IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re: WASHINGTON MUTUAL, INC., *et al.*, Debtors.	Chapter 11 Case No. 08-12229 (MFW) Jointly Administered **Re: Dkt. No. 8179** **Response Deadline: August 10, 2011** **Hearing Date (if necessary): August 24, 2011 at 9:30 a.m. (ET)**

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

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Aurelius Capital Management, LP ("Aurelius"), on behalf of certain of its respective managed entities[1] that are creditors of the above-captioned debtors and debtors in possession (collectively, the "Debtors"), hereby submits this objection to the motion of the Official Committee of Equity Security Holders (the "Equity Committee") for an order authorizing it to commence and prosecute certain purported claims of the estates (the "Motion to Authorize") (D.I. 8179) that were first asserted in the Equity Committee's objection (the "EC Plan Objection") (D.I. 8073) to the Modified Sixth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Modified Sixth Amended Plan" or the "Plan") (D.I. 6965). In response to the Motion to Authorize, Aurelius respectfully states as follows:

PRELIMINARY STATEMENT[2]

1. As previously threatened, the Equity Committee has moved for leave to file a proposed adversary complaint (the "Complaint") that seeks to morph its baseless attacks on the Settlement Noteholders into formal claims asserted in the name of the Debtors. The Complaint, however, is riddled with falsehoods; irresponsibly ignores settled procedural and substantive law; and invents legal obligations and claims out of whole cloth. More fundamentally, it distorts benign, and indeed constructive, conduct by the Settlement Noteholders carefully complying with the securities and the bankruptcy laws and, without justification, threatens the reputations of highly regarded investment funds and their principals.

[1] Aurelius manages three separate and independent investment funds, each of which has its own trading history in these cases and one of which did not even commence operations until February 2010.

[2] Capitalized terms not defined herein have the meanings set forth in the Plan, the Revised Supplemental Disclosure Statement for the Modified Sixth Amended Plan (the "Disclosure Statement") (D.I. 6966), or the Omnibus Response of Aurelius Capital Management, LP to Certain Objections to Confirmation of Modified Sixth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Aurelius Pre-Hearing Response") (D.I. 8191). Unless otherwise noted, citations to "Exhibits" herein refer to exhibits admitted into evidence in connection with the Confirmation Hearing.

The Debtors and the Creditors' Committee rightfully have declined to prosecute these "claims" because they are completely without substance. The Equity Committee should not be permitted to legitimize its baseless allegations by repeating them, standing in the Debtors' shoes.

2. While plan-related litigation by out-of-the-money interests is not uncommon, the allegations here are particularly grave, calling into question the fundamental integrity of highly regarded businesses that depend on their valued reputations to maintain the confidence of their investors. The Equity Committee does not appear to care about integrity or reputations even in the face of uncontroverted facts that make clear its claims have no merit. Rather, the Committee is desperately using every available tool to extort a pay-off for classes of equity holders that have no legal entitlement to a recovery. We urge the Court to halt these groundless and defamatory allegations, which have no basis in the facts of the cases or the applicable law.

3. The Equity Committee strategically suggests (Motion to Authorize ¶ 17) that the Court may confirm the Plan and permit the proposed adversary proceeding to go forward, while reserving Aurelius's and Centerbridge's distributions. But the proposed Complaint is part and parcel of the Equity Committee's confirmation objections, and the Court has *already heard* the evidence relevant to these charges. If it rejects the allegations and confirms the Plan, approving post-petition interest at the contract rate and overruling objections based on equitable subordination and equitable disallowance, it logically should also find that the claims asserted in the Complaint are not colorable. That would require denial of the Motion to Authorize and finally end this campaign of intimidation.

4. Leaving the door open – either by granting the Motion to Authorize or even by failing to decide it along with Plan confirmation – would have serious consequences.

First, it would leave these scandalous allegations hanging over the heads of the parties, which may in and of itself permanently damage innocent reputations. Having already permitted extensive discovery and an actual *trial* of the claims asserted in the Complaint, the Court cannot permit the adversary proceeding to go forward without signaling its belief that Aurelius and Centerbridge may well be guilty of federal crimes – a conclusion that would be grossly unjustified and that could very well jeopardize the existence of these two substantial and respected businesses and the careers of their principals.

5. Moreover, failing to definitively reject the Complaint would complicate implementation of the Plan. If Aurelius's claims are subordinated or disallowed because of a finding that it traded improperly while in possession of material nonpublic information provided by the Debtors during the contractual confidentiality periods, Aurelius will have an administrative claim against the estates for the Debtors' breach of the Confidentiality Agreements, which required *the Debtors* to *disclose* any material nonpublic information they shared with Aurelius. Confirming the Plan without definitively disposing of the threat to equitably disallow Aurelius's claims would thus require the Debtors to reserve hundreds of millions of dollars, which would materially interfere with distributions to other creditors. *See* Objection of Aurelius Capital Management, LP to Confirmation of the Modified Sixth Amended Joint Plan of Affiliated Debtors, dated June 22, 2011, ¶¶ 56-60 (D.I. 7951).

6. The Motion to Authorize does not write on a clean slate. The Equity Committee obtained extensive discovery and submitted a detailed objection to the Plan laying out its theories of inequitable conduct by Aurelius and the other Settlement Noteholders. Aurelius set forth in detail its factual and legal refutations of those specious charges and certain other Plan objections in its Pre-Hearing Response, which is hereby incorporated in full by

reference. The Equity Committee was free to present any evidence it had at the Confirmation Hearing, and the Court heard detailed testimony by Aurelius Managing Director Dan Gropper, senior officers of the other Settlement Noteholders, and the Debtors' CRO William Kosturos thoroughly refuting the Equity Committee's fantasies of a conspiracy to cede control of the cases to, and facilitate improper trading by, the Settlement Noteholders. The Court has thus already *tried* the very claims now asserted in the Complaint and has heard comprehensive live testimony demonstrating that they totally lack substance. It need not accept pleaded conclusions and generalizations contrary to the actual record – and indeed the Equity Committee has invited the Court to consider the Complaint in the context of the full record. Motion to Authorize ¶ 13. The Court has actually tried the "domination" allegation *twice*, since the current theory is merely a retread of the conflict of interest allegations that this Court *rejected* in its decision approving the fairness (but denying confirmation) of the prior version of the Plan, with the Settlement Noteholders now substituted for Weil Gotshal as chief villains. *See In re Washington Mutual, Inc.*, 442 B.R. 314, 326-27 (Bankr. D. Del. 2011) (cited herein as the "January Opinion").

7. Crucially, however, the operative facts regarding the claims against Aurelius are not really in dispute – and the key facts make clear that the Equity Committee's charges are utterly baseless. The Equity Committee has never alleged that Aurelius breached the ethical wall established pursuant to the March 2009 Confidentiality Agreement or traded during the six weeks covered by the November 2009 Confidentiality Agreement. The theory of the EC Plan Objection was that Aurelius was restricted from trading because the details of unsuccessful settlement negotiations constituted material nonpublic information. Stripped of rhetoric, the Complaint does not allege much more than this. Its new allegations – including that settlement proposals *formulated by the noteholders themselves* somehow also constituted material

nonpublic information – are similarly based on largely undisputed facts. These new theories are not just meritless but frivolous – suggesting that an outsider's mere thoughts and ideas can constitute material nonpublic information about an issuer. The Complaint's total lack of substance is obvious, and these empty attacks should be definitively rejected and ended once and for all.

8. Under *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003), the Court may authorize an appropriate fiduciary (usually a creditors' committee) to assert facially colorable claims of the estate where a debtor unreasonably refuses to pursue such claims itself. The Equity Committee fails to meet either of these requirements.

9. *First*, the Complaint fails on multiple grounds to allege a colorable claim:

- The Equity Committee's primary legal theory – equitable disallowance – is simply not available under the Bankruptcy Code, even if conduct were alleged that could support such a claim.
- The Debtors (and thus the Equity Committee standing in their shoes) lack standing to pursue equitable disallowance (assuming such a claim exists under bankruptcy law) or the alternative theory of equitable subordination, based on conduct that allegedly harmed only specific creditors and not the estates as a whole. Here, the core allegations of improper trading (even if they had an ounce of substance, which they do not) have not been connected to any general harm to the estates. And the further allegations of conspiracy to dominate the settlement negotiations do not coherently allege *any* harm. The undisputed evidence shows that the Settlement Noteholders consistently pushed the Debtors to get the *best* possible settlement from JPMC, and

indeed that the noteholders' strategy was routinely *ignored*. There are no facts pled that even suggest that the settlement ended up *lower* than it would have but for the involvement of the Settlement Noteholders. In fact, the record establishes the opposite. The Equity Committee alleges no harm over which the Debtors themselves would have standing to sue.

- Nor does the Complaint allege actionable inequitable conduct. The Equity Committee must allege wrongdoing on the level of fraud because Aurelius was *not* a fiduciary. It acted in the cases only on behalf of its own investors and did *not* assume any special duties to the estates (much less to equity) simply because it acquired a substantial position in the Debtors' securities and at times sought a voice in settlement negotiations. The Complaint contains no specific factual allegations (and no facts were introduced at the Confirmation Hearing) to overcome the strong, natural presumption (already confirmed by the Court in the January Opinion) that Aurelius acted in these cases simply as a creditor, at arm's-length with the estates.
- In any event, even assuming some sort of "duty" to the estates, Aurelius did not engage in any inequitable conduct in connection with settlement negotiations that could have breached such a duty. Aurelius consistently advocated for the largest possible settlement with JPMC. It violated no duty by eventually agreeing to endorse a settlement reached directly among the Debtors, JPMC, and the FDIC with minimal input from Aurelius. The Court has already held that the *Debtors* breached no duty by negotiating that settlement; *a fortiori*, Aurelius could not breach any duty by merely agreeing to *support* it. Moreover, far from harming the estates, Aurelius voluntarily assumed costs – in connection with trading restrictions during the

confidentiality periods as well as lock-up provisions once it signed onto the Global Settlement Agreement – in order to facilitate a consensual resolution of these cases.

- Nor did Aurelius violate the federal securities laws. Even under the facts alleged in the Complaint, it fully satisfied and performed all obligations under the Confidentiality Agreements with the Debtors and was careful to avoid receiving material nonpublic information outside of express confidentiality periods. It thus breached no duty and employed no manipulative device, defeating an insider trading claim at the threshold. Equally important, there are no allegations that could support a compelling inference that Aurelius acted with scienter, i.e., knew or recklessly disregarded that it was trading while in possession of material nonpublic information. Finally, the nonpublic information in Aurelius's possession when it traded – stale, rejected proposals exchanged during unsuccessful settlement negotiations – was immaterial as a matter of law.

10. *Second*, the Equity Committee cannot establish that the Debtors have unreasonably refused to prosecute the so-called claims. The Complaint does not coherently allege how the estates were harmed by *anything* that Aurelius or Centerbridge did during the cases. To the contrary, these creditors worked hard to *maximize* the value of the estates, including by consistently urging the Debtors to more vigorously pursue litigation against JPMC. Indeed, the most logical fiduciary to assert claims if individual creditors had in fact acted to harm these insolvent estates – the Unsecured Creditors' Committee, which undertook its own investigation – *agrees* with the Debtors that the Equity Committee's claims are baseless and interposed for improper purposes.

