SETTLEMENT TALKS IN CHAPTER 11 AFTER "*WAMU*": A PLAN MEDIATOR'S PERSPECTIVE

HON. JAMES M. PECK[*]

My judicial career has evolved in unforeseen ways. The Lehman Brothers case[1] certainly has been a major factor in that evolution, but another less obvious influence is my extracurricular work as a mediator who has been recruited to deal with intractable bankruptcy disputes arising in cases assigned to other judges. Shortly after confirmation of Lehman's plan, I was appointed as mediator to facilitate plan negotiations in some of the largest and most difficult cases in New York and Delaware. It has been a wonderfully rewarding experience for me, and I now have a deeply personal understanding of what goes on behind the scenes in really big cases, and of the motivations of key participants in the plan process.

Each case has its own character and unique challenges, but the common goal is a commercially reasonable outcome that takes into account the risks, costs, burdens and delays of unresolved conflict. Getting to that outcome takes a winning combination of issue spotting and evaluation, persistence, creativity, persuasion, diplomacy, empathy, and psychology. Some magic helps, too. These mediation activities have given me new insights regarding the art of the deal. The experience is a major change from my day job where I get to judge the quality of the sausage, but mercifully am spared first hand exposure to the messy grinding, mixing and seasoning. I have a renewed appreciation for how very hard it is to solve intricate restructuring problems in super-sized cases with multiple players and moving parts.

Late last year, my colleague Judge Glenn asked me if I would be willing to serve as plan mediator in the complex and contentious chapter 11 cases of Residential Capital—"ResCap" for short.[2] The jointly administered cases were then seven months old: assets had been sold in a favorable sale process, Judge Gonzalez was conducting an examination of potential colorable causes of action, there was the potential for years of crushing litigation, activity and the parties had determined that they needed adult supervision with plan negotiations that had not even started in earnest at that point.[3] It was an unusually early request for a mediator.

When I readily agreed to accept the appointment, I had no idea what I was getting myself into. This project turned out to be a second career and an assignment in a class by itself involving the most difficult three dimensional plan negotiations that I had ever encountered. For the past ten months, I have functioned as consultant, sounding board, deal therapist and cheerleader for consensus. I have

---

[*] United States Bankruptcy Judge, Southern District of New York.

[1] *In re* Lehman Bros. Holdings Inc., Nos. 08-13555 (JMP) (Bankr. S.D.N.Y.).

[2] *In re* Residential Capital, LLC, No. 12-12020 (MG) (Bankr. S.D.N.Y.).

[3] *See In re* Residential Capital, LLC, 480 B.R. 529, 550 (Bankr. S.D.N.Y. 2012) (directing parties to meet and confer regarding document production and allocation of costs).

also come to learn something about the risk-averse nature of hedge funds, and that will be my main topic: are funds overreacting to remote risks and thereby needlessly complicating and prolonging the process of achieving settlements in mega bankruptcy cases? My answer is that in acting rationally to manage and minimize perceived risks of potential claims based on hypothetical theories of insider trading liability, funds are getting in the way of progress, impeding plan negotiations and adding inefficiencies to an already expensive and labor intensive process.

A column in the New York Times by Maureen Dowd describes the problem in an entirely different context.[4] She writes about the stars of the television show "Homeland" who go on a field trip to visit Langley and meet actual C.I.A. operatives in the flesh.[5] Claire Danes describes the encounter: "There was one long table of C.I.A. folk and then us, directly facing each other . . . . They couldn't tell us anything about themselves, really. And we couldn't tell them anything about our show, really. So what kind of conversation could we have?"[6] Sounds like some meetings we have all attended.

The point, of course, is that private and confidential information needs to be accessible so that it can be shared and evaluated in a risk-free setting in order for there to be constructive dialogue. Plan negotiations in cases that involve publicly traded distressed debt securities require the safe handling of material non-public information. The alternative is superficial talk about "unclassified" information that fails to tell the entire story or periods of awkward and unproductive silence. Many distressed hedge funds today, like the actors in "Homeland," gather data for modeling from public sources but make conscious choices that limit their ability to engage in the private conversations needed to foster a more fully informed, reliable and nuanced understanding of the asset valuations and business prospects of debtor enterprise groups.

