Docket #8424 Date Filed: 8/10/2011

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re	:	**Chapter 11**
WASHINGTON MUTUAL, INC., et al.,[1]	:	**Case No. 08-12229 (MFW)**
Debtors.	:	**(Jointly Administered)**
	:	**Re: Docket No. 8179**

DEBTORS' OBJECTION TO MOTION FOR AN ORDER AUTHORIZING THE OFFICIAL COMMITTEE OF EQUITY SECURITY HOLDERS TO COMMENCE AND PROSECUTE CERTAIN CLAIMS OF DEBTORS' ESTATES

Washington Mutual, Inc. ("WMI") and WMI Investment Corp., as debtors and debtors in possession (collectively, the "Debtors"), file this objection to the *Motion for an Order Authorizing the Official Committee of Equity Security Holders to Commence and Prosecute Certain Claims of Debtors' Estates*, dated July 12, 2011 [D.I. 8179] (the "Motion"), and respectfully represent as follows:

PRELIMINARY STATEMENT

1. In furtherance of its desperate attempt to disrupt the Debtors' confirmation proceedings and improperly grab assets, or at least headlines, on the eve of confirmation, the Official Committee of Equity Security Holders (the "Equity Committee") filed the Motion seeking authority to commence an action to equitably disallow certain creditors' claims. Unfortunately for the Equity Committee, this latest gambit is as flawed as its prior "Hail Mary" attempts and fails to satisfy the legal requirements for the relief requested. To usurp the Debtors'

[1] The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, are: (i) Washington Mutual, Inc. (3725); and (ii) WMI Investment Corp. (5395). The Debtors' principal offices are located at 925 Fourth Avenue, Suite 2500, Seattle, Washington 98104.

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standing to pursue such claims, the Equity Committee must demonstrate that there is a colorable claim and that the Debtors have unjustifiably refused to pursue the claim. Here, the Equity Committee seeks standing to pursue claims that are not recognized as a valid causes of action. This in and of itself should end the inquiry.

2. Even if equitable disallowance were a valid cause of action, which it is not, the Equity Committee's allegations in support of equitable disallowance against Aurelius Capital Management, LP. (and affiliates) and Centerbridge Partners, L.P. (and affiliates) (collectively, the "Targets") are unsupported, by the facts adduced at the confirmation hearing.

3. Moreover, the costs attendant to such litigation, including the large sums of money to be spent by the Equity Committee in pursuing and litigating the claims, and the sizeable administrative counterclaims likely to be asserted against the Debtors for, among other things, alleged breaches of postpetition contracts, render the Debtors' position more than reasonable. The Equity Committee's attempt to disallow all of the Targets' claims – as opposed to just any alleged profits connected to the trading about which it complains – only underlines the overreaching nature of the allegations and, ultimately, the relief requested.

4. Furthermore, the right to pursue claims of the Debtors and their chapter 11 estates, including equitable disallowance (if such a claim were to exist), will vest with the Liquidating Trust and the Liquidating Trustee, both of which are subject to the oversight of a Trust Advisory Board, that includes a member designated by the Equity Committee, on the Effective Date of the Modified Plan. Indeed, the Equity Committee acknowledges in the Motion that its game plan should not hold up confirmation and consummation of the Modified Plan, as distributions to the Targets with respect thereto can always be reserved. While the Debtors have concluded that an equitable disallowance claim is non-existent or, if it were to exist, is meritless,

the Equity Committee should not be allowed to usurp the power given to the Liquidating Trustee (and the Trust Advisory Board) to reach their own conclusion on the claim consistent with their fiduciary duties to the Liquidating Trust Beneficiaries.

BACKGROUND

5. On September 26, 2008 (the "Commencement Date"), each of the Debtors commenced with this Court a voluntary case pursuant to chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). The Debtors are authorized to continue to operate their businesses and manage their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

6. On October 15, 2008, the United States Trustee for the District of Delaware (the "U.S. Trustee") appointed the official committee of unsecured creditors (the "Creditors' Committee"). On January 11, 2010, the U.S. Trustee appointed the Equity Committee in these chapter 11 cases.

7. On February 8, 2011, the Debtors filed the *Modified Sixth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code*, dated February 7, 2011 (as amended, the "Modified Plan"), premised upon that certain Second Amended and Restated Settlement Agreement, dated as of February 7, 2011, by and among the Debtors, JPMorgan Chase Bank, National Association ("JPMC"), the Federal Deposit Insurance Corporation (the "FDIC"), as receiver (the "FDIC Receiver") for Washington Mutual Bank ("WMB") and in its corporate capacity ("FDIC Corporate"), and the Creditors' Committee (as amended, the "Global Settlement Agreement").

8. On July 1, 2011, the Equity Committee filed its *Objection of the Official Committee of Equity Security Holders to Confirmation of the Modified Sixth Amended Plan of*

Reorganization [D.I. 8073] (the "Confirmation Objection").[2] Therein, the Equity Committee alleged, among other things, that certain hedge funds (the "Settlement Noteholders") participated in inequitable conduct, including trading on inside information, and as a result, their claims should be disallowed.

9. On July 12, 2011, the day before the commencement of the Confirmation Hearing, the Equity Committee filed the Motion [D.I. 8179] seeking standing to commence, on the Debtors' behalf, an action for equitable disallowance of the claims held by the Targets.[3] In support thereof, the Equity Committee claims that the Targets "engaged in a campaign to obtain confidential information" about the Debtors' assets and then used such information to unlawfully trade for profit.

10. Commencing on July 13, 2011, the Court held a hearing to consider confirmation of the Modified Plan. At that time, counsel for the Equity Committee requested that the Court, "take into account the evidence . . . adduced at [the Confirmation Hearing] on the inequitable conduct allegations, take that into account when deciding the colorable claim prong of the standing motion." Hr'g Tr. 7/13/2011 at 54:5-7. The evidence adduced at the Confirmation Hearing demonstrates convincingly that both the Debtors and the Targets took careful steps to ensure proper protections for confidential information and the Equity Committee's allegations of inequitable conduct against the Targets lack all merit.

[2] The Confirmation Objection was first filed under seal and subsequently, on July 12, 2011, the Equity Committee filed an unredacted version of the Confirmation Objection [D.I. 8192].

[3] The proposed draft complaint attached to the Motion (the "Draft Complaint") also names WMI as a "nominal defendant."

ARGUMENT

A. Standard for Derivative Standing

11. Because the claim asserted by the Equity Committee fails as a matter of law, the first element of the test for derivative standing cannot be satisfied. In order for the Equity Committee to obtain derivative standing to assert its equitable disallowance claim, it must establish (i) the existence of a colorable claim, (ii) that the Debtors have unjustifiably refused to pursue the claim, and (iii) permission of the Court to initiate the action. *See Infinity Investors Ltd. v. Kingsborough (In re Yes Entm't Corp.),* 316 B.R. 141, 145 (D. Del. 2004) (citing *In re Valley Media, Inc.*, Nos. 01-11353, 02-04553, 2003 WL 21956410, at *2 (Bankr. D. Del. Aug. 14, 2003)). It is the Equity Committee's burden in the first instance to demonstrate that it has satisfied each of the foregoing requirements in order to obtain derivative standing. *See id.* (citing *In re G-I Holdings, Inc.*, 313 B.R. 612, 629 (Bankr. D.N.J. 2004)). It has failed to do so because its equitable disallowance claims are not legally cognizable. Even if legally cognizable, the record of the confirmation hearing provides no support for claims of inequitable conduct by the Targets. Finally, the Debtors are more than justified in electing not to pursue claims against the Targets under the circumstances in this case and the Court should therefore deny the Equity Committee permission to initiate the action.

