EXHIBIT LIST FOR NOTEHOLDERS' OBJECTION TO 2019 MOTION	
EXH	TITLE
A	Excerpts from SEC Report
B	Tabb Article, 3 Am. Bankr. Inst. L. Rev. 5 (1995)
C	Scotia Order [Scotia Docket 659]
D	Scotia Motion to Compel [Scotia Docket 492]
E	Scotia Noteholders Group's Objection [Scotia Docket 599]
F	Scotia SIFMA & LSTA Amici Curiae Brief [Scotia Docket 610]
G	Scotia Transcript – April 10, 2007 [Scotia Docket 695]
H	Scotia Transcript – April 17, 2007 [Scotia Docket 696]
I	Scotia Transcript – May 22, 2007 [Scotia Docket 885]
J	SIFMA & LSTA Letter, dated November 20, 2007
K	Owens Corning Order [Docket 13091]
L	Goldschmid Article, 2005 Columb. Bus. L. Rev. 191 (2005)
M	Musicland SIFMA & LSTA Amicus Brief [Musicland Docket 1687]
N	Geithner Remarks, "Hedge Funds and Derivatives and Their Implications for the Financial System"
O	Sea Containers Transcript – May 14, 2008 [SCL Docket 1890]
P	Sea Containers Group's Objection [SCL Docket 1760]

EXHIBIT A

SECURITIES AND EXCHANGE COMMISSION

REPORT
ON THE
STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES

PURSUANT TO SECTION 211 OF THE
SECURITIES EXCHANGE ACT OF 1934

PART I
STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES

WASHINGTON, D. C.
May 10, 1937

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the real estate field,[480] in the municipal field,[481] and to a somewhat lesser extent in the foreign field.[482] In fact, it is true with respect to reorganizations of all types of companies or securities. There are cases, of course, where banker-management committees have sought to represent the security holders by other means, such as proxies. But such instances are the exception rather than the rule. As we show hereafter, the use of proxies has more commonly been a characteristic of independent committees.[483]

The deposit agreement has in many respects been the foundation of the control which committees dominated by the inside group have been able to obtain over the security holders. It is this agreement which has given the committees their unifying quality. As one witness before this Commission has stated,[484] these agreements "bind the depositor to go along with the Committee through thick and thin." [485]

The deposit agreement is a contract. One party to it is the committee; the other, the depositing security holders. The latter usually become parties by the act of depositing their bonds under the agreement through any one of the designated depositaries or sub-depositaries. But this contract is not one that has been negotiated by persons dealing at arm's length. Whether or not particular provisions should be included has been the decision of the committee, or more realistically, of its counsel; in this decision depositors have not participated.

In fact, it is seldom that the security holders have seen the completed agreement, either before or after depositing. It is a rare practice to send copies of the agreement with letters soliciting deposits. Occasionally, the circulars state that copies of the agreement will be mailed to applicants on request. In other cases the practice has been to state that copies of the agreement were on file with the depositary or sub-depositary where they might be examined. To

[480] Part III, Committees for the Holders of Real Estate Bonds (1936), at 55.

[481] Part IV, Committees for the Holders of Municipal and Quasi-Municipal Obligations (1936), at 61.

[482] Part V, Protective Committees and Agencies for Holders of Defaulted Foreign Governmental Bonds (1937), Sec. IV, A, 1. As we point out in that section of the report, a number of committees in the foreign bond field solicit neither deposits nor proxies but merely request the bondholders to "register" their names, addresses and bond holdings with the committee. The same practice has been followed by committees in domestic corporate reorganizations. Examples are the committee for the debentures of Cuban Cane Products Co., Inc., in the 1935 reorganization of that corporation (*op. cit. supra* note 56, at 765–770), and the committees respectively for the consolidated mortgage bonds and the preferred stock in the recent 77B reorganization of The Baldwin Locomotive Works. *Op. cit. supra* note 1, at 412–415, 434–436.

[483] See Sec. III. B, 2, *infra*.

[484] Arnold Bernhard, chairman of the Independent Consolidated Bondholders Committee in the recent reorganization of The Baldwin Locomotive Works. *Op. cit. supra* note 1, at 470.

[485] *Id.*, at 492.

SECTION V

CONCLUSIONS AND RECOMMENDATIONS

The foregoing survey supplies ample evidence of the necessity of refashioning the process of reorganization to the end that primary emphasis be given to the protection of the interests of investors. There are three needs which should be met in this connection.

First: It is essential that measures should be taken to place the control of reorganizations with *bona fide* security holders and their direct representatives. It is their investment which is at stake in any reorganization. The right to be heard in all matters arising in a reorganization proceeding, and the privilege of submitting plans and suggestions for plans should be freely accorded them. The activities of independent groups who represent *bona fide* interests should be encouraged. By the same token, control of reorganizations should be denied to persons whose sole claim is derived from a position in the management of the corporation or from banking associations with it. The history of reorganization demonstrates that the objectives of such persons are often incompatible with the interests of the real owners. Racketeering groups who neither own nor represent *bona fide* interests should be excluded from participation in the reorganization, so that the pressure of their nuisance value will be removed. Similarly, control of reorganizations should not be subject to seizure by financial interests primarily motivated by the desire to obtain control of the new or reorganized company. Likewise, measures should be adopted to deal with those who acquire securities or claims at default prices and either capitalize on their nuisance position or endeavor to effectuate settlements or plans favorable to those who bought at depressed prices but disadvantageous to those who purchased at pre-default prices.

Second: It is essential that renewed emphasis be given to the fact that representatives of security holders in reorganization occupy a fiduciary position. It is intolerable that they or their lawyers should possess dual or multiple interests. Likewise, neither committees nor other participants in reorganization should be permitted to be the sole arbiters of their fees and expenses.

Third: It is essential that the abuses which have characterized the strategy and techniques of reorganization should be eliminated. The use of deposit agreements as means of preserving or obtaining arbitrary and exclusive control over security holders should not be permitted. The virtual monopoly on lists of security holders

EXHIBIT B

THE HISTORY OF THE BANKRUPTCY LAWS IN THE UNITED STATES

CHARLES JORDAN TABB*

INTRODUCTION

"Bankruptcy," one observer noted, "is a gloomy and depressing subject."[1] It is a subject, however, that commands much attention in modern American life. No corner of our society seems immune from the ubiquitous reach of bankruptcy. It touches mass tort victims, mega corporations, mom-and-pop businesses, (supposedly) wealthy California counties, fraudulent schemers, polluters, unfortunate individuals—the list is endless. Since the enactment of the Bankruptcy Reform Act of 1978,[2] bankruptcy filings have multiplied dramatically.[3] In 1994, Congress passed the Bankruptcy Reform Act of 1994.[4] The 1994 law was significant in two ways. First, it amended the current bankruptcy law in dozens of places. Second, it provided for the creation of a National Bankruptcy Review Commission, to study the bankruptcy law over the next two years and recommend further changes.[5]

Mindful of Janus, the Roman god who represents beginnings,[6] and is depicted with two faces, one looking forward and one back, this Article seeks to inform the Commission's forward look with a brief look back at the history of the bankruptcy laws. Many radical proposals have been floated in recent years with regard to bankruptcy reform. Before those ideas are too readily embraced, the Commission and Congress should bear in mind the experience of almost five hundred years of Anglo-American bankruptcy experience.

Part I of the Article examines the history of the bankruptcy law before 1978, which as noted is the year our current bankruptcy law was enacted. That first

* Professor of Law, University of Illinois College of Law.

[1] CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 1 (1935).

[2] Pub. L. No. 95-598, 92 Stat. 2549.

[3] *See* Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, 67 AM. BANKR. L.J. 1, 2 (1993) (reporting a 185% increase in bankruptcy filing rate from 1980, shortly after 1978 Act took effect, to 1991). The data was obtained from the Administrative Office of the United States Courts. *Id.* at 1 n.1. Scholars disagree over whether the increased filing rate was due to the changes rendered by the 1978 Act. *Compare* William J. Boyes & Roger L. Faith, *Some Effects of the Bankruptcy Reform Act of 1978*, 29 J.L. & ECON. 139, 148 (1986) (concluding empirical data demonstrates 1978 Act to be determining, but not sole factor, in increased number of filings subsequent to effective date of Act) *and* Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 IND. L.J. 1, 45-49 (1987) (arguing that increased exemption levels effected by 1978 Act and increased unemployment rate primary contributors to increased filing rate for personal bankruptcies, with other economic and demographic changes contributing to lesser extent) *with* Bhandari & Weiss, *supra* at 12 (arguing increased number of filings due to decreased debt servicing capacity rather than 1978 Act).

[4] Pub. L. No. 103-394, 108 Stat. 4106.

[5] *Id.* §§ 601-610.

[6] The word January, the first month of the year, is derived from Janus.

section is broken down into several parts: the English antecedents of our United States law; the Constitution and United States bankruptcy laws before 1898; and the Bankruptcy Act of 1898[7] and the numerous amendments thereunder, notably the Chandler Act of 1938[8] and other Depression-era legislation. Part II examines the history of the passage of the Bankruptcy Reform Act of 1978. Part III then looks at bankruptcy legislation since the enactment of the 1978 Bankruptcy Code. Finally, in Part IV, the Article shifts from a chronological review to a thematic study, with a brief consideration of major constitutional issues that have arisen with regard to the bankruptcy laws.

I. BANKRUPTCY LAW PRIOR TO 1978

A. *English Antecedents*

1. Origins

The framers of the United States Constitution had the English bankruptcy system in mind when they included the power to enact "uniform laws on the subject of bankruptcies" in the Article I powers of the legislative branch.[9] The first United

[7] Ch. 541, 30 Stat. 544, *amended by* Act of June 22, 1938, (Chandler Act), ch. 575, 52 Stat. 840, *repealed by* Bankruptcy Reform Act of 1978, Pub, L. No. 95-598, 92 Stat. 2549.

[8] Act of June 22, 1938, ch. 575, 52 Stat. 840 (1938), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

[9] U.S. CONST. art. I, § 8, cl. 4.

For discussions of the history of the United States bankruptcy laws, see PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY 1607-1900 (1974); 1 COLLIER ON BANKRUPTCY ¶¶ 0.01-0.10 (James W. Moore et al. eds., 14th ed. 1974); FRANK O. LOVELAND, A TREATISE ON THE LAW AND PROCEEDINGS IN BANKRUPTCY §§ 1-8 (4th ed. 1912); F. REGIS NOEL, HISTORY OF THE BANKRUPTCY LAW (1919); 1 NORTON BANKRUPTCY LAW AND PRACTICE 2D, chs. 1, 2 (1994); 1 HAROLD REMINGTON, A TREATISE ON THE BANKRUPTCY LAWS OF THE UNITED STATES, §§ 1 *et seq.* (J. Henderson ed., 5th ed. 1950); WARREN, *supra* note 1; Vern Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226 (1976); Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325 (1991). A delightful companion piece to the Countryman article just cited, set (sort of) in rhyme, is Lawrence P. King, *An Ode to the Bankruptcy Lawr*, 81 COM. L.J. 234 (1976).

Good discussions of the development of the English system are found in Jay Cohen, *The History of Imprisonment for Debt and its Relation to the Development of Discharge in Bankruptcy*, 3 J. LEG. HIST. 153 (1982); Ian P. Duffy, *English Bankrupts, 1571-1861*, 24 AM. J. LEG. HIST. 283 (1980); Louis E. Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1 (1919). Blackstone's well-known work covered bankruptcy law. 2 WILLIAM BLACKSTONE, COMMENTARIES *471-88. So too did the work of the second Vinerian Professor of Law at Oxford, Sir Robert Chambers. 2 ROBERT CHAMBERS, A COURSE OF LECTURES ON THE ENGLISH LAW 199-203 (T. Curley ed. 1986). Professor Holdsworth addressed bankruptcy law in numerous places in his monumental work. 1 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 470-73 (1922); 8 *id.* at 229-45 (1926); 11 *id.* at 444-47 (1938); 12 *id.* at 387-88, 541-42 (1938); vol. 15 *id.* at 97-100 (1965). Other treatise writers have delved into the topic as well. *See, e.g.*, EDWARD JENKS, A SHORT HISTORY OF ENGLISH LAW 373-79 (1912); LOVELAND, *supra* § 3. Even Professor Samuel Williston, later known as one of the giants of American contract law, discussed bankruptcy history, from

States bankruptcy law, passed in 1800,[10] virtually copied the existing English law.[11] United States bankruptcy laws thus have their conceptual origins in English bankruptcy law prior to 1800. On both sides of the Atlantic, however, much has changed since then.

Early English law had a distinctly pro-creditor orientation, and was noteworthy for its harsh treatment of defaulting debtors.[12] Imprisonment for debt was the order of the day, from the time of the Statute of Merchants in 1285,[13] until Dickens' time in the mid-nineteenth century. The common law writs of *capias* authorized "body execution," *i.e.*, seizure of the body of the debtor, to be held until payment of the debt.

English law was not unique in its lack of solicitude for debtors. History's annals are replete with tales of draconian treatment of debtors. Punishments inflicted upon debtors included forfeiture of all property, relinquishment of the consortium of a spouse, imprisonment, and death. In Rome, creditors were apparently authorized to carve up the body of the debtor, although scholars debate the extent to which the letter of that law was actually enforced.

As commerce expanded, the need for a collective procedure to collect debts became evident. Individual collection remedies, such as the common law execution writs of *fieri facias*,[14] *elegit*,[15] and *levari facias*,[16] did not address the distinct problems presented by a debtor's multiple defaults. Creditors needed protection from defaulting debtors and from each other.

2. First Bankruptcy Laws: 1542 and 1570

In 1542, during the reign of Henry VIII, the first bankruptcy law was passed in England, entitled "An act against such persons as do make bankrupts."[17] This law viewed debtors as quasi-criminals (they were called "offenders"), and placed additional remedies in the hands of creditors. A more comprehensive bankruptcy

England to the 1898 Act. SAMUEL WILLISTON, SELECTED CASES AND STATUTES ON THE LAW OF BANKRUPTCY 1-6 (1902).

[10] Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).

[11] Much of the language of the Act of 1800 was copied verbatim from the statute of Geo. 2, ch. 30, § 10 (1732).

[12] E. BALDWIN, A TREATISE UPON THE LAW OF BANKRUPTCY AND BILLS OF SALE 1 (10th ed. 1910). Professors Baird and Jackson have described the early English laws as "viciously punitive from the perspective of the debtor." DOUGLAS BAIRD & THOMAS JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 27-28 (2d ed. 1990).

[13] 13 Edw. 1, stat. 3 (1285). *See also* Statute of Acton Burnell, 11 Edw. 1 (1283); Statute of Westminster II, 13 Edw. 1, stat. 1, chs. 11, 18, and 45 (1285).

[14] A writ of *fieri facias* authorized the judicial seizure and sale of a debtor's chattels. BLACK'S LAW DICTIONARY 627 (6th ed. 1990).

[15] A writ of *elegit* caused a defendant's goods and chattels to be appraised. *Id.* at 520.

[16] A writ of levari facias authorized judicial seizure and sale of the produce of a debtor's land. *Id.* at 906.

[17] 34 & 35 Hen. 8, ch. 4 (1542-43).

law was passed in 1570 during the reign of Queen Elizabeth I.[18] That law filled out the basic parameters of the English bankruptcy system, lacking only the discharge provisions added in the early eighteenth century, and remained in effect until the time of the American Revolution.

Only creditors could commence a bankruptcy proceeding.[19] This limitation, which persisted for three centuries,[20] was indicative of the law's overriding purpose, namely, to aid creditors in the collection of debts.[21] Relief was not *for* debtors, but *from* debtors. Debtors could be imprisoned for committing fraudulent acts of bankruptcy. A discharge of debts was unheard of, and indeed would have been at odds with the entire premise of the law. The ground for commencing a bankruptcy proceeding by the creditor was the commission of an "act of bankruptcy" by the debtor. An act of bankruptcy was a form of conduct that indicated that the debtor was attempting to prevent creditors from recovering on debts justly owed them.[22] For example, one act of bankruptcy was "keeping house," whereby the debtor would hole up in their home, immune from the reach of creditors. Another, added by the 1570 law, was making a fraudulent conveyance. The premise of debtor misconduct as the basis for involuntary bankruptcy, rather than financial status, remained in place until the Bankruptcy Reform Act of 1978 was enacted.

Upon the occurrence of an act of bankruptcy, creditors could petition the Lord Chancellor to convene a bankruptcy proceeding. The Chancellor would appoint bankruptcy "commissioners" to supervise the process. In broad form, the process mirrored a modern straight liquidation case. The bankrupt's assets were seized, appraised, and sold, and the proceeds distributed pro rata to creditors. The centrality of the principle of equal distribution in the bankruptcy case was emphasized by Lord Coke in 1584 in *The Case of Bankrupts*.[23] Since there was no discharge, creditors were free after bankruptcy to continue to pursue individual collection remedies against the debtor.

The commissioners had substantial powers, originally somewhat akin to a combination of today's trustee and bankruptcy judge. In addition to the normal trustee-like activities of collecting, liquidating, and distributing the debtor's property to creditors, commissioners could seize property, summon persons to appear before them, and commit people to prison. Although appointed by the Chancellor, commissioners initially were not subject to his jurisdiction. Recourse was to the common law courts. By the early eighteenth century, however, the Chancellor had

[18] 13 Eliz., ch. 7 (1570).

[19] *Id.* § 1.

[20] The first purely voluntary bankruptcy law was the United States Bankruptcy Act of 1841. Act of Aug. 9, 1841, ch. 9, 5 Stat. 440 (repealed 1843).

[21] NOEL, *supra* note 9 at 25-27; 1 REMINGTON, *supra* note 9, § 2.

[22] For discussions of acts of bankruptcy during this early period, see 2 BLACKSTONE, *supra* note 9 at *477-79; 2 CHAMBERS, *supra* note 9, at 200-01; 8 HOLDSWORTH, *supra* note 9, at 237-38.

[23] 76 Eng. Rep. 441, 473 (K.B. 1584) (stating debtor's preferential payment to single creditor was act opposite to bankruptcy statute's goal of equal distribution among creditors).

largely taken over direct jurisdiction of bankruptcy matters.[24] Later the trustee-like functions were delegated to "assignees," so named because the bankruptcy estate was assigned to them.

The bankruptcy law only applied to "traders," *i.e.*, to *merchant* debtors.[25] This limitation remained until the nineteenth century. Non-merchants were relegated to the separate "insolvency" laws, which sporadically allowed for release from prison in certain circumstances and occasional relief from debt.[26] For us today, it is somewhat difficult to fathom the purpose of the limitation of the bankruptcy laws to traders. But at that time, the bankruptcy laws were viewed as a necessary concomitant to the exigencies of commerce, but no more. Credit generally was viewed as immoral and almost fraudulent; as Blackstone noted:

> [T]he law holds it to be an unjustifiable practice, for any person but a trader to encumber himself with debts of any considerable value. If a gentleman, or one in a liberal profession, at the time of contracting his debts, has a sufficient fund to pay them, the delay of payment is a species of dishonesty, and a temporary injustice to his creditor: and if, at such time, he has no sufficient fund, the dishonesty and injustice is the greater.[27]

In commerce, however, credit became recognized as a necessary evil. And once credit is used, things can go wrong.[28] Defaults happen, and in the instance of multiple defaults, a collective remedy such as bankruptcy is needed. Bankruptcy was limited to traders because it was believed that they had "peculiar facilities for delaying and defrauding creditors."[29] Non-traders, in short, simply lacked the wherewithal to commit a wrong sufficient to need the bankruptcy remedy.

Over the next two centuries, Parliament periodically amended the bankruptcy

[24] 1 HOLDSWORTH, *supra* note 9, at 470.

[25] The first English bankruptcy statute, 34 & 35 Hen. 8, ch. 4 (1542-43), was not on its face restricted to traders, although in practice such a limitation may have existed. NOEL, *supra* note 9, at 25-26; Countryman, *supra* note 9 at 227. This limit first appeared expressly in the next English bankruptcy statute, 13 Eliz., ch. 7, § 1 (1570). BALDWIN, *supra* note 12, at 237-38.

[26] NOEL, *supra* note 9, at 140-41; WARREN, *supra* note 1, at 61.

[27] 2 BLACKSTONE, *supra* note 9, at *473-74.

[28] Blackstone continued:

> But in mercantile transactions the case is far otherwise. Trade cannot be carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable but necessary. And if by accidental calamities, . . . a merchant or trader becomes incapable of discharging his own debts, it is his misfortune and not his fault.

Id.

[29] Levinthal, *supra* note 9, at 16 n.59; *see also* NOEL, *supra* note 9 at 25-26 (same).

laws.[30] In many instances, especially in the seventeenth century, Parliament sought: (1) to enhance the power of the bankruptcy commissioners to reach more of the debtor's assets; and (2) to increase the penalties against noncompliant debtors. For example, the commissioner was empowered to break into the debtor's house or shop to seize the debtor's property, thus eliminating the effectiveness of "keeping house."[31] A debtor could be pilloried and have his ear cut off.[32] During this long period, bankruptcy remained an involuntary remedy to be used by creditors only against debtors who were merchant traders.

3. Discharge Introduced in 1705

The English bankruptcy law of this era became complete with the passage of the Statute of Anne in 1705.[33] That law introduced the discharge of debts for the benefit of a debtor who cooperated in the bankruptcy proceeding.[34] A cooperative debtor also was granted a monetary allowance out of the bankruptcy estate, the amount of which depended on the percentage dividend that was paid to creditors.[35] At the same time, however, the Statute of Anne raised the stakes even higher for uncooperative debtors by providing for the death penalty for fraudulent bankrupts.[36] While the quasi-criminal nature of bankruptcy remained, the Statute of Anne first established the roots of a more humanitarian legislative treatment of honest but unfortunate debtors.

It is unlikely, however, that humanitarian concerns for debtors primarily motivated the legislators of 1705.[37] Rather, the main focus was on assisting

[30] English laws dealing with the topic of bankruptcy after the passage of the 1570 Statute of Elizabeth up to the ratification of the United States Constitution were: 1 Jam., ch. 15 (1604); 21 Jam., ch. 19 (1623); 14 Car. 2, ch. 24 (1662); 4 Anne, ch. 17 (1705); 5 Anne, ch. 22 (1706); 7 Anne, ch. 25, § 3 (1708); 10 Anne, ch. 15 (1711); 3 Geo., ch. 12 (1716); 5 Geo., ch. 24 (1718); 6 Geo., ch. 22 (1719); 7 Geo., stat. 1, ch. 31 (1720); 11 Geo. 1, ch. 29 § 1, (1724); 13 Geo., ch. 27 § 2 (1726); 3 Geo. 2, ch. 29 (1730); 5 Geo. 2, ch. 30 (1732); 9 Geo. 2, ch. 18 § 2 (1736); 16 Geo. 2, ch. 27 (1743); 19 Geo. 2, ch. 32 (1746); 24 Geo. 2, ch. 57 §§ 9-10 (1751); 31 Geo. 2, ch. 35, § 2 (1758); 4 Geo. 3, ch. 33 (1764); 4 Geo. 3, ch. 36 (1764); 12 Geo. 3, ch. 47 (1772); 14 Geo. 3, ch. 77, §§ 58-59 (1774); 16 Geo. 3, ch. 38, §§ 68-69 (1776); 18 Geo. 3, ch. 52, §§ 75-76 (1778); 21 Geo. 3, ch. 29 (1781); 28 Geo. 3, ch. 24 (1788).

[31] 21 Jam. 1, ch. 19, § 8 (1623).

[32] 1 Jam. 1, ch. 15, § 9 (1604).

[33] 4 Anne, ch. 17 (1705).

[34] *Id.* § 7. This provided that "all and every person and persons so becoming bankrupt . . . who shall . . . in all things conform . . . shall be discharged from all debts by him, her, or thems due and owing at the time that he, she, or they did become bankrupt." *Id.*

[35] *Id.* §§ 7-8.

[36] *Id.* §§ 1, 18. The typically English terminology for the death penalty was that the criminal "shall suffer as a felon, without benefit of clergy." *Id.*

[37] *See* Tabb, *supra* note 9, at 333, 337-39.

creditors; the title and preamble to the act reflect as much.[38] Indeed, the fact that only creditors could file a bankruptcy petition negates any serious argument that the 1705 law was intended as a debtor relief measure. Furthermore, non-traders remained ineligible for bankruptcy. Nor was a discharge an automatic entitlement. The commissioners had to certify that the debtor had "conformed" to the requirements of the act, meaning in essence that the debtor cooperated in the bankruptcy proceeding. Interestingly, the same basic premise persists today in section 727 of the United States Bankruptcy Code,[39] which predicates denial of a debtor's discharge on various acts that hinder the trustee in the collection and distribution of the estate.

More evidence of the predominantly pro-creditor orientation of even the discharge provision is the fact that during the very next year, 1706, creditor consent was added as a prerequisite to the granting of a discharge.[40] In various forms creditors retained some voice in whether the debtor received a discharge until the late nineteenth century. In practice the creditor consent provision seriously undercut any beneficial effects of the discharge. It is reputed that a lack of creditor consent blocked Daniel Defoe from obtaining a discharge.[41]

While obviously quite dramatic, the importance of the death penalty for fraudulent bankrupts should not be overstated (except for the few unfortunate souls who suffered that punishment). Although some writers have highlighted the travails of some of those who were executed, in fact at most five executions occurred in the 115 years that the death penalty for fraudulent bankruptcy was on the books.[42] It also should be remembered that bankruptcy was no different from most property crimes of that era, which also provided for the possible imposition of the death penalty.

Although on the books the laws remained strongly pro-creditor, by the middle of the eighteenth century a somewhat more enlightened attitude toward bankruptcy had taken hold. Attitudes about credit and commerce were changing as the Industrial Revolution took hold.[43] Blackstone, writing in 1765, observed:

[38] The act was entitled: "An act to prevent frauds frequently committed by bankrupts." 4 Anne, ch. 17 (1705). The preamble refers to the need for "the prevention" of losses caused by persons who become bankrupt "not so much by reason of losses and unavoidable misfortunes, as to the intent to defraud and hinder their creditors." *Id.* § 1.

[39] 11 U.S.C. § 727(a) (1988).

[40] 5 Anne, ch. 22, § 2 (1706).

[41] Tabb, *supra* note 9, at 340.

[42] *See* LEON RADZINOWICZ, A HISTORY OF ENGLISH CRIMINAL LAW AND ITS ADMINISTRATION FROM 1750: THE MOVEMENT FOR REFORM, 1750-1833, at 520-21 n.94 (1948) (citing J. STEPHEN, A HISTORY OF THE CRIMINAL LAW OF ENGLAND 229, 230 (1883)).

[43] *See* Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 32 (1986). "[T]he idealogy of commerce that took hold in the eighteenth century . . . turned the morally questionable and perceptually elusive phenomena of trade and credit into necessities, and then into virtues." *Id.*

> A bankrupt . . . was formerly considered merely in the light of a criminal. . . . But at present the laws of bankruptcy are considered as laws calculated for the benefit of trade, and founded on the principles of humanity as well as justice: and to that end they confer some privileges, not only on the creditors, but also on the debtor or bankrupt himself.[44]

The 1732 Statute of George II[45] was the English bankruptcy law in effect at the time of the ratification of the United States Constitution and the passage of the first United States bankruptcy law in 1800. That English law served in many respects as the model for the American 1800 Act. The carrot and stick approach of prior laws was continued: a discharge and an allowance for the debtor who cooperated, and death for the fraudulent debtor.[46] Debtors also were permitted to retain a modest amount of property as exempt. The 1732 law gave direct jurisdiction to the Chancellor.

Bankruptcy throughout remained an involuntary proceeding available only against traders. A separate set of "insolvency" laws addressed the concerns of debtor relief more directly. These laws dealt with relief from debts and, more commonly, release from imprisonment.[47] In this early English period, such laws were only infrequently in force, and were often ineffective. Discharge from debts was rare. The Privy Council had intervened directly on behalf of debtors with greater effect, but the Council's jurisdiction was abolished in 1641.[48] Debtor relief laws became more common, and effective, in the nineteenth century.

B. The Constitution and American Bankruptcy Law Prior to 1898

1. The Constitution

In the colonial era, many of the states had comprehensive laws regulating debtor-creditor relations.[49] Some of these were bankruptcy laws, and others were insolvency laws. Imprisonment for debt was commonplace in the colonies and then in the states, until the mid-nineteenth century. Some states had more liberal debtor relief measures than did England. Since no provision was made for federal

[44] 2 BLACKSTONE, *supra* note 9, at *471.

[45] 5 Geo. 2, ch. 30 (1732).

[46] BAIRD & JACKSON, *supra* note 12, at 28-29.

[47] For a particularly enlightening discussion of the movements to assist honest debtors through the insolvency laws, see Cohen, *supra* note 9; Duffy, *supra* note 9. Professor Holdsworth deals with the subject in some detail. 8 HOLDSWORTH, *supra* note 9, at 233-36. The first relief measure was passed in 1670. 22 & 23 Car. 2, ch. 20 (1670). Subsequent measures included 30 Car. 2, ch. 4 (1678); 2 W. & M., sess. 2, ch. 15 (1690); 5 & 6 W. & M., ch. 8 (1694); 7 & 8 Will. 3, ch. 12 (1696); 8 & 9 Will. 3, ch. 18 (1697); 1 Anne, stat. 1, ch. 25 (1701); 2 & 3 Anne, ch. 16 (1703).

[48] Countryman, *supra* note 9, at 227.

[49] The standard reference on this subject is COLEMAN, *supra* note 9. *See also* NOEL, *supra* note 9, ch. 3.

bankruptcy legislation in the Articles of Confederation, state regulation continued.

The subject of bankruptcy received only passing attention from the framers at the Constitutional Convention of 1787.[50] A bankruptcy law was apparently believed to be a necessary subject of federal legislation because of the problems that varying and discriminatory state laws caused for nonresident creditors and interstate commerce in general.[51] James Madison described the perceived purpose of the Bankruptcy Clause:

> The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different states that the expediency of it seems not likely to be drawn into question.[52]

The Bankruptcy Clause, empowering Congress to "pass uniform laws on the subject of bankruptcies,"[53] was added late in the proceedings of the Constitutional Convention, after very little debate. Charles Pinckney of South Carolina is generally credited with first drafting the Bankruptcy Clause.[54] The only vote against was by Connecticut, with Roger Sherman expressing concern that bankruptcies could be punished by death, as was still the law in England.[55] An unsuccessful attempt was made to extend the prohibition against impairing the obligation of contracts from the states to the federal government, which if successful would have undermined the utility of any federal bankruptcy legislation.[56]

For over a century after the Constitution, however, the Bankruptcy Clause remained largely unexercised by Congress. During this period, many states stepped into the void and passed their own bankruptcy legislation. A federal bankruptcy law was in existence only from 1800 to 1803,[57] from 1841 to 1843,[58] and from 1867 to 1878.[59] Permanent federal bankruptcy legislation did not go into effect

[50] NOEL, *supra* note 9, ch. 4; WARREN, *supra* note 1, at 4-7; Frank R. Kennedy, *Bankruptcy and the Constitution*, 33 U. MICH. L. QUAD. 40 (Spring 1989); *cf.* James M. Olmstead, *Bankruptcy a Commercial Regulation*, 15 HARV. L. REV. 829, 831 (1902) (explaining entire historical origin of Bankruptcy Clause in one paragraph).

[51] Judith Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y.U. L. REV. 22, 36 (1983).

[52] THE FEDERALIST NO. 42 (James Madison).

[53] U.S. CONST. art. I, §, 8 cl. 4.

[54] Koffler, *supra* note 51, at 35 (citing THE RECORDS OF THE FEDERAL CONVENTION OF 1787 447 (M. Farrand ed. 1911)).

[55] Symposium, *Contemporary Issues in Bankruptcy and Corporate Law: "A View From the Bench"*, 61 U. CIN. L. REV. 511, 513-14 (noting this was not regarded as serious objection).

[56] Koffler, *supra* note 51 at 37.

[57] Bankruptcy Act of 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248.

[58] Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.

[59] Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99.

until 1898. Thus, states were free to act in bankruptcy matters for all but 16 of the first 109 years after the Constitution was ratified. Each instance of federal legislation followed a major financial disaster: the Act of 1800 followed the Panic of 1797; the Act of 1841 came after the Panic of 1837; the 1867 Act followed the Panic of 1857 and the Civil War; and finally the 1898 Act was passed in the wake of the Panic of 1893.

2. Bankruptcy Act of 1800

The first federal bankruptcy law was passed on April 4, 1800, eleven years after the ratification of the Constitution.[60] Pressure had been brought for a national bankruptcy law by a crash in 1792, but nothing was done until 1797, when another panic caused widespread ruin and the imprisonment of thousands of debtors. Robert Morris, one of the main financiers of the Revolution, spent three years in debtor's prison owing $12 million, and Supreme Court Justice James Wilson fled from Pennsylvania to avoid a like fate.[61] The 1800 Act finally was passed, carrying by but a single vote in the House. Federalist representatives of commercial interests pushed the bill, while the law was opposed by anti-Federalist southerners and agricultural sympathizers.[62] The 1800 Act was designed as a temporary measure, to sunset in five years, but actually was repealed after only three.[63]

The 1800 Act was very similar to the 1732 English act, and also had many of the features of the Pennsylvania statute. It was purely a creditors' remedy. Only creditors, upon proof of the debtor's commission of an act of bankruptcy,[64] could initiate a bankruptcy.[65] Debtors, however, apparently were often able to persuade a friendly creditor to bring a case. Only merchants were eligible debtors.[66] Fraudulent bankruptcy was a criminal offense, but was not punishable by death.[67] Commissioners appointed by the district court[68] supervised the process, and had powers very similar to the English commissioners. The commissioners would appoint assignees to effect the liquidation and distribution.[69]

A discharge of the debts[70] and the person[71] of a cooperative debtor was

[60] Ch. 19, 2 Stat. 19.

[61] WARREN, *supra* note 1, at 13.

[62] *Id.* at 19.

[63] Ch. 6, 2 Stat. 248 (1803) (repealing 1800 Act).

[64] Ch. 19, § 1, 2 Stat. at 18-21.

[65] *Id.* § 2, 2 Stat. at 21-22. A creditor owed at least $1000 by the debtor could initiate bankruptcy without the cooperation of other creditors of the bankrupt. *Id.*, 2 Stat. at 21.

[66] *Id.* § 1.

[67] *Id.* § 18, 2 Stat. at 26-27 (providing prison term of twelve months to ten years).

[68] *Id.* § 2, 2 Stat. at 21-22.

[69] *Id.* § 7, 2 Stat. at 23. The creditors of the debtor were permitted to elect an assignee to replace the one chosen appointed by the commissioners. *Id.* §§ 6-7, 2 Stat. at 23.

[70] *Id.* § 34, 2 Stat. at 30-31.

allowed. Before a discharge could be granted, the bankruptcy commissioners had to certify to the federal district judge that the debtor had cooperated, and two-thirds of the creditors, by number *and* by value of claims, had to consent to the discharge.[72] The debtor received a graduated allowance out of the estate, depending on the size of the dividend to creditors.[73] Modest exemptions were also permitted.[74] The 1800 Act did provide a discharge for some of the prominent financiers, including Robert Morris, who had been ruined in 1797.

By 1803, the sentiment for repeal of the 1800 Act was overwhelming. Some of the objections ring familiar. Small dividends were paid, and many of the discharged debtors were high-rolling speculators who went through bankruptcy and then started their operations anew. In addition, travel to the distant federal courts was difficult. Finally, agricultural interests were outraged at the perceived favoritism of mercantile groups.[75]

3. State Law in Nineteenth Century

The states picked up part of the slack and continued to regulate relations between debtors and creditors, bankruptcy, and insolvency during the lengthy era of federal inaction after the 1803 repeal. In some important respects state relief was limited. In 1819, the Supreme Court, in *Sturges v. Crowninshield*,[76] held that states could not constitutionally discharge preexisting debts.[77] In 1827, the Court, in *Ogden v. Saunders*[78] held that states could not discharge the debts due a citizen of another state.[79] *Ogden* did hold, however, that states could discharge future debts against citizens of the same state.[80] The *Sturges* decision in particular caused considerable consternation, because the period around 1819-1820 was one of extreme economic depression. During this depression there was no federal bankruptcy law by which debtors could be relieved, and because of *Sturges*, state relief was not possible as to preexisting debts.

[71] *Id.* § 38, 2 Stat. at 32 (providing district court judge *may* order incarcerated debtor released upon proof, in form of certificate, that all debtor's nonexempt assets were turned over).

[72] *Id.* § 36, 2 Stat. at 31. Only creditors owed at least fifty dollars by the debtor were entitled to vote on whether the debtor should receive a discharge. *Id.*

[73] *Id.* § 34, 2 Stat. at 30-31. For example, if the amount distributed to creditors gave them a 50% return on their claims, the debtor received 5% of the proceeds collected for distribution, up to a maximum of $500. *Id.* If the return to creditors was 75% or more, the debtor received 10% of the proceeds collected for distribution, up to a maximum of $800. *Id.*

[74] *Id.* § 5, 2 Stat. at 23 (exempting necessary wearing apparel and bedding of debtor and family); *id.* § 18, 2 Stat. at 26-27 (same).

[75] WARREN, *supra* note 1, at 19-20.

[76] 17 U.S. (4 Wheat.) 122 (1819).

[77] *Id.* at 208.

[78] 25 U.S. (12 Wheat.) 213 (1827).

[79] *Id.* at 368-69.

[80] *Id.*

In the meantime, the lengthy era of widespread use of imprisonment for debt was coming to an end. The practice was abolished at the federal level in 1833, and many states followed suit in the 1830s and 1840s. In England, general abolition of the practice did not come until 1869. Today only vestiges of "body execution" remain, usually in cases where the debtor is perceived to be morally culpable, such as a debt incurred through fraud, or for failure to make alimony[81] or child support payments.[82]

Even though debtors eventually no longer went to prison, they lacked any means to discharge preexisting debts during the first four decades of the nineteenth century after 1803. At times, especially in the 1830s, states did give partial relief through the enactment of stay laws or moratoria on debt collection. These laws presaged the stay laws to follow a century later.

4. Bankruptcy Act of 1841

Throughout the 1820s attempts were made to pass a bill permitting voluntary bankruptcy for the direct relief of debtors, merchant and non-merchant alike.[83] Yet throughout that period all such efforts were rebuffed by an alliance of southerners, who opposed any federal bankruptcy bill, and others who believed that voluntary bankruptcy was unconstitutional.[84] John Calhoun, for example, heatedly fought off federal intervention. Daniel Webster, conversely, was a leading advocate of a national bankruptcy law, and often fronted for Joseph Story, who wrote a number of bankruptcy bills.[85] Even those who favored a bankruptcy bill differed on whether involuntary bankruptcy should be permitted and whether corporations should be eligible debtors. Finally, the devastating Panic of 1837, coupled with the victory by the Whigs over the Democrats in the 1840 election, turned the tide. In a very close vote, the Bankruptcy Act of 1841[86] was passed. Again a major national financial crisis had forced Congress's hand. The legislative background to the passage of the 1841 Act is a fascinating story in itself, demonstrating how strange bedfellows and apt logrolling can sometimes work to accomplish seemingly impossible legislative goals.[87] The final compromise allowed both involuntary and voluntary bankruptcy, did not limit eligibility to merchant debtors, but did exclude

[81] *See, e.g.*, Bible v. Bible (*In re* Bible), 110 B.R. 1002, 1005 (S.D. Ga. 1990) (noting that any sanction against debtor, including imprisonment, would be to coerce debtor to make payments, not to punish debtor for failure to make payments).

[82] *See, e.g.*, Nathan v. Ehrhart (*In re* Ehrhart), 155 B.R. 458, 460 (E.D. Mich. 1993) (noting contempt proceedings against noncustodial parent could result in incarceration).

[83] For a detailed treatment of these attempts, see WARREN, *supra* note 1, part III.

[84] CARL B. SWISHER, 5 HISTORY OF THE SUPREME COURT OF THE UNITED STATES: THE TANEY PERIOD, 1836-1864, at 138 (1974).

[85] *Id.* at 133.

[86] Ch. 9, 5 Stat. 440, *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.

[87] WARREN, *supra* note 1, at 56-79. A thorough discussion of the background of the 1841 law is found in SWISHER, *supra* note 84, ch. 6.

corporations from eligibility.

While the 1800 Act was nothing more than a reprise of the old English bankruptcy model, the 1841 Act, because of its establishment of voluntary bankruptcy, was a watershed event in bankruptcy history.[88] For the first time, a financially troubled debtor could file for bankruptcy and receive a discharge. Nor was relief limited to merchant debtors; eligibility was extended to "all persons whatsoever . . . owing debts . . . ."[89] Considerable debate focused on whether such a law even fell within the "subject of bankruptcies" specified by the Constitution as one of Congress's enumerated powers.[90] Ultimately Congress's power was upheld, although never directly by the Supreme Court.[91]

The 1841 Act was a coordinated, simple, and short act of only seventeen sections. It was reputedly written in large part by Story[92] and modeled after the Massachusetts insolvency law of 1838.[93] The act provided that "[a]ll persons whatsoever . . . owing debts" who did petition "for the benefit of this act, and therein declare themselves to be unable to meet their debts . . . shall be deemed bankrupts within the purview of this act."[94] Involuntary bankruptcy was permitted against merchants.[95] Jurisdiction was vested in the district court, "in the nature of summary proceedings in equity."[96] Assignees effected the liquidation and distribution,[97] thus replacing the commissioners featured in previous bankruptcy laws.

The debtor was allowed basic exemptions,[98] but was not permitted to invoke state exemption laws. This restriction became a point of considerable contention during the consideration of later federal bankruptcy acts. The discharge extended to "every bankrupt, who shall bona fide surrender all his property [except that made exempt], and shall fully comply with . . . and conform to . . . this act."[99] Creditors still could block the discharge, but only through a written dissent filed by a majority in number and value of creditors.[100] Even then the debtor could

[88] *See* John C. McCoid, II, *The Origins of Voluntary Bankruptcy*, 5 BANKR. DEV. J. 361, 361-62 (1988) (noting that currently, far more voluntary filings occur than involuntary filings and stating "Congress seemingly broke new ground" by departing from English precedent and providing for voluntary bankruptcy).

[89] Ch. 9, § 1, 5 Stat. at 441.

[90] *See infra* part IV.A (discussing scope of Bankruptcy Clause).

[91] *See* SWISHER, *supra* note 84, at 141 (noting that while Supreme Court interpreted 1841 Act in numerous decisions, the Act's constitutionality was discussed only in lower court cases).

[92] *Id.* at 133.

[93] WARREN, *supra* note 1, at 70.

[94] Ch. 9, § 1, 5 Stat. at 441.

[95] *Id.*, 5 Stat. at 441-42. An involuntary petition could be initiated by any creditor owed more than $500 by the debtor, but only if the total amount of the debtor's indebtedness was at least $2000. *Id.*

[96] *Id.* § 6, 5 Stat. at 445.

[97] *Id.* § 3, 5 Stat. at 443. In this respect, the assignee's duties were similar to those of today's trustees.

[98] *Id.* (exempting "necessary household and kitchen furniture" and other items at discretion of assignee, up to a maximum of $300, as well as wearing apparel of debtor and debtor's family).

[99] *Id.* § 4, 5 Stat. at 443.

[100] *Id.*

demand a trial by jury or appeal to the circuit court on the issue of whether the debtor had conformed.[101] Unlike the 1800 Act, a number of grounds for denying discharge were included.[102] Like the 1800 Act, very few debts were excepted from the discharge. Special emphasis in the new law was placed on halting preferences. The giving of preferences was made a ground for denial of discharge.[103] A hearing on the discharge was held in the district court.[104] The old practice of commissioners certifying the discharge to the court was abandoned. The discharge was enforced as an affirmative defense raised by the debtor in subsequent collection efforts.[105] This practice did not change until 1970.

Even though in operation the law worked well, from the viewpoint of creditors, the 1841 Act, like its 1800 predecessor, was a dismal failure. Many thousands of debtors were discharged, minimal dividends were paid to creditors, and administrative fees were high.[106] Control was in the hands of the courts and the assignees, not creditors. With the immediate goal of relieving the plight of the mass of insolvent debtors accomplished, and with little continuing political capital to be gained from the law, the 1841 Act was repealed in early 1843 after little more than a year of operation.[107] Nonetheless, the 1841 Act established the fact of voluntary bankruptcy for all debtors. Voluntary proceedings have been a feature of all subsequent bankruptcy laws. Never again was the constitutionality of voluntary bankruptcy seriously questioned. The 1841 Act, with its marriage of the concepts of "bankruptcy" and "insolvency," could be called the first modern bankruptcy law.

5. Bankruptcy Act of 1867

The years after the 1843 repeal of the 1841 Act were finally times of prosperity for the United States, and consequently, no push was made for a federal bankruptcy law. To the Whigs, considering the political harm done to them by the 1841 Act, a bankruptcy law was anathema. Determined to stave off any more disastrous federal laws, states experimented even more with stay and insolvency laws. England, meanwhile, finally liberalized its bankruptcy law in favor of debtors by abolishing the requirement of creditor consent to the discharge in 1842,[108] allowing voluntary bankruptcy in 1844,[109] and extending eligibility to non-merchants in 1861.[110]

[101] *Id.* 5 Stat. at 444.

[102] *Id.* 5 Stat. at 443-44. Grounds for discharge included fraud, willful concealment of assets, preferential treatment of creditors, and willfully refusing to comply with court orders. *Id.*

[103] *Id.* § 2, 5 Stat. at 442; *id.* § 4, 5 Stat. at 443-44.

[104] *Id.* § 4, 5 Stat. at 443-44.

[105] *Id.* § 4, 5 Stat. at 444.

[106] WARREN, *supra* note 1, at 81-82.

[107] Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.

[108] Bankruptcy Law Amendment Act, 1842, 5 & 6 Vict., ch. 122, § 39.

[109] Law of Insolvency, Bankruptcy and Execution Amendment Act, 1844, 7 & 8 Vict., ch. 96, § 41.

[110] Bankruptcy and Insolvency Law Amendment Act, 1861, 24 & 25 Vict., ch. 134, §§ 69, 86.

After the Panic of 1857 and the financial cataclysm caused by the American Civil War, overwhelming pressure for another federal bankruptcy law led to the enactment of the Bankruptcy Act of 1867.[111] The inability of state laws to discharge preexisting debts[112] or debts of nonresident creditors[113] contributed to the need for a federal law. Northern creditors pushed hard for the bankruptcy bill, viewing such a law as essential to their ability to collect anything from southern debtors. The compromise bill that eventually passed was described as "unwieldy because of too great attention to details."[114]

The 1867 Act included both voluntary[115] and involuntary[116] bankruptcy. The constitutionality of voluntary bankruptcy was now taken for granted. Unlike the 1841 Act, corporations were permitted to take advantage of the act.[117] In keeping with the times, an oath of allegiance to the United States had to be taken by a petitioning bankrupt.[118] The 1841 Act's restriction of involuntary bankruptcy to merchants was dropped. Now "any person" was subject to the threat of involuntary bankruptcy. The list of "acts of bankruptcy" that would support an involuntary petition was greatly extended as well.[119]

The judicial machinery for dealing with bankruptcy cases was much closer to the system in place today. The district courts were given original jurisdiction as "courts of bankruptcy."[120] The district courts were directed, however, to appoint one or more "registers in bankruptcy, to assist the judge of the district court in the performance of his duties."[121] These registers thus were the predecessors of the twentieth century referee and bankruptcy judge. Assignees superintended the liquidation itself.

In time, this law too proved to be a failure and was eventually repealed in 1878.[122] As with the prior federal bankruptcy acts, criticisms levied by creditors included small dividends, high fees and expenses, and lengthy delays.[123] Northern creditors who had hoped to use the bankruptcy law to facilitate collection from southern debtors were disappointed. Indeed, most of the pressure for repeal came from creditors.

[111] Ch. 176, 14 Stat. 517, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99 (1878).

[112] *See supra* text accompanying notes 76-77 (discussing Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122 (1819)).

[113] *See supra* text accompanying notes 78-80 (discussing Ogden v. Saunders, 25 U.S. (12 Wheat.) 213 (1827)).

[114] NOEL, *supra* note 9, at 153.

[115] Ch. 176, § 11, 14 Stat. at 521-22.

[116] *Id.* § 39, 14 Stat. at 536-37.

[117] *Id.* §§ 36-37, 14 Stat. at 534-35.

[118] *Id.* § 11, 14 Stat. at 521.

[119] *Id.* § 39, 14 Stat. at 536.

[120] *Id.* § 1, 14 Stat. at 517.

[121] *Id.* § 3, 14 Stat. at 518.

[122] Act of June 7, 1878, ch. 160, 20 Stat. 99.

[123] NOEL, *supra* note 9, at 153-54; WARREN, *supra* note 1, at 127.

Nor did debtors do very well under the 1867 law. Due to the inclusion of numerous grounds for denying discharge,[124] only about one-third of the debtors received a discharge.[125] Procedurally, the discharge was obtained after application by the debtor, upon notice to creditors and a court hearing.[126] The discharge still had to be raised as an affirmative defense to subsequent collection efforts.[127]

The issues of creditor consent to the discharge and the need for a minimum dividend were very hotly debated, and produced an odd history. In the 1867 Act itself, creditors seemingly carried the day; unless a majority of creditors consented, the law required a fifty percent dividend as a prerequisite to the granting of a discharge.[128] However, the effective date of this provision was postponed for a year, which of course allowed debtors to file before that time and discharge their debts. Later amendments denuded the provision of what little vitality it still had.[129] Later laws completely abandoned the creditor consent restriction.

An important benefit of the 1867 Act to debtors, however, was that it allowed debtors to elect the benefit of generous state exemption laws as an alternative to the federal scheme.[130] The constitutionality of this provision was contested, on the ground that it violated the uniformity requirement of the Bankruptcy Clause. In 1902, while construing the 1898 Act, the Supreme Court finally held that the uniformity requirement was satisfied notwithstanding the incorporation of state exemptions.[131] The utilization of state exemption laws in federal bankruptcy cases has continued to the present.[132]

A major innovation, the composition agreement, was introduced into the

[124] Ch. 176, § 29, 14 Stat. at 531-32.

[125] Countryman, *supra* note 9, at 230 (citing ANNUAL REPORT OF THE ATTORNEY GENERAL OF THE UNITED STATES 34 (1879)).

[126] Ch. 176, § 29, 14 Stat. at 531-32.

[127] *Id.* § 34, 14 Stat. at 533.

[128] *Id.* § 33, 14 Stat. at 533.

[129] An 1870 amendment provided that the provision did not apply to any debts contracted before January 1, 1869. Act of July 14, 1870, ch. 262, § 1, 16 Stat. 276. In 1874, the law again was amended, so that the consent rule was eliminated entirely for involuntary cases, and reduced voluntary cases to either a 30% dividend or the consent of one-fourth in number and one-third in value of creditors. Act of June 22, 1874, ch. 390, § 9, 18 Stat. 180.

[130] Ch. 176, § 14, 14 Stat. at 523.

[131] Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188-90 (1902). For a more detailed discussion of the uniformity requirement, see *infra* part IV.B.

[132] An intriguing aspect of the state exemption question under the 1867 Act concerned fixing the date of the effective state exemption law that was to be used in federal bankruptcy cases. The 1867 Act allowed debtors to use state exemption laws as of 1864. Ch. 176, § 14, 14 Stat. at 523. This of course excluded the southern states. After the war the southern and many western states adopted new exemption laws that were very generous to debtors. In 1872 the incorporation date was changed to 1871. Act of June 8, 1872, ch. 339, 17 Stat. 334. This allowed debtors to take advantage of those post-war amendments. A serious question developed over the constitutionality of applying the 1872 amendment against preexisting debts. Congress passed a "clarifying" law in 1873 that stated that the prior year's amendment did apply to preexisting debts. Act of Mar. 3, 1873, ch. 235, 17 Stat. 577. However, some courts held that the clarifying law was unconstitutional.

bankruptcy law in 1874.[133] England had taken a similar step in 1869.[134] Congressional action had been hastened by the Panic of 1873. The composition agreement, the forerunner of modern reorganization provisions, allowed the debtor to propose payment of a certain percentage of his debts over time in full discharge of those debts, while also keeping his property. If the proposed composition was accepted by a majority in number and three-fourths in value of the creditors,[135] it was binding on all creditors named in the composition.[136] Dissenters were protected by a "best interests" test,[137] which required that creditors be paid as much as they would receive in a liquidation.[138]

The new composition law also was held to be within the "subject of bankruptcies,"[139] thus complying with the Bankruptcy Clause. Indeed, as a proceeding in bankruptcy, compositions were governed by other provisions of the bankruptcy law. For example, in 1881 the Supreme Court held that a debt based on fraud could not be discharged in a composition without creditor assent.[140] Of course, the composition law died with the rest of the bankruptcy law upon its repeal in 1878. By all accounts, the sentiment for repeal was overwhelming.

The twenty years following the repeal of the bankruptcy act in 1878 marked the final period during which there was no federal bankruptcy law. One last attempt was made to solve bankruptcy and insolvency problems at the state level, and again these efforts did not succeed. The Panics of 1884 and 1893 highlighted the inability of the states to deal with national financial problems.

6. Equity Receiverships

Federal courts entered the reorganization business with the advent of the equity receivership. Use of this device blossomed in the late nineteenth century as a means to keep the railroads running. At a time when railroads were of great economic importance, but in dire financial straits, there was no federal bankruptcy law or composition provision on the books to deal with their problems. Given the interstate nature of virtually all of the railroads, state remedies were entirely

[133] Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178, 182-84 (repealed 1878).

[134] The Bankruptcy Act, 1869, 32 & 33 Vict., ch. 71, § 126.

[135] Ch. 390, § 17, 18 Stat. at 183. Fully secured creditors were not entitled to vote on a proposed composition unless their security was relinquished. *Id.*

[136] *Id.*

[137] *Id.* (providing that court will approve composition if, inter alia, it is "satisfied that the . . . [composition] is for the best interest of all concerned . . . .").

[138] *See, e.g.*, *In re* Whipple, 29 F. Cas. 929, 930 (D. Mass. 1875) (No. 17, 513) (rejecting composition that proposed to distribute $11,000 among unsecured creditors where forced sale of debtor's net assets would have yielded $18,000). The court explained that compositions must be rejected "even if opposed by a small minority of creditors when it is made to appear that a settlement in bankruptcy would be more for their advantage." *Id.*

[139] *In re* Reiman, 20 F. Cas. 490, 497 (S.D.N.Y. 1874) (No. 11,673).

[140] Wilmot v. Mudge, 103 U.S. 217, 219 (1880).

inadequate. The creative solution achieved was to invoke the power of the federal courts to supervise the restructuring of troubled railroads.[141] Court-supervised receiverships remained the predominant means of corporate reorganization for about a half century, until federal reorganization laws were enacted during the Great Depression.

A receivership was commenced by a creditor's petition[142] to the federal court to exercise its equity jurisdiction to appoint a receiver to take control of the corporate debtor's assets.[143] The receiver would take title to the assets, thereby stopping collection efforts by individual creditors. The receiver, while looking for a buyer for the assets, would continue to run the railroad. Eventually the creditors would be paid out of the proceeds of a foreclosure sale of the assets. Since the business could be sold as a going concern, a higher price could be realized and jobs could be preserved.

In practice, the equity receivership came to be dominated by insiders, and was subject to much abuse. In form, the receivership resulted in the sale of the debtor's assets, with the proceeds distributed to creditors. In substance, however, the entire elaborate proceeding often resulted in old management retaining control of the enterprise, and dictating the terms of the sale. While a market sale was supposedly utilized, the only bidder in many cases was a "reorganization committee" or "protective committee" controlled by insiders.[144] The equity receivership had a number of other defects that limited its usefulness.[145]

A number of judicial doctrines were developed to curb insider abuses. The most important was the "absolute priority rule," which precluded shareholders from retaining their interests unless all creditors were paid.[146] Another was the use of an "upset price," to ensure that an adequate price was paid at the foreclosure sale. The "best interests" test used in compositions was not applied to equity receiver-

[141] The issue of whether federal courts possessed jurisdiction to take charge of a debtor corporation's assets in the absence of statutory authority is discussed in Garrard Glenn, *The Basis of the Federal Receivership*, 25 COLUM. L. REV. 434, 436-46 (1925).

[142] *But see* Wabash, St. L. & P. Ry. v. Central Trust Co., 22 F. 272, 273-75 (C.C.E.D. Mo. 1884) (describing federal court's appointment of receiver for financially troubled railroad upon request of *debtor* railroad); D.H. Chamberlain, *New-Fashioned Receiverships*, 10 HARV. L. REV. 139, 142-43 (1896) (criticizing appointment of receiver by federal court upon request of debtor in *Wabash* case, and noting that receivers have been appointed upon request of debtors in other cases).

[143] For a brief, informative discussion of the equity receivership, see *supra* BAIRD & JACKSON note 12, at 960-64.

[144] Jacob Trieber, *The Abuses of Receiverships*, 19 YALE L.J. 275, 276-77 (1910).

[145] For a discussion of some of these defects, see THOMAS K. FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION (1939); JOHN GERDES, CORPORATE REORGANIZATIONS (1936); Trieber, *supra* note 144, at 277-78 (noting tendency of receivers to hire numerous professionals at considerable expense to debtor business).

[146] *See* Northern Pacific Ry. Co. v. Boyd, 228 U.S. 482, 501-08 (1913) (where shareholders of railroad to be foreclosed pursuant to reorganization plan are reserved stock interest in reorganized company, transferees interests are subject to claims of nonconsenting unsecured creditors of foreclosed railroad not made parties to foreclosure).

ships.

Vestiges of many of the judicial doctrines developed in the receivership cases remain in present-day corporate reorganizations. Furthermore, many of the issues confronted in the receivership cases—notably, how to protect dissenting creditors and ensure that the sale price is fair—are still sources of considerable controversy in the current debate over the merits of Chapter 11.

C. Bankruptcy Act of 1898 and Amendments

1. Bankruptcy Act of 1898

The Bankruptcy Act of 1898[147] marked the beginning of the era of permanent federal bankruptcy legislation. The 1898 Act remained in effect for eighty years, until being replaced by the Bankruptcy Reform Act of 1978.[148] During the course of its existence, the 1898 Act was amended numerous times; most radically in 1938 by the Chandler Act.[149]

The road to the passage of the 1898 Act was anything but smooth.[150] Enormous hostility against a federal bankruptcy law of any sort had been generated by the 1867 law. However, the panics of 1884 and 1893 clearly exposed the need for some form of federal bankruptcy law. State laws were simply incapable of dealing with the financial problems created by these widespread calamities.

As had been true throughout much of the nineteenth century, southern and western congressmen, in particular, opposed a national bankruptcy bill. Their opposition focused on the use of involuntary bankruptcy as a means of collection by northern and eastern creditors. An alternative bill, introduced by Bailey of Texas, provided only for voluntary bankruptcy. In 1894, it actually was passed by the House. Ironically, in half a century the debate had come full circle; bankruptcy was now being urged *only* as a relief measure for debtors.

Another major point of contention was whether bankruptcy law should be instituted as a permanent regulation, or instead as a temporary expedient to resolve the immediate financial crisis only. The earlier laws had been of the latter variety, and substantial sentiment remained for that view, especially in the Senate. In the end, the forces seeking to establish bankruptcy law as a permanent part of the federal code prevailed.

A leading advocate and draftsman of a bankruptcy bill during the 1880s was Judge Lowell of Massachusetts. His bill proposed striking revisions to bankruptcy administration, anticipating some of the changes to come many decades later.

[147] Ch. 541, 30 Stat. 544 (repealed 1978).

[148] Pub. L. No. 95-598, 92 Stat. 2549.

[149] Ch. 575, 52 Stat. 840 (1938) (repealed 1978).

[150] For a discussion of the events that ultimately led to the enactment of the 1898 Act, see WARREN, *supra* note 1, at 128-41.

Although at one point the Lowell bill did pass the Senate, his efforts did not bear fruit.[151] More successful was the bill drafted by Jay Torrey, a St. Louis lawyer. The "Torrey Bill" originally was inspired by commercial creditor interests. First introduced in 1889, the Torrey Bill eventually became the Bankruptcy Act of 1898. Numerous amendments that were more favorable to debtors were added during the 1890s to secure its passage.

Notwithstanding its origins with the credit industry, the 1898 Act ushered in the modern era of liberal debtor treatment in United States bankruptcy laws.[152] While the earlier laws had allowed a debtor a discharge, many restrictions qualified that privilege. In particular, the 1867 Act, containing numerous grounds for denial of the discharge, had made discharge hard to obtain. All prior bankruptcy laws had conditioned discharge upon the consent (or at least failure to object) of a specified percentage of creditors and a minimum dividend payment to creditors. The 1898 Act abolished those restrictions, and also severely limited the number of grounds for denial of discharge.[153] Furthermore, very few debts were excepted from the discharge.[154] Indeed, some contemporary commentators suggested that Congress went too far in favoring debtors.[155] One commentator suggested that Congress had forgotten that bankruptcy was primarily a "commercial regulation," not a general debtor "jubilee" on the Biblical model.[156] Congress did not elect to follow the English system of conditional and suspended discharges.

The exemption question, so divisive under the 1867 Act, was resolved in favor of allowing the debtor to claim only state exemptions.[157] No separate federal exemptions were permitted. In 1902, the Supreme Court held that this delegation to the states did not run afoul of the Bankruptcy Clause mandate for uniform

[151] On this point, Professor King's *Ode* is entertaining:

Venture to the State of Mass./Judge named Lowell, quite upper class.
What a bill he put in draft./Many must have thought him daft. . . .
Many years ahead of time,/Lowell's bill met a hostile clime. . . .
For a more successful story/Let's turn to a Colonel Torrey.
While at Lowell so many laughed,/Torrey handed in his draft.

King, *supra* note 9, at 235 (emphasis omitted).

[152] Tabb, *supra* note 9, at 364.

[153] Ch. 541, § 14, 30 Stat. at 550 (discharge granted unless debtor commits crime or fraudulently conceals financial condition).

[154] *Id.* § 17, 30 Stat. at 550-51.

[155] *See, e.g.*, Walter D. Coles, *The Bankrupt Law of 1898—Its Merits and Defects*, 7 AMER. LAW. 283 (1899); John W. Hinsdale, *The New Bankruptcy Law*, 59 ALBANY L.J. 497, 501 (1898) (criticizing discharge without consent of creditors and lack of means for court to hear creditor objections to discharge). Another commentator observed that "the principal object of the law appears to be to make discharges easy, inexpensive and certain." Henry G. Newton, *The United States Bankruptcy Law of 1898*, 9 YALE L.J. 287, 290 (1900).

[156] Olmstead, *supra* note 50, at 843. The Bible has been acknowledged as a fundamental source of Western law concerning relationships between debtors and creditors. HOWARD L. OLECK, DEBTOR-CREDITOR LAW 3 (1953).

[157] Ch. 541, § 6, 30 Stat. at 548.

laws.[158]

Much of the 1898 Act was directed not at debtor relief, but rather at facilitating the equitable and efficient administration and distribution of the debtor's property to creditors. Considerable attention was devoted to the details of estate administration. Unlike the 1978 Act, which left most procedural questions to the Bankruptcy Rules, the 1898 Act addressed many procedural matters. The Supreme Court was given the power to prescribe rules, forms, and orders for procedure.[159] Creditors exercised significant control over the bankruptcy process through the power to elect the trustee[160] (no longer called an assignee) and creditors' committees.

The federal district courts sat as "courts of bankruptcy,"[161] but the bulk of the judicial and administrative work was done by "referees in bankruptcy" appointed by the district courts.[162] Referees were compensated on a fee basis[163] which did not change until 1946, when a salary based compensation scheme was substituted.[164] Referees became "bankruptcy judges" in 1973. The referees were the successor to the "registers" of the 1867 Act, and the "commissioners" of earlier times. Through references by district judges, referees exercised much of the jurisdiction given to the district court.[165] State courts retained concurrent jurisdiction of many bankruptcy-related issues.[166] Litigation over which court had jurisdiction was frequent. The distinction between "summary" jurisdiction and "plenary" jurisdiction[167] became a point of enormous contention. Indeed, one of the main thrusts of the reforms of the 1970s was to give the federal bankruptcy courts comprehensive, unified jurisdiction. Unfortunately, that effort failed.

Provisions were made in the 1898 Act for both voluntary[168] and involun-

[158] Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188-90 (1902).

[159] Ch. 541, § 30, 30 Stat. at 554.

[160] *Id.* § 44, 30 Stat at 557.

[161] *Id.* § 2, 30 Stat. at 545.

[162] *Id.* § 34, 30 Stat. at 555.

[163] *Id.* § 40, 30 Stat. at 556.

[164] Act of June 28, 1946, ch. 512, § 40, 60 Stat. 323, 326-28.

[165] Ch. 541, § 22, 30 Stat. at 552; *id.* § 38, 30 Stat. at 555.

[166] *Id.* § 23, 30 Stat. at 552-53.

[167] Generally, the term "summary jurisdiction" referred to proceedings over which federal courts of bankruptcy exercised exclusive jurisdiction; proceedings involving administration of the bankruptcy estate under the Bankruptcy Act, and those involving property in the bankruptcy court's possession. 2 COLLIER ON BANKRUPTCY, *supra* note 9, ¶ 23.02 [1]; OLECK, *supra* note 156, at 204-05. The term was derived from the common bankruptcy court practice of acting through summary proceedings—those in which formal pleading were not required. 2 COLLIER ON BANKRUPTCY, *supra* note 9, ¶ 23.02 [1], [2].

"Plenary jurisdiction" referred to authority to adjudicate disputes between the bankruptcy trustee or receiver and third parties concerning property not in the possession of the bankruptcy court. *Id.* [1]. If the adverse party did not consent to bankruptcy court jurisdiction, a case involving a plenary matter could only be brought in a court that would have jurisdiction of the matter in a non-bankruptcy context, *i.e.*, a state court or, if subject matter jurisdiction exists on an alternative basis, a federal district court not sitting in bankruptcy. Ch. 541, § 23b, 30 Stat. 552-53; 2 COLLIER ON BANKRUPTCY, *supra* note 9, ¶ 23.12; OLECK, *supra* note 156, at 204-05.

[168] Ch. 541 § 4, 30 Stat. at 547; *id.* § 18, 30 Stat. at 551.

tary[169] bankruptcy. Acts of bankruptcy were retained as the basis for submitting a debtor to involuntary bankruptcy,[170] but there were fewer acts than had been included under the 1867 law. Furthermore, a new definition of "insolvency" replaced the former equity test of whether the debtor was paying his debts as they came due with a balance sheet test.[171]

Eligibility for voluntary bankruptcy was extended to "any person who owes debts, except a corporation."[172] No requirement was imposed of either insolvency or a minimum amount of debts. Although corporations were excluded from voluntary bankruptcy, certain types of business corporations were subject to involuntary bankruptcy.[173] Provisions were made for partnership bankruptcy.[174]

The 1898 Act gave the trustee important powers to avoid preferential[175] and fraudulent transfers[176] and to recapture their value for the bankruptcy estate. In addition, such transfers constituted an act of bankruptcy that could subject the debtor to involuntary bankruptcy.[177] The need to unwind preferential transfers was viewed as a primary justification for the passage of the national bankruptcy law.

Compositions in lieu of liquidation were authorized much along the lines of the 1874 law.[178] For the composition to be confirmed, a majority of creditors in both number and value had to accept the composition, and the court had to approve it as being in the "best interests" of creditors.[179] A debtor could not confirm a composition if the debtor had committed any acts that would be a bar to the discharge under section 14.[180] Upon confirmation, the consideration was distributed and the bankruptcy case was dismissed.[181]

2. Legislation Between 1898 and the Depression

The enactment of the Bankruptcy Act of 1898 did not end Congressional infatuation with the bankruptcy law. To the contrary, this century has witnessed an unending parade of bankruptcy legislation. During the period between the

[169] *Id.* § 3, 30 Stat. at 546-47.

[170] *Id.*

[171] *Id.* § 1, 30 Stat. at 544. The definition of insolvency was important because many of the acts of bankruptcy hinged on whether the debtor completed certain transfers of property while insolvent. *See id.* § 3, 30 Stat. at 546.

[172] *Id.* § 4a, 30 Stat. at 547.

[173] *Id.* § 4b.

[174] *Id.* § 5.

[175] *Id.* § 60, 30 Stat. at 562; *id.* § 67c, 30 Stat. 564.

[176] *Id.* § 67e, 30 Stat. at 564.

[177] *Id.* § 3, 30 Stat. at 546.

[178] *Id.* § 12, 30 Stat. at 549.

[179] *Id.* § 12b, d, 30 Stat. at 549-50.

[180] *Id.* § 12d, 30 Stat. at 550.

[181] *Id.* § 12e, 30 Stat. at 550.

passage of the 1898 Act and the onset of the Depression, Congress made a number of changes.[182] The most comprehensive of these amendatory acts was that of 1926.[183] While many in number, these amendments did not reflect any sea change in fundamental attitude. Periodic attempts were made to ameliorate the perceived extreme pro-debtor orientation of the 1898 Act. Several of the acts added grounds for denial of discharge[184] or added debts excepted from the discharge,[185] and the number of acts of bankruptcy was increased.[186] The penal provisions were strengthened considerably in 1926.[187] Corporations were made eligible for voluntary bankruptcy in 1910.[188] Preferences were another favorite subject of congressional tinkering.[189]

Not all congressmen were enamored of the permanent bankruptcy law. Concerted efforts were made to repeal the law in 1902, 1903, 1909, and 1910.[190] Those efforts failed. The main objections were raised by southern congressmen who believed that bankruptcy should only be used to relieve debtors, not as a collection law.

By the time of the Hoover administration,[191] the credit industry had come to question the wisdom of the still generous discharge provisions. In efforts similar to those launched by the credit industry in the 1960s, 1980s and 1990s, a serious attempt was made in the late 1920s and early 1930s to change the basic premise of the discharge. The credit industry wanted to impose a form of payment requirement upon those debtors with some ability to pay as a condition to receiving a discharge. The idea of a suspended or conditional discharge along the lines of the English system was suggested. However, the creditors' timing was bad. With the Depression deepening daily, their concerns over debtor abuse of the bankruptcy discharge were hard to sell to Congress. The creditors' attempts were rebuffed. With the coming of the New Deal and its militant pro-debtor attitude, the credit industry could do little in Congress but fight a rear-guard action, then take their fight to the Supreme Court.

[182] Act of Feb. 5, 1903, ch. 487, 32 Stat. 797; Act of June 15, 1906, ch. 3333, 34 Stat. 267; Act of June 25, ch. 412, 36 Stat. 838; Act of Jan. 28, 1915, ch. 22, § 4, 38 Stat. 803; Act of Sept. 6, 1916, ch. 448, § 3, 39 Stat. 726; Act of Mar. 2, 1917, ch. 153, 39 Stat. 999; Act of Jan. 7, 1922, ch. 22, 42 Stat. 354; Act of Feb. 13, 1925, ch. 229, 43 Stat. 936 ; Act of May 27, 1926, ch. 406, 44 Stat. 662.

[183] Act of May 27, 1926, ch. 406, 44 Stat. 662. For a detailed discussion of those amendments, see James A. McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 341 (1927).

[184] Act of Jan. 7, 1922, Ch. 22, 42 Stat. 354; Act of Mar. 2, 1917, ch. 153, 39 Stat. 999; Act of Feb. 5, 1903, ch. 487, § 5, 32 Stat. 797, 798.

[185] Ch. 406, § 6, 44 Stat. at 663-64; Act of June 25, 1910, ch. 412, § 6, 36 Stat. 838, 839-40.

[186] Ch. 406, § 3, 44 Stat. at 663.

[187] *Id.* § 11, 44 Stat. at 665-66.

[188] Ch. 412, § 3, 36 Stat. at 839 (1910). The act extended eligibility for voluntary bankruptcy to "[a]ny person except a municipal, railroad, insurance, or banking corporation. . . ." *Id.*

[189] Ch. 406, § 3, 44 Stat. at 662; ch. 412, § 11, 36 Stat. at 842; ch. 487, §§ 12-13, 32 Stat. at 799-800.

[190] *See* NOEL, *supra* note 9, at 161-62, 166-67; WARREN, *supra* note 1, at 143.

[191] Herbert Hoover served as President from 1929 to 1933.

3. Depression-Era Legislation: Congress Versus the Court and the Chandler Act

After the Depression came crashing down in 1929, Congress passed several pro-debtor amendments that facilitated rehabilitation through bankruptcy. Severe restraints were laid upon the ability of creditors to collect, even upon their collateral. The Supreme Court that infuriated President Roosevelt so much held some of these acts to be unconstitutional. Ultimately however, Congress was able to enact revised versions that passed constitutional muster. The pro-reorganization sentiment in Congress became cemented during these trying times. With the passage of these amendments, federal equity receiverships fell into disuse.

The legislative onslaught began in 1933 with a law that made compositions more readily and widely available,[192] authorized agricultural compositions,[193] and permitted railroads to reorganize.[194] Corporate reorganizations were sanctioned just a year later.[195] Also in 1934, Congress introduced a reorganization law for municipalities.[196] The Supreme Court overturned this law in 1936.[197] Congress passed yet another version in 1937,[198] which then was upheld by the Court.[199] The Frazier-Lemke Act was passed in 1934, giving farmers greater ability to keep their farms.[200] In 1935, the Supreme Court struck down this act on the ground that it violated the Fifth Amendment property rights of mortgagees.[201] In just a few weeks Congress responded by passing a revised amendment,[202] which then survived judicial review.[203] The railroad reorganization law was amended in 1935,[204] as was the corporate reorganization section.[205] In a crucial decision, the Supreme Court upheld the constitutionality of § 77, the railroad reorganization section.[206] Numerous other amendments were made to the

[192] Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467, 1467-70 (creating § 74 of Bankruptcy Act of 1898).

[193] *Id.*, 47 Stat. at 1470-74 (creating § 75 of 1898 Act).

[194] *Id.*, 47 Stat. at 1474-82 (creating § 77 of 1898 Act).

[195] Act of June 7, 1934, ch. 424, 48 Stat. 911, 912-25 (creating § 77B of 1898 Act). Good discussions of the corporate reorganization provisions are found in FINLETTER, *supra* note 145; GERDES, *supra* note 145; GEORGE E.Q. JOHNSON, BANKRUPTCY REORGANIZATION (1936).

[196] Act of May 24, 1934, ch. 345, 48 Stat. 798 (creating Chapter IX of 1898 Act).

[197] Ashton v. Cameron County Water Improvement Dist. No. 1, 298 U.S. 513, 527-532 (1936) (holding law permitting local governmental units to voluntarily attain bankruptcy relief unconstitutionally interferes with states sovereignty).

[198] Act of Aug. 16, 1937, ch. 657, 50 Stat. 653 (creating Chapter X of 1898 Act).

[199] United States v. Bekins, 304 U.S. 27, 51-54 (1938) (upholding provision allowing state taxing authorities to enter into compositions with creditors).

[200] Ch. 869, 48 Stat. 1289 (1934) (amending § 75 of 1898 Act).

[201] Louisville Joint Stock Bank v. Radford, 295 U.S. 555, 589-602 (1935).

[202] Act of Aug. 28, 1935 (Second Frazier-Lemke Act), ch. 792, 49 Stat. 942.

[203] Wright v. Vinton Branch, 300 U.S. 440, 470 (1937).

[204] Act of Aug. 27, 1935, ch. 774, 49 Stat. 911 (amending § 77 of 1898 Act).

[205] Act of Aug. 19, 1935, ch. 809, 49 Stat. 965 (amending § 77B of 1898 Act).

[206] Continental Illinois Nat'l Bank & Trust Co. v. Chicago, Rock I. & P. Ry., 294 U.S. 648, 667-685 (1935).

Bankruptcy Act in the mid-1930s.[207]

The fury of bankruptcy legislation in the 1930s came to a head in 1938 with the passage of the comprehensive Chandler Act.[208] The Chandler Act followed a lengthy period of careful study of the bankruptcy law, although not by a formal commission.[209] At the instance of President Hoover, Congress published the Donovan Report[210] in 1931, and the Thacher-Garrison Report in 1932.[211] The American Bar Association successfully opposed the enactment of the recommendations of the Thacher Report, which had been introduced as the Hastings-Michener bill.[212] However, some of the ideas in that bill found their way into the Chandler Act. The National Bankruptcy Conference, formed in 1932 to study bankruptcy reform, played an important role in the enactment of the Chandler Act. Other influential organizations included the National Association of Referees in Bankruptcy, the Commercial law League of America, and the National Association of Credit Men.[213]

Extensive hearings were held in 1937 and 1938 on Congressman Walter Chandler's bill,[214] which had been introduced in 1936. The bill finally was enacted in the summer of 1938, forty years after the 1898 Act had become law, and forty years before the 1978 Code was enacted.

The Chandler Act substantially revised virtually all of the provisions of the 1898 Act.[215] The substantive law and procedural workings of liquidation cases were thoroughly updated. A serious attempt was made to improve bankruptcy administration. Perhaps most significant, however, was its reworking of the

[207] Act of Feb. 11, 1932, ch. 38, 47 Stat. 47; Act of June 18, 1934, ch. 580, 48 Stat. 991; Act of May 15, 1935, ch. 114, 49 Stat. 246; Act of Aug. 20, 1935, ch. 577, 49 Stat. 664; Act of April 10, 1936, ch. 186, 49 Stat. 1198; Act of April 11, 1936, ch. 210, 49 Stat. 1203; Act of June 5, 1936, ch. 512, 49 Stat. 1475; Act of June 26, 1936, ch. 833, 49 Stat. 1969; Act of Aug. 12, 1937, ch. 589, 50 Stat. 622; Act of Aug. 25, 1937, ch. 777, 50 Stat. 810; Act of Mar. 4, 1938, ch. 41, 52 Stat. 84.

[208] Ch. 575, 52 Stat. 840 (1938) (repealed 1978).

[209] Much of the background to the Chandler Act can be found in Mitchell S. Dvoret, *Bankruptcy Under the Chandler Act: Background,* 27 GEO. L.J. 194 (1938).

[210] HOUSE JUDICIARY COMM., 71ST CONG., 3D SESS., DONOVAN REPORT (Comm. Print 1931). For a summary of the report, see Dvoret, *supra* note 209, at 197-99.

[211] S. DOC. NO. 65, 72d Cong., 1st Sess. (1932). For a summary of the Thacher Report, see Dvoret, *supra* note 209, at 199-200.

[212] S. 3866, 72d Cong., 1st sess. (1932).

[213] Dvoret, *supra* note 209, at 203.

[214] *Hearings Before Comm. on Judiciary of H. Rep. on H.R. 6439 and H.R. 8046,* 75th Cong., 1st Sess. (1937); *Hearings Before Subcomm. of Comm. on Judiciary of Senate on H.R. 8046,* 75th Cong., 2d Sess. (1937 and 1938). The first version of Chandler's bill, H.R. 12889, was followed by H.R. 6439 and H.R. 8046.

[215] Some of the contemporary commentary on the Chandler Act included: Jacob M. Lashly, *The Chandler Bill,* 23 VA. L. REV. 880 (1937); Dvoret, *supra* note 209; Mitchell S. Dvoret, *Bankruptcy Under the Chandler Act: Legislative History and Summary,* 27 GEO. L.J. 345 (1939); Mitchell S. Dvoret, *Bankruptcy Under the Chandler Act: Analysis,* 27 GEO. L.J. 599 (1939); W. Randolph Montgomery & Garrard Glenn, *The Chandler Act Again: Two Criticisms,* 25 VA. L. REV. 881 (1939). For a more complete listing, see 1 COLLIER ON BANKRUPTCY, *supra* note 9, ¶ 0.07 n.1.

recently enacted reorganization provisions into the form that prevailed for the next forty years: Chapter X governed corporate reorganizations; Chapter XI dealt with arrangements; Chapter XII applied to real property arrangements; and Chapter XIII provided for wage earners' plans.

Another important development at the time was the investigation of protective and reorganization committees by the Securities and Exchange Commission under the leadership of William Douglas. The end result was a monumental eight-part study, published between 1937 and 1940.[216] The essential conclusion of the report was that public investors needed protection from insiders in reorganization cases.

4. Legislation After 1938

Over the next forty years, Congress amended the bankruptcy laws dozens of times, but only as to specific and discrete issues.[217] A few of these amendments

[216] SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, pts. 1-8, (1937-1940).

[217] Act of July 28, 1939, ch. 393, 53 Stat. 1134; Act of Aug. 11, 1939, ch. 689, 53 Stat. 1406; Act of Mar. 4, 1940, ch. 41, 54 Stat. 44; Act of June 28, 1940, ch. 438, 54 Stat. 667; Act of July 1, 1940, ch. 500, 54 Stat. 709; Act of June 22, 1942, ch. 434, 56 Stat. 377; Act of Oct. 16, 1942, ch. 610, 56 Stat. 787; Act of Mar. 11, 1944, ch. 87, 58 Stat. 113; Act of June 3, 1946, ch. 280, 60 Stat. 230; Act of June 28, 1946, ch. 512, 60 Stat. 323; Act of July 1, 1946, ch. 532, 60 Stat. 409; Act of Apr. 2, 1948, ch. 225, 62 Stat. 198; Act of June 25, 1948, ch. 645, §§ 151-155, 62 Stat. 683, 689-90; Act of Mar. 18, 1950, ch. 70, 64 Stat. 24; Act of Sept. 19, 1950, ch. 954, 64 Stat. 866; Act of Dec. 20, 1950, ch. 1138, 64 Stat. 1113; Act of Dec. 29, 1950, ch. 1193, 64 Stat. 1134; Act of May 16, 1951, ch. 81, 65 Stat. 42; Act of May 16, 1951, ch. 82, 65 Stat. 42; Act of July 3, 1951, ch. 205, 65 Stat. 114 ; Act of Oct. 24, 1951, ch. 543, 65 Stat. 606; Act of July 7, 1952, ch. 579, 66 Stat. 420; Act of July 7, 1952, ch. 580, 66 Stat. 438; Act of Aug. 5, 1953, ch. 327, 67 Stat. 366; Act of May 10, 1956, ch. 257, 70 Stat. 151; Act of July 30, 1956, ch. 784, 70 Stat. 725; Act of Aug. 1, 1956, ch. 819, 70 Stat. 785; Act of Aug. 2, 1956, ch. 893, 70 Stat. 955; Act of Sept. 2, 1957, Pub. L. No. 85-275, 71 Stat. 599; Act of Sept. 4, 1957, Pub. L. No. 85-295, 71 Stat. 617; Act of July 11, 1958, Pub. L. No. 85-515, 72 Stat. 357; Act of Aug. 23, 1958, Pub. L. No. 85-732, 72 Stat. 820; Act of Aug. 28, 1958, Pub. L. No. 85-824, 72 Stat. 984; Act of May 13, 1959, Pub. L. No. 86-24, 73 Stat. 24; Act of June 23, 1959, Pub. L. No. 86-49, 73 Stat. 80; Act of June 23, 1959, Pub. L. No. 86-64, 73 Stat. 109; Act of July 28, 1959, Pub. L. No. 86-110, 73 Stat. 259; Act of Aug. 7, 1959, Pub. L. No. 86-144; 73 Stat. 296; Act of Sept. 21, 1959, Pub. L. No. 86-293, 73 Stat. 571; Act of June 11, 1960, Pub. L. No. 86-504, 74 Stat. 198; Act of June 12, 1960, Pub. L. No. 86-519, 74 Stat. 217; Act of July 12, 1960, Pub. L. No. 86-621, 74 Stat. 408; Act of July 12, 1960, Pub. L. No. 86-631, 74 Stat. 466; Act of July 14, 1960, Pub. L. No. 86-662, 74 Stat. 528; Act of Sept. 2, 1960, Pub. L. No. 86-701, 74 Stat. 753; Act of Sept. 19, 1962, Pub. L. No. 87-677, 76 Stat. 559; Act of Sept. 25, 1962, Pub. L. No. 87-681, 76 Stat. 570; Act of May 8, 1963, Pub. L. No. 88-16, 77 Stat. 14; Act of May 8, 1963, Pub. L. No. 88-17, 77 Stat. 14; Act of Nov. 13, 1963, Pub. L. No. 88-175, 77 Stat. 330; Act of Oct. 3, 1964, Pub. L. No. 88-623, 78 Stat. 1001; Act of Sept. 2, 1965, Pub. L. No. 89-166, 79 Stat. 646; Act of May 10, 1966, Pub. L. No. 89-414, 80 Stat. 135; Act of July 5, 1966, Pub. L. No. 89-495, 80 Stat. 268; Act of July 5, 1966, Pub. L. No. 89-496, 80 Stat. 270; Act of Nov. 28, 1967, Pub. L. No. 90-156, 81 Stat. 510; Act of Nov. 28, 1967, Pub. L. No. 90-157, 81 Stat. 511; Act of Nov. 28, 1967, Pub. L. No. 90-158, 81 Stat. 516; Act of Nov. 1967, Pub. L. No. 90-161, 81 Stat. 518; Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468; Act of Oct. 19, 1970, Pub. L. No. 91-467, 84 Stat. 990; Act of Dec. 27, 1973, Pub. L. No. 93-

were fairly significant. Specifically, a 1946 amendment changed the compensation of referees from a fee to a salary basis.[218] The amendments of 1952,[219] responded to a number of undesirable court decisions (including some from the Supreme Court),[220] made clear that the "fair and equitable" requirement for plan confirmation[221] did not apply in Chapters XI,[222] and otherwise cleared up some ambiguities in the 1938 law.[223] In 1966 Congress limited the priority and non-dischargeability of tax claims in bankruptcy cases.[224]

Bankruptcy procedure was governed in substantial part by many sections of the 1898 Act. Under the authority of section 30 of the 1898 Act, the Supreme Court periodically passed General Orders in Bankruptcy to further govern procedure. In 1960, an Advisory Committee on Bankruptcy Rules was established. In 1964, Congress authorized the promulgation of rules of bankruptcy procedure by the Supreme Court.[225] After years of effort by the Rules Committee, the bankruptcy rules took effect in 1973. Special rules for the various rehabilitation chapters came into being in the years following. The rules superseded inconsistent statutory provisions, which was quite important under the Act, given its detailed procedural provisions. Today the situation is reversed; rules cannot supersede a statute.[226]

200, 87 Stat. 838; Act of Feb. 27, 1976, Pub. L. No. 94-217, 90 Stat. 192; Act of Apr. 8, 1976, Pub. L. No. 94-260, 90 Stat. 315; Act of Sept. 22, 1978, Pub. L. No. 95-383, 92 Stat. 729.

[218] Act of June 28, 1946, ch. 512, § 6, 60 Stat. 323.

[219] Act of July 7, 1952, ch. 579, 66 Stat. 420.

[220] In Cline v. Kaplan, 323 U.S. 97 (1944), the Court held that a defendant could object to the bankruptcy court's summary jurisdiction at any time until the court rendered its decision, *i.e.*, that appearing, answering, and participating in the proceeding did not waive the jurisdictional objection. *Id.* at 100. The 1952 amendment to § 2a(7) reversed this result. Ch. 579, § 2(b), 66 Stat. at 420. In SEC v. United States Realty and Improvement Co., 310 U.S. 434 (1940), the Court held that an improperly filed Chapter XI case had to be dismissed. *Id.* at 456-57. An amendment to § 328 allowed the judge to permit a debtor to amend a pleading and seek relief instead under Chapter X without having the case dismissed. Ch. 579, § 30, 66 Stat. at 432. *See generally*, H.R. REP. NO. 2320, 82d Cong., 2d Sess. (1952), *reprinted in* 1952 U.S.C.C.A.N. 1960 (outlining legislative history of 1952 amendments).

[221] The central premise of the fair and equitable rule was that in order for the equity owners of a debtor business to retain any ownership interest pursuant to a reorganization plan, the plan must provide for payment in full of the claims of both secured and unsecured creditors. *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 115-19 (1939) (explaining rule). The rule was described as one of "absolute priority." *Id.* at 117. *See supra* note 146 and accompanying text (explaining operation of rule as applied to equity receiverships).

[222] Ch. 579, § 35, 66 Stat. at 433 (omitting fair and equitable rule from list of Chapter XI plan confirmation requirements).

[223] For discussions of the 1952 amendments, see Samuel C. Duberstein, *Highlights of Bankruptcy Amendments (1952)*, 58 COM. L.J. 42 (Feb. 1953); Charles E. Nadler, *The Bankruptcy Act Materially Overhauled*, 15 GA. B.J. 178 (1952).

[224] Act of July 5, 1966, Pub. L. No. 89-496, 80 Stat. 270 (1966).

[225] Act of Oct. 3, 1964, Pub. L. No. 88-623, 78 Stat. 1001, 1001 (1964) (codified at 28 U.S.C. § 2075, amended 1978, 1994). The amendment did check the rule making power of the Supreme Court by providing that bankruptcy rules were not permitted to "abridge, enlarge, or modify any substantive right." *Id.*

[226] 28 U.S.C. § 2075 (1988), *as amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 104(f), 108 Stat. 4106, 4110.

However, since the current Bankruptcy Code has very few procedural provisions, the rules still actually have a fairly unfettered field in which to operate.

In 1970, Congress enacted a new dischargeability law,[227] strongly enhancing the debtor's ability to protect and enforce the discharge. The law made the discharge self-executing rather than just an affirmative defense. It also gave the bankruptcy court exclusive jurisdiction over some common types of dischargeability litigation.[228] The principal features of that reform of the discharge provisions were continued in the 1978 Code.

5. The Commission

In 1970, Congress created the Commission on the Bankruptcy Laws of the United States to study and report on the existing law.[229] The Commission filed its two-part report in 1973.[230] Five years later, almost a decade of study and debate about bankruptcy reform culminated when the Bankruptcy Reform Act of 1978 replaced the 1898 Act with the Bankruptcy Code.[231]

II. THE BANKRUPTCY REFORM ACT OF 1978

The Bankruptcy Reform Act of 1978[232] was the first comprehensive reform of the federal bankruptcy law in the forty years since the passage of the Chandler Act and replaced the law that had been in effect since the end of the nineteenth century. The 1978 Act is unique in the history of the nation's bankruptcy legislation in that it was the first major enactment that was not enacted as a response to a severe economic depression. The Bankruptcy Code governs bankruptcy law in the United States today. As will be discussed in the following section, the Code has been the subject of a number of amendments in the years since 1978, most recently in 1994.

The reform process that led to the passage of the 1978 Act lasted for a decade.[233] The process began in 1968, when Senator Quentin Burdick chaired hearings before a subcommittee of the Senate Judiciary Committee to determine

[227] Act of Oct. 19, 1970, Pub. L. No. 91-467, 84 Stat. 990.

[228] *See* Vern C. Countryman, *The New Dischargeability Law*, 45 AM. BANKR. L.J. 1 (1971).

[229] Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468.

[230] *Report of the Commission on the Bankruptcy Laws of the United States*, pts. I and II, H.R. DOC. NO. 137, 93d Cong., 1st Sess. (1973).

[231] Pub. L. No. 95-598, 92 Stat. 2549 (1978).

[232] This law is variously referred to as "BRA," "the 1978 Act," "The Reform Act," or, most often, with reference to the primary law it created, the "Bankruptcy Code" or "Code" (except for aficionados of the Uniform Commercial Code or the Internal Revenue Code, who also jealously refer to their patron saint law as "the" "Code").

[233] For a good review of the legislative history of the Bankruptcy Reform Act, see Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941 (1979). Mr. Klee, along with Richard Levin, served on the congressional staff that drafted the Bankruptcy Code.

whether a bankruptcy review commission should be formed.[234] Congress created such a review commission in 1970, charged with the mission to "study, analyze, evaluate, and recommend changes to the [1898] Act . . . in order for such Act to reflect and adequately meet the demands of present technical, financial, and commercial activities."[235]

The Commission, under the able guidance of Professor Frank Kennedy as Executive Director, filed its two-part report in July 1973.[236] Part I contained a series of reports and recommendations. Part II consisted of a draft bankruptcy statute, which then was introduced as a bill in both the House and Senate.[237] The "Commission Bill" recommended many substantial changes from prior law, including expansion of the jurisdiction of bankruptcy judges, creation of a Bankruptcy Administration to handle all administrative matters, consolidation of all of the business reorganization chapters into a single chapter, and greater protection on a uniform basis of the rights of consumer debtors.

