IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re WASHINGTON MUTUAL, INC., *et al.*,[1] Debtors.	))))))))	Chapter 11 Case No. 08-12229 (MFW) Jointly Administered **Related Docket Nos. 8672, 8674, 8675, 8727, 8781**

THE OFFICIAL COMMITTEE OF EQUITY SECURITY HOLDERS' OPPOSITION TO THE MOTIONS FOR LEAVE TO APPEAL FILED BY AURELIUS CAPITAL MANAGEMENT L.P., THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS, APPALOOSA MANAGEMENT L.P., CENTERBRIDGE PARTNERS, L.P. AND OWL CREEK ASSET MANAGEMENT, L.P. AND THE JOINDER FILED BY THE DEBTORS

Dated: October 14, 2011

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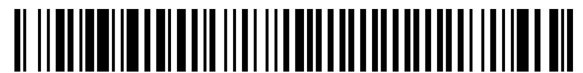
[1] Debtors in these Chapter 11 cases and the last four digits of each Debtor's federal tax identification numbers are: (i) Washington Mutual, Inc. (3725) and (ii) WMI Investment Corp. (5395). The Debtors are located at 925 Fourth Avenue, Suite 2500, Seattle, Washington 98104.



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FOR THE DISTRICT OF DELAWARE

In re	)	Chapter 11
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WASHINGTON MUTUAL, INC., *et al.*,[1]	)	Case No. 08-12229 (MFW)
	)	
Debtors.	)	Jointly Administered
	)	
	)	**Related Docket Nos. 8672,**
	)	**8674, 8675, 8727, 8781**

THE OFFICIAL COMMITTEE OF EQUITY SECURITY HOLDERS' OPPOSITION TO THE MOTIONS FOR LEAVE TO APPEAL FILED BY AURELIUS CAPITAL MANAGEMENT L.P., THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS, APPALOOSA MANAGEMENT L.P., CENTERBRIDGE PARTNERS, L.P. AND OWL CREEK ASSET MANAGEMENT, L.P. AND THE JOINDER FILED BY THE DEBTORS

The Official Committee of Equity Security Holders (the "Equity Committee") respectfully submits this opposition to motions for leave to appeal certain portions of the Bankruptcy Court's September 13, 2011 Order (the "Order") [Docket No. 8613] and Opinion (the "Opinion") [Docket No. 8612] that were filed by Appaloosa Management L.P. ("Appaloosa"), Centerbridge Partners, L.P. ("Centerbridge"), Owl Creek Asset Management, L.P. ("Owl Creek") (Appaloosa, Centerbridge, and Owl Creek filed a joint brief in support of their motions for leave to appeal and are referred to collectively as "AOC") [Docket Nos. 8674, 8675], Aurelius Capital Management, L.P. ("Aurelius" and collectively with AOC the "Settlement Note Holders" or "SNH") [Docket No. 8672], and the Official Committee of Unsecured Creditors ("Creditors Committee") [Docket No. 8727] and the joinder filed by the Debtors [Docket No. 8781].[2]

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

[2] By agreement of the parties, the Equity Committee's deadline to respond to the motions for leave to appeal was extended until October 14, 2011.

I. PRELIMINARY STATEMENT

The motions for leave to appeal seek premature review, at a point when a complaint has not even been filed, of claims against four distressed-debt hedge funds (the Settlement Note Holders) for trading in the Debtors' securities while in possession of material, non-public information. At this point, the Bankruptcy Court has done nothing more than find that these claims are colorable and authorized the Equity Committee to pursue them in the name of the Debtors. The Bankruptcy Court made this determination based, in part, on several days of testimony concerning the hedge funds' participation in confidential settlement negotiations and their trading activities. Both the legal basis and the evidentiary support for these claims is unassailable, and the hedge funds' effort to derail the litigation through this premature and unjustified interlocutory appeal should be rejected.

Evidence adduced at the hearing demonstrates that the SNH entered into confidentiality agreements with the Debtors in order to participate in the Debtors' negotiations concerning settlement of multi-billion dollar claims with JPMorgan Chase Bank, N.A. ("JPMC"). During those negotiations, which led to a $6 billion settlement for the Estates within one year, JPMC made a series of ever-increasing offers that would have made several classes of the Debtors' securities whole. The content of these negotiations were never publicly disclosed. While in possession of this confidential information, the SNH acquired tens of millions of dollars worth of WMI securities in the public bond markets. Not surprisingly, these acquisitions frequently demonstrated that the SNH were taking advantage of their knowledge to acquire bonds that would provide a

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The Bankruptcy Court transmitted Aurelius' motion for leave to appeal to the District Court on October 13, 2011, and AOC's motion for leave to appeal on October 14, 2011, prior to the filing of this opposition. The motion for leave to appeal filed by the Creditors Committee (as well as the joinder filed by the Debtors) has not yet been transmitted to the District Court. Since the Equity Committee submits this combined response in opposition to all three motions (as well as to the joinder), it is being filed in both the Bankruptcy Court and the District Court.

significant profit if JPMC's most recent offer (or a still-greater future offer) were accepted. It is undisputed that the SNH stand to collect hundreds of millions of dollars in profits on the steeply discounted WMI securities that they acquired after the bankruptcy.

By seeking an immediate appeal and reversal as a matter of law, the hedge funds are trying to establish legal insulation for a business model that depends on their ability to exploit confidential information obtained through the bankruptcy system. No court should sanction this misconduct. Appeal of the Bankruptcy Court's carefully-reasoned decision should be denied, and the Equity Committee should be permitted to commence their adversary case on behalf of the Debtors and proceed to discovery.

II. FACTUAL BACKGROUND

Immediately after Washington Mutual Bank's holding company parent WMI filed for bankruptcy protection on September 25, 2008, hedge funds specializing in distressed debt began acquiring large amounts of WMI's bonds. These sizable holdings allowed the funds, either alone or in coalitions with other funds, to assume a prominent role in the management of the bankruptcy, working closely with the Debtors' professionals to resolve major litigation on behalf of the Debtor and draft a plan of reorganization. At the same time, at least four of these funds – the Settlement Note Holders – continued trading the Debtors' securities. Because their role in the Debtors' affairs gave the SNH access to non-public information bearing on the ultimate recovery anticipated by the Estates, this trading activity constituted unlawful insider trading, or, at the very least, an inequitable abuse of the hedge funds' position in the management of the bankruptcy.