11. Presumably, the Debtors and Creditors' Committee understand how arbitrary and baseless it is for the Equity Committee to assert these claims only against Aurelius and Centerbridge among the many other parties in the cases – including bank bondholders, holders of trust preferred securities and litigation tracking warrants, and other noteholders in the White & Case Group – that participated in settlement negotiations with the Debtors at various points in time, many of which also entered into confidentiality agreements and then traded once the restricted periods terminated. Moreover, Aurelius in particular had a relatively modest role in the cases overall, participating in confidential negotiations only during two short periods and otherwise being "out of the loop" for months at a time. It had no direct contact with JPMC, and saw its suggestions and advice to the Debtors routinely ignored. Aurelius became the subject of this "investigation" not because its conduct was unusual, inappropriate, or particularly prominent, but simply through the fortuity of having been a "Settlement Noteholder" in October 2010 and thus drawing the attention of a disgruntled pro se objector. Moreover, by narrowing the focus from the "Settlement Noteholders" to only Aurelius and Centerbridge, the Equity Committee renders its central theme of domination and control even more factually absurd, while inappropriately attempting to hold two noteholders responsible for alleged misconduct elsewhere attributed more generally to the larger group.

12. The Equity Committee's attempt to arrogate for itself the mantle of champion of the estates is, in the final analysis, rather grotesque. It is the Equity Committee and certain of its constituents (most notably the holders of trust preferred securities) that have done the most to *harm* these estates by interposing phony conspiracy theories and reckless allegations of misconduct and breach of duty against virtually every other party in the cases. These relentless, interrelated attack campaigns have wreaked havoc on the estates, causing *hundreds*

upon hundreds of millions of dollars in harm through delay, based on the mounting accrual of post-petition interest, professional costs, and other expenses of administering the estates. The Equity Committee is the *last* party in the cases to be heard to complain about the conduct of others, and the *last* party that should be entrusted to prosecute claims on behalf of the greater good of all stakeholders, even if any such valid claims existed.

13. Moreover, there is an even more fundamental problem with the Equity Committee's attacks: even if they had merit, they threaten to skew the bankruptcy process by imposing extreme remedies that bear little rational relationship to the actual harms alleged. In an ordinary insider trading suit, the parties actually harmed by trading sue for damages based on what the securities bought or sold would have been worth with full disclosure of the material nonpublic information. Here, Aurelius's trading partners were mostly creditors, not equity holders, and indeed many may no longer even *be* creditors. These trading partners were generally other sophisticated hedge funds that were also following developments in these cases – indeed, on several occasions Aurelius sold PIERS on the same day that Owl Creek purchased them, or bought PIERS on the same day that Centerbridge sold them. Thus the gap between Aurelius's knowledge and that of its trading partners likely ranged from slight to non-existent, suggesting that "damages" in a traditional insider trading case would be similarly minimal or actually zero. *See* Aurelius Post-Hearing Mem. at 12, 34-35. In any event, any such damages would have to be alleged and proven by the parties actually affected.

14. This is a far cry from the sweeping remedies the Equity Committee seeks here – wiping out Aurelius's entire investment in the Debtors by disallowing or subordinating its claims, or imposing hundreds of millions of dollars of penalty on Aurelius and other creditors by denying confirmation and requiring the payment of post-petition interest under a new plan at the

federal judgment rate. Imposing such remedies here would be deeply irrational for multiple reasons.

15. First, either of these remedies would be grossly excessive, totally disconnected from any actual harm that could be traced to Aurelius's conduct (even assuming, against all the evidence, that Aurelius did anything wrong). Second, these remedies would inure to the benefit of different parties than were allegedly harmed by Aurelius's trading. And finally, even after imposing these harsh remedies, Aurelius would still be exposed to the possibility of duplicative judgments if the actual parties to its trades chose to pursue their own private lawsuits.

16. If these claims had any merit, they would be pursued by the parties affected. There is no need to license a bankruptcy fiduciary to act as a securities law ombudsman, importing an entire body of law that has ample forums elsewhere for its enforcement and its own specific purposes and remedies. The Court's appropriate role would be to consider any alleged "inequitable conduct" that actually affected or harmed the conduct of the cases – which was not even coherently alleged here, much less proven. The insider trading changes, in contrast, even if they were true, involve conduct that manifestly had no impact on the bankruptcy cases or the overall fortunes of the estates. Entertaining the Equity Committee's attempt to fold securities law enforcement into the bankruptcy plan process would set an unfortunate precedent that would invite similar mischief in future cases.

FACTS ALLEGED IN THE COMPLAINT

17. The Court already has before it both the detailed factual presentation included in Aurelius's Pre-Hearing Response (at ¶¶ 16-60) and, of course, the records of two confirmation hearings in these cases. The record of the second hearing is marshaled in the Post-Hearing Memorandum of Aurelius Capital Management, LP (the "Aurelius Post-Hearing

Mem.”), filed simultaneously herewith. We summarize more briefly here the facts alleged in the Complaint, separating the actual allegations – which are largely undisputed and entirely benign – from the Equity Committee’s rhetoric *characterizing* the facts, which the Court need not accept. We also cross-reference to the larger factual record where clear, uncontradicted testimony fills in crucial gaps in the story told in the Complaint.

18. As the Complaint acknowledges, the “Settlement Noteholders” are not a monolithic group, but in fact are four separate investment management firms that participated in the cases at various times on their own behalf or as part of two different ad hoc groups, one represented by White & Case and the other by Fried Frank. *See* Complaint ¶¶ 11-15, 19. The Complaint alleges generally that the Settlement Noteholders and “other significant investors in the Debtors’ securities” began communicating with the Debtors in January 2009 “in efforts to obtain information and exert influence over the management of the Estate[s].” *Id.* at ¶ 19. Of course, as with many of the other facts recited in the Complaint, there is nothing improper about large creditors communicating with a debtor in order to share their views about the direction of the case or a plan. Indeed, it is entirely consistent with the Bankruptcy Code’s built-in preference for consensual resolutions.

19. The Complaint then describes certain of the issues disputed between the Debtors and JPMC at the outset of the cases (including ownership of both the Debtors’ $4 billion in deposits with Washington Mutual Bank and its pending tax refunds). *Id.* at ¶¶ 20-22. The Complaint alleges that in January 2009, around the time when Aurelius joined the group, the White & Case Group put together a proposal to resolve certain of these issues, which it allegedly provided to the Debtors in the form of a draft term sheet. *Id.* at ¶ 23. In fact, the record reflects that White & Case sent the term sheet only to another informal creditor group and that an

individual member of the White & Case Group chose to forward it to the Debtors. *See* Aurelius Post-Hearing Mem. at 23. Remarkably, the Complaint alleges that this creditor-developed wish list – not based on nonpublic information, never adopted by the Debtors, and not even *shared* with JPMC – constituted material nonpublic information *about the Debtors* that disabled the members of the White & Case Group from trading in the Debtors' securities continuously from January 2009 through the March 12, 2010 announcement of the first tentative global settlement. *Id.* This is an astonishing assertion, since it suggests that *every member of the White & Case Group that received the termsheet and presumably continued trading throughout these cases was potentially guilty of insider trading.* And with respect to Aurelius, *the Complaint ignores that Aurelius was not yet a member of the White & Case Group when the proposal was formulated and had not been aware of the proposal prior to the discovery initiated by the Equity Committee in connection with its claims.* July 18 Tr. 129:5-25 (Gropper).

20. Next, the Complaint describes a March 2009 meeting at which a settlement offer was presented to JPMC reflecting proposed settlement terms allegedly developed by the White & Case Group. Complaint ¶¶ 24-25. Although the Complaint improperly alleges that the proposal emanated solely from White & Case, the Equity Committee at least concedes that the Debtors thereafter reduced it to writing and sent it to JPMC. Aurelius Ex. 18. Again, the Complaint alleges that this offer, standing alone, constituted material nonpublic information that disabled the creditors involved from trading until March 12, 2010. Complaint ¶ 26. The Complaint further alleges that the JPMC counter-proposal received a few days later reflected "agreement" on many of the issues in dispute and also should be viewed as material nonpublic information. *Id.* at ¶¶ 27-28. The Complaint ignores substantial, uncontradicted testimony of the Settlement Noteholders and Mr. Kosturos establishing that the

JPMC counter-proposal was viewed as wholly unacceptable, that the parties were billions of dollars apart, and that they had reached no binding agreement on *any* issue. Aurelius Post-Hearing Mem. at 28-29.

21. The Complaint describes a further exchange of settlement proposals between the Debtors and JPMC in April 2009, but appears to concede that these proposals were shared with outside counsel for the Settlement Noteholders *without* being passed along to the clients. Complaint at ¶¶ 29-30.

22. The Complaint next describes an email sent by Mr. Gropper to the Debtors on behalf of three members of the White & Case Group (*not* on behalf of the Settlement Noteholders, as the Complaint incorrectly states) expressing concern about the Debtors' making unilateral settlement offers to JPMC without consulting noteholders that had recently agreed to restrict their trading for the very purpose of participating in settlement negotiations. *See id.* at ¶ 31; Aurelius Ex. 22. In the email referenced in the Complaint, Mr. Gropper urged the Debtors to aggressively pursue litigation against JPMC, in service of the Debtors' duty of "maximizing value *for all the stakeholders*, rather than just those who are simply looking for a quick deal that compromises significant value for the estate." Aurelius Ex. 22 (emphasis added). Not surprisingly, the Complaint ignores this important statement by Mr. Gropper.

23. In describing the meeting held at Weil Gotshal's office as a result of Mr. Gropper's email, the Complaint insinuates (but does not directly allege) that the Debtors disclosed to the creditors in attendance the contents of the April 2009 term sheets and made a presentation of material, nonpublic information about the Debtors' litigation claims. Complaint ¶ 32. These suggestions are directly undermined by undisputed testimony at the Confirmation Hearing that this meeting consisted mainly of the Debtors' listening to the *noteholders'* ideas

about the litigation, and that no nonpublic information was shared with the noteholders; discussion of *public* aspects of litigation is, by definition, not material nonpublic information. *See* Aurelius Post-Hearing Mem. at 30. The testimony also confirmed that the Debtors' special litigation counsel, Quinn Emanuel, did not share any written litigation analyses or other confidential information with the noteholders at the May 6 meeting. *Id.*. The Equity Committee introduced *no* evidence that either of the April proposals was discussed at the meeting and Mr. Gropper testified affirmatively that the JPMC April 24 response was *not* discussed. *Id*.

24. The Complaint describes the confidentiality agreements in place between March 9 and May 8, 2009, incorrectly suggesting that such agreements were entered into only with the Settlement Noteholders (Complaint ¶ 34), when in fact several other members of the White & Case Group entered into similar agreements. Aurelius Post-Hearing Mem. at 23. The Equity Committee appears to concede that Aurelius honored the ethical wall it established pursuant to the Confidentiality Agreement (Complaint ¶ 35), and acknowledges that the parties to the agreement intended to cleanse Aurelius and permit it to resume unrestricted trading at the conclusion of the confidentiality period (*id.* at ¶ 37).

25. The Complaint acknowledges that, pursuant to their obligations under the Confidentiality Agreement, the Debtors publicly disclosed certain financial information that had been shared with Aurelius, including the expected size of the tax refunds due under the existing tax law, but did not disclose the details of the March or April negotiations or any information shared at the May 6, 2009 meeting. *Id.* at ¶¶ 38-39. The Complaint alleges that Aurelius and Centerbridge bought securities of the Debtors in the days and weeks following the end of the first confidentiality period. *Id.* The Complaint does not allege facts showing that these transactions were of unusual volume for these parties or so disassociated from publicly disclosed

developments or general events in the markets as to give rise to inferences that Aurelius acted with scienter or that undisclosed information in its possession must have been material. Of course, the Complaint ignores the uncontroverted testimony from each of the Settlement Noteholders and the Debtors that the settlement negotiations that took place during the March-May 2009 confidentiality period were unsuccessful, stale, and not material at the time the confidentiality period expired.

