issue rather than 5%. (17 C.F.R. § 240.16(a) - 1(a)(i); Release No. 34-28869, n.34, 56 FR 7242 (February 1991)).

Also, not every group will be considered a group for purposes of the Regulation 13D-G. A group for purposes of the Regulation consists of two or more persons “who agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities.” [Exch. Act Rule

¹ The panel consists of the following: Marc Abrams, Esq., a partner in the Business Reorganization & Restructuring Group at Willkie Farr & Gallagher LLP (moderator); Alistaire Bambach, Esq., Chief Bankruptcy Counsel and Assistant Regional Director in the Division of Enforcement at the Securities and Exchange Commission (panelist); Hon. Stuart M. Bernstein of the U.S. Bankruptcy Court for the Southern District of New York (panelist); Jeffrey S. Sabin, Esq., a partner in the Business Reorganization Group at Schulte Roth & Zabel LLP (panelist); and Daniel J. Kramer, Esq., a partner in the Litigation Department at Paul, Weiss, Rifkind, Wharton & Garrison LLP (panelist).

The following individuals participated in the preparation of this summary: (a) Sections I.B.3., I.B.4., and II.A.: Marc Abrams, Esq., a partner in the Business Reorganization & Restructuring Group at Willkie Farr & Gallagher LLP; Jodi B. Leibowitz, Esq., an associate in the Litigation Group at Willkie Farr & Gallagher LLP; Seth J. Kleinman, an associate (admission pending) in the Business Reorganization & Restructuring Group at Willkie Farr & Gallagher LLP; (b) Sections I.B.1., I.B.2., I.B.5., II.B.1., II.B.2., II.C.1., and II.C.2.: Jeffrey S. Sabin, Esq., a partner in the Business Reorganization Group at Schulte Roth & Zabel LLP; Meghan Breen, Esq., an associate in the Business Reorganization Group at Schulte Roth & Zabel LLP; and (c) Sections I.A.1., II.D.1., II.E.1., and II.E.2.: Alistaire Bambach, Esq., Chief Bankruptcy Counsel and Assistant Regional Director in the Division of Enforcement at the Securities and Exchange Commission.

² It is assumed that individual holders hold less than 5% or 10% under the applicable SEC Rules.

13d-5(b)(1)]. These terms are not well-defined. They are not intended to trap the ordinary equity security holder who is merely seeking to obtain a recovery in the case. However, it may be that any concerted group action taken to influence the case might fall within the Regulation (e.g., if the group gains more clout or leverage in the case by virtue of the collective holdings the members may be deemed to have agreed to act together for one of the enumerated purposes). In addition, there is no carve-out from the disclosure rules for official bankruptcy committees.

(i) Does the type of action make a difference on applicability of the compliance/disclosure obligation (i.e., suing for breach of the promissory notes vs. foreclosing on collateral, if any, vs. actions/claims against the directors and officers vs. seeking to enjoin a proposed corporate transaction (asset sale, merger) vs. filing an involuntary petition (with or without a motion to appoint an interim trustee) vs. hiring common advisors to assist in negotiating the restructuring of the debt)?

Yes. The action that triggers the compliance/disclosure obligations under Regulation 13D-G is that the group agrees to act together for the purpose of acquiring, holding, voting or disposing of equity securities. If the type of action would fit into one of these categories, then the filing requirement would kick in.

(ii) If a group is formed, is it possible to avoid applicability of Section 16? How? When?

Yes, if the group is the beneficial holder of 10% or less. Also an institution listed in Rule 16a-1(a)(1), which holds the securities for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business, without the purpose or effect of changing or influencing control, would be excluded from the 10% calculation.

(iii) Is it possible for only counsel and some members to receive confidential information? If not, why not?

To be discussed at conference.

(b) Can holders of any equity securities (common or preferred stock) of a public company take “group” action without complying with Regulation 13D-G or Section 16?

Yes, as discussed above, pursuant to Regulation 13D-G, if the group owns 5% or less of equity securities and/or the action is not for the purpose of acquiring, holding, voting or disposing of equity securities. Similarly, the answer is yes under Section 16 if the group owns 10% or less of the equity securities and/or the members are specified institutions holding the securities for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business, without the purpose or effect of changing or influencing control. Also, the filing requirements are only triggered with respect to equity securities that are both registered under Section 12 of the Exchange Act and are voting securities, so that the disclosure requirements would not typically apply to preferred stock.

(i) Does the type of action make a difference on applicability of the compliance/disclosure obligation (i.e., class action for damages from misrepresentation or omissions vs. a letter to the Board demanding action vs. hiring common advisors to assist in negotiating a pre-pak or other restructuring)?

Yes, see answer to Question 1(a)(i) above.

2. Company Compliance Issues

(a) Disclosure of material defaults and other material events – when, how and to whom?

- (i) Reg. FD**
- (ii) Section 10A of the ‘34 Act**
- (iii) 8-K Reports and/or Press Releases**
- (iv) Rule 10b-5**
- (v) SOX Certification under Rule 13(a)-14**

To be discussed at conference.

(b) Do the Company auditors/advisors have disclosure obligations? To whom, of what and when?

- (i) Section 10A of the ‘34 Act**
- (ii) General Counsel Obligations**

To be discussed at conference.

B. Post-Bankruptcy

1. Bankruptcy Rule 2019 Group Disclosure Requirements/Issues

(a) Entities representing groups (other than official committees) of creditors or stockholders must file a verified statement (when? is there an obligation to update regarding new group members or the trading positions of members?) identifying:

(i) Names/addresses of holder (who is deemed the holder: the money manager, the fund in whose name the note or stock is held or the investors? do the fund formation documents matter?);

(ii) Nature and amount of claim stock and when it was acquired and the price paid to acquire or receive if sold;

(iii) Facts regarding governance terms of the group (must the bylaws be described or filed?).

(b) When can a court modify or eliminate any of the above requirements? What is the standard? Who has the burden of proof?

(c) Failure to comply with BR 2019 could permit a court to deny party-in-interest status and/or to disqualify votes on a plan.

(d) Does compliance with BR 2019 eliminate/satisfy obligations under Rules 13d, 13g and 16 or is it additive?

(a) *Applicability:* Rule 2019 applies in chapter 9 and 11 cases to entities acting in a fiduciary capacity, including attorneys and/or a committee representing groups of creditors or stockholders. The rule does not apply to any official committees approved by the court under Sections 1102 or 1114 of the Bankruptcy Code (the “Code”). Attorneys representing one or more creditor or equity interest holder, any unofficial committee, and

any indenture trustee must comply with the requirements of Rule 2019. On the other hand, a certified class is a single claimant with potentially thousands of class members making fulfilling the requirements very difficult; therefore, neither the class nor the attorneys representing the class are required to file a Rule 2019 statement.³

- (i) *Requirements:* Rule 2019 mandates the filing of a verified statement with the information discussed below. The rule provides no deadline for filing such statement but it should be filed before a proof of claim is filed. An entity that does not comply with the rule may be brought before the court on a motion of a party in interest or by motion of the court. Rule 2019(a) does require a supplemental statement to be filed “promptly” setting forth any material changes in the facts contained in the statement filed. In addition to attaching a copy of the instrument, if any, that gives the entity, committee, or indenture trustee the power to act, the Rule 2019 verified statement must identify each of the following:
1. The names and addresses of each creditor or equity security holder, such as investors, being represented by the filing entity.
 2. The nature and amount of claim or interest held by each creditor or equity holder, as well as the time at which the holder acquired the claim or interest if it was within a year of the debtor’s filing of the petition.
 3. A recital of the relevant facts and circumstances in connection with the employment of the representative filing the Rule 2019 statement. For a committee, the statement must disclose the name or names of the entity or entities at whose request or direction the employment was arranged or the committee was organized or agreed to act.
 4. Finally, the party filing the Rule 2019 statement (*e.g.*, the law firm or the committee itself) must make a declaration regarding the claims or equity interests it owns, the times when acquired, the amounts paid therefor, and any sales or other distributions thereof. The language of this provision as written⁴ has caused confusion as to what entity was required to disclose this information.
- (A) The movant in one case believed the Section was requiring the law firm to disclose information on the amount of claims or interests the law firm’s clients owned, the times the interests were acquired, the amounts paid therefor, and any sales or disposition thereof.⁵ The court clarified that

³ See, *e.g.*, Trebol Motors Distrib. Corp. v. Bonilla (In re Trebol Motors Distrib. Corp.), 220 B.R. 500, 503 (B.A.P. 1st Cir. 1998) (certified class is single claimant and compliance with Rule 2019 is unnecessary); Wilson v. Valley Elec. Membership Corp., 141 B.R. 309, 314 (E.D. La. 1992) (imposing requirements of Rule 2019 in class context is “impractical, if not impossible”); In re Spring Ford Indus., Inc., 2004 WL 231010, at **2-4 (Bankr. E.D. Pa. 2004).

