

Insolvency and Restructuring Update

Second Washington Mutual Plan Confirmation Denial May Have Significant Impact on Claims Trading and Plan Negotiation

On September 13, 2011, Judge Mary Walrath of the United States Bankruptcy Court for the District of Delaware surprised many parties in interest and observers of the case by issuing an opinion denying confirmation of the modified proposed plan of reorganization of Washington Mutual, Inc. (“**WMI**”) and its affiliated debtors. The modified plan incorporated certain changes Judge Walrath had indicated were necessary in a January 2011 opinion denying confirmation of a prior version of the plan, and many expected that these changes would be sufficient to ensure confirmation of the modified plan. Although the decision turned primarily on the rate of post-petition interest awarded to certain creditors of WMI, the Court’s extensive discussion of allegations of “insider trading” raised against certain claims purchasers is likely to attract the most attention. Judge Walrath’s findings on these allegations may have a significant impact on claims trading and negotiation dynamics in complex chapter 11 cases going forward.

Case Background

In order to best understand the opinion, it is helpful to have a basic understanding of the primary events that have taken place in the Washington Mutual cases. WMI, the lead debtor in the case, is the former parent of Washington Mutual Bank (“**WMB**”), frequently referred to as WaMu. During the financial crisis of 2008, after a steady decline in revenues at WMB culminated in credit rating downgrades for WMI and WMB and a “run on the bank,” WMB was taken over by the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (the “**FDIC**”) was appointed as receiver. In an FDIC assisted transaction conducted on the same day as the regulatory takeover of WMB, JPMorgan Chase Bank, N.A. (“**JPMCB**”) acquired substantially all of the assets of WMB for an aggregate purchase price of \$1.88 billion, plus assumption of over \$145 billion in deposit and general liabilities of WMB.

After the takeover of WMB by JPMCB, WMI and its affiliated debtors commenced bankruptcy proceedings in Delaware on September 26, 2008. Because WMI was left with minimal assets following the collapse of WMB, initial recovery expectations for WMI’s creditors were low, claims against WMI traded at very low prices, and many of the claims were purchased by professional distressed debt investors. Although WMI had few assets of its own and no material ongoing business, it became clear early in the case that WMI would assert several potential causes of action against JPMCB arising from the takeover of WMB, and that recoveries of WMI creditors would be primarily driven by any value that could be obtained for WMI from litigation or settlement of those claims. Described very generally, the claims asserted were for turnover of assets — the ownership of which was disputed as between JPMCB, WMI and the FDIC receivership for WMB — and miscellaneous other claims the parties to the transaction asserted against one another. Chief in importance among the disputed assets were (i) roughly \$4 billion in cash held in accounts at WMB in the name of WMI (the “**Deposited Funds**”) and (ii) various large tax refund claims and tax assets arising from prior losses of WMB.

The claims arising from the takeover of WMB were partially litigated in bankruptcy court, federal district court and the federal court of claims. As is common, however, settlement negotiations were ongoing during this preliminary litigation. A “global settlement” (the “**GSA**”) of all issues relating to the WMB takeover was first announced on March 12, 2010, and this GSA formed the foundation of (and primary source of value for distributions under) WMI’s Sixth Amended Plan. A confirmation hearing for the Sixth

Amended Plan was held in December 2010. At this hearing, allegations of improper trading in public WMI debt by a group of four hedge funds (the so-called “**Settlement Noteholders**”) that had participated, to varying degrees, in settlement discussions, were raised for the first time by an individual investor that held subordinated WMI securities and believed that the GSA had been improperly structured to benefit the Settlement Noteholders at the expense of other creditors. Generally, the investor alleged that the Settlement Noteholders had strategically bought and sold public debt in different parts of WMI’s capital structure while in possession of material nonpublic information (“**MNPI**”) gained through their participation in confidential settlement negotiations with JPMCB, which informed their expectations as to recoveries of the different classes.