A competing bill was drafted by the National Conference of Bankruptcy Judges. The "Judges' Bill" was also introduced in both the House and Senate.[238] In 1975 and 1976, Representative Don Edwards presided over thirty-five days of hearings on the two bills.[239] Senator Burdick presided over twenty-one days of hearings in the Senate on the companion bills in 1975.[240] From 1973 to 1978, the bankruptcy reform bills underwent numerous metamorphoses, and were the subject of extensive commentary and debate.

Committee reports regarding the extant versions of the bill were published in 1977 by the House[241] and in 1978 by the Senate.[242] While these reports are of great assistance as legislative history in construing the Bankruptcy Code, in some

[234] *Id.* at 942 (citing *Hearings on S.J. Res. 100 Before the Subcomm. on Bankruptcy of the Senate Comm. on the Judiciary*, 90th Cong., 2d Sess. (1968)).

[235] Act of July 24, 1970, Pub. L. No. 91-354, § 1(b), 84 Stat. 468, 468 (1970).

[236] *Report of the Commission on the Bankruptcy Laws of the United States*, pts. I and II, H.R. DOC. NO. 137, 93d Cong., 1st Sess. (1973).

In 1971, while the Commission was engaged in its work, a useful study of bankruptcy was published by the Brookings Institution. DAVID T. STANLEY & MARJORIE GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM (1971).

[237] H.R. 10,792, 93d Cong., 1st Sess. (1973); S. 4026, 93d Cong., 1st Sess. (1973). The bills were reintroduced in the 94th Congress as H.R. 31 and S. 236.

[238] H.R. 32, 94th Cong., 1st Sess. (1975); S. 235, 94th Cong., 1st Sess. (1975).

[239] *Hearings on H.R. 31 & H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess. (1975-1976).

[240] *Hearings on S. 235 and 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess. (1975).

[241] H.R. REP. NO. 595, 95th Cong., 1st Sess. (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 (accompanying H.R. 8200, which was reported favorably by House Judiciary Committee in September 1977).

[242] S. REP. NO. 989, 95th Cong., 2d Sess. (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787 (accompanying S. 2266, which was reported favorably by Senate Judiciary Committee in July 1978). The Senate Finance Committee also published a report on S. 2266. S. REP. NO. 1106, 95th Cong., 2d Sess. (1978).

instances the reports refer to bill provisions which underwent further amendment before the final bill became law. No conference report on the 1978 Act was prepared. Instead, the floor leaders of the bill, Congressman Edwards and Senator DeConcini, issued a joint explanatory statement as to the compromise bill that became law.[243]

A decade of study and debate came to a conclusion when President Carter signed the Bankruptcy Reform Act of 1978 into law on November 6, 1978. The law took effect, for the most part, on October 1, 1979.[244] Some of the provisions, in particular those affecting the bankruptcy courts, were to be phased in over a five-year transition period.[245]

A major point of debate in the bankruptcy bill concerned the status of bankruptcy judges. One of the major weaknesses of the 1898 Act was the splintered jurisdictional scheme, in which bankruptcy referees (renamed judges in 1973) could only hear certain core matters. A key aspect of the 1978 Act's substantial enlargement of bankruptcy court jurisdiction was the enabling of bankruptcy judges to hear virtually any matter arising in, or related to the bankruptcy case. Everyone agreed that creating a unified jurisdictional system would be a substantial improvement.[246]

What was not agreed upon was the status of the judges who would exercise that enlarged jurisdiction.[247] The options were to (1) keep the bankruptcy judges as non-Article III adjuncts to the federal district court judges, or (2) make the bankruptcy judges Article III judges in their own right, with the constitutional guarantees of life tenure and protection against diminution in salary. The latter course would eliminate the constitutional concern over non-Article III bankruptcy judges exercising the judicial power of the United States in derogation of Article III, and would enhance the status of the bankruptcy bench. The House favored giving bankruptcy judges Article III status, while the Senate steadfastly opposed such a course.[248] Chief Justice Burger lobbied against the creation of Article III bankruptcy judges. In the end the Senate prevailed: bankruptcy judges were given jurisdiction over all matters arising in, under, or related to bankruptcy cases as adjuncts of the district court, without the protections of Article III. This choice proved improvident, however, for in 1982, the Supreme Court held in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*[249] that the 1978 Act

[243] 124 CONG. REC. 32,350-420 (1978); 124 CONG. REC. S17403-34 (daily ed. Oct. 6, 1978).

[244] Pub. L. No. 95-598, tit. IV, § 402(a), 92 Stat. 2549, 2682 (1978).

[245] *Id.* §§ 402(b), 404-407, 92 Stat. at 2682-86.

[246] S. REP. NO. 989, *supra* note 242, at 15-16, *reprinted in* 1978 U.S.C.C.A.N. at 5801-02.

[247] H.R. REP. NO. 595, *supra* note 241, app. II at 63-87, *reprinted in* 1978 U.S.C.C.A.N. at 6023-6049 (publishing differing scholarly opinions regarding the constitutionality of bankruptcy judges powers under 1978 Act).

[248] *Compare id.* at 7, *reprinted in* 1978 U.S.C.C.A.N. at 5968 (arguing bankruptcy judges should be granted full powers and protections of Article III) *with* S. REP. NO. 989, *supra* note 242 at 16, *reprinted in* 1978 U.S.C.C.A.N. at 5802 (arguing bankruptcy courts should be adjuncts of district courts).

[249] 458 U.S. 50 (1982).

unconstitutionally gave Article III powers to non-Article III judges.

A strong effort was made in the 1978 Act to improve the administration of bankruptcy cases. The Commission had recommended the use of a Bankruptcy Administrator. This suggestion was not adopted, although a pilot program utilizing "United States trustees" as administrative officers was implemented. In 1986 the United States Trustee system was established nationwide (except in Alabama and North Carolina). An attempt was made to relieve bankruptcy judges of administrative duties, thereby permitting them to focus more exclusively on their judicial role. For example, judges were no longer to preside at the first meeting of creditors.[250]

Another administrative matter concerned professional fees. Under the 1898 Act, the "economy" principle artificially capped the amount of fees that could be paid to lawyers and other professionals. The drafters of the 1978 Act rejected the economy principle, concluding that bankruptcy administration would be better served if the best professionals were willing to serve in bankruptcy cases.[251] Competitive fees were seen as necessary to that end.

Another notable feature of the 1978 law was the merger of the reorganization chapters into a single chapter. This marriage combined features of old Chapter X and Chapter XI. The new Chapter 11 left the debtor in possession, with a trustee to be appointed only for cause;[252] gave the debtor in possession a limited exclusive period to file a reorganization plan;[253] adopted a modified form of the absolute priority rule, to be applied only when a class dissents;[254] limited the involvement of the SEC in reorganization cases,[255] and otherwise attempted to streamline reorganization practice. The success of this reform is a matter of considerable debate.

The 1978 Act also sought to encourage greater use of Chapter 13, the mode of relief allowing for the readjustment of the debts of individuals with regular income (the old "wage-earner" chapter expanded). The hope was that creditors would be paid more in a Chapter 13 and that debtors would emerge with better credit. Congress rejected suggestions for a compulsory Chapter 13, however. Thus only voluntary Chapter 13 cases are allowed. Congress did offer a number of inducements to encourage debtors to select Chapter 13, such as the "super discharge" of some debts that would not be dischargeable in a straight liquidation

[250] 11 U.S.C. § 341(c) (1988) (prohibiting court from attending creditors' meetings).

[251] See H.R. REP. NO. 595, *supra* note 241, at 329-30, *reprinted in* 1978 U.S.C.C.A.N. 6286 (explaining that consistently low bankruptcy attorneys' fees will result in dearth of bankruptcy specialists with result that bankruptcy system will operate less smoothly); *see also* 11 U.S.C.A. § 330(a)(1)(e) (West Supp. 1995) (fees to be allowed attorneys in bankruptcy are to be based in part on "customary compensation charged by comparably skilled practitioners . . ." in non-bankruptcy cases).

[252] 11 U.S.C. § 1104(a) (1988).

[253] *Id.* § 1121(b) (providing for 120 day exclusivity period).

[254] *Id.* § 1129(b).

[255] For a discussion of how the Act altered the role of the SEC in the bankruptcy process see Allen F. Corotto & Irving H. Picard, *Business Reorganizations Under the Bankruptcy Reform Act of 1978—A New Approach to Investor Protections and the Role of the SEC*, 28 DEPAUL L. REV. 961 (1979).

case.[256] In the ensuing years, however, Congress has made Chapter 13 less favorable to debtors by weakening the discharge and requiring compliance with a "disposable income" test as a prerequisite to plan confirmation.[257] And yet, at the same time Congress has indirectly attempted to force some debtors out of Chapter 7 and into Chapter 13, primarily by authorizing bankruptcy courts to dismiss Chapter 7 cases where it is determined that granting Chapter 7 relief would be a "substantial abuse" of the liquidation process.[258]

The treatment of individual debtors otherwise represented a fairly even balance between the interests of the credit industry and debtors (although creditors might take issue with that assertion!). The basic format of the discharge established in the 1970 amendments was retained. Discharge was made readily available save but for a number of excepted debts.[259] Discharge was also still subject to grounds for complete denial.[260] In the years since 1978, many additional types of debts have been excepted from the discharge. The discharge was enforced by statutory injunction, with no need for the debtor to assert the discharge as an affirmative defense.[261] In addition, certain forms of discrimination on the basis of bankruptcy were outlawed.[262]

Other aspects of the bill favored creditors. While reaffirmation agreements were regulated more strictly than they had been under the 1898 Act,[263] the enacted law did not go as far to prevent uninformed or ill-advised decisions to reaffirm as reformers had suggested. Also, the discharge provisions were not as favorable to debtors as early drafts of the bill had provided.

The legislative history of the exemption provision under the 1978 law was especially bizarre. The old issue of state versus federal exemptions[264] was played out yet again. Until the last minute, the bill provided for debtors to have a choice of state or federal exemptions. However, a final change gave states the right to "opt out" of the federal exemptions for debtors residing in their state.[265] To date, three-fourths of the states have enacted legislation limiting resident debtors to the

[256] 11 U.S.C. § 1328(a) (1988 & Supp. V 1993), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 1328(a) (West Supp. 1995).

[257] 11 U.S.C. § 1325(b) (1988).

[258] *Id.* § 707(b).

[259] *Id.* § 523(a) (1988 & Supp. V 1993), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 523(a) (West Supp. 1995).

[260] 11 U.S.C. § 727(a) (1988).

[261] *Id.* § 524(a) *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 524(a) (West Supp. 1995).

[262] *Id.* § 525, *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 525 (West Supp. 1995).

[263] *Id.* § 524(c), (d), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 524(c), (d) (West Supp. 1995).

[264] *See supra* notes 130-31, 157-58 and accompanying text (discussing exemption provisions of 1867 and 1898 Acts).

[265] 11 U.S.C. § 522(b) *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 522(b) (West Supp. 1995).

bankruptcy exemptions provided under state law.

III. LEGISLATION SINCE 1978

The passage of the Bankruptcy Reform Act of 1978 did not put an end to congressional tinkering with bankruptcy legislation.[266] Several factors have spurred Congress into almost non-stop consideration of the federal bankruptcy laws since 1978. First, Congress has felt compelled to respond to court decisions handed down by both the Supreme Court and lower courts. Second, the credit industry, unhappy with increased bankruptcy filings and mounting bad debt losses, has steadily lobbied for amendments providing for harsher treatment of debtors. Third, the farm crisis of the early 1980s prompted a call for relief for family farmers. Fourth, the bankruptcy court has unexpectedly become the forum in which many complex social problems have been aired. Fifth, special interest groups have tried to persuade Congress to amend the Code in ways favoring their interests. Finally, the exponential growth in the number of bankruptcy cases since the enactment of

[266] Since the Bankruptcy Reform Act of 1978, the following laws relating to bankruptcy have been enacted: Act of Aug. 14, 1979, Pub. L. No. 96-56, 93 Stat. 387; Staggers Rail Act of 1980, Pub. L. No. 96-448, § 227, 94 Stat. 1895, 1931; Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389; Act of July 27, 1982, Pub. L. No. 97-222, 96 Stat. 235; Technical Corrections Act of 1982, Pub. L. No. 97-448, § 304, 96 Stat. 2365, 2398-99; Rail Safety and Service Improvement Act of 1982, Pub. L. No. 97-468, tit. II, 96 Stat. 2543, 2543-47; Act of Nov. 28, 1983, Pub. L. No. 98-166, 97 Stat. 1071; Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333; Act of Oct. 19, 1984, Pub. L. No. 98-531, 98 Stat. 2704; Act of Sept. 30, 1986, Pub. L. No. 99-429, 100 Stat. 985; Judicial Improvements Act of 1985, Pub. L. No. 99-336, § 7, 100 Stat. 633, 639; Act of Oct. 18, 1986, Pub. L. No. 99-500, tit. II, 100 Stat. 1783, 1783-45 to 1783-46; Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, § 501, 100 Stat. 1874, 1911-12; Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088; Act of Oct. 30, 1986, Pub. L. No. 99-591, tit. II, 100 Stat. 3341, 3341-45 to 3341-46; Act of Nov. 14, 1986, Pub. L. No. 99-651, § 375, 100 Stat. 3642, 3647; Act of Nov. 14, 1986, Pub. L. No. 99-656, § 2, 100 Stat. 3668, 3668-69; Act of May 15, 1987, Pub. L. No. 100-41, 101 Stat. 309; Act of Aug. 18, 1987, Pub. L. No. 100-99, 101 Stat. 716; Agricultural Reconciliation Act of 1987, Pub. L. No. 100-203, § 10103, 101 Stat. 1330, 1330-386; Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610; Act of Oct. 18, 1988, Pub. L. No. 100-506, 102 Stat. 2538; Act of Nov. 3, 1988, Pub. L. No. 100-587, 102 Stat. 2982; Act of Nov. 3, 1988, Pub. L. No. 100-597, 102 Stat. 3028; Retirement and Survivors' Annuities for Bankruptcy Judges and Magistrates Act of 1988, Pub. L. No. 100-659, 102 Stat. 3910; Judicial Improvements and Access to Justice Act, Pub. L. No. 100-702, § 1003, 102 Stat. 4642, 4665 (1988); Act of Nov. 21, 1989, Pub. L. No. 101-162, tit. IV, 103 Stat. 988, 1011; Act of June 25, 1990, Pub. L. No. 101-311, 104 Stat. 267; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 3007, 104 Stat. 1388, 1388-28; Act of Nov. 5, 1990, Pub. L. No. 101-509, § 110, 104 Stat. 1389, 1452; Criminal Victims Protection Act of 1990, Pub. L. No. 101-581, 104 Stat. 2865; Criminal Victims Protection Act of 1990, Pub. L. No. 101-647, tit. XXXI, 104 Stat. 4916; Judicial Improvements Act of 1990, Pub. L. No. 101-650, § 317, 104 Stat. 5089, 5115-16; Act of Oct. 28, 1991, Pub. L. No. 102-140, tit. III, 105 Stat. 782, 808; Bankruptcy Judgeship Act of 1992, Pub. L. No. 102-361, 106 Stat. 965; Rail Safety Enforcement and Review Act, Pub. L. No. 102-365, § 19, 106 Stat. 972, 982-85 (1992); Energy Policy Act of 1992, Pub. L. No. 102-486, § 3017, 106 Stat. 2776, 3130-31; Act of Aug. 6, 1993, Pub. L. No. 103-65, 107 Stat. 311; Act of Oct. 27, 1993, Pub. L. No. 103-121, tit. I, 107 Stat. 1153, 1157; Id. § 111, 107 Stat. at 1164-65; Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106.

the 1978 Act has impeded the administration of those cases and clogged the bankruptcy courts.

A. The 1984 Amendments: BAFJA

The Supreme Court's decision on June 28, 1982 in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*[267] forced Congress to restructure the bankruptcy court system. In *Marathon*, the Court held that the broad grant of jurisdiction to bankruptcy courts in the 1978 Act violated Article III of the Constitution by vesting non-Article III bankruptcy judges with too much of the "judicial power" of the United States.[268] The Court further held that the unconstitutional portion of the jurisdictional grant could not be severed from the constitutional portion, thus condemning the entire bankruptcy court system, and forcing Congress to reorganize the jurisdictional and court scheme.[269] The Court did avoid wholesale disaster by deciding that its holding of unconstitutionality should only apply prospectively, thus validating actions taken by bankruptcy courts under the Code to that date.[270] To give Congress time to fix the broken court system, the *Marathon* Court stayed its judgment until October 4, 1982,[271] and later extended the stay until December 24, 1982.[272]

Surprisingly, Congress did not act to amend the bankruptcy court system before the expiration of the *Marathon* stay on Christmas Eve 1982, instead delaying any response until July 1984. During the eighteen month interregnum in which no federal statute governed the operation of the bankruptcy courts, the Judicial Conference of the United States stepped into the breach by proposing a model "Emergency Rule." Adopted as a local rule by all United States District Courts, the Emergency Rule used a bifurcated jurisdictional scheme, with some core bankruptcy matters heard by bankruptcy judges on reference from the district courts, and the remaining matters heard in the district courts.[273] Although many doubts were raised as to the constitutionality of the Emergency Rule,[274] the circuit courts upheld the Rule and the Supreme Court refused to decide the Rule's validity. The Supreme Court's decision in February 1984 in *NLRB v. Bildisco & Bildisco*[275]- finally triggered congressional action. In *Bildisco*, the Court held that a Chapter

[267] 458 U.S. 50 (1982).

[268] *Id.* at 61, 76, 87.

[269] *Id.* at 88.

[270] *Id.*

[271] *Id.*

[272] Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 459 U.S. 813, 813 (1982).

[273] The Emergency Rule eventually transmitted by the Administrative Office of the United States Courts to the circuit courts of appeal, district courts, and bankruptcy courts as a model rule is reprinted in 11 U.S.C.A. FED. R. BANKR. P. app. at 377-80 (West 1984).

[274] *See, e.g.*, Vern Countryman, *Emergency Rule Compounds Emergency*, 57 AM. BANKR. L.J. 1, 6 (1983) (describing draft version of proposed rule as "both invalid and unworkable").

[275] 465 U.S. 513 (1984).

11 debtor in possession could reject its collective bargaining agreement in bankruptcy and that the debtor did not commit an unfair labor practice by unilaterally modifying that labor contract.[276] The resulting furor pushed Congress into speedy action, and the jurisdictional problem was corrected along with the labor problem. The consumer credit industry and other special interest groups took advantage of the congressional activity and seized the opportunity to obtain desired changes in the Bankruptcy Code.

The result was the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA).[277] Congressional consideration of the *Marathon* problem revived the long-running debate of the 1970s over whether the bankruptcy judges should have comprehensive jurisdiction, and if so, whether they should be made Article III judges. The *Marathon* decision prevented Congress from granting comprehensive jurisdiction to bankruptcy courts without conferring Article III status on bankruptcy judges. One or the other had to go. The House again favored Article III status and unified jurisdiction, and the Senate favored non-Article III status and bifurcated jurisdiction. The Senate position prevailed. The jurisdictional and court scheme established by Title I of BAFJA created the bankruptcy courts as units of the district court.[278] Bankruptcy courts hear cases and proceedings in bankruptcy only by reference from the district courts.[279] BAFJA made a distinction between "core" bankruptcy matters, in which the bankruptcy court can enter a final order, and "non-core" matters, which are reviewable de novo by the district court.[280]

Title II of BAFJA created additional judgeships.[281] Title III contained a series of amendments to the Bankruptcy Code itself.[282] In Subtitle J,[283] Congress responded to the *Bildisco* decision by enacting a new section to govern the rejection of collective bargaining agreements.[284] The consumer credit industry got many of the items on its wish list in Subtitle A, the "Consumer Credit Amendments."[285] These amendments, Congress's reaction to the hotly debated allegation that many consumer debtors were abusing the bankruptcy laws,[286] tightened the reins on

[276] *Id.* at 534.

[277] Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in scattered sections of 11 and 28 U.S.C.).

[278] 28 U.S.C. § 151 (1988).

[279] *Id.* §§ 157(a), 1334(a).

[280] *Id.* § 157(b), (c).

[281] Pub. L. No. 98-353, §§ 201-202, 98 Stat. at 346-51.

[282] *Id.* §§ 301-553, 98 Stat. at 352-92.

[283] *Id.* § 541, 98 Stat. at 390-91.

[284] 11 U.S.C. § 1113 (1988).

[285] Pub. L. No. 98-353, §§ 301-324, 98 Stat. at 352-58.

[286] Much of the fuel for the consumer credit industry's fire was provided by a study financed by the industry itself. CREDIT RESEARCH CENTER, KRANNERT GRADUATE SCHOOL OF MANAGEMENT, PURDUE UNIVERSITY, MONOGRAPHS NO. 23-24, CONSUMER BANKRUPTCY STUDY (1982) [hereinafter PURDUE STUDY]. Monograph no. 23 is reprinted in *Personal Bankruptcy: Oversight Hearings Before the Subcomm. on Monopolies and Commercial Law of the Comm. on the Judiciary*, 97th Cong., 1st and 2d Sess. at 868 (1982), *available in* WESTLAW, BANKR84-LH Library. The Purdue study concluded that at least a third of consumer debtors could repay a significant portion of their debts. The Purdue Study has been severely

consumer debtors.[287] Not fully satisfied with these changes, the consumer credit industry has continued to lobby vigorously for more amendments, but has not yet repeated the coup of 1984. Other special interest groups shared in the bounty of the 1984 amendments. For example, lessors of commercial real estate obtained substantial beneficial changes in Subtitle C, the Leasehold Management Amendments.[288]

B. The 1986 Amendments: Family Farmers and United States Trustees

The farm crisis motivated Congress to pass yet another major bankruptcy bill just over two years after BAFJA became law. In October 1986, the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 was enacted.[289] The 1986 legislation created Chapter 12, designed specifically for "family farmers." The avowed purpose of Chapter 12 was to make it easier for such farmers to keep their farms and pay their creditors over time. Chapter 12 was not enacted as permanent legislation, but was to sunset after seven years. The sunset period has since been extended until October 1998.[290] Chapter 12 is largely analogous to Chapter 13 as tailored to farm bankruptcies.

The 1986 bill also made the United States Trustee System permanent on a nationwide basis (except in Alabama and North Carolina).[291] The United States Trustee performs many of the administrative and supervisory tasks in a bankruptcy case,[292] enabling the bankruptcy judge to serve more exclusively in a judicial role than was the case under the 1898 Act. In 1993, Congress's commitment to the United States Trustee program was reaffirmed through a ninety-nine million dollar appropriation for it.[293]

C. Legislation Between 1986 and 1994

In July 1986, the LTV Corporation filed Chapter 11 and stopped paying for medical and life insurance benefits for retired employees. That fall Congress

criticized. *See* Teresa A. Sullivan et al., *Rejoinder: Limiting Access to Bankruptcy Discharge*, 1984 WIS. L. REV. 1087, 1088-89 (noting that calculations in Purdue Study for debtor's allowed expenses put debtor at federal poverty level); Teresa A. Sullivan et al., *Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors' Data*, 1983 WIS. L. REV. 1091.

[287] For a review of the 1984 consumer credit amendments, see Karen Gross, *Preserving a Fresh Start for the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59 (1986).

[288] Pub. L. No. 98-353, §§ 361-363, 98 Stat. at 361-64.

[289] Pub. L. No. 99-554, 100 Stat. 3088.

[290] Pub. L. No. 103-65, 107 Stat. 311 (1993).

[291] In the 1978 Act, Congress had instituted the system as a pilot program in a few judicial districts.

[292] *See* 28 U.S.C. § 586 (1988), *as amended by* Bankruptcy Act of 1994, Pub. L. No. 103-394, § 224, 108 Stat. 4106 (listing duties of United States Trustee).

[293] Act of Oct. 27, 1993, Pub. L. No. 103-121, 107 Stat. 1153, 1157.

responded with a joint resolution that required the continued payment of benefits.[294] In June 1988 permanent legislation to protect retirees' benefits was passed.[295] The 1988 legislation created a new Code section, governing the payment of insurance benefits to retired employees,[296] and added the requirement that a plan could be confirmed only if it provided for the continued payment of retiree benefits.[297]

Meanwhile, the Fourth Circuit had issued a controversial holding in 1985, allowing a debtor to reject a technology licensing agreement and thereby deprive the licensee of the right to use the licensed technology.[298] Congress effectively overruled this holding by adding a new section to the Code, which permits licensees to retain the use of intellectual property even after rejection of a licensing agreement.[299]

The year 1990 proved bountiful for specific bankruptcy legislation. Six separate public laws that affected bankruptcy in some manner were enacted. Part of this legislation[300] overruled the Supreme Court's decision earlier that same year in *Pennsylvania Department of Public Welfare v. Davenport*[301] that a debtor's criminal restitution obligation could be discharged in Chapter 13.[302] The savings and loan crisis was addressed by amendments designed to protect the rights of federal depository institutions.[303]

Special interest legislation continues. In 1992, a provision regarding airport leases, was enacted to protect the St. Louis airport in connection with the TWA bankruptcy case.[304] The oil and gas industry obtained the passage of an amendment affecting farmout agreements, excluding property covered by such an agreement from the bankruptcy estate.[305]

[294] Act of Oct. 30, 1986, Pub. L. No. 99-591, 100 Stat. 3341; Act of Nov. 14, 1986, Pub. L. No. 99-656, § 2, 100 Stat. 3668, 3668.

[295] Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in scattered sections of 11 U.S.C.).

[296] *Id.* § 2(a), 102 Stat. at 610-13 (creating 11 U.S.C. § 1114).

[297] *Id.* § 2(b), 102 Stat. at 613 (amending 11 U.S.C. § 1129(a)(13)).

[298] Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986).

[299] Act of Oct. 18, 1988, Pub. L. No. 100-506, 102 Stat. 2538 (1988) (creating 11 U.S.C. § 365(n)).

[300] Criminal Victims Protection Act of 1990, Pub. L. No. 101-581, § 3, 104 Stat. 2865, 2865 (amending 11 U.S.C. § 1328(a)); Crime Control Act of 1990, Pub. L. No. 101-647, § 3103, 104 Stat. 4789, 4916 (same).

[301] 495 U.S. 552 (1990).

[302] *Id.* at 563-64.

[303] Crime Control Act of 1990, Pub. L. No. 101-647, § 2522, 104 Stat. 4789, 4865-68 (inter alia, excepting from discharge certain debts incurred through fraudulent acts practiced upon federal depository institutions).

[304] Rail Safety Enforcement and Review Act, Pub. L. No. 102-365, § 19, 106 Stat. 972, 982-84 (1992).

[305] Energy Policy Act of 1992, Pub. L. No. 102-486, § 3017, 106 Stat. 2776, 3130-31.

D. The Bankruptcy Reform Act of 1994

In the fall of 1994 Congress passed a major bankruptcy bill; the Bankruptcy Reform Act of 1994.[306] It was significant on two counts. First, Congress created a second National Bankruptcy Review Commission,[307] just less than a quarter century after the first Commission was established in 1970. The 1994 Commission was charged with the duty of studying the Code and submitting a report in two years suggesting proposed reforms.[308] Congress made clear, however, that it "is generally satisfied with the basic framework" of the current Code, and that the Commission should therefore focus on "reviewing, improving, and updating the Code in ways which do not disturb the fundamental tenets and balance of current law."[309] The Senate had pushed for a review commission for several years, and in 1992 had unanimously passed a bill that would have created a commission.[310] The House had been more reticent about a commission, but eventually acquiesced in 1994.

The second significant aspect of the Bankruptcy Reform Act of 1994 was the unprecedented number of substantive amendments by Congress made to the Bankruptcy Code. This feature of the bill was somewhat paradoxical, given the concurrent creation of a review commission charged with the responsibility of studying the Code and suggesting amendments thereto. Nevertheless, the 1994 Act made literally scores of changes in the bankruptcy law. Congress took the opportunity to resolve numerous specific issues that had arisen under the Code, and to overrule many court decisions. One prominent example is the overruling of a Seventh Circuit decision which held non-insiders vulnerable to recovery of preferential payments received after the expiration of standard preference period when payments were received by such non-insiders for the benefit of insiders.[311] Special emphasis was also placed on means of improving bankruptcy administration.

The 1994 Act was also noteworthy for what it did not contain. Earlier reform bills in the 1990s had proposed the creation of a separate reorganization chapter (Chapter 10) for "small business" debtors.[312] Chapter 10 was scuttled in the final version of the bill that was passed,[313] with only a vestige remaining in the form of a handful of special Chapter 11 rules for small business debtors.[314] Likewise,

[306] Pub. L. No. 103-394, 108 Stat. 4106.

[307] *Id.* § 602, 108 Stat. at 4147.

[308] *Id.* § 603; *Id.* § 608, 108 Stat. at 4149.

[309] 140 CONG. REC. H10,764 (daily ed. Oct. 4, 1994) (Section-by-Section Description of Bankruptcy Reform Act of 1994).

[310] S. 1985, 102d Cong., 2d Sess., tit. 1 (1992).

[311] Pub. L. No. 103-394, § 202, 108 Stat. at 4121 (amending 11 U.S.C. § 550 to overrule Levit v. Ingersoll-Rand Fin. Corp. (*In re* V.N. DePrizio Constr. Co.), 874 F.2d 1186 (7th Cir. 1989)).

[312] S. 540, 103d Cong., 1st Sess., § 201 (1993); S. 1985, 102d Cong., 2d Sess., § 205 (1992); H.R. 6020, 102d Cong., 2d Sess., § 205 (1992).

[313] H.R. 5116, 103d Cong., 2d Sess. (1994).

[314] Pub. L. No. 103-394, § 217, 108 Stat. at 4127-28.

a controversial provision from the 1992 Senate bill that would have mandated the payment of retiree benefits[315] was dropped from the bill that eventually became law.

On several occasions since the passage of the 1978 Act Congress has authorized the creation of additional bankruptcy judgeships in response to the quantum increase in the number of bankruptcy filings under the Code. In late 1993, however, the number of filings began to decline slightly, and some of the authorized judgeships have been put on hold until it can be determined whether they will be necessary.

IV. CONSTITUTIONAL ISSUES

The Bankruptcy Clause of The United States Constitution[316] gives Congress the power to establish "uniform laws on the subject of bankruptcies." As noted earlier, the framers gave little attention to the subject of bankruptcy at the Constitutional Convention of 1787.[317] The need for a federal bankruptcy law was believed to stem from potential interstate commerce problems. Without a federal law, the ability of nonresident creditors to collect their debts might be impaired, thereby hindering interstate commerce to the detriment of the nation. Nonresident creditors might be discriminated against by local state laws, and also might have difficulty in reaching property of the debtor located in or removed to another state.[318] The idea of a bankruptcy law as a means of providing a fresh start for distressed debtors was foreign to the framers.

The Bankruptcy Clause has raised four main constitutional issues.[319] The first issue questions what comprises the "subject of bankruptcies." The second is determining whether a bankruptcy law is "uniform." The third major concern is establishing when a state law regulating relationships between debtors and creditors is preempted by Congress's exercise of its powers under the Bankruptcy Clause. Finally, courts have had to sort out the relationship between the Bankruptcy Clause and other constitutional provisions, such as the Fifth Amendment Takings Clause and the Seventh Amendment right to a jury trial.

A. *The "Subject of Bankruptcies"*

The constitutional framers probably well understood the scope of the "subject

[315] S. 1985, § 212, 102d Cong., 2d Sess. (1992).

[316] U.S. CONST. art. I, § 8, cl. 4.

[317] *See supra* notes 50-56 and accompanying text.

[318] THE FEDERALIST No. 42 (James Madison).

[319] A good short study of the topic of constitutional bankruptcy issues is found in Kennedy, *supra* note 50.

of bankruptcies." The model they had in mind was the one in existence in England,[320] where bankruptcy was a collective collection remedy that creditors could invoke involuntarily against a merchant trader who had committed an "act of bankruptcy." Debtors had no right to institute a voluntary bankruptcy case. By contrast, an "insolvency" law was one that a financially distressed debtor could invoke to obtain relief.[321]

As the forms of available bankruptcy relief evolved over time, questions were raised as to whether the newer types of relief fell within the constitutional grant of power over the subject of bankruptcies. The Supreme Court has regularly rejected these challenges, declining to limit the reach of the bankruptcy power to the conception of bankruptcy existing at the time of the Constitution. It has been suggested that the "emotional suggestiveness" of new bankruptcy legislation, which in most instances is a product of "commercial crisis," makes the expansion of the conception of bankruptcy "as a need of commercial life" almost inevitable.[322]

The first major expansion in the concept of a bankruptcy law came with the adoption of voluntary bankruptcy for nonmerchant debtors in the Bankruptcy Act of 1841.[323] The constitutionality of the law was challenged by John Calhoun and Thomas Benton, among others, and defended by Daniel Webster and Joseph Story. Story, the chief architect of the 1841 Act, had suggested that the "subject" of bankruptcies was quite broad:

> A bankrupt law . . . is a law for the benefit and relief of creditors and their debtors in cases in which the latter are unable or unwilling to pay their debts. And a law on the subject of bankruptcies in the sense of the Constitution is a law making provisions for cases of persons who fail to pay their debts.[324]

The Supreme Court never directly decided the constitutionality of voluntary bankruptcy, although Justice Catron sitting on circuit did uphold the constitutionality of the new law in 1843.[325] Justice Catron's broad definition of the scope of the Bankruptcy Clause has been quoted with approval by the Supreme Court in the twentieth century:

[320] *See* Garrard Glenn, *Essentials of Bankruptcy: Prevention of Fraud, and Control of the Debtor*, 23 VA. L. REV. 373, 376 (1937); Olmstead, *supra* note 50, at 833; Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1, 1 (1940).

[321] *See* Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 194 (1819) (discussing historical distinction between bankruptcy and insolvency laws). In *Sturges*, Justice Marshall did note, however, that the historical distinction between bankruptcy laws and insolvency laws did not necessarily define the limits of the constitutional grant. *Id.* at 194-97.

[322] Radin, *supra* note 320, at 2.

[323] Ch. 9, 5 Stat. 441 (1841) (repealed 1843).

[324] JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 543 [also cited as § 1113] (abridged ed. Boston 1833).

[325] *In re* Klein, appended in notes at 42 U.S. (1 How.) 277 (1843).

> I hold, it [the bankruptcy power] extends to all cases where the law causes to be distributed, the property of the debtor among his creditors: this is its least limit. Its greatest, is a discharge of the debtor from his contracts. And all intermediate legislation, affecting substance and form, but tending to further the great end of the subject—distribution and discharge—are in the competency and discretion of Congress.[326]

Thus, after the 1841 Act, the question of the constitutionality of voluntary bankruptcy for nonmerchants was settled in the affirmative.

The authorization for composition agreements, contained in the 1874 amendments to the 1867 Act,[327] represented the next significant expansion in the scope of the subject of bankruptcies. The composition agreement, if accepted by the requisite percentage of creditors, allowed the debtor to retain property and discharge debts by paying the amounts specified in the composition. The constitutionality of the new provision was upheld,[328] although never by the Supreme Court. In an 1881 case, the Supreme Court recognized that the composition provision was a proceeding "in bankruptcy," and thus had to be applied consistently with the other provisions of the bankruptcy law.[329]

The Depression of the 1930s produced a spate of bankruptcy legislation. Although the Supreme Court overturned two acts during this period on other grounds, the Court continued to reaffirm the expansive scope of the bankruptcy power.[330] In *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.*,[331] the Court upheld the provisions of section 77 of the 1898 Act, permitting railroad reorganizations, as within the scope of the Bankruptcy Clause.[332] In the 1970s the Court again held that a railroad reorgani-

[326] *Id.* at 281, *quoted in* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588 n.18 (1935).

[327] Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178, 182-84 (repealed 1878); *see supra* notes 133-40 and accompanying text (discussing composition provisions of 1867 Act).

[328] *In re* Reiman, 20 F. Cas. 490, 496 (S.D.N.Y. 1874) (No. 11,673) (stating subject of bankruptcy cannot properly be defined as "anything less than the subject of the relations between an insolvent or non-paying or fraudulent debtor, and his creditors, extending to his and their relief."). The Supreme Court has often quoted this statement with approval. *See* Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513-514 (1938); Continental Illinois Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co., 294 U.S. 648, 672-73 (1935).

[329] Wilmot v. Mudge, 103 U.S. 217 (1881) (holding debt based on fraud could not be discharged in composition when defrauded creditor did not assent).

[330] In the two cases in which the Court struck down bankruptcy legislation, it did not do so on the ground that the legislation exceeded the scope of the bankruptcy power, but rather that the exercise of the bankruptcy power had to yield to other constitutional demands. *See* Ashton v. Cameron County Water Improvement Dist., 298 U.S. 513, 531 (1936) (discussing state sovereignty); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589-93 (1935) (discussing Fifth Amendment).

[331] 294 U.S. 648 (1935).

[332] *Id.* at 675.

zation law fell within the subject of bankruptcies.[333] Today, virtually any law that readjusts the respective rights between creditors and a financially distressed debtor falls within the "subject of bankruptcies." Indeed, according to the Supreme Court, the bankruptcy power encompasses the "subject of the relations between an insolvent or nonpaying or fraudulent debtor and his creditors, extending to his and their relief."[334]

B. Uniformity

A second major constitutional bankruptcy issue is whether a given law is a "uniform" law within the meaning of the Bankruptcy Clause. "Uniformity" is problematic in the bankruptcy context because: (i) most laws governing the substance of relationships between debtor and creditors are *state* laws; (ii) these state laws are incorporated into and applied in the federal Bankruptcy Code; and (iii) these state laws are not necessarily uniform. Since debtors and creditors in similar factual situations will often receive different treatment in bankruptcy from state to state, one might conclude that constitutional uniformity is not achieved by the bankruptcy law. This type of uniformity (or lack thereof) has been described by the Supreme Court as "personal" uniformity.[335] For example, a debtor in California might be liable in bankruptcy on a claim for breach of a cohabitation agreement, while a Vermont debtor might not be liable on such a claim on identical facts. A debtor in Florida may be able to exempt a palatial homestead, while a Pennsylvania debtor may be entitled to almost no homestead exemption. Does this destroy bankruptcy uniformity?

Perhaps somewhat surprisingly, the short answer is no.[336] According to a landmark 1902 Supreme Court decision, *Hanover National Bank v. Moyses*,[337] all the Constitution requires is "geographical" uniformity, rather than personal uniformity.[338] In *Moyses*, the Court upheld the incorporation of state exemption laws in the 1898 Bankruptcy Act. Geographical uniformity in this context, the Court observed, was satisfied "when the trustee takes in each state whatever would

[333] Blanchette v. Connecticut General Ins. Corp. (Regional Rail Reorganization Act Cases), 419 U.S. 102 (1974).

[334] Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513-14 (1938) (citing *In re* Reiman, 20 F. Cas. 490 (No. 11,673) (S.D.N.Y. 1874)).

[335] Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902).

[336] *See* Judith S. Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y.U. L. REV. 22 (1983). The answer is surprising in part because "uniformity" is given a much narrower meaning when applied to other constitutional powers, such as naturalization and taxation. *Id.* at 38-40.

[337] 186 U.S. 181 (1902).

[338] *Id.* at 188. Although the Court later explained the difference between personal and geographic uniformity, *id.* at 190, it did not explain its choice of labels for the two different aspects of uniformity.

have been available to the creditor if the bankrupt law had not been passed."[339]

Thus, a bankruptcy law is "uniform" when (i) the substantive law applied in a bankruptcy case conforms to that applied outside of bankruptcy under state law; (ii) the same law is applied to all debtors within a state and to their creditors; and (iii) Congress uniformly delegates to the states the power to fix those laws. The fact that debtors and creditors in different states may receive different treatment does not render the law unconstitutional.

In 1918, the Court reaffirmed the *Moyses* principle in a case involving the use of state fraudulent conveyance laws in bankruptcy.[340] More recently, lower courts have followed *Moyses* in upholding the exemption provisions of the 1978 Bankruptcy Code against uniformity challenges.[341] The Supreme Court has not addressed the issue. The Court continues to affirm, however, that "[T]he uniformity requirement is not a straitjacket that forbids Congress to distinguish among classes of debtors, nor does it prohibit Congress from recognizing that state laws do not treat commercial transactions in a uniform manner."[342]

A uniformity issue is also presented when Congress passes a bankruptcy law that is not available to all debtors across the country. Private bankruptcy laws for particular debtors are not permitted. In recent years the Supreme Court has twice confronted this problem with regard to special railroad legislation. In *Blanchette v. Connecticut General Insurance Corp. (The Regional Rail Reorganization Act Cases)*,[343] the Court upheld the Regional Rail Reorganization Act even though the law was restricted in its application to the railroads of a single geographic region. The saving grace in the law stemmed from the reality that all of the railroads then operating under the bankruptcy laws were in that region; even if the statute had been drafted to be of general applicability, its operation and effect would have been unchanged.[344] According to the Court in *Railway Labor Executives' Association v. Gibbons*,[345] however, Congress did overreach its authority in passing a private bankruptcy law that affected only the employees of the Rock Island Railroad.[346]

C. Preemption

The third major concern raised by the Bankruptcy Clause is preemption. In the bankruptcy context, there are two basic types of preemption issues. The first issue is the more global question of whether a state insolvency law is a "bankruptcy" law

[339] *Id.* at 190. The Court went on to note: "The general operation of the law is uniform although it may result in certain particulars differently in different states." *Id.*

[340] Stellwagen v. Clum, 245 U.S. 605, 613 (1918).

[341] *See, e.g., In re* Sullivan, 680 F.2d 1131 (7th Cir.), *cert. denied*, 459 U.S. 992 (1982).

[342] Railway Labor Executives' Ass'n v. Gibbons, 455 U.S. 457, 469 (1982).

[343] 419 U.S. 102 (1974).

[344] *Id.* at 159-60.

[345] 455 U.S. 457 (1982).

[346] *Id.* at 470-71.

and thus generally preempted by Congress's exercise of its power under the Bankruptcy Clause. The second issue concerns whether a particular state statute conflicts with some specific aspect of the federal bankruptcy law.

For much of the nineteenth century, Congress did not exercise the bankruptcy power. Subject to the limitation that states may not impair the obligation of contracts,[347] states were free to fill this vacuum with bankruptcy and insolvency laws of their own. Many states did enact such bankruptcy laws. Since 1898, however, a federal bankruptcy law has occupied the field. In 1929 in *International Shoe Co. v. Pinkus*,[348] the Supreme Court struck down an Arkansas insolvency law that forced creditors to stipulate to the debtor's discharge in order to share in the distribution of the debtor's property. In sweeping language, the Court held that states were precluded from enacting competing bankruptcy legislation.[349] Although state laws governing assignments for the benefit of creditors are permitted, such laws may not provide for a discharge of debts because discharge is a feature of bankruptcy law.[350]

Preemption questions occasionally arise regarding whether specific state legislation might conflict with the federal scheme spelled out in the Bankruptcy Code. The form of analysis here is not peculiar to the bankruptcy field, but follows standard constitutional preemption doctrine. Under the Supremacy Clause, of course, federal law controls in the event of conflict. Nevertheless, resolution of the issue can be tricky in bankruptcy. One problem concerns the widespread use of state laws in bankruptcy cases. For example, Congress has authorized the states to pass exemption laws that will be available to bankruptcy debtors.[351] State exemption laws are therefore not preempted in their entirety. In some particulars, however, a state's exemption law may conflict with the federal scheme, and to that

[347] U.S. CONST. art. I, § 10, cl. 1.

[348] 278 U.S. 261 (1929).

[349] *Id.* at 265-66.

> The power of Congress to establish uniform laws on the subject of bankruptcies is paramount. . . . In respect of bankruptcies the intention of Congress is plain. The national purpose to establish uniformity necessarily excludes state regulation. It is apparent ... that intolerable inconsistencies and confusion would result if that [Arkansas] insolvency law be given effect while the national [Bankruptcy] Act is in force. Congress did not intend to give insolvent debtors seeking discharge, or their creditors seeking to collect claims, choice between the relief provided by the Bankruptcy Act and that specified in state insolvency laws. . . . It is clear that the provisions of the Arkansas law governing the distribution of property of insolvents for the payment of their debts and providing for their discharge . . . are within the field entered by Congress when it passed the Bankruptcy Act, and therefore such provisions must be held to have been superseded.

Id.

[350] *Id.* at 268.

[351] 11 U.S.C. § 522(b) (1988), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 522(b) (West Supp 1995).

extent may be preempted.[352]

Another problem arises in defining the scope of the federal interest and the extent of state interference in cases of indirect conflict. Perhaps the best-known example is the Supreme Court's decision in *Perez v. Campbell*,[353] holding that an Arizona driver's responsibility statute was invalid under the Supremacy Clause as conflicting with the federal fresh start policy manifested in the bankruptcy discharge.[354] The offending law required suspension of a debtor's driver's license as long as a judgment arising out of the operation of a motor vehicle remained unsatisfied, even if that debtor obtained a discharge of the debt in bankruptcy. Yet, cases after *Perez* have upheld other state driver's responsibility laws as applied against bankruptcy debtors when those laws interfered less directly with the federal scheme.[355] Drawing the line is not easy.

D. *Relationship of Bankruptcy Clause to Other Constitutional Provisions*

A final type of constitutional issue is whether Congress's exercise of its Bankruptcy Clause powers in a particular instance conflicts with other provisions of the Constitution. The Supreme Court has held that the reach of the Bankruptcy Clause is limited by other constitutional provisions, such as the Fifth Amendment, the Seventh Amendment, and Article III. In each instance, defining the appropriate constitutional accommodation has proved to be an elusive task.

The Fifth Amendment prohibitions against the taking of private property without just compensation and without due process of law limit the Bankruptcy Clause. In *Louisville Joint Stock Land Bank v. Radford*,[356] the Supreme Court struck down the Frazier-Lemke Act—a Depression era bankruptcy law designed to alleviate the plight of farmers—on the ground that it deprived mortgagees of their collateral without just compensation.[357] Yet, just two years later, the Court upheld a very slightly revised version of the invalidated law in *Wright v. Vinton Branch*.[358] The very next year the Court again read narrowly the Fifth Amendment limitation on the Bankruptcy Clause in *Wright v. Union Central Life Insurance Co.*[359] In 1982,

[352] For example, the Code permits the avoidance of certain liens that impair exemptions. States thus may not define exemptions so as to preclude lien avoidance. 11 U.S.C. § 522(f) (1988), *as amended by* Bankruptcy Reform Act of 1994, 11 U.S.C.A. § 522(f) (West Supp. 1995).

[353] 402 U.S. 637 (1971).

[354] *Id.* at 656.

[355] *E.g.*, Duffey v. Dollison, 734 F.2d 265, 273 (6th Cir. 1984) (upholding statute requiring drivers, who failed to satisfy judgements against them from operation of motor vehicle, to purchase insurance or post surety bond as a condition of restoration of driving privileges, even where judgement is stayed or judgement debt discharged in bankruptcy).

[356] 295 U.S. 555 (1935).

[357] *Id.* at 560-61.

[358] 300 U.S. 440, 457 (1937).

[359] 304 U.S. 502 (1938).

however, the Supreme Court in *United States v. Security Industrial Bank*[360] squelched any speculation that it had abandoned *Radford*, citing that decision with approval for the proposition that the Fifth Amendment limits the bankruptcy power.[361] To avoid a constitutional problem, the Court construed the lien avoidance provisions in section 522(f) of the Code as only applying prospectively.[362]

The Seventh Amendment preserves the right to a trial by jury in suits at common law as that right existed at the time the Constitution was ratified. In 1966, the Supreme Court in *Katchen v. Landy*,[363] cast doubt on whether Seventh Amendment guarantees apply in bankruptcy. In 1989, the Supreme Court removed the doubts when it held in *Granfinanciera, S. A. v. Nordberg*[364] that a trustee's suit to recover a fraudulent conveyance in bankruptcy was subject to the defendant's right to trial by jury.[365] The next year, the Court in *Langenkamp v. Culp*[366] concluded that both *Katchen* and *Granfinanciera* were still good law, holding that a creditor has a jury trial right when sued for a preference (under *Granfinanciera*), but that the creditor lost that right when it filed a claim against the estate (under *Katchen*).

The Court in *Granfinanciera* expressly left open the question whether a non-Article III bankruptcy judge could preside over a constitutionally mandated jury trial.[367] The concern is whether doing so constitutes an exercise of "the essential attributes of judicial power," which the Court in *Marathon Pipe Line* and in *Granfinanciera* had suggested could only be done by an Article III court in the federal system. Prior to 1994 most courts of appeals dodged the difficult constitutional question by ruling that bankruptcy courts did not have the statutory authority to preside over a jury trial.[368] Although the Court initially granted certiorari on the question in the case of *Ben Cooper, Inc. v. Insurance Co. of Pennsylvania, (In re Ben Cooper, Inc.)* out of the Second Circuit, it remanded on

[360] 459 U.S. 70 (1982).

[361] *Id.* at 75.

[362] *Id.* at 78-82. The Court's decision was criticized in James S. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983).

[363] 382 U.S. 323, 336-37 (1966) (creditor sued for recovery of preference did not have jury trial right when creditor filed claim against the estate). The Court explained that because the dispute over the creditor's claim could not be adjudicated without first determining whether a voidable preference existed, the preference issue would be adjudicated within a claims proceeding which is equitable in nature, and thus no right to a jury trial attached. *Id.*

[364] 492 U.S. 33 (1989).

[365] *Id.* at 61.

[366] 498 U.S. 42 (1990).

[367] 492 U.S. at 64.

[368] *E.g., In re* Grabill Corp., 967 F.2d 1152, 1158 (7th Cir. 1992).

an unrelated procedural issue and then refused to grant certiorari again.[369] In the Bankruptcy Reform Act of 1994, Congress has forced the courts to reach the constitutional question by conferring on bankruptcy judges express statutory authority to conduct jury trials.[370] However, the party consent provision in that law probably solves any constitutional infirmity.

Although all of the foregoing constitutional decisions have been significant, each pales next to the Supreme Court's 1982 decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*[371] that the bankruptcy jurisdictional and court system instituted in the 1978 Act unconstitutionally violated Article III. The Court concluded that bankruptcy judges, who did not enjoy the Article III guarantees of life tenure and protection against diminution in salary, could not exercise the judicial power of the United States to the extent authorized by the 1978 Act.[372] The Supreme Court has not passed on the constitutionality, under Article III, of the court system as revised by the 1984 amendments.

CONCLUSION

The Chinese have a saying, "May you live in interesting times." For those connected with bankruptcy law and practice, the concluding years of the second millennium promise to be interesting times. The Bankruptcy Review Commission is due to report its findings in 1997, which will surely prompt a further spate of legislative activity. Bankruptcy has become a central feature in our society, touching the lives of almost everyone. This Article has taken a look at the path we have traveled over the past 450 years. Perhaps some knowledge of where we have been will help us make an informed choice of which road to take in the years ahead.

[369] 896 F.2d 1394 (2d Cir.), *cert. granted*, 497 U.S. 1023, *vacated and remanded*, 498 U.S. 964 (1990), *decision on remand*, 924 F.2d 36 (2d Cir.), *cert. denied*, 500 U.S. 928 (1991). The Second Circuit was the only circuit court to hold that bankruptcy judges had the statutory and constitutional authority to conduct a jury trial.

[370] Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 112, 108 Stat. 4106 (1994).

[371] 458 U.S. 50 (1982).

[372] *Id.* at 87.

EXHIBIT C

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

In re:	§	
	§	
SCOTIA DEVELOPMENT LLC,	§	Case No. 07-20027-C-11
	§	Jointly Administered
Debtor.	§	(Chapter 11)

ORDER DENYING SCOTIA PACIFIC COMPANY LLC'S MOTION FOR AN ORDER COMPELLING THE AD HOC NOTEHOLDER GROUP TO FULLY COMPLY WITH BANKRUPTCY RULE 2019(A) BY FILING A COMPLETE AND PROPER VERIFIED STATEMENT DISCLOSING ITS MEMBERSHIP AND THEIR INTERESTS #492

CAME ON FOR HEARING on April 10, 2007, the Motion for an Order Compelling the Ad Hoc Noteholder Committee to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper Verified Statement Disclosing Its Membership and Their Interests (the “Motion”) (Doc. #492) filed by Scotia Pacific Company LLC ("Scopac"). The Court has considered the pleadings and arguments presented at the hearing, and the objections to the Motion, including (a) The Noteholder Group’s Objection to Scotia Pacific Company LLC’s Motion for an Order Compelling the Noteholders to Fully Comply with Bankruptcy Rule 2019(A) . . . (Doc. #599); (b) the Securities Industry and Financial Markets Association and Loan Syndications and Trading Association, as amici curiae, Motion for Leave of Court Pursuant to 11 U.S.C. Sec. 1109(b) OR, Alternatively, FED. R. BANKR. P. 2018(a) and 11 U.S.C Sec. 105(a), to Appear in Support of the Noteholder Group’s Objection . . . (Doc. #610); and (c) Scotia Pacific Company LLC’s Response to the Noteholder Group’s Objection to the Motion. . . (Doc. #604); and upon all of the proceedings had before the Court; and after due deliberation and sufficient cause appearing therefore, it is

ORDERED that the Motion is denied in its entirety; and it is further

ORDERED that the Court finds that the Noteholder Group is not a "committee" within the meaning of Bankruptcy Rule 2019; and it is further

ORDERED that the Noteholder Group is not subject to the disclosure requirements under Bankruptcy Rule 2019.

SIGNED APR 1 8 2007

RICHARD S. SCHMIDT
UNITED STATES BANKRUPTCY JUDGE

SUBMITTED BY:

Evan D. Flaschen (304232)
Gregory W. Nye (300188)
Kurt A. Mayr (425858)
BRACEWELL & GIULIANI LLP
One Goodwin Square
225 Asylum Street, 26th Floor
Hartford, CT 06103
Telephone: (860) 947-9000
Facsimile: (860) 760-6789

-and-

John P. Melko (13919600)
GARDERE WYNNE SEWELL LLP
1000 Louisiana, Suite 3400
Houston, TX 77002-5007
Telephone: (713) 276-5727
Facsimile: (713) 276-6727

Attorneys for the Ad Hoc Group of
Timber Noteholders

EXHIBIT D

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

In re:	§	
	§	
SCOTIA DEVELOPMENT LLC,	§	Case No. 07-20027-C-11
	§	Jointly Administered
Debtor.	§	(Chapter 11)

SCOTIA PACIFIC COMPANY LLC'S MOTION FOR AN ORDER COMPELLING THE AD HOC COMMITTEE TO FULLY COMPLY WITH BANKRUPTCY RULE 2019(A) BY FILING A COMPLETE AND PROPER VERIFIED STATEMENT DISCLOSING ITS MEMBERSHIP AND THEIR INTERESTS

A HEARING WILL BE CONDUCTED ON THIS MATTER ON APRIL 10, 2007 AT 11:00 A.M. BEFORE THE HONORABLE RICHARD S. SCHMIDT, 1133 NORTH SHORELINE, 2^{ND} FLOOR, CORPUS CHRISTI, TEXAS 78471. IF YOU OBJECT TO THE RELIEF REQUESTED, YOU MUST RESPOND IN WRITING SPECIFICALLY ANSWERING EACH PARAGRAPH OF THIS PLEADING. YOU MUST FILE YOUR RESPONSE WITH THE CLERK OF THE BANKRUPTCY COURT WITHIN TWENTY-THREE DAYS FROM THE DATE YOU WERE SERVED WITH THIS PLEADING UNLESS YOU DID NOT RECEIVE THIS NOTICE IN TIME TO DO SO. IN THAT SITUATION, FILE YOUR RESPONSE AS SOON AS POSSIBLE. IN ADDITION TO FILING YOUR RESPONSE WITH THE CLERK, YOU MUST GIVE A COPY OF YOUR RESPONSE TO THE PERSON WHO SENT YOU THE NOTICE; OTHERWISE, THE COURT MAY TREAT THE PLEADING AS UNOPPOSED AND GRANT THE RELIEF REQUESTED.

Scotia Pacific Company LLC ("Scopac") files its Motion for an order compelling the Ad Hoc Committee of Noteholders (the "Ad Hoc Committee") to file a verified statement complying fully with the requirements of Bankruptcy Rule 2019(a) (the "Motion"). In support of this Motion, Scopac respectfully states as follows:

I.
THE AD HOC COMMITTEE THREATENS SCOPAC'S REORGANIZATION WHILE HIDING BEHIND A VEIL OF SECRECY.

1. Scopac has come to this Court to reorganize its business. Throughout the eight weeks this case has been pending, however, the Ad Hoc Committee has done its best to distract

Scopac by adopting an aggressive and improper posture – a posture manifested most recently by its filing of several pleadings on venue that focused not on the relevant law but on fanciful accusations regarding, and *ad hominem* attacks on, Scopac, Scopac's management, the Pacific Lumber Company ("Palco") (Scopac's parent and co-debtor), and MAXXAM, Palco's ultimate corporate parent. Scopac has been forced to expend considerable time and resources in responding to the Ad Hoc Committee's patently absurd pleadings and "hard line" positions on everything from the character of Scopac's business to Scopac's request for a financial advisor.[1] The Ad Hoc Committee has taken these positions while hiding behind a veil of secrecy that is patently contrary to the open disclosure policies underlying the Bankruptcy Code and the express provisions of Bankruptcy Rule 2019(a).

2. Thus, the Ad Hoc Committee has, to date, failed to disclose to Scopac, the Court, or any other interested party, crucial information required by the Bankruptcy Rules, including the composition of the ad hoc committee, the interests each committee member holds and at what price such interests were acquired. The Ad Hoc Committee's decision to keep such information shrouded in mystery both violates the clear and express provisions of Federal Rule of Bankruptcy Procedure 2019 ("Rule 2019") and creates an unnecessary and improper risk of overreaching and unfairness in Scopac's reorganization process. Accordingly, Scopac respectfully requests that the Court issue an order compelling the Ad Hoc Committee to file a verified statement in accordance with the requirements of Rule 2019(a). Scopac also respectfully

[1] Nor does the Ad Hoc Committee stop at filing its pleadings with scurrilous, baseless, and personal accusations; in addition, its counsel continually seeks to try this case in the press. Moreover, counsel for the Ad Hoc Committee is demanding that the estate bear the cost of these attacks.

requests that unless and until the Ad Hoc Committee files an adequate verified statement under Rule 2019, this Court refuse to further hear the Ad Hoc Committee in connection with this case.

II. JURISDICTION AND VENUE

3. This Court has jurisdiction to consider this Motion pursuant to 28 U.S.C. §§ 157 and 1334. Consideration of this Motion is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). Venue of this proceeding is proper in this district pursuant to 28 U.S.C. §§ 1408 and 1409.

III. BACKGROUND

4. On January 18, 2007 (the "Petition Date"), Scopac filed a voluntary petition for relief under chapter 11 of title 11 of the United States Code, Sections 101 *et seq.*, as amended (the "Bankruptcy Code"). Scopac's bankruptcy case is being jointly administered under Case No. 07-20027.

5. Scopac continues to operate its business and manage its properties as a debtor in possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

6. No trustee or examiner has been appointed in Scopac's bankruptcy case.

7. Scopac owns approximately 200,000 acres of timberland (the "Scopac Timberlands") and has the exclusive rights to harvest timber on 12,200 additional acres of timberland (the "Scopac Timber Rights" and, together with the Scopac Timberlands, the "Scopac Timber") owned by Palco. Scopac's business is to manage every stage of the lives of the trees on the Scopac Timber, to negotiate a Byzantine regulatory process to obtain approval for the harvest of those trees, and to sell standing timber for harvest, usually to Palco pursuant to the terms of certain agreements between Palco and Scopac and sometimes to other third parties.

A. **The Timber Notes**.

8. Scopac is a party to the indenture dated July 20, 1998 (as amended from time to time, the "Indenture"), by and between Scopac and The Bank of New York, as successor trustee (the "Indenture Trustee"), pursuant to which Scopac issued $867.2 million in aggregate principal amount of Timber Notes, which were issued in three classes: 6.55% Series B Class A-1 Timber Collateralized Notes due 2028 (the "Class A-1 Notes"), 7.11% Series B Class A-2 Timber Collateralized Notes due 2028 (the "Class A-2 Notes") and 7.71% Series B Class A-3 Timber Collateralized Notes due 2028 (the "Class A-3 Notes," together with the Class A-1 Notes and the Class A-2 Notes, the "Timber Notes"). The Timber Notes are due July 20, 2028 and are subject to prepayment out of funds that may become available for that purpose as provided in the Indenture. Scopac's annual interest payments on the Timber Notes are approximately $54 million. The Timber Notes are presently traded on the public market.

9. The Timber Notes are senior secured obligations of Scopac and do not constitute obligations of, and are not guaranteed by, any other entity. Interest and any principal is paid to the holders of the Timber Notes (the "Noteholders") on a semi-annual basis, on January 20th and July 20th of each year (each, a "Note Payment Date").

B. **The Ad Hoc Committee**.

10. The Ad Hoc Committee appeared in the above-captioned matter at the first day hearings held on January 19, 2007. In short order, the Ad Hoc Committee began aggressively inserting itself into these cases. In one day, for example, the Ad Hoc Committee launched three pleadings designed to halt Scopacs's reorganization:

- Motion for (A) Determination that Scotia Pacific Company LLC is a Single Asset Real Estate Debtor, and (B) Order Requiring that Scotia Pacific Company

Comply with the Requirements of Bankruptcy Code 362(d)(3) (the "SARE Motion") (Dkt. no. 188);

- Objection to Emergency Motion of Scotia Pacific Company LLC for an Order Granting Extension of Time for Filing Creditor List, Schedules and Statement of Financial Affairs (Dkt. no. 189); and
- Objection to Scopac's Continued Use of Cash Collateral (Dkt. no. 190).

From that time forward, the Ad Hoc Committee has been extremely aggressive in its filing of additional motions, objections and responses, each one designed to distract from the true focus of these cases.

11. For instance, in just the last seven weeks, the Ad Hoc Committee has filed:

- On February 6, 2007, a (A) Limited Objection to Motion of California Resources Agency, Et Al., For Expedited Hearing on Motion to Transfer Venue, or (B) In the Alternative, Motion to Expedite Hearing on the Noteholder Committee's Single Asset Real Estate Motion (Dkt. no. 202);
- On February 6, 2007, an amended SARE Motion (Dkt. no. 212);
- On February 13, 2007, a Supplemental Objection to Entry of Final Order Authorizing Scopac's Use of Cash Collateral Pursuant to Section 363 of the Bankruptcy Code (Dkt. no. 264);
- On February 14, 2007, an objection to Emergency Motion of Debtors the Pacific Lumber Company and Scotia Pacific Company LLC For Authority to Make Payment to One Another, As Critical Vendors, Of Specified Amounts For Pre Petition Period January 1-18, 2007, By Means Of Net Payment (After Setoff or Recoupment) From The Pacific Lumber Company To Scotia Pacific Company

LLC; And For Relief From Stay To Permit Such Setoff or Recoupment (Dkt. no. 291);

- On February 14, 2007, an objection to Scotia Pacific Company LLC's Application Pursuant to Sections 327(A), 328(A), and 1107 of the Bankruptcy Code for Order Authorizing the Retention of the Blackstone Group as Financial Advisor (Dkt. no. 292);
- On February 19, 2007, an objection to the Application of the Official Unsecured Creditors' Committee for Order Approving Employment of Pachulski Stang Ziehl Young Jones & Weintraub LLP as Committee Counsel (Dkt. no. 323);
- On February 23, 2007, a Motion to Continue Hearing on Scotia Pacific Company LLC's Application to Retain and Employ the Blackstone Group L.P. as Financial Advisor Under Sections 327(A), 328(A), and 1107 (Dkt. no. 341);
- On February 26, 2007, an Initial Response to Motions to Transfer Venue (Dkt. no. 348);
- On March 2, 2007, a Final Response in Support of Motions to Transfer Venue (Dkt. no. 381);
- On March 2, 2007, an (A) Emergency Motion to Strike Scotia Pacific Company LLC's Emergency Cash Collateral Motion and Accompanying Exhibits, (B) Objection to Same, and (C) Offer of DIP Financing (Dkt. no. 383);
- On March 5, 2007, an Emergency Motion to Set Concurrent Hearing On Noteholder Committee's (A) Emergency Motion to Strike Scotia Pacific Company LLC's Emergency Cash Collateral Motion and Accompanying

Exhibits, (B) Objection to Same, and (C) Proffer of DIP Financing (Dkt. no. 399); and

- On March 5, 2007, a Joinder in Motions to Transfer Venue (Dkt. no. 410).

12. On February 13, 2007, in a purported attempt to comply with Bankruptcy Rule 2019, the Ad Hoc Committee filed a Verified Statement of Bingham McCutchen LLP and Gardere Wynne Sewell LLP Pursuant to Bankruptcy Rule 2019 in connection with its representation of the Ad Hoc Committee (the "2019 Statement"). (Dkt. no. 265.) The 2019 Statement clarifies that Bingham and Gardere represent "an ad hoc committee of holders of" the Timber Notes. 2019 Statement at 1. The 2019 Statement states that the Ad Hoc Committee consists of multiple note holders:

> The current members of the [Ad Hoc] Committee include: Angelo, Gordon & Co. L.P., on behalf of certain managed accounts and funds; Avenue Investments, L.P.; Avenue International, Ltd.; Avenue Special Situations Fund III, L.P.; Avenue-CDP Global Opportunities Fund, L.P. US; Avenue Special Situations Fund IV, L.P.; Banc of America Securities, Inc.; Camulos Master Fund LP; CarVal Investors LLC; Citigroup Global Markets Inc.; CSG Investments, Inc; Deutsche Bank Securities, Inc.; D.E. Shaw Laminar Portfolios, L.L.C.; Davidson Kempner Capital Management LLC, on behalf of certain affiliated investment funds; Gruss & Co., funds managed by GSO Capital Partners LP; Intermarket Corp.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Murray Capital Management (on behalf of certain managed accounts and funds); Northeast Investors Trust; Par IV Capital; Phoenix Investment Partners; Plainfield Special Situations Master Fund Limited; QDRF Master Ltd; QVT Financial LP; RockView Capital; and TCW Credit Mortgage.

2019 Statement at 2, n.1. According to 2019 Statement, "the aggregate holdings … of the active members of the [Ad Hoc] Committee amount to more than 90% of the principal amount outstanding under the Indenture." 2019 Statement at 2. Notably absent from the 2019 Statement are (i) any indication of each of the Committee members' relative holdings of the Timber Notes; (ii) the time period when each committee member obtained its interest; (iii) how such interest was obtained and (iv) the price paid for its note or notes by each committee member -- all items of information specifically required by Rule 2019. Notwithstanding the Ad Hoc Committee's representation that it represents "90%" of the amount outstanding under the Timber Notes, the Ad Hoc Committee has at various times stated to this Court that it represents between 97% and 99% of the amounts outstanding. The Ad Hoc Committee has not, as of yet, revised the 2019 Statement to reflect any increases in its position.

IV.
THE AD HOC COMMITTEE MUST COMPLY WITH ITS DISCLOSURE OBLIGATIONS UNDER BANKRUPTCY RULE 2019(A)

13. Rule 2019(a) is clear. It requires "every entity or committee … representing more than one creditor or equity security holder" to "file a verified statement setting forth" the following:

> (1) the name and address of the creditor or equity security holder;
>
> (2) the name and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;
>
> (3) … in the case of a committee, the name or names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and
>
> (4) with reference to the time of … the organization or formation of the committee … the amounts of claims or interests owned by … the members of the committee … the times when acquired, the amounts paid therefor, and any sales or other dispositions thereof.

Fed. R. Bankr. P. 2019(a)(emphasis added).

14. Rule 2019(a) further provides that "[t]he statement shall include a copy of the instrument, if any, whereby the … committee … is empowered to act on behalf of the creditors …" Fed. R. Bankr. P. 2019(a).

15. Pursuant to Rule 2019(a), any entity or committee representing more than one creditor or equity security holder, such as the Ad Hoc Committee which admittedly represents a committee of *numerous* note holders, must file a verified statement setting forth the information

required by that rule. *See* Fed. R. Bankr. P. 2019(a) (excepting committees appointed pursuant to sections 1102 or 1113 of the Bankruptcy Code, but not other committees); 9 L. King, et al,, Collier on Bankruptcy ¶ 2019.02 (15th ed. rev. 2006) ("Any … unofficial committee must comply with Rule 2019 by its terms.") (*quoted in In re Oklahoma P.A.C. First Ltd. P'Ship*, 122 B.R. 387, 391 (Bankr. D. Ariz. 1990)). That verified statement must include "the amounts of claims or interests owned by the members of the committee, the times when acquired, the amounts paid therefor, and any sales or other dispositions thereof." *In re Northwest Airlines Corp.*, Case No. 05-17930, 2007 Bankr. LEXIS 557, at *4 (Bankr. S.D.N.Y. Feb. 26, 2007) (quoting Rule 2019(a) and holding that an ad hoc committee has an obligation to supplement a defective Rule 2019 statement).

16. Despite Rule 2019's clear requirements for detailed information, the only responsive information the Ad Hoc Committee provided in its 2019 Statement was a list of current members and the vague statement that, "[b]ased upon information provided to [Ad Hoc Committee counsel], the aggregate holdings (on their own behalf or as advisors) of the active members of the [Ad Hoc] Committee amount to more than 90% of the principal amount outstanding under the Indenture." 2019 Statement at 2 & n.1. The Ad Hoc Committee's Rule 2019 Statement thus "is insufficient on its face" and must be supplemented. *In re Northwest Airlines Corp.*, 2007 Bankr. LEXIS, at *4.

17. The bankruptcy court overseeing the Northwest Airlines chapter 11 case recently heard a similar issue. *See id*. In *Northwest Airlines*, an ad hoc committee of equity holders had taken an active role in the case. The committee, however, filed a very sparse 2019 statement, similar to the statement filed in this case. The court held that "[b]y its plain terms, [Rule 2019] requires disclosure of 'the amounts of claims or interests owned by the members of the

committee, the times when acquired, the amounts paid therefor, and any sales or dispositions thereof.'" *Id*. at *5. The court noted that "[b]y appearing as a 'committee' … the members purport to speak for a group and implicitly ask the court…to give their positions a degree of credibility…." *Id*. at *7. As a result of a committee's position in a bankruptcy case and the history of Rule 2019,[2] the court held that the "Rule is long-standing and there is no basis for failure to apply it as written." *Id*. at *10. The rule thus recognizes that if a committee seeks to play an active, important role in the debtor's reorganization, it must first, in all fairness, simply disclose to that debtor, the Court, and all other interested parties, details regarding its constituents and their interests. The policies behind Rule 2019, like the plain language of the rule itself, thus require that the Ad Hoc Committee set forth in full the information required by Rule 2019. Further, the need for the Ad Hoc Committee to fully comply with Rule 2019 is particularly critical in this case given the Ad Hoc Committee's overly aggressive behavior, repeated baseless filings, and unwillingness to compromise – tactics and strategies that are diverting Scopac's attention away from and, therefore, delaying the successful reorganization of its business. The Ad Hoc Committee is thus in a position to "play an important role in [this] reorganization case[.]" *Id*. at 5. Yet to date, rather than exercise its power and authority to help facilitate the reorganization, the Ad Hoc Committee's actions have only unnecessarily and improperly hindered and delayed it.

[2] The predecessor to Rule 2019, Rule 10-211 was adopted (and retained as Rule 2019) in direct response to a study on "perceived abuses by unofficial committees in … corporate reorganizations … in order to help foster [through mandatory disclosure provisions] fair and equitable plans free from deception and overreaching." *Id*. at *9 (quoting 13A King *et al*., *Collier on Bankruptcy*, ¶ 10-211.04 (14th ed. 1976).

18. Moreover, unless and until the Ad Hoc Committee complies with its disclosure obligations under Rule 2019(a), it should not be heard further in this case. Fed. R. Bankr. P. 2019(b). Such relief is specifically provided by Federal Rule of Bankruptcy Procedure 2019(b), which states that where, as here, a committee has not complied with its Rule 2019(a) disclosure obligations, the Court may "refuse to permit that … committee ... to be heard further … in the case" and "hold invalid any authority, acceptance, rejection, or objection given, procured, or received" by that committee. Accordingly, Scopac seeks an order (a) compelling the Ad Hoc Committee to file a verified statement pursuant to Rule 2019(a) setting forth all the information required by that rule, and (b) stating that the Court will refuse to further hear the Ad Hoc Committee unless and until it files an adequate verified Rule 2019 statement.

WHEREFORE, Scopac requests entry of an order (1) compelling the Ad Hoc Committee to file a verified statement pursuant to Bankruptcy Rule 2019(a), (2) stating that the Court will refuse to further hear the Ad Hoc Committee unless and until it files an adequate verified Rule 2019 statement; and (3) granting any other relief this Court deems just and proper.

Respectfully submitted this 16th day of March 2007.

/s/
Kathryn A. Coleman
California State Bar No. 110937
Eric J. Fromme
California State Bar No. 193517
Robert K. Dakis
Lise J. Johnson
Gibson, Dunn & Crutcher LLP
200 Park Avenue
New York, NY 10166
Telephone: 212.351.4000
Facsimile: 212.351.3889
kcoleman@gibsondunn.com
efromme@gibsondunn.com

-and-

John F. Higgins
State Bar No. 09597500
James Matthew Vaughn
State Bar No. 24028088
Joshua W. Wolfshohl
State Bar No. 24038592
PORTER & HEDGES, L.L.P.
1000 Main Street, 36th Floor
Houston, TX 77002
Telephone: 713.226.6000
Facsimile: 713.226.6248
jhiggins@porterhedges.com
mvaughn@porterhedges.com

BANKRUPTCY COUNSEL TO SCOTIA PACIFIC COMPANY, LLC

EXHIBIT E

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

IN RE:	§	JOINTLY ADMINISTERED
	§	
SCOTIA DEVELOPMENT LLC, ET AL.,	§	Case No. 07-20027-C-11
	§	
Debtors.	§	Chapter 11

Related Docket Nos. 265 & 492
Hearing Date: April 10, 2007 @ 11:00 am CST

THIS PLEADING APPLIES ONLY TO
SCOTIA PACIFIC COMPANY LLC, CASE NO. 07-20032

NOTEHOLDER GROUP'S OBJECTION TO SCOTIA PACIFIC COMPANY LLC'S MOTION FOR AN ORDER COMPELLING THE AD HOC COMMITTEE TO FULLY COMPLY WITH BANKRUPTCY RULE 2019(A) BY FILING A COMPLETE AND PROPER VERIFIED STATEMENT DISCLOSING ITS MEMBERSHIP AND THEIR INTERESTS

The Ad Hoc Group of Timber Noteholders (the members of which hold or manage, as of the date hereof, more than 95% in principal aggregate amount outstanding of the Timber Notes, the "**Noteholder Group**")[1] in the above captioned chapter 11 case, respectfully submits this objection to Scotia Pacific Company LLC's ("**Scopac**") above referenced motion (dkt. no. 492,

[1] The current members of the Noteholder Group include: Angelo, Gordon & Co. L.P., on behalf of certain managed accounts and funds; Avenue Investments, L.P.; Avenue International, Ltd.; Avenue Special Situations Fund III, L.P.; Avenue-CDP Global Opportunities Fund, L.P. US; Avenue Special Situations Fund IV, L.P.; Banc of America Securities, Inc.; Camulos Master Fund LP; CarVal Investors LLC; Citigroup Global Markets Inc.; CSG Investments, Inc.; Davidson Kempner Capital Management LLC, on behalf of certain affiliated investment funds; Deutsche Bank Securities Inc.; D. E. Shaw Laminar Portfolios, L.L.C.; ECO Master Fund Ltd.; ECR Master Fund Ltd.; Gruss & Co.; funds managed by GSO Capital Partners LP; HBK Capital Management; Intermarket Corp.; J.P. Morgan Securities Inc.; KeyBanc Capital Markets; KS Capital Partners, L.P.; KS International; Lehman Brothers Inc.; Murray Capital Management (on behalf of certain managed accounts and funds); Northeast Investors Trust; Par IV Capital; Phoenix Investment Partners; Plainfield Special Situations Master Fund Limited; QDRF Master Ltd; QVT Financial LP; RockView Capital; TCW Credit Mortgage and Watershed Asset Management, L.L.C. The members of the Noteholder Group each act in their own individual interests, and neither the individual members nor the Group as a whole purport to act on behalf of or to represent any other holder of Timber Notes.

the "**2019 Motion**") pursuant to Rule 2019 of the Federal Rules of Bankruptcy Procedure (the "**Bankruptcy Rules**").

OVERVIEW

1. Bankruptcy Rule 2019 requires (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 (i) is ***not*** a "committee," (ii) does ***not*** "represent" any creditors, (iii) does ***not*** have any "instrument," and (iv) is ***not*** "empowered to act on behalf of creditors." ***In short, Bankruptcy Rule 2019 simply does not apply to the Noteholder Group.***

2. Scopac knows this. In fact, in numerous Form 8-K filings in 2005, Scopac complained that it was having discussions with an "Ad Hoc Committee" (*i.e.*, the Noteholder Group) that held only a small percentage of the outstanding principal amount of the Timber Notes. Scopac was actually wrong on this point[2], but it demonstrates that Scopac did not believe that the Ad Hoc Committee represented, or ever asserted that it represented, the entire class of Timber Notes. In fact, one of Scopac's Form 8-K filings stated that Scopac was seeking "to facilitate direct negotiations with the Noteholders," because Scopac knew that the Ad Hoc Committee did not have authority to commit to any proposal on behalf of any Noteholder other than the members of the Ad Hoc Committee itself. *See*, *e.g.*, Scotia Pacific Form 8-K filings dated August 1, 2005, September 26, 2005 & October 5, 2005 (Exhibits A, B & C hereto).

3. Just three weeks ago, Scopac complained yet again that it was unable to negotiate a restructuring in 2005 "at least partly because counsel for the noteholder group represented

[2] The overall group held approximately 80% in outstanding principal amount of the Timber Notes, as Scopac knew. The 15-20% that Scopac always referred to was just the "restricted" holders in the group.

fewer than twenty percent (20%) of the outstanding debt on the Timber Notes." Scotia Pacific Company LLC's Omnibus Response filed March 15, 2007, at ¶ 4 (dkt. no. 480). In sum, until Scopac filed the 2019 Motion, Scopac always understood (and complained) that the Noteholder Group did not represent all of the holders of the Timber Notes.

4. Furthermore, even if the Noteholder Group did purport to represent other Noteholders, the purpose of Bankruptcy Rule 2019 is to provide disclosure to the other members of the class that the "committee" represents. Here, the members of the Noteholder Group hold more than 95% in outstanding principal amount of the Timber Notes, and the one or two Noteholders who are not currently members of the Noteholder Group are welcome to join the group at any time. Thus, no useful purpose would be served by seeking to compel investors to reveal confidential and highly proprietary commercial information that they do not even share with each other, only with counsel in strictest confidence. *See In re I. G. Servs. Ltd.*, 244 B.R. 377, 389 (Bankr. W.D. Tex. 2000) (declining to apply Rule 2019 where "[t]he only interest that the court might have in enforcing the letter of Rule 2019 is to protect these very investors.") This reveals Scopac's true motives. Scopac is not seeking "to vindicate the rights of innocent investors who are being shut out of the process by their secretive and conflicted representatives." Scopac is simply continuing its unrelenting campaign of attempting to demonize the Noteholder Group in every way possible.

5. For example, the 2019 Motion attacks the Noteholder Group for "hiding behind a veil of secrecy" (2019 Motion ¶ 1) in an effort to remain "shrouded in secrecy" (2019 Motion ¶ 2). Scopac asserts that this "secrecy" is particularly inappropriate given the Noteholder Group's "patently absurd pleadings" (2019 Motion ¶ 1). Scopac further asserts that additional disclosure "is particularly critical in this case given the Ad Hoc Committee's overly aggressive behavior,

repeated baseless filings, and unwillingness to compromise – tactics and strategies that are diverting Scopac's attention away from and, therefore, delaying the successful reorganization of its business." (2019 Motion ¶ 17).

6. Scopac's allegations that the Noteholder Group's positions are "absurd," "baseless," etc. etc., will not be dignified with a response. However, Scopac's allegation that the Noteholder Group is "hiding behind a veil of secrecy" can easily be answered by the record in this case. Every single pleading that the Noteholder Group has filed in this case (including this one) has provided up-to-the-minute information as to both the members of the Noteholder Group and their approximate aggregate holdings. Bankruptcy Rule 2019 does not apply to the Noteholder Group, but even if it did, the Noteholder Group's pleadings already disclose everything that is relevant to know about the Noteholder Group.

BACKGROUND

7. In 1998, Scopac borrowed $876 million from investors ("**Noteholders**") through the issuance of timber collateralized notes (the "**Timber Notes**"). Approximately $714 million of the Timber Notes remain outstanding. More than 95% of that principal amount is held by the members of the Noteholder Group.[3]

8. In March 2005, Scopac contacted several Noteholders to request that the Noteholders form a group for the purpose of engaging in restructuring discussions. After several organizational calls, the Noteholder Group had its first formal call on March 21, 2005.[4] The

[3] To be even more precise, as of March 29, 2007, the Noteholder Group members hold, in the aggregate, $695,502,014 in outstanding principal amount of Timber Notes, equating to 97.41% of the total issue.

[4] The original members of the Noteholder Group AEGON USA Investment Management, LLC; Capital Research and Management Company; Delaware Investment Advisers; Genworth Financial Inc.; and Ohio National Life Insurance Company.

Noteholder Group interviewed a number of law firms on March 23, 2005, and selected Bingham McCutchen LLP ("**Bingham**") as Noteholder Group counsel (the assignment has since been transferred to Bracewell & Giuliani LLP ("**Bracewell**") as a result of the move of the lead Bingham attorney to Bracewell).

9. Over the Summer of 2005, the Noteholder Group discussed a potential restructuring with Scopac until Scopac abruptly terminated the discussions in September 2005.

10. The Noteholder Group has remained intact and in communication since then (although the members of the group have changed from time to time), with periods of relative activity or inactivity depending on matters such as Scopac's periodic financial reporting, litigation and regulatory developments affecting Scopac, and the semi-annual payments due on the Timber Notes.

11. The Noteholder Group has never had, and still does not have, any by-laws, procedural rules, agreements or other "instruments" concerning its existence. The simple reason for this is that the Noteholder Group has never purported to "represent" anyone or to make decisions on behalf of anyone.

12. The members of the Noteholder Group are required to keep Bracewell updated as to their individual holdings so that Bracewell can accurately represent the current overall holdings of the group to this Court. The individual holdings are provided only to Bracewell and on a strictly confidential basis; they are not shared with other members of the Noteholder Group, with the group's Texas counsel, Gardere Wynne Sewell LLP ("**Gardere**"), or with any other professionals for the Noteholder Group.

13. When the Noteholder Group takes positions, such as the group's decision to file the so-called "SARE Motion," the decisions are typically made via consensus after frequent e-

mail discussions and occasional group calls. The "consensus decision" is not binding on the individual Noteholder Group members and any member is free to drop off or re-join the group at any time. Regardless of whether they remain part of the Noteholder Group, individual group members are free at any time to take individual positions that are inconsistent with the positions taken by the Noteholder Group as a whole.

14. The Noteholder Group members do not owe fiduciary duties to each other or to any other Noteholder.

15. On February 13, 2007, Bingham and Gardere made a voluntary disclosure pursuant to Bankruptcy Rule 2019 identifying the Noteholder Group members and their aggregate holdings. The 2019 Motion incorrectly describes the disclosure as having been filed by the Noteholder Group, but in fact it was filed by counsel on their own behalf, as its title makes clear: "Verified Statement of Bingham McCutchen LLP and Gardere Wynne Sewell LLP Pursuant to Bankruptcy Rule 2019" (dkt. no. 265). This was not a required disclosure, given that Bracewell and Gardere have only one client in this case -- the Noteholder Group --but it was made so that this Court would have a verified statement of counsel as to the members and aggregate holdings of the Noteholder Group.[5] This disclosure was consistent with the practice in courts throughout this country, including this Court. *See, e.g.*, Verified Statement of Stroock & Stroock & Lavan LLP Pursuant to Bankruptcy Rule 2019, *In re Asarco*, case no. 05-21207, dkt. no. 2072 (Bankr. S.D. Tex., pleading filed Apr. 28, 2006) (copy attached as Exhibit D).

[5] While Bracewell has only one client in Scopac's chapter 11 case, a separate Bracewell team represents two creditors in the separate chapter 11 case for Palco. As a result, Bracewell filed a 2019 statement in the Palco case with respect to those two creditors (dkt. no. 516). As noted in that 2019 statement, there is a strict "fire wall" between the two Bracewell teams.

OBJECTION

I. BANKRUPTCY RULE 2019 DOES NOT APPLY TO THE NOTEHOLDER GROUP

A. The Noteholder Group is not a "Committee" within the meaning of Bankruptcy Rule 2019(a)

16. Bankruptcy Rule 2019(a) requires "every entity or committee representing more than one creditor ... and every indenture trustee," to file a Rule 2019(a) Statement. The 2019 Motion is based upon the assumption that the Noteholder Group is a "committee" within the meaning of Bankruptcy Rule 2019(a). "Committee" is a common term in both legal and non-legal contexts and, therefore, the analysis must start with the plain meaning of the term "committee." *See United States v. Ron Pair Enter.*, 489 U.S. 235, 241 (1989) ("where, as here, the statute's language is plain, the sole function of the courts is to enforce it according to its terms") (internal quotations omitted).[6]

17. The legal definition of "committee" is, "A group of people appointed or elected to consider, determine, or manage a matter." BLACK'S LAW DICTIONARY (7th ed. 1999). While the Noteholder Group is certainly "a group," its members have not been "appointed or elected" by anyone "to consider, determine, or manage" anything. As noted above, the Noteholder Group is self-selecting (any Noteholder can join, any Noteholder can drop off) and does not speak for anyone except itself. To the contrary, the Noteholder Group expressly disclaims any right or duty to speak on behalf of anyone else or to consider or determine anything on behalf of anyone

[6] Scopac does not assert that the Noteholder Group is an "indenture trustee" or an "entity" under Rule 2019(a). The 2019 Motion demands that the members of the Noteholder Group disclose specific information regarding their holdings of Timber Notes (*e.g.*, individual amounts, times of acquisition and prices paid), none of which would be required if the Noteholder Group were an "entity" because 2019(a) would only apply to "the amounts of claims or interests ***owned by the entity***." *See In re C.F. Holdings Corp.*, 145 B.R. 124, 127 (Bankr. D. Conn. 1992) (Rule 2019(a)(4) "applies to the entity filing the Rule 2019 statement ... not the parties represented by the [entity].").

else. It is for this reason that the Noteholder Group has stopped referring to itself imprecisely as the "Ad Hoc Committee" – the group is not a "committee" of any nature, regardless of the terminology employed.

18. Indeed, as discussed in paragraphs 2 & 3 above, even when the Noteholder Group was informally called the "Ad Hoc Committee," Scopac itself never believed or understood that the group was a "committee" that purported to represent any other Noteholders. This was a continuing sore spot for Scopac because Scopac ***wanted*** to be able to negotiate with a true "committee" and was repeatedly frustrated that the Noteholder Group refused to represent anyone other than its individual members.

19. The non-legal definition of "committee" is, "A group of people ***officially delegated to perform*** a function, such as investigating, considering, reporting, or acting on a matter." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2004) (emphasis added). This language demonstrates even more succinctly that the Noteholder Group is not a "committee." There is nothing "official" about the group and no one has "delegated" anything to the group.

B. The Noteholder Group Does Not "Represent More Than One Creditor" Within the Meaning of Bankruptcy Rule 2019(a)

20. The "representative capacity" which is at the heart of the meaning of the term "committee" is confirmed by Rule 2019's text. Indeed, it is explicitly stated in the most important part of Rule 2019(a), its first clause, which defines the parties who are subject to the disclosure obligations set forth in clauses (1) through (4) that follow. That clause states that it

applies to every "committee ***representing*** more than one creditor" except for "committee[s] appointed pursuant to §§ 1102 or 1114 of the Code."[7]

21. BLACK'S LAW DICTIONARY (7th ed. 1999) does not define "represent" but it does define a "representative" as, "One who stands for or acts on behalf of another <the owner was the football team's representative at the labor negotiations>. See AGENT." Thus, in order to "represent" other Noteholders, the Noteholder Group would need to have the authority to "stand for" or to "act on behalf of" the other Noteholders as their "agent." The Noteholder Group does not have any such authority and does not stand for or act on behalf of anyone. The Noteholder Group also does not operate as anyone's agent, not even as the "agent" of its own members, who remain free to advocate whatever positions they wish without regard to the views expressed by the Noteholder Group as a whole.

22. The word "represent" and variations thereof are used in many places in the Bankruptcy Code, and in each place it is clear that the term is used consistent with the definition noted above as denoting someone who represents someone else. *See* Bankruptcy Code §§ 101(24) ("The term 'foreign representative' means a person or body … authorized … to act as a representative of such foreign proceeding"); 323(a) ("The trustee in a case under this title is the representative of the estate"); 327(a) & (e) (referring to professionals eligible to "represent" the trustee); 329(a) ("Any attorney representing a debtor…"); 333(a)(1) (appointment of an ombudsman "to represent the interests of patients"); 503(b)(3)(D) (ability of "a committee

[7] Notably, the two other targets of Rule 2019(a) also function in a representative and fiduciary capacity. Those two are (a) any "entity ... ***representing*** more than one creditor," which is typically applicable to law firms whose business it is to "represent" the interests of its clients, and (b) indenture trustees, who are contractual trustees acting on behalf of the holders of the securities issued under the relevant indenture.

representing creditors" to seek payment for making a substantial contribution);[8] 1102(a)(2) (authorizing the court to appoint additional committees of creditors "if necessary to assure adequate representation of creditors"); 1102(a)(4) (the court can reconstitute a committee if "necessary to ensure adequate representation of creditors"); 1102(b)(1) (a committee should be "representative of the different kinds of claims to be represented"); 1102(b)(3)(A) (a committee "shall 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"); 1103(a) & (b) (referring to a committee's ability to employ professionals to "represent" the committee); 1103(c)(3) (permitting a committee to "advise those represented by such committee," meaning other creditors of the same class); 1113 (repeated references to a "representative of employees"); & 1114 (defining "authorized representative" as the "representative ... for persons receiving any retiree benefits" and repeatedly referring to the representative's "representative" capacity).

23. Consistent with the Bankruptcy Code's concept that a "committee" "represents" others who are not on the committee, Palco has filed a scathing motion in the Palco case demanding that the Official Creditors' Committee must be reconstituted because its members do not adequately "represent" unsecured creditors in general. *See* Amended Motion of Palco Debtors To Reconstitute the Official Unsecured Creditors' Committee To Allow Unsecured Creditors (With Claims Against the Estates) Adequate Representation (dkt. no. 534). If Scopac's interpretation of Rule 2019 is correct, it could lead to the remarkable result that Scopac would

[8] Bankruptcy Code § 503(b)(3)(D) also contemplates that a "creditor" can make a substantial contribution. The members of the Noteholder Group will be seeking "substantial contribution" status in their capacity as a group of creditors, not as a "committee representing creditors." *See* Bankruptcy Code § 102(7) ("the singular includes the plural," meaning that the reference to a "creditor" includes a reference to "creditors"); *In re Mirant Corp.*, 354 B.R. 113, 135 & n.60 (Bankr. N.D. Tex. 2006) (group of "Convenience Creditors" awarded payment of attorneys' fees for making a substantial contribution).

actually have the ability to file a motion to compel the Noteholder Group to be reconstituted. That makes no sense, of course, because the members of the Noteholder Group do not represent anyone other than themselves.

24. Finally, the non-legal definition of "represent" reinforces the fact that the Noteholder Group does not represent other creditors. As relevant here, AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2004) defines "represent" as, "To serve as the official and authorized delegate or agent for." The Noteholder Group is neither "official and authorized" nor a "delegate or agent" for anyone.