⁴ “[V]erified statement setting forth... (4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of an indenture trustee, the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.” Fed. R. Bankr. P. 2019(a)(4).

⁵ In re CF Holding Corp., 145 B.R. 124, 126-27 (Bankr. D. Conn. 1992).

where a law firm represents several individual clients and is the only entity required to file a Rule 2019 statement, it only needs to make these disclosures on its own behalf, not for the creditors or equity holders it represents.⁶

- (B) However, where an unofficial committee is formed, which is also represented by a law firm, the Southern District of New York recently held that both the committee and the firm must disclose the amounts of claims or interests owned, the times when acquired, the amounts paid thereunder and any sales or other disposition thereof.⁷ Following this decision, the *ad hoc* committee moved to file its disclosures under seal, arguing that the trading information the court determined should be disclosed “constitutes trade secrets, and is sensitive and confidential information, the disclosure of which is highly prejudicial to the shareholders.”⁸ The court denied the motion of the unofficial shareholder committee to file its Rule 2019 statement under seal, holding that “any interest that individual Committee members may have in keeping this information confidential is overridden by the interests that Rule 2019 seeks to protect.”⁹ According to the court, Rule 2019 gives shareholders a right to the committee members’ trading information, enabling the shareholders to make an informed decision whether the committee will represent their interests.¹⁰ It further allows parties to gauge “the credibility of an important group that has chosen to appear in the bankruptcy case and play a major role.”¹¹ If this decision stands, acting as a group will deny investors assurance that their trading facts will remain confidential in a reorganization case.

- (b) A bankruptcy court has the authority under Section 105 of the Code to modify the requirements of bankruptcy rules, including Rule 2019. One court, however, declined to alter the express terms of Rule 2019, which limits the rule’s application to chapter 9 and 11 cases, in order to apply the requirements of the rule to a chapter 7 case.¹² Another court recognized that it had authority to modify the Rule 2019 requirement of listing the names of the investors if listing the names of the investors could lead to a threat of

⁶ Id. at 127.

⁷ See In re Northwest Airlines Corp., No. 05-17930, 2007 WL 609214, at **2, 4 (Bankr. S.D.N.Y. Feb. 26, 2007) (holding that both law firm and committee must file a Rule 2019 statement where the committee speaks for the group).

⁸ In re Northwest Airlines Corp., *Motion of the Ad Hoc Committee for an Order (A) Pursuant to Sections 105(a) and 107(b) of the Bankruptcy Code and Rule 9018 of the Federal Rules of Bankruptcy Procedure Granting Leave to File its Bankruptcy Rule 2019(a) Statement Under Seal, and (B) Granting a Temporary Stay Pending Determination of this Motion*, No. 05-17930 (Bankr. S.D.N.Y. Feb. 23, 2007) (Gropper, J.) (No. 5092).

⁹ In re Northwest Airlines Corp., *Memorandum of Opinion and Order* at p. 7, No. 05-17930 (Bankr. S.D.N.Y. Mar. 9, 2007) (No. 5220).

¹⁰ Id.

¹¹ Id. at 7-8.

¹² In re Great W. Cities, Inc. of N.M., 107 B.R. 117, 119 (N.D. Tex. 1989).

danger, death or kidnapping.¹³ However, the court declined to allow anonymity because the evidence of the threat was inadequate to overcome the presumption in favor of disclosure of creditors' names.¹⁴ In other cases, privacy of the creditors and equity holders was protected when the court declined to post the Rule 2019 statement on the electronic docket and instead made the information available upon motion.¹⁵

- (c) Rule 2019(b) vests with the bankruptcy court the discretion to determine whether there was a failure to comply with the requirements of Rule 2019(a) or with any other applicable law regulating the activities and personnel of any entity, committee or indenture trustee. Upon determining there was a failure to comply with the disclosure requirements, the court may sanction a party by refusing to permit the entity acting on behalf of the parties from being heard or intervening in the bankruptcy case or by granting other "appropriate relief." The court also has the discretion to invalidate a vote on a plan if the party did not comply with Rule 2019 or with Section 1125(b) of the Code. Imposition of any sanctions are discretionary and a court may impose no sanctions or any other sanction it deems appropriate, such as monetary sanctions.¹⁶ One court looked to Rule 2019(b) to support its order, as part of a sanction for non-compliance, requiring disclosure of whole documents creating fee sharing or co-counsel relationships.¹⁷

2. B.R. 3001 - Claims Trading Disclosure Requirements

(a) Requires buyers/seller of claims to file evidence of their transactions (other than the purchase/sale of a claim based on a publicly traded note, bond or indenture) including the terms of the sale purchase.

(i) What constitutes publicly traded? Should there be an exemption for publicly traded debt transfers?

(ii) Must the price be disclosed?

(iii) If the transaction is conditional (*i.e.*, right of buyer to "put" claim back to seller or if the transfer is as security), must the terms be disclosed?

(iv) Who has rights to "force" disclosure? Only the buyer/seller or also the debtor and other parties in interest?

(v) What remedies, if any, exist for failure to comply with the rule? Does/should Section 1125(e) be applicable to enforce non-compliance with B.R. 3001? If so, by whom?

(vi) Does/should the rule apply to "short sales"?

¹³ San Antonio Express-News v. Blackwell (In re Blackwell), 263 B.R. 505, 509 (W.D. Tex. 2000).

¹⁴ Id. at 509-10.

¹⁵ Certain Underwriters at Lloyd's v. Future Asbestos Claim Representative (In re Kaiser Aluminum Corp.), 327 B.R. 554, 560 (D. Del. 2005).

¹⁶ In re Century Glove, Inc., 74 B.R. 952 (Bankr. D. Del. 1987) (holding that request that creditor be prohibited from participating in plan, and that its rejection of the plan be held invalid, to be too harsh even though it is permitted under Rule 2019(b)), rev'd in part on other grounds, 81 B.R. 274 (D. Del. 1988).

¹⁷ Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm., 321 B.R. 147, 167-68 (D.N.J. 2005).

- (a) *In general*: Bankruptcy Rule 3001(e) governs (i) who may file a proof of claim after a claim has been transferred but before a proof of claim has been filed and (ii) what notice must be given to the court when a claim has been transferred after a proof of claim has already been filed.
- (b) *The 3001(e)(1) rule*: Bankruptcy Rule 3001(e)(1) provides that, for trades (other than those done for security) made prior to the filing of a proof of claim, the transferee files the proof of claim.
- (c) *The 3001(e)(2) rule*: Bankruptcy Rule 3001(e)(2) requires that, if a claim (other than one based on a publicly traded note, bond or debenture) is transferred (other than for security) after a proof of claim has been filed, then *evidence of the transfer* must be filed by the transferee. The clerk of the court must then notify the transferor of the filing of the evidence of transfer and *the transferor* has 20 days within which to object to the transfer. If a timely objection is filed, then the court must determine whether the transfer actually took place, and, if so, must enter an order substituting the transferee for the transferor in the bankruptcy case. If no objection is timely filed, then the substitution is made automatically by the clerk.¹⁸
- (i) Under Rule 3001(e)(2), evidence of the transfer does not mean the terms of the claim trade must be disclosed.¹⁹ Only evidence that the claim was transferred must be filed with the court, unless the transferee owes some special fiduciary duty to the debtor or the estate.²⁰
- (ii) Typically, the names and addresses of the transferor and transferee are included, as well as the claim number and amount and a statement, signed by the transferor, that the claim has been transferred. The consideration paid for the claim is not disclosed.
- (iii) Transferors often waive, in writing, the 20-day objection period.
- (iv) *The purpose of the rule*: The purpose of Rule 3001(e)(2) has changed dramatically since it was first codified. What started as a control on claims trading has transformed into an administrative tracking of claimholders.
- (A) **Pre-1991 Amendment**: Prior to the 1991 Amendments, Rule 3001(e)(2) was used to avoid what was perceived as the “evils of post-bankruptcy traffic in claims.” As evidenced by the legislative history and certain pre-Code and early Code cases, courts were given the authority to approve or reject a proposed claim trade depending on a variety of concerns such as the motive of the transferee in buying the claim or the relative sophistication of the parties to the transaction. Moreover, any party-in-

¹⁸ See Fed. R. Bankr. P. 3001(e)(2).