Much of the non-public information obtained by the SNH related to settlement of the Debtors' claims against JPMC and the FDIC. WMI's bankruptcy had been precipitated by the seizure of Washington Mutual Bank ("WMB") by the Office of Thrift

Supervision and the FDIC's almost simultaneous pre-arranged sale of substantially all of WMB's assets to JPMC. In the wake of the seizure and sale, ownership of a number of multi-billion dollar assets were in dispute, including over $4 billion in deposits WMI had with WMB, billions in tax refunds, and an even greater amount of collateral that had been tied to securities issued by WMI. In addition, WMI had tort claims against JPMC for alleged actions that contributed to the failure of WMB and for conspiring with other potential bidders for WMB's assets. No other assets or claims held by the WMI estate even approached the potential value of these disputes with JPMC, which ultimately were settled for an amount just shy of making all $7 billion-plus of WMI creditors whole.

Intensive negotiations with JPMC began no later than March 2009, a year before the global settlement agreement ("GSA") with JPMC and the FDIC was announced publicly in March 2010. During this year, as far as the public was aware, the Debtors and JPMC were locked in contentious litigation. Complaints were filed by both parties in the Bankruptcy Court, and WMI also filed suit against JPMC in Washington D.C. The Debtors sought and received authorization from the Court to obtain discovery from JPMC under Bankruptcy Rule 2004, and then near the end of 2009 sought to expand the discovery, but were denied permission to do that under Rule 2004. The Debtors also filed a summary judgment motion seeking ownership of the $4 billion in deposits, which JPMC opposed. The Bankruptcy Court had heard oral argument on that motion, but had not yet ruled, when the GSA was announced.

What the SNH knew, but the public did not, was that during this apparently litigious period the Debtors were conducting a series of negotiations with JPMC that brought the two parties ever closer to reaching a deal. Beginning with the first session at which actual terms were exchanged, which occurred in early March 2009, the Debtors

invited the SNH to participate in negotiations. The SNH were involved in, or at least aware of, the exchange of term sheets on several subsequent occasions through December 2009. Two of the SNH, Appaloosa and Centerbridge, contacted JPMC on their own, without the involvement of the Debtors, and exchanged term sheets in July and August 2009, which became the basis for further negotiations in which the Debtors (along with the SNH) were directly involved.

The structure of the offers and counter-offers in this negotiation would have been particularly informative for any investor trying to predict the ultimate recovery for the Estates. The parties did not simply offer or demand a bottom-line amount, but broke down the term sheets into the different assets in dispute and proposed a resolution for each. Three of the assets had a value in excess of $4 billion each – specifically, the deposits WMI claimed to own at WMB, the tax refunds, and the collateral for the so-called "Trust Preferred" securities. The term sheets reflected that the parties agreed on the allocation of the first and third of these almost from the outset: in March 2009, subject to resolution of other outstanding issues, both JPMC and the Debtors agreed that the Debtors were entitled to the $4 billion in deposits and that JPMC would get the Trust Preferred collateral. JPMC's in-house counsel indicated in a statement that was given to the SNH that this division reflected JPMC's view of which entity was likely to prevail on each of these claims in litigation.

JPMC's concession on the deposit claim was an enormous boon to the Estates. This recovery alone would be very nearly sufficient to satisfy the claims of WMI's senior class of bonds. Further concessions by JPMC on the tax refunds and other items as the negotiations proceeded made significant recovery on junior bonds and other junior securities look very likely as well.

During the majority of 2009, when they were privy to this settlement information, the SNH continued very active trading in the Debtors securities. In order to participate directly in settlement talks during two periods, March-April and November-December 2009, the SNH agreed either to restrict their trading or to erect ethical walls between SNH participants in the negotiations and their trading desks. When these restrictions expired, however, the SNH resumed trading with no effort to insulate the trading decisions from the information about the progress of settlement talks that they had learned during the restricted periods. Even during the non-restricted periods, the SNH's outside counsel participated in negotiations and obtained confidential information from the Debtors. Although the SNH now claim that the attorneys shared none of this information with them, the Bankruptcy Court rightly found this testimony dubious at best.

The SNH's trading patterns support the notion that the funds were making trading decisions based on information learned in the settlement talks. Centerbridge and Aurelius, for example, both bought large quantities of debt securities shortly after each of the restricted periods ended. The classes of debt purchased by each reflect knowledge of what priority level of debt was likely to recover given the concessions JPMC had made in the most recent negotiations.

The Equity Committee has taken only limited discovery into the SNH's trading activities. The Bankruptcy Court granted discovery under Rule 2004, but only into the amount and timing of actual trades made by the SNH and the history of the JPMC settlement negotiations. The Equity Committee has taken no discovery into the SNH's internal analysis of their investment decisions and has only limited trading information. Only one deposition has been taken of each of the Settlement Note Holders. Despite

these limitations, the evidence that has been developed offers clear and detailed support for the Equity Committee's allegations that the SNH engaged in insider trading and the Bankruptcy Court's finding that the Equity Committee has asserted "colorable claims" against the Settlement Note Holders.

III. ARGUMENT

A. THE ORDER GRANTING STANDING TO THE EQUITY COMMITTEE IS NOT FINAL

The SNH and the Creditors Committee argue that this appeal should be heard as of right because the order granting standing to the Equity Committee (the "Standing Order") is a final order under the "flexible and pragmatic" interpretation of finality given to orders in bankruptcy. *See, e.g.*, *In re Amatex Corp.*, 755 F.2d 1034, 1039 (3d Cir. 1985).