C. The Noteholder Group Does Not Have Any "Instrument" Pursuant To Which It Is "Empowered To Act on Behalf of Creditors" Within the Meaning of Bankruptcy Rule 2019(a)

25. Bankruptcy Rule 2019(a) requires "committees" to file "a copy of the instrument, if any, whereby the ... committee ... is empowered to act on behalf of creditors or equity security holders." The importance of this documentary aspect of Rule 2019 "committees" is further evidenced by subsection (b)(2), which contemplates that, when enforcing the rule, the court should "examine any representation provision of a ... committee or other authorization." *See In re Kaiser Aluminum Corp.*, 327 B.R. 554, 559 (D. Del. 2005) ("As Rule 2019(b) suggests, the ***operative portion*** of the agreements deposited under 2019(a) are the ***representation provisions***.") (emphasis added).

26. As noted above, there is no instrument or any other agreement with respect to the Noteholder Group's authority to represent any other Noteholders, for the simple reason that the Noteholder Group does not "represent" any other Noteholders.

27. Courts recognize that, "The purpose of Rule 2019 is to ensure that plans of reorganization are negotiated and voted upon by people ***who are authorized to act*** on behalf of

the real parties in interest." *Kaiser Aluminum Corp.*, 327 B.R. at 559 (emphasis added). Similarly, the limited Rule 2019 jurisprudence focuses upon whether the party at issue has "authority" to act as an "agent" on behalf of others, particularly where the party asserts that it represents a larger class of creditors. *See In re White Motor Corp.*, 886 F.2d 1462, 1471 (6th Cir. 1989) (attorney purporting to represent class action claimants in bankruptcy failed to comply with Rule 2019 because attorney failed to prove his "authority to act as an agent for any purported class"); *In re Craft*, 321 B.R. 189, 197-98 (Bankr. N.D. Tex. 2005) (requiring putative class action representatives to comply with Rule 2019 to establish "authority to represent" the class members); *In re Wang Labs.,* 164 B.R. 401, 403 (Bankr. D. Mass. 1994) (Rule 2019 requires party seeking to represent class of mass tort claimants to "demonstrate authority" to act as "agent" for class members in bankruptcy); *In re Ionosphere Clubs*, 101 B.R. 844, 851-53 (Bankr. S.D.N.Y. 1989) (Consumers Union whose members held only 0.05% of relevant claims needed to show "express authorization" and "fiduciary relationship" to represent the remaining 99.95% of the claimant class under Rule 2019); *In re Great Western Cities*, 88 B.R. 109, 112 (Bankr. N.D. Tex. 1988) (Rule 2019 required attorney claiming to represent class of claimants beyond immediate client must show authority to act as "agent" for class members); *In re Vestra Indus.*, 82 B.R. 21, 22 (Bankr. D.S.C. 1987) (union failed to comply with Rule 2019 where it failed to show "authority" to act as agent on behalf of individual union members); *In re Continental Airlines Corp.*, 64 B.R. 874, 880 (Bankr. S.D. Tex. 1986) (same); *In re Electronic Theatre Rests. Corp.*, 57 B.R. 147, 148 (Bankr. N.D. Ohio 1986) (class action representative failed to comply with Rule 2019 because it did not show "authority" to act as an "agent" for individual class members); *In re Baldwin-United Corp.*, 52 B.R. 146, 148 (Bankr. S.D. Ohio 1985) (class action representative failed to comply with Rule 2019 because it failed to show that

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it was an "agent" of the individual class members with "fiduciary duties" to class). *See also* 8 COLLIER ON BANKRUPTCY, ¶ 2019.03, 2019-3 to 2019-5 (15th ed. 1989) ("Rule 2019 covers entities which ***act in a fiduciary capacity*** but which are not otherwise subject to the control of the court.") (emphasis added).

28. In sum, the plain meaning of the words used in Bankruptcy Rule 2019 compels the conclusion that the rule does not apply to the Noteholder Group regardless of whether the group colloquially refers to itself as the "Ad Hoc Group," the "Ad Hoc Committee," or the "Noteholder Group."

D. The Origins of Bankruptcy Rule 2019 Confirm that the Noteholder Group Is Not a "Committee" Within the Meaning of the Rule

29. When a "statute's language is plain," there is no reason to look behind the statute to discern Congressional intent. United States v. Ron Pair Enterprise, 489 U.S. 235, 241 (1989). This is even more of a truism when interpreting a rule promulgated by the Supreme Court itself. See 28 U.S.C. § 2075 ("The Supreme Court shall have the power to prescribe by general rules ... the practice and procedure in cases under title 11."). Nevertheless, a review of the origins of Bankruptcy Rule 2019 also confirms that the rule is not intended to apply to non-representative creditor groups.

30. Bankruptcy Rule 2019 can be traced to the post-Depression era and several initiatives enacted to codify suggestions made in a report of the Securities Exchange Commission (the "SEC Report").9 The self-stated purpose of the SEC Report was to deal with the perceived harms caused by "protective committees" in the context of equity receiverships.

[9] *See* Report on the Study And Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937). A copy of certain excerpts of the SEC Report is attached hereto as Exhibit E. The SEC Report was part of a larger set of reports delivered to Congress in the wake of the Depression that suggested numerous changes to

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31. "Protective committees" were privately formed committees that were often organized by insider groups dominated by the debtor or its investment bank and institutional investors who would solicit smaller investors to enter into a "deposit agreement" (or other instrument, which was rarely arms-length) whereby the smaller investor would deposit their securities and then the "committee" would negotiate with the debtor with little, if any, participation by the smaller holders who the committee represented. See Charles Jordan Tabb, The History of the Bankruptcy Laws in the United States, 3 Am. Bankr. Inst. L. Rev. 5, 30 (1995) (noting that the SEC Report involved "the investigation of protective and reorganization committees" and that "the essential conclusion of the report was that public investors needed protection from insiders in reorganization cases"); SEC Report at 586 (discussing deposit agreements). The SEC Report described the "deposit agreement" as follows:

> The deposit agreement has in many respects been the foundation of the control which committees dominated by the inside group have been able to obtain over the security holders. It is this agreement that has given the committees their unifying quality.... [T]hese agreements bind the depositor to go along with the Committee through thick and thin.

The "Conclusions and Recommendations" of the SEC Report advised (at 897):

> It is essential that renewed emphasis be given to the fact that representatives of security holders in reorganization occupy a fiduciary position.... The use of deposit agreements as means of preserving or obtaining arbitrary and exclusive control over security holders should not be permitted.

32. Justice William O. Douglas, who served as the Chairman of the SEC that oversaw the SEC Report, echoed this concern in his testimony before Congress urging adoption of the SEC Report's recommendations:

> There is at present the problem and the necessity of affording to the individual investors of this country protection against a type of abuse and exploitation with which existing

the bankruptcy laws, enactment of the Trust Indenture Act and other changes to the federal securities laws.

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> legislation cannot cope—the abuses on the part of protective committees in reorganization....
>
> [C]ommittees have been sponsored by the management of the debtor company or by the investment bankers, not by security holders or their authorized representatives.... As a consequence the debtors (which, in any realistic sense, means the corporate management) together with the investment bankers for the corporation have been able to control the effective formation and operation of protective committees. The individual investor has had little choice but to throw in his lot with committees sanctioned and sponsored by banker-management groups....
>
> ***I cannot emphasize too strongly that committee members are fiduciaries.*** As such they owe exclusive loyalty to the class of investors that they represent. They owe that class diligence, efficiency, and single minded devotion.[10]

33. Congress adopted the SEC Report's recommendation for legislation to combat the evils of "protective committees" by adopting § 210 and § 211 of Chapter X of the Bankruptcy Act, which subsequently were combined in the form of Rule 10-211 (under Chapter X), the text of which is virtually identical to Bankruptcy Rule 2019.[11]

34. Further evidence of the "representative" concern regarding "protective committees" can also be found in the Trust Indenture Act of 1939, which, like Rule 2019, resulted from action to implement the SEC Report's recommendations to curtain abusive

[10] Comments of William O. Douglas to Congress, attached hereto as Exhibit F (emphasis added).

[11] *See* Chapter X, § 210 & Chapter X, Rule 10-211 ("Every person or committee representing more than one creditor or stockholder, and every indenture trustee, shall file a signed statement with the court setting forth (1) the names and addresses of such creditors or stockholder; (2) the nature and amounts of their claims or stock and the time of acquisition thereof unless they are alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent fact and circumstances in connection with the employment of such person or indenture trustee, and, in the case of a committee, the name or names of the person or persons at those instance, directly or indirectly, such employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of the employment of such person, or the organization or formation of such committee, or the appearance in the case of any indenture trustee, a showing of the amounts of claims or stock owned by such person, the members of such committee or such indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.").

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behavior by protective committees. the Trust Indenture Act prohibits any provision in an indenture from impairing any individual bondholders' right to payment of principal and interest. *See* 15 U.S.C. § 77ppp(b). This provision was specifically enacted to curtail so-called "majority action clauses" in indentures that were used by "protective committees" to negotiate out-of-court restructurings that were binding upon all bondholders. *See In re Multicanal*, 307 B.R. 386, 388-89 (Bankr. S.D.N.Y. 2004) ("One purpose of the [Trust Indenture Act] was to regulate and reform prior practice whereby indentures contained provisions that permitted a group of bondholders, often controlled by insiders, to agree to amendments to the indenture that affected the rights of other holders -- so-called "majority" or "collective" action clauses."

35. Thus, the origins of Bankruptcy Rule 2019 confirm that the term "committee" is focused on true committees that stand in a fiduciary and representative capacity and have the ability to bind other creditors in the same class. Nothing in the history of the rule suggests that it should apply to informal groups that gather for the purpose of sharing expenses and conveniently speaking with one voice in a bankruptcy proceeding and do not purport to represent any party's interest other than the individual interests of the members of such group. The essential concern for the manipulation of small investors by a "committee" that purportedly represents their interests is simply not present in such circumstances, let alone where, as here, the Noteholder Group represents more than 95% of the principal amount of the securities at issue.

E. *Northwest Airlines* Was Wrongly Decided and Is Distinguishable in Any Event

36. Perhaps the best proof that Bankruptcy Rule 2019 means exactly what it says is the fact that, prior to the *Northwest Airlines* slip opinions earlier this year, no published decision in the ***70 years*** that Rule 2019 (or its predecessor) has been on the books has ever ordered a non-fiduciary creditor group such as the Noteholder Group to make public disclosure of the confidential and highly proprietary commercial information that Scopac demands here.

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37. *Northwest Airlines* presented a situation of a group of shareholders holding only 27% of the debtor's outstanding stock that sought to negotiate improved treatment for shareholders generally. *See In re Northwest Airlines Corp.*, case no. 05-17930, slip op. (Bankr. S.D.N.Y. Feb. 26, 2007), *appeal pending* ("*Northwest I*"), & *In re Northwest Airlines Corp.*, case no. 05-17930, slip op. (Bankr. S.D.N.Y. Mar. 9, 2007), *appeal pending* ("*Northwest II*"). In *Northwest I*, the court concluded that the "Ad-hoc Committee of Equity Holders" was required to file a Rule 2019 Statement because "the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings." Slip op. at 5. In *Northwest II*, the court denied the ad hoc committee's motion to file certain confidential and proprietary information under seal pursuant to Bankruptcy Code § 107(b), because "Rule 2019 protects other members of the group -- here, the shareholders -- and informs them where a committee is coming from by requiring full disclosure." Slip op. at 7.

38. The *Northwest* decisions are wrongly decided because the court wrongly interpreted the plain meaning of Bankruptcy Rule 2019. Moreover, it simply cannot be the case that, as Scopac and the *Northwest* decisions assert, the test for whether any group of creditors is a "committee" under Rule 2019 is whether a creditor group wishes to be "taken seriously" by the bankruptcy court and colloquially calls itself a "committee." This logic suggests that creditors who are not members of a creditor group do not deserve to be "taken seriously," a remarkable proposition that would turn the bankruptcy world on its head. Every party-in-interest wants to be considered seriously in bankruptcy. This logic also suggests that two Noteholders holding $10,000,000 in claims who decide to call themselves a "committee" should be taken more seriously than a group of Noteholders holding almost $700,000,000 in claims that decides to call

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itself a "group." It is not the self-labeling that is important here, it is whether the group is a "committee" as that term is used in Bankruptcy Rule 2019. The Noteholder Group / Ad Hoc Committee, regardless of what it calls itself, is simply not a "committee" within the meaning of Rule 2019.

39. In any event, the *Northwest* decisions are also plainly distinguishable.

40. *First*, the members of the *Northwest* group actively sought to be appointed as an official committee of equity security holders in the case but were repeatedly turned down by the United States Trustee and the Court. Thus, unlike the Noteholder Group, it can be argued that the *Northwest* group effectively announced its desire to serve in a representative and fiduciary capacity on behalf of other equity holders.

41. *Second*, the *Northwest* group held only 27% of the securities in question. This led the court to be concerned that a group would appear to be representing an entire class of which the group was only a small part: "other shareholders have a right to information as to Committee member purchases and sales so that they can make an informed decision whether this Committee will represent their interests or whether they should consider forming a ***more broadly based*** committee of their own." *Northwest II*, slip op. at 7. Here, the Noteholder Group holds more than 95% in outstanding principal amount of the Timber Notes. Even if the one or two Noteholders not in the group had a concern, it would obviously be impossible for them to form a "more broadly based" group of their own. In addition, they remain welcome to join the Noteholder Group at any time should they feel a pressing need to have their particular viewpoints included as part of group discussions.

42. *Third*, the *Northwest* case involves a much more complicated capital structure. Members of the *Northwest* group admittedly "own a very significant amount of debt" in addition

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to their equity interests, "a fact that might raise questions as to divided loyalties." *Id.* at 8. Here, on the other hand, there are no divided loyalties and no secrets: the members of the Noteholder Group own Timber Notes, nothing else.

43. *Fourth*, the *Northwest* group hoped to increase its leverage by seeking to negotiate the recovery for the entire class of shareholders, even though the members of the *Northwest* group did not even hold enough shares to block a plan, let alone the number of shares necessary for class approval of a plan. Here, the members of the Noteholder Group are easily a majority in number of Noteholders and hold more than 95% in aggregate principal amount of the Timber Notes. Their vote alone will be determinative of whether the class of Timber Notes accepts or rejects a plan and they do not need (and do not want) the appearance of representing others in order to give the group any additional voting power.

44. *Fifth*, Northwest Airlines asserts that it is insolvent, thus putting the ad hoc shareholder group in the position of fighting for any recovery at all in the case. This fight would inevitably be bolstered by the appearance that the group represented the entire class of shareholders and, therefore, could deliver plan consents to a negotiated deal. Scopac, on the other hand, has asserted from the beginning that it is solvent and, therefore, the Noteholders are entitled to full recovery. As a result, the Noteholder Group does not need the appearance of representing any larger constituency in order to negotiate an appropriate recovery for its members.

45. *Sixth*, the *Northwest* court believed that disclosure would serve the important public purpose of providing valuable information to the substantial majority of shareholders who were not members of the ad hoc shareholder group. Here, there is no important public purpose to be served. The members of the Noteholder Group already are the substantial majority of the

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Noteholders (in both amount and number) and *they do not want to know* the individualized details of each other's holdings.

46. Thus, neither the plain meaning of Bankruptcy Rule 2019, the history of Rule 2019 nor the *Northwest* decisions present any basis to consider the Noteholder Group a "committee" within the meaning of the rule.

II. BANKRUPTCY RULE 2019 CANNOT BE USED AS A SWORD TO ABRIDGE THE NOTEHOLDER GROUP'S SUBSTANTIVE RIGHTS UNDER THE BANKRUPTCY CODE AND THE UNITED STATES CONSTITUTION

47. Scopac's 2019 Motion requests an order "stating that the Court will refuse to further hear the Ad Hoc Committee unless and until it files an adequate verified Rule 2019 statement." 2019 Motion ¶ 18. Even if the Court were to determine that the term "committee" under Bankruptcy Rule 2019 somehow encompasses the Noteholder Group, Rule 2019 cannot be applied in the manner that Scopac seeks.

48. To begin with, Bankruptcy Rule 1001 mandates that the Bankruptcy Rules "shall be construed to secure the just, speedy, and inexpensive determination of every case and proceeding." As discussed below, Scopac's 2019 Motion has been brought for a highly improper purpose that would abridge several fundamental rights of the members of the Noteholder Group; therefore, construing the rule as Scopac suggests would not be "just." Scopac's misuse of Rule 2019 has also impaired the "speedy and inexpensive" resolution of this case by diverting the parties' attention from the essential business of reorganization. *See In re Shank*, 315 B.R. 799, 812 (Bankr. N.D. Ga. 2004) (citing Bankruptcy Rule 1001 to overrule debtor's objection that claims should be denied because they did not provide information expressly required by Bankruptcy Rule 3001 and stating that "[a] bankruptcy case imposes burdens on creditors.... But that injury need not be compounded by imposing unnecessary costs on creditors who desire to

participate fairly in the process. Rule 1001's directive requires a bankruptcy court to apply the bankruptcy rules to permit creditors to realize their fair share in a bankruptcy case without unnecessary expense.").

49. Even more fundamentally, Congress has specifically mandated that the Bankruptcy Rules "shall not abridge, enlarge, or modify any substantive right." 28 U.S.C. § 2075.[12] The Fifth Circuit has held that this mandate also preserves the equitable jurisprudence of the bankruptcy courts from impairment by the Bankruptcy Rules. *See In re Mobile Steel Co.* 563 F.2d 692, 699 (5th Cir. 1977). Accordingly, courts will not apply the Bankruptcy Rules where such application would violate a substantive Bankruptcy Code provision. *See Caudill v N.C. Mach., Inc. (In re American Eagle Mfg.)*, 231 B.R. 320 (B.A.P. 9th Cir. 1999) (Bankruptcy Rule 2003(d) violates 28 U.S.C. § 2075 because its ten-day period unreasonably frustrates substantive rights established by Bankruptcy Code § 702 and creates unwarranted bias towards invalidating trustee election.); *In re Barnes*, 308 B.R. 77 (Bankr. D. Colo. 2004) (pursuant to 28 U.S.C. § 2075, Bankruptcy Rule 9006(b) could not override substantive provisions of Bankruptcy Code § 1121(e) to extend exclusivity period beyond 160 day deadline).

50. Scopac's efforts to bar the Noteholder Group from further participation in this case violate at least four fundamental rights of the Noteholder Group's members.

[12] The mandate of § 2075 is a crucial historical difference between the application of Rule 2019 today and its predecessors that emerged from the SEC Report under the former Bankruptcy Act.

> Bankruptcy procedure was governed in substantial part by many sections of the 1898 Act.... In 1964, Congress authorized the promulgation of rules of bankruptcy procedure by the Supreme Court.... The rules superseded inconsistent statutory provisions, which was quite important under the Act, given its detailed procedural provisions. Today the situation is reversed, rules cannot supersede a statute.

Tabb, *supra* at 31.

51. *First*, the most fundamental policy underlying U.S. bankruptcy law is the equality of treatment of creditors. *See Board of Directors of Multicanal*, 314 B.R. 486, 518-19 (Bankr. S.D.N.Y. 2004) ("The principle of equality between identically situated creditors is fundamental under U.S. insolvency law."); Bankruptcy Code § 1129(b) (prohibiting discrimination in chapter 11 plans). At an even more fundamental level, the U.S. Constitution guarantees "equal protection" under the laws of the United States. *See* U.S. CONST. amend. V & XIV. Scopac's 2019 Motion seeks to deny to the members of the Noteholder Group both the equality of treatment and the equal protection to which they are entitled.

52. *Second*, the objective of Scopac's discrimination is to use this Court's jurisdiction to terminate the Noteholder Group's opportunity to be heard in this bankruptcy case. Not only does this impermissibly infringe upon the Noteholder Group members' fundamental rights to participate in bankruptcy under Bankruptcy Code § 1109(b), it also violates the most basic Constitutional due process protections -- the opportunity and right to be heard before a court takes action that could affect a party's rights. *See* U.S. CONST. amend. V ("No person shall ... be deprived of life, liberty or property without due process of law."); *Multicanal*, 314 B.R. at 503 (holding that the key issue in recognizing foreign insolvency is whether due process, including notice and opportunity to be heard, were provided in bankruptcy proceeding).

53. *Third*, the property rights at issue here are those of a secured creditor, which are property rights that are protected by the Takings Clause of the Fifth Amendment against governmental action. *See* U.S. CONST. amend. V ("[N]or shall private property be taken for public use without just compensation."); *In re Treco*, 240 F.3d 148, 158-60 (2d Cir. 2000) ("security interests have been recognized as property rights protected by our Constitution's prohibition against takings without just compensation."). Plainly stated, Scopac seeks an order

that would violate the Fifth Amendment by precluding the Noteholder Group from protecting the property rights of its members.

54. *Fourth*, the Noteholder Group's members also have the right to maintain the confidentiality of their proprietary commercial information as recognized by, among other legal sources, Bankruptcy Code § 107(b). While disclosure of confidential information can sometimes be compelled in litigation where the information is actually relevant to an issue in dispute, such disclosure is invariably done pursuant to a protective order. Scopac's ultimatum that the Noteholder Group publicly disclose information that has no relevance to any dispute between Scopac and the Noteholder Group improperly abridges the Noteholder Group's members' property rights and liberty interests in their confidential proprietary information, which are protected by the Constitution's due process guarantee and the First Amendment freedom of speech guaranty, which includes the right not to speak. *See Int'l Dairy Foods Assoc. v. Amestoy*, 92 F.3d 67, 71-72 (2d Cir. 1996) (statute compelling disclosure of commercial information infringed upon defendants companies' First Amendment "right not to speak"); *see also Wooley v. Maynard*, 430 U.S. 705, 714 (1977) (stating that "the First Amendment's [protection] against state action includes both the right to speak freely and the right to refrain from speaking at all.").

III. SCOPAC IS INVOKING BANKRUPTCY RULE 2019 FOR IMPROPER PURPOSES AND THE COURT HAS DISCRETION TO DENY SCOPAC THE RELIEF IT IS SEEKING

55. Scopac seeks to use Bankruptcy Rule 2019 as a weapon against the Noteholder Group. Scopac understands full well the confidential and highly proprietary commercial nature of the information it is demanding. What Scopac is really seeking to do is nothing less than to silence the voices of Noteholders holding $695 million of the approximately $750 million in claims asserted against the Scopac estate. This is not a good faith objective, to say the least. ***The***

information that Scopac seeks has absolutely no relevant purpose for Scopac in this chapter 11 case. It is well settled that a chapter 11 debtor cannot treat its similarly situated creditors differently based upon the price that they paid for their claims. *See* Hon. Robert D. Drain, *Are Bankruptcy Claims Subject to the Federal Securities Laws*, 10 AM. BANKR. INST. L. REV. 569, 578 (2002) ("[A] discounted purchase price is irrelevant to the ability to enforce the claim in full."); *In re Executive Office Ctrs.*, 96 B.R. 642, 649 (Bankr. W.D. La. 1988) (purchasers of bankruptcy claims at a discount succeed to the rights of the sellers).

56. Moreover, any argument that this information might be relevant to explain the "motivations" of the Noteholder Group's members for the benefit of other parties-in-interest does not hold water. What "motivates" creditors to enforce their claims is legally irrelevant, nor does Rule 2019 require any disclosure of "motivations." In any event, such motivations are crystal clear -- the members of the Noteholder Group want to maximize recovery on their claims.[13]

57. Thus, it is abundantly evident that Scopac has resorted to its pretextual 2019 Motion for the purpose of harassing the Noteholder Group by seeking the disclosure of confidential information that Scopac has no legitimate use for and that has not been requested by any member of the Noteholder class that Scopac asserts that the Noteholder Group supposedly "represents."

58. Even if the Court were to determine that Rule 2019's text applied to the Noteholder Group and did not violate 28 U.S.C. § 2075, the rule is clearly discretionary and the Court should exercise its discretion to protect the Noteholder Group from the unnecessary disclosure of highly confidential and proprietary information that can serve no useful purpose in

[13] Some have argued that disclosure of holdings can be useful in cases like *Northwest* where the debtor's capital structure includes numerous levels for investor participation, which can lead to conflicting motivations. Even if this were a legitimate concern, it simply is not an issue in this case for the reasons discussed *supra* in paragraph 42.

these proceedings. Bankruptcy Rule 2019(b) only provides that the court "may" order various remedies for a failure to comply with Rule 2019, not that it "shall" order such remedies. *See Kaiser Aluminum Corp.*, 327 B.R. at 559 ("It has been recognized that Rule 2019 need not always be strictly applied."); *In re Hudson Shipbuilders*, No. Civ. S.84-0757, 1985 U.S. Dist. LEXIS 17654, at *14 (S.D. Miss. July 22, 1985) (holding that "Bankruptcy Rule 2019(b) affords the court the discretion, and does not mandate" that the court must order a remedy).

59. The Court also has the power under Bankruptcy Code § 105 to enter an order protecting the Noteholder Group members from the unwarranted application of Rule 2019, particularly where it is being invoked by Scopac in a manner completely inconsistent with the rule's actual purpose. *See In re I. G. Servs. Ltd.*, 244 B.R. 377, 389 (Bankr. W.D. Tex. 2000), *rev'd on other grounds*, 263 B.R. 505 (W.D. Tex. 2000) (holding that § 105 provided power to protect party against application of Rule 2019 where application of the rule did not serve the purpose of protecting against improper participation in bankruptcy proceedings). At bottom, Bankruptcy Rule 2019 is designed to protect investors, not debtors. *See id.* at 389 ("The only interest that the court might have in enforcing the letter of Rule 2019 is to protect these very investors."). Where, as here, application of Rule 2019 would not serve the purpose of protecting investors (because investors holding 97.41% in outstanding principal amount of the Timber Notes are already part of the Noteholder Group and the remainder are free to join at any time), there is no rational purpose to apply it. *See id.* at 389-90 (denying motion by press to require strict public disclosure of Rule 2019 information because rule was designed to protect investor participation in bankruptcy, not the press); *Kaiser Aluminum Corp.*, 327 B.R. at 559. Accordingly, even if the Noteholder Group were a "committee" within the meaning of Rule 2019, the Court should exercise its discretion not to enforce the rule as the 2019 Motion requests.

CONCLUSION

60. The Noteholder Group respectfully requests that the Court deny the 2019 Motion and grant the Noteholder Group such other relief as the Court deems just and fair under the circumstances.

Dated: April 6, 2007

BRACEWELL & GIULIANI LLP

Evan D. Flaschen (304232)
Gregory W. Nye (300188)
Kurt A. Mayr (425858)
One Goodwin Square
225 Asylum Street, 26th Floor
Hartford, CT 06103
Telephone: (860) 947-9000
Facsimile: (860) 760-6789
E-Mail: evan.flaschen@bgllp.com

and

GARDERE WYNNE SEWELL LLP

By: /s/ John. P Melko
John P. Melko (13919600)
1000 Louisiana, Suite 3400
Houston, TX 77002-5007
Telephone: (713) 276-5727
Facsimile: (713) 276-6727

Attorneys for the Ad Hoc Group of Timber Noteholders

CERTIFICATE OF SERVICE

I hereby certify that on the 6th day of April, 2007 a true and correct copy of the foregoing instrument was forwarded to all parties listed on the attached Service list

/s/ John P. Melko
John P. Melko

Master Service List
Scotia Development, LLC, et al
Exhibit "1"

Debtor
Gary L. Clark
Scotia Pacific LLC
125 Main Street
Scotia, CA 95565-0000

Debtor's Attorneys
John F. Higgins
James Matthew Vaughn
Porter & Hedges, L.L.P.
1000 Main Street, 36th Floor
Houston, TX 77002

Kathryn Coleman
Gibson Dunn & Crutcher LLP
One Montgomery Street, Suite 3100
San Francisco, CA 94104

Eric J. Fromme
Gibson Dunn & Crutcher LLP
Jamboree Center
4 Park Plaza, Suite 1400
Irvine, CA 92614

Debtors
Scotia Development LLC
921 N. Chaparral, Suite 104
Corpus Christi, TX 78401

Salmon Creek LLC
P.O. Box 37
Scotia, CA 95565

Scotia Inn Inc.
100 Main Street
Scotia, CA 95565

Britt Lumber Co., Inc.
449 15th Street, Suite 401
Oakland, CA 94612

The Pacific Lumber Company
P.O. Box 37
Scotia, CA 95565

Debtors' Counsel
Shelby A. Jordan
Harlin C. Womble, Jr.
Nathaniel Peter Holzer
Jordan, Hyden, Womble, Culbreth & Holzer
500 N. Shoreline Blvd., Suite 900
Corpus Christi, TX 78471

Jeffrey Schaffer
Gary M. Kaplan
Howard Rice Nemerovski, et al.
Three Embarcadero Center, 7th Floor
San Francisco, CA 94111

U.S. Trustee
United States Trustee
606 N. Carancahua, Suite 1107
Corpus Christi, TX 78476

Committee of Unsecured Creditors
Environmental Protection Information Center, Interim Chairman
c/o Sharon E. Duggan
370 Grand Avenue, Suite 5
Oakland, CA 94610

John Miller, Interim City Manager
City of Rio Dell
675 Wildwood Ave.
Rio Dell, CA 95562

Pacific Coast Trading, Inc.
c/o Miles T. Crail
1690 Green Ash Road
Reno, NV 89511

United Steelworkers
c/o David Jury
Five Gateway Center, Suite 807
Pittsburgh, PA 15222

Steve Cave
2332 Wrigley Road
Eureka, CA 95503

Counsel for Committee of Unsecured Creditors
Maxim B. Litvak
John D. Fiero
Pachulski Stang Ziehl Young Jones & Weintraub
150 California Street, 15th Floor
San Francisco, CA 94111-4500

Governmental Entities
Susan Combs, Comptroller
LBJ State Office Bldg.
111 E. 17th Street
P.O. Box 13528
Austin, TX 78711

Securities Exchange Commission
Attn: Merri Jo Gillette, Regional Director
175 W. Jackson Blvd., Suite 900
Chicago, IL 60604-2908

Internal Revenue Service
P.O. Box 21126
Philadelphia, PA 19114

Internal Revenue Service
1919 Smith Street
Stop 5022 HOU
Houston, TX 77002

U.S. Department of Justice
950 Pennsylvania Ave., NW
Washington, DC 20530-0001

U.S. Attorney's Office
Southern District
Donald J. Degabrielle, Jr.
Judy A. Robbins
P.O. Box 61129
Houston, TX 77208-1129

Kimberly A. Walsh
Assistant Attorney General
Bankruptcy & Collections Division
P.O. Box 12548
Austin, TX 78711-2548
Counsel for The Comptroller of Public Accounts of the State of Texas

Employment Development Dept.
Bankruptcy Group MIC 92E
P.O. Box 826880-0001
Sacramento, CA 94280-0001

Michael M. Stahl
Lisa Lund
U.S. Environmental Protection Agency
Office of Compliance
1200 Pennsylvania Avenue, NW
Washington, DC 20640-0001

Walker Smith
Randy Hill
U.S. Environmental Protection Agency
Office of Civil Enforcement
1200 Pennsylvania Avenue, NW
Washington, DC 20640-0001

Office of Enforcement and Compliance Assurance
U.S. Environmental Protection Agency
401 M Street, S.W.
Washington, DC 20460

Arizona Department of Revenue
P.O. Box 29079
Phoenix, AZ 85038-9079

State of California
Franchise Tax Board
P.O. Box 2952
Sacramento, CA 95812-2952

Kentucky Revenue Cabinet
Department of Revenue
200 Fair Oaks Lane
Frankfort KY 40620

Louisiana Department of Revenue
P.O. Box 91011
Baton Rouge, LA 70821-9011

Michigan Department of Treasury
430 W. Allegan Street
Lansing, MI 48922

Missouri Director of Revenue
P.O. Box 3020
Jefferson City, MO 65105-3020

Corporation Income Tax
P.O. Box 700
Jefferson City, MO 65105-0700

Ohio Treasurer of State
Ohio Department of Taxation
P.O. Box 804
Columbus, OH 43216-0804

West Virginia State Tax Department
Bankruptcy Unit
P.O. Box 766
Charleston, WV 25323-0766

Stephanie Tom Coupe
State of California
Department of Fish and Game
1416 Ninth Street, 12th Floor
Sacramento, CA 95814
Department of Fish and Game

Department of Fish and Wildlife Service
Attn: Anne Badgely, Regional Director
911 N.E. 11th Avenue
Portland, OR 97232
U.S. Department of the Interior

Pacific Region, Region 1 Offices
Attn: Ren Lohoefener, Regional Director
911 NE 11th Ave
Portland, OR 97232

California and Nevada Operations:
Steve Thompson, California and Nevada Operations (CNO) Manager
Kenneth McDermond, Deputy Operations Manager
2800 Cottage Way
Sacramento, CA 95825
U.S. Department of the Interior
U.S. Fish and Wildlife Service

National Marine Fisheries Services
US Department of Commerce
Attn: Dr. William Hogarth
Deanna Harwood, Office of Counsel
501 W. Ocean Blvd., Suite 4200
Long Beach, CA 90802
U.S. Department of Commerce National Oceanic and Atmospheric Administration; National Marine Fisheries Service, Southwest Regional Office

Lisa Roberts
John Clancey
1655 Heindon Road
Arcata, CA 95521
U.S. Department of Commerce National Oceanic and Atmospheric Administration; National Marine Fisheries Service

The Resources Agency
Secretary of Resources
Attn: Mary Nichols
1416 Ninth Street, Suite 1131
Sacramento, CA 95814

Department of Forestry and Fire Protection
Norman Hill, Chief Counsel
Ginevra Chandler, Chief Counsel
P.O. Box 944246
Sacramento, CA 94244-2460

Tom Osipovich, Unit Chief
Joe Fassler, Forest Inspector
118 S. Fortuna Boulevard
Fortuna, CA 95540
State of California – Department of Forestry and Fire Protection, Humboldt Del Norte Unit

Wildlife Conservation Board
W. John Schmidt, Executive Director
RETURNED MAIL

Wildlife Conservation Board
John P. Donnelly, Executive Director
1807 13th Street, Suite 103
Sacramento, CA 95814
State of California; Wildlife Conservation Board

Sacramento Fish & Wildlife Office
Lynn Cox, Deputy Solicitor General
2800 Cottage Way, Room W-2605
Sacramento, CA 95825
U.S. Department of the Interior
U.S. Fish and Wildlife Service

Arcata Fish & Wildlife Office
Mike Long
Amedee Brickey
James Bond
1655 Heindon Road
Arcata, CA 95521
U.S. Department of the Interior
U.S. Fish and Wildlife Service

Ted Cobb, Assistant Chief Counsel
1001 "I" Street
P.O. Box 100
Sacramento, CA 95814
California Environmental Protection Agency
State Water Resources Control Board

Robert Klamt, Chief, Timber Harvest Division
5550 Skylane Boulevard, Suite A
Santa Rosa, CA 95403
California Environmental Protection Agency
State Water Resources Control Board
North Coast Regional Water Control Board

Rick Martin, Director
North Coast Unified Air Quality Mgmt. District
2300 Myrtle Avenue
Eureka, CA 95501
North Coast Unified Air Quality Management District

California Forest Products Commission
Attn: Donn Zea, President
853 Lincoln Way, Suite 208
Auburn, CA 95603

Alan Tenenbaum
National Bankruptcy Coordinator
Department of Justice
Environment and Natural Resources Division
Environmental Enforcement Section
P.O. Box 7611
Washington, DC 20044
Counsel for the United States on behalf of the Department of the Interior and NOAA

Margarita Padilla
Mary Hackenbracht
Irene Tamura
Deputy Attorney General
Office of the California Attorney General
1515 Clay Street, 20th Floor
P.O. Box 70550
Oakland, CA 94612-0550
Counsel for the California Department of Fish and Game, the California Department of Forestry and Fire Protection, the North Coast Region Water Quality Control Board, the California State Water Resources Control Board and the California Wildlife Conservation Board

Michael Neville
Tiffany Yee
Deputy Attorney General
Office of the California Attorney General
455 Golden Gate Avenue, Suite 11000
San Francisco, CA 94102-7004
Counsel for the California Department of Fish and Game, the California Department of Forestry and Fire Protection, the North Coast Region Water Quality Control Board, the California State Water Resources Control Board and the California Wildlife Conservation Board

Secured Creditors

The Bank of New York Trust Company, N.A.
John Stohlmann
600 North Pearl St., Suite 420
Dallas, TX 75201
Indenture Trustee

Bank of America
Clara Yang Strand
333 South Hope Street
Los Angeles, CA 90071

Counsel to Secured Creditors

Evan M. Jones
Brian M. Metcalf
O'Melveny & Myers LLP
400 South Hope Street
Los Angeles, CA 90071-2899
Counsel for Bank of America

Evan D. Flaschen
Bracewell & Giuliani LLP
One Goodwin Square
225 Asylum Street, 26th Floor
Hartford CT 06103
Counsel to Ad Hoc Committee of Bondholders

Rhett G. Campbell
Diana M. Woodman
Matthew R. Reed
Thompson & Knight LLP
333 Clay Street, Suite 3300
Houston, TX 77002
Counsel for The Bank of New York Trust Company, N.A., Indenture Trustee

Ira L. Herman
Thompson & Knight LLP
919 Third Avenue, 39th Floor
New York, NY 10022-3915
Counsel for The Bank of New York Trust Company, N.A., Indenture Trustee

Twenty Largest Unsecured Creditors

Aetna – Middletown
11300 Tomahawk Creek Parkway, Suite 300
Leawood, KS 66211

Blair Forest Consulting
1225 Central Avenue #3
Mckinleyville, CA 95519

California Forest Products Commission
853 Lincoln Way, Suite 208
Auburn, CA 95603

D.R. Systems
2599 McCullough Road
Nanaimo B.C.
Canada

David Gillott
Tall Trees Forestry
P.O. Box 413
Blue Lake, CA 95525

Environmental Protection Information Ctr.
c/o Brian Gaffney
Law Offices of Brian Gaffney
605 Market Street, Suite 505
San Francisco, CA 94105

Hohman & Associates
P.O. Box 733
Hydesville, CA 95547-0733

Humboldt Del Norte IPA
3100 Edgewood Road
Eureka, CA 95502

Humboldt Fish Action Council
c/o Fisheries Biology Department
Humboldt State University
1 Harpst Street
Arcata, CA 95519

IBM Corporation
275 Viger East
Montreal, QC
Canada

Laco Associates
21 West 4th Street
P.O. Box 1023
Eureka, CA 95501

Les Schwab Tire Center
275 N. Fortuna Bl.
Fortuna, CA 95540

Maxey Forestry
P.O. Box 4858
Arcata, CA 95518

Metlife
Dept. CH 10579
Palatine, IL 60055-0579

National Benefit Resources
Attn. Michael Ann Johnson
16004 SW Tualatin-Sherwood Rd., #447
Portland, OR 97140

NCASI
P.O. Box 13318
Research Triangle Park, NC 279909-3318

Steve Cave, et al.
c/o William G. Bertain
Law Offices of William G. Bertain
1310 Sixth Street
Eureka, CA 95501

SWRCB
5550 Skylane Blvd. #A
Santa Rosa, CA 95403

Timberland Res. Consultants
165 S. Fortuna Bl. Suite 4
Fortuna, CA 95540

United Steelworkers of America, et al.
c/o Jonathan Weissglass
Altshuler Berzon LLP
177 Post Street, Suite 300
San Francisco, CA 94108

Interested Parties and Parties Requesting Notice

Alan Gover
White & Case LLP
1155 Avenue of the Americas
New York, NY 10036-2787
Counsel for MAXXAM Group, Inc.

Craig H. Averch
Roberto J. Kampfner
White & Case LLP
633 West Fifth Street, 19th Floor
Los Angeles, CA 90071
Counsel for MAXXAM Group, Inc.

Vincent E. Lazar
Michael S. Terrien
Phillip W. Nelson
Jenner & Block LLP
330 N. Wabash Avenue
Chicago, IL 60611
Counsel for LaSalle Bank, N.A. and LaSalle Business Credit, LLC

Vicky Namken
IBM Corporation
13800 Diplomat
Dallas, TX 75234
Counsel for International Business Machines Credit LLC and International Business Machines Corporation

Bruce G. MacIntyre
Perkins Coie LLP
1201 Third Avenue, 40th Floor
Seattle, WA 98101-3099
Counsel for Green Diamond Resource Company

Andrew Herenstein
Patrick Bartels
Quandrangle Group LLC
375 Park Avenue, 14th Floor
New York, NY 10152

David Neier
Winston & Strawn LLP
200 Park Avenue
New York, NY 10166
Counsel for Marathon Structured Finance Fund L.P.

Eric E. Sagerman
Winston & Strawn
333 South Grand avenue, Suite 3800
Los Angeles, CA 90071
Counsel for Marathon Structured Finance Fund L.P.

John D. Penn
Haynes and Boone LLP
201 Main Street, Suite 2200
Fort Worth, TX 76102
Counsel for Marathon Structured Finance Fund L.P.

David E. Martinek
Dun & Martinek LLP
2313 I Street
Eureka, CA 95501
Counsel for City of Rio Dell

Steven H. Felderstein
Paul J. Pascuzzi
Felderstein Fitzgerald Willoughby & Pascuzzi
400 Capitol Mall, Suite 1450
Sacramento, CA 95814
Counsel for State of California ex rel. Edmund G. Brown, Jr., A.G., CA Resources Agency, CA Dept. of Fish & Game, CA Dept. of Forestry & Fire Protection, North Coast Region Water Quality Control Board, CA State Water Resources Control Board, and CA Wildlife Conservation Board

Michael A. Axel
KeyBank National Association
127 Public Square, Second Floor
Cleveland, OH 44114-1306
Counsel for Key Equipment Finance Inc.

Phillip W. Nelson
Jenner and Block LLP
330 North Wabash Ave.
Chicago, IL 60611

North Coast Unified Air Quality
Rick Martin, APCO
c/o Nancy Diamond
Law Offices of Nancy Diamond
822 G Street, Suite 3
Arcata, CA 95521

Pacific Forest Trust
101-A O-Riley Avenue
San Francisco, CA 94129

Tiffany Yee
Office of the Attorney General
455 Golden Gate Ave., Suite 11000
San Francisco, CA 94102

Chanin Capital Partners LLC
c/o Brent C. Williams
330 Madison Ave.
New York, NY 10017

Dallas County
Linebarger Goggan Blair & Sampson
2323 Bryant St., Suite 1600
Dallas, TX 85201

Development Specialists Inc. (DSI)
345 California St., Suite 1150
San Francisco, CA 94104-2664

Mattole Restoration Council
P.O. Box 160
Petrolia, CA 95558

Ray Miller
3147 Dolbeer St., #13
Eureka, CA 95503

John C. Morrison
1890 Loop Road
Fortuna, CA 85540

Ira L. Herman
Thompson & Knight
919 Third Ave., 39th Floor
New York, NY 10022-3915

Humboldt Watershed Council
Post Office Box 1301
Eureka, CA 95502

Lewis Logging
3908 Rohnerville Rd.
Fortuna, CA 85540

James A. Shepherd
Office of the U. S. Trustee
235 Pine St., Suite 700
San Francisco, CA 94708

EXHIBIT F

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

IN RE:	§	**JOINTLY ADMINISTERED**
	§	
SCOTIA DEVELOPMENT LLC, ET AL.,	§	**Case No. 07-20027-C-11**
	§	
Debtors.	§	**Chapter 11**

Related Docket Nos. 265, 492 & 599
Hearing Date: April 10, 2007 @ 11:00 am CST

THIS PLEADING APPLIES ONLY TO
SCOTIA PACIFIC COMPANY LLC, CASE NO. 07-20032

MOTION OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND LOAN SYNDICATIONS AND TRADING ASSOCIATION FOR LEAVE OF COURT PURSUANT TO 11 U.S.C. § 1109(b) OR, ALTERNATIVELY, FED. R. BANKR. P. 2018(a) AND 11 U.S.C. § 105(a), TO APPEAR AS AMICI CURIAE, FILE BRIEF AND MAKE ORAL ARGUMENT IN SUPPORT OF NOTEHOLDER GROUP'S OBJECTION TO SCOTIA PACIFIC COMPANY LLC'S MOTION FOR ORDER COMPELLING AD HOC COMMITTEE TO FULLY COMPLY WITH BANKRUPTCY RULE 2019(a) BY FILING COMPLETE AND PROPER VERIFIED STATEMENT DISCLOSING ITS MEMBERSHIP AND THEIR INTERESTS

Securities Industry and Financial Markets Association ("SIFMA") and Loan Syndications And Trading Association ("LSTA", and along with SIFMA, the "Movants"),[1] through their under-signed counsel, hereby submit this motion (the "Motion") for leave of the Court, pursuant to section 1109(b) of title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as amended, the "Bankruptcy Code") or, alternatively, Rule 2018(a) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") and section 105(a) of the Bankruptcy Code, to (i) appear as amici curiae, (ii) file the brief attached hereto (the "Amicus Brief") in support of the objection

[1] As described at greater length in the Amicus Brief (as defined below), Movants are two of the nation's leading industry groups focused on the health and vitality of the debt and equity markets, whose members include many of the largest and best-known participants in today's financial markets.

(the "Objection", Docket. No. 599) of the Ad Hoc Group of Timber Noteholders (the "Noteholder Group") to the motion of Scotia Pacific Company LLC ("Scopac"), debtor in possession in the above-captioned chapter 11 case, for an order compelling the Noteholder Group to file a statement pursuant to Bankruptcy Rule 2019 publicly disclosing the Noteholder Group's membership and certain proprietary trading information (the "2019 Motion", Docket. No. 492), and (iii) make oral argument in support of the Amicus Brief.

Movants respectfully request leave of the Court to appear as amici curiae, file the Amicus Brief and make oral argument with respect thereto pursuant to section 1109(b) of the Bankruptcy Code, which provides, in pertinent part, that "a party in interest . . . may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109(b). Movants believe, as set forth in greater detail in the Amicus Brief, that, if granted, the relief sought in the 2019 Motion will have detrimental impacts on the liquidity of the active and vibrant trading markets as well as the willingness and ability of many stakeholders to participate in future chapter 11 cases. Accordingly, as leading industry associations focused on the health and vitality of the financial markets, Movants respectfully represent that, solely with respect to the Court's resolution of the 2019 Motion, they are "parties in interest" in the above-captioned matter. See In re Johns-Manville Corp., 36 B.R. 743, 747 (Bankr. S.D.N.Y. 1984) ("The term 'party in interest' has no specific definition in the Code and its applicability must be determined on an '*ad hoc*' basis [and] construed broadly so that parties affected by a Chapter 11 case have an opportunity to be heard.") (internal citations omitted).

Alternatively, Movants request leave of the Court to file the Amicus Brief and make oral argument with respect thereto pursuant to (a) Bankruptcy Rule 2018(a), which provides that "after hearing on such notice as the court directs and for cause shown, the court may permit any interested entity to intervene . . . with respect to any specified matter," and (b) the Court's broad equitable powers under section 105 of the Bankruptcy Code.

Dated: April 9, 2007
New York, New York

MILBANK, TWEED, HADLEY & M^{c}CLOY LLP

By: /s/ Matthew S. Barr
Matthew S. Barr (MB 9170)*
Peter K. Newman (PN 8603)*
1 Chase Manhattan Plaza
New York, New York 10005-1413
(212) 530-5000

Attorneys For Amici Curiae Securities Industry And
Financial Markets Association And
Loan Syndications And Trading Association

* indicates motion for *pro hac vice* admission of this attorney is pending before this Court

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

IN RE:	§	**JOINTLY ADMINISTERED**
	§	
SCOTIA DEVELOPMENT LLC, ET AL.,	§	**Case No. 07-20027-C-11**
	§	
Debtors.	§	**Chapter 11**

Related Docket Nos. 265, 492 & 599
Hearing Date: April 10, 2007 @ 11:00 am CST

THIS PLEADING APPLIES ONLY TO
SCOTIA PACIFIC COMPANY LLC, CASE NO. 07-20032

BRIEF OF AMICI CURIAE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND LOAN SYNDICATIONS AND TRADING ASSOCIATION IN SUPPORT OF NOTEHOLDER GROUP'S OBJECTION TO SCOTIA PACIFIC COMPANY LLC'S MOTION FOR ORDER COMPELLING AD HOC COMMITTEE TO FULLY COMPLY WITH RULE 2019(a) BY FILING COMPLETE AND PROPER VERIFIED STATEMENT DISCLOSING ITS MEMBERSHIP AND THEIR INTERESTS

Securities Industry and Financial Markets Association ("SIFMA") and Loan Syndications and Trading Association ("LSTA", and along with SIFMA, the "Amici") hereby submit this brief (the "Amicus Brief") as amici curiae[1] in support of the objection (the "Noteholder Group Objection", Docket. No. 599) of the Ad Hoc Group of Timber Noteholders (the "Noteholder Group") to the motion of Scotia Pacific Company LLC ("Scopac"), debtor in possession in the above-captioned chapter 11 case, for an order compelling the Noteholder Group to file a statement pursuant to Rule 2019 of the Federal Rules of Bankruptcy Procedure ("Rule 2019") publicly disclosing the Noteholder Group's membership and certain proprietary trading information of each member (the "2019 Motion", Docket. No. 492), and respectfully state as follows:

[1] By Motion filed contemporaneously herewith, Amici have moved for leave to file this Amicus Brief as amici curiae.

STATEMENT OF INTEREST

1. Amici are two of the nation's leading industry groups in the debt and equity markets, whose members include many of the largest and best-known participants in today's financial markets. While Amici have no view on the underlying merits of the various disputes between Scopac and the Noteholder Group in these bankruptcy cases, Amici are very concerned that an order approving the 2019 Motion will have a detrimental impact on the active and vibrant markets that trade in distressed companies' debt and equity securities and the willingness and ability of many sophisticated parties to participate in future chapter 11 cases.

2. Forcing disclosure of the information Scopac seeks will require public dissemination of highly confidential and proprietary information from certain stakeholders. Amici believe that such a requirement will in all likelihood erect a substantial obstacle to the participation of certain parties and stakeholders in bankruptcy cases. This obstacle will (a) prevent involvement by sophisticated parties that have frequently made positive contributions and offered valuable input in reorganizations and (b) negatively impact the markets that create liquidity in a debtor's securities by hampering the ability of parties to manage their exposures by liquidating their claims and avoiding the delay and uncertainty of a bankruptcy case. Although Scopac and the Noteholder Group are currently at odds in these cases, there are countless examples in other cases where groups of stakeholders have cooperated, many times as "*ad hoc*" committees, to create imaginative and strikingly successful solutions in reorganization cases.

3. SIFMA[2] represents the interests of more than 650 securities firms, banks and asset managers. SIFMA's mandate is to promote policies and practices that work to expand and

[2] SIFMA represents a diverse mix of securities firms and banks, ranging from large, multi-product firms to companies with special market niches. With offices in New York, Washington, D.C., London, Frankfurt, Brussels and Tokyo and issuer and investor groups worldwide, SIFMA represents the shared interests of securities firms active in all U.S. and foreign markets and in all phases of corporate and public finance.

perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the securities markets and the industry.

4. LSTA is the trade association for all segments of the floating rate corporate loan market, with over 240 members, including broker-dealers, commercial banks, investment banks, mutual funds, merchant banks, and other major financial organizations worldwide. LSTA seeks to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims. LSTA's mission is to promote the orderly development of a fair, efficient, liquid, and professional trading market for commercial loans and other similar private debt.

5. As associations that focus on the health and vitality of the financial markets, Amici are well situated to address the negative market impact and public interest concerns of granting Scopac's 2019 Motion and submit this Amicus Brief to provide the Court with the benefit of their respective vantage points.

ARGUMENT

I. Requested Disclosure Is Inconsistent With Customary Practice And History Of Rule 2019

6. ***Inconsistent with Customary Practice.*** At the outset, Amici note that, as discussed extensively in the Noteholder Group Objection, with the exception of a single recent decision in the chapter 11 cases of Northwest Airlines Corporation and its affiliated debtors

SIFMA serves as the voice for the global bond industry, the largest securities markets in the world comprising roughly $50 trillion in outstanding securities. SIFMA is composed of member firms of the former Bond Market Association (BMA) and Securities Industry Association (SIA), each of whose member firms voted to merge the two associations last year.

pending in the United States Bankruptcy Court for the Southern District of New York, which is currently on appeal, counsel for *ad hoc* committees have customarily satisfied the requirements of Rule 2019 by filing a statement disclosing (a) the identity of the members of the *ad hoc* committee, (b) the holdings of *ad hoc* committee counsel, if any, and (c) occasionally, the holdings of the committee members in the aggregate (at par). The commonly held view, which Amici maintain is the proper interpretation of Rule 2019 and consistent with the circumstances that led to the promulgation of Rule 2019 (as discussed below), is that Rule 2019 does not apply to the members of *ad hoc* committees because they represent only their own interests and are not fiduciaries for other stakeholders.

7. It should also be noted that the customary practice of stakeholders maintaining their proprietary trading information in strict confidence is a corollary to a fundamental principle of the market for trading in the securities of bankrupt companies: the value of a claim or interest is determined by the nature of the debtor's obligation under the instrument, not the price paid by the stakeholder asserting its rights under such instrument. It is well-established law that the consideration paid for a claim or interest is irrelevant to the treatment of such claim or interest in bankruptcy. See, e.g., Shropshire, Woodliff & Co. v. Bush, 204 U.S. 186, 189 (1907) (holding that senior bankruptcy claims (there, priority wage claims "due to workmen, clerks, or servants") "did not cease to be within that description by their assignment to another" as "[t]he character of the debts was fixed when they were incurred, and could not be changed by an assignment."); Texas Hotel Secs. Corp. v. Waco Dev. Co., 87 F.2d 395, 399 (5th Cir. 1936) (transfer of claim during bankruptcy "usually does not deprive the claim of any of its incidents"); Resurgent Capital Servs. v. Burnett (In re Burnett), 306 B.R. 313, 319 (B.A.P. 9th Cir. 2004) (claim filed in bankruptcy case by an assignee may not, in absence of evidence of breach of some specialized

duty of assignee, be disallowed solely because assignee does not reveal consideration it paid to assignor) ("[T]he consideration paid by [the assignee] is, as a matter of law, irrelevant to the allowance of [its] claims"), aff'd, 435 F.3d 971 (9th Cir. 2006); In re Executive Office Ctrs., Inc., 96 B.R. 642, 649 (Bankr. E.D. La. 1988) ("Once a claim is assigned, the assignee succeeds to all rights of his transferor.").

8. Courts have repeatedly recognized that to reduce the value of a claim or interest based on the price at which such claim or interest is acquired, is to visit an unearned windfall upon a debtor and to destroy the incentive for investors to purchase distressed claims.[3] Yet that is exactly what will happen if a stakeholder is required to disclose its basis in a debtor's securities. When such information is made available, debtors and other parties in interest will inevitably use such information to their advantage in negotiations over such things as treatment of the security under a plan of reorganization or the price of the security in a subsequent disposition thereof. By simply requiring that such information be disclosed, the terms of

[3] In the words of the Court of Appeals for the Seventh Circuit:

> The debtor's obligation is to pay his debts. . . . In the absence of some equitable reason, taking the case out of the ordinary rule, the prices which security holders pay for their securities in no [way] affects the measure of their participation in reorganization or their voting power. ***To reduce the participation to the amount paid for securities, in the absence of exceptional circumstances which are not present here, would reduce the value of such bonds to those who have them and want to sell them. This would result in unearned, undeserved profit for the debtor, destroy or impair the sales value of securities by abolishing the profit motive, which inspires purchasers.***

Lorraine Castle Apts. Bldg. Corp. v. Machiewich (In re Lorraine Castle Apts. Bldg. Corp.), 149 F.2d 55, 57-58 (7th Cir. 1945) (emphasis added).

Similarly, the Court of Appeals for the Ninth Circuit flatly rejected any limitation on the rights of a claim purchaser to recover the full value of his claim in bankruptcy:

> Analysis shows the application of such a principle [limiting a creditor's recovery based on the price at which its claim was purchased] would be grossly inequitable to the holder of the . . . debt. It would destroy or impair its sales value. ***Buyers purchase bonds or other secured indebtedness primarily from the profit motive. .*** .He expects to realize out of the purchase more than the purchase price, at the same time running the risk of recovering less. Under the proposed equity, a buyer, confined to the maximum of his purchase price, buys nothing but the chance to "break even" or make a loss.

Security-First Nat. Bank v. Rindge Land & Navig. Co., 85 F.2d 557, 563 (9th Cir. 1936) (emphasis added).

negotiation will unavoidably shift from being focused on the obligations of the debtor under the terms of the relevant instrument to consideration of the relative return to the specific stakeholder, thereby effectuating a significant departure from well-settled law and customary practice. Likewise, it should come as no surprise that parties trade in securities with an expectation to make a profit. Disclosure of a party's basis in a security may impair this prospect and ultimately parties may decide not to purchase securities and participate in a restructuring.

9. ***Inconsistent With History of Rule 2019.*** If Scopac's 2019 Motion is granted, the disclosure requirements of Rule 2019 will be visited upon "committees" that do not raise the concerns that the rule was created to address. Since the prospect of such disclosure will force certain stakeholders with relatively small individual positions to choose between participating efficiently in a bankruptcy case, on the one hand, and revealing highly confidential proprietary information and strategies, on the other, many will effectively be unable to organize and act collectively. Therefore, these parties will be disadvantaged in terms of their ability to negotiate with larger stakeholders and debtors and effectively handcuffed by unintended restraints on engaging in collective action. Amici submit this result is inconsistent with Rule 2019's intent of assuring small stakeholders a voice (and a principle of bankruptcy law that encourages settlement and collaboration among parties).

A. Rule 2019's Disclosure Requirements Intended For Representative Committees With Fiduciary Duties

10. The linchpin for Scopac's argument that members of the Noteholder Group should be required to make disclosures under Rule 2019 is the coincidental usage of the word "committee" in both Rule 2019 as well as in the terminology commonly used to refer to a group or consortium of similarly-situated stakeholders that seek to share costs of professional fees in connection with a bankruptcy case. As discussed at length in the Noteholder Group Objection,

the use of the term "committee" in Rule 2019 is a relic of the inclusion of that same term in the Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees issued by the Securities and Exchange Commission in 1937 under the supervision of then-SEC Commissioner (and later Supreme Court Justice) William O. Douglas (the "Douglas Report"), which led to Congress' adoption of sections 210 and 211 of Chapter X of the Bankruptcy Act and, subsequently, Rule 10-211 (also under Chapter X), the direct predecessor of Rule 2019.

11. As the Douglas Report makes apparent, the mention of "committees" contained therein refers to the "protective committees" that typically dominated corporate restructurings during the time period that is the subject of the Douglas Report (i.e., before and during the 1930's). As documented at length in that report, the protective committees served as fiduciaries in a representative capacity for individual creditors that deposited their securities with the representative agents pursuant to one-sided depository agreements. According to the Douglas Report, typical depository agreements at the time essentially gave the protective committees *carte blanche* to agree to virtually any disposition of the securities they held for their depositors while exculpating the fiduciaries from any liability for self-dealing, insider trading and other conflicts of interests, leading to widespread behavior of exactly that sort. Recognizing the rampant abuse of the agency relationship established by the protective committee mechanism, the Douglas Report recommended that committee members be required to disclose their conflicting interests to those stakeholders that the committees would purport to represent. In this respect, the Douglas Report proposed the disclosure requirements found today in Rule 2019 as a solution to an agency problem that is simply irrelevant to *ad hoc* committees who typically

expressly disclaim any intent to represent and do not owe a fiduciary duty to each other or any third parties.

B. Application Of Disclosure Requirements Will Eviscerate Rule 2019's Intent

12. If the Court grants Scopac's 2019 Motion, the chapter 11 process will likely suffer from decreased involvement from all but the largest, most affluent investors. Smaller investors (or large investors with small positions), faced with the prospect of disclosing highly confidential and proprietary trading information, will not coordinate efforts in order to share costs and it will, therefore, become economically irrational for many such stakeholders to actively participate in bankruptcy cases. These parties, many of which are highly sophisticated and experienced in restructuring matters, will be forced to participate individually and bear the significant time and expense thereof, which will ultimately lead many to a business decision to not purchase the security -- to the detriment of those that want to liquidate their positions -- and not become actively involved in a bankruptcy case -- potentially to the detriment of all parties in interest.

13. Such a result would actually run contrary to the broader intent behind Rule 2019 -- i.e., to protect stakeholders from having their claims or interests restructured on terms negotiated by larger stakeholders without proper representation of their interests. As demonstrated by the Douglas Report, the disclosure requirements embodied in Rule 2019 were developed to expose the self-dealing of conflicted protective committees that took advantage of small stakeholders. Presumably, the disclosure of such self-dealing, along with other protections recommended by the Douglas Report, was intended to encourage stakeholders to find alternative ways to represent their interests. Today, the empowerment of stakeholders is often realized by collective action of *ad hoc* committees. To require stakeholders to choose between effective

representation of their individual interests through collectivization and maintaining the confidentiality of their proprietary information, is to thwart Rule 2019's broader aims.

II. Discouraging Collective Action in Bankruptcy Cases Will Likely Decrease Successful Reorganizations

14. Courts have repeatedly recognized that "[j]oint activity by creditors facing a debtor is commonly in the interests of all parties." Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1052 (2d Cir. 1982) (citing Falstaff Brewing Corp. v. New York Life Insurance Co., 513 F. Supp. 289 (N.D. Cal. 1978)); see also United Airlines, Inc. v. U.S. Bank, N.A., 406 F.3d 918, 921 (7th. Cir.) ("Coordination is especially common in bankruptcy, which often is described as a collective proceeding among lenders"), mandate enforced by 409 F.3d 812 (7th Cir.), cert. dismissed, 126 S. Ct. 508 (2005); In re Balderas, 328 B.R. 707, 726 (Bankr. W.D. Tex. 2005) (applying "game theory" to analysis of creditors' incentives, likening isolated creditors' positions to the "volunteer's dilemma" and noting that "creditors do not know what one another are doing with respect to a given motion [and w]ithout that knowledge (and the concomitant ability to coordinate a response and share costs), each creditor will wait for someone else to "fall on the grenade" by filing an objection").

15. If this Court grants the 2019 Motion and requires disclosures of stakeholders' proprietary strategies, such a ruling will have the practical effect of forcing many creditors to act only in their individual capacities. Leaving these stakeholders with no practical choice but to act on their own will compel each of them to resort to the most extreme action available in order to protect its individual claim or interest. See Sharon Steel, 691 F.2d at 1052. Encouraging such action will obviously not foster consensual reorganization and "might well drive [debtors] out of business thereby eliminating any opportunity for [them] to work out of present difficulties and ultimately satisfy [their] debts." Id. "[B]y reducing both losses to creditors and the transaction

costs resulting from bankruptcy, [concerted creditor action] reduces the costs of borrowing and the costs of doing business, all of which is to the consumer's advantage." Id.

16. Specifically, the negative impact of the decreased cooperation that will likely result from granting of the 2019 Motion will be borne by, among others, the following parties.

(i) Individual Claim and Interest Holders. If forced to disclose confidential proprietary trading information and strategies, many investors in a debtor's securities will be less willing to enter the market for such claims or interests. The holders of a debtor's securities will suffer from decreased vitality and diminished liquidity in the markets for such securities, which will drive down the value of those securities. Furthermore, it should be noted that liquid markets provide benefits not only to sophisticated investors that seek out opportunities for investment in bankruptcy situations but also offer those creditors or interest holders that do not wish to endure the time and uncertainty of the bankruptcy process the ability to efficiently liquidate their claims or interests.

Individual securities holders will also be disadvantaged by decreased collective action because individual claimants or interest holders that are forced to bear the costs of their own representation on any given issue (as opposed to sharing the cost with other similarly situated stakeholders in a collective fashion) will be less likely to appear and be heard to vindicate their rights provided for under the securities they hold. Without such representation, recoveries will become more arbitrary, thereby decreasing market efficiency and, consequently, liquidity.

(ii) Creditor Body. It is common practice in large reorganizations for groups of sophisticated investors to retain professionals to negotiate with debtors on their own behalf in order to quickly and efficiently formulate plans of reorganization that maximize recoveries to creditors and equity holders. Other similarly situated creditors will benefit from the actions of these consortiums although they are not represented by these investors because of the protections afforded by the Bankruptcy Code (particularly the "fair and equitable" and "best interest of the creditors" tests of section 1129). By discouraging the collective action of stakeholders, fewer sophisticated and knowledgeable investors will be willing or able to efficiently and effectively negotiate restructurings that have the effect of increasing recoveries for debtors' creditors and interest holders.

(iii) Bankruptcy Debtors. In the present case, Scopac currently purports to see the actions of its organized creditors as "diverting Scopac's attention away from and, therefore, delaying the successful reorganization of its business." 2019 Motion at 10. Nonetheless, it is indisputable that debtors must have counterparties with a stake in the restructuring with which to

> negotiate any plan of reorganization that will ultimately be successful. More and more *ad hoc* committees are forming in recent cases irrespective of the appointment of official committees because of certain stakeholders' view that their specific voice needs additional representation given the complex corporate structures of today's debtors. Because of the class voting requirements of section 1126(c) and (d) of the Bankruptcy Code, in situations where there is no single creditor or equity holder in an impaired class with sufficient holdings to offer an accepting class, it is highly probable that a debtor seeking to reorganize will inevitably have to negotiate with multiple members of a given class and their respective professionals (assuming the debtor can find such parties to negotiate with in the first instance) or it will run the risk that a proposed plan is voted down by parties entitled to vote. Accordingly, debtors may suffer from unnecessary delay and duplication of efforts if stakeholders are discouraged from forming groups represented by professionals with which the debtors can negotiate.

17. Furthermore, imposing the disclosure requirements of Rule 2019 on members of an *ad hoc* committee risks the presumably unintended consequence of creating potential liability for the members by adjudging them representatives for others when, in fact, it is clear their participation is solely intended to represent their own economic interest. Therefore, if the Court chooses to imply a representative capacity upon stakeholders who have not sought to assume such a role, the Court will discourage the productive activity of groups of organized and sophisticated stakeholders in bankruptcy cases.

CONCLUSION

18. Amici fear that firms will conclude that the only rational business decision for parties that buy and sell securities of a debtor or distressed company would be to not participate in a case if required to disclose confidential proprietary information under Rule 2019. This may ultimately lead to firms deciding not to buy distressed securities, which, for reasons discussed above, would likely be detrimental to reorganizations to come.

WHEREFORE, Amici respectfully request that the Court enter an order (i) sustaining the Noteholder Group Objection, (ii) denying Scopac's 2019 Motion, and (iii) awarding such other, further relief as is just and proper.

Dated: April 9, 2007
New York, New York

MILBANK, TWEED, HADLEY & M^{c}CLOY LLP

By: /s/ Matthew S. Barr
Matthew S. Barr (MB 9170)*
Peter K. Newman (PN 8603)*
1 Chase Manhattan Plaza
New York, New York 10005-1413
(212) 530-5000

Attorneys For Amici Curiae Securities Industry
And Financial Markets Association And
Loan Syndications And Trading Association

* indicates motion for *pro hac vice* admission of this attorney is pending before this Court

EXHIBIT G

United States District Court
Southern District of Texas
FILED
APR 24 2007
Michael N. Milby, Clerk

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF

TEXAS

CASE NO.:	07-20027
STYLE:	Scotia Pacific Co., LLC
HEARD ON:	04/10/07
FILED ON:	04/24/07
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UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

CORPUS CHRISTI DIVISION

United States Courts
Southern District of Texas
FILED

APR 2 4 2007

Michael N. Milby, Clerk of Court

IN RE: SCOTIA DEVELOPMENT LLC, .	CASE NO. 07-20027
.	
.	CORPUS CHRISTI, TEXAS
DEBTOR. .	TUESDAY, APRIL 10, 2007
.	11:03 A.M. TO 1:12 P.M.
. . . .	

MOTION HEARING

SOME PARTIES APPEARING TELEPHONICALLY

BEFORE THE HONORABLE RICHARD SCHMIDT
UNITED STATES BANKRUPTCY JUDGE

Trinity Transcription Services
122 Trinity Oaks Circle
The Woodlands, TX 77381
281-296-2290

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

CORPUS CHRISTI DIVISION

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MOTION HEARING

SOME PARTIES APPEARING TELEPHONEICALLY

BEFORE THE HONORABLE RICHARD SCHMIDT
UNITED STATES BANKRUPTCY JUDGE

Appearances:

For Scotia Pacific Company:

Kathryn A. Coleman, Esq.
Eric J. Fromme, Esq.
Robert Davis, Esq.
Gibson, Dunn & Crutcher LLP
200 Park Avenue
New York, NY 10166-0193

John F. Higgins, Esq.
Robert Dakis, Esq.
Porter & Hedges LLP
Reliant Energy Plaza
1000 Main Street, 36th Floor
Houston, TX 77002

Gary Clark, Esq.
No Address Provided

Bank of New York Trust Co.:

Diana M. Woodman, Esq.
Matt Reed, Esq.
Thompson & Knight LLP
333 Clay Street, Suite 3300
Houston, TX 77002

Appearances (continued):

Official Committee of
Unsecured Creditors:

John D. Fiero, Esq.
Maxim B. Litvak, Esq.
Pachulski Stang Ziehl Young
Jones & Weintraub
150 California Street, 15th Floor
San Francisco, CA 94111-4500

Ad Hoc Committee of
Timber Noteholders:

Evan D. Flaschen, Esq.
Kurt Mayr, Esq.
Bracewell & Giuliani, LLP
711 Louisiana Street, Suite 2300
Houston, TX 77002-2270

Ad Hoc Noteholders:

John P. Melko, Esq.
Gardere Wynne Sewell LLP
1000 Louisiana, Suite 3400
Houston, TX 77002-5007

For Pacific Lumber Company:

Shelby Jordan, Esq.
Peter Holzer, Esq.
No Address Provided

Frank Bacik, Esq.
The Pacific Lumber Company
No Address Provided

U.S. Trustee:

Christine A. March, Esq.
Assistant United States Trustee
Office of the United States
Trustee
606 No. Carancahua, Suite 1107
Corpus Christi, TX 78476

CSG Investments:

Roberto Kampfner, Esq.
Alan Gover, Esq.
White & Case LLP
No Address Provided

Bank of America:

Evan Jones, Esq.
O'Melveny & Myers
No Address Provided

California State Agencies:

Paul Pascuzzi, Esq.
Felderstein Fitzgerald & Pascuzzi
No Address Provided

Appearances (continued):

Marathon Structured Finance Fund:	David Neier, Esq. Winston & Strauser No Address Provided John D. Penn, Esq. Haynes and Boone, LLP 201 Main Street, Suite 2200 Fort Worth, TX 76102-3126
Interested Party:	Brian Lennon, Esq. Kirkland & Ellis, LLP No Address Provided
CSG Investments:	Jacob Cherner, Esq. CSG Investments No Address Provided
Avenue Capital Group:	Stephen Burnazian, Esq. Avenue Capital No Address Provided
Quadrangle Group:	Robert Burns, Esq. Quadrangle Group No Address Provided
Houlihan Lokey Howard & Zukin:	Todd Hanson, Esq. Houlihan Lokey Howard & Zukin No Address Provided
DE Shaw:	Sarah Johnson, Esq. DE Shaw No Address Provided
Maxxam, Inc.	Joli Pecht, Esq. Maxxam, Inc. No Address Provided
LaSalle Bank:	Mark W. Wege, Partner Bracewell & Giuliani, LLP 711 Louisiana Street, Suite 2300 Houston, TX 77002-2770
Pension Benefit Guaranty Corporation	Theresa Betro, Esq. Pension Benefit Guaranty Corp. No Address Provided

Appearances (continued):

SIFFMAA & LLSTA:	Matthew Barr, Esq. Peter Newman, Esq. Milbank Tweed Hadley & McCloy No Address Provided
Scotia Development, LLC:	Gary M. Kaplan, Esq. Howard, Rice, Nemerovski, Canady No Address Provided
Marathon Asset Management:	Richard K. Ronzetti, Esq. Marathon Asset Management No Address Provided
U.S. Department of Interior And Department of Commerce:	Alan Tenenbaum, Esq. U.S. Department of Justice No Address Provided
Aurelius Capital Management:	Wei Wang, Esq. Aurelius Capital Management No Address Provided
Mendocino Forest Products:	Daniel Zazove, Esq. Perkins Cole LLP No Address Provided
Bond Holder:	Ceki Aluf Medina Esq. EOS Partners No Address Provided
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Corpus Christi, Texas; Tuesday, April 10, 2007; 11:03 a.m.

(Some parties appearing telephonically)

THE COURT: Send in the call.

(Pause)

THE COURT: All right. I'm going to call everyone's name.

Theresa Betro?

MS. BETRO: Here, your Honor.

THE COURT: Maxim Litvak?

MR. LITVAK: Here, your Honor.

THE COURT: Matthew Barr?

MR. BARR: Here, your Honor.

THE COURT: Even Flaschen?

MR. FLASCHEN: Here, your Honor.

THE COURT: Gary Kaplan?

MR. KAPLAN: Here, your Honor.

THE COURT: Evan Jones?

MR. JONES: Here, your Honor.

THE COURT: David Neier?

MR. NEIER: Here, your Honor.

THE COURT: Richard Ronzetti?

MR. RONZETTI: Here, your Honor.

THE COURT: Frank Bacik?

MR. BACIK: Good morning, your Honor. Present.

THE COURT: Paul Pascuzzi?

MR. PASCUZZI: Here, your Honor.

THE COURT: Alan Tenenbaum?

MR. TENENBAUM: Good morning, your Honor.

THE COURT: Brian Lennon?

MR. LENNON: Present, your Honor.

THE COURT: Diane [sic] Woodman?

MS. WOODMAN: Here, your Honor.

THE COURT: Matt Reed?

MR. REED: Here, your Honor.

THE COURT: Peter Newman?

MR. NEWMAN: Here, your Honor.

THE COURT: Molly Bogdan?

OPERATOR: This is the Court Call Operator, Ms. Bogdon has not dialed in yet.

THE COURT: Anyone for Bank of America Securities?

(No audible response)

THE COURT: No. All right.

Wei Wang?

MR. WANG: Here, your Honor.

THE COURT: Joli Pecht?

MS. PECHT: Present, your Honor.

THE COURT: Sarah Johnson?

MS. JOHNSON: Present, your Honor.

THE COURT: Francine Brodowicz?

(No audible response)

THE COURT: Daniel Zazove, or Zazove?

MR. ZAZOVE: Present, your Honor.

THE COURT: Jacob Cherner?

MR. CHERNER: Present, your Honor.

THE COURT: Stephen Burnazian?

MR. BURNAZIAN: Here, your Honor.

THE COURT: Alan Gover?

MR. GOVER: Present, your Honor.

THE COURT: Roberto Kampfner.

MR. KAMPFNER: Here, your Honor.

THE COURT: Gren Day?

(No audible response)

THE COURT: Ceki Aluf Medina?

MR. MEDINA: Present, your Honor.

THE COURT: Robert Burns?

MR. BURNS: Present, your Honor.

THE COURT: And Todd Hanson?

MR. HANSON: Present, your Honor.

THE COURT: All right. Anyone from Murray Capital Management?

(No audible response)

THE COURT: Anyone from Bank of America Securities?

(No audible response)

THE COURT: Anyone else on the line?

MR. CLARK: Yes, your Honor. This is Gary Clark for the Debtors.

THE COURT: All right. Go ahead, Mr. Holzer.

MR. HOLZER: Pete Holzer, your Honor and Shelby Jordan for Pacific Lumber and its subsidiaries, except Scopac.

THE COURT: All right.

MS. COLEMAN: Good morning, your Honor, Kathryn Coleman, Eric Fromme, Robert Davis, Gibson, Dunn & Crutcher for Debtor, Scotia Pacific.

THE COURT: All right.

MR. HIGGINS: John Higgins on behalf of Scopac, your Honor.

THE COURT: All right.

MR. WEGE: Good morning, your Honor. Mark Wege here on behalf of LaSalle Bank.

MR. FIERO John Fiero from Pachulski, Stang for the Official Committee, your Honor.

MR. PENN: John Penn on behalf of Marathon Structured Finance.

MS. MARCH: Your Honor, Christine March on behalf of the United States Trustee.

MR. MEYER: Good morning, your Honor. Kurt Meyr, Bracewell & Giuliani on behalf of the Noteholder Group.

THE COURT: All right.

MR. MELKO: Good morning, your Honor, John Melko on behalf of the Ad Hoc Noteholder Group in Scopac.

THE COURT: Okay.

MR. HOLZER: We have a number of matters up this morning, your Honor. Pete Holzer for Pacific Lumber.

I guess with the Court's permission I'll take care of passes and -- and unopposed orders first.

THE COURT: All right.

MR. HOLZER: And the first one taking in that order is Docket Number 531 and 532. Those are the two motions related to the retention of Morris and Forester as Debtor's Special Counsel.

By agreement we'd like to pass those to the April the 17th.

THE COURT: April 17th.

MR. HOLZER: Eleven o'clock.

THE COURT: All right.

MR. HOLZER: The next is Docket Number 534. That's the motion to reconstitute the committee by agreement. We'd like to pass that matter to April the 24th also at 11 o'clock.

THE COURT: All right.

MR. HOLZER: Dropping back then to Docket Number 506. It's the Debtor's application to retain Pierce Baymiller as its Human Resources Manager.

We've had some discussions with the Committee and, based on my understanding, there are no objections. I have an order to present on that.

THE COURT: Is that correct?

MR. FIERO: Yes, your Honor.

THE COURT: All right. You may submit the order.

MR. HOLZER: Your Honor, Docket Number 5-9-8, 598, is the Pacific Lumber side motion to pay a secured pre-petition and post-petition real estate ad valorem property taxes.

The U.S. Trustee asked me to clarify that for Pacific Lumber that these taxes are all being paid to Humboldt County. And with that, I believe there are no objections on Docket Number 598. I have an order.

THE COURT: The Creditors Committee agree?

MR. FIERO: Yes, your Honor.

THE COURT: U.S. Trustee agree now?

MS. MARCH: Yes, your Honor.

THE COURT: All right. Submit the order.

(Pause)

MR. HOLZER: Continuing in the same -- the same way, I believe I'd like to go to a matter that is -- is actually not on the docket. And this was Docket Number 4-9-4, and this was the joint application to retain Deloitte Touche as the Debtor's auditors.

And I understand there's -- there's no objections on the Palco side to that order. But I understand we have a clarification on the Scopac side.

MR. HIGGINS: We do, your Honor. On the Scopac side, and it's Docket Number 4-9-5 is the order that the Debtor filed, your Honor, yesterday.

Scopac is retaining Deloitte to assist in the audit for 12/31/06. The audit -- engagement letter, excuse me, not the audit, the engagement letters refer to who will be responsible for directing the services of Deloitte. And it specifically provides that the Maxxam independent directors are responsible for that. That is because Maxxam is the SEC registrant.

We've agreed to clarify on the record for the noteholders that for any work related to the 2007 accounting and/or audit services, that Deloitte will be reporting to the board of managers of Scopac.

The only portion that relates to the Maxxam independent directors is with respect to the '06 audit.

THE COURT: All right.

MR. FIERO: And with that, your Honor, there's no other action needed by the Court on that order.

THE COURT: All right. Mr. Melko, is that correct?

MR. MELKO: It is correct, your Honor. It was a little confusing, because as the Court, they have seen Scopac was a public -- the monthly report and they've elected to stop the public reporting, because the number of holders is -- is under the threshold.

What's being done here is Deloitte is -- is going to do a consolidated audit. And for that -- for those purposes for '06, they will report to the audit committee of the public reporting entity, which is the ultimate parent company, Maxxam.

THE COURT: All right. Thank you.

MR. HOLZER: Your Honor, the next matter is the -- is Docket Number 5-9-6. This is the parallel taxes motion for Scopac.

MR. HIGGINS: Your Honor, we received one objection from the Official Committee of Unsecured Creditors. We've had an opportunity to speak with the Creditors Committee. And we have suggested, your Honor, is that we will pass the portion of the motion with respect to the timber yield taxes until April 24th to allow the parties to further discussion.

And there were no objections to the request for authority to pay the pre-petition property taxes and the sales and use taxes.

I've modified the proposed form of order to make -- to reflect that agreement.

THE COURT: All right.

MR. HIGGINS: May I?

THE COURT: You may. And the Court will note for the record the nodding of the Creditors Committee lawyer.

MR. FIERO: Yes, your Honor.

MR. HOLZER: I think, Judge, we have basically three contested issues spread over the docket. And I'll just go down the docket in order.

Docket Number 7 is Pacific Lumber's continuing cash collateral usage. And on the docket this morning, that shows up as 5-22, which I believe is a prior order.

But any event, that's Pacific Lumber's cash collateral. There is one disputed issue on that matter. And it really has to do more with the Docket Number 12, which is Pacific Lumber's application to pay pre-petition compensation and benefits.

One of those sub-items in that -- that particular motion, we've had two prior interim orders. We've been carrying forward one issue, and the issue is payments with respect to the defined benefit pension plan.

And we do have an objection on that payment from LaSalle. So I think that'll be the first matter we'll here this morning.

If I go ahead and go through what else is up, Docket 492 is Scopac's motion to require that the Ad Hoc Committee/Group file a 2019 Disclosure Statement.

That is opposed. And I believe we'll have extensive arguments on that. So I think that should come after.

And related to that is Docket Number 610, which is a Motion for Leave to File an Amicus Brief in that matter by another group of interested parties.

So those, I believe, should be taken together. So that's the second.

Then the third issue is --

THE COURT: Who's the interested party?

MR. BARR: Your Honor, it's Matthew Barr, Milbank Tweed, on behalf of the Securities Industry and Financial Markets Association, and the Loans, Syndications, and Trading Association.

We are the two parties that filed the Motion for Leave to File an Amicus Brief in support of the Ad Hoc's Committee's objection to the 2019 motion.

THE COURT: Okay.

MR. HOLZER: And then lastly, yesterday the noteholder group filed a Motion for Emergency Hearing and what they're asking the Court to do in their motion -- no one objects to hearing it today. So I don't think there's any opposition on the emergency hearing motion.

But the application, they want a certification of your Honor's opinion on the SARE Motion. They're asking the Court to certify it -- certify that for a direct appeal to the Fifth Circuit.

And that also is not on the docket today. But I don't think anyone's objecting to go forward on that. It would be Docket Number 612 was the Motion for Hearing. And 613 was the actual application itself.

And the Debtors do oppose that. And I'm not sure what the other parties' position are.

So I guess what I would like to do then is proceed on the Docket Number 12, the pre-petition compensation and benefits. I have some exhibits that have been circulated. I'd like to offer 1 through 7.

MR. WEGE: Your Honor, we would object to, I believe, it's to number 3 for lack of foundation.

(Pause)

THE COURT: Number 3 is what you're objecting to?

MR. WEGE: Yes, your Honor.

THE COURT: Thank you. What is your objection?

MR. WEGE: Foundation. There is no information as to what this document is or who sponsors it, or, you know, it would have --

THE COURT: A witness.

MR. HOLZER: Your Honor, Gary Clark is on the phone. And he would testify as far as foundation for this document that this -- this is the --

MR. WEGE: Your Honor, I would object to any testimony offered by phone.

(Pause)

THE COURT: Is the only issue as to this document is foundation? And you're objecting to the foundation witness appearing by phone?

MR. WEGE: Yes, your Honor.

THE COURT: And why is that?

MR. WEGE: Your Honor, if their witness is available to be here to testify, they filed the emergency motion. I would like the opportunity to cross exam him in person.

MR. HOLZER: Your Honor, we didn't know there was an objection until last night about nine o'clock.

So we would have had him here had we known there was an objection.

MR. WEGE: Your Honor, that's actually not correct. We filed our objection to this on February the 14th, 2007, Docket Number 295.

(Pause)

THE COURT: Well do you have any -- any information to suggest that these figures are incorrect? I mean, they just appear to be calculations.

MR. WEGE: Your Honor, I have no information whatsoever for this -- for this chart.

MR. HOLZER: Your Honor, there's only one figure on this chart that we're really talking about today. Because all we're asking the Court to approve is the payment of $588,625 that is due three days from now on April the 13th.

And so that's really the only relevant figure. For the Court's information, this is a -- a calculation prepared by Fidelity Investments, who is the administrator of the defined benefit pension plan.

MR. WEGE: Your Honor, I would object. Unless there is testimony for this matter, I would object to the counsel providing evidence.

(Pause)

THE COURT: Do we have someone from Fidelity?

MR. HOLZER: No, your Honor. The company would treat this as a business record.

THE COURT: So you are hoping to be able to have Mr. Clark assert that this was taken from the business records of the Debtor, and that they get -- they get something like this from time to time from Fidelity. And they just pay whatever they tell them.

MR. HOLZER: Yes, your Honor.

THE COURT: And the amount was 588,625 for the April 13th payment.

MR. HOLZER: Yes, your Honor. It actually does change over time. We've had a series of reports over the last few weeks where the number --

MR. WEGE: Your Honor, I would object again to counsel testifying.

THE COURT: Okay. All right. So what is the committee's position with respect to this?

MR. FIERO: Your Honor, the committee previously imposed an objection to the payment of pre-petition debt under the cash collateral order.

The committee has elected with respect to this payment only, this payment which is due in three days, not to assert that objection, but rather to reserve it for later payments if --

The committee wants to see how this case is going to turn out. And if it is, in fact, the reorganization that we expect it to be, we think this issue will recede.

But in the -- in the interim, we simply elected not to oppose this particular payment.

THE COURT: Okay.

MR. HOLZER: Your Honor, the application with respect to the -- the pension plan payment was supported by Mr. Clark's declaration. And we did file in connection with the first stay hearings.

That's in evidence. And I've attached the excerpts from that declaration as Exhibit Number 7.

THE COURT: Okay. For everything but -- but 3, you're not objecting to. So those are --

MR. WEGE: That's correct, your Honor.

THE COURT: So the rest of the documents will be admitted.

(Pacific Lumber's Exhibits Number 1, 2, 4, 5, 6, and 7 were received into evidence)

MR. HOLZER: Your Honor, the --

THE COURT: Number 7 you think provides some assistance?

MR. HOLZER: Well it's -- it's general background, your Honor, for the Debtor's request to pay what it believes are a pre-petition obligation under the Necessity of Payment Doctrine.

What the testimony, the prior testimony, showed you was that at the time we filed the case, we believe that the unfunded portion -- the underfunded portion of the pension plan was approximately $20.5 million.

We believe that amount is less now, but I don't think it matters one way or the other for this hearing. But if you'll turn to what's the third page, and it's actually paragraph 63, 64, and 65 was Mr. Clark's testimony with respect to the request to make the pre-petition payments under the pension plan.

(Pause)

THE COURT: All right. Mr. Clark, you on the phone?

MR. CLARK: Yes, your Honor.

THE COURT: All right. I'm going to overrule the objection concerning testimony by telephone.

Raise your right hand and be sworn.

MR. CLARK: Okay.

(Witness sworn)

THE COURT: Go ahead, Mr. Holzer.

//

DIRECT EXAMINATION

BY MR. HOLZER:

Q Mr. Clark, do you have Exhibit 3 in front of you?

A Yes, I do.

Q And could you tell the Court what Exhibit 3 is?

A Exhibit is a regularly prepared report by Fidelity Investments who acts as our administrator and our actuary, telling us the amount that is due for the coming four periods as a contribution to the pension plan.

Q All right.

MR. HOLZER: Your Honor, I believe that's all the testimony I need from Mr. -- from Mr. Clark.

THE COURT: Do you have any questions you wanted to ask?

MR. WEGE: Your Honor, I would continue my objection. If this is a document by Fidelity, then we need a witness by Fidelity if it's offered for the truth of the matter.

THE COURT: Do you want to complete the foundation?

MR. HOLZER: Well you've already admitted the document and overruled the objection.

THE COURT: I haven't -- no. I overruled the --

MR. HOLZER: Oh, okay.

THE COURT: -- objection to testimony.

MR. HOLZER: I apologize, your Honor.

Yes, I will continue, then, Judge.

BY MR. HOLZER:

Q Mr. Clark, could you tell the Court how -- how the company -- what the company does in response to these documents. So let's talk specifically about line number, the April 13 line, and the $588,625 payment.

A Yes. When we receive these updates from the actuary, that is the amount that we set in our budget to make the payments, the contribution.

We have used the 588,625, which was the most recent document received from Fidelity just yesterday for payment on the 13th, pending Court approval.

Q And does the company rely on Fidelity to calculate and provide the amount that is owed on -- in respect to its pension plan obligations?

A Yes, we do.

THE COURT: Well, normally we would have to know that it was kept in the ordinary course of business, that he was a custodian of the record, those kinds of things.

I mean, this is unusual for Bankruptcy Court to have actual evidentiary issues come up, but go ahead.

MR. HOLZER: Yes, Judge.

THE COURT: Finish it off.

BY MR. HOLZER:

Q Mr. Clark, these reports you get from Fidelity are they kept in Pacific Lumber's regular course of business?

A Yes.

Q And does the -- you or the persons that you supervise, rely on these documents and keep them in the company's regular course of business?

A Yes, we do keep them as part of our records, business records. And we use them to make the payments.

THE COURT: Okay. Well do you still have an objection to Number 3?

MR. WEGE: Your Honor, I have no objection as it be admitted as offered as a business record. If it's offered for more than that.

THE COURT: Okay. It'll be admitted.

(Pacific Lumber's Exhibit Number 3 was received into evidence)

THE COURT: Do you have any questions for Mr. Clark?

MR. WEGE: Your Honor, with respect to the document, or --

THE COURT: Any questions that you want. He just had him testify, so you can ask questions.

(Pause)

MR. WEGE: Your Honor, the only questions I would have is with respect to the affidavit of Mr. Clark. I just wanted to ask if there's anything -- if he has any dispute with any of the information in the affidavit that was submitted today, or in the motion that was filed with the Court. And in particular, the description of the defined contribution plan and the defined benefit pension plan, that if, in fact, all those representations are true and correct.

MR. HOLZER: Objection, your Honor.

THE WITNESS: Yes.

MR. HOLZER: That's a very broad question.

THE COURT: Well he answered it, so -- are you familiar with all of those documents that he just talked about?

THE WITNESS: Yes, your Honor.

THE COURT: And do you agree with the fact statements made therein?

THE WITNESS: Yes, sir.

THE COURT: Okay.

THE WITNESS: Yes, your Honor.

CROSS EXAMINATION

BY MR. WEGE:

Q And, in fact, that the -- the defined benefit plan was, in fact frozen as of December 31st, 2005.

A The benefits were frozen as of 12/31/05, yes.

Q And, in fact, there is a defined contribution plan that is provided to employees that is a transition from the defined benefit plan; is that correct?

A There is a defined contribution plan, yes. And it was modified at the time that the pension plan was frozen to provide a transition for the -- the employees, yes.

Q And that the new employees were not offered any benefits, new employees being the employees following 12/31/05, the new employees are not offered benefits under the terms of the defined benefit pension plan.

A That is correct, yes.

MR. WEGE: That's all the questions I have.

THE COURT: All right. Anything further?

MR. HOLZER: Not evidentiary, your Honor.

THE COURT: Anyone else have any questions for Mr. Clark?

(No audible response)

THE COURT: All right. Were there any other opposition to the -- to the funding?

MR. HOLZER: None other than the committees, which has been withdrawn.

MR. FIERO: No, your Honor. I want to make sure I set for the record that originally the Debtor's motion sought to make all future pension payment.

THE COURT: Yeah. All you're doing in authorizing this one.

MR. FIERO: That's correct. And that was something that --

THE COURT: All right.

MR. FIERO: -- that was okay with the Debtors.

THE COURT: And did the, let's see, Theresa Betro?

MS. BETRO: Yes, your Honor.

THE COURT: Did you have any comment on this issue?

MS. BETRO: CFC supports the Debtor's motion to make this payment of minimum funding due on April 13th as within the Debtor's business judgment, I believe that their motion was under 353(b), to make it as an outside of the ordinary course payment. And HBGC believes that they have satisfied their business judgment, that this is a proper exercise of their business judgment for various reasons.

One would be that nothing in bankruptcy law relieves the Debtors of their pension funding obligations under ERISA. And, in fact, the Bankruptcy Code at §1106(a)(1) requires the Debtor to continue to perform its obligations as the plan administrator.