B. The Claims that the Equity Committee Seeks to Pursue are Not Colorable

12. When determining if a colorable claim exists in connection with a derivative standing motion, courts apply the same standard as when a defendant moves to dismiss a complaint for failure to state a claim. *See In re Centaur, LLC*, No. 10-10799, 2010 WL 4624910, at *4 (Bankr. D. Del. Nov. 5, 2010). Specifically, in deciding a motion under Fed.R.Civ.P. 12(b)(6), the Court is "required to accept as true all factual allegations in the

complaint and draw all inferences from the facts alleged in the light most favorable to [the plaintiff]." *Phillips v. Cnty of Allegheny*, 515 F.3d 224, 228 (3d Cir. 2008) (citing *Worldcom, Inc. v. Graphnet, Inc.*, 343 F.3d 651, 653 (3d Cir. 2003)).

1) The Equity Committee Cannot Maintain a Cause of Action for Equitable Disallowance or Equitable Subordination

13. Here, the Equity Committee has failed to assert a colorable claim because the primary cause of action which the Equity Committee seeks to invoke, equitable disallowance, does not exist. Thus, even assuming all of the Equity Committee's allegations as true, the Equity Committee has failed to state a claim upon which relief can be granted.

14. Section 502(b) of the Bankruptcy Code, which governs the allowance and disallowance of claims, enumerates nine exclusive grounds on which a court may disallow a claim. *See* 11 U.S.C. §§ 502(b)(1)-(b)(9) ("[T]he court . . . shall allow such claim in such amount, except to the extent that . . .") (emphasis added). The Bankruptcy Code's utilization of the word "shall" denotes "a mandatory requirement[]". *In re Haven Projects L.L.C.*, 225 F.3d 283, 287 (2d Cir. 2000). Importantly, nowhere in section 502(b) is "equity" listed as a basis for disallowance. Accordingly, the Court lacks the authority to disallow a claim for any reason other than one of the nine enumerated reasons in section 502(b), and for this reason alone, the Equity Committee has failed to state a claim upon which relief may be granted.

15. Indeed, the United States Supreme Court, in a unanimous decision, concurred in this interpretation of section 502(b). *Travelers Casualty & Surety Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007). In *Travelers*, the debtor objected to a creditor's contractual right to attorney's fees on the ground that, under equitable principles, fees incurred in litigating bankruptcy cases are not recoverable. *Id.* The Supreme Court rejected this argument

and held that, unless a ground for disallowance appears in one of the enumerated subsections of 502(b), the claim is allowed. *Id.*

16. The Supreme Court in *Travelers* explained that, "'where Congress has intended to provide . . . exceptions to provisions of the Bankruptcy Code, it has done so clearly and expressly.'" *Id.* at 453 (quoting *FCC v. NextWave Personal Commc'ns Inc.*, 537 U.S. 293 (2003)). The Supreme Court further noted:

> But even where a party in interest objects, the Court "shall allow" the claim "except to the extent that" claim implicates any of the nine exceptions enumerated in § 502(b) . . . [Because] Travelers' claim for attorney's fees has nothing to do with [§§ 502(b)(2)-(9)] . . . Travelers' claim must be allowed under § 502(b) unless it is unenforceable within the meaning of § 502(b)(1).

Id. at 449-50. Applying this rule here, because Congress has not provided an express exception to the bases for claim disallowance listed in section 502(b) (i.e., based upon inequitable conduct), there is no such remedy. Indeed, courts have interpreted expressly the *Travelers* decision to prohibit equitable disallowance of claims. In *Grede v. Bank of New York*, 2009 WL 188460 (N.D. Ill. Jan. 27, 2009), the court, citing *Travelers*, dismissed a chapter 11 trustee's equitable disallowance claim because that remedy is not authorized under the Bankruptcy Code.

17. Presumably because the Equity Committee understands the infirmities of its argument for disallowance under applicable law, the Equity Committee's Draft Complaint makes a brief reference to section 105 of the Bankruptcy Code. However, the Equity Committee's purported reliance on section 105 is misplaced. Courts have held that the grant of equitable powers contained in section 105(a) of the Bankruptcy Code does not allow a bankruptcy court to create new remedies not otherwise contained in the Bankruptcy Code. *See Nw. Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); *see also In re Combustion Eng'g, Inc.* 391 F.3d 190, 236 (3d Cir. 2004)

("The general grant of equitable power contained in § 105(a) cannot trump specific provisions of the Bankruptcy Code, and must be exercised within the parameters of the Code itself."). Here, the language of the Bankruptcy Code is clear, and section 105(a) of the Bankruptcy Code cannot be used to create a new remedy not otherwise found in the Bankruptcy Code (i.e., equitable disallowance). Accordingly, this is "where the inquiry should end, for where, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (citation omitted). As explained by the Supreme Court in *Ron Pair*, "[t]he task of resolving the dispute over the meaning of [a Bankruptcy Code section] begins where all such inquiries must begin: with the language of the statute itself." *Id.*

18. Had Congress intended equitable disallowance to be permissible, it would have included a provision for this in section 502(b) or elsewhere in the Bankruptcy Code, including section 510(c) (as discussed herein). Congress, however, did not. And for good reason. As aptly reasoned by the United States Court of Appeals for the Fifth Circuit:

> Disallowance of claims on equitable grounds would add nothing to the protection against unfairness already afforded the bankrupt and its creditors. If the claimant's inequitable conduct is directed against the creditors, they are fully protected by subordination. If the misconduct directed against the bankrupt is so extreme that disallowance might appear to be warranted, then surely the claim is either invalid or the bankrupt possesses a clear defense against it. See 3 J. Moore & L. King, Collier on Bankruptcy p. 57.14, at 233 (14 ed. 1976). Thus, where the bankrupt is the victim it has an adequate remedy at law. It follows that disallowance of a wrongdoer's claim on nonstatutory grounds would be an inappropriate form of equitable relief.

Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 699 n.10 (5th Cir. 1977) (citations omitted). In *Mobile Steel*, the Fifth Circuit ruled that "equitable considerations can justify only the subordination of claims, not their disallowance." *Id.* at 699. This Congressional decision

must be respected. Thus, because equitable disallowance is not a cause of action provided by the Bankruptcy Code, there is no colorable claim for the Equity Committee to pursue.

