IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

	)	Chapter 11
In re:	)	
	)	Case No. 08-12229 (MFW)
WASHINGTON MUTUAL, INC., *et al.*,[1]	)	Jointly Administered
	)	
Debtors	)	Obj. Deadline: January 25, 2012
	)	Hearing Date: January 18, 2012
	)	Related to Docket No. 9358

OPPOSITION TO MOTION OF WASHINGTON MUTUAL, INC., AND WMI INVESTMENT CORP. FOR AN ORDER PURSUANT TO BANKRUPTCY RULE 9024, FEDERAL RULE OF CIVIL PROCEDURE 60(b) AND SECTION 105(a) OF THE BANKRUPTCY CODE, TO VACATE, IN PART, THE SEPTEMBER OPINION AND SEPTEMBER ORDER, AS A CONDITION OF MEDIATED SETTLEMENT EMBODIED IN THE SEVENTH AMENDED PLAN

1. VR Global Partners, L.P., The Visium Funds, Black Horse Capital, Greywolf Capital Management LP, and Pine River Capital, L.P. (collectively, "the TPS Group"), by and through their undersigned counsel, submit this memorandum in opposition to the motion of Washington Mutual, Inc. and WMI Investment Corp. (collectively, "the Debtors"), on behalf of Aurelius Capital Management LP ("Aurelius"), Centerbridge Partners, LP ("Centerbridge"), Appaloosa Management, L.P. ("Appaloosa"), and Owl Creek Asset Management, L.P. ("Owl Creek") (collectively, with their respective affiliates, "the Settlement Noteholders"), to vacate portions of this Court's opinion and order of September 13, 2011 (the "September Opinion").[2]

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[1] The Debtors in these chapter 11 cases along with the last four digits of each Debtor's federal tax identification number are: (i) Washington Mutual, Inc. (3725); and (ii) WMI Investment Corp. (5395). The Debtors' principal offices are located at 925 Fourth Avenue, Seattle, Washington 98104. Unless otherwise indicated, capitalized terms us herein shall have the meanings ascribed by the Seventh Amended Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code [Docket No. 9178] (hereinafter, the "Plan").

[2] Although other parties have indicated their non-opposition to the motion (*see* Motion of Washington Mutual, Inc., and WMI Investment Corp. for an Order Pursuant To Bankruptcy Rule 9024, Federal Rule of Civil Procedure 60(b) and Section 105(a) of the Bankruptcy Code, To Vacate, in Part, the September Opinion and September Order, As a Condition Of Mediated Settlement Embodied in the Seventh Amended Plan, dated January 9, 2012 (the "Motion") ¶ 1), the Settlement Noteholders are the only parties who actively desire the specific relief requested (*see id.* ¶ 18).

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PRELIMINARY STATEMENT

2. Vacatur as a condition of settlement is barred by binding Supreme Court and Third Circuit precedent. The Court therefore should deny the Debtors' request that the Court issue an "order" stating that it is inclined to grant the motion to vacate.

3. Based on the extensive evidentiary record developed during four days of testimony this past summer, the Court concluded that "the Equity Committee and TPS Group have stated a colorable claim that the Settlement Noteholders engaged in insider trading." (September Opinion at 137.) The Court thus granted standing to the Equity Committee to pursue claims of inequitable conduct against the Settlement Noteholders. (*Id.* at 139.) The evidence on which the Court relied was virtually unrefuted. And yet, with no additional discovery, the Plan Proponents now present a settlement in which the Settlement Noteholders pay nothing, and no part of their claims are disallowed. The only consequence to the Settlement Noteholders is that they stand to make a 7 percent profit on future secured loans to the Reorganized Debtor. For this they receive full releases and a seat on the board of directors of the Reorganized Debtor.

4. But perhaps the most breathtaking aspect of the Plan is the requirement that this Court vacate more than 30 pages of its September 13, 2011, opinion addressing several key issues, including the availability of a claim for equitable disallowance, the impact of confidentiality agreements and "cleansing" provisions, and various insider trading issues (including the materiality of settlement negotiations in bankruptcy cases).

5. This requirement runs afoul of the Supreme Court's decision in *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994), which is controlling. As the Supreme Court held in *Bonner Mall*, a party forfeits its right to seek vacatur of an order when it moots its appeal of that order by settlement. While the Supreme Court held that exceptional circumstances "may conceivably counsel in favor of such a course," such circumstances "do not

include the mere fact that the settlement provides for vacatur." *Id.* at 29. Even if such circumstances exist, the Court must find that the public interest would be served by vacatur. *Id.* at 26.

6. No such circumstances are present here. To the contrary, the Court's rulings regarding the inequitable conduct claims against the Settlement Noteholders are a matter of serious and widespread public interest. The Court's rulings—unquestionably accurate and fully supported by the evidentiary record—have had a significant impact in this proceeding, and have been addressed by numerous commentators. The Plan requirement that the Court simply sweep its ruling "under the rug" is nothing less then an assault upon the integrity of this Court and the bankruptcy process.

7. The Settlement Noteholders—the parties who demanded the vacatur condition—bear the burden of showing "equitable entitlement to the extraordinary remedy of vacatur." *See id.* at 26. These parties, however, do not submit any justification to the Court for this provision, by affidavit, brief, or otherwise. The reason for this failure is obvious: any conceivable arguments that the Settlement Noteholders could make in support of vacatur have been repeatedly rejected by courts in this Circuit.

8. Instead, the Plan Proponents have decided that the Debtors alone should move for vacatur. However, the Debtors fail to identify any extraordinary or exceptional circumstances justifying vacatur. The Debtors argue that unless vacatur is granted the settlement will fail (an issue far from certain and not supported by any evidence), and that such failure will result in further delay, additional expenditure of judicial resources and potentially the loss of the benefits of the Global Settlement Agreement. However, as numerous cases make clear, these are typical consequences and are not "exceptional." Indeed, if the reasons proffered by the Debtors were

sufficient, then vacatur would be permitted in any large bankruptcy case. This is clearly not the case.

9. The Settlement Noteholders' decision to "roll the dice" with respect to the Equity Committee's standing motion bars them from seeking vacatur of the Court's September Opinion. *Id.* at 28. They cannot now attempt to "wash away the unfavorable outcome" as part of a settlement. *Id.*

STATEMENT OF FACTS

A. The Court Denies Confirmation of the Sixth Amended Plan and Orders Discovery With Respect to Allegations of Inequitable Conduct By the Settlement Noteholders

10. On January 7, 2011, the Court denied confirmation of the Sixth Amended Plan due to certain deficiencies. *See In re Wash. Mut., Inc.*, 442 B.R. 314, 344-45, 365 (Bankr. D. Del. 2011). Among other things, the Court noted that

> [O]ne of the individual creditors who objected to the Plan, Mr. Thoma, sought to introduce evidence that the Settlement Noteholders used their position in the negotiations to gain non-public information about the Debtors which permitted them to trade in the Debtors' debt. While the evidence was not admitted because it was hearsay, the Court is reluctant to approve any releases of the Settlement Noteholders in light of those allegations.

Id. at 349.

11. In the wake of the Order denying confirmation of the Sixth Amended Plan, the Official Committee of Equity Security Holders ("Equity Committee") and the TPS Group sought discovery from the Settlement Noteholders with respect to Mr. Thoma's allegations.

12. On February 8, 2011, during argument on the Equity Committee's motion to compel discovery, the Court expressed "concern" regarding the issues Mr. Thoma raised with respect to the Settlement Noteholders' actions, and stated its desire to explore those issues: "He

raised an issue that the Court has a concern about. And I think it should be explored." (Equity Committee Motion to Compel Hr'g Tr., 45:10-13, Feb. 8, 2011.)

B. The Court Denies Confirmation of the Modified Sixth Amended Plan

13. On July 13-15 and 18-21, 2011, this Court held a hearing to consider confirmation of the Modified Sixth Amended Plan. A substantial portion of those hearings—nearly four days in total—were devoted to the allegations of inequitable conduct against the Settlement Noteholders in connection with their trading in the Debtors' securities, and the Equity Committee's related motion for standing to prosecute claims against the Settlement Noteholders on the Debtors' behalf (the "Standing Motion"). A representative of each of the Settlement Noteholders was examined, and more than 200 exhibits were introduced as evidence.

14. The parties submitted extensive post-hearing briefs, and the Court held closing arguments on August 24, 2011. On September 13, 2011, the Court issued an opinion denying confirmation of the Modified Sixth Amended Plan. [Docket No. 8612 (as previously defined, the "September Opinion")]. Among other things, the Court, over the strenuous objections of the Settlement Noteholders, recognized the continued viability of the remedy of equitable disallowance. (*Id.* at 112-17.) The Court then spent more than 20 pages of its opinion analyzing, in meticulous detail, the law governing insider trading and the evidence adduced against the Settlement Noteholders, and concluded that "the Equity Committee and TPS Group have stated a colorable claim that the Settlement Noteholders engaged in insider trading." (September Opinion at 137.)

15. The Court further rejected the Settlement Noteholders' contention that a "finding of insider trading" would "chill the participation of creditors in settlement discussions in bankruptcy cases of public companies." (*Id.*) Rather, the Court observed, "creditors who want to participate in settlement discussions in which they receive material nonpublic information

about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case." (*Id.* at 137-38.)

C. The Court's September Opinion Receives Widespread Attention

16. The September Opinion has been widely reported in the national press. *See, e.g.*, Randall Chase, "JUDGE REJECTS WAMU REORGANIZATION PLAN" AP (Sept. 13, 2011)[3]; Peg Brickley, "WAMU CHAPTER 11 PLAN REJECTED AGAIN, IN PART" The Wall Street Journal Online (Sept. 14, 2011)[4]; "WAMU REORGANIZATION PLAN REJECTED AGAIN" Reuters (Sept. 14, 2011)[5]; Charles Duhigg and Peter Lattman, "JUDGE SAYS HEDGE FUNDS MAY HAVE USED INSIDE INFORMATION" New York Times (Sept. 15, 2011).[6] One blog reported:

> Last month, Judge Walrath issued a terrifically thorough 139-page decision denying the Wamu debtors' 'Modified Sixth Amended Joint Plan of Affiliated Debtors.' Judge Walrath's opinion has become the topic of much debate and discussion, mainly due the fact that it addresses the Equity Committee's claims of insider trading against four major creditors.

Cosgrove Bankruptcy Blog, "Judge Walrath's September Opinion in the Wamu Case Covers a Wide Range of Issues Including the Valuation of NOLs and the Now Infamous Insider Trading Claims" (Oct. 11, 2011).[7]

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[3] Available at http://seattletimes.nwsource.com/html/localnews/2016196687_apuswashingtonmutual bankruptcy.html. A compendium of all media reports cited herein is attached as Exhibit A.

[4] Available at http://online.wsj.com/article/SB10001424053111903927204576570583662908942.html.

[5] Available at http://newsandinsight.thomsonreuters.com/Bankruptcy/News/2011/09_-_September/WaMu_reorganization_plan_rejected_again/.

[6] Available at http://dealbook.nytimes.com/2011/09/14/judge-says-hedge-funds-may-have-used-inside-information/.

[7] Available at http://www.cosgrovebankruptcyblog.com/post/11333534381/judge-walraths-september-opinion-in-the-wamu-case. *See also, e.g.*, NACM (National Association of Credit Management) blog, "WaMu Bankruptcy: It Ain't Over Till It's Over" (Sept. 15, 2011), available at http://blog.nacm.org/blog/shappell/wamu-bankruptcy-it-aint-over-till-its-over; Tom Hals "Analysis: WaMu Ruling May Change Big Bankruptcy Negotiations" Reuters (Sept. 21, 2011), available at http://newsandinsight.thomsonreuters.com/ Bankruptcy/News/2011/09_-_September/Analysis__WaMu_ruling_may_change_big_bankruptcy_negotiations/; Seeking Alpha, "Washington Mutual Reorganization: Fund Insider Trading Charges Prompt Mediation Order" (Sept. 27, 2011), available at http://seekingalpha.com/article/296151-washington-mutual-reorganization-part-1-fund-

17. The September Opinion also has received scholarly notice. *See* Jonathan P. Friedland, Commercial Bankruptcy Litigation § 9:55 Equitable disallowance n.13; Marc Abrams, Joseph G. Minias, and Richard J. Kurdziel, "Key Rulings from Delaware Bankruptcy Court's Rejection of Washington Mutual's Plan Of Reorganization," J. of Bankr. L. 2011.12-3 ("The Decision is significant both because of the large number of Chapter 11 cases filed in Delaware, and because courts outside of the Third Circuit tend to view decisions from Delaware bankruptcy courts as influential. Accordingly, all parties involved in Chapter 11 cases must be aware of the Decision's key holdings."); Lisa Schweitzer and Martin Kostov, "Equitable Disallowance Rears Its Head in 'WaMu,'" N.Y.L.J., December 5, 2011.

18. Perhaps most significant, however, has been the impact of the decision on legal practitioners and participants in bankruptcy cases. At least six major law firms have produced memoranda and client alerts with respect to the September Opinion, all of which are available on the internet at the firms' websites and several of which were reproduced by various services. Uniformly, these memoranda acknowledge the importance of the Court's rulings concerning equitable disallowance and insider trading and their value in providing guidance for investors. For example, one firm notes that "Judge Walrath's opinion will inform best practices for investors involved in plan negotiations with debtors, both before and during a bankruptcy proceeding."[8] Another commented that "the decision is a must-read for restructuring

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insider-trading-charges-prompt-mediation-order http://seekingalpha.com/article/296155-washington-mutual-reorganization-part-2-fund-insider-trading-charges-prompt-mediation-order; 8 No. 11 Westlaw Journal Bankruptcy 3 "Washington Mutual Loses Plan-Confirmation Bid Over Insider-Trading Claims" (Sept. 30, 2011); 26 No. 6 Westlaw Journal Delaware Corporate 9 "Washington Mutual Loses Plan-Confirmation Bid Over Insider-Trading Claims" (Oct. 3, 2011); 17 No. 11 Westlaw Journal Bank & Lender Liability 9 "Washington Mutual Loses Plan-Confirmation Bid Over Insider-Trading Claims" (Oct. 10, 2011).

[8] Sullivan & Cromwell, "RESTRUCTURING AND BANKRUPTCY ALERT: WASHINGTON MUTUAL DECISION REINFORCES APPLICABILITY OF INSIDER TRADING LAWS TO PARTICIPATION IN BANKRUPTCY NEGOTIATIONS" (Sept. 27, 2011), available at http://www.sullcrom.com/Restructuring-and-Bankruptcy-Alert--Washington-Mutual-Decision-Reinforces-Applicability-of-Insider-Trading-Laws-to-Participation-in-Bankruptcy-Negotiations-09-27-2011/. A compendium of all law firm comments cited herein is attached as Exhibit B.

professionals, particularly those in the distressed investing field . . . . [D]istressed investors that regularly trade claims in bankruptcy cases would be well advised to consider the court's analysis of the insider-trading allegations in Washington Mutual."[9]

19. Other reports similarly noted the importance of the Court's September Opinion:

- Judge Walrath's opinion – one of the most comprehensive on the topic in some time – articulated the restrictions that must be implemented by distressed funds that participate in chapter 11 plan and settlement negotiations to comply with applicable securities laws . . . . In light of this important ruling, creditors in a bankruptcy case should proceed carefully and cautiously when engaging in settlement or other discussions with the debtor and other stakeholders.[10]

- The principal lesson from the Washington Mutual case is that claims traders who have access to confidential information need to be very careful about how and when they trade based upon that information . . . . The Washington Mutual decision should serve as a reminder that creditors cannot merely rely on a debtor's contractual commitment to publicly disclose confidential information at the end of a confidentiality period, but rather need to make sure that such information is actually disclosed . . . . Judge Walrath's ruling should serve as a reminder that claims traders and their counsel need to be vigilant in making sure that they know precisely when a debtor has released information to the public, and what information has been released, and that they do not engage in trading activities while in possession of information that is still confidential unless proper ethical walls are established and maintained.[11]

- A recent 139-page decision (the "Decision") with far-reaching implication for parties involved in chapter 11 proceedings . . . . [C]ertain of Judge Walrath's rulings are significant for practitioners and participants in chapter 11 cases . . . . The Decision is significant both because of the

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[9] Jones Day, "WAMU CONFIRMATION DENIED: INTEREST RATES, EQUITABLE DISALLOWANCE, AND INSIDER TRADING" (Nov./Dec. 2011), available at http://www.jonesday.com/wamu-confirmation-denied-interest-rates-equitable-disallowance-and-insider-trading-12-01-2011/.

[10] Kirkland & Ellis, Kirkland Alert: WAMU COURT'S DECISION A LESSON FOR HEDGE FUNDS (Sept. 2011), available at http://www.kirkland.com/siteFiles/Publications/Alert_092611.pdf.

[11] Shearman & Sterling, "RISKS FOR CLAIMS TRADERS WHO HAVE ACCESS TO CONFIDENTIAL INFORMATION: LESSONS FROM THE RECENT *WASHINGTON MUTUAL* DECISION" (Oct. 5, 2011), available at http://www.shearman.com/risks-for-claims-traders-who-have-access-to-confidential-information--lessons-from-the-recent-washington-mutual-decision-10-05-2011/. Excerpts from this memo were reproduced by Mondaq Business Briefing (Oct. 11, 2011), "UNITED STATES: RISKS FOR CLAIMS TRADERS WHO HAVE ACCESS TO CONFIDENTIAL INFORMATION: LESSONS FROM THE RECENT WASHINGTON MUTUAL DECISION."

large number of chapter 11 cases filed in Delaware, and because courts outside of the Third Circuit tend to view decisions form Delaware bankruptcy courts as influential.[12]

- [T]he Court's analysis of the application of insider trading laws to claims traders in the bankruptcy process may have a significant impact on the way claims traders do business and on the way settlement and restructuring negotiations are conducted in bankruptcy.[13]

D. The Debtors and Settlement Noteholders Insist That the Court Vacate Its September Opinion in Part

20. While the Court held that colorable claims against the Settlement Noteholders existed, it directed "that the parties go to mediation on this issue, as well as the issues that remain an impediment to confirmation of any plan or reorganization in this case." (*Id.* at 138-39.) Prior to the commencement of the mediation, each of the Settlement Noteholders sought to appeal the Court's decision.[14] For the most part, the appeals assert that equitable disallowance is not an available remedy, (ACO Br. 16-20; Aurelius Br. 20-23, 24-27), that the Equity Committee lacked standing (ACO Br. 22-24; Aurelius Br. 23-24), and that the pleading requirements of the PSLRA were not met (ACO Br. 32-36; Aurelius Br. 31-36). These motions are pending.

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[12] Willkie, Farr & Gallagher, Client Memorandum: KEY RULINGS FROM DELAWARE BANKRUPTCY COURT'S REJECTION OF WASHINGTON MUTUAL'S PLAN OF REORGANIZATION (Sept. 20, 2011), available at http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3881%5CKey-Rulings-From-Delaware-Bankruptcy-Court1.pdf.

[13] Davis Polk Client Newsletter, INSOLVENCY AND RESTRUCTURING UPDATE: SECOND WASHINGTON MUTUAL PLAN CONFIRMATION DENIAL MAY HAVE SIGNIFICANT IMPACT ON CLAIMS TRADING AND PLAN NEGOTIATION (Sept. 20, 2011), available at http://www.davispolk.com/files/Publication/e6636a22-e0dd-4260-be16-03a4df5e507c/Presentation/PublicationAttachment/06c77e1f-6190-4b3b-9a3d-0417422e5f3e/091911_insolvency_restruct_update.pdf. Excerpts from this memo were reproduced by the Harvard Law School Forum on Corporate Governance and Financial Regulation "BANKRUPTCY COURT DECISION MAY IMPACT CLAIMS TRADING AND PLAN NEGOTIATION" (Oct. 6, 2011).

[14] The Settlement Noteholders filed two appeals. The brief of Aurelius (Memo of Aurelius Capital Management, LP for Leave to Appeal Under 28 U.S.C. § 158(a) ("Aurelius Br.") was filed in *In re: Washington Mutual Inc.*, No. 11-cv-00971-GMS (D. Del. Oct. 13, 2011). The brief of Appaloosa, Centerbridge, and Owl Creek (Joint Memorandum of Law of Appaloosa Management L.P., Centerbridge Partners LP, Owl Creek Asset Management LP. in Support of Motion for Leave to Appeal from the Decision of the Bankruptcy Court or, Alternatively, for Issuance of a Writ of Mandamus ("ACO Br.")) was filed in *In Re: Washington Mutual Inc.*, No. 11-cv-00979-GMS (D. Del. Oct. 14, 2011).

21. The mediation commenced on October 19, 2011. According to the Debtors, the Plan is a result of that mediation.

22. On December 12, 2011, the Debtors filed the Plan. The Plan's proposed treatment of the inequitable conduct claims is nothing short of astonishing. The Settlement Noteholders will not make any settlement payment, and none of their claims will be disallowed. They instead will receive full releases of all potential claims relating to their trading in the Debtors' securities in exchange for no consideration at all. (Plan §§ 41.5 & 41.6.) Indeed, notwithstanding the Court's conclusion that the Debtors' estates possess colorable inequitable conduct claims against the Settlement Noteholders, the Settlement Noteholders appear to have incurred no negative repercussions whatsoever in connection with the Plan. In fact, the Plan contemplates that the Settlement Noteholders will make a secured loan (subject to various conditions) to the Reorganized Debtor at a 7 percent interest rate and will receive the right to appoint a director to the board of directors of the Reorganized Debtor. (Disclosure Statement at 24-26.)

23. The Plan also requires that this Court enter an order

> withdrawing and vacating for all purposes (a) the September Order to the extent relating to the Standing Motion and (b) those portions of the September Opinion relating to the Standing Motion, including, but not limited to, (i) Section III(H) of the September Opinion, pages 108 through 139, and (ii) the first sentence on page 68, footnote 31 on page 70 and the last paragraph of Section III(D) of the September Opinion, page 73.

(*Id.*) These portions of the Court's September Opinion include (among other things) the Court's discussion and rulings concerning the viability of the remedy of equitable disallowance, the application of insider trading laws to settlement negotiations in bankruptcy proceedings, the impact of so-called "cleansing provisions" in confidentiality agreements, and the independent obligations imposed on parties by the federal securities laws. The vacatur requirement is also

directed at the Court's conclusion that creditors who receive material nonpublic information during settlement negotiations must either restrict trading or establish an ethical wall to prevent use of that information in trading decisions.

24. According to the Debtors, the vacatur requirement was inserted at the insistence of the Settlement Noteholders "[b]ecause … securities trading is at the core of [the Settlement Noteholders]'s businesses . . . absent vacatur, they will have no choice but to clear themselves of the Equity Committee's allegations through litigation." (Motion ¶ 18.)

25. On January 9, 2012, the Debtors filed the Motion to Vacate. The motion in title seeks vacatur, but in substance asks this Court to issue an order indicating that it would be inclined to vacate the September Opinion if the Plan is confirmed, and to advise legal publishers of the vacatur. (Motion ¶¶ 20-21.)[15] According to the Debtors, they intend to seek remand of all the pending appeals prior to confirmation (presumably because the divestiture rule deprives the Court of jurisdiction to vacate its opinion while the appeals are pending).

ARGUMENT

I. VACATUR IS BARRED UNDER BONNER MALL AND THIRD CIRCUIT PRECEDENT

A. The Supreme Court Requires "Exceptional Circumstances" To Justify Vacatur

26. In *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994) ("*Bonner Mall*"), the Supreme Court prohibited vacatur except in the narrowest of circumstances.[16] As the *Bonner Mall* Court observed, the remedy of vacatur is animated by

[15] This latter element is sometimes known as an "Amtrak order," based on the widely-criticized decision in *Klein v. Amtrak*, a personal injury case in which the court, as part of a settlement, vacated its opinions and instructed Westlaw and Lexis to remove them from their databases. *See* Shannon P. Duffy, "AFTER SETTLEMENT IN AMTRAK CASE, OPINIONS ERASED FROM LEXIS AND WESTLAW," The Legal Intelligencer (Aug. 19, 2009).

[16] The Debtors suggest that, because the September 15 Order was issued by this Court, and may not be final, a lesser standard than *Bonner Mall* applies. (Motion ¶ 24 n. 15, ¶ 25 n. 16.) But this is not the law in this Circuit.

considerations of mootness. *See id.* at 25. Thus, where a losing party seeks appellate review of the decision below, but its appeal becomes moot "by the vagaries of circumstance," the losing party may seek vacatur because it "ought not in fairness be forced to acquiesce in the judgment." *Id.* "Where mootness results from settlement, however, the losing party has voluntarily forfeited [its] legal remedy by the ordinary processes of appeal or certiorari, thereby surrendering [its] claim to the equitable remedy of vacatur." *Id.* As such, the Supreme Court held, "mootness by reason of settlement does not justify vacatur of a judgment under review." *Id.* at 29.

27. While the Supreme Court did allow that vacatur "may conceivably" be available in connection with a settlement, it cautioned that the remedy should be granted only under "exceptional circumstances." *Id*. But "the mere fact that the settlement agreement provides for vacatur" does not constitute "exceptional circumstances." *Id*. Nor is the requirement met simply because the prevailing party joins in the request. *Bonner Mall*, 513 U.S. at 26. Vacatur, moreover, must be in the public interest. As the Supreme Court explained in *Bonner Mall*, "[j]udicial precedents are presumptively correct and valuable to the legal community as a whole. They are not merely the property of private litigants and should stand unless a court concludes that the public interest would be served by a *vacatur*." *Id.* at 26. "To allow a party who steps off the statutory path to employ the secondary remedy of vacatur as a refined form of collateral

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See, e.g., *Gammino v. SBC Communs., Inc.*, 2010 WL 1257653 (E.D. Pa. Mar. 29, 2010) (applying *Bonner Mall* standard in denying motion to vacate its own order on personal jurisdiction); *Mahogany Run Condo. Ass'n v. ICG Realty Mgmt. Corp. (In Re: Icon Investment Trust No. 1)*, No. 399-00013, 2004 Bankr. LEXIS 183 (Bankr. D.V.I. Jan. 27, 2004) (applying *Bonner Mall* standard in denying motion to vacate its own order); *PolyMASC Pharms., PLC v. Alza Corp.*, 2004 WL 633256 (D. Del. Mar. 26, 2004); (applying *Bonner Mall* standard in denying motion to vacate its own order); *Avellino v. Herron*, 181 F.R.D. 294 (E.D. Pa. 1998) (applying *Bonner Mall* standard in denying motion to vacate its own order denying a motion to dismiss); *see also Sentinel Trust Co. v. Universal Bonding Ins. Co.*, 316 F.3d 213 (2003) (invoking *Bonner Mall* in determining Tennessee law regarding vacatur by the Tennessee Chancery Court of its own decision); *McKinney v. Philadelphia Housing Auth.*, 2010 WL 2510382, 2010 U.S. Dist. LEXIS 60410 (E.D. Pa. June 16, 2010) (applying *Bonner Mall* standard in determining whether to vacate is own order denying summary judgment in part); *see generally* Richard A. Rosen, SETTLEMENT AGREEMENTS IN COMMERCIAL DISPUTES: NEGOTIATING, DRAFTING AND ENFORCEMENT § 21.04 Vacatur Upon Settlement After *Bonner Mall*.

attack on the judgment would -- quite apart from any considerations of fairness to the parties -- disturb the orderly operation of the federal judicial system." *Id*. at 27. *See also Alvarez v. Smith*, 130 S. Ct. 576, 581, 175 L. Ed. 2d 447, 453 (2009) ("where mootness results from settlement rather than happenstance, the losing party has voluntarily forfeited his legal remedy and thereby surrendered his claim to the equitable remedy of *vacatur*").

