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Recent Bankruptcy Court Decision Finds Colorable Claim for Equitable Disallowance on the Basis of Alleged Insider Trading by Creditors

A recent Delaware bankruptcy court decision raises the possibility of equitable disallowance of claims as a result of alleged insider trading by creditors participating in Chapter 11 settlement discussions. The court in In re Washington Mutual, Inc., No. 08-12229 (MFW), 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011), held that the official committee of equityholders had stated a colorable claim for equitable disallowance of certain noteholders' claims, finding that the noteholders may have engaged in insider trading by trading debt securities issued by the Debtors while in possession of material non-public information arising out of settlement negotiations.

Under the "classical" theory of insider trading, securities laws prohibit corporate insiders from trading in securities while in possession of material non-public information ("MNPI"). Under the "misappropriation" theory of insider trading, corporate outsiders also are prohibited from trading while in possession of MNPI if such information was obtained in breach of a duty owed to the source of the information. Therefore, in the "tipper-tippee" context, a tippee can be liable for insider trading where a tipper has breached a duty of confidentiality and the tippee knows or should have known about such breach. Although decided in the context of a standing motion rather than a ruling on the merits, the WaMu decision suggests that stakeholders may face the risk of claims disallowance under theories of insider trading.

The Facts

Washington Mutual, Inc. ("WMI") and its affiliate WMI Investment Corp. (collectively, the "Debtors") are debtors under Chapter 11 of the Bankruptcy Code. Disputes arose early in the cases regarding ownership of assets and retention of claims following the seizure of the Debtors' savings and loan association by the Federal Deposit Insurance Company ("FDIC") and its sale to JPMorgan Chase Bank, N.A. ("JPMC"). Extensive negotiations among the Debtors, the FDIC, JPMC, and the "Settlement Noteholders", described below, culminated in a global settlement agreement ("GSA") that was incorporated as a key component into the Debtors' proposed Chapter 11 plan.

Four distressed debt investors (collectively, the "Settlement Noteholders") collectively held blocking positions in two classes of subordinated debt securities, which could allow them to control the Chapter 11 plan voting with respect to these classes. The Settlement Noteholders actively participated in the Debtors' negotiations with JPMC and the FDIC, subject to confidentiality agreements with the Debtors. The official committee of equityholders (the "Equity Committee") and certain equityholders alleged that the Settlement Noteholders had engaged in insider trading by actively trading in the market for debt securities of the Debtors while in the possession of MNPI – specifically, settlement term sheets and other information on the respective stances of the negotiating parties. Certain equityholders further alleged that at least one of the Settlement Noteholders had traded on MNPI that it had obtained as tippee through wrongful disclosure by counsel as tipper. On the basis of these allegations of insider trading, the Equity Committee sought standing to pursue equitable subordination and equitable disallowance of claims of the Settlement Noteholders. The Equity Committee also argued that the Debtors' Chapter 11 plan could not be confirmed because it had not been proposed in good faith (within the meaning of 11 U.S.C. § 1129(a)(3)) because of the Settlement Noteholders' alleged misconduct.

The Bankruptcy Court's Decision

The court (J. Walrath) denied confirmation of the Debtors' Chapter 11 plan on unrelated grounds, and granted (but stayed pending mediation) the Equity Committee's motion for standing to pursue a claim for equitable disallowance on the basis of alleged insider trading, ruling that:

- Under these circumstances, the Settlement Noteholders' conduct did not bar the confirmation of the Debtors' Chapter 11 plan as not having been proposed in good faith.

- The Equity Committee failed to state a colorable claim for *equitable subordination* because even if the Settlement Noteholders' claims were equitably subordinated to other claims, they would still be paid ahead of the equity.

- The Equity Committee stated a colorable claim for *equitable disallowance* of the Settlement Noteholders' claims on the grounds of insider trading, and was granted standing to pursue such disallowance, but they must first attempt to mediate the dispute.

The court evaluated the Equity Committee's claim for equitable disallowance under the relatively low threshold applicable to defeating a motion to dismiss for failure to state a claim. In holding that the allegations against the Settlement Noteholders satisfied this legal standard, the court found there was a colorable claim that:

- Settlement offers (and in particular, proposed settlement term sheets) during the protracted GSA negotiations could be considered material even at times when there was no agreement in principle and the negotiating parties remained far from reaching common ground. According to the court, because the Debtors did not disclose the respective negotiating stances of the parties (JPMC, FDIC, and the Debtors) to the public, the Settlement Noteholders privy to such negotiations were in possession of MNPI.

- The Settlement Noteholders became "temporary insiders" under federal securities law, with fiduciary duties toward other creditors and shareholders, when they received MNPI (as well as an opportunity to participate in negotiations with JPMC) from the Debtors for the common goal of achieving a consensual Chapter 11 plan.

- The Settlement Noteholders' blocking positions in two classes of the Debtors' debt securities could make them Bankruptcy Code insiders of the Debtors with fiduciary duties toward other members of those classes to act for their benefit.

- The Settlement Noteholders' reliance on the Debtors to disclose all MNPI to the public at the end of each restricted period under the confidentiality agreements is not a defense to a claim of insider trading.

- The fact that the Settlement Noteholders made contrary trades does not provide a defense to a claim of insider trading.

- There are colorable allegations that at least one Settlement Noteholder traded on misappropriated information obtained from counsel in breach of counsel's confidentiality agreement with the Debtors.

Key Lessons

Although the WaMu decision did not involve a decision on the merits – instead finding only that there was a colorable claim for equitable disallowance – it could have wide-ranging implications.

- Large stakeholders and members of ad hoc committees may be exposed to litigation asserting insider trading on the basis of alleged MNPI obtained in the course of Chapter 11 negotiations and discussions with a Chapter 11 debtor. In particular, creditors should carefully consider whether settlement discussions are material even absent an actual agreement or an agreement in principle.

- Various parties may obtain standing to assert allegations of insider trading, which claims may survive scrutiny under the "colorable claim" standard. Courts may permit discovery to explore such claims, even if many such claims are dismissed at a subsequent stage (as litigation arising from the Chapter 11 cases of Adelphia demonstrates).

- The risk of insider trading allegations could have a chilling effect on creditors' willingness to participate in discussions relating to pre-packaged and pre-negotiated Chapter 11 filings, and out-of-court restructurings generally.

- Stakeholders in possession of MNPI should restrict trading in claims and interests in the applicable debtors, or erect internal ethical walls between the public and private side of their institutions. A bankruptcy court may permit discovery to explore and evaluate the efficacy of any such ethical walls.

- Stakeholders should take steps to undertake their own evaluation of debtors' cleansing procedures and disclosures to the public and should be careful when relying on the debtors' assessment of the scope of MNPI requiring disclosure.

- When negotiating confidentiality agreements, stakeholders should seek, and be prepared to exercise, self-cleansing disclosure in case the debtors do not timely disclose all MNPI to the public.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Bankruptcy and Restructuring" in the "Practices" section of our website (www.clearygottlieb.com).

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