Characterizing the Standing Order as final stretches to the breaking point even the "flexible" standards governing bankruptcy orders. The Standing Order *initiates* a case, it does not end one. It does not finally resolve any party's rights, the size of any claim, or any other disputed issue in the bankruptcy. Not surprisingly, courts have repeatedly found that orders granting standing are not final and not subject to immediate appellate review. *See, e.g.*, *Moran v. Official Comm. of Admin. Claimants*, 2006 WL 3253128, at *2 (N.D. Ohio Nov. 8, 2006), *aff'd*, 560 F.3d 449 (6th Cir. 2009); *In re Tile Outlet*, 2006 WL 1716125, at *4-5 (S.D. Tex. June 16, 2006); *In re Adelphia Commc'ns Corp.*, 2006 WL 1114054, at *2 (S.D.N.Y. Apr. 26, 2006).

As the SNH acknowledge, Third Circuit courts consider four factors when analyzing the finality of an order for purposes of appeal: (1) the impact of the order on the assets of the bankruptcy estate; (2) the necessity of further fact-finding on remand to the bankruptcy court; (3) the preclusive effect of the decision on the merits of subsequent

litigation; and (4) the furtherance of judicial economy. *See In re Armstrong World Indus., Inc.*, 432 F.3d 507, 511 (3d Cir. 2005). In their briefing, the SNH focus on the first and fourth factors, arguing that the order is final because, in their view, immediate appeal will avoid both estate expenditures on litigation and unnecessary court time. (AOC Br. at 11-12; Aurelius Br. at 17-18). This argument misapplies the factors to a distorted picture of this litigation and the WMI bankruptcy.

The cost to the estate of litigating the claims at issue against the SNH will not have a material impact on the estate. The Debtor currently projects that it will be distributing assets worth over $7 billion to its creditors. In this context, even the grossly excessive estimates of "tens of millions" in litigation expenses suggested by the SNH is not material. A more realistic estimate of those costs in the range of $3 to $5 million is even less significant. By contrast, the amount in dispute is apparently over $2 billion based on the face amount of the securities, potentially reflecting hundreds of millions in profits.[3] Certainly, litigation with these stakes in the context of a bankruptcy of this size does not present the type of potential squandering of estate assets that would justify treating this preliminary order as final and granting immediate appellate review.

Judicial efficiency presents a no more compelling case for appeal. The litigation against the SNH has been stayed by the Bankruptcy Court while the parties attempt to mediate a settlement, but that mediation is scheduled to conclude by no later than early December and, if it does not succeed in resolving the claims, litigation will commence. (Opinion at 138-39). Thus, if an appeal is granted, the litigation would be simultaneously proceeding along parallel tracks in two courts, the appeal in this Court and discovery in the Bankruptcy Court. This is not efficient, but wasteful. And the SNH are wrong to

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[3] As of October 5, 2010, the SNH have not disclosed the full amount of their current holdings of WMI securities.

suggest that the grounds they seek for reversal would definitively end the litigation. A number of the issues they raise, including claimed deficiencies in the pleading on several issues, the Bankruptcy Court's alleged failure to balance the costs and benefits of the litigation, and the decision to allow claims to proceed against Owl Creek and Appaloosa though they were not named in the initial Complaint attached to the Standing Motion, are all inarguably matters that could be addressed and cured on remand.

None of the factors used to determine the finality of bankruptcy orders is genuinely satisfied in this case, and this appeal cannot be heard on that basis.

B. THE ORDER DOES NOT MEET THE STRICT REQUIREMENTS FOR INTERLOCUTORY APPEAL

Because the Order is not final, it may be appealed only with the permission of this Court under 28 U.S.C. § 158(a)(3). To grant an interlocutory appeal, this Court must find three elements: (i) that the appeal addresses a controlling question of law; (ii) on which there is reasonable ground for disagreement; and (iii) immediate appeal will materially advance the bankruptcy. *See, e.g.*, *In re Phila. Newspapers*, 418 B.R. 548, 556-57 (E.D. Pa. 2009); *In re SemCrude, L.P.*, 407 B.R. 553, 556-57 (D. Del. 2009). The SNH and Creditors Committee have the burden of establishing that all three elements have been met here. *In re Prosser*, 2011 WL 2181619, at *2 (D.V.I. June 3, 2011).

Even if the SNH and Creditors Committee could establish these elements, and they cannot, interlocutory review remains discretionary. Leave to file an interlocutory appeal "is itself an extraordinary measure that is not lightly granted." *In re Frascella Enters. Inc.*, 388 B.R. 619, 623 (Bankr. E.D. Pa. 2008). The District Court may reject the appeal because, for example, it would prefer "to have a full record before considering the disputed legal issue." *In re SemCrude*, 407 B.R. at 557. In addition to the three requirements, the party seeking review has the burden to demonstrate that exceptional

circumstances exist. *Id.*

No exceptional circumstances justify immediate appellate review here. The rights of creditors other than the defendants are not implicated, nor is the Debtors' ability to proceed with plan confirmation and reorganization. The SNH are in the position of defendants who have lost an initial motion to dismiss (more accurately, a motion that precedes a motion to dismiss). Like others in that situation, the SNH undoubtedly feel that it would be "more efficient" if they can take a second shot with their legal arguments in an effort to have the case dismissed prior to discovery. Yet even the existence of potentially decisive legal issues does not justify routine interlocutory appeal of motions to dismiss. Nor can the same concerns justify interlocutory appeal of the Bankruptcy Court's preliminary order authorizing this adversary proceeding.

The SNH and Creditors Committee have assembled a host of complaints about the Bankruptcy Court's ruling. None of these issues is as controversial as the SNH contend and none justifies the extraordinary relief of an interlocutory appeal.

1. The Debtors Have Standing To Remedy Inequitable Conduct By An Estate Fiduciary

The SNH insist that no matter how egregious their misuse of the Debtors' confidential information, the Debtors lack standing to maintain this action. In the SNH's view, the Estates suffered no harm as a result of the insider trading, and so standing resides only with defrauded creditors. This argument ignores precedent in both bankruptcy cases and securities cases, both of which authorize an entity to bring an action against a fiduciary that has breached its duties by trading in securities while in possession of material non-public information.

The SNH insist that under bankruptcy precedent a debtor has no standing to bring a claim based on an injury to creditors. Case law addressing claims for equitable

subordination and equitable disallowance holds exactly the opposite. Indeed, one of the elements of a claim for equitable subordination is that "the misconduct must have resulted in injury *to the creditors* or conferred an unfair advantage on the claimant." *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986 (3d Cir. 1998) (citing *U.S. v. Noland*, 517 U.S. 535, 538-39 (1996)) (emphasis added).