19. Aside from the brief reference to section 105 (and 510) of the Bankruptcy Code, the Equity Committee does not assert a legal basis – statutory or otherwise – in the Motion or the Draft Complaint for the claims it seeks to pursue. The only scant demonstration in this regard is in the Equity Committee's Confirmation Objection, where it cites to three cases in support of its argument for equitable disallowance. The Equity Committee's reliance on section 510(c) is misplaced, and the cases to which it cites are distinguishable.[4]

(a) The Cases Cited by the Equity Committee in Support of Equitable Disallowance are Distinguishable

20. The Equity Committee's reliance on *Pepper v. Litton*, 308 U.S. 295 (1939) is misplaced. *Pepper*, a pre-Code case, was decided by the United States Supreme Court without the benefit of section 502(b) of the Bankruptcy Code. There, the Supreme Court disallowed an insider's claim on equitable grounds on account of the insider's "planned and fraudulent scheme" to defraud creditors, *id.* at 312, saying that disallowance is an appropriate remedy for claims that are "fictitious or a sham." *Id.* at 310. After the enactment of the Bankruptcy Code, however, the broad grant of equity jurisdiction conferred on bankruptcy courts pursuant to Section 2 of the former Act (which *Pepper* is premised upon) was repealed. So, today, such claim would need to be disallowed upon explicit grounds set forth in the Bankruptcy Code, and not based upon equitable powers (i.e., section 105(a)). *See In re Smart World Techs., LLC*, 423 F.3d 166, 184 (2d Cir. 2005) ("The equitable power conferred . . . by section 105(a) is the power to exercise equity in carrying out the provisions of the Bankruptcy Code, rather than to further

[4] Significantly, the Equity Committee's discussion of equitable disallowance contained in its Confirmation Objection focuses on the conduct of insiders: "Equity does not permit insiders from using their strategic position . . ."; "Where an insider uses insider information . . ." See EC Conf. Obj. ¶¶ 39-41.

the purposes of the Code generally, or otherwise to do the right thing.") (citations omitted). Even if equitable disallowance is a viable claim under *Pepper* – and the Debtors submit it is not – it is an extraordinary remedy that is limited to the rare situation where an <u>insider</u> alleges a "fictitious" claim and engages in <u>extreme wrongdoing</u> that harms a <u>creditor</u> – something no party has alleged. The Equity Committee's conclusory allegations fall far short of these stringent requirements as set forth in section B.2, *infra*. Moreover, *Pepper* was decided prior to *Travelers*, and the Debtors submit that the portion of the *Pepper* decision at issue has been effectively abrogated by *Travelers*.

21. Further, the Equity Committee's reliance on *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3d Cir. 1998), in support of equitable disallowance is unpersuasive. The Third Circuit has never determined whether the doctrine of equitable disallowance retained any viability after the enactment of the Bankruptcy Code. Although, in *Citicorp*, the Third Circuit suggested that it might not agree with the decision by the district court below that section 510(c) subordination is the exclusive remedy for inequitable conduct by a creditor, ultimately, the Third Circuit specifically declined to decide the issue. *Citicorp*, 160 F.3d at 991 n.7 ("We find it unnecessary here to resolve the issue as to whether equitable 'disallowance' remains an available remedy."). Again, however, *Citicorp* was decided prior to *Travelers*. Furthermore, in the thirteen (13) years since *Citicorp* was decided, not a single court in the District of Delaware has ruled that equitable disallowance is permitted under the Bankruptcy Code, and the Equity Committee does not dispute this point.

22. Rather, subsequent decisions of this Court specifically have held otherwise. Bankruptcy Judge Walsh recently cited with approval the oft-cited quote contained in *Mobile Steel* that, "[e]quitable considerations can justify only the subordination of claims, not

their disallowance." *In re Mid-American Waste Sys., Inc.*, 284 B.R. 53, 68 (Bankr. D. Del. 2002). Moreover, in *In re Zenith Electronics Corp.*, 241 B.R. 92, 107 (Bankr. D. Del. 1999), this Court stated that, "[i]n order for a claim to be disallowed, there must be no legitimate basis for it."

23. The one recent case that the Equity Committee cites in its Confirmation Objection to support application of equitable disallowance stated that equitable disallowance remains in theory available, but the court did not actually use equitable disallowance based upon the facts of the case. *Adelphia Recovery Trust v. Bank of Am.N.A.*, 390 B.R. 64 (S.D.N.Y. 2008) (McKenna, J.). Indeed, in a subsequent opinion, the court stated that it did not need to decide the issue of whether equitable disallowance remains a permissible bankruptcy remedy. *See Adelphia Recovery Trust v. Bank of Am.N.A.*, 390 B.R. 80, 99 (S.D.N.Y. 2008) (McKenna, J.)("The Court finds it unnecessary to decide the issue . . . of whether or not equitable disallowance is a permissible remedy in bankruptcy under any circumstances" and stated that "to the extent equitable disallowance is a permissible remedy in bankruptcy it is available only in 'extreme instances – perhaps very rare – where it is necessary as a remedy' and is '[p]lainly . . . more draconian' than equitable subordination, and therefore applied more rarely" (internal citation omitted)). Regardless, the Equity Committee has not demonstrated anything requiring such a questionable and extreme remedy.

24. This Court should take this opportunity to put to bed any lingering doubt that the doctrine of equitable disallowance has any vitality after enactment of the Bankruptcy Code and deny the Motion for the simple reason that the Equity Committee states no valid cause of action.

(b) Section 510(c) of the Bankruptcy Code is Inapplicable

25. Section 510(c) of the Bankruptcy Code is also of no assistance to the Equity Committee. Section 510(c) of the Bankruptcy Code allows for equitable *subordination* of a claim, but does not permit a court to equitably *disallow* a claim. Section 510(c) provides, in relevant part, that "the court may – (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . ." The Debtors are not aware of any case where this statute has been construed to provide for disallowance of a claim. Further, the Equity Committee cannot rely upon section 105(a) of the Bankruptcy Code to read equitable disallowance into section 510(c). The Second Circuit has stated that:

> The equitable power conferred . . . by section 105(a) is the power to exercise equity in carrying out the provisions of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language suggests that an exercise of section 105 power be tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective.

Smart World, 423 F.3d at 184 (citations omitted).

26. The Equity Committee's Draft Complaint seeks in the alternative to equitably subordinate the claims to equity,[5] but section 510(c) prohibits such a result. Section 510(c)(1) of the Bankruptcy Code only allows claims to be subordinated to other claims, and not to the level of equity. *In re Winstar Commc'ns, Inc.*, 554 F.3d 382, 414 (3d. Cir. 2009) (section 510(c) "plainly provides that a creditor's claim can be subordinated only to the claims of other creditors, not equity interests.") Third Circuit law also provides that any subordination

[5] Although, confusingly, the text of the Equity Committee's Draft Complaint does not explicitly state that they are requesting equitable subordination, the heading for their proposed count states that they are seeking in the alternative equitable subordination and the relief requested is broad enough to encompass that alternative request.

must be consistent with the principle that it cannot result in a windfall to those outside the class of persons injured by the challenged conduct. *Citicorp,* 160 F.3d at 991. The Equity Committee is prohibited from receiving a windfall by jumping ahead of creditors. The Equity Committee's attempt use this section of the Bankruptcy Code, either to support equitable disallowance or as an alternative remedy, must fail because where a statute is clear, the "sole function of the courts is to enforce it according to its terms." *Ron Pair*, 489 U.S. at 241.

(c) The Equity Committee Lacks Standing to Pursue Equitable Disallowance

27. In addition to there being no legal cause of action for equitable disallowance, even if such a claim existed, the Equity Committee lacks standing to pursue it. Countless decisions have stated that official committees lack standing to pursue claims (e.g., equitable subordination) based upon injury to particular creditors. *See, e.g., In re AppliedTheory Corp.*, 493 F.3d 82, 87 (2d Cir. 2007). Instead, official committees can only bring claims based upon general harm to the estate. *See e.g., In re Elrod Holdings Corp.*, 392 B.R. 110, 114 (Bankr. D. Del. 2008) (stating that "In order for [a] claim to be the 'legal or equitable interest of the debtor in property,' the claim must be a 'general one, with no particularized injury arising from it.'") (citations omitted).