In an opinion issued in January 2011, the Court approved the GSA, but denied confirmation of the plan for other reasons, primarily deficiencies in the release, indemnity and exculpation provisions. Although the allegations of insider trading did not play a role in the Court’s decision to deny confirmation (as no evidence had been presented at that time), Judge Walrath noted in her opinion that plan releases for the Settlement Noteholders would not be appropriate in light of the allegations and that further discovery would be helpful.

After the January 2011 opinion was issued, negotiations began around a modified plan remedying the cited deficiencies. At this time, a committee of equity security holders of WMI (the “**Equity Committee**”), that were expected to receive no recovery under the plan and had been one of the main objectors to the GSA at the first confirmation hearing, sought and obtained discovery from the Settlement Noteholders relating to the insider trading allegations. Efforts of the plan supporters to reach a consensual settlement with the Equity Committee ultimately failed. In its objection to plan confirmation, the Equity Committee focused on the insider trading allegations, and then presented extensive argument and testimony on the insider trading allegations at the confirmation hearing on the modified plan in July 2011. In early July, the Equity Committee also moved for standing to pursue claims against the Settlement Noteholders for equitable subordination or equitable disallowance based on the insider trading allegations.

Involvement of the Settlement Noteholders in the Case

Certain basic facts of the role that the Settlement Noteholders played in the case and in negotiations between WMI and JPMCB are not in dispute. The negotiation process between WMI and JPMCB began in early March 2009 and continued intermittently until the announcement of the GSA in March 2010. During this period of intermittent negotiations, the Settlement Noteholders were parties to confidentiality agreements with WMI, and were subject to two formal “lockup periods” in which the Settlement Noteholders were required either to restrict trading of the Debtors’ securities or to establish an ethical wall screening their traders from any confidential information. At the end of each lockup period, WMI was required to publicly disclose any MNPI that had been given to the Settlement Noteholders during the lockup period and to confirm that they had done so. After the Settlement Noteholders were thus “cleansed,” they would resume active trading in the Debtors’ securities. Information to which the Settlement Noteholders were exposed during the lockup periods included the size and amount of a tax refund the Debtors believed they would receive (which the Debtors made public at the end of the lockup period) and terms and offers in settlement term sheets that were exchanged and discussed (which were not made public at the end of the lockup period). It is not in dispute that outside of the lockup periods, when the Settlement Noteholders were actively trading, they did have some involvement in settlement negotiations with JPMCB either directly or through conversations with WMI; the Settlement Noteholders take the position however, that any such involvement did not expose them to information that was material, even if nonpublic.

Analysis of Insider Trading Allegations and the Settlement Noteholders' Asserted Defenses

It is important to note that the Court did not reach any final judgment on the merits of the insider trading allegations against the Settlement Noteholders. Rather, Judge Walrath's analysis was limited to whether those allegations gave rise to "colorable" claims sufficient to confer standing on the Equity Committee to pursue claims for equitable disallowance against the Settlement Noteholders based on their allegedly improper trading. In undertaking this analysis, Judge Walrath described the relevant standard as an exceedingly low one, commensurate with "the standard applicable to a motion to dismiss for failure to state a claim."¹

Elements of Insider Trading

Under section 10(b) of the 1934 Act, two theories of insider trading are recognized: the classical theory and the misappropriation theory. Under the classical theory, insider trading occurs when a corporate insider (i) trades in the securities of his corporation (ii) on the basis of (iii) MNPI (iv) in violation of a fiduciary duty owed to shareholders. Under the misappropriation theory, insider trading occurs when a corporate *outsider* "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information" rather than a duty owed to the shareholders of the securities.² The Settlement Noteholders argued that the only MNPI they received during the lockup periods were the estimated amounts of the Debtors' tax refunds, which were disclosed to the public before the Settlement Noteholders actually resumed trading, and that any other nonpublic information on which they traded was not material.