B. The Third Circuit Narrowly Construes the "Exceptional Circumstance" Exception

28. Even before the *Bonner Mall* decision, the Third Circuit had made clear that it would not vacate decisions as part of a settlement agreement. In *Clarendon, Ltd. v. Nu-West Industries, Inc.*, 936 F.2d 127 (3d Cir. 1991), the parties settled their dispute while an appeal was pending before the Court of Appeals and jointly moved that the District Court's opinion be vacated. The Court of Appeals refused, noting that it "routinely declined to approve such provisions." *Id*. at 129. The Court of Appeals explained that, "[w]hen a clash between genuine adversaries produces a precedent . . . the judicial system ought not allow the social value of that precedent, created at cost to the public and other litigants, to be a bargaining chip in the process of settlement. The precedent, a public act of a public official, is not the parties' property." *Id*. (quoting *Matter of Memorial Hosp. of Iowa County, Inc.*, 862 F.2d 1299, 1302 (7th Cir. 1988)). "[A]ction by the court," the Court of Appeals said, "can be neither purchased nor parleyed by the parties." 936 F.2d at 129.[17]

29. *Bonner Mall* only reinforced the Third Circuit's position, which has been repeated several times since. *See Donovan v. Punxsutawney Area School Bd.*, 336 F.3d 211, 218 (3d Cir.

[17] The Court of Appeals noted that its position differed from that of the Second Circuit. *Clarendon*, 936 F.2d at 129. Even after *Bonner Mall*, a few cases in the Second Circuit have applied a more flexible "balancing" test. Not surprisingly, the Motion relies on more cases from that circuit than from this one. But even these cases have been criticized and are generally not followed. *See, e.g.*, *Young v. Cooper Cameron Corp.*, 2008 WL 1748462, at *4, 8-9 (S.D.N.Y. Apr. 15, 2008).

2003) ("neither 'mootness by reason of settlement,' nor mootness due to the voluntary act of the losing party, justifies vacatur of a judgment") (citations omitted); *Sentinel Trust Co. v. Universal Bonding Ins. Co.*, 316 F.3d 213, 220 (3d Cir. 2003) (vacatur should "generally no[t]" be granted due to "the public interest in judicial precedents that are presumptively correct and valuable to the legal community as a whole") (citation omitted); *Salovaara v. Jackson Nat'l Life Ins. Co.*, 246 F.3d 289, 296 (3d Cir. 2001) ("[b]ecause mootness by reason of a settlement is a result of the voluntary actions of the party, it does not justify vacatur of a federal civil judgment") (citation omitted).

30. Lower courts in this circuit have followed the lead of the Court of Appeals. As one court noted in denying an unopposed motion to vacate its decision, "settlement ordinarily bars vacatur." *Gammino v. SBC Commc'ns., Inc.*, 2010 WL 1257653, at *1, 2010 U.S. Dist. LEXIS 29843, at *4 (E.D. Pa. Mar. 29, 2010). For example, the bankruptcy court in *Mahogany Run Condo. Ass'n v. ICG Realty Mgmt. Corp. (In Re: Icon Investment Trust No. 1)*, No. 399-00013, 2004 Bankr. LEXIS 183, at *10 (Bankr. D.V.I. Jan. 27, 2004), denied a motion to vacate an opinion that was on appeal even though the parties had settled. The court held: "[t]he parties are free to sign written releases to satisfy each others' claims. However, they are not free to agree to nullify a memorandum opinion and order of court which sets honorable precedent without appellate judicial review and determination." *Id.* at *10. Similarly, in *PolyMASC Pharms., PLC v. Alza Corp.*, 2004 WL 633256 (D. Del. Mar. 26, 2004), the court refused to vacate an opinion it had issued in a patent dispute. The parties settled while the judgment was on appeal, but the court held that was not enough to sustain the motion to vacate. It held that "PolyMASC has not proven 'exceptional circumstances' in the context of the parties' settlement warranting vacatur." 2004 WL 633256, at *2. The court also refused to vacate its opinion in

Avellino v. Herron, 181 F.R.D. 294 (E.D. Pa. 1998), commenting that "no public purpose, other than perhaps erasing what defendant may view as a meddlesome precedent, would be advanced by vacatur." *Id.* at 297.

31. In *Devore v. City of Philadelphia*, 2003 WL 21961975 (E.D. Pa. June 24, 2003), the defendants settled and then sought vacatur, which they said "would serve the salutary purpose of abating the financial, reputational or other lasting personal effect the judgments would have on the individual defendants, who continue to deny any wrongdoing." *Id.* at *1. Denying the unopposed motion to vacate, the court stated that "we do not believe the law of this circuit permits this court to vacate a judgment in aid of settlement." *Id.*[18]

C. The Plan Proponents Have Failed To Establish An "Equitable Entitlement To The Extraordinary Remedy of Vacatur"

1. Vacatur Would Not Serve the Public Interest

32. The Court's September Opinion is unquestionably an important decision in the fields of both bankruptcy and securities law. There is today in this country an intense focus by the public and the government on insider trading issues, as well as on ensuring the integrity of the securities markets. The September Opinion centered directly on the intersection of the securities laws and bankruptcy proceedings, a topic that is being addressed with greater frequency.

33. The Court provided necessary clarification on a number of important issues, including the availability of the remedy of equitable disallowance, the use of confidentiality

[18] The law in the State of Delaware is the same. "Justice does not require vacatur where the parties voluntarily settle a matter unless exceptional circumstances abound." *Tyson Foods, Inc. v. Aetos Corp.*, 818 A.2d 145, 148 (Del. 2003). As the Chancery Court explained, "[i]n this republican democracy, our citizens place great value on public decision-making and on the rule of law. It seems unnecessarily Orwellian to encourage a practice that erases -- in some vague but perceptible way -- a decision of a court rendered when a dispute was 'live' at the instance of a party whose own conduct caused that decision not to be reviewed. A judicial decision is a public document. [Movant]'s approach would convert the decisions of this court into a species of private property." *In re IBP S'holders Litig.*, 793 A.2d 396, 408-09 (Del. Ch. 2002) (footnotes omitted) (refusing vacatur), *aff'd*, 818 A.2d 145 (Del. 2003).

provisions and so-called "cleansing" provisions, the potential materiality of settlement negotiations, and the best practices for active traders who participate in such negotiations. The prompt and extensive commentary on the September Opinion by law firms, scholars, and news outlets establish the widespread public interest in these rulings. Indeed, the Settlement Noteholders themselves, in seeking expedited treatment of their motion for leave to appeal, pointed to "the impact this type of opinion can have on other potential bankruptcies and securities suits." (ACO Br. at 16.) The widespread recognition of the importance of this decision, and the Settlement Noteholders' own admissions in prior filings, belie the claim that the September Opinion is of "limited precedential effect" (Motion ¶ 3).[19]

34. Vacatur of an opinion which has had such an impact would be extraordinary, if not unprecedented. Vacatur would undermine the precedential value of the decision and the ensuing uncertainty would affect the entire legal community. Indeed it is likely that the Settlement Noteholders will declare that the Court reversed its ruling and vindicated them, further casting doubt on whether the Court's rulings in fact are to be followed or are simply of no force or effect. Such a result is inconsistent with the policies articulated by the Supreme Court.

35. The overwhelming public interests at issue should be determinative. *See In re Admetric Biochem, Inc.*, 300 B.R. 141, 147 (Bankr. D. Mass. 2003).

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[19] The precedential value of the September Opinion is not diminished by the procedural context of the Standing Motion (*i.e.*, whether there were "colorable" claims against for inequitable conduct against the Settlement Noteholders). *Avellino*, 181 F.R.D. at 297 (court refused to vacate decision denying a motion to dismiss on grounds that it was not a "final adjudication" and contained no findings of fact; assuming truth of facts does not destroy the value or the power of the court's opinion).

2. The Settlement Noteholders Have Failed To Meet Their Burden

36. The Debtors report in their Motion that the Settlement Noteholders have "made clear that, absent vacatur, they will have no choice but to clear themselves of the Equity Committee's allegations through litigation." (Motion ¶ 18; *see also* ¶¶ 2-4, 18, 27-29.)[20]

37. The Settling Noteholders, who caused the mootness of their respective appeals by settling with the Equity Committee, thus bear the burden of establishing their "equitable entitlement to the extraordinary remedy of vacatur." *Bonner Mall*, 513 U.S. at 26. They must at least demonstrate exceptional circumstances justifying vacatur, and the Court must conclude that the "public interest would be served by a vacatur." *Id.* Faced with this heavy burden, the Settlement Noteholders present no facts or circumstances supporting the request for vacatur. They submit no brief or affidavit in support of the motion, and make no arguments at all. As stated repeatedly in binding precedent, the fact that the Settlement Noteholders conditioned their agreement to the Plan on vacatur is not an exceptional circumstance warranting vacatur (see Motion at ¶ 18).

38. This case is thus completely different than the few cases in which a court vacated an opinion in connection with a settlement. For example, in *Major League Baseball Props., Inc. v. Pacific Trading Cards, Inc.*, 150 F.3d 149 (2d Cir. 1998) (Motion ¶¶ 18, 31), the lower court denied Major League Baseball Properties' ("MLB") motion to enjoin defendant from infringing MLB's trademark. MLB filed an emergency appeal to the Second Circuit and sought an injunction pending appeal. At argument, the Second Circuit informed the parties that it was

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[20] The argument that the settlement will collapse unless this Court surrenders to the Settlement Noteholders' demand is based entirely on what the Debtors report that the Settlement Noteholders said, presumably during mediation talks. (Motion ¶ 18; *see* Local. Bankr. R. 9019-5(d)(i).) It is, of course, obvious that "parties typically engage in extensive bargaining, an intrinsic part of which almost invariably involves some puffery, or the exaggeration of one's position." *Promotion in Motion v. Kenny's Candy Co.*, No. 97-3512, 1999 U.S. Dist. LEXIS 22173, at *14 (D.N.J. Nov. 30, 1999), citing *Stickler v. Comm'r of Internal Revenue*, 464 F.2d 368, 370 (3d Cir. 1972). *See Harrelson Utilities*, 2010 WL 4824419, at *3 n.2, 2010 Bankr. LEXIS 4122, at *8 n.2.

likely to grant the motion, and that the earliest the appeal could be heard was approximately two months later. Defendant (the prevailing party) indicated that the injunction pending appeal would be "financially ruinous." The parties thereafter settled the matter but only on the condition that the lower court's decision was vacated. The court held that, "when a judgment is mooted by settlement, vacatur is usually not justified because the social value in preserving precedents in not outweighed by equitable considerations." The court nonetheless found that these facts presented "extraordinary circumstances" because MLB did not by its own initiative relinquish its right to vacatur. Rather, the defendant strongly desired a settlement to avoid a bankruptcy. The plaintiff, for its part, was willing to settle, but unless the lower court decision was vacated, plaintiff would be required to continue to test the merits of the district court's opinion in future unrelated cases. This would in essence cause more litigation for MLB, not less.

39. Similarly, *McKinney v. Philadelphia Housing Authority*, 2010 WL 2510382, 2010 U.S. Dist. LEXIS 60410 (E.D. Pa. June 16, 2010) (Motion ¶ ¶ 25-27), involved a suit on behalf of a young woman who had suffered severe brain injury as a consequence of mold in her dwelling and needed immediate and expensive medical care. The court granted in part and denied in part the summary judgment motion of defendant Philadelphia Housing Authority ("PHA"). Before trial, the parties entered into a settlement agreement, under which the plaintiffs agreed not to contest the PHA's motion for vacatur.

40. The court acknowledged "the disfavor with which the Third Circuit and the Supreme Court view vacatur of prior decisions," and that "there must be a finger on the scale against vacatur." 2010 WL 2510382, at *2, *4. It nevertheless decided to vacate its opinion. The court focused on the recovery to the plaintiff, "a young girl with a significant brain injury in need of a great deal of expensive care." 2010 WL 2510382, at *3. The Court also noted the fact

that its summary judgment decision did not involve any issue of unsettled law and was "fact-specific" and "idiosyncratic," with only "limited preclusive or precedential effect." 2010 WL 2510382, at *2.[21] Moreover, the court drew some comfort from the fact that PHA had won several issues in the summary judgment opinion and was not therefore just "rolling the dice," and then seeking to avoid an unfavorable decision through vacatur.

41. These cases thus focused on the extraordinary impact on the *prevailing* party, which were facing catastrophic losses, and are otherwise distinguishable. The September Opinion was not limited to "fact-specific" inquiries with limited precedential effect, but rather focused on disputed legal issues which have already had an impact on the legal community and other bankruptcy proceedings. Moreover, while the motion papers are silent on this issue, the only reason the Settlement Noteholders have insisted on vacatur is clear: They wish to avoid the consequences of their decision to "roll the dice" on the Standing Motion by seeking to vacate the unfavorable ruling. Indeed, the Debtors seek to vacate only the portion of the September Opinion that is unfavorable to the Settlement Noteholders and to them.[22] In both *MLB* and *McKinney*, the courts specifically found that the request for vacatur was not the result of such circumstances.

42. The facts of this case are far closer to *Young v. Cooper Cameron Corp.*, 2008 WL 1748462 (S.D.N.Y. Apr. 15, 2008), in which the court denied vacatur. The plaintiff brought suit against his former employer for failure to pay overtime wages, and the court granted partial summary judgment on liability to the plaintiff. The parties then settled subject to the condition

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[21] Such coverage as the story received in the press focused on the human interest aspects of the case, not the legal doctrines. *See, e.g.*, myfoxphilly.com, "PHA Settles Mold Lawsuit for $9.5M," http://www.myfoxphilly.com/dpp/news/local_news/pha-settles-mold-lawsuit-for-$9.5m.

[22] The Debtors note that a small portion of the September Opinion that will be vacated held for the Settlement Noteholders, on the equitable subordination issue. (Motion ¶ 33 n.17.) As this Court well knows, that issue was of minor importance compared to those decided against the Settlement Noteholders.

that the court vacate its decision. The defendant urged the court to apply a balancing test, but the court held that "the Supreme Court has already balanced these interests, and decided that the public interest outweighs the interest in honoring settlements unless there are exceptional circumstances." 2008 WL 1748462, at *4. In response to the movant's contention that the "decision does not affect any other parties," that "vacatur is of great importance to both parties," and that "vacatur saves judicial resources," the court countered that "[t]hese circumstances, however, are not 'exceptional' but rather typify the vast majority of settlements." *Id.* (quotation marks omitted).

43. The court noted the precedential value of the decision and noted as well that the decision could also have an important effect on the defendant in considering whether to adjust the practices in question: "Indeed, it is the avoidance of any need to change its practices that is likely the very reason [defendant] seeks to vacate the partial summary judgment decision in this case." 2008 WL 1748462, at *4. The court found that that the wage laws were designed to protect employees, and to the extent that defendant is violating the law, vacatur would make it more likely that it will continue to do so. *Id.*

44. The *Young* court's reasoning applies equally to this case.[23]

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[23] The Debtors rely on a case from the Southern District of New York, *Tommy Hilfiger Licensing, Inc. v. Costco Companies, Inc.*, 2002 WL 31654958, 2002 U.S. Dist. LEXIS 22696 (S.D.N.Y. Nov. 25, 2002) (Motion ¶ 22). This case incorrectly evaluated a motion to vacate by "balanc[ing] the interests of honoring settlements reached by the parties against the public interest in the finality of judgments and the development of decisional law." *Tommy Hilfiger*, 2002 WL 31654958, at *2 (citation omitted). In distinguishing *Tommy Hilfiger*, the *Young* court stated that "the Supreme Court has already balanced these interests, and decided that the public interest outweighs the interest in honoring settlements unless there are exceptional circumstances." 2008 WL 1748462, at *4. The *Young* court also noted that *Tommy Hilfiger* is the only case since 1996 (when the MLB case was decided) that granted vacatur, and that the decision "does not discuss in what manner the circumstances presented constituted 'exceptional circumstances' or even allude to the need to show such circumstances." *Id.* at *2. Another case relied on by Debtors is *BMC, LLC v. Verlan Fire Ins. Co.*, 2008 WL 2858737, 2008 U.S. Dist. LEXIS 56178 (W.D.N.Y. July 22, 2008) (Motion ¶¶ 25, 28, 33), which was decided two months after *Young* (which is not cited) and simply follows *Tommy Hilfiger*. In any event, as noted *supra* at Section I.B., the Third Circuit has always had greater restrictions on vacatur than the Second Circuit.

3. The Debtors Do Not Present Any Exceptional Circumstances

45. The Court found in its September Opinion that the Debtors failed to pursue claims of inequitable conduct against the Settlement Noteholders and that this failure was not justified. Indeed, the Debtors have consistently demonstrated hostility to the inequitable conduct claims and the Court's decision. The Debtors' outright and vociferous rejection of the Court's decision in the face of unrefuted evidence demonstrating colorable claims of insider trading against the Settlement Noteholders renders their pleading suspect.[24] Neither the Equity Committee nor Settlement Noteholders (the parties who apparently settled the claims) have submitted to the Court any of their respective justifications for conditioning the settlement on vacatur. Instead, the Debtors alone make this motion.

46. The Debtors provide a parade of "horribles" that may result if the Court denies vacatur (and the Settlement Noteholders refuse to waive this condition). (Motion ¶ 27.) The list includes continuing burden on the judicial resources of the Court, accrual of post-petition interest, diminished recoveries for certain constituencies, and the potential collapse of the Global Settlement Agreement.

47. Courts have repeatedly held that these natural consequences of a failed settlement are not "extraordinary." The future expenditure of judicial resources and (in a bankruptcy) the continued accrual of interest are typical consequences of a settlement that falls through, and do not justify vacatur. *See Young*, 2008 WL 1748462, at *5. Furthermore, vacatur in circumstances such as these would have the perverse effect of fostering more, not less, litigation, because it would encourage others (particularly in large bankruptcies) to "roll the dice" secure in the knowledge that they will be able to collaterally attack a negative result through vacatur. *Bonner*

[24] Moreover, the Settlement Noteholders have threatened to seek relief in this proceeding as a result of the Debtors' failure to make appropriate disclosures under the Confidentiality Agreements.

Mall, 513 U.S. at 27-28; *accord Summit Fin. Res., L.P. v. Kathy's Gen. Store, Inc.*, 2011 WL 3666607, at *2 (D. Kan. Aug. 22, 2011) ("The . . . argument similarly does not justify vacatur because vacating . . . might set precedent that would not conserve judicial resources in the future."). In addition, these arguments ignore the considerable judicial resources that already have been expended in this case. *See, e.g.*, *Young*, 2008 WL 1748462, at *5; *Avellino*, 181 F.R.D. at 297.

48. The Debtors' arguments were rejected in *In re Admetric Biochem, Inc.*, 300 B.R. 141 (Bankr. D. Mass. 2003) as well. In that case, the parties presented the court with a settlement which included a requirement of vacatur. As here, they argued that, without vacatur, the party who had lost "intend[ed] to appeal any final judgment entered in this matter . . . . [T]he costs of an appeal, whether successful or not, would diminish or eliminate the recovery by the bankruptcy estate. … [T]he settlement will result in an immediate and substantial benefit to creditors, and will avoid potentially protracted and expensive litigation." *Id*. at 144. In addition, "the parties have touted the results of the settlement and have argued that the Court's September 30, 2002 decision concerned merely a 'fact-specific issue involving a mixed question of bankruptcy and state law, and thus does not have broad precedential significance.'" *Id*. at 148. No creditors objected. *Id*. at 142.

49. The Court denied the motion to vacate. It held that "the public interest concerns discussed by the Supreme Court are determinative." *Id*. at 147. The justifications advanced by the parties, the Court held, "do not justify relief from the operation of the judgment." *Id*. at 148. Although the settlement itself, in isolation, was acceptable, *id*. at 145, the Court determined that

"[a] careful reading of the Supreme Court's decision in *Bonner Mall* compels the conclusion that *vacatur* is unwarranted." *Id.*[25] The same result should apply here.

50. Finally, the argument for vacatur, besides lacking legal support, comes with especially ill grace when made on behalf of the Settlement Noteholders, since they were responsible in the first instance for the delays that have added costs to this proceeding. Indeed, the delay in these proceedings (including the denial of confirmation of the Modified Sixth Amended Plan) was caused by the conduct of the Settlement Noteholders. It was their deliberate decision to contest the Standing Motion (rather than settle) that resulted in the July hearing, and that led to the Court's extensive rulings in its September Opinion. Moreover, the mediation, which was focused principally on the inequitable conduct claims, lasted for months.[26]

51. The Settlement Noteholders "rolled the dice," *Admetric*, 300 B.R. at 148 (quoting *Bonner Mall*, 513 U.S. at 28), with respect to the standing motion. They cannot use *vacatur* to "wash away" the unfavorable outcome. *Id.*

CONCLUSION

52. For the foregoing reasons, the Motion should be denied.

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[25] The Debtors cite to another decision from the District of Massachusetts, *Freedom Wireless, Inc. v. Boston Communications Group, Inc.*, 2006 WL 4451477, 2006 U.S. Dist. LEXIS 95871 (D. Mass. Oct. 11, 2006) (Motion ¶¶ 22, 25, 32). That decision does not cite any cases (it does not even mention *Bonner Mall*) and provides virtually no legal analysis. The Debtors also cite *Fairchild Aircraft Corp. v. Campbell (In re Fairchild Aircraft Corp.)*, 220 B.R. 909, 917 (Bankr. W.D. Tex. 1998) (Motion ¶ 23). That decision is inapposite. As the *Fairchild* court observed, the movant's "appeal was rendered moot not by its settlement, but by the passage of time." 220 B.R. at 914. Such is not the case here.

[26] Likewise, "[t]he mere fact that Debtor still believes the bankruptcy court's order is wrong is not grounds for *vacatur*." *Rafter Seven Ranches L.P. v. WNL Invs., L.L.C. (In re Rafter Seven Ranches L.P.)*, 414 B.R. 722, 742-43 (B.A.P. 10th Cir. 2009); *see also In re Harrelson Util., Inc.*, 2010 WL 4824419, at *3 (Bankr. E.D.N.C. Nov. 22, 2010) (refusing to acquiesce to settlement agreement requiring vacatur, holding that "[j]ust because a decision of this court is controversial or causes consternation, does not constitute an exceptional circumstance that would justify vacatur.").

Dated: Wilmington, Delaware
January 18, 2012

Respectfully submitted,

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Exhibit
A

Judge rejects Washington Mutual reorganization plan

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DOVER, Del. — A Delaware bankruptcy judge on Tuesday refused for the second time to approve bank holding company Washington Mutual Inc.'s reorganization plan.

The judge said WaMu's committee of equity security holders had made credible claims that that hedge funds supporting the plan engaged in insider trading of WMI securities based on information they obtained during the bankruptcy.

The hedge funds, referred to in court documents as the settlement noteholders, denied the allegations of insider trading. But Judge Mary Walrath said their conduct raises questions about how they treated settlement discussions in which they were involved.

"The court finds that the equity committee has made sufficient allegations and presented enough evidence to state a colorable claim that the settlement noteholders acted recklessly in their use of material nonpublic information," Walrath wrote in the 139-page ruling.

The judge also said she was concerned that the bankruptcy case, already three years old, could "devolve into a litigation morass," and that as the case drags on, potential recoveries for all parties dwindle.

As a result, Walrath ordered that the parties engage in mediation. She scheduled a status hearing for Oct. 7.

Washington Mutual's reorganization plan is based on the proposed settlement of lawsuits that pitted Washington Mutual, the Federal Deposit Insurance Corp. and JPMorgan Chase against one another after the

FDIC seized WaMu's Seattle-based flagship bank in 2008 and sold its assets to JPMorgan for $1.9 billion in the largest bank failure in U.S. history.

Under the proposed settlement, the competing lawsuits would be dismissed and some $10 billion in disputed assets would be distributed among Washington Mutual, JPMorgan and the FDIC.

Walrath ruled in January that the proposed settlement was reasonable, but she refused to confirm WaMu's plan until certain changes were made. The judge concluded, among other things, that the protections from future legal liabilities that the plan granted to the company's directors, officers and professionals, as well as members of its creditors committee and certain third parties, were either unwarranted or too broad.

Walrath specifically noted in her January ruling that she was reluctant to approve any legal releases for the settlement noteholders in light of the insider trading allegations.

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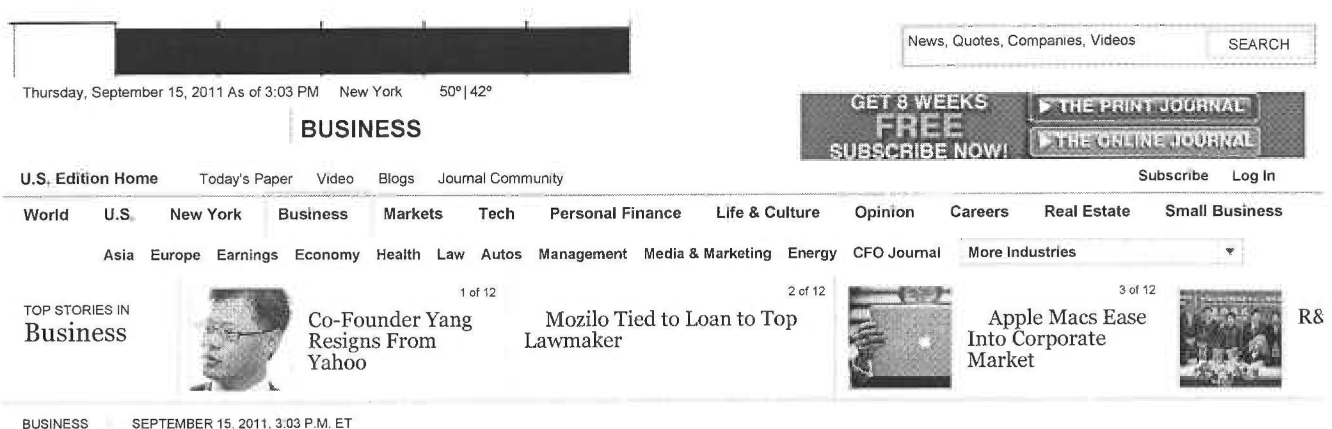

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WaMu Chapter 11 Plan Rejected Again, in Part

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By PEG BRICKLEY

A bankruptcy judge Tuesday rejected Washington Mutual Inc.'s Chapter 11 plan for a second time, finding the company was too generous with senior creditors but not dismissing the central details of the plan.