Equitable disallowance derives from the same principles and also allows the debtor to bring a claim to redress misconduct by one creditor, generally a fiduciary, who injured another. For example, the *Citicorp* case cited in the preceding paragraph addressed claims that a fiduciary had abused its position by acquiring the debtor's securities based on inside information. *Id.* at 986 (discussing injuries to creditors resulting from insider trading by a fiduciary). The Third Circuit held that the debtor had standing to seek equitable subordination or disallowance of the fiduciary's claims against the estate on the basis of the insider trading. *Id.* at 991 n.7. Similarly, in a case involving a major creditor that had used its influence over the debtor to negotiate loan terms that disadvantaged other creditors, the court found that equitable disallowance was an available remedy for the debtor. *In re Outdoor Sports Headquarters, Inc.*, 168 B.R. 177, 181 (Bankr. S.D. Ohio 1994) (rejecting the defendant's summary judgment argument that equitable disallowance is not available for conduct that injured creditors but not the debtor). Indeed, *Pepper v. Litton*, the Supreme Court's seminal case on equitable disallowance, endorses the proposition that such claims are a tool for remedying misconduct by one creditor that victimizes another. 308 U.S. 295, 311 (1939) (listing forms of inequitable conduct that may justify subordination or disallowance as including a fiduciary who "use[s] his power for his personal advantage and to the detriment of the

stockholders and creditors").

In the non-bankruptcy context, a corporation has standing to bring an action against a fiduciary who has engaged in insider trading even if the corporation cannot identify an injury that it has suffered as a result. Challenging this point, Aurelius claims that there is no legal support for the Bankruptcy Court's assertion that the Debtor here would have had a defense to the SNH's claims outside bankruptcy. (Aurelius Br. at 24). Aurelius is flat wrong. Just this past summer, the Supreme Court of Delaware issued an opinion reinforcing the long-standing principle that a corporation may bring a claim (known as a *Brophy* claim) against its own fiduciary for insider trading. *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 2011 WL 2447690 (Del. June 20, 2011). The Court held specifically that injury to the corporation is not a prerequisite for the claim, rejecting a position taken by a lower court in the *Pfeiffer* decision:

> We decline to adopt *Pfeiffer's* thoughtful, but unduly narrow, interpretation of *Brophy* and its progeny. We also disagree with the *Pfeiffer* court's conclusion that the purpose of *Brophy* is to "remedy harm to the corporation." In fact, *Brophy* explicitly held that the corporation did not need to suffer an actual loss for there to be a viable claim. Importantly, *Brophy* focused on preventing a fiduciary wrongdoer from being unjustly enriched. . . .
>
> We decline to adopt *Pfeiffer's* interpretation that would limit the disgorgement remedy to a usurpation of corporate opportunity or cases where the insider used confidential information to compete directly with the corporation. *Brophy* was not premised on either of those rationales. Rather, *Brophy* focused on the public policy of preventing unjust enrichment based on the misuse of confidential corporate information . . . .
>
> The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.

Id. at *6.

Thus, there is ample legal authority in bankruptcy and in securities cases for the

Debtors, and, derivatively, the Equity Committee, to assert claims against the SNH based on the use of non-public information to trade in the Debtors' securities.

2. Equitable Disallowance Is An Available Remedy In Bankruptcy

The Creditors Committee, among others, argue at length that equitable disallowance is not an available remedy. Their arguments are three-fold: (i) the Supreme Court, the Third Circuit, and the *Adelphia* District Court incorrectly recognized the validity of the equitable disallowance remedy; (ii) the Supreme Court's decision in *Traveler's* implicitly abrogated *sub silencio* prior Supreme Court precedent recognizing disallowance as a remedy; and (iii) prior Supreme Court precedent is distinguishable. For the reasons explained at length in Judge Walrath's Opinion and below, none of these arguments has any merit.

a. Equitable Disallowance Continues To Be A Valid Remedy

In *Pepper v. Litton*, the Supreme Court explicitly found that where an insider is guilty of a "violation of rules of fair play and good conscience," that may be a "sufficient consideration" to invoke equity to disallow the insider's claims. 308 U.S. at 311. In reaching that conclusion, the Court noted that a fiduciary "cannot serve himself first and his cestuis second," and in particular, "cannot utilize his inside information and his strategic position for his own preferment." *Id.* The Court went on to hold:

> [The creditor] cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

Id.

More recently, the Third Circuit has held that where an insider uses inside information to purchase a debtor's claims at a discount without prior disclosure, "[a]t a minimum, the remedy [] should deprive [the insider-fiduciary] of its profit on the purchases of the notes" and expressly declined to "endorse" the district court's conclusion that it was "without authority to fashion a 'disallowance remedy'" if needed to compensate the debtor's estate. *See Citicorp*, 160 F.3d at 991 & n.7; *Comm. of Unsecured Creditors v. Citicorp Venture Capital, Ltd.* (*"In re Papercraft, Corp."*), 253 B.R. 385 (Bankr. W.D. Pa. 2000) (on remand, further reducing insider's claim to account for additional administrative expenses, professional fees, lost interest, and other costs).

Finally, in the most expansive discussions of this topic in recent years, the *Adelphia* Bankruptcy and District Courts concluded that "equitable disallowance is permissible under *Pepper*" and its progeny, even after the passage of the Bankruptcy Code. *Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 64, 76 (S.D.N.Y. 2008) (quoting and affirming *In re Adelphia Commc'ns Corp.*, 365 B.R. 24, 71-73 (Bankr. S.D.N.Y. 2007)).

b. *Travelers* Does Not Silently Abrogate Prior Supreme Court Precedent

Notwithstanding this precedent, which Judge Walrath discussed and endorsed, the Creditors Committee, among others, argues that equitable disallowance does not exist as a remedy under the Bankruptcy Code. In particular, those seeking leave to appeal argue that under *Travelers Casualty & Surety Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), a court may not equitably disallow a claim because inequitable conduct is not one of Section 502(b)'s nine enumerated grounds for disallowing claims. (AOC Br. at 26-27; Aurelius Br. at 37-38.) The SNH also argue that the legislative history of Section 510, relating to equitable subordination, supports their argument because language about the

court's power to disallow claims was dropped before the final version of the Code was enacted. These arguments were considered and rejected by Judge Walrath and the bankruptcy and district courts in the *Adelphia* bankruptcy litigation.