And LaSalle's statement, supplemental objection filed last night at midnight, they stated that PBGC is the plan administrator, and that is not correct. Upon information and belief, Pacific Lumber is the administrator of the pension plan.

THE COURT: All right.

MS. BETRO: We also believe that it is within the Debtor's proper exercise of business judgment to make this payment because if the pension's minimum funding payment is missed, an excise tax will come due that could be as much as 110 percent of any funding deficiency.

THE COURT: Okay.

MS. BETRO: Also the Debtors have stated in their motion that this is a critical issue to their employees and it could affect the employees support for the reorganization of this company.

And missed funding might, in fact, cause the PBGC to feel that the pension is at risk, in which case it may terminate the pension plan. And that would result -- may result in increased cost to the estate. And it certainly result in the liquidation of PBGC's now contingent claim for unfunded benefit liabilities, which we currently estimate at $24 million.

And in regard to LaSalle's supplemental objection which they filed last night, they have cited cases. But those cases are only as to the administrative expense issue. Whether or not PBGC's claims that it -- it will file -- would be entitled to administrative expense or not is not the issue before the Court, but only as to whether or not it was in the proper business judgment to make this payment on April 13th. PBGC, by the way, disagrees with those cases.

I think it's most helpful, your Honor, to view this pension plan as similar to an executory contract. Although that's not what it is. Although it's not an executory contract, if a reorganizing Debtor decides to continue its pension plan, and assume the obligations of that going forward, it would have to cure the arrears upon exit.

If the economic costs making these payment can reasonably be said it will far outweigh any cost of making them.

THE COURT: All right. Thank you.

MS. BETRO: Thank you, your Honor.

THE COURT: Anyone else have any comments? LaSalle Bank have anything further.

MR. WEGE: Sure, your Honor. I wish to make a brief comment --

THE COURT: Go right ahead.

MR. WEGE: -- if I may.

Your Honor, there's no question that this is a pre-petition obligation. There's no question that the legal standard to pay a pre-petition unsecured obligation is not the Debtor's business judgment.

In fact, there's got to be some basis to pay a pre-petition obligation, whether it's the Necessity of Payment Doctrine, or some priority, or some other basis to pay a pre-petition obligation.

So we would respectfully disagree with the PBGC on their theory as to what the standard is to pay pre-petition obligations.

Clearly, it's a pre-petition obligation. It's a pre-petition contract. We would agree that that's the case. The pension plan, based on the evidence, was frozen on December 31st, 2005. So the employees could not have earned any benefits in the 180 days before the case with respect to that plan.

It's clearly not an administrative claim. Again, because there -- there's no earning or there's no benefit to the estate post-petition for the -- for that plan.

So in sum, this is a pre-petition unsecured claim. It's wholly premature to pay this claim. It's a very sizeable claim on whether it be in full or whether it be over time, it's inappropriate to pay this pre-petition claim until we know where this case is going.

And this case could -- could go in a number of different directions. It could go into liquidation. It could go -- it could be, you know, it could proceed to reorganization. We just don't know.

And, frankly, to elevate a pre-petition claim above secured claims in this case, based upon some long term pay out, is inappropriate. I don't think the law supports it.

The cases we've cited in our supplemental brief which was filed yesterday, make it clear that any claims for these -- these pre-petition claims should not be paid. There's no basis in the Code to elevate their status.

So that's our --

THE COURT: All right.

MR. HOLZER: Your Honor, I find myself agreeing and disagreeing with both sides.

I do agree with LaSalle's position that this is a pre-petition claim, not an administrative claim. And the basis we're asking for approval for payment is the Necessity of Payment Doctrine as we pled in our first day -- day pleadings.

And the reason we need to do that was touched on by PBGC. There is risk of plan termination if the payment's not made. The penalties and potential excise taxes, if they become due, could be substantial. And at the bottom line is the severe impact on employee morale that failure to make a payment like this would create.

And so on those bases, we think it is appropriate under Section 105 in the Necessity of Payment Doctrine to make this payment. But we have limited it to just the one payment, as opposed to all future payments.

So we're trying to minimize the impact. And we'll come back and talk about the rest at another day.

If this company's going to go forward, then this is important to make this payment. One thing, by failing to make the payment, while LaSalle may very well be starting down the road into ensuring the collapse of the company, 'cause the effect on morale by failing to make something like this that the employees rely on, could be substantial.

So we are requesting approval.

THE COURT: Okay.

MR. WEGE: Your Honor, may I just note. There's been no testimony as to the effect on morale. The only testimony was that the -- the plan was frozen and that they're getting 401(k) from Scopac. So I disagree that the evidence incorporates an effect on morale. There's been no evidence --

THE COURT: Well --

MR. WEGE: -- of that.

THE COURT: I think there -- there is no doubt as to what the test is that this Necessity of Payment Doctrine is the test that would apply in this particular situation. No question that it's a pre-petition obligation, although it's a special pre-petition obligation. And I think that there -- the Code and recent amendments to the Code, and certainly lots of the -- whatever background information there is for the Code, suggests that pension plans certainly have a peculiar position in the Bankruptcy Code, and a different position anyway than normal unsecured claims.

I think that the -- the showing today is sufficient to -- to justify the payment as necessary. I think that while there's no testimony from employees, there certainly is a inference that can be drawn with respect to morale.

I think the penalty, there's no question about the penalties that might be imposed by virtue of the missed payment. And, as well as the -- the failure to make it, the impact on plan stability, as well as the -- not only the future plan of the organization of this company, but these companies, but the -- the plan itself, the pension plan stability with respect to what -- what may or may not happen with respect to that.

So for all of those reasons, and based on the almost unanimous agreement of the parties, I will approve the payment.

MR. HOLZER: Thank you very much.

We're now to the 2019.

MR. HOLZER: Judge, I think before we go there, I think we need to talk about Pacific Lumber's cash collateral, which would be Docket Number, 7.

THE COURT: Oh, okay.

MR. HOLZER: And Mr. Kaplan is going to proceed with that.

THE COURT: All right.

MR. HOLZER: I think with respect to cash collateral, we have an agreement on the budget and the form of order, except perhaps with -- LaSalle may still have an objection on use of its cash collateral to make the payment you just approved.

Other than that, I don't know if there are any other objections.

MR. WEGE: Your Honor, just a couple of things.

One, of course, we objected to the use of cash collateral for the -- the payment of the 656, which was in the budget for the pension payment.

The other note I would make, really not an objection, just a clarification is, there's a $5 million payment to Scopac by Palco listed in the budget. We just asked that it be clarified in the record that that $5 million relates to all post-petition sales, no pre-petition.

I received an email that -- that indicated that that was for March purchases. And I just wanted to clarify that that's, in fact, the case.

THE COURT: Mr. Holzer?

MR. HOLZER: Actually, we can have Mr. Clark --

THE COURT: Mr. Clark, is that correct?

MR. CLARK: Yes, your Honor. That is correct.

THE COURT: All right.

MR. HOLZER: And with that I don't think there are any other --

THE COURT: Well, so --

MR. HOLZER: -- objections to cash collateral.

THE COURT: Yes.

MR. FIERO: Nothing from the committee, your Honor, except that the sixth interim cash collateral order has been distributed, I've never seen it. The last thing I got from Mr. Kaplan is the -- is just a .pdf of the fifth.

And I assume that if they're the same it's going to be fine. But if there are changes, I'm interested in what they are.

THE COURT: So make sure they get a copy and submit the order. I'll approve the cash collateral.

MR. HOLZER: I have it here, Judge. And it is the same order with the only difference being reset dates. And I think we need to set a reset date.

The order approves use of cash collateral through -- Mr. Kaplan, help me out, through April 27th?

MR. KAPLAN: April 27th, yes.

I believe that order was circulated by Marathon's counsel yesterday. And it's identical to the prior order, save for changing the dates for use of cash collateral from April 13th to April the 27th.

MR. HOLZER: So it's like to interlineate the 24th as the reset date with the Court's permission.

THE COURT: All right. Twenty-fourth at ten o'clock.

MR. HOLZER: Eleven, your Honor?

THE COURT: Eleven o'clock. That's right.

All right.

MR. HOLZER: Now the 2019, Judge.

THE COURT: Now the 2019. All right. Is this -- Mr. Melko, or as are -- are we going to --

MR. MELKO: It's the Debtor's motion, your Honor.

THE COURT: Debtor's motion.

MS. COLEMAN: It's the Debtor's motion, your Honor.

THE COURT: All right. Go ahead.

MS. COLEMAN: Thank you, your Honor.

Your Honor, the reason we're here to day is really quite simple. It's not that there's any doubt about what Rule 2019 says, nor is there any real doubt that the Rule applies in this situation to the committee.

The reason we're here is -- is reality, your Honor. You can't have it both ways. We all know that the bankruptcy process requires transparency. And Rule 2019 is really just one example of many of that public policy.

The Ad Hoc Committee has made it very clear that it's going to assert a -- itself in this case a very significant voice in this case, because it represents more than 90 percent. The numbers moved around a little bit, but it represents more than 90 percent of the Debtor, Scopac. I think it's always said that.

You remember at the venue trial, your Honor, even though the Ad Hoc Committee was not one of the initial moving parties, and they didn't come in supporting the transfer of venue, until one business day before the hearing.

They argued first. And why did they argue first, because they represented that the moving parties, the other moving parties, asked the noteholders to speak first, because they're such an important constituency in the case.

Now contrary to what they say in their papers, we don't want to silence them. That's not what we're about here. In fact, we tried to settle this motion. We tried to not -- to not bring this in front of your Honor. It didn't work out, but -- and we're not trying to silence them.

The trouble is really that the Ad Hoc Committee does not like one of the consequences of having this enhanced voice in this case and of acting collectively. Because they're acting collectively, they have an enhanced voice.

You get a lot of benefits out of doing that. One of the things they're going to get is presumably a better shot of making an argument to your Honor that they've made a substantial contribution at the end of the case and getting their fees paid.

But there are consequences for having that -- for having that bigger voice. And one of them is they have to comply with Rule 2019.

At heart, 2019 is a public disclosure rule. It applies to parties to act together to increase their leverage in the case.

And, your Honor, Judge Gropper (phonetic) recently issued two opinions in the *Northwest Airlines Case*. And we've prepared a small binder with both of those opinions and some other items in it.

May I hand it up?

THE COURT: You may.

(Counsel approaches the Court)

MS. COLEMAN: So in *Northwest*, your Honor, the situation was really very similar to this one.

All of the arguments that the Ad Hoc Committee is making to oppose this relief were made there. And Judge Gropper didn't accept any of them.

What he said is, you hold yourself out as a committee, you take an active role in an attempt to affect the outcome of the case, you're acting collectively. The Ad Hoc Committee has certainly done that here. You've brought yourself under Rule 2019.

Twenty nineteen is self-executing. It's automatic. It's mandatory. The only --

THE COURT: Is this your motion to require them to do it, or is there a motion to have leave not to do it?

MS. COLEMAN: Well technically, your Honor, our motion is to require them to do it. We sent them a letter requesting that they do it. And they haven't done it. So we brought the motion.

THE COURT: Okay.

MS. COLEMAN: So the motion is to -- is to require them to do it.

But there's no -- there's no exceptions in 2019.

THE COURT: But is -- is it -- is it the position of the committee that they -- they are going to -- that they don't have to comply with 2019, or is it that they are requesting permission not to comply.

MR. FROME: Your Honor, Evan Flaschen of Bracewell & Giuliani for the Ad Hoc Group of Noteholders.

Our position is that the Rule does not apply to our group. If your Honor finds that it does apply, we would request in the alternative that since the relief to 2019(b) is discretionary, we would request you exercise your discretion and not require us to comply with the Rule.

THE COURT: Okay.

MR. FROME: In the further alternative, if you deny both of those, we would request we have the ability to file the information under seal.

THE COURT: Okay.

MS. COLEMAN: Your Honor, just -- just one note there.

I don't believe that 2019(b) gives you the ability to -- gives you the discretion to not allow them to comply. There was one case that was cited in the Ad Hoc Committee's brief that was -- that was reversed on appeal that says that.

But 2019(b) talks about the discretion of the Court to -- to order relief for failure to do it. It doesn't talk about giving them relief from actually filing.

So, your Honor, again 2019 going exactly to this point, it's self-executing. It's automatic and mandatory. It's been on the books for 70 years. And it is something that parties who seek to act collectively in a case are required to do, and they haven't done it.

So the rule is very clear. So given that, what's the Ad Hoc Committee going to argue? Well they're going to argue exactly what Mr. Flaschen just said. They're going --

THE COURT: Well (a) says, unless otherwise directed by the Court, doesn't it?

MS. COLEMAN: I'm sorry, your Honor?

THE COURT: (a) is unless otherwise directed by the Court.

MS. COLEMAN: Only as to indentured trustees, your Honor. And unless otherwise directed by the Court, as an indentured trustee.

So the only possibility for escape is --

THE COURT: All right.

MS. COLEMAN: -- indentured trustees.

THE COURT: Okay.

MS. COLEMAN: And, your Honor, the only argument the committee can make is to argue that they're not a committee. So that's what they've done. Now they're a group. As of March 28th, they're a group.

Nothing changed, though, your Honor, on March 28th, except that they changed their name from a committee to a group, because they wanted to get out from under 2019.

We filed our motion on March -- on March 16th. On March 28th they responded and said, okay, we're not a committee anymore. Now all I know, your Honor, is these noteholders have been acting through the same counsel. They've had the same financial advisor since 2005.

And part of your exhibit book is that we have three engagement letters and confidentiality agreements in there between -- two of them are between Mr. Flaschen's former firm, Bingham, McCutcheon (phonetic). And the other one is between the financial adviser to the noteholders, Houlihan Lokey.

All of those refer to representing an Ad Hoc Committee. They use the word committee. So, your Honor, they -- as the Court knows, the committee referred to itself as a committee all the up through late March.

We also -- also in your exhibit book we've got a list of 17 or 18 pleadings they filed as a committee with all the docket numbers for the Court's convenience.

It's very simple. If it looks like a committee, acts like a committee, calls itself a committee, I think we know it's a committee. Now they say, well, we can't be a committee, because we're only 27, or 35, or some number, they put a footnote on all their pleadings saying -- saying the committee includes 27, or 35, or some number of -- of entities.

And they say we -- we act independently. We don't represent all the other -- there's over a hundred noteholders. I don't know the exact number, your Honor, today. But there's over a hundred, that we know, there are less than 300. But some numbers put it high -- as high as 200.

We don't represent those. We just act for ourselves. And there are lots of examples to refute this, your Honor. But the most obvious one is back at the cash collateral hearing on March 9th.

Without saying that the 20, or 30, or however many entities in the footnote represented all 99 percent of the timbernotes that Mr. Flaschen said he represented, the committee offered to credit its counsel fees against the principal of all 99 percent of the timber notes that they purport to represent.

And it wasn't just those held by the committee members. In fact, the offer even applied to future holders when Mr. Campbell raised the question, well, these are publicly traded, what are you going to do with the people who buy these in the future? Nobody's restricted. These things are trading.

Mr. Flaschen said that's no problem. We'll tell them, too. And, your Honor, if that's not representing other people who are not part of the committee, I don't know what is.

Just to conclude, your Honor, again, very simple. This Ad Hoc Committee was a committee in 2005. They were a committee on the first day of this case. They were a committee on March 16th when he filed the motion. They're a committee now.

THE COURT: Was there some requirement they represent people other than the actual members of the group?

MS. COLEMAN: Well the Rule says, your Honor -- the Rules says every entity or committee representing more than one creditor or equity security holder.

So --

THE COURT: But there's no requirement that they actually represent a class of people --

MS. COLEMAN: No, your Honor, there's not.

THE COURT: -- that is larger than the actual membership of the committee.

MS. COLEMAN: That's correct, your Honor, they still have to disclose, even if they don't represent a class that's larger than them. There's still disclosure required.

THE COURT: You were trying to suggest to me that they represent people other than their own clients --

MS. COLEMAN: Well I'm trying --

THE COURT: -- by virtue by the -- what they said with respect in the -- to the motion concerning their fees.

MS. COLEMAN: Yes. What I'm saying, your Honor, is that -- that their argument as to how they're not a committee is, look, we just -- we have this committee. We have this group. And we -- you can't call us a committee, because a committee represents other people.

And I'm saying even if that were the test, which I'm not sure it is, quite frankly. I think that you could have a committee just representing itself and you'd still have to have the same disclosures. But even if --

THE COURT: Well, as I recall the conversation with respect to Mr. Campbell and -- and the charge against other, in other words, fees of other people who might buy in, that that was more of an issue of how will this affect the transferability of future notes, since these are traded in the open market.

MS. COLEMAN: That's certainly right, your Honor.

THE COURT: And the statement was made, well that can be another statement with respect to those notes. It wasn't that they were actually representing those people.

MS. COLEMAN: No, your Honor, it wasn't.

But, again, if you're willing to -- if you're willing to say that something I do in this Court from authority from my clients is going to affect people who are -- going to affect people in the future, it seems that you are -- you are at least affecting -- you're at least affecting a larger group than yourself.

And I only offer that because the Ad Hoc Committee said we don't represent anybody other than ourselves. And they may not represent them, but -- but I think they do, because they're purporting to affect them.

That's my only point. You're certainly right that the public -- public trading.

THE COURT: All right.

MS. COLEMAN: Now, your Honor, the only thing that has changed since we filed this motion is they've now decided to call themselves a group, because they want to take themselves out of the literal words of 2019.

But the Rule applies anyway. It doesn't matter what they call themselves. There's no reason it doesn't apply here. And, therefore, they should be required to comply.

THE COURT: All right.

MS. COLEMAN: Thank you, your Honor.

THE COURT: The U.S. Trustee have a position in this?

MS. MARCH: No, sir.

THE COURT: Okay. Does the committee have a position?

MR. FIERO: No, your Honor. The committee did not take a position.

THE COURT: All right. Anyone else besides the group

MR. BARR: Your Honor, again, this is Matthew Barr of Milbank Tweed on behalf of the Securities Industry and Financial Markets Association --

THE COURT: Yes, sir.

MR. BARR: -- Loans Syndication and Trading

Association.

If, your Honor, would prefer, our statement is in -- and our brief is in support of the Ad Hoc group's objection.

THE COURT: Well why don't we let them talk first, then.

MR. BARR: Thank you, your Honor.

MR. FROME: Your Honor, Evan Flaschen --

THE COURT: Go right ahead, sir.

MR. FROME: -- Bracewell & Giuliani for the noteholder group.

A brief response to counsel's comments. There's some irony about the use of the word transparency. Your Honor, would not be aware, but to this date, for example, the official committee has not been given any confidential information.

The noteholder group has not been given any confidential information. Now we're all working on confidentiality agreements.

My experience I have never been in a case where for this lengthy period the Debtor still is refusing to give confidential information to its own unsecured creditors committee. So transparency's a relevant, relative topic.

Why do we care so much about this? This is a matter of monumental importance, your Honor, to the point where the securities industries and the LSTA have filed *amicus* briefs. And you will be hearing from them.

We care very much because this is public debt. Public debt means it is freely tradable. It means you trade through brokers. It means the holdings of specific individuals, which includes companies, and the amounts they pay for their debt are not public information.

More than that, more than the fact that it's confidential, it is proprietary information. How funds engage in trade, the methods they employ, the frequency that they trade, the prices which they pay, are highly confidential, proprietary information that should not be disclosed.

Because of that, we raised several very important arguments in our brief. And even more than in other situations in this case, we strongly urge you to review our brief and therefore to take this matter under advisement today, rather than issue a decision on the spot.

For example, our brief raises four separate issues of Constitutional law that we think apply to this situation.

THE COURT: Okay.

MR. FROME: The custom for the past 70 years that we're aware of, I'm told the *Northwest* decision, including the custom in this very Court, for example, Asarco, is that counsel for an ad hoc group, files a statement saying here who -- here are the names of the people in the group. Here is the aggregate amount of the holdings in the groups.

For 70 years, no one has required a so-called ad hoc committee that is not acting in a fiduciary capacity, to disclose anything more than that. The *Northwest* Courts did, and I'll come back to *Northwest* in a few minutes.

It begs the question why does Scopac care? They know who we are. We've identified it in footnote one of every single pleading we've filed in this case. We've updated footnote one every single time the membership of the group has changed, or the amount of the holdings has changed.

They know all the information they need to know. So why do they care? In 2005, when the Ad Hoc Group negotiated with this Debtor. The Ad Hoc Group was formed in March, 2005, by the way, your Honor. It's been in existence and in communication ever since then. This is not a new group.

In 2005, the Debtor made several public filings, and we attached them to our brief, complaining they can't negotiate with this group, 'cause it's only 15 or 20 percent of the noteholders.

In fact, that was an inaccurate statement. But the point is, in 2005, this Debtor complained that this group did not represent the class of noteholders. Now they're saying differently.

In their pleadings in support of *Blackstone* (phonetic) filed in this case filed three weeks ago, they complained that in 2005 counsel for the noteholder group represented only 15 percent of the noteholders. And therefore, you could not get an agreement with the noteholders of the class.

Again, their percentages were wrong, and they know it. The point is, they always recognized this was a group that consisted of holders and of their holdings. The group never purported to speak on behalf of the timbernotes as a class.

Scopac never stated and never recognized the group as speaking on behalf of the noteholders as a class.

So why does Scopac care? Because they know how confidential and proprietary this information is. They do not appreciate the extent of our involvement in the case and the fact that we do not say yes, sir to everything they wish to do. And they want to break up our group.

It is that simple. For whose benefit is this rule anyway? It's not for the Debtor's benefit.

THE COURT: But can we -- before you go any further, can you tell me, the information -- you don't mind giving the total amount of information -- of debt that you have and the members of your group? That --

MR. FROME: Right.

THE COURT: That you say is the tradition.

MR. FROME: That is tradition. And we've done that throughout this case without needing to file a 2019 statement.

THE COURT: And so --

MR. FROME: We

THE COURT: -- what is it that you object to specifically? What information is it that you specifically object to giving?

MR. FROME: Well --

THE COURT: The specific amount of each person's claim.

MR. FROME: Person's claim.

THE COURT: And how much they paid for them?

MR. FROME: Depending on how you interpret the Rule.

But if you interpreted the Rule the way Scopac believes it should be interpreted, the individual holdings of each member of the group, we would object to that. Object to saying, for example, A holds $10; B holds $20. That's clause two of the definition.

Clause four, which we happen to think is not relevant in any event, but under Scopac's interpretation, clause four would say every member of our group has to disclose its entire trading history, including the price it paid every time it bought or sold the securities, which for some members of our group, could be a hundred times or more, given the business they're in.

And that is the most confidential, proprietary trade information these folks have in this case.

THE COURT: Okay.

MR. FROME: And it begs the question why does Scopac care? Scopac knows it owes $714 million, whether our group paid a hundred cents on the dollar, or once cent on the dollar, and I assure you it didn't ay one cent, they still owe the same amount of money.

There is plenty of case authority that says the amount you paid for your debt is not relevant to the amount that the Debtor owes on the debt.

The statute is for the benefit of the other members of the class that the committee purports to represent. For example, in *Northwest*, there the equity -- ad hoc committee of equity security holders held 27 percent in amount of the shares.

They sought to negotiate the recovery for the entire shareholder class. I'm taking this right out of the *Northwest* decision. Judge Gropper said that if you are going to say that you represent the entire class, if you are going to seek to negotiate a recovery for the entire class, then the other members of that class, the other shareholders, have a right to know what your particular motivations are. And in two ways in *Northwest*.

First, what did you pay for your shares. As it happens that the ad hoc equity security holder committee all paid one cent for their shares, and all other shareholders paid $10, that would be relevant to other shareholders. So they could then form a conclusion should we form our own group.

And using the *Northwest Airlines* decision term, should be form a larger group to negotiate on behalf of shares, 'cause we don't think this 27 percent group has the same interest we are.

Second in *Northwest*, the 27 percent group admitted its members held substantial debt claims as well as equity claims. Judge Gropper found it important to disclose that. Again, so that other shareholders could determine for themselves are they willing to rely on this 27 percent group to negotiate the recovery for 100 percent of the shareholders.

Here we do not have a single noteholder saying I need this information, I want this information, I don't feel comfortable with this group. To the contrary, your Honor, to emphasize how confidential and proprietary this information is, the only one who knows the individual holdings of all the members of the group is me.

The members of the group themselves do not know what each other individually holds or what their trading prices are. They don't want to know, because if they want to know someone else's, then the someone else will want to know theirs.

It's important for me to know, of course, so that when I sign a pleading and represent what I've been told, I can do so accurately. So they do update me quite constantly. And I remind them of that, which is why our footnote one keeps changing.

It's also why we as counsel, at the time Bingham, now Bracewell, and Gardere Wynne filed a voluntary 2019 statement. We were not required to do one, because we only have one client, the group. But we filed a voluntary statement as is the custom so that there was a verified statement on record as to the members of the group and their aggregate holdings.

So all the information this Debtor and this Court needs is already of record. Any information any other noteholder needs, none of them have asked for. And therefore, there's no point in making this disclosure. It's not for the Debtor's benefit. It's for the benefit of other noteholders.

Continuing with the *Northwest* comparison. Northwest is a situation of bad facts. There the group did say we represent all holders. And we try to negotiate on behalf of the class. We do not say that.

We are negotiating only for our own position. We don't need to say we negotiate on behalf of the class, because our votes are more than a majority in numbers and two-third of an amount, or we thought maybe more a majority number. Now Ms. Coleman says it might be different.

But we have enough on our own to vote in favor of a plan. We do not need the support of other noteholders. We do not request the support of other noteholders. We do not speak for other noteholders.

Turning to the statute itself.

THE COURT: Was I correct about the statement with respect to the charges, if we -- if there had been an agreement with respect to your fees that I made earlier that you were not, at that time, suggesting that you represented those other parties, but that --

MR. FROME: We -- in our engagement letter in 2005 and our confidentiality letter of 2005, each identified us as counsel on behalf of an ad hoc committee of noteholders.

The engagement letter in particular attached a list naming every member of the group. And therefore, explicitly not naming other holders who were not part of that group.

The engagement letter also -- no, I'm sorry. I'll return to the confidentiality letter.

We do call ourselves an Ad Hoc Committee, and I'll get back to that. But the confidentiality letter is clear, only Bingham, 'cause at the time we were Bingham, is bound by the confidentiality. We do not bind the group. The group does not bind the group.

It says on page four, we, Bingham, are not entitled to share with any member of the group, except an individual member who signs its own confidentiality agreement. Again demonstrating that the group does not represent anyone. It's a bunch of individual holders who, for purposes of expressing a common view, have retained common advisors.

The alternative in Scopac's perspective is that the

40 members of the group should hire 40 different law firms, or the law firms for the 40 members of the group should have separate communications with each of the 40 members, which is an absurd approach to how to deal with this.

In the cash collateral discussions, your Honor, recalls correctly. We indicated quite clearly that we were willing to have fees paid to counsel for the group deducted from the distribution solely to the group members, not distributions to all noteholders.

Again, we represent no one other than ourselves. Your comments about future holders was, not that this was binding as to a holder, as opposed to it being binding as to a note, so that if you sold a note, the future holder would be advised that with that note comes various things, principal, interest, and so forth, and the potential of having fees deducted from the amount paid on that note.

So even in the cash collateral context, we did not propose on a voluntary basis to charge all noteholders, only those holders of notes in the group.

Turning to the statute itself. Counsel's right. We've always called ourself an Ad Hoc Committee. In every case they called themselves an Ad Hoc Committee.

I have to note an irony. The same with the use of the word transparency.

This is a Debtor, who in every SEC statement they ever filed, referred to their principal place of business as being the Northern District of California. This is a Debtor, who in their bankruptcy petition, where it says where is your principal place of business said Northern District of California.

This is a Debtor who has said, what is your venue? It said we're only venued here because of Scotia Development. This is a Debtor who says, oh, we don't care what we said our principal place of business was, our principal place of business is different.

So to hang us by the use of the word committee we think is not appropriate. Instead, we need to examine what the word committee means in Rule 2019.

Another reason to read our brief, your Honor, is we trace the use of the word committee back to the late 1930's, when the predecessor to Rule 2019 was created. It was created as a result of an SEC, Securities and Exchange Commission, report to Congress to deal with abuses in equity reorganizations. So I'll just give you the short version. We have a longer version in our brief.

At the time, there was a phenomenon known as a protective committee. It was a group that was formed to represent all members of a class. In order to be a part of that group, you had to sign a deposit agreement and deposit your securities with the committee.

The problem with protective committees was they were insider affairs. They included affiliates of the Debtor. They included brokers or industry participants who did not hold any debt themselves.

Therefore, the SEC was very concerned that these so-called protective committees were only protecting insider interests, not the actual holders of the securities in that class.

In that context, the SEC reported that there should be a rule saying for protected committees, for committees who act on behalf of a class, they should be required to disclose their particular interests, so that other members of that class could decide whether they feel appropriately represented by that committee, or should obtain their own representation.

That is not the case in our situation. Again, we focus on the word committee. Where it came from is important. Also, the definition of committee is important.

Under Black's Legal Dictionary,

> "A committee is a group of people appointed or elected to consider, determine, or manage a matter."

Noteholder group was not appointed. It has not been elected to consider, determine, or manage anything. It is a group of holders who'd gotten together because they have a common interest.

The non-legal definition, this is from American

Heritage Dictionary.

"A group of people officially delegated to perform a function, such as investigating, considering, reporting, or acting on a matter."

Our group is not official. We have not been delegated by anyone to do anything. We are a group that has gotten together to act in our mutual interests.

For example, our group has no by-laws. It has no written agreement forming the group. There are no rules as to how things are conducted.

That is because any noteholder is entitled to join the group, or drop off the group at any time. Any noteholder is free to take any position it wants, regardless of the consensus of the group. We are not a committee. We do not act on behalf of anyone else.

Rule 2019, by its own terms, makes it clear what they mean by committee, 'cause after it says every committee, it uses the word "representing." We do not represent others. We do not serve as the agent.

For our brief provides various definitions of the word represent, which means, you act in the name of, with the authority of, on behalf of, as the agent for, others. We do not. We do not represent anyone.

Further down in Rule 2019, it talks about you should deposit with the Court the instrument, if any, showing how the committee "is empowered to act on behalf of creditors or equity security holders."

Now the "if any" means it's possible you don't have an instrument, but my point is, we are not empowered to act on behalf of anyone. We don't have an instrument anyway, but if we did, it would not empower us to do anything. We are not a committee within the meaning of this statute.

Turning again to *Northwest*, it talks about a couple of other points. First, *Northwest* is the first decision, 70 years, to compel a non-fiduciary committee to make this kind of disclosure.

And in doing that, when you read the *Northwest* decision, you'll find that Judge Gropper concluded that, in fact, they were holding themselves out to be quasi fiduciary. Therefore, they should be treated as a fiduciary committee.

Let me direct quote from the decision. When I talked about for whose benefit is this. Quote --

THE COURT: Which page.

MR. FROME: "Northwest decides through the" -- the *Northwest* decision.

THE COURT: I know, but do you know which page it is?

MR. FROME: This is Northwest 2. There's two slip opinions. This is the second one, the second one being March 9th at page 7.

THE COURT: All right.

MR. FLASCHEN: "Rule 2019 protects other members of the group," meaning of the class, here the shareholders, "and it forms them where a committee is coming from by requiring full disclosure, protects other members of the group." It doesn't protect the Debtor. It doesn't protect other parties in the case, other members of the group, meaning the class.

Here there are no other members of the class interested or asking for this information. They don't even want it from each other if they're on the group.

Similarly, in *Northwest*, again Northwest 2 at page 7,

> "Other shareholders have a right to information as to committee member purchases and sales so that they can make an informed decision whether this committee will represent their interest, or whether they should consider forming a more broadly based committee of their own."

We do not represent their interests. We expressly disclaim representing the interest of any other noteholder. In addition, it would not be possible for other noteholders to form a more broadly based committee. There's only two, three, five percent of notes not on the committee.

Again, *Northwest* really focused on the fact this group's holding 27 percent. And also holding substantial debt claims, purporting to negotiate for the entire class of shareholders.

The *Northwest* Court also talks about this group trying to leverage its position by saying it could negotiate on behalf of the entire group of shareholders. It's a variation of what I just said before.

We're only 27 percent. But if you come to agreement with us, it will deliver the class of shareholders. We are not saying that.

We're saying if you come to agree -- agreement with us, it will deliver the votes of the members of our group who are in support of that agreement, nothing more than that.

In *Northwest*, Northwest was an insolvent entity. The shareholder committee there was fighting to get any recovery at all. To them it was, therefore, critical that they be appear -- they appear to represent the entire class of shareholders.

Again, motivation being if you negotiate a deal with us 27 percent, you will have the consent of the entire class of shareholders. Therefore, there will be no confirmation fight.

Here everyone talks about Scopac being solvent. There is no issue of a recovery for the timber noteholders. We're not seeking to exercise that type of leverage. We don't need it.

Finally, and again, these are all variations of the same theme, but these are phrases taken straight out of the *Northwest* decisions.

Judge Gropper felt it would serve an important public purpose, and would provide valuable information to the substantial majority of the shareholders who were not members of the ad hoc shareholders as a group.

Again, it emphasizes for those benefit disclosure was. And it emphasizes that in Northwest's financial majority holders were not on that committee.

We do not believe the use of the word committee in 2019(a) applies to the type of group we are. Whether we walk like a committee, or talk like a committee, we do not. Whether we call ourselves a committee, we plead guilty on that. But we are not a committee within the meaning of 2019(a).

Turning to 2019(b). Counsel's correct. It does not literally say the Court can permit someone not to comply.

It says if the Court finds that 2019(a) applies, which we believe it does not, the Court may enter various types of -- types of orders. And the word is may. It's not shall.

The Court may determine with that, that the Court may refuse the Court to permit the entity to participate, but it's not required to. It may do other things. It is all discretionary.

We site a case in our pleading to the proposition that this includes the ability of a Court to enter no relief at all on the basis that no purpose would be served by complying with the Rule. No one's ox is being gored by failing to comply with the Rule.

It was reversed on appeal. We say that in our pleading. The reversal was on a different issue entirely. This involved whether the press had access to information. But was the classic reversed on other grounds.

We then get to our statutory arguments. Rule 1001 says that the Bankruptcy Rules, "Shall be applied to ensure a just, speedy, and efficient reorganization."

It would not be just to apply Rule 2019 to a group of this nature, because many members of the group would drop off. That would harm the speedy and efficient reorganization, because then there are far fewer timber noteholders involved in the discussion and the process.

So requiring our group to comply with this Rule would result in the opposite of a just, speedy, and efficient reorganization.

Next, we believe that applying this rule would deny our right to free speech. It is a fundamental Constitutional provision. Applying this rule would say we are not permitted to speak as a group, because there is a condition to our doing so.

We are also a secured creditors. And therefore, the United States Constitution, we have a property interest that is protected. This would deny us our property interest by denying us the ability to appear and be heard on the basis of this rule.

We also talk in our pleadings, and it's more in depth there. I'm not going to bore you too much with the U.S. Constitution, but about the equal protection of the laws. We do not believe this would be equal protection to compel a group to disclose its individual holdings in this fashion. So there's a whole host of reasons here. I encourage you to take this under advisement and read our pleadings.

I want to bring it right back to where we started. We do not believe this applies to us at all. Even were your Honor to say maybe it does apply to us, we ask you to what end?

No one needs this information. No one has any use for this information, except possibly a noteholder itself. And none of the noteholders want this information.

It's not just, oh, that's nice. The members of our group affirmatively instruct me. I am not permitted to share with other members of the group what the holdings are. In fact, Gardere Wynne, who's in Court today, our financial advisor, Houlihan Lokey, they do not know the individual holdings, or the amounts of the timing people paid for their debt. Only Bracewell, and only Evan Flaschen knows that information to show you how important it is.

This is simply Scopac taking advantage of a *Northwest* decision and saying ah, ha! Here's another way maybe we can attack the noteholder group.

And I'll say it again. I said it at the last hearing, all we want in this case, your Honor, whether it's through S-A-R-E, or through this pleading or anything else, it just gets Scopac to file its plan of reorganization, and to do it soon, so that we can all engage in the real battle of this case, which is the valuation and the treatment of the timbernotes. And please permit that 95 percent of the timbernotes represented in this group, do represent in a just, speedy, and efficient manner, the views of that 95 percent.

Rather than compelling us to break up into 40 separate, individual noteholders, filing 40 separate, individual pleadings, all advocating pretty similar things, that would hardly be an efficient result in this case.

Thank you, your Honor.

THE COURT: All right. Thank you.

I'm going to take a three minute break. And then we'll hear from the other counsel on the phone --

UNITED STATES MARSHAL: All rise.

THE COURT: -- Milbank Tweed.

MR. BARR: Thank you, your Honor.

(Recess taken from 12:18 p.m. to 12:24 p.m.)

THE COURT: Be seated. All right. Go ahead.

MR. BARR: Thank you, your Honor.

Again, this is Matthew Barr of Milbank Tweed, on behalf of the Securities Industry and Financial Markets

Association, and the Loan Syndications and Trading Association.

Your Honor, these institutions are two of the nation's leading industry groups in the debt and equity markets, whose members include many of the largest and best known participants in today's financial markets.

While our clients have no view on the underlying merits of any disputes between the Debtors and the noteholder group in these cases, our clients are very concerned, your Honor, that any order approving the Debtor's 2019 motion will have a detrimental impact on the active and vibrant market that trading distressed company's debt and equity security, and an willingness and ability of many sophisticated parties in interest in these cases, and sophisticated institutions, from participating in future bankruptcy cases.

So as institutions that focus on the health and vitality of these financial markets, we believe that our concerns are much broader than those that you heard here today so far, your Honor. And we also believe that we're well situation to bring forth to you negative market implications and public interest concerns. And that's why we filed our amicus brief in support of the Ad Hoc Group's objection to the motion, your Honor.

Forcing disclosure of the information that the Debtors see here will require public dissemination of highly confidential and proprietary information from certain stake holders.

We believe that requiring that information, in all likelihood, will erect a substantial obstacle to certain parties participating in future Chapter 11 cases. And, in fact, may in, as you've heard from other counsel, cause certain parties from dropping out of currently pending Chapter 11 cases.

We believe that these obstacles will prevent the involvement of sophisticated parties that have frequently made positive contributions, and offered valuable input in restructurings, and will continue to hopefully in the future, and also negatively impact the markets that create liquidity in Debtor's securities, by preventing and hampering the ability of parties to manage their expose.

Because these markets allow certain parties to liquidate their exposure and avoid the delay and uncertainty of a bankruptcy case, and also create volatility in -- in certain securities, which also increase values of restructurings, your Honor.

As you heard, seeking by motion, or compelling to seek a party to file a disclosure by 2019, for an ad hoc group, is inconsistent with -- with customary practice. We've also heard that -- that counsel here, if he filed a 2019 motion, which is generally how that rule is complied with when you deal with ad hoc groups of creditors acting collectively by sharing costs of counsel, and other professionals, whether they're acting on their own behalf.

So we would submit, your Honor, that like in other cases, 2019 had been complied with in this case by counsel. And that is customary practice.

We believe that that commonly-held view is the proper interpretation of 2019 under these circumstances, and consistent with the history that led to the promulgation of 2019 when ad hoc groups are acting on their own behalf and don't have a fiduciary obligation to other parties that they may be similarly situated to.

It should also be noted, your Honor, that customary practice of stakeholders maintaining their proprietary trading information in strict confidence is a corollary to the fundamental principal of trading in these types of securities. Which is, that the value of a claim in a -- or an interest in a bankruptcy case is determined by the nature of the Debtor's obligation under that instrument or equity security, not the price that a stakeholder paid that's asserting that right in that interest or in that claim.

It's well established that the consideration paid for a claim or interest is irrelevant to the treatment of that claim or interests. Courts have also repeatedly held, your Honor, and we site in our brief, that to reduce the value of a claim or interest based upon the price at which someone purchased that claim or interest, is to visit an unearned windfall upon a Debtor. And to destroy the incentive for investors to purchase distressed claims.

And these are some of the concerns that we have if these parties, of course, disclose how much they paid for these securities.

And this is exactly, your Honor, what will happen if these parties are forced to disclose their basis in the Debtor's securities. It is inevitable that this information will be used to the advantage of other parties in negotiations in such things as treatment of securities under a plan, or if these parties that have disclosed the information, decide to liquidate their position, this information will be used against them in the marketplace, because people understand and know the basis upon which they purchased this security.

Requiring the information, your Honor, will undoubtedly shift the focus of negotiations in bankruptcy cases from the Debtor's obligation to these parties, under the terms of the relevant instruments, to the consideration that the specific stakeholder should be receiving based upon what he or she purchased the security at.

It should come as no surprise, your Honor, and I don't think anybody's been hiding it, that parties trade in securities with an expectation to make a profit. Disclosure of somebody's basis will impair that prospect. And ultimately, we believe, and we fear, will leave parties not betrayed in these types of securities or to participate in restructuring.

Your Honor, as you heard briefly from counsel, and it is set forth in our papers as filed, we do believe that the motion filed by the Debtor, and an order granting it, would be inconsistent with the history of why 2019 is in the Bankruptcy Rules.

The disclosure found today in 2019 is a solution to an agency problem that is simply irrelevant to ad hoc groups that are formed in today's bankruptcy cases, who typically expressly disclaim any intent to represent any other parties but themselves, and do not owe a fiduciary duty to any other party.

Twenty-nineteen was promulgated to allow smaller investors, or at certain -- in certain cases, larger investors with small positions, your Honor, faced with the prospects of -- of having to negotiate with larger investors, or Debtors, or larger committees, with the ability to understand who was negotiating with them, which you heard before the so-called protective committees. And again, that's laid out in much more detail in the pleadings as filed.

If these parties, these smaller investors, or larger investors with the small positions, were faced with the prospect of having to disclose this highly confidential and proprietary trading information, it is highly likely, and this is another fear that our clients have, that they will not coordinate efforts in order to share the costs. And will, therefore, it will become economically irrational for them to take active roles and participate in bankruptcy cases.

This may be parties, and these are very highly sophisticated parties, who hire not only experienced and sophisticated counsel and advisors, but bring their own experience to a restructuring process, would likely be that the business decisions not to purchase securities, to the detriment of those who want to liquidate their position, and to a debtor's case, and not get involved in restructuring matters to the detriment of all involved.

Again, because there's -- although we have an ad hoc group that the Debtors believe is detrimental to the process in causing delays and what -- what I guess could be characterized as side shows, there are many, many cases where ad hoc groups add tremendous value to cases, irrespective of official committees being appointed.

Giving today's debt structures and capital structures, there are many ad hoc groups that form because they believe, given the complexity of a company's structure, they need an added voice to be heard. And there are many, many examples of where these sophisticated, experienced parties help a process and bring it towards reorganization.

In the same vein, your Honor, and we site the cases, there are many Courts that recognize that joint activity by creditors facing a debtor is commonly in the best interests of all parties.

Forcing these creditors to act alone, because, unfortunately, that is likely the outcome if these creditors are forced to disclose this confidential, proprietary information, will lead these stakeholders with no practical choice but to either decide to act on their own, which would compel them to resort to the most extreme action available, which is likely litigating many, many issues to protect their individual claims.

This obviously is contrary to bankruptcy principals of encouraging collective action, which will foster consensual reorganization.

Specifically, your Honor, our clients are concerned that a 2019 ruling forcing these parties to disclose the confidential, proprietary information, the impact of that will be borne by not only by the markets as we discussed, and the parties, but will be borne by lots of parties involved in reorganization cases.

Individual creditors and interest holders that want to liquidate their claims to get out of a -- a Chapter 11 or a restructuring, and not endure the time and certainty of that case, will be impacted because potentially there is no longer an efficient liquid market out there.

Individuals, as opposed to groups, will have to share -- would have to, excuse me, bear the costs of litigation, which would absolutely go right to somebody's bottom line of how much they believe they can get out of a particular claim, or interest, which goes into a business decision of whether or not he or she wants to buy that interest from a holder.

Again, collective actions share and spread those costs. And that's why groups are -- are very prevalent in bankruptcy cases today. These groups also retain typically highly sophisticated and experienced professionals to negotiate with the debtors. Which, I'm sure, your Honor, can appreciated a negotiated outcome of a Chapter 11 is by far superior than a litigated time costly, expensive process in a confirmation.

By discouraging collective actions, you're going to have fewer sophisticated and knowledgeable investors willing to go through these negotiation processes, because of just the cost and expense, which will hurt all.

Again, your Honor, we heard that this particular Ad Hoc Group in the Debtor's view is diverting the Debtor's attention from and delaying a reorganization process.

Again, it's indisputable there are many, many cases where, even though there are official committees appointed, the ad hoc committees bring tremendous to restructurings.

We fear that if parties are imposed upon to file these 2019 statements, the business decision, in and of itself, may prevent them from getting involved in restructurings. The requirement of this may directly impact public markets will then hurt small creditors.

Also, it may just be an unintended consequence, by forcing people to comply with 2019 in these circumstances, where they expressly disclaim any fiduciary duty to other parties or that they're representing anything other than their self interests, your Honor, may unintendedly imply some kind of representative capacity upon these stakeholders, which they didn't assume as a role in the case, because of the history of 2019.

Therefore, complying with that rule, or forcing them to comply, is another reason why these parties may in and of themselves decide we can't get involved in a restructuring, because we don't want to have the appearance of having a representative fiduciary capacity to parties we are not intending to represent.

Again, your Honor, the fear is that at the end of the day, being required to disclose confidential and proprietary information will lead people to the rational business decision of not buying or selling securities of a distressed company, and not participating in Chapter 11 cases.

If they decide to, we believe that it won't lead to a consensual negotiation process, which most parties promote in

Chapter 11. So it would lead to much more a liquidation, time consuming costs, and be detrimental to all of the parties involved in restructurings.

So we respectfully support, your Honor, the Ad Hoc Group's motion -- objection to the motion, and believe that the motion should be denied for the reasons stated here and in our brief, your Honor.

THE COURT: All right. Anyone else have anything further?

MS. COLEMAN: Can I just be heard very briefly, your Honor.

THE COURT: All right.

MS. COLEMAN: I'd just like to respond very quickly.

And your Honor, Mr. Flaschen said why does Scopac care? Well, your Honor, with all due respect, it doesn't really matter. I'll tell you why we care. But it doesn't really matter why we care.

We care for all the reasons that the Rule is there in the first place. Let's take another example of disclosure required in a bankruptcy case.

Every Debtor has to file a disclosure statement. And you could take the position that in any given case why does anybody care about this particular piece of the disclosure statement? It's not relevant here because, set forth your reason.

It doesn't matter why we care. That being said, I'll tell you why we are. And it's all -- it's actually not even just about us. We care because we have to do a plan. We care precisely because the Ad Hoc Committee does have a big voice in this case. They represent a lot of the debt in our case. Well one could argue almost all the debt in our case.

So we care because we have to negotiate with these people. And we need to know who we're talking to. It doesn't help us to say we have $695 million of your $714 million of debt. It helps us a little bit, but it doesn't help us as much as we need. Because if you say our committee is these 30 people. Well, okay, they're freely trading.

What if one of them has 20 percent of the notes on a given day, and at the time of the filing of a given pleading, and then they're still in footnote one at the time of the next pleading, but they've sold down in the public markets, which they're able to do, and then they only own one percent.

We are entitled to know that information. And that's exactly what 2019 says we are entitled to get. And we're entitled to get the information as of the date of the committee was formed, and we're entitled to -- to frequent updates. We're entitled to the same information that Mr. Flaschen has.

We care because we need to know who we're talking to and who owns what. Moreover, your Honor, as I said, it's not all about us. The process requires disclosure. And process requires transparency.

And I'm just going to ignore Mr. Flaschen's comments about that, because -- because information is currency in bankruptcy. And the process does require -- does require this kind of disclosure.

Now Mr. Flaschen says it doesn't apply to a committee like this, and he went through the history. And I would recommend you to read the first *Northwest* opinion does a wonderful job of doing this as well, better than I can do here. So I will simply refer you to that.

But it's very simple, your Honor. Yes, the initial SEC report focused on protective and reorganization committees. But when the rule, which was the predecessor rule to current rule 2019 was drafted, it wasn't so narrow, your Honor. They didn't say protective or reorganization committees, like the kind referred to in Justice Douglas' SEC Report of 1937.

It says committees. These people are acting as a committee. Mr. Flaschen say we don't need to be a committee here. And you don't need to -- we don't need to make the disclosure, 'cause we don't -- because all you're doing is protecting other people in the class. And we already represent everybody anyway, so they don't need protection.

That's just not right, your Honor. If you refer to the sentence that he -- that Mr. Flaschen referenced on page seven, it's actually my sentence is seven going on to *Northwest*

2, which is at tab six in our binder.

Mr. Flaschen read you a sentence talking about -- about protecting the others in the class that the Ad Hoc Committee is in. Very next sentence, your Honor, says, "It also give," "it" being disclosure,

> "Also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy case and play a major role."

That's exactly, your Honor, what we have here.

I'd like to read another sentence from six to seven to *Northwest 2*, again at tab six in our book. And this goes to the issue of the percentage. Mr. Flaschen makes much of the fact that --

THE COURT: Now we're on tab six?

MS. COLEMAN: We're on tab six, page six, your Honor, at the very bottom. Staring the sentence, "By acting as a group." It's three lines up from the bottom.

> "By acting as a group, the members of this shareholders committee subordinated to the requirements of Rule 2019, their interest in keeping private the prices at which they individually purchased or sold the Debtor's security."

They chose to act as a group. They didn't have to do that. They chose to act as a group. And once they do, they bring themselves under Rule 2019. And I don't care if they call themselves, a group, or a committee, or -- or whatever they call themselves.

Your Honor, very briefly, with respect to the -- to the industry association concerns. First I would point out that of the -- of the funds that have been required to disclose -- that were required to disclose in Judge Gropper's opinion in *Northwest,* a number of them have chosen to simply make the disclosures. And I have not heard of any -- of any market crashes.

THE COURT: Okay. Well, does the -- Mr. Flaschen suggested that the New York Judge did, in fact, place an emphasis on the fact that they were representing people other than the members of the committee.

MS. COLEMAN: Well, your Honor --

THE COURT: Is that in there or is he wrong?

MS. COLEMAN: It is --

THE COURT: I mean, that's always been my understanding. I just went back to look at Colliers, and as we all have to go back to the beginning from time to time. And they talk about -- about fiduciary. It only applies to the fiduciary representations.

MS. COLEMAN: Well, no. No, Judge.

THE COURT: It doesn't use the word representative fiduciary representations. And I don't know whether it makes any difference. I hadn't really thought about it that much.

But -- but there's no question that if there are two or three people being represented -- two or three claimants being represented by one lawyer, I think the rule requires the lawyer to file the -- the -- because he represents more.

But when you -- the committee itself as an entity, has to file, I'd always thought, when they represent more than the committee. They purport to represent not only their 93 percent, but the hundred percent.

MS. COLEMAN: Well, your Honor, they are clearly not --

THE COURT: Is that distinction in the -- in -- I haven't read the *Northwest* opinion. So is that --

MS. COLEMAN: I bet you're going to.

No. Judge Gropper does not -- does not talk about the fiduciary issue in either, I believe, either of the opinions. However --

THE COURT: Colliers clearly limits the requirement to file to fiduciaries --

MS. COLEMAN: But --

THE COURT: -- the fiduciary committees.

In other words, if there's a -- if you have some sort of fiduciary responsibility to people that you're not actually representing, then it makes sense that the people that you're -- that you're purporting to represent ought to know about you.

Now in -- and in addition to that, it also lets everybody else know about you. But the paramount responsibility is to those people that you're purporting to represent. And the Court has an interest in making certain that that's done appropriately.

MS. COLEMAN: Your Honor, Judge Gropper did address this issue, but he addressed it --

THE COURT: Okay. So you got help.

MS. COLEMAN: Yeah. He did address it. It's on -- it's in --

THE COURT: Which --

MS. COLEMAN: -- tab six.

(Voices speaking off the record)

THE COURT: Tab six. At page -- this is the opinion on *Sealand* (phonetic)

MS. COLEMAN: Yeah. Exactly.

THE COURT: Where?

MS. COLEMAN: Yeah. It's the same pagination, your Honor. It is on page seven --

THE COURT: All right.

MS. COLEMAN: -- tab six. And --

THE COURT: And what does it --

MS. COLEMAN: I'll read it -- I'll read it as follows.

THE COURT: Okay.

MS. COLEMAN: "This committee contends that it did not take on any fiduciary responsibility to the shareholders as a group when it appeared in these cases.

Assuming arguendo for purposes of this motion that the committee does not as a fiduciary, Rule 2019 is based on the premise that the other shareholders have a right to information as to committee member purchases and sales, so that they make an informed decision whether this committee will represent their interests, or whether they should consider forming a more broadly based committee of their own.

It also" --

Then it goes into the sentence I just read.

"It also gives all parties a better ability to gauge the credibility of an important group that has chosen to appear in a bankruptcy and play a major role."

So, your Honor, Judge Gropper assumed that -- assumed no fiduciary responsibility and does not -- does not read -- read it in the same way as Colliers. I haven't looked at Colliers, but if Colliers requires a fiduciary, then Judge Gropper does not -- does not agree with that.

Your Honor, I'll just close by briefly addressing the -- briefly addressing the trade industry -- the trade industry concerns.

First of all, your Honor, it's very clear that -- that the industry just doesn't like this Rule. I think they don't like this Rule, though, your Honor, not because they're worried about the Debtor finding out what they paid for their claims.

Because it is clear, and Scopac absolutely concedes, that what is paid for a claim does not affect how much has to be -- how it has to be treated under a plan of reorganization. That's absolutely clear. And there's no point in spending any time on it.

What they really don't like is that each other are going to find out -- they're all competitors, they're all going to find out what they paid. And that's really what they -- that's really what they don't want to do. And unfortunately, that is -- that is simply not a problem that this Court can address.

Rule 2019 says what it says. I'd like to read a quotation from Dow Jones Newswire today in a -- in an article about this case. It says,

> "Hedge funds, lightly regulated private investment funds, have managed to turn the bankruptcy system into a return-driven market, while keeping their trading secrets in tact, in spite of the Bankruptcy Code's disclosure requirements."

Your Honor, counsel -- the counsel for the industry association makes it sound like you're talking about something radical, and crazy, and new. And if you force people to disclose all of this stuff, wait a minute, the statute -- this Rule has been on the books for -- for 70 years. It's not new. There are plenty of situations in which it's been required.

As I said, in *Northwest*, some of the -- some of the committee members who've -- who were ordered to disclose have actually done so. And, again, we don't have any record that the markets are crashing.

Your Honor, I want to close with a quotation from the end of the first *Northwest* opinion, which is tab five.

> "The Rule is longstanding. There is not basis for failure to apply it as written. Although the committee argues that the Rule has been frequently ignored or watered down, there is no shortage of cases applying it."

Your Honor, we would submit that it should be applied in this case. And the Ad Hoc Committee should be required to disclose.

Thank you.

THE COURT: All right. Well I'll take this matter under advisement.

MR. JORDAN: Your Honor, may I just submit for the record --

THE COURT: Okay.

MR. JORDAN: -- on behalf of members, we support the motion of Scopac for reason. And I want to reference for you page six of the brief and response that was filed by the Ad Hoc Committee, on for this purpose.

They indicate that they operated by consensus. And then, "The consensus decision," which there is no rules, no majority, nothing, it just says they sent emails around. It says,

> "The consensus decision is not binding on an individual noteholder group members. And any member is free to drop off or rejoin a group at any time."

Now there's one lawyer who says that he is representing people who may disagree with him, and drop off, and then come back onto the committee. And the only reference that I want to be certain, only because we seem to get the fallout from the activity of this committee, which, by the way, has been incredibly active in this case, not in support of what we believe is reorganization.

So we obviously have somewhat different goals. And I only point this out, and the Palco Debtors stress that the Court gauge the credibility as -- as the New York Judge says, of the representation.

What is it when Mr. -- when Mr. Flaschen shows up at the podium and says, I represent, and then we find that what he actually represents is maybe a group who has reached some undefined consensus with a bunch of them dropping off for this particular reason, in case anybody later asked, well who gave you the authority to do that. Would it be nice for some of them said, well we dropped off. We didn't want to deal with it. So we had ten percent left, or five percent left. He said, well I had a majority, 'cause that's all that were left.

So the problem that we have as the Palco Debtors is how do you gauge the credibility of someone who's going to be as active and aggressive as Mr. Flaschen is when he says I have no signed agreement, lawyer agreement, which I thought every lawyer had to have with every filing. In Texas you do. It's a matter of ethical requirements that you must have a signed agreement to the extent of your representation.

And I have a committee that someone can disagree and drop off, and then later come back on, and I could represent then again, even though I may have represented something which was a conflict to them in an earlier case.

So aside from the confusion, I simply want to point out that this committee could not possibly have any credibility attributed to them, unless every time Mr. Flaschen approaches the podium he gives you a complete count of everyone who has said yea, said nay, gotten off the committee, decided not to vote, so that his consensus might be of a different percentage or a different method.

And, your Honor, it just -- to me 2019 --

THE COURT: I thought he did that in the footnote for each time he filed a pleading.

MR. JORDAN: Well my problem is this. He might -- he may do that from time to time. He certainly isn't obligated to do that. This is something I said he -- has suggested he can do or would do. But he's not obligated to do that.

And that isn't, then, the compliance with 2019 in any event. We don't know when he represents -- I still represent so-and-so, who at one point in time, claimed to have a -- a 20 percent stake, only has a 1 percent stake.

And so, your Honor, I'm not suggesting that you don't fashion whatever you think is the right type of disclosure, if any. I'm really pointing to the -- the issue of without that kind of disclosure, gauging the credibility of this committee would be -- is, to me, practically impossibly.

THE COURT: Okay.

MR. FROME: Your Honor, Evan Flaschen. I do want to respond briefly. I'm an officer of this Court. I will stack my credibility up against Shelby Jordan's or anyone else in the room. I resent the implications otherwise.

When I sign a pleading, I mean what I say. And up in Court --

THE COURT: I don't think --

MR. FROME: -- on behalf of those rules --

THE COURT: Before you get upset, I think what he was saying was not that -- that you're undependable. But that -- that there are times when you have argued or, I mean, apparently you have filed -- in every one of your pleadings that you filed, did you put a footnote one that said how members of your -- that you represented?

MR. FROME: That is correct, your Honor.

THE COURT: Okay. So now the only problem would be is when between the time when you file it, and we actually hear it, should you be required to do a, basically a footnote one, when you stand up to argue it?

MR. FROME: All right. Since Rule 2019 does not apply, no, we should not be required. I am happy to do so voluntarily.

THE COURT: Okay.

MR. BARR: Your Honor, I'm sorry. This is Matt Barr from Milbank, just two --

THE COURT: Yes, sir. Go ahead.

MR. BARR: Thank you. Two very quick data points, just so you have them in front of you in response to Debtor's counsel.

First it is our understanding that after the *Northwest* ruling that certain members of the ad hoc equity committee did drop off that committee. And number two, from a market perspective, your Honor, the equity was trading at about $1.50 right before Judge Gropper's ruling. It is now at 72 cents, or a 50 percent reduction in the equity value, your Honor.

So there is some data to prove that it did have some impact. Don't know the extent of the impact, but that's exactly what we fear, your Honor, is that the impact would be detrimental.

THE COURT: All right. Thank you.

MR. FIERO: Your Honor, If I might.

THE COURT: Yes, sir.

MR. FIERO: Your Honor, as you know, John Fiero, for the Official Committee of Unsecured Creditors.

As you know, the Committee did not take a position on this motion. But I'm just struck that every time any committee or group in this case takes a position, the first thing that the Debtors suggest is that we have to examine the credibility of the Committee.

I don't understand why in this case. And, in particularly in this case, where the briefs are incredibly detailed. The arguments are well thought out, and presented with all of the time that -- that you've graciously allowed us, that the question of the credibility of the speaker is somehow more important or superseding to the credibility of the arguments.

And, you know, this issue is not going away. There is still pending a potential attack on the Unsecured Creditors

Committee, with respect to a as yet unruled upon and unargued Motion to Reconstitute the Official Committee of Creditors.

And so, at some point in this case, we have to get past these issues and start thinking about reorganization And the Committee's ready to do that now, your Honor.

THE COURT: Okay.

MR. JORDAN: Your Honor, If I can make it clear for the record, I wasn't talking about credibility of any person. I was talking about how you gauge the credibility of this group when they are an amoeba. They're a moving target. That's all I had a reference to.

If Mr. Fiero worries about representation I make every time I go to the podium, that was his comment just then. I don't think I made any representation about any counsel or any party credibility.

I only want the Court to keep in mind that there's a committee who is -- who is the 500 pound gorilla in many occasions, even Mr. Fiero's committee when there was a SARE motion pending, deferred to that committee to speak; didn't take a position at all which, to me, was a very loud position. So --

THE COURT: Well he took a editorial position earlier on in the case. But it changed when we got to the -- they didn't take an official position --

MR. JORDAN: But I just please --

THE COURT: -- when we got to the case.

MR. JORDAN: Yes, sir. If it just please for the record, so that the --

THE COURT: The committees in cases do have great, I mean, I have the -- you know, I often defer to the committee --

MR. JORDAN: Well that's why --

THE COURT: -- because they are the people who have the most at stake. They're the -- the unsecured creditors. And I think that if --

MR. JORDAN: If that was the only reference I meant is what bases do you have --

THE COURT: I understand that. And I didn't, I mean, I -- I can also understand how somebody might have their feelings hurt by what you said, but I think they misunderstood what you said. 'Cause they were not, I mean, I think -- I think it's important to have groups to be able to represent parties so that we don't have 500 noteholders in here with 500 lawyers. We've got enough lawyers involved already. That's a good thing.

I mean, it's important to have creditors committees. That's a good thing. All of those things are good things. And it's also important to have a plan. That's a good thing.

So we'd love to have a plan and a disclosure statement, even though it's just required. I mean, I agree that it's required and we have to have that also.

But as for this motion, I will -- I will take it under advisement and -- and rule on it.

All right.

MR. FROME: And, your Honor --

THE COURT: And I do think it would be important for you to -- if there's been any significant change in the people you represent at any time when you make a presentation, you need to -- you need -- I think it would be good, I mean, there's no question I would want you to tell us that.

MR. FROME: As I said, I voluntarily am happy to do so.

THE COURT: All right.

MR. FROME: I would also suggest, your Honor, should you decide that we are required to make disclosure, we would request time, then, to file a motion to file that information under seal, in the same way this Debtor has already sought to file under seal, information about its relationship with the Morris and Forester firm.

THE COURT: All right. Thank you.

MR. FROME: Thank you.

THE COURT: All right. Now we're down to the -- oh, certification. Okay. So somebody has to remind me what it is that I do when somebody wants an issue certified to the Fifth Circuit. Is that my call? Or is it initially my call and then it goes to the District Court to make the call? Exactly what -- do I have to make a recommendation to the District Court under circumstances like that? What does the Code say?

MR. MAYR: Your Honor, this is -- I'd be happy to address that, your Honor, Kurt Mayr, Bracewell & Giuliani on behalf of the noteholder group.

Certification is a two step process under Title 28, --

THE COURT: Okay.

MR. MAYR: -- Section 158(d)(2). New provision cannot --

THE COURT: 158(d)(2) is the --

MR. MAYR: (d)(2).

THE COURT: D as in David?

MR. MAYR: D as in David.

THE COURT: Okay.

MR. MAYR: An act that is part of the 2005 amendments, has expanded the Court of appeals appellate jurisdiction in bankruptcy matters, skipping the District Court appeal process in certain circumstances.

And the process for certifying to do that, is two step, fist before your Honor or before the District Court, or before both, the appellant, if there is no agreement of the parties with respect to certification, makes a request for certification, and the Court can issue a very brief order that certifies the issues in the relevant decision to the Circuit

Court.

We've elected to come to your Honor, obviously, having just received your decision last Friday. At that point, the issue is sent to the Fifth Circuit Court of Appeals. And the Fifth Circuit Court of Appeals has the discretion to determine whether or not to accept the certification.

One big distinction between the two steps is that at the Bankruptcy Court, District Court level, certification is required if any of the three circumstances in the statute are present. The Circuit Court of Appeals, however, has discretion to determine whether or not it wants to accept that certification.

THE COURT: Okay. So what impact -- first of all, do you have to make sort of interim order? Do I have to sort of recommend, first of all, that the matter be -- be appealed --

MR. MAYR: No, your Honor.

THE COURT: -- and then certified?

MR. MAYR: No, your Honor. All we have to do is file a Notice of Appeal, then it is on appeal. And then we request your Honor to --

THE COURT: This isn't an order -- this is an order that is appeallable as a matter of right?

MR. MAYR: I believe so, your Honor. I even titled it a final order. It is a Relief From Stay order which -- which -- which is final in this Circuit under *In re: Chun* (phonetic).

THE COURT: Okay.

MR. MAYR: And in any event --

THE COURT: Okay.

MR. MAYR: -- that's an issue more for the Appellate Court to determine at the end of the day.

THE COURT: Okay. So go ahead.

MR. MAYR: So the -- why don't I just skip ahead to the three grounds, all of which we think are present here. The first --

THE COURT: The statute sets out three grounds?

MR. MAYR: It does, 158(d)(2)(A) sets out three separate grounds, any one of which is sufficient to support certification.

The first is whether or not the decision being appealed presents the legal question for which there's no controlling Court of Appeals or Supreme Court authority. We think that as your Honor's decision, and the parties' briefs in this case, indicate, there is no controlling Fifth Circuit or Supreme Court decision on interpreting the scope of §101(51)(b), the single asset real estate definition in the Bankruptcy Code, either when it was enacted in '94 through to the recent enactments in 2005.

I understand that the -- the Debtor has fled a response claiming that the *In Re: Humble Place* decision in 1991 is somehow Fifth Circuit controlling the jurisprudence. That case, obviously, predates enactment of the SARE definition in the Bankruptcy Code and can't be controlling on the meaning of that definition.

The second ground is whether or not the legal question requires reconciling conflicting decisions. And as -- as your Honor saw on the parties' briefs, there are conflicting decisions; one by your Honor and by the Eastern District of Texas in the *Golf Partners Case*, which have adopted passive versus active test. And the *Kara* (phonetic) *Homes Decision* recently in the District of New Jersey, which rejected that test.

There's a conflict between the two decisions that urgently needs reconciliation at the Court of Appeals level. It's be very helpful for -- for parties to understand what exactly single asset real estate cases mean in the aftermath --

THE COURT: The *Golf Partners Case*, did it get appealed?

MR. MAYR: I don't know the answer to that, your Honor.

THE COURT: It didn't get certified.

MR. MAYR: Not that I know of.

THE COURT: That we know of. Okay.

Has anything been certified?

MR. MAYR: In the Fifth Circuit?

THE COURT: In the Fifth Circuit.

MR. MAYR: It's funny that you ask. Mr. Melko was telling me earlier today that he had a -- had heard that there was a discussion recently among the fifth Circuit Judges that they were so surprised that parties had not been certifying bankruptcy appeals.

So far, they had really thought that they would get more than they are getting, and they're looking forward to getting some. Hopefully, we can give them one.

The third ground under the statute is whether the appeal would materially advance the Chapter 11 case. The star motion, given the economic realities of this case has always been about getting this Debtor to put a plan of reorganization on the table on an expedited basis.

And obviously in a bankruptcy case, which is about reorganizing a Debtor, getting a plan on the table sooner rather than later, which would be the result of a successful appeal, would materially advance Scopac's Chapter 11 case.

For those reasons, your Honor, we believe that all three of the grounds for certification are present. The statute is worded in a mandatory shell with respect to certification by Bankruptcy Courts and District Courts.

And we would respectfully request your Honor to certify the questions presented in your Honor's final decision, which are legal questions. As you will recall, we -- as your

Honor I think observed the first time that we had a status conference on the SAFE motion, you thought it was a legal issue. We agreed. And we stipulated to the Debtor's facts in their pleadings, and in their opening statements is a relatively focused legal question that was ripe for direct review by the Fifth Circuit.

It is the -- the new §158(d)(2) was enacted for situates just like this, situations where Congress recognized the -- the double layered appellate process in bankruptcy often moves too slow for parties who need expedited review. And that's what the SARE statute is all about, expedition. And we would like to move this -- move this along as your Honor has moved the termination of the SARE Motion along before this Court, at the appellate level now, though.

THE COURT: All right. Thank you.

MR. MELKO: One clarification, your Honor.

THE COURT: Yes, sir.

MR. MELKO: Mr. Mayr gives me way too much credit. I wasn't privy to the Fifth Circuit discussion. What actually happened was Judge Jones spoke at a Court function in Houston last week. And apparently said that she was -- wanted to be sure the bankruptcy lawyers knew about this provision, and expressed some surprise that they has not seen a number of these come up.

Thank you.

MR. FROME: Good afternoon, your Honor. Eric Fromme, Gibson, Dunn, and Crutcher on behalf of Scotia Pacific Company.

Just a clarification to first start off with. The new section 28 U.S.C. 158(d)(2), needs to be read a little bit more closely. (d)(2)(A) starts off with,

> "The appropriate Court of Appeals to have jurisdiction of appeals described in the first sentence of subsection (a)."

So we go back to subsection (a) of 158,

> "The District Courts of the United States shall have jurisdiction to hear appeals from final judgments, or orders, and decrees, from interlocutory orders regarding exclusivity."

I shortened that up. And then,

> "With leave of the Court from other interlocutory orders of decrees."

To the extent that this -- that your order regarding the SARE Motion is an interlocutory order, they first must obtain leave from the Court. SO you do have discretion to -- to grant that appeal.

Then you go into the three factors that Mr. Mayr went through that's laid forth in 28 U.S.C. 158(d)(2)(A). And that's Roman, that's i, ii, and iii.

First of all, this matter is -- this matter is -- it says it involves a question of, although there's no controlling decision at the Court of Appeals level. The *Humble Place* decision, your Honor, has been followed in this Circuit on SARE decisions. And we believe it is controlling -- controlling authority.

The second factor is that there's a question of law regarding conflicting decisions. Okay. There's no conflicting decisions out there. *Kara Homes* follows every case that's out there. The determining factors in *Kara Homes* were factual decisions, factual findings by the Court.

This Court made factual decisions in a factual application of the law. When pressed during oral argument, counsel for the noteholders admitted that's a fact specific inquiry. At best, it's a mixed question of law and fact. It's not a question of law.

The next factor is this is going to materially advance the progress of the case. And really the only reason given is that a SARE -- SARE provisions allow for expedited relief. Therefore, since -- since it's denied, we should get an expedited appellate process.

But Congress didn't provide for expedited appeals of SARE decisions. They simply didn't. If it wanted to do so, it would have.

Here they don't meet any of the -- of the requirements of the section. It's up to your Honor, and it's your discretion, as well, to determine whether this is an interlocutory appeal -- interlocutory order.

The issue before your Honor is -- is why can't we go through the normal appellate process? There's really no -- there's really no reason. The Debtors are moving forward. Scopac is moving forward, formulating its plans of reorganization, formulating alternatives, based on what Blackstone -- the work that Blackstone's been doing.

They're working on their long-term projections. And they're working on hiring an evaluation consultant. They're moving forward expeditiously.

There's no reason to -- to unnecessarily short circuit that process.

THE COURT: All right.

MR. FROME: Thank you, your Honor.

THE COURT: Thank you.

(Pause)

MR. MAYR: Your Honor, if I may, just a couple of very quick points.

On the issue of whether this is an interlocutory appeal, I think I mentioned the *Chun Case*, just want to give your Honor a citation for that if you think that's an issue that you need to decide. I think that's an issue that the Court of Appeals for the District Court decides.

But *In re: Chun* in 106th F.3d. 1239, Fifth Circuit Case, 1997. In addition, if, in fact --

THE COURT: And it said that a Motion to Lift Stay -- proceeding on a lift stay is a final order.

MR. MAYR: It's a final order, yes.

THE COURT: Okay.

MR. MAYR: And that is the majority -- majority rule, your Honor.

In additional, you know, I think that at the first scheduling conference where we raised -- where we discussed the SARE motion, it was the Debtor's position that this essentially was a declaratory judgment relief. You could view it also as though this were a complaint with one claim that you have now denied.

That is a final order, final judgment on the merits for our request for determination whether or not this is a single asset real estate debtor. And

THE COURT: Okay. All right.

MR. MAYR: That's all I have, your Honor.

THE COURT: Okay. You wanted to say one more thing?

MR. FROME: Your Honor, I just want to clarify. I've never been quite clear what the motion, the SARE Motion was. It's a motion for declaratory judgment. We made that clear that the status should be -- should have been an adversary proceeding, or it was a relief from stay.

They argued that it wasn't for a relief from stay. The issue is is that I still think it's an interlocutory order.

Regardless, I think the case law is -- is that if the motion to grant a relief from stay, then that's a final order.

But if it's a motion to deny relief from stay, I think the law is less clear in that it's a -- it's an interlocutory order.

Thank you your Honor.

THE COURT: All right. Does the Creditors Committee have a position on this?

(Pause)

MR. HOLZER: Your Honor, as you know, this -- this motion was filed on an emergency basis. And the Creditors Committee did not take an explicit position yet.

But what I'm struck by is the fact that six parties moved to transfer venue in this case. And we now see more and more things happening, matters going either upstairs or all the way to New Orleans.

And I'm sure that the Creditors Committee and the other Movants, including the State of California, are not interested in seeing the merits of the venue motion prejudiced by anything that happens in this Court, one week, one month, two months after the motion was presented and argued to the Court.

THE COURT: Okay. Anything else?

(No audible response)

THE COURT: Does that conclude everything?

MR. HOLZER: That's all the matters on the docket for today, your Honor.

THE COURT: All right. I did promise to have the venue ruling last week, and I didn't finish it. So I apologize for that. We're working as hard as -- hard as we can.

Thank you.

MR. FROME: Your Honor, before you -- this is Evan Flaschen again.

THE COURT: Yes, sir.

MR. FROME: The one item which I request you not take under advisement is this certification, because if your Honor should decide it, we will take it to the District Court. Because, again, timing is of the essence.

So whether it's now or after a short period, we would just like a top ruling on that.

THE COURT: Yeah. I agree with you. I mean, it either needs to go to the Circuit Court, because it needs to be decided quickly, and the relief is basically mooted by not granting the appeal or -- and things of that sort. Or it doesn't, one of the two.

But in any event, so I -- I agree with you for various reasons. But perhaps the most important one is is that whatever I do in that, it's going to be looked at by the District Court.

I assure that I got to get it done quickly.

MR. FROME: Yes, your Honor.

THE COURT: So thank you.

SOME COUNSEL: Thank you, your Honor.

THE COURT: You all are excused.

(This proceeding was adjourned at 1:13 p.m.)

CERTIFICATION

I certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

April 20, 2007

Transcriber Date

07-20027

04/10/07 - 04/20/07

EXHIBIT H

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

United States Courts
Southern District of Texas
FILED

APR 2 4 2007

Michael N. Milby, Clerk of Court

CASE NO.:	07-20027
STYLE:	Scotia Development, LLC
HEARD ON:	04/17/07
FILED ON:	04/24/07
NO. OF PAGES:	9
JUDGE:	Richard S. Schmidt
COURT REPORTER:	Sharon Russell

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

CORPUS CHRISTI DIVISION

IN RE: SCOTIA DEVELOPMENT LLC, . CASE NO. 07-20027
.
. CORPUS CHRISTI, TEXAS
DEBTOR. . TUESDAY, APRIL 17, 2007
. 10:57 A.M. TO 11:05 A.M.
. . . .

MOTION HEARING

SOME PARTIES APPEARING TELEPHONICALLY

BEFORE THE HONORABLE RICHARD SCHMIDT
UNITED STATES BANKRUPTCY JUDGE

Appearances:

For Scotia Pacific Company:
Kathryn A. Coleman, Esq.
Eric J. Fromme, Esq.
Gibson, Dunn & Crutcher LLP
200 Park Avenue
New York, NY 10166-0193

Official Committee of
Maxim B. Litvak, Esq.
Pachulski Stang Ziehl Young
Jones & Weintraub
150 California Street, 15th Floor
San Francisco, CA 94111-4500

Timber Noteholders:
Gregory W. Nye, Esq.
Kurt Mayr, Esq.
Bracewell & Giuliani
No Address Provided

For Pacific Lumber Company:
Peter Holzer, Esq.
No Address Provided

Bank of America:
Ana Acevedo, Esq.
O'Melveny & Myers
No Address Provided

Appearances (continued):

Marathon Structured Finance Fund:	John Penn, Esq. Haynes & Boone No Address Provided
CSG Investments:	Roberto Kampfner, Esq. Alan Gover, Esq. CSG Investments No Address Provided
Houlihan Lokey Howard & Zukin:	Todd Hanson, Esq. Houlihan Lokey Howard & Zukin No Address Provided
Maxxam, Inc.	Joli Pecht, Esq. Maxxam, Inc. No Address Provided
	John Melko, Esq. No Address Provided
	Mark Wege, Esq. No Address Provided
	Matt Reed, Esq. No Address Provided
Court Recorder:	Sharon Russell
Transcriber:	Cheryl Hendershot Trinity Transcription Services 122 Trinity Oaks Circle The Woodlands, TX 77381 281-296-2290

Proceedings recorded by electronic sound recording;
Transcript produced by transcription service.

Corpus Christi, Texas; Tuesday, April 17, 2007; 10:57 a.m.

(Some parties appearing telephonically)

THE COURT: Send in the call.

(Pause)

THE COURT: Good morning.

SOME COUNSEL: Good morning, your Honor.

THE COURT: John Penn?

MR. PENN: Present, your Honor.

THE COURT: Kathryn Coleman?

MS. COLEMAN: Present, your Honor.

THE COURT: Eric Fromme?

MR. FROMME: Present, your Honor.

THE COURT: Mark Wege?

MR. WEGE: Present, your Honor.

THE COURT: Maxim Litvak?

(No audible response)

THE COURT: No.

Evan Flaschen?

MR. MAYR: Mr. Flaschen's not here, your Honor. But Kurt Mayr and Greg Nye are.

THE COURT: All right. Brian Lennon?

(No audible response)

THE COURT: Matt Reed?

MR. REED: Present, your Honor.

THE COURT: Todd Hanson?

MR. HANSON: Present, your Honor.

THE COURT: Francine Brodowicz?

(No audible response)

THE COURT: Joli Pecht?

MS. PECHT: Present, your Honor.

THE COURT: Ann [sic] Acevedo?

MS. ACEVEDO: Present, your Honor.

THE COURT: Alan Gover?

MR. GOVER: Present, your Honor.

THE COURT: Roberto Kampfner.

MR. KAMPFNER: Present, your Honor.

THE COURT: Daniel Zazove, or Zazove of whatever, Z-a-z-o-v-e.

(No audible response)

THE COURT: Anyone else on the phone call?

MR. MELKO: John Melko.

THE COURT: Mr. Melko.

And Mr. Holzer's in the courtroom.

MR. HOLZER: Yes, your Honor. For --

THE COURT: What do we have scheduled today?

MR. HOLZER: We have several matters on. I was wondering if -- if Mr. Litvak is not on, I wonder if anyone else from the committee is on the call, 'cause we were expecting the committee. Well --

THE COURT: Pachulski, Stang, Ziehl, and Young.

(No audible response)

MR. HOLZER: Well I guess I'll proceed, then, Judge. The committee did consent to the only matter that we're actually going to do today. We have four matters appearing on the docket. The first is Docket Number 247, which we refer to as the netting motion. And we're going to ask the Court to push that to May the 1 -- May 1 at 11 o'clock.

THE COURT: All right.

MR. HOLZER: The next two items, 531 and 532, are applications and a motion to seal with respect to the retention of Morrison and Forester. And we'd like to push that to next Tuesday's docket. That's April the 24th at 11 o'clock.

THE COURT: Okay.

MR. HOLZER: That leaves us, then, with docket number 632. That's the emergency application of Brit Lumber for authority to pay some specified severance benefits to 27 employees who were terminated post-petition.

Your Honor, we're asking for approval to do this It's a modest, fairly modest severance benefits. Brit believes that it's decent to do this for laid off employees to help tide them over, and also believes that doing so will help with respect to Palco and Scopac, the other -- the larger employers, to help foster loyalty, good will, and so forth, all the things you'd expect them --

THE COURT: What is the total amount?

MR. HOLZER: -- to do.

Total amount, Judge is $25,732 spread among the 27 employees. They have to sign a release to get it. The form of release was filed with the pleading. And it's based on --

THE COURT: What's the largest amount?

MR. HOLZER: Largest amount, Judge, is $3,420 to an employee for over 20 years. And it's based on length of service. One to five year gets one week base pay. Six to ten --

THE COURT: Has the committee approved --

MR. HOLZER: -- years --

THE COURT: -- the -- committee approved the pay?

MR. HOLZER: Committee has approved this, your Honor. And we've asked the bank's approval. And we believe they also agree. There have been no objections.

THE COURT: Anyone on the phone objecting?

(No audible response)

THE COURT: Okay. I'm prepared to rule on the 2019 Motion. After reviewing carefully all of the pleadings that have been filed, I've decided in this case, because of the -- a number of reasons, but primarily because this is primarily it appears to me to be a financial reorganization that, in this particular case, while I suspect that my ruling will be contrary to the recent decision that was cited, I'm going to take an approach, a practical approach, and find that this is not a committee, that this is -- at this point that this is just one law firm representing a bunch of creditors.

And I am not going to require at this time any filings. I do -- I am aware that Mr. Flaschen has indicated he has previously filed on his own behalf a filing that sets out who he represents. And I -- I will continue to require that he keep that updated in the event that there is any significant to the change -- change to the parties that he represents.

In addition to that, I think that he needs to be also careful that his, and this is just, this is not a ruling, but I suspect that there could well be situations where his representation of this group of people could have some conflicts of interest.

And thereby, it would be important that all of the parties that he represents understands those conflicts in order to waive them. So that's his responsibility with respect to the conflicts that might well exist by virtue of his representation.

I'm not suggesting there are any at the present time. I'm just saying, obviously, if one of the claimants happen to have a large unsecured claim as well as a secured claim, there could be a conflict in the position taken with respect to -- to all of his representation.

But I'm not addressing that at this time. All I'm doing is -- is denying the motion to file the 2019 information as requested.

So if Mr. Flaschen's on line, but if you would have him submit an order to that effect.

Thank you.

MR. MELKO: Your Honor?

THE COURT: Yes.

MR. MELKO: John Melko.

THE COURT: Well Mr. Melko, you can submit the order.

MR. MELKO: Well and also two of the members -- two of Mr. Flaschen's partners are on line. So we're -- we're mindful and appreciative of the Court's ruling.

With respect to the motion we filed about eight days ago with respect to the appeal of the SARE Motion --

THE COURT: Right.

MR. MELKO: Yeah. I don't know if the Court's aware, but there's been some recent activity. We had another late night pleading by Scopac last night, where essentially they're asking the District Court to dismiss the -- dismiss the Notice of Appeal.

The appeal has not yet formally been docketed, although, of course there is a filing file number assigned to it at the District Court. Your Honor mentioned when we talked about the -- when we had the SARE hearing, that the notice appeal filed, that you understood that it was a new procedure, that it was time sensitive.

That you were trying to rule promptly, given the recent -- particularly by the recent acts by Scopac. We would ask that your Honor issue a ruling --

THE COURT: All right. All right. I appreciate that.

And I -- as far as those of you on the line, you can tell your compatriots, too, I don't -- I have no problem with people hounding me for opinions.

So that's not what you're doing, Mr. Melko. But just bringing it up is not a faux paux. That's helpful.

MR. MELKO: I've been called a hound before, your Honor.

THE COURT: We got plenty of things that we're working on in this case. But -- and that one is one of them.

So that one has got a priority as well as the vending motion.

Thank you very much. You all are excused.

MR. HOLZER: Thank you, Judge.

UNITED STATES MARSHAL: All rise.

(This proceeding was adjourned at 11:05 a.m.)

CERTIFICATION

I certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

April 20, 2007

Transcriber Date

07-20027

04/17/07 - 04/20/07

EXHIBIT I

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

United States Courts
Southern District of Texas
FILED

JUN - 7 2007

Michael N. Milby, Clerk of Court

CASE NO.:	07-20027
STYLE:	Scotia Development, LLC
HEARD ON:	5/22/07
FILED ON:	6/7/07
NO. OF PAGES:	26
JUDGE:	Richard S. Schmidt
COURT REPORTER:	Sharon Russell

ORIGINAL

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

CORPUS CHRISTI DIVISION

United States Courts
Southern District of Texas
FILED
JUN - 7 2007
Michael N. Milby, Clerk of Court

IN RE: SCOTIA DEVELOPMENT LLC, . CASE NO. 07-20027
.
. CORPUS CHRISTI, TEXAS
DEBTOR. . TUESDAY, MAY 22, 2007
. 2:01 P.M. TO 2:25 P.M.
. . . .

MOTION HEARING

SOME PARTIES APPEARING TELEPHONICALLY

BEFORE THE HONORABLE RICHARD SCHMIDT
UNITED STATES BANKRUPTCY JUDGE

Trinity Transcription Services
122 Trinity Oaks Circle
The Woodlands, TX 77381
281-296-2290

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF TEXAS

CORPUS CHRISTI DIVISION

IN RE: SCOTIA DEVELOPMENT LLC, . CASE NO. 07-20027
.
. CORPUS CHRISTI, TEXAS
DEBTOR. . TUESDAY, MAY 22, 2007
. 2:01 P.M. TO 2:25 P.M.
. . . .

MOTION HEARING

SOME PARTIES APPEARING TELEPHONICALLY

BEFORE THE HONORABLE RICHARD SCHMIDT
UNITED STATES BANKRUPTCY JUDGE

Appearances:

Aurelius Capital Management:
Wei Wang, Esq.
Aurelius Capital Management
No Address Provided

Bank of America:
Evan Jones, Esq.
O'Melveny & Myers
400 South Hope Street
Los Angeles, CA 90071-2899

Bank of America Securities:
Molly Bogdan, Esq.
Bank of America Securities
No Address Provided

Bank of New York Trust Co.:
Matt Reed, Esq.
Thompson & Knight LLP
333 Clay Street, Suite 3300
Houston, TX 77002

Bank of New York Indentured Trustee:
Mark Worden, Esq.
Fulbright & Jaworski
No Address Provided

California State Agencies:

Paul Pascuzzi, Esq.
Felderstein Fitzgerald & Pascuzzi
No Address Provided

CSG Investments:

Jacob Cherner, Esq.
CSG Investments
No Address Provided

Deutsche Bank:

Matt Doheney, Esq.
No Address Provided

Houlihan Lokey Howard & Zukin:

Todd Hanson, Esq.
Houlihan Lokey Howard & Zukin
No Address Provided

LaSalle Bank:

Mark W. Wege, Partner
Bracewell & Giuliani, LLP
711 Louisiana Street, Suite 2300
Houston, TX 77002-2770

Marathon Structured Finance Fund:

John Penn, Esq.
Haynes & Boone
201 Main Street, Suite 2200
Fort Worth, TX 76102-3126

Marathon Structured Finance Fund:

David Neier, Esq.
Winston & Strauser
No Address Provided

Maxxam, Inc.

Roberto Kampfner, Esq.
Matt Garofalo, Esq.
Alan Gover, Esq.
White & Case LLP
No Address Provided

Maxxam, Inc.

Joli Pecht, Esq.
Maxxam, Inc.
No Address Provided

Murray Capital Management:

Francine Brodowicz, Esq.
Murray Capital Management, Inc.
No Address Provided

Official Committee of Unsecured Creditors:

Maxim B. Litvak, Esq.
Pachulski Stang Ziehl Young Jones & Weintraub
150 California Street, 15th Floor
San Francisco, CA 94111-4500

Appearances (continued):

For Pacific Lumber Company:

Peter Holzer, Esq.
Gary Clark, Esq.
Kevin Franta, Esq.
No Address Provided

Frank Bacik, Esq.
The Pacific Lumber Company
No Address Provided

C. Luckey McDowell, Esq.
Baker Botts
No Address Provided

Scotia Development, LLC:

Gary M. Kaplan, Esq.
Howard, Rice, Nemerovski, Canady
No Address Provided

For Scotia Pacific Company:

Kathryn A. Coleman, Esq.
Eric J. Fromme, Esq.
Robert Davis, Esq.
Gibson, Dunn & Crutcher LLP
200 Park Avenue
New York, NY 10166-0193

For Scotia Pacific Company:

John F. Higgins, Esq.
Porter & Hedges LLP
Reliant Energy Plaza
1000 Main Street, 36th Floor
Houston, TX 77002

T&C

Susan Fennessey, Esq.
Shearman & Sterling
No Address Provided

Ad Hoc Committee of
Timber Noteholders:

Evan D. Flaschen, Esq.
Kurt Mayr, Esq.
Bracewell & Giuliani, LLP
711 Louisiana Street, Suite 2300
Houston, TX 77002-2270

Ad Hoc Noteholders:

John P. Melko, Esq.
Gardere Wynne Sewell LLP
1000 Louisiana, Suite 3400
Houston, TX 77002-5007

Court Recorder:

Sharon Russell

Appearances (continued):

Transcriber:	Cheryl Hendershot Trinity Transcription Services 122 Trinity Oaks Circle The Woodlands, TX 77381 281-296-2290

Proceedings recorded by electronic sound recording;
Transcript produced by transcription service.

Corpus Christi, Texas; Tuesday, May 22, 2007; 2:01 p.m.

(Some Parties Appearing Telephonically)

THE COURT: Be seated.

(Pause)

THE COURT: Send in the call. All right.

Paul Pascuzzi?

MR. PASCUZZI: Present, your Honor.

THE COURT: Kurt Mayr, Mayr.

MR. MAYR: -- your Honor.

THE COURT: Evan Flaschen?

MR. FLASCHEN: Present, your Honor.

THE COURT: John Higgins.

MR. HIGGINS: Present, your Honor.

THE COURT: Maxim Litvak?

MR. LITVAK: I'm here, your Honor, along with John Fiero from my firm for the Committee.

THE COURT: All right. Gary Kaplan?

MR. KAPLAN: Present, your Honor.

THE COURT: Evan Jones?

MR. JONES: Present, your Honor.

THE COURT: Mark Wege?

MR. WEGE: Present, your Honor.

THE COURT: Mark Worden?

MR. WORDEN: Present, your Honor.

THE COURT: And then another Mark Worden, probably the same guy.

Alan Gover?

MR. GARAFALO: Matt Garafalo standing in for Alan Gover, your Honor.

THE COURT: And Roberto Kampfner?

MR. GARAFALO: He won't be calling in, your Honor.

THE COURT: All right. Todd Hanson?

MR. HANSON: Present, your Honor.

THE COURT: Joli Pecht?

MS. PECHT: Present, your Honor.

THE COURT: David Zazove or Zazove?

(No audible response)

THE COURT: Daniel, pardon me, Zazove, Z-a-z-o-v-e, Perkins Cole?

(No audible response)

THE COURT: All right. Susan Fennessey?

MS. FENNESSEY: Present, your Honor.

THE COURT: Francine Brodowicz?

MR. BRODOWICZ: Present, your Honor.

THE COURT: Jacob Cherner?

MR. CHERNER: Present, your Honor.

THE COURT: Luckey McDowell?

MR. MCDOWELL: Present, your Honor.

THE COURT: Molly Bogdan?

MS. BOGDAN: Present, your Honor.

THE COURT: Matt Doheny?

MR. DOHENY: Present.

THE COURT: Wei Wang?

MR. WANG: Present, your Honor.

THE COURT: And Matt Reed?

MR. REED: Present, your Honor.

THE COURT: Anyone else on the call?

MR. MELKO: John Melko here, your Honor.

THE COURT: All right.

MR. BACIK: Frank Bacik here with Gary Clark, your Honor.

THE COURT: All right.

MR. NEIER: David Neier on behalf of Marathon, your Honor.

THE COURT: Thank you. Anyone else?

(No audible response)

THE COURT: All right. In the courtroom? Mr. Holzer?

MR. HOLZER: For Pacific Lumber and its subsidiaries, except Scotia Pacific.