Judge Mary Walrath refused to confirm Washington Mutual's Chapter 11 plan in part because it awarded interest at the contract rate to holders of senior debt. The lower federal judgment rate of interest should apply, the judge said, a finding that potentially frees up hundreds of millions of dollars of value in the case.

The judge also said shareholders had sketched out a "colorable" case of insider trading against Appaloosa Management LP, Centerbridge Partners LP, Owl Creek Asset Management LP and Aurelius Capital Management LP. Known as the "settlement noteholders," the four invested in Washington Mutual's debt, buying and selling while they were involved in continuing Chapter 11 plan negotiations. All deny running afoul of laws against profiting from material, nonpublic knowledge.

Earlier

- **Deal Journal:** WaMu Plan Ruling Puts Distressed Investors on Notice
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- **FDIC Loses Bid to Dodge $10 Billion WaMu Suit**
- **WaMu Probe Ends With No Charges**

Tuesday's ruling, however, signals that they could have to face trial against shareholders and risk losing the profits on their $2.5 billion of debt holdings. Judge Walrath found that shareholders had turned up enough proof to move ahead with a case that "the settlement noteholders knowingly traded with knowledge that the debtors were engaged in global settlement negotiations ... of which the trading public was unaware."

Washington Mutual's Chapter 11 plan is the result of lengthy negotiations with J.P. Morgan Chase & Co., which bought Washington Mutual Bank after it was seized by regulators in September 2008, and with the Federal Deposit Insurance Corp., which brokered the deal. The central pact at the heart of the plan wasn't rejected Tuesday.

In a decision filed with the U.S. Bankruptcy Court in Wilmington, Del., Judge Walrath said she was concerned that more delay in the case would erode the value going to creditors of the company, the former parent of Washington Mutual Bank, or WaMu. She directed Washington Mutual and shareholders that once again succeeded in blocking the plan to go to mediation to resolve issues that are blocking confirmation.

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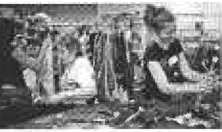

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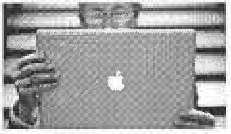

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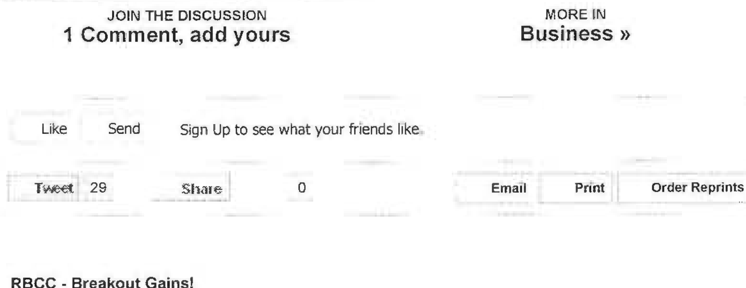
A settlement over the loss of WaMu struck in bankruptcy court provided about $7 billion in cash for the parent company creditors. The cash can't be paid out, however, until a plan is confirmed.

Earlier this year, Judge Walrath kicked back the plan due to a number of defects, many of which have since been remedied. Hedge funds that invested in the debt have been grumbling about the wait for their money in a big bankruptcy case where interest to senior creditors and legal fees were eating an estimated $30 million or more in value out of the recovery going to junior creditors.

That estimate will come down now that the judge has knocked down the interest due on Washington Mutual's senior debt.

WaMu was seized by regulators in September 2008, sending its parent racing for bankruptcy with billions of dollars in debts to pay, angry shareholders and only scraps of its operating business left.



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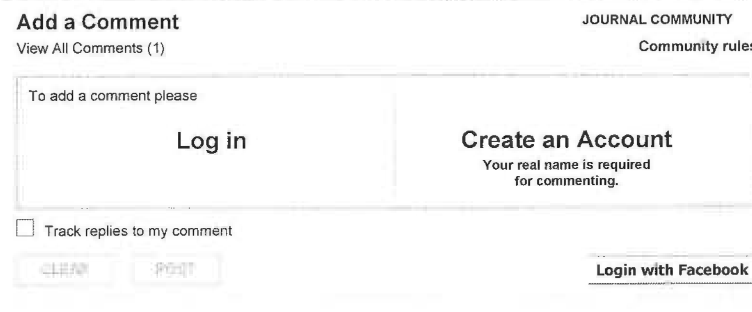

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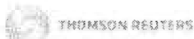

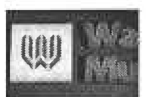

WaMu reorganization plan rejected again

9/14/2011 COMMENTS (0)

Sept 13 (Reuters) - Washington Mutual Inc's plan to pay more than $7 billion to creditors and exit bankruptcy was rejected for a second time by a judge who ordered the warring parties into mediation, according to a Tuesday ruling.

The ruling is likely to be held up as a victory for shareholders, who would likely have gotten very little in terms of a payout if the plan was approved.

In January, Delaware Bankruptcy Judge Mary Walrath rejected the company's first reorganization plan, which details how it will repay the hedge funds and other investors who hold its securities.

Walrath said in her 139-page ruling that shareholders made a viable claim that the plan was tainted by insider trading by four hedge funds.

Shareholders spent nearly two weeks in July presenting evidence to Walrath that the funds gleaned information from their role in negotiating Washington Mutual's bankruptcy plan to make big profits trading the company's securities.

However, Walrath stopped short of allowing shareholders to pursue their claim against the hedge funds. If successful on that claim, they could prevent the funds from collecting the more than $1 billion they are owed and also greatly increase the payout to shareholders.

Instead, she ordered mediation.

"The Court is concerned that the case will devolve into a litigation morass," Walrath wrote. "In addition, the Court notes that as the case continues, the potential recoveries for all parties in the case dwindles."

Washington Mutual filed for bankruptcy in September 2008, at the height of the financial crisis, after regulators seized its savings and loan business in the biggest bank failure in U.S. history.

The banking business was sold by the Federal Deposit Insurance Corp to JPMorgan Chase & Co for $1.88 billion.

Almost immediately after the bankruptcy started, Washington Mutual, the FDIC and JPMorgan began a legal battle to sort out who owned what of the failed bank.

In 2010, the parties agreed to end their legal battles and split among them $10 billion of disputed assets, with the bulk going to Washington Mutual.

The company planned to bring a small mortgage reinsurance business out of bankruptcy, mainly to preserve potentially valuable tax breaks. Otherwise its reorganization plan distributes cash to creditors, but little or nothing to shareholders.

Walrath rejected the company's first reorganization in part because an individual investor from New Jersey, Nate Thoma, claimed insider trading by four funds: Owl Creek Asset Management LP, Appaloosa Management LP, Centerbridge Partners LP and Aurelius Capital Management LP.

The official committee of equity holders seized upon those accusations to try to prove the plan was not drafted in good faith.

The hedge funds defended themselves against the insider trading claims by pointing to confidentiality agreements and walls they erected between those at the negotiating table and those on the trading desks.

The law firm of Fried Frank was also accused of sharing material information with the hedge funds. The hedge funds asserted the information was not material.

"The court has substantial doubts about these assertions," Walrath wrote. "Further discovery on this issue would clarify the point."

The case is In re Washington Mutual Inc, U.S. Bankruptcy Court for the District of Delaware, No. 08-12229.

(Reporting by Tom Hals)

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SEPTEMBER 14, 2011, 9:28 PM

Judge Says Hedge Funds May Have Used Inside Information

By CHARLES DUHIGG and PETER LATTMAN

Fred Prouser/ReutersA customer used the ATM at a Washington Mutual branch in Burbank, Calif., the day after federal regulators seized the bank in September 2008.

There have long been whispers on Wall Street that hedge funds have hijacked the bankruptcy process, using their influence as debt holders to obtain and trade on insider information about when and how a company will restructure.

A federal court ruling highlighted such concerns late Tuesday when a judge raised the possibility that four large hedge funds might have used confidential information to trade in the debt of Washington Mutual.

The issue was raised amid the derailment of Washington Mutual's emergence from bankruptcy protection, the final chapter in the largest bank failure in the nation's history.

Judge Mary F. Walrath, in dismissing a proposed settlement in the federal bankruptcy court in Delaware, wrote that four hedge funds that had played a role in Washington Mutual's restructuring might have received confidential information that could have been used to trade improperly in the bank's debt.

The four hedge funds are Appaloosa Management, Aurelius Capital Management, Centerbridge Partners and Owl Creek Asset Management. All have denied any wrongdoing.

The Washington Mutual bankruptcy, and Judge Walrath's ruling, have slightly thrown back the covers on the sharp-elbowed tactics used by investors in trading the stocks and bonds of companies in Chapter 11 bankruptcy protection. That market has exploded in recent years, driven by hedge funds buying up the loans of companies in bankruptcy at a steep discount in the hopes of obtaining big profits when the companies emerge from Chapter 11.

Judge Walrath's ruling is a victory for the Washington Mutual shareholders who claimed that hedge funds had been using insider knowledge to influence proceedings and seek profits. And the ruling is a potential blow to the funds — who have long argued they acted properly — and the large law firm Fried, Frank, Harris, Shriver & Jacobson, which was representing some of the funds and is accused of passing them confidential information.

Part of Judge Walrath's ruling focused on a dispute involving $4 billion held by JPMorgan Chase when Washington Mutual was put into bankruptcy. Early in the bankruptcy proceedings, Washington Mutual claimed ownership of those funds, and in confidential settlement talks, JPMorgan agreed to hand them over.

If the public had been aware of that agreement, the value of Washington Mutual's bonds would probably rise, since the $4 billion could be used to pay bondholders, including hedge funds that had bought the debt.

The deal, however, was kept secret.

Lawyers representing some Washington Mutual shareholders, in a brief filed this year, claimed that lawyers from Fried, Frank, Harris, Shriver & Jacobson, which was involved in the bankruptcy negotiations, told its clients, the hedge funds, about the secret agreement. As a result, those hedge fund investors were able to buy bonds on the cheap, and then wait for their value to rise when the agreement came to light.

Judge Walrath, in her Tuesday decision, noted that certain shareholders said that Fried, Frank "was under a

written confidentiality agreement barring it from sharing information with its clients, unless they were subject to confidentiality agreements of their own. Nonetheless, on July 1, 2009, Fried, Frank shared summaries of the April negotiations with both Centerbridge and Appaloosa, who were not at the time subject to a confidentiality agreement." Centerbridge, the judge wrote, continued to trade in Washington Mutual bonds, while Appaloosa voluntarily restricted its trading activities.

The hedge funds and others have argued that though they may have had talks with Fried, Frank or others privy to confidential information, they received no "material information" that would rise to the level of insider trading.

The judge did not rule on whether the hedge funds had committed wrongdoing or whether the claims made by shareholders' lawyers were true. Still, those accusations, she wrote, were "a colorable claim that" the hedge funds had "received material nonpublic information," that could be resolved only through further inquiry.

But first, the judge wrote, the parties should go to mediation to resolve the dispute.

Representatives of Fried, Frank and Aurelius Capital Management declined to comment on the judge's ruling. Owl Creek Asset Management did not return phone calls seeking its perspective. Centerbridge Partners declined to comment.

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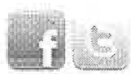
Cosgrove Bankruptcy Blog



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OCTOBER 11, 2011

Judge Walrath's September Opinion in the Wamu Case Covers a Wide Range of Issues Including the Valuation of NOLs and the Now Infamous Insider Trading Claims

Last month, Judge Walrath issued a terrifically thorough 139-page decision denying the Wamu debtors' "Modified Sixth Amended Joint Plan of Affiliated Debtors." Judge Walrath's opinion has become the topic of much debate and discussion, mainly due the fact that it addresses the Equity Committee's claims of insider trading against four major creditors (collectively, the Settlement Noteholders). Those insider trading claims were first raised by individual equity-holder Nate Thoma back in January of this year. However, Mr. Thoma raised the issue in an improper form, relying on inadmissible hearsay to make his argument. More recently, the Equity Committee filed a motion asking the Judge to find that the committee has standing to file an adversary proceeding against the alleged insider-culprits. In the September opinion, the Judge found that the committee does have standing, but is requiring the parties to enter mediation prior to the filing of any new adversary action.

In addition to discussing the Section 10b and Rule 10b-5 claims, the Judge also addressed important tax issues in great detail. The main tax issue arises in a valuation context. The parties have been arguing over how to value the debtors' net operating losses ("NOLs"), which are very valuable to companies that have current operating gains that can be offset by the NOLs. In particular, the Court's discussion focused on section 269 of the Internal Revenue Code, which allows the IRS to disallow the use of NOLs by any company that obtains them in a transaction that was set up for the sole purpose of evading taxes. Any reorganization plan confirmed in this case that transfers control of the Wamu NOLs to any other entity may be scrutinized by the IRS under section 269. The Court found that the current valuations of the debtors must factor in the risk that the NOLs will be disallowed by the IRS, and could therefore be worthless.

In terms of the insider trading claims, this case could be groundbreaking. The Equity Committee basically is arguing that four major creditors obtained material non-public information ("MNPI") during settlement negotiations with the the Wamu debtors and JP Morgan Chase, and then traded on that information in violation of fiduciary duties owed to shareholders. In

part, the committee is claiming that the knowledge the four creditors had that settlement talks we[Follow] [Join tumblr] of itself MNPI. If the committee does go forward with its suit, the committee will likely be fighting an uphill battle. However, the impact of a committee victory here could permanently change the way that distressed debt is traded. Needless to say, everyone is interested in the outcome here.

In discussing the insider trading issue, the Court quoted the following language from the landmark case of Pepper v. Litton (380 U.S. 311 (1939)):

"He who is in...a fiduciary position...cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He 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."

These issues are far from decided and the case appears to be far from its conclusion.

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Analysis: WaMu ruling may change big bankruptcy negotiations

9/21/2011 COMMENTS (0)

Sept 21 (Reuters) - For big hedge funds that throw themselves into large bankruptcies with an eye on outsized profits, the Chapter 11 case of Washington Mutual Inc may be remembered as a game-changer.

A Delaware bankruptcy judge's ruling in the case rejecting the company's reorganization plan could chip away at the funds' underlying investing strategy and change how large restructurings are negotiated, according to legal experts.

In her ruling, Judge Mary Walrath suggested that hedge funds that buy large blocks of a bankrupt company's debt and then help negotiate a reorganization plan could be considered insiders.

Her opinion also suggests the funds have a fiduciary duty to other creditors.

"I think Judge Walrath's comments in this decision are an extreme departure from what everybody in the distressed community thought were the rules of the road," said Kurt Mayr of law firm Bracewell & Giuliani.

The case revolves around four hedge funds -- Owl Creek Asset Management LP, Appaloosa Management LP, Centerbridge Partners LP and Aurelius Capital Management LP -- which regularly take active roles in large bankruptcies.

The funds bought Washington Mutual securities at knock-down prices, banded together in an ad hoc committee and used their combined holdings to get a seat at the negotiating table.

They also traded the company's securities at the same time, although they subjected themselves to various restrictions.

The plan they helped craft paid most creditors in full but left almost nothing for the company's shareholders, who bitterly opposed the proposal.

In addition, shareholders presented evidence that the funds engaged in insider trading by cashing in on non-public, material information gleaned from the negotiations.

The funds denied the allegations, arguing among other things that they did not meet the definition of insiders.

Walrath disagreed. In her written ruling last week, she found that the funds may have become insiders when Washington Mutual provided them confidential information and allowed them to join negotiations for a reorganization plan.

She also found the funds had a fiduciary duty to other creditors because they hold such large positions in some securities that they could block any reorganization that they opposed.

Walrath did not rule on the merits of the insider trading allegations, merely that they met the low bar for being "colorable" or viable claims.

However, her ruling suggests that funds that participate in talks must take greater care when trading at the same time, or they could be at heightened risk of violating insider trading laws, said Benjamin Feder of law firm Kelley Drye.

"Obviously there is going to be significant possibility that trading on such information without protective mechanism will be a violation of securities laws," he said.

In a client note, Davis Polk said the ruling could limit the willingness of funds to participate in reorganization talks.

In turn, Davis Polk said that could make it hard for a bankrupt company to find a critical mass of creditors to support a plan to get out of Chapter 11, prolonging the reorganization process.

Walrath was not terribly sympathetic to warnings about the chilling impact she might have the reorganization process.

She noted in her ruling that official committees, which are organized by the U.S. Trustee and recognized by the court, are always subject to restrictions on trading.

"The court does not believe that a requirement to restrict trading or create an ethical wall in exchange for a seat at the negotiating table places an undue burden on creditors who wish to receive confidential information and give their input," she wrote.

The ruling is not the first time the funds felt a sting from Walrath. Early in the case she broadened what many had accepted as proper disclosure to require ad hoc committees to divulge not just their cumulative investment, but when they bought the securities and what they paid.

Shareholders seized upon information from those disclosures to accuse the four funds of insider trading, which led to the current ruling.

The case is In re Washington Mutual, U.S. Bankruptcy Court, District of Delaware, No. 08-12229.

(Reporting by Tom Hals)

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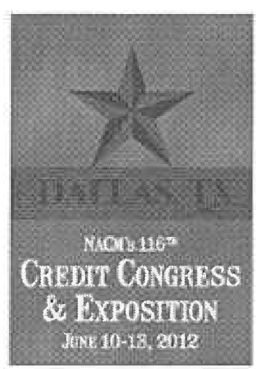

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WaMu Bankruptcy: It Ain't Over Till It's Over

Thursday, September 15, 2011 by Brian Shappell

Some bankruptcy and business watchers thought the three-year saga that is the Washington Mutual, on of the two largest Chapter 11 bankruptcy filings, was closing in on eyeshot of the finish line. Then, a judge in the U.S. Bankruptcy Court's Third District (Delaware) dealt it another setback by siding with lower-level creditors.

Three years since filing for Chapter 11 bankruptcy protection, WaMu's creditors and shareholders presented final arguments in bankruptcy court asking for the judge to reject a $7 billion reorganization plan last month. Opponents argued a settlement deal WaMu made with a group of hedge funds undermines the fairness of the bankruptcy process and alleged incidents of insider trading. U.S. Bankruptcy Judge Mary Walrath evidently found the argument compelling as she rejected the reorganization plan this week in court and ordered the sides to enter mediation. In the process, she reportedly intimated it was likely some involved in WaMu proceedings, namely a quartet of hedge funds, indeed engaged in insider trading practices to shape the bankruptcy process, as some lower-level creditors alleged.

The proposed settlement, like many proposed bankruptcy plans in recent years, would have left unsecured creditors and shareholders with little or nothing, more likely the latter. Even Walrath herself has described the case as convoluted and intimated that litigation was likely to rage on in one form or another for some time.

Brian Shappell, NACM staff writer

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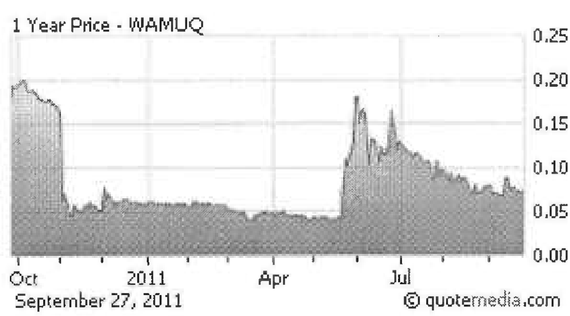
Washington Mutual Reorganization Part 1: Fund Insider Trading Charges Prompt Mediation Order

by: Troy Racki

September 27, 2011 | about: WAMUQ.PK, includes: JPM

On September 13th, Federal bankruptcy Judge Mary F. Walrath denied Washington Mutual's (WAMUQ.PK) reorganization plan for the second time, citing improper post-petition interest rates and "colorable" claims of insider trading. However out of concern that the case would simply unravel into more costly litigation, she immediately ordered that all parties proceed to mediation.



In January the judge had denied WaMu's reorganization plan for the first time based on multiple minor issues but approved the majority of the plan built around a global settlement agreement that paid all WaMu's creditors, the FDIC, JP Morgan (JPM), and some WaMu bank bondholders. The GSA however left nothing for shareholders, resulting in many individual objectors to the plan. During the confirmation hearing, one independent shareholder, Nate Thoma, raised sufficient enough concern with hearsay evidence of insider trading by four hedge funds involved in the case that the judge ordered a limited scope probe of the allegations.

A Previous Settlement

While the insider trading charges had been 10 months in the making, they almost never made it to trial. After repeated rescheduling of depositions, a May settlement was announced that included all parties involved. The terms of the settlement had WaMu shareholders receiving the reorganized company valued at $160 million, but with $160 million in debt and preferred securities to pay back, a $100 million bridge loan for the company, and $30 million for a litigation fund to pursue some third parties not exempted by the GSA. While on the surface, this settlement appeared to give equity very little, the main value was that WaMu shareholders would have been able to preserve valuable tax breaks from net operating losses against future income between the amount of $6 and $17.7 billion.

Talks eventually broke down in June though after some WaMu shareholders deemed the settlement insufficient. Attorneys representing equity wanted a recovery for both preferred and common shares, however there was simply not enough money available from the deal to appease everyone. In an attempt to preserve the settlement, equity attorneys sought additional considerations from the hedge funds. They refused, gambling that a win at trial would dispel the need for any concessions.

A Lost Gamble, "Reckless" Actions

Despite their best efforts to persuade her otherwise, the hedge funds arguments – which ranged from that the ethical trading walls are too cumbersome and expensive to that they lost money on some of their trades so they couldn't have known what was going on – were largely ineffective with Judge Walrath. She decided that the hedge funds were suspicious of engaging in insider trading both under the classical and misappropriation theories. In her 139 page opinion, the court wrote that, "The Court finds that the Equity Committee has made sufficient allegations and presented enough evidence to state a colorable claim that the Settlement Noteholders acted recklessly in their use of material nonpublic information."

Instead Judge Walrath opined that while there was sufficient merit to the insider trading claims for the equity committee to proceed with their litigation, she ruled that in order to preserve the estate's limited assets all parties would go to mediation. This order came with an added pressure to settle. Should mediation attempts fail, the judge indicated that she is prepared to allow the equity committee to proceed with a more detailed discovery of the funds' actions. If successful at trial, the equity committee would then be able to hold equitable disallowance against the hedge funds, resulting in their debt claims being expunged and their distribution to be redistributed to other creditors and ultimately to shareholders.

Strength of the Case

Now with the judge ruling that the insider trading charges have merit, once again the hedge funds are in the hot seat. Shareholders allege that

the four hedge funds, Appaloosa Management, Aurelius Capital Management, Centerbridge Partners, and Owl Creek Asset Management used non public material information from closed door settlement negotiations between WaMu, JP Morgan, and the FDIC to purchase deeply discounted parent company debt with the knowledge they would certainly profit. As the on and off negotiations progressed, it is alleged that at least two of the hedge funds also used their insider knowledge to sell higher seniority debt they had already profited on to buy up junior debt as it became clearer that WaMu's lower priority creditors were more likely to be paid. This knowledge provided an unfair advantage over the rest of the investing public, which was unaware that negotiations were even in progress. In one such example, a $4 billion dollar deposit asset held by WaMu had been agreed upon early on by all that it belonged with the parent corporation. This material insider knowledge however was in direct contrast to court filings and news reports which led the public to believe the asset was still hotly contested.

As usual, Judge Walrath refrained from showing her hand in regards to her level of conviction on the strength of the charges. Instead she only ruled that the minimum bar had been achieved in order to allow for the charges to progress. It is evident that by deciding to hold back a more detailed opinion the judge is looking for all the parties to come to an unbiased settlement, one not weighted towards any one side by a preliminary judiciary decision.

Disclosure: I am long WAMKQ.PK, WFC.

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Washington Mutual Reorganization Part 2: Fund Insider Trading Charges Prompt Mediation Order

by: Troy Racki

September 27, 2011 | about: WAMUQ.PK, includes: GS, JPM, WAMKQ.PK, WFC

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Billions at Stake

The hedge funds stand to lose possibly billions should equity eventually prevail at trial. Together the four funds hold approximately $2.5 billion of the parent company's debt which is at risk for disallowance. The equity committee has also made a motion to litigate seeking that the hedge funds pay the estate's legal fees and compensate the estate for interest accruals because their actions have unduly prolonged the bankruptcy process. So far legal fees in the case have amassed at $240 million in conjunction with over $785 million in bond interest. In all the hedge funds could possibly be on the hook for over $3.5 billion.

Then there is the matter of the SEC. One of the hedge funds involved already has had a recent run in with the law. In July 2010, Appaloosa Management paid more than $1.3 million in forfeited profits and penalties resulting from stock trades that regulators said "willfully violated" federal rules. The trades involved a Wells Fargo (WFC) shorting maneuver in November 2008. The fine included a civil penalty of $421,250 and disgorgement of $842,500 in profits. Should a future ruling of insider trading come down strong enough it is possible authorities would then make their own pass at the hedge funds, with accompanying civil penalties in the hundreds of millions. If the SEC were to exact a 50% civil penalty on the hedge fund's total WaMu (WAMUQ.PK) holdings, the fine could be up to $1.25 billion, two and a quarter times more than Goldman Sachs (GS) record $550 million settlement. Finally there's the possibility of loss of goodwill in the form of negative publicity and lost clientele from an SEC investigation and penalty.

All in all, a lost trial could possibly cost some of the hedge funds their businesses entirely.

An Urge to Settle, Impassioned Shareholders

As all parties head towards mediation there is certainly an urge to settle as far as the hedge funds are concerned. If they do not make an adequate settlement offer then the shareholders will likely fight on with the intent of inflicting the maximum financial penalty. Currently with how the debtors have structured their reorganization, shareholders have nothing to lose and everything to gain by going to trial.

The dilemma the hedge funds now face is entirely of their own creation. Early on in the case WaMu, likely highly influenced by the hedge funds blocking position of debt holdings, repeatedly urged the courts that the parent company was insolvent and that the shareholders should have no official representation. By doing so the hedge funds only managed to accomplish infuriating thousands of individual shareholders, resulting in the independent objections like Nate Thoma's which has since placed them at this financial precipice. Had the hedge funds brought equity on board early with even a small recovery they may have not faced the resistance they do now.