First, Judge Walrath and the district court in *Adelphia* correctly noted that *Travelers* did not purport to overturn *Pepper v. Litton*'s clear holding that equitable disallowance is available under the appropriate circumstances as a remedy for inequitable conduct. *Adelphia*, 390 B.R. at 76 ("Nor does the Supreme Court's reading of 11 U.S.C. § 502(b) in [*Travelers*] suggest the abandonment of *Pepper v. Litton*."). Rather, *Travelers* more narrowly held that the so-called *Fobian* rule, a judge-made rule in the Ninth Circuit relating to attorney's fees, was not a viable ground for disallowance under Section 502(b). *Travelers*, 549 U.S. at 451-52. There was no allegation of inequitable conduct in *Travelers*, nor any appeal to the bankruptcy court's equitable powers. Indeed, when the parties attempted to argue that other equitable principles beyond the *Fobian* rule might support disallowance, the Court declined to reach the question because it was not briefed below. Thus, the Court "express[ed] no opinion with regard to whether, following the demise of the *Fobian* rule, other principles of bankruptcy law might provide an independent basis for disallowing Travelers' claim for attorney's fees." *Id.* at 456. Given that the Supreme Court did not reach other equitable grounds for disallowing the attorney-fee question in front of it, the decision cannot be read to preclude equitable disallowance theories, such as this one, that did not even touch on any issue in front of the Court. As Judge Walrath indicated, the narrow holding of *Travelers* simply has nothing to do with this case. (Opinion at 113 (characterizing *Travelers* as "holding that Bankruptcy Code does not bar contractual claim for attorneys' fees incurred during bankruptcy case because it was not disallowable under one of the nine exceptions to

disallowance under section 502(b)")).

Second, contrary to the SNH's arguments here, the absence of statutory language addressing disallowance is not tantamount to a clear rejection of the remedy. Indeed, the district court in *Adelphia* noted that, in deciding to drop the language from the final enactment, "Congress could have decided to do away with equitable disallowance, or it could have thought specific reference to it was superfluous." *Adelphia*, 390 B.R. at 76.

Third, in considering the viability of equitable disallowance, the bankruptcy court in *Adelphia* noted that the legislative history of Section 510 of the Bankruptcy Code specifically acknowledges the existence of disallowance as an appropriate remedy:

> This section is intended to codify case law, such as *Pepper v. Litton* . . . , and is not intended to limit the court's power in any way. . . . *Nor does this subsection preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances.*

Adelphia, 365 B.R. at 71 (quoting legislative history).[4] The court noted that this legislative history is persuasive in light of the absence of clear direction in the Bankruptcy Code itself. *Id.* Because of the lack of legislative history to the contrary, the *Adelphia* courts followed longstanding jurisprudential practice of assuming that pre-Code practices survived the enactment of the Code absent strong indications to the contrary. *See, e.g., Dewsnup v. Timm,* 502 U.S. 410, 419 (1992) ("this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history").

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[4] The SNH argue that *Adelphia* is wrongly decided merely because the bankruptcy court looked to the legislative history of the statute. This is an odd argument from parties who themselves use legislative history to make their argument to the contrary. (*See* AOC Br. at 28). Nevertheless, their argument is wrong. The court in *Adelphia* reasonably looked to other non-statutory sources given that the statute is silent on the issue of whether equitable disallowance is a viable remedy. The SNH's argument that the statute is clear on its face is misleading, given that the Code simply does not expressly address equitable disallowance either way.

c. The SNH's Misconduct Falls Squarely Within The Disallowance Theory

There is no merit to the suggestion that, if equitable disallowance is a viable remedy and if the SNH traded on material non-public information in violation of a duty not to, the facts in this case do not fall within the parameters of traditional equitable disallowance theory. In describing the equitable disallowance remedy in *Pepper*, the Supreme Court explicitly found that where an insider is guilty of a "violation of rules of fair play and good conscience," that may be a "sufficient consideration" to invoke equity to disallow the insider's claims. 308 U.S. at 311. In reaching that conclusion, the Court noted that a fiduciary "cannot utilize his inside information and his strategic position for his own preferment." *Id.* That is exactly what happened here.

3. The Equity Committee Is Not Required To Plead Or Prove The Elements Of Federal Securities Fraud

The SNH devote large sections of their briefing to arguments that various elements of a federal securities law violation cannot be met in this case. These arguments are fundamentally misguided. In assuming that the Equity Committee's complaint must strictly adhere to the technical requirements for pleading federal securities fraud, the SNH ignore the fact that the Equity Committee has alleged a claim for equitable disallowance, not a securities claim. As the Bankruptcy Court observes, the securities laws provide guidance and demonstrate the seriousness of the conduct at issue. (Opinion at 117). There is not, however, any absolute legal requirement that the inequitable conduct proved in these cases conform to every element of a state or federal securities law violation.

The Bankruptcy Court was confronted with the following undisputed facts:

> (a) the SNH acquired large quantities of WMI's debt securities at deeply discounted prices, at least partly with the intent of using their large positions to insinuate themselves into the management of the WMI estate;

(b) in conjunction with their involvement with the estate, the SNH participated in negotiations to settle, on the estate's behalf, multi-billion dollar claims against JPMC during which significant concessions were made by both sides that were not known to the public;

(c) the SNH traded in WMI's securities, both by buying and selling, while in possession of material information about these settlement talks that had not been disclosed to the public.