¹⁹ Official Unsecured Creditors Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1314 (1st Cir. 1993) (“[A]ssignees do not have to submit to the bankruptcy court the terms of the transfer.”); Resurgent Capital Svcs. v. Burnett (In re Burnett), 306 B.R. 313, 318 (BAP 9th Cir. 2004) (Post-1991, neither Rule 3001(e)(1) nor (e)(2) require disclosure of the terms of the transfer.).

²⁰ See Resurgent Capital, 306 B.R. at 319 (The consideration supporting a claim transfer is not, “in the absence of special fiduciary obligations to the debtor . . . , pertinent” to the claim transfer.).

interest in the case could object to the claims trade, thereby making each trade a potential litigation black hole.²¹

(B) **Post-1991 Amendment:** In 1991, Rule 3001(e)(2) was amended to “limit the court’s role to the adjudication of disputes regarding transfers of claims.”²² As the post-1991 legislative history states, “[t]his rule is not intended to either encourage or discourage postpetition transfers of claims”²³ Rather, the purpose is simply to track the identity of claimholders for administrative purposes so that the court can have an accurate register of who holds what claims.²⁴

- (1) No one other than the transferor can object to a transfer.²⁵ If the debtor wishes to control claims trading, it must get an order of the court restricting claims trading (which order is generally obtained only after notice and a hearing) rather than invoking Bankruptcy Rule 3001(e)(2).
- (2) The rule does not apply to claims based on a publicly traded note, bond or debenture or to transfers of syndicated bank debt because those transactions are already reflected in a register maintained by an indenture trustee, agent or similar registrar in whose name the proof of claim is filed. There is no reason for the court clerk to duplicate the administrative efforts of the agent or trustee and no proof of claim is generally changing hands in such trades.

(d) Rule 3001(e)(3) and (4) – “other than for security”: Rule 3001(e)(3) and (4) deal specifically with claims traded for security and require that evidence of *the terms of the transfer* be filed with the court in such instances.

- (i) What does “security” mean? The rule does not define the term “security.” According to the pre-1991 legislative history, there were two kinds of claims transfers: an “unconditional transfer” or one for “security.” Presumably, then, anything that was not unconditional was considered for security. However, the 1991 Amendments disposed of the requirement that a trade needed to be

²¹ See, e.g., In re Ionosphere Clubs, Inc., 119 B.R. 440, 443 (Bankr. S.D.N.Y. 1990) (discussing old Bankruptcy Rule 3001, the court noted that the rule authorized courts “to monitor the manner in which claims are transferred or assigned and thereby prevent, inter alia, the improper proliferation of claims wrongdoing or inequitable conduct”); see also Advisory Committee Note to Bankruptcy Rule 3001(e)(2).

²² See Viking Assocs., L.L.C. v. Drewes (In re Olson), 120 F.3d 98, 102 (8th Cir. 1997), citing Advisory Committee Notes to Bankruptcy Rule 3001(e)(2), 1991 Amendments.

²³ Advisory Committee Notes to Bankruptcy Rule 3001(e)(2), 1991 Amendments.

²⁴ In re Odd Lot Trading, Inc., 115 B.R. 97, 100 (Bankr. N.D. Ohio 1990) (Reviewing the intent of the 1991 amendments being proposed by Congress, the court found that “the purpose of the amendments is to lessen the court’s involvement when claims are transferred.”); SPM Mfg., 984 F.2d at 1314 (“ . . . [T]he Bankruptcy Rules provide only for procedures for the filing of notice requirements for a transferee to be recognized as the holder of the claim.”).

²⁵ Although only the transferor can object to the transfer, the debtor or trustee may still object to the underlying claim.

unconditional,²⁶ so the meaning of the phrase “other than for security” in the current version of the rule is unclear.

- (A) Clearly, a claim transferred as part of a pledge agreement or similar arrangement constitutes a claim traded for security.
 - (B) Presently, standard claim transfer agreements (other than bank debt purchase and sale agreements) contain a put device that permits the transferee to “put” the claim (or a portion thereof) back to the transferor if the claim is reduced, disallowed or otherwise impaired under certain circumstances. The transfer is subject to the triggering of the put and is, therefore, conditional to some degree, but whether it falls within the category of having been traded for security is unclear.
- (ii) Evidence of the *terms* of the transfer.
- (A) The rule provides that the agreement governing the parties’ relative rights in the claim must be filed with either the proof of claim or the notice provided to the court (depending on whether the transfer took place before the proof of claim was filed or after).
 - (B) The types of rights the rule expressly refers to are voting rights, payment of dividends and the right to participate in the debtor’s case.²⁷ Presumably, the purpose is to identify which party is entitled to deal with the debtor and be heard by the court rather than to monitor the remedies available to claims traders who intend to purchase a claim outright but desire to have a financial backstop should something be wrong with the claim.
 - (C) Moreover, unlike pledge and security agreements, most claims trading agreements provide that the portion of the claim impaired is to be put back to the transferor, but do not specify how the rights subject to the put are to be governed. As such, the kind of agreement required to be disclosed by Rule 3001(e)(3) and (4) is not the kind of agreement that could be provided by a claims transferor.
- (e) Claim Splitting: Historically, claim splitting (selling only a portion of one’s claim or selling the whole claim to multiple parties) was not allowed, because it increases the number of creditors that can vote on a debtor’s reorganization plan, potentially impacting a debtor’s ability to confirm its plan.²⁸ Pre-1991 case law regularly cited claim splitting as one of the “evils” of claims trading. Moreover, claim splitting is still not allowed pre-petition by an involuntary petitioning creditor if the purpose of the transfer is to enable a

²⁶ In re Northwest Airlines Corp., 2007 Bankr. LEXIS 521, 527, n.3 (Bankr. S.D.N.Y. February 9, 2007) (“The amended version . . . eliminates the requirement that claims be transferred ‘unconditionally.’”).

²⁷ Notably, the price paid for the claim is not referred to in the rule and it is unlikely that such a requirement would pass muster in the claims trading community. Indeed, claims transfer agreements typically forbid disclosure of the purchase price by either party to the agreement.

²⁸ See In re Latham Lithographic Corp., 107 F.2d 749 (2d Cir. 1939).

petitioner to satisfy the three-entity requirement.²⁹ However, there have been no recent cases prohibiting claim splitting or addressing its appropriateness.³⁰

3. Official Committee Membership Disclosure Requirements

(a) U.S. Trustee, who appoints Creditors and/or Equity Committees, interprets § 1102 to require prospective members of Official Committees to disclose any/all claim and equity security holdings as of application date (but not the price or the date acquired).

(b) Once an entity becomes a member of an Official Committee, the U.S. Trustee no longer monitors purchases/sales by members and, instead, Committee Bylaws and/or Chinese Wall orders govern. For example, almost all members will be subject to confidentiality agreements with debtors but may still be free to buy or sell with “big boy” letters and/or from the other side of the wall. Should such activity be permitted?

Below is the text of the relevant statute, 11 U.S.C. § 1102, which governs committee disclosure requirements. Also provided is a summary of relevant case law and authority in connection with the issues related to such disclosure requirements.

11 U.S.C. § 1102: Creditors' and Equity Security Holders' Committees

(a)(1) Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.

(2) On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee.

(3) On request of a party in interest in a case in which the debtor is a small business debtor and for cause, the court may order that a committee of creditors not be appointed.