Instead the shareholders have good reason to be upset, considering the suspicion generated by the current hedge fund influenced GSA. In it, $10 billion of cash and tax refunds are split among WaMu, JP Morgan (JPM), and the FDIC with such financial precision that that the "goal posts" of distributable money land almost exactly between WaMu's debt and equity. By all appearances the hedge funds seemed only concerned about themselves at the bargaining table. When they were assured full payment of their claims they stopped trying to maximize any further recovery for the estate.

According to WaMu's last reorganization plan the money comes just $40 million short of equity in an estate worth over $8 billion. Restated, the shareholders currently stand just one half of one percent out of the money; in a plan that also pays JP Morgan $2.1 billion in tax refunds.

"Bonanza" for JP Morgan

The legitimacy of the $2.1 billion payment to JP Morgan remains questionable to some, given the terms under which the bank accepted TARP. In order to skirt the law, the current arrangement is for WaMu to receive all of their tax refunds from the IRS, after which they will then make a recourse payment to JP Morgan and the FDIC. Put plainly, WaMu will act as a middleman to help JP Morgan circumvent the law. Whether this is legal or equitable has never been decided by the court. Instead Judge Walrath admits that:

> "The Court's conclusion in the January 7 Opinion was not a decision on the merits of the underlying claims but merely a determination that the settlement of those claims by the Debtors on the terms of the GSA was reasonable."

In other words the judge is allowing for "under the table" agreements to exist, regardless if JP Morgan actually has a legal right to the tax refunds. If most all parties agree to it, her intent is to support any form a "reasonable" settlement so the case can be resolved. Keep in mind that in bankruptcy court, the bar for "reasonableness," like the current insider trading claims, is exceptionally low. As the hedge funds have now suddenly learned, in Delaware the sword cuts both ways.

So far the collapse of Washington Mutual has been called a "bonanza" for JP Morgan, according to Peg Brickley of Dow Jones Daily Bankruptcy Review (article later redacted). As I reported previously, according to the GSA's current terms JP Morgan will receive $5 billion in HELOC backed securities valued on the open market at 60% of par, $193 million in Visa class B securities, $2.1 billion in cash, and a $20 million wind farm, all from WaMu. Given the initial purchase price of WaMu for $1.9 billion in 2008, these additional assets received means that JP Morgan will pay a **negative** $3.4 billion for their purchase of the bank.

The very lucrative nature of this settlement leads *American Banker* to believe that JP Morgan may eventually chip more into the pot to pay shareholders. *Banker* concludes in their most recent article, "Many creditors are looking to JPMorgan Chase to drive mediation discussions, as it can't get the benefit of its deal until Washington Mutual's Chapter 11 plan is in place."

Uncertainty and "Skepticism"

It is uncertain how much WaMu's shareholders will receive from mediation. Unless the terms of the current GSA change, all equity will be able to recover is what debt claims the hedge funds are willing to part with to settle not going to trial. Then even among equity there is a hurdle, with approximately $7.5 billion in preferred stock that under the typical waterfall scenario should be paid in full before common shares receive a payment.

WaMu however is far from the typical bankruptcy. The standard waterfall scenario will likely be overlooked in an effort to reach a compromise among everyone. One possibility would be for the hedge funds to reduce their claims sufficiently to allow equity to take full ownership of the reorganized company. An agreement would also likely include enough cash for WMMRC to operate going forward. It would then be up to the shareholders to make the most of the company's large NOL asset.

Some however are not so optimistic. CRT Capital Group analyst Kevin Starke told Dow Jones Daily Bankruptcy Review that he was "skeptical" mediation would resolve the impasse. I think otherwise. The fact that the case nearly settled once before is a hint there may be a second chance at success. Back in May the stakes for the hedge funds were much lower. Now with the judge's preliminary ruling in favor of the equity the funds have to weigh out the real risk of what insider trading would do to them and what that risk is worth to them.

WaMu's shareholders are likely to get something. The million dollar question is how much. To that no one knows the answer, except for the insiders.

Disclosure: I am long WAMKQ.PK, WFC.

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After Settlement in Amtrak Case, Opinions Erased From Lexis and Westlaw

Shannon P. Duffy

The Legal Intelligencer
August 19, 2009

In Klein v. Amtrak -- a case in which two trespassing teenagers climbed atop a parked train car and suffered serious burns when they got too close to a 12,000-volt catenary wire -- a team of defense lawyers fighting to overturn a $24 million verdict figured out a way to have their settlement cake and eat their jurisprudence, too. The confidential settlement included an unusual provision that called for the trial judge to vacate all unfavorable published opinions and have them removed from Lexis and Westlaw.

Ordinarily, the decision to settle a case while an appeal is pending means giving up the opportunity to set a legal precedent as well as forgoing the chance to win a reversal of any unfavorable published decisions handed down by the lower court.

But a team of defense lawyers fighting to overturn a $24 million verdict have figured out a way to have their settlement cake and eat their jurisprudence, too.

The confidential settlement in Klein v. Amtrak—a case in which two trespassing teenagers climbed atop a parked train car and suffered serious burns when they got too close to a 12,000-volt catenary wire—included an unusual provision that called for the trial judge to vacate all of his published opinions and have them removed from Lexis and Westlaw.

And it worked.

A few months after holding an hourlong oral argument, the 3rd U.S. Circuit Court of Appeals agreed in late July to remand the case to the trial judge, U.S. District Judge Lawrence F. Stengel, who, in turn, agreed to vacate eight of his published opinions and to "direct" Lexis and Westlaw to remove them from their databases.

Gretchen DeSutter, a spokeswoman for Westlaw, said Stengel's request to remove the opinions would "absolutely" be honored, and that any instance in which a judge vacates a published opinion automatically leads to its withdrawal from Westlaw's database.

Calls to Lexis were not returned by press time.

Exactly how the lawyers went about persuading Stengel to take such an unusual step is impossible to say because all of the court papers are under seal and none of the lawyers will talk about it.

Plaintiffs attorney Joseph F. Roda of Roda & Nast in Lancaster, Pa., said, "All I can tell you, I think, is that the case has settled."

Robert C. Clothier of Fox Rothschild, who has handled access cases for The Legal Intelligencer, said he was troubled by the court's decision to allow the defense lawyers to file all of their motions under seal, including the motion that asked for permission to seal the other papers.

To justify sealing any document, Clothier said, the courts have consistently held that it is necessary to "articulate on the record" the extraordinary circumstances that justify secrecy. As a result, he said, the motion to seal itself cannot be under seal.

The audiotape of the 3rd Circuit oral argument reveals that the three-judge panel had tough questions for both sides and that no clear winner emerged.

In five years of litigation, Klein v. Amtrak spawned a series of legally significant decisions—all now withdrawn—on issues such as how to apply the "attractive nuisance" doctrine in a case where the injured plaintiff was nearly 18 years old, and the standard of proof required to show that a landowner was aware of a risk because of similar prior accidents.

In April 2008, Stengel issued a 60-page opinion that upheld the jury's verdict, rejecting a slew of arguments that challenged his pretrial rulings, his jury instructions and the size of both the compensatory and punitive damage awards.

Stengel found that the jury's conclusions were supported by clear evidence that "Amtrak had every reason to know trespassers were regularly on its tracks and that teenage boys were inclined to climb to the top of parked boxcars."

In the October 2006 trial, Roda told the jury that catenary wires pose a grave danger because they can inflict a lethal shock even if the victim doesn't come in direct contact with them because of the phenomenon of "arcing" in which the electricity "jumps" from the source to any grounded object.

Roda said at the trial the two defendants—Amtrak, which owned the property, and Norfolk Southern Corp., which owned the parked boxcar—were aware of the dangers, and also knew that parked boxcars with ladders on the side that make it possible to climb atop them are attractive to teenage boys.

Amtrak was also aware that trespassers were common in its rail yard, Roda said at the trial, because of pervasive graffiti. But despite regularly training their own employees about the risks of electrocution, Roda said, the defendants did nothing to prevent injuries to trespassers.

Since the boxcars were parked for four days, Roda said, Amtrak could have turned off the power to the catenary lines or at least posted warning signs that labeled the boxcars as a high-voltage area.

The 11-day trial was bifurcated, and the jury found in its first verdict that Amtrak was both negligent and "wanton" and that Norfolk Southern was negligent. It also found that Amtrak was 70 percent responsible; that Norfolk Southern was 30 percent responsible; and that the two plaintiffs were zero percent responsible.

Following a brief trial on the issue of damages, the jury awarded a total of $24,227,435 to plaintiffs Jeffrey Klein and Brett Birdwell.

Klein, who suffered burns over 75 percent of his body and was hospitalized for nearly 11 weeks, was awarded more than $11 million in compensatory damages. Birdwell, who was burned over 18 percent of his body, was awarded more than $588,000.

The jury also awarded $12.5 million in punitive damages—$8.75 million against Amtrak and $3.75 million against Norfolk Southern Railroad—to be split equally by the two plaintiffs.

TOUGH QUESTIONS AT ARGUMENT

In the 3rd Circuit oral argument, Amtrak's lawyer, William G. Ballaine of Landman Corsi Ballaine & Fordin New York, argued that Stengel misunderstood some of the basic tenets of Pennsylvania law with respect to the duty that landowners owe to trespassers.

Ballaine said landowners "don't have to anticipate trespassers.
"

But U.S. Circuit Judge Michael A. Chagares interrupted and reminded Ballaine of the evidence of graffiti that put Amtrak on notice of the trespassers, and said the jury had decided the issues against the railroads.

Ballaine insisted that if Stengel had gotten the law right, Amtrak would have prevailed on summary judgment. "So it shouldn't make a difference that the jury came out the way it did if, as a matter of law, the evidence wasn't there," Ballaine said.

U.S. Circuit Judge Julio M. Fuentes also seemed at first to be rejecting Ballaine's arguments, saying: "You owe a certain duty to trespassers," and reminding Ballaine that the evidence included other similar accidents.

But Ballaine insisted that the evidence of previous accidents didn't satisfy Pennsylvania's rigorous test, which requires proof that similar accidents occurred in the same place and in the same time frame. Stengel erred, he said, by allowing the jury to hear of accidents that occurred decades ago and in other states.

Fuentes seemed less than impressed, saying Ballaine seemed to be arguing that "substantially similar" accidents needed to be "precisely identical."

Norfolk Southern's lawyer, Nancy Winkelman of Schnader Harrison Segal & Lewis, argued that Stengel should have allowed her client out of the case before trial because, unlike the landowning Amtrak, it had no knowledge of the trespassers.

Winkelman said the "perverse result" of the case was that Norfolk Southern was held liable under a negligence standard for allegedly being a co-creator of a dangerous condition, while Amtrak was liable only if the plaintiffs could prove wanton conduct.

But the judges also had tough questions for plaintiffs attorney Roda.

Fuentes pressed Roda on whether he had "any caselaw support" for his argument that the jury was properly told of other accidents that occurred long ago or far away from Pennsylvania.

Roda insisted that the evidence was used only to show Amtrak's "state of mind" and that the theme of the evidence was always the same—teenagers trespassing and climbing on train cars and getting injured from catenary wires.

Fuentes asked: "Isn't the problem that trespassers are not necessarily foreseeable, and that's why you have the elevated standard when trespassers are involved?"
Roda agreed, but insisted that he had satisfied the test by showing that Amtrak did nothing to eliminate a known and lethal risk even though doing so would have been as simple as flicking a switch.

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8 No. 11 Westlaw Journal Bankruptcy 3
*1 September 30, 2011

Reorganization Plan

WASHINGTON MUTUAL LOSES PLAN-CONFIRMATION BID OVER INSIDER-TRADING CLAIMS
In re Wash. Mut.

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Washington Mutual Inc. has again failed to win court approval for its proposed Chapter 11 reorganization plan.
In re Washington Mutual Inc., No. 08-12229, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011).
U.S. Bankruptcy Judge Mary Walrath of the District of Delaware rejected the plan for the second time this year. This time she found objectors to the plan stated a "colorable" claim of insider trading against four hedge funds that allegedly used their role in negotiating the plan to generate profits trading Washington Mutual's securities.

Washington Mutual filed for Chapter 11 protection in September 2008 after federal regulators seized its saving and loan, commonly known as WaMu. The Federal Deposit Insurance Corp. sold WaMu to JPMorgan for $1.9 billion.

The seizure and bankruptcy set off a series of legal battles that ended with a global settlement agreement last year among the FDIC, Washington Mutual and JPMorgan. The three agreed to divide $10 billion in disputed assets.

In January Judge Walrath found the agreement to be fair and reasonable but concluded that releases given to the company's directors, officers and other parties were too broad. *In re Wash. Mut.*, 2011 WL 57111 (Bankr. D. Del. Jan. 7, 2011).

The judge said at the time that Washington Mutual's shareholders, who probably will recover nothing under the reorganization, should not be barred from suing those whose misconduct might have caused the company's collapse.

The agreement was modified in March to include limitations on the releases, and Washington Mutual again sought plan approval.

But a committee representing the shareholders objected. It said that after the earlier denial of plan confirmation, the shareholders learned through discovery that certain large creditors, identified in the court's opinion as "settlement noteholders," traded in Washington Mutual's securities while in possession of material, nonpublic information.

Ruling on the objection, Judge Walrath first concluded she still had jurisdiction to consider the plan, which incorporates the settlement agreement, in light of the U.S. Supreme Court's recent decision in *Stern v. Marshall,* 131 S. Ct. 2594 (June 23, 2011).

The decision has been read to bar bankruptcy judges from entering final judgments on any non-core proceedings.

"The [global settlement agreement] in this case is particularly within the core jurisdiction of the Bankruptcy Court because it deals with a determination of what is property of the estate," the judge said.

***2** She then reiterated her prior finding that the agreement is fair and reasonable.

Judge Walrath concluded, however, that the shareholders stated a "colorable" claim for the equitable disallowance of any disbursements the settlement noteholders might receive under the plan.

She said she has the authority to disallow a claim on equitable grounds in extreme instances and that based on the evidence presented so far, it appears the settlement noteholders traded on information not known to the public.

Judge Walrath expressed concern, however, that the case "will devolve into a litigation morass."

As a result, she directed the parties to engage in mediation on the equitable-disallowance claim and set a status conference for Oct. 7.

Attorneys:
Debtor: Mark D. Collins, Richards Layton & Finger, Wilmington, DE; Brian S. Rosen, Weil Gotshal & Manges, New York,

NY
Judge: Mary F. Walrath

Company: Washington Mutual Inc.

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26 No. 6 Westlaw Journal Delaware Corporate 9
*1 October 3, 2011

Bankruptcy Issues/Reorganization Plan

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17 No. 11 Westlaw Journal Bank & Lender Liability 9
*1 October 10, 2011

Reorganization Plan

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Commercial Bankruptcy Litigation § 9:55

Commercial Bankruptcy Litigation
Database updated January 2012

Jonathan P. Friedland

Chapter 9. Claims Litigation
Chapter Author: Philip D. Anker*
V. Subordination of Claims

§ 9:55. Equitable disallowance

May a bankruptcy court apply "principles of equity," not merely to subordinate one claim to another, but to disallow altogether the claim of the creditor that engaged in the misconduct? A strict reading of the Bankruptcy Code might suggest the answer is no. First, § 510(c) expressly provides that a bankruptcy court may "subordinate," not disallow, a claim, and it also specifies that it may subordinate a claim only to another claim, not to an equity interest.1 Second, § 502(b) provides that, if an objection is filed to a claim, the court "shall allow" the claim unless it falls within one of the specified conditions warranting disallowance, none of which is seemingly "equitable disallowance."2

The Fifth Circuit seemingly agrees with this view. In Mobile Steel, it described as one of the "principal bounds" of a bankruptcy court's prerogative to relegate claims to inferior status on equitable grounds that "equitable considerations can justify only the subordination of claims, not their disallowance."3 It reasoned:

Disallowance of claims on equitable grounds would add nothing to the protection against unfairness already afforded the bankrupt and its creditors. If the claimant's inequitable conduct is directed against the creditors, they are fully protected by subordination. If the misconduct directed against the bankrupt is so extreme that disallowance might appear to be warranted, then surely the claim is either invalid or the bankrupt possesses a clear defense against it. Thus, where the bankrupt is the victim it has an adequate remedy at law. It follows that disallowance of a wrongdoer's claim on nonstatutory grounds would be an inappropriate form of equitable relief.4

However, some courts have reached the opposite conclusion, holding that in appropriate circumstances—they have suggested those circumstances are very limited—a bankruptcy court applying the Bankruptcy Code could disallow a claim altogether on equitable grounds. These courts have cited the Supreme Court's 1939 decision in Pepper v. Litton.5 In that case, the Supreme Court affirmed a district court judgment disallowing the claim of the controlling stockholder of the debtor corporation as either a secured or unsecured claim.6 In doing so, the Court opined on the equitable powers of bankruptcy courts, at least when addressing a claim of an insider:

The equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it pari passu treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence.7

Noting the general rule that courts "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure,"8 some lower courts have suggested that Pepper may potentially continue to authorize the disallowance and not merely the subordination of a claim on equitable grounds.9 For example, in litigation arising out of the well-publicized Adelphia Chapter 11 bankruptcy, the creditors' committee (and later the postconfirmation creditors' trust) sought not only equitable subordination of the defendant banks' claims but also equitable disallowance of those claims. The bankruptcy court denied the defendants' motion to dismiss the action.10 Terming the text of the Bankruptcy Code as inconclusive (as neither authorizing nor prohibiting equitable disallowance), the bankruptcy court relied on Pepper, reading it as treating subordination and disallowance as separate remedies, each of which was potentially available.11 Nevertheless, the bankruptcy court cautioned that disallowance is an even more "draconian" remedy than subordination and "would be appropriate in just a few circumstances."12 On appeal, the district court affirmed, agreeing with the bankruptcy court's conclusions both that equitable disallowance is available in appropriate circumstances and that those circumstances are limited at best.13

Although the courts in Adelphia disagreed, it appears difficult to reconcile their interpretation of the Bankruptcy Code either with its statutory language or with the Supreme Court's decision in the Travelers case. There, the Court rejected a proffered

ground for objecting to a claim nowhere set forth in the statutory text: "Consistent with our prior statements regarding creditors' entitlements in bankruptcy ... we generally presume that claims enforceable under applicable state law will be allowed in Bankruptcy unless they are expressly disallowed" under the Bankruptcy Code.14 Moreover, it seems doubtful whether "equitable disallowance" serves any valid bankruptcy purpose. As the Fifth Circuit noted in Mobile Steel, the doctrine of equitable subordination already protects the legitimate interests of innocent creditors by allowing, in appropriate circumstances, their claims to be given priority over the claims of other creditors that engaged in misconduct.15 Disallowing the latter claims altogether seemingly would benefit only the debtor's shareholders, allowing them to receive more in bankruptcy than they would under state law outside of bankruptcy. In this regard, it is worth noting that the claims the Supreme Court in Pepper suggested could be disallowed on equitable grounds were held by the controlling shareholder of the debtor, not by third-party creditors.

Nevertheless, it is likely that there will continue to be litigation over whether equitable disallowance may ever be permitted and, if so, the circumstances and showing required. The issue may arise most often in cases such as Adelphia in which there were many different affiliated debtors and the banks had liens against the assets of the subsidiaries that were seemingly solvent, but there remained unpaid unsecured claims at the level of the parent debtors and hence the creditors holding those claims wanted the disallowance altogether of the banks' secured claims against the subsidiaries so more value could be dividended from the bankruptcy estates of the subsidiary debtors to those of the parent debtors.

* The author would like to thank Caroline Rogus for her valuable assistance in the preparation of this chapter.

1 11 U.S.C.A. § 510(c)(1). By its terms, § 510(c) permits only the subordination of one equity "interest" to another, not the subordination of a debt claim to an equity interest. 11 U.S.C.A. § 510(c)(1). See also In re Winstar Communications, Inc., 554 F.3d 382, 414, 51 Bankr. Ct. Dec. (CRR) 45, Bankr. L. Rep. (CCH) P 81408 (3d Cir. 2009) ("§ 510(c)'s language plainly provides that a creditor's claim can be subordinated only to the claims of other creditors, not equity interests").

2 11 U.S.C.A. § 502(b). In other contexts that are arguably analogous, the Supreme Court has read the term "shall" in a statute or rule to mandate the specified action unless a specified exception applied. See, e.g., Crosby v. U.S., 506 U.S. 255, 258–59, 113 S. Ct. 748, 122 L. Ed. 2d 25 (1993) (interpreting Fed. R. Crim. P. 43, "[t]he Rule declares explicitly: 'The defendant shall be present ... at every stage of the trial ... except as otherwise provided by this rule' (emphasis added). The list of situations in which the trial may proceed without the defendant is marked as exclusive not by the 'expression of one' circumstance, but rather by the express use of a limiting phrase. In that respect the language and structure of the Rule could not be more clear"); see also National Ass'n of Home Builders v. Defenders of Wildlife, 551 U.S. 644, 127 S. Ct. 2518, 2531–32, 168 L. Ed. 2d 467, 64 Env't. Rep. Cas. (BNA) 1513 (2007); Escoe v. Zerbst, 295 U.S. 490, 55 S. Ct. 818, 79 L. Ed. 1566 (1935); Alabama v. Bozeman, 533 U.S. 146, 121 S. Ct. 2079, 150 L. Ed. 2d 188 (2001).

3 Matter of Mobile Steel Co., 563 F.2d 692, 699, 15 C.B.C. 1 (5th Cir. 1977); see also In re Adler, Coleman Clearing Corp., 277 B.R. 520, 563 (Bankr. S.D. N.Y. 2002).

4 Matter of Mobile Steel Co., 563 F.2d 692, 699 n.10, 15 C.B.C. 1 (5th Cir. 1977) (internal citations omitted).

5 Pepper v. Litton, 308 U.S. 295, 306, 60 S. Ct. 238, 84 L. Ed. 281 (1939).

6 Pepper v. Litton, 308 U.S. 295, 301–02, 60 S. Ct. 238, 84 L. Ed. 281 (1939).

7 Pepper v. Litton, 308 U.S. 295, 306, 60 S. Ct. 238, 84 L. Ed. 281 (1939).

8 Pennsylvania Dept. of Public Welfare v. Davenport, 495 U.S. 552, 563, 110 S. Ct. 2126, 109 L. Ed. 2d 588, 20 Bankr. Ct. Dec. (CRR) 833, 22 Collier Bankr. Cas. 2d (MB) 1067, Bankr. L. Rep. (CCH) P 73382 (1990).

9 See, e.g., Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 991 n.7, 33 Bankr. Ct. Dec. (CRR) 647, Bankr. L. Rep. (CCH) P 77846 (3d Cir. 1998) (noting that Pepper suggests that a bankruptcy court was authorized to disallow a portion of a fiduciary's claim "when that would produce an equitable result" but declining to resolve the issue as to whether equitable disallowance remains a viable remedy under the Bankruptcy Code); Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 498 (S.D. N.Y. 1994) ("It is well settled that bankruptcy courts possess a broad range of equitable powers, including the authority to disallow or subordinate the claims of any creditor who attempts to take unfair advantage of the

debtor or other creditors"); In re Outdoor Sports Headquarters, Inc., 168 B.R. 177, 182, 25 Bankr. Ct. Dec. (CRR) 1137, Bankr. L. Rep. (CCH) P 75992 (Bankr. S.D. Ohio 1994) (denying summary judgment on issue of equitable disallowance but stating that "authority exists which would authorize the court to disallow a claim based upon equitable principles").

10 In re Adelphia Communications Corp., 365 B.R. 24, 73 (Bankr. S.D. N.Y. 2007), aff'd in part, 390 B.R. 64 (S.D. N.Y. 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D. N.Y. 2008).

11 In re Adelphia Communications Corp., 365 B.R. 24, 73 (Bankr. S.D. N.Y. 2007), aff'd in part, 390 B.R. 64 (S.D. N.Y. 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D. N.Y. 2008).

12 In re Adelphia Communications Corp., 365 B.R. 24, 73 (Bankr. S.D. N.Y. 2007), aff'd in part, 390 B.R. 64 (S.D. N.Y. 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D. N.Y. 2008).

13 Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 64, 73–77 (S.D. N.Y. 2008), adhered to on reconsideration, 2008 WL 1959542 (S.D. N.Y. 2008). In a subsequent opinion, however, the district court dismissed the trust's equitable disallowance claim (as well as its claim for equitable subordination) because all unsecured creditors of the Adelphia debtors that were obligated to the secured bank lenders had been paid in full and hence could not benefit from the claim. See Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 80, 99 (S.D. N.Y. 2008), aff'd, 379 Fed. Appx. 10 (2d Cir. 2010), cert. dismissed, 131 S. Ct. 896, 178 L. Ed. 2d 586 (2011). In the *Washington Mutual* bankruptcy case, the bankruptcy court agreed with the Adelphia decisions that, *Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co.* notwithstanding, it had the authority to disallow a claim on equitable grounds. Thus, although the court determined that the Equity Committee in that case did not have standing to pursue an equitable subordination claim, it held that the Equity Committee did have standing to assert a claim for equitable disallowance based on allegations that certain holders of the debtor's notes had engaged in insider trading. In re Washington Mut., Inc., 55 Bankr. Ct. Dec. (CRR) 113, 2011 WL 4090757, *43 (Bankr. D. Del. 2011).

14 Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co., 549 U.S. 443, 127 S. Ct. 1199, 1205–1206, 167 L. Ed. 2d 178, 47 Bankr. Ct. Dec. (CRR) 265, 57 Collier Bankr. Cas. 2d (MB) 314, Bankr. L. Rep. (CCH) P 80880 (2007).

15 Matter of Mobile Steel Co., 563 F.2d 692, 699 n.10, 15 C.B.C. 1 (5th Cir. 1977).

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KEY RULINGS FROM DELAWARE BANKRUPTCY COURT'S REJECTION OF WASHINGTON MUTUAL'S PLAN OF REORGANIZATION

MARC ABRAMS, JOSEPH G. MINIAS, AND RICHARD J. KURDZIEL[1]

Current through MR 11.27 11/17/2011

The Bankruptcy Court for the District of Delaware has denied, for the second time, confirmation of Washington Mutual, Inc.'s and WMI Investment Corp.'s plan of reorganization. The authors of this article discuss the court's ruling and explain its far-reaching implications for parties involved in Chapter 11 proceedings.

In a recent 139 page decision (the "Decision") with far-reaching implications for parties involved in Chapter 11 proceedings, Judge Mary F. Walrath of the Bankruptcy Court for the District of Delaware denied, for the second time, confirmation of Washington Mutual, Inc.'s ("WMI") and WMI Investment Corp.'s (collectively, the "Debtors") plan of reorganization (the "Plan").[2] Judge Walrath found several deficiencies in the Plan that violated the best interests of creditors test articulated in Section 1129(a)(7) of title 11 of the United States Code (the "Bankruptcy Code").[3]

In addition to denying confirmation of the Plan, the court also granted (and then stayed) a motion by the Official Committee of Equity Security Holders (the "Equity Committee") to prosecute an action to equitably subordinate or disallow the claims of certain

noteholders (the "Settlement Noteholders").[4] While denying standing to bring a claim for equitable subordination, the court held that the Equity Committee had standing to bring a claim for equitable disallowance based on allegations of insider trading by the Settlement Noteholders. In so ruling, Judge Walrath found that the Equity Committee stated a colorable claim for equitable disallowance, and ordered the parties to mediate to avoid a litigation morass which would further drain the estates' resources.