26. The Complaint then describes certain alleged negotiations during the summer of 2009 involving Centerbridge and Appaloosa, but *not* alleged to involve Aurelius. *Id.* at ¶¶ 40-42.

27. The Complaint next mentions Aurelius in connection with the November-December 2009 confidentiality agreements and negotiations, again alleging that inconclusive offers and responses exchanged between the Debtors and JPMC constituted material nonpublic information. *Id.* at ¶¶ 43-48. The Complaint again ignores the uncontradicted evidence that the Debtors viewed the JPMC counter-offer as "resetting the bookends" and wholly unacceptable; that JPMC itself felt that the parties were "far apart" at the end of November; and that Aurelius was not aware whether a further counter-proposal from the Debtors had even been delivered before the confidentiality period ended. Aurelius Post-Hearing Mem. at 37, 58.

28. Again, the Complaint alleges that Aurelius bought securities of the Debtors following termination of the second confidentiality period. Complaint ¶¶ 49-50. But again, it alleges no facts that would suggest that these purchases were inherently suspicious or unusual, in view of the publicly available information then in the marketplace. Aurelius bought PIERS on December 31, 2009, *after* the market had absorbed the Debtors' disclosure of the second expected tax refund, at prices 250 percent higher than its last trades in mid-November.

Aurelius Post-Hearing Mem. at 40-41. Significantly, despite the Equity Committee's insinuations at trial, the Complaint does *not* allege that Aurelius received any material nonpublic information after December 30, 2009. *See* Complaint ¶ 51 (describing 2010 settlement process leading to March 12, 2010 announcement).

29. Based on these remarkably thin factual allegations, the Complaint alleges that Aurelius and Centerbridge assumed fiduciary obligations to the Debtors, other creditors, and even equity holders simply by (1) purchasing large quantities of WMI securities "in order to obtain a blocking position and assert control over key decisions in the bankruptcy" (Complaint ¶ 55), although the Complaint does not allege the size of the positions or what decisions the two noteholders controlled; (2) undertaking settlement negotiations with JPMC "on behalf of the entire Estate" (*id.* at ¶ 55), even though Aurelius had no direct contact with JPMC and was undisputedly excluded from most of the settlement negotiations (Aurelius Post-Hearing Mem. at 20-21, 29, 43); and (3) by becoming "temporary insiders," apparently based solely on receiving discrete bits of material nonpublic information pursuant to arm's length confidentiality agreements (Complaint ¶ 55).

30. The Complaint alleges that Aurelius and Centerbridge breached these duties in two ways – first, by supposedly using their alleged domination of the Debtors "to negotiate a settlement that paid them out nearly in full . . . without attempting to pursue a recovery for equity" (*id.* at ¶ 56) and, second, by allegedly engaging in improper trading while in possession of material nonpublic information (*id.* at ¶¶ 57-60). Remarkably, among the supposed material nonpublic information alleged to be in Aurelius's possession are the terms of at least one settlement offer formulated by the noteholders themselves as a suggestion for the Debtors but never even sent to JPMC. *Id.* at ¶ 57.

ARGUMENT

31. The Motion to Authorize should be denied because the Equity Committee cannot satisfy the requirements for derivative standing in the Third Circuit. While the Bankruptcy Code contains no explicit authority for a committee or other party-in-interest to prosecute a derivative suit on behalf of a debtor's estate, the Third Circuit has recognized a qualified right to derivative standing in certain limited circumstances: where (i) the claim that the party is seeking to prosecute is "colorable" and (2) the debtor has unjustifiably refused to prosecute such "colorable" claim. *See Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 566-67 (3d Cir. 2003); *Infinity Investors Ltd. v. Kingsborough (In re Yes! Entm't Corp.)*, 316 B.R. 141, 145 (D. Del. 2004); *see also Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (In re STN Enters.)*, 779 F.2d 901, 905 (2d Cir. 1985). The party seeking standing (here, the Equity Committee) bears the burden of demonstrating that it has satisfied these derivative standing requirements. *G-I Holdings, Inc. v. Those Parties Listed on Exhibit A (In re G-I Holdings, Inc.)*, 313 B.R. 612, 629 (Bankr. D.N.J. 2004).

32. As we show below, the Equity Committee has not even come close to satisfying the requirements for derivative standing. In seeking to assert claims that both the Debtors and the more appropriate fiduciary, the Creditors' Committee, believe have no merit, the Equity Committee calls to mind the cautionary words of Judge Posner in *Maxwell v. KPMG LLP*, 520 F.3d 713 (7th Cir. 2008), which recognized the perverse incentives for bankruptcy fiduciaries (there, a chapter 7 trustee, and here, the Equity Committee) to bring frivolous litigation in circumstances where they are not deterred by ongoing business relationships or litigation costs. Judge Posner urged that judges must "be vigilant in policing the litigation judgment exercised by trustees in bankruptcy, and in an appropriate case must give consideration

to imposing sanctions for the filing of a frivolous suit." *Id.* at 718-19. He stressed that "[t]he Bankruptcy Code forbids reimbursing trustees for expenses incurred in actions 'not reasonably likely to benefit the debtor's estate' and authorizes an 'appropriate sanction' against parties who file such a claim." *Id.* (affirming summary judgment against trustee and inviting defendant to seek sanctions).

33. Judge Posner's words resonate loudly here, where the Equity Committee has been imposing massive legal fees and even larger costs resulting from delay pursuing patently groundless claims for the sole purpose of harassing and intimidating legitimate creditors into paying a ransom to out of the money equity interests. We respectfully call upon the Court to act as gatekeeper and prevent the Equity Committee from wasting even more of the estates' valuable time and resources as well as those of the Court pursuing this ill-conceived frolic.

I. THE EQUITY COMMITTEE DOES NOT ALLEGE ANY COLORABLE CLAIMS AGAINST AURELIUS

34. The Complaint (read with an understanding of the largely undisputed factual record) does not allege *any* colorable claims against Aurelius. The entire pleading fails on multiple procedural and substantive grounds.

35. In the usual situation where a *Cybergenics* motion is made prior to discovery and trial of a claim, the "colorable claim" analysis is similar to that undertaken "when a defendant moves to dismiss a complaint for failure to state a claim." *In re Centaur, LLC*, No. 10-10799, 2010 Bankr. LEXIS 3918 at *13 (Bankr. D. Del. Nov. 5, 2010) (citing *Official Comm. of Unsecured Creditors of America's Hobby Ctr., Inc. v. Hudson United Bank (In re America's Hobby Center, Inc.)*, 223 B.R. 275, 282 (Bankr. S.D.N.Y. 1998)); *see also Official Comm. of Unsecured Creditors v. Austin Fin. Servs. (In re KDI Holdings, Inc.)*, 277 B.R. 493, 508 (Bankr. S.D.N.Y. 1999). Accordingly, as with a motion to dismiss, the bankruptcy court should dismiss

a derivative claim that is "facially defective." *See Adelphia Commc'ns Corp. v. Bank. of Am. (In re Adelphia Commc'ns Corp.)*, 330 B.R. 364, 376 (Bankr. S.D.N.Y. 2005) (quoting *America's Hobby Center*, 223 B.R. at 288).

36. Modern pleading standards require a plaintiff to allege more than the bare elements of a claim: "[A] complaint must contain 'sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face.'" *Youkelsone v. Wash. Mut. Inc.*, Adv. Pro. No. 09-50039, 2010 WL 3238903, at *2 (Bankr. D. Del. Aug. 13, 2010) (quoting *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1940 (2009)); *see also Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007). That means alleging "factual content that allows the court to draw the reasonable inference that the defendant is liable." *Walker v. Sonafi Pasteur (In re Aphton Corp.),* 423 B.R. 76, 86 (Bankr. D. Del 2010) (quoting *Iqbal*, 129 S. Ct. at 1949). Allegations that "do not permit the court to infer more than the mere possibility of misconduct" do not suffice. *Id.; see also Crowe v. Moran (In re Moran)*, 413 B.R. 168, 176 (Bankr. D. Del. 2009).

37. Here, however, the Court need not and should not consider the Complaint in a vacuum. The Equity Committee has directly invited the Court to consider the full factual record promulgated at the Confirmation Hearing (*see* Motion to Authorize ¶ 13), and the Court confirmed at the outset of the hearing that "I'm inclined to not erase my memory of what I hear in the next few days" (July 13, 2011 Tr. 38:9-11). This is consistent with the Third Circuit's holding that, in evaluating a motion to dismiss, a trial court is entitled to take judicial notice of prior proceedings. *See Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 415-16 (3d Cir. 1988); *see also Youkelsone*, 2010 WL 3238903 at *3 (court deciding Rule 12(b)(6) motion may take judicial notice of prior proceedings). Even in situations where claims have not already been fully tried, a court assessing "plausibility" should draw on "its judicial experience

and common sense" and may consider facts not alleged in the complaint to frame this analysis. *Iqbal*, 129 S. Ct. at 1950, 1954 ("[T]he Federal Rules do not require courts to credit a complaint's conclusory statements without reference to its factual context.").

38. As we show below, the Motion to Authorize should be dismissed because the Complaint fails to allege the existence of colorable claims.

A. Equitable Disallowance is Not a Remedy Available Under the Bankruptcy Code

39. Even assuming all the allegations in the Complaint are true (which clearly is not the case), the Equity Committee has still not stated a colorable claim for equitable disallowance because equitable disallowance is simply not a remedy recognized or available under the Bankruptcy Code. *See, e.g., Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 699 (5th Cir. 1977) ("Equitable considerations can justify only the subordination of claims, not their disallowance."); *see also In re Mid-American Waste Sys., Inc.*, 284 B.R. 53, 68 (Bankr. D. Del. 2002) (Walsh, J.) (quoting *Mobile Steel* for proposition that equitable considerations cannot justify claim disallowance); *American Cigar Co. v. MNC Commercial Corp. (In re M. Paolella & Sons, Inc.)*, Adv. Pro. No. 87-1007F, 1991 Bankr. LEXIS 1181, at *38 (Bankr. E.D. Pa. April 15, 1991) (same).

40. This conclusion is mandated by the well-settled principles limiting the power of the bankruptcy courts to create new remedies through the exercise of equitable discretion. As the Third Circuit held in *In re Combustion Engineering, Inc.*, 391 F.3d 190, 236 (3d Cir. 2004), "[t]he 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." *See also Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988)

("Whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.").

41. Here, Section 510(c) of the Bankruptcy Code expressly creates an equitable remedy – equitable subordination – that addresses creditor misconduct, and neither that section nor any other in the Bankruptcy Code contemplates the use of the Court's equitable powers to *disallow* a claim. In fact, Section 510(c) by its terms permits only the subordination of all or part of an allowed claim to all or part of another allowed claim – it does not permit the subordination of a claim to equity. 11 U.S.C. § 510(c). A remedy of "equitable disallowance" would be an end run around that express limitation.[3]

42. Moreover, section 502(b) of the Bankruptcy Code enumerates the nine circumstances that may subject a claim to disallowance. The Supreme Court has confirmed that these constitute the *only permissible grounds* on which a court may disallow a claim. *Travelers Cas. & Sur. Co. of Am. v. PG&E*, 549 U.S. 443, 449 (2007). Notably, Section 502(b) of the Bankruptcy Code does not provide for the disallowance of claims on equitable grounds. Accordingly, the remedy of equitable disallowance is simply unavailable under the Bankruptcy Code.