(4) On request of a party in interest and after notice and a hearing, the court may order the United States trustee to change the membership of a committee appointed under this subsection, if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders. The court may order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern (as described in section 3(a)(1) of the Small Business Act), if the court determines

²⁹ See Fed. R. Bankr. P. 1003(a); Focus Media, Inc. v. NBC (In re Focus Media, Inc.), 378 F.3d 916, 927-28 (9th Cir. 2004).

³⁰ Even if a court were to rule that claim splitting is still prohibited under Bankruptcy Rule 3001(e) or were to disallow the votes of holders who split claims under Section 1126(e) of the Bankruptcy Code, a claim purchaser may, nonetheless, purchase a portion of a claim through a participation (as opposed to an outright assignment). The disadvantages of a participation include (i) the inability to directly vote the claim and (ii) the lack of standing the participant has to appear before the Bankruptcy Court.

that the creditor holds claims (of the kind represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.

(b)(1) A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee, or of the members of a committee organized by creditors before the commencement of the case under this chapter, if such committee was fairly chosen and is representative of the different kinds of claims to be represented.

(2) A committee of equity security holders appointed under subsection (a)(2) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such committee.

(3) A committee appointed under subsection (a) shall--

(A) provide access to information for creditors who--

(i) hold claims of the kind represented by that committee; and

(ii) are not appointed to the committee;

(B) solicit and receive comments from the creditors described in subparagraph (A); and

(C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

11 U.S.C. § 1102.

Relevant Case Law

In re Federated Department Stores, Inc., 1991 Bankr. LEXIS 288 (Bankr. S.D. Ohio Mar. 7, 1991)

The bankruptcy court held that a committee member would not violate its fiduciary duties or subject its claims “to possible disallowance, subordination, or other adverse treatment, by trading in securities of the Debtors . . . during the pendency of these [c]ases, provided that [the member] employs an appropriate information blocking device or [Trading] Wall” The Trading Wall procedures approved in this case included: (i) a written acknowledgement by personnel performing committee work that they could receive nonpublic information and were aware of the Trading Wall procedures in effect; (ii) a prohibition on the sharing of nonpublic committee information with other employees; (iii) separate file space for committee work which was inaccessible to other employees; (iv) restrictions on committee personnel’s access to trading information; and (v) a compliance review process.

The Federated Department Stores Trading Wall procedures have been followed by courts in subsequent cases. See, e.g., In re Calpine Corp., Case No. 05-60200 (Bankr. S.D.N.Y. Jan. 25, 2006); In re Pliant Corp., Case No. 06-10001 (Bankr. D. Del. May 15, 2006); In re Foamex Int’l Inc., Case No. 05-12685 (Bankr. D. Del. Nov. 22, 2005); In re The Finova Group, Inc., Case No. 01-0697 (Bankr. D. Del. Apr. 12, 2001).

Relevant Authority

Robert A. Benjamin, *Fiduciary Responsibilities of Creditors' Committee Members with Respect to Securities and Commodities Transactions*, 10 AM. BANKR. INST. L. REV. 493 (2002)

The SEC has approved the use of ethical walls by creditors' committee members who wish to trade in the debtor's securities. The court in Federated Department Stores adopted the view of the SEC.

Ethical walls provide the "best solution" to the dilemma facing creditors' committee members who also wish to continue conducting their underlying business. By erecting an ethical wall, "members should be able to have the piece of mind that they are not committing a *per se* breach of their fiduciary duty. Ethical walls are not perfect and there is no way to completely ensure that improper information will not trade hands." The wall is merely a vehicle allowing "creditors' committee members to participate in the formation of a plan while still allowing the committee member to continue to conduct their underlying business activities."

Greg M. Zipes and Lisa L. Lambert, *Creditors' Committee Formation Dynamics: Issues in the Real World*, 77 AM. BANKR. L.J. 229 (2003)

Since Federated Department Stores, "the United States trustee has appointed creditors trading in claims, subject to appropriate safeguards to ensure that they can fulfill their fiduciary duties. The United States trustee has required either the committee or the specific individual member to file a motion, colloquially referred to as a 'blocking motion' that establishes adequate protective procedures with notice to all parties in interest. The motion should be specific in outlining the factual underpinnings behind the request, including specific information regarding the procedures of the committee members seeking such an order. The requirement of a motion allows parties in interest to scrutinize the proposed procedures. At a minimum, the proposed procedures should prohibit a committee member's trading personnel from contacting personnel performing committee work."

4. Committee Disclosure Obligations

(a) **How can a Committee (its members and advisors) satisfy the recent disclosure obligations mandated by Section 1102(b)(3) of the Bankruptcy Code but still protect confidential information?**

(b) **Even under Refco type § 1102(b)(3) Orders, can creditors force "confidential" information to become public? If so, how?**

Below is a summary of the relevant statute and related case law and authority.

Application of 11 U.S.C. § 1102(b)(3)

Committee's Duty to Provide Access to Information:

The first clause of Section 1102(b)(3) of the Bankruptcy Code requires committees who hold claims of the kind represented by the committee to provide such creditors with access to information. "What this means will vary from case to case." Creditors' committees have moved for orders under this Section seeking the approval of information access procedures that address the committee's fiduciary responsibility to maintain the confidentiality of sensitive information. 7 COLLIER ON BANKRUPTCY ¶ 1102.08 (15th ed. rev.).

Committee's Other Duties Under § 1102(b)(3):

“The second clause of section 1102(b)(3) of the Bankruptcy Code requires committees to solicit and receive comments from holders of claims of the kind represented by the committee.” 7 COLLIER ON BANKRUPTCY ¶ 1102.08 (15th ed. rev.).

“The third clause of section 1102(b)(3) of the Bankruptcy Code requires that a creditors’ committee be subject to a court order compelling any additional report or disclosure to be made to creditors represented by such committee.” 7 COLLIER ON BANKRUPTCY ¶ 1102.08 (15th ed. rev.).

Relevant Case Law

The bankruptcy courts of Delaware and the Southern District of New York have entered orders addressing the concerns raised by the broad language in Section 1102(b)(3) of the Bankruptcy Code. In doing so, these bankruptcy courts have created uniform procedures and protected the fiduciary duties of committees regarding confidential information. See, e.g., In re FLYi, Inc., Case No. 05-20011 (Bankr. D. Del. 2005); In re Nobex Corp., Case No. 05-20050 (Bankr. D. Del. 2005); In re Refco Inc., Case No. 05-6000 (Bankr. S.D.N.Y. 2005); In re Musicland Holdings Corp., Case No. 06-10064 (Bankr. S.D.N.Y. 2006); In re Calpine Corp., Case No. 05-60200 (Bankr. S.D.N.Y. 2005).

In re Refco Inc., Case No. 05-60006 (Bankr. S.D.N.Y. 2005)

In Refco, the creditors’ committee filed a motion seeking clarification of its obligations under Section 1102(b)(3) of the Bankruptcy Code. The court ruled that the committee would not have to disclose information: (i) that could reasonably be determined to be confidential and nonpublic or proprietary; (ii) the disclosure of which could reasonably be determined to result in the general waiver of the attorney-client or other applicable privilege; or (iii) whose disclosure could reasonably be determined to violate an agreement, order or law, including applicable securities laws.

In re FLYi, Inc., Case No. 05-20011 (Bankr. D. Del. 2005)

In FLYi, the debtor sought an order from the court limiting the dissemination of information from the creditors’ committee to its constituencies. The debtor was concerned that the disclosure of information, such as compensation levels and business strategies, would provide its competitors with an unfair advantage and ultimately harm the estate. In response, the court entered an order providing that any creditors’ committee would not be authorized or required to provide access to any confidential information of the debtors to any creditor it represents. In addition, the committee was encouraged to use a website to allow creditors to access public documents and other materials.

Relevant Authority

C.R. Bowles Jr., “*We Haf Vays to Make You Talk” No Really, We Do: Committees’ New Duties Under Amended § 1102(b)(3) After BAPCPA*, 24-7 ABIJ 20 (2005)

Issues of particular concern to creditors’ committees under 11 U.S.C. § 1102(b)(3)(A) are: (i) the protection of privileged and work product information; (ii) the protection of confidential information; (iii) the Trojan constituent creditors; (iv) the level of detail to be provided; (v) the nature of access to be provided; and (vi) the cost of providing the information.