While the Decision analyzed numerous objections to the Plan asserted by various creditors and shareholders, certain of Judge Walrath's rulings are significant for practitioners and participants in Chapter 11 cases, namely, the rulings on:

- jurisdiction;

- postpetition interest;

- equitable disallowance; and

- non-statutory insider status under applicable law.

These key rulings are discussed in further detail below.
In rejecting the argument that the court lacked jurisdiction over modification of the Plan, Judge Walrath interpreted and applied the Supreme Court's recent decision in Stern v. Marshall, which has generated much commentary and uncertainty regarding a bankruptcy court's constitutional authority to enter a final judgment under certain circumstances.[5]
In determining what constitutes the "legal rate" for payment of postpetition interest on unsecured creditors' claims under Section 726(a)(5) of the Bankruptcy Code, Judge Walrath concluded that the federal judgment rate, rather than the contract rate, is applicable.[6] This was surprising as many believed that Judge Walrath's decision in *In re Coram Healthcare Corp.* provided support for the proposition that an unsecured creditor may be entitled to its contract rate of interest.[7]

The court granted the Equity Committee's motion for standing to prosecute a claim for equitable disallowance, even though the Settlement Noteholders argued that no such cause of action exists as a matter of law.

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The court found that the "Settlement Noteholders owed duties as non-statutory insiders under bankruptcy law" due to their blocking position in two classes of the Debtors' debt structure.[8] The imposition of fiduciary duties on creditors with blocking positions goes further than a previous decision in which Judge Walrath suggested that "members of a class of creditors may, in fact, owe fiduciary duties to other members of the class" when holding themselves out in a representative capacity.[9]

BACKGROUND

During the global credit crisis in the Fall of 2008, the rating agencies significantly downgraded the credit rating of Washington Mutual Bank ("WMB") and its holding company, WMI. A bank run followed, resulting in $16 billion of withdrawals from WMB in a 10-day period.

On September 25, 2008, the Office of Thrift Supervision closed WMB and appointed the Federal Deposit Insurance Corporation (the "FDIC") as receiver for WMB. Immediately after its appointment as receiver, the FDIC sold substantially all of WMB's assets to JPMorgan Chase Bank, N.A. ("JPMC"). On September 26, 2008, the Debtors filed petitions under Chapter 11 of the Bankruptcy Code.

The seizure and sale of WMB's assets gave rise to disputes among the Debtors, the FDIC and JPMC "regarding ownership of certain assets and various claims that the parties asserted against each other."[10] Nearly three years into the contentious Chapter 11 cases, negotiations led to a global settlement agreement (the "GSA") that resolved issues among the Debtors, JPMC, the FDIC, and certain creditors, including the Settlement Noteholders. The GSA served as the cornerstone of the Plan, and, although there were a myriad of objections, Judge Walrath found it to be fair and reasonable in an initial January 7, 2011 opinion (the "January 7 Opinion") denying confirmation.[11]

Despite modifications to the Plan to address the deficiencies identified in the January 7 Opinion, certain creditors and shareholders opposed the amended Plan. Following the July 2011 confirmation hearings and submission of post-hearing briefs, Judge Walrath issued the Decision but once again denied confirmation of the Plan and reaffirmed the conclusion in the January 7 Opinion that the GSA was fair and reasonable.[12]

JURISDICTIONAL ANALYSIS

As an objection to confirmation of the Plan, certain creditors asserted that the court could not enter a final order to confirm the Plan in light of the Supreme Court's ruling in *Stern,* because the Plan incorporated the GSA, and thus confirmation would require the court to decide the estates' claims against JPMC and the FDIC, for which the court lacked jurisdiction.[13] These objecting creditors further contended that the claims of the estate against JPMC and the FDIC were traditional actions at common law (*i.e.*, state corporate law, tort law and fraudulent conveyance law, as well as federal intellectual property and tort claims) and, therefore, had to be decided by an Article III court in accordance with *Stern*.[14] Proponents of the Plan disagreed for several reasons, principally that the *Stern* court characterized its ruling as narrow.[15]

Judge Walrath concluded that *Stern* did not support the objecting creditors' argument.[16] First, Judge Walrath noted that bankruptcy court approval of settlements is a firmly established historical practice, currently recognized by Federal Bankruptcy Rule 9019, which is based on a similar provision of the Bankruptcy Act.[17] Judge Walrath then cited Section 1123(b)(3)(A) of the Bankruptcy Code, which states that a plan may provide for the settlement of any claim or interest, and further explained that confirmation of such a plan is within the court's core jurisdiction.[18]

Second, Judge Walrath distinguished approval of a settlement of claims from a ruling on the merits of such claims, stating that a court does not need jurisdiction over the underlying claims to approve a resulting compromise.[19] Judge Walrath explained: "the January 7 Opinion was not a decision on the merits of the underlying claims but merely a determination that the settlement of those claims by the Debtors on the terms of the [settlement] was reasonable."[20]

Finally, Judge Walrath found that the approval of the GSA was particularly within the "core jurisdiction" of the court because approval includes a determination of what is property of the estate. And, Judge Walrath held, "[i]t is without question that bankruptcy courts have exclusive jurisdiction over property of the estate," including whether disputed property is property of the estate.[21]

As Stern is a recent decision being interpreted by the courts, the Decision provides insight into how it could potentially affect numerous previously undisputed aspects of a bankruptcy court's jurisdiction.

POSTPETITION INTEREST

Certain creditors alleged that the Plan failed to comply with the best interests of creditors test because it provided for the payment of postpetition interest on certain creditors' claims at their contract rate of interest, as opposed to the federal judgment rate. The court held the "legal rate" for payment of postpetition interest on creditors' unsecured claims under

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Section 726(a)(5) of the Bankruptcy Code is the federal judgment rate.22
In support of this holding, Judge Walrath first observed that "section 726(a)(5) states that interest on unsecured claims shall be paid at 'the legal rate' as opposed to 'a' legal rate or the contract rate."23 Judge Walrath reasoned that since Congress specifically provided for the contract rate in Section 506(b) of the Bankruptcy Code, it would have been specific in Section 726 as well had it intended the contract rate to apply. Second, Judge Walrath reasoned that the payment of postpetition interest is procedural in nature, and as such is governed by federal law rather than state law. From a policy standpoint, Judge Walrath added that the federal judgment rate promotes "fairness among creditors and administrative efficiency."24
Judge Walrath relied heavily on *In re Cardelucci* in her postpetition interest analysis, especially with respect to the lack of specific language in Section 726(a)(5) suggesting that Congress intended the contract rate to apply.25 There, the Ninth Circuit ruled that the legal rate meant the federal judgment rate due to principles of statutory interpretation and policy considerations.26
This aspect of the Decision was surprising given Judge Walrath's previous decision in *Coram* "that the specific facts of each case will determine what rate of interest is 'fair and equitable.'"27 Indeed, Judge Walrath acknowledged as much in a footnote stating, "[t]o the extent I suggested in *Coram* that the federal judgment rate was not required by section 726(a)(5), I was wrong."28

Judge Walrath, however, identified some circumstances where creditors might receive interest at the contract rate. For example, the court found that oversecured creditors are entitled to interest at the contract rate.29 In addition, the court recognized an entitlement to interest at the contract rate where contractual subordination provisions explicitly require junior creditors to make payments to senior creditors. Specifically, Judge Walrath addressed the argument of certain subordinated creditors that if the federal judgment rate were found to be applicable, then they are not obligated to pay the senior creditors the difference between what the Debtors pay under the federal judgment rate and the contract rate of interest. In accordance with the Rule of Explicitness that the court held was applicable under New York law,30 Judge Walrath found that the relevant indentures contained subordination provisions that "adequately apprised the subordinated creditors that their payments were subordinate to *all* contractual postpetition interest, even if the Court allowed *none*."31 Thus, the court held that the Plan provisions "that give effect to the subordination provisions in the indentures...are not violative of the Bankruptcy Code."32
With the exception of these limited circumstances, the Decision establishes that creditors are not entitled to their contract rate of interest in the Third Circuit.

EQUITY COMMITTEE STANDING MOTION

In addition to its objection to the Plan, the Equity Committee also sought standing to bring a claim for equitable subordination or equitable disallowance against the Settlement Noteholders. Not only did the Settlement Noteholders contend that the Equity Committee failed to allege a colorable claim, they also vigorously argued that no such cause of action exists as a matter of law.33 In considering whether the Equity Committee had standing, the court held that it depended on whether the Equity Committee "stated a 'colorable' claim which the Debtors have unjustifiably refused to prosecute."34 The court first held that a claim for equitable disallowance exists as a matter of law, and that the Equity Committee had stated a colorable claim against the Settlement Noteholders.35 However, Judge Walrath held, as did Judge Gerber in *Adelphia*, that equitable disallowance should be limited to "those extreme instances — perhaps very rare — where it is necessary as a remedy."36 Notwithstanding this limitation, and given the draconian nature of the remedy, parties involved in Chapter 11 cases in the Third Circuit must be mindful of the potential serious consequences that flow from the Decision.

EXISTENCE OF COLORABLE CLAIMS FOR INSIDER TRADING

After finding that a cause of action for equitable disallowance exists as a matter of law, the court considered the merits of the insider trading allegations against the Settlement Noteholders and concluded that the Equity Committee stated a colorable claim that the Settlement Noteholders engaged in insider trading.37
With respect to the Settlement Noteholders' status as temporary insiders by virtue of their access to the Debtors' confidential information and participation in the settlement negotiations, Judge Walrath also discussed the Equity Committee's alternative assertion that the Settlement Noteholders "owed duties as non-statutory insiders under bankruptcy law."38 Among the cases cited in support of this proposition was a previous decision in *In re Washington Mutual, Inc.* (the "2019 Opinion"), where Judge Walrath held that an informal group of noteholders was acting as an ad hoc committee or entity representing more than one creditor, and therefore was required to comply with the disclosure provisions of Federal Bankruptcy Rule 2019.39 In the 2019 Opinion, Judge Walrath stated that "members of a class of creditors may, in fact, owe fiduciary duties to other members of the class" when holding themselves out in a representative capacity.40

While Judge Walrath found it unnecessary to determine the extent of fiduciary duties owed by creditor groups in the 2019

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Opinion, the Decision reasoned that due to the Settlement Noteholders' "status as holders of blocking positions in two classes of the Debtors' debt structure..., it could be found that they owed a duty to the other members of the classes to act for their benefit."[41] This goes further than the 2019 Opinion, which focused on actions rather than debt holdings. Whether imposing fiduciary duties on a creditor group with blocking positions chills the participation of similarly situated creditors in bankruptcy negotiations remains to be seen, but the Decision will likely lead many such creditors to reassess the costs versus benefits of maintaining or acquiring a blocking position.

CONCLUSION

The Decision is significant both because of the large number of Chapter 11 cases filed in Delaware, and because courts outside of the Third Circuit tend to view decisions from Delaware bankruptcy courts as influential. Accordingly, all parties involved in Chapter 11 cases must be aware of the Decision's key holdings.[42]

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1 * Marc Abrams (mabrams@willkie.com) and Joseph G. Minias (jminias @willkie.com) are partners at Willkie Farr & Gallagher LLP in the Business Reorganization and Restructuring Department. Richard J. Kurdziel (rkurdziel @willkie.com) is an associate at the firm.

2 *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011) [Docket No. 8612].

3 11 U.S.C. § 1129(a)(7).

4 *Motion for an Order Authorizing the Official Committee of Equity Security Holders to Commence and Prosecute Certain Claims of Debtors' Estates, In re Washington Mutual, Inc.,* Case No. 08-12229 (MFW) (Bankr. D. Del. July 12, 2011) [Docket No. 8179].

5 131 S. Ct. 2594 (2011).

6 Section 726(a)(5) of the Bankruptcy Code provides that, after all other priority claims, unsecured claims (including certain tardily filed claims) and claims for fines, penalties or forfeitures are paid in full, distributions will be made in "payment of interest [on such claims] at the *legal rate* from the date of the filing of the petition." 11 U.S.C. § 726(a)(5) (emphasis added).

7 315 B.R. 321, 346 (Bankr. D. Del. 2004).

8 Decision at 130, 132.

9 *In re Washington Mutual, Inc.,* 419 B.R. 271, 280 (Bankr. D. Del. 2009).

10 Decision at 2.

11 *In re Washington Mutual, Inc.,* 442 B.R. 314, 347 (Bankr. D. Del 2011).

12 Decision at 31-32.

13 Decision at 6.

14 Decision at 7.

15 Decision at 8.

16 *Stern* held that a bankruptcy court, as a non-Article III court, "lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." 131 S. Ct. at 2620. Although the Supreme Court viewed the issue before it as narrow, the *Stern* decision has nonetheless been an area of uncertainty for many bankruptcy judges and litigants.

17 Decision at 9.

18 Decision at 11.

19 Decision at 12.

20 Decision at 14.

21 Decision at 14-15.

22 Decision at 77-78.

23 Decision at 78.

24 Decision at 78-79.

25 285 F.3d 1231 (9th Cir. 2002).

26 *Id.* at 1234-35.

27 315 B.R. at 346.

28 Decision at 78 n.35.

29 Decision at 80.

30 The relevant indentures containing the subordination provisions were governed by New York law. In determining whether the Rule of Explicitness was valid under New York law, Judge Walrath relied on a decision by the New York Court of Appeals that answered the question in the affirmative. *Chem. Bank v. First Trust of N.Y.*, 93 N.Y.2d 178, 186 (N.Y. 1999).

31 Decision at 97 (emphasis in original).

32 Decision at 97-98.

33 Decision at 113.

34 Decision at 108 (citing *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 566-67 (3d Cir. 2003)).

35 In recognizing the validity of equitable disallowance as a remedy for wrongdoing, Judge Walrath relied heavily on *Adelphia Recovery Trust v. Bank of America, N.A.*, which interpreted *Pepper v. Litton* as providing for "the equitable disallowance of claims, not on the basis of any statutory language, but as within the equitable powers of a bankruptcy court." 390 B.R. 64, 76 (S.D.N.Y. 2008).

36 *Adelphia Commc'ns Corp. v. Bank of Am., N.A.*, 365 B.R. 24, 73 (Bankr. S.D.N.Y. 2007).

37 The court's discussion of whether the Equity Committee's allegations sufficed to establish a colorable claim for insider trading was solely for the purpose of determining whether the Debtors' decision not to pursue the claim was justified under *In re STN Enterprises*, 779 F.2d 901, 905 (2d Cir. 1985). Any findings beyond those related to standing are merely dicta.

38 Decision at 130.

39 419 B.R. at 280.

40 *Id.* at 278 (quoting *In re Mirant Corp.* as imposing a fiduciary duty on parties that purport "to act for the benefit of a class." 334 B.R. 787, 793 (Bankr. N.D. Tex. 2005)). However, in *In re Northwest Airlines Corp.*, Judge Gropper assumed, for purposes of ruling on a motion to compel disclosure under Federal Bankruptcy Rule 2019, that an ad hoc committee of equity security holders did not act as a fiduciary. 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007).

41 Decision at 132.

42 Notably, on September 27, 2011, the Settlement Noteholders filed motions for leave to appeal various aspects of the Decision, including the rulings with respect to post-petition interest, equitable disallowance and the insider trading allegations. The Debtors followed suit on October 11 by filing a notice of appeal regarding the court's ruling on the Equity Committee's standing motion.

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Equitable Disallowance Rears Its Head in 'WaMu'

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In bankruptcy, a creditor's ability to recover on its claim against a debtor results from two basic factors—the amount for which the claim is allowed and the priority granted to the claim in the waterfall of payments made by the debtor under a chapter 11 plan.

In addition to applying the statutory priorities for certain categories of claims and seeking subordination of claims under §510 of the Bankruptcy Code,[1] debtors and other parties in interest have in certain instances sought—with varying success—the equitable disallowance of claims. A recent decision in the Washington Mutual (WaMu) chapter 11 case pending in the U.S. Bankruptcy Court for the District of Delaware again raises the possibility that equitable disallowance of claims may be within the power of bankruptcy courts, although the WaMu court did not actually disallow claims in its ruling or define the precise standards for granting such a remedy.[2]

Equitable Disallowance

Since the enactment of the Bankruptcy Code in 1978, courts have split as to whether the remedy of equitable disallowance of a claim exists in addition to the statutory claims provisions set forth under the Code. However, in considering this question, courts generally start at the same place—by examining the other remedies that indisputably do exist.

Section 510 of the Bankruptcy Code, aptly titled "Subordination," sets forth three instances in which an otherwise allowed claim may be subordinated in payment priority.[3] First, §510(a) provides that a bankruptcy court will respect a contractual subordination agreement to the same extent as enforceable under non-bankruptcy law.

Second, §510(b) provides for the statutory subordination of claims arising from the rescission of a securities transaction or damages arising from a securities transaction, which subordination is generally intended to prevent an otherwise subordinated securities holder from improving its recovery against the debtor by asserting additional contract or tort claims.[4] Finally, §510(c) provides that a court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim [or interest] to all or part of another allowed claim [or interest]" or transfer any lien securing such a claim to the debtor's estate.[5]

Courts have occasionally grappled with the question of whether an additional remedy—equitable disallowance of a claim—exists in addition to the codified subordination provisions. This analysis usually begins with an examination of the historic availability of equitable disallowance, starting with the seminal 1939 U.S. Supreme Court decision in *Pepper v. Litton*.[6]

In *Pepper*, the trustee sought to disallow a claim based on a state court judgment obtained on account of alleged salary claims by the dominant controlling stockholder of the bankrupt company. The prior judgment and underlying claim were alleged to be the result of a "planned and fraudulent scheme."[7] The Supreme Court, reversing the U.S. Court of Appeals for the Fourth Circuit, held that the bankruptcy court had the equitable power to subordinate or disallow the claim based on a prior court judgment, where there was evidence of collusion in obtaining the judgment or no valid underlying debt existed, particularly where the claim would inure to the benefit of an insider such as an officer, director or shareholder.[8]

Several decades later, shortly before the adoption of the Bankruptcy Code that replaced the prior Bankruptcy Act, the U.S. Court of Appeals for the Fifth Circuit again considered the issue in *In re Mobile Steel*.[9] There, the Fifth Circuit was presented with the question of whether two groups of claims—one based on alleged contributions to capital in the form of debentures, and another based on promissory notes given for the purchase of commercial property—should be disallowed or subordinated based on the inequitable conduct of the debtor's directors and officers.

In reversing the lower court's exercise of equitable disallowance, the Court of Appeals concluded that recognizing an independent remedy of equitable disallowance would not aid creditors who would be fully protected by subordination alone, and it seemed superfluous to remedy instances of particularly extreme behavior, where a claim should be defeasible without the exercise of the court's general equitable powers.[10]

With this backdrop, both proponents and opponents of equitable disallowance look to the legislative history surrounding §510 to support their position as to whether the remedy should be recognized. The House Judiciary Committee Report accompanying the bill proposing a subordination provision (which provision ultimately was codified as §510(b)) explained that it intended to codify decisions such as *Pepper* and the provision "is not intended to limit the court's power in any way...[nor] preclude a bankruptcy court from completely disallowing a claim in the appropriate circumstances."[11]

However, a bill proposed by the Senate Judiciary Committee contained a subsection specifically providing for the equitable disallowance of claims that ultimately was not included in the Bankruptcy Code.[12] Courts rejecting the authority to equitably disallow claims have relied on the considered omission of an equitable disallowance remedy and on the *Mobile Steel*[13] decision to demonstrate equitable disallowance neither exists nor is necessary, while courts ruling the other way cite to *Pepper* and to bankruptcy courts' generally broad equitable powers.[14]

The *WaMu* court fell squarely in the second camp. In *WaMu*, the official committee of equityholders brought a motion for standing to pursue the equitable subordination and equitable disallowance of certain noteholders' claims. In support of their motion, the equityholders alleged the noteholders had engaged in insider trading during the time they were negotiating a settlement with WaMu in its bankruptcy case.

In partly granting the motion, U.S. Bankruptcy Judge Mary Walrath held that the equity committee lacked standing to seek equitable subordination of the noteholder claims under §510(c), as such a remedy (which only would subordinate the noteholder claims to other claims) would not affect equityholders' recoveries in the case. However, the court granted the equityholders standing to pursue equitable disallowance of the noteholder claims. While conceding that its authority should be exercised in only extreme instances, the *WaMu* court determined that based on the legislative history of §510 and the *Pepper* decision, it had the authority to equitably disallow claims in certain extreme and rare circumstances.[15] The court did not make any ruling with respect to the ultimate merits of whether the noteholder claims should be disallowed.

The Standard

Since the adoption of the Bankruptcy Code, equitable disallowance has been recognized as an available remedy in only one other bankruptcy case, *In re Adelphia Communications Corp.*,[16] while several other courts have considered and rejected the existence of this potential remedy.[17] In *Adelphia*, as in the recent *WaMu* decision, the court did not articulate a precise standard to determine whether the claims in question (claims of bank creditors that were challenged by the official creditors committee appointed to the case) could be either equitably subordinated or disallowed.

Rather, Judge Robert Gerber of the U.S. Bankruptcy Court for the Southern District of New York described equitable disallowance as a "draconian" remedy only appropriate in extreme and "perhaps very rare" situations.[18] On appeal, the U.S. District Court for the Southern District of New York affirmed the availability of equitable disallowance and concurred with the bankruptcy court's limitations regarding the actual exercise of equitable disallowance.[19] The *Adelphia* courts did not have to articulate a more precise standard or rule on the facts at hand, as the equitable subordination and disallowance actions were dismissed in that case for failure to allege an injury.

Characterization of equitable disallowance as a rare and draconian remedy is understandable when one considers the availability of alternative remedies that would be sufficient for most circumstances. Equitable subordination, which is generally available on a showing of inequitable conduct and injury to other creditors or unfair advantage to the claimant, demotes a claimant's right to get paid behind the claims of other creditors, and in most cases effectively deprives the claimant of the right to get paid at all.

Furthermore, claims may be disallowed based on other available non-bankruptcy defenses. As the *Mobile Steel* court noted, "if the misconduct directed against the bankrupt is so extreme that disallowance might appear to be warranted, then surely the claim is either invalid or the bankrupt possesses a clear defense against it."[20]

Given the existence of these alternative remedies and other available defenses and counterclaims to a claim that a debtor likely would have in the face of egregious conduct by a claimant, it remains to be seen whether an instance exists where debtors are not adequately protected by such other rights and remedies. In fact, the *WaMu* court did not prejudge the adequacy of other alternative remedies in that case, noting that the debtors could well have a defense to the challenged claims outside of bankruptcy, under securities law.[21] Although the remark is not entirely clear, the suggestion may be that both remedies are valid and available. Why equitable disallowance should be necessary or whether it should be granted in the presence of an alternative securities law defense is a question *WaMu* does not address.

Who Is at Risk?

The *WaMu* decision raises further questions regarding whether equitable disallowance is intended to remedy inequities in having to make distributions on a specific claim, to a specific creditor, or both. The *WaMu* decision indicates in a footnote that to the extent claims are equitably disallowed, they would be disallowed regardless of who holds them. The court does not elaborate on this statement, which potentially raises its own questions.

Taken at its face, the proposition articulated by the *WaMu* court could be argued to be noncontroversial. If a court were to rule that a claim should be equitably disallowed, such disallowance cannot subsequently be remedied merely by selling or transferring the disallowed claim to a third party. However, it is less clear whether a court would equitably disallow a claim held by a transferee who purchased the claim in good faith and both without knowledge of and prior to any allegation of the alleged inequitable conduct (such as a transferee of notes held by a target noteholder in the *WaMu* case). In fact, in other circumstances, courts have concluded that similar equitable remedies do not necessarily travel with a claim.

In *In re Enron Corp.*, the debtors filed an action seeking equitable subordination under §510(c) and disallowance of certain claims under §502 (d),[22] based on the alleged inequitable conduct of the claims' original holders.[23] The debtors sought subordination or disallowance of the claims held by good-faith purchasers for value as well. The U.S. District Court for the Southern District of New York declined to subordinate or disallow the claims held by purchasers, ruling that subordination is a "personal disability" of the original creditor that travels with claim assignment, but not in a sale of the claim.[24] While *Enron* does not address equitable disallowance directly, the court's broad policy reasoning—that equitable subordination is remedial instead of penal and that a good-faith purchaser need not suffer from the wrongful conduct of the original claimant—could certainly apply to a situation in which equitable disallowance is sought with respect to a claim. The importance of whether an equitable disallowance remedy is personal to a claimant or follows a claim is particularly heightened where, as in *WaMu*, the claim arises from public securities of a debtor freely and regularly traded by parties on an arms-length basis prior to and during a debtor's bankruptcy case.

To Be Continued

It remains to be seen whether equitable disallowance will ever become a firmly recognized remedy available in bankruptcy cases. The *WaMu* decision is currently on appeal to the District Court for the District of Delaware (pending the mediation appointed by the bankruptcy court), so a district court may have the chance to further consider the availability of such a remedy. Moreover, both the *Adelphia* and *WaMu* courts recognized that to the extent such a remedy is available, its use would be reserved for the most extreme and rare circumstances of egregious conduct.

However, the *WaMu* decision serves as a reminder to creditors and claimants regarding the importance of dealing with a debtor in good faith, both prior to and during a bankruptcy proceeding, and the willingness of bankruptcy courts to consider what remedies may be available to address wrongful conduct to protect the interests of the debtor and its stakeholders.

Lisa Schweitzer *is a partner, and* **Martin Kostov** *an associate, at Cleary Gottlieb Steen & Hamilton.*

Endnotes:

1. Unless otherwise indicated, all section references herein are to the Bankruptcy Code.

2. *In re Washington Mut. Inc.*, 2011 Bankr. LEXIS 3361 (Bankr. D. Del. Sept. 13, 2011).

3. 11 U.S.C. §510.

4. See, e.g., Baroda Hill Inv. Inc. v. Telegroup Inc. (In re Telegroup Inc.), 281 F.3d 133, 142 (3d Cir. 2002) (Section 510(b) is meant to "prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity").

5. 11 U.S.C. §510(c).

6. *Pepper v. Litton*, 308 U.S. 295 (1939).

7. Id. at 312.

8. Id. at 306.

9. *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977).

10. Id. at 699, n.10.

11. H.R. Rep. No. 595, 95th Cong., 1st Session 359 (1977). See, e.g., *Adelphia Communs. Corp. v. Bank of Am., N.A. (In re Adelphia Communs. Corp.)*, 365 B.R. 24, 70-73 (Bankr. S.D.N.Y. 2007).