MS. COLEMAN: Good afternoon, your Honor. Kathryn Coleman, Eric Fromme of Gibson, Dunn, & Crutcher for Scotia Pacific.

MR. PENN: And John Penn on behalf of Marathon.

THE COURT: All right.

MR. HOLZER: Couple of matters up, your Honor. One I think will take some argument. That's the Motion to Reconsider Docket Number 717, dropped to the end. Docket Number 766 is the Motion of LaSalle Bank to Approve Transfer of Claim.

LaSalle Bank filed a notice of withdrawal of that motion already. That's at Docket Number 807. So I don't think this one --

THE COURT: They're not transferring their claim?

MR. HOLZER: I think their claim is transferred, your Honor. I don't know -- I don't have any first-hand personal knowledge. But they -- they withdrew their motion to transfer the claim. And they've dismissed their lawsuit with respect to that. We haven't heard from Mr. Kaim since.

MR. WEGE: Your Honor, Mark Wege here on behalf of LaSalle.

We have received the consent by Marathon with respect to the transfer of the claim. As we sit here right now, I don't know if that has been closed, but that is pending.

THE COURT: Okay. Thank you.

MR. HOLZER: Your Honor, Docket Number 5, 9, 1 is the Motion to Assume or Reject a contract with NEC.

There is a -- and we'd like to pass that for, I believe about 30 days. There's a pending motion for a settlement at Docket Number 732 that --

THE COURT: Okay.

MR. HOLZER: -- if that is approved then this motion will become moot.

THE COURT: All right.

MR. HOLZER: So if we can set that 30 days off, I think that'll be enough time.

THE COURT: Whatever the day is 30 days from now then, probably just -- do you have -- do you know the 30 day date?

MR. HOLZER: I don't offhand, Judge.

THE COURT: Today is the -- that would be about the 26th?

THE CLERK: We have Scotia on the --

THE COURT: Yeah.

THE CLERK: -- 22nd at 2.

MR. HOLZER: That would be --

THE COURT: Twenty-second? Okay. Then --

THE CLERK: At two.

THE COURT: Then let's go to the 22nd, June 22nd.

THE CLERK: Yes, sir.

MR. HOLZER: June.

THE COURT: All right.

MR. HOLZER: Thank you, Judge.

So that leaves Docket Number 589, is the Pacific Lumber's application to approve a compromise and settlement with Northern California Riverwatch. This motion's been on for

30 days. There have been no objections.

Basically, this is settlement of some pre-petition litigation on which a settlement agreement had actually been signed prior to the bankruptcy. And we're asking the Court to approve --

THE COURT: Okay. The Committee?

MR. LITVAK: Your Honor, no objection.

THE COURT: All right. Anyone else have an objection?

(No audible response)

THE COURT: All right. Submit the order.

MR. HOLZER: It's submitted, your Honor.

That leaves Docket Number 7, 1, 7, Scopac's Motion to Reconsider on the 2019 ruling.

THE COURT: Okay.

MS. COLEMAN: Good afternoon, your Honor. Your Honor, very briefly, we filed the 2019 Motion, as well as the Motion for Reconsideration, in an attempt to create a level playing field for everybody.

Really all we want is the noteholder group to comply with the statutory obligation to disclose some basic information. Now the price of participation, your Honor, is disclosure.

And when you denied the 2019, you really decided two things. You decided, first, the noteholder group is not a committee. And then you also decided that Bracewell, the noteholder group's counsel is an entity representing more than one creditor and, therefore, subject to the disclosure requirements of 2019.

So what we're asking for today is first for the Court to reexamine the initial factual finding about whether the Ad Hoc Group is a committee. Second, we're asking your Honor to clarify your bench ruling that Bracewell is an entity representing more than one creditor and, therefore, requires to make continuing disclosure under 2019.

So let's go for the first thing first, the reconsidering the factual findings. You found this is not a committee. Quote, you said, "At this point, this is just one law firm representing a bunch of creditors."

Your Honor, during the hearing, we presented fairly considerable evidence that the noteholder group was formed back in 2005, over two years ago, as an ad hoc committee. It held itself out to Scopac and to the world as an ad hoc committee. It appeared before this Court as an ad hoc committee.

Specifically, we presented copies of the ad hoc committee's engagement letter with counsel, the engagement letter with their financial advisor, a copy of their non-disclosure agreement between Scopac and counsel for the committee, as well as the listing of every pleading filed by the ad hoc committee stating that they are an ad hoc committee.

Each of those documents clearly -- clearly shows you that the noteholder group organized itself as a committee, retained counsel at Scopac's request as a committee, retained a financial advisor as a committee, entered into a confidentiality agreement with Scopac as a committee, and appeared, I think some 17 times in this case, as a committee.

What do we have on the other side? The noteholder group didn't present any evidence to the contrary showing that they were not a committee. They just said they weren't.

Your Honor, we would submit that the clear weight of evidence before the Court demonstrates this group --

THE COURT: Then they changed their name to group.

MS. COLEMAN: And they changed their name to group. That's true, your Honor. That's the change they made.

And that's kind of the point, your Honor. They are a committee. They've held themselves out to the Court and the world as a committee. And they shouldn't be able to avoid the requirements of 2019, which are not onerous by simply changing their name or changing the heading on their pleadings. So that's the first thing you were asking for, your Honor.

And we're respectfully asking that you reconsider your decision and find that they are, in fact a committee.

Now second, and kind of separate from the first -- the first request that we have. We would ask the Court to clarify its bench ruling that Bracewell is subject to 2019, and therefore subject to continuing disclosure.

And in their response to the 2019 motion, your Honor, Bracewell said we're not an entity representing a bunch of creditors, because we only have one client, the noteholder group. And therefore, we don't really have to disclose, even though we did file a cursory statement voluntarily, we didn't really have to.

And you rejected that position, your Honor. You said, during the April 17th hearing, you said that, no, I don't accept the one client theory. I think that Bracewell is a law firm representing a bunch of creditors.

You clearly directed Bracewell in that hearing, or at that -- at the time of that ruling, to update its 2019 statement.

Before we filed this motion, we sent a letter asking Bracewell to update its 2019 statement and provide the information. They've still not answered our letter.

And, your Honor, it's very clear. Rule 2019 applies to any "entity representing more than one creditor." And that's what you found here.

So what do they have to file? What do we want? Well they've got to file a few things, not very much, but a few.

The name and address of each of the creditors that the entity represents, the nature and amount of the claim, and then a recital of the pertinent facts and circumstances in connection with the entity's employment.

So that's what we're asking for, your Honor. Now what does Bracewell say? Well they make two arguments against our motion.

First they said, well because Scopac participated in drafting the form of order, somehow it's precluded from asking for a clarification. Your Honor, Rule 60 was designed for precisely this situation.

And second of all, the Court clearly directed Bracewell in your oral ruling to update its statement. We didn't think we had to put it in the order, because we thought your direction was apparent. But since we've received no response to our request for updated information under 2019, we felt we needed to file a motion.

The next thing that Bracewell argues is that they were not a party to the motion and therefore no relief can be entered against them. You can't order them to file any more -- any more disclosure.

And that's not right, because in their response to the motion, Bracewell brought itself into play by arguing it only had one client, the group, although that group was not a committee.

But you rejected that, your Honor, and your found that Bracewell was a law firm representing a number of creditors, not just one.

So now, they're saying, well notwithstanding the Court's clear holding, it still doesn't have to require -- it still isn't required to comply with 2019.

Your Honor, final point, they can't have it both ways. Either the noteholder group is a committee and they have to make that disclosure under 2019, or Bracewell is an entity representing multiple creditors, and they have to make the disclosure required by 2019.

The Rule clearly applies to the group. The group knows the rule applies. And they're tap dancing around the fringes of the rule in an attempt to show it doesn't apply.

And, your Honor, respectively -- respectfully, we would like to require all parties to comply with their statutory obligations to provide some very basic information. Thank you.

THE COURT: All right. Thank you.

MR. FLASCHEN: Your Honor, Evan Flaschen of Bracewell & Giuliani for the noteholder group.

This is a Motion for Reconsideration. Your Honor entered an order. And using your words, "After reviewing carefully all of the pleadings."

The form of order was the form submitted by Scotia Pacific. Quoting from their pleading objecting to the noteholder form of order,

"Scopac respectfully requests that this Court reject the noteholder proposed order and, instead, enters Scopac's proposed form of order."

Noteholders consented to Scopac's form, and that's what your Honor entered.

There are only two grounds for reopening that order which Scopac conceived in its pleading.

The first ground is manifest error of law or fact. Manifest error is defined as an error that is plain indisputable that amounts to a complete disregard of the controlling law, or the credible evidence in the record.

No one here has argued that there is any controlling law on this issue that is adverse to the noteholders. Therefore, your Honor will need to tell us whether you completely disregarded the credible evidence in the record.

There was, in fact, no evidence in the record --

THE COURT: Do you know the docket number on the order?

MR. HOLZER: I have a copy for you.

MR. FLASCHEN: Six fifty-nine, your Honor.

And the actual order as entered also has at the top of it a second docket number 658-4, which shows you just signed the form of order they submitted to you.

THE COURT: Okay.

MR. FLASCHEN: So even though the order itself says submitted by Evan Flaschen and Gregory Nye, it's, in fact, the order that they submitted.

So there's no controlling law you disregarded. There's no credible evidence in the record at all. But even if there is evidence, we believe it was countered by the documents attached to our pleadings, showing repeated statements by Scopac expressing frustration that our group was only, in their view, 15 or 20 percent of the notes. And, therefore, could not represent the noteholders.

We also had oral argument. And again, unless your Honor believes you completely disregarded the pleadings, the arguments, the documents, then there is no ground for reopening this under Rule 9023.

Rule 9024 is even more basic. Was there a clerical error? Did you intend one thing, but by mere clerical mistake or oversight do another? I was paraphrasing from a Fifth Circuit decision.

(Pause)

MR. FLASCHEN: It seems to us you did exactly what you intended to do, which was enter an order finding that the committee did not -- was not a committee within the meaning of the specific rule, and that the noteholder group did not need to comply with the rule.

For the first time in their Motion for Reconsideration, Scopac now raises arguments about Bracewell. Their original motion did not seek relief against Bracewell.

It was a Motion to Compel the noteholder group.

At no time did any of their pleadings seek relief against Bracewell. This was an argument they could have made in their original motion, and they did not. And I will now quote from *In re: Kellogg*. It's an Eleventh Circuit decision. It is cited in our brief of pleading, which says that, in that case,

> "Kellogg may not use a Rule 5019 Motion to raise argument available but not advanced at the hearing."

They did not advance any arguments about Bracewell. They cannot do so now on a Motion for Reconsideration.

Finally, repeating Ms. Coleman's words about what they want Bracewell to disclose, the names and addresses of its clients. Well we disclosed the names. The addresses you can find on the internet. But we're happy to send along the addresses of the clients if they would find that helpful, on a voluntary basis.

We disclose that in footnote one of every single pleading we have filed in this case, including long before they filed their 2019 motion.

Second, the amount of the claim. We have repeatedly disclosed the amount of the aggregate claim of the noteholder group. Sometimes more than 90 percent, sometimes more than 95 percent. To be precise for this hearing, based on the most recent information reported to me, the noteholder group holds

98.06 percent of the notes in the Timber Noteholder Indenture.

Three, are the circumstances of engagement. We have repeatedly stated the circumstances of engagement in our own pleadings. Scopac contacted noteholders in March, 2005 and said, would you please form a group to have discussions with us.

In March, 2005, that group retained Bingham McCutcheon, which then became, because of the lawyers transferred to Bracewell, became Bracewell. So we have repeatedly disclosed those circumstances. And we're repeatedly said we do not have an engagement letter.

Well starting over, it would take remarkable circumstances to change an order. The proper vehicle for Scopac, if they disagree with, your Honor's decision, is to file an appeal.

Second, they can't now seek relief against Bracewell when they didn't, in their pleadings, to begin with. Three, even if Bracewell were subject to 2019, which we dispute, and if they ever file a motion, which we will dispute in writing, we believe we have complied with what the order would require.

So why they even filed this motion, I don't know. But unless your Honor says it completely disregarded everything that's been filed to date, your Honor cannot, as a matter of law, alter or amend the order that you've already entered.

Thank you.

MS. COLEMAN: Your Honor, very, very briefly in response.

The evidence point, your Honor. At trial we presented all the documents I described to you and gave copies to the other parties in the courtroom. They were handed up to you and accepted into the record.

No objection was made to their admission into evidence at that time. So I don't think that -- that Bracewell can now raise that -- raise that point.

Second, your Honor, the issue with respect to including Bracewell in the order, you said it on the record, your Honor. And you ordered Bracewell to do something.

The fact that it wasn't in the order was because we didn't think we needed to have it in the order, because we thought it was so self-evident. Clearly, it wasn't, because we have still not received a response. Although, Mr. Flaschen now says that he will send along some things.

And finally, your Honor, the disclosure of the aggregate claim is not response to what's required by 2019. Twenty nineteen clearly requires an entity representing more than one creditor to disclose the amount of the claim, not what it paid, that's only if it's a -- it's only if it's a committee. You don't have to disclose the amount you paid if you're an entity representing more than one creditor. But you do have to disclose the amount of each creditor's claim, not simply the aggregate amount.

And finally, your Honor, with respect to the -- the question of whether Bracewell was or was not a party to the original motion, the fact remains that your Honor told Bracewell it had to do something in your oral ruling. And I don't think that they can now say that they are not required to do so simply because the original motion was seeking relief against the committee.

Thank you, your Honor.

MR. FLASCHEN: And then, your Honor, an even briefer response.

Your oral ruling, and I quote, "All I'm doing is denying the Motion to File the 2019 Information as requested." Your order, "The noteholder group is not a committee. The noteholder group is not subject to disclosure."

There is no order here that Bracewell need to do anything. And if they want Bracewell to do something, they should file a motion against Bracewell, which we will vigorously defend, because that motion will also be in error.

Thank you, your Honor.

THE COURT: Okay. Okay. I agree that the original motion did not request that Bracewell do anything. It was a request that -- that the committee or slash group comply with 2019. And I think I ruled consistent with the -- with the order.

I suspect if I wanted to change the order, I probably would change it to say that I -- the motion's denied, that they're not a committee. But to the extent that they are, then I grant them permission not to file the stuff.

But I did. And second, I think I can probably reconsider any of my orders and redraw them any way I want. I'm not going to reconsider this one.

And then further, I think I did point out that I thought that Bracewell & Giuliani, although it's not before me, and I reserve the right to change my mind if it's brought before me, because I'm not prejudging the issue, but that -- that reading 2019, which, you know, it's one of those provisions in the Code that, you know, you guys probably read these things all the time, has never, ever came before me. I forgot it was even there.

And if from time to time when I read through the Code I find new things again that I probably knew at one time that I don't remember.

And now this seems to be on -- I mean, since -- well probably since the airline case, this is now on everybody's radar as a current topic to discuss.

In any event, I personally think that -- that you should comply with the provisions of 2019 with respect to your representation. I thought to the extent that, I mean, you know, I said that from the bench. I don't think it needs to be in the order either, because that was not the relief that was requested.

I think you need to comply. However that takes form, or if you want to, you know, using the sporting theory or jurisprudence, wait till they file a motion, and then -- then we argue about it. I don't know what the remedy is if you don't comply. But I -- you know, you have pretty much complied with it.

I suspect technically you should file the specific amounts of the claims of each of the -- of your people you represent. But I think this is -- I know that this is one of those things that everybody finds important.

I think it's far more important in the sense of the impact it might have on the trading of claims and the distressed claims market. And that's the reason I -- I made sort of a practical decision when I made the decision.

In any event, I also understand that -- that this is one of those things that -- that, I mean, you can't fault the reasoning of the New York Court. I just don't think that was what was intended by the statute originally. I think the statute went back to the old Douglass group and whatever that -- those -- that group, the study of -- of committees as they existed back then, and not committee in the sense that we talk about them now. And so what's why I sort of drew that line.

In short, I'm denying the Motion to Reconsider.

Anything further?

MR. FLASCHEN: Judge, yes, your Honor. Evan Flaschen of Bracewell.

My understanding of what you said is somewhere between you think we should comply, or you're asking us to comply. Bracewell as a law firm respectfully, we would request Scopac to file a motion, because we would be the Defendant on several grounds, both that it does not apply to us. And even if it does, they're not interpreting it --

THE COURT: So you're going to argue about all this over whether or not you have to file a list of the -- the claims that -- of the people that you -- that you represent when you're already doing everything else? In fact, you're doing more.

MR. FLASCHEN: The amount of their individual holdings, absolutely, your Honor. We do not believe the rule requires that disclosure.

THE COURT: Well --

MR. FLASCHEN: And we welcome --

THE COURT: -- don't they all have to file claims anyway?

MR. FLASCHEN: And we welcome the opportunity to brief it, your Honor.

No the indenture trustee files a single claim on behalf of all of them.

THE COURT: All of them. Okay.

Well maybe then it's an issue worth arguing about it. It doesn't seem like it to me, but we'll argue about it when it finally gets in front of me.

MR. FLASCHEN: Thank you.

THE COURT: Great. Thank you very much.

Anything further? Yes, sir.

MR. PENN: Your Honor, John Penn on behalf of Marathon. Just wanted to give you a heads up that next week on the hearings on the 31st, we may be bringing before you an issue dealing with the order last week on exclusivity and document availability and access.

THE COURT: Okay. So --

MR. PENN: Just a heads up that --

THE COURT: -- there seems to be a --

MR. PENN: -- that might be coming.

THE COURT: -- slip up on the access to documents?

MR. PENN: There's a disagreement that we're still trying to work through.

THE COURT: Okay.

MR. PENN: And if we're not able to work through it, we'll be in front on you next Thursday to argue about it.

THE COURT: And that hearing's in Houston.

MR. PENN: Correct.

THE COURT: All right. Good. Anything else?

(No audible response)

THE COURT: Thank you. You're all excused.

MR. FLASCHEN: Thank you, your Honor,

MS. COLEMAN: Thank you, your Honor.

(This proceeding was adjourned at 2:25 p.m.)

CERTIFICATION

I certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

June 4, 2007

Transcriber Date

07-20027

05/22/07 - 06/04/07

EXHIBIT J

SIFMA®
Securities Industry and
Financial Markets Association

LSTA
[illegible]

November 30, 2007

Re: Federal Rule of Bankruptcy Procedure 2019

Mr. Peter G. McCabe
Secretary
Committee on Rules of Practice
  and Procedure of the Judicial
  Conference of the United States
Administrative Office of the United States Courts
Thurgood Marshall Federal Judiciary Building
One Columbus Circle, N.E.
Washington, D.C. 20544

Dear Mr. McCabe:

The Loan Syndications and Trading Association ("LSTA") and the Securities Industry and Financial Markets Association ("SIFMA") submit that Federal Rule of Bankruptcy Procedure 2019 should be repealed, because it does not sensibly implement Federal bankruptcy law, has become obsolete due to changes in the nature of chapter 11 cases, and adversely affects, with no compensating benefit, the interests of key participants in the chapter 11 process.

TABLE OF CONTENTS

Page

1. Who Are the LSTA and SIFMA? 3

2. LSTA and SIFMA Urge the Committee to Recommend the Repeal of Rule 2019 4

3. Rule 2019 Does Not Perform any Vital Functions 7

4. There are Alternative and More Efficient Means to Obtain the Information Required by the Rule 10

   (a) Prices Paid By Specific Holders 11

   (b) Purchase Prices in General 14

   (c) Rule 2004 14

5. The Rule Irrationally and Inefficiently Singles Out Holders Who Choose to Form *Ad Hoc* Committees 15

   (a) History of Rule 2019 16

   (b) The Rule is Under-inclusive 17

   (c) Rule 2019 is Being Used as an Offensive Weapon against Activist Investors 18

   (d) Ad Hoc Committees Facilitate a More Efficient Reorganization 21

6. Rule 2019 Can Deter Distressed Investors and Harm the Reorganization Process ... 22

1. Who Are the LSTA and SIFMA?

LSTA and SIFMA are two large not-for-profit organizations that promote sound practices and advocate effective policies in relation to the commercial loan markets and securities markets. On the issue of Rule 2019, LSTA and SIFMA have submitted jointly amicus briefs in four different chapter 11 cases in 2007 alone.[1]

LSTA is a not-for-profit organization that undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable principles for transactions among institutional investors engaged in buying and selling commercial loans.[2] Through its activities, the LSTA seeks to encourage cooperation and coordination with firms facilitating transactions in loans and related claims. The LSTA was formed by a small group of debt traders in an effort to develop standard settlement and operational procedures, market practices, and other mechanisms to more efficiently trade the increasing volume of both high-quality and distressed bank debt. The LSTA has become the principal advocate for the commercial loan asset market participants with the goal of promoting greater transparency, regularity and confidence among all market participants. LSTA membership provides member firms with the opportunity to participate in the decision-making process that ultimately establishes market practices, develops standard documentation related to loan transactions and strengthens and influences the direction of financial market infrastructure. The LSTA currently has over 250 members, including the

[1] Those briefs, in the LeNature, Musicland, Northwest Airlines and Scotia Development cases, can be accessed at SIFMA's website (www.sifma.org) under the "Regulatory/Legal" tab.

[2] All information concerning the LSTA comes from http://www.lsta.org.

leading broker-dealers, commercial banks, investment banks, mutual funds, hedge funds, fund managers, insurance companies and other major institutional investors worldwide.

The Securities Industry and Financial Markets Association, also a not-for-profit organization ("SIFMA"), brings together the shared interests of more that 605 securities firms, banks and asset managers.[3] SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. In pursuit of this mission, SIFMA provides its members with a network of access and forward-looking services as well as educational resources for the professionals in the financial services industry and the investors whom they serve. Among its goals for 2007, SIFMA is seeking to encourage retirement savings and investment, promote effective and efficient regulation, and facilitate more open, competitive and efficient global capital markets. By accomplishing these goals, SIFMA hopes to earn, inspire and uphold the public's trust in the financial industry and the markets. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C, and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

2. LSTA and SIFMA Urge the Committee to Recommend the Repeal of Rule 2019

Pursuant to their respective missions and having the benefit of substantial consultation with their respective constituencies, both the LSTA and SIFMA oppose Federal Rule of Bankruptcy Procedure 2019 in its current form. Rule 2019 requires certain

[3] All information concerning the SIFMA comes from http://www.sifma.org.

disclosures from "unofficial" or "*ad hoc*" committees and their members (and only from those entities). Specifically, Rule 2019 requires that:

> [I]n a… chapter 11 reorganization case, except ["official" committees], every… committee representing more than one creditor or equity security holder… shall file a verified statement setting forth:
>
> (1) the name and address of the creditor or equity security holder;
>
> (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition;
>
> (3) a recital of the pertinent facts and circumstances in connection with the employment of the… committee… [and] the names of the entity or entities at whose instance, directly or indirectly… the committee was organized or agreed to act; and
>
> (4) with reference to the time… the organization or formation of the committee… the amounts of claims or interests owned by… the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.[4]

Earlier this year, in the *Northwest Airlines* bankruptcy case,[5] the bankruptcy court required eleven (11) members of an *ad hoc* committee of equity security holders (the "Ad Hoc Committee") to disclose the information required by Rule 2019—notably, the amount paid for the securities. The ruling came in response to the debtor's motion to compel the disclosure, which was itself a response to the Ad Hoc Committee's efforts to have an official equity-holders' committee appointed to challenge the debtor's self-valuation and plan of reorganization strategy to eliminate the equity holders' status in the company.

[4] Fed. R. Bankr. P. 2019(a).

[5] *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

There was no evidence that the Ad Hoc Committee's efforts violated any statute or were undertaken in bad faith.

Since *Northwest Airlines*, at least three other cases have generated litigation over Rule 2019 – *Le Nature, Mirant and Scotia Development*. In the first two, the litigation was compromised without ruling. In *Scotia Development*, the court found, on the specific facts of the dispute, that the rule did not apply to the investors against whom the debtor was litigating. LSTA and SIFMA submitted joint *amicus* briefs in each of those cases (except *Mirant*) in support of the investors who were the targets of the litigation. LSTA and SIFMA do not concede that *Northwest Airlines* correctly interpreted Rule 2019, but, in light of the failure of any subsequent case to generate a contrary precedential ruling, have concluded that *ad hoc* litigation about the application of the Rule will not provide a forum in which the soundness of the Rule itself can be properly debated, and have determined, therefore, to seek repeal of the Rule.

There are four important public policy reasons why Rule 2019 should not be maintained in its current form.

First, Rule 2019 actually has very little utility to the sound administration of chapter 11 cases. The disclosures it requires are unlikely to provide information that could assist the court or any other party in applying bankruptcy law properly or in reaching a successful disposition of the case.

Second, in the rare instance where Rule 2019 might provide relevant information, that information is already readily attainable through tried-and-true discovery methods; the Rule is, at best, redundant.

Third, Rule 2019 irrationally and inefficiently singles out parties in interest who choose to form *ad hoc* committees, an efficient mechanism for participating in cases that ought to be encouraged, not penalized.

Fourth, by encouraging satellite disputes and discouraging active, efficient participation, Rule 2019 has the potential to affect the debtor's reorganization negatively.

In light of these reasons, Rule 2019 should be repealed in favor of reliance on traditional discovery.

3. Rule 2019 Does Not Perform any Vital Functions

Rule 2019 has very little utility in the chapter 11 process. The disclosures it requires will rarely add relevant information to the bankruptcy reorganization process.

The most troublesome provision of the Rule to credit market participants is subsection (a)(4), which requires that each *ad hoc* committee member disclose the price at which it acquired claims against, or equity in the debtor and when it acquired such claim or interest. But it has long been established that information about when a claim was purchased, or for how much, has no legal relevance to the claim holder's rights under the Code or non-bankruptcy law, or to the amount the claim holder may recover in the case.

An examination of several Code provisions supports that proposition. First, Section 1122(a) calls for claims and interests to be classified with other claims or interests that are "substantially similar." Second, Section 1123(a)(4) requires that a plan must provide the same treatment for each claim or interest in a particular class.[6] Third, Section 1129(a)(8)

[6] This provision is crucial because it reflects one of the most important policies of the Code, which is equality of distribution among claim and interest holders. *See Begier v. IRS*, 496 U.S. 53, 54 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code"); H.R. Rep. No. 595, 95th Cong., 1st Sess. 178 (1977) (A "prime bankruptcy policy" is "equality of distribution

requires that each class of claims or interests accept the plan (by the required majorities specified in Section 1126) in order for it to be confirmed.[7]

Courts have consistently rejected classification and treatment schemes that are based on the price that an individual creditor may have paid for its claim. For example, in *Fairfield Executive Associates*, the district court explicitly rejected the debtor's attempt to classify a secured creditor's deficiency claim separately from other general unsecured claims on the ground that the secured creditor had purchased the claim at a discount.[8] The debtor argued that, because the creditor knew the loan was in default when it purchased the loan and the creditor paid less than the collateral for the loan was worth, the creditor did not expect at the time of purchase, and should not expect, to recover the face value on the loan.[9] Holding that a creditor's motivation for investing is an irrelevant basis for classification, the *Fairfield* court quoted from a 1946 opinion of the Third Circuit that "*the price paid for a claim does not affect the amount of the creditor's claim, or the creditor's voting power.*"[10]

among creditors of the debtor."); 5 Collier on Bankruptcy ¶ 547.01, at 547-10 & n.8 (15th ed. Rev. 2007).

[7] Under Sections 1129(a)(8) and 1129(b), a plan may alternatively be "crammed down" on a dissenting class of claims or interests if certain requirements are met. Among the most important "cramdown" requirements is that the plan either provides for full satisfaction of the claims in the dissenting class, or eliminates the recoveries of those in classes, if any, junior to the dissenting class. Because the "cramdown" option is analyzed on a class-by-class basis, its existence does not alter the analysis set forth in the text and we omit further references to it solely for simplicity's sake.

[8] 161 B.R. 595, 602-603 (D.N.J. 1993).

[9] *Id.*

[10] *Id.* (emphasis added) (citing *In re Pittsburgh Rys. Co.*, 159 F.2d 630, 632-33 (3d Cir. 1946) ("In the absence of fraud, the prices which security holders pay for their securities do not affect the measure of their participation under the plan of reorganization."), *cert. denied*, 331 U.S. 819, 67 S.Ct. 1309, 91 L.Ed. 1837 (1947)).

Similarly, in *Hillside Park Apts., L.P.*, the bankruptcy court rejected a debtor's attempt to classify a secured creditor's deficiency claim separately from trade creditors on the ground that the secured creditor purchased the note and deed of trust for substantially less than the full amount of the claim—*i.e.*, less than the full market value of the property.[11] The debtor argued that, since the secured creditor "did not in fact expend the sums that make up its deficiency claim, [the secured creditor] does not have the concerns of a normal creditor in recovering the deficiency sum."[12] The court flatly rejected that argument.[13] Specifically, the court held that *the price paid* for the note and the deed of trust was "irrelevant" and that the purchaser of a secured claim has the same interest in getting paid on its claim as do other unsecured creditors.[14] Therefore, the court rejected the debtor's attempt to offer the deficiency claim holder and the trade creditors different treatment under the plan.[15] Clearly, the fact that the creditor purchased the claim at a discount could not lawfully support a disparity of treatment.[16] It follows, then, that information about the amount paid and the other details of that purchase – the principal kind of information required under Rule 2019 – was legally irrelevant to the court's application of the law.

A claim or interest holder's recovery in a chapter 11 case is contingent upon two legal principles: first, the debtor's obligation under the debt or equity instrument; and

[11] 205 B.R. 177, 188 (Bankr. W.D.Mo. 1997).

[12] *Id.*

[13] *Id.* at 189. The debtor proposed a 90% distribution to the trade creditors for their claims and a 1% distribution to the secured-creditor on its deficiency claim. *Id.*

[14] 205 B.R. 177, 188 (Bankr. W.D.Mo. 1997).

[15] *Id.* at 189.

[16] *Id.*

second, the claim's classification and ranking under the reorganization plan, as governed by the Bankruptcy Code.[17] That information is obtainable entirely by reference to the plan and the terms of the relevant debt contract or equity instrument (*e.g.*, a bond indenture or stock certificate). Even if a debtor were aware that two different holders of a particular class of its debt had acquired such debt at significantly different prices, or at different times (*e.g.*, following a default under a bond indenture), it has to classify and treat them in similar fashion to comply with Sections 1122 and 1123(a)(4). The disclosures required under Rule 2019 will not assist the debtor in doing that. Therefore, insofar as Rule 2019 requires the disclosure of such surplus information, such disclosure is, as a matter of law, irrelevant when applying the Code properly.

In similarly pointless fashion, Rule 2019(a)(3) requires that each *ad hoc* committee member disclose all employment arrangements made by the committee (*e.g.*, counsel's compensation). Clearly, under the Code, an *ad hoc* committee member's financial arrangements with its counsel or other representatives are irrelevant to determining that creditor or equity holder's rights under the Code or the outcome of the bankruptcy case.

4. There are Alternative and More Efficient Means to Obtain the Information Required by the Rule

Even in the rare case where the information required to be disclosed under Rule 2019 might be relevant to the chapter 11 case, the same information is readily obtainable through traditional discovery. To obtain information about what a particular creditor or interest holder paid for a certain claim or interest, or any other information

[17] *Amici* Brief for the Securities Industry and Financial Markets Ass'n, *et al. In re Scotia Development LLC, et al.* (No. 07-20027) at 4.

required to be disclosed under Rule 2019, traditional discovery under the Federal Rules of Civil Procedure, as incorporated into the Federal Rules of Bankruptcy Procedure[18] (the "Federal Rules"), has proven to be perfectly effective. On the other hand, to the extent that information such as the price at which claims are trading in general is valuable to the debtor's reorganization process, that information is readily obtainable from numerous sources every trading day. Finally, Federal Rule of Bankruptcy Procedure 2004 also empowers a court to order any needed investigation, including, for example, information related to the arrangements between *ad hoc* committee members and their counsel or representative.

(a) Prices Paid By Specific Holders

In the case where a chapter 11 debtor needs to know the price that a particular holder paid for its claims or equity interests, or the time when such claim or interest was acquired, routine discovery is quite sufficient to obtain that information. For example, in the *Papercraft* bankruptcy case, the bankruptcy court found that an insider of the debtor secretly purchased claims at a discount, voted those claims to block the debtor's plan, coerced the debtor to file another plan, and consequently delayed the final disposition of the case.[19] The court sanctioned the insider's conduct by limiting the insider's recovery to the amount it paid for the claims, without interest.[20] Because the insider was not a "committee," Rule

[18] *See* Fed. R. Bankr. P. 7026, 7037 and 9014.

[19] *In re Papercraft Corporation*, 187 B.R. 486 (Bankr. W.D.Pa. 1995), *rev'd and remanded*, 211 B.R. 813 (W.D.Pa. 1997), *aff'd and remanded*, 160 F.3d 982 (3d Cir. 1998), *on remand*, 247 B.R. 625, 629-30 (Bankr. W.D.Pa. 2000).

[20] *Id.*

2019 was inapplicable. Yet, the debtor was able to uncover all the details regarding the insider's claim purchases without resort to Rule 2019.

In the *Mirant* bankruptcy case, the court appointed an examiner to investigate a distressed debt purchasing firm that allegedly used misleading documents to purchase trade claims from creditors at a fraction of their market value without the creditors' informed consent.[21] The examiner brought an adversary proceeding. The examiner requested that the court, pursuant to its authority under Section 105, "expunge" each trade-claim purchase and "restor[e] each purported [purchased] claim to the creditor originally holding such claim."[22] Completely independent of Rule 2019, the examiner was able to compile evidence about the firm's purchases (*i.e.*, the purchase prices and the timing of the purchases) in order to prove that the firm's scheme was in violation of the Code. The *Fairfield Executive Associates* and *Hillside Park Apts.* cases described in Part 3 also prove that Rule 2019 is unnecessary to uncover claim purchase price and related details.

Traditional discovery bears two very significant differences from Rule 2019. First, under the Federal Rules, discovery is limited to what is relevant.[23] By requiring relevance, the Federal Rules ensure that the time and expense of disclosure about one's business is not imposed pointlessly. Rule 2019 does not afford claim holders even the minimal protection of the relevance standard. Second, under the Federal Rules, the data produced in discovery are not automatically placed in the public docket for the world to

[21] *See* Complaint, *Snyder v. DSA*, No. 03-46590 (Bankr. N.D.Tex. Oct. 25, 2005).

[22] *Id.*

[23] *See* Fed. R. Civ. P. 26 ("Parties may obtain discovery regarding any matter, not privileged, that is relevant to the claim or defense of any party... .").

view over the Internet. Conversely, Rule 2019 requires the publication of such data in a filing which is then posted on the court's electronic docket.

Remitting participants in bankruptcy cases to traditional discovery is an entirely reasonable and appropriate substitute for Rule 2019. For example, in the *Northwest Airlines* case, the debtor argued that disclosure was required to "test the credibility of the positions being taken into court" by the ad hoc committee.[24] The "credibility" of a position in a bankruptcy case can be adequately tested through traditional discovery and cross-examination, both of which are governed by relevance standards. Because traditional tools of discovery and cross-examination have repeatedly proved sufficient to "test credibility" in other settings (including in the bankruptcy context, as shown by the *Mirant* and *Papercraft* cases), reliance on them upon repeal of Rule 2019 will cause no harm. On the contrary, Rule 2019 presently requires disclosure without regard to relevance, and then publication of the disclosure in the Court's dockets and PACER.

Similarly, in the rare instance where the Bankruptcy Code provides that a party in interest's subjective state of mind is relevant — such as upon a motion under Section 1126(e) to designate an entity's acceptance or rejection of a plan, an inquiry into good faith of a proponent of a creditor plan under Section 1129(a)(3), or an examination of the adequacy of a creditor plan proponent's disclosure statement — traditional discovery fully equips courts to compel the information described by Rule 2019.

[24] Jordan Siev, et al., *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC: PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http://www.andersonkill.com/webpdfext/CommitteeNewsletter.pdf.

(b) Purchase Prices in General

In addition to having the legal tools to compel disclosure of a particular investor's holdings, a debtor also has sufficient resources to obtain general information about the prices at which its claims or equity securities may be trading. Specifically, the debtor's financial personnel or outside financial advisors can (and do) contact trading desks and market makers who routinely make markets in distressed debt. Even easier, numerous print publications and electronic services like Bloomberg report daily on the prices being quoted for distressed debt, just as the Wall Street Journal publishes quotes for instruments being traded in other capital markets. (Some recent examples are attached as Exhibit A). Through those sources, the debtor can easily determine the price at which its debt may be trading on any given trading day, including past trading days. Because that market is sufficiently well developed and its quotations are readily accessible, the debtor is in a position to evaluate the prices being paid for its debt generally without need for Rule 2019.

(c) Rule 2004

We know of no case in which the information described in Rule 2019 was considered relevant, yet was not obtainable by means of traditional discovery. However, in the hypothetical instance when a debtor or some other party in interest might need information about a particular person's prior transactions in the debtor's debt or equity securities, yet, the Federal Rules' traditional discovery methods were for some reason unavailing, Federal Rule of Bankruptcy Procedure 2004 empowers the court to order an investigation of the matter.[25] But, in contrast with Rule 2019, the court has discretion under

[25] On motion of any party in interest, the court may order the examination of any entity.... The examination of an entity under this rule... may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to

Rule 2004 to deny the request if it is irrelevant and to balance the interests of the target of the request.

5. The Rule Irrationally and Inefficiently Singles Out Holders Who Choose to Form *Ad Hoc* Committees

If the information required by Rule 2019 were truly important to bankruptcy reorganizations, it would be required of all active participants and not merely those who form *ad hoc* committees. Rule 2019 in its current form is therefore irrational because it only requires such purportedly important information from *ad hoc* committee members. The primary explanation for this lies in bankruptcy history which varies dramatically from present bankruptcy practices. In light of that disparity, the Rule is irrational, because it is under-inclusive and does not apply to investors who are not members of *ad hoc* committees but who may nonetheless pursue the same strategies the Rule ostensibly deters.

At the same time, the Rule is also inefficient because, as we show below, the truth of the matter is that Rule 2019 and the information disclosed pursuant to it are being used nowadays principally as weapons to deter *ad hoc* committee members from taking positions in court opposed to the debtor's strategies. Thus, the Rule 2019 tends to create pointless satellite litigation and unproductive rhetorical sideshows. In addition, if compulsory disclosure under the Rule deters distressed investors from forming *ad hoc* committees, the efficiencies created by *ad hoc* committee representation may be eliminated.

> any matter which may affect the administration of the debtor's estate… and any other matter relevant to the case or to the formulation of a plan.

Fed. R. Bankr. P. 2004(a)-(b).

(a) History of Rule 2019

In the early twentieth century, "protective committees" were organized by insider groups dominated by debtors and institutional investors "who would solicit smaller investors to enter into a deposit agreement whereby the smaller investors would deposit their securities with the committee and delegate to the committee the responsibility of negotiating with the debtor."[26] These committees often took advantage of small public investors rather than fairly representing their interests, while using the deposited securities to gain influence in support of their own initiatives.[27] The predecessor of Rule 2019 was adopted in reaction to those practices, to protect small investors. It did so by requiring the "disclosure of 'personnel and activities of those acting in a representative activity' in order to foster fair and equitable plans free from deception and overreaching."[28] In a 1937 Securities and Exchange Commission Report, future Supreme Court Justice Douglas stated that the predecessor Rule "is designed to ensure that the 'inside group' does not manipulate a pre-petition committee to 'secure a dominant position in the reorganization' and capture the 'emoluments of control.'"[29]

While that oversight was and is certainly important to protect small holders, the function of *ad hoc* committees in modern bankruptcy reorganizations is dramatically

[26] Brian S. Herman and James M. Millerman, *Ad Hoc Attack*, THEDEAL.COM: JUDGMENT CALL, May 25, 2007, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1179177764565.

[27] *Id.*

[28] *Id.* (citing *Baron & Budd, P.C. v. Unsecured Asbestos Claimants Committee*, 321 B.R. 147, 166 (D. N.J. 2005).

[29] *Baron & Budd, P.C. v. Unsecured Asbestos Claimants Committee*, 321 B.R. 147, 166 (D.N.J. 2005).

distinguishable from pre-Code reorganizations. Most notably, distressed investors no longer "sneak" into bankruptcy cases such that potential committee members require warning and specifics about their fellow investors' holdings. Today, the buying and selling of distressed claims is the rule rather than the exception, particularly with respect to large public debtors. Distressed investors are often among the largest claim holders in chapter 11 cases.[30] In addition, the *ad hoc* committees those players create do not solicit public investors in any way and do not claim to represent the interests of other investors. As a function of these differences, there is no longer any rational relationship between the original purposes of Rule 2019 and the current practices.

(b) The Rule is Under-inclusive

To the extent that Rule 2019 provides the court and the debtor with an understanding of the motives of participants in the process, it is under-inclusive, because it does not require disclosures from all participants, just from *ad hoc* committees. Therefore, if transparency truly allows the court and the debtor to "root out" investors who act in bad faith or to uncover conflicts of interest between committee members and their representatives, then the Rule should apply *equally* to all participants in a bankruptcy case and not just to members of *ad hoc* committees. For example, in the *Papercraft* and *Mirant* cases, the wrongdoers were individual creditors, not *ad hoc* committees or members thereof. Thus, Rule 2019 is under-inclusive because it does not adduce disclosure from a suspect investor — distressed or not — unless the investor has joined a committee.

[30] Paul M. Goldschmid, More Phoenix than Vulture: *The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUMBIA BUS. L. REV. 191, 200 (2005).

Rule 2019 in its current form also explicitly exempts official creditors' and equity security holders' committees ("Official Committees") from its disclosure requirements. At the same time, there is no federal rule analogous to Rule 2019 that requires the court to compel disclosure from members of Official Committees concerning their holdings of the debtor's claims or stock. More important to a comparison with Rule 2019, there is no rule or provision that requires that any such information obtained from Official Committees be published in the publicly accessible court docket. While Official Committees are identified to the court in a Notice of Appointment, such notice only contains the name and contact information for each committee member—*not* the amounts such member paid for the claim or interest, or when the claim or interest was obtained. Since Official Committees are representative, as a matter of law, of their constituency, whereas "*ad hoc*" committees typically disclaim any representative role, it calls into question any defense of Rule 2019 based on fear of distressed claim holders dominating representative bodies. Rather, it is completely irrational to hold non-representative "*ad hoc*" committees to greater disclosure requirements than are imposed on members of Official Committees.

(c) Rule 2019 is Being Used as an Offensive Weapon against Activist Investors

In addition to being irrational, Rule 2019 in its current form is inefficient because it allows debtors to use the disclosure requirements as an offensive weapon to deter distressed investors from taking activist positions in chapter cases.[31] This creates inefficiencies because bankruptcy courts already have effective means independent of Rule

[31] Jordan Siev, et al., *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC: PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http://www.andersonkill.com/webpdfext/CommitteeNewsletter.pdf.

2019 to investigate and punish misconduct by participants. Conversely, collateral disputes over Rule 2019 disclosures in the absence of misconduct distract from the main issues in the case, compounding the inefficiency.

There are numerous examples of debtors using Rule 2019 as an offensive weapon to curb distressed-investor activity. It is important to stress that, in those cases, while the distressed investors' actions were certainly activist, and designed to protect their own economic interests, they cannot remotely be considered to have been illegal or unreasonably aggressive.[32]

For example, in the *Northwest Airlines* case, the debtor sought to compel Rule 2019 disclosures in response to the *ad hoc* committee's efforts to have an official equity committee appointed to represent all stockholders.[33] It is difficult to argue that the *ad hoc* committee was working to the detriment of small public stockholders in seeking appointment of an official committee to represent all stockholders.

In a different context, in the *Le Nature's* bankruptcy case, a debtor's bank agent brought an adversary proceeding to compel various distressed investors to make disclosures under Rule 2019.[34] In the *Le Nature's* case, observers have theorized that the

[32] In *Fairfield Executive Associates*, the court held that a distressed claim holder's express representation that it would not vote for any plan does constitute bad faith. 161 B.R. 595 at 603. The court, citing a 1993 Third Circuit case, noted that a creditor typically votes according to its economic interest. *Id.* (citing *John Hancock Mutual Life Ins. Co. v. Route 37 Business Park Associates*, 987 F.2d 154, 161 (3d Cir. 1993). The court concluded that "Section 1126(e) does not require a creditor to have an interest in seeing the debtor reorganize." 161 B.R. at 603.

[33] Paul D. Leake and Mark G. Douglas, *Ad Hoc Committee Disclosure Requirements – A Bitter Pill to Swallow for Distressed Investors*, JONES DAY, PUBLICATIONS (May/June 2007), *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4311.

[34] Dealflowmedia.com, The Secured Debt Wire: Ruling Expected in August on Wachovia's Motion to Liquidate Le-Nature's, June 29, 2007, http://www.dealflowmedia.com.

move was meant to pressure the distressed investors not to sue the bank agent for some of the debtor's losses that were allegedly due to the bank agent's conduct.[35]

In *Mirant*, a group of investors who had purchased claims against the debtor were appealing a bankruptcy court order approving a settlement by the debtor in which another creditor received a claim worth over $500,000,000 after the company had emerged from bankruptcy. While the matter was on appeal (*i.e.*, when the bankruptcy court no longer had jurisdiction over the controversy), a successor to the debtor moved the bankruptcy court for an order that the appellants comply with Rule 2019. After oral argument, the bankruptcy judge took the matter under advisement and, within a few weeks, the appellants agreed to drop the appeal.[36]

Simply seeking relief that is statutorily authorized should not expose *ad hoc* committees to disclosure requirements. However, Rule 2019 does not give bankruptcy judges the discretion to consider, let alone weigh, the context of the case or the motives of the parties seeking disclosure in adjudicating Rule 2019 disputes.

The only recent instance in which a bankruptcy judge denied a Rule 2019 request was in *In re Scotia Development LLC*, where the judge concluded that the target of the motion, a self-styled "ad hoc noteholder group" that was opposing many of the debtor's motions was not "a committee" within the meaning of Rule 2019.[37] While the outcome was

[35] *Id.*

[36] *See* Motion of New Mirant Entities to Compel Certain Holders of Class 3 Claims to Comply with Rule 2019 of the Federal Rules of Bankruptcy Procedure, *In re Mirant Corp.*, Case No 03-46590 (Bankr. N.D.Tx. May 16, 2007); "Mirant to Complete Settlement with Pepco," Press Release of Mirant Corporation, August 7, 2007 (www.mirant.com).

[37] Order Denying Scotia Pacific Company LLC's Motion For An Order Compelling The Ad Hoc Noteholder Group To Fully Comply With Bankruptcy Rule 2019 By Filing A Complete and Proper

clearly correct, the very brief, unpublished and fact-specific ruling has no precedential value. Moreover, the "group" was forced to incur substantial expenses to defeat the motion, which relied heavily on the *Northwest Airlines* precedent discussed herein.

(d) Ad Hoc Committees Facilitate a More Efficient Reorganization

Deterring *ad hoc* committee formation and participation can only decrease the efficiency of a bankruptcy case. In court, if numerous parties-in-interest choose to participate via a single *ad hoc* committee, proceedings will run much more efficiently than if they had appeared individually. Representation by an *ad hoc* committee also allows claim and interest holders to spread the costs of participating in the bankruptcy case. For many distressed investors, the costs of participating in a chapter 11 case can significantly diminish their returns on already risky investments. In an attempt to reduce these costs, it is economically prudent to employ single legal counsel to negotiate and institute legal process on their behalf. From the perspective of the estate, collective action avoids unnecessary delays and duplication of efforts in responding to, or negotiating with, the creditors.[38] By eliminating inefficiencies, the estate is better able to retain its value, which will be passed on to the debtor's creditors and equity holders if the debtor successfully emerges from bankruptcy.

The efficiency that results from *ad hoc* committee participation is exactly what Congress envisioned in the Rules Enabling Act[39] when it authorized the federal

Verified Statement Disclosing Its Membership and Their Interests, *In re Scotia Development LLC*, Case No. 07-20027(Bankr. S.D. Tex. Apr 18 2007).

[38] Brief for Securities Industry and Financial Markets Ass'n. *et al.* as *Amici Curiae* Supporting the Noteholders Group at 11, *In re Scotia Development LLC, et al.* (No. 07-20027).

[39] 28 U.S.C. §§ 2071-2077.

judiciary to draft the rules of federal practice. Federal Rule of Bankruptcy Procedure 1001 states that the "rules shall be construed to secure the just, speedy, and inexpensive determination of every case and proceeding." Therefore, in the event that any of the Rules no longer serve these purposes, or conflicts with a stated policy of the Code, the rule must be repealed.

Rule 2019 cannot be said "to secure the just, speedy, and inexpensive determination of every case and proceeding" if it inhibits or penalizes collective action. In addition, by making it less likely that debt and equity holders with common interests will band together, Rule 2019 cannot be said to reflect and enhance the policies embodied in the Code—the most important of which is to solve complex business problems through *collective* action, negotiation, and compromise.[40]

6. Rule 2019 Can Deter Distressed Investors and Harm the Reorganization Process

If Rule 2019 remains in its current form, it will also negatively affect the debtor's reorganization and the interests of certain debt and equity holders.

First, revealing the purchase price and the time of acquisition of *ad hoc* committee members' holdings can have a potentially counterproductive effect. Theoretically, arming a debtor with the information about prices paid by the creditors with whom the debtor is negotiating its reorganization plan might enable the debtor to negotiate more effectively with those creditors to the benefit of the debtor's equity holders. But buyers of distressed debt are sophisticated investors. They know that they are entitled to a

[40] Posting of Bob Rasmussen to The University of Chicago Law School Faculty Blog, *Hedge Funds and Collective* Action, http://uchicagolaw.typepad.com/faculty/2006/06/hedge_funds_and.html (June 1, 2006, 2:51 PM).

full payout of the claims they hold regardless of the price paid for them, as courts have held for decades. *See* Part 3, *supra.* Therefore, it is naïve to think that those creditors would gullibly take a low-ball price that is marginally above their acquisition price. Thus, if a particularly stubborn debtor actually tried to ground its reorganization plans on its knowledge of investors' purchase prices, it would likely waste everyone's time and money because the plan would have little probability of acceptance.

Secondly, the reorganization process would also be negatively affected if distressed investors were to forgo investing in distressed companies altogether to avoid constantly having to disclose their investment positions. As a threshold matter, distressed investors have an interest in the confidentiality of their investment positions because of the nature of their investment strategies. Notably, distressed investors such as hedge funds employ aggressive and complex investment strategies that often include a combination of diversification, leverage, long, short and derivative positions. The effectiveness of these strategies is dependent on the recognition of trends, inefficiencies, and valuations of the market that *have not been recognized* by other investors. Therefore, public disclosure of a hedge fund's investment positions could compromise a fund's ability to execute its own strategy and provide incremental value to its investors. Specifically, competitor funds will be able to access an *ad hoc* committee's Rule 2019 statement quickly and economically through electronic filing systems.[41] With that access, competitors will be better able to

[41] Jordan Siev, et al., *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC: PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http://www.andersonkill.com/webpdfext/CommitteeNewsletter.pdf.

reconstruct the unique trading systems developed by the fund that was forced to disclose.[42] In addition, knowledge of a particular long or short position could allow a competitor fund with a significant market presence to trade in a manner that could move the market in a direction adverse to the fund that was forced to disclose. Furthermore, in the long term, if hedge funds are required to disclose their investment strategies, their incentive to innovate and take risks will decrease.[43] In addition, an exodus of distressed investors from the market of distressed securities would likely lead to a decrease in liquidity for the debt and equity of bankrupt companies, which would be detrimental to the original security holders. Liquidity is crucial because it allows pre-petition/pre-insolvency security holders to easily "cash out" of the bankruptcy process. Even banks and large institutional investors often do not want to participate in lengthy bankruptcy proceedings.[44] Other pre-petition security holders may choose to sell the securities at a loss for tax purposes.[45] Others may be subject to regulatory accounting requirements or fund restrictions that do not allow them to carry defaulted bonds.[46] Finally, many pre-petition security holders "purchased the claims on margin and owe debts of [their] own and, therefore, need to sell the claim to provide [their] own

[42] Nicholas F. Kajon, *Northwest Rulings May Chill Hedge Fund Participation in Chapter 11 Cases*, STEVENS & LEE PC: BANKRUPTCY CLIENT ALERT, March 16, 2007, *available at* http://www.stevenslee.com/news/bankruptcy/Northwest_Ruling_0307.pdf.

[43] Kenneth Rogoff, *The Hedge Fund Hegemon*, PROJECT SYNDICATE, *available at* http://www.project-syndicate.org/commentary/rogoff28.

[44] The Journal of the Business Law Society, *Hedge Funds Active in Bankruptcy Proceedings*, September 27, 2006, http://iblsjournal.typepad.com/illinois_business_law_soc/2006/09/not_your_usual_.html.

[45] Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUMBIA BUS. L. REV. 191, 206 (2005).

[46] *Id.* at 206-07.

creditors with cash."[47] Thus, it is clear that many investors, for many different reasons, wish to exit the bankruptcy process or desire to cash out of their investments as soon as possible. Without distressed-investor participation, non-distressed investors will be unable to rid themselves of unwanted securities and will suffer a loss in the time value of money by losing the ability to cash-out and reinvest elsewhere.

Conclusion: An Appropriate Framework

For the reasons stated above, Rule 2019 should not be maintained in its current form because it does not provide any useful information, is unnecessary to support a modern administration of the Code, is inefficient because it is both over- and under-inclusive, and is potentially counterproductive to the reorganization process. Discovery under the Federal Rules is not only less burdensome to those forced to disclose, but it is more than adequate for those isolated cases when the *information* required by Rule 2019 may be helpful to the administration of the case, such as to investigate and punish investor misconduct.

Multiple courts have permitted *in camera* disclosure as a middle ground between full mandatory disclosure and complete confidentiality. Under Section 107(b) of the Code, bankruptcy courts are authorized to "protect any entity with respect to a trade secret or confidential research, development, or commercial information." However, in making the decision to protect information, a court is also required to consider Section 107(a), which states that all papers filed in a bankruptcy case, including Rule 2019 disclosures, "are public records and open to examination by an entity at reasonable times without charge." However, because Section 107(a) begins with the modifier, "Except as

[47] *Id.*

provided in subsection (b)," the language of the Code implies that there are times when transparency must yield to confidentiality. In the *Owens Corning* bankruptcy case, for example, the bankruptcy court employed this exact solution, which it found to "adequately balance the creditors' privacy interests with the public's competing interests in full disclosure."[48] In addition, the *Owens Corning* court noted that a showing by the requesting party that such disclosure is both "necessary" and "relevant" will not "violate anybody's substantial rights."[49]

Therefore, given the availability of an existing, more efficient, more equitable, and less intrusive alternative, Rule 2019 in its current form should be repealed. Courts and other parties in interest will retain the broad power to investigate and discover facts under Rule 2004 and Federal Rules 7026 – 7037.

[48] Jordan Siev, et al., *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC: PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http://www.andersonkill.com/webpdfext/CommitteeNewsletter.pdf (referring to Transcript of Argument on all Delaware Asbestos Cases Regarding 2019, *In re Owens Corning, et al.*, No. 00-3837, (Bankr. D.Del. Oct. 6, 2004) at 55 (order allowing counsel representing more than one creditor or equity security holder to file the 2019 statements under seal)); *see In re Mirant Corp., et al.*, No. 03-46590, (Bankr. N.D.Tex. May 24, 2005) (authorizing the members of an *ad hoc* committee to file under seal only the proprietary information contained in their Rule disclosures).

[49] *Id.*

We would be pleased to discuss this subject further with the Reporter for the Committee. Please contact our counsel in this matter, whose contact information appears below.

Very truly yours,

SECURITIES INDUSTRY AND
FINANCIAL MARKETS
ASSOCIATION

By: Kevin M. Carroll
Ira D. Hammerman
Senior Managing Director and
General Counsel
Kevin M. Carroll
Managing Director and
Associate General Counsel
1101 New York Avenue, NW
Washington, DC 20005
kcarroll@sifma.org

THE LOAN SYNDICATION AND
TRADING ASSOCIATION

By: ______________________
Elliot Ganz
Executive Vice President and
General Counsel
366 Madison Avenue
15th Floor
New York, New York 10017
eganz@lsta.org

OF COUNSEL TO
LSTA AND SIFMA:

Mark Thompson
SIMPSON THACHER & BARTLETT LLP
425 Lexington Avenue
New York, New York 10017-3954
Email: mthompson@stblaw.com
Tel: (212) 455-7355

We would be pleased to discuss this subject further with the Reporter for the Committee. Please contact our counsel in this matter, whose contact information appears below.

Very truly yours,

SECURITIES INDUSTRY AND
FINANCIAL MARKETS
ASSOCIATION

By: ______________________________
Ira D. Hammerman
Senior Managing Director and
General Counsel
Kevin M. Carroll
Managing Director and
Associate General Counsel
1101 New York Avenue, NW
Washington, DC 20005
kcarroll@sifma.org

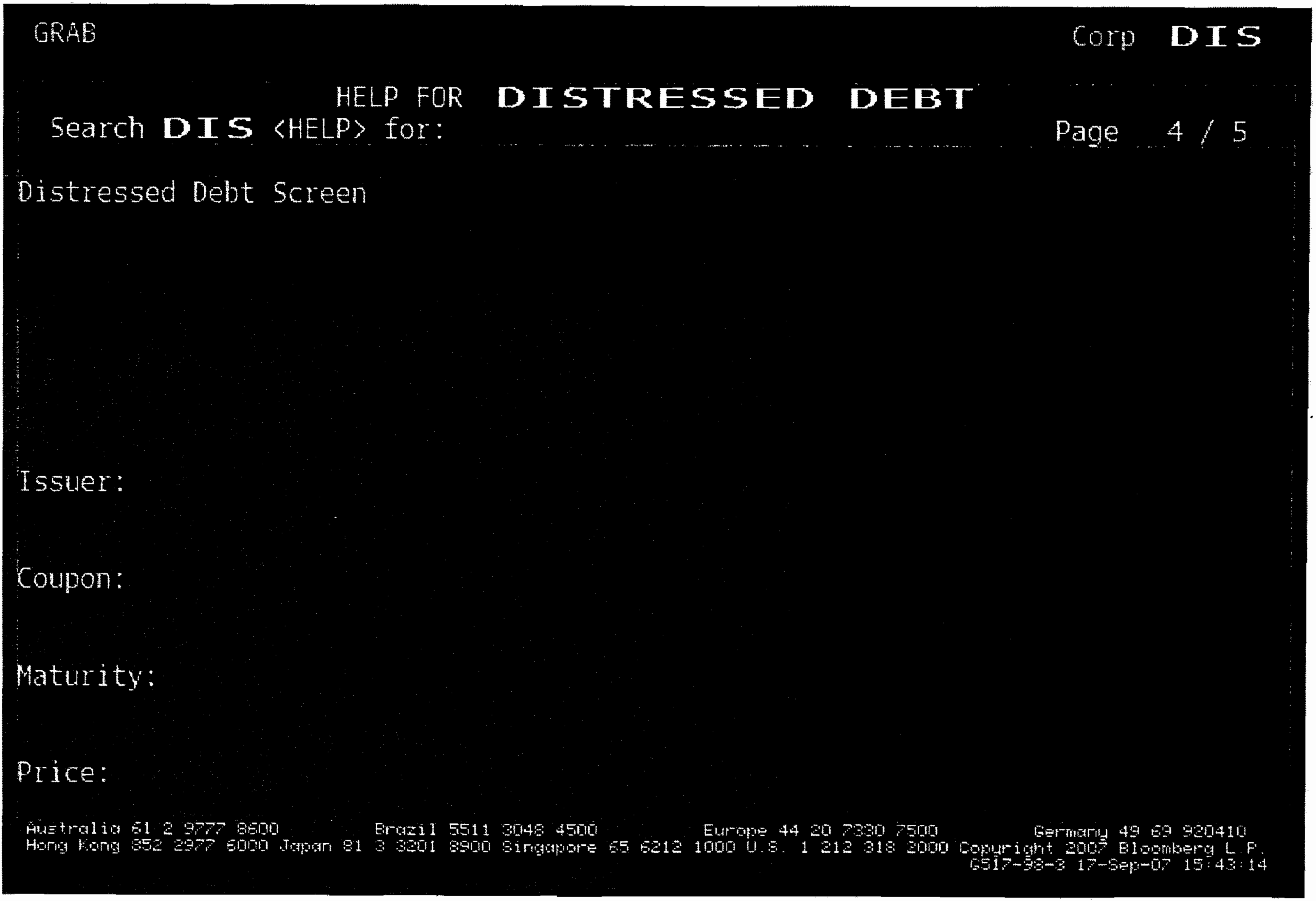
THE LOAN SYNDICATION AND
TRADING ASSOCIATION

By: ______________________________
Elliot Ganz
Executive Vice President and
General Counsel
366 Madison Avenue
15th Floor
New York, New York 10017
eganz@lsta.org

OF COUNSEL TO
LSTA AND SIFMA:

Mark Thompson
SIMPSON THACHER & BARTLETT LLP
425 Lexington Avenue
New York, New York 10017-3954
Email: mthompson@stblaw.com
Tel: (212) 455-7355

Exhibit A



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Page 4 / 5

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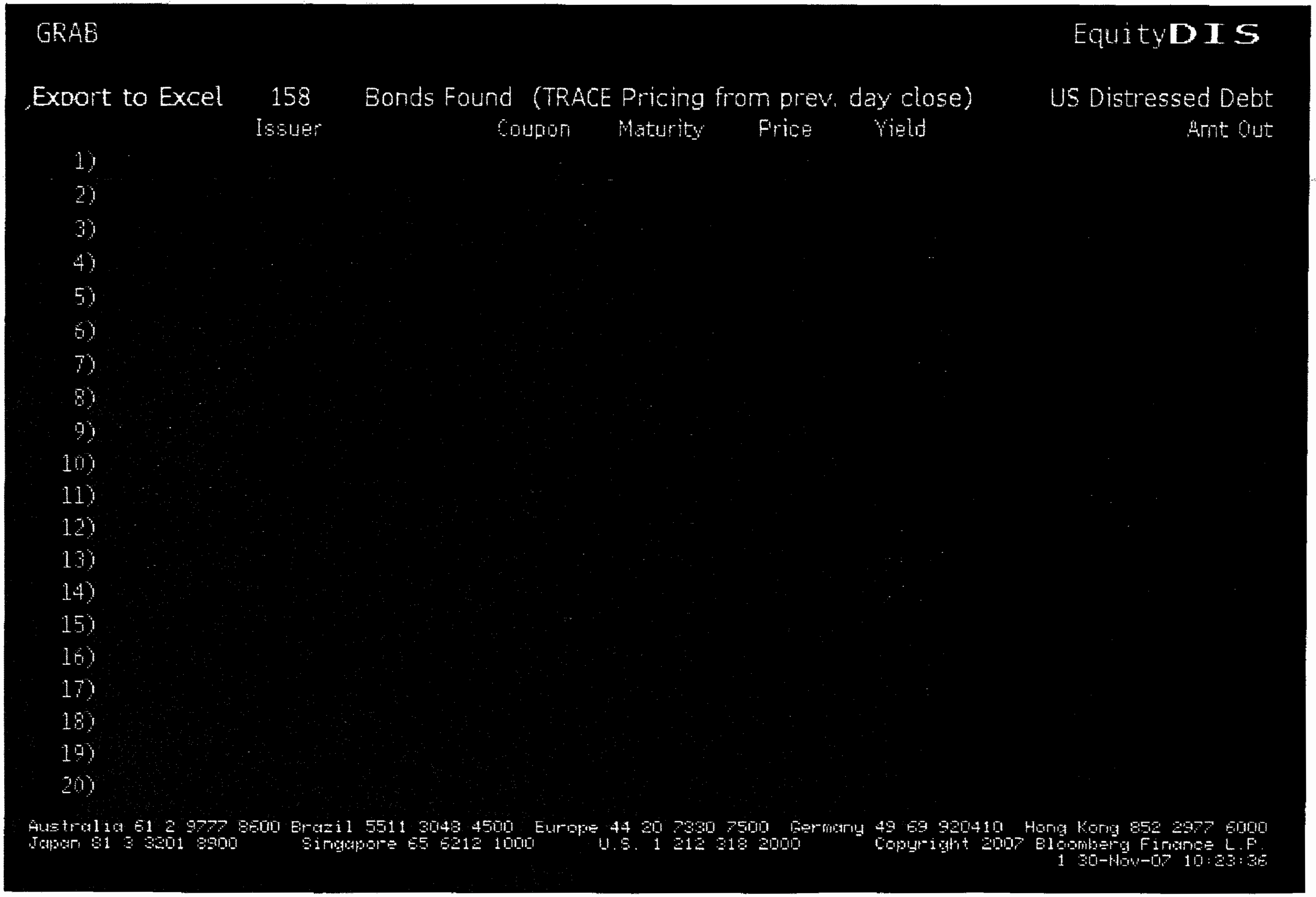

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BLOOMBERG SCREEN, NOV. 30, 2007

Homebuilder Stocks Seem Enticing, But Where's The Cash?

By Michael Corkery

With home sales slowing to a crawl and buyers unable to qualify for mortgages, some home builders are struggling to keep their operations going.

Already, Levitt Corp.'s **Levitt & Sons** unit has filed for bankruptcy-court protection, and a second builder, Tousa Inc., said it is considering several "in and out of court restructuring and reorganization" options, including a possible Chapter 11 filing. While those small Florida-based builders were partly crippled by company-specific issues, the make-or-break matter for most builders — and for those who may be enticed by their cheap stock prices — is the ability to generate cash to service debt and to pay for the construction of new homes. Such liquidity risks could trap investors.

"Liquidity is the No. 1 concern for builders, and rightly so," says Nishu Sood, an analyst at Deutsche Bank. "It's a matter of survival," he says of the many builders that borrowed heavily for the land they stockpiled during the housing boom.

For months, builders have been slashing prices to move houses and generate cash. But in recent weeks, Sood says, the new-home market in some regions is behaving like there already is a broad economic recession. "In some communities, builders can't give away homes," he says. "They will end up with fewer tools to come up with cash."

Amid the distress, investors may be tempted to go bargain hunting. According to UBS, the home builders are trading on average near 40% of their tangible book value, which is typically a rough estimation of what the company would be worth if liquidated. That makes them appear extremely inexpensive.

One red flag: Some builders have violated, or are close to violating, credit agreements with their banks. Until now, the banks have been willing to relax their rules to avoid technical defaults. But their patience could be wearing thin for some builders as the housing market deteriorates.

WCI Communities Inc., which focuses on high-rise condominium towers in coastal Florida, is currently testing the banks' patience. The company recently violated an "interest coverage" test, which requires a minimum ratio of earnings before interest, taxes, depreciation and amortization to the interest it owes on its debt, says Andrew Brausa, a debt analyst at Banc of America Securities.

WCI received a waiver until Dec. 7 and has negotiated with its banks for more breathing room. James Dietz, WCI's chief financial officer, says the banks are close to signing off on a new agreement. "We believe we can generate sufficient cash to pay debt service and all our obligations," says Dietz.

WCI may have little leverage to assuage its lenders. As the condo market falters, WCI's cash-flow projections for this year have eroded to between $210 million and $460 million from an earlier range of $530 million to $730 million. The company is expecting to generate significant cash by completing a large condo project, One Bal Harbour, near Miami. But some analysts fear more home buyers will walk away from that project than the company expects amid falling property values.

WCI has to pay about $120 million to service the interest on its debt next year, which it will be able to do if cash flow doesn't dip further. But that isn't certain given the direction of sales in the Florida condo market. The company has about $200 million left to draw on its credit line, Dietz says.

continued on page 10

Active Bonds

Active Bankrupt Bond Price Indications

The following table of bankrupt companies' bonds shows recent price indications for the issues listed.

Issuer	Description	Latest Session	Previous Session	Chg.
Calpine Corp.	7.75% Nts-9	100.50	100.50	....
Dana Corp.	5.85% Nts-15	71.25	71.75	-0.500
Delphi	6.55% Nts-06	68.50	68.25	0.250
Dura Automotive	8.625% Nts-12	28.00	28.00	....
Movie Gallery	11% Nts-12	17.00	17.25	-0.250
Sea Containers Ltd.	10.5% Nts-12	61.00	61.50	-0.500
Solutia	11.25% Nts-09	99.63	99.63	....
Solutia	7.375% Nts-27	96.75	97.00	-0.250
Stelco Inc.	FLT% Nts-16	108.75	108.75	....

Source: The High Yield Advantage, 617.261.9700, advantagedata.com

Composite high yield bond price indications are compiled from various market sources, some of which may make a market in or have financial interest in the issues for which prices are provided. PRICES ARE INDICATIVE ONLY. The information contained herein does not represent a solicitation to sell or buy the underlying issues. Dow Jones shall not be held liable for any reason for any errors or omissions, delays or inaccuracies in the indications or any decision made in reliance upon the indications. Dow Jones shall not be liable to any person for any loss of business revenues or lost profits or for any indirect, special, consequential or exemplary damages whatsoever, whether in contract, tort or otherwise, arising in connection with the indications, even if Dow Jones has been advised of the possibility of such damages. Dow Jones makes no warranty whatsoever, express or implied, including specifically any warranty of merchantability or fitness for a particular purpose with respect to the indications and specifically disclaims any such warranty.

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Date: 8 June 2007
Analyst: Howard Tang; 1-212-686-6559; howard.tang@debtwire.com

DEBTWIRE
NORTH AMERICA

Movie Gallery
USA, Consumer Retail **Distressed**

CREDIT RATING	Caa1 (Moody's) B- (S&P)	TOTAL DEBT	USD 1.1bn	TOTAL ASSETS	USD 1.14bn

DEBT STRUCTURE (in USD m):

Category	Amount Out	Interest %	Price (6/8/07)
Senior Unsecured Notes '12	322	11	81.94
Revolver	0	LIBOR + 2.5	N/A
First Lien Term Loan	600	LIBOR + 3.5	99.15
Second Lien Term Loan	175	LIBOR + 6.5	97.4
Other	3	N/A	N/A

DEBT MATURITIES (in USD m):

2007	2008	2009	2010	2011	Thereafter
3	-	-	-	-	1097

Financial Covenants (2007 credit facility):

- Maximum leverage ratio of 6.75x throughout FY07.
- Maximum Secured leverage ratio of 4.75x throughout FY07.
- Interest Coverage Ratio cannot be less than 1.4 throughout FY07.

SUMMARY FINANCIALS:

In USD m	1Q 07	1Q 06	2006	2005[1]
Revenues	646	694	2542	1987
EBITDA	57	113	210	139
Interest	27	30	120	69
EBITDA/Interest	2.11	3.77	1.75	2.01
Cash	27	33	33	135
Total assets	1136	1153	1153	1385
Equity	-251	-236	-236	-213
Total debt	1100	1092	1092	1161
Debt/EBITDA	7.17[2]	5.2	5.2	8.35
EBITDA	57	113	210	139
Interest	27	30	120	69
CAPEX	1	9	20	58
Available for Debt	20	74	70	12

[1] Recognizes the consolidated results of Movie Gallery and Hollywood for the period subsequent to our merger on April 27, 2005.
[2] TTM EBITDA = USD 153.38m

CREDITORS & BONDHOLDERS:
Goldman Sachs Credit Partners — Lead Arranger/Lender
Wachovia Bank— Lender
CT Investment Mgmt Group Inc—Bondholder
Putnam Investment Management—Bondholder
Wellington Management Co LLP—Bondholder

OFFICERS & DIRECTORS:

Name (Position)	Name (Position)
J.T. Malugen (Chairman, CEO)	S Page Todd (EVP, GC)
Thomas D Johnson Jr (EVP, CFO)	Keith A Cousins (EVP, CDO)
Jeffrey S Stubbs (EVP, COO)	H Harrison Parrish (VC, SVP)

ADVISORY ENGAGEMENTS:

Firm	Capacity	Date
Alvarez & Marsal	Financial Advisor	2007
Merrill Lynch	Financial Advisor	2007
Peter Solomon	Financial Advisor	2007

BUSINESS: Headquartered in Alabama, Movie Gallery has grown considerably since its initial public offering in 1994. Traded on the NASDAQ, the Company is the second largest specialty home video retailer in the US. Movie Gallery rents out and sells DVDs, videocassettes and video games through approximately 4,590 retail stores throughout North America. The recent acquisition of Hollywood Entertainment on 27 April 2005 almost doubled the number of locations of Movie Gallery and added the Hollywood and Game Crazy brands to the Company's existing branches.

SOURCES OF DISTRESS:

- **Hollywood Acquisition Financing:** Prior to the acquisition of Hollywood Entertainment, Movie Gallery had negligible debt obligations in its capital structure. Post acquisition, the company added over USD 1bn in long-term notes, credit facilities, and acquired liabilities to its balance sheet.
- **Deteriorating Business Fundamentals:** Movie Gallery is being besieged by a number of lower cost options that is rapidly changing the fundamentals of the movie rental business. Consumers are quickly shifting their preference to online mail order options such as the Netflix service and Blockbuster's online rental service. Late to the game, Movie Gallery has begun to explore other alternatives for providing movie rentals. Recently, the company has acquired MovieBeam, a service which provides digital delivery of movie rentals, and has begun testing movie rental kiosks in select locations. How effective these new delivery platforms will be, is yet to be known as the company still needs to roll them out with some significance.

PROFITABILITY (1Q 07 vs. 1Q 06): Movie Gallery has shown little improvement in its profitability from last period. Total revenues fell by 6.72% driven mainly by reduced rental revenues of 10.41% on a YOY comparison. The bright spot in their results was a surge in product sales of 10.26% from 1Q 06 to 1Q 07. The company's gross margins have been somewhat resilient dropping only 138 bps YOY to 60.1% from 1Q 06. Movie's operating income fell by 50.2% reflecting the drop in total revenues and the increased cost of product sales. EBITDA for 1Q 07 demonstrated a similar drop from 1Q 06 of 49.56% despite the elimination of one-time non-recurring charges. Management continues to rationalize costs and generate cash flow through the shuttering of unprofitable stores and sub-leasing. During 1Q 07 the company closed 54 underperforming stores recognizing USD 0.9m relating to these closures. The operational restructuring has achieved little success as operating margins continue to deteriorate; YOY, margins fell by 453 bps to 5.19% in 1Q 07.

MAJOR RESTRUCTURING INITIATIVES:

- **March '07 Refinancing:** Movie Gallery refinanced its April 2005, USD 900m senior secured credit facility. The new facility consists of USD 100m revolver, USD 25m first lien synthetic letter of credit facility, USD 600m first lien term loan and USD 175m second lien term loan. The second lien term loan is a PIK, allowing the company to defer cash interest payments for a time.
- **Lease Restructuring Initiatives:** The company has entered into a management agreement with Excess Space Retail Services to pursue subleasing opportunities at 2,200 store locations. Movie expects that retail partners from this initiative will occupy an approx. average of 2,500 square feet at each location. In a separate agreement, Movie is working with Hilco Real Estate to restructure leases at 1,100 store locations.

LIQUIDITY: The Company's liquidity position is bolstered by USD 27.3m in cash and cash equivalents and USD 100m availability on its revolver. Cash provided by operations improved significantly on a YOY basis; for 1Q 07 the company generated USD 16.78m from operations as opposed to a deficit of USD 20.6m in 1Q 06. No major debt repayments are due for several years. The company's interest and lease expenses are the major drain on the company's cash position amounting to USD 485m for 2007. Management expects that the company's capital expenditures for fiscal 2007 to be USD 38m which would go to fund store openings, maintenance on the existing store base and other strategic investments.

Est. liquidity as of 1 April 2007 — USD 127.3m

USD 27.3m	Cash and Cash Equivalents
USD 100m	Revolver Availability

Est. one year capital requirements as of 1 April 2007 — USD 147m

USD 38m	Capital Expenditures
USD 109m	Interest payments on First & Second Lien, Senior Notes, and Capital Leases; reduced by Hedge agreement

STANDARD & POOR'S

Leveraged Commentary & Data

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LCD News

December 03, 2007

Deal Dossier

Movie Gallery (2nd Lien 3/07)

Related News

- Movie Gallery debt falls amid market weakness, sector woes (11/16/07)
- As defaults loom, accounts eye recovery values, ratings (10/24/07)
- Movie Gallery LCDS auction sets price at 91.5 (10/23/07)
- Movie Gallery DIP allocates; LCDS auction set for Tuesday (10/19/07)
- Movie Gallery shops $150M DIP loan to existing lender group (10/16/07)
- Movie Gallery files for Ch. 11, hands 2nd-lien lender key stake (10/16/07)

All Related News

Related Deals

- Movie Gallery (DIP 11/07)
- Movie Gallery (RC 3/07)
- Movie Gallery (TL 3/07)
- Movie Gallery (Add-on 10/05)
- Movie Gallery (4/05)
- Movie Gallery (12/98)
- Movie Gallery (HY 5/05)

headlines only GO

Some distressed credits off lows, but general trend lower

New York, Nov. 27 (LCD) - Several distressed credits have bounced from rec
though the general trend over the past few weeks has been broadly negative.

Movie Gallery first-lien bank debt rebounded from lows in the mid-70s touche
today, gaining to 77/79, compared to 80/82 yesterday. The lower levels were
investor distaste for credits exposed to consumer and retail trends. Markets in
company's second-lien debt were scarce, sources said.

Bonds backing stronger rival **Blockbuster** (9% notes due 2012) traded at 84/
one point lower since early last week, for a total drop of six points in one mont
Blockbuster stock has tumbled 32% since the company reported a 6% fall in t
revenue and losses of $0.20 per share, compared to losses of $0.15 per shar
same quarter one year ago. Blockbuster shares traded at $3.60 today, up 1.7

Another credit exposed to reduced consumer spending, restaurant chain oper
Buffets, remains under pressure. The company's term debt continued to fall,
today, higher than bids at 85.5 in recent days but compared to 88.25/89.75 ea
week. The company's 12.5% notes due 2014 have steadied at 46/47 in anticip
restructuring, sources said.

Housing credits remain in focus as negative headlines for the sector continue.

WCI Communities revolving debt was at 91/93 today, unchanged with levels
ago, sources said. WCI 9.125% notes due 2012 traded at 60 today, steady w
week, but down 10 points over two weeks. WCI 6.625% notes due 2015 ease
today, to 54/55, for a 14-point drop this month.

Realogy's institutional strip changed hands today in an 87/88 context, compa
86.5/87.5 on Nov. 21. Realogy bonds have ticked steadily lower in recent wee
company's 12.375% subordinated notes due 2017 fell three points today, to 6
compared to 68/70 three weeks ago. Realogy 10.5% notes due 2014 slid two
today, to 71/73, from an 80 context three weeks ago, sources said.

ResCap term debt benefited from news that the company moved to strengthe
metrics and stave off bankruptcy by tendering for $750 million of bonds. The c
term loan due 2008 traded today in an 85/86 context, compared to 72/73 early
Over the same time ResCap bonds have climbed 10 points. - *Abby Latour*

abigail_latour@standardandpoors.com

Printer Friendly Format

Published: 27 Nov 2007 - 18:43 GMT

Standard & Poor's LCD news, analysis and data covering the leveraged and secondary loan mar
high-yield bonds, is available on www.lcdcomps.com. For more information or to subscribe to LC
Marc Auerbach at 212-438-2703. Info: www.lcdcomps.com

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EXHIBIT K

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

IN RE:	)	In Proceedings for a Reorganization under
Owens Corning, et al. ,	)	Chapter 11
Debtor.	)	Case No. 00-3837-JKF

REVISED ORDER REQUIRING FILING OF STATEMENTS PURSUANT TO FED. R. BANKR. P. 2019

AND NOW, this ___**22nd** day of __**October**___________, 2004, it is **ORDERED** that the Amendatory Order Requiring Filing of Statements Pursuant to Fed.R.Bankr.P. 2019 entered on August 27, 2004 is hereby amended and replaced in full as follows:

Within 60 days from the date of this order, except with respect to a committee appointed pursuant to §1102 or §1114 of the Bankruptcy Code, any entity or committee representing more than one creditor or equity security holder and any indenture trustee that has entered an appearance, filed a claim, cast a ballot or taken any other affirmative action to participate in the Debtor's bankruptcy case in any way shall file with the Clerk a statement (a "2019 Statement") containing the information described below;

It is further **ORDERED** that, except with respect to a committee appointed pursuant to §1102 or §1114 of the Bankruptcy Code, any entity or committee that represents more than one creditor or equity security holder and any indenture trustee that enters an appearance, files a claim, casts a ballot or takes any other affirmative action to participate in the Debtor's bankruptcy case in any way for the first time after the date of this Order shall, within 10 days of such action, electronically file with the Clerk a 2019 Statement containing the information described below;

It is further **ORDERED** that the docket entry of the statement that is filed shall state that Exhibits (as described below) have not been scanned into the docket but are available upon motion to and order of the Court. The docket entry shall be in substantially the following format:

> Verified Statement Pursuant to Fed.R.Bankr.P. 2019 filed by ([INSERT FILING ENTITY'S NAME]. Exhibits have not been scanned but may be accessed by parties who obtain Court order authorizing access.

It is further **ORDERED** that exhibits required to be filed and listed below shall **not** be electronically filed but shall be submitted to the Clerk on compact disk ("CD"). Two sets of CDs shall be submitted and shall be identified on their faces as "Set 1" and "Set 2" and shall note the name, address, and telephone number of the attorney submitting the disks.

It is further **ORDERED** that the 2019 Statement shall be a verified statement identifying the name and address of the entity filing such statement and that includes the following exhibits:

1. A blank, but unredacted, exemplar or an actual copy, of each form of agreement or instrument, if any, whereby such entity is empowered to act on behalf of creditors or equity security holders in this case;

2. An Excel spreadsheet in electronic format in substantially the form attached hereto as Exhibit A containing the following data:

a. name of each creditor or equity security holder represented by the entity filing the 2019 Statement;

b. the personal address of each such creditor or equity security holder;

c. reserved space for the social security number or other identifier as may be required by a further order of the Court;

d. identification of the form of exemplar referenced in item #1 above executed by the creditor or equity security holder, and the date such agreement was executed;

e. the amount of the claim of any creditor if liquidated, and for unliquidated claims, an indication that such claims are unliquidated;

f. the date of acquisition of the creditor's claim unless such claim was acquired beyond one year prior to the filing of the Debtor's petition for relief;

g. for personal injury claimants, the type of disease giving rise to the claim; and for all other claimants, the nature of the claim or interest; and

h. a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or names of the entity or entities at whose instance directly or indirectly the employment was arranged or the committee was organized or agreed to act;

3. 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 any indenture trustee, a statement of

a. the amounts of claims or interests owned by the entity, the committee members or the indenture trustee;

b. the times when acquired;

c. the amounts paid therefor, and

d. any sales or other disposition thereof;

It is further **ORDERED** that upon filing a 2019 Statement with the Clerk, each entity filing a 2019 Statement shall electronically file the 2019 Statement without exhibits, and shall provide all exhibits on CD's only to the Clerk, who shall maintain the exhibits without putting them into the electronic database;

It is further **ORDERED** that each entity filing a 2019 Statement shall serve a copy of the 2019 Statement that includes all exhibits on CD's on the Debtor and the United States Trustee, who shall keep such exhibits confidential and shall not release the exhibits to any party without further Order of Court;

It is further **ORDERED** that each entity filing a 2019 Statement or a Supplement thereto shall serve a notice of filing a 2019 Statement or Supplement, as the case may be, on all parties on the Official Service List;

It is further **ORDERED** that filing and updating as necessary a 2019 Statement that complies with this Order, as it may be amended from time to time, shall be deemed to be complete compliance with Bankruptcy Rule 2019 for all purposes in this case;

It is further **ORDERED** that the Debtor shall maintain copies of the 2019 Statements and shall make them available for inspection and copying as directed by the Court from time to time;

It is further **ORDERED** that entities shall supplement their 2019 Statements, as necessary, every 90 days, covering any material changes of fact occurring up to 30 days prior to such supplemental filing of the 2019 Statement;

It is further **ORDERED** that any entity that fails to comply with the terms of this Order may be subject to appropriate sanctions as the Court may determine;

It is further **ORDERED** that when this case is closed, the Clerk shall archive the 2019 Statements and Supplements with the case file;

It is further **ORDERED** that the Debtor or counsel for the Debtor shall serve a copy of this Order on the Official Service List; on all entities who have entered, or in the future enter, an appearance or have requested, or in the future request, notices in the case; the United States Trustee; and on persons or entities or any supplemental service lists used to notify attorneys for claimants with asbestos, silica and/or mixed dust personal injuries or property damage claims, and file a certificate of service with the Clerk of the Bankruptcy Court within ten (10) days hereof.

Judith K. Fitzgerald reb

Judith K. Fitzgerald
U.S. Bankruptcy Judge

EXHIBIT L

MORE PHOENIX THAN VULTURE: THE CASE FOR DISTRESSED INVESTOR PRESENCE IN THE BANKRUPTCY REORGANIZATION PROCESS

Paul M. Goldschmid[*]

I. Introduction 192
II. The Residual Actor Problem in Bankruptcy Reorganizations 196
III. The Dramatic Growth of Distressed Debt Investing in Recent Years 200
IV. Recent Trends in Bankruptcy Proceedings and the Distressed Debt Investor 209
V. The Alternative Hypothesis of Baird and Rasmussen 218
A. Revolving Credit Facilities 223
B. Bank Loan Syndication 229
C. Credit Default Swaps 230
D. Collateralized Debt/Loan Obligations 233
E. DIP Financing.. 235
F. Distressed debt funds as DIP lenders 249
VI. Why Distressed Debt Investors Make Better Residual Actors than Senior Creditors 255
VII. The Dark Side of Distressed Debt Investing 265
VIII. Reply to Harvey Miller and Policy Implications of Findings.. 267

[*] J.D. Candidate 2006, Columbia University School of Law; M.B.A. Candidate 2006, Columbia Business School; A.B. Government 2000, Harvard College. The author thanks Professor Edward R. Morrison and the many financial and legal practitioners who provided invaluable advice, guidance and information on this note.

I. INTRODUCTION

Firms in Chapter 11 bankruptcy are presumed to have going-concern value, with operational efficiencies, even though they are usually technically insolvent.[1] A primary objective of Chapter 11 bankruptcy proceedings, therefore, is to protect such going-concern value from the potentially inefficient and destructive behavior of competing and self-motivated creditors. Commentators have often described the challenges of Chapter 11 proceedings as the "residual actor problem." When the firm is solvent, shareholders, as the residual owners, know that their wealth, often reflected by a publicly traded stock value, is closely tied to firm value, and hence to the success of managerial decision-making. Consequently, it is in shareholders' interests to champion strategies for long-run profit maximization.

By contrast, when the firm is insolvent and in Chapter 11, shareholders' claims are, by definition, negligible, and creditors cannot be relied upon to maximize an insolvent firm's value.[2] Senior creditor classes, whose debt may be fully secured or "above water," will presumably favor risk-averse strategies that maximize the probability of recovering the full value of their loans. Junior creditors, who face low probabilities of appreciable recovery, will prefer high-risk strategies because there is little to lose and potentially something to gain by "swinging for the fences." The unfortunate result in many bankruptcies is discord between two groups of potential decision makers: overly risk-averse creditors holding claims that are close to or are "above water," and overly risk-tolerant creditors with claims that

[1] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) (from a purely economic view, firms without going-concern value should be liquidated as long as the liquidation will preserve the highest value for the firm's investors) [hereinafter EASTERBROOK & FISCHEL]

[2] *See id.* at 68-69.

are far "below water."[3] The dynamic is "a basic form of the prisoner's dilemma: the aggregation of individualistic, albeit rational, decisions leading to an inferior collective result."[4] An appropriate goal for Chapter 11 proceedings, therefore, is the effective provision of a collective forum for the re-creation of an efficient residual claimant class by creating a new "above-water" equity actor whose self-interest is aligned with the long-run value maximization of the firm.[5]

This study examines how the increased presence of distressed-debt investors[6] in bankruptcy proceedings has greatly affected the residual actor problem. The thesis of this paper is that distressed-debt investors generally have a salutary impact on the residual actor problem of bankruptcy by expediting business reorganizations and protecting going-concern enterprise values. The argument proceeds in seven steps: Part II restates the theoretical residual actor problem in Chapter 11 bankruptcy reorganizations; Part III analyzes the dramatic growth of distressed-debt investing in recent years and the increased presence and control of distressed investors in bankruptcy proceedings; Part IV explains how distressed-debt investors have driven other important and desirable bankruptcy trends: faster reorganizations, increased liquidity in the markets for debtor assets, greater flexibility in creditor-debtor negotiations under Delaware law, and improved focus on enterprise strategies that maximize long-term enterprise value; Part V is an extended examination and subsequent refutation of the alternative hypothesis, advanced by Douglas Baird and Robert

[3] Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1496 (1993).

[4] Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 544 (1983).

[5] Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 735 (1993).

[6] The qualifier "distressed-debt" in the term "distressed-debt investors" does not imply an exclusive investment in distressed debt. Rather, it refers to a class of investors who purchase the assets or claims of firms once their debt or operations become "distressed."

Rasmussen, that these salutary recent changes in bankruptcy proceedings have occurred, not as a result of the increased influence of distressed-debt funds, but rather as a consequence of significant changes in pre- and post-petition debt contracting by senior bank creditors. According to Baird and Rasmussen, such "dynamic debt contracting" has enabled these traditional fixed-income claimants to re-establish wealth maximization as the principal goal of bankruptcy;[7] Part VI explains why distressed-debt funds are better incentivized and positioned than senior creditors to effectively perform the residual actor role in Chapter 11 reorganizations; Part VII evaluates the principal public policy criticism of distressed-debt funds: they may cause higher bankruptcy recidivism rates if companies emerge from Chapter 11 either too highly leveraged or before they are operationally sound and secure. Finally, Part VIII offers some concluding thoughts about the public policy implications[8] of this study for bankruptcy reorganizations.

[7] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 786 (2002) [hereinafter Baird & Rasmussen, *End of Bankruptcy*] While the authors do not specifically mention the increased presence of distressed investors in the reorganization process, Baird and Rasmussen point specifically to capital markets improvements as having a significant influence on the recent trends in bankruptcy. The authors point out that capital market improvements have made it much easier for large corporations to sell assets or the entire firm during bankruptcy. *See also* Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons From Enron*, 55 VAND. L. REV. 1787, 1808-09 (2002) (explaining that modern capital markets can easily deal with the sale of a diverse set of corporate assets, making it no longer necessary to preserve the firm as a going concern to avoid losing significant value in a sale, as was once the case with bankrupt companies such as railroads).

[8] It is rare to find anything positive written about distressed-debt investors. Most often, they are referred to by the derogatory title of "vultures." Hilary Rosenberg is one of the only authors to actually take an in-depth look at these investors, their motivations and activities. In her 1992 book The Vulture Investors, Rosenberg examined the actions of distressed investors by focusing on their investments in a number of the corporate bankruptcies in the 80's and early 90's. But Rosenberg does little to quell the investors' image as circling scavengers who pick apart

Following the 2001-2002 period in which corporate-debt default rates reached all-time highs, a number of the most fragile U.S. industries have been turned around and consolidated by long-term, operationally minded distressed-debt investors. The trading of claims from the hands of inflexible, fixed-income oriented banks to the hands of operations-minded, equity-oriented distressed investors has been instrumental in reviving dozens, if not hundreds, of corporations. While some have called for further regulating the trading of distressed claims because they fear that the interests of distressed-debt "vulture" funds are insufficiently aligned with those of shareholders, this paper argues that such fears are unfounded.[9] Likewise, the paper counters the argument that distressed-debt investors are too quick to push the firm out of Chapter 11, and that they exacerbate bankruptcy recidivism rates, with empirical evidence to the contrary.[10]

the carcasses of dead or dying businesses. While Rosenberg is clearly fascinated by the so-called vultures' strategy and their power in modern bankruptcies, she never specifically finds that their presence had a net salutary affect on any of the reorganization processes she examines. Moreover, constant allusions to the investors' vulture-like strategies, predilection for devouring dying businesses, and "cold opportunism" only reinforce their reputation as "rapacious speculators." HILARY ROSENBERG, THE VULTURE INVESTORS, 20 (1992).