Encouraging compromise can be especially hard in those instances where hedge funds have made significant distressed investments within the capital structure of a debtor enterprise and have strongly articulated recovery goals and expectations. Those goals can easily become uncompromising positions. I have found that funds research their way into certain desired ranges of recovery based on a risk adjusted assessment of disputed legal theories and valuations that may be implicit in trading that occurs in the distressed marketplace. Some aspirational ranges of recovery also seem to be based more on wishful thinking than hard data. Predictive uncertainty and imperfect information are almost always givens in multi-billion dollar bankruptcy cases, and such doubts, despite vocal disagreements as to likely future outcomes, help to motivate the good faith bargaining that must occur in order to achieve settlements.

---

[4] Maureen Dowd, *My So-Called C.I.A. Life*, N.Y. TIMES, Sept. 14, 2013, at SR11.
[5] *Id.*
[6] *Id.*

To state an obvious point, bargaining and bankruptcy are linked and go together. Consensual chapter 11 plans are a natural by-product of good faith bargaining by parties that often have competing views as to the rights of creditors and appropriate plan treatment. In order to resolve their differences, these parties must talk with one another, share sensitive information—some of it material and confidential—and bargain to the point that parties are relatively indifferent to the possible benefits of ongoing conflict.

Thus, from a policy perspective it is plainly desirable that all pathways to free discourse and consensus building should be unobstructed. Unfortunately, I have seen that these pathways are being clogged as parties have chosen to be guided by a perverse application of the law of unintended consequences. Many distressed hedge funds are opting not to engage in negotiations that might expose them to any incremental threat of potential liability based on insider trading claims, however remote such claims may be, without first taking precautions with respect to the proper handling of material non-public information. No one disputes that this is rational behavior. Unfortunately, it is also behavior that tends to slow things down, increase administrative costs and unduly complicate the rules of engagement.

The trend is to call in the lawyers to fight the phantom dragons guarding the gates to the conference room. This process of posturing necessarily delays and complicates the sharing of non-public data, opinions and creative ideas about how to resolve cases. The concern here, based on my recent experiences, is that investment funds, acting prudently and naturally wanting to limit or reduce the perceived incremental risks associated with obtaining material non-public information in plan negotiations, may decide not to engage in such discussions at all, may choose to do so only through retained professional firms acting as intermediaries, or may adopt a layered approach to managing risk that includes information barriers, short term voluntary restrictions on trading set forth in heavily negotiated non-disclosure agreements that call for the public disclosure of information at the conclusion of the trading restrictions and even comfort orders issued by the bankruptcy court. What funds are most reluctant to do is to restrict their ability to trade for extended periods of time or to assume any open-ended risks of potential claims based on their own conduct or the inferences to be drawn from that conduct.

Referencing my mediation experiences in *ResCap* as background,[7] I am concerned about the negotiating conundrum caused by risk management procedures that are opposed to achieving core bankruptcy objectives. These procedures are well intentioned, but serve to restrain parties from freely talking to one another. The problem is most pronounced for hedge funds that have invested in publicly traded distressed debt securities and that want to retain the right to trade in the secondary market for these securities while also assuming an active role in plan negotiations.

[7] *See* Order in Aid of Mediation and Settlement at 1, *In re* Residential Capital, LLC, No. 4379, 12-12020 (Bankr. S.D.N.Y. 2013) (appointing the Honorable James M. Peck as mediator).

That recognizable investment philosophy brings together two potentially combustible components—trading and the risk that someone may later allege the misappropriation of or failure to disclose material non-public information. None of this would be an issue if funds either chose not to become involved in negotiations or were willing to be restricted from trading for the extended periods of time needed to negotiate the terms of a plan in a complex case. That sort of liquidity penalty, however, is neither a practical nor an acceptable alternative for distressed funds that are in the business of executing transactions. Such funds, acting for the benefit of their investors, inevitably will want access to non-public information for limited periods and to retain the flexibility to engage in market transactions to profit on the upside, trim or exit positions and, of course, not suffer the consequences of adverse claims or regulatory challenges.

Fund managers and compliance officers for funds with these investment goals are hesitant to become restricted and to discuss settlement, and this protective behavior is making it more difficult to bring essential parties into the room for settlement talks. Funds are noticeably sensitive—perhaps overly so—to the risks inherent in receiving material non-public information acquired in the course of plan negotiations and later trading in the debtor's securities even after a "blowout" or public disclosure of all information considered to be material. That sensitivity may lead a conservative fund adviser to conclude that it is better to stay on the sidelines than to engage. For a mediator, this is a frustrating development that hampers the ability to promote the discussions that may lead to settlements.