Classical Insider Trading Analysis

Materiality of Nonpublic Information. As to nonpublic information that was either provided to the Settlement Noteholders outside of lockup periods or not disclosed at the end of lockup periods – primarily the existence and substance of settlement discussions with JPMCB – the Settlement Noteholders argued that such information failed to meet the materiality threshold because of the speculative nature of the settlement discussions and the uncertainty inherent in any fluid negotiation. Materiality of nonpublic information is generally determined by an *objective* "reasonable investor" test that asks whether the information in question "would be important to a reasonable investor in making his or her investment decision."³ With regard to information on transformative corporate events like a potential merger, courts use a balancing test that looks to the "indicated *probability* that the event will occur and the anticipated *magnitude* of the event in light of the totality of the company activity."⁴ The parties did not dispute the potential magnitude of a settlement with JPMCB, but rather focused on the probability that such a settlement would occur. The Settlement Noteholders argued that settlement negotiations were too tentative, the parties' positions too far apart, and the core terms of the settlement proposals too fluid for the settlement that was ultimately struck to be sufficiently probable to constitute material information. The Settlement Noteholders contended that settlement discussions in the context of complex, multi-party, multi-issue negotiations such as those that occurred between the parties became material only after an agreement-in-principle had been reached or when the parties had become sufficiently close to reaching a deal as to suggest a high probability that the deal would be consummated.

¹ *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW), slip op at p. 109 (Bankr. D. Del. 2011).

² *U.S. v. O'Hagan*, 521 U.S. 642, 652 (1997).

³ *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d. Cir. 1997).

⁴ *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (emphasis added).

The Court rejected this argument. It is again important to note that the Court did not definitively hold that any of the relevant settlement discussions were material, only that some of those discussions may have gone to the “material end of the spectrum” and that several rules for determining materiality proposed by the Settlement Noteholders were not correct. Addressing certain specific issues, Judge Walrath found the fact that the parties executed confidentiality agreements, exchanged significant amounts of information and engaged in multi-party discussions for more than a year to be indicative of materiality and evidence that the parties to the agreements regarded the information as material. In rejecting arguments by the Settlement Noteholders that they reasonably believed after each confidentiality period had ended without a definitive agreement that the deals were “dead,” and therefore, that past discussions were not material, Judge Walrath pointed to other facts, such as the Debtors’ continued negotiations with several key parties outside of the confidentiality periods and the unhappy reaction of other parties that were excluded from those discussions, as evidence that the discussions were potentially material. Judge Walrath also suggested that the actions of certain of the Settlement Noteholders in restricting their own trading during separate negotiations with the Debtors outside of the formal confidentiality periods belied any notion that such Settlement Noteholders believed the negotiations to be over.

Importantly, the Court also discussed the relevance of trading activity in determining materiality, and whether materiality in this case could be adduced from the trading patterns of the Settlement Noteholders immediately following each confidentiality period. The Equity Committee asserted that the trading patterns of the parties was suggestive of such a finding because the Settlement Noteholders engaged in what amounted to a “buying spree” in junior claims, which the Equity Committee contended was based on knowledge that the settlement was likely to yield enough value to generate a recovery for the junior claims in excess of their trading prices. In response, the Settlement Noteholders argued that such a conclusion was not supported by the evidence because many of the Settlement Noteholders took different and even opposite trading positions. The Settlement Noteholders argued that had such information been material, all parties would have had economically similar trading patterns.

The Court again sided with the Equity Committee and found the evidence of contrary or random trading unpersuasive. Although the Court found it difficult to draw any conclusions based on the Settlement Noteholders’ trading activity, the Court went on to state that it believed that (1) the “negotiations may have shifted towards the material end of the spectrum,” and (2) the Settlement Noteholders “traded on that information, which was not known to the public.” Consequently, the Court concluded that a colorable claim existed that the Settlement Noteholders possessed MNPI while trading.