28. Notably absent from the Motion is any allegation that the Targets' activities harmed the Debtors' estates. Instead, to skirt this requirement, the Confirmation Objection (and <u>not</u> the Motion) alleges that the Targets' actions have injured the Debtors by depriving them of a "corporate opportunity." As discussed below, this is an absurd allegation as

the Debtors cannot invest in their own securities (and such an investment would likely have been deemed to be on the basis of non-public material information).[6]

29. In *Citicorp*, the Court noted, in the equitable subordination context, that subordination is proper "only to the extent necessary to offset the harm the creditors suffered as a result of the inequitable conduct." 160 F.3d at 991 (quoting *Matter of Herby's Foods Inc.*, 2 F.3d 128, 131 (5th Cir. 1993)). The alleged harm caused by alleged insider trading was arguably directed to certain sellers of various WMI securities. However, such creditors who already sold their claims "will not benefit from any subordination [and] [a]ccordingly, any injury to them must play no role in determining the extent of any subordination . . ." *Id.* This reasoning equally applies in the equitable disallowance context. Any equitable disallowance of the Targets' claims will not benefit the parties allegedly injured by the Targets' alleged inequitable conduct.

30. Moreover, equitable disallowance in this case overwhelmingly benefits the Debtors' shareholders, thus allowing them to receive more in bankruptcy than they would otherwise receive under state law outside of bankruptcy. Accordingly, equitable disallowance is inappropriate.

2) There is No Merit to the Assertion that the Targets Acted Inequitably

31. Even if equitable disallowance were a cognizable legal claim, the Equity Committee has not met its burden of demonstrating any chance of success on the merits. After extensive discovery and litigating these same issues during plan confirmation, the Equity Committee failed to present a scintilla of evidence, through exhibits or direct or cross-

[6] While the *Citicorp* case states that the purchases by a fiduciary of a corporation's claims against the debtor in a bankruptcy at a discount is a corporate opportunity, the Targets are not fiduciaries of the Debtors' estate, as explained herein. *See Citicorp*, 160 F.3d at 987-88.

examination, establishing the existence of inequitable conduct or demonstrating that the Global Settlement Agreement was negotiated in bad faith as a result of the participation of the Targets.

(a) The Targets Do Not Owe Fiduciary Duties

32. The Equity Committee asserts that the Targets assumed fiduciary duties "(1) by buying up large quantities of WMI debt securities in order to obtain a blocking position and asserting control over key decisions in the bankruptcy; (2) by undertaking settlement negotiations with JPMC on behalf of the entire estate; [and] (3) by becoming temporary insiders who were made privy to confidential information concerning the Debtors." Draft Complaint ¶ 55. This conclusion is wrong based upon a review of both the facts and the law.

33. The Targets were but one group in lengthy, multi-party negotiations in which all the participants had "their own agenda and their own items that were very important to them." Hr.'g Tr. 7/21/2011 at 98:1-5 (Kosturos Direct). The assertion that the Targets dominated the Debtors or the negotiations is categorically incorrect and unsupported by *any* evidence. In fact, the evidence at trial clearly demonstrated that the Settlement Noteholders, including the Targets, were not acting on behalf of the Debtors during the Global Settlement Agreement negotiations. Mr. Kosturos, the Debtors' Chief Restructuring Officer and lead negotiator, was expressly asked

> Q: "What role did the settlement noteholders have in making decisions on behalf of the debtor with respect to the settlement negotiations with JPMorgan?"
>
> A: None whatsoever."

Id. at 96:9-12. In addition, Mr. Kosturos explained that the Equity Committee's allegations that the Settlement Noteholders controlled and dominated the Debtors were "completely false" and further explained that the Debtors were willing, and did, reject the Settlement Noteholders' ideas

when they conflict with what was best for the estate.[7] *Id*. at 137:2-17. In fact, Mr. Kosturos testified that the Debtors led the negotiations and, with respect to the final negotiated deal, that "ultimately the debtor exercised its judgment, its sole judgment in entering into the global settlement agreement." *Id.* In fact, at critical points in the negotiations the Debtors did not even include the Targets in discussions or share information directly with them. *Id.* at 104:22-105:5, 105:10-106:11, and 136:10-23. Likewise, the Targets did not supplant the role of the Creditors' Committee in the negotiations. The Creditors' Committee itself participated directly in the negotiations along with the Targets and other constituencies. *Id.* at 137: 9-17. The Equity Committee failed to rebut any of this testimony or to present anything to support its spurious allegations.

34. Simply stated, the Debtors believed it would be helpful to include the Targets, and other parties in interest, in the Global Settlement Agreement negotiations because they were major constituency creditors who held large positions in the case. *Id.*at 100:7-101:4. This is not unusual or sinister. Rather, it is the process designed by Congress to reach consensual resolutions. Moreover, the record is replete with facts that demonstrate that the Debtors took adequate steps to protect and then disclose material non-public information. The Debtors required that each of the Targets execute a confidentiality agreement to preclude disclosure of any confidential information that might be exchanged in the settlement negotiations. *Id.* at 102:4-21, 101:17-102:3, and 122:12-25. During these periods, the Targets were either restricted from trading in the securities of the Debtors or had erected ethical walls to prevent the sharing of material non-public information between persons participating in the

[7] The Settlement Noteholders also testified that they did not dominate the Debtors or control the Global Settlement Agreement negotiations. Hr'g. Tr. 7/18/2011 at 40:22 - 41:6 (Gropper Direct); *see also* Hr'g. Tr. 7/20/2011 at 55:5-7 (Question: "In your view, would it have been possible to have a settlement agreement in this case without the debtors involved?" Answer: "No.")

settlement negotiations and persons making trading decisions. All material non-public information that the Debtors shared with the Targets was then publicly disclosed before the end of confidentiality periods *Id.* at 113:12-17.

35. The Equity Committee argues that the Targets, by their "dominant role" in the negotiations, became fiduciaries of the other claimants and violated their obligations as such through their failure to disclose information regarding those negotiations. No fiduciary obligations can be imputed to the Targets, and the Equity Committee's claim based upon a breach of fiduciary duty is unfounded and legally deficient. The communication of confidential information does not by itself create a fiduciary relationship, *see Walton v. Morgan Stanley & Co., Inc.*, 623 F.2d 796, 798-799 (2d Cir. 1980), nor does the signing of a confidentiality agreement between two parties "necessarily create a fiduciary relationship." *Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb Inc.*, 767 F. Supp. 1220, 1231 (S.D.N.Y. 1991) ("the existence of a fiduciary duty is not coterminous with a contractual obligation.") The Court recently held in another case that a boilerplate "confidentiality agreement alone does not establish that there was a fiduciary relationship between… two parties." *In re Am. Bus. Fin. Servs., Inc.*, Nos. 05-10203, 06-50826, 2011 WL 3240596 at *3 (Bankr. D. Del. July 28, 2011). Where, as here, the confidentiality agreement arose out of arm's-length commercial dealings between sophisticated parties, no fiduciary relationship may be found. *Boccardi Capital Sys., Inc. v. D.E. Shaw Laminar Portfolios, L.L.C.*, No. 05-6882, 2009 WL 362118, at *7 (S.D.N.Y. Feb. 9, 2009) ("[T]he Confidentiality Agreement was executed by parties on equal footing, as part of a 'purely commercial relationship,' one in which courts will not impose fiduciary obligations on either contracting party.") *aff'd*, 355 F. App'x. 516 (2d Cir. 2009); *see also City Solutions, Inc. v. Clear Channel Comm'ns, Inc.*, 201 F. Supp. 2d 1048, 1049 (N.D. Cal. 2002) ("it makes great sense not

to impose fiduciary duties concomitantly with confidentiality agreements. The existence of a detailed confidentiality agreement suggests arms'-length dealings between co-equals.").