[9] *See* Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1749 (1996) (calling for a "trading injunction" after an initial period following a bankruptcy filing. This injunction, Tung believes, would prevent the delay and disruptions to the negotiation caused when claims are traded during the reorganization process.).

[10] The question of whether distressed debt investors should be treated as a friend or foe of the reorganizing firm reached an unprecedented level as Worldcom emerged from Chapter 11. Worldcom's two largest investors, distressed investors MatlinPatterson and Silver Lake Partners, were forced into a decision not to take positions on the emerging company's board (the two firms, along with Cerberus Capital, had all initially been granted one seat each on the 11 member board). Richard Breeden, former Chairman of the SEC and corporate monitor in the Worldcom case, warned that these firms' self-interests may be severely at odds with best interests of the corporation, making it improper to elect those firms' representatives as board members. Said Breeden: "there's no guarantee that these people

II. THE RESIDUAL ACTOR PROBLEM IN BANKRUPTCY REORGANIZATIONS

The residual actor of economic theory is the party whose investment will reap the marginal dollar of the firm's gain or suffer the marginal dollar of its losses.[11] The residual actor is the "frequently-invoked hero of economic theory,"[12] because the residual actor's rational, self-motivated decision-making is so directly tied to the best interests of the firm as a whole that its self-motivated actions will also maximize that firm's overall wealth.[13] In a solvent corporation, shareholders are the residual actors because they suffer the marginal gain and loss of managerial decision-making through the value of their publicly traded stock.[14] Shareholders seek to maximize the market value of their equity, which is almost tantamount to firm value. Therefore, as appropriately incentivized decision-makers, shareholders are given the right to certain decision-making authority, including the right to vote at corporate meetings.[15] By contrast, the corporation's creditors have fixed claims, usually involving coupon payments and a principal amount. Because creditors of a solvent company do

are going to be holding securities six months after you emerge from bankruptcy." Breeden therefore rebuffed the original reorganization plan which would have given the distressed investors control of a majority of the seats on the new board, proposing instead that, if the funds want to sit on the board, they must publicize their future trading plans, an unprecedented proposal for corporate directors. Mitchell Paccelle & Shawn Young, *As MCI Tries for a Second Act, 'Vultures' Add to Drama*, WALL ST. J., Apr. 16, 2004, at A1.

[11] Lynn M. LoPucki, *The Nature of The Bankrupt Firm: A Reply to Baird and Rasmussen's The End Of Bankruptcy*, 56 STAN. L. REV. 645, 661 (2003).

[12] Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, No. 3-11, at *4 (2003) (unpublished manuscript, on file at The Social Science Research Network Electronic Paper Collection) [hereinafter, LoPucki, *Myth of the Residual Owner*].

[13] *Id.*

[14] Marcia L. Goldstein & Scott E. Cohen, *Fiduciary Duties of Directors of an Insolvent Corporation*, SG 108 ALI-ABA 193, 200-203 (2002) (commenting on the definition of "balance sheet insolvency.").

[15] EASTERBROOK & FISCHEL, *supra* note 1, at 68.

not benefit from increases in corporate value beyond their individual claims, they are not incentivized to increase the total value of the firm.[16] Their interest in the firm is fixed at their claims' par, or "face," value and their rights protected by contract. As long as the value of their claims does not drop below par, creditors lack incentive to favor business strategies that would further increase the total value of the firm.

As long as the company remains solvent, self-motivated shareholder decision-making aligns perfectly with the welfare of the firm as a whole, but the efficiently organized corporate form begins to break down as a firm enters the "vicinity of insolvency."[17] Once a firm is insolvent, shareholders' claims are, by definition, negligible.[18] The claims of junior creditors and unsecured suppliers likewise may be worth only pennies on the dollar. When insolvency occurs, investors across the company's capital structure stop thinking about their claims as "equity" or "fixed" returns, and begin to evaluate their claims in terms of their "recovery value." While senior or secured debt holders may estimate an expected recovery close to full face value, those holding junior priorities may estimate a recovery of next to nothing after all senior classes are paid. Obviously, those investors holding claims whose expected recovery is close to 100% have very little upside potential, but tremendous downside risk; while those with almost no expected recovery at the start of a Chapter 11 process have almost no downside risk, but tremendous upside potential if the firm can get back on track.

The asymmetrical risks of creditors and shareholders are the source of the residual actor problem in Chapter 11 bankruptcy proceedings. The self-interest of the senior

[16] Harvey Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1477-78 (1993).

[17] *See* Credit Lyonnais Bank Nederland N.V. v. Pathe Comm. Co., 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

[18] Lin, *supra* note 3, at 1490.

classes favors risk-averse, conservative strategies that ensure recovery of fixed claims; while the self-interest of junior classes and equity is the opposite: high risk/high reward activities.[19] These interests are likely to clash in the first and most important decision of bankruptcy: whether the firm should seek reorganization in Chapter 11 or liquidation in Chapter 7. A *financially* distressed firm with operational efficiencies and profitable opportunities ought to be restructured in Chapter 11 to protect its going-concern value while debt pressures are relieved. On the other hand, an *economically* distressed firm lacking profitable prospects ought to be liquidated immediately in Chapter 7 before its market value deteriorates any further. A bona fide residual actor would be capable of making this basic decision in a balanced manner that would satisfy the public policy interest in economic efficiency. But not all of the creditors in bankruptcy proceedings are likely to be bona fide residual actors. While the fundamental bias of senior creditors is toward Chapter 7 liquidations, that of junior creditors and shareholders is toward Chapter 11 reorganization. And, if Chapter 11 is the chosen course, these biases will continue to affect other critical operational and strategic decisions: Should management be replaced; should certain assets be sold; should the firm take on post-petition debt; and what should the capital structure of the reorganized firm look like? When a firm is insolvent, there is often no party whose self-interested decisions can be relied on to maximize economic value.

Legal scholars have recommended theoretical solutions to the residual actor problem of bankruptcy. For example, according to Thomas Jackson and Robert Scott, the potential biases and economic inefficiencies of bankruptcy might be overcome if decision-making authority were conferred on a

[19] Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganziation of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 787 (1993).

single residual claimant[20] whose wealth, when a firm's balance sheet's assets are worth less than its liabilities,[21] directly increases or decreases from any movement upwards or downwards in the company's value.[22] The ideal candidate, therefore, would be a creditor holding a claim whose current reorganization value is 50% of its face value. Therefore, this claim holder would have relatively equal upside and downside potential from decisions that the corporation makes, and a dollar earned or lost at the corporate level would directly affect the recovery on the investor's claim.

The practical problem, of course, is that the real world is far less tidy than the world of theoretical scholarship, and there is no easy way to identify and then shift decision-making authority to some putative residual claimant. The empirical research of Lynn LoPucki, for example, finds that the "paradigm financial structure"—the three-level structure scholars often refer to of equity, unsecured and secured debt —is simply not the way that modern firms are structured.[23] Instead, modern firms have complex credit covenants that create secured and unsecured classes with many different seniority and structural levels.[24] In LoPucki's research of large, public bankruptcies, 62% of firms had a capital structure in which there was more than one creditor class, often across multiple priority levels, that might qualify as the ideal residual owner with claims directly affected by marginal gains and losses in firm value.[25] Even by the time that a large corporate reorganization is nearly complete, the identity of an individual class of residual claimants is often far from certain.[26] LoPucki concludes bluntly that "any

[20] *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain,* 75 VA. L. REV. 155, 159 (1989).

[21] Goldstein & Cohen, *supra* note 14, at 200-03 (commenting on the definition of "balance sheet insolvency").

[22] EASTERBROOK & FISCHEL, *supra* note 1, at 69.

[23] LoPucki, *Myth of the Residual Owner*, *supra* note 12, at 15.

[24] *Id.*

[25] *Id.* at 18.

[26] *Id.* at 8.

bankruptcy governance scheme that depends on identification of the residual owner [is] unworkable."[27]

. It is also significant that bankruptcy claims are rarely, if ever, consolidated in the hands of an investor with enough at stake to take significant interest and control in the debtor. If claims are trade claims, they are likely to be spread across hundreds or even thousands of suppliers or customers. If they are high-yield notes, they may be held by thousands of different investors. It is usually difficult to find creditors with enough at stake to dedicate the resources, absorb the administrative expenses, and bear the opportunity costs of a Chapter 11 proceeding.[28] Substantial administrative and opportunity costs result from a lengthy reorganization process. Claimholders without a great deal at stake lack the financial leverage and patience to even make decisions that may be in their own best interest. Instead, these claimholders may support the easiest, most liquid reorganization plan. Therefore, even if a residual claimant class could be identified, it might lack sufficient motivation or inclination to take control of the firm and steer it in an economically efficient, value maximizing direction.

III. THE DRAMATIC GROWTH OF DISTRESSED DEBT INVESTING IN RECENT YEARS

When the executives of Adelphia Communications, which filed for bankruptcy in June 2002, sat down for the first time at the Chapter 11 bargaining table to begin negotiations with its six largest bondholders, three of those bondholders were completely expected: Fidelity Investments, Oppenheimer Funds, and Alliance Capital. As three of the largest institutional investors in the world, it was natural that Fidelity, Oppenheimer, and Alliance would have acquired hundreds of millions of dollars worth of Adelphia's bonds at par value during the bonds' primary syndication into the

[27] *Id.* at 19.

[28] Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 6-7 (1990).

debt market.[29] Less foreseeable was the presence of distressed debt investors, Oaktree Capital Management, Och-Ziff Capital, and Angelo, Gordon & Co., as the three other leading creditors at the bankruptcy proceeding. As Adelphia had spiraled into bankruptcy, each of these distressed debt funds had purchased their claims on Adephia in the secondary market for pennies on the dollar.[30] The Adelphia bankruptcy is not unique. When Enron filed for bankruptcy, distressed investors Angelo, Gordon & Co., and the Baupost Group numbered among its three largest claimholders, with each having purchased approximately $1 billion (face value) worth of Enron's corporate notes as the company was sliding towards bankruptcy.[31] In the bankruptcy of Worldcom (now MCI), distressed investors MatlinPatterson, Silver Lake Capital, and Bain Capital purchased approximately 25% of the company's outstanding debt for more than a billion dollars.[32] In fact, Worldcom had more distressed debt investors than financial institutions on its creditors' committee with distressed investors Cerberus Partners and Blue River acting as co-chairs of the committee.[33] Kmart Corporation, which emerged from bankruptcy in May of 2003, is now controlled by ESL Investments, a hedge fund that purchased $1.16 billion worth of Kmart's publicly traded bonds and $600 million face value worth of Kmart's bank debt, all after the company had already filed for bankruptcy.[34] ESL now owns 49% of the

[29] Peter Lauria, *Adelphia off to Chapter 11*, DAILY DEAL, June 22, 2002.

[30] *Id.*

[31] Henry Sender, *Enron Bets May Bite 'Vulture' Firms*, WALL ST. J., May 23, 2002, at C1.

[32] Gregory Zuckerman, *MCI Bondholders Get Distressed*, WALL ST. J., July 29, 2003, at C1.

[33] Bankruptcy Datasource, 12/1/02, Worldcom's creditors committee includes ESL Investments, Cerberus Capital Management, GSC Partners, Elliott Management and Blue River LLC *available at* http://bankrupt.com/TCREUR_Public/020801.mbx.

[34] Mitchell Pacelle & Amy Merrick, *Salvage Operation: Behind Kmart Exit from Chapter 11*, WALL ST. J., May 6, 2003, at A1.

reorganized company's shares, and has nominated four of the company's nine directors.[35] The creditors' committee of the Mirant Corporation, which filed for bankruptcy in July 2003 with $11.6 billion in liabilities, is chaired by Appaloosa Management, a multi-billion dollar hedge fund and distressed debt investor.[36] Veteran San Francisco bankruptcy lawyer Pat Murphy concedes that times have drastically changed; when a company gets in trouble, it no longer faces familiar bankers across the negotiating table. Instead, it faces distressed debt investors having no prior relationship with the company.[37] Professor Edward Altman, one of the nation's leading experts on distressed securities, calls distressed debt the "hottest alternative investment area."[38] According to Altman's research, there was at least $65 billion dedicated solely to distressed debt investing in 2003[39] compared to only about $6 billion as recently as 1991.[40]

Oaktree Capital Management, one of the world's largest distressed debt investors, controls more than $25 billion and has been found among the largest claim holders in dozens of recent bankruptcies.[41] Cerberus Capital Management, a distressed debt hedge fund, controls more than $10 billion in capital and is among the top five largest hedge funds in the

[35] *Id.*

[36] Gregory Zuckerman, *Heard on the Street: Appaloosa: Galloping 'Vulture,'* WALL ST. J., Aug. 19, 2003, at C1.

[37] John E. Morris, *Bankrupt: Times are Changing*, DAILY DEAL, June 20, 2002.

[38] Matt Miller, *Disciple of Doom*, DAILY DEAL, June 5, 2003.

[39] *Id.*

[40] Edward Altman et al., *The Link Between Default and Recovery Rates: Theory, Empirical Evidence and Implications* (Apr. 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=314719 (noting that there is clearly more than $65 billion if you include hedge funds and private equity firms willing to invest in distressed securities and assets as opposed to dollars solely dedicated to such purposes).

[41] Vyvyan Tenorio, *Oaktree to Close $1B Fund*, DAILY DEAL, Feb. 20, 2004. Oaktree does not dedicate the entire $25 billion to distressed investing. The firm has significant investment funds dedicated to real estate, emerging markets, high yield and convertible investments, as well.

world.[42] During just the last few years, Cerberus has succeeded in taking controlling positions in sportswear group Fila for about $350 million, bottling company Anchor Glass for $380 million, Conseco's lending business in a partnership with Fortress Investments for $850 million, and the major assets of ANC Rental, a car rental group that includes Alamo and National, for $230 million. Cerberus controls Teleglobe Canada, and owns countertop manufacturer Formica Corporation through a joint venture with distressed investor Oaktree Capital Management. In 2004, Cerberus became Air Canada's largest shareholder after investing $183 million in the bankrupt company, purchased troubled department store Mervyn's in a $1.2 billion deal,[43] and owns a significant stake and has a board seat in MCI (formerly Worldcom).[44] Without actually purchasing a controlling position, Cerberus has also acquired significant stakes in numerous other major bankruptcies in the past few years, gaining seats on the creditors' committees of many large corporate debtors.

The table below documents the extent of distressed debt investor presence in the largest Chapter 11 bankruptcies of 2001 and 2002.[45] In almost every case, the distressed investors have held significant or controlling debt postitions. Often, these investors have been major players in asset sales or have even made a bid for the entire corporation.

[42] Louis Forster, portfolio manager at Cerberus Capital Management, Aozora Bank: The Contest Over the Future Begins, Remarks at The Program on Alternative Investments, Center on Japanese Economy and Business at Columbia Business School in New York, NY (Sept. 24, 2003).

[43] David Carey, *PE Firms Snag Mervyn's*, DAILY DEAL, Aug. 2, 2004.

[44] Peter Smith et al., *A Three-headed Dog with a Fearsome Reputation Tries to Prove it can Really be a Loyal, Tame Animal...*, FIN. TIMES, Oct. 20, 2003 at 19 (Cerberus is a member of Worldcom's Creditors' Committee).

[45] The list includes the largest domestic Chapter 11 bankruptcies from 2001 and 2002 which have now emerged according to Lynn LoPucki's bankruptcy database located at http://lopucki.law.ucla.edu.

Table 1: GROWTH OF DISTRESSED DEBT INVESTOR PRESENCE IN LARGE CORPORATE BANKRUPTCIES, 2001—2002[46]

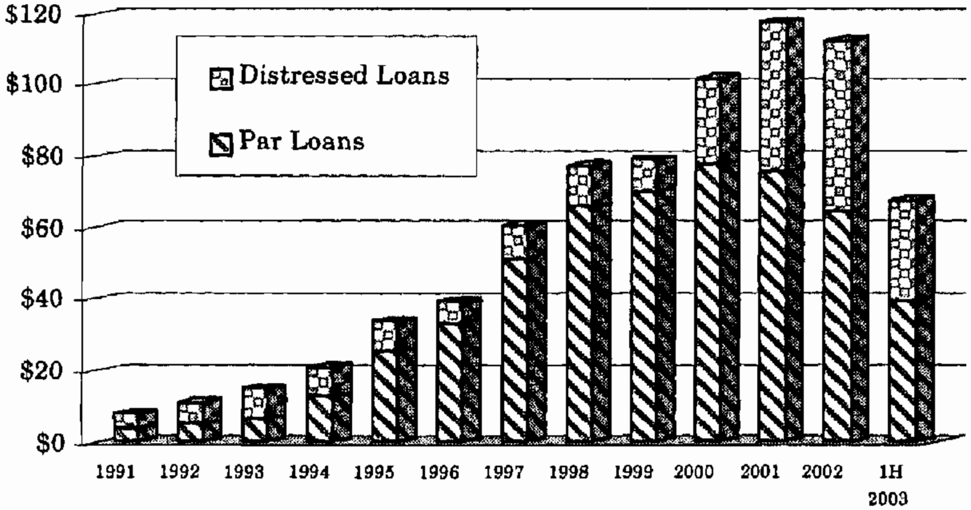
($ in millions)

Distressed Debt Investor Involvement					
Company Name	**Year**	**Assets**	**Controlling Stake**	**Board Seats**	**Significant Stake**
Global Crossing	2002	$30,185	N/A	N/A	Carl Icahn, Cerberus Capital Management
NTL Inc.	2002	$16,581	N/A	WR Huff Fund (2), Apollo Management (1), Oaktree Capital (1), Appaloosa Partners (1)	Franklin Advisors, WR Huff, Oaktree Capital, Appaloosa Partners, Angelo Gordon
Kmart	2002	$14,832	ESL owns approximately 50% of the company's equity	ESL (3), Third Avenue Fund (1)	Third Avenue Fund
US Airways	2002	$7,865	Alabama State Pension Fund	N/A	Texas Pacific Group
XO Communications	2002	$7,807	Carl Icahn	Carl Icahn (4)	Appaloosa Management, Carlson Capital
WilTel Communications (Formerly Williams Communications)	2002	$5,902	Leucadia National Corp.	Leucadia National Corp. (3), Q Investments (1)	Q Investments
McCleod USA	2002	$4,755	Forstmann Little & Co.	Apollo Management (1)	Apollo Management
Sunbeam	2001	$3,155	Oaktree Capital Management controls the company along with Morgan Stanley and Bank of America	Bank of America, Morgan Stanley, Oaktree Capital Management	Elliott Management, KS Capital Partners
Spectrasite Holdings	2002	$3,128	N/A	Apollo Management (1), Oaktree Capital (1)	Apollo Management, Oaktree Capital, Franklin Mutual Advisors
Hayes Lemmerz International	2001	$2,817	N/A	Apollo Management (2)	Apollo Management
Warnaco	2001	$2,331	N/A	N/A	TWC Management (8%), Chilton Investments (5%)
Arch Wireless	2001	$2,306	N/A	N/A	Franklin Advisors (10%), Tudor Investments
Loews Cineplex	2001	$1,921	Partnership between Onex and Oaktree Capital Management	Onex (3), Oaktree Capital Management (1)	N/A
AMF Bowling	2001	$1,730	Partnership between Farallon Capital Management, Oaktree Capital and Satellite Asset Management (92.5%)	Farallon Capital Management (1), Oaktree Capital (1) and Satellite Asset Management (1)	N/A
Nations Rent	2001	$1,724	Baupost and Island (through portfolio company Phoenix Rental Partners) control the firm	Baupost Group (1), Island Partners (2)	Apollo Management, Seneca Capital Management
Covad Communications	2001	$1,509	N/A	N/A	Oaktree Capital, Fir Tree Partners
Chiquita Brands International, Inc.	2001	$1,496	N/A	Apollo Management (1)	Apollo Management
APW	2002	$1,284	Oaktree Capital Management	Oaktree Capital Management, Greenwich Street Capital	Greenwich Street Capital
Teligent Inc.	2002	$1,205	N/A	N/A	Goldman Sachs Credit Partners
Washington Group International	2002	$1,192	N/A	N/A	N/A
Lodgian Inc.	2002	$1,167	Oaktree Capital Management (22.5%)	Oaktree Capital Management (2)	Third Avenue Fund (6%)
Metals USA	2002	$1,106	Citadel Investment Group (23%)	Citadel Investment Group (2)	MatlinPatterson, Triton Partners
Link Energy (formerly EOTT Energy)	2002	$1,075	Farallon Capital Management (21%), Lehman Brothers Energy Fund (20%)	Lehman Brothers Energy Fund (1)	N/A
Pinnacle Holdings	2002	$1,018	Greenhill Capital and Fortress Investment control the company through a JV investment	Greenhill Capital (1), Fortress Investment (2)	N/A

[46] Lynn LoPucki's Bankruptcy Database, *available at* http://lopucki.law.ucla.edu (containing companies that emerged from Chapter 11, based on asset size and using shareholder, creditors' committee, and board data from SEC filings and bankruptcy court filings found on Lexis–Nexis' Bankruptcy DataSource).

The recent dramatic growth in distressed debt investing is surely linked to the similarly dramatic growth in the issuance of high-yield bonds and highly leveraged bank loans, as well as the increased ease with which they have been traded in the secondary loan market. The issuance of high-yield bonds and leveraged loans has grown tremendously over the past decade, with high yield bonds peaking in 1998 at $145 billion in issuances, and leveraged loans peaking in 1999 with $320 billion.[47] As the chart below demonstrates, there has also been a dramatic increase in the size of the secondary markets for senior bank loans. In 1991, a total of only $8 billion (face value) of bank loans traded in the secondary market. By 2002, secondary volume grew to a total of $118 billion (face value) with the greatest growth attributable to distressed loans.[48]

Table 2: U.S. SECONDARY LOAN MARKET VOLUME (1991-1H 2003)



[47] Keven S. Buehler et al., *The Allure of Distressed Debt*, MCKINSEY QUARTERLY, APR. 14, 2003.

[48] Loan Pricing Data Corporation, *available at* http://www.loanpricing.com.

A 1990 amendment to the Federal Bankruptcy Code also stimulated the growth of distressed debt investing. The amended language of Rule 3001(e)(2) vastly reduced court interference with the transfer of bankruptcy claims by making it clear that only the transferor has standing to object to a transfer, and by eliminating the need for a court hearing and court order to effect a transfer.[49] This amendment paved the way for the growth of distressed debt funds by lowering both the transaction costs of claims trading and diminishing the uncertainty over the legitimacy of claims acquired after bankruptcy filing.[50]

As the supply of distressed and defaulted debt has grown, the demand for these claims has risen apace. Distressed debt investors, like all other investors, seek to buy low and sell high. Buying opportunities arise when the market value of debtors' claims falls below what these investors consider to be the "true" value, often due to the shock of an unexpected bankruptcy filing or uncertainty about the capacity of the firm to restructure successfully. Distressed investors offer liquidity, albeit often at a steep discount, for owners of nearly every kind of claim, including publicly traded debt, bank loans, trade claims, tort claims, and rejected executory contract claims.[51] Often, sellers may be willing to "sell low" to unload these claims to avoid the administrative hassle and costs of bankruptcy proceedings. The seller may seek to establish a tax loss on his investment.[52] The seller may face regulatory requirements, including Basel Accord capital requirements, auditing rules for balance sheet asset write-offs or mark-to-market accounting requirements for securities.[53] If they do not have a large enough financial

[49] Tung, *supra* note 9, at 1704.

[50] It should be noted that Rule 3001(e)(2) does not apply to publicly traded securities. Because all classes of debt are much more widely securitized today than they were in 1990, the percentage of claims trading falling under Rule 3001(e)(2)'s "proof of claim" requirements has decreased significantly over the past fourteen years.

[51] Fortgang & Mayer, *supra* note 28, at 4.

[52] *Id.*

[53] *Id.*

stake in the debtor to warrant bearing the expense and delay of a bankruptcy proceeding, sellers may also choose to "sell low." The seller may be a mutual fund whose covenants do not allow the fund to carry defaulted bonds. The seller may have purchased the claims on margin and owe debts of its own and, therefore, needs to sell the claim to provide its own creditors with cash. Alternatively, the seller may be a supplier or customer who values its long-term relationship with the debtor and does not want to get involved in an acrimonious bankruptcy proceeding.[54]

The purchase of various claims in a bankruptcy proceeding does not directly give the distressed debt investor any legal standing beyond that provided by the explicit contractual agreement. But there are indirect means to gain strategic and operative influence. Statutorily, the distressed debt investor will have the right to move to lift the automatic stay, move to lift the debtor's exclusive right to file a plan, raise objections to operating decisions made outside the ordinary course of business, and vote against the debtor's plan of reorganization—potentially forcing a difficult and time consuming "cram down" under Section 1129(b)(2). A distressed investor, because of its proportionally large presence among claimholders, may be appointed to the debtor's creditors' committee[55] where the distressed debt investor may threaten or move for the court appointment of a trustee.[56] The threat of management's losing control to a trustee may be enough for the creditors' committee to gain significant input into firm decision making.[57]

[54] *Id.*

[55] Note that distressed investors may prefer not to join the creditors' committee. Often this decision is made based on the committee's occasional access to inside information and the distressed investor's desire to remain legally able to trade in and out of its position in the company.

[56] LoPucki & Whitford, *supra* note 19, at 699.

[57] That said, appointment of a trustee is thought to be an extraordinary measure in Chapter 11, often reserved for cases of bad faith or fraud. In fact, research on large corporate bankruptcies conducted by Lynn LoPucki and William Whitford found that a trustee was appointed in only two of the forty-three major corporate bankruptcies examined. *Id.*

Much more common is a significant creditor gaining leverage through an informal understanding that: 1) the debtor will need the creditor's approval of its reorganization plan (especially if the creditor holds a blocking position—33% of value or 50% of claims—in its particular class), or 2) the creditor is likely to become a major shareholder of the reorganized entity, potentially having the power to nominate a director or sway management choices in the future. In this manner, there is often a tremendous amount of indirect control that creditors' committees have in the day-to-day operations of the debtor. As Harvey Miller explains, the creditors' committee can oppose anything that happens in the case; it simply comes down to an issue of how far the bankruptcy court will support the creditors and their demands.[58]

The creditors' committees, thinking of themselves more as the Board of Directors than as claimholders, will often argue that that they should be involved in every decision and negotiation.[59] Understandably, the fact that creditors may end up being the controlling shareholders of the restructured company has a tendency to provide the creditors' committee with a great deal of authority, even with ordinary course, day-to-day decision making of the debtor. Irwin Gold, senior managing director of Houlihan, Lokey, Howard & Zukin, and former financial advisor to the creditors of MCI, points out that the creditors' committee played an active role in many important management decisions, including the selection of Mr. Capellas as the company's new CEO. Mr. Gold points out that the creditors developed a close relationship with Mr. Capellas, often stressing the importance of emerging from bankruptcy as quickly as possible.[60] Especially in situations where the creditors' committee includes a single creditor who is likely to have control of the restructured company's equity,

[58] Interview with Harvey Miller, Senior Partner, Greenhill & Co., in New York, NY (Mar. 2, 2004).

[59] *Id.*

[60] Rebecca Blumenstein & Shawn Young, *Worldcom Creditors Back Plan to Reorganize in Bankruptcy*, WALL ST. J., Apr. 14, 2003, at A1.

Harvey Miller points out that it is natural for the debtor's management to give the creditors' committee significant input in strategic decision making.[61] One distressed investor remarked that his firm often gains the ear of the debtor's management because of its willingness to discuss management retention plans, potential post-emergence bonuses, and future strategic directions.[62]

IV. RECENT TRENDS IN BANKRUPTCY PROCEEDINGS AND THE DISTRESSED DEBT INVESTOR

The significant presence of distressed debt investors on creditors' committees has transformed the dynamics of bankruptcy. A decade or two ago, a bankruptcy filing created a relationship-based, communitarian process in which the creditors and the debtor worked together to rehabilitate and preserve the going-concern value of a corporation. Today, a bankruptcy filing effectively puts a "for sale" sign on the debtor; it communicates to the financial world, and especially to distressed debt investors, that it is time to evaluate the debtor's assets for potential Section 363 purchases.[63] Miller maintains that:

> the ability of third parties, such as private equity firms and hedge funds, to gain access to $1 billion or more in capital is adding to the thrust toward liquidation . . . [t]he effect of that access to capital has been to dramatically change the nature of Chapter 11 from rehabilitation of the debtor to a potential auction sale.[64]

[61] Interview with Harvey Miller, *supra* note 58.

[62] Interview with portfolio manager at New York-based multi-billion dollar hedge fund, in New York, NY (June 22, 2004).

[63] Section 363 asset purchases are those made "outside the ordinary course of business" under Section 363(b)(1).

[64] Terry Brennan, *Miller: Liquidations Set to Rise*, DAILY DEAL, Dec. 3, 2003.

Protecting the debtor's going-concern value through court-monitored rehabilitation might have been appropriate in the thinly traded "lemons" markets that dominated bankruptcies of a decade or more ago. An empirical study of large bankruptcy asset sales, published by Hotchkiss and Mooradian in 1998, found the "lemons problem" to be the prevalent pattern for firms acquired while in Chapter 11 between 1983-1992. During that period, out of the fifty-five sales the authors examined, only eighteen had multiple bidders.[65] When there are few potential buyers in an imperfect market, an appropriate goal for the bankruptcy process may be to protect the debtor from asset liquidations at depressed "fire-sale" valuations.[66] Today, the "lemons-market" case is hard to make. A senior managing director at a large New York-based distressed investment fund points out that the number of buyers for distressed assets has grown dramatically since the period studied by Hotchkiss and Mooradian. The director specifically identifies two driving factors behind this increased activity: first, the significant investment returns of distressed investors in the late 1980's and early 1990's brought more competitors to the marketplace and demonstrated that there was significant investment opportunity; and second, the tremendous growth of the high-yield market over the last decade has helped investors become more comfortable and familiar with distressed investing and the bankruptcy process.[67]

With a well-capitalized group of distressed debt funds seemingly eager to bid on assets, there is more reason for bankruptcy courts to push the debtor towards speedy asset

[65] Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11,* 7 J. FIN. INTERMEDIATION 240, 243 (1998), *available at* http://www.sciencedirect.com/science?_ob=MImg&_imagekey=B6WJD-45K19MC-3-1&_cdi=6876&_user=18704&_orig=browse&_coverDate=07%2F31%2F1998&_sk=999929996&view=c&wchp=dGLbVzb-zSkWA&md5=7fc456b4b5a4ecf9f675ae0d22dd3888&ie=/sdarticle.pdf [hereinafter Hotchkiss & Mooradian, *Acquisitions*].

[66] *Id.* at 244

[67] Interview with Senior Managing Director of New York-based distressed investor, in New York, NY (Apr. 13, 2004).

sales or M&A events. Miller notes that courts have decreased the amount of time during which debtors are given "plan exclusivity"—the exclusive right to file and solicit acceptance of a reorganization plan—as debtors' assets have become more liquid. Miller cites the lackadaisical pace of the 1982 Johns Manville bankruptcy, in which the debtor was granted plan exclusivity through court extensions for more than four and a half years, as treatment of a bygone era. Likewise, he regards the repeated extensions of plan exclusivity in Eastern Airlines' Chapter 11 proceedings, which led to the erosion of the firm's asset values and a 93% loss of bondholders' original open market claim value, as largely a preventable, and now a probably unlikely, court error.[68] With large distressed debt investors standing ready to purchase assets, a firm in Chapter 11 can no longer count on exclusivity extensions.[69]

As debtor firms increasingly turn to distressed debt funds to expedite their reorganizations, the average time in bankruptcy has declined. According to Lynn LoPucki's bankruptcy database, the mean number of days a company spends under bankruptcy protection has decreased from 741 in 1990 to 367 in 2002.[70] Baird and Rasmussen point out that, during the 1980's, 88% of the large businesses entered Chapter 11 without a clear reorganization plan; but by 2002, that ratio had fallen to 24%.[71] The figure demonstrates that debtors are no longer "protected" by a Chapter 11 filing. Modern bankruptcy courts are no longer willing to allow the

[68] Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines*, 48 J. FIN. ECON. 55, at *22 (1998), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=60064.

[69] Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2013 (2002) [hereinafter Miller, *Delaware Myth*].

[70] Alix Nyberg, *Second Acts: After Bankruptcy, Companies Often Teeter Between Encore and Final Curtain Call*, CFO MAG., June 1, 2003, at 40.

[71] Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 674 (2003) [hereinafter Baird & Rasmussen, *Chapter 11 at Twilight*].

debtor a great deal of time to proceed without creditor approval. Harvey Miller concurs, adding that courts have become much more responsive to creditors' liquidation demands over the last decade.[72]

Shorter times in bankruptcy reorganization are driven by the financial incentives and the distinctive business culture of distressed debt investors. Distressed investors are usually private investment funds whose principals' fees and bonuses rise dramatically when the fund's rate of return exceeds a "hurdle rate," which is significantly above that expected by fixed-income investors.[73] As Fred Hodara, a partner at Akin, Gump, Strauss & Feld, explains, "[t]hese funds aren't looking to get principal and interest back on their loans, they want equity-style returns."[74] Distressed investors commonly purchase relatively low-yielding bank loans and bonds with a high probability of eventually being converted into equity positions that can provide much higher rates of return *if* the bankruptcy reorganization is successful and *if* the company emerges from bankruptcy with revitalized earnings power.

It follows that the distressed debt investor's bet is extremely time sensitive; in order to attain high required rates of return, funds cannot tolerate delayed or inefficient bankruptcy proceedings. When a distressed debt fund invests in post-petition claims, it believes, by implication, that the plan of reorganization will be confirmed and consummated before the high opportunity cost of carrying the investment destroys any net profit that the investor might be able to book.[75] The funds report their results to

[72] Interview with Harvey Miller, *supra* note 58.

[73] A majority of the fund managers whom I interviewed said that they are looking for about a 20% internal rate of return on invested funds.

[74] Shanon D. Murray, *Bankrupt: Letter From Delaware*, DAILY DEAL, Sept. 25, 2003. (The difference between debt and equity returns is substantial. Since 1946, stocks have had average annual returns of 7.5% and bonds 1%, after adjusting for inflation.).

[75] Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 407, at *5 (1997), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1883.

their investors on a quarterly, or sometimes even a monthly basis; consequently there is constant pressure to achieve high expected rates of return with liquid positions which can be "marked to market" in companies that have emerged from bankruptcy.[76] Hedge funds, most of which face redemptions from their investors at any time, are particularly prone to be "battling against the clock from an IRR [internal rate of return] perspective."[77] While economic theory might suggest near equivalency between the time value of money to a pre-petition fixed-income investor and its value to a post-petition distressed debt investor, in practice, as Chaim Fortgang and Thomas Mayer observe, "[t]here is a real world difference between the attitude of the longtime creditor and an investor who has just invested its money."[78] According to Harvey Miller, exit strategies are paramount to the managers of distressed debt funds:

> All they're concerned about is, how can I get this company to a point where I can either do an IPO or I can sell. . . . The distressed traders will call up [the debtor] in the first three months and say: "alright, we're converting debt to equity, we don't want to hear anything else, we want you out of Chapter 11."[79]

When the IPO [initial public offering] market is "hot," distressed investors will be pushing especially hard to get debtors out of bankruptcy; "they are thinking, 'the market time is now, if we wait, we may not be able to do IPO.'"[80]

The incentives and culture of distressed debt funds also favor Delaware for Chapter 11 bankruptcy proceedings because Delaware courts are often believed to be faster, more knowledgeable, and more predictable than other jurisdictions. Delaware courts are said to understand the

[76] Telephone Interview with founder of distressed debt investing hedge fund (Mar. 31, 2004).

[77] Telephone Interview with principal at multi-billion dollar distressed investment fund (Apr. 2, 2004).

[78] Fortgang & Mayer, *supra* note 28, at 4.

[79] Interview with Harvey Miller, *supra* note 58.

[80] *Id.*

importance of "first day motions" which allow a debtor to carry on its business as usual by approving DIP financing, the payment of wages, and critical vendor orders.[81] Delaware courts are also more likely to accept pre-packaged plans between the debtor and the creditors, and are generally faster in approving such plans (on average taking less than fifty-two days).[82] Harvey Miller notes how Delaware judges routinely make themselves available at almost any time during the initial phase of filing, and emergency hearings can be scheduled quickly.[83] The characteristic expertise of Delaware judges in corporate law also allows them to get through issues more quickly and with a greater understanding of financial and corporate issues.[84] Lynn LoPucki sums up the available evidence by suggesting that Delaware courts offer more latitude or "laissez faire" to enable the quick negotiation of asset sales or reorganization plans.[85] One common argument is that large creditors (often commercial banks and mutual funds) pressure the debtor to file in Delaware in order to increase the value of their post-petition claims, knowing that the distressed investors prefer a Delaware jurisdiction.[86] Research data support the professional observations: Theodore Eisenberg and Lynn LoPucki, examining 284 public company bankruptcies with more than $100 million in assets between 1980-1997, conclude that there has been a shift in forum shopping from New York courts to Delaware courts and that a major factor behind this shift has been a significant difference in case processing time.[87]

[81] Miller, *Delaware Myth*, *supra* note 69, at 1992-93.

[82] David Marcus, *Destination Delaware*, DAILY DEAL, May 5, 2001.

[83] Miller, *Delaware Myth*, *supra* note 69, at 1993.

[84] *Id.* at 1992-93.

[85] Marcus, *supra* note 82.

[86] *Id.*

[87] *See* Theodore Eisenberg & Lynn M. LoPucki, *Shopping For Judges: An Empirical Analysis of -Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 987-92 (1999). While the authors point out that the Delaware Court's perceived processing time is a major explanation for this trend, they argue that Delaware is only faster

By reducing the time spent in bankruptcy, distressed debt investors are helping to mitigate the tremendous transaction costs that usually accompany a Chapter 11 proceeding. For years, scholars have argued that the transaction costs of the bankruptcy process are inefficiently high.[88] Transaction costs of the Chapter 11 process can usually be broken down into direct costs and indirect costs.[89] Direct costs are those costs that come directly out of the debtor's pocket because of the filing. These costs include all of the costs of administering the Chapter 11 process, and negotiating a reorganization plan including fees paid to investment bankers, commercial bankers, lawyers, and accountants. In fact, the direct costs of bankruptcy, in the form of legal fees and administrative expenses, can range from 3 to 25% of debtor's total value.[90] As far back as 1986, Baird argued that the transaction costs of Chapter 11 were too high and that all cases should immediately be converted to Chapter 7, regardless of going-concern value.[91]

While scholars usually concentrate on direct and easily quantifiable transaction costs, the indirect costs of a Chapter

because of its large proportion of pre-packaged cases. The authors point out that Delaware is statistically faster than New York, but not necessarily faster than other jurisdictions.

[88] *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV 439, 463-64 (1992). *See also* LoPucki & Whitford, *supra* note 18, at 776 n.339, 788. In their 1991 study of large corporate bankruptcies, LoPucki and Whitford found that in thirty-four of forty-three cases studied (79%), exclusivity was granted throughout the entire reorganization. The authors suggest two reforms: first, a "preemptive cram down" in which, early in the case, after providing fair hearing, the court would eliminate the interests of the equity holders if it could be shown that the company was clearly insolvent. This method could also be used, at the discretion of the court to eliminate particular creditor interests. Second, the authors suggest that there should be specific statutory limitations for plan exclusivity, perhaps a bright line rule requiring greater review of court extensions.

[89] *See* Adler, *supra* note 88, at 465-67.

[90] *See* Adler, *supra* note 88, at 465.

[91] Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 139 (1986).

11 filing, while not easily quantifiable, are likely to be greater still. These indirect costs are mostly the "uncertainty costs" which surround a debtor.[92] Doubts about whether a firm will survive reorganization cause critical employees to leave, trading partners to curtail potentially profitable dealings, and a company's brand name to be degraded.[93] Each additional day in bankruptcy proceedings increases these costs of uncertainty. A complicated and public bankruptcy will also create significant opportunity costs for the debtor. A drawn-out Chapter 11 process is a significant distraction to managers, consuming their valuable time and negatively affecting their ability to concentrate on the day-to-day operations and long-term strategy of the firm. Moreover, the bankruptcy process often forces managers to sacrifice profitable long-term ventures in pursuit of short-term projects with high free cash flow that can satisfy creditors' immediate property interests.[94]

By trying to expedite the bankruptcy process, distressed debt funds mitigate both the direct and indirect costs of bankruptcy. In the 2002 Kmart Chapter 11 filing, for example, before distressed investor ESL stepped in and purchased a controlling stake in the company's debt, the company was paying lawyers, advisors, and investment bankers $10-12 million per month.[95] Focused on its own internal rate of return, ESL was eager to trim these fees by ensuring that Kmart management could no longer delay the negotiation of a reorganization plan. Toward this end, ESL forced Kmart CEO James Adamson to resign and replaced him with a former Sears executive (ESL also owns approximately 9% of Sears).[96] ESL also focused on curbing the damage from the high-profile bankruptcy on Kmart's brand image and supplier relations. The fund provided

[92] Adler, *supra* note 88, at 465-66.

[93] *Id.*

[94] *Id.*

[95] Mitchell Pacelle & Amy Merrick, *Salvage Operation: Behind Kmart Exit from Chapter 11*, WALL ST. J., May 6, 2003, at A1.

[96] *Id.*

Kmart with a significant exit debt financing package, bɔt based the attractive financing terms on Kmart's ability to quickly emerge from Chapter 11—threatening to rescind the financing if a quick exit were not achieved.[97] In a similar move, rather than risk the possibility of further delay and legal costs, ESL quickly struck a financial settlement with large unsecured trade creditor, Capitol Factors, who had threatened to hold-up the plan confirmation.[98]

A senior managing director at a New York-based distressed investor told me that his firm relies on Chapter 11 to help the debtor rehabilitate its operations and balance sheet. That said, he believes that distressed investors, often faced with significant investment return responsibilities to their own limited partners ("LPs"), are in a good position to tightly monitor the fees and expenses of a Chapter 11 filing, which he deems "out of control."[99] A portfolio manager at a NY-based distressed hedge fund remarked that the most important advantage of private distressed investors is their flexibility in negotiations. He said that his fund is able to "get deals done quickly and efficiently" because the fund is willing to own any part of the company's capital structure or accept any kind of corporate security—something other creditors are often unwilling or unable to do.[100] Distressed funds are appropriately incentivized to find a proper balance between Chapter 11's rehabilitation benefits and the direct and indirect costs of an overly extended Chapter 11 reorganization. In this manner, distressed debt investors can lower the transaction costs of a Chapter 11 filing and

[97] Laura Heller, *Kmart to Emerge After 15 Months in Chapter 11*, DSN RETAILING TODAY, May 5, 2003, at 1, 38.

[98] *Id.*

[99] Interview with a senior managing director of New York-based distressed investor, in New York, NY (Apr. 13, 2004). Specifically, the investor points out that restructuring advisors are often monetarily incentivized to convince the debtor to stay in Chapter 11 because the advisors want to continue to collect monthly retainer fees and asset sale success fees. *Id.*

[100] Interview with a portfolio manager at New York-based multi-billion dollar hedge fund, *supra* note 62.

thereby improve the economic efficiency of large corporate bankruptcies.

V. THE ALTERNATIVE HYPOTHESIS OF BAIRD AND RASMUSSEN

In *The End of Bankruptcy* and other articles, Douglas Baird and Robert Rasmussen have noted that the "traditional" bankruptcies, in which the bankruptcy court provides a collective forum for the debtor-in-possession to control the firm's rehabilitation and emergence as a going concern, have all but come to an end.[101] Baird and Rasmussen were early in recognizing what is now widely acknowledged—that the principal players (in bankruptcy proceedings) understand that a Chapter 11 filing has the effect of putting the company on the auction block.[102] Likewise, Baird and Rasmussen were early in both recognizing and documenting the trends toward faster reorganizations and more M&A events in bankruptcy proceedings, along with the migration of legal filings from New York to Delaware. What is surprising is that Baird and Rasmussen virtually ignore the influence of distressed debt investors in driving these trends. Instead, they largely credit the "end of bankruptcy" to the modern process of "dynamic contracting," in which senior bank creditors gain control over debtors, without a change in bankruptcy laws, by exercising rights contained in covenants to both pre-petition revolving credit agreements and post-petition debtor-in-possession (DIP) loans.

Baird and Rasmussen's basic argument is that modern senior creditors have learned to structure their debt covenants so that control rights begin to shift to the firm's creditors at the first sign of financial distress, even before the bankruptcy petition, and continue to shift through post-petition financing. The principal vehicles of encroaching creditor control are the revolving credit facility (pre-petition)

[101] Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 71, at 674.

[102] *Id.*

and the post-petition debtor-in-possession (DIP) financing. According to Baird and Rasmussen, when serious signs of financial distress first arise, multiple institutional creditors respond by morphing into a single revolving credit facility[103] with a first-priority lien over all of the firm's property and the power to declare the firm in default. In the words of Baird and Rasmussen, "[t]he power to declare defaults can give them the de facto power to hire and fire the managers and the ability to review decisions the managers make about how assets are to be used."[104] Even before the bankruptcy petition is filed, creditors are said to have the wherewithal to "turn off the cash," to monitor and approve every decision "out of the ordinary course," and often to appoint a chief restructuring officer.[105]

In the ineluctable cycle of "dynamic contracting," it is post-petition, DIP financing that finalizes the shift of enterprise control to senior creditors. Baird and Rasmussen describe how debtors have little alternative to the draconian demands of the DIP creditors. Moreover, faced with the risk that the enterprise will lose critical suppliers or customer security if DIP financing is not immediately forthcoming, bankruptcy courts are prone to approve highly restrictive contracting terms.[106] In his *Creditor's Ball* article, David Skeel reiterates Baird and Rasmussen's theory. "The magical provision is section 364 . . . it authorizes the bankruptcy court to roll out the red carpet for a lender that is willing to make a new loan to the debtor."[107] Skeel, Baird and Rasmussen agree that the DIP contract characteristically specifies the fate of every asset and every division in the company, completely transferring control to

[103] *Id.* at 696.

[104] *See* Baird & Rasmussen, *End of Bankruptcy, supra* note 7, at 782.

[105] Douglas G. Baird & Robert K. Rasmussen, *Controlling the Agents of Enterprise* (Oct. 2002) (unpublished manuscript on file with author) [hereinafter Baird & Rasmussen, *Agents of Enterprise*].

[106] *Id.*

[107] David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 924 (2003).

the post-petition lender. Harvey Miller agrees: "Increasingly sophisticated DIP lenders are succeeding in subjecting all the company's assets to liens and security interests at the very start of a filing, when the debtor is in its most fragile state."[108] As Baird and Rasmussen explain, once the DIP is in place, the debtor's Board of Directors and management have lost the ability to make decisions against the wishes of their DIP lenders.[109] Often, the DIP covenants require certain assets to be sold, certain financial milestones to be met, and the reorganization plan to be completed by a certain date. Skeel acknowledges, "it is not an overstatement to say that the terms of the debtor's post-petition financing regularly set the course, and even the outcome, of the Chapter 11 case."[110]

Critics of the Chapter 11 bankruptcy process often argue that the DIP financer and secured pre-petition lender are often fully protected under their financing agreements and may thus be indifferent to the fate of the firm as a whole. Residual actor theorists argue that creditor control in Chapter 11 may even encourage the pursuit of negative net-present-value strategies as long as these strategies create sufficient cash flow to permit senior claims to be accommodated. Baird and Rasmussen's most important argument is that this process of shifting control to senior lenders is economically efficient; as long as control rights are sensibly allocated, control will always rest with those best able to make strategic decisions with the firm's best interests in mind.[111] Baird and Rasmussen never explicitly say that modern "dynamic contracting" by senior creditors has eliminated the residual actor problem in Chapter 11 proceedings, but their discussion of the incentives of senior creditors suggests as much. Because large creditors have so much at stake, they are said to have ample incentive to

[108] Cheryl Meyer, *Provell Declares Bankruptcy*, DAILY DEAL, May 11, 2002.

[109] Baird & Rasmussen, *End of Bankruptcy*, *supra* note 7, at 785.

[110] Skeel, *supra* note 107, at 927.

[111] Baird & Rasmussen, *End of Bankruptcy*, *supra* note 7, at 778.

revitalize the debtor as a going concern. Baird and Rasmussen conclude that better incentives create a better outcome: as senior creditors seek to maximize the firm value, all of the debtor's claimants are better off, including junior bondholders and even equity.[112]

In this manner, Baird and Rasmussen describe a process that largely solves the classic residual actor problem—the economic efficiency problem—of Chapter 11 bankruptcy proceedings. Baird and Rasmussen maintain that in the process of obtaining total control over strategic and tactical firm decisions, senior creditors also begin to act like equity owners in that they seek to maximize total firm value through efficiency improvements.[113] With their power solidified over both strategic and tactical decisions, and with their debt capital providing essentially all of the bankrupt firm's financing, senior creditors are said to be adequately incentivized to maximize the total value of the firm, rather than just enough value to repay fixed obligations.[114] As Baird explains, "remember, if you lend a little money to someone, you're a creditor. If you lend a lot of money to someone, you're a partner."[115]

While Baird and Rasmussen's thesis has great logical appeal, it does not fully describe the realities of modern bankruptcy proceedings. Contracting appearances can be deceptive; recent capital market innovations enable large senior creditors to "lend a lot of money" without incurring a

[112] Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

[113] *See* Baird & Rasmussen, *End of Bankruptcy*, *supra* note 7, at 784-85; *see also* Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

[114] Douglas G. Baird & Martin Bienenstock, *Panel 5: Debtor-In Possession Financing (Pre-Petition & Lock-up Agreements)* 1 DEPAUL BUS. & COMM. L.J. 589, 592 (2003). Empirical research adds credence to Baird and Rasmussen's efficiency argument. Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 270-76 (2003) examined Chapter 11 cases between 1988-1997, finding DIP financed firms more likely to emerge successfully from bankruptcy, and that their time spent in the reorganization period is shorter than that of the non-DIP financed firms.

[115] *See* Baird & Bienenstock, *supra* note 114, at 592.

lot of financial risk. Although consortiums of large banks may indeed be the first to originate substantial commercial loans for financially distressed companies, they are seldom doing so in a manner that establishes a long-term or "partnering" relationship with the creditor. Instead, senior debtors typically off-load these loans to others through syndications, collateralized loan obligations (CLOs), and collaterized bond obligations (CBOs), often leaving them with "little money" in true credit exposure.[116] In addition, commercial banks have reduced their default-risk exposure by buying credit insurance in the form of credit default swaps, which effectively transfer credit risk and, hence, the incentive to "partner" to default swap sellers. And finally, much of what commercial banks contract to loan in post-petition DIP financing is in the form of contingent or revolving credit loans, which are typically more cosmetic than real, and seldom confer enterprise control because debtors seldom tap them anywhere close to stated capacity. In short, Baird and Rasmussen wrongly focus their research on initial contractual relationships with large commercial banks rather than eventual economic realities with distressed debt investors. Although they proclaim the importance of dynamic contracting in bankruptcy proceedings, Baird and Rasmussen largely neglect second-order contracting dynamics that enable activist-minded distressed debt investors to have more "skin in the game" than senior commercial bank creditors. Over the last twenty years, commercial banks have increasingly de-emphasized the "classic" creditor-debtor relationship and built a "modern" service-oriented and less-risky relationship in which bank income depends more on fees for services provided and less on interest for credit extended. The principal dynamic of modern large corporate bankruptcy proceedings is the transfer of claims and financial risks from the hands of short-term oriented financial institutions to

[116] Baird and Rasmussen also fail to point out that the revolving credit facilities themselves are widely syndicated, at times to more than 100 financial institutions.

long-term, operations-minded third-party investors. This transfer has created a new class of residual actors—distressed debt funds—that are sufficiently motivated and positioned to re-establish long-run profit maximization as the principal goal of firms being reorganized under Chapter 11 proceedings.

A. Revolving Credit Facilities

Baird and Rasmussen err by using Warnaco as the prototypical example of how a company facing bankruptcy is likely to refinance. As Warnaco became distressed, it consolidated 97% of its debt into a $1.7 billion secured revolving credit facility—precisely the kind of pre-petition financing vehicle that Baird and Rasmussen describe as modern "dynamic contracting."[117] A few commercial banks accounted for the bulk of debt in this revolving credit facility: JP Morgan, Citigroup, Société Générale, Bank of Nova Scotia, and Commerzbank AG.[118] Since Warnaco was clearly insolvent, and because 97% of its debt was consolidated in its revolving credit facility, these pre-petition secured claims were "under water." Any loss in Warnaco's firm value produced a loss for these creditors; likewise, marginal gains redounded equally to the creditors.[119] For the leading commercial lenders, therefore, there was little practical difference between their own economic prospects and Warnaco's total market value, and there was much reason to pursue enterprise strategies that would maximize this total market value. As Baird and Rasmussen point out, these commercial banking lenders had so much at stake that they had become Warnaco's "partner" in essence, if not in name.

Warnaco turns out to be a significant exception to prevalent patterns in pre-petition U.S. debt financings. Data

[117] Warnaco Group, 2002 10-K (July 31, 2002).

[118] *Id.*

[119] Of course, the revolving credit facility creditors' gains were capped by the par value of their claims. Had Warnaco gone through a remarkable operating turnaround in Chapter 11, stockholders might have shared in the gains.

from the twenty largest bankruptcy filings of both 2001 and 2002 reveal that Warnaco's capital structure was far from the norm. Warnaco had 97% of its pre-petition debt in secured revolving credit; the weighted average for the 20 largest 2001-2002 filings was only 16.8%. As shown in the table below, in three cases, the debtor did not have any pre-petition revolving credit. For most of the companies listed, the majority of their pre-petition debt was held in publicly tradable notes; instead of being concentrated in the hands of a few commercial lending "partners," it was widely dispersed among thousands of largely anonymous institutional and private investors. For instance, 100% of Adelphia Communications', 98% of United Airlines', 97% of Metromedia International's, 95% of ANC Rental's, 88% of Exodus Communications', and 83% of XO Communications' pre-petition debt was in the form of underwritten notes and bonds.

Table 3: REVOLVING CREDIT FACILITY DEBT 2001-2002[120]

($ in millions)

Company	Credit Facility Debt	Total Debt	Credit Facility as % of Total
Enron	$3,336	$16,855	20.0%
Comdisco	$1,068	$5,059	21.1%
ANC Rental	$40	$4,260	0.9%
Bethlehem Steel	$354	$1,174	30.1%
Exodus Communications	$224	$2,841	7.9%
Winstar Communications	$697	$2,330	29.9%
Hayes Lemmerz International	$808	$1,708	47.3%
PSInet	$0	$3,700	0.0%
Finova Group	$4,691	$10,998	42.7%
Worldcom	$2,650	$36,000	7.4%
Conseco	$2,001	$6,616	30.2%
Global Crossing	$2,211	$6,641	33.3%
United Air Lines	$133	$8,032	1.7%
Adelphia Communications	$0	$14,850	0.0%
NTL Inc.	$4,195	$14,206	29.5%
Kmart Corp.	$1,069	$3,348	31.9%
US Airways Group	$369	$3,218	11.5%
XO Communications	$1,000	$6,008	16.6%
Metromedia International	$0	$217	0.0%
WilTel Communications Group	$1,011	$5,911	17.1%
Weighted Average	$25,887	$153,972	16.8%
Warnaco Group	*$1,777*	*$1,839*	*96.6%*

Furthermore, when debt is consolidated in a revolving credit facility, it is almost always syndicated, with one "agent" bank creditor typically leading restructuring

[120] List of largest bankruptcies compiled from Lynn LoPucki's Bankruptcy Database, *available at* http://lopucki.law.ucla.edu. Financial information from: Enron 10-Q (Sept. 30, 2001), Comdisco 10-K (Sept. 30, 2001), ANC Rental 10-K (Dec. 31, 2001), Bethlehem Steel 10-K (Dec. 30, 2001), Exodus Communications 10-K (Dec. 31, 2001), Winstar Communications 8-K (Nov. 7, 2000), Hayes Lemmerz International 10-K (Jan. 31, 2001), PSInet 10-K (Dec. 31, 2000), Finova Group 10-K (Dec. 31, 2000), Conseco 10-K (Dec. 31, 2001), Global Crossing 10-K (Dec. 31, 2002), United Air Lines 10-K (Dec. 31, 2001), Adelphia Communications 10-Q (Sept. 30, 2001), NTL, Inc., 10-K/A (Dec. 31, 2002), Kmart 10-K (Jan. 31, 2002), US Airways Group 10-K (Dec. 31, 2002), XO Communications 10-K (Dec. 31, 2001), Metromedia International 10-K (Dec. 31, 2002); WilTel Communications Group 10-K/A (Dec. 31, 2002), Warnaco Group 10-K (Jan. 5, 2002), Chris Nolter, *Creditors Soon to Meet With Worldcom*, DAILY DEAL, Aug. 3, 2002.

negotiations for about ten to twenty syndicates. In most cases, the "agent" creditor will account for a relatively small amount of the total debt: approximately 10% is typical.[121] Since 10% is hardly a compelling "partnership" share, there is a natural inclination for the creditor with negotiating power to think more about recovering its own relatively limited fixed claim than maximizing total firm value. Even in the Warnaco example, in which the revolving credit facility represented claims totaling close to total firm value, the agent who represents this facility is likely to have a much narrower perspective.

In decades past, it was more common to have revolving credit facilities with only a few principal lenders. Today, preferring the reduced risks and servicing fees of syndicated loan agreements or public debt underwriting, banks often refuse to take such a significant stake in an individual debtor. The world of commercial banking has changed, and Baird and Rasmussen's analysis does not account for this change. Baird and Rasmussen see the commercial banking environment as it might have been years ago. Gregory Schweb, partner at Loeb & Loeb LLP, explains that, in the past "the same banker who put the loan out did the workout," and when debtors ran into trouble, the banks, riding out the downturn while paying careful attention to the debtor's operations, would keep the loans on their books.[122] Harvey Miller adds that lenders tended to negotiate in unison; while the largest lender might syndicate the debtor's credit facility, it would continue to hold sway over the entire syndicate.[123] Miller believes that, "relationship banking is dead. . . . [D]ebt has become a commodity and it has created an entirely different environment."[124] Moreover, as banks expose themselves less to the risk of direct commercial lending, there is reduced reason to demand onerous contract

[121] Interview with Bankruptcy Partner at Major New York Corporate Law Firm, at Columbia Law School in New York, N.Y. (Apr. 7, 2004).

[122] Morris, *supra* note 37.

[123] *Id.*

[124] Interview with Harvey Miller, *supra* note 58.

covenants. As one hedge fund manager put it, "If anything, there are less strict covenants in today's bank loans [than there were a decade ago]. .There's less security, little margin, and no banks want to hold onto their loans."[125]

Twenty years ago, financial institutions were usually judged and ranked according to "asset base," measured by the amount of commercial loans on their balance sheets.[126] Today, "return on capital" and other profitability ratios have become the principal metrics of success,[127] and so-called "[b]alance sheet obesity" has given way to the art of removing risk from the balance sheet.[128] Many experts cite the sovereign debt crisis of 1982, involving Mexico and several other developing countries, as a major shifting point in commercial banking strategy. The efforts of regulators to reassess the adequacy of capital reserves led to the Basle Concordat of 1983, which created minimum capital requirements at eight percent of risk-weighted assets.[129] In response, banks began to focus more on removing from their balance sheets heavily weighted risks, such as commercial loans, and thereby freed up capital for more profitable reinvestment. Loan origination became less of an effort to establish a long-term lending relationship with clients and more of an effort to earn a steady stream of servicing fees by syndicating or monetizing the loan. Most banks have found that it is more profitable to get fees from arranging a loan than from collecting interest.[130] Raymond Minella, a senior partner at Berenson Minella, sums up the situation thus: "[commercial banks] really have an eye when they originate

[125] Telephone Interview with Founder of Distressed Debt Investing Hedge Fund (Mar. 31, 2004).

[126] Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP & INT'L L. 541 (2002).

[127] *Id.* at 545.

[128] *Id.* at 542.

[129] *Id.* at 544.

[130] Morris, *supra* note 37.

the loan on how you get out the back door rather than on what you put on your books."[131]

The wave of consolidation between commercial and investment banks in the 1990's has elevated the importance of servicing fees and related capital-market servicing capabilities over the prior focus on loan portfolios.[132] Some commentators explain that banks increasingly analyze their relationship with a debtor based on their "return on relationship"—in which the relationship is judged primarily on the bank's return from servicing fees, rather than direct interest payments on loans.[133] But the "supply-push" of changing profitability considerations has been paralleled by the "demand-pull" of altered customer preferences. According to numerous commentators, institutional investors are eagerly buying what banks increasingly wish to sell.[134] Risk-averse institutional investors often prefer commercial bank loans, which tend to involve extensive covenants, but are relatively easy to amend, to bond instruments, which often feature more permissive covenants and are rarely restructured outside of a bankruptcy process.[135] The 2003 bankruptcy of energy company NRG provides a case in point. NRG's debt had been so widely syndicated that there were 105 different banks involved in the talks, and the largest stake in bank debt was actually held by distressed debt investor MatlinPatterson who had purchased the claims in the secondary market.[136] Veteran San Francisco bankruptcy lawyer Pat Murphy remembers the "good old days" in the 1980's when banks and insurance companies would keep their commercial loans on their balance sheets. Today, when a company gets in trouble, debtors rarely see the familiar

[131] *Id.*

[132] Stephen A. Lumpkin, *The Integration of the Corporate Bond and Commercial Loan Markets*, FIN. MKT. TRENDS, Oct. 1, 2003, at 51.

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] Soma Biswas, *NRG Energy May Seek Prepack*, DAILY DEAL, Mar. 27, 2003.

faces of commercial lenders across the table; instead, with most of their debt syndicated, anonymous institutional investors, and especially distressed debt investors, are the most common sight.[137]

B. Bank Loan Syndication

In the former world of relationship banking, commercial banks feared that syndicating bank loans would jeopardize their long-term relationships with debtors. The syndication of a loan was seen as an indication that the bank believed the debtor to be a risk.[138] Today, syndication of bank loans is the norm, accounting for just over half of all new corporate financings.[139] Recent data from *International Finance Review* placed the number of 2002 syndicated loans in the United States at 2,756, with a face value of $969 billion, versus only $137 billion in 1987.[140]

The syndication agreement between the lead bank and the syndicate is often structured as an "assignment," providing the purchaser of the loan with the rights to payments but not providing the purchaser with a direct claim on the borrower's assets.[141] The lead bank/arranger of the syndication will then continue to structure and manage the banking relationship, even though the bank will have far less financial risk at stake.[142] In situations where the debtor is highly leveraged or distressed, it is even more likely that the loans will be widely syndicated as debtors tend to have far less leverage to prevent assignment or refuse to waive assignment fees.[143]

[137] Morris, *supra* note 37.

[138] Lumpkin, *supra* note 132, at 51.

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.*

C. Credit Default Swaps

Credit default swaps are a method by which a bank or an investor who buys a syndicated loan or bond may reduce default-risk exposure by buying credit insurance for the debt.[144] The seller of the insurance is usually an insurance company or hedge fund that guarantees against a "negative credit event" such as default or bankruptcy.[145] Credit default swaps are traded on an annual payment basis. For instance, if a credit default swap is traded at five percent it means that the seller of the insurance must be paid five percent of the insured debt's face value each year in order to provide insurance against default.[146] Once a "credit event" occurs—usually meaning a default—the parties to the swap will enter into their pre-arranged "cash" or "physical" settlement. Most credit default swaps have "physically settled arrangements," meaning that the underlying debt will be transferred from the buyer of the swap to the seller of the swap, in exchange for a payment equal to the par value of the debt.[147] When a credit swap is a "cash" settlement, there is a prescribed valuation to determine the "market price" (recovery price) for the underlying loan. Once the price is determined, the seller of the insurance will pay the commercial bank the difference between the par value of the loan and the new market price.[148]

Credit default swaps are particularly popular for the type of lender Baird and Rasmussen cite as having so much control in modern bankruptcies—banks who have lent to "relationship clients," whom they are reluctant to offend by

[144] Charles Batchelor, *Credit Default Swaps Take Off*, FIN. TIMES, Sept. 30, 2003, at 49.

[145] *Id.*

[146] *See Gone too Far? The Dangers of Credit-Risk Transfer*, ECONOMIST, Aug. 16, 2003.

[147] Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, COLUM. BUS. L. REV. 677, 708-09 (2002).

[148] E-mail from Managing Director, Fitch Credit Ratings, to author, (Feb. 25, 2004) (on file with author).

selling their exposure in primary markets.[149] "Default swaps allow banks to hedge their risk without the client being any wiser."[150] Swaps allow a bank to originate more loans, and to keep the loans on its balance sheets, even though the credit risk and actual "ownership" of the loans have largely been shifted to third party default swap sellers.[151] According to the International Swaps and Derivatives Association Market Survey, the value of credit default swaps outstanding has gone from $631 billion in the first half of 2001, to $2.7 trillion in the first half of 2003. Indeed, the credit default swap market has doubled in size, on average, every year since 1997.[152] For 2003, the global commercial banking industry as a whole used credit derivatives to reduce the risk of their commercial bank loans by a "net" $229 billion. The "gross" amount of risk transferred off of bank balance sheets was $1.34 trillion. However, the vast bulk of it was from one commercial bank to another; and hence the net amount of risk reduction for the banking industry as a whole was far smaller. Moreover, sixty-three percent of the "gross" sold position was attributable to ten international commercial banks: JP Morgan, Merrill Lynch, Deutsche Bank, Morgan Stanley, CSFB, Goldman Sachs, UBS, Lehman Brothers, Citigroup and Commerzbank.[153]

During JP Morgan's fourth quarter 2003 earnings conference call, the company offered one example of how banks have used these financial instruments to reduce their bank loan risk. Since the end of 2001, JP Morgan reported that its total commercial credit exposure declined by $60 billion, with the addition of $35 billion in single name (single company) credit default swaps. Morgan has also sold into

[149] Batchelor, *supra* note 144.

[150] *Id.*

[151] Hilary Rosenberg, *Compromising Positions*, CFO MAG., Sept. 1, 2003.

[152] *See* Dave Watts, *Editor's Letter*, CREDIT, Apr. 1, 2003, *at* http://db.riskwaters.com/public/showPage.html?page=11369.

[153] *Global Credit Derivatives: A Qualified Success*, FITCH RATINGS, Sept. 24, 2003, at 6 (on file with author).

secondary markets what it calls "higher risk loans and commitments" and is actively reducing its "single name concentration."[154]

Credit default swaps enabled commercial banks to weather the 2001-2002 onslaught of corporate defaults by greatly reducing their credit exposure.[155] In stark contrast to Baird and Rasmussen, Charles Batchelor of the *Financial Times* worries that, with so little financial risk at stake, banks are likely to neglect the operational concerns of debtors and be far less rigorous in their initial assessments of a borrower's financial wherewithal.[156] Ian Powell, head of business recovery services at PriceWaterhouseCoopers, explains that what you end up having in some situations is, "a creditor with [£100 million] at stake who is relaxed about what happens [in financial restructuring] because he has laid off all his debt exposure through credit derivatives..."[157] Ruth Trougott, managing director and head of restructuring at JP Morgan, understands that credit derivatives "may change a bank's behavior because it feels it has less skin in the game."[158]

The *Wall Street Journal* reported in 2003 that Mirant Corp.'s commercial banking lenders (especially Citigroup) may have been unwilling to restructure the company's debt out of bankruptcy court because they had insured most of their liability on the credit default market.[159] The *Journal* estimated that commercial lenders purchased between $500-600 million of protection against Mirant's default and concluded that :

[154] JP Morgan 2003 Fourth Quarter Earnings Conference Call (Jan. 24, 2004).

[155] Bill Shepherd, *Behind the Mask: The Booming Credit Derivatives Market Harbors Unseen Risks*, INV. DEALERS' DIG., June 9, 2003.

[156] Batchelor, *supra* note 144.

[157] Charles Batchelor, *Credit Default Swaps Join Booming Derivatives Line-Up*, FIN. TIMES, Feb. 11, 2004, at 44.

[158] Geraldine Lambe, *Investment Banking: Complexity Muddies Restructuring Process*, BANKER, May 1, 2003.

[159] *See* Henry Sender, *Mirant Reveals New Reality for Lenders to Ailing Firms,* WALL ST. J., Feb. 3, 2004, at C1.

> [U]p until the past few years, banks usually worked together to try and keep ailing companies from collapsing into bankruptcy in order to protect their own interests . . . but new financial markets, especially markets that provide lenders with 'insurance' against loan defaults, have created a world where banks no longer find themselves holding common interests.[160]

D. Collateralized Debt/Loan Obligations

After credit default swaps, the fastest growing credit derivatives are portfolio securitizations, CLOs and CBOs. CLOs emerged into the global capital markets in 1996 when National Westminster Bank sponsored a $5 billion CLO security.[161] CLOs enable banks to sell large portfolios of commercial loans, or the credit risk associated with such loans, directly into the international capital markets. In a CLO structure, a "sponsor" commercial bank transfers (often through a sale) a portion of its multi-corporation loan portfolio to a special purpose vehicle ("SPV"), which, in turn, issues CLO securities to the capital markets that are backed by its diversified collection of bank loans. These CLO securities usually consist of one of more classes ("tranches") of rated debt securities, typically having different interest

[160] *See id.* It should be noted that credit derivatives swaps have been primarily provided for the debt of companies with "investment grade" credit. While a market for credit default swaps in non-investment grade loans is developing, the bulk of these contracts are still made on investment grade loans. That said, over the past few years, there has been a dramatic rise of "fallen angel" bankruptcies of companies that once had investment grade debt. In 2002, $55 billion of the $163 billion of defaulted corporate bonds was in investment grade firms. Lambe, *supra* note 158. It is likely that there were significant credit default swap contracts written for these companies. One principal at a distressed investment firm told me that he expects the further development of the credit default market to "revolutionize" the way that commercial bank credit risk is treated.

[161] Kenneth Kohler, *Collateralized Loan Obligations: A Powerful New Portfolio Management Tool For Banks* (1998), *at* http://www.mayerbrownrowe.com/cdo/news/newport.asp.

rates and credit ratings.[162] They are normally purchased by a wide variety of financial institutions, pension funds, and individual investors. A portfolio manager, often a bank employee, is appointed to service and manage the loans on behalf of the SPV.[163]

CLOs have several advantages. By using CLOs to remove higher-risk commercial loans from their balance sheets, commercial banks can lower their Basel Accord capital requirements, and use the freed-up capital for new investments.[164] This alternative investment income, plus the fees earned from managing the CLOs, is expected to more than offset the interest income lost from the offloading of loans, thereby boosting net bank income, on average. In addition, CLOs are less likely to damage customer relationships than syndications. Often, the debtor does not even know that the loan has been transferred to a CLO.[165]

In the 2002 Survey of Credit Portfolio Management Practices, encompassing 41 leading financial institutions, more than two thirds of respondents indicated that they had issued a CLO to transfer credit risk from the institution.[166] CSFB and Merrill Lynch recently estimated that CLOs represent between 13.5% to 25% of the bank debt market.[167] It is to be expected, therefore, that CLOs are a part of modern bankruptcy filings. When Worldcom filed for bankruptcy, for example, $211 million of its debt was

[162] *Id.* (the most common tranche formula is a "waterfall" structure in which the junior level securities—often called the "equity"—will absorb the first losses from any credit defaults on the underlying debt. Once the equity level is "insolvent," the next lowest seniority level will suffer credit default losses until the highest rated "senior" level CLO security is reached. The CLO securities' interest rates will be priced according to their seniority and the credit ratings of the underlying securities).

[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] Charles Smithson, et al., *2002 Survey of Credit Portfolio Management Practices* (2002), *available at* http://www.isda.org/c_and_a/pdf/2002-cpm-survey.pdf.

[167] Morris, *supra* note 37.

controlled by such vehicles. Likewise, CLOs accounted for an estimated $135 million worth of Enron's debt upon its filing; $90 million of Cŏmdisco debt, and $84 million of NRG debt.[168]

The use of CLOs has also made it easier for this debt to end up in the hands of distressed investors. Often, the CLOs face severe contractual restrictions with the purchasers of their securities, and when loans go bad, the CLO manager is forced to sell the debt, establishing its recovery value.[169] Many CLO funds are also leveraged and need cash-generating securities to cover their own interest obligations. If there is a credit default, and interest payments are no longer forthcoming, the CLO manager may be forced to immediately sell the underlying debt to obtain the needed liquidity to satisfy its own obligations.[170] Many CDO and CLO funds are contractually forbidden to hold equity shares, which means that they can't agree to debt-for-equity swaps.[171] It follows that, when companies get into trouble, even before bankruptcy proceedings begin, CLO funds are usually eagerly selling the underlying debt of these companies to equally-eager distressed debt investors in what appears to be a win-win situation for both parties.[172]

E. DIP Financing

Baird and Rasmussen consider DIP lending to be the last phase in the "dynamic contracting" that shifts enterprise control from the debtor to the senior commercial creditors.[173] Using Warnaco as the compelling example of this shift, Baird and Rasmussen emphasize how Warnaco had to turn to its pre-petition lenders—JP Morgan, Bank of Nova Scotia and

[168] *Credit Events in Global Synthetic CDOs: 2000-2003*, FITCH RATINGS, May 12, 2003. (It should be noted that these CLO figures represent a very small percent of the debtor's total pre-petition claims).

[169] Morris, *supra* note 37.

[170] *Id.*

[171] *Id.*

[172] *Id.*

[173] Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

Citigroup—for DIP lending due to a dearth of alternatives.[174] Baird and Rasmussen use the Warnaco DIP (along with United Airlines' DIP) as their primary examples of the immense control that the DIP lenders wield. Warnaco's DIP lenders were able to create and appoint a corporate Chief Restructuring Officer "CRO" who was later appointed as the company's CEO. The DIP covenants included requirements for: 1) $200 million in asset sales in the first ninety days, 2) an additional $275 million in asset sales in the first six months, and 3) the filing of a reorganization plan within six months.[175] Warnaco's DIP lenders even gained the power of attorney over the company.[176] When Warnaco emerged from bankruptcy, its bank lenders got ninety-six percent of its new equity, $104 million in cash, and $200 million in new bonds. Common shareholders of the pre-petition company were completely wiped out.[177]

The Warnaco example demonstrates the power that the DIP lenders can wield. As Baird and Rasmussen point out, DIP covenants are typically extensive and strict, and if a debtor is forced to rely heavily on the DIP loan (by drawing down a significant percent of the facility), these covenants may shift significant control to the originators of these facilities. But again, Baird and Rasmussen focus their attention too much on the contract itself, rather than the owners of the debt. By focusing on the contract, Baird and Rasmussen fail to point out that in most cases, DIP financing is provided for "cosmetic" purposes; it is rarely drawn down completely, and it is usually as attractive to creditors as it is to debtors. After filing for bankruptcy, debtors characteristically rely on DIP financing as part of their "first day orders" to reassure suppliers and customers that their enterprise is not about to go out of business by demonstrating that there is ample credit available to pay for goods and services.

[174] *Id.*

[175] *Id.*

[176] *Id.*

[177] Soma Biswas, *Warnaco Set to Emerge*, DAILY DEAL, Jan. 17, 2003.

James Connolly, President and CEO of DIP financer Fleet Capital Corporation, explains: "just as important as cash is confidence. Many suppliers get nervous when they hear a company is filing Chapter 11 because they mistake a reorganization for a liquidation . . . a key value of DIP financing is to reassure trade creditors and keep goods and services coming."[178] Robert S. Rosenberg, a partner at Latham and Watkins in New York, similarly describes DIP as serving a "public relations function. . . . The DIP has become an announcement to the world that the debtor is here to stay and that it's safe to do business with it."[179]

Debtors seem willing to accept hefty fees and interest rates in order to gain this security. In Comdisco's DIP press release, following its 2001 bankruptcy, its CEO explained the value of its $450 million DIP package, for which it paid a $9 million fee, even though it never drew down a penny of the credit made available:

> The final approval granted to Comdisco by the court for $450 million in DIP financing, along with significant cash reserves, should give all of our customers, employees and business partners added reassurance that we have sufficient financial resources to continue to run our businesses as usual and meet our commitments without disruptions.[180]

Martin Bienenstock, a partner in Weil Gotshal's bankruptcy practice, explains why agreeing to DIP financing in the first-day hearing is so important: "Frequently you have to, because you have to assure the public—the people that you do business with—that you have financing, otherwise you can't do business the next day."[181] There's also

[178] James G. Connolly, *DIP Financing: New Life for Ailing Companies*, FIN. EXECUTIVE, May 1, 2003, at 33.

[179] Anthony Baldo, *Hard Times for Those Needing DIP Financing*, DAILY DEAL, July 6, 2001.

[180] Press Release, Comdisco, Comdisco Receives Court Approval of Debtor-In-Possession (DIP) Financing (Aug. 24, 2001), *available at* http://www.comdisco.com/press_release.asp?pressreleaseid=42.

[181] *See* Baird & Bienenstock, *supra* note 114.

an element of "capital, markets discipline" in the DIP agreements and the covenants attached to it. It's an assurance to suppliers, customers, and even other creditors that the debtor will be careful with its money, and that it has an experienced DIP financier to oversee its operations and financial wherewithal.[182]

Given these cosmetic objectives, the debtor seldom taps DIP financing anywhere close to capacity. Indeed, if the debtor actually needed the money, it might not be able to get it. In almost every major Chapter 11 bankruptcy, the firm needs to demonstrate positive operating cash flow before senior creditors are willing to extend DIP financing. In theory, most companies in Chapter 11 should be cash flow positive once they are allowed to suspend their interest payments.[183] Therefore, there is often plenty of cash to pay the DIP interest and still maintain a cash cushion. The credit quality of DIP borrowers is often better than many of their solvent competitors; some will even have investment grade credit ratings.[184] In fact, there is only one major DIP loan that has ever gone bad—Winstar's 2001 DIP in which the lender underestimated the eventual collapse of the telecom market.[185]

Since bankrupt companies get DIP financing when they don't need it, it follows that they seldom use it.[186] The financial reports of the top thirty bankrupt debtors (who

[182] *See id.*

[183] The basis for this assumption is that Chapter 11 is supposed to preserve the going-concern value of financially distressed companies. If a company were economically distressed—unable to generate cash flow on an un-leveraged basis—the company should be in Chapter 7 liquidation because it has no going-concern value. A principal at a distressed investment fund also pointed out that "most" bankrupt companies that restructure Chapter 11 are cash flow positive (post-petition). Telephone interview, *supra* note 77.

[184] Robert Manor, *Lending to Bankrupt Firms is Not as Crazy as it Sounds*, ORLANDO SENTINEL TRIB., Jan. 12, 2003, at H1.

[185] *Id.* (as this article goes to press, it appears that United Airlines' DIP may become a second).

[186] Telephone interview, *supra* note 77.

obtained post-petition financing) between 2001-2003 reveals a stark contrast between Warnaco and what is the typical minimal use of DIP financing.

Table 4: PERCENTAGE OF DIP FACILITY DRAWN DOWN 2001-2003:[187]

Debtor's Name	Year	Assets ($ in millions)	Lending Institutions (Agents)	DIP Amount	Amount Drawn	% Drawn
Worldcom	2002	$102,183	Citigroup, JP Morgan, GE Capital	Originally $2 billion, subsequently reduced to $1.1billion	Nominal, immediately repaid	0%

[187] Top thirty bankruptcies between 2001-2003 based on asset size and found on Lynn LoPucki's Bankruptcy Database, *at* http://lopucki.law.ucla.edu. For the largest 2003 bankruptcies, the database on bankrupt.com was used. Financial information found in Jonathan Berke, *DIP Dimensions: WorldCom Inc.*, DAILY DEAL, July 25, 2002; Jonathan Berke, *GE Capital is MIA in United's DIP*, DAILY DEAL, Dec. 11, 2002; UAL Corp. Form 10-Q, filed Oct. 30, 2003; Adelphia Comm. Corp. Form 8-K, filed Oct. 27, 2003; Mirant Corp. Form 10-Q, filed Dec. 22, 2003; NTL Inc. Form 10-Q, filed Nov. 14, 2003; Kmart Holding Corp. Form 10-Q, filed Dec. 5, 2003; Kmart Corp. Form 10-K, filed Mar. 24, 2003; NRG Energy Inc. Form 10-Q, filed Nov. 13, 2003; Federal-Mogul Corp. Form 10-Q, filed Nov. 5, 2003; Comdisco Holding Co. Inc. Form 10-K, filed Dec. 23, 2003; Bethlehem Steel Corp. Form 10-K, filed Feb. 4, 2002; Budget Group Inc. Form 10-Q, filed Nov. 14, 2002; Exds Inc. Form 8-K, filed May 3, 2002; Amerco Form 10-Q, filed Nov. 14, 2003; Fleming Companies Inc. Form 8-K, filed Dec. 15, 2003; Solutia Inc. Form 10-K, filed Mar. 15, 2004; Jonathan Berke, *DIP Dimensions: Solutia Inc.*, DAILY DEAL, Feb. 12, 2004; Jonathan Berke, *Solutia Rounds Up New DIP*, DAILY DEAL, Jan. 21, 2004; Sunbeam Corp. Form 10-Q, filed Nov. 19, 2001; Robert Manor, *Lending to Bankrupt Firms is not as Crazy as it Sounds*, ORLANDO SENTINEL TRIB., Jan. 12, 2003, at H1; Hayes Lemmerz International Inc. Form 10-K, filed Apr. 2, 2003; Kaiser Aluminum Corp. Form 10-Q, art. 154, filed Nov. 14, 2003; Farmland Industries Inc. Form 10-Q, filed July 15, 2003; Warnaco Group Inc. Form 10-K, filed Apr. 4, 2003; Arch Wireless Inc. Form 10-Q, art. 153, filed May 15, 2002; National Steel Corp. Form 10-K, filed Mar. 31, 2003; Jonathan Berke, *DIP Dimensions: National Steel Corp.*, DAILY DEAL, Mar. 14, 2002; Exide Technologies Form 10-Q, filed Nov. 14, 2003; Primary PDC Inc. Form 8-K, filed Jan. 17, 2003; Spiegel Inc. Forms 8-K, filed Nov. 26, 2003, and Sept. 22, 2003; NationsRent Inc. Form 10-K, art. 157, filed Mar. 31, 2003.

Enron Corp.	2001	$65,651	JP Morgan, Citigroup	$1.5 billion, later reduced to $250 million	None	0%
Conseco	2002	$60,102	Fortress Investment Group, JC Flowers & Co., Cerberus Capital Management	$125 million	$121.8 million	97%
UAL Corp.	2002	$24,668	Bank One, JP Morgan, CIT Group	$1.5 billion	$727 million	48%
Adelphia Communications	2002	$21,164	JP Morgan, Citigroup	$1.5 billion	$220 million	15%
Mirant Corp.	2003	$19,415	GE Capital	$500 million	None	0%
NTL Inc.	2002	$16,581	Angelo & Gordon, Appaloosa Investment, and Franklin Resources	$500 million	$229 million	46%
Kmart	2002	$14,832	JP Morgan Chase, Fleet Finance, GE Capital, CSFB	$2 billion	$300 million drawn in 2001, fully repaid in 2002	15%
NRG Energy	2003	$10,884	GE Capital	$250 million	None	0%
Federal-Mogul Corp.	2001	$10,220	JP Morgan	$675 million, subsequently reduced to $600 million	$310 million	46%
Comdisco Holding Co.	2001	$8,734	Citigroup, Chase Manhattan Bank, Heller Financial	$450 million	None	0%
US Airways	2002	$7,865	The Retirement System of Alabama	$500 million	$369 million	74%
Bethlehem Steel	2001	$5,449	GE Capital	$450 million	$280.7 million	62%
Budget Group Inc.	2002	$4,396	GE Capital	$100 million primary tranche	None	0%
Exodus Communications	2001	$3,868	GE Capital	$200 million	None	0%
Amerco	2003	$3,773	Wells Fargo Foothill	$300 million	None	0%
Flemming Companies	2003	$3,654	Deutsche Bank Trust, JP Morgan, Citigroup	$150 million	None	0%
Solutia Inc.	2003	$3,342	Citigroup, Citadel Investment Group, Perry Strategic Capital, Satellite Asset Management	$515 million	$425 million	83%
USG Corp.	2001	$3,198	JP Morgan	Originally $350 million, later reduced to $100 million, terminated in June 2003	None	0%
Sunbeam Corp.	2001	$3,155	Wachovia, Morgan Stanley, Bank of America	$285 million, later reduced to $160 million	$42 million	15%

Winstar Communications	2001	$3,068	Bank of New York, Salomon Smith Barney, CIBC, JP Morgan, CSFB	$175 million	$175 million	100%
Hayes Lemmerz	2001	$2,817	CIBC World Markets, Bank of America, Citigroup	$200 million	$55 million	28%
Kaiser Aluminum	2002	$2,733	Bank of America	Initial facility of $300 million, reduced to $285 million	None	0%
Farmland Industries	2002	$2,696	Deutsche Bank Trust	Originally provided with $306 million DIP facility, amount reduced under amendments twice to $72.5 million	None	0%
Encompass Services Group	2002	$2,345	Bank of America, GE Capital, JP Morgan Chase	$60 million	$24.8 million	41%
Warnaco	2001	$2,331	Citgroup, Bank of America, Bank of Nova Scotia	$600 million	$203.4 million	34%
Arch Wireless	2001	$2,306	Toronto Dominion Securities	$50 million	None	0%
National Steel Corp.	2002	$2,286	Citigroup	$450 million	$128.5 million	29%
Exide Technologies	2002	$2,264	Citigroup	$250 million	$166 million	66%

When debtors actually use DIP loans, they characteristically repay them quickly because of their high interest rates. These high rates, along with substantial up-front fees, strict covenants, and significant protection from downside risks make DIP loans a relatively attractive business. For instance, by agreeing to provide a DIP loan to WorldCom, which was never even drawn down,[188] Citigroup, JPM, and GE Capital received a $30 million arrangement fee, a $15 million closing fee, and $500,000 annual monitoring and agent fees.[189] For Enron's DIP commitment of $1.5 billion, which was also never drawn down, JP Morgan and Citigroup split $5.25 million as soon as usage was

[188] WorldCom drew down a minimal amount of the DIP in the first few weeks of its bankruptcy, immediately repaying the debt. Telephone interview with principal at restructuring firm involved with case (Nov. 12, 2003).

[189] Savita Iyer, *WorldCom Loans Come Back to Bite*, BANK LOAN REP., July 29, 2002.

granted on the first $250 million of the DIP, along with annual fees of $250,000, regardless of whether the DIP was ever drawn down.[190] Michael Druker, head of CIT Group specialty finance, says that DIP fees generally run between two to five percent of the total DIP commitment (as opposed to just the amount drawn down), and these payments are almost always upfront and in cash.[191] That said, these fees can run as high as six or seven percent. The Washington Group, for example, paid six percent upfront on its $350 million DIP led by CSFB.[192] Recently, during Mirant Corp.'s bankruptcy, GE Capital received a $1 million penalty fee from the debtor when the DIP financing was delayed for two weeks because of one investor group's objections to the DIP. Mirant had more than $1 billion in cash on its balance sheet at the time of filing, but felt that its suppliers would react favorably and its trading partners would feel more secure if it acquired an extra $500 million of DIP as a "backstop" for energy trading operations.[193] Adelphia Communications paid its upfront DIP fee before the loan was even approved, and without approval being a contingency.[194]

The table below provides the DIP fees (where available) of the top thirty debtors with DIP loans between 2001-2003. These fees are often upfront, cash payments before the DIP is even approved by the court, and without a dollar ever needing to be drawn down.

[190] Jonathan Berke, *DIP Dimensions: Kmart Corp.*, DAILY DEAL, Jan. 31, 2002.

[191] Baldo, *supra* note 179.

[192] *Id.*

[193] Jonathan Berke, *GE Capital Gets Fee to Delay Mirant DIP*, DAILY DEAL, Oct. 2, 2003.

[194] Berke, *supra* note 190.

Table 5: DIP LENDING FEES: 2001-2003[195]

Debtor's Name	Year	Assets ($ in millions)	Interest Rate	Banking Fees
Worldcom	2002	$102,183	Libor + 350 basis points	Letter of credit fee of 3.5%, $30 million arrangement fee, $250,000 agent fee, $250,000 collateral fee, unused commitment fee of between 0.25% and 1%
Enron Corp.	2001	$65,651	Libor + 350 basis points	Banks received $5.25 million each (1%) as soon as DIP was granted, regardless of if it was ever used. Additionally, banks receive $500,000 administration fee whether or not DIP is used
Conseco	2002	$60,102	Minimum 10% rate	Commitment fees of up to $3.75 million, service fee of $50,000 per month
UAL Corp.	2002	$24,668	Libor + 450 basis points	The DIP syndicate shares between $4 million and $8 million upfront fees on the primary DIP of $800 million. When UAL uses the $300 million secondary DIP, there are another $15 million in fees. Letter of credit fee of 4.5% on the primary DIP ($800 million)
Adelphia Communications Corp.	2002	$21,164	Libor + 350 basis points	$10 million in commitment fees, $1 million upfront "work fee," 2.5% underwriting fee ($37.5 million), annual administration fee to JP Morgan and Citigroup of $500,000
Mirant Corp.	2003	$19,415	Libor + 350 basis points	Issuance fee of .25% per annum, letter of credit fee of 3.5% per annum, unused portion fee of .75% per annum
NTL Inc.	2002	$16,581	11% initial rate increasing by 1% for every month in bankruptcy	In May, NTL paid commitment fee of 2% of amount committed ($10 million). Two months later, the company paid a "closing fee" of 2%, an additional $10 million. There is also an unused commitment fee of 0.5% per annum
Kmart	2002	$14,832	Libor + 350 basis points	Unused commitment fee between 1% and 0.5% per annum depending percent of DIP drawn
NRG Energy	2003	$10,884	Libor + 350 basis points	Facility fee of $900,000, unused commitment fee between 1% and 0.5% per annum
Federal-Mogul Corp.	2001	$10,220	Libor + 350 basis points	Underwriting fee of 2.25%, agency fee of $350,000 annually, undrawn commitment fee of 0.5% per annum
Comdisco Holding Co.	2001	$8,734	N/A	Arrangement and structuring fee of 2%, or $9 million, 0.5% unused line fee
US Airways	2002	$7,865	Libor + 400 basis points	N/A
Bethlehem Steel	2001	$5,449	Libor + 350 basis points	$8 million in fees from the facility
Budget Group Inc.	2002	$4,396	Average Libor + 325 basis points	Letter of credit fee up to 3.5%, unused facility fee of up to 0.75%, commitment fees of $300,000
Exodus Communications	2001	$3,868	N/A	Company paid total of $2.2 million in DIP financing fees without draw down
Amerco	2003	$3,773	Libor + 350 basis points	0.5% unused line fee per annum, 3.5% letter of credit fees, $850 / day per analyst "field examination fees"

[195] *See supra* note 187, where information was unavailable in SEC Filings, marked "N/A."