Insider Status. In support of its argument that the actions of the Settlement Noteholders constituted insider trading under the classical theory, the Equity Committee argued that although the Settlement Noteholders were not insiders of WMI in the typical sense of directors or officers, they were “temporary insiders” of the Debtors and thus assumed a duty not to trade. Recognized case law suggests that “insiders” for purposes of classical insider trading are not limited solely to officers and directors of a corporation but also include in certain instances “temporary insiders” who have “entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”⁵ The Equity Committee argued that such a relationship was created between the Debtors and the Settlement Noteholders when the Settlement Noteholders were given MNPI, triggering a fiduciary duty on their part to other creditors and shareholders. Additionally, the Equity Committee asserted that the Settlement Noteholders’ blocking positions in two subordinated classes of creditors potentially conferred fiduciary obligations on the Settlement Noteholders with respect to those two classes of creditors. The Settlement Noteholders countered that temporary insider status

⁵ *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

was not conferred where, as here, the Debtors and the Settlement Noteholders were working toward a goal in which each had diverse interests.

The Court did not wholly adopt the Equity Committee's first argument – that insider status should be imputed to the Settlement Noteholders purely on account of their possession of MNPI – but, nonetheless, found that there was a colorable claim that such status existed because the Debtors (i) gave the Settlement Noteholders confidential information and (ii) allowed the Settlement Noteholders to participate in negotiations with JPMCB for the shared goal of reaching a settlement that would form the basis of a consensual plan of reorganization. The Court agreed with the Equity Committee's second assertion – that the Settlement Noteholders could be considered “insiders” as a consequence of their status as holders of blocking positions in two classes of the Debtors' debt structure – because such significant holdings could create a duty to other members of those classes to act for their benefit. Interestingly, although the Equity Committee couched this second argument as conferring a potential fiduciary duty on the Settlement Noteholders as to other members of the two classes in which the Settlement Noteholders owned blocking positions, Judge Walrath's analysis is unclear and could be interpreted to mean that such duties also ran to other classes, including the equity class to which standing was granted.

Knowledge. In order to meet the scienter requirement for classical insider trading, it must be shown that, at the time of trading, the defendant “knew or recklessly disregarded” that it possessed MNPI. In support of their position that this requirement was not satisfied, the Settlement Noteholders argued that (1) their confidentiality agreements explicitly required the Debtors to disclose any MNPI at the end of each confidentiality period, (2) the Debtors certified that they had disclosed all MNPI, and (3) the Settlement Noteholders independently confirmed that such disclosure had occurred. The Settlement Noteholders also argued that the inconsistent trading patterns exhibited by different Settlement Noteholders throughout the periods in question further supported the notion that any information received during settlement talks that was not subsequently made public was not material.

The Court disagreed with the Settlement Noteholders on all counts, finding that the Settlement Noteholders' reliance on the Debtors for proper disclosure of any applicable MNPI did not provide a safe harbor with respect to the Settlement Noteholders' trading activity. Further, notwithstanding each Settlement Noteholder's own internal policies, the Court found that the Settlement Noteholders traded while in possession of the knowledge that the Debtors were engaged in discussions with JPMCB relating to issues of which the trading public was unaware. Based on these findings, the Court concluded that there was a colorable claim that the Settlement Noteholders were at least reckless as to their use of MNPI. In response to the additional assertion by the Settlement Noteholders that their inconsistent trading patterns undercut any argument that they traded based on MNPI, Judge Walrath stated that the statute only required that the Settlement Noteholders have knowledge that they were in possession of MNPI while trading, not that they profited from such knowledge or actually applied such knowledge in their trading.

Misappropriation Theory Insider Trading Analysis

The misappropriation theory of insider trading examines whether (i) the defendant possessed MNPI (ii) which he had a duty to keep confidential and (iii) breached that duty by acting on or revealing the information in question.”⁶ Liability attaches when the person who received MNPI trades on the misappropriated information under circumstances in which that person knew or should have known the MNPI was misappropriated.⁷ Here, the evidence presented suggested that the Debtors shared information with counsel to certain of the Settlement Noteholders pursuant to a strict confidentiality

⁶ *SEC v. Lyon*, 605 F. Supp. 2d 531, 541 (S.D.N.Y. 2009).