36. The Debtors' view of the role of the Settlement Noteholders (including the Targets) in the settlement negotiations is consistent with that expressed by the Court in the Opinion: "The Settlement Noteholders were not acting in this case in any fiduciary capacity; their actions were taken solely on their own behalf, not others." Opinion at 349. It also is consistent with the view of the Equity Committee itself, which stated its view last December that the Settlement Noteholders had no duty to obtain or improve recoveries for equity, and particularly not at the risk of delay to creditors. Hr'g Tr. 12/7/2010 155:3-6. Indeed, this view is consistent with the evidence adduced at the Confirmation Hearing when Mr. Kosturos testified that each of the original signatories to the Global Settlement Agreement, including the Settlement Noteholders, had their own agendas. Hr'g. Tr. 7/21/2011 at 97:23-98:5.

37. It was the Debtors' role – and one that they fulfilled properly – to ensure the settlement maximized the overall value of the estate and then distribute that value in accordance with the Bankruptcy Code. Hr'g Tr. 12/2/10 at 62:21-63:2, 63:12-15, 93:9-18, 118:7-9, 126:16-19, 135:25-136:4, 137:24-138:3; Hr'g Tr. 7/21/2011 at 136:10-137:17.

(b) Preliminary Settlement Negotiations Are Not Material Non-Public Information

38. The Equity Committee asserts that the Targets traded on material non-public information – a violation of the securities laws. This argument simply ignores the consistent testimony from the parties involved in the negotiations. As discussed above, the Debtors disclosed all material non-public information that had been shared with the Targets

during the confidentiality period. Hr'g. Tr. 7/21/2011 at 113:12-17 (Kosturos Direct). Indeed, the evidence introduced at the Confirmation Hearing established that:[8]

- The Debtors, JPMC, and the FDIC engaged only in tentative discussions during the period between the filing of the chapter 11 petition and March 9, 2009 (*see* Kosturos Tr. 6/30/2011 103:6-104:21) and that the Debtors did not give "any documents or materials to the settlement noteholders" during this period. Hr'g Tr. 7/21/2011. 100:2-3. Information that the Debtors had during this period regarding conversations with JPMC was shared only with counsel to the Targets, who had executed confidentiality agreements requiring all shared information "to be kept confidential and not to be shared with anyone," including their clients. *Id.* 100:22-25.

- The period from March 9, 2009, when the Debtors entered into confidentiality agreements with the Settlement Note Holders and certain other noteholders, through May 8, 2009, to when the March confidentiality agreements expired is the second period of negotiations (the "March Confidentiality Period"). Near the end of the March Confidentiality Period, the Debtors filed their March Monthly Operating Report under Form 8-K in which they disclosed certain information that had been shared with the Targets, including "the estimated size of the expected [tax] refunds in the approximate range of $2.6 to $3 billion," along with information pertaining to "restricted cash balances," "unsecured notes receivable that . . . non-debtor subsidiaries had with WMB or JPMorgan in the total of $178 million," and "an accrued liability that [the Debtors] had that was not previously" disclosed. *Id.* 115: 12-13; *see also* Ex. DX 427-WMI Form 8-K ("The current estimate for the total expected refunds, net of potential payments, is in the range of approximately $2.6-$3.0 billion."). The Debtors concluded that there was no additional material non-public information that needed to be disclosed at this time *Id.* 115: 18-20, and the record is devoid of any evidence that the Debtors shared any other material non-public information with the Targets during the March Confidentiality Period.

- No evidence exists showing that the Debtors shared material non-public information regarding the settlement negotiations or any other subject with the Targets during the period between March 8, 2009 and mid-November 2009. *Id.* 135: 18-22; *Id.* 118:11-12 ("there was not much negotiation going on" between the Debtors and JPMC at this time). Although the Targets separately negotiated with JPMC, they did not have "any ability to make a deal and bind the Debtor." *Id.* at 119:14-18. Any information the Targets obtained during these separate

[8] A more thorough description of the non-material nature of the various term sheets and settlement discussions is included in section III(C) of the Debtors' *Post-Hearing Brief in Further Support of Confirmation of the Modified Sixth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code* (the "Debtors' Post Trial Brief"). The Debtors hereby incorporate by reference the Debtors' Post Trial Brief, including section III(C) and the Facts section.

negotiations would have been from JPMC. In fact, the Debtors did not share any confidential information with any of the Settlement Noteholders during this period. *Id.* at 122:8-11. In addition, the negotiations between the Debtors and JPMC were very far apart as both a matter of dollars and because all of the necessary parties – including the FDIC and the Bank Bondholders – had not yet become fully engaged. *Id.* at 121:19-122:7.

- From mid-November 2009 through December 30, 2009 (the "November Confidentiality Period"), the Debtors allowed the Settlement Noteholders to participate in another round of negotiations as long as they were subject to confidentiality agreements. *Id.* at 122:12-123:5. At the conclusion of the November Confidentiality Period, the Debtors filed their November MOR with the SEC under Form 8-K and simultaneously filed it with the Bankruptcy Court. *Id.* at 127:3-18; *see*, Conf DX 428- WMI Form 8-K; EC Ex. 39 – November MOR. Consistent with the Debtors' obligation under the confidentiality agreements to publicly disclose all material non-public information provided to the Settlement Noteholders, the November MOR disclosed the size of a second tax refund. *Id.* The Debtors, after consulting with counsel, concluded that there was no additional material non-public information that needed to be disclosed at this time. Likewise, the Settlement Noteholders independently confirmed that they did not believe the term sheets exchanged between the Debtors and JPMC during this period were material because the parties were still far apart on a deal. *See*, Hr'g. Tr. 7/18/2011 at 113:25-114:7 (Gropper Direct) ("[Aurelius] did [its] own analysis… [T]he only information we had was a failed back and forth with JPMorgan in which the parties were extremely far apart. There was not semblance of a deal… No one thought that a deal was eminent, so we concluded independently that we were not in possession of material non-public information.")

- Following the expiration of the November Confidentiality Period, the Debtors continued to negotiate with JPMC and the FDIC but did not share material non-public information with the Settlement Noteholders. While the Debtors had a few meetings with the Settlement Noteholders, the Debtors listened to the Settlement Noteholders' general suggestions but did not provide them with material non-public information. *See e.g.*, Hr'g. Tr. 7/21/2011 at 130:14-20 (Kosturos Direct) (the Debtors began a meeting to listen to the Settlement Noteholders' plan suggestions by stating "that the debtor would not be producing or discussing… non-public information."); *Id.* at 134:2-24 (Kosturos Direct) (during another meeting the Debtors only discussed public information with the Settlement Noteholders and only the Settlement Noteholders' counsel, who remained under a separate confidentiality agreement, were allowed to stay during discussions of non-public information). The Settlement Noteholders had no involvement in the negotiations for the tentative deal that was announced to the Court on March 12, 2010. *Id.* at 136: 18-23 (Kosturos Direct). Likewise, the Debtors, and not the Settlement Noteholders, led the negotiation of the final agreement with the participation of the Creditors' Committee. *Id.* at 137:9-15. "Ultimately, the

debtor exercised its judgment in entering into the global settlement agreement." *Id.* at 137:9-17.