Flemming Companies	2003	$3,654	Prime + 200 basis points (represents rate on bridge DIP provided by JP Morgan)	Paid $750,000 bridge financing fee
Solutia Inc.	2003	$3,342	Term loan carries Prime + 400 basis points, Revolver carries Libor + 300 basis points	$5 million closing fee to first DIP providers (Ableco). 0.25% commitment fee
USG Corp.	2001	$3,198	Libor + 200 basis points on first $200 million drawn	N/A
Sunbeam Corp.	2001	$3,155	Libor + 350 basis points	A facility fee of 2%, commitment fee of 0.5%, letter of credit fee of 3.5%, annual administration fee of $200,000, $3 million fee in the event of default
Winstar Communications	2001	$3,068	Libor + 400 basis points	N/A
Hayes Lemmerz	2001	$2,817	Libor + 350 basis points	$5 million facility fee. Unused commitment fee of 0.75%, administrative and collateral agent fee of 0.75%. Total booked cash costs of $7.2 million for fiscal year 2002
Kaiser Aluminum	2002	$2,733	Libor + 325 basis points	Arrangement fee of $1.5 million, closing fee for all members of syndicate of $6 million. Recorded total financing costs of $12.1 million
Farmland Industries	2002	$2,696	Prime + 250 basis points	Unused commitment fee of up to 1% on $25 million "tranche A" commitment
Encompass Services Group	2002	$2,345	Libor + 340 basis points	N/A
Warnaco	2001	$2,331	Libor + 275 basis points	Commitment fee of 0.5% on first $200 million
Arch Wireless	2001	$2,306	Libor + 325 basis points on first $25 million, Libor + 400 basis points on second $25 million	$875,000 upon closing, $500,000 if more than $25 million drawn down, 0.5% fee on unused amount per year
National Steel Corp.	2002	$2,286	Libor + 350 basis points	$4.5 million in closing fees, 0.5% unused commitment fee per annum, administrative and collateral monitoring fees of $300,000 deferred fee of $550,000
Exide Technologies	2002	$2,264	Libor + 375 basis points	N/A
Polaroid Corp.	2001	$2,036	Libor + 325 basis points for first 6 months, Libor + 375 basis points subsequently	$500,000 advisory and structuring fee, $750,000 facility fee, 0.75% undrawn commitment fee per annum

DIP lending is very profitable business for commercial lenders. Interest rates range up to three hundred basis points more than traditional leveraged loans for BB and B rated companies, and interest plus fees from the loan can range from ten to twenty percent.[196] Many lenders charge exit fees, unused line fees, and monthly or quarterly monitoring fees, and the debtor is expected to pay the lenders' due diligence and documentation costs. Lenders willing to take higher risks may require warrants or other equity-type "kickers" in the reorganized firm. Any draw-downs of the DIP credit line will trigger onerous budgeting and performance requirements (e.g., EBITDA margins, minimum cash balances, etc.). The lender will generally receive a first-priority lien over all of the estate's assets. If the DIP lender is also a pre-petition secured creditor, it is not unusual for the lender, as part of a DIP loan, to ask for waivers from the debtor covering possible lender liability issues as well as preferences, fraudulent transfers or equitable subordination actions.[197] Below are some sample DIP covenants for the top thirty bankruptcies between 2001-2003.

Table 6: DIP FINANCING COVENANTS 2001-2003:[198]

Debtor's Name	Year	Assets ($ in millions)	Collateral	Covenants
Worldcom	2002	$102,183	First priority liens on all unencumbered assets, with exception of foreign subsidiaries, lien on 65% of foreign subsidiaries' voting stock	N/A
Conseco	2002	$60,102	Secured by Conseco's private-label credit card operations	N/A
UAL Corp.	2002	$24,668	Secured by first priority on all unencumbered present and future assets of the debtor and by junior liens on all other assets	DIP financing requires company to meet monthly financial requirements based on EBITDA and restricts additional capital expenditures and borrowing. $700 million of the DIP is only made available once certain financial results are met. Covenants also include substantial labor savings from employees which forced the company to impose immediate wage reductions

[196] Baldo, *supra* note 179.

[197] Connolly, *supra* note 178.

[198] *See supra* note 187, where information was unavailable in SEC Filings, marked "N/A."

Adelphia Communications	2002	$21,164	First priority liens on all unencumbered assets, priming first priority lien on all assets securing pre-petition bank debt, junior lien on all other assets	The DIP facility contains certain restrictive covenants, which include limitation on the incurrence of additional guarantees, liens and indebtedness, the sale of assets, and the funding of capital expenditures. The DIP facility also requires that the Company meet certain financial covenants, which became effective for periods beginning May 1, 2003
Mirant Corp.	2003	$19,415	Secured by substantially all the debtor's assets	Will provide updated weekly cash flows, restrictions concerning ability to merge or acquire assets, incur new debt, make changes to business objectives, and make capital expenditures. Required to maintain $50 million in liquidity at all times.
Kmart	2002	$14,832	First priority liens on all unencumbered assets. Of the net cash proceeds received from any asset sale greater than $150 million, 50% must go to reduction of indebtedness. Capital expenditures restricted, required to maintain certain level of EBITDA	Required to maintain minimum levels of EBITDA and indebtedness. Restricts capital expenditures and sale of assets.
NRG Energy	2003	$10,884	First priority liens on all unencumbered assets	Covenants restrict mergers or acquisitions, incurrence of additional debt, sale of assets and capital expenditures
Federal-Mogul Corp.	2001	$10,220	N/A	Maintain certain levels of EBITDA, limitations on capital expenditures, limitations on early retirement of debt, additional borrowings, sale of assets
US Airways	2002	$7,865	First priority liens on all unencumbered assets	Debtor must satisfy certain financial requirements including operating results, cash receipts, liquidity, and additional indebtedness
Bethlehem Steel	2001	$5,449	Senior lien on all of debtor's assets, junior lien on all inventory and other assets previously subject to a lien	N/A
Amerco	2003	$3,773	Debtor must have $40 million available cash or credit at all times, quarterly EBITDA requirements	Covenants requiring minimum level of EBITDA, limitation on capital expenditures
Fleming Companies	2003	$3,654	Secured by virtually all debtor's assets on a super priority basis	N/A
Solutia Inc.	2003	$3,342	Lien on substantially all debtor's domestic assets, and 65% of outstanding stock of certain foreign subsidiaries	DIP facility requires minimum EBITDA targets, The DIP limits the incurrence of additional debt, aggregate capital expenditures, issuance of guarantees, liens, investments, asset sales, dividends, certain payments, acquisitions, mergers, consolidations and dissolutions, change of business, and transactions with affiliates
USG Corp.	2001	$3,198	N/A	Limits capital spending to $175 million per year
Sunbeam Corp.	2001	$3,155	First liens on debtor's unencumbered property, including 100% of the stock of first-tier subsidiaries. Priming liens on all collateral securing the pre-petition credit facility. Junior liens on all property	N/A

Hayes Lemmerz	2001	$2,817	Perfected first priority lien on majority of company's assets, Junior lien on other assets	Requires compliance with monthly EBITDA tests, and limits on capital expenditures
Kaiser Aluminum	2002	$2,733	DIP lenders must approve any substantial sale of assets	Restrictions on ability to incur debt, make investments, sell assets, and make capital expenditures
Farmland Industries	2002	$2,696	First priority lien on all assets	Restrictions on incurring additional debt, making investments
Warnaco	2001	$2,331	Secured by substantially all the domestic assets of the company	Required to maintain minimum EBITDA, limited capital expenditures and incurrence of material additional indebtedness, power of attorney
Arch Wireless	2001	$2,306	Perfected first priority priming lien on all of company's assets	N/A
National Steel Corp.	2002	$2,286	Secured by lien on all of debtor's assets, required liquidity reserve of $35 million	As part of DIP facility, portion of cash account is applied to outstanding DIP amount
Exide Technologies	2002	$2,264	Senior secured by all assets	N/A
Polaroid Corp.	2001	$2,036	First priority priming lien under 364(d)(1) on all property of the debtor that is subject to priming liens	Waiver from asserting a claim under section 506(c) for any expenses incurred with the preservation of secured assets. Debtor will provide weekly use of proceeds budget. DIP availability will decrease with time.
Spiegel Inc.	2003	$1,817	Senior secured asset-based facility tied to inventory, receivables, and other collateral	Restrictions on ability to incur or create indebtedness or liens, sell assets, enter in to certain transactions
Nations Rent	2001	$1,724	Priming lien on all corporate assets	Maintain minimum EBITDA levels, spending restrictions

With a prospectively high risk-reward ratio, the DIP loan market has invited a surge of entry. Historically, asset-based lenders provided most DIP financing, but over the last fifteen years, distressed debt funds, institutional investors, hedge funds, and commercial banks have crowded into the market.[199] Cerberus Capital Management and Angelo, Gordon & Co., two of the largest distressed debt hedge funds, for example, have built their own DIP lending organizations.[200] Other hedge funds and pension funds have followed their lead. For instance, when Solutia, a herbicide products maker with over $3 billion in assets, filed for bankruptcy in late 2003, Ableco, Cerberus' DIP financing arm, provided its initial $500 million DIP. Only three weeks later, the DIP was replaced by a second DIP, led by Citigroup

[199] Connolly, *supra* note 178.

[200] Cerberus' Ableco Finance unit has consistently ranked in the top DIP lenders over the last few years. *Bankrupt DIP Lender Portfolios*, DAILY DEAL, Sept. 27, 2002.

but co-lent by major hedge funds Citadel Investment Group, Perry Strategic Capital, and Satellite Asset Management.[201] For hedge funds and institutional investors, DIP lending provides a relatively safe way to make a "fast" return on their investment.[202] "Lending institutions are falling all over each other trying to get DIP financing," says Joel Getzler, president of Getzler & Co., a restructuring firm.[203]

As competition has grown, debtors have gained significantly more leverage in this competitive process than Baird and Rasmussen indicate.[204] When Adelphia Communications filed for bankruptcy in 2002, the company is said to have been inundated with lenders pitching their DIP business.[205] Oakwood Homes' 2002 bankruptcy included a battle between Warren Buffett and Wilbur Ross (chairman of unsecured creditors) for control of the company, but just as important was the battle for control of the DIP financing. Wilbur Ross favored DIP financing of $140 million to come from GE Capital and Chicago distressed investor Citadel Investment Group. Buffett preferred financing the DIP himself, along with the help of Greenwich Capital Management.[206] Most observers consider Mirant Corp.'s choice of GE Capital for its $500 million DIP to be a "punishment" for the company's pre-petition lenders'

[201] Jonathan Berke, *Solutia Rounds Up New DIP*, DAILY DEAL, Jan. 21, 2004.

[202] Jonathan Berke, *DIP Dimensions: International Wire Co.*, DAILY DEAL, Apr. 8, 2004 (explaining why Highbridge, a $4 billion hedge fund based in New York that typically uses a convertible arbitrage investment strategy, has recently entered the DIP financing business).

[203] Heke Wipperfurth, *Lending Frenzy: Bankruptcy Financing Soars; Competitors Rush In*, CRAIN'S N.Y. BUS., June 3, 2002.

[204] Baird and Rasmussen attribute much of the DIP financer's ability to control the Chapter 11 case to the debtor's inability to obtain alternate financing. Baird & Rasmussen, *Agents of Enterprise*, *supra* note 105.

[205] Wipperfurth, *supra* note 203 (Kevin Genda, head of Ableco Finance, is quoted as saying, "It's huge . . . everyone is starting to surround it, call up the company, call up the advisers, see how they can offer them something to help them out.").

[206] Jonathan Berke, *Oakwood DIP Sparks Tug-of-war*, DAILY DEAL, Dec. 21, 2002.

unwillingness to restructure Mirant's pre-petition debt (forcing Mirant into bankruptcy). Instead of inviting its two biggest pre-petition lenders, Citigroup and CSFB, to participate in DIP financing and produce millions in upfront fees, Mirant offered the business to GE Capital.[207] When aluminum maker Ormet Corp. filed for bankruptcy in February, 2004, the firm received five different proposals for its $210 million DIP financing needs. The firm eventually chose a proposal by GE Capital and distressed debt investor MatlinPatterson over a more expensive offer from its pre-petition bank loan agent, Fleet Boston Financial.[208] DIP financing for Sun World International (fruit producer) actually led to a court-monitored DIP auction between Ableco and Black Diamond Capital, with Black Diamond eventually winning the $40 million DIP business.[209] Most recently, Mississippi Chemical went through three separate consensual DIPs, each with better terms than the previous agreement, and without the company drawing down a dollar for most of the Chapter 11 case.[210]

F. Distressed Debt Funds as DIP Lenders

The previous arguments should not be taken to imply that DIP loans never cause the type of shifts in enterprise control that Baird and Rasmussen attribute to them. When commercial lenders are unwilling to provide DIP financing, distressed investors may indeed take control of the debtor through the use of carefully constructed DIP covenants. Commercial lenders are prone to withhold DIP financing from companies with insufficient unsecuritized assets, or the inability to produce operating cash flow, absent new loans.

[207] Soma Biswas, *GE Capital to Provide Mirant DIP*, DAILY DEAL, July 17, 2003.

[208] Jonathan Berke, *DIP Dimensions: Ormet Corp.*, DAILY DEAL, Feb. 26, 2004.

[209] Jonathan Berke, *DIP Dimensions: Sun Wǒrld International*, DAILY DEAL, Mar. 20, 2003.

[210] Beard Group Distressed Investing Conference, Mississippi Chemical Round-table, The Plaza Hotel, New York, NY (Nov. 29, 2004).

In such cases, DIP financing is not "cosmetic," rather, it is essential for the debtor's survival and is often fully drawn down. Moreover, a distressed debt investor in these circumstances will structure DIP financing to maximize its ability to acquire the debtor as a going concern, or to acquire particular assets of the debtor, while at the same time increasing the costs of acquisition to other potential purchasers. For example, it is not uncommon to see a distressed investor provide the DIP as part of a stalking horse bid for the entire company. The DIP terms may state that, if the distressed investor is the successful bidder, the DIP debt may convert into equity or may be allowed to be repaid out over time post-confirmation, while if their bid is not accepted, the DIP will require 100% pay off at the effective date.[211]

For example, after filing for bankruptcy, it was commonly believed among financial critics that Arthur D. Little, a 116-year-old, Boston-based technology consulting firm, would not be able to obtain DIP financing, and would therefore have to cease operations. While DIP financing is almost always provided with a lien on hard assets, Little's only major asset was its human capital.[212] As the company's largest claims holder with $63 million in pre-petition claims, Cerberus Capital Management came forward, providing Little with $68 million in DIP financing through its Ableco unit, and at the same time making a $71 million stalking horse offer for the entire company.[213] Ableco included significant fees, timing requirements, and high interest rates on the DIP, forcing Little to proceed quickly and efficiently. When Little did get better offers in individual asset sales (the company completed asset sales to five different companies in just two

[211] That said, hedge funds and private equity funds are developing their DIP lending businesses on a pure returns basis as well. Due to the significant upfront fees and high interest rates, DIP loans may provide private equity funds with "equity-type" returns. Interview *supra* note 62.

[212] Jonathan Berke, *DIP Dimensions: Arthur D. Little, Inc.*, DAILY DEAL, Feb. 14, 2002.

[213] Jonathan Berke, *Sale of ADL Units Approved*, DAILY DEAL, Apr. 9, 2002.

months), Little used the $96.5 million it received in the sales to pay off the Cerberus DIP and its significant financing fees.[214]

When distressed investor W.L. Ross signed an agreement, subject to court approval, to buy textile maker Cone Mills Corp. out of bankruptcy, the firm also agreed to assume Cone Mills' DIP financing of approximately $40 million.[215] The same day that Carl Icahn made a stalking horse bid to acquire Philip Services out of bankruptcy, his subsidiary, High River Ventures, provided the company with $35 million in DIP financing.[216] When healthcare finance company DVI was unable to get pre-petition bank lender Fleet Boston to provide DIP financing, the company turned to distressed investors, ultimately getting $20 million in DIP financing from Ableco and Goldman Sachs' distressed debt investment firm, Goldman Sachs Credit Partners. Many believe that Ableco and Goldman will be willing to forego the DIP repayment in order to get equity in the reorganized entity.[217]

When SLI Inc., a lighting fixtures manufacturer, went bankrupt in September 2002, Ableco provided the company with $8.89 million of its $35 million DIP. (Meanwhile DDJ Capital management, another distressed debt firm, also provided part of the DIP.) With Ableco's parent, Cerberus Capital Management, owning twenty percent of SLI's $366 million in pre-petition debt, Ableco wanted the firm in and out of bankruptcy as quickly as possible—giving the company only eight months to pay off the DIP.[218] Using a similar strategy, Ableco created an "exploding DIP" when Sunterra went into bankruptcy, providing that the DIP's interest rate would double each month, basically tying the

[214] *Id.*

[215] Jonathon Berke, *Cone Mills Seen in the Clear*, DAILY DEAL Feb. 26, 2004.

[216] Greg Johnson, *Icahn Bids for Philip Services*, DAILY DEAL, Aug. 7, 2003.

[217] Jonathan Berke, *DIP Dimensions: DVI Inc.*, DAILY DEAL, Oct. 16, 2003.

[218] Jonathan Berke, *DIP Dimensions: SLI Inc.*, DAILY DEAL, Sept. 19, 2002.

company's hands to either quickly reorganize or sell its assets.[219] When catalog company Provell went bankrupt, Cerberus, holding $8 million of the company's secured claims, used Ableco to join another provider in a $21 million DIP financing, but gave the company only three months to either find a buyer or agree to a reorganization plan.[220] In Ableco's $25 million DIP to the Buffalo Sabres, the loan's interest rate jumped one hundred basis points every forty-five days.[221] The table below demonstrates the extent of recent DIP loan financings provided by distressed debt investors. The table also suggests that the distressed investors are often providing the DIP as part of a larger plan to take over control of the company.

Table 7: DISTRESSED DEBT INVESTOR PRESENCE IN DIP FINANCING:

Company	Distressed Debt Investor Presence	DIP Amount	Long Term Investment?
AMF Bowling	Farallon Capital Management part of syndicate	$75 million	AMF emerged from Chapter 11 in 2002 with Farallon part of partnership group that acquired controlling 92.5% stake
Conseco	$150 million DIP facility led by distressed debt investors Fortress Investment Group and Cerberus Capital Management, along with private equity firm J.C. Flowers & Co.	$150 million	DIP part of stalking horse bid, and eventual purchase, of Conseco Finance Company for $1 billion
DVI Inc.	Ableco and Goldman Sachs Credit Partners (distressed debt investment vehicle of Goldman Sachs)	$148 million	Ableco and Goldman Sachs Credit Partners stepped in to provide DIP when lead creditor Fleet Bank backed away because of fear from accounting irregularities. Ableco and Goldman recovered 100% of their loan, and also provided exit financing, while the remaining creditors received close to zero recovery
NTL Inc.	Appalossa Investment, Angelo Gordon & Co. and Franklin Resources	$500 million	The three distressed debt funds were major debt holders of NTL, and all three remain major shareholders of the reorganized company

[219] Jonathan Berke, *No Vacation For You*, DAILY DEAL, Aug. 15, 2002.

[220] Jonathan Berke, *DIP Dimensions: Provell Inc.*, DAILY DEAL, June 13, 2002.

[221] Jonathan Berke, *Sabres Get 'Exploding' DIP*, DAILY DEAL, Jan. 15, 2003.

Philip Services Co.	Carl Icahn's High River LP	$35 million	Provided DIP as part of stalking horse offer for the assets of the bankrupt recycler. At same time, offered exit financing of $160 million, fee of 5% of stock of reorganized company
LTV Corp.	Ableco Finance, a unit of Cerberus Capital Management	$100 million	LTV's assets eventually sold to distressed investor W.L. Ross
Oakwood Homes	Berkshire Hathaway, part of DIP syndicate (led by Greenwich Capital Markets) for Oakwood's $215 million DIP (Nov. 2002)	$215 million	Signed stalking horse offer for Oakwood Homes one year after providing DIP financing. Observers believe that offer was held up by Berkshire's quest to take over fellow manufactured home company Clayton Homes
American Plumbing and Management	Ableco Finance, a unit of Cerberus Capital Managment	$25 million	Under reorganization, Harbert Management Corp. and Ableco Finance LLC will receive preferred shares convertible into 49% of the equity
General Media Inc.	Madeleine Capital, a unit of Cerberus Capital Management	$5 million	DIP agreement included 60 day term to complete reorganization
Gingiss Group Inc.	Distressed investor Antares Capital Corp. along with pre-petition lender GE Capital	$4 million	DIP agreement includes covenant giving company less than two months to find a buyer
Arthur D. Little	Ableco Finance, a unit of Cerberus Capital Management	$69 million	Cerberus, the company's largest debt holder, made stalking horse bid for the entire company, but lost auction to higher bidders.
Advanced Lighting Technologies	Ableco Finance, a unit of Cerberus Capital Managment	$37 million	Ableco supplanted the original DIP lender when the debtor could not find a buyer by a required date under the original DIP. Company found a buyer, private equity firm Saratoga Partners, five months later.
Washington Group International	Ableco Finance, a unit of Cerberus Capital Management, along with M.D. Sass (distressed debt hedge fund) and Citadel Investment (Chicago hedge fund)	$20 million	None
E.spire Communication	Ableco Finance, a unit of Cerberus Capital Management	$85 million	Cerberus provided the acquisition financing when Xspedius Management Co. (a private equity firm) acquired E.spire's assets through a 363 sale
International Wire Group	Distressed debt investing hedge fund Highbridge/Zwirn	$140 million	$82 million of DIP will be used to pay off pre-petition secured notes. Highbridge Fund is one of the largest holders of the secured notes
Lernout & Houspie	Ableco Finance, a unit of Cerberus Capital Management	$60 million	None
Formica	Angelo & Gordon and Cerberus (Ableco)	$10 million each ($78 million in total DIP financing)	Cerberus gained control of the company in a joint venture with Oaktree Capital Management
Anchor Glass	Ableco Finance, a unit of Cerberus Capital Management	$100 million	DIP provided as part of pre-packaged bankruptcy in which Cerberus Capital Management provided $100 million investment to take control of the company

Oxford Automotive	MatlinPatterson Fund	$50 million	Fund already owned 80% of bonds ($200 million in unsecured notes). MatlinPatterson's counsel, Ronald Rose of Dykema Gossett, said that MatlinPatterson used the DIP to further its investment position, eventually taking control of the company when it exited
Railworks	MatlinPatterson Fund	$55 million	MatlinPatterson took control of the company
APW	Oaktree Managment	$22 million	DIP included warrants giving Oaktree opportunity to exchange them for 20% of the company's reorganized equity. Oaktree Capital Management ended taking control of the company
ICG Communications	Ableco Finance, a unit of Cerberus Capital Management	$20 million	Welsh, Carson, Anderson & Stowe, a private equity fund, acquired $150 million face value of the company's senior notes and have a controlling stake in the company (now merged with another Welsh portfolio company).

By focusing on the actual DIP or credit facility contract, Baird and Rasmussen fail to see that it is the holder of these contracts that matters. Without a significant financial stake in the debtor firm, the economic efficiency of Baird and Rasmussen's "control shift" breaks down. As a general matter, unless they have an enormous financial stake in the firm, commercial lenders generally should not be making the strategic decisions of the company. The reasoning goes back to the classic residual actor problems in bankruptcy: control should only be placed in the hands of the investors whose interests are identical with those of the firm as a whole. If the senior lenders do not have enough at stake, their interests may run counter to the interests of the firm as a whole.[222]

As explained earlier, the classic problem with shifting control to senior lenders is that these lenders are often excessively risk-averse. They are overly prone to pursue suboptimal, low-risk strategies: to sell the debtor's assets prematurely for cash and to engage in "low-beta" transactions with expected net present values that are

[222] *See* Lynn M. LoPucki, *The Nature of The Bankrupt Firm: A Response to Baird and Rasmussen's 'The End Of Bankruptcy'*, 56 STAN. L. REV. 645, 661-62 (2003) (questioning whether Baird and Rasmussen's single residual actor exists).

sometimes negative.[223] Especially if DIP financing is fully protected, or if the senior lenders do not have a substantial amount of pre-petition loans at stake, a risk-averse senior creditor is likely to be indifferent to the long-run going-concern prospects of the firm.[224] In very few instances beyond Warnaco can senior creditors be expected to offer the kind of balanced, long-term wealth maximization that Baird and Rasmussen admire.

On the other hand, when distressed investors provide DIP financing, they are generally motivated as true residual actors. Because distressed investors often have a great deal at stake in the reorganizing firm, they are efficiently motivated to deploy DIP loans to maximize firm wealth. Evidence of this is the willingness of distressed investors to convert DIP loans to post-emergence equity, thereby aligning their interests as the future equity holders with firm wealth maximization. When distressed investors gain practical control of the firm through their DIP loans, it is reasonable to expect management strategies that maximize the long-run profits of the firm.

VI. WHY DISTRESSED DEBT INVESTORS MAKE BETTER RESIDUAL ACTORS THAN SENIOR CREDITORS

Financial institutions are very imperfect enterprise owners for three principal reasons: one, strategic; one, regulatory; and the last based on social psychology and group dynamics. Strategically, financial institutions seldom see their "mission" as the use of short-term financing to maximize the firm's long-run market value. Rather, bankers typically have little reason to take interest in speculative, long-term business plans; they are primarily interested in a debtor's ability to produce cash in the short term to pay the

[223] David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 937 (2003).

[224] *Id.* at 939.

coupon and repay the principal.[225] As one observer put it, "the senior lender's goal is to be repaid in full in cash, or failing that, to get a renegotiated, well collateralized senior debt instrument with a short timetable for repayment."[226]

Within the negotiating room of a Chapter 11, the self-interest of senior bank creditors will be to keep as much debt as possible on the bankrupt firm since they see little to be gained and, potentially, much to be lost by providing the debtor with financial flexibility.[227] Bank lenders may regard the behavioral constraints of a highly leveraged capital structure as an effective way to keep the debtor from dissipating cash flow in unproven ventures. Distressed debt funds, by contrast, tend to favor increased financial flexibility for debtors in Chapter 11. Bankruptcy negotiations, therefore, often involve disagreements between distressed debt investors who want to reduce debt and raise equity, and senior creditors who resist such change.[228] According to one distressed investor, bank work-out groups are generally "highly professional," but they fail to take the time to understand the problems of the debtor; they just want the problem "off their plate."[229] Distressed investors, by contrast, "will spend a great deal of time in the plants and with the management team."[230] For this reason, the relationship between major distressed debt investors and the debtor's management can be quite harmonious. Both parties want the debtor out of bankruptcy as quickly as possible to

[225] John Mueller, *The Business Dynamics of Bankruptcy*, 16 AM. BANKR. INST. J. 28, 28-29 (Feb. 1997).

[226] *Id.*

[227] Telephone interview, *supra* note 77.

[228] *Id.*

[229] *Id.* This said, during another interview with a distressed investment portfolio manager, I learned that the agent bank of the original loan will often remain an integral part of the restructuring process, even if the bank no longer has an economic stake. The portfolio manager explained that the agent bank often feels a sense of responsibility for the investors in the loan and wants to uphold its longer term reputation with the syndicate. Interview, *supra* note 67.

[230] Telephone interview, *supra* note 77.

minimize the tremendous direct and indirect costs of the filing. Both parties want a "safe, sane capital structure" to ensure that the company does not fall back into financial distress. And both parties want a viable long-term growth plan to ensure the profitability of the company's future operations.[231]

Some of the negotiating intransigence (and financial myopia) of senior bank creditors in Chapter 11 proceedings can be traced to regulatory concerns. Debt crises in the past, especially the sovereign debt crisis of 1982, prompted significant new bank reporting and capital requirements that limit a bank's options when faced with a defaulting debtor.[232] Foremost among these is the requirement that securities be revalued ("mark-to-market") on the balance sheet when a "credit event" such as bankruptcy occurs.[233] Because the write-down of loan values is not required at the first signs of financial distress, a debtor's default may precipitate an unwelcome jolt to bank asset values.[234] To exacerbate matters, auditing requirements often mandate that banks write down the value of these loans to a level *below* potential recovery value.[235] When the resulting book asset value of the loan falls below its realistic liquidation value, banks naturally become eager to sell the claim.[236] As long as the cash generated from the sale is greater than the

[231] Interview, *supra* note 67.

[232] Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivitive Technology For Credit Transfer*, 12 DUKE J. COMP. & INT'L L. 541, 544 (2002).

[233] J. A. McQuown, *Managing Corporate Credit Risk: Catalytic Effects of Basel II*, 86 RISK MGMT. ASS'N J. 94 (2003).

[234] *Id.*

[235] Fortgang & Mayer, *supra* note 28, at 4.

[236] *Id.* Banks will be eager to sell the claim because, just as the firm had to book an income statement loss when it initially wrote down the value of the asset on its balance sheet, it will be able to book a one-time gain to its income statement if the sale of the debt results in a value higher than the recently reduced balance sheet value.

markdown value on the books, there will be a one-time gain on the bank's income statement.[237]

The Bank Holding Act of 1956 poses another regulatory hurdle for institutional creditors. The Act generally prohibits bank holding companies from owning shares of non-banking companies, but provides an exception for shares acquired in satisfaction of debt previously contracted, provided such shares are disposed of within two years.[238] If the number of shares is substantial, the required disposal, or even the expectation of such disposal, can depress market prices. Carter Pate, U.S. Managing Partner of PriceWaterhouseCoopers, adds that when debtors emerge as new entities, and pre-petition claimants have taken stock in lieu of debt, they don't behave like normal investors; "instead of thinking capital appreciation, they're looking at capital retrieval."[239]

Psychological factors also impede senior creditors' ability to effectively manage debtor assets. It is common for pre-petition lenders to enter the Chapter 11 process feeling bitter and angry about their financial losses and the alleged deception of debtor's management. As Chaim Fortgang and Thomas Mayer explain, the pre- and post-bankruptcy negotiations with the old debtors may have created a very hostile environment in which it is difficult to work together and come to a compromise. They point out, "[i]n most

[237] Jonathan Berke, *Bankrupt: Fool's Gold*, DAILY DEAL, March 27, 2003.

[238] 12 U.S.C. § 1843(c)(2) (2000).

[239] Nyberg, *supra* note 70. There is abundant evidence that the financial flexibility endorsed by distressed debt investors tends to produce less highly leveraged companies emerging from bankruptcy. Two recent examples: in WorldCom's (MCI) bankruptcy, 90% of the creditors (many of them distressed debt investors) approved a reorganization plan that left the company with only $4.5 to $5.5 billion in debt, down from $36 billion upon filing. Rebecca Blumenstein & Shawn Young, *WorldCom Creditors Back Plan to Reorganize in Bankruptcy*, WALL ST. J., Apr. 14, 2003. Likewise, in Mirant's Chapter 11, experts believe the creditors' committee, chaired by distressed debt investor Appaloosa Management, to be more interested in Mirant's post-Chapter 11 equity than in a senior fixed income notes. Murray, *supra* note 74.

traditional [C]hapter 11 cases, claims and interests are held by parties who are losing money."[240] One reorganization expert recently commented that the last thing he wants to see when he begins bankruptcy negotiations is a pre-petition, par investor "stuck in the headlights" from the default of his debt.[241]

The arrival of distressed debt investors can add new, positive energy to the reorganization process. The distressed debt investor may find it easier to facilitate a reorganization agreement with the debtor and the other creditors simply because the new investor is not "encumbered by the hostilities of a prior relationship."[242] Distressed investing also changes the nature and outlook of those who are negotiating in bankruptcy; claimholders who have lost a tremendous amount of money through the debtor's operations sell their claims to new investors who treat the Chapter 11 process as their opportunity for profit.[243] Barry Ridings, co-head of the restructuring group at Lazard, remarks: "I would rather deal with a distressed debt investor who paid fifty cents on the dollar than a dozen bankers who all made the original loan. The bankers signed onto the original business plan that failed, and they want their money back."[244] Stephen Lubben adds that a forty percent rise in the value of debt means significantly different things in the hands of a distressed investor than in the hands of the par investor.[245] The holders that bought at par will treat anything less than full repayment or reinstitution of the same claim as a loss, making negotiations significantly more difficult with pre-petition par investors.[246]

[240] Fortgang & Mayer, *supra* note 28, at 114.

[241] Lambe, *supra* note 158.

[242] Fortgang & Mayer, *supra* note 28, at 7.

[243] *Id.* at 54.

[244] Ian Springsteel, *Vultures of the New Economy*, WASH. POST, Sept. 9, 2001.

[245] Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 301 (2001).

[246] *Id.*

In 1983, Professor Mark Roe argued that, once a corporation files for bankruptcy, there should be a complete debt-to-equity swap.[247] By converting all credit claims to equity, the holders of these claims would no longer be able to base their self-motivated decisions on debt "recovery value" and instead would become residual actors in a reorganized, debt-free firm.[248] In a less dramatic suggestion, Barry Adler has argued that, upon default, the lowest level of common stock should automatically be cancelled and the next lowest-level claim should become the common shareholders.[249] Even though the plans of Roe and Adler are impractical because of huge barriers to legal implementation, their theoretical appeal is undeniable. The solution to the residual claimant problem in bankruptcy is to get creditor classes to think like shareholders in a financially solvent firm. The thesis of this study is that the emergence of distressed debt investors has largely accomplished informally what Roe and Adler proposed for government regulation. Distressed debtors think more like shareholders than bondholders in Chapter 11 proceedings.

The investors often take significant or even controlling stakes in the debtor, hoping to profit once the company emerges with a restructured balance sheet and potentially a new strategic plan. One restructuring expert recently commented that Cerberus Capital Management, the largest and most active distressed debt investor, "doesn't buy things because [they think] they'll be worth more in three months. They think three to five years out."[250] A principal at one of the largest distressed investment funds in the world remarked that their limited partners ("LPs") are told that

[247] Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 530 (1983).

[248] *Id.* at 542-43.

[249] Lubben, *supra* note 245, at 285.

[250] David Carey, *Cerberus Breaks Out*, DAILY DEAL, Sept. 15, 2003.

they should not be surprised if they have to wait at least ten years for full investment returns.[251]

Modern distressed investors often aggressively seek to take control positions.[252] The same principal explained that they almost exclusively purchase distressed debt where they believe that it will lead to significant equity stakes in the reorganized company, and significant control within the reorganization process—optimally a thirty-four percent blocking position in a particular class of claims. Moreover, the fund tries to develop a long-term strategic plan with the debtor's management and outside consultants soon after a position is taken so that implementation can begin shortly after the company emerges.[253]

Cerberus Capital Management relies on an in-house staff of about forty financial and operations experts—most of them former CFOs, CEOs, and CIOs—to help Cerberus plan its long-term turnaround investments in the diligence phase of the process and again once control is secured. For example, Cerberus appointed Edward Harshfield, ex-CEO of California Federal Bank, as chief executive of Aozora Bank in Japan and Liam Strong, former head of MCI's international operations, as CEO of Teleglobe.[254]

In a 1997 study, Edith Hotchkiss and Robert Mooradian examined 288 firms who filed for bankruptcy between 1980 and 1993, including 172 firms that had some evidence of "vulture" activity in their debt. The study indicated that, even in this fairly "infant" period of distressed debt investing, investors joined the boards of 27.8% (of total sample) of the post-bankruptcy reorganized firms, appointed the chairman or CEO in 9.4% (of total sample) of the cases,

[251] A portfolio manager at a New York-based distressed hedge fund told me that his fund's distressed investments are typically held for two to three years. Interview, *supra* note 67.

[252] Telephone interview, *supra* note 77.

[253] *Id.*

[254] Carey, *supra* note 250.

and became the controlling shareholder of 16.3% of firms (of the total sample).[255]

The 2003 restructuring of Vantico, a European chemical maker, is an interesting case in which two distressed debt investors had to compete against each other for equity control. After distressed debt investor MatlinPatterson acquired a majority of Vantico's publicly traded bonds, it sought to exchange the bonds for a controlling equity position in the restructured entity. MatlinPatterson favored a reorganization plan that would leave the senior bank debt (which they did not own) in place, while converting their debt to equity. Sensing an opportunity, Apollo Management, a competing distressed debt fund, purchased a blocking position (greater than thirty-three percent) in the senior bank debt, and announced that it would only vote for a reorganization plan which would convert their own senior debt into a controlling equity position, while leaving the MatlinPatterson debt in place. This particular example ended with MatlinPatterson purchasing Apollo's senior debt at a premium, and converting its entire position into a controlling equity stake, while marketing new high yield bonds.[256] Likewise, in Exide Technologies' bankruptcy, four distressed debt hedge funds purchased seventy percent of the senior bank debt.[257] These investors supported Exide's reorganization plan, which sought to convert the senior bank debt into ninety-nine percent of the post-Chapter 11 equity.[258] Twenty years ago, a debt-to-equity strategy might have meant getting involved in only the junior, or unsecured levels of the capital structure where debt was typically converted to equity (while the senior levels of debt remained in place). Today, however, every level of debt could potentially be converted into equity.[259]

[255] Hotchkiss & Mooradian, *supra* note 75, at 4-5.

[256] Nicola Hobday, *Fight to the Debt*, DAILY DEAL, Aug. 7, 2003.

[257] Murray, *supra* note 74.

[258] *Id.*

[259] Hobday, *supra* note 256.

As residual actors in bankruptcy, distressed debtors appear to be superior to senior creditors, but are they also superior to bankruptcy judges? Is there reason to prefer the reasoned judgment of a bankruptcy court official in Chapter 11 proceedings? Economic logic and legal reasoning would suggest not. Markets tend to make decisions as to the proper allocation of assets, or the proper valuation of the firm, better than individual actors or the courts.[260] Giving a judge the power, under Section 363, to approve decisions made outside the "ordinary course" endorses the misconception that judges are more capable than private parties of making the proper decisions. Moreover, there is justified concern about judicially endorsed "asset stripping."[261] Weiss and Wruck, for example, contend that judges habitually favor maintaining the debtor as a going concern, regardless of its economic distress.[262] The classic "bad example" is the Eastern Airlines case, in which bondholders lost almost all of their investment as the judge continued to extend the exclusivity period and prevented important asset sales from taking place.[263]

By creating a market for distressed debt, claims are valued on a liquid market, rather than behind a judicial bench. More importantly, strategic decisions are placed in the hands of those in the market for corporate control: individuals who are willing to "put their money where their mouth is."[264] When distressed debt investors purchase claims from pre-petition creditors, presumably at a premium over what the claim is worth in the pre-petition owner's hands, the market signals value creation. As Easterbrook and Fischel explain, "self-interest assures us that changes of

[260] Robert K. Rasmussen & David A. Skeel, *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85 (1995).

[261] Weiss & Wruck, *supra* note 68, at 4.

[262] *Id.* at 26-27.

[263] *Id.* at 21.

[264] *Id.* at 5.

corporate control, like other voluntary exchanges, move assets to higher valued uses."[265]

The distressed debt investment is an informed wager that the company is worth more if taken out of the control of widely syndicated debt holders, potentially given new management, and run by operations-minded strategic investors. Empirical research has documented the superior economic performance of such takeovers. Professors Hotchkiss and Mooradian's research on acquisitions consummated during bankruptcies that occurred between 1979 and 1992 found significant evidence of improvements in operational efficiency and profitability of the bankrupt target, largely due to decreases in operating expenses and employment costs.[266] In sixty-five percent of the cases examined, the takeover could be considered, from an operational standpoint, either "clearly successful" or "marginally successful," leading the authors to conclude that takeovers in bankruptcy facilitate the efficient redeployment of the bankrupt firm's assets.[267]

Later research by Hotchkiss and Mooradian further supports the idea that aggregating claims in the hands of distressed debt investors maximizes firm value. In evaluating their data on 288 large firms that had filed for bankruptcy between 1980 and 1993, the authors concluded that firms with the presence of distressed investors were operationally stronger than those firms without "vulture" presence, especially for firms in which vultures purchased controlling equity positions or where the vulture gained a board seat or the CEO position.[268] In firms where the vulture investor emerged as CEO or chairman, only 4.8% had negative operating income in their first year out of bankruptcy, and their average operating income margin was 12.9%. By comparison, in reorganized firms where vultures were not active, 15.5% had negative operating income in

[265] EASTERBROOK & FISCHEL, *supra* note 1, at 113.

[266] Hotchkiss & Mooradian, *Acquisitions*, *supra* note 65, at 6.

[267] *Id.* at 20-21.

[268] Hotchkiss & Mooradian, *supra* note 75, at 6-7.

their first year out, while operating margins only averaged 5.3% in year one.[269] Similar differences were apparent in operating income. For all non-vulture firms, there was no improvement, on average, in operating margins after firms emerged from bankruptcy; for firms with vulture involvement, however, operating margin improvement was significant—up nineteen percent on average.[270] And firms in which distressed debt investors took an active role as Chairman or CEO registered an impressive sixty percent improvement, on average, in their operating margins upon exit from bankruptcy. In summarizing their findings, Hotchkiss and Mooradian conclude, "[t]he positive valuation effects, together with evidence on the frequency of vulture management and control activity, suggest that vultures do more than bargain to increase distributions on their own behalf."[271]

Hotchkiss and Mooradian's findings are not surprising. As the residual actors of large corporation bankruptcies, the distressed debt investors mitigate transaction costs, aggregate control, and make decisions that are better aligned with the long-term value of the firm.

VII. THE DARK SIDE OF DISTRESSED DEBT INVESTING

Harvey Miller is, perhaps, the most renowned critic of distressed debt investors.[272] His criticisms about the potential "dark side" of distressed debt investing strategies deserve careful review. Miller's principal concern is recidivism; he believes that distressed investors' success in achieving faster restructurings and less time in expensive reorganization proceedings may also result in debtors

[269] *Id.* at table 6.

[270] *Id.* at table 7 (note that operating margins are used for the analysis because operating margins are *before* interest expense and are therefore independent of the leverage (debt) in the firm's capital structure).

[271] *Id.* at 6.

[272] *See* Miller, *Delaware Myth*, *supra* note 69 (Miller reiterated these points during my interview with him on March 2, 2004).

emerging from Chapter 11 before they are fully rehabilitated. The unfortunate consequence, says Miller, is a high probability that debtors will relapse into bankruptcy a second or third time.[273] Miller argues that the distressed investor's focus on returns in the short run may run counter to the long-term needs of the debtor, and may force the debtor back into bankruptcy months or years later.[274] "Often, it's the creditors forcing companies out of bankruptcy. The motto is, we'll fix your balance sheet, and you can fix the operational problems when you get out."[275]

Miller believes that distressed debt investors are only interested in getting the debtor out of Chapter 11 and towards an IPO or M&A event in which the funds can liquidate their investments. He argues that distressed debt investors will rehabilitate a company only to the minimum degree necessary to make it attractive to potential buyers. Miller believes that the "pushing" of the debtor to leave Chapter 11 can, at times, reach a level of "commercial bribery."[276] Miller describes the typical scenario of a debtor's management needing more time to figure out its operational problems, while the distressed investor is restless, arguing that the "market is hot," and that if the company waits, it may not be able to do an IPO.[277] Eventually, according to Miller, the negotiations come to point where the controlling distressed investors tell the CEO, "if you want to be CEO of the company, don't fight us—because if you fight and we win, you're dead."[278] According to Miller, some management teams will eventually give in, often after the distressed

[273] Terry Brennan, *Miller: Liquidations Set to Rise*, DAILY DEAL, Dec. 3, 2003.

[274] Morris, *supra* note 37.

[275] Marcus, *supra* note 82.

[276] Interview with Harvey Miller, *supra* note 58.

[277] *Id.*

[278] *Id.*

investors have agreed to provide them with post-emergence employment contracts.[279]

Without saying so explicitly, Miller leaves the impression that distressed debt investors are "window dressers" who neglect the kind of fundamental reform needed for long-term business durability.[280] In this manner, Miller questions the long-term restorative benefit of distressed investors as residual actors. He contends that distressed investors are more interested in the "quick flip" than in the slow process of corporate recovery. He bluntly suggests that, "distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investment."[281]

VIII. REPLY TO HARVEY MILLER AND POLICY IMPLICATIONS OF FINDINGS

Clearly, not all distressed debt investors are ideal long-term equity holders who faithfully perform the role of residual actor in bankruptcy proceedings. The relevant public policy concern, however, is not whether perfection reigns in the distressed debt world—it does not—but whether the imperfections are both systemic, and economically and legally injurious. If flipping is legally wrong, then it is deserving of regulations to curb it; if flipping creates economic distortions and inefficiencies, there is additional reason to impose restrictions. But if flipping in the market for distressed debt is akin to short-term trading in other property markets, there may not be a problem.

[279] *Id.* One principal at a distressed investment fund whom I interviewed acknowledged that such discussions take place, but argued that, instead of being damaging, such discussions in fact serve several useful purposes. First, they adequately incentivize management during a period in which all other incentives (equity, options) may be below water; and second, they can create a healthy relationship between the management and the future shareholders. Telephone interview, *supra* note 77.

[280] Miller, *supra* note 69, at 2014-15.

[281] *Id.* at 2016.

Instead, the flipping may simply be providing beneficial market liquidity.

These are, of course, difficult issues to address. On the empirical question of the prevalence of flipping, the data are limited but somewhat reassuring. Evidence demonstrates that the major distressed debt investors do not usually sell their holdings soon after a company has emerged from bankruptcy, and for good reason: post-emergence SEC filings demonstrate that these stakes are usually too large (and thus illiquid) to sell en masse without significant price reduction. A quick examination of some of the largest bankruptcies of the past couple of years reveals that distressed investors are still holding their significant stakes in the restructured debtors. ESL Fund continues to hold a controlling stake in Kmart, while Martin Whitman's Third Avenue Management fund owns over $400 million dollars of Kmart's equity.[282] As Conseco's largest post-emergence shareholder, Appaloosa Management continues to hold almost $200 million of the company's reorganized equity, with Angelo, Gordon & Co., and Cerberus Management still owning significant stakes, as well.[283] Distressed investor WR Huff continues to be NTL's largest shareholder, with Oaktree Capital and Franklin Resources owning close to $500 million of the company's reorganized equity.[284] Carl Icahn continues to own more than 60.7% of XO Communications' restructured equity.[285] Before merging into Mittal Steel in late October of 2004, WL Ross & Co. still owned more than thirty percent of International Steel Group, the holding company of both LTV Steel and Bethlehem Steel, years after those companies' bankruptcy filings and almost a year after

[282] Kmart Holding Co. Form DEF 14A, filed Apr. 8, 2004.

[283] Conseco Inc. Form SC 13G, filed Sept. 22, 2003; and Form 3, filed Sept. 10, 2003.

[284] NTL Inc. Form 4, filed Dec. 29, 2003, and Form 10K, filed Mar. 11, 2004 (as of March 10, 2004, WR Huff owned approximately 12.9% of the company's common stock and Oaktree owned 7.1%).

[285] XO Communications Form 10Q, filed Nov. 9, 2004.

Ross took the company public.[286] Even at Warnaco, distressed investor TCW and hedge fund Chilton Investments own over $110 million of the company's post emergence equity.[287] One hedge fund manager told me that, for every case where a distressed investor might try to pull a firm out of bankruptcy before it is operationally sound, there are ten other cases where the company is much better off because of the attention it gets from a major distressed investor.[288]

That said, even long-term investors are financially motivated to receive the highest return on their invested capital, and if they feel that the greatest value can be had from a short-term "flip" of their investment, they will do so. A Senior Managing Director at a New York-based distressed investor concedes that, while his fund has typically purchased debt and assets in bankruptcy with a long-term operational interest, he also has an obligation to his own investors. If he owns debt and sees that he can get an "easy twenty percent return" rather than wait out a potentially long Chapter 11 process, he is likely to trade out of his position.[289]

In addition there will always be certain investors, often hedge funds, who come in and buy up relatively small amounts of claims with the hope that a short-term event or a particular kind of leverage will increase the trading value of

[286] International Steel Group Inc. Form 10K, filed Mar. 11, 2004, and Form 425, filed Oct. 25, 2004 (on October 25, 2004 ISG agreed to merge into Mittal Steel, and Wilber Ross will become a board member of Mittal).

[287] Warnaco Group Inc. Major Holders, Yahoo Finance, *at* http://www.finance.yahoo.com/q/mh?s=WRNC.

[288] Telephone interview with founder of distressed debt investing hedge fund (Mar. 31, 2004). That said, Miller's "flipping" theory seems to have a great deal of advocates. During Worldcom's emergence from Chapter 11, its two largest shareholders, MatlinPatterson and Silver Lake Partners, decided not to take positions on the company's board (the two firms, along with Cerberus Capital, had all initially been granted one seat on the eleven-member board). Richard Breeden, former Chairman of the SEC and corporate monitor in the Worldcom case, seems to share Harvey Miller's "flipping" fears. *See supra* note 10.

[289] Interview, *supra* note 67.

this claim. The funds may sell the positions days, weeks, or months later for a short-term trading gain. The funds are not unwilling to own equity in the reerganized firm—in fact, they often do—but the funds usually prefer significantly smaller stakes in the reorganized company. These short-term "trading oriented" funds often face redemptions from their LP investors and therefore don't want to be caught holding illiquid controlling equity positions.[290] There is a significant presence of these trading funds, and they often get the wrath of debtor-oriented literature lamenting that the funds' only interest is to "flip" their investment, capitalizing on a short term gain, at the debtor's expense.[291]

But, these "traders" are really no different than the trade creditors or banks from whom they may buy their claims; they will always favor corporate decisions that will increase the value of their individual claims (often at the expense of maximizing firm wealth). The short-term "flip" investors would really be no different in their motivations than the commercial banks or institutional investors from whom they purchased their claim. All of these investors are interested in a short term, cash return on their claim. In a worst-case scenario, we can expect that their self-motivated actions would mimic the actions of classic claimholders (too risk-averse when holding senior debt, too risk-loving when holding junior positions). In the best-case scenario, we can expect these holders to be far superior to the classic par holders. Even if these investors only want the company to trade well when it emerges, they will still want to make sure

[290] Telephone interview, *supra* note 77.

[291] Brennan, *supra* note 273. It should also be noted that, as recently as the mid 1990's, many of the major distressed debt investors—Cerberus Capital Management, Oaktree Capital Management, Angelo, Gordon & Co., DE Shaw, WR Huff, GSC Partners, Elliott Associates—did not have the capital resources necessary to take the type of controlling positions that they routinely take in today's market. Therefore, a decade ago, most of these funds' primary investment strategy was to profit from shorter-term trading gains in distressed debt. It should also be noted that, even as their invested capital has increased, these funds continue to profit from short-term trading of distressed securities.

that the management team is impressive and the capital structure is sound.[292]

In his writing on the subject, Miller fails to make a clear distinction between these short-term, trader-oriented distressed investors and the more recent trend of longer term, operations-oriented, distressed investors whom I believe create the greatest efficiency gains in Chapter 11.[293]

The problem with Miller's argument is two-fold. First, Miller erroneously attributes to short-term "flip" traders the ability of long-term distressed-debt investors to control the reorganization process. Short-term traders, however, rarely purchase the substantial stakes that larger distressed investors do, and they rarely end up on a creditors' committee, in the courtroom, or at the negotiating table. While they provide a great deal of liquidity to distressed-debt markets, they rarely take on vocal or activist positions with the company. Short-term traders simply do not control the reorganization process. They are incapable of forcing debtors out of bankruptcy before they are ready.

The second, more fundamental concern is that Miller's reasoning is counter-intuitive. Distressed investors would not rationally risk the long-term viability of the debtor in order to get the company out of Chapter 11. This paper has

[292] *See* email from Portfolio Manager at New York-based hedge fund (Dec. 12, 2004) (on file with author).

[293] Miller does acknowledge this distinction. While the pure traders may be only making a calculation about how long the Chapter 11 is going to take, the presence of distressed investors taking much larger stakes has "grown enormously" and Miller acknowledges that their strategies have changed "from being short term traders to the investor side." These larger distressed investors look to value the assets of the debtor and aim to be a "major stockholder" in the emerged company and hold their stake for a while—only exiting through an eventual sale or IPO. Interview with Harvey Miller, *supra* note 58. Hilary Rosenberg may have been the first to point out this important difference between distressed investors. In *The Vulture Investors*, she classifies "vultures" as either "migratory birds," the speculator/traders; or "nest builders," who "throw their fate in with a company for the long term." Rosenberg does not, however, imply that either group has a salutary affect on reorganizations. ROSENBERG, *supra* note 8, at 26.

recounted example after example of distressed investors' preference for equity—the debtor's most risky post-emergence currency—over fixed-income securities. Bankruptcy recidivism, should it occur, harms equity holders far more than fixed-income creditors.[294] It follows that distressed investors, as the most junior residual claimholders in the reorganized company, ought to be the most concerned about premature emergence from Chapter 11's protective shell. If distressed investors were concerned about the viability of the restructured company, they would require a significantly safer currency—perhaps senior secured debt. Instead, we see the funds going out of their way to demand new equity.[295]

What Miller and other critics of distressed-claim trading seem to miss are the bygone days when a Chapter 11 filing meant that creditors and the debtor would work together in a collective environment to rehabilitate the operations of the debtor and help it emerge as a healthy company.[296] In 1996, Frederick Tung argued that claims trading has the tendency to destroy the traditional "community" that a Chapter 11 filing is meant to facilitate. Tung argued that claims trading takes the claims out of the hands of those parties who have long-term relationships with the debtor—its commercial bankers, its suppliers and customers—and inserts self-centered players into the Chapter 11 who will only be concerned about the debtor's eventual rehabilitation if it increases the value of their own claims.[297]

The days of "community" based Chapter 11 negotiations are history, if they ever existed. They are a remnant of the

[294] *See* David A. Skeel Jr., *What's so Bad About Delaware?*, 54 VAND. L. REV. 309, 318 (2001). Naturally, equity holders are likely to have no financial recovery in a bankruptcy while fixed-income creditors, depending on priority, may have a significant recovery.

[295] This is true for both long- and short-term distressed investors. Both usually operate in the riskiest level of the bankrupt firm's capital structure and seek profit from operational turnarounds.

[296] *See* Tung, *supra* note 9 (similar arguments are made by Harvey Miller in article by Brennan, *supra* note 273).

[297] *See* Brennan, *supra* note 273.

days when commercial banks cared more about their long-term client relationships and loan asset base than their debt syndications and servicing fees. Today, defaulted bank loans are immediately transferred to the bank's "work-out group" at the first sign of distress,[298] and trade creditors are rarely willing to hold their claims through the entire Chapter 11.[299] Instead of longing for the days of the past, we should tentatively applaud the way that distressed-debt investors have brought enterprises closer toward an efficient communitarian relationship. Where distressed claims of the 1980s and early 1990s may have traded hands from one inefficient owner to the next, today, these claims are being aggregated in the hands of what often turn out to be long-term residual owners. The bankruptcy code and the courts should generally facilitate such transfers. This may involve amending the still onerous "proof of claim" requirements for privately owned claims under Rule 3001.[300] It may involve an amendment to the Section 1126(e) "good faith" requirement, or at least an interpretation by courts that would encourage the aggregation of claims in the hands of a distressed investor, even if they contemplate a hostile takeover of the company.[301] It may mean that the code should be amended to

[298] Lambe, *supra* note 158. Carsten Brink, Head of European Restructuring at UBS Warburg, says "Once the debt goes into default, then it generally passes to another part of the bank. The recovery bankers will typically look at the debt in a different way. Their priority will be to manage the credit exposure, and the overall relationship with the borrower will be of secondary relevance. In a restructuring, the power moves from the relationship manager to the workout specialist." *Id.*

[299] A modern trade creditor in a major Chapter 11 will typically get multiple solicitations from distressed investors for their trade claims. Interview, *supra* note 67.

[300] *Contra* W. Andrew P. Logan III, Note, *Claims Trading: The Need For Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495 (1994) (arguing that Rule 3001 should actually be amended to require a greater burdens of disclosure for purchasing claims in bankruptcy).

[301] *See, e.g., In re* Allegheny, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990) (wherein the court designated the votes of Japonica, a distressed debt investor, because the judge found that Japonica had acted with bad faith

make the selection of an unsecured creditors' committee members a more dynamic process, with required adjustments to its membership as debt becomes aggregated in the hands of a few distressed investors during the course of the case.[302]

In the end, there is reason to be optimistic. Distressed-debt investing, while "vulture-like" to many, is better described as a phoenix. Rising from the ashes of bankruptcy are revitalized firms, thanks to the determination of investors who immolate short-run destructive behaviors in favor of long-run value maximization.

and "in aid of an interest other than an interest as a creditor." Japonica's "other interest" was its desire to take hostile control of Allegheny. The judge found that Japonica's acquisition of claims and its voting record were based solely on their desire to take control. *Id.* at 290).

[302] It may be that the creditors committee should also be given greater statutory power to affect corporate decision making and board membership.

EXHIBIT M

Hearing Date: August 9, 2007 at 10:00 a.m. (Eastern)

Andrew N. Goldman (AG 1010)
James H. Millar (JM 6091)
WILMER CUTLER PICKERING HALE AND DORR LLP
399 Park Avenue
New York, New York 10022
Telephone: (212) 230-8800
Facsimile: (212) 230-8888

Attorneys for Amici Curiae The Loan Syndications and Trading Association and The Securities Industry and Financial Markets Association

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	Chapter 11
	Case No. 06-10064 (SMB)
MUSICLAND HOLDINGS CORP., et al.,	(Jointly Administered)
Debtors	

BRIEF OF *AMICI CURIAE* THE LOAN SYNDICATIONS AND TRADING ASSOCIATION AND THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN OPPOSITION TO WACHOVIA BANK'S MOTION TO COMPEL THE INFORMAL COMMITTEE OF SECURED TRADE VENDORS TO FILE A VERIFIED STATEMENT PURSUANT TO BANKRUPTCY RULE 2019

TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

PRELIMINARY STATEMENT 1

STATEMENT OF INTEREST...2

ARGUMENT..3

I. Requiring members of informal groups to make rule 2019 disclosures would have significant, negative consequences..3

II. Informal groups are not subject to rule 2019..5

A. Rule 2019 Does Not Apply To Informal Groups Because They Do Not Act As Fiduciaries..5

B. The History and Purpose of Rule 2019 Likewise Demonstrate That It Was Intended to Apply to Fiduciaries, Not Informal Groups. 8

III. Wachovia's points lack merit..12

A. Rule 2019 Does Not Seek To Protect Those Entities To Which No Fiduciary Duties Are Owed. 12

B. Even Though Claims Are Sold At Less than Face Value, the Economics of the Debtor's Obligation Does Not Change. 13

C. Plan Issues Are Not the Province of Rule 2019...14

CONCLUSION..14

TABLE OF AUTHORITIES

CASES

Page(s)

Am. Bank and Trust Co. v. Jardine Ins. Servs. Texas, Inc.,
104 F.3d 1241 (10th Cir. 1997) 12

In re Andersen,
179 F.3d 1253 (10th Cir. 1999) 12

Caplin v. Marine Midland Grace Trust Co. of N. Y.,
406 U.S. 416 (1972) 10

Certain Underwriters at Lloyd's, London v. Future Asbestos Claim Representative (In re Kaiser Aluminum Corp.),
327 B.R. 554 (D. Del. 2005) 6

In re CF Holding Corp.,
145 B.R. 124 (Bankr. D. Conn. 1992) 7

In re Ionosphere Clubs, Inc.,
101 B.R. 844 (Bankr. S.D.N.Y. 1989) 7

In re Northwest Airlines Corp.,
No. 05-17930, 2007 WL 724977 (Bankr. S.D.N.Y. Mar. 9, 2007) 11

In re Philadelphia & Reading Coal & Iron Co.,
105 F.2d 358 (3d Cir. 1939) 10

In re Rosenbaum Brain Co.,
13 F. Supp. 600 (N.D. Ill. 1935) 9

In re Scotia Dev., LLC,
No. 07-20027 (Bankr. S.D. Tex. April 17, 2007) 7

In re Szostek,
886 F.2d 1405 (3d Cir. 1989) 12–13

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Texas Hotel Secs. Corp. v. Waco Dev. Co.,
87 F.2d 395 (5th Cir. 1936) 13–14

FEDERAL STATUTES AND RULES

11 U.S.C. § 205(p) 9

Fed. R. Bankr. Proc. 2019(a)(4)..6

MISCELLANEOUS

Ballentine's Law Dictionary 225 (3d ed. 1969) 6

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The Loan Syndications and Trading Association (the "LSTA") and the Securities Industry and Financial Markets Association ("SIFMA" and, collectively with LSTA, "*Amici*") respectfully submit this brief in opposition to the Motion Of Wachovia Bank, National Association ("Wachovia"), For Order Compelling The Informal Committee Of Secured Trade Vendors To File A Verified Statement Pursuant To Bankruptcy Rule 2019 (the "Wachovia Motion").

PRELIMINARY STATEMENT

Amici's position is grounded in the views of their collective memberships, parties who regularly participate in *ad hoc* or informal groups of bond and bank debt holders during the pendency of chapter 11 cases filed by issuers of that debt. Were this Court were to grant the Wachovia Motion, sophisticated financial institutions would be discouraged from playing active roles in chapter 11 restructurings, a result antithetical to the goals and design of the Bankruptcy Code. By this submission, *Amici* seek to assist the Court in analyzing these issues with due regard for the proper and efficient functioning of the chapter 11 process and the financial markets for trading bankruptcy claims.

So-called "*ad hoc* or informal committees"—which today act as nothing more than a collection of similarly situated holders of claims or interests represented by a set of advisors — nonetheless play a vital role in chapter 11 restructurings. As typically the largest stakeholders in chapter 11 cases, these parties—whose economic rights and interests lie at the heart of such chapter 11 cases—not only give voice to small holders who, acting separately, would have little say in the debtor's restructuring, but also provide the debtor with negotiating partners with the goal of efficiently and economically fashioning a consensual resolution to a bankruptcy case. And, as here, such groups satisfy any practical disclosure concerns, since they publicly disclose the quantum of their holdings—information which enables the debtor and other parties in interest to understand how large the group's voice looms in the restructuring process.

The Wachovia Motion, however, goes beyond the practical and seeks public disclosure of a market participant's most confidential and proprietary information: the price at which that institution purchased (and/or sold) its claims. In seeking such information, Wachovia points to no reasoning (rational or otherwise) for such information; rather, it simply seeks Pavlovian application of an inapposite rule, which—due to language crafted decades before the emergence of the secondary markets for debt trading—seeks pricing information wholly irrelevant to the orderly administration of the case and restructuring of the debtors. Respectfully, this Court should deny the Wachovia Motion.

STATEMENT OF INTEREST

The LSTA is the trade association for all segments of the floating rate corporate loan market. With over 220 members, including broker-dealers, commercial banks, investment banks, mutual funds, merchant banks, and other major financial organizations worldwide, the LSTA seeks to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims.

SIFMA is the organization formed from the 2006 merger of the Bond Market Association and the Securities Industry Association. SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers active in U.S. and foreign markets. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry.

Collectively, *Amici* are uniquely positioned to address the impact that the resolution of this issue will have on the financial markets for trading bankruptcy claims.

ARGUMENT

I. REQUIRING MEMBERS OF INFORMAL GROUPS TO MAKE RULE 2019 DISCLOSURES WOULD HAVE SIGNIFICANT, NEGATIVE CONSEQUENCES

Participants in the postpetition claims trading market consist primarily of financial institutions that make decisions to trade claims or interests based on highly confidential and proprietary methods of valuation analysis. Of critical importance, those participants do not engage in a one-time transaction to buy or sell debt. Rather, each implements its respective investment strategy and manages its risk through a continual evaluation and adjustment to its position in a given credit. As the court-ordered disclosures made in the *Northwest* case demonstrate, that continual process typically gives rise to an extensive series of trades. (*See* Exhibit A, attached hereto.)

Each of these market participants, of course, intends for its investment strategy not only to prove profitable, but also to provide returns that distinguish it from the crowded field of competitors. And each views its strategy as a trade secret to be held in great confidence, not to be shared with its competitors. While a participant will disclose that it has joined a member of an informal group, it will strenuously resist disclosing information concerning its underlying trades for fear that competitors would then have a window into its unique formula for success (and a heightened appreciation for that participant's threshold for risk, upside recognition and downside tolerance).

Approval of the Wachovia Motion—and specifically, Wachovia's request that the Informal Committee of Secured Trade Vendors reveal not only their holdings but the prices at which these entities purchased their securities—will likely have a dramatic effect on the willingness of financial institutions to participate in the restructuring process. Given the choice between disclosing their highly confidential and proprietary trading strategies, on the one hand, and not participating in informal groups, on the other, most institutions will choose the latter. And that result will threaten serious disruption of the otherwise well balanced mechanisms of the chapter 11 process, since those participants—often the largest true economic stakeholders in a case—will not participate.

First, small stakeholders will suffer the absence of a collective larger economic voice in the case. An institution's willingness to spend the time and energy required to work through often-contentious chapter 11 processes is a function of the price paid for such securities relative to the expected value of the return that such purchase will afford. As one would expect, small stakeholders, if forced to work independently, would not have the financial incentive to expend the time and bear the expense to play a significant role in a debtor's reorganization process. These small stakeholders will thus be left on the sidelines, with no remaining party willing to espouse positions shared by these smaller constituents. Said differently, an informal committee's withdrawal from the restructuring process will leave smaller (but similarly situated) creditors with no practical, cost-effective mechanism to promulgate their views of the restructuring process.

Second and relatedly, the debtor will lose a vital negotiating partner in the restructuring process. In most chapter 11 cases (*i.e.*, cases with complex capital structures), the statutory creditors' committee is comprised of a wide cross-section of creditors, and thus cannot adequately advocate a position on behalf of any one constituency. In those instances, informal groups move to the forefront of the plan restructuring process. While the holders within those informal groups do not divulge to each other their trading histories and strategy, they do amalgamate into loosely held groups that effectively neutralize any real or perceived conflicts of interest between the various parties in interest. That economical and efficient *ad hoc* process—developed and refined through market forces—provides the best means for organizing suitably cohesive groups of similarly situated holders to negotiate with the debtor over the treatment of their claims or interest and the resolution of the debtor's chapter 11 case. If Rule 2019 is interpreted rotely, it will erect a practical obstacle to a constituent's willingness to participate in that process. Without their participation, the debtor will be forced to endure a time-consuming and intractable series of one-off negotiations with individual stakeholders, thereby substantially interfering with—and dramatically lengthening—the reorganization process.

Third, Wachovia's desired interpretation of Rule 2019 provides no legitimate benefit to this case (or to restructuring processes in general). So long as information concerning the quantum of an informal group's holdings in the aggregate is made available (which is current practice and has been disclosed in this case), the debtor and other parties in interest will have sufficient information to understand how loud that group's voice may loom in the restructuring process. Requiring further disclosure would simply give obstinate parties a bare-knuckled litigation device to use, not for the purpose of obtaining relevant information, but rather to bludgeon an opponent as part of a scorched-earth litigation strategy. Approval of the Wachovia Motion would thus only serve to empower parties to act more litigiously.

II. INFORMAL GROUPS ARE NOT SUBJECT TO RULE 2019

A. Rule 2019 Does Not Apply To Informal Groups Because They Do Not Act As Fiduciaries.

The Wachovia Motion is premised on the assumption that the Informal Committee of Secured Trade Vendors is a true "committee" within the rubric of Rule 2019. In today's environment, that premise is false.

Rule 2019 provides that “every entity or *committee* representing more than one creditor” must file a verified statement pursuant to Rule 2019 disclosing “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. Proc. 2019(a)(4) (emphasis added).

Here, Wachovia assumes that the Informal Committee of Secured Trade Vendors is a true “committee” simply because of the nomenclature used. Wachovia is wrong. The idea that the applicability of Rule 2019 turns on self-labeling makes no sense, as a collection of creditors could simply call themselves a “group” and defeat much of Wachovia’s argument. Rather, as used in Rule 2019, the term “committee” has a more exacting definition in furtherance of a specific purpose.

Informal groups of creditors, such as the Informal Committee of Secured Trade Vendors here, do not satisfy the definition of a “committee”. Under both the legal and colloquial definitions, a “committee” constitutes a group of people that act on behalf of others. *See Webster’s Third New International Dictionary, Unabridged* 458 (2002) (“a body of persons delegated to consider, investigate, or take action upon and usu[ally] to report concerning some matter of business . . . .”); *see also Ballentine’s Law Dictionary* 225 (3d ed. 1969) (“A body of persons who have been selected and appointed with authority to perform some public service or duty”). Indeed, the case law surrounding Rule 2019 likewise makes clear that the term “committee” refers only to groups that act in a representative or fiduciary capacity with respect to other creditors or interest holders. *E.g., Certain Underwriters at Lloyd’s, London v. Future Asbestos Claim Representative (In re Kaiser Aluminum Corp.)*, 327 B.R. 554, 559 (D. Del. 2005) (“The purpose of Rule 2019 is to ensure that plans of reorganization are negotiated and voted upon by people who are authorized to act on behalf of the real parties in interest."); *In re CF Holding Corp.*, 145 B.R. 124, 126 (Bankr. D. Conn. 1992) (Rule 2019 "was designed to cover entities which, during the bankruptcy case, act in a fiduciary capacity to those they represent, but are not otherwise subject to control of the court."); *In re Ionosphere Clubs, Inc.*, 101 B.R. 844, 852 (Bankr. S.D.N.Y. 1989) (Rule 2019 "places the burden on the party seeking agency status for several claimants.").

While it is true that informal groups of creditors or interest holders—like the Informal Committee of Secured Trade Vendors here—nominally label themselves as "*ad hoc* or informal committees", it is beyond dispute that the members do not act on behalf of anyone except themselves and do not stand in a representative or fiduciary capacity with respect to others. Under any construct, these groups are not "committees" within the meaning of Rule 2019.

In promulgating the Wachovia Motion, Wachovia demonstrates its fundamental misunderstanding of the role played by "informal committees" in bankruptcy cases. These groups do *not* typically form a separate entity (a general partnership or limited liability company, for example) to act on behalf of their (or others') collective interests. They do *not* have any agreement that binds them together, whereby the majority can impose its will on the minority. And they do *not* require that their members must remain part of the group for the duration of the case.

Recently in the *ScoPac* case, Judge Schmidt —in denying the very relief that Wachovia seeks here—offered the best description of "informal committees" as just a "bunch of creditors".[1] These groups form when circumstances drive them together. In most every instance, these groups are comprised of stakeholders that:

[1] Transcript of Hearing, at 4-5, *In re Scotia Dev., LLC*, No. 07-20027 (Bankr. S.D. Tex. April 17, 2007), attached hereto as Exhibit B.

- Hold the same (or substantially similar) types of claims or interests in the debtor (such as unsecured bond debt or secured bank debt);
- Choose to exchange ideas and collectively formulate strategies so that each will realize the greatest return on its respective claims or interests;
- Seek to negotiate in lockstep so that the process can result in a global solution; and
- Engage a single law firm to maximize efficiencies and minimize costs.

When they work together as a group, these participants are engaged in an alliance of convenience. Each seeks only to do what is best in its individual economic interest at that particular time. Nothing prevents any participant from dropping out, either because the holder has sold its position or simply no longer wishes to be part of the group. Indeed, should some—even a majority—of an informal group wish to pursue a path that does not meet with unanimous approval, the dissenters remain free to take their own action and, if they choose, oppose the group effort.

None of these characteristics suggests that any of the members are even empowered to bind other members of the group, much less act on behalf of other creditors generally. They act only for their own benefit, and seek to advance only their own economic interests. Those actions may involve, of course, forming allegiances with others who are similarly situated, but that conduct does not create a fiduciary or representative capacity that gives rise to status as a "committee" for purposes of Rule 2019.

B. The History and Purpose of Rule 2019 Likewise Demonstrate That It Was Intended to Apply to Fiduciaries, Not Informal Groups.

The historical and statutory roots of Rule 2019 confirm that the word "committee", as used therein, does not refer to informal groups (like the one at issue here), but rather refers to committees that act in a fiduciary capacity.

In the 1930s, fiduciary committees were dubbed “protective committees”, as they were meant—in theory—to act in “protection of those whose interest they represent”. *In re Rosenbaum Brain Co.*, 13 F. Supp. 600, 601 (N.D. Ill. 1935) (“[V]ery frequently large numbers of persons with small means hold bonds in quite small amounts. These creditors have great difficulty protecting their interests”). As the *Rosenbaum Brain* court stated:

> In a great many cases, however, the bondholders' committee is set up by the debtor, itself, or by individuals who promoted the organization of the debtor and the sale of its securities.
>
> * * * * *
>
> As a result of such practices, great public scandal has arisen and there has been much newspaper publicity and many legislative investigations. The public has come to distrust all committees, lumping the good with the bad, though there is no doubt that a very large proportion of the committees are honestly and faithfully performing the duties imposed upon them.

Id.

In the midst of that scandal, the Interstate Commerce Commission received authority to supervise the role of protective committees in railroad reorganizations. *See* Section 77(p) of the Bankruptcy Act of 1935 (11 U.S.C. § 205(p) (Supp. 1938)); *see also* William G. Fennell, *Protective Committees and Deposit Agreements in Railroad Reorganizations*, 49 Yale L.J. 224 (1939). Of critical importance, what are now known as “*ad hoc* or informal committees” were *not* subject to such oversight, as the statute stated, “groups of mutual institutions shall not be prohibited from acting together for their own interests through representatives.” 11 U.S.C. § 205(p) (Supp. 1938). This was (and still is) only logical, since only committees that acted in a *fiduciary* capacity—*i.e.*, the *protective* committees—could potentially abuse the power they retained over the stakeholders that they represented. That concern simply did not exist (nor does it today) for institutions acting on their own behalf.

Shortly thereafter, in 1937, the SEC—after undertaking a comprehensive study under the leadership of Commissioner William O. Douglas—issued a report on the widespread abuses of protective committees in bankruptcy reorganizations generally (that is, beyond railroad reorganizations). *See generally Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees*, Parts I-VIII (1937) (the "SEC Report"). Unsurprisingly, the SEC Report "emphasized the need for corrective legislation regulating protective committees", finding that the law should "demand a new and greater measure of assurance that those who act in fiduciary or representative capacities are free from adverse interests and appropriate to themselves only those discretionary powers which are necessary or desirable for the protection of investors." *See* SEC Report, Part II at 528 (1937).

The SEC Report led to the enactment of Chapter X of the Bankruptcy Act (the predecessor to Chapter 11 of the current Bankruptcy Code). *See, e.g.*, *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 422 (1972) ("Chapter X . . . stemmed from a comprehensive S.E.C. study . . . . In enacting Chapter X, Congress had protection of public investors primarily in mind."); *In re Philadelphia & Reading Coal & Iron Co.*, 105 F.2d 358, 359 (3d Cir. 1939) (the "rules [of Chapter X] were laid down in light of abuses which had become manifest in reorganization proceedings . . . [where] it had appeared that unqualified and unrepresentative committees sought and obtained the right to represent defenseless security holders while actually working in the interests of the debtor or other adverse parties."). The current Rule 2019 can be traced back to Sections 210 and 211 of Chapter X of the Bankruptcy Act of 1938,[2] which later became Bankruptcy Rule 10-211 in 1973.[3] To be sure, the language of the current Rule 2019 is identical to its predecessors in all relevant respects.[4]

[2] *See* Sections 210 and 211 of Chapter X, enacted as part of the Chandler Act of 1938, 52 Stat. 895.

Thus, the disclosure requirements of Rule 2019—just like that of its predecessors—are intended to prevent abuses by “committee” members whose supposed function is to “protect” other stakeholders as their fiduciary. That is certainly not the function of informal groups, such as the ones at issue here. Indeed, the representatives of the Informal Committee of Secured Trade Vendors cannot abuse their fiduciary duties to other creditors because *they have no fiduciary duties*. As the historical underpinnings of the rule demonstrate, the contention that this Court should force the Informal Committee of Secured Trade Vendors to make Rule 2019 disclosures has no legal or historical footing.

[3] *See In re Northwest Airlines Corp.*, No. 05-17930, 2007 WL 724977, at *2 (Bankr. S.D.N.Y. Mar. 9, 2007) (Explaining that Rule 10-211 is the “direct antecedent of Rule 2019”).

[4] *See* Section 211 of Chapter X, 52 Stat. 895 (“Every person or committee, representing more than twelve creditors or stockholders, and every indenture trustee who appears in this proceeding shall file with the court a statement, under oath, which shall include—(1) a copy of the instrument, if any, whereby such person, committee, or indenture trustee is empowered to act on behalf of creditors or stockholders; (2) a recital of the pertinent facts and circumstances in connection with the employment of such person or indenture trustee, and, in the case of a committee, the name or names of the person or persons at whose instance, directly or indirectly, such employment was arranged or the committee was organized or formed or agreed to act; (3) with reference to the time of the employment of such person, of the organization or formation of such committee, or the appearance in the proceeding of any indenture trustee, a showing of the amounts of claims or stock owned by such person or persons at whose instance, directly or indirectly, such employment was arranged or the committee was organized or formed or agreed to act; and (4) a showing of the claims or stock represented by such person or committee and the respective amounts thereof, with an averment that each holder of such claims or stock acquired them at least one year before the filing of the petition or with a showing of the times of acquisition thereof”); *see also* Rule 10-211 of Chapter X (enacted in 1973) (“Every person or committee representing more than one creditor or stockholder, and every indenture trustee, shall file a signed statement with the court setting forth (1) the names and addresses of such creditors or stockholder; (2) the nature and amounts of their claims or stock and the time of acquisition thereof unless they are alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of such person or indenture trustee, and, in the case of a committee, the name or names of the person or persons at those instance, directly or indirectly, such employment was arranged or the committee was organized or agreed to act; and (4) with reference to the time of employment of such person, or the organization or formation of such committee, or the appearance in the case of any indenture trustee, a showing of the amounts of claims or stock owned by such person, the members of such committee or such indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.”).

III. WACHOVIA'S POINTS LACK MERIT

A. Rule 2019 Does Not Seek To Protect Those Entities To Which No Fiduciary Duties Are Owed.

Wachovia's argument concerning application of Rule 2019 fails, as discussed above, because informal groups are not fiduciaries and are not otherwise "represent[ing]" in any way anyone else's interests. They thus have no obligation to make any such disclosures. But Wachovia's argument also fails for other reasons.

First, Wachovia claims that "full disclosure is particularly necessary in this case because the composition of the Informal Committee has changed during the bankruptcy proceedings." (Wachovia Motion, at 9.) But the Informal Committee *has* disclosed its aggregate holdings. No legitimate purpose is served by requiring this informal group to tell the world the dates and prices at which each member acquired its respective position.

Second, Wachovia's construction of the rule purportedly seeks to protect those that choose *not* to incur the time and expense of participating in the chapter 11 process: the so-called "free-riders." That position, however, runs counter to established bankruptcy policy. Without question, bankruptcy provides a forum where all parties in interest have an opportunity to participate in a process that seeks a fair and equitable resolution and maximizes value for all. But the bankruptcy process encourages parties in interest to vigilantly protect their rights, and does not look favorably on those that sit on their hands. *See, e.g.*, *In re Andersen*, 179 F.3d 1253, 1257 (10th Cir. 1999) ("A creditor cannot simply sit on its rights and expect that the bankruptcy court or trustee will assume the duty of protecting its interests."); *Am. Bank and Trust Co. v. Jardine Ins. Servs. Texas, Inc.*, 104 F.3d 1241, 1246 (10th Cir. 1997) (creditors are obligated to take an active role in protecting their claims); *In re Szostek*, 886 F.2d 1405, 1414 (3d

Cir. 1989) (same). So, too, here. Rule 2019 should not be construed to reward those that choose not to participate.

Third, Wachovia does not explain why Rule 2019 (as it construes that rule) would require a collection of smaller holders acting together to make disclosures for the benefit of other stakeholders, but would *not* require the same disclosures by a single, large and active holder. Stakeholders that follow the lead of others in a chapter 11 case—one could, of course, question the wisdom of uncritically following those that owe no fiduciary duty—would seemingly ascribe the same weight to a single, large holder's strategy as they would to that of a collection of smaller holders that, in the aggregate, hold an equal stake. If Rule 2019 really sought to protect those that do not take an active role, then it would not distinguish between an active group of stakeholders, on the one hand, and a single, active holder, on the other. Because Rule 2019 unquestionably is not applicable to a single, active holder, however, one must conclude that the rule was not intended to protect those that had not ceded control of their claims to a fiduciary and who otherwise remain free to protect their own interests.

B. Even Though Claims Are Sold At Less than Face Value, the Economics of the Debtor's Obligation Does Not Change.

Wachovia might suggest, as it did in its objection to plan confirmation, that members of the Informal Committee of Secured Trade Vendors purchased their claims at a discount, and the other bankruptcy parties in interest know that discounted price. (*See* Wachovia's plan objection, docket no. 1600, at 6.) But that argument misunderstands a fundamental principle of the market for trading in the securities of bankrupt companies: the value of a claim or interest is determined by the nature of the debtor's obligation under the instrument, not by the price paid for that instrument. It is well established law that the consideration paid for a claim or interest is irrelevant to the treatment of such claim or interest in bankruptcy. *Texas Hotel Secs. Corp. v.*

Waco Dev. Co., 87 F.2d 395, 399 (5th Cir. 1936) (transfer of claim during bankruptcy "usually does not deprive the claim of any of its incidents"); *Resurgent Capital Servs. v. Burnett (In re Burnett)*, 306 B.R. 313, 319 (B.A.P. 9th Cir. 2004) (claim filed in bankruptcy case by an assignee may not, in absence of evidence of breach of some specialized duty of assignee, be disallowed solely because assignee does not reveal consideration it paid to assignor) ("[T]he consideration paid by [the assignee] is, as a matter of law, irrelevant to the allowance of [its] claims"), *aff'd*, 435 F.3d 971 (9th Cir. 2006). *See also* Hon. Robert D. Drain, *Are Bankruptcy Claims Subject to the Federal Securities Laws*, 10 Am Bankr. Inst. L. Rev. 569, 575 n.31 (2002) ("[A] discounted purchase price is irrelevant to the ability to enforce the claim in full."). Wachovia's argument is simply wrong.

C. Plan Issues Are Not the Province of Rule 2019.

At bottom, Wachovia obviously has objections to the proposed plan. While *Amici* takes no position on the confirmability of any proposed plan of reorganization, the reality is that if Wachovia seeks to challenge plan confirmation, it should seek whatever information it wishes through typical discovery procedures. Using Rule 2019 as a weapon in a confirmation battle is both inappropriate and abusive. Such tactics cannot be countenanced.

CONCLUSION

For the foregoing reasons, the Court should deny the Wachovia Motion.

August 7, 2007

Respectfully submitted,

/s/ Andrew N. Goldman

Andrew N. Goldman (AG 1010)
James H. Millar (JM 6091)
WILMER CUTLER PICKERING
HALE and DORR LLP
399 Park Avenue
New York, NY 10022
Telephone: (212) 230-8800
Facsimile: (212) 230-8888

Attorneys for Amici Curiae The Loan Syndications and Trading Association And The Securities Industry and Financial Markets Association

EXHIBIT N

FEDERAL RESERVE BANK of NEW YORK

SPEECH

Hedge Funds and Derivatives and Their Implications for the Financial System

September 15, 2006

Timothy F. Geithner, President and Chief Executive Officer

Remarks at the Distinguished Lecture 2006, sponsored by the Hong Kong Monetary Authority and Hong Kong Association of Banks, Hong Kong

I want to thank Joseph Yam for inviting me to Hong Kong for this occasion.

We are approaching the 10-year anniversary of the financial crises of 1997-99. Those crises were remarkable both in the scope of countries and markets they affected, and for their speed and severity. The circumstances leading up to the crises varied across countries and regions, as did the magnitude of the resulting damage to the real economy. But each of these events had one dynamic in common—the confluence of a sharp increase in risk perception, and the subsequent actions taken by financial institutions and investors to limit their exposure to future losses. As asset prices declined and volatility increased in response to increased concern about risk, firms moved to call margin, to reduce positions and to hedge against further losses. These individual actions had the aggregate effect of inducing even larger price declines and further heightening perceptions of risk, ultimately propagating and amplifying the effects of the initial shock.

The dynamic I just described was not unique to the crises of the late 1990s, nor was the damage to overall economic activity they left in their wakes. Systemic financial events with spillovers to the real economy have been a persistent feature of the economic environment, and both financial market participants and policymakers have grappled with the challenge of how to reduce their incidence and to minimize their severity, longevity and impact on the broader economy.

There is a lot we do not understand about these challenges, but we know more today than we once did. In the case of the crises of the late 1990s, despite the broad-based nature of the financial market turmoil, in countries where capital cushions in the financial sector were strong relative to risk, where there was a greater diversity of institutions in the financial system to absorb the losses, and where monetary authorities were in a position to provide liquidity to restore confidence, the financial and macroeconomic impact of the crises was relatively modest. Where those conditions did not exist, the damage was acute.

The U.S. economy appears to have become more resilient to financial shocks. Over the past two decades, the U.S. economy has experienced several episodes of significant financial market strain. These episodes were associated with spikes in risk perception and significant market volatility within financial markets, but none proved exceptionally damaging in terms of the overall macroeconomic impact. The mild impact of these episodes on the real economy contrasts with financial events such as the “credit crunch” that exacerbated the 1990-91 recession. That episode was characterized by a widespread reduction in the provision of credit by banks in response to loan losses and the need to raise capital.

The resiliency we have observed over the past decade or so is not just good luck. It is the consequence of efforts by regulatory, supervisory and private financial institutions to address previous sources of systemic instability. Risk management has improved significantly, and the major firms have made substantial progress toward more sophisticated measurement and control of concentration to specific risk factors. What seems to have been most critical in preventing financial market turmoil from translating into a significant reduction in credit provision by banks and other financial institutions were the steps taken by regulatory authorities and financial institutions alike to strengthen capital in the core of the financial system, and to measure and manage risk.

These efforts have most notably manifested themselves in increased levels of risk-adjusted capital in the core of the system relative to what prevailed in the early 1990s. In the United States, for example, tier-one risk-based capital ratios have stabilized near 8.5 percent, considerably higher than the estimated levels around 6.5 percent for the early 1990s. This is based on a relatively crude measure of risk, but the direction of the improvement is right and the magnitude of the change is significant.

Relative to the conditions that prevailed in the early 1990s, the higher levels of capital in the core now provide a larger buffer against shocks and enhance the ability of the banking industry to act as a critical stabilizer in times of stress by providing liquidity to the corporate sector. When financial markets dry up, firms turn to banks and their unused loan commitments and lines of credit. Banks are in a position to fund this liquidity because transaction deposits tend to flow into the banking sector. In times of crisis, it appears that U.S. investors now run to banks, not away from them.

In view of the critical role that efficient credit provision plays in economic growth and development, the benefits to the global economy of getting the underpinnings of a stable, efficient financial system in place are substantial. At the same time, we also know that these important markets are susceptible to certain “market failures,” such as information asymmetries, incentive conflicts, moral hazard and agency problems. By at times distorting incentives to manage risk, these market imperfections can alter credit decisions and lead to a higher overall level of risk-taking than may be optimal for the economy as a whole. This provides the classic rationale for supervision and regulation. Supervision and regulation have the potential to help mitigate these sources of market failure. The recognition of a market failure does not mean, of course, that policymakers have the capacity to design solutions that can effectively mitigate those failures without raising others problems.

The fundamental challenge for policy is how to achieve the appropriate balance between efficiency and financial resilience. With too much government intervention, innovation is constrained and the system is stifled. With too little, the probability of systemic crisis may rise to levels that are unacceptably high. We judge the appropriate balance not against the standard of whether it reduces to zero the probability of a major financial crisis, the failure of a large individual financial institution or a major reduction in asset prices. That is not an appropriate objective of policy. Some vulnerability to crisis is a necessary and unavoidable feature of a dynamic and efficient financial system where asset prices need to be able to adjust to changes in fundamentals. The consequences of trying to induce regulated financial institutions to self-insure against all conceivable potential risks would do substantial damage to the level and efficiency of economic activity and cause the same risks to migrate to other institutions.

This leaves policymakers with a set of normative questions, the answers to which must be based on knowledge about how markets work, as well as a substantial degree of judgment about what policy actions are likely to be both appropriate and effective. What level of exposure to very low probability, extreme adverse events should we be comfortable living with? What fraction of that residual exposure to the potential range of adverse events can and should the official sector try to protect the system against?

The apparent success that market participants and supervisors have had so far in confronting these issues does not imply that the potential for systemic risk in financial markets no longer deserves the attention of central banks and supervisors. Although improvements in capital adequacy and risk-management tools seem to have been a key part of the increased resiliency we've seen in recent years, we can't assume that the standards and risk-management practices consistent with stability in the recent past are the ones that will perform well in the future. This is partly because it is impossible to know for sure how the favorable macroeconomic conditions and the financial sector stability interacted and reinforced each other. That is, would financial sector outcomes be as favorable in a weaker macro environment?

But probably more important is the fact that even as we have pushed forward on regulatory, supervisory and risk-management efforts, financial markets, instruments and institutions have continued to evolve as well. Among the most notable of these changes has been the rapid growth and innovation in derivatives and the greater relative importance of private leveraged financial institutions, such as hedge funds.

The changes in credit markets that have accompanied the latest wave of innovation in derivatives and the large role played by leveraged financial institutions in those markets may exacerbate some of the traditional sources of challenges in financial markets. And they present new challenges for the framework of incentives and constraints that central banks and supervisors set for financial institutions.

On balance, we believe these changes in the financial environment are likely to come with substantial benefits in terms of overall market efficiency. In the remainder of my remarks today, I will highlight some of these benefits, but will also consider some of the challenges they present for central banks and governments in determining where on the spectrum of efficiency and vulnerability to crisis the financial system should operate, and in crafting the policies consistent with achieving that objective.

Changes in Financial Markets Since the Late 1990s

In the United States and the other major markets, the policies designed to mitigate the risk of financial crises rely primarily on a capital-based system of supervision of the major financial institutions, reinforced by measures to improve market discipline. These policies have evolved to reflect both the fundamentally important role credit markets play in the economy, as well as the reality that these complex markets are susceptible to a range of potential market failures.

In thinking about the potential supervisory and regulatory challenges presented by the broad evolution of the financial system over the past decade, it makes sense to first consider how some of these changes may have enhanced market functioning by mitigating at least some of the imperfections that characterize these markets. My remarks here are a mix of what we see happening in practice and how we might expect things to work in principle.

To begin with, financial institutions within the regulated core of the financial sector have become larger, and the industry considerably more concentrated. The 10 largest bank holding companies now hold roughly half of banking assets, compared to less than a third in 1990. These institutions now operate with greater geographic scope and offer a broader range of financial products, but overall volatility of earnings has not changed much relative to capital.

Hedge funds, private equity funds and other leveraged financial institutions control increasingly large shares of aggregate financial capital and play very active roles in many asset markets and in credit markets. Although assets under management in hedge funds still represent a relatively small share of total financial assets, their relative share has increased significantly and their ability to take on substantial leverage magnifies their potential impact on financial market conditions. These private leveraged funds have become an important source of protection to regulated institutions by being large sellers of credit insurance in the rapidly growing market for credit default swaps.

In terms of enhancing overall market efficiency, the growth of these private leveraged institutions can be expected to provide benefits in terms of improved liquidity, price discovery via arbitrage, diversity of opinion and diversification opportunities for investors. The increase in the share of assets managed by private pools of capital devoted to arbitrage activity should improve the overall functioning of markets. In most circumstances, increased trading and participation contributes to market liquidity and makes markets less volatile. The ultimate benefit should be lower risks for all market participants. This in turn should reduce the risk premia associated with holding financial assets, and ultimately reduce the cost of capital.

The rapid growth in the relative importance of these leveraged financial institutions has been accompanied by a number of structural changes as well. The total number of funds has grown dramatically. There are more very large hedge funds and private equity firms. Greater institutionalization, and the maturity of risk management and operational infrastructure in the largest of these private funds, has likely reduced operational risk. To the extent these changes have increased the diversity of firms and strategies in this part of the financial system, and this is hard to measure with any confidence, this heterogeneity should provide diversification opportunities, foster more efficient price discovery and could help improve stability.

These changes in market participants have occurred in conjunction with a dramatic acceleration in number and type of derivative instruments. These developments have likely had the important impact of allowing for a more efficient distribution and more effective management of risk.

All of these changes should move the market in the direction of fostering the efficient allocation of credit and capital formation, and thus enhancing the economy's real growth potential.

The available evidence is consistent with the view that the changes in the core of supervised institutions, growth of the leveraged sector and rapid financial innovation have strengthened the efficiency and resiliency of the overall financial system. As I mentioned at the start, a broad range of recent financial shocks do not seem to have adversely impacted the real economy. The international financial crisis that began in 1997 did not spillover to the nonfinancial sector in the United States. The equity price collapse and deterioration in credit in 2000 did not cause significant damage to the core institutions in the U.S. market. The relatively limited damage caused by operations failures of the 9/11 attacks reflected the strength of the capital position of major intermediaries, as well as the policy actions by the Federal Reserve to provide liquidity to the markets.

More recently, the series of smaller financial shocks experienced since 2001, including the corporate bond defaults after 2001, the corporate accounting scandals in 2002, credit downgrades in the U.S. automobile industry in 2005, the failure of Refco, the sharp declines in mid-2006 in equity, commodity and emerging markets debt prices caused little contagion to other markets and limited strain on financial institutions.