12. See Adelphia Recovery Trust v. Bank of Am., N.A., 390 B.R. 64, 75 (S.D.N.Y. 2008).

13. See, e.g., 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.), 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994); Official Comm. of Unsecured Creditors of Lois/USA Inc. v. Conseco Fin. Servicing Corp. (In re Lois/USA Inc.), 264 B.R. 69, 132-33, n.158 (Bankr. S.D.N.Y. 2001); Austin v. Chisick (In re First Alliance Mortg. Co.), 298 B.R. 652, 666 (C.D. Cal. 2003).

14. See *In re Adelphia*, 365 B.R. at 73; *Adelphia Recovery Trust*, 390 B.R. at 76.

15. *WaMu*, 2011 Bankr. LEXIS 3361 at *141.

16. *In re Adelphia*, 365 B.R. 24; *Adelphia Recovery Trust*, 390 B.R. 64.

17. Other courts have considered the availability of equitable disallowance without reaching a ruling. See Citicorp Venture Capital v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 991 (3d Cir. 1998); Official Comm. of Unsecured Creditors of Sunbeam Corp. v. Morgan Stanley & Co. (In re Sunbeam Corp.), 284 B.R. 355, 369 (Bankr. S.D.N.Y. 2002); *Congoleum Corp. v. Pergament (In re Congoleum Corp.)*, 2007 Bankr. LEXIS 4357 at *34 (Bankr. D.N.J. Dec. 28, 2007).

18. *In re Adelphia*, 365 B.R. at 73.

19. *Adelphia Recovery Trust*, 390 B.R at 76.

20. *Mobile Steel*, 563 F.2d at 699.

21. *WaMu*, 2011 Bankr. LEXIS 3361 at *142.

22. Section 502(d) deals with the estate's ability to disallow claims against creditors who have failed to transfer back property of the estate that was the subject of an avoidable transfer. 11 U.S.C. §502(d).

23. *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007).

24. Id. at 436.

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Exhibit B

SULLIVAN & CROMWELL LLP

September 27, 2011

Restructuring & Bankruptcy Alert

Washington Mutual Decision Reinforces Applicability of Insider Trading Laws to Participation in Bankruptcy Negotiations

SUMMARY

In a September 13 opinion denying confirmation of debtor Washington Mutual, Inc.'s modified plan of reorganization, the Honorable Mary Walrath of the United States Bankruptcy Court for the District of Delaware issued a clear reminder that general insider trading principles apply to material non-public information learned in bankruptcy plan negotiations. Judge Walrath found that the equity committee had stated a colorable claim against four hedge funds for violations of U.S. insider trading laws. Although the Court did not conclude that the hedge funds had violated U.S. securities laws, the decision raises questions as to the precautions distressed investors should consider when participating in bankruptcy plan and settlement negotiations.

BACKGROUND

Washington Mutual, Inc. ("WaMu") is the former parent holding company of Washington Mutual Bank ("WaMu Bank") and is the lead debtor in the three year old chapter 11 case pending before Judge Mary Walrath in the United States Bankruptcy Court for the District of Delaware (the "Court"). WaMu filed its chapter 11 petition on September 26, 2008, one day after WaMu Bank, its primary banking subsidiary, was closed by the Office of Thrift Supervision and the FDIC was appointed as receiver (the "FDIC Receiver").[1]

Following WaMu's bankruptcy filing, WaMu, creditors of WaMu, JPMC, and the FDIC Receiver litigated in multiple fora, among other things, disputed claims to ownership of billions of dollars in assets. A global settlement agreement (the "GSA") providing for resolution of the competing claims to the assets and other disputes among WaMu, the FDIC and JPMC was announced on March 12, 2010. That GSA was finalized in May 2010 and serves as the foundation of WaMu's proposed plan of reorganization.[2]

In connection with a contested July 2011 confirmation hearing on the Debtors' Modified Sixth Amended Plan, the equity committee brought a motion for standing to commence an adversary proceeding seeking to, among other things, equitably disallow claims of four hedge funds (referred to as the "Settlement Noteholders") on the basis that the Settlement Noteholders violated insider trading laws. Evidence in support of the equity committee's allegations was presented at the confirmation hearing. In granting the equity committee's motion,[3] the Court held that equitable disallowance could be an appropriate remedy, and that the equity committee had presented a "colorable" claim against the Settlement Noteholders.

The facts were largely undisputed as to the Settlement Noteholders' participation in the plan negotiation process. The dispute centered on the Settlement Noteholders' duties and the nature of the information they possessed while trading in WaMu's securities. At various times during the intermittent settlement negotiations that took place between March 2009 and May 2010, the Settlement Noteholders and WaMu executed confidentiality agreements that permitted the Settlement Noteholders to receive MNPI and participate in settlement discussions with the debtors, JPMC and the FDIC Receiver. The confidentiality agreements contained provisions requiring WaMu to publicly disclose MNPI provided to the Settlement Noteholders at the end of specified periods (the "Confidentiality Periods").

Each of the Settlement Noteholders claimed to have followed their restricted trading procedures during the Confidentiality Periods or refrained from trading during those periods. Each Confidentiality Period ended with WaMu, in light of its agreement to disclose MNPI, publicly disclosing certain information in the Settlement Noteholders' possession. WaMu, however, did not disclose the fact that settlement negotiations had commenced, nor the status of those negotiations, nor any of the substantive terms of the proposals and counter-proposals to which the Settlement Noteholders had been privy during the Confidentiality Periods.

A central theme of the equity committee's insider trading allegations was that the existence, status and terms of the settlement negotiations *in and of themselves* constituted MNPI, and the Settlement Noteholders improperly traded on the basis of that information outside of the Confidentiality Periods. In response, the Settlement Noteholders and WaMu took the position that the terms of the failed negotiations were not material and that their involvement in discussions outside of the Confidentiality Periods did not expose them to MNPI.

INSIDER TRADING ANALYSIS

The Court undertook a detailed analysis of the classical and misappropriation theories of insider trading under section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. Under the classical theory, the law is violated "when a corporate insider (i) trades in the securities of his corporation (ii) on the basis of (iii) material nonpublic information (iv) in violation of the fiduciary duty owed to his shareholders."[4] Under the misappropriation theory, insider trading can be established where "(1) ... the defendant possessed material, nonpublic information; (2) which he had a

duty to keep confidential; and (3) ... the defendant breached his duty by acting or revealing the information in question."[5]

The Court found that the equity committee had established a colorable claim that the Settlement Noteholders violated insider trading rules based on the classical theory, and in the case of one Settlement Noteholder, the misappropriation theory. Although the full opinion is worth reviewing for its application of general insider trading doctrine to bankruptcy negotiations, we believe five points of the Court's analysis are particularly noteworthy:

- ***Negotiating Creditors May Become Temporary Insiders.*** The Settlement Noteholders argued that they were only creditors, and not "insiders" for purposes of the classical theory of insider trading. The Court rejected this argument and held that the equity committee stated a colorable claim that the Settlement Noteholders had become temporary insiders of WaMu by executing confidentiality agreements, receiving MNPI, establishing a blocking position in a class of claims, and participating in multi-party negotiations with the shared goal of reaching a settlement that would form the basis of a plan of reorganization.[6]
- ***Negotiations Themselves Can Be MNPI.*** The Settlement Noteholders also argued that knowledge of the negotiations and the positions taken by parties is not itself material because of the distance between the parties' proposals and the uncertainty whether a party's position at any one time would remain that way in future complex negotiations. The Court disagreed, applying general materiality principles and stating that the Supreme Court "has explicitly rejected the argument that there is no materiality to discussions until an agreement-in-principle has been reached."[7]
- ***The Debtor's View of What is MNPI is Not Dispositive.*** The Settlement Noteholders argued that they did not act with scienter because there was no evidence that they knowingly or recklessly traded in WaMu securities while in possession of MNPI. They pointed to the cleansing provision contained in the confidentiality agreements and argued that WaMu had the burden to assure that all MNPI was disclosed at the conclusion of each Confidentiality Period. The Court rejected this argument, specifically noting that each Settlement Noteholder has its own obligation to comply with securities laws and could not use WaMu's own view as to the materiality of the information as a "shield" if they violated those policies.[8]
- ***Courts May Be Skeptical About Use of Outside Counsel as "Gatekeepers."*** The Settlement Noteholders engaged an outside law firm that executed a confidentiality agreement directly with WaMu. The agreement prevented the law firm from disclosing information to its clients, unless the clients agreed to keep the information confidential and to refrain from trading until the information was publicly disclosed. The Settlement Noteholders and the equity committee disputed whether as a matter of fact confidential information was shared with the Settlement Noteholders in violation of that agreement. The Court noted it had "substantial doubts" about the Settlement Noteholders' assertions on this point and that further discovery would clarify.[9]
- ***Application of Insider Trading Laws Will Not Chill Creditor Participation.*** Finally, the Settlement Noteholders suggested that the equity committee's pursuit of insider trading in this context would stifle a debtor's ability to effectively hold plan formation and settlement discussions with significant holders. The Court was unmoved and issued a clear reminder:

> [C]reditors who want to participate in settlement discussions in which they receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case. These types of restrictions are common in bankruptcy cases . . . . The Court does not believe that a requirement to restrict trading or create an ethical wall in exchange for a seat at the negotiating table places an undue burden on creditors . . . .[10]

IMPLICATIONS

Judge Walrath's opinion will inform best practices for investors involved in plan negotiations with debtors, both before and during a bankruptcy proceeding. Investors should remember in particular:

- General insider trading rules apply in bankruptcy. An investor cannot follow a "conventional" bankruptcy approach without regard to broader securities laws, and expert securities law advice should be obtained before trading when difficult questions arise.
- Investors that violate insider trading laws in a bankruptcy context risk having the allowance or ranking of their claims challenged by parties in interest, in addition to other potential sanctions, fines or penalties.
- Investors with MNPI that become "unrestricted" pursuant to the terms of a confidentiality agreement must *independently* ensure that any MNPI in their possession is adequately disclosed and disseminated prior to their resumption of trading. Investors cannot rely on the debtor's judgment without further analysis. In particular, investors should carefully consider whether undisclosed details of prior settlement discussions remain material after a confidentiality period, even if the debtor does not or is not free to disclose them.
- Significant investors that participate in plan negotiations may be considered "temporary insiders" for purposes of an insider trading analysis, and should proceed accordingly.

For debtors, the key takeaway is the need to weigh carefully the risks of "cleansing" provisions and other special confidentiality agreement provisions against the benefit of involving investors in plan negotiations. The terms of these agreements may require some attention as well, especially in situations involving multi-party plan negotiations or settlement discussions where MNPI may include not only information about the debtor, but information about confidential positions taken by other stakeholders in discussions.

* * *

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ENDNOTES

[1] On September 25, 2008, JPMorgan Chase Bank, N.A. ("JPMC") purchased substantially all of the assets and certain liabilities of WaMu Bank from the FDIC Receiver pursuant to a purchase and assumption agreement.

[2] Sullivan & Cromwell LLP is lead counsel to JPMC in these matters.

[3] The court stayed its order granting the equity committee's standing pending court ordered mediation on a potential settlement of the issues. *In re Washington Mutual, Inc.*, No. 08-12229 (MFW), 2011 WL 4090757, at *56 (Bankr. D. Del. Sept. 13, 2011).

[4] *Id.* at *47.

[5] *Id.* at *55 (quoting *SEC* v. *Lyon*, 605 F. Supp. 2d 531, 541 (S.D.N.Y. 2009)).

[6] *Id.* at *52-53.

[7] *Id.* at *51 (citing *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 238 (1988)).

[8] *Id.* at *54.

[9] *Id.* at *55.

[10] *Id.*

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WaMu Confirmation Denied: Interest Rates, Equitable Disallowance, and Insider Trading

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In *In re Washington Mutual, Inc.*, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011), Judge Mary F. Walrath of the U.S. Bankruptcy Court for the District of Delaware denied confirmation of the debtors' proposed chapter 11 plan and instead referred the litigants to mediation in order to move the case toward a confirmable resolution. The lengthy opinion denying confirmation covers issues ranging from the award of interest in a chapter 11 plan to equitable claims disallowance and insider trading. While some of the topics discussed in the opinion are relatively straightforward, other issues examined in the ruling have divided bankruptcy courts throughout the nation. As a consequence, the decision is a must-read for restructuring professionals, particularly those in the distressed investing field.

Washington Mutual's Confirmation Process

Washington Mutual, Inc., was the bank holding company that formerly owned Washington Mutual Bank ("WaMu"). WaMu was the nation's largest savings and loan association. In 2007, as with many other large financial institutions at that time, WaMu's revenues and earnings began to decline. By September 2008, the rating agencies had significantly downgraded the credit ratings of both the bank and the holding company. A run on the bank ensued.

On September 25, 2008, the U.S. Office of Thrift Supervision seized WaMu and appointed the Federal Deposit Insurance Corporation (the "FDIC") as receiver. The takeover of WaMu by the FDIC represented the largest bank failure in this country's history. On the day of the takeover, the FDIC sold substantially all of WaMu's assets to JPMorgan Chase Bank, N.A. ("JPMorgan"). A day later, Washington Mutual, Inc., and affiliate WM Investment Corp. (the "debtors") filed for chapter 11 protection in Delaware.

On March 26, 2010, the debtors proposed a sixth amended chapter 11 plan, which was modified various times thereafter. The sixth amended plan incorporated a global settlement agreement among the debtors, JPMorgan, the FDIC, and certain other stakeholders regarding ownership of certain assets and various claims that the parties asserted against each other. In a January 7, 2011, opinion, the bankruptcy court approved the global settlement agreement but denied confirmation of the plan for other reasons.

The debtors subsequently revised the plan and again sought confirmation. The debtors, JPMorgan, the FDIC, the official committee of creditors, a group of senior noteholders, the indenture trustees for the debtors' senior notes and senior subordinated notes, and certain other parties in interest all supported confirmation of the revised plan. Others, including the official equity committee and certain putative holders of "trust preferred securities," opposed it.

Confirmation Issues

As is common in many large chapter 11 cases, the plan objectors disputed the debtors' proffered valuation of the reorganized company. They argued that, as a result of this low valuation, creditors receiving stock in the reorganized company were receiving too much on account of the expense of their claims at equity. After hearing expert testimony from both sides, the court determined that, although the debtors' valuation was in fact too low, the plan objectors' competing valuation was too high. The court then valued the company at an amount between the two proposed valuations.

The plan opponents also attacked the global settlement agreement as unreasonable. In its prior decision denying confirmation, the court had already passed on the global settlement and determined that it met the applicable legal standards for approval. However, certain objectors argued that the court was not bound by its prior decision, some maintaining that subsequent case law justified a departure from the previous determination. The court rejected these arguments, ruling that it had already decided the issue and no intervening change in law or fact warranted reconsideration of its prior determination.

Next, the plan objectors argued that the plan's award of postbankruptcy interest was too rich. Typically, unsecured creditors may not recover postpetition interest on their claims. However, courts have awarded such interest in rare cases where the estate is solvent. One rationale for doing so is based upon a combined reading of sections 726 and 1129(a)(7) of the Bankruptcy Code. Section 726 provides that, in a chapter 7 liquidation, postpetition interest at the "legal rate" shall be paid on unsecured claims before any distribution to equity holders. Courts have imported section 726's priority scheme into chapter 11 cases on the basis of the "best interests" test in section 1129(a)(7), which requires that in order to confirm a chapter 11 plan, a dissenting creditor or interest holder must receive at least as much under a chapter 11 plan as it would in a chapter 7 liquidation.

Although most courts agree that interest should be awarded to unsecured creditors in a solvent estate, courts are split on the permissible rate of interest and the meaning of the term "legal rate" in section 726. In *Washington Mutual*, the court concluded that "legal rate" means the federal judgment rate at the time of the bankruptcy filing. In a prior decision in the case, the court noted authorities for the proposition that the term "legal rate" establishes a rebuttable presumption in favor of the contract rate, which can be overcome only by the equities of the case. Among these authorities was Judge Walrath's own earlier opinion in *In re Coram Healthcare Corp.*, 271 B.R. 228 (Bankr. D. Del. 2001), wherein the judge applied the federal judgment rate only after determining that the equities in that case did not favor application of the contract rate. Accordingly, *Washington Mutual* would appear to represent a shift in the court's position on this issue.

The plan objectors also argued that the plan violated section 1129(a)(3) of the Bankruptcy Code because it was not proposed in good faith. The objectors complained of alleged misconduct on the part of certain of the noteholders that were party to the global settlement agreement (the "settlement noteholders"). In particular, the equity committee complained that the settlement noteholders "hijacked" the settlement-negotiation process and engaged in wrongful conduct, including insider trading.

In rejecting this argument, the court determined that the settlement noteholders' conduct neither negatively impacted the chapter 11 plan nor tainted negotiation of the global settlement. According to the court, the settlement noteholders' conduct appeared to have assisted in augmenting the debtors' estates by encouraging a more aggressive settlement with JPMorgan. The court therefore held that, although it was not suggesting that the settlement noteholders' conduct was commendable, any harm caused by their conduct could be remedied in other ways.

Insider Trading and the Doctrine of Equitable Disallowance

Relatedly, after explaining that confirmation must be denied, the court granted a motion of the equity committee for standing to pursue equitable disallowance of the settlement noteholders' claims.

The continued vitality of the doctrine of equitable disallowance has been a controversial topic in recent years. Some courts have held that the doctrine did not survive the enactment of the Bankruptcy Code. Other courts, however, continue to recognize its existence. The *Washington Mutual* court aligned itself with the latter group.

The court next considered whether the equity committee had articulated a colorable claim for equitable disallowance based on alleged insider trading on the part of certain of the settlement noteholders. The

court began by identifying two types of insider trading under section 10(b) of the Securities Exchange Act of 1934: the "classical theory" and the "misappropriation theory." The classical theory of insider trading applies where a corporate insider (i) trades in the securities of the corporation, (ii) on the basis of (iii) material nonpublic information, (iv) in violation of a fiduciary duty owed to shareholders.

The equity committee alleged that the classical theory of insider trading applied. According to the equity committee: (a) the settlement noteholders had knowledge of the global settlement negotiations and the parties' position therein; (b) such knowledge constituted material nonpublic information; (c) the noteholders actively traded in the debtors' securities after the expiration of certain restriction periods; and (d) such noteholders became "temporary insiders" of the debtors when they were given material nonpublic information creating a fiduciary duty on their part to other creditors and shareholders.

With respect to the question of whether the information at issue was material, the settlement noteholders argued that their knowledge of the negotiations and the parties' positions during the negotiations could not be considered material because the parties neither reached an agreement in principle nor came close to reaching a deal. The court rejected this argument and concluded, on the basis of the evidence presented, that it appeared that the "settlement negotiations may have shifted towards the material end of the spectrum" and that the settlement noteholders may have traded on information that was nonpublic.

The court also determined that the settlement noteholders could have become "temporary insiders" or "non-statutory insiders" of the debtors. According to the court, the settlement noteholders could colorably be temporary insiders due to the fact that the debtors provided them with confidential information to allow them to participate in negotiating the global settlement agreement and plan. Also, the court explained, the settlement noteholders could be considered non-statutory insiders of the debtors because they held blocking positions in two classes of the debtors' debt structure. As such, the court concluded that it could find that these noteholders owed a duty to the other members of the affected classes.

The court also rejected the settlement noteholders' argument that they lacked the requisite "scienter" for insider trading. Specifically, the settlement noteholders argued that, even assuming the information obtained was material nonpublic information, they did not know this was the case because the debtors had agreed to disclose all material nonpublic information at the end of each confidentiality period. The equity committee responded that good-faith reliance on assurances of a third party to disclose all material information to the public cannot be a defense to insider trading. The bankruptcy court agreed.

Accordingly, the court determined that the equity committee stated a colorable claim for insider trading under the classical theory (and, for similar reasons, the misappropriation theory) and, hence, a claim for equitable disallowance. It therefore conferred derivative standing upon the equity committee to pursue the claim. However, the court stayed prosecution of the action pending mediation.

Analysis

Washington Mutual covers a broad waterfront of issues pertinent to distressed investors and other bankruptcy stakeholders. The court's analysis of the valuation dispute and the proposed global settlement in the case addresses topics that frequently arise in contested chapter 11 plan cases.

The court also had occasion to address matters that arise less frequently, such as the appropriate interest rate payable under a chapter 11 plan on unsecured claims when a debtor is insolvent, as well as the vitality and contours of the doctrine of equitable disallowance of claims.

Finally, distressed investors that regularly trade claims in bankruptcy cases would be well advised to consider the court's analysis of the insider-trading allegations in *Washington Mutual*. Of particular note is the court's determination that the noteholders' participation in the settlement negotiations potentially

provided them with material nonpublic information. In addition, the court made important rulings regarding the noteholders' blocking positions and the consequences thereof to the noteholders' insider status.

WaMu Court's Decision A Lesson for Hedge Funds

Introduction

On September 13, 2011, Judge Mary F. Walrath of the United States Bankruptcy Court for the District of Delaware issued a 139-page opinion denying, for the second time, confirmation of Washington Mutual, Inc.'s and its affiliated debtors' (collectively, "WaMu") proposed chapter 11 plan. In her opinion, Judge Walrath also granted a motion by WaMu's official equity committee (the "Equity Committee") for authority to prosecute equitable subordination and disallowance claims against several hedge funds (the "Settlement Noteholders") that participated in WaMu's chapter 11 plan negotiations.[1] Specifically, Judge Walrath held that the Equity Committee had established a "colorable" claim of insider trading against the Settlement Noteholders for their investment in, and the purchase and sale of, WaMu debt while involved in material, non-public postpetition restructuring negotiations with WaMu and other stakeholders. Judge Walrath's opinion — one of the most comprehensive on the topic in some time — articulated the restrictions that must be implemented by distressed funds that participate in chapter 11 plan and settlement negotiations to comply with applicable securities laws.

The WaMu Proceedings To Date

WaMu commenced its chapter 11 cases on September 26, 2008, a day after its former savings and loan association, Washington Mutual Bank, was closed by the Office of Thrift Supervision. The Federal Deposit Insurance Corporation (the "FDIC") promptly was appointed as the bank's receiver, and the bank's assets were sold to JPMorgan Chase Bank, N.A. ("JPMorgan"). Since the beginning of the bankruptcy cases, WaMu, JPMorgan, and the FDIC had been engaged in litigation regarding ownership of various bank assets and resolution of various claims against each other. At various points in time, the parties had engaged in on-and-off-again settlement discussions. The Settlement Noteholders, who held significant amounts of WaMu's debt, at various times participated (either directly or through counsel) in these settlement discussions. These discussions ultimately culminated in a global settlement agreement embodied in a plan of reorganization filed by WaMu on March 12, 2010.

However, on January 7, 2011, Judge Walrath issued an opinion denying confirmation of the plan. Among other things, she held that the plan's "non-consensual" releases by creditors and shareholders of claims against certain third parties, including the Settlement Noteholders, were improper because none of the parties to be released had contributed significantly to the reorganization or shared an identity of interest with WaMu to merit a non-consensual release.[2] Judge Walrath also noted that she was troubled by allegations by a *pro se* equity holder that the Settlement Noteholders had traded in WaMu's securities while in possession of confidential information, although she did not admit any evidence of the allegations at the time because it was hearsay.[3]

After Judge Walrath's January 7 ruling, WaMu worked to modify the Plan to comply with her opinion, and the Equity Committee and the Settlement Noteholders engaged in extensive (albeit not comprehensive) discovery regarding the insider trading allegations.[4] The Equity Committee then sought authority to prosecute an action to equitably subordinate or disallow the Settlement Noteholders' claims. The Equity Committee also objected to WaMu's modified plan, claiming that it was not proposed in good faith because the Settlement Noteholders "hijacked" the settlement discussions, and used "material nonpublic information to acquire a blocking position

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in the various creditor classes to get a seat at the negotiating table and assure that their claims got paid while nothing was given to shareholders."[5]

Settlement Noteholders' Participation in Negotiations

Judge Walrath conducted a joint hearing on the standing motion and the confirmation of WaMu's modified chapter 11 plan and found the following:[6]

- WaMu and JPMorgan began negotiating a resolution of their disputes in March 2009, and those negotiations continued off and on until the announcement of an agreement in principal in March 2010. During this period, the Settlement Noteholders participated directly in the negotiations, subject to confidentiality agreements.
- During two formal "confidentiality periods" — the first running from March 9 to May 8, 2009, the second from November 16 to December 31, 2009 — the Settlement Noteholders were required to restrict trading of WaMu securities or establish appropriate "ethical walls" to control information flow between those persons involved in the settlement negotiations and their trading desks.
- The Settlement Noteholders' counsel participated in settlement negotiations and was prohibited from sharing information with noteholders who themselves were not subject to confidentiality agreements.
- Certain Settlement Noteholders participated directly in the negotiations (conditioned on their entry into confidentiality agreements); on certain occasions, the Settlement Noteholders independently approached JPMorgan to further the negotiations
- During settlement negotiations, JPMorgan and WaMu exchanged term sheets, which were shown to the Settlement Noteholders.
- While WaMu had made public its estimated receipt of more than $2 billion in tax refunds and committed to disclose all material non-public information at the conclusion of each confidentiality period, neither the parties' term sheets nor the fact that settlement negotiations had been occurring were ever made public.
- Immediately after the first confidentiality period (i.e., May 8, 2009), the Settlement Noteholders' negotiators shared all confidential information they had received from WaMu with their respective trading desks, who then actively traded in WaMu securities.
- During July and August 2009 — in between the two confidentiality periods — one of the Settlement Noteholders approached JPMorgan directly and restricted trading while another Noteholder restricted trading only upon receipt of a settlement counteroffer from JPMorgan.
- During the second confidentiality period, all Settlement Noteholders restricted trading. At the end of the second confidentiality period, WaMu again publicly disclosed its estimated receipt of more than $2 billion in tax refunds, and the Settlement Noteholders' negotiators again shared information they had received from WaMu, including the status of settlement negotiations, with their traders, who again traded in WaMu securities.
- After the second confidentiality period ended, the Settlement Noteholders met only a few times with the other settlement parties, and one of the Settlement Noteholders restricted trading until the terms of the global settlement was announced.
- After the global settlement was announced, the Settlement Noteholders reviewed advance drafts of the plan of reorganization and related documents and restricted trading until the documents were publicly filed.

The Court's Rulings

In her opinion, Judge Walrath first addressed the Equity Committee's assertions that WaMu's plan had not been proposed in "good faith." Judge Walrath rejected this argument. Judge Walrath held that "while … not suggesting that the Settlement Noteholders be commended for their actions…" those actions did not "ha[ve] a negative impact on the [p]lan or taint[] the [global settlement]."[7]

Next, Judge Walrath considered the Equity Commit-

tee's motion for standing to pursue an equitable subordination claim against the Settlement Noteholders. She denied this request, holding that at most a court could only equitably subordinate the Settlement Noteholders' claims to other creditor claims and not to equity. Thus, the remedy of equitable subordination would never benefit equity holders, and so there was no point allowing the Equity Committee standing to pursue that remedy.