Richard Levin and Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603 (2005)

Section 1102(b)(3) of the Bankruptcy Code provides no guidance on the extent of the obligation to provide access to non-committee constituents, and also “raises difficult questions regarding the timing and circumstances under which nonpublic information must be shared.” The rule leaves unclear: (i) whether a confidentiality agreement between the debtor-in-possession and the committee or a court order can eliminate, or at least limit, the committee’s information sharing obligation; (ii) what kinds of protections can and should be established to prevent improper claims trading; (iii) how often must the committee prepare reports; and (iv) how often and/or what information committees must solicit from its constituents.

Deborah L. Thorne, *Creditors’ Committees: The Fallout from BAPCPA Changes to § 1102*, 25-3 ABIJ 20 (2006)

Section 1102(b)(3) of the Bankruptcy Code fails to indicate how a creditors’ committee should provide access to required information, and does not indicate the nature, scope or extent of the information that a committee must provide to its constituency. Congress has left debtors and courts struggling to implement the change.

5. NOL Trading Order Disclosure Requirements

Subsequent to circuit law determining that NOL’s constitute 541 property of the estate, debtors that are public companies that believe their assets include a material amount of NOL’s seek court orders limiting/restricting the sale/purchase of claims and/or stock. Typical provisions in such orders include prior notice procedures on holders and/or the possible voiding of transfers that would adversely effect the NOL. Does the Court have jurisdiction to provide such relief?

- (a) *NOL Trading Orders*: Subsequent to circuit law determining that NOL’s (net operating losses) and other tax attributes constitute property of a debtor’s estate,³¹ debtors that are public companies that believe their assets include a material amount of NOL’s seek court orders restricting the sale and purchase of claims against, and stock in, the debtor company.
- (i) *Section 382 of the Internal Revenue Code*: NOL’s and other tax attributes may be eliminated or restricted under the Internal Revenue Code if increases in the percentage of the stock owned by 5% shareholders total more than 50% over a three-year testing period.
- (ii) *Section 382 Exemption*: Under what has become known as the “old and cold exemption,” where historic shareholders and qualified creditors own at least 50% of the value and voting power of the stock after a reorganization takes place, a debtor may receive an exemption from the 382 rule. “Qualified Creditors” must have either (A) owned their debt for 18 months before the filing of the bankruptcy case or (B) be the original holders of ordinary course debt.

³¹ See *Official Comm. of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines)*, 928 F.2d 565, 573 (2d Cir. 1991); *Gibson v. United States (In re Russell)*, 927 F.2d 413, 417-19 (8th Cir. 1991).

(b) Disclosure Required:

- (i) Model NOL Trading Order: The Bond Market Association together with the Loan Syndications and Trading Association have created model interim and final NOL trading orders to be used in chapter 11 cases. The model orders seek to balance the interests of the debtor in tracking its debtholders and preserving the use of its tax attributes with the interests of the debt markets in permitting free trade.³² Though not identical to the model orders, most recently approved NOL orders have used the model orders as a basis from which to create their own trading order.
- (ii) To determine whether a potential sale or acquisition of a claim or share of stock might trigger the loss of a debtor's NOL's, debtors seek to keep a register of all "substantial" claim and equityholders and force these holders to serve a notice on the debtor when they seek to acquire more debt/equity or dispose of their currently held debt/equity.
- (iii) "Substantial" is not a defined term, but it generally refers to holders of claims and equity that own close to 5% of the equity or total claims of the debtor. Recently approved NOL orders have used 4.75% as the standard threshold amount for triggering disclosure requirements.
- (iv) Information to be disclosed:
 - (A) Name and address of holder of debt/equity;
 - (B) Date debt/equity was acquired; and
 - (C) Notice required of any potential disposition of debt/equity currently owned or acquisition of additional debt/equity and terms of the trade (other than pricing).

(c) Approval of acquisitions/dispositions and voiding of transfers:

- (i) NOL orders typically require all substantial debt/equity holders to provide notice to the debtor if the holder intends to either acquire more debt/equity or dispose of currently held debt/equity. The debtor is then given a period of time (courts have approved anywhere from 10 to 30 days) in which to determine whether the transaction would jeopardize its NOLs or other tax attributes and object to the transfer. If no objection is made within the specified period of time, the transaction is deemed approved and may be consummated.
- (ii) If the debtor objects to the transaction, then the transaction cannot be consummated until the bankruptcy court approves the trade. The NOL order usually provides that any transaction objected to by the debtor is null and void unless approved by the court and may be subject to sanctions for violation of the automatic stay.

³² The model orders may be found at www.lsta.org.

- (d) *“Sell down” procedures*: Some NOL orders provide for a “sell down” procedure in the event the debtor proposes a reorganization plan that relies on the Section 382 exemption. The sell down procedure requires a substantial debt/equity holder to sell its claims or equity down to the point necessary for the debtor to use the exemption. Often, the sell down procedures are not included in the original NOL order but are negotiated later, when it appears that the debtor will actually need to preserve the exemption. In addition, sell down procedures usually do not require a holder to sell debt/equity that was held prior to the entry of the initial NOL order or that was approved by the debtor or the court as part of the NOL order procedures.
- (e) *Court’s jurisdiction*: Though circuit courts have determined that NOLs and other tax attributes are property of a debtor’s estate and, therefore, subject to bankruptcy court jurisdiction, no court has yet addressed the issue of whether it has jurisdiction over the debt/equity over which NOL orders seek to exercise control.

6. Public Debtor ‘34 Act Compliance Issues

(a) **Must public debtors in chapter 11 timely comply with all reporting obligations?**

To be discussed at conference.

(b) **If not, how can such debtors obtain relief from the SEC? When?**

To be discussed at conference.

II. Plan Issues

A. Absolute Priority Rule vs. SOX

Although the Bankruptcy Code provisions embracing the “absolute priority” rule generally provide that shareholders and/or unsecured creditors are not to receive distributions from the debtor without the consent of the senior creditors (or payment in full with interest), when, if ever, can the Congressional purposes and principles contained in SOX effectively provide for material shareholder recoveries? What is the learning of WorldCom and Adelphia? Does the DOJ/SEC really have the right to force the forfeiture of Debtor assets during a chapter 11 case? What if such assets are subject to prior properly perfected security interests? Should they have such power? Did Congress intend that SOX take precedence over the equitable distribution to creditors as set forth in the Bankruptcy Code? If so, is such power constitutional? Once the SEC creates a SOX fund from a “settlement” of claims against a debtor, what discretion does it have as to how to allocate the fund for distributions between creditors and shareholders? Who has standing to challenge such allocation? What standards, if any, govern the distribution of a “SOX” fund? Should potential distributions to creditors under a plan be relevant to the allocation?

Below is a summary of the relevant statutes, case law, and related authority.

Relevant Statutes11 U.S.C. § 510

Section 510 provides for the subordination of claims arising from a claimant's purchase or sale of a security of the debtor. As a result, the claims of allegedly defrauded shareholders are subordinate to creditors' claims such that creditors will receive their distributions before shareholders. The SEC has successfully argued that claims by the government would not fall under Section 510 on the basis that a claim by the SEC is not premised on the SEC's purchase or sale of securities. Rather, a claim by the SEC would be premised on its regulatory powers to enforce the securities laws and to seek disgorgement from those who violate those laws.

11 U.S.C. § 1129

Under Section 1129(b), which is applicable in the context of confirmation of a plan of reorganization, a senior class of creditors that has rejected a plan must receive full payment before a junior class may receive anything at all. In addition, no class of equity securities (such as common shareholders) may receive any payment until all creditors and senior equity security holders, if any, have been paid in full.

Section 1129(a)(7) sets forth an additional requirement, referred to as the "Best Interests of Creditors" rule, which imports into chapter 11 the priority scheme set forth in Section 726(a)(4) for purposes of evaluating the confirmability of a chapter 11 plan of reorganization.

