WaMu Court Allows Equity Committee to Pursue "Equitable Disallowance" of Noteholder Claims Based on Allegations of Insider Trading

On September 13, 2011, Judge Mary F. Walrath of the United States Bankruptcy Court for the District of Delaware granted standing for an equity committee in *In re Washington Mutual, Inc.* ("*WaMu*") to seek "equitable disallowance" of claims held by noteholders that had traded claims after engaging in negotiations with WaMu over the terms of a global restructuring. The decision highlights the question of whether creditors may engage in restructuring negotiations with a debtor and continue to trade in claims without establishing an ethical wall restricting traders from access to information related to the negotiations.

In *WaMu*, the equity committee argued that "equitable disallowance" of the claims held by certain hedge funds that held Washington Mutual notes (the "Noteholders") was warranted because the Noteholders had allegedly traded securities of the Debtors while in possession of material, non-public information concerning plan-related settlement negotiations. The Noteholders had signed confidentiality agreements with WaMu that required them either to establish an ethical wall or to refrain from trading during two specified limited duration confidentiality periods. In exchange for the Noteholders submitting to those restrictions, WaMu agreed to make cleansing disclosures of material, non-public information at the conclusion of the specified confidentiality periods, so as to permit the Noteholders to resume trading without an ethical wall. Following the confidentiality periods and cleansing disclosures by WaMu, certain of the Noteholders traded in WaMu debt. WaMu did not include in its cleansing disclosures the fact that negotiations were ongoing or the content of the various settlement term sheets that had been exchanged among the parties to the negotiations. Despite the fact that the discussions and term sheets had not resulted in any agreement in principle, the equity committee argued that the fact of the ongoing negotiations and the settlement terms under discussion constituted material, non-public information.

The Bankruptcy Court made several notable statements in the course of concluding that the equity committee had stated "colorable claims" relating to insider trading that could provide a basis for "equitable disallowance" of the Noteholders' bankruptcy claims. The Court, in light of these rulings, granted the equity committee standing to pursue these allegations and to seek "equitable disallowance."

Court's Discussion of Insider Trading Allegations

For a party to be held liable for insider trading, it must have traded while in possession of material, non-public information in breach of a duty of trust or confidence owed either to the issuer of the securities or to the source of the information.

Materiality

The Bankruptcy Court held that the equity committee had stated colorable claims that the Noteholders received material, non-public information during the specified confidentiality periods, even though the parties did not reach any agreement. The Court rejected arguments that the content of plan negotiations could only be material once an agreement in principle had been reached, and found unconvincing the Noteholders' appeals to the impracticality of mandating disclosure of constantly changing settlement proposals. The Court also dismissed the Noteholders' arguments that the information could not have been material because the various Noteholders did not trade consistently after the specified confidentiality periods—some of the Noteholders were selling while others were buying or not trading at all. In this regard, the Court commented that the fact that certain Noteholders may have made unwise or contrary trades does not provide a defense to an insider trading action.

Insider Status

Under the "classical theory" of insider trading, the defendant must be a "corporate insider," which may include "temporary insiders" as well as officers and directors. The *WaMu* Court held that the equity committee had stated a colorable claim that the Noteholders became temporary insiders when they were given material, non-public information during negotiations toward a shared goal of a consensual reorganization, and that that insider status gave rise to a fiduciary duty on their part to other creditors in the classes in which the Noteholders held blocking positions. In so holding, the Court relied on an observation made by the United States Supreme Court in a footnote in the seminal case of *Dirks v. SEC*, which observed in relevant part:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they 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.

Thus, the *WaMu* Court appears to have extended the scope of the *Dirks* decision from contractual agents of a corporation to a corporation's adversaries in a restructuring negotiation, solely because the parties have a common purpose in achieving a reorganization.

The *WaMu* Court also held that the equity committee presented evidence that the Noteholders could be considered "non-statutory insiders" because of their status as holders of blocking positions in two classes of the Debtors' securities. The Court observed that the Noteholders with blocking positions could be found to have owed a fiduciary duty to the other members of those classes to act for their benefit and, for this reason, also found that the equity committee had stated colorable claims that the Noteholders were temporary insiders for purposes of securities laws.

Scienter

As a defense to the insider trading allegations, the Noteholders asserted that the necessary element of scienter was lacking. Specifically, they argued that they could not have engaged in insider trading knowingly or recklessly because the Debtors had explicitly agreed to disclose any material, non-public information at the expiration of the confidentiality periods and had, in fact, made cleansing disclosures, which the Noteholders believed had included any material, non-public information. Therefore, the Noteholders argued, they could not have known that they still possessed material, non-public information. The Court rejected this defense, noting that each Noteholder had explicit policies prohibiting insider trading and could not use the Debtor as a shield if these policies were violated.

"Equitable Disallowance" Permitted as a Remedy to Benefit Equity Holders

Bankruptcy Code section 510(c) permits a Bankruptcy Court, under appropriate circumstances, to subordinate all or a part of an allowed claim to all or part of another allowed claim, or to subordinate all or part of an allowed equity interest to all or part of another allowed equity interest. It does not authorize the subordination of claims to equity interests. This alone, the Noteholders argued, should have defeated the claims of the equity committee—since what the equity holders were seeking was to subordinate the recovery of the Noteholders to permit value to flow to the equity. The Court acknowledged that equitable subordination was not an available remedy for the equity committee, but nevertheless approved the equity committee's novel pursuit of the "equitable disallowance" of the Noteholders' claims, citing the decisions of the Bankruptcy and District Courts in *Adelphia* as precedent for its authority to disallow a claim on equitable grounds in "extreme" cases.

Implications of the WaMu Decision

Creditors holding substantial positions in bankruptcy cases, particularly in cases pending in Delaware, may be concerned about the implications of the *WaMu* decision on a number of grounds.

First, creditors seeking to engage in plan negotiations with a debtor or creditors' committee must now consider whether doing so results in a potentially indefinite restriction on trading, even where such creditors take care to include protections and "cleansing" provisions in confidentiality agreements. The Court dismissed concerns that its findings would chill the participation of creditors in restructuring discussions, stating: "[T]here is an easy solution: 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." This choice will be unattractive to many market participants.

Second, significant creditors and creditor groups may be concerned about suggestions in the decision that participants in the restructuring process may become fiduciaries for the classes in which they hold claims, despite the fact that they are not members of the official creditors' committee.

Third, creditors and investors may be concerned that the emergence of a novel doctrine permitting "equitable disallowance" could undermine the structural seniority of claims to equity.

The *WaMu* Court's order granting standing to the equity committee has been stayed pending mediation, and therefore, the likelihood of an appeal is uncertain. If no appeal is taken from the decision, there will be no direct opportunity for the Noteholders, or other parties with an interest in these issues, to test the Court's conclusions regarding the legal validity of the equity committee's claims of insider trading or the availability of the remedy of "equitable disallowance." It should be noted that the *WaMu* decision is the view of one Bankruptcy Court, albeit an important and potentially influential one, and that as a technical matter, the decision does not have binding effect either on other Delaware Bankruptcy Courts or in Districts outside of Delaware. Nonetheless, creditors seeking to participate in a restructuring process or considering investing in securities that are, or may become, subject to such a process, will need to consider carefully the implications of this decision.

For further information, please contact Alyson Allen, Mark I. Bane, D. Ross Martin, or Keith H. Wofford.