Even if this course of conduct did not constitute a "colorable" violation of the federal securities laws – and it does, as explained more fully below – it is unquestionably a "colorable" abuse of the bankruptcy process about which the Bankruptcy Court was justifiably concerned. Inequitable conduct is not confined to conduct that constitutes a federal crime. If, as suggested by these facts, certain powerful creditors have been able to exploit confidential information they obtained in the bankruptcy to take advantage of other less-powerful, and less-well-informed, parties-in-interest, and if the Debtors' own professionals were complicit in the scheme that allowed this to happen, there is no doubt that a remedy punishing the wrongdoers is a legitimate exercise of the Bankruptcy Court's equitable authority. *See, e.g.*, *Pepper*, 308 U.S. at 311; *Citicorp*, 160 F.3d at 991; *In re Papercraft*, 253 B.R. 385.

Although it is not essential to the Equity Committee's claims or to the Bankruptcy Court's finding that those claims are colorable, the allegations in the Complaint are sufficient to state a claim for insider trading under the federal securities laws. The SNH argue that two of the elements cannot be satisfied as a matter of law. First they insist that they owed no duty to other securities holders to refrain from trading when in possession of material, non-public information. Second, they argue that they lacked the requisite scienter. Neither of these arguments is persuasive, even assuming that federal securities law governs these claims. With respect to each of these elements, the Bankruptcy Court relied on well-established federal securities precedent to find colorable claims of

misconduct.

a. The Equity Committee Has Pled Facts Demonstrating A Fiduciary Duty

The SNH insist that the Bankruptcy Court committed an error of law in finding that they had a fiduciary duty to the Debtors in conjunction with the negotiation of the Global Settlement. According to the SNH, they were acting solely in their own interest and, because their relationship was governed by a contract, *i.e.*, the confidentiality agreements, they could not have assumed fiduciary duties as a matter of law. This argument fails to acknowledge the nature of the role played by the SNH and misconstrues federal securities case law on "temporary insiders."

The SNH's claim that they were acting solely in their own interest does not stand up to scrutiny. They were involved in negotiations with JPMC – at times negotiating on their own without the involvement of the Debtors' professionals – in order to settle claims on behalf of the Debtors, not on behalf of themselves. Any concessions they made or benefit they obtained would impact *all* of the Debtors' constituents, not only themselves. Most importantly, any information they received as part of this process, whether from the Debtors' professionals or from JPMC, was given to them in order to further the Debtors' interest in settlement (from which the SNH would benefit only indirectly), not to give the SNH a leg up in their trading decisions.

This situation fits the definition of a "temporary insider" perfectly. Under the relevant case law, "temporary insiders" are corporate outsiders who "have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." *Dirks v. S.E.C.*, 463 U.S. 646, 655 n.14 (1983). The SNH entered into such a relationship expressly by signing confidentiality agreements in order to participate in settlement negotiations. Under the

terms of these agreements, the SNH were being given access to confidential information "for the limited purpose of Participant's participation in negotiations among the Debtors, the [FDIC], JPMorgan Chase & Co."

Repeating an argument that failed to persuade the Bankruptcy Court, Aurelius tries to argue that the temporary insider doctrine applies only to "those who actually become insiders" such as lawyers and accountants. (Aurelius Br. at 29). It is not clear why Aurelius believes an accountant "actually becomes" an insider, but it and the other SNH did not. The point of the temporary insider doctrine is that individuals who are not traditional insiders (*i.e.*, who are not employees), but who are given access to confidential, internal information in order to advance the interests of the corporation, cannot then use that information to disadvantage securities holders to whom any insider owes a fiduciary duty. This doctrine prevents accountants who have early access to earnings information from trading based on that information. And, on the same principle, it prevents Aurelius, which had early access to JPMC settlement information, from trading based on that information. There is no meaningful distinction between these situations with respect to the policy that the securities laws were intended to advance.

Aurelius also argues that under New York law "the existence of an arm's length contract" prevents the formation of a fiduciary relationship. (Aurelius Br. at 28 (citing *LFD Operating, Inc. v. Ames Dep't Stores, Inc.*, 274 B.R. 600, 626 (Bankr. S.D.N.Y. 2002)). The case holds nothing of the kind, stating instead only the unremarkable proposition that an arm's length business transaction does not necessarily establish a fiduciary relationship. *Ames Dep't Stores, Inc.*, 274 B.R. at 626 (quoting *Oursler v. Women's Interart Ctr., Inc.*, 170 A.D.2d 407, 408 (N.Y. App. Div. 1991) (holding that "[a] conventional business relationship, without more, does not become a fiduciary

relationship by mere allegation")). Aurelius' absurd reading of these cases would mean that even attorneys and accountants lack fiduciary obligations since those relationships too are typically founded on "arm's-length contracts." Where a contract gives an outsider access to confidential, inside information in order to advance a corporate purpose, that contract establishes temporary insider status. The Bankruptcy Court's findings are perfectly consistent with this long-settled legal principle and there is no justification whatsoever for an extraordinary interlocutory appeal to reconsider the issue.

b. The Equity Committee Has Pled Scienter

Liability for federal securities fraud under Section 10(b)(5) requires proof that the misrepresentation or omission at issue created a danger of misleading buyers and sellers that was either known to the defendant or that is so obvious that the defendant must have been aware of it. *See, e.g., Majer v. Sonex Research, Inc.*, 541 F. Supp. 2d 693, 709 (E.D. Pa. 2008). To raise a strong inference of scienter based on recklessness, securities fraud plaintiffs must allege conduct that is highly unreasonable and represents an extreme departure from the standards of ordinary care. *In re Pfizer, Inc. Sec. Litig.*, 538 F. Supp. 2d 621, 636 (S.D.N.Y. 2008). Direct evidence of a defendants' state of mind is understood to be rarely available and is not required; scienter is most frequently established through circumstantial evidence. *See, e.g., S.E.C. v. Espuelas*, 698 F. Supp. 2d 415, 426 (S.D.N.Y. 2010) (holding that scienter can be proved either through facts showing that the defendant had motive and opportunity to commit fraud or other circumstances showing a strong inference of conscious misbehavior or recklessness.)

In the decision below, the Bankruptcy Court found that the Equity Committee had pled a colorable claim of scienter based on several allegations. First, the Bankruptcy Court noted the amount and significance of the non-public information in the SNH's

possession. The settlement negotiations with JPMC focused on the most significant and valuable assets of the estate, and agreements between the parties on various components of the settlement were, on their own, sufficient to make senior classes of WMI securities whole. This information was so obviously material that any investor, particularly a sophisticated player in the distressed debt markets, who claims otherwise raises serious doubts about his or her credibility.