39. All other information that the Debtors provided to the Targets during the course of the negotiation of the Global Settlement Agreement—including, but not limited to, the contents of term sheets exchanged between the Debtors and JPMC during the March and November Confidentiality Periods—concerned settlement negotiations that were too speculative and tentative for a reasonable investor to have considered important in making an investment decision or as having significantly altered the total mix of information available. At all relevant times during these negotiations, the parties remained far apart, and a deal was exceedingly remote. *Id.* 121:19-122:7.

40. Negotiations start, stall, fail, and then restart. Tentative deals emerge and collapse. Indeed, the history of this case clearly demonstrates that no deal is certain until it is signed. For example, even after the Debtors publicly announced to the Court a settlement, they were forced to renegotiate new terms. *Id.* at 135:25-136:9. Likewise, the various settlement terms exchanged during negotiations were always too tentative to be material. Mr. Kosturos explained that, despite agreement on some potential terms that there was really no agreement at all because "[t]his was an offer that need[ed] to be taken in its whole" and "unless [a party] agree[d] to the entire offer, [a party was] not agreeing…to anything…." *Id.* 109:15-18. As discussed in detail in the Debtors' Post Trial Brief, the settlement negotiations were speculative, with multiple parties proposing and withdrawing term sheets.

41. Information is "material" if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision or as having significantly altered the "total mix" of information available. *See, e.g., TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Where, as here, information concerns "contingent or

speculative information or events," "materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968). "Those in business routinely discuss and exchange information on matters which may or may not eventuate in some future agreement," and "[n]ot every such business conversation gives rise to legal obligations." *Taylor v. First Union Corp. of South Carolina*, 857 F.2d 240, 244 (4th Cir. 1988). As such, "[i]nformation of speculative and tentative discussions is of dubious and marginal significance to" a reasonable investor's investment decisions and, accordingly, can rarely constitute "material" information. *Id.* at 245.

42. The Equity Committee's attempt to use merger negotiation cases in its previous objection as support for its insider trading claims is unavailing. While merger discussions are viewed by courts as a uniquely critical event in a company's history and, therefore, have a prominent place in securities law cases,[9] even these cases suggest that discussions of a tentative and speculative nature are not material. *See, e.g., Levie v. Sears Roebuck & Co.*, 676 F. Supp. 2d 680, 688 (N.D. Ill. 2009) (noting that "[t]he materiality of information concerning a proposed merger is directly related to the likelihood that the merger would be accomplished," and finding that merger negotiations that were preliminary in nature at time of challenged transaction were not "material" for purposes of a 10(b) claim). Thus, in the context of merger negotiations, courts have held that discussions unlikely to lead to a merger and activities relating to the prospect of a merger are not material under Section 10(b) of the

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[9] *See, e.g., Mill Bridge V, Inc. v. Benton*, No. 08-2806, 2010 WL 5186078, at *11 (E.D. Pa. Dec. 21, 2010) (noting that "because a merger is one of the most important events that can occur for a company, insider information regarding a merger 'can become material at an earlier stage than would be the case as regards lesser transactions'") (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988)).

Securities and Exchange Act of 1934 and SEC Rule 10b-5. *Filing v. Phipps,* No. 5:07CV1712, 2010 WL 3789539 (N.D. Oh. Sept. 24, 2010) (finding that merger talks were not material where parties had a "get acquainted" meeting and had proposed entering into a confidentiality agreement with one another).

43. *Taylor v. First Union Corp. of South Carolina*, 857 F.2d 240 (4th Cir. 1988), is instructive. In *Taylor*, the plaintiff sold his stock in the defendant's predecessor for $18.00 per share seven months before the company (a South Carolina bank holding company) entered into a merger agreement whereby an acquirer (a North Carolina bank holding company) purchased all of its outstanding stock for $33.00 per share. *Id.* at 242. Plaintiff alleged that defendant was obligated to disclose as "material" the facts that the parties to the merger had met "to discuss the possibility of the two companies developing 'a relationship,'" and that the acquirer had raised the possibility of a merger in the event that interstate banking became legal. *Id.* Five months after these preliminary talks, but after the plaintiff's sale of his shares, the Supreme Court held that interstate banking was constitutional and state enabling legislation was passed permitting mergers between South and North Carolina banks. *Id.* at 242-43. The merger was effectuated approximately three months later. *Id.* at 243.

44. The *Taylor* court declined to find the alleged omissions material, observing that "the discussions at issue …were preliminary, contingent, and speculative" because "[t]here was no agreement as to the price or structure of the deal" and "neither the factual nor the legal predicates for a merger were in place." *Id.* at 244. As the court observed:

> The materiality of information concerning a proposed merger is directly related to the likelihood the merger will be accomplished; the more tentative the discussions the less useful such information will be to a reasonable investor in reaching a decision. Information of speculative and tentative discussions is of dubious and marginal significance to that decision. To hold otherwise would result in

> endless and bewildering guesses as to the need for disclosure, operate as a deterrent to the legitimate conduct of corporate operations, and threaten to "bury the shareholders in an avalanche of trivial information"; the very perils that the limit on disclosure imposed by the materiality requirement serves to avoid.

Id. at 244-45 (citation omitted).[10]

45. Here, as in *Taylor*, the term sheets reflect that discussions related to a potential settlement between the Debtors and JPMC were tentative and uncertain, with the parties consistently far apart in making a deal. The Debtors' lead negotiator, Mr. Kosturos, testified that the parties were "very far apart throughout most of the period when [they] were negotiating," Hr'g. Tr. 7/21/2011 at 97:9-17, and that, during all of 2009, the parties were hundreds of millions, if not many billions, of dollars apart.[11] Further, the absence of the FDIC and the bank bondholders from settlement negotiations during the March and November confidentiality periods confirms, as in *Taylor*, that a key predicate to a final settlement—namely, agreement by the FDIC—was not in place.[12] Moreover, a rule requiring companies to disclose interim

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[10] *See also Levie v. Sears Roebuck & Co.*, 676 F. Supp. 2d 680, 687 (N.D. Ill. 2009) (preliminary merger negotiations were not material when, even though the parties had raised the possibility of a merger with outside advisors and senior management for the parties had discussed the possibility of strategic combinations, "none of the factual or legal predicates for a merger were in place," "[t]here were no board resolutions, no actual negotiations and no instructions to investment bankers to facilitate or explore a merger"); *Filing v. Phipps*, No. 5:07CV1712, 2010 WL 3789539 (N.D. Ohio Sept. 24, 2010) (merger talks were not material where parties had a "get acquainted" meeting and had proposed entering into a confidentiality agreement with one another).

[11] *See* Hr'g Tr. 7/21/2011 at 112:23-113:1 (Kosturos Direct) (the final proposals made between March and May 2009 placed the parties apart by "well over $3 billion"); *Id.* at 129:19-130:7 (Kosturos Direct); 182:2-8 (Kosturos Cross) (the parties had not reached agreement between November and December 2009 regarding a settlement structure that would address the claims of the FDIC and the Bank Bondholders, who were "mak[ing] allegations that they owned the [$2.6 billion] second NOL via the FDIC receivership").

[12] Notably, *SEC v. Thrasher*, 152 F. Supp. 2d 291 (S.D.N.Y. 2001), which involved merger negotiations, does not hold that discussions regarding a merger are always material. Indeed, contrary to the Equity Committee's representation, *Thrasher* does not address the materiality of merger negotiations where significant obstacles might prevent parties from reaching a deal. The case instead simply rejects a

settlement offers even when the parties are far apart in negotiations would lead to the same "endless and bewildering guesses as to the need for disclosure" that was criticized in *Taylor.* 857 F.2d at 244-45. Under the Equity Committee's overbroad concept of materiality, a company would be required to make constant nuanced "guesses" as to whether a new term sheet or offer was material and disclose those negotiations, regardless of the likelihood that a settlement could be reached.

