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Memorandum

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

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"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

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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

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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

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