43. The Equity Committee ignored these points in its Plan Objection, relying heavily on a footnote in *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3d Cir. 1998), which declined to address whether equitable

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[3] The drafting history of Section 510(c) suggests that the omission of an equitable disallowance remedy was no accident: Congress actually considered – and ultimately rejected – the inclusion of equitable disallowance as a remedy in the new Bankruptcy Code. Specifically, a version of a Senate bill considered by Congress prior to the enactment of the Bankruptcy Code included the following language: "[a]fter notice and a hearing the court may disallow, in part or in whole, any claim or interest in accordance with the equities of the case." *See* S. 2266, 95th Cong. § 510(c)(3) (1977). However, shortly before Congress enacted the final legislation, which included the Bankruptcy Code, that language was deleted, thereby evidencing Congressional intent to exclude the remedy altogether.

disallowance exists under the Bankruptcy Code based on the possible continuing vitality of a pre-code case, *Pepper v. Litton*, 308 U.S. 295 (1939), that had approved equitable disallowance of a fraudulent claim. *See Citicorp*, 160 F.3d at 991 n.7.

44. However, the *Travelers* case, decided after *Citicorp*, eliminates any lingering doubts as to the obsolescence of this judicially crafted remedy. And *Pepper* itself – the only case the Equity Committee cited as actually enforcing equitable disallowance – rested on unique, extreme facts: disallowance of a judgment based on an insider's fraudulent salary claim intended to dissipate assets and evade legitimate creditors. *See* 308 U.S. at 296-98. Such a claim would now likely be disallowed pursuant to section 502(b)(1) of the Bankruptcy Code as unenforceable under state and federal fraudulent conveyance laws.

45. The *Citicorp* dictum referenced by the Equity Committee has not been interpreted by any court in this circuit to support the conclusion that equitable disallowance is a valid remedy in bankruptcy. Indeed, four years after *Citicorp*'s publication, the bankruptcy court for this district reaffirmed, in an opinion that cited heavily to *Citicorp*, the widely held conclusion that "equitable considerations can justify only the subordination of claims, not their disallowance." *Mid-American Waste*, 284 B.R. at 68 (quoting *Mobile Steel*, 563 F.3d at 699). The *Mid-American Waste* court's conclusion was correct and accords with the well-settled principles governing the bankruptcy court's use of its equitable powers.[4]

[4] The Equity Committee also cited an earlier decision by Judge Gerber in *Adelphia* holding that equitable disallowance is still potentially available as a remedy. *See Adelphia Commc'ns Corp. v. Bank of Am., N.A. (In re Adelphia Commc'ns Corp.)*, 365 B.R. 24, 71-72 (Bankr. S.D.N.Y. 2007), *aff'd in part*, 390 B.R. 64, 74-76 (S.D.N.Y. 2008). Notwithstanding the indicated affirmance, the district court in a later decision found it "unnecessary to decide the issue . . . of whether or not equitable disallowance is a permissible remedy in bankruptcy under any circumstances," and stressed Judge Gerber's additional observations that even if theoretically available the remedy is especially draconian and should be applied only in extreme, rare instances. *See Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 80, 99 (S.D.N.Y. 2008). The district court went on to dismiss the equitable disallowance claim holding that the remedy of equitable disallowance, even assuming it exists, cannot be asserted for the benefit of equity. *Id*.

46. Accordingly, the Complaint fails to state a colorable claim for equitable disallowance.

B. **<u>The Complaint Does Not Allege an Injury Upon Which the Equity Committee Can Obtain Standing to Sue</u>**

47. Even assuming the allegations in the Complaint are true (although they are in fact demonstrably false), the Equity Committee has not alleged an injury upon which the Equity Committee can obtain standing to seek equitable subordination (or equitable disallowance for that matter).

48. Section 510(c) of the Bankruptcy Code permits a bankruptcy court, based on equitable principles, to subordinate all or part of an allowed claim to all or part of another allowed claim (or all or part of an allowed interest to all or part of another allowed interest). 11 U.S.C. § 510(c). Equitable subordination is "a 'drastic' and 'unusual remedy' that should not be granted lightly." *Official Comm. of Unsecured Creditors v. Goldman Sachs Credit Partners L.P. (In re Fedders N. Am., Inc.)*, 405 B.R. 527, 554 (Bankr. D. Del. 2009) (quoting *Official Comm. of Unsecured Creditors v. Tennenbaum Cap. Partners, LLC (In re Radnor Holdings Corp.),* 353 B.R. 820, 841 (Bankr. D. Del. 2006)). It requires a showing that (i) the claimant engaged in some type of inequitable conduct, (ii) the misconduct resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (iii) equitable subordination of the claim is not inconsistent with the provisions of the Bankruptcy Code. *See Cohen v. KB Mezzanine Fund II, LP (In re Submicron Sys. Corp.)*, 432 F.3d 448, 461-62 (3d Cir. 2006) (citing *Citicorp Venture Capital Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986-87 (3d Cir. 1998)). To equitably subordinate a non-insider claim, a party must demonstrate "egregious conduct such as fraud, spoliation, or overreaching." *Fedders*, 405 B.R. at 554 (citation omitted).

49. Most importantly for present purposes, equitable subordination is remedial, not penal, and is "applied only to the extent necessary to offset *specific harm that creditors have suffered on account of the inequitable conduct*." *Submicron*, 432 F.3d at 462 (emphasis added; citation omitted); *see also Norwest Bank Wisc. Nat'l Ass'n v. Malachi Corp.*, No. 99-CV-40146, 2009 U.S. Dist. LEXIS 121417, at *11 (E.D. Mich. Dec. 30, 2009); *Cadleway Props. Inc. v. Andrews (In re Andrews)*, Adv. Pro. No. 02-0001, 2009 Bankr. LEXIS 1052, at *1 (Bankr. S.D. Tex. April 2, 2009) ("[T]he remedy of equitable subordination is available only to the extent of the injury caused by inequitable conduct."). The remedy may not be used to create a windfall for some creditors based on an injury to others. *See Citicorp*, 160 F.3d at 991.

50. While the Complaint does not identify the extent to which the Equity Committee is seeking equitable subordination, if it is seeking to equitably subordinate Aurelius's claims to holders of equity interests, such a claim could not survive a motion to dismiss. Section 510(c), by its express terms, does not permit the equitable subordination of a claim to an equity interest, but rather only the subordination of a claim to another claim. 11 U.S.C. § 510(c). As a result, the Third Circuit has held that equitable subordination cannot be used to benefit equity holders. *Shubert v. Lucent Techs. Inc. (In re Winstar Communications, Inc.),* 554 F.3d 382, 414 (3d Cir. 2009) ("[C]reditors' claims may not be equitably subordinated to equity interests.").

51. In any event, the Complaint fails to allege an injury upon which the Equity Committee can obtain standing to sue. To the extent the Complaint seeks a remedy for alleged harm caused to specific creditors (*e.g.*, those who purchased or sold securities from Aurelius while Aurelius was allegedly in possession of material nonpublic information), only those creditors would have standing to bring suit. The Debtors themselves lack standing to bring

claims based on particularized injury suffered by individual creditors. *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 434 (1972) (bankruptcy trustees lack standing to pursue claims of individual creditors); *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1093-94 (2d Cir. 1995) (same); *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979, 986-87 (11th Cir. 1990) (same); *cf. OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, 340 B.R. 510, 534 (Bankr. D. Del. 2006) (liquidating trust "has no right to prosecute a claim on behalf of an individual creditor"); *Citicorp*, 160 F.3d at 991 (holding that injury caused to creditors who sold claims to insider "must play no role in determining the extent of any [equitable] subordination").

52. Official committees are no different and, like debtors and bankruptcy trustees, lack standing to bring claims based on particularized harm to specific individuals. *Official Comm. of Unsecured Creditors v. Halifax Fund L.P. (In re AppliedTheory Corp.)*, 493 F.3d 82, 87 (2d Cir. 2007) (committee lacks standing to pursue equitable subordination based on injury to particular creditors); *Official Comm. of Unsecured Creditors v. Foss (In re Felt Mfg. Co.)*, No. 06-1171, 2007 Bankr. LEXIS 2569, at *24 (Bankr. D.N.H. July 27, 2007) (committee has no standing to bring claims belonging to individual creditors) (citing *Caplin*, 406 U.S. at 434).

53. Like debtors, official committees can only bring claims based on general harm to the estate. While the Complaint alleges generally that Aurelius "engaged in wrongful conduct that injured the Debtors, other creditors and the Debtors' equity owners" (Complaint ¶ 53), the Complaint does not plead plausible and specific factual detail supporting that allegation. The Complaint appears actually to allege only two injuries – neither of which can give rise to Equity Committee standing: (i) injury caused by Aurelius's trading in the Debtors'

securities while allegedly in possession of material nonpublic information (*id.* at ¶ 60) and (ii) injury caused by Aurelius's alleged negotiation of a settlement with JPMC that did not provide for a return to equity investors (*id.* at ¶ 56).

54. With respect to the alleged injury caused by Aurelius's trading activity, the Complaint does not plead any plausible basis upon which the Court could conclude that the *Debtors' estates* were harmed – even assuming that Aurelius violated the federal securities laws (which, as demonstrated below, it most assuredly did not). As discussed above, even assuming that individual creditors or equity holders were harmed by any such trading, the Equity Committee lacks standing to seek redress of those harms.[5] If any individual parties believe they were injured by Aurelius's trading, they may pursue their non-bankruptcy remedies in an appropriate forum. *See Viking Assocs., L.L.C. v. Drewes (In re Olson)*, 120 F.3d 98, 102 & n.4 (8th Cir. 1997) (holding that debtor lacked standing to challenge transfer of claims despite evidence that fiduciary had bought claims by misleading sellers for purpose of gaining control of estate's primary asset, suggesting that parties who considered themselves wronged could individually object or pursue non-bankruptcy remedies).[6]

55. Similarly, complaints about the Settlement Noteholders' alleged domination of the settlement process and failure to pursue a recovery for equity investors (even if true) do not translate into a cognizable allegation of injury to the Debtors' estates. The Court has already concluded that the Global Settlement Agreement is fair and reasonable and within the Debtors' sound business judgment even though it provides no value to equity. January

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[5] Indeed, at least some parties with which Aurelius traded benefitted from the transactions, as when Aurelius sold a significant block of PIERS on March 8, 2010, shortly before announcement of a tentative settlement that drove the price of PIERS up by several dollars. *See* Aurelius Post-Hearing Mem. at 42-42.

[6] In this respect, bankruptcy law mirrors the federal securities laws, under which only parties to the alleged transactions have standing to bring private suits for securities fraud. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 732-33 (1975) (only purchasers or sellers have standing).

Opinion, 442 B.R. at 345. Likewise, the Court has already determined that in entering into the Global Settlement Agreement, the Debtors acted in good faith. *Id*. at 364. It is simply implausible for the Equity Committee to allege that the Debtors' estates were injured by a settlement that was found by the Court at the time (after a four day evidentiary hearing) to have been fair, reasonable, and entered into in good faith.

56. Moreover, the evidence adduced in the Confirmation Hearing unequivocally established that the Settlement Noteholders in general, and Aurelius in particular, in no way dominated the Debtors and in fact had only limited and sporadic input into the settlement and plan negotiation process. Aurelius Post-Hearing Mem. at 20-22, 60. In any event, Aurelius consistently advocated for more aggressive negotiations and repeatedly urged the Debtors to step up the litigation pressure against JPMC. *Id.* at 30. Significantly, the Debtors systematically *disregarded* this advice and charted their own course in both the litigation and negotiation process. *Id.* at 21.

57. The accusations against Aurelius are particularly implausible because it was motivated to push for the *largest* possible settlement to provide a cushion for its PIERS recoveries, which have in fact eroded substantially due to the passage of time and are now projected to amount to only 35 percent of pre-petition claims under the Plan. *See* July 6, 2011 Updated Liquidation Analysis (the "Liquidation Analysis") attached as Exhibit A to the Declaration of Jonathan Goulding (D.I. 8105) and admitted as Debtors' Exhibit 375 at the Confirmation Hearing. The Complaint does not articulate what Aurelius supposedly did to cause the Debtors to accept a *lower* settlement than they otherwise could have achieved – or why it would even have desired that result.