11 U.S.C. § 726

Section 726 specifies that, in a liquidation under chapter 7 of the Bankruptcy Code, any distributions on account of a claim for a "fine, penalty or forfeiture" are accorded a "fourth" priority (behind administrative expense claims (subsection (1)), timely filed unsecured claims (subsection (2)), and untimely filed unsecured claims (subsection (3))). 11 U.S.C. § 726(a)(4). Section 726(a)(1) also provides a first priority (senior to unsecured claims) to tax liens.

18 U.S.C. § 3613

Section 3613 provides that a judgment imposing a fine may be enforced against all property or rights of the person fined. The Section further provides that "an order of restitution made pursuant to section[] . . . 3663 . . . of this title is a lien in favor of the United States on all property and rights to property of the person fined as if the liability of the person fined were a liability for a tax assessed under the Internal Revenue Code of 1986."

18 U.S.C. § 3663

Section 3663 permits the government to seek penalties or an order of restitution for violations of certain offenses, including securities fraud.

Section 308(a) of the Sarbanes-Oxley Act ("Fair Funds for Investors")

This provision permits the SEC to distribute civil penalties to victims of securities fraud so long as the SEC has also obtained an order or agreement for disgorgement. Thus, the provision enables the SEC to add civil penalties to disgorgement funds for the relief of victims of securities fraud. This provision supplants prior law, which required civil penalties to be paid to the U.S. Treasury even if victims remained uncompensated.

Relevant Case Law

In re WorldCom, Inc., Case No. 02-13533 (AJG), No. 8125 (Bankr. S.D.N.Y. Aug. 6, 2003) (approving settlement in the context of Rule 9019 motion seeking approval of settlement)

The bankruptcy court considered whether the absolute priority rule is applicable in a non-plan settlement context. After describing the “unsettled nature of the law,” the court concluded that the requirements of the absolute priority rule were not an impediment to approval of a settlement agreement pursuant to Rule 9019 as the objectors’ claims raised several issues that created sufficient doubt about the outcome of any litigation seeking to reduce the status of the SEC penalty below other general unsecured claims. The court concluded that the uncertainty of such litigation could have a “negative impact” on the overall outcome of the case and therefore “the settlement falls within the range of reasonableness.”³³

S.E.C. v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003) (approving settlement within context of SEC enforcement proceeding)

The court approved a \$750 million settlement between the SEC and WorldCom in connection with the SEC’s civil enforcement action against WorldCom. In approving the settlement, the district court recognized the tension between the Fair Funds provision and Section 510(b) but concluded that the Section does not prohibit the SEC from giving its penalty to the shareholders as prescribed by the Fair Funds provision. The court also acknowledged that under the bankruptcy laws, the SEC’s penalty claim would be treated as simply another claim by one of many unsecured creditors. The court cautioned, however, that the SEC must be wary of the extent to which the justification for the penalty amount relies on the amount of defrauded shareholders’ losses that will be recompensed. Nonetheless, in approving the settlement the court noted that it was satisfied that the SEC did not use shareholder loss as the primary basis for its penalty proposal; rather, the court reasoned that the SEC “carefully reviewed all relevant considerations” and formulated a penalty that took “adequate account of the magnitude of the fraud and the need for punishment and deterrence” while “fairly and reasonably reflect[ing] the realities of [the] complex situation.”

³³ In a recent decision, the Second Circuit held that a settlement proposed under Bankruptcy Rule 9019 prior to and outside of a plan of reorganization must nonetheless satisfy the requirements of the absolute priority rule provided by section 1129(b) of the Bankruptcy Code, unless the court determines that a departure from the absolute priority rule is justified. Iridium Operating LLC v. Official Comm. of Unsecured Creditors and JPMorgan Chase Bank, N.A., 05-2236-BK, --- F.3d ----, 2007 WL 642590, at *1, 8 (2d Cir. Mar. 5, 2007). The Court recognized that, in some circumstances, a bankruptcy court may, in its discretion, properly approve a settlement that deviates from the absolute priority rule where the remaining factors used to evaluate whether the settlement is fair and equitable “weigh heavily in favor of approving a settlement” and the parties to the settlement justify that deviation. Id. at *8. However, the bankruptcy court must clearly articulate the reasons for approving a settlement which impairs the rules of priorities. Id. Unlike WorldCom or Adelphia, neither the proponents of the settlement in Iridium, nor the bankruptcy court, provided specific and credible justifications for approval of the settlement in light of the claimed deviations from the absolute priority rule. Thus, on remand, the Court sought clarification as to whether the settlement justified a departure from the absolute priority rule. Moreover, the settlement in Iridium did not involve consideration of the tension between the absolute priority rule and the provisions of Sarbanes-Oxley, which permit the SEC to distribute civil penalties to victims of securities fraud. That tension and the uncertainty of litigation concerning the government’s claims and its status in terms of subordination, coupled with the other factors that weighed heavily in favor of settlement, justified approval of the settlements in WorldCom and Adelphia despite claimed deviations from the rules of priorities.

Official Committee of Unsecured Creditors of WorldCom, Inc. v. S.E.C., 467 F.3d 73 (2d Cir. 2006)

The Second Circuit rejected the creditors' committee's argument that the SEC's proposed distribution plan violated the absolute priority rule, finding that "the SEC's charge to enforce securities laws carries with it the discretion to determine how to distribute recovered profits among injured investors." The court also recognized that even after the enactment of the Fair Fund provision, the decision remains in the hands of the SEC whether to distribute civil penalties to victims at all as the SEC could potentially distribute all of the recovered funds to the U.S. Treasury. In addition, while noting the tensions between the SEC's power to distribute funds to injured investors outside the bankruptcy proceeding and the Bankruptcy Code, the Court held that "[w]e see no indication in the Fair Fund provision, however, that the SEC must follow the Bankruptcy Code's claim priorities when developing a distribution plan. In the absence of such an indication, it is not our role to mitigate this tension."

In re Adelphia Communications Corp., 327 B.R. 143 (Bankr. S.D.N.Y. 2005)

In approving Adelphia's settlement with the government, the bankruptcy court noted that should any equity holders and defrauded noteholders receive compensation from the government through its restitution fund, they would not be sharing in assets of the estate under a plan or in a chapter 7 liquidation. Rather, "they would be sharing in a fund to be created and owned by the Government" The bankruptcy court also stressed that the settlement was presented pursuant to Rule 9019 and not pursuant to a proposed plan or claim objection. Thus, "while defrauded equity holders will plainly have to confront the Absolute Priority Rule and section 510(b) when trying to share in assets of the estate in [the bankruptcy] court, what [the court is] asked to approve here is twice removed from that scenario." The court also cited Judge Gonzalez's opinion in WorldCom to support the notion that because the issue of the status and potential subordination of SEC claims is a "close and difficult one," this was all the more reason for approving the settlement.

The court further held that invocation of Section 726(a)(4) would in no circumstances result in subordination or disallowance of a claim noting that "the failure to satisfy the Best Interest of Creditors rule would merely result in the inability to confirm a plan – not subordination or a disallowance of the claim in question in the chapter 11 case."

In re Adelphia Communications Corp., 337 B.R. 475 (S.D.N.Y. 2006)

The district court noted that the creditors' premise "that the government is likely to distribute the victim restitution fund in part to equity security holders who could not take ahead of the [creditors] in a plan of reorganization in light of the absolute priority rule" is correct; however, the court agreed with the bankruptcy court that any payments from the restitution fund would be from "a fund to be created and owned by the Government," not a distribution of assets of the debtors' estates as part of a plan of reorganization. Consequently, the funds would not come within the language of Sections 510(b) and 1129 of the Bankruptcy Code. The court also noted that if Adelphia had rejected the government's settlement offer and the government succeeded in forfeiting its assets, the government's interest in the assets would have been superior to those of the creditors.

In re Adelphia Communications Corp., Slip Copy, 2006 WL 3826700 (2d Cir. 2006)

The Second Circuit dismissed the appeal challenging the order of the district court, which held that the Bankruptcy Court had committed no manifest error or abuse of discretion when approving the settlements between the government and Adelphia. The Court concluded that the

“circumstances surrounding [the] appeal have changed comprehensively during the pendency of [the] appeal,” and dismissed the appeal on grounds of mootness.

