

KIRKLAND ALERT

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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 JP-Morgan 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

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, JP-Morgan 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.

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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