Judge Walrath next considered the Equity Committee's motion for standing to pursue an equitable disallowance claim against the Settlement Noteholders. Because at that time the Equity Committee only sought standing to pursue claims against the Settlement Noteholders, she only had to decide whether the Equity Committee had presented "colorable" claims that merited their standing to pursue those claims.

In response, the Settlement Noteholders first argued that equitable disallowance is not a valid remedy, relying on, among other precedent, a 2007 Supreme Court opinion, *Travelers Casualty*, that refused to disallow a claim because it was not within the statutory exceptions to the allowance of a claim under the Bankruptcy Code.[8] Judge Walrath rejected the Settlement Noteholders' argument, noting that bankruptcy courts have continued to entertain equitable disallowance actions and that nothing in *Travelers Casualty* purported to overrule prior precedent in which insider trading was used as a basis to equitably disallow claims.[9]

Second, the Settlement Noteholders argued that the Equity Committee's insider trading allegations were not colorable. The Settlement Noteholders argued that the only material non-public information they received were WaMu's estimates of their expected tax refunds, which were publicly disclosed at the end of each confidentiality period. In response, the Equity Committee argued that the Settlement Noteholders also were aware of the non-public information that settlement discussions were ongoing and the parties' relative stances, as evidenced by the term sheets they received, while the public was only aware that the parties were engaged in contentious litigation.

The Settlement Noteholders also disputed the materiality of the parties' settlement discussions and whether the Settlement Noteholders had reason to know it was non-public and material. Specifically, the Settlement Noteholders emphasized the tentativeness of the negotiations — including the apparent breakdown of negotiations after the conclusion of the first confidentiality period — as well as the relative commonality of chapter 11 settlement negotiations in comparison to mergers or other major transactions commonly associated with insider trading issues.[10] In sum, the Settlement Noteholders argued that the parties' settlement discussions and relative stances were too tentative and too far apart to be material.

On the insider trading allegations, Judge Walrath held that the Equity Committee had made at least a "colorable" claim under the so-called "classical theory" of insider trading,[11] specifically:

- The mere fact that settlements in chapter 11 are common does not make information regarding their negotiation any less material. Indications of interest and merger proposals may be just as common outside of chapter 11 as settlement negotiations are in chapter 11, but yet may also be material under applicable Supreme Court precedent.[12]

- The complex, multi-party/multi-issue nature of the negotiations between JPMorgan and WaMu, and the fact that a deal was not imminent at the time the Settlement Noteholders engaged in trading, were irrelevant considerations for the "materiality" inquiry. Judge Walrath noted that the Supreme Court had explicitly rejected the very argument that negotiations are not material until an "agreement-in-principle" is reached.[13]

- The mere fact that the parties constantly changed their negotiating posture throughout settlement discussions did not relieve the Settlement Noteholders of their securities law obligation to either ensure the public disclosure of the material information or forbear from trading. Judge Walrath emphasized the Supreme Court's express rejection of arguments that the market and public will only be confused by disclosure of allegedly conflicting or "trivial" information.[14] If the Settlement Noteholders wished to trade in WaMu securities, it was their obligation to ensure disclosure of the material information at their disposal.

- The parties' execution of confidentiality agreements, exchange of significant amounts of infor-

mation, and engagement in a year's worth of multi-party negotiations weighed heavily in favor of an inference that the settlement negotiations were material.[15]

- The Settlement Noteholders' argument that the breakdown in negotiations illustrates that those negotiations were not material was belied by the Settlement Noteholders' repeated — if often sporadic — overtures to continue negotiations after the first confidentiality period. In addition, JPMorgan and WaMu continued certain limited negotiations in which the Settlement Noteholders sought to participate.[16]
- Although Judge Walrath could not draw any conclusions from the Settlement Noteholders' trades at the time, the fact that certain of the Settlement Noteholders made unwise or contrary trades was not a defense.
- Although the Settlement Noteholders were not classic "insiders" of WaMu, there were colorable claims that the noteholders were "temporary insiders," either because they "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," or because they owed duties as non-statutory insiders under bankruptcy law.[17]
- The Settlement Noteholders acted sufficiently recklessly to support colorable claims when they traded based on the material non-public information. The Settlement Noteholders only had to know that they possessed material non-public information, whether or not they actually applied that knowledge in trading. Further, the Settlement Noteholders could not rely, with no duty of further inquiry, on WaMu's commitment to disclose all material non-public information subsequent to the confidentiality periods as a means to disclaim all knowledge that the information the Noteholders held was material.
- Finally, there was a colorable claim of insider trading against one Settlement Noteholder under the so-called misappropriation theory, where the Settlement Noteholders' counsel provided confidential information to one of the Settlement Noteholders in breach of a confidentiality agreement with WaMu.[18]

After finding that the Equity Committee had stated colorable claims and that the Settlement Noteholders had engaged in insider trading, Judge Walrath denied confirmation of the plan and granted the Equity Committee's standing motion. However, Judge Walrath stayed the effect of the standing order and ordered the parties to mediate their disputes, because Judge Walrath was "concerned that the case will devolve into litigation morass."[19]

Impact of the Court's Decision

In light of this important ruling, creditors in a bankruptcy case should proceed carefully and cautiously when engaging in settlement or other discussions with the debtor and other stakeholders. Judge Walrath's opinion stated that "creditors who want to participate in settlement discussions in which they receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case."[20] Further, if a creditor in possession of material nonpublic information is going to rely on the debtor's promise to publicly disclose that information at the end of a restriction period, such that the creditor's trading desk can begin to trade while in possession of that information, the creditor has an independent duty to inquire whether the relevant information has been publicly disclosed to the creditor's own independent satisfaction. Judge Walrath concluded that in exchange for a seat at the negotiating table, these restrictions, which are already commonly applied in bankruptcy to members of official committees, are not an undue burden on creditors who wish to receive confidential information and provide their input on the direction of a chapter 11 restructuring.

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1 *See* Opinion, *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011).

2 *See In re Washington Mutual, Inc.*, 442 B.R. 314, 344-45 (Bankr. D. Del. 2011).

3 *See Wash. Mutual*, 442 B.R. at 349 (noting court was "reluctant to approve any releases of the Settlement Noteholders" due to the insider trading allegations).

[4] *See* Opinion at 64, *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011). Discovery was limited to the information that the Settlement Noteholders received from WaMu, but did not include discovery of analysis done by the Settlement Noteholders in determining whether to trade in WaMu securities. *See id.* at 65 n.30.

[5] *See id.* at 70.

[6] *See id.* at 66-70.

[7] *Id.* at 71-73.

[8] *See Travelers Casualty & Surety Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 449-50 (2007).

[9] *See id.* at 115-17 (citing *Pepper v. Litton*, 308 U.S. 295, 311 (1939) (upholding equitable disallowance of claim of insider who traded on material inside information) and *Adelphia Commc'ns Corp. v. Bank of Am., N.A. (In re Adelphia Commc'ns Corp.)*, 365 B.R. 24, 71-73 (Bankr. S.D.N.Y. 2007) (denying motion to dismiss equitable disallowance action notwithstanding Supreme Court's *Travelers Casualty* opinion)).

[10] *See* Opinion at 118-28 & n.45, *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011). *Cf. Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (holding materiality is a factor of the "probability that the event will occur" and the "anticipated magnitude of the event").

[11] *See U.S. v. O'Hagan*, 521 U.S. 642, 651-52 (1997) (holding classical theory of insider trading under Securities Law section 10(b) and Rule 10b-5 is violated when a corporate insider trades in securities of the corporation on the basis of material non-public information in violation of a fiduciary duty owed to shareholders).

[12] Opinion at 120 n.45, *In re Washington Mutual, Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011) (citing *Basic*, 485 U.S. at 238-39).

[13] *See id.* at 121 (citing *Basic*, 485 U.S. at 237).

[14] *See id.* at 125 (citing *Basic*, 485 U.S. at 237 ("Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress.")).

[15] *See id.* at 122.

[16] *See id.* at 122-23.

[17] *See id* at 128-30.

[18] *See id.* at 135-138.

[19] *Id.* at 138

[20] *Id.* at 137-38.

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Risks for Claims Traders Who Have Access to Confidential Information: Lessons from the Recent *Washington Mutual* Decision

Distressed investors often find themselves confronting the dilemma over how to best exert the influence they have at critical times in the chapter 11 process, which almost always will involve negotiations over key disputed issues, and their ability to continue to trade in claims against the debtor. As demonstrated by a recent decision of the United States Bankruptcy Court for the District of Delaware in the *Washington Mutual* chapter 11 cases,[1] what such investors do with the potentially inside information they gain from those negotiations, and how and when they use it, may significantly affect their bankruptcy recovery and expose them to potential liability. Additionally, the decision, which is now on appeal, suggests that a creditor who has a blocking position in a creditor class may be considered an insider of the debtor and have a fiduciary duty to act for the benefit of other creditors within that class, even if the creditor does not sit on an official creditors' committee appointed in the case.

Background

In *Washington Mutual*, the debtors' plan of reorganization was predicated upon a global settlement agreement involving certain hedge funds (collectively, the "Settlement Noteholders"). The official Equity Committee challenged the plan and the settlement and sought standing to bring actions against the Settlement Noteholders for allegedly trading in the debtors' securities while in the possession of confidential information provided to them during plan negotiations. In the course of denying confirmation of the plan on other grounds, the Bankruptcy Court concluded that the Equity Committee had presented colorable claims regarding the Settlement Noteholders' trading activities. In an attempt to avoid having the

[1] *In re Washington Mutual, Inc.*, No. 08-12229 (MFW), 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011).

chapter 11 process derailed with a morass of litigation, the Bankruptcy Court directed the parties to participate in mediation. Thus, it remains to be seen whether the issues will ever be litigated on the merits.

Facts

Washington Mutual was the largest bank holding company failure in the nation's history. Shortly after the commencement of its chapter 11 cases, it became embroiled in a dispute with JP Morgan Chase ("JPMC") over the ownership of $4 billion held by JPMC. JPMC and Washington Mutual thereafter engaged in protracted settlement discussions as part of the plan negotiation process. The negotiations continued off and on from March 2009 until an agreement in principle was announced on March 4, 2010, and included the exchange of various term sheets between Washington Mutual and its affiliates (collectively, the "Debtors") and JPMC. Counsel for the Settlement Noteholders participated in many of these negotiations, but were contractually precluded from sharing information with the Settlement Noteholders unless and until the Settlement Noteholders were bound by confidentiality agreements. The Settlement Noteholders themselves, who collectively held a sufficient amount of claims to have a blocking position in two classes under any plan, had also participated directly in the negotiations, and were at various times subject to confidentiality agreements. During two specific confidentiality periods, the Settlement Noteholders were required to restrict trading of the Debtors' securities or to establish an ethical wall so that confidential information was not used by their traders. The understanding of the Settlement Noteholders was that after the restricted period, the Debtors would disclose all material information, which would then allow the Settlement Noteholders to become unrestricted.

During the first confidentiality period, one of the Settlement Noteholders established an ethical wall, whereas the others restricted their trading. During that first confidentiality period, there were settlement discussions among the Debtors, JPMC, and the Settlement Noteholders. It was undisputed that, during that time period, terms of a possible settlement were discussed and various term sheets were exchanged, but that the negotiations did not lead to a settlement. With the discussions having been inconclusive, the Debtors apparently decided that there was no need for them to disclose the fact that settlement negotiations were occurring, and, therefore, none of the terms that had been discussed were disclosed. Although no disclosure had been made by the Debtors, based upon their understanding that they had been cleansed by the passage of the first confidentiality period, immediately after that period ended, the Settlement Noteholders shared all confidential information they had received from the Debtors with their traders and resumed their trading in the Debtors' debt.

After the conclusion of the first confidentiality period, two of the Settlement Noteholders independently resumed negotiations with JPMC, and term sheets were exchanged. One of those two Settlement Noteholders restricted its trading during these negotiations, while the other restricted trading only upon receipt of a formal counter-proposal from JPMC.

When JPMC settlement negotiations resumed during the second confidentiality period, each of the Settlement Noteholders restricted trading. During that period, term sheets were exchanged and the Settlement Noteholders received information with respect to the progress of those settlement talks and with respect to a very large tax refund that the Debtors were expecting to receive. During the settlement talks, JPMC indicated a willingness to turn over the $4 billion that had been in dispute. The Bankruptcy Court concluded in hindsight that had the public been aware that there had been a meeting of the minds on that point, the value of Washington Mutual's bonds presumably would have risen, since those funds could have been used to pay bondholders under a plan of reorganization. As previously mentioned, however, the agreement was not publicly disclosed. Ultimately, it became clear that a deal was not imminent with JPMC and near the end of the second confidentiality period, one of the Settlement Noteholders asked the Debtors to terminate the confidentiality period one day early so it could begin trading. Because the JPMC settlement negotiations were once again inconclusive, however, the Debtors did not release to the public either the fact that the JPMC settlement talks had occurred or any of the details of those negotiations although they did disclose information regarding the anticipated tax refund. Immediately after the second

confidentiality period, the Settlement Noteholders, believing that the non-public information they had received had been cleansed upon expiration of the second confidentiality period, immediately resumed their claims trading activities.

The Bankruptcy Court's Rulings

Certain Washington Mutual shareholders contended that the Settlement Noteholders' counsel, which was involved in the relevant negotiations, improperly tipped off its clients about the undisclosed JPMC agreement in violation of the terms of its confidentiality agreement. Specifically, on July 1, 2009, counsel allegedly shared summaries of the April 2009 settlement negotiations with two of the Settlement Noteholders, which were not subject to confidentiality restrictions at that time. Although one of those Settlement Noteholders voluntarily restricted its trading activities, the other continued to trade. As a result, the latter ostensibly was afforded an opportunity to profit by purchasing bonds and waiting for their value to appreciate when the agreement with JPMC was ultimately announced. While the Settlement Noteholders denied any wrongdoing and contended that they received no "material information" that would rise to the level of insider trading, the Bankruptcy Court found, based upon the evidentiary record, that the allegations against them were colorable and that further discovery was warranted before any definitive ruling could be made.

In the course of its ruling, the Bankruptcy Court made a number of notable determinations. First, it held that the alleged misconduct was not a basis upon which to find that the Debtors' plan had not been proposed in good faith because the actions of the Settlement Noteholders actually added value to the Debtors' estates. Additionally, the Bankruptcy Court rejected the Equity Committee's motion to equitably subordinate the claims of the Settlement Noteholders to the interests of the equityholders because "under the plain language of the statute [section 510(c) of the Bankruptcy Code] equitable subordination only permits a creditor's claim to be subordinated to another claim and not to equity."[2] However, it then determined that the rarely-used remedy of "equitable disallowance" could be invoked, if the necessary facts were established, to disallow the claims of the Settlement Noteholders on equitable grounds. Drawing on case law authority from the Supreme Court's decision in *Pepper v. Litton*[3] and the Bankruptcy Court's and District Court's decisions in the *Adelphia* chapter 11 cases, Judge Walrath concluded that she did "have the authority to disallow a claim on equitable grounds 'in those extreme instances – perhaps very rare – where it is necessary as a remedy.'"[4]

In analyzing the equitable disallowance claim, Judge Walrath rejected the argument of the Settlement Noteholders that the information exchanged about the settlement discussions with JMPC did not become "material" for securities law violation purposes until an agreement in principle on the settlement was reached with JPMC. The Settlement Noteholders argued it would have created a great deal of uncertainty as to when disclosure was necessary and would have been impracticable to require disclosure prior to an agreement in principle because the proposed settlement terms were constantly changing. Nevertheless, Judge Walrath noted that the Supreme Court in *Basic, Inc. v. Levinson*[5] had "rejected the

[2] *Id.* at *44.

[3] 308 U.S. 295 (1939).

[4] *Washington Mutual*, 2011 WL 4090757, at *46 (quoting *Adelphia Commc'ns Corp. v. Bank of Am., N.A. (In re Adelphia Commc'ns Corp.)*, 365 B.R. 24, 73 (Bankr. S.D.N.Y. 2007)).

[5] 485 U.S. 224, 237 (1988).

'agreement-in-principle' standard for evaluating materiality" in the context of merger discussions and found that the same rationale applied in *Washington Mutual*.[6] Judge Walrath further found that the Equity Committee stated a colorable claim that the Settlement Noteholders received material non-public information, because the evidence presented up to that point showed that "the negotiations may have shifted towards the material end of the spectrum and that the Settlement Noteholders traded on that information which was not known to the public."[7] The Bankruptcy Court concluded that discovery "would help shed light on how the Settlement Noteholders internally treated the settlement discussions and if they considered them material to their trading decisions."[8]

Additionally, Judge Walrath found that the Equity Committee stated colorable claims for securities law violations under both the "classical theory" and the "misappropriation theory" of liability of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Under the classical theory, the securities laws are violated when a corporate insider trades the corporation's securities on the basis of material non-public information and in violation of the insider's fiduciary duty owed to shareholders. In contrast, under the misappropriation theory, a corporate "outsider" violates securities laws when he or she misappropriates confidential information in breach of a fiduciary duty owed to the source of the information. Judge Walrath was persuaded that a colorable claim was stated under the classical theory because (i) the Settlement Noteholders became "temporary insiders" when the Debtors gave them confidential information and allowed them to participate in settlement negotiations with JPMC, and (ii) there was sufficient evidence to raise a serious question as to whether the Settlement Noteholders acted recklessly in their use of material non-public information. Judge Walrath was also persuaded that a colorable claim was stated against the Settlement Noteholders under the misappropriation theory based upon evidence that one of the Settlement Noteholders continued to trade after its counsel improperly shared confidential information about the JPMC settlement discussions with certain of the Settlement Noteholders. In making that determination, Judge Walrath found that the Settlement Noteholders might be considered insiders of the Debtors "because of their status as holders of blocking positions in two classes of the Debtors' debt structure" and therefore might have "owed a duty to the other members of those classes to act for their benefit."[9]

Judge Walrath found that it was not a valid defense to argue, as the Settlement Noteholders did, that they assumed the Debtors had complied with their obligation under the confidentiality agreements to disclose material non-public information at the end of each restricted period. She adopted the Equity Committee's argument that despite the fact that the Settlement Noteholders had strict internal policies prohibiting insider trading, they "knowingly traded with knowledge that the Debtors were engaged in global settlement negotiations with JPMC of which the trading public was unaware."[10] Judge Walrath also rejected as a defense the fact that certain of the Settlement Noteholders made contrary trades which allegedly showed that the Settlement Noteholders were not trading on the basis of the confidential information they had received.

[6] *Washington Mutual,* 2011 WL 4090757, at *50.

[7] *Id.* at *51.

[8] *Id.*

[9] *Id.* at *53.

[10] *Id.* at *54.

Discussion

The ruling by Judge Walrath that a creditor who has a blocking position with respect to a plan of reorganization may become an insider and thereby take on a fiduciary duty to other creditors within its class is a significant departure from the usual rule that a creditor owes no fiduciary duty to its fellow creditors and may act in its own self-interest.[11] Notably, however, this is not the first time that Judge Walrath has suggested that creditors can take on a fiduciary duty to other creditors within its class even though they are not purporting to represent them. Rather, she made a similar suggestion in *dicta* in a prior *Washington Mutual* decision involving a Bankruptcy Rule 9019 dispute.[12] In that decision, Judge Walrath stated that "collective action by creditors in a class implies some obligation to other members of that class."[13] For a variety of reasons, it would be problematic if this rationale were ever formally adopted. Creditors who acquire blocking positions usually do so specifically to be able to influence plan negotiations in a way that is best suited to their own individual needs. To impose a fiduciary obligation on such a creditor would greatly alter the dynamics of the chapter 11 process and limit key parties in a chapter 11 case in ways that presumably were never envisioned. Additionally, not allowing a creditor to act in its own self-interest would likely create a great deal of uncertainty with respect to that creditor's rights and obligations, because such creditor would not always be in a position to know what the official position of the class would be or what degree of deviation from that position might be permissible under the facts of a particular case. It will be interesting to see the extent to which Judge Walrath's rationale may be followed and extended under the facts of other cases. In the meantime, creditors who hold, or are considering acquiring, a blocking position or who are purporting to take action on a collective basis that affects the larger creditor class need to take account of these risks.

In rejecting the contention of the Settlement Noteholders that equitable disallowance of their claims would have a chilling effect on investors' willingness to participate in settlement discussions in bankruptcy cases of public companies, Judge Walrath concluded that "creditors who want to participate in settlement discussions in which they receive material non-public information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case."[14] Whether or not creditors have the ability to avoid allegations that they are improperly using confidential information, however, it is not difficult to imagine that the *Washington Mutual* decision may discourage some creditors from actively participating in key settlement discussions in chapter 11 cases. If this were to occur, it could ultimately harm debtors whose aim is to emerge from chapter 11 by obtaining consensus among their various creditor groups.

The principal lesson from the *Washington Mutual* case is that claims traders who have access to confidential information need to be very careful about how and when they trade based upon that information. A tension exists between debtors and key creditors over the disclosure of non-public information that is exchanged during the plan negotiation process. Very often debtors are reluctant to publicly disclose information at the end of a confidentiality period unless a definitive conclusion has been reached with respect to the matter being negotiated, because, in their view, doing so needlessly creates a lot of extra

[11] *E.g., In re W.T. Grant Company, et al.*, 699 F.2d 599, 609 (2d Cir. 1983) (in which the Second Circuit concluded "[a] creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim").

[12] *In re Washington Mutual, Inc.*, 419 B.R. 271, 278-79 (Bankr. D. Del. 2009).

[13] *Id.* at 279.

[14] *Washington Mutual,* 2011 WL 4090757, at *55.

work, inundates parties in interest with information that as a practical matter may be irrelevant, and leads to undue uncertainty and confusion. The *Washington Mutual* decision should serve as a reminder that creditors cannot merely rely on a debtor's contractual commitment to publicly disclose confidential information at the end of a confidentiality period, but rather need to make sure that such information is actually disclosed. In addition, the Bankruptcy Court was clear that it was not convinced that evidence that the trading market may have known about the confidential information sufficiently established that the public at large was on notice of it. In the absence of full public disclosure, the creditors who are in possession of the non-public information have not been "cleansed" and, therefore, may not be free to trade claims. Judge Walrath's ruling should serve as a reminder that claims traders and their counsel need to be vigilant in making sure that they know precisely when a debtor has released information to the public, and what information has been released, and that they do not engage in trading activities while in possession of information that is still confidential unless proper ethical walls are established and maintained.

Regardless of the outcome of the litigation and mediation in *Washington Mutual*, that decision is sure to place hedge funds and other claims traders squarely into the cross-hairs of equityholders and creditors in other chapter 11 cases. Indeed, it would not be surprising to see an increase in discovery requests and litigations aimed at ascertaining what information claims traders in a particular chapter 11 case had and when. If for no other reason, this would give equityholders and creditors, who might otherwise be relatively powerless in a particular case, increased leverage during plan negotiations. However, it could complicate the reorganization process from the debtor's standpoint, because, in addition to the litigation-related costs and delays, the risk of insider trading claims may cause key creditors to become less willing to participate actively in a debtor's settlement discussions and plan negotiations, both in the chapter 11 context and in out-of-court restructurings.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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KEY RULINGS FROM DELAWARE BANKRUPTCY COURT'S REJECTION OF WASHINGTON MUTUAL'S PLAN OF REORGANIZATION

In a recent 139-page decision (the "Decision") with far-reaching implications for parties involved in chapter 11 proceedings, Judge Mary F. Walrath of the Bankruptcy Court for the District of Delaware denied, for the second time, confirmation of Washington Mutual, Inc.'s ("WMI") and WMI Investment Corp.'s (collectively, the "Debtors") plan of reorganization (the "Plan").[1] Judge Walrath found several deficiencies in the Plan that violated the best interests of creditors test articulated in section 1129(a)(7) of title 11 of the United States Code (the "Bankruptcy Code").[2]

In addition to denying confirmation of the Plan, the Court also granted (and then stayed) a motion by the Official Committee of Equity Security Holders (the "Equity Committee") to prosecute an action to equitably subordinate or disallow the claims of certain noteholders (the "Settlement Noteholders").[3] While denying standing to bring a claim for equitable subordination, the Court held that the Equity Committee had standing to bring a claim for equitable disallowance based on allegations of insider trading by the Settlement Noteholders. In so ruling, Judge Walrath found that the Equity Committee stated a colorable claim for equitable disallowance, and ordered the parties to mediate to avoid a litigation morass which would further drain the estates' resources.

While the Decision analyzed numerous objections to the Plan asserted by various creditors and shareholders, certain of Judge Walrath's rulings are significant for practitioners and participants in chapter 11 cases, namely, the rulings on: (i) jurisdiction; (ii) post-petition interest; (iii) equitable disallowance; and (iv) non-statutory insider status under applicable law. These key rulings are discussed in further detail below:

- In rejecting the argument that the Court lacked jurisdiction over modification of the Plan, Judge Walrath interpreted and applied the Supreme Court's recent decision in Stern v. Marshall, which has generated much commentary and uncertainty regarding a bankruptcy court's constitutional authority to enter a final judgment under certain circumstances.[4]

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1 In re Washington Mutual, Inc., Case No. 08-12229 (MFW) (Bankr. D. Del. Sept. 13, 2011) [Docket No. 8612].

2 11 U.S.C. § 1129(a)(7).

3 *Motion for an Order Authorizing the Official Committee of Equity Security Holders to Commence and Prosecute Certain Claims of Debtors' Estates*, In re Washington Mutual, Inc., Case No. 08-12229 (MFW) (Bankr. D. Del. July 12, 2011) [Docket No. 8179].

4 131 S. Ct. 2594 (2011).

- In determining what constitutes the "legal rate" for payment of post-petition interest on unsecured creditors' claims under section 726(a)(5) of the Bankruptcy Code, Judge Walrath concluded that the federal judgment rate, rather than the contract rate, is applicable.[5] This was surprising as many believed that Judge Walrath's decision in In re Coram Healthcare Corp. provided support for the proposition that an unsecured creditor may be entitled to its contract rate of interest.[6]

- The Court granted the Equity Committee's motion for standing to prosecute a claim for equitable disallowance, even though the Settlement Noteholders argued that no such cause of action exists as a matter of law.

- The Court found that the "Settlement Noteholders owed duties as non-statutory insiders under bankruptcy law" due to their blocking position in two classes of the Debtors' debt structure.[7] The imposition of fiduciary duties on creditors with blocking positions goes further than a previous decision in which Judge Walrath suggested that "members of a class of creditors may, in fact, owe fiduciary duties to other members of the class" when holding themselves out in a representative capacity.[8]

Background

During the global credit crisis in the Fall of 2008, the rating agencies significantly downgraded the credit rating of Washington Mutual Bank ("WMB") and its holding company, WMI. A bank run followed, resulting in $16 billion of withdrawals from WMB in a 10-day period.