Contrary to representations in Aurelius' brief, however, the materiality of the information in the SNH's possession was not the only circumstantial evidence of scienter considered by the Bankruptcy Court. The SNH's own buying patterns give strong support for the allegation that the SNH understood the significance of the settlement negotiations and therefore also understood the unfair advantage they had over sellers who were not privy to the same information. Immediately after the expiration of the lock-up periods, several of the SNH started acquiring large quantities of bonds, frequently in classes that were most likely to be impacted by settlement concessions that had been made in the most recent round of talks.

The SNH contend that at least some of these purchases may be explained by other factors. These explanations do not stand up to scrutiny, as the Equity Committee demonstrated at the evidentiary hearing. For example, the SNH contend that May 2009 purchases of securities were driven by the Debtors' public disclosure of the amount of a tax refund. But this tax refund was disclosed on April 30th and Aurelius, who was not restricted during this period, did not begin acquiring significant quantities of subordinated securities until May 11th. By that time, of course, the market had completely absorbed any increase in value attributable to the tax refund. But what the market had not absorbed was the confidential information about JPMC settlement talks, information that

Aurelius was first able to take into account in its trading decisions on that very day (but which was still not disclosed to the public at large.)

Additional circumstantial evidence of scienter is provided in the SNH's own internal policies on insider trading. These policies make a number of points establishing the materiality of the non-public information at issue here, and thus demonstrate that the SNH were aware that trading without disclosing the information was deceptive. For example, the policies emphasize that negotiations for significant deals such as mergers need not be finalized to be material and that even preliminary stages of negotiations may be relevant to market participants if the deal is of sufficient magnitude. This policy guidance (which tracks the securities laws) not only demonstrates that the SNH understood the significance of the non-public information they had, it calls into question the credibility of their witnesses at the evidentiary hearing, each of whom disclaimed the materiality of the JPMC negotiations because the terms were not finalized. This dubious testimony is itself further evidence that the SNH not only did something wrong, they knew it and are now trying to excuse or cover it up. (*See* Opinion at 137 (finding the SNH's testimony that their attorneys were not sharing confidential information about settlement talks lacking in credibility)).

Aurelius argues that the Bankruptcy Court erred in failing to employ an analysis of scienter required by the Private Securities Litigation Reform Act of 1995 (PSLRA). (Aurelius Br. at 31-32). Even if it were true, this argument is irrelevant. The Equity Committee's proposed Complaint does not plead a cause of action for federal securities fraud and so need not satisfy the pleading requirements for such a claim.

The SNH also insist that scienter cannot be demonstrated because the Debtors' professionals authorized the funds to resume trading, knowing that the details of the

settlement discussions had not been disclosed. AOC insists that the Equity Committee cannot demonstrate the necessary deception because the Debtors' authorization of trading shows that they were not deceived. (AOC Br. at 31). This argument misses the point that it is not the Debtors' professionals who are the victims of the deception at issue, but other WMI securities holders. *See GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 239 (3d Cir. 2004) (holding that recklessness is shown by a departure from the ordinary standard of care that "presents a danger of misleading *buyers or sellers*" (emphasis added)).

AOC's citation to the Supreme Court's opinion in the *O'Hagan* case is off-point. That case addressed a misappropriation claim, which involves a duty to the source of the information, not an insider or temporary insider claim, such as this one, which involves a duty to the entity's investors. *See United States v. O'Hagen*, 521 U.S. 642, 652, 655 (1997) (distinguishing between classical insider liability based on a duty to investors and misappropriation liability based on a duty to the source of the information and holding that misappropriation cannot be found when the source of the information authorizes its use).

For its part, Aurelius relies upon the Debtors' awareness of the SNH's trading activities as factual evidence that "undercuts" evidence of scienter. (Aurelius Br. at 32). The Bankruptcy Court considered this evidence and rejected it. (Opinion at 134-35). At most, Aurelius has only identified a piece of evidence that it believes weighs against the Bankruptcy Court's conclusions. This evidentiary dispute is no grounds for appeal, certainly not for the immediate interlocutory appeal sought by the SNH.

4. Authorizing Suit To Be Filed Against Owl Creek And Appaloosa Did Not Infringe Their Rights

Appaloosa and Owl Creek argue that the Bankruptcy Court's authorization of the

filing of a complaint against them fails to comport with due process because they were not given sufficient notice and opportunity to oppose such an action. There is no legal or factual basis for this claim whatsoever. Granting interlocutory appellate review of this issue would be a pointless waste of resources, and the issue certainly cannot support a motion for leave to appeal an interlocutory order.

First, there is no legal support for the notion that Owl Creek or Appaloosa had a due process right to oppose the filing of a complaint. Of course, suits are filed constantly in our legal system against defendants who have been given no opportunity to "oppose" the filing. Nothing in the Bankruptcy Court's Opinion and Order deprives Owl Creek or Appaloosa of any of the due process protections afforded defendants in any other federal court litigation. AOC relies on a case holding that the entry of judgment without an opportunity to be heard constitutes error. (AOC Br. at 37 (citing *Chambers Dev. Co., Inc. v. Passaic County Utils. Auth.*, 62 F.3d 582, 584 n.5 (3d Cir. 1995)). Of course, entry of judgment is not equivalent to an order authorizing suit to be filed, and this case is utterly off point.

Because this suit will be filed by the Equity Committee acting on behalf of the Debtor in a bankruptcy, a motion for leave to proceed was required. But the purpose of this requirement is not to protect defendants from having to defend the claim, it is to protect debtors from having to fund baseless litigation. *See, e.g.*, *In re Baltimore Emergency Servs. II, Corp.*, 432 F.3d 557, 563 (4th Cir. 2005); *In re Copperfield Invs., LLC*, 421 B.R. 604, 609 (Bankr. E.D.N.Y. 2010).

