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Expert Analysis

Unclear Status of Stakeholder Negotiations in a Post-'WaMu' World

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Among the several issues addressed in the Sept. 13 opinion of the U.S. Bankruptcy Court for the District of Delaware in *In re Washington Mutual Inc.*[1] (*WaMu*), the distressed investment and restructuring community has been focused on the holding that the participation of certain noteholders (the "settlement noteholders") in plan-related settlement negotiations and subsequent trading activity gave rise to colorable claims that could be asserted against them.[2] This ruling has cast uncertainty upon creditors' ability to play a constructive role in achieving successful reorganization outcomes by way of consensual agreement. In light of the essential policy interest favoring settlements over protracted litigation, the framework set forth in *WaMu* may have the regrettable effect of chilling creditor participation in negotiations that would otherwise serve to benefit all stakeholders.

Factual Background

Early in the *WaMu* case, the FDIC, the debtors, their creditors (including the settlement noteholders), and the purchaser of much of WaMu's banking assets were in the midst of litigation over the ownership of billions of dollars of assets. After negotiations that took place between March 2009 and March 2010, the parties agreed on a global settlement, which was central to the completion of the debtors' plan of reorganization.

During the settlement negotiations, the settlement noteholders executed two confidentiality agreements (collectively, NDAs) that required them to restrict trading of the debtors' securities or to establish an ethical wall within their organizations to prevent leakage of confidential information from negotiators to traders. In addition, the debtors were required to publicly disclose material non-public information (MNPI) it provided to the settlement noteholders at the end of the two formal confidentiality periods.

While the settlement discussions were ongoing, the public was unaware that they were taking place. As part of the negotiation process, certain parties exchanged term sheets. One of the settlement noteholders established an ethical wall during the first confidentiality period, and the remaining parties restricted trading throughout the period. After the expiration of the first confidentiality period, the settlement noteholders shared what the debtors believed to be the only disclosed MNPI—the existence and amount of the debtors' estimated $2 billion tax refund—with their traders and actively traded the debtors' debt securities.

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Two of the settlement noteholders then engaged in additional negotiations that involved the further exchange of term sheets. One of these parties restricted its trading during the entirety of these negotiations, while the other only restricted its trading upon receipt of a counterproposal. This counterproposal was withdrawn, and these interim negotiations ended. During the second confidentiality period, all of the settlement noteholders restricted their trading on the debtors' securities. The debtors once again disclosed to the public the amount of an additional tax refund it believed it would receive—the only MNPI it believed had been shared throughout the second confidentiality period—but never disclosed any of the term sheets or the fact that negotiations had taken place.

In July 2011, a committee of equity holders (the equity committee) filed a motion seeking standing to equitably disallow the claims of the settlement noteholders on the basis of their alleged violation of securities laws, including Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Although the settlement noteholders asserted they adhered to the trading restrictions set forth in the NDAs, the equity committee argued that their knowledge of the existence of the settlement negotiations and the parties' stances memorialized in term sheets constituted MNPI on which the settlement noteholders traded.

The Opinion

The court's decision addressed several key issues raised by the standing motion, including (i) what constitutes "material non-public information," (ii) who qualifies as an insider for purposes of an insider trading analysis, and (iii) the applicability of various insider trading securities laws to the settlement noteholders' conduct. It is critical to note the low bar that governed the standing motion, whereby the court was only required to determine whether there existed a "colorable claim" for equitable disallowance before permitting the equity committee to assert it. As such, the *WaMu* ruling is not a final determination that the settlement noteholders' conduct in fact violated securities law and requires the equitable disallowance of their claims.

• Material Non-Public Information. The settlement noteholders argued that the debtors disclosed to the public the estimated amounts of their tax refunds and that was the only MNPI disclosed during settlement negotiations. The equity committee, on the other hand, argued that the settlement moteholders' awareness that negotia-

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tions were taking place as well as the respective stances of the parties during the negotiations placed the settlement noteholders at an unfair advantage when subsequently trading the debtors' securities.

In addressing the standard governing the materiality of non-public information, the *WaMu* court noted that it is an objective standard determined by whether or not a reasonable investor would consider it important in making an investment decision.[3] Analogizing to consideration of MNPI in the merger context, the court relied on a standard pursuant to which materiality is determined by balancing the probability that the merger will occur against the anticipated magnitude of the event in relation to the company's overall activity.[4]

Though it was clear that a potential settlement would be an event of significant magnitude, the settlement noteholders and the debtors contended that the non-disclosed information raised by the equity committee was not material because of the wide span of disagreement reflected in the parties' negotiating positions and several instances when the parties believed negotiations had failed or a settlement would be improbable. Dismissing these arguments, the court held that the knowledge of the existence of the settlement negotiations and the information shared among the parties constituted MNPI, relying primarily on the U.S. Supreme Court's rejection of the bright-line proposition that settlement discussions are immaterial until the parties have reached an agreement in principle.[5]

• Status as "Temporary Insiders." Next, the *WaMu* court examined whether the settlement noteholders for insider trading purposes became "temporary insiders" upon executing NDAs, accepting MNPI, and participating in settlement discussions that, if successful, were sure to form a critical part of the debtors' plan of reorganization. The court defined "temporary insiders" to include parties who "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" and in connection with a common goal.[6] The settlement noteholders argued that they could not be insiders of the debtors because they and the debtors had divergent interests. In contrast, the equity committee maintained that reaching settlement constituted the negotiating parties' common goal.