58. In sum, the Complaint simply alleges no plausible injury to the Debtors' estates upon which the Equity Committee can obtain standing to sue.

C. The Complaint Does Not Adequately Allege Inequitable Conduct that Could Support Subordination or Disallowance

59. Even if the Complaint stated a valid legal theory on which the Equity Committee could obtain standing, which it does not, it still fails because it does not validly allege that Aurelius engaged in the type of serious inequitable conduct that could justify reducing or eliminating its claims. Because, as demonstrated below, Aurelius is not a fiduciary, the Equity Committee bears the burden of proving that Aurelius was guilty of "egregious conduct such as fraud, spoliation or overreaching." *Bank of New York v. Epic Resorts-Palm Springs Marquis Villas LLC (In re Epic Capital Corp.)*, 290 B.R. 514, 522-23 (Bankr. D. Del 2003) (discussing standard for equitable subordination under *Citicorp*). The Complaint does not allege any such grievously wrongful and damaging conduct by Aurelius – indeed, it does not allege facts showing *any* misconduct at all.

1. On the Facts Alleged, Aurelius Assumed Contractual, Not Fiduciary, Duties to The Debtors and Their Estates

60. This Court has already held that "[t]he Settlement Noteholders were not acting in this case in any fiduciary capacity." January Opinion, 442 B.R. at 349. This holding is consistent with the undisputed facts that Aurelius (like the other three Settlement Noteholders) is not a member of any official committee; has acted in these cases solely as an individual creditor (sometimes as part of an informal group); and never purported to act on behalf of or bind any other entity or individual. The Equity Committee nevertheless alleges in the Complaint that Aurelius and Centerbridge "assumed" fiduciary duties by their actions in the cases – mainly "buying up large quantities" of the Debtors' securities and taking an active role in settlement negotiations. Complaint ¶ 55.

61. There is no legal authority to support the notion that merely by holding a large position and participating actively in a bankruptcy a creditor assumes fiduciary duties. To the contrary, it is well-established that unofficial group members have no fiduciary obligations to other parties in the case. *See In re Drexel Burnham Lambert Group,* 123 B.R. 702, 706 (Bankr. S.D.N.Y. 1991) (ad hoc groups, "unlike members of officially appointed committees, have no fiduciary obligations under the Bankruptcy Code"); *see also Dixon v. Am. Cmty. Bank & Trust (In re Gluth Bros. Constr.)*, 424 B.R. 379, 390 (Bankr. N.D. Ill. 2009) ("[C]reditors have no fiduciary duty to debtors or other creditors.")

62. Notwithstanding the Complaint's conclusory allegations, the Equity Committee actually alleges no facts that could give rise to a fiduciary duty. It is undisputed that Aurelius was granted access to material nonpublic information about the Debtors only in narrow, controlled circumstances, governed by express written contracts. Under New York law, which governs the Confidentiality Agreements, "no fiduciary relationship exists where parties were acting and contracting at arm's-length to a business transaction." *LFD Operating, Inc. v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores, Inc.)*, 274 B.R. 600, 626 (Bankr. S.D.N.Y. 2002); *see also Compania Sud-Americana de Vapores v. IBJ Schroder Bank & Trust*, 785 F. Supp. 411, 426 (S.D.N.Y. 1992) (New York law "quite clear" that "a conventional business relationship, without more, does not become a fiduciary relationship by mere allegation.") (internal citations omitted).

63. Further, receipt of confidential information does not by itself create a fiduciary duty, particularly where parties operate under an arm's-length agreement. *See Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 799 (2d Cir. 1980); *see also Nolan Bros. of Tex., Inc. v. WhiteRaven, L.L.C.*, No. 99-CV-10256, 2004 U.S. Dist. LEXIS 3053, at *3-4 (S.D.N.Y. Feb. 27,

2004) (neither communication of confidential information nor signing of a confidentiality agreement creates fiduciary relationship). Indeed, "it makes great sense not to impose fiduciary duties concomitantly with confidentiality agreements. The existence of a detailed confidentiality agreement suggests arm's-length dealings between co-equals." *Nolan Bros.* 2004 U.S. Dist. LEXIS, at *4 (internal citations and quotations omitted). Thus, it is Aurelius's contracts with the Debtors – not any imagined fiduciary duties – that should frame the Court's inquiry into Aurelius's conduct.

64. Ignoring this authority, the Complaint alleges that Aurelius assumed fiduciary duties by essentially being too active and dominant in the bankruptcy proceedings. The only legal basis for this mentioned in the Complaint is the argument that Aurelius should be viewed as a "temporary insider," a term derived from the famous footnote 14 in *Dirks v. S.E.C.*, 463 U.S. 646 (1983). *See* Complaint ¶ 55. But this doctrine exists to define the duties of "an underwriter, accountant, lawyer, or consultant working for the corporation" who has thereby entered into a "special confidential relationship in the conduct of the business of the enterprise" and is "given access to information solely for corporate purposes." *Dirks*, 463 U.S. at 655 n.14. In other words, the doctrine imposes the ordinary obligations of an insider on professionals who actually *become* insiders, but only on a temporary basis. *See also, e.g., United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (citing *Dirks* for proposition that "classical theory" of misappropriation liability extends beyond "permanent insiders" to embrace "attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation"); *Sawant v. Ramsey*, 742 F. Supp. 2d 219, 238 (D. Conn. 2010) (refusing to apply temporary insider doctrine to major shareholder who obtained confidential information but was "not a professional advisor or consultant, and was not employed by [the company] as such").

65. This category obviously has nothing to do with Aurelius, which, even assuming the truth of the entire Complaint, acted as a creditor and never (even temporarily) had a relationship with the Debtors remotely analogous to an attorney, accountant, or other professional working for the estates. *See* Aurelius Post-Hearing Mem. at 52-53. The temporary insider designation is necessary to determine the obligations imposed upon a temporary fiduciary with general, unrestricted access to a company's nonpublic information. Aurelius, in contrast, received material nonpublic information prior to announcement of the initial settlement only in highly structured circumstances, pursuant to specific written agreements that spelled out its obligations. While the Equity Committee suggests that Aurelius had a "special confidential relationship" with the Debtors even outside of the restricted periods (EC Plan Objection ¶ 49), Mr. Gropper testified without contradiction as to Aurelius's limited access and input throughout these cases, and Mr. Kosturos confirmed that the Debtors took seriously their obligation not to disclose material nonpublic information in meetings and discussions outside of the restricted periods. Aurelius Post-Hearing Mem. at 20-21, 24-25, 30, 45. Any confidential information was shared with Aurelius *not* "solely for corporate purposes," i.e., to facilitate the performance of professional services for the estates, but in its role as a creditor attempting to negotiate a settlement. *See Sawant*, 742 F. Supp. 2d at 238 (no "temporary insider" status where defendant received confidential information "in his capacity as a shareholder"). The Equity Committee has not even *alleged* facts that would establish actual "insider" status within the meaning of *Dirks*.

66. The EC Plan Objection also argued that Aurelius may be a "non-statutory insider" – *i.e.*, a party not in one of the categories enumerated in 11 U.S.C. § 101(31) but having a sufficiently close and controlling relationship with a debtor as to suggest that transactions were

not conducted at arm's-length. But the standard governing this doctrine makes clear that Aurelius could not, by any stretch of the imagination, be considered a non-statutory insider:

> Courts have looked at various factors in determining a creditor's insider status, including whether the creditor: (1) attempted to influence decisions made by the debtor; (2) selected new management for the debtor; (3) had special access to the debtor's premises and personnel; (4) was the debtor's sole source of financial support; (5) generally acted as a joint venture or prospective partner with the debtor rather than an arm's-length creditor; (6) [had] control over the debtor's voting stock; (7) [had] managerial control, including personnel decisions and decisions as to which creditors should be paid; (8) whether the relationship between the debtor and lender was the result of an arm's-length transaction.

Official Unsecured Creditors Comm. of Broadstripe, LLC v. Highland Capital Mgmt., LP (In re Broadstripe, LLC), 444 B.R. 51, 80 (Bankr. D. Del. 2010). Here, only the first and most benign factor could conceivably be implicated – and that would be true as well of any major creditor who became actively involved in any bankruptcy case. *See also* Aurelius Pre-Hearing Response ¶ 92 (distinguishing cases cited in EC Plan Objection). The Complaint does not even *begin* to allege the kind of facts that could meet this standard, and Mr. Gropper's testimony made clear that these factors do not apply here. Aurelius was a vigorous negotiator and advocate for its position, when it could get in the room, but it always acted at arm's-length as a *creditor* and obtained access to material nonpublic information only in strictly controlled circumstances. The Debtors routinely excluded it from negotiations and ignored its advice and input with impunity. It was not an insider of any kind – "temporary," "non-statutory," or otherwise.

67. The Equity Committee refers in the Complaint to no other doctrine providing that creditors with large positions who merely participate in plan negotiations individually or as part of unofficial groups thereby assume fiduciary duties to other creditors or the Debtors generally. Aurelius's behavior in these cases therefore must be measured by the standards applicable to an ordinary creditor acting on its own behalf. But even if Aurelius did

have some type of duty to other creditors or the estates, that would at most extend to honest and vigorous representation of such interests in the negotiations – an obligation that Aurelius satisfied by urging the Debtors to litigate aggressively and seek the best possible settlement with JPMC. And the Court has already determined that the settlement actually reached was fair and reasonable as of January 2011. Importantly, Aurelius did not act in any way to bind or prejudice other creditors when it agreed to support the October 2010 Plan – other creditors and equity holders were free to evaluate, vote on, or object to the Plan on the same basis as Aurelius. As further explained below, the Complaint simply fails to allege a breach of any duty that Aurelius conceivably had.

2. The Equity Committee Does Not Allege a Colorable Claim Against Aurelius for Breach of Fiduciary Duty in Connection with Plan Negotiations

68. The Complaint's first alleged breach of fiduciary duty (a basis upon which the Equity committee is seeking to equitable disallow or subordinate all of Aurelius's claims) is the claim that Aurelius improperly seized control over the settlement negotiations and used this control to force a settlement that paid out its claims "without attempting to pursue a recovery for equity." Complaint ¶ 56. While the Complaint's scant paragraph on this theory is not very illuminating, the allegation appears to be that the Settlement Noteholders somehow contrived to have the negotiations end just at the point where enough money had been generated to cover their claims, with nothing left over for equity. *See also* EC Plan Objection ¶ 62. How exactly the Settlement Noteholders achieved this precise result is never explained, nor does it make any sense that the holders of the fulcrum security in this capital structure would not seek and obtain, if at all possible, a healthy cushion to protect their fragile recoveries from the dangers of delay. Indeed, as the passage of time has eroded recoveries, the PIERS have been reduced to a current expected recovery on their pre-petition claims of only 35 percent – putting equity more than

$700 million out of the money and rendering any suggestion of "harm" to equity even more far-fetched.[7]

69. Indeed, it is not surprising that the undisputed record reveals this claim to be frivolous and irresponsible. The extensive, uncontradicted testimony of all of the Settlement Noteholders and Mr. Kosturos confirmed that Aurelius was involved in settlement talks and the Plan process only on a limited and sporadic basis; that it was frequently *excluded* from key meetings and negotiations and saw its advice and suggestions routinely rejected or ignored; and that in any event Aurelius consistently exhorted the Debtors to take more aggressive litigation and negotiating positions against JPMC so that the pie to be divided among estate constituencies could be as large as possible. *See* Aurelius Post-Hearing Mem. at 20, 30. The Equity Committee has admitted that this advocacy resulted in "a steady upward trajectory that gave the estate more and more money." *See* EC Plan Objection ¶ 42. In fact, the negotiations were more complicated than that, with frequent setbacks. *See* Aurelius Post-Hearing Br. at 28-29, 36-37. In any event, the Complaint contains *no facts* suggesting that Aurelius or the other Settlement Noteholders did anything to actually limit or reduce the amount of the settlement with JPMC. There would thus be nothing to this claim even if it were being asserted now for the first time.