Moreover, Owl Creek and Appaloosa were on ample notice that claims might be filed against them for insider trading, and the Court's decision to authorize suit was based on an extensive record about their trading practices. The Equity Committee indicated

both before and after the evidentiary hearing that it was reserving its right to pursue claims against Owl Creek and Appaloosa. (Equity Committee Standing Motion [Docket No. 8179] at 7). Certainly the Bankruptcy Court's question to counsel for the Equity Committee at post-hearing oral argument about whether the Committee intended to limit its suit to the other SNH would have put Owl Creek and Appaloosa on notice that the Bankruptcy Court was considering authorizing the claims.

Finally, and most importantly, evidence supporting the claims against Owl Creek and Appaloosa is more than sufficient to sustain the claims on the same basis as those against the two other SNH. When deciding to authorize the claims, the Bankruptcy Court had the benefit of four days of testimony on the insider trading allegations, including hours of testimony by representatives of both Owl Creek and Appaloosa. The Court also had hundreds of pages of post-trial briefing (including briefs filed by Owl Creek and Appaloosa), much of which addressed the merits of the insider trading allegations. The Bankruptcy Court undoubtedly concluded, for good reason, that proceeding against all four Settlement Note Holders from the outset would be more efficient and less burdensome on the Estates than proceeding against only two with the likelihood that two more suits would be filed at a later date. Given the overwhelming record evidence supporting the colorability of the claims, there is no doubt that reversal on this issue would be an empty exercise, leading only to the entry of a second order authorizing the same litigation.

5. The Bankruptcy Court Weighed The Burdens And Benefits Of The Litigation

The SNH contend that the Bankruptcy Court's decision must be reversed because the Court failed to compare the burdens of the litigation to the potential benefits. Remarkably, in making this argument, the SNH cite to the very section of the Opinion

where the Court makes it clear that it has performed precisely this analysis. (Aurelius Br. at 38-41 (citing Opinion at 138)). Indeed, in considering this question, the Court cites most if not all of the "burdens" described by the SNH, including costs to the estate and delay in resolution of these claims. (Opinion at 138). After considering these factors, the Bankruptcy Court concluded that the potential burdens are sufficiently substantial that it would order the parties to mediate in an attempt to resolve the claims prior to litigation, but not so substantial that it would preclude the litigation altogether. (*Id.*). Apparently, although the conclusion of the balancing analysis is perfectly clear on the face of the Opinion, the SNH seek reversal because of the Bankruptcy Court's omission of explicit language along the lines of "I have weighed the costs and benefits of litigation." But there are no magic words that a Bankruptcy Court must repeat in order to satisfy this requirement. The Opinion cites the test, discusses the factors, and then reaches a conclusion. Granting appellate review of this issue would be a ridiculously technical and pointless exercise, and the SNH's argument does not remotely approach the "extraordinary" showing necessary to justify interlocutory appeal.

6. The Bankruptcy Court Did Not Establish A *Per Se* Rule Requiring Ethical Walls

The SNH and Creditors Committee insist that the Bankruptcy Court has erected a new *per se* rule barring creditors in bankruptcy from participating in settlement negotiations unless they have erected an internal ethical wall and maintain it throughout the pendency of the case. This is a gross misreading of the Opinion. First, despite the undisputed violation of this supposed *per se* rule, the Bankruptcy Court has not entered judgment against the SNH for insider trading. It has only found that claims for insider trading are colorable and may be litigated. If a *per se* rule were the Bankruptcy Court's intent, the further discovery and litigation anticipated by the Court would not be

necessary as liability would already have been proven.

Read in context, the intent of the Bankruptcy Court in this section of the Opinion is clearly not the novel rule that the SNH suggest. The Court was responding to an argument by the SNH that a finding of insider trading in this case would chill creditor involvement in bankruptcy proceedings and settlement negotiations in particular. (Opinion at 137-38). The Court points out that creditors' involvement in settlement talks and other affairs of the debtor would be free of any risk if the creditors establish ethical walls. (*Id.*). The Court did not find that the failure to maintain such a wall establishes liability, as a *per se* rule would require, only that the failure to maintain the wall has the *potential* to expose creditors to material, non-public information, and thus the *potential* for insider trading liability. In other words, if the risk of insider trading liability would be to chill creditors' willingness to participate in the bankruptcy, then the creditors can easily remove that chill by erecting and maintaining an internal ethical wall between the bankruptcy and the traders.

In essence, the Bankruptcy Court held nothing more surprising or controversial than that creditors who obtain access to confidential information about a publicly traded debtor may be subject to insider trading liability. Indeed, it is the SNH who hope to establish a *per se* rule, a rule that would permit them and many others like them to continue to trade in public securities markets with impunity while in possession of confidential information about a debtor, no matter how significant or material that information happens to be. By insisting that they are insulated, as a matter of law, from scrutiny for insider trading, the SNH seek absolute protection for a business model based on their ability to obtain confidential information from a debtor and then trade in a less-well-informed market. Arbitrage of this information gap unquestionably violates the

intent of the securities laws and constitutes an inequitable abuse of the bankruptcy process, as commentators have warned. *See* Mark J. Krudys, *Insider Trading By Members Of Creditors' Committees – Actionable!*, 44 DePaul L. Rev. 99, 142 (1994). Contrary to the alarmist rhetoric in the SNH's briefs, the Bankruptcy Court's Opinion in this case is not a threat to the integrity of the bankruptcy system; it is instead a substantial step in the direction of restoring that integrity.

7. Appeal Of The Court's Ruling On The Correct Post-Petition Rate Of Interest Is Premature

In addition to the issues in the portion of the Opinion granting standing to the Equity Committee, Aurelius also seeks leave to appeal the Bankruptcy Court's ruling that post-petition interest on the claims in this bankruptcy will be paid at the federal judgment rate. Appeal of this issue is premature because no plan has been confirmed and no final order has yet been entered on payment of claims or post-petition interest. This portion of the Bankruptcy Court's Opinion does not constitute a final order appealable as of right. Nor can Aurelius satisfy the requirements for an interlocutory appeal.

IV. CONCLUSION

For these reasons, the motions for leave to appeal filed by Aurelius, AOC, and the Creditors Committee should be denied.

Dated: October 14, 2011
Wilmington, Delaware

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