Challenges

The favorable balance between efficiency and resilience in the financial system we have observed recently does not of course guarantee we will achieve as favorable a balance in the future. The prospects for future stability will depend in part on how effective supervisors are in adapting policies in response to the ongoing evolution in markets.

Financial institutions face strong incentives to monitor and limit their risk profile and the risk-taking of their leveraged counterparties to some efficient level where benefits balance costs at the margin. This is good for the firm and also good from society's perspective.

Private pools of capital have the capacity to use extensive leverage to amplify returns. This leverage can be acquired in a variety of ways: through repurchase agreements and reverse repos, through secured financing and securities lending and through derivatives and structured financial products.

The ability of funds to take on risk and leverage is constrained by two external sources of discipline—the returns required by their investors, and the terms on which their dealers/financers are willing to extend credit. In other words, the fund is constrained by the willingness of outsiders, collectively, to take exposure to the fund. The willingness of banks and investment banks to take on exposure to hedge funds is in turn influenced by the capital and supervisory framework that applies to those institutions and the discipline imposed on them by the market.

The effectiveness of market discipline in constraining the risk-taking behavior of financial firms, however, may be compromised by the presence of market failures of the type mentioned above. While this issue is at the heart of risk management challenges for the provision of credit more broadly, the rise in the relative size of the private leveraged fund sector and the rise in the importance of new derivative financial instruments may complicate the design of policies and risk-management practices to counteract these traditional frictions.

Virtually all types of credit markets suffer from informational problems—consider the challenge faced by a bank in assessing the risk associated with lending to a small unrated company. But the complexity of new financial products, the rapidity with which positions can change, and the lack of a long time series of historical relationships seems likely to enhance these problems for leveraged institutions operating in new markets such as credit derivatives.

Funds typically deal with several different banks and investments banks. The desire to maintain the confidentiality of their trading strategies has traditionally led firms to be quite opaque to outsiders and reluctant to give their banks sufficiently detailed information on a real time basis about the risk profile of the overall fund. Without that information, individual dealers or banks have a difficult time evaluating the probability of default of a leveraged counterparty and the potential covariance with other positions of the firm.

Individual firms may also see only a piece of the hedge fund's positions, and if their direct exposure to the individual fund is small, may perceive less need to worry about the overall risk profile of the fund. Public disclosure requirements designed to compensate for this information problem do not exist. Even if information on the overall size of the fund's positions were available periodically, it would be difficult to accurately ascertain its risk profile. This gives individual firms an incentive to free-ride on the due diligence or monitoring by others, which may render resultant collective discipline inadequate.

The foundations of modern risk measurement rest on a framework that uses past returns to measure or estimate the distribution of future returns. The stability of the recent past, even if much of it proves durable, probably understates potential risk. The parameters used to estimate value at risk can produce very large differences in predicted exposure, especially at extreme confidence intervals.

Estimating the potential interactions among these exposures in conditions of stress is even harder, due to the uncertainty about the behavior of investors and other market participants and because of the potential effects of financial distress on overall economic activity.

The relatively short history of returns for new products, the complexity of measuring exposure in many new instruments and limitations on transparency also create the potential for classic “agency” problems—internal conflicts of interest that can lead to problematic outcomes. In exposures where the measurement of potential loss is more uncertain, more subjective, and less amenable to independent evaluation, for example, reasonable people can come to very different judgments about the potential risk in a particular position. Normal competitive pressures can push valuation methods away from the conservative extreme and generate larger exposures to risk. As a result, individual firms and the overall market are more exposed to risk in a stress scenario than would be desirable.

Another set of challenges comes with the broader damage to markets that can accompany the failure of a major financial institution. Firms have strong incentives to avoid large financial losses and to reduce the risk of failure, of course, but they do not have the incentive to internalize the potential external consequences of their distress on the financial system, and it is unrealistic for market participants to incorporate these risks into market prices. This “public good” dimension of financial stability means that while the whole economy benefits from a more stable financial system, each individual institution would prefer that others incur the costs associated with its provision. As a result, firms may collectively underinsure against the risk of failure and underinvest in the infrastructure and policies that promote financial stability.

And finally, policies designed to reduce the risk of failure in financial markets create moral hazard, dulling the incentive individual firms face to self-insure against potential loss. We apply a set of capital requirements and supervisory constraints to offset the distortion created by the safety net, but these may not fully compensate for the impact on behavior of the broader range of financial intermediaries of the perception that the authorities will act to protect the financial system from systemic risk.

While these constraints and challenges may weaken the effectiveness of counterparty discipline, they are not fatal constraints. If individual dealers to a very large hedge fund each operate with adequate knowledge of the risk profile of the fund, if they each make conservative judgments about their potential direct exposure to the fund in a stress scenario, if they limit the overall exposure of the firm as a whole to the broader market distress that might accompany that failure of a major hedge fund, if they compensate for the uncertainty in making these judgments by charging appropriate risk premia or building in a greater cushion against adversity, and if the supervisory constraints on the core institutions adequately offset the moral hazard that comes with that relationship, then the financial system as a whole will be less vulnerable to distress in the hedge fund sector. These are exacting conditions, but they are not unachievable. And we all have an interest in encouraging progress toward that objective.

Implications for Policy and Risk Management

What are the implications of these challenges for central banks and supervisors? The changes in the financial system we’ve seen over the past decade don’t change the principal objectives of policy—to ensure that the core financial institutions maintain an adequate cushion of capital in relation to risk, and to build greater resilience into the infrastructure that supports the financial markets. We have very limited ability to predict the sources of stress to the financial system, but if the cushions at the core of the system are robust, the risk of a systemic crisis will be diminished, and central banks will have greater ability to mitigate the risk of broader damage to the economy.

The pace and extent of the changes in financial markets requires supervisors to work harder to understand the consequences of changing market practice for the incentives and constraints we impose on financial institutions. Let me give two examples of evolving market practices that may help alleviate one concern only to exacerbate another.

Collateral plays an increasingly important role in counterparty credit risk management, particularly for highly leveraged counterparties. The increased importance of variation margining plays a critical role in counterparty credit risk management. These changes help limit the exposure of the core financial institution to losses among their leveraged counterparties, but they also act to exacerbate volatility, with asset price declines forcing further margin calls, adding for further market declines. Where initial margin is thin in relation to potential exposure, counterparties are more exposed to adverse movements in asset prices, and in a situation of stress the actions they take to reduce their exposure to further losses are likely to have a greater negative impact on market dynamics.

In market conditions where initial margin may be low relative to potential future exposure, the self-preserving behavior of leveraged funds and their counterparties may be more likely to exacerbate rather than mitigate an unexpected deterioration in asset prices and market liquidity. As financial firms demand more collateral, funds are forced to liquidate positions, adding to volatility and pushing down asset prices, leading to more margin calls and efforts by the major firms to reduce their exposure to future losses. In the context of the previous discussion of externalities, firms' incentives to minimize their own exposure can amplify the initial shock and impose on others the negative externality of a broader disruption to market liquidity.

The fact that this potential adverse dynamic exists does not mean it will occur. The deviation of prices from their fundamental values in times of stress is likely to create incentives for firms and investors with resources to step in and provide liquidity. In other words, the market may itself have the capacity to self-correct and prevent a disruptive loss of liquidity.

A second example is the recent trend to lengthen lock-ups, implement redemption gates that limit withdrawals, and create special side-pocket accounts for particularly illiquid investments by hedge funds. Each of these changes may serve to reduce the liquidity risk of the fund, which should be beneficial and potentially reduce the disruption from the forced liquidation of positions. They may also, however, reduce market discipline and increase the overall scale of leverage assumed by those funds. We don't have the capacity to assess with confidence the balance of these effects on the probability of crisis and the severity of market dynamics in conditions of stress.

What should be the focus of supervisory efforts in this new context? Clearly, capital supervision and market discipline remain the key tools for limiting systemic risk. The emergence of new market participants such as leverage institutions does not change that. I am going focus on three broad policy priorities—risk management, capital and margining practices, and the financial infrastructure.

Risk Management

We should focus more attention on parts of the risk-management process where uncertainty is greatest and materiality of the risks that we can't readily quantify is highest. This means more attention on the risk factors where the measurement challenges are most complex. It means more attention on assessing potential exposure in extreme events that lie outside past experience, not just those outside of the recent past.

These challenges require using a mix of different analytical tools to help illustrate the range of possible outcomes and the dimensions of uncertainty that apply to the measurement of exposure. The focus should be not on the specific estimates produced for various types of asset price movements or stress events, but the uncertainty that surrounds those estimates and the magnitude of the potential underestimation of losses. Another way to say this is that we probably need to spend as much time discussing the limits of the quantitative outputs of the risk-management process as we do on the estimates produced by the models.

Understanding and evaluating "tail events"—low probability, high severity instances of stress—is a principal, and extraordinarily difficult, aspect of risk management. These challenges have likely increased with the complexity of financial instruments, the opacity of some counterparties, the rapidity with which large positions can change, and the potential feedback effects associated with leveraged positions.

Stress testing and scenario analysis have become central to the process of risk management, and we have seen substantial progress since 1998. The efficacy of these tools should be judged in part by the extent to which they capture, on a high frequency basis, the full exposure of the firm to a sufficiently broad range of adverse conditions, the aggregate exposure to specific types of different risk factors and types of counterparties, the potential interactions among those factors, the effects of a general loss of liquidity and confidence in markets, and the constraints on the ability of the firm to move to reduce its exposure to further losses.

And, of course, the credibility of the risk-management process should be judged not just by the quality of attempts to estimate stress exposure, but also by the impact of these results on the decisions about how much exposure the firm actually takes. In other words, effective stress testing must be viewed not only as a tool for monitoring the risks a firm has taken, but for actually influencing and changing behavior.

Supervisors should focus on concentrations of exposure to a range of different risk factors, not just on the concern of the particular moment or the most recent sources of shocks. Just as generals are often accused of preparing to fight the last war, practice tends to chase measures of direct exposure implicated in past crises, or what seem like the plausible candidates for future crises, whether to real estate, to hedge funds, to structured financial products, to emerging markets or to a particular industry.

This may be necessary and desirable, but it is not the most challenging task in risk management, and we generally don’t put ourselves in the position of trying to substitute our judgment for the markets on what level of direct exposure to a particular company or industry is prudent relative to capital.

The better approach is to look at what might happen to the firm’s losses in various alternative, more adverse states of the world, and then assess the direct and indirect effects of distress in different parts of the portfolio and the interactions among them. The major financial institutions, for example, typically take on very little direct current exposure to hedge funds as group. But, as you might expect, the scale of potential future exposure is more substantial. An even greater challenge is measuring the exposure of the firm not simply to the direct effects of the failure of a particular hedge fund counterparty, but to the broader distress that it might cause to other market participants or its impact on the other exposures of the firm. The management of these direct and indirect exposures needs to be an important focus of attention.

Capital and Margin

Supervisors have put a considerable amount of effort over the past decade into designing a successor to the Basel capital accord. The present regime does not do a good enough job of capturing the risks a major institution typically assumes today. Because it understates the amount of capital required against some risks, overstates others, and ignores still others, we should work to put in place a replacement regime as quickly as we can be confident we have a viable alternative. The prudent, conservative approach should be to move forward to a more risk sensitive framework that creates better incentives for prudent risk management, not to try to extend the life of the present accord.

It is critical that these broader efforts to fix the capital regime be reinforced with more attention by supervisors to margin practice and limits around the counterparty risk-management process within the major financial institutions. The regulatory capital regime is designed to offset the effects on individual firms of lower margin. Where margin levels are low relative to potential exposure, the capital requirement is higher. Where margin is higher, the capital charge is lower.

Both capital and margins have costs, and firms seek to limit these costs and choose their preferred combination.

The question for policymakers is whether the mix of capital and margins produced by the market is appropriate from the perspective of the financial system as a whole. As forms of financing that enable leverage and as leveraged funds grow in importance, the overall level of margin held against positions can provide an important cushion against the type of adverse market dynamics and general run on liquidity we saw in 1998. For these reasons, in the 2005 report of the Counterparty Risk Management Policy Group, chaired by Gerry Corrigan, a diverse mix of major market participants recommended that margin levels be set at a threshold that is "sustainable over the cycle." This reflects a view that, in general, the initial margin required of unregulated leverage counterparties should be set to provide some cushion against potential exposure.

Financial Infrastructure

Supervisors should continue to encourage improvements in the infrastructure that supports financial markets. When we think about infrastructure in today's market, it's not enough to look just at the technology and risk-management systems that support the major exchanges and the payments and settlement systems operated by central banks and private utilities. This view is reflected in the amount of recent supervisory attention that has been focused on the systems within and among private institutions that support the bilateral over-the-counter derivatives markets. Last September, 14 major financial institutions and their principal supervisors met at the Federal Reserve Bank of New York to undertake a concerted program of improvements to the infrastructure that supports the OTC credit derivatives market. When that group reconvenes next week, we will review the extent of progress in reducing the backlog on unconfirmed trades and increasing the number of trade confirmed through automatic systems. We will also assess the progress toward agreement on a protocol for settlement events. And we will review new commitments to expand this effort to other OTC derivatives, including equity derivatives.

These priorities for policy and supervision have the potential to strengthen our financial system and make it more robust to real systemic events. To be effective, however, we must continue to explore ways for supervisors and regulators to cooperate more closely together. The changes in market structure and financial innovation during the past decade, along with the increased global integration of capital markets, have increased opportunities for regulatory arbitrage. Policy initiatives that focus only on the U.S. market or on a specific class of institutions will push the activity to other markets or other institutions, raising costs on the regulated intermediaries without reducing overall risk in the system. Balancing the imperative of a cooperative approach across markets and institutions with the need for a more agile response to the rapid pace of evolution in markets will be a continuing challenge.

Conclusion

The changes in the financial system since 1998 confront us with a mix of benefits and challenges. The larger size and scope of the core institutions, the greater opportunities for risk transfer and hedging provided by innovation in derivatives, the improvements in risk management, the larger role played by a much expanded number and more diverse mix of private fund managers seem likely to have improved the stability and resilience of the financial system across a broader range of circumstances.

The same factors that may have reduced the probability of future systemic events, however, may amplify the damage caused by and complicate the management of very severe financial shocks. The changes that have reduced the vulnerability of the system to smaller shocks may have increased the severity of the large ones.

Supervisors need to continue to focus attention on reducing the vulnerability of the market to these low probability, but extreme events, while preserving the benefits that have come with these changes in financial markets. The limitations of the conventional risk-management tools in assessing potential losses in the adverse tail of possible outcomes in today's financial system magnify the risk that individual institutions will operate with less of a cushion than might be desirable for the market as a whole.

As the structure of markets change, we need to continue to review whether the overall framework of supervision over the core banks and investment banks provides the right balance of efficiency and resilience for the system as a whole. The capital requirements and other constraints we place on the regulated institutions have played an important role in encouraging the transfer of risk to a broader range of institutions, including the leveraged private pools of capital. As the aggregate size and importance of those funds increases, distress among those institutions can have greater effects on overall market dynamics, potentially increasing risks to the regulated core. Over time, this will force us to consider how to adapt the design and scope of the supervisory framework to achieve the protection against systemic risk that is so important to economic growth and stability.

For the present, however, our hierarchy of priorities should focus on improving supervisory incentives to make counterparty discipline more effective and to strengthen the resilience of the core institutions to more adverse economic and financial conditions.

Thank you.

I would like to thank Kevin Stiroh and Meg McConnell of the Research and Statistics Group at the Federal Reserve Bank of New York for assistance and comments.

EXHIBIT O

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

Case No. 06-11156

- -x

In the Matter of:

SEA CONTAINERS LTD, ET AL.,

Debtors.

- -x

U.S. Bankruptcy Court

824 North Market Street

Wilmington, Delaware 19801

May 14, 2008

2:34 p.m.

BEFORE:

HON. KEVIN J. CAREY

U.S. BANKRUPTCY JUDGE

DEBTORS' Motion for Authority to Supplement Non-Insider Retention Plan for Certain Employees

DEBTORS' Motion to File Under Seal Exhibit to Debtors' Motion for Authority to Supplement Non-Insider Retention Plan for Certain Employees

DEBTORS' Motion for Order Approving Settlement Regarding Pension Claims

MOTION of the Official Committee of Unsecured Creditors of Sea Containers Services, Ltd. to Compel Production of Documents

JOINT Motion of the Official Committee of Unsecured Creditors of Sea Containers Services Ltd, Trustees of the 1983 Pension Scheme, and Trustees of the 1990 Pension Scheme for Protective Order

MOTION of SCL Committee for Entry of an Order Under 11 U.S.C. Section 102(a) Shortening Notice of Motion of SCL Committee for Protective Order

Transcribed By: Esther Accardi

APPEARANCES:

YOUNG CONAWAY STARGATT & TAYLOR, LLP

Attorneys for Debtors
100 West Street
Wilmington, Delaware 19801

BY: EDMON L. MORTON, ESQ.

KIRKLAND & ELLIS, LLP

Attorneys for Debtors
200 East Randolph Drive
Chicago, Illinois 60601

BY: AARON SCHECHTER, ESQ.
DAVID AGAY, ESQ.
MATTHEW WAWRZYN, ESQ.
(TELEPHONICALLY)

KIRKLAND & ELLIS

Attorneys for Debtors
153 East 53rd Street
New York, New York 10022

BY: YOSEF RIEMER, ESQ. (TELEPHONICALLY)

APPEARANCES: (continued)

KRAMER LEVIN NAFTALIS & FRANKEL, LLP
Attorneys for 6 Individual Bondholders
1177 Avenue of the Americas
New York, New York 10036

BY: BRAD O'NEILL, ESQ.
JOSH BRODY, ESQ.

PEPPER HAMILTON, LLP
Attorneys for SCSL Committee
1313 Market Street
Wilmington, Delaware 19899

BY: DAVID B. STRATTON, ESQ.

MORRIS NICHOLS ARSHT & TUNNELL, LLP
Attorney for SCL Committee
1201 North Market Street
Wilmington, Delaware 19899

BY: DEREK C. ABBOTT, ESQ.

APPEARANCES: (continued)

WILLKIE FARR & GALLAGHER, LLP
Attorneys for Official Committee of
Unsecured Creditors
787 Seventh Avenue
New York, New York 10019

BY: BRIAN O'CONNOR, ESQ.
MICHAEL J. KELLY, ESQ.
MARC ABRAMS, ESQ.
SETH KLEINMAN, ESQ.
MARA SIERCHIO, ESQ.
(TELEPHONICALLY)

FOX ROTHSCHILD, LLC
Attorneys for 6 Individual Bondholders
919 North Market Street
Wilmington, Delaware 19801

BY: SETH NIEDERMAN, ESQ.

APPEARANCES: (continued)

DRINKER BIDDLE
      Attorneys for GE Entities
      1100 North Market Street
      Wilmington, Delaware 19801

BY: HOWARD COHEN, ESQ.

BINGHAM MCCUTCHEN, LLP
      Attorneys for SCL Committee
      399 Park Avenue
      New York, New York 10022

BY: RONALD SILVERMAN, ESQ. (TELEPHONICALLY)

BINGHAM MCCUTCHEN, LLP
      Attorneys for Official Committee of
       Unsecured Creditors
      One Federal Street
      Boston, Massachusetts 02110

BY: WILLIAM BENSON, ESQ.
      SABIN WILLETT, ESQ.
      (TELEPHONICALLY)

APPEARANCES: (continued)

APPEARANCES: (continued)

GIBSON DUNN & CRUTCHER, LLP
Attorneys for
200 Park Avenue
New York, New York 10166

BY: JENNIFER REARDEN, ESQ. (TELEPHONICALLY)

WEIL GOTSHAL & MANGES, LLP
Attorneys for GE Capital Corp.
767 Fifth Avenue
New York, New York 10153

BY: SHERRI L. TOUB, ESQ. (TELEPHONICALLY)

SONNENSCHEIN NATH & ROSENTHAL
Attorneys for 1990 Pension Scheme
601 South Figueroa Street
Los Angeles, California 90017

BY: CHRISTOPHER E. PRINCE, ESQ. (TELEPHONICALLY)

APPEARANCES: (continued)

SONNENSCHEIN NATH & ROSENTHAL, LLP

Attorneys for 1990 Pension Scheme

1221 Avenue of the Americas

New York, New York 10020

BY: D. FARRINGTON YATES, ESQ. (TELEPHONICALLY)

GE EQUIPMENT SERVICES

BY: JOSEPH L. LINCOLN (TELEPHONICALLY)

GE CAPITAL CONTAINER

BY: DOMINIC BUCKWELL (TELEPHONICALLY)

P R O C E E D I N G S

THE CLERK: All rise.

THE COURT: Go ahead.

MR. MORTON: Good afternoon, Your Honor.

THE COURT: Sorry about that.

MR. MORTON: Certainly. For the record, Edmon Morton from Young Conaway on behalf of the debtors.

If I may briefly ask Your Honor for a slight indulgent on the order of the agenda. I believe there's only one matter that is truly contested today, it's matter number related to the services committee's request for 2019 compliance on behalf of certain bondholders. If we could move that to the end of the agenda, I know there are a number of people on the phone who have dialed in from a deposition solely to attend the discovery status conference portion of the hearing. That might allow them to get back to doing the litigation work they've been doing for the better part of the day.

THE COURT: All right.

MR. MORTON: To that end, Your Honor, item number 1 was the subject of a certificate of no objection. This is our motion for a small supplementation to the non-insider KERP program. We did file a short declaration of law Barlow in support of that. I'm not sure if Your Honor had any questions.

THE COURT: Well, I did until I received the declaration, but more particularly, the exhibit, which I wanted to review before signing off on any order. I have now had the opportunity to review both. Does anyone else care to be heard in connection with this matter? I hear no response. I am prepared to grant the relief that's been requested.

MR. MORTON: Thank you, Your Honor.

THE COURT: Do you have an order to hand up?

MR. MORTON: I do not have a form of order with me at the podium. If you'll give me just --

THE COURT: I have the binder, let me --

MR. MORTON: Thank you, Your Honor.

THE COURT: -- if it's in there. All right. That order has been signed.

MR. MORTON: Thank you. Obviously, item number 2 was taken care of by an order entered earlier by Your Honor. Items 3, 4, and 5 of the agenda are the portion that's basically the discovery status conference that's scheduled for today. I don't believe there's anything specific that needs to be said on items 4 or 5, unless a party wants to correct me on that front.

As for item 3, the general discovery status conference, I believe we had two small issues we wanted to raise with Your Honor, I'll address them in turn, because the first is fairly straight-forward and is really just a request for clarification on your end.

Presently contemplated as one of the last deliverables in the case, is the joint pre-trial memorandum. As has been done in the past with truly expedited litigation like this, where the parties are also engaging in simultaneous briefing, we simply wanted to confirm with Your Honor if it was acceptable for us to use the form of pretrial memo we used in the GE DIP litigation. And since I don't expect Your Honor remembers that with any degree of particularity, basically that --

THE COURT: Thank you for that indulgence, I appreciate it.

MR. MORTON: Certainly. Basically, that form of joint pretrial memorandum did set forth the witnesses to be called and a brief description of the testimony they would provide. The issues that the parties believe were going to be addressed at the hearing, as well as the exhibit list with designations as confidential and non-confidential. But because of the compressed schedule of briefing it's very difficult to come up with statements of undisputed facts and what not. And typically, you know, those, when you're engaging in this type of briefing, will be pretty well covered in any event. If that is acceptable with Your Honor.

THE COURT: Well, let me make one request.

MR. MORTON: Certainly.

THE COURT: And that is if there is a set of undisputed facts that fall into, you know, the low hanging fruit category to which the parties can agree and reduce to writing without too much haggling, I'd ask that you do that. But I will not ask that you undertake, you know, the full exercise of trying to haggle everything out.

MR. MORTON: Certainly, Your Honor. We will do our best to come to agreement on that. And if can't for whatever reason, we'll at least note that in the form of pre-trial memo so that it is clear to Your Honor.

THE COURT: All right, thank you.

MR. MORTON: Thank you. Your Honor, the second point -- and simply because I'm at the podium I guess I'll raise it first. The present schedule that is before Your Honor contemplates that the objections to the 9019 motion on the part of the SCL committee will be due this Friday, May 16th. There was a request by the services committee to move this deadline to Monday based upon the fact that, you know, current discovery and depositions are still ongoing. Certainly, and I know Mr. Abbott will be coming up in a moment, Your Honor, to fill out the services of the Sea Containers Ltd. committee's idea of this, but unfortunately, this is one of those few times where we really were not able to accommodate this request. As Your Honor, I can see you now, is already looking at the calendar and has surmised --

THE COURT: Well, I'm looking at the second revised scheduling order.

MR. MORTON: Oh, certainly. And that does set May 16th as the deadline for the objection itself. And it sets as the reciprocal deadlines May 23rd, which is the following Friday, for our deadline to respond.

Your Honor, we view the current staggering as fairly critical for two reasons. The first is, obviously, we want to make sure that we get these pleadings to Your Honor in time that you're able to sufficiently review them in an appropriate fashion, and certainly getting them to you the day before the hearing, you know, we believe is fairly problematic from our perspective. More importantly, I think it's worthwhile from all parties' perspective that the briefing be able to be closed out going into the weekend, that parties are going to need to prepare for trial. It's certainly far from ideal for the debtors to have to be spending time working on a trial brief and preparing for the actual trial. And, certainly, the statements that are going to be contained in our reply will shape, no doubt, the trial preparation of others. So from our perspective, we believe that the fact that current depositions are ongoing, and indeed it's everyone's hope that the two depositions that have been highlighted as the need, you know, for the further extended deadline are going to be completed by the end of today, certainly our position that the revised scheduling order that is in place now is the appropriate timeframe and the appropriate deadline.

Unless Your Honor has any initial questions for me, I cede the podium to Mr. Abbott.

THE COURT: I do not.

MR. ABBOTT: Thank you, Your Honor. Derek Abbott here on behalf of the SCL committee. I think Mr. Morton misspoke, it's actually my committee's request to move that objection not the services committee, through Monday.

Your Honor, there are a couple of issues I'd like to raise. But among them -- and I understand the debtors' concern. We're obviously most concerned with the Court and if we're stuck with a week, Your Honor, we'd ask for Monday, that would leave their reply due -- essentially, the business day before trial.

THE COURT: The 26th. Monday, the 26th, which is Memorial Day.

MR. ABBOTT: Correct, Your Honor. Which leaves the Court in the difficult position of having one day before the trial to read it. We don't make this request lightly, Your Honor.

I'll add to the request in a minute, but the important thing for us, Your Honor, is that we intend this objection, essentially, to work the kinds of things that you might typically see as contested fact statements in a pre-trial order and be much more useful to Your Honor. In the conduct of the trial, we intend to have significant citation to the record, both documentary and testimony. And given that literally transcripts of today, you know, probably will be ready later tonight, maybe tomorrow, it does put the onus -- we realize that it puts all the burden on the -- strike that. We realize it puts a greater burden on all the parties as we move towards trial. But we think that with that extra time it will significantly allow us to focus the Court on the critical issues, show the Court some evidentiary indications of why we believe those are the right way to view things. And we think, Your Honor, it will help the Court at trial. We recognize that their reply will be due on the eve of trial, but, Your Honor, given that we are the ones that will most have to shape our trial response to their reply, you know, that's a burden we're willing to take. The real question, Your Honor, is whether the court is willing to accept something that late to review before trial. And we think that it is, again, important and will be useful in streamlining the trial and the parties' consideration and the Court's consideration of the issues.

And I will say, Your Honor, the debtors were gracious and did offer what they could in terms of a modest extension but not one that was adequate for the purpose, we didn't think so, Your Honor.

THE COURT: Well, which was what?

MR. ABBOTT: Saturday at 3 p.m., Your Honor.

MR. MORTON: Your Honor, if I may briefly respond to a couple of the points?

First and foremost, well certainly, everyone's primary concern is always the Court and the Court's level of preparedness.

THE COURT: Oh, thank you for saying that.

MR. MORTON: And, Your Honor, of course well knows that there's a but coming right after I say that. The but is that I believe that Your Honor's preparation for trial will be aided by sticking to the current schedule because it is necessary for all parties to prepare cohesive trial strategy to be able to productively use what is, unfortunately, a holiday weekend to get ready for a trial that has been, you know, put in a fairly tight track for very good reason.

THE COURT: Mostly everybody wanted.

MR. MORTON: Absolutely. And we are very pleased that Your Honor accommodated the track. But where we are now is I don't think that it is a simple, even from our trial preparation prospective, which will inevitably benefit Your Honor through more cohesive and joint presentations for us to try to drop our reply on everyone the day after a holiday weekend. And more importantly, have taken so much of that time on our own right to prepare it. And it should be clear that the extension that we gave based on the Saturday timeframe was given specifically to avoid having this argument before Your Honor, it was a settlement offer, and not actually just a carte blanche extension that they could come in and try to get, yet, a better date from Your Honor. We believe that the appropriate deadline is to keep them to Friday, because it is our intent to get the briefing to you during the business day on Friday of the following week for purposes of actually having you have the pleadings in your hand by the time you go into the weekend.

THE COURT: Oh, so you want to make me work over the weekend.

MR. MORTON: We want you to have the opportunity to work whenever Your Honor's schedule permits.

THE COURT: Always thoughtful.

MR. MORTON: So to that end, Your Honor, I wanted to make clear that we believe that the schedule embodied in the present order is the appropriate one to get us to the trial track. Certainly, there are depositions that are going to be ongoing as we are, in our efforts to prepare, as well. This is not, you know, a burden that is not shared by all parties as we finalize our discovery process. But, nevertheless, we think its critical that this not shift back, yet another weekend for purposes of making sure this trial is conducted in an orderly fashion.

THE COURT: Well, in a way you're picking your own poison. I'll extend the deadline to Sunday the 18th at 3 o'clock. Without moving the deadline which follows. And since that probably makes everybody unhappy we'll leave it at that.

MR. ABBOTT: Thank you, Your Honor. I have two more minor issues with respect to the brief, Your Honor. One is typically one might file an appendix with this sort of a document because there will be those heavy citations that I mentioned earlier. In light of the pretrial order that will be following nearly immediately after that, that we just talked about, that will have those exhibits attached, we thought it might make sense to rely on that rather than prepare a separate appendix that will contain certainly all -- a subset of all the documents that will be in that pretrial order. And I just wanted to make sure that that was acceptable with the Court.

THE COURT: That's fine with me. Does anyone have an objection to that?

MR. MORTON: Your Honor, I think that, actually, makes good sense as long as its clear that all parties putting in a briefing can avail themselves of the same thing.

THE COURT: That's fine.

MR. ABBOTT: And, Your Honor, the last matter is the issue of page length on the brief that I've now asked everybody to take a little bit later. For the reasons that we described, and again, in order to try to focus the trial of these matters, we would like some relief from the forty-page limit if the Court could see fit. And we will endeavor to make this brief as short as we possibly could.

THE COURT: Well, make it thirty pages then.

MR. ABBOTT: Well, Your Honor, I was actually thinking in the other direction.

THE COURT: I thought so. How much relief are you requesting?

MR. ABBOTT: Your Honor, I don't know what it will ultimately turn out to be. I'd like the ability to go to seventy-five pages if necessary. Realizing that the Court may not want to read seventy-five pages and trying to keep it as short as we reasonably can.

THE COURT: I once heard Justice Scalia speak. And in light of his view on the importance of -- or unimportance of legislative history, he said once that when he would get to that part of the brief he'd just skip over it. I haven't got the discipline to skip over anything, I tend to read every page. So I appreciate the sentiment, but, you know, whether it's fifty or seventy-five pages, I read all the pages. Because I feel if I skip over them I do so at my own risk. Is there any objection to that request?

MR. MORTON: Your Honor, I feel compelled to simply, based on your facial expressions, perhaps a better way to go about it -- I mean, unfortunately, we may find ourselves in a similar position. Because as Your Honor knows from these disputes we put forth a motion, you know, this motion is not actually a full brief, you know, that addresses all of their issues. So the page limit that may, you know, correspond to our reply is going to be directly impacted by how long their opening is.

THE COURT: Well, it takes up a whole binder, the motion.

MR. MORTON: That's correct.

THE COURT: With all the bells and whistles attached.

MR. MORTON: Certainly. And I don't think we would need anywhere close to seventy-five pages. I simply think that perhaps the -- you know, the -- perhaps an appropriate way to handle this would be, you know, what is the more standard practice. Parties make the brief as absolutely lean as they are able, they file a concurrent motion for relief from the page limit, and understand that because they haven't gotten a pre-blessing from the Court they're slightly at the Court's peril. Either that or we could establish some sort of preset page limits. But, I personally -- this is an issue that was given to me as I walked in the door. While I'm positive that if they filed a seventy-five page brief we will need more pages to respond. I certainly couldn't commit right now, IÆm not the party who has been in charge of the briefing, as to how much we would need.

THE COURT: Well, if I allow seventy-five pages to Mr. Abbott, I'll allow it to the debtor.

MR. MORTON: Based on that then, I believe we have no objection.

THE COURT: All right. Shall we do yet another scheduling order to embody those modifications?

MR. MORTON: Your Honor, I think all the parties that needed to hear it heard it. I'm happy if the Court or the other parties would rather put in an order, but I think we all get it after this hearing and see no need to further burden the Court with additional paper.

THE COURT: Well, that was no so bad but -- I'm content with it if the parties are.

MR. MORTON: Thank you, Your Honor.

THE COURT: Okay. Anything further on that?

MR. MORTON: No, Your Honor.

THE COURT: All right.

MR. MORTON: I believe that takes us to the end of the discovery status conference. One small item, if I may skip over item 6 for just a moment, items 7 and 8 all relate to a protective order that was sought by the SCL committee. We believe and we still believe that there was pertinent information that was non-privileged that we could have gotten from Mr. Marshall. But after the exchange and also after the clear and unequivocal statements that were contained in the motion for protective order, neither Houlihan nor Mr. Marshall, individually, will be testifying either, you know, as a fact witness or as an expert, and will be designated as an expert, we have agreed to forego the deposition at this time.

THE COURT: All right. So the motion is now moot.

MR. MORTON: That's correct, Your Honor.

THE COURT: All right.

MR. MORTON: To that end, I believe we are now back to item number 6, and just on behalf of those who are on the phone, that have to get back to a deposition I would ask if they may be excused?

THE COURT: Yes. Anyone who wishes to be excused at this point may be.

MR. MORTON: Thank you, Your Honor.

THE COURT: But before we get into the main item for today, let me just say that I did get the motion to authorize the retention of Punter Southall and the request to shorten notice. It asks for a hearing date of May 20th and an objection deadline of May 19. And since I just received it, I knew the parties were coming in today, I just wanted to ask on the record whether anyone wished to be heard on this matter?

MR. MORTON: Your Honor, I can simply say for the debtors it's not something that we discussed with out client yet, so we really can't take a position.

THE COURT: Anyone else care to weigh in?

MR. STRATTON: Good afternoon, Your Honor. David Stratton, Pepper Hamilton. As I think Your Honor knows, but I want to make sure we all are on the same page, is that we have filed an application to retain an expert witness to assist in the litigation. The question was whether we could just do it, hire them and pay them as a disbursement under either my firm's statements, monthly statements, or my co-counsel statements. We opted in favor of full disclosure because we didn't want anybody second-guessing a decision to spend some thousands of dollars on an expert. In light of that, and in light of what I think should be -- it's not a typical retention application, we're not disinterestedness and rolling the case and all of that, isn't really the issue here. We thought it could be done in a very compressed timeframe. They've been working already, the application is nunc pro tunc to the date -- actually, the date it was filed or maybe the day before. I'm not sure, but there may be depositions scheduled or reports due very soon. And we have a hearing in what, two weeks. So that's the explanation. I don't think you probably needed that, but so it's on the record, that's why we wanted to do it that way. Hopefully no one from the U.S. Trustee's Office to Your Honor, but more importantly the folks in between will have an issue with it, but I wanted to add that to the record.

THE COURT: All right. Anyone else care to be heard?

MR. ABBOTT: Your Honor, Derek Abbott, again, for the SCL committee. Unfortunately, I too, don't have instructions from my client on this issue. But, Your Honor, I'll endeavor to get those. And if we oppose the timing, which I'm hard-pressed to understand why we would, given the circumstances Mr.

Stratton just laid out, we'll endeavor to get something of record by the end of the day tomorrow. If that's acceptable to the Court, obviously.

THE COURT: Well, today's the 14th. Can you get me something by noon tomorrow?

MR. ABBOTT: Yes, sir. And, Your Honor, we will only file something, unless you tell me different, if we object to the timing.

THE COURT: Yes. And just let Ms. Hunt know either way. So --

MR. ABBOTT: Will do, Your Honor.

THE COURT: Absent an objection, I'm inclined to grant the motion for May 20th at 11, and setting objection deadline of May 19th at, I don't know, 4 p.m.

MR. ABBOTT: Thank you, Your Honor.

MR. STRATTON: Your Honor, just for purposes of clarification -- for the record, this is David Stratton again. The hearing would be on May 20th at 11?

THE COURT: Yes.

MR. STRATTON: If there are no objections to the underlying retention we would not need a hearing I assume?

THE COURT: Assuming that upon my review of the application, which I have not yet reviewed, I have no questions, that would be fine.

MR. STRATTON: Thank you, Your Honor.

THE COURT: Okay.

MR. MORTON: Your Honor, a small point of clarification for all of those who didn't have Klein (ph.) instruction today, I presume that if for any reason the debtors also wish to weigh in on time, we can by noon tomorrow as well.

THE COURT: Certainly.

MR. MORTON: Thank you. Your Honor, I believe that takes us to item number 6.

THE COURT: Okay.

MR. STRATTON: Your Honor, this is the committee's 2019 motion, as I think of it. Mr. O'Connor from the Willkie Farr firm is on the phone and he will be presenting our committee's position on the motion.

THE COURT: All right.

MR. O'CONNOR: Thank you, Your Honor. Brian O'Connor from Willkie Farr on behalf of the services committee. And let me thank you for allowing me to participate by telephone. Actually, we have completed our depositions in this case just shortly before this. And, obviously, that's why we are not down there in person.

Your Honor, if I could spend just a couple of moments to put this motion in context with all the jockeying that's gone back and forth on discovery issues between the SCL committee, and us, and the bondholder group.

As Your Honor will recall, on March 5th the services committee served subpoenas on the bondholders who had formed a group and are being represented by Kramer Levin. We served that discovery on the bondholders because we understood from them that they intended to -- or likely intended to object to the pension settlement, which is the subject of the 9019 theory.

At the same time, we also made a motion to compel the bondholders to make supplemental disclosures under Rule 2019 because we didn't think the disclosures they had made to date were adequate. In response to the motions and the subpoenas, the bondholders moved to quash the subpoenas and also declined to supplement their Rule 2019 disclosures. In the motion to quash the bondholders argued that, although their counsel had met with the settlement parties and had participated in the settlement negotiations, they had not, at least at that time, formally objected to the pension settlement and were not parties to the 9019 contested matter.

THE COURT: Well, until this day they haven't yet objected, have they?

MR. O'CONNOR: To this day they haven't, but they have indicated to us last week that they are going to object. They argued at the time, Your Honor, in their papers that it was the SCL committee that was litigating the 9019 motion as a fiduciary for all the unsecured creditors, and that they were not, at least at that time, actively participating in that litigation.

In the spirit of compromise, we told the bondholders that we would not need discovery from them pursuant to the subpoenas or frankly would we pursue the 2019 supplemental disclosure if they were not going to object, and would not be appearing and actively participating in the 9019 hearing. And based upon that proposal, we agreed to continue the motion to compel and the motion to quash provided the bondholders gave us, by a date certain, notification as to if they were, in fact, going to object to the settlement.

Last week on Wednesday, I believe, possibly Thursday, but I think Wednesday, Kramer Levin gave us notice, to me, that the bondholders were, in fact, now planning to object to the 9019 motion and participate in the 9019 hearing. Again, we thought in the spirit of compromise we told Kramer Levin that we would forego the subpoena discovery if they would, at least, agree to supplement their Rule 2019 disclosures. They, again, rejected that offer and that led us then to ask Your Honor to recalendar the continued motion to compel for today's hearing.

Now, the bondholders here, represented by Kramer Levin -- we're talking about five bondholders. They're Contrarian Capital, JPMorgan Securities, Post Advisory, Trilogy Capital and Varde Investment. Among them they hold over 200 million dollars in face amount of the debtors' bonds, which I think is about one-half of the total amount of the outstanding bonds.

As Your Honor will probably also recall, earlier in the case the U.S. Trustee had removed three of the bondholders, one of whom was Trilogy, because they were participating as DIP lenders. And when the new committee was reconstituted the only member of that committee is the indentured trustee, HSBC, which, frankly, is more of a figurehead than having any real authority to speak on behalf of the individual bondholders.

Now, Your Honor will also recall, that we had some squirmishes with the SCL committee over discovery. And we had made a motion to compel the production of documents from the SCL committee. And, frankly, they produced about seven pages of documents to us, and advised that there were many documents that they were withholding which were communications with these bondholders, represented by Kramer Levin, which they were withholding on the grounds that they shared a common interest, which shielded those communications from disclosure.

And at the time, you'll recall both, the committee and the bondholders, argued that they shared a common legal interest, not merely a common financial interest. The common legal interest they said was that the -- their common interest was to demonstrate that the pension settlement was not in the best interest of creditors of SCL. And the committee said in it's papers, that if they were successful in that objection that would result in a benefit to all SCL's non-pension unsecured creditors.

Now, the bondholders who have now told us they do intend to object, and of course, they don't want to provide us with any discovery pursuant to the subpoenas, they now want to join in with the SCL committee and actively participate in the hearing. And although they seek to act, I think, in a common legal interest they would contend, which they claim benefit all SCL's unsecured creditors, they don't want to make any disclosures that are required under Rule 2019. And they make three, as I see it, principal arguments in support of that position.

First they say they're really not a group, they're just individual creditors that are represented by the same counsel. And they say, for example, that they don't have any governance like a committee would have. But they omit to discuss the fact that in their retention or engagement letter with Kramer Levin, there are a number of governance type provisions which are more indicative of a group representation than an individual representation. For example, there's a provision that allows majority clients, which is defined as those holding majority of the bonds in the group to have authority to direct counsel how to proceed. There's also a provision that allows majority clients to be the ones that have to consent to Kramer taking on any additional bondholder clients. When it comes to compensation, compensation to Kramer

Levin is based upon the members pro rata bond ownership. And there's a provision in the letter which also contemplates Kramer, at some point, seeking approval from the Court to have the group seized paid by the estate. So to us it seems that that's more indicative of a group membership of an ad hoc committee than it is of an individual representation of separate clients.

Secondly, they also distinguish the Northwest case by saying that well, they're really not purporting to act to protect anyone's interest but their own. But the problem that we see with that, Your Honor, is that from the get go these bondholders, although they've chosen not to participate on the committee, the committee consists only of the indentured trustee who has very little authority to make any real economic decisions on behalf of these bondholders. And from the get-go they have been behind the committee we believe really controlling the decisions of the committee, not the indentured trustee. And, frankly, in a situation like they argued in response to our motion to -- in their motion to quash and this SCL committee argued in response to our motion to compel, you know, they've contended all along that they have a common interest which is designed to benefit all unsecured creditors of SCL in reducing, to the extent they can, the claims of the pension schemes here.

So it's hard, it seems to me, to say that they're not acting in some way they would contend, other than in their own pecuniary interest. They're contending that they're doing this together with the committee on behalf of all the unsecured creditors of SCL.

Thirdly, they also cite to the Scotia decision down in Texas, in which there's not a reported opinion, but they do attach the transcript. And they make the argument there that the Scotia court, you know, rejected the argument that an ad hoc committee of bondholders need to comply with Rule 2019. And I guess I have two points on that score. Number one, I think that there's no evidence that the committee in Scotia was anything like this group of bondholders. There's no evidence that that group of bondholders was essentially controlling the unsecured creditors' committee as there is here. And secondly, even there it was clear that the group of bondholders represented approximately ninety percent of the outstanding bonds there. And I think one of the reasons the court reached its conclusion was that there was really no evidence there that they were acting to protect anyone who wasn't already a member of the group. So that we think that's different. Here, they have only about half of the percentage of the outstanding bonds. And there certainly are a number of bondholders that are not in the group whose interests are outstanding.

You also received, Your Honor, a brief of Amicus submitted by the Loan Syndications and Trading Association.

And as I read their brief, the principal arguments that they made were that, Judge, you shouldn't do anything here to compel these bondholders to comply with Rule 2019 because some parade of horribles is going to occur in which the liquidity in the bankruptcy process is going to dry up because of a fear that these hedge funds and other vulture type investors are going to be chilled from buying claims and participating in the bankruptcy process. And I think there's one thing that's safe to say, Your Honor, tat if Your Honor were to rule today that these particular bondholders are required to comply fully with Rule 2019, that would not be a general precedent that would require each and every ad hoc group who joined together to comply with Rule 2019 of disclosures. It seems to me that this case is quite unique given the structure of the SCL committee with only an indentured trustee as its sole member. And with, effectively, the committee being controlled by this group of bondholders.

You know, it's clear they've gone to great lengths to protect any communications between the committee and these bondholders from any disclosure. They've objected to the subpoenas. They refused -- the committee has withheld documents, all communications between the committee and this group on the basis of a common interest. And, so, you know, to argue or contend that a ruling here would compel all groups of similarly situated creditors, who happened to join together to comply with Rule 2019, I think is not accurate.

The other argument that the Amicus makes is that, of course, there's other ways to deal with this. They say, of course, you have the protection of discovery. You can serve them with interrogatories and take depositions and find out the information. Well, of course, they won't let us do that here either. So we're faced with the prospect of absolutely no discovery essentially from the SCL committee because everything was withheld except for seven documents. We can't take any discovery from the bondholders pursuant to our subpoenas, because they said they weren't objecting to the settlement, and they're not parties to the litigation. And now we're on the verge of the hearing and it's very late for us to really effectively do that. So we offered, as a compromise, at least disclose the information required by Rule 2019 so the Court and everyone else knows exactly what your interest is. And they refused to do that. So we're essentially left with no information about this group at all.

And for all those reasons, Your Honor, we think that they should be required to comply with Rule 2019 and make the disclosures required.

Unless Your Honor has further questions of me, I will cede the podium either to Kramer Levin or whoever else is going to address the issue.

THE COURT: Thank you.

MR. O'NEILL: Good afternoon, Your Honor. Brad O'Neill on behalf of the five bondholders. I guess there were a lot of points made in that argument. I think I'd begin by making our affirmative points and then I'll respond to what Mr. O'Connor said.

Rule 2019 requires an entity or a committee that is representing other creditors to make certain disclosures. Here there's only one entity that is representing creditors, and that's Kramer Levin. And Kramer Levin has made appropriate disclosures. Kramer Levin has disclosed the identity of it's clients, the nature of their claims. We've even, although technically not required to, disclosed the aggregate amount of their claims. There's no requirement, however, that the entity representing creditors disclosed specific trading information, dates, prices at which purchases were made.

THE COURT: Well, let's take a look at the rule, which I think has to be our starting point.

MR. O'NEILL: That's fine.

MR. O'CONNOR: Your Honor, if I could interrupt. This is Brian O'Connor again. Can I ask the Court if you could speak a little bit closer to the microphone, we're having difficulty hearing you?

THE COURT: All right, how's that? Is that better?

MR. O'CONNOR: That's much better, thank you.

THE COURT: All right. "2019(a) provides that every entity or committee representing more than one creditor or equity security holder, blah, blah, blah, has to provide the information provided in the four categories which follow." Now, I'm familiar with the arguments about what makes a committee and what doesn't. But I will tell you that this is probably, in my view, a committee within the meaning of the rule.

Here's how I reach that conclusion. I look at the Merriam Webster definition, one of them, which says, "Self-constituted organization for the promotion of a common object." Let me turn then to your objection to the motion that's before me. On page 4 you say, in paragraph 5, "The bondholders are five investment/money management funds that have come together in an effort to share the costs of representation by counsel and enable their voices to be heard more effectively." So in my mind that states two common purposes. I think you have a committee. Now, that's just the tip of the iceberg. There's a lot more, at least as I, in preparation for today's argument, think is involved in how the framework should work to figure out what the answer should be. And even if you weren't the committee, the definition -- the language in the rules in the disjunctive. It says "entity or committee." Entity is defined under Section 101. The term is pretty broad. I just don't see how under the plain language of the rule you escape the net. Can you respond to that?

MR. O'NEILL: Well, I think Your Honor has read our argument about why we are not a committee.

THE COURT: I read everything.

MR. O'NEILL: Yes. So, I mean, I can repeat those but I don't think you really want me to.

THE COURT: All right.

MR. O'NEILL: And as to whether -- we are a collection of individuals who are acting collectively. I don't think that that -- simply because we are doing that we somehow become responsible to make additional disclosures of confidential information. If we all acted separately with separate counsel there would be no such obligation.

THE COURT: And I thing you're right about that. Which leads to yet another level of inquiry. And I think that in examining this situation and, frankly, I've had others, which for one reason or another I've been able to move around the issue that I think the parties pretty much have squarely put before me today. And that is, you know, does 2019 apply to -- I'll use the phrase ad hoc committees, but not in the way -- not in the bad way that you would take that to mean. Groups called -- call them what you will. And that is, I think, each situation presents unique facts and circumstances. And a situation has to be viewed in light of the particular dynamics of a Chapter 11 case and of the matter within the case, the context within the case within which the issue arises. Because today what we're really here on is a 2019(b) motion, and that is if I conclude that this group is required to comply with 2019(a). The decision I have to make is whether there has been compliance and if -- and I don't think anyone would disagree if I conclude there is -- there does need to be compliance, that the rule has not been complied with, what sanction should I impose, if any. Because under the language of 2019(b) it seems to me that the Court has discretion about whether to impose a sanction or not. So, I guess that's one way of saying yes, I agree with you the facts are important.

MR. O'NEILL: If you want me, I could just move on to 2019(b), if you want I can make one more point about 2019(a).

THE COURT: Go ahead.

MR. O'NEILL: And that is that the entity or the committee has to be representing other creditors. I think it proves too much to say that the entity, merely by representing itself, somehow becomes subject to 2019. I mean, the purpose of the rule is to assure disclosures where an entity or a committee is representing other people to make sure that the people who are represented to whom a duty is owned, receive appropriate disclosure. However, the only people who are at issue are the people who you say constitute the entity itself, or the committee itself. There's no purpose served by requiring the disclosure, anymore than there would be a purpose served by requiring disclosure from any individual creditor who seeks to represent its interest in the bankruptcy. The disclosure at least becomes arguably -- and I think the policy of 2019 is implicated when you have an entity as in the Northwest Airlines case, that is purporting to represent a group of creditors broader than itself.

THE COURT: Well, indeed, in that case sought official recognition but did not get it.

MR. O'NEILL: But negotiated arguably essentially that it was representing the equity, and was negotiating a plan. There's nothing like that here, nothing even close to it.

THE COURT: I agree that the facts here are different.

MR. O'NEILL: And, in fact, there is a court appointed fiduciary who is doing that and who, frankly -- you know, we fall into the realm or the range of creditors whom it owes a duty to, and we're simply here articulating our own separate point of view. But we are not purporting to represent anybody other than ourselves.

THE COURT: But you are gathering together for the purpose of amplifying the position that you hold -- that your clients hold, and that may be shared by others. Now, I acknowledge I saw nothing in the submissions that tell me, and probably the reason for it is that your clients have been well advised. I see nothing in the record that indicates that this group purports to act on behalf of anyone but themselves. And the engagement letter is carefully drawn to indicate that.

MR. O'NEILL: Okay. I mean Mr. O'Connor took a stab at arguing that we're somehow purporting to act on behalf of creditors at large. But I think attributing arguments that the SCL committee has made to us we never made those arguments, the SCL committee does purport to speak on behalf of creditors at large, that's its function. But we didn't do that. All we did was pipe up in response to a motion made by the SCL committee to protect our privileged information.

THE COURT: Well, let's pursue that a little bit. Now, I don't know where, if anywhere in the record, the trust indenture exists. But if it's like many other indentures there are provisions in it which restrict the action of the indentured trustee without receiving a certain level of approval from a certain number of the noteholders. So when the argument is made that essentially the bondholders here control the committee because the indentured trustee is powerless in any major way to act without them, you know, has some merit to it. What do you think?

MR. O'NEILL: Certainly, bondholders can -- I mean, I'm not familiar with the precise provisions of our indenture, but certainly bondholders, collectively, operating in some collective capacity can give direction to an indentured trustee. I'm not sure how that relates to 2019, however. What

I think that concern addresses is what the committee -- the SCL committee, itself, should consist of. It doesn't mean that if the bondholders are to appear separately that suddenly their trading information becomes fair game.

THE COURT: No. But I think what I'm being asked to do is to draw an inference, that because of the legal constraints under which the indentured trustee acts, the real power behind the throne are the bondholders themselves.

MR. O'NEILL: Well, Mr. --

THE COURT: And arguably those -- I donÆt know if its true but arguably those who hold fifty percent of the face amount would have a large say in what the indentured trustee can or can't do.

MR. O'NEILL: I think Mr. O'Connor argued that there was evidence of that, and he was pretty direct about it. I don't think he's asking you to draw an inference, I think he's telling you exactly what he thinks. And I think that that basically -- I mean, that takes us right into 2019(b) because -- I mean, that's why he's here, that's the purpose of this motion, is to get some counter leverage of the people he perceives as driving the bus with the committee. And, frankly, is that the purpose of 2019?

THE COURT: Well, actually, it may be. Bear with me for a moment.

(Pause)

THE COURT: In what has been characterized as Northwest 1, Judge Gropper, who I think is a pretty bright guy, said this. "Ad hoc or unofficial committees play an important role in reorganization cases. But appearing as a committee of shareholders," in his case that's what it was "the members purport to speak for a group and implicitly ask the Court and other parties to give their positions a degree of credibility appropriate to unified group with large holdings." Now in Northwest 2, which was the 107 decision which followed his 2019 decision he says "as discussed in the Court's memorandum of February 26th" that's the 2019 decision, "it requires unofficial committees, that play significant public role in reorganization proceedings and enjoy a level of credibility and influence consonant with group status, to file a statement containing certain information." So if the dynamics that are described in argument, I have no evidence one way or the other on this, are true I would tend to think that it may be then under these circumstances those who are in this unofficial group might very well have more influence indirectly through the committee which purportedly represents them. So, I don't know, maybe it is relevant.

But that having been said, I'd like to walk -- and before we go to 2019(b), because this is in a way going to set up what ought to happen under 2019(a), let's go through the subsets of information that are required and compare that to what's already been disclosed in the 2019 statement that has been filed, and what it contains with what it does not yet contain. The name and address of the creditor or equity security holder that's in the present statement, that's under sub (1); (a)(1), (a)(2) requires that the nature and amount of the claim or interest and the time of acquisition thereof, must allege to have been acquired more than one year prior to the filing of the petition. Now, it seems to me that that information doesnÆt impact on anybody's trading strategy. Am I wrong about that?

MR. O'NEILL: Well, it depends on what form in which it's presented. The timing of acquisitions can be relevant to a trading strategy if you're talking about individual trades.

THE COURT: But do they do so here?

MR. O'NEILL: I can't answer that question.

THE COURT: And that's the problem. I know Judge Gropper was -- to use my words not his, unimpressed by the argument that trading strategies were what were really key here. And, in fact, and I forget in which opinion, I think it's the 107 opinion, he says it wasn't an issue. There those who were opposing the disclosure didn't set that up as a supposed barter to disclosure. But the parties here have presented that issue and especially the Amicus brief does.

Well, let's go to 3. "Recital of the pertinent facts and circumstances in connection with the employment of the entity or indentured trustee and the case of the committee the name and names of the entity or entities at whose instance directly or indirectly the employment was arranged or the committee was organized or agreed to act." It doesn't seem to me that would be harmful in any way to the bondholders here, disclosure of that information.

MR. O'NEILL: But we have attached the retention agreement.

THE COURT: And I've read it. But it doesnÆt -- I mean, unless that's all the information there is. And I can see from the language of the rule in part that it was designed to deal with the issues which form the basis for the rule as it was promulgated many years ago. So that everyone would know who was behind the committee. In other words, that it wasn't being manipulated by the debtor, that was a simple way of explaining the problem that gave rise to this rule. But I don't see how -- and, for example, I'll use an illustration. You know, maybe it was JPMorgan that said maybe we ought to try to get together and share expenses? I don't see how disclosure of that information is harmful or impinges on any improprietary information or in any way, if it's to be assumed and I don't decide this, but if it's to be assumed that trading strategies are things which should be protected.

MR. O'NEILL: I would agree that that does not implicate trading strategies.

THE COURT: Okay. So then we come to 4, which is really, I think, the issues. Which calls for "the disclosure of the times when acquired, the amounts paid for and any sales or other disposition thereof." And here's what my thought is about those items. It seems to me that disclosure of 1, 2 and 3 don't impinge on that sensitive area that not only in this case but others have publicly decried would just ruin liquidity in Chapter 11 cases. And by the way, nobody has presented me any evidence of this in this case. So I don't think I have anything from which I can conclude that that would be the case.

But I donÆt think I have to make that decision and I'll tell you why. Because I don't think it's relevant to the matter before me. I don't know what the relevance of it would be. Now, I know it stings that parties who don't have that information would like to have, so they can disparage he who owns the debt by saying ah, you picked it up for a song, therefore, either your position shouldn't be accorded much importance or that there's some malevolent intent involved in buying things at a discount. There may be context in which it is relevant. Voting for a plan, negotiating for a plan, situations in which -- like in Northwest Airlines there were conflicted interests, the holders held debt and equity. I mean, so there -- and there could be many more situations, I just don't see the relevance of it here.

So, frankly, what I'm inclined to do, and -- the narrowest way I think I can approach this because I'm going to rule from the bench, I don't have -- I don't have the time to write on it right now and I don't think the parties want me to take the time to write on it, because the hearing's coming up, is to hold that the language of the rule does sweep you in. But that with respect to the request for sanctions, I don't think it's appropriate to bar your participation in the hearing. But I would condition not imposing the sanction of keeping you silent, that you revise the 2019 statement to provide the information that's required by 2019(a)(1), (2) and (3) but not (4) because I don't think it's relevant in any way.

Now, I'll hear what else, if anything, you have to say and then I'll allow others to take their turn at telling me why I'm wrong.

MR. O'NEILL: I understand your ruling I don't think I'm going to spend a lot of time trying to persuade you you're incorrect, not that I agree with everything. But I would only clarify that to the extent that we comply with Your Honor's ruling that whatever extensions of deadlines you made earlier today would also apply to the bondholders.

THE COURT: They will apply equally.

MR. O'NEILL: Thank you.

MR. O'CONNOR: Your Honor, this is Brian O'Connor. May I just make one point which I'm not sure has been -- actually, two points that I'm not sure I have made before, which I think is important?

And that is, if you take a look at the first amended and restated verified 2019 statement, and you take a look at the list on Exhibit A, that's where it lists the various five entities which we've been referring to as the bondholders. But if you take a look at the retainer agreement, and if you look in the first sentence of the retainer agreement it reads "we are pleased that you, on behalf of yourself and funds and accounts that you manage, collectively, have agreed to retain Kramer Levin." It seems to us, Your Honor, that the list of the five entities is actually a list of entities that manage either funds or accounts. And so it's not clear to us that the actual owners of these securities are even identified. That was point one.

And point two is I just wanted to make clear that we were not seeking any sanctions with respect to the bondholders of Kramer Levin for not complying with 2019. What we did say in our motion to compel, was that their right to appear and be heard as a group ought to be conditioned on their compliance with Rule 2019.

THE COURT: All right. Well, I think we're saying the same thing but in different ways. Mr. Abbott?

MR. ABBOTT: Your Honor, Derek Abbott for the SCL committee. We don't really have a dog in this fight, Your Honor. I just didn't want my silence to Mr. O'Connor's representations about the committee, the nature of it's deliberations and control thereof, to be admissions to any of that stuff, Your Honor. I think we would disagree with a lot of it, but I don't want to belabor it, the Court's already ruled.

I also note that the indentured trustee, who is a member of the committee, and it's counsel, are not here and I would presume that they would take some affront at some of the things that were said as well. That's all, Your Honor.

THE COURT: All right. Does anyone else care to be heard?

All right. I do think that the rule has to be modified to address the situation that is coming up with increasing regularity. And I may very well send a letter to the Rules Committee suggesting that for whatever that's worth. But I think the exercise, at least for now, has to be one of balancing the interests, not just of the parties but of the particular context with sensitivity to the particular context in which the issue arises. And always keeping in mind that, you know, the rules should be read as Rule 1001 provides, to secure the just, speedy, and inexpensive determination of every case and proceeding.

All right. Let's set a deadline by which -- well, let me ask counsel to confer and submit a form of order which I guess grants the motion in part and denies it in part, and directs that a revised 2019(a) statement be filed and that the information called for in 2019(a)(1), (a)(2) and (a)(3) be provided. How much time do you need to make such a filing?

MR. O'NEILL: Well, certainly, Your Honor, we can do it before we have to submit anything in connection with the 9019. I would say, you know, the middle of next week.

THE COURT: I hear no one standing to complain. All right.

MR. O'NEILL: I'm sorry, I got the date wrong. We can do it by the end of the week, Your Honor.

THE COURT: Okay. That's Friday the 16th. Or you're talking about the 23rd, you're talking about Friday the 16th?

MR. STRATTON: Your Honor, David Stratton. Just to be clear, that's the submission of an order not the amended 2019 statement.

THE COURT: No, that's talking about the amendment to the 2019 statement as well.

MR. STRATTON: Okay.

MR. O'NEILL: I'm sorry, I wasn't --

THE COURT: My question was directed to when could you file the amended 2019 statement?

MR. O'NEILL: That's what I understood.

THE COURT: Okay.

MR. STRATTON: That's fine, Your Honor.

THE COURT: All right. Anything further for today?

MR. O'CONNOR: Yes, Your Honor. It's Brian O'Connor again. We had one other item. You'll recall, Your Honor, when we made our motion to compel the production of documents by the SCL committee, Your Honor ruled in part on that that the committee was required to produce a privilege log to us. And then we continued that motion.

We did receive a copy of the privilege log and there were a handful, I think five or six documents that we, after reviewing the privilege log, wrote to the SCL committee and advised them that we didn't see any basis on the privilege log for them to be able to contend that those particular documents were governed by any common interest privilege. These were documents, again, with the bondholders. There were no attorneys listed as an author or recipient on these documents. And the SCL committee then went ahead and produced, I think, all but one of the documents that we requested. Although there were portions of the documents that were redacted. And, more importantly, there was at least one attachment to one of the documents that they did produce that they withheld claiming that was governed by the common interest privilege. And we were unable to reach agreement with the SCL committee on the production of the redacted and missing attachment.

And what we would request Your Honor do is conduct an in-camera review of -- as I said, it's probably two documents, to make your own determination as to whether or not those documents should be withheld on the ground of the common interest privilege.

MR. ABBOTT: Your Honor, Derek Abbott on behalf of the SCL committee. Your Honor, we understand what Mr. O'Connor is trying to do here. We think that the appropriate way to do it, Your Honor, would be for him to file a motion, allow us to respond, and make appropriate argument. And then the Court can consider the issues at hand. We don't think it's appropriate to raise it as an off-agenda item here today. We have made that known to them. In fact, we've made known to them that we'd be willing to consider such a motion on an expedited basis at the Court's convenience. But we don't think that this is the appropriate way to handle it. He hasn't even, Your Honor, identified specifically for the Court what documents he's talking about. I think we all probably know what they are. But we just don't think this is the procedurally proper way to handle this sort of an issue. And would ask the Court, if it wants to consider this, to ask Mr. O'Connor's client to file an appropriate motion and we'll respond, as expedited as the Court believes is necessary, to try to get the issues properly before the Court and well framed for a decision, Your Honor.

MR. O'CONNOR: Your Honor, if I may respond to that? The order that Your Honor signed in connection with our motion to compel I think clearly carried that motion and allowed us to request any additional relief based upon the privilege log. I certainly did not think Your Honor was contemplating that we would have to file a completely knew motion if we had an issue with the privilege log. And as for the other point, it's quite clear we've gone back and forth with the SCL committee about which documents we're talking about. They know exactly what documents are redacted. They say this is a handful of documents in one attachment. So there can be absolutely no issue about what the documents are.

It just seems to us given the timeframe here, that this would be a colossal delay and waste of time if they required us to file a separate motion to ask Your Honor to conduct an in-camera review of two documents.

THE COURT: All right. Here's what we'll do. Send me a letter telling me what it is you want me to do and attaching the documents. E-file it and have that chambers copy here, you know, by say, 5 o'clock on Friday the 16th.

MR. O'CONNOR: That's fine.

THE COURT: And, Mr. Abbott, I'll give you till noon on the 19th to respond. And I'll hear it on the 20th at 11 o'clock.

MR. ABBOTT: You're going to regret giving us that date, Your Honor.

I assume when you say attaching the documents, that we will attach what we've been giving and they will attach what they withheld, is that -- so you can decide whether what they withheld should be subject to a claim of privilege?

THE COURT: That's, I think, a good suggestion, Mr. Abbott.

MR. ABBOTT: Because we don't have the document we'd like to see.

THE COURT: You can file it under --

MR. ABBOTT: Now, if they give it to us then we could -- no, I guess --

THE COURT: Oh, wouldn't that make things easier, Mr. Stratton.

MR. STRATTON: That wasn't my understanding. I thought what the Court had requested would be that they attach copies, perhaps, of the redacted documents --

THE COURT: They're going to. That's what I intended.

MR. STRATTON: -- and indicate what they need.

MR. O'CONNOR: Yes, Your Honor. We would attach the obviously -- the only documents we have is the one redacted document and we're missing the attachment. And I think David Stratton's suggestion is the right one. We would assume, in response to our letter, the other side would remit the unredacted document and the missing attachment. And Your Honor can decide whether or not it should be produced to us.

THE COURT: Yes. How else would I decide whether it should be produced? That's how I typically do it.

MR. ABBOTT: Your Honor, I'll certainly abide by the Court's decision. I understood that they were going to ask for relief and the hearing on the 20th was going to be to determine whether the Court would conduct such an in-camera view. I'm not sure what they're asking.

THE COURT: Well, it's a dispute about privilege. And that's typically how I resolve them by looking at what one side doesn't want to produce and deciding whether it should be produced or not.

MR. ABBOTT: Fair enough, Your Honor. May we then have permission, perhaps today, to file our response to that letter under seal or --

THE COURT: Yes.

MR. ABBOTT: -- you want a separate motion under it?

THE COURT: No. You can file that under seal.

MR. ABBOTT: We'll do so, Your Honor.

THE COURT: And deliver your chambers copy. I'll order that now from the bench.

MR. ABBOTT: Thank you, Your Honor.

THE COURT: All right.

MR. O'NEILL: File under seal, who gets a copy of it?

THE COURT: Of the enclosure?

MR. O'NEILL: Not the enclosures, clearly we're not going to get to see those.

THE COURT: Well, all the relevant parties would get a copy of the response I presume.

MR. O'NEILL: All right. I wasn't clear on what was being sealed.

THE COURT: Without the attachments.

MR. O'NEILL: The attachments would be sealed.

MR. ABBOTT: Our intent, Your Honor, was to seal the documents not the letter.

THE COURT: I understood it.

MR. O'NEILL: I thought it was the letter, I'm sorry, Your Honor.

THE COURT: No, I understood it to be that way. All right.

Anything further?

MS. REARDEN: Your Honor, this is Jennifer Rearden at Gibson Dunn & Crutcher on behalf of Marrier & Gutzman Group (ph.) which is an individual bondholder and the DIP lender. I just wanted to request, very briefly, that we be given notice of any further developments relating to these motions to compel in this privilege log. We filed a limited joinder in the objection of the SCL committee. We were -- the joinder related to discovery directed to the SCL committee, relating to communications with my client. And I'm learning for the first time today, that this privilege log, which reflects more than thirty communications involving my client, have already been produced. And so that ship has sailed obviously. But I would like to make sure that we are given advance notice of any additional developments relating to this matter.

And I would also like to preserve our position for the record, which is that the objections to the 9019 motion have argued, in essence, and we agree that the debtors have the burden of providing evidence that the settlement is reasonable. And, in addition, that the parties to the settlement have that evidence not the objectives. Well, Your Honor, our relationship to this situation is even more attenuated than that. We haven't even taken a position at all. Nothing that we think or say or have said, is probative of whether this settlement is reasonable. And for that reason, we donÆt think that our communications involving us should be produced.

THE COURT: Well it sounds --

MS. REARDEN: I guess at this point all I can do is just preserve that argument for the record and ask for notice going forward.

THE COURT: Well, it sounds to me like the horse is out of the barn on that one.

MS. REARDEN: I agree. I just -- I do believe I heard counsel talking about some additional documents on the privilege log that may end up being produced. And we would like to be notified of any such developments in advance --

THE COURT: Well, all I'll --

MS. REARDEN: -- especially involving our client.

THE COURT: -- order is that you be served with the letter and attachments and the response that are filed with the Court.

MS. REARDEN: Correct.

THE COURT: Okay.

MS. REARDEN: Thank you, Your Honor.

MR. O'NEILL: Your Honor, if I may return to the 2019 issue?

THE COURT: Sure.

MR. O'NEILL: My colleague points out what I overlooked, which is that items 2 and 4 contain some of the same information, particularly the time of the acquisition of the interest. We had a brief discussion of this during the argument, I took the position that that timing of acquisition can be reflective of a trading strategy.

THE COURT: But I have no evidence of that, and that's the problem. I mean, you tell me it is and the papers argue that it could be, but there's no evidence that that's actually the case either in this case or ever. But I limit my focus to this case.

MR. O'NEILL: All right. Secondarily, I would say it's no more relevant to this case and the issues on the 9019 motion than the prices at which interest were acquired. I mean, it's as irrelevant as everything else in Section 4.

THE COURT: Well, frankly, again, it just seems to me that the sensitive information is the pricing information. You hold what you hold, you acquired it when you acquired it, and I think that needs to be disclosed under the language of the rule.

MR. O'NEILL: Consistent with Section 2, okay.

THE COURT: Yes. Any other questions?

You're just full of them today, Mr. Stratton.

MR. STRATTON: I'm trying not to be but I want to -- since we're divided by a common language I want to make sure we're communicating.

I will submit, after they've seen it, a form of order granting the motion in part, denying the motion in part, directing that the Kramer Levin committee -- my tongue's in my cheek for those of you who can't see me, file an amended 2019 statement providing the information set forth in 2019(a)(1), (2) and (3). And it be filed by the end of the day Friday. That's all it's going to say. Is that what Your Honor's looking for?

THE COURT: That's what I'm looking for.

MR. STRATTON: There you go. Thank you very much.

THE COURT: And if the parties, after consultation, figured I missed something and can agree upon it, you may add that for my consideration.

MR. STRATTON: Thank you.

THE COURT: But it seems to me it ought to be that simple.

MR. STRATTON: That's what I hope. Thank you, Your Honor.

THE COURT: Okay. Anything further for today?

MR. MORTON: No, Your Honor.

THE COURT: All right. Thank you, counsel. That concludes this hearing. Court is adjourned.

MR. O'CONNOR: Thank you, Your Honor.

(Proceedings concluded at 3:48 p.m.)

INDEX

RULINGS

	Page	Line
Motion for Supplementation to Non-Insider KERP Program Granted	10	4
2019 Statement to be Revised to Provide the Information That is Required by 2019(a)(1), (2) and (3)	45	9
Notice of Letter and Attachments to be Served on Gibson Dunn & Crutcher	56	1

C E R T I F I C A T I O N

I, Esther Accardi, court approved transcriber, certify that the foregoing is a correct transcript from the official electronic sound recording of the proceedings in the above-entitled matter.

_______________________________________ ___June 4, 2008________

Signature of Transcriber Date

_ESTHER ACCARDI________________________

typed or printed name

EXHIBIT P

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:	:	Chapter 11
SEA CONTAINERS LTD., *et. al.*,	:	Case No. 06-11156 (KJC)
	:	Jointly Administered
Debtors.	:	**Hearing Date: May 14, 2008, 2:30 p.m.**

OBJECTION OF CONTRARIAN CAPITAL ADVISORS, LLC, J.P. MORGAN SECURITIES INC., CREDIT TRADING GROUP, POST ADVISORY GROUP, LLC, TRILOGY CAPITAL LLC, AND VARDE INVESTMENT PARTNERS, L.P. TO MOTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF SEA CONTAINERS SERVICES LIMITED FOR AN ORDER PURSUANT TO BANKRUPTCY RULE 2019(b) CONDITIONING THE AFFILIATED HOLDERS OF UNSECURED NOTES ISSUED BY SEA CONTAINERS LTD.'S ABILITY TO APPEAR AND BE HEARD ON COMPLIANCE WITH BANKRUPTCY RULE 2019(a)

Contrarian Capital Advisors, LLC, J.P. Morgan Securities Inc., Credit Trading Group, Post Advisory Group, LLC, Trilogy Capital LLC, and Varde Investment Partners, L.P. (collectively, the "Bondholders") submit this Objection (the "Objection") to the Motion of the Official Committee of Unsecured Creditors of Sea Containers Services Limited (the "SCSL Committee") for an order conditioning the Bondholders' ability to appear and be heard on compliance with Bankruptcy Rule 2019(a) (the "2019 Motion"). In support of the Objection, the Bondholders respectfully state as follows:

Preliminary Statement

In the 2019 Motion, the SCSL Committee — which is not a creditor in this Chapter 11 case — asks the Court to compel the Bondholders — who are among the largest unsecured creditors in the case — to disclose highly confidential proprietary trading information and, if they will not do so, to bar them from even being heard in connection with a 9019 Motion that is one of the central events in the case. In support of this remarkable relief, the SCSL Committee fails to demonstrate that the disclosure requirements of Bankruptcy Rule 2019 apply to the Bondholders, who are not a "committee" of any type, who purport to represent no one but themselves and who have no fiduciary or other duty to unsecured creditors generally. Just as importantly, the SCSL Committee offers no substantive reason why the information it demands is in any way relevant to the 9019 motion or to this proceeding generally, let alone so material that the penalty for failing to disclose it should be the silencing of substantial unsecured creditors of the estate in connection with one of the case's main events.

The absence of substantive justification for the drastic relief the SCSL Committee seeks is not hard to discern. The SCSL Committee is party to the settlement that is the subject of the 9019 motion − a settlement that the Bondholders believe is unreasonable and not in the best interests of the unsecured creditors of the estate. In the face of such opposition, the SCSL Committee has opted to pursue the same transparently cynical tactics that have proliferated since the decision early last year in the *Northwest Airlines* case, trying to drive litigation opponents out of the case by forcing disclosure of irrelevant confidential proprietary information. The Court should not reward such gamesmanship and should decline the SCSL Committee's institution to restrict the expression of creditor views in connection with the 9019 motion.

In short, Rule 2019(a) does not apply to the Bondholders but, even if did, the Court should exercise its discretion to deny the relief sought by the SCSL Committee and allow full litigation of the 9019 motion by all interested parties.

Background

The 9019 Motion

1. The Trustees of the Sea Containers 1983 Pension Scheme (the "1983 Scheme"), and the Trustees of the Sea Containers 1990 Pension Scheme (the "1990 Scheme," and together with the 1983 Scheme, the "Pension Schemes") have asserted claims (the "Pension Claims") against Sea Containers Ltd. and its subsidiaries (the "Debtors") relating to the underfunded status of the Debtors' pension obligations pursuant to each of the Pension Schemes' governing rules and regulations. On September 17, 2007, the Official Committee of Unsecured Creditors of Sea Containers Ltd. (the "SCL Committee"), filed an objection to the Pension Claims (the "Objection").

2. On February 18, 2008, the Debtors filed a motion pursuant to Bankruptcy Rule 9019 (the "9019 Motion") for an order approving a proposed settlement (the "Settlement") by and between the Debtors, the SCSL Committee, and the Pension Schemes.

3. The SCL Committee has indicated that it is going to object to the 9019 Motion and, accordingly, has served document requests and deposition notices on the parties to the Settlement (the "Settlement Parties"): the Debtors, the SCSL Committee and the Pension Schemes.

4. Although it is not and cannot be a proponent of the 9019 Motion, the SCSL Committee, which is a party to the settlement, has actively sought to support it. The SCSL Committee (but, interestingly, not the Pension Schemes) has also served discovery requests on the SCL Committee.

The Bondholders

5. The Bondholders are five investment/money management funds that have come together in an effort to share the costs of representation by counsel and enable their voices to be heard more effectively. Notwithstanding that they are represented by a single law firm, each of the Bondholders makes its own decisions as to how it wishes to proceed and does not speak for, or on behalf of, any other creditor, including other Bondholders. Although the terms of the representation of each Bondholder by Kramer Levin are governed by an engagement letter (attached to the Kramer Levin Rule 2019 statement), the Bondholders do not have any documents or instrument that governs their relationship with each other.

6. On February 25, 2008, shortly after the 9019 Motion was filed, Kramer Levin filed a Bankruptcy Rule 2019 statement on behalf of itself describing the individual Bondholders it purported to represent in this proceeding. Because they do not purport to represent anyone other than themselves in this Chapter 11 and do not constitute a "committee," the Bondholders did not also file a Bankruptcy Rule 2019 Statement.

The SCSL Committee Campaign to Prevent the
Bondholders from Objecting to the 9019 Motion

7. On February 28, 2008 (the "February 28th Letter") the SCSL Committee, which is not even a creditor of the Sea Containers Ltd. estate, wrote to Kramer Levin, asserting that its Rule 2019 Statement was deficient. A copy of the February 28 Letter is attached as Exhibit A. The SCSL Committee further demanded that Kramer Levin supplement the Rule 2019 Statement to disclose the nature, amount paid, time of acquisition, and any related sales of each claim held by the Bondholders against Sea Containers Ltd. (the "Claims Information"), threatening to file a motion to compel if the Bondholders did not accede to its demand. Tellingly, the SCSL Committee did not offer any reason why such

disclosures were relevant to it – an entity that is not even a direct party in interest in the SCL case. Instead, the February 28 Letter revealed only the SCSL Committee's tactical objective, expressly demanding to be informed whether the Bondholders intended to oppose the 9019 Motion.

8. On March 3, 2008, Kramer Levin responded that it was in full compliance with Bankruptcy Rule 2019 and that no further disclosure was necessary. A copy of this letter is attached as Exhibit B.

9. Shortly thereafter, on March 5, 2008, the SCSL Committee served each of the Bondholders with separate Subpoenas, seeking extensive document productions and Federal Rule of Civil Procedure 30(b)(6) depositions on no fewer than 17 separate topics. These requests overwhelmingly seek discovery concerning communications between the Bondholders and others concerning the Settlement or the 9019 Motion.

10. On March 19, 2008, the Bondholders filed a *Motion to Quash or, in the Alternative, for Protective Order Concerning Subpoenas Served by the Official Committee of Unsecured Creditors of Sea Containers Services Ltd.* (the "Motion to Quash"). In the Motion to Quash, the Bondholders stated that they were deferring to the SCL Committee in the discovery and evidentiary portions of the litigation of the 9019 Motion, but expressly reserved the right to join in an objection to the 9019 Motion by the May 14, 2008 objection deadline and be heard at the hearing on the 9019 Motion.

11. On March 20, 2008, the SCSL Committee wrote to Kramer Levin (the "March 20 Letter") offering to stay the discovery sought by the Subpoenas so long as the Bondholders did not file an objection to the 9019 Motion or appear and object at the hearing of that motion. A copy of that letter is attached as Exhibit C. If the Bondholders filed or otherwise asserted

an objection, then the discovery would be rescheduled. In subsequent discussions, the Bondholders and the SCSL Committee agreed to adjourn the response date to both the Subpoenas and the 2019 Motion until such time as the Bondholders informed the SCSL Committee, no later than May 7, 2008, whether they would file an objection to the 9019 Motion.

12. On May 7, 2008, by telephone and e-mail, Kramer Levin informed counsel to the SCSL Committee that the Bondholders would be filing a joinder to the SCL Committee's objection to the 9019 Motion. In response, on Thursday, May 8, 2008, counsel to the SCSL Committee sent an e-mail to Kramer Levin stating that the SCSL Committee would forgo the discovery sought by the Subpoenas so long as the Bondholders would make the disclosures that the SCSL Committee asserts is required under Rule 2019(a).

Rule 2019 Does Not Require the Bondholders To Make the Disclosures Sought by the SCSL Committee

13. Bankruptcy Rule 2019(a) requires "every entity or *committee* representing more than one creditor or equity security holder" to file a verified statement disclosing "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." The SCSL Committee asserts that the Bondholders themselves are a "committee" within the meaning of Rule 2019 and, therefore, that the Bondholders are required to file a verified statement setting forth the information required by Rule 2019(a). The SCSL Committee is wrong.

14. Although the term "committee" is not defined in the Bankruptcy Code or the Bankruptcy Rules, the term is commonly understood to refer to a group of persons that have been delegated with authority to act on behalf of others, generally in a representative or

fiduciary capacity. *See*, *e.g.*, *American Heritgage Dictionary* (3d ed. 1994)(defining "committee" as "a group of people officially delegated to perform a function, such as investigating, considering, reporting, or acting on a matter"); *Black's Law Dictionary* (6th ed. 1991) (defining "committee" as "an individual or body to whom others have delegated or committed a particular duty, or who have taken it upon themselves to perform it in the expectation of their act being confirmed by the body they profess to represent or act for"). This understanding, moreover, is confirmed by Rule 2019 and some of the very authorities on which the SCSL Committee relies, which specify that Rule 2019's coverage is limited to "committees" acting in a representative or fiduciary capacity. *See* Fed. R. Bankr. Pro. 2019(a) (Rule applies to "committees . . . representing more than one creditor . . . ."); *In re CF Holding Corp.*, 145 B.R. 124, 126 (Bankr. D. Conn. 1992) (Rule 2019 "was designed to cover entities which, during the bankruptcy case, act in a fiduciary capacity to those they represent, but are not otherwise subject to control of the court") (cited at 2019 Motion ¶ 18).

15. Moreover, as set forth in the Brief of *Amicus Curiae* the Loan Syndications and Trading Association in opposition to the SCSL Committee's Rule 2019 Motion (the arguments of which are incorporated herein by reference), the historical background to Rule 2019 makes clear that the intention of the rule is to protect parties from official committees that act in a fiduciary capacity, and not to informal groups that are acting solely on their own behalf. *See* Brief of *Amicus Curiae* the Loan Syndications and Trading Association in opposition to the SCSL Committee's Rule 2019 Motion, at 11-14.

16. Here, the Bondholders are simply a group of creditors acting in conjunction with one another and a single common counsel. They have not been "appointed" or "elected" to a position by any court or other body. They have not received any "delegation" of

authority (officially or otherwise) to perform any function on behalf of any other party. As importantly, they have assumed no duty, fiduciary or otherwise, to creditors other than themselves. On the contrary, the Bondholders act only on their own individual behalf, and do not, and have never purported to, act in a fiduciary or representative capacity with respect to any other person or entity.

17. Thus, by its terms, Rule 2019(a) does not require the Bondholders to make any disclosures in this case. Rather, because Rule 2019 speaks to "an entity or committee representing more than one creditor," only Kramer Levin, which does represent more than one creditor, is even arguably required to file a Rule 2019 verified statement and make disclosures about who it represents. But Kramer Levin has fully complied with Rule 2019 and neither the SCSL Committee nor any party has asserted that Kramer Levin's disclosure is defective. Accordingly, the Court should enforce the rule as written and the Motion must be denied as a matter of law. See Lamie v. U.S. Trustee, 540 U.S. 526, 534 (2004) ("It is well established that when a statute's language is plain, the sole function of the courts … is to enforce it according to its terms").

18. The terms of Kramer Levin's retention agreement, which the SCSL Committee cites, are not to the contrary. That agreement merely outlines the terms under which the Bondholders have agreed to manage and pay for their common legal representation in this case. Nowhere does that agreement indicate, let alone require, that the Bondholders undertake any fiduciary obligation to any other creditor (or even to one another) or to act in any representative capacity.

19. The SCSL Committee is also incorrect when it argues that the decisions in the *Northwest Airlines* case somehow require the Bondholders to file a Rule 2019 Statement here.

While the bankruptcy court in *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) ("*Northwest I*"), required an *ad hoc* committee of equity holders to file a Rule 2019 Statement, that group had affirmatively styled itself as an "ad hoc committee," had sought to have itself recognized as an official committee, had members with significant holdings of debt as well as equity and which purported "to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holders." Id. at 703. To protect other equity holders from relying on this potentially conflicted ad hoc committee to protect their interests, the bankruptcy court required the ad hoc committee to make additional disclosures under Rule 2019. *In re Northwest Airlines Corp.,* 363 B.R. 704, 708 (Bankr. S.D.N.Y. 2007) ("*Northwest II*").

20. But this case is nothing like *Northwest*. The Bondholders have never purported to act as a "committee," have never sought to represent other creditors or assume fiduciary obligations to them by becoming an official committee, or purported to represent other creditors or buttress positions they have taken in court by claiming to do so. Moreover, unlike *Northwest*, there is no issue of a conflict of interest here. The members of the ad hoc equity committee in *Northwest* owned "a very significant amount of debt" in addition to their equity interests, "a fact that might raise questions as to divided loyalties." *Northwest II*, 363 B.R. at 708. The Bondholders, in contrast, hold only the Debtors' bonds (and, in the case of one Bondholder, a trade claim that is *pari passu* with the Bonds), so their interests do not even arguably conflict with those of other bondholders.

21. Moreover, there are no reported decisions of courts that have followed *Northwest*. Indeed, in *In re Scotia Dev. LLC*, Case No. 07-20027 (Bankr. S.D. Tex. Apr. 17, 2007), a case decided soon after *Northwest* and not cited by the SCSL Committee, the

Bankruptcy Court for the Southern District of Texas refused to require an ad hoc committee of noteholders to file a Bankruptcy Rule 2019 statement. *See* Hearing Transcript, at 4-5 (attached hereto as Exhibit D). Declining to follow *Northwest*, the *Scotia* court held that the ad hoc committee appearing in that case was not a "committee" for purposes of Bankruptcy Rule 2019; rather, it was "just one law firm representing a bunch of creditors." *See id.* at 5. While the court did not issue a written opinion, its comments reflected its conclusion that Bankruptcy Rule 2019 applies only to "fiduciary representations," and not to fee-sharing consortia of creditors like the ad hoc noteholders' committee in that case (or the Bondholders here). *See In re Scotia Dev. LLC*, Case No. 07-20027 (Bankr. S.D. Tex. Apr. 10, 2007), April 10 Hearing Transcript, at 73 (attached hereto as Exhibit E).

22. Accordingly, even if the *Northwest* decision was correctly decided based on the specific facts before that Court, this Court should decline to follow that decision and instead should not require the Bondholders to make the disclosures sought by the SCSL Committee.

Even if the Bondholders Were Required to Make Disclosure, The Court Should Not Deny Their Right to Be Heard

23. Not only are the requirements of Bankruptcy Rule 2019 inapplicable to the Bondholders themselves, but the remedy the SCSL Committee seeks — to muzzle the Bondholders and prevent them from participating in the litigation of the 9019 Motion — is inappropriate and unwarranted. Even where it applies, Bankruptcy Rule 2019 does not contain a mandatory remedy or sanction. Rather, the plain text of the rule provides the Court with broad discretion "to determine whether there has been a failure to comply with the Rule 2019(a) requirements" and, if so, what sanction to impose. *See In re Kaiser Aluminum Corp.*, 327 B.R. 554, 559 (Bankr. D. Del. 2005). Far from concluding that Rule 2019 dictates the

automatic silencing of non-complying creditors, courts have held that Bankruptcy Rule 2019 "need not always be strictly applied." *See id.*; 9 Collier on Bankruptcy, at ¶ 2019.04[4]. In fact, a bankruptcy court may "determine that a failure to comply with Bankruptcy Rule 2019(a) may result in the imposition of *no sanctions or remedies* under Bankruptcy Rule 2019(b)." *In re Oklahoma P.A.C. First Ltd. P'ship*, 122 B.R. 387, 391 (Bankr. D. Ariz. 1990) (emphasis in original).

24. As an initial matter, the SCSL Committee has completely failed to identify any legitimate interests requiring disclosure of the Bondholders' specific purchase information or compelling them to be silenced if that information is not produced. The SCSL Committee is not a creditor in this proceeding and, even if it were, has not offered even a single reason why disclosure of the Bondholders' purchase information is relevant to the 9019 Motion, much less necessary to protect creditor interests. Rather, the only "ground" the SCSL Committee has tendered is its assertion that "the disclosure requirements are particularly important here as the Noteholders have expressed their opposition to the Settlement." 2019 Motion, at ¶20. But the information sought by the SCSL Committee has no bearing whatsoever on the Pension Claim or any aspect of the 9019 Motion.

25. Furthermore, the information sought by the SCSL Committee is of a highly confidential and proprietary nature. Investment funds customarily accord their trading strategies and practice the highest degree confidentiality. To require the members to divulge such important proprietary information would be highly prejudicial to the Bondholders. To do so without the SCSL Committee having offered any reason, beyond conclusory *ipse dixit* assertions, would be a perversion of the purposes of Rule 2019.

26. Indeed, in the absence of any legitimate basis for the motion, the SCSL Committee's objectives appear nakedly tactical. The SCSL Committee is a party to the settlement and wants the 9019 Motion approved. To advance that end, it wants potential objectors out of the picture. In fact, the SCSL Committee has all but announced its goals from the first time its sought the Rule 2019 disclosures. See, e.g., February 28th Letter, at bottom of page 1 ("Accordingly, please advise us whether you will fully comply with Rule 2019(a)...or whether it will be necessary...to file a motion to compel compliance pursuant to Rule 2019(b). *In addition*, please confirm that each of your clients remain committed to objecting to the [9019 Motion].") (emphasis added). Underscoring the connection, after the Motion to Quash was filed the SCSL Committee agreed to hold off on both the discovery it was seeking and the 2019 Motion so long as the Bondholders agreed not to file an objection to the 9019 Motion.

27. Bankruptcy Rule 2019 and the remedies it authorizes were not created just to provide litigants with leverage or a tactical advantage. In view of the absence of any legitimate reason for the information sought by the SCSL Committee, and the highly confidential and proprietary nature of such information, even if it finds that Bankruptcy Rule 2019 applies – and it should not – the Court should not exercise its discretion to require the production of information that is irrelevant to the 9019 Motion or bar the Bondholders from participating in one of the "main events" in the case for unsecured creditors. The litigation of the 9019 Motion should not be influenced by cynical tactical stratagems deployed by interested non-parties, like the SCSL Committee. Rather, the 9019 Motion should be considered on the merits, after a full hearing of all legitimate creditor viewpoints. While such

a prospect undoubtedly causes the SCSL Committee considerable anxiety, proper interpretation of the Bankruptcy Code requires nothing less. [1]

Conclusion

For the foregoing reasons, the Court should deny the 2019 Motion in all respects and grant the Bondholders such other and further relief as the Court deems just and proper.

Dated: Wilmington, Delaware
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FOX ROTHSCHILD LLP

By: /s/ Neal J. Levitsky
Neal J. Levitsky, Esquire (No. 2092)
Seth A. Niederman, Esquire (No. 4588)
Citizens Bank Center, Suite 1300
919 North Market Street
Wilmington, DE 19801
(302) 654-7444

-and-

KRAMER LEVIN NAFTALIS &
FRANKEL LLP
Thomas Moers Mayer, Esquire
P. Bradley O'Neill, Esquire
Joshua K. Brody, Esquire
1177 Avenue of the Americas
New York, New York 10036
(212) 715-9100

Attorneys for the Bondholders

[1] It is further unclear what exactly the SCSL Committee hopes to gain by its continued harassment of the Bondholders. Although the Bondholders have been, and continue to be, in opposition to the Pension Settlement, it is the SCL Committee that is taking the laboring oar in litigating the 9109 Motion. Accordingly, even if the SCSL Committee were to obtain the relief it is seeking (i.e., that the Court would deny the Bondholders' right to be heard on its joinder to the SCL Committee's objection to the 9019 Motion), it would still be forced to litigate the 9019 Motion.