70. The claim is all the more remarkable, however, because the Court already rejected a very similar "domination" theory in connection with the prior Confirmation Hearing. The Court specifically *rejected* arguments by the same objectors that the Global Settlement Agreement was tainted because JPMC's dominant relationship with Weil Gotshal created a conflict of interest. And the Court specifically held in its January Opinion that the settlement was, at the time, fair, reasonable, and within the Debtors' sound business judgment even though

[7] In fact, equity holders may be significantly more than $700 million out of the money as there are more than $40 billion of claims subordinated under Section 510(b) of the Bankruptcy Code that must be resolved and paid in full before a distribution can be made to holders of preferred stock. July 14 Tr. at 182:18-183:8 (Goulding).

it provided no value to equity. This holding is consistent with the well-settled rule that a debtor is *not* obligated to serve the interests of any particular stakeholder but only to maximize the overall value of the estate. *See Cybergenics*, 330 F.3d at 573 (debtor's management owes fiduciary duty to maximize value of bankruptcy estate); *see also Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215 at *108 n.55 (Del. Ch. Dec. 30, 1991) (debtor must take into account total community of interest of bankruptcy estate and may reasonably agree to settlement that maximizes value even if it leaves little or nothing for equity). Even if it were a fiduciary, which it is not, Aurelius could have no greater duty. It did nothing wrong in supporting the Global Settlement Agreement and prior Plan in October 2010. It did not dominate these Debtors or these cases. The Equity Committee's claim that it did so is frivolous and certainly not "colorable."

3. The Equity Committee Does Not Allege a Colorable Claim against Aurelius with Respect to Insider Trading

71. The Equity Committee's claim of improper trading (another basis upon which the Equity Committee is seeking to equitably disallow or subordinate Aurelius's claims), finally reduced to a pleading that can be evaluated on the merits, is equally insubstantial and non-colorable. It is, in fact, facially invalid on three independent grounds.

a) The Equity Committee does not plead facts showing that Aurelius breached any duty to the Debtors or acted deceptively

72. The Equity Committee's insider trading claim against Aurelius fails at the threshold because there is no valid allegation that Aurelius breached any duty or employed any deceptive device. For an individual or entity to become liable for insider trading under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, it must trade on material, nonpublic information in violation of a fiduciary duty and employing "manipulation or

deception." *See Dirks v. S.E.C.*, 463 U.S. 646, 653-54 (1993). Trading by a non-fiduciary does not violate the securities laws unless done *in breach of a duty to the source of the information*. *See id.* at 657 ("[O]nly some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information." (citing *Chiarella v. United States*, 445 U.S. 222, 232 (1980) (no duty not to trade where party is neither the corporation's "agent" nor its "fiduciary"))); *see also United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997) (trading prohibited only when done "in breach of a duty owed . . . to the source of the information").

73. The need for a breach of duty flows from the requirement of deception or manipulation as an element of securities fraud. The party misappropriating inside information must be guilty of "deception of those who entrusted him with access to confidential information." *O'Hagan*, U.S. 521 at 652. Where the recipient of information discloses to the source that he plans to trade on it, "there is no 'deceptive device' and thus no section 10(b) violation." *Id.* at 655.

74. Here, Aurelius was not a fiduciary but undisputedly acted solely on behalf of itself and its own investors. Its obligations to the Debtors were assumed contractually, through the Confidentiality Agreements. Under New York law, the existence of an arm's-length contract bars any inference of an additional fiduciary duty. *See* above at ¶ 62. Moreover, Aurelius indisputably satisfied all of its duties to the Debtors, and any obligations it had under the Confidentiality Agreements with respect to trading terminated with those agreements. The EC Plan Objection did not allege that Aurelius in any way deceived the Debtors or misappropriated any information. To the contrary, the very structure of the Confidentiality Agreements reflects that the parties understood and expected that the Settlement Noteholders would resume unrestricted trading upon termination of the confidentiality periods. This

understanding was confirmed in undisputed Confirmation Hearing testimony. Having breached no duty, Aurelius cannot be liable for improper trading.

75. Recognizing that the absence of any misappropriation or deception dooms its claim, the Equity Committee now alleges in the Complaint that the Confidentiality Agreements required Aurelius to use the information provided to it "only for the Debtors' corporate purpose of advancing settlement negotiations with JPMC," and that "use of this information to inform trading" amounted to "misappropriation" under the federal securities laws. Complaint ¶ 59.

76. This is a nonsensical reading that would defeat a central purpose of the Confidentiality Agreements – which was to require public disclosure by the Debtors of all material nonpublic information provided to Aurelius *so that it could resume unrestricted trading at the conclusion of the confidentiality periods*. The language on which the Equity Committee relies says nothing about a "corporate purpose of advancing settlement negotiations" – by which language the Equity Committee hopes to invoke the inapposite *Dirks* footnote. The actual contract language says only that Aurelius must use confidential information provided "only for the purpose of participating in the Cases" and not "in any manner inconsistent with this Agreement." Aurelius Exs. 16 and 27 § 1. But as noted, the entire purpose of the agreement was to facilitate negotiations by having Aurelius become restricted only *temporarily*; if Aurelius could never trade while in possession of *any* information provided to it during the confidentiality period, then this cleansing agreement would be totally ineffective. Under the Equity Committee's reading, unless the Debtors agreed to disclose not just material nonpublic information but *all* information provided during the confidentiality period, whether material or not, Aurelius would be *permanently* restricted from trading. It was not "inconsistent with this

agreement" for Aurelius to resume trading while still in possession of information provided to it during the restricted period that the Debtors had not disclosed. Such information was by definition *non-material* and thus irrelevant under the securities laws. The agreement expressly contemplated that Aurelius would be cleansed and able to resume trading once *material* nonpublic information had been disclosed.

77. Not surprisingly, the actual parties to the Confidentiality Agreements – the four Settlement Noteholders and the Debtors themselves – all understood the contracts to *permit* trading after all material nonpublic information was disclosed, notwithstanding that the noteholders might still be in possession of *immaterial* nonpublic information gleaned from the negotiations. Mr. Kosturos specifically rejected the idea that the Confidentiality Agreements in any way continued to restrict the noteholders' trading activities after they terminated – and indeed he confirmed the Debtors' view that Aurelius had no continuing confidentiality obligations of any kind once the agreements terminated. *See* Aurelius Post-Hearing Mem. at 25-27. The Equity Committee's tortured reading of the contract is therefore not only illogical and unworkable, but also flatly inconsistent with the parties' actual understanding.

78. Aurelius's good faith satisfaction of its contractual undertakings to the Debtors should end the improper trading inquiry. Significantly, the EC Plan Objection did not cite a single case in which a party's obligations to refrain from trading were spelled out in a contract that was meticulously honored, but liability for improper trading nevertheless was imposed. The cases it did cite were worlds apart from the facts here and only underscored the absence of any cognizable "inequitable conduct" on the facts alleged or proven.

79. For example, the Equity Committee relied heavily on *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3d Cir. 1998),

which the Third Circuit described as the "paradigm case of inequitable conduct by a fiduciary" (*id.* at 987-88) – but the contrasts between that case and these cases highlight exactly why the improper trading allegations here fail on their face. In *Citicorp*, an entity called Citicorp Venture Capital, Ltd. ("CVC") was a dominant shareholder of the parent company of Papercraft Corporation ("Papercraft") and had a seat on Papercraft's board. It was thus indisputably a traditional fiduciary with duties running to Papercraft's estate. In violation of those duties, CVC obtained extensive confidential information about Papercraft's financial stability and assets and then "surreptitiously" purchased a significant proportion of Papercraft's outstanding debt without informing either Papercraft or its creditors' committee. *See* 160 F.3d at 985. CVC then leveraged its new holdings to promote a plan of reorganization that would permit it to purchase Papercraft's assets. *Id.* The bankruptcy court found CVC's conduct to constitute an obvious and serious breach of fiduciary duty that created severe conflicts of interest and injured other creditors. *Id.* at 986.

80. Thus, *Citicorp* addresses the problem of true corporate insiders who abuse their unfettered access to material nonpublic information to obtain an unfair advantage over the very parties to whom they owe a fiduciary duty. Here, in contrast, Aurelius (i) was *not* an insider; (ii) obtained only limited and controlled access to material nonpublic information; and, (iii) *most crucially*, breached no duty to the Debtors or any other party by resuming trading after the Debtors' disclosures. In fact, after those disclosures, the Debtors themselves represented to counsel for Aurelius and others that the Debtors had disclosed all material nonpublic information provided to noteholders during the confidentiality periods. *See* Aurelius Ex. 31; EC Ex. 146.

81. The Equity Committee also cited *S.E.C. v. Cuban*, 620 F.3d 551 (5th Cir. 2010), which dealt with a problem not presented here: whether a duty to abstain from trading

may be implied from a naked agreement to keep information confidential. In *Cuban*, a minority shareholder received information from the company's CEO, agreed to keep the information confidential, and appeared to acknowledge a trading restriction by stating, "well, now I am screwed. I can't sell." *Id*. at 555 (internal quotation marks omitted). While the parties did not *expressly* agree that the shareholder would not trade on the basis of the confidential information, the Fifth Circuit concluded that this was one reasonable inference from the ambiguous interaction. *Id*. at 557-58.

82. Here, in contrast, no one has to guess about the scope of Aurelius's and the Debtors' undertakings – they are spelled out clearly in the Confidentiality Agreements. Upon termination, the agreements expressly required *the Debtors to disclose* any confidential information that constituted *material nonpublic* information under the securities laws. Aurelius Exs. 16 and 27 at § 13. Nothing in the Confidentiality Agreements restricted Aurelius's use of *non*-material information after termination. Mr. Kosturos specifically testified that once the Confidentiality Agreements terminated "the parties are free to do whatever they want to do" because "the agreement is no longer in place." July 21 Tr. 153:5-7 (Kosturos). Indeed, the Confidentiality Agreements did not even require that this non-material information be kept confidential after termination – as Mr. Kosturos again confirmed in his testimony. *Id.* at 151:24-152:6 (public disclosure of settlement terms after termination of agreements "would not be a breach of the agreement"). But even if the agreements required continuing confidentiality, there would be no basis to infer a trading restriction, since the entire purpose of the contract was to preserve Aurelius's ability to trade after being cleansed. Unlike in *Citicorp* and *Cuban*, the Court need not speculate, infer, or independently assess the scope of Aurelius's obligations; they are spelled out explicitly and were indisputably honored in full. On this basis alone, the Court

may conclude that Aurelius did not engage in improper trading and that the inequitable conduct allegation is not colorable.

b) The Equity Committee does not plead facts showing that Aurelius acted with scienter

83. Although the Court need not reach the additional elements of an insider trading claim, the Complaint fails to properly allege another indispensible element: facts giving rise to a "strong inference" that Aurelius "knew or recklessly disregarded" that information in its possession when trading was material, i.e., scienter. The Private Securities Litigation Reform Act of 1995 (PSLRA) set forth stringent new pleading requirements that the Supreme Court construed in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007). *Tellabs* requires that a court reviewing allegations of scienter on a motion to dismiss consider whether all of the facts alleged taken together, along with matters of which the court may take judicial notice, give rise to a "strong inference of scienter." *Id.* at 322-23. Congress required that a plaintiff plead with particularity facts showing not just that an inference of knowledge or recklesness "rationally could be drawn," but rather facts giving rise to a "powerful or cogent" inference. *Id.* at 323. And a court also "must consider plausible nonculpable explanations for the defendant's conduct," such that a complaint will not be sustained unless "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324; see also *Winer Family Trust v. Queen*, 503 F.3d 319, 328-29 (3d Cir. 2007) (affirming dismissal of scienter pleading under *Tellabs* standard).