(c) Neither the Estate Nor Shareholders Have Been Harmed

46. Neither the Debtors nor their shareholders have been harmed in any way by the conduct of the Targets now alleged to be inequitable. Indeed, because participation by these creditors in the settlement process helped facilitate the successful resolution of the underlying disputes, the estates have been *enhanced* by billions of dollars.

47. The Equity Committee's assertion in their Confirmation Objection that the Settlement Noteholders (including the Targets) deprived the Debtors of the corporate opportunity to purchase WMI notes does not withstand scrutiny. As a practical matter, the Debtors were in no position to use estate assets to purchase debt claims during the Chapter 11 Cases, and the Bankruptcy Code prohibits use of estate resources to do so without leave of the Court. Arbitrage in its own distressed debt securities simply is not a corporate opportunity for a chapter 11 debtor. The implication of the Equity Committee's argument is that the Debtors could have proposed to creditors that they accept less for their debt claims than they would be entitled in the normal course and that the Debtors would then reallocate the savings to equity. Just stating that proposition demonstrates the absurdity of the Equity Committee's argument. Shareholders have

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defendant-tippee's claim that his tipper was of dubious reliability and therefore that information provided by the tipper was immaterial even if it turned out to be partially true. *See Id.* at 299.

not been harmed by virtue of not receiving a reallocation of value to which they were never entitled in the first place.

48. The suggestion that responsibility for the cost of "delay" in these cases falls on the Targets ignores what has happened over the last fourteen months. The Global Settlement Agreement *expedited* these cases, not delayed them. The delay since proposal of the Global Settlement Agreement has been caused (almost exclusively) by the Equity Committee's insistence that the Court appoint an examiner, causing delay and the expenditure or loss of value of over $100 million to the estate (examiner fees, accrued interest and administrative expenses), only to then dispute every conclusion the examiner reached. Compounding the administrative expenses is the Equity Committee's appeal from a non-final order denying confirmation. Further delay and expense has been caused by the Equity Committee's decision to walk away from a plan that would have provided an equity recovery, but only after weeks of negotiation and even documentation of the deal at significant expense to the estate. And now, the Equity Committee is causing the estates to incur still more professional fees in its effort to re-litigate (even though the Court advised all parties that it would not entertain such efforts) the Court's conclusions as to the Global Settlement Agreement being fair, reasonable and in the best interests of the estate.

49. The result of the negotiations, in which the Targets were but one of many participants, was a comprehensive settlement that expedited, not delayed, resolution of these bankruptcy estates. Assisting the Debtors in reaching a beneficial settlement – one that this Court already has reviewed and determined to be fair and reasonable – and working with the Debtors to propose a plan of reorganization that allocates value in accordance with the requirements of the Bankruptcy Code cannot be inequitable conduct.

(d) The Modified Plan and Global Settlement Agreement Were Proposed In Good Faith

50. The Equity Committee's contention that the Debtors favored creditors over equity is based on the false assumption that the Debtors had an obligation to reject a settlement merely because it does not provide enough value to reach shareholders. The Court, in rejecting the same argument raised in the first confirmation hearing, explained that "[s]imply because the Debtors were not able to achieve a greater recovery in the Global Settlement, does not mean that they did not meet their fiduciary duty to all constituents. More than mere innuendo and speculation is needed to establish a lack of good faith." Opinion at 106.

51. Despite ample opportunity, the Equity Committee failed to provide any evidence at trial establishing the Debtors did not act in good faith when negotiating the Global Settlement Agreement. Instead, the evidence demonstrates that the Debtors have not favored any constituency to the exclusion of any other.[13] Indeed, the evidence in the record unequivocally shows that the Debtors sought at all times to maximize the value of the estate. Conf DX 150 – Exhibit A -Kosturos Decl. at ¶ 94; Conf DX 150 – Exhibit C -First Goulding Decl. at ¶ 151; Hr'g Tr. 12/2/2010 at 62:21-63:2, 63:12-15, 93:9-18, 118:7-9, 126:16-19, 135:25-136:4, 137:18-138:3; Conf DX 374 - Goulding Decl. at ¶ 25. Claims against JPMC and the FDIC were investigated and pursued and, after the filing of multiple lawsuits in multiple courts and over a year of litigation, the Debtors pursued contentious, multi-party settlement negotiations that spanned more than eighteen months and resulted in a compromise that will allow the estates to distribute in excess of $7 billion in value in accordance with the priorities of the Bankruptcy Code. *Id.* Moreover, the evidence demonstrated that the Modified Plan and the Global

[13] In fact, for months prior to the Confirmation Hearing, the Debtors attempted to negotiate a compromise plan with the Equity Committee which would have allowed preferred and common shareholders to receive a greater recovery, but the Equity Committee walked away from those negotiations.

Settlement Agreement (including all other documents necessary to effectuate the Modified Plan) are the result of extensive arm's-length negotiations, Conf DX 374 – Goulding Decl. at ¶ 26; *see also* Hr'g Tr. 7/21/2011 at 158:1-16, in which the Debtors, the Creditors' Committee, the indenture trustees for the funded debt instruments, the Settlement Note Holders, JPMC, the FDIC, and their respective professionals participated. *Id.* at 158:1-12.

52. There is no evidence that the Settlement Note Holders or any other particular constituency dominated or controlled this process, "engineered" it to favor their interests at the expense of other stakeholders, or purposefully settled at an amount that provides payment in full for creditors but no distribution to equity. See, e.g., Conf DX 265 - Opinion at 60 ("The fact that the recovery may not reach shareholders is not enough to find [the Global Settlement Agreement] unreasonable . . ."). In fact, the Debtors did not seek the input of the Settlement Note Holders on "many major issues." Hr'g Tr. 7/21/2011 at 157:12-14. Moreover, as discussed above, there is no basis for concluding that the Settlement Note Holders traded on material, non-public information or that the Debtors were complicit in any way with respect to any such alleged improper trading activity.

53. Based upon the Targets' legal trading, the lack of harm, the fact that the Global Settlement Agreement was negotiated in good faith, and the non-availability of equitable disallowance as a cause of action under the Bankruptcy Code, the Equity Committee has not satisfied its burden for establishing a colorable claim.

C. **The Debtors Have Not Unjustifiably Refused to Pursue Meritless Claims**

54. The foregoing provides sufficient grounds upon which to deny the Motion. Nevertheless, a balancing of the costs and benefits in bringing the equitable disallowance claim leads to the conclusion that the Debtors were (and continue to be) justified in not pursuing this

claim. If a claim is found to be colorable, then the court should "evaluate the benefit to the estate of asserting the claims, taking into consideration the costs that will be incurred by the estate in the litigation." *In re Copperfield Invs., LLC,* 421 B.R. 604, 609 (Bankr. E.D.N.Y. 2010); *see also In re Centaur*, 2010 WL 4624910, at *5 (stating that such an analysis looks to "whether the creditors' claims have colorable merit and whether, in light of the probable costs of litigation, the claims would likely benefit the estate if pursued.") (quoting *Official Comm. of Unsecured Creditors v. Clark (In re Nat'l Forge Co.)*, 326 B.R. 532, 548 (W.D. Pa. 2005)). However, this inquiry should only be conducted after the party who requests derivative standing has established it has a colorable claim. *See Copperfield*, 421 B.R. at 609 (citing *In re STN Enters.*, 779 F.2d 901, 905 (2d Cir. 1985)). As discussed above, the Equity Committee has failed to establish it has a colorable claim and this analysis is unnecessary. Nevertheless, even if the Equity Committee had a colorable claim, the benefits of the litigation do not outweigh the costs.