Relevant Authority

Douglas A. Henry, *Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley’s Fair Funds Provision on Distributions in Bankruptcy*, 21 EMORY BANKR. DEV. J. 259 (2004)

The equitable remedy of disgorgement compels defendants to relinquish amounts in which they were unjustly enriched including profits (with interest) that were gained by the defendants’ wrong-doing. Although disgorgement is not intended to compensate fraud victims for losses, when appropriate the payments received by the SEC as a result of disgorgement may be distributed to injured investors. Otherwise, disgorgement funds are distributed to the U.S. Treasury.

The SEC also has the authority to seek civil penalties against defendants, which is regulated exclusively by statute. Prior to Sarbanes-Oxley, the governing statutes mandated that all civil penalties the SEC obtained were to be forwarded to the U.S. Treasury. However, under the Fair Funds provision, the SEC can now add civil penalties to disgorgement funds. As a result, the funds that were previously allocated to the U.S. Treasury can now be allocated to the disgorgement fund and distributed to victims of the securities law violations.

Marvin E. Sprouse III, *A Collision of Fairness: Sarbanes-Oxley and § 510(b) of the Bankruptcy Code*, 24-OCT ABIJ 9 (October 2005)

In connection with violations of the securities laws, the SEC may seek disgorgement or the imposition of civil penalties, and it may seek both remedies in the same action. Prior to Sarbanes-Oxley, however, funds obtained as a result of civil penalties imposed in an SEC action (or settlement), as opposed to disgorgement funds, could not be distributed to investors and were instead paid into the U.S. Treasury. Under the Fair Funds for Investors provision of Sarbanes-Oxley, however, “in SEC actions where a disgorgement fund for investors is established, the SEC may now seek court authority to add monies to the fund recovered pursuant to civil penalties.”

Courts have acknowledged, but not resolved, the tension between Sarbanes-Oxley and the Bankruptcy Code. Indeed, “[r]ather than attempt to resolve the apparent conflicts between Sarbanes-Oxley and the [Bankruptcy Code], the bankruptcy courts in WorldCom and Adelphia invoked their settlement authority under Federal Rule of Bankruptcy 9019, and identified the uncertainties associated with the conflicting regulatory schemes as reasons to support the proposed settlements.”

Alistaire Bambach and Samuel R. Maizel, *The SEC’s Role In Public Company Bankruptcy Cases Where There is a Significant Enforcement Interest*, 2005 ANN. SURV. OF BANKR. LAW PART I § 3 (September 2006)

Although interested parties may seek to subordinate the SEC’s claims under Section 510(b), which mandates subordination of claims arising from the purchase or sale of a security, the SEC routinely argues, and numerous courts agree, that this Section is inapplicable to an SEC disgorgement claim because: (i) disgorgement is an equitable remedy and its purpose, rather than being compensatory, is “to deter violations of the federal securities laws by depriving the wrongdoer of its ill-gotten gains”; and (ii) the SEC claim is “an independent claim brought by the SEC in its own name and right” pursuant to the securities laws to enforce such laws in the public interest. “Although the SEC may exercise its discretion to ask the district court to permit it to distribute the proceeds of its claims to victims of fraud, the SEC is not legally obligated to do so and it does not stand in anyone else’s shoes when it is asserting its claim.”

B. Plan Negotiation Matters

1. Prior to Court approval of a disclosure statement, is it possible to build a consensual plan and not violate Reg. FD?

Prior to court approval of a disclosure statement, the debtor(s) and creditors may find it desirable to negotiate for and create a consensual plan. Interacting with the creditors and creditors' committee may present an issue for a public company debtor with regard to Regulation FD (for "fair disclosure") under the Securities Exchange Act of 1934. Regulation FD was designed to prevent selective disclosure to market participants by public companies and there is no Securities and Exchange Commission exception from disclosure obligations resulting from a bankruptcy filing. While it is a possibility that any negotiations with creditors before the approval or filing of the disclosure statement would implicate Regulation FD, if the committee signed a confidentiality agreement, an exception to Regulation FD for persons who "expressly agree to maintain the disclosed information in confidence" may apply.³⁴

2. How should information be protected under Bankruptcy Rule 9018?

Generally, all papers filed in a bankruptcy case and on the docket of a bankruptcy case are of public record.³⁵ However, on request of a party in interest, the bankruptcy court shall protect the debtor or any entity with respect to a trade secret or confidential research, development, or commercial information.³⁶ The Code requires a court to protect a "person" against scandalous or defamatory matter contained in any paper filed in a case under the Code, while Rule 9018 permits extension of this protection to "any entity."³⁷ Rule 9018 gives the court the discretion to order such protection on its own initiative if justice so warrants. In addition, Rule 9018 protects governmental matters that are made confidential by statute or regulation.

The Second Circuit has held that neither Section 107(b) nor Rule 9018 require a showing of good cause as a prerequisite to a protective order.³⁸ The Second Circuit further held that Section 107(b) and Rule 9018 do "not require that commercial information be the equivalent of a trade secret before protecting such information."³⁹

Rule 9018 motions are becoming increasingly more common. Within the last few months of the case, the court in Adelphia Commc'ns Corp. granted at least three Rule 9018 motions to file certain items under seal.⁴⁰

³⁴ 17 C.F.R. § 243.100(b)(2)(ii).

³⁵ 11 U.S.C. § 107(a).

³⁶ 11 U.S.C. § 107(b)(1).

³⁷ 11 U.S.C. § 107(b)(2); Fed. R. Bankr. P. 9018(2). "Person" is defined to include an individual, partnership and corporation, while the term "entity" includes persons, estates, trusts, governmental units, and United States trustees. 11 U.S.C. § 101(15) and (41).

³⁸ Video Software Dealers Ass'n v. Orion Pictures Corp. (In re Orion Pictures Corp.), 21 F.3d 24, 28 (2d Cir. 1994).

³⁹ Id.

⁴⁰ In re Adelphia Commc'ns Corp., Orders dated Aug. 15, 2006 (No. 11793), Aug. 30, 2006 (No. 11909), and Jan. 25, 2007 (No. 13092), No. 02-41729 (Bankr. S.D.N.Y.)

C. Negative Solicitation Matters

1. **What right/risk do creditors/equity security holders have/take if they engage, as a “group,” in unauthorized (*i.e.*, not approved by the Bankruptcy Court) letters, publications (by email, press conference) “attacking” a proposed plan? – before the approval of a disclosure statement? – after the approval of a disclosure statement?**

Solicitation Standard Before Court Approved Disclosure Statement: Section 1125 of the Code generally prohibits soliciting the rejection of a plan from claim holders with respect to their claims after the commencement of a bankruptcy case and before the claim holders receive a court approved disclosure statement.⁴¹ The purpose of requiring an approved disclosure plan is to ensure, at a minimum, that a creditor receives adequate information about the plan to allow it to make an informed decision regarding whether to vote for or against the plan.⁴²

- (a) The Code does not define solicitation, but a majority of courts have held the term must “be very narrowly interpreted to mean only specific requests for an official vote for or against the plan.”⁴³ The court in Snyder determined an unauthorized solicitation under § 1125 included a specific request for an official vote for or against a plan of reorganization (a) that is made before dissemination to parties in interest of an approved disclosure statement, or (b) that is made after the dissemination of a disclosure statement, and which contains misrepresentations or deliberate falsehoods and misleading statements calculated to deceive parties entitled to vote, or (c) that refers to a plan of reorganization predicated upon arrangements that were arrived at by fraud or that were not adequately disclosed to the court and to parties in interest in the approved disclosure statement.⁴⁴
- (b) However, a specific request for plan rejection is not the only form of solicitation. As seen in California Fidelity, a letter sent to 300 creditors thirteen days before the hearing on the disclosure statement which compared proposed plans was deemed to be an improper solicitation.⁴⁵ Even applying the narrowest definition of “solicitation” the court found the letter to violate § 1125(b) because the letter’s message encouraged unsecured creditors to vote against the trustee’s proposed plan.⁴⁶ Another court found that a press release or other widely disseminated forms of communication may be deemed to be an improper solicitation in

⁴¹ 11 U.S.C. § 1125(b).