84. The Equity Committee's pleading fails to satisfy this stringent standard. It is undisputed that Aurelius and the Debtors specifically agreed that *the Debtors would disclose* any material nonpublic information at the end of each confidentiality period. It is also factually undisputed, despite unsupported insinuations, that the Debtors, in consultation with their

experienced securities counsel, actually made informed good faith judgments about what information did and did not have to be disclosed. *See* Aurelius Post-Hearing Mem. at 26-27, 39. Aurelius's good faith reliance on both the Debtors' contractual duties *and* the Debtors' actual judgments in performing these duties undercuts any reasonable inference of scienter, let alone a cogent or compelling one. And it is undisputed that Aurelius independently confirmed the Debtors' conclusions based on its own understanding and experience. *Id.* at 27, 39. These undisputed facts defeat any attempt to infer that Aurelius *knowingly* or *recklessly* traded while in the possession of material nonpublic information.

85. The Complaint contains no well pleaded allegations that Aurelius's trading was inherently suspicious or otherwise so unusual as to give rise to a strong inference of guilty knowledge. *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997) (declining to infer fraudulent intent from trading "in the normal course of events"); *see also, e.g., Zumpano v. Juniper Networks, Inc. (In re Juniper Networks, Inc.)*, 158 F. App'x 899, 901 (9th Cir. 2005) (granting motion to dismiss based on failure to allege that defendants' stock sales were "inconsistent with prior trading histories"); *Oran v. Stafford*, 34 F. Supp. 2d 906, 910 (D. N.J. 1999) (refusing to find scienter where there was no showing that trades by insiders were unusual or abnormal). Here, the Complaint alleges only that Aurelius bought certain of the Debtors' securities at the conclusion of the confidentiality periods, but offers no reason to infer that this trading was driven by knowledge of stale settlement offers rather than the recent public disclosure of material new information about the company (e.g., the size of expected tax refunds). Indeed, a review of Aurelius's pattern of trading from early 2009 through early 2010 shows that it correlated closely with publicly available information about taxes – both the on again/off again fate of the tax bill, and the resulting estimated refund numbers released by the

Debtors – rather than any developments in the fitful and inconclusive settlement negotiations. *See* Aurelius Post-Hearing Mem. at 32-33, 39-42. The record also reflects a number of other innocent factors – including market volatility, Aurelius's need to invest new capital the firm had recently taken in, and information about the absence of investor requests for cash redemptions – that were part of the environment informing Aurelius's trading. *Id*. The "nonculpable explanations" for Aurelius's conduct, *see Tellabs*, 551 U.S. at 324, are far more cogent than any inference of scienter.

86. Indeed, the S.E.C. itself intended to protect against unfair allegations of scienter in the very circumstances presented here. Upon the passage of Rule 101 of Regulation Fair Disclosure, codified at 17 C.F.R. § 243.100 *et seq.* (effective Oct. 23, 2000) ("Regulation FD") – which informs the use and cleansing of material nonpublic information in this type of setting and is explicitly invoked in the Confidentiality Agreements (*see* Aurelius Exs. 16 and 27 at § 13) – the S.E.C. issued a contemporaneous release explaining that the Regulation FD scienter standard is "*knowing or reckless conduct*." Securities Exchange Act Release No. 43154, Sec. II.A.3 (Aug. 15, 2000), 25 Securities Prac. Fed. & State Enforcement Appendix 2H (the "S.E.C. Release"); 17 C.F.R. § 243.101 (emphasis added). The Commission explained that it had "revised Regulation FD to make absolutely clear that it *does not establish a duty* for purposes of Rule 10b-5" and failure to make disclosure would not result in a Rule 10b-5 violation. Release at II.A.4; 17 C.F.R. § 243.102. Significantly, this made "clear that where the regulation speaks of 'knowing or reckless' conduct, liability will arise only when an issuer's personnel knows or is reckless in not knowing that the information selectively disclosed is both material and nonpublic." Release at II.A.4.

87. Amplifying the agency's intent, Richard Walker, Director of the Division of Enforcement at the S.E.C. at the time Regulation FD was passed, said:

> Regulation FD was *not* designed as a trap for the unwary . . . . [W]e're not going to second-guess close calls regarding the materiality of a potential disclosure. An issuer's incorrect determination that information is not material must represent an "extreme departure" from standards of reasonable care in order for us to allege a violation of FD.

Richard H. Walker, Director, Div. of Enforcement, Sec. Exch. Comm'n, Regulation FD – An Enforcement Perspective (Nov. 1, 2000), 2000 WL 1635668, at *3 (the "Walker Speech"). This was intended to "*provide additional assurance that issuers will not be second-guessed on close materiality judgments*" and the SEC would not "bring enforcement actions under Regulation FD for mistaken materiality determinations that were not reckless." S.E.C. Release at II.A.4. (emphasis added). Regulation FD "places the responsibility for avoiding selective disclosure, and the risks of engaging in it, squarely on the issuer." Walker Speech at *3. It follows that a party relying in good faith on such determinations as a bargained-for safe harbor did not act with scienter. The failure to adequately plead this element by itself defeats the insider trading claim.

c) The Equity Committee does not plead facts establishing that the stale details of unsuccessful settlement talks were material and needed to be disclosed under the terms of the Confidentiality Agreements

88. While the Court need not reach this issue either because Aurelius's compliance with its own obligations and lack of scienter are sufficient, the undisputed evidence shows that *the Debtors were correct* in concluding that the information provided to Aurelius in settlement negotiations either was disclosed (e.g., tax information) or was not material (e.g., details of unsuccessful settlement proposals). No facts alleged in the Complaint support any different conclusion.

89. Materiality is determined by an objective, “reasonable investor” test: “[T]he law defines ‘material’ information as information that would be important to a reasonable investor in making his or her investment decision.” *Burlington Coat Factory*, 114 F.3d at 1425; *see also TSC Indus., v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (“An omitted fact is material if there is a substantial likelihood that a reasonable [investor] would consider it important in [making his or her investment decisions].”). Recognizing that it might be difficult to determine the materiality of “contingent or speculative information or events,” the Supreme Court has held that “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).

90. Under this rule, information about preliminary, inconclusive, or stale negotiations is immaterial as a matter of law. *See Taylor v. First Union Corp. of S.C.*, 857 F.2d 240, 244-45 (4th Cir. 1988). *Taylor* held that the “preliminary, contingent, and speculative” negotiations in that case were immaterial because there was “no agreement as to the price or structure of the deal.” *Id.* at 244. Requiring disclosure in such situations “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.’” *Id.* at 245 (citation omitted); *see also Shamrock Holdings, Inc. v. Polaroid Corp.*, 709 F. Supp. 1311, 1320 (D. Del. 1989) (disclosures in tender offer context of “information regarding the status of settlement talks have the same potential to mislead as they do to help a shareholder make a considered decision whether to tender.”). Moreover, “stale information is immaterial as a matter of law.” *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 412 (S.D.N.Y. 1998).

91. Here, it is undisputed that both confidentiality periods ended with the parties dramatically apart, settlement discussions suspended, and no binding agreement in place on any settlement terms. The Equity Committee's allegations that the settlement proposals were nonetheless material are unsupported by any specific facts tending to show materiality. The allegations that the Debtors' own proposals *to* JPMC were independently material (Complaint ¶¶ 26, 45) were not substantiated in the record, since, among other things, these proposals revealed nothing about the terms on which JPMC might actually settle. The allegation that the JPMC responses to those offers embodied "agreement" on key terms (*e.g.*, Complaint ¶¶ 27, 43), ignores the uncontroverted testimony of every witness that the settlement negotiations were unsuccessful and inconclusive until very close to March 12, 2010, when the initial three-way agreement was announced – and, of course, even that deal fell apart soon thereafter. No reliance could be placed on any supposed interim "agreements" because they were all conditioned on the resolution of multiple issues as to which the parties remained far, far apart. *See* Aurelius Post-Hearing Mem. at 31, 37-38.

92. For example, the fact that JPMC stated in March 2009, during the first confidentiality period, that it would relinquish the $4 billion deposit *if the Debtors gave in on every other issue in dispute* provided no assurance that the same concession would be available later, in the context of a different settlement embodying different trade-offs in these complex, multi-party cases. *Id.* at 28-29. Similarly, the last JPMC counter-proposal during the second confidentiality period in November 2009 was viewed by Mr. Kosturos as completely "resetting the bookends" of the negotiations – and JPMC itself acknowledged that the parties were "far apart." Talks did not get back on track and advance towards resolution until early the following

year, *after* Aurelius was no longer privy to these discussions. *See* Aurelius Post-Hearing Mem. at 42-43.

93. In addition to the stale settlement offers shared with the Settlement Noteholders during the confidential periods, paragraph 57 of the Complaint includes several other facially inadequate allegations of receipt by Aurelius of material nonpublic information:

- First, the Equity Committee alleges that the terms of a January 22, 2009 settlement term sheet sent by the White & Case Group to the Fried Frank Group (and shared informally with the Debtors by an individual member of the White & Case Group) was *itself* material nonpublic information *about the Debtors* – a remarkable assertion that would bar trading by any creditor who formulated and shared its own ideas about resolving a litigation without misappropriating or even *receiving* any information from any other party. This suggestion is absurd, and indeed would mean that *every member* of the White & Case group that received this document (including, at least, the seven members of the steering committee) became restricted until the March 12, 2010 settlement announcement.

- The Equity Committee further argues that April 2009 settlement proposals exchanged between the Debtors and JPMC *without* the involvement of the Settlement Noteholders also constituted material nonpublic information. But it is uncertain whether Aurelius ever learned the details of the Debtors' proposal – which standing alone said nothing about the state of any potential agreement and therefore could not have been material. Moreover, it is undisputed that the Settlement Noteholders *never received JPMC's counter-proposal* and thus had no idea whether the huge gap between the parties in March had narrowed. *See* Aurelius Post-Hearing Mem. at 29.

- The Equity Committee also alleges that the Debtors and their litigation counsel provided material nonpublic information to the Settlement Noteholders at a meeting on May 6, 2009, although the undisputed trial testimony established that this meeting was primarily devoted to the Debtors' listening to the noteholders' ideas and suggestions; that *no* nonpublic information was shared at the meeting; and in fact that counsel for the Debtors announced to the participants that all disclosures required by the March 9 Confidentiality Agreement had been made and they were therefore already free to trade. *See id.* at 25-26, 30. Discussion of *public* information about pending litigation claims cannot constitute material nonpublic information.
- Finally, the Equity Committee now argues that settlement proposals made by Appaloosa, Centerbridge, and JPMC in July and August 2009 constituted material nonpublic information, but Aurelius had no involvement in these negotiations and never learned the terms of these offers. *See id.* at 33-34.