⁷ *SEC v. Willis*, 777 F. Supp. 1165, 1169 (S.D.N.Y. 1991).

agreement restricting any further distribution of such shared information to the law firm's clients unless the receiving party had entered into a separate confidentiality agreement directly with the Debtors. Notwithstanding such restrictions, the law firm allegedly shared summaries of April negotiations with two of its clients who were freely trading at the time and who had not entered into the required confidentiality agreements. After receipt of this information, one client continued to trade, while the other voluntarily restricted its trading. In light of the foregoing, the Court found that there was a colorable claim against the fund that had continued trading on a misappropriation theory, because the fund "knew or should have known" that the information was restricted and subject to the law firm's confidentiality obligation to the Debtors (it was also alleged that the law firm breached its confidentiality agreement with the Debtors in sharing the MNPI with its clients). The Court also concluded that a colorable claim of insider trading under the misappropriation theory existed with respect to whether the same attorneys had similarly breached their confidentiality agreement by allegedly sharing protected MNPI with the Settlement Noteholders.

Possible Effects of the Decision

As noted above, although Judge Walrath discusses the law of insider trading in significant detail, the Court did not reach any final conclusion as to the merits of the specific allegations at issue. The Court's ultimate finding is only that the allegations meet the low bar of being "colorable" claims, justifying a grant of standing to the Equity Committee to pursue the claims further. In spite of this, however, the Court's analysis of the application of insider trading laws to claims traders in the bankruptcy process may have a significant impact on the way claims traders do business and on the way settlement and restructuring negotiations are conducted in bankruptcy. In concluding its analysis of the insider trading allegations, the Court addressed this issue, noting that the Settlement Noteholders and others had warned that a finding of insider trading would chill the participation of creditors in settlement discussions in bankruptcy cases of public companies. On this point the Court displayed little sympathy, contending that "[t]here is an easy solution: creditors who want to participate in settlement discussions in which they receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case."⁸ Judge Walrath found these restrictions appropriate and not unduly burdensome because these creditors were doing so in exchange "for a seat at the negotiating table," which would not only allow them to receive confidential information in return but would also give them the opportunity to influence the reorganization process.

Judge Walrath's decision seems to propose a bright line rule for the conservative investor: if you wish to participate in nonpublic negotiations, you should not make trading decisions at any time after beginning such negotiations. Institutions involved in negotiations would refrain from trading entirely or implement an "ethical wall" between those engaged in negotiations and those making trading decisions for the duration of the case. For investors that are willing and able to adopt one of these approaches, Walrath's decision will not be problematic. For some investors, however, these approaches will be either difficult or impossible, and these investors will not be willing to take the risk of becoming restricted indefinitely by engaging in settlement discussions.

Investors unwilling to be indefinitely restricted have typically used confidentiality arrangements similar to those used by the Settlement Noteholders, providing for intermittent restricted periods during which they halted trading or walled off traders, followed by a publication of MNPI to which they were exposed at the end of the restricted period, thus "cleansing" them before they resumed trading or removed the ethical wall. The full impact of Judge Walrath's decision on market practice will not fully be known for some time. In the wake of this opinion, however, confidentiality agreements that allow investors to move back and

⁸ *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW), slip op at p. 138 (Bankr. D. Del. 2011).

forth between restricted and unrestricted status through a “cleansing” of MNPI would seem to carry with them either a burden on the debtor to disclose enormous amounts of information at the end of lockup periods (some of which could be problematic for evolving negotiations), or a risk that determinations as to materiality would later be vulnerable to attack. This could impact both claims trading and plan negotiation dynamics. From the investor’s perspective, inability to use these arrangements could discourage active participation in negotiations by funds that are not able or willing to establish ethical walls for the duration of a case, and thus limit such investors’ ability to protect their interests. From the debtor’s perspective, this shrinking of the universe of negotiation participants could make it difficult to craft a plan the debtor could be confident would succeed due to an inability to find a critical mass of creditors with whom to negotiate. Needless to say, it is preferable for a debtor to be able to know with some certainty that its proposed plan structure will succeed, and having to guess at what creditors will vote to support could lead to an inefficient and drawn out plan process, prolonging case duration and expense.

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