⁴² See Duff v. U.S. Trustee (In re California Fidelity, Inc.), 198 B.R. 567, 571 (B.A.P. 9th Cir. 1996); In re Clamp-All Corp., 233 B.R. 198, 204 (Bankr. D. Mass. 1999).

⁴³ In re Gilbert, 104 B.R. 206, 214 (Bankr. W.D. Mo. 1989). See also California Fidelity, Inc., 198 B.R. at 573 (holding letter sent to 300 unsecured creditors by debtor’s president thirteen days before the disclosure statement hearing to violate § 1125(b) only because the letter’s message encouraged creditors to reject the trustee’s plan); Century Glove, Inc. v. First Am. Bank of New York, 860 F.2d 94, 101 (3d Cir. 1988) (“‘solicitation’ must be read narrowly” as to not inhibit free creditor negotiations). But see Clamp-All Corp., 233 B.R. at 206-08 (criticizing Century Glove’s narrow interpretation of “solicitation” and holding creditors’ distribution of competing plan before approval of debtor’s disclosure statement to violate § 1125(b)).

⁴⁴ In re Snyder, 51 B.R. 432, 437 (Bankr. D. Utah 1985).

⁴⁵ California Fidelity, 198 B.R. at 571-73.

⁴⁶ California Fidelity, 198 B.R. at 573.

violation of § 1125(b) “if the communication includes a specific request for the reader’s, listener’s or viewer’s vote.”⁴⁷

- (c) Oral solicitations may also violate § 1125(b). In Gilbert, one creditor called a second creditor four months prior to the filing of the debtor’s plan and the court’s approval of the solicitation statement to say that he “hoped” the second creditor would vote for the debtor’s proposed plan.⁴⁸ The court held that the creditor’s oral request was in fact an untimely solicitation in violation of § 1125.⁴⁹ The court, however, held that the conduct did not warrant the imposition of sanctions absent a showing of bad faith.⁵⁰

Solicitation Standard After Approved Disclosure Statement: Section 1125(b) specifically applies to solicitation that occurs before the transmittal of a plan and the approval of a disclosure statement. However, several cases discuss its application in situations where the solicitation in question occurred after a plan was distributed and the disclosure statement was approved.⁵¹

- (a) In Century Glove, after the court had approved the debtor’s disclosure statement, one creditor sent certain other creditors a draft copy of an alternative plan attempting to solicit rejections of the debtor’s plan.⁵² The bankruptcy court held that, although a disclosure statement had been filed and approved, solicitations must be limited by the contents of the plan, the disclosure statement, and any other court-approved solicitation material – information outside of these approved documents may not be distributed.⁵³ The Third Circuit reversed, holding that § 1125(b) does not empower a bankruptcy court to require its approval of all materials used to solicit a claim holders acceptance or rejection of a plan of reorganization.⁵⁴ The court reasoned that “[r]ather than limiting the information available to a creditor, § 1125 seeks to guarantee a minimum amount of information to the creditor asked for its vote.”⁵⁵
- (b) The United States Bankruptcy Court for the Eastern District of Pennsylvania followed the precedent set by Century Glove in holding that a letter sent by a debtor to creditors urging their rejection of a competing plan was not in itself an act in violation of § 1125(b).⁵⁶ The court did note, however, that any solicitation

⁴⁷ In re Dow Corning Corp., 227 B.R. 111 (Bankr. E.D. Mich. 1999) (determination of when a communication becomes a solicitation requires consideration of the content and the timing of the communication).

⁴⁸ In re Gilbert, 104 B.R. at 208.

⁴⁹ Id. at 215.

⁵⁰ Id.

⁵¹ See Century Glove, Inc., 860 F.2d at 95-96; In re Apex Oil Co., 111 B.R. 245 (Bankr. E.D. Mo. 1990); In re Gulph Woods Corp., 83 B.R. 339 (Bankr. E.D. Pa. 1988).

⁵² Century Glove, Inc., 860 F.2d at 95.

⁵³ Century Glove, Inc., 860 F.2d at 96 referring to 74 B.R. 952, 955 (Bankr. D. Del. 1987).

⁵⁴ Id. at 100.

⁵⁵ Id.

⁵⁶ In re Gulph Woods Corp., 83 B.R. 339, 343 (Bankr. E.D. Pa. 1988).

sent during the voting period that contained falsehoods or mischaracterizations would violate § 1125(b) as it would unfairly influence the votes.⁵⁷

- (c) Although court approval of solicitation materials is not required, the better practice is to receive court approval and to include a court approved solicitation letter with the disclosure package. This procedure was followed recently in Adelphia as well as in the FLYi case in the Bankruptcy Court for the District of Delaware.
- (d) The bankruptcy court in Apex Oil held that once a debtor’s exclusivity period expired, a soliciting party need not obtain prior court approval of solicited materials only if: (1) the information provided is truthful and absent of any false or misleading statements or legal or factual mischaracterizations; (2) the information is presented in good faith; and (3) the soliciting party does not propose or suggest an alternative plan which has yet to gain court approval or otherwise failed to travel through the appropriate legal channels, as dictated by the Bankruptcy Code.⁵⁸ The Apex Oil court suggested three situations in which solicitation without prior court approval may be appropriate: a soliciting party may, without court approval, (1) offer a narrative, evidence, conclusions, or opinions contrary to that enunciated in the plan or disclosure statement; (2) assert positions, evidence, conclusions, or opinions of relevant matters which are not contained in the plan or court-approved disclosure statement; or (3) offer evidence or opinions of an alternative liquidation analysis, since the debtors have a liquidation analysis as part of their disclosure statement.⁵⁹
- (e) If opponents of a plan do solicit votes without the bankruptcy court’s approval, it is possible that any negative votes so received will be disallowed under § 1126(e). Section 1126(e) allows a bankruptcy court to hold invalid any vote that was not made or solicited “in good faith or in accordance with the provisions of this title.”⁶⁰

2. Even if creditors/equity security holders have such rights to engage in negative solicitation, must they disclose their trading positions and history if requested?

It is not clear if creditors/equity security holders engaging in negative solicitation must disclose their trading positions and history if requested.

D. Plan Structure Matters

1. If a plan seeks a reorganization of the debtor and to have its equity securities freely tradable, must all financials be completed and “clean” (i.e., any restatement complete and the audit firm has “signed off”) prior to the plan becoming effective? Must the debtor be in compliance with SOX?

As a practical matter, yes. Although Section 1145 of the Bankruptcy Code provides an exemption from registration under the Securities Act for the offering of stock in exchange for

⁵⁷ Id.

⁵⁸ Apex Oil Co., 111 B.R. at 249.

⁵⁹ Id. at 250.

⁶⁰ See 11 U.S.C. § 1126(e).

claims and interests pursuant to a Chapter 11 plan, the company's stock must be registered under the Exchange Act in order to be listed on a national exchange and the company must be a reporting company in order to list its stock on a bulletin board. Although in some instances a public company might be able to avail itself of modified reporting requirements while in bankruptcy [Exchange Act Release No. 9660 (June 1972) (the Commission expressed the general position that with respect to issuers that have filed bankruptcy, it would accept reports which "differ in form or content from reports required to be filed under the Exchange Act.")] , "[a]ny post-reorganization filings under the Securities Act or the Exchange Act must include audited financial statements prepared in accordance with generally accepted accounting principles for all periods for which audited financial statements are required even though the issuer may have been subject to bankruptcy proceedings during some portion of those periods." SEC Staff Legal Bulletin No. 2 (April 15, 1997) (The Division of Corporate Finance's views on requests to modify the Exchange Act periodic reporting of issuers that are either reorganizing or liquidating under the provisions of the Bankruptcy Code.).

E. Effective Date Consequences

1. Unintended Consequences. Must a creditor with a large pre-petition claim that receives 5% or more of the public debtor's new common stock file a Form 13-D?

Yes, if the debtor's new common stock is a class of stock that is an equity security registered pursuant to Section 12 of the Exchange Act and has voting rights.

2. Intended Consequences. When do post-petition claims purchases, if ever, make the buyer an underwriter under § 1145(b)(1)?

This is a fact specific inquiry. The inquiry goes to the intent of the purchaser and whether the buyer purchased the shares with a view to distribute the securities.