94. None of this qualifies as material nonpublic information. While the Equity Committee argued in its Plan Objection that "facts about the settlement of a litigation *can* be material within the meaning of Rule 10b-5" (EC Plan Objection ¶ 45 (emphasis added)), no case of which we are aware has found materiality attaching to settlement talks this inchoate and unsuccessful. The cases the Equity Committee cited on this point were far different. In *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 929 (9th Cir. 2003), insiders traded with knowledge of FAA safety violation negotiations while simultaneously issuing knowingly false statements about the negotiations – it was not the status of negotiations per se but the affirmative misrepresentations that led to liability. And in *S.E.C. v.*

Thrasher, 152 F. Supp. 2d 291, 294-95 (S.D.N.Y. 2001), an executive of Motel Six tipped a friend that acquisition of the company by a French corporation "was imminent."

95. But it is well-established that *merger* negotiations, because they may represent major, unexpected news about a company, may be material at an earlier stage than other types of negotiations. *See Basic, Inc.*, 485 U.S. at 238-39. In contrast, where the contours of a dispute are well-known to the public (as was the case with the disputes between the estates and JPMC over ownership of the deposits and tax refunds) neither the mere fact that negotiations have started nor the early, inconclusive results of such negotiations can be viewed as material. A *deal* – or something very close to it – must be in place before the settlement talks themselves become material. Moreover, the *fact* that negotiations were being held – for example, during early 2010 – was generally known to the market and, indeed, announced by the Debtors in open court and in motion papers filed in the cases. Aurelius Post-Hearing Mem. at 44-45. The Equity Committee cites *no* authority suggesting that rejected settlement offers by parties as far apart as those in these cases constitute material nonpublic information. To hold that they do would require disclosure of a confusing and unhelpful array of information and would chill the ongoing negotiation process in most large bankruptcy cases.

96. Finally, just as Aurelius's pattern of trading fails to give rise to an inference of scienter, it also does nothing to help establish materiality. Again, the Equity Committee cited in its plan objection only obviously distinguishable cases. In *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (6th Cir. 1968) (cited in *Basic*, 485 U.S. at 240 n.18, for the proposition that trading by insiders can serve as an indication of materiality), the court determined that the timing of stock purchases "virtually compell[ed]" the inference that trades had been made based on material information. There, trades were primarily made by

"individuals who had never before purchased calls or even TGS stock." *Id.* The court further noted that the information at issue was "so remarkable" that none of the individuals involved in the trades "had ever seen or heard of a comparable" situation before. *Id.* at 843. Similarly, in *United States v. Victor Teicher & Co.*, No. 88 Cr. 796, 1990 WL 29697, at *1 (S.D.N.Y. Mar. 9, 1990), a law firm insider conveyed merger information to defendants, who, by and large, traded in the securities thereafter for the very first time.

97. Here, in contrast, the trades at issue are part of a larger, unremarkable pattern of trading in the same securities by diligent and informed professional investors based on publicly available information. The trading correlates with the progress of the NOL tax bill and other factors unrelated to the settlement talks, and indeed certain aspects of the trading were affirmatively *inconsistent* with the idea that Aurelius had any inside knowledge of a pending deal. For example, following the first confidentiality period, Aurelius *reduced* its PIERS position during the summer of 2009 – and indeed owned *less* total face amount of the Debtor's securities by the end of August 2009 then it had at the end of the first confidentiality period on May 9. Further, just days before announcement of the first tentative settlement in March 2010, Aurelius *sold* a major block of PIERS, the price of which traded *up* by several dollars following announcement of the deal. Moreover, after the first confidentiality period ended, the Settlement Noteholders often traded in opposite directions at the same time (sometimes even on the same day), further demonstrating that the stale information they possessed about settlement negotiations could not be viewed as material. *See* Aurelius Post-Hearing Mem. at 34-35. These facts bear no resemblance to cases in which trading cannot be explained by anything other than access to material nonpublic information.

* * *

98. In sum, the Complaint simply fails to allege the existence of inequitable conduct on the part of Aurelius that could justify the equitable subordination or disallowance of its claims.

II. THE EQUITY COMMITTEE CANNOT DEMONSTRATE THAT THE DEBTORS HAVE UNREASONABLY FAILED TO PURSUE CLAIMS OF THE ESTATES

99. Although the failure to satisfy the first prong of derivative standing by itself requires denial of the Motion to Authorize, the Equity Committee has also failed to demonstrate that the Debtors have *unjustifiably* refused to pursue the claims asserted in the Complaint.

100. In determining whether a debtor's refusal to pursue claims on behalf of its estate is unjustified, courts generally consider whether the claims are likely to benefit the estate, which includes considering the probability of "legal success and potential financial recovery" and the cost of pursuing such litigation. *Official Comm. of Unsecured Creditors v. Austin Fin. Servs., Inc. (In re KDI Holdings, Inc.)*, 277 B.R. 493, 508 (Bankr. S.D.N.Y. 1999) (quoting *In re STN Enters.*, 779 F.2d 901, 905 (2d Cir. 1985)); *see also In re Xonics*, 841 F.2d 198, 203 (7th Cir. 1988) (before derivative standing is granted, party must show that "debtor was shirking [its] statutory responsibilities"); *Official Comm. of Unsecured Creditors v. Clark (In re Nat'l Forge Co.)*, 326 B.R. 532, 548 (W.D. Pa. 2005) (noting that "courts generally perform a cost-benefit analysis of the claims to determine 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.").

101. Here, the Equity Committee cannot demonstrate that the Debtors have unjustifiably refused to bring the frivolous claims that form the basis of the Complaint. The Debtors themselves have been given access to and have reviewed the same materials that were

provided to the Equity Committee and "see not a scintilla" of merit in the Equity Committee's claims. *See* Debtors' Supplemental Response to the Objection of the Official Committee of Equity Security Holders to Confirmation of the Modified Sixth Amended Plan of Reorganization at ¶ 4 (the "Debtors' Supplemental Confirmation Response") (D.I. 8188).

102. The Debtors' Supplemental Confirmation Response sets forth in detail the Debtors' reasons for rejecting the Equity Committee's allegations. *Id.* at ¶¶ 20-47. The Debtors concluded that those allegations are "libelous" (*id*. at ¶ 2) and "wrong on every level" (*id*. at ¶ 20), and criticized the Equity Committee's attempt to pursue claims against Aurelius and Centerbridge as "one more example of an endless desire to spend estate resources on litigations for tactical purposes" (*id*.).

103. While the Equity Committee predictably – though implausibly – contends that the Debtors themselves conspired to permit unlawful trading activities, rendering them "incapable of acting in the Estate's best interest" (Motion to Authorize ¶ 15), the Creditors' Committee independently came to the same conclusion as the Debtors. Given the seriousness of the allegations, the Creditors' Committee "undertook to evaluate the evidence and form its own opinion as to the propriety of the challenged conduct." *See* Reply of the Official Committee of Unsecured Creditors to Insider Trading and Equitable Conduct Arguments Set Forth in Objection of the Official Committee of Equity Security Holders to Confirmation of the Modified Sixth Amended Plan of Reorganization at p. 1 (D.I. 8184).

104. And the results of that undertaking demonstrate that the Debtors were entirely justified in refusing to pursue the claims asserted in the Complaint:

> The Creditors' Committee's review of documents and testimony produced in the course of the Equity Committee's Rule 2004 investigation . . . as well as the record in this case, has not revealed *any basis* to find that the securities trading cited by the Equity Committee as the basis for

> overturning the GSA, denying confirmation of the Plan and disallowing contract-rate interest for the Settlement Note Holders and other creditors was unlawful or that the conduct of the Settlement Note Holders was inequitable.
>
> *   *   *
>
> Regardless of the legal principles upon which this Court bases its analysis, nothing has come to the attention of the Creditors' Committee that would suggest that the Settlement Note Holders have engaged in conduct that might warrant reconsideration of the GSA, denial of confirmation or any of the other extreme consequences advocated by the Equity Committee. To the contrary, the documents and deposition testimony reviewed by the Creditors Committee do not reflect *any evidence* of improper use of confidential information obtained during the cases.

Id. at 1-2 (emphasis added).

105. The Creditors' Committee's unequivocal rejection of these claims should be conclusive, because it is the unsecured creditors who are the real parties in interest here. The undisputed evidence at the Confirmation Hearing demonstrated that the Equity Committee's constituents are hopelessly out of the money. The Liquidation Analysis projects that there will be a shortfall of more than $700 million from what is necessary to pay the unsecured PIERS creditors in full. The Equity Committee's constituents simply do not have a dog in this fight, and consequently their fiduciary should have little say in how the estates spend their money to maximize value for those who do.

106. The Adelphia bankruptcy proceedings involved an instructive variation on the situation now before this Court. There, an equity committee obtained standing to pursue certain claims on behalf of the debtor's estate. *Adelphia Commc'ns Corp. v. Bank of Am., N.A. (In re Adelphia Commc'ns Corp.)*, 330 B.R. 364 (Bankr. S.D.N.Y. 2005). While the bankruptcy court initially questioned the merits of those claims, the debtors did not object to standing at the time and the equity committee's claims added little burden to the estate since they were to be

asserted as an adjunct to more legitimate claims being pursued by the creditors' committee. *Id*. at 385-86.

107. However, as the *Adelphia* cases progressed, it became apparent that the equity holders – like the Equity Committee's constituents here – were out of the money. Accordingly, the bankruptcy court *withdrew* the equity committee's standing. *See Official Comm. of Equity Sec. Holders v. Adelphia Commc'ns Corp. (In re Adelphia Commc'ns Corp.)*, 371 B.R. 660, 664 (S.D.N.Y. 2007). The district court affirmed the bankruptcy court's decision in that regard. The district court explained that the bankruptcy court properly determined that, because the equity holders were "so far out of the money, it would have an inherent conflict of interest in controlling any litigation." *Id*. at 673. Indeed, "given the order of priority for recoveries, *the Equity Committee would always have the incentive to do nothing but swing for the fences*." *Id*. (citation omitted) (emphasis added).

108. Swinging for the fences is the most charitable way to describe what the Equity Committee is doing here. Rather than accept the reality that there are simply insufficient assets in the Debtors' estates to provide for a distribution to equity holders in accordance with the priorities set forth in the Bankruptcy Code, the Equity Committee has dreamed up claims out of thin air based on nothing but the uninformed musings of a pro se equity security holder (Mr. Thoma) who did not even participate in the recent Confirmation Hearing to pursue those claims himself. After six months of discovery and trial, the improper trading charges have no more substance than they did at the outset. This remains an unconscionable shake-down campaign rather than a legitimate litigation.

109. Ironically, it is the Equity Committee's litigation tactics – rather than anything done by Aurelius or the other Settlement Noteholders, who acted only to facilitate a

consensual resolution of these cases – that have grievously injured these estates by forcing months of needless litigation and causing the accrual of hundreds of millions of dollars in additional post-petition interest and administrative expenses. The pursuit of this baseless litigation would lead to further gross waste of estate assets to pay the legal fees of the Equity Committee, Creditors' Committee, and Debtors, and would unfairly cause Aurelius and Centerbridge to incur millions of dollars in needless additional expense. Beyond the out-of-pocket costs, the continued pendency of these baseless but grave allegations would consume the time and attention of senior officers at the defendant firms, as well as keeping a cloud of uncertainty over the heads of investment professionals whose livelihoods and careers depend on maintaining investor confidence in their honesty and integrity. This litigation is not a legitimate, much less reasonable or necessary, expenditure of estate assets.

110. In sum, the Equity Committee cannot demonstrate that the Debtors have unjustifiably refused to pursue the claims asserted in the Complaint. Accordingly, the Equity Committee's Motion to Authorize should be denied.

CONCLUSION

For the reasons stated above, Aurelius respectfully requests that the Court deny the Motion to Authorize and grant such other and further relief as it deems just and proper.

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