55. The Court may consider many factors when conducting a cost-benefit analysis including, (i) the likelihood of success versus the costs of the litigation, (ii) the delays and fees of the litigation, and (iii) the fee arrangement of the proposed proceeding. *See, e.g., STN Enters.*, 779 F.2d at 905; *In re Nat'l Forge Co.,* 326 B.R. at 548.

56. Further, the Debtors' decision to not pursue the equitable disallowance claim is entitled to the "deference normally accorded pursuant to the business judgment rule." *See Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 575 (3d Cir. 2003). The burden of overturning that deference lies with the Equity Committee.

1) Likelihood of Success vs. Costs of the Litigation

57. As discussed in section B.1 *supra*, the Equity Committee has no chance of success because equitable disallowance is not a valid cause of action under the Bankruptcy Code.

Even if it were, which it is not, as discussed in section B.2 *supra*, the Equity Committee would have no chance of success because (i) the Targets have not acted inequitably, (ii) the Targets do not owe fiduciary duties to the Debtors, (iii) preliminary settlement negotiations are not material non-public information, and (iv) neither the estate nor shareholders have been harmed by the Targets' actions.

58. Importantly, in the "costs of the litigation" part of the calculus, this Court must consider the sizeable administrative counterclaims likely to be asserted against the Debtors if derivative standing was granted to assert equitable disallowance claims. In the *Objection of Aurelius Capital Management, LP to Confirmation of the Modified Sixth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code*, dated June 22, 2011 [D.I. 7951], Aurelius stated that, "[i]f the Equity Committee were correct, the Debtors would have breached their post-petition obligations to Aurelius under the Confidentiality Agreements to publicly disclose all material non-public information provided to Aurelius thereunder [and] [i]n that circumstance, Aurelius would hold (and would assert) administrative expense claims against the Debtors." While the Debtors vigorously contend that they fully complied with the provisions of the applicable confidentiality agreements, the fact remains that Aurelius (and in all likelihood Centerbridge) would assert huge counterclaims against the Debtors' estate that, if successful, would cancel out any recovery the Equity Committee obtains.

59. Further, the costs of the proposed litigation cannot be overstated. For Aurlieus and Centerbridge, not only are billions of dollars of their recoveries at stake, but their very existences' as well. So, Aurelius and Centerbridge, multi-billion dollar hedge funds, will spare no expense at defending themselves from these most serious allegations. By extension, so too will the Equity Committee be required to spend huge sums of money in this meritless

litigation in responding to motions, objections, discovery demands, and the likely ensuing appeals.

60. Because the Equity Committee's fees are borne directly by the Debtors' estate, these substantial administrative expenses will result in lower recoveries for holders of PIERS Claims. These diminished returns for holders of PIERS Claim must be considered. *See STN Enters.*, 779 F.2d at 905 (stating that the "impos[ition] [of] such [attorneys'] fees on other creditors or the chapter 11 estate . . . would obviously affect the cost-benefit analysis the court must make in determining whether to grant leave to sue."). Aurelius and Centerbridge as large holders of the PIERS Claims will bear the brunt of reduced recovery in the PIERS.

2) Delay and Fees of the Litigation

61. As discussed above, the fees of the litigation cannot be understated. Such fees will be borne directly by the PIERS creditors. Further, holders of PIERS Claims will likely have to wait for the conclusion of the litigation in order to obtain their recoveries as money will need to be set aside for the litigation fees of the Equity Committee. This needless delay could be months, if not years.

62. If the Court is inclined to grant the Motion, the Debtors submit that it would be appropriate for the Court to require that the Equity Committee obtain funding from its members or enter into a contingent fee arrangement expressly providing that no litigation fees are payable, except from a judgment in favor of the Equity Committee. Such an arrangement has been looked upon favorably by courts. *See, e.g., In re Smart World Techs.*, 423 F.3d 166, 180 (2d. Cir. 2005) (stating that "[i]n derivative standing cases, courts often view favorably the willingness of the party seeking derivative standing to absorb the costs of litigation, since such willingness not only demonstrates a belief in the merits of the claim, but also spares the

bankruptcy estate from absorbing any further costs."). This arrangement avoids the inequitable situation of the Targets, who are substantial holders of PIERS, paying for litigation against themselves.

3) <u>Other Pertinent Considerations</u>

63. The right to pursue certain claims, including the claims against Aurelius and Centerbridge, will vest with the Liquidating Trust. The Modified Plan specifically provides that, on the effective date, all of the Debtor's property, including causes of action, shall vest in the Liquidating Trust, and the Liquidating Trustee is vested with the right to prosecute, settle, or dispose of any causes of action that could be asserted by the debtor. *See* Modified Plan, art. XXVII. The Liquidating Trust will operate with oversight by the Trust Advisory Board, which includes a member designated by the Equity Committee.

64. While the Debtors have concluded that such claims are meritless (and such judgment should be afforded considerable weight akin to the deference normally accorded pursuant to the business judgment rule, *see supra* Section B2), the Liquidating Trustee (and the Trust Advisory Board) will reach their own conclusions consistent with their fiduciary duties to the Liquidating Trust Beneficiaries. The Equity Committee should not be allowed to usurp this power.

65. Based upon the foregoing, the Court should conclude that the Debtors justifiably did not pursue the meritless claims against Aurelius and Centerbridge.

D. If the Court Grants the Equity Committee Standing, <u>the Equity Committee Should Not be Granted the Exclusive Right to Settle</u>

66. The Equity Committee's request for "exclusive authority" to settle all or a portion of the equitable disallowance claim must be denied. Similar requests in this Court have been denied outright. In *In re Centaur, LLC*, 2010 WL 4624910, at *7 (Bankr. D. Del. Nov. 5,

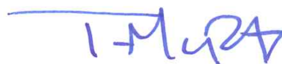
2010), the creditors' committee sought exclusive authority to pursue and settle claims on behalf of the debtors' estates. While the Court granted the derivative standing to pursue and settle the claims, the Court stated that such a right is not exclusive and that "[a] grant of derivative standing does not strip a debtor of ownership of the Claims and, accordingly, the Debtors continue to have the right, subject to Court approval, to settle the Claims." *Id.; see also In re Exide Tech.*, 303 B.R. 48, 66-67 (Bankr. D. Del. 2003) (rejecting the argument that "allowing the Debtor to control and settle the [claims] directly contravenes the purpose . . . [of] allow[ing] a creditors committee to bring a derivative avoidance action on behalf of the Debtor's estate.").

67. The Equity Committee has offered no reason to depart from this general rule. Importantly, the Debtors must retain the right, subject to court approval, to settle the equitable disallowance claim in light of the likely counterclaims that will be asserted by Aurelius and Centerbridge. *See supra* ¶¶ 57-60 Such counterclaims have the potential to exceed the equitable disallowance claims, thus implicating the recovering of other "innocent creditors." Accordingly, the Debtors should retain the ability to settle the equitable disallowance claim.

CONCLUSION

For the foregoing reasons, the Court should deny the relief requested in the Motion and grant the Debtors such other and further relief as is just.

Dated: Wilmington, Delaware
August 10, 2011



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