On September 25, 2008, the Office of Thrift Supervision closed WMB and appointed the Federal Deposit Insurance Corporation (the "FDIC") as receiver for WMB. Immediately after its appointment as receiver, the FDIC sold substantially all of WMB's assets to JPMorgan Chase Bank, N.A. ("JPMC"). On September 26, 2008, the Debtors filed petitions under chapter 11 of the Bankruptcy Code.

The seizure and sale of WMB's assets gave rise to disputes among the Debtors, the FDIC and JPMC "regarding ownership of certain assets and various claims that the parties asserted against each other."[9] Nearly three years into the contentious chapter 11 cases, negotiations led to a global settlement agreement (the "GSA") that resolved issues among the Debtors, JPMC, the

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5 Section 726(a)(5) of the Bankruptcy Code provides that, after all other priority claims, unsecured claims (including certain tardily filed claims) and claims for fines, penalties or forfeitures are paid in full, distributions will be made in "payment of interest [on such claims] at the *legal rate* from the date of the filing of the petition." 11 U.S.C. § 726(a)(5) (emphasis added).

6 315 B.R. 321, 346 (Bankr. D. Del. 2004).

7 Decision at 130, 132.

8 In re Washington Mutual, Inc., 419 B.R. 271, 280 (Bankr. D. Del. 2009).

9 Decision at 2.

FDIC and certain creditors, including the Settlement Noteholders. The GSA served as the cornerstone of the Plan, and, although there were a myriad of objections, Judge Walrath found it to be fair and reasonable in an initial January 7, 2011 opinion (the "January 7 Opinion") denying confirmation.[10]

Despite modifications to the Plan to address the deficiencies identified in the January 7 Opinion, certain creditors and shareholders opposed the amended Plan. Following the July 2011 confirmation hearings and submission of post-hearing briefs, Judge Walrath issued the Decision but once again denied confirmation of the Plan and reaffirmed the conclusion in the January 7 Opinion that the GSA was fair and reasonable.[11]

Jurisdictional Analysis

As an objection to confirmation of the Plan, certain creditors asserted that the Court could not enter a final order to confirm the Plan in light of the Supreme Court's ruling in Stern, because the Plan incorporated the GSA, and thus confirmation would require the Court to decide the estates' claims against JPMC and the FDIC, for which the Court lacked jurisdiction.[12] These objecting creditors further contended that the claims of the estate against JPMC and the FDIC were traditional actions at common law (*i.e.*, state corporate law, tort law and fraudulent conveyance law, as well as federal intellectual property and tort claims) and, therefore, had to be decided by an Article III court in accordance with Stern.[13] Proponents of the Plan disagreed for several reasons, principally that the Stern Court characterized its ruling as narrow.[14]

Judge Walrath concluded that Stern did not support the objecting creditors' argument.[15] First, Judge Walrath noted that bankruptcy court approval of settlements is a firmly established historical practice, currently recognized by Federal Bankruptcy Rule 9019, which is based on a similar provision of the Bankruptcy Act.[16] Judge Walrath then cited section 1123(b)(3)(A) of the Bankruptcy Code, which states that a plan may provide for the settlement of any claim or interest, and further explained that confirmation of such a plan is within the Court's core jurisdiction.[17]

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10 In re Washington Mutual, Inc., 442 B.R. 314, 347 (Bankr. D. Del 2011).

11 Decision at 31-32.

12 Decision at 6.

13 Decision at 7.

14 Decision at 8.

15 Stern held that a bankruptcy court, as a non-Article III court, "lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." 131 S. Ct. at 2620. Although the Supreme Court viewed the issue before it as narrow, the Stern decision has nonetheless been an area of uncertainty for many bankruptcy judges and litigants.

16 Decision at 9.

17 Decision at 11.

Second, Judge Walrath distinguished approval of a settlement of claims from a ruling on the merits of such claims, stating that a court does not need jurisdiction over the underlying claims to approve a resulting compromise.[18] Judge Walrath explained: "the January 7 Opinion was not a decision on the merits of the underlying claims but merely a determination that the settlement of those claims by the Debtors on the terms of the [settlement] was reasonable."[19]

Finally, Judge Walrath found that the approval of the GSA was particularly within the "core jurisdiction" of the Court because approval includes a determination of what is property of the estate. And, Judge Walrath held, "[i]t is without question that bankruptcy courts have exclusive jurisdiction over property of the estate," including whether disputed property is property of the estate.[20]

As Stern is a recent decision being interpreted by the courts, the Decision provides insight into how it could potentially affect numerous previously undisputed aspects of a bankruptcy court's jurisdiction.

Post-Petition Interest

Certain creditors alleged that the Plan failed to comply with the best interests of creditors test because it provided for the payment of post-petition interest on certain creditors' claims at their contract rate of interest, as opposed to the federal judgment rate. The Court held the "legal rate" for payment of post-petition interest on creditors' unsecured claims under section 726(a)(5) of the Bankruptcy Code is the federal judgment rate.[21]

In support of this holding, Judge Walrath first observed that "section 726(a)(5) states that interest on unsecured claims shall be paid at 'the legal rate' as opposed to 'a' legal rate or the contract rate."[22] Judge Walrath reasoned that since Congress specifically provided for the contract rate in section 506(b) of the Bankruptcy Code, it would have been specific in section 726 as well had it intended the contract rate to apply. Second, Judge Walrath reasoned that the payment of post-petition interest is procedural in nature, and as such is governed by federal law rather than state law. From a policy standpoint, Judge Walrath added that the federal judgment rate promotes "fairness among creditors and administrative efficiency."[23]

Judge Walrath relied heavily on In re Cardelucci in her post-petition interest analysis, especially with respect to the lack of specific language in section 726(a)(5) suggesting that Congress

18 Decision at 12.

19 Decision at 14.

20 Decision at 14-15.

21 Decision at 77-78.

22 Decision at 78.

23 Decision at 78-79.

intended the contract rate to apply.[24] There, the Ninth Circuit ruled that the legal rate meant the federal judgment rate due to principles of statutory interpretation and policy considerations.[25]

This aspect of the Decision was surprising given Judge Walrath's previous decision in Coram "that the specific facts of each case will determine what rate of interest is 'fair and equitable.'"[26] Indeed, Judge Walrath acknowledged as much in a footnote stating, "[t]o the extent I suggested in Coram that the federal judgment rate was not required by section 726(a)(5), I was wrong."[27]

Judge Walrath, however, identified some circumstances where creditors might receive interest at the contract rate. For example, the Court found that oversecured creditors are entitled to interest at the contract rate.[28] In addition, the Court recognized an entitlement to interest at the contract rate where contractual subordination provisions explicitly require junior creditors to make payments to senior creditors. Specifically, Judge Walrath addressed the argument of certain subordinated creditors that if the federal judgment rate were found to be applicable, then they are not obligated to pay the senior creditors the difference between what the Debtors pay under the federal judgment rate and the contract rate of interest. In accordance with the Rule of Explicitness that the Court held was applicable under New York law,[29] Judge Walrath found that the relevant indentures contained subordination provisions that "adequately apprised the subordinated creditors that their payments were subordinate to *all* contractual post-petition interest, even if the Court allowed *none*."[30] Thus, the Court held that the Plan provisions "that give effect to the subordination provisions in the indentures . . . are not violative of the Bankruptcy Code."[31] With the exception of these limited circumstances, the Decision establishes that creditors are not entitled to their contract rate of interest in the Third Circuit.

Equity Committee Standing Motion

In addition to its objection to the Plan, the Equity Committee also sought standing to bring a claim for equitable subordination or equitable disallowance against the Settlement Noteholders. Not only did the Settlement Noteholders contend that the Equity Committee failed to allege a colorable claim, they also vigorously argued that no such cause of action exists as a matter of law.[32]

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24 285 F.3d 1231 (9th Cir. 2002).

25 Id. at 1234-35.

26 315 B.R. at 346.

27 Decision at 78 n.35.

28 Decision at 80.

29 The relevant indentures containing the subordination provisions were governed by New York law. In determining whether the Rule of Explicitness was valid under New York law, Judge Walrath relied on a decision by the New York Court of Appeals that answered the question in the affirmative. Chem. Bank v. First Trust of N.Y., 93 N.Y.2d 178, 186 (N.Y. 1999).

30 Decision at 97 (emphasis in original).

31 Decision at 97-98.

32 Decision at 113.

In considering whether the Equity Committee had standing, the Court held that it depended on whether the Equity Committee "stated a 'colorable' claim which the Debtors have unjustifiably refused to prosecute."[33] The Court first held that a claim for equitable disallowance exists as a matter of law, and that the Equity Committee had stated a colorable claim against the Settlement Noteholders.[34] However, Judge Walrath held, as did Judge Gerber in Adelphia, that equitable disallowance should be limited to "those extreme instances – perhaps very rare – where it is necessary as a remedy."[35] Notwithstanding this limitation, and given the draconian nature of the remedy, parties involved in chapter 11 cases in the Third Circuit must be mindful of the potential serious consequences that flow from the Decision.

Existence of Colorable Claims for Insider Trading

After finding that a cause of action for equitable disallowance exists as a matter of law, the Court considered the merits of the insider trading allegations against the Settlement Noteholders and concluded that the Equity Committee stated a colorable claim that the Settlement Noteholders engaged in insider trading.[36]

With respect to the Settlement Noteholders' status as temporary insiders by virtue of their access to the Debtors' confidential information and participation in the settlement negotiations, Judge Walrath also discussed the Equity Committee's alternative assertion that the Settlement Noteholders "owed duties as non-statutory insiders under bankruptcy law."[37] Among the cases cited in support of this proposition was a previous decision in In re Washington Mutual, Inc. (the "2019 Opinion"), where Judge Walrath held that an informal group of noteholders was acting as an ad hoc committee or entity representing more than one creditor, and therefore was required to comply with the disclosure provisions of Federal Bankruptcy Rule 2019.[38] In the 2019 Opinion, Judge Walrath stated that "members of a class of creditors may, in fact, owe fiduciary duties to other members of the class" when holding themselves out in a representative capacity.[39]

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33 Decision at 108 (citing Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 566-67 (3d Cir. 2003)).

34 In recognizing the validity of equitable disallowance as a remedy for wrongdoing, Judge Walrath relied heavily on Adelphia Recovery Trust v. Bank of America, N.A., which interpreted Pepper v. Litton as providing for "the equitable disallowance of claims, not on the basis of any statutory language, but as within the equitable powers of a bankruptcy court." 390 B.R. 64, 76 (S.D.N.Y. 2008).

35 Adelphia Commc'ns Corp. v. Bank of Am., N.A., 365 B.R. 24, 73 (Bankr. S.D.N.Y. 2007).

36 The Court's discussion of whether the Equity Committee's allegations sufficed to establish a colorable claim for insider trading was solely for the purpose of determining whether the Debtors' decision not to pursue the claim was justified under In re STN Enterprises, 779 F.2d 901, 905 (2d Cir. 1985). Any findings beyond those related to standing are merely dicta.

37 Decision at 130.

38 419 B.R. at 280.

39 Id. at 278 (quoting In re Mirant Corp. as imposing a fiduciary duty on parties that purport "to act for the benefit of a class." 334 B.R. 787, 793 (Bankr. N.D. Tex. 2005)). However, in In re Northwest Airlines Corp., Judge Gropper assumed, for purposes of ruling on a motion to compel disclosure under Federal Bankruptcy Rule 2019, that an ad hoc committee of equity security holders did not act as a fiduciary. 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007).

While Judge Walrath found it unnecessary to determine the extent of fiduciary duties owed by creditor groups in the 2019 Opinion, the Decision reasoned that due to the Settlement Noteholders' "status as holders of blocking positions in two classes of the Debtors' debt structure . . ., it could be found that they owed a duty to the other members of the classes to act for their benefit."[40] This goes further than the 2019 Opinion, which focused on actions rather than debt holdings. Whether imposing fiduciary duties on a creditor group with blocking positions chills the participation of similarly situated creditors in bankruptcy negotiations remains to be seen, but the Decision will likely lead many such creditors to reassess the costs versus benefits of maintaining or acquiring a blocking position.

The Decision is significant both because of the large number of chapter 11 cases filed in Delaware, and because courts outside of the Third Circuit tend to view decisions from Delaware bankruptcy courts as influential. Accordingly, all parties involved in chapter 11 cases must be aware of the Decision's key holdings.

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[40] Decision at 132.

Insolvency and Restructuring Update

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

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

Case Background

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

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

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

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

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

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

Involvement of the Settlement Noteholders in the Case

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

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

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

Elements of Insider Trading

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

Classical Insider Trading Analysis

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Misappropriation Theory Insider Trading Analysis

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

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

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

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

Possible Effects of the Decision

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

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

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

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

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

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Memorandum

January 6, 2012

Deconstructing *WaMu*: Managing Insider Trading Risks as an Ad Hoc Committee Member

By Eva Marie Carney, Michael D. Mann and Scott C. Budlong[1]

"The *WaMu* opinion, once deconstructed, yields an approach to analyzing duties, materiality, nonpublic information and the ability to trade that can be constructively applied by ad hoc committee members."

The recent—and unexpected—rejection by a U.S. Bankruptcy Court of the modified plan of reorganization of Washington Mutual, Inc. ("WaMu")[2] on the ground of a "colorable claim" of insider trading has raised questions about the standards of conduct for members of ad hoc creditors committees during corporate reorganizations.[3] In *WaMu*, Judge Mary F. Walrath found that a committee of equity holders (the "Equity Committee") stated a colorable claim that certain hedge fund noteholders participating in an ad hoc committee (the "Noteholders") had engaged in insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder[4] when they traded claims while negotiating with the debtor over the terms of a global settlement underlying the proposed plan of reorganization. It remains to be seen whether the court's finding, which yielded the Equity Committee a grant of standing to pursue the unusual remedy of "equitable disallowance" of the Noteholders' bankruptcy claims, will spur Rule 10b-5 lawsuits by allegedly defrauded investors or the SEC.[5] Regardless of that possibility, however, the court's visceral reaction to the facts and conclusion that the Noteholders may well have traded on inside information should have an indelible impact on the practices of market participants that choose to involve themselves in the bankruptcy process.

Judge Walrath's opinion methodically recounts the court's concerns that the Noteholders used potentially valuable nonpublic information they obtained as a result of their special status and access to the company to engage in "buying sprees"[6] with counterparties who did not have that nonpublic information. Some commentators have suggested that *WaMu* stakes out significant new legal ground and will render service on ad hoc committees untenably risky. We disagree. While the language of

1 Richards Kibbe & Orbe LLP associate Kimberly M. Versace also contributed substantially to the preparation of this memorandum.

2 *In re Washington Mutual, Inc.*, No. 08-12229 (MFW), 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011) ("*WaMu* Opinion").

3 By "ad hoc committee" we mean an unofficial group of claim holders that confer with each other about the debtor's reorganization and work collectively—sometimes with the assistance of counsel they specially engage—to advance the claim holders' interests as the reorganization takes shape. Official creditors committees, in contrast to ad hoc committees, are subject to bankruptcy law-imposed fiduciary duties and restrictions on trading. This article does not address participation in official creditors committees.

4 While there is no statutory definition of insider trading, it is generally understood to be trading in securities while in possession of material nonpublic information, in breach of a fiduciary or similar duty to the issuer or the source of the information, with scienter (i.e., a mental state of intentional wrongdoing or recklessness).

5 It appears that the 10b-5 claims have run their course in the bankruptcy court. In December 2011 WaMu announced that the Equity Committee's claims against the Noteholders would be dropped as part of a comprehensive settlement that will allow the debtor to distribute $7 billion to creditors. *See WaMu settles dispute, eyes bankruptcy exit* (Reuters, Dec. 13, 2011). In fact, one of the proposed conditions precedent to that settlement and the proposed plan confirmation is that the portions of Judge Walrath's opinion that address the 10b-5 claims be "withdraw[n] and vacat[ed] for all purposes." *See* Articles 1.77 and 36.1(a)(11) of the Seventh Amended Joint Plan of Affiliated Debtors filed by Washington Mutual, Inc. on Dec. 12, 2011, *available at* http://www.kccllc.net/wamu. A hearing on the plan is scheduled for January 11, 2012.

6 *WaMu* Opinion at 126.

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the opinion is provocative, the analysis offered is not particularly groundbreaking. Below, we deconstruct the opinion, separating visceral reaction from factual recitation and sorting those facts into the constituent elements of an insider trading claim. The result is an analysis of the elements of duty, materiality, nonpublic information and the ability to trade that we believe can be constructively applied by ad hoc committee members determined to avoid the type of attention that has been paid to the Noteholders' conduct.

To provide context, we start with a brief review of the *WaMu* facts.

THE *WAMU* FACTS

WaMu entered FDIC receivership in September 2008. In an FDIC-assisted transaction, JPMorgan Chase ("JPM") bought WaMu's assets and assumed its liabilities. Immediately thereafter, WaMu filed a Chapter 11 petition in Delaware. Disputes soon arose between JPM and WaMu, centered on ownership of cash deposits at WaMu and large tax assets arising from WaMu's prior losses. Recovery by WaMu's creditors would be driven by the value that WaMu could obtain by litigating or settling its dispute with JPM over ownership of those assets.

WaMu, JPM and the FDIC engaged in settlement negotiations related to the dispute commencing in March 2009 and continuing intermittently until a global settlement agreement—the basis for WaMu's plan of reorganization—was announced in March 2010. The Noteholders participated in the settlement discussions, sometimes directly and sometimes through counsel. The Noteholders signed confidentiality agreements with WaMu that required them, during two specified lock-up periods, to either refrain from trading in WaMu's securities or to establish an ethical wall to permit trading. WaMu agreed to make "cleansing disclosures" at the conclusion of each lock-up period of any material nonpublic information shared with the Noteholders, and did in fact timely disclose certain information regarding the size and amount of a tax refund WaMu believed it would receive. Information about the negotiations and the likelihood of a settlement of the dispute was not included in the disclosures (providing the grist for the Equity Committee's insider trading claims). Following the termination of the lock-up periods, certain of the Noteholders traded in WaMu's debt securities.

The Equity Committee represented WaMu equity holders who would be denied recovery under the proposed plan of reorganization. It sought to derail the plan, alleging that the Noteholders' trading was illicit because the Noteholders traded while in possession of information regarding the content of the settlement term sheets and the status and ongoing nature of the negotiations, which information WaMu did not include in its post-lock-up disclosures. The Equity Committee argued that this information was material and nonpublic, and Judge Walrath deemed "colorable" the Equity Committee's claim of illegal insider trading.

AN "ELEMENTAL" APPROACH TO THE ELEMENTS OF INSIDER TRADING

Below we deconstruct Judge Walrath's opinion for the benefit of ad hoc committee members intent on avoiding allegations that they are engaged in insider trading.

<u>Duty</u>: A critical element for establishing insider trading liability under Section 10(b) and Rule 10b-5 is that the defendant violated a duty in connection with its trading. Courts may take an expansive view of duties. *WaMu* illustrates this possibility, as the court was willing to stretch the notion of "temporary insider" by holding that a negotiating creditor might become a temporary insider—and thus have duties to the debtor's security holders—by participating with the debtor in negotiations with the shared goal of reaching a settlement that would underlie a plan of reorganization. The court reached this conclusion even though the Noteholders and WaMu were pursuing divergent interests in connection with the negotiations. Similarly, to the consternation of market participants and commenters, the *WaMu* court accepted the possibility that claim holders with a blocking position acquire a fiduciary duty to other members of the class and thus

could be deemed temporary insiders. Potential confusion over whether duties exist may be minimized by (i) ensuring, before joining an ad hoc committee, that all committee members are similarly situated with regard to access to material nonpublic information or are alert to any information-access disparities, and (ii) establishing consensus as to whether committee discussions are to be considered confidential and the amount and timing of trading, if any, that will be effected by committee members. If a committee member has a confidentiality obligation to the debtor or to another source of material nonpublic information, another member that learns the material nonpublic information during committee discussions under an agreement to maintain confidentiality, and then trades, may be subject to insider trading liability under the misappropriation theory.[7] It is therefore important for committee members to be clear at the outset regarding their status with respect to the debtor and each other, and regarding whether committee discussions will be confidential.

Materiality: Materiality judgments are necessarily contextual and not subject to bright-line analysis. The *WaMu* opinion reflects this point. The Equity Committee asserted that the Noteholders' special knowledge that a settlement was being discussed, and regarding the relative stances the parties were taking in those negotiations, was material information—as the court summarized the Equity Committee's point, "the parties were conceding issues at a time when the public knew only that [they] were engaged in contentious litigation."[8] The Noteholders defended themselves on the ground that the content of fluid negotiations was inherently not material, and that such negotiations could become material only when an agreement-in-principle was reached. Judge Walrath disagreed, finding that the parties' execution of confidentiality agreements, exchange of significant amounts of information, and engagement in discussions for over a year placed the information concerning settlement negotiations far enough along the "materiality spectrum" to make insider trading allegations "colorable." In other words, she concluded that there is no rule that an agreement has to reach a precise degree of definitiveness to be deemed material. *WaMu* is thus a reminder that it may be perilous for an ad hoc committee member to attempt to draw such precise lines and implement a trading strategy premised on a conclusion that information learned during negotiations with the debtor and others is too tenuous to restrict trading.

Reliance on others and knowledge of wrongdoing: The *WaMu* decision also reflects that it is foolhardy to rely exclusively on another party for a materiality assessment—even if that party is a debtor with an obligation to release all "material" information on a date certain, specifically so that ad hoc committee members are free to trade. Reliance on another party will not, as a matter of law, negate the element of knowing or reckless misconduct (scienter, in legal terms) that is required to establish insider trading liability. As *WaMu* states starkly, "Such a rule would vitiate the insider trading laws if a third party's assurances, with no further duty of inquiry, automatically insulated a party from insider trading liability."[9] While evidence of third-party judgments about materiality is certainly relevant, an ad hoc committee member must reach its own conclusion about the materiality of particular information it has received as a result of the committee's operations. Acting in reliance on the advice of one's own counsel will help negate scienter, however, as discussed below.

The *WaMu* court gave short shrift to the Noteholders' argument that they could not knowingly have traded on material nonpublic information because the debtor made contractually-required disclosures at the end of each confidentiality period. Even if a confidentiality agreement has a specified lock-up period and imposes a "cleansing" obligation on the debtor, after which

7 Section 10(b) and Rule 10b-5 are violated by a non-insider who trades in possession of material nonpublic information in breach of a duty of trust or confidence owed to the source of the information. This duty may arise in various ways, including where the trader has assumed an obligation to the source to keep the information confidential. Under the misappropriation theory, "deception" occurs for purposes of Section 10(b) when the trader converts the information to its own use, thereby defrauding the source of exclusive use of the information.

8 *WaMu* Opinion at 119.

9 *WaMu* Opinion at 133.

trading is contractually permitted, a committee member should make its own assessment regarding whether it possesses any material information that has not been made public. If it can be arranged, securing the debtor's agreement to consult with committee members on the content of disclosures to be made at the end of a lock-up period can be helpful in allowing committee members an opportunity for real input on the completeness of the disclosure.

An ad hoc committee member may bolster its ability to negate scienter by engaging in a probing conversation with competent counsel as to whether the member is restricted as a result of its exposure to nonpublic information, and then by following counsel's advice. The committee member's personnel most conversant with the relevant facts and information should be involved in the consultation with counsel—if they are not, the member runs the risk of a hindsight conclusion that the discussion with counsel did not relay all relevant facts and therefore could not be relied upon.

Nonpublic information: A committee member with a thoughtful process for controlling and managing nonpublic information received by firm personnel can mount a strong defense to insider trading claims. Firms with undisciplined information management practices develop reputations that make them easier targets for insider trading claims by disgruntled counterparties. Further, stark statements included in a firm's compliance policies can be turned against the firm by a court concerned with that firm's conduct.

For example, the *WaMu* court viewed the presence of an issuer on a firm's restricted list as evidence that the firm possessed material nonpublic information about that issuer. This view was not pulled from thin air—many firms have insider trading policies that characterize the restricted list as comprised of companies as to which the firm has material nonpublic information. Compliance policies that describe the restricted list as having a broader purpose will serve to guard the firm against evidentiary rulings like that in *WaMu*. As a general matter, the restricted list is best used and portrayed in the firm's compliance materials as a list of issuers in which the firm simply does not wish to trade without internal discussion, at the close of which legal and compliance staff decide whether trading will be permitted. One reason to refrain from trading is, of course, the possession of material nonpublic information, but other reasons might include appearance concerns and consideration of issues attendant to exceeding a certain percentage ownership threshold.

Equities and appearances: When all is said and done, a strategy of buying up claims and then seeking to participate aggressively in reorganization negotiations is troubling to some—including certain bankruptcy courts. Judge Walrath's ruling seems to reflect judicial offense at the idea of a firm using the bankruptcy process for its own gain. Consideration of appearances and how the equities will be weighed by the court overseeing the bankruptcy process should be part of any determination as to whether, and for how long, an ad hoc committee member will restrict trading in the debtor's securities. The best defense, in the long run, may be either a no-trade policy or the establishment—if feasible—of an ethical wall that separates the ad hoc committee member's negotiators from its traders. As the *WaMu* opinion put it: "There is an easy solution: creditors who want to participate in settlement discussions in which they receive material nonpublic information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case. . . . The Court does not believe that a requirement to restrict trading or create an ethical wall in exchange for a seat at the negotiating table places an undue burden on creditors who wish to receive confidential information and give their input."[10]

CONCLUSION

The *WaMu* opinion illustrates that ad hoc committee participation creates enhanced risk of insider trading

10 WaMu Opinion at 137-38.

claims for creditors that engage in active trading. Deconstructing the opinion yields constructive guidance for ad hoc committee members determined to avoid the type of attention paid to their counterparts in *WaMu*.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	)	
	)	Chapter 11
WASHINGTON MUTUAL, INC., et al.,	)	
	)	Case No. 08-12229 (MFW)
Debtors	)	Jointly Administered

CERTIFICATE OF SERVICE

I, Kathleen Campbell Davis, of Campbell & Levine, LLC, hereby certify that on January 18, 2012, I caused a copy of the *Opposition to Motion of Washington Mutual, Inc., and WMI Investment Corp. for an Order Pursuant to Bankruptcy Rule 9024, Federal Rule of Civil Procedure 60(b) and Section 105(a) of the Bankruptcy Code, to Vacate, in Part, the September Opinion and September Order, as a Condition of Mediated Settlement Embodied in the Seventh Amended Plan* to be served upon the attached service list via First Class Mail.

Dated: January 18, 2012

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08-12229
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