The equity committee also asserted that under bankruptcy law the settlement noteholders owed duties as non-statutory insiders to creditors in the two classes of claims in which the settlement noteholders held blocking positions. Based on both of these theories, the court concluded that the equity committee had stated a colorable claim that the settlement noteholders had become temporary insiders.

• Insider Trading Laws. The *WaMu* court then examined the "classical" and "misappropriation" theories of insider trading recognized by the U.S. Supreme Court.[7] Under the classical theory, insider trading rules are violated when a corporate insider (i) trades in the securities of his corporation (ii) on the basis of MNPI (iii) in violation of the fiduciary duty owed to the corporation's shareholders.[8] Under the misappropriation theory, a corporate "outsider" violates securities law "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information," as opposed to a breach of a duty owed to the counterparty to the trade.[9]

Addressing the classical theory of insider trading, the court rejected the settlement noteholders' argument that there was no evidence that they knowingly or recklessly traded while in possession of MNPI because the debtors had agreed to disclose all such information to the public at the end of each confidentiality period. The court viewed the fact the settlement noteholders knew settlement negotiations were occurring as enough to satisfy this element, whether or not they actually profited from trading on such knowledge.[10] Further, the court was not persuaded by the settlement noteholders' argument that good-faith reliance on the debtors' assurances that they would disclose all MNPI neutered any knowledge on their part that they possessed MNPI.

Impact of 'WaMu'

Toward the conclusion of the portion of *WaMu* dealing with the insider trading issue, the court stated that it did not share the settlement noteholders' concern that its finding would chill creditor participation in settlement discussions in bankruptcy cases.[11] The court posited that the "easy" solution would be that creditors seeking to enter into settlement negotiations must either restrict their trading or establish an ethical wall between traders and those participating in the negotiations.

While there is a bright-line simplicity to this approach, the practical effect of *WaMu* will likely make creditors think twice before participating in settlement negotiations. Creditors or debtors will not only have to publicly disclose that negotiations are taking place, but they will have to be extremely vigilant and overinclusive in their determination of what information will need to be disclosed to the public. The public disclosure of such overinclusive information in the midst of negotiations is not palatable to most debtors, and the premature glare of public scrutiny over terms may chill negotiating parties' ability to achieve a consensual outcome.

The imposition of such burdens is a troublesome development for bankruptcy stakeholders due to the critical and necessary role settlement discussions play in bankruptcy cases. While the *WaMu* court limned a spectrum between immaterial "preliminary discussions" and material negotiations, in the real world of complex restructuring negotiations, it will be exceedingly difficult for parties to get comfortable they are merely wading in the shallow waters of "preliminary discussions."

An additional factor that creates uncertainty is the likelihood that parties will have no choice but to prosecute expensive and protracted litigation over critical bankruptcy issues, see increased waste of precious judicial and economic resources, and suffer the overhang of significant process and execution risk with respect to chapter 11 plans, all of which would disserve the core bankruptcy objective of maximizing estate value for creditors and general policy favoring settlement.

Despite the cloud cast by *WaMu*, the necessity of settlements in bankruptcy will mean that negotiations will still undoubtedly take place. However, there is no doubt that security-holding creditors will tread very carefully before signing NDAs and entering into negotiations and will require that all MNPI—which will likely be viewed broadly to include any data that expresses a position on any issue under discussion—obtained through such negotiations is fully, timely and publicly disclosed at the conclusion of negotiations, whether or not an agreement is reached.

Finally, it bears noting that certain of the settlement noteholders have moved for leave to appeal the *WaMu* ruling. If the decision is ultimately upheld, however, this emerging and expanding grey area will require all participants in the bankruptcy process to pay special and close attention to these considerations before determining whether to commence negotiations.

1. No. 08-12229, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011).
2. Several of the settlement noteholders have filed a motion for leave to appeal the ruling or, in the alternative, to vacate the order through the issuance of a writ of mandamus.
3. *WaMu*, 2011 WL 4090757 at *48 (citing *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997)).
4. Id. (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988)).
5. Id. at *49 (citing *Basic*, 485 U.S. at 237).
6. Id. at *52 (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).
7. See *SEC v. Cuban*, 620 F.3d 551, 553 (5th Cir. 2010).
8. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1977).
9. Id. at 652.
10. *WaMu*, 2011 WL 4090757 at *54 (citing *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993).
11. Id. at *55.

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