This heightened concern within the hedge fund community is traceable to procedural determinations made two years ago by the Wilmington bankruptcy court in the Washington Mutual case.[8] The case has a nickname, and everyone calls it "WaMu." Even though the determinations in *WaMu* were later vacated and have been removed from the Court's published decision, they have made an indelible impression that weighs heavily in the minds of managing directors, compliance officers and outside counsel.[9] The reasoning of the case lingers and has produced an elevated threat level when funds think about engaging in unprotected plan negotiations with or without a mediator.

WaMu has implications within the hedge fund world that extend beyond the actual holding of the decision. Funds are suffering from what I call the "*WaMu* effect"—a firm belief that what happened in *WaMu* is now more likely to happen again on the theory that any adverse claims that can be made will be made. The *WaMu* effect is the fear of being called an insider and of being accused of misusing material non-public information. Because of the reputational repercussions of

---

[8] *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011), *vacated in part*, No. 08-12229, 2012 WL 1563880 (Bankr. D. Del. February 24, 2012).

[9] *See* Tiffany Kary, *Hedge Funds Seek to Trade in Comfort as Bankruptcy Insiders*, BLOOMBERG NEWS, Oct. 18, 2013, http://www.bloomberg.com/news/2013-10-18/hedge-funds-seek-to-trade-in-comfort-as-bankruptcy-inside.html ("Hedge funds that invest in bankrupt companies are demanding protection from insider-trading lawsuits before agreeing to take part in restructuring talks -- a reaction by the industry's top performers to an obscure court decision involving the 2008 collapse of Washington Mutual Inc.").

insider trading rumors—consider SAC Capital,[10] for example—this phobia is a real concern, and I am sympathetic to those who suffer from it. I will briefly describe the *WaMu* case and the *WaMu* effect in hopes of identifying a remedy for this condition that, if unchecked, can undermine and side track plan negotiations.

One aspect of the disorder is the refusal of some market participants to obtain MNPI[11] and negotiate unless acceptable steps are taken to protect against claims of insider status. As I will explain, that is what happened in *ResCap*.[12] The *WaMu* effect has spawned a cottage industry dedicated to a variety of workarounds, precautions, defenses and prophylactic measures. Without these measures designed to manage hypothetical risks, funds are unwilling to become restricted, to gain access to needed MNPI and to engage in the very conversations that are the predicate acts to compromise in chapter 11. My own view is that this reluctance to engage, while understandable from a risk management perspective, is an overreaction to a case that is limited to its particular facts.

Washington Mutual is less about a ground breaking legal precedent and more about the recognition of potential exposure that has always been hiding in plain sight at the intersection of bankruptcy law and the securities laws. In *WaMu*, the risks were crystalized in a very high profile case to the consternation of the affected funds. My impression is that the various claims in question were alleged, as they often are, to gain leverage and for negotiating advantage. In this instance, the economically motivated party was an equity committee seeking standing to sue.[13]

The bankruptcy court found standing but did not address the merits or find that the funds were liable on account of their use of MNPI.[14] Instead, the court was testing the adequacy of threatened claims against funds that had participated in plan discussions. The essence of the claims was that the funds should be penalized for having received confidential information during the course of plan negotiations and thereafter having taken advantage of that information in market transactions.[15] According to the equity committee, the funds had liability as alleged insiders even

---

[10] *See* Peter Lattman & Ben Protess, *SAC Capital Is Indicted, and Called a Magnet for Cheating*, N.Y. TIMES, July 25, 2013, http://dealbook.nytimes.com/2013/07/25/sac-capital-is-indicted/?_r=0 (providing background on SAC's insider trading charges).

[11] Staff of the Office of Compliance Inspections and Examinations, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, *Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices Under Section 15(g) of the Securities Exchange Act of 1934*, at 4–5 (Sept. 27, 2012), https://www.sec.gov/about/offices/ocie/informationbarriers.pdf (defining "MNPI" as material nonpublic information, which is regulated by SEC under Exchange Act of 1934 section 15(g)).

[12] Transcript of Record at 36–37, *In re* Residential Capital, LLC (Bankr. S.D.N.Y. 2013) (No. 12-12020) (moving for mediation not to be considered insider trading).

[13] *See In re Wash. Mut.*, 461 B.R. at 263 ("The Court finds that the Equity Committee has stated a colorable claim that the Settlement Noteholders became temporary insiders of the Debtors when the Debtors gave them confidential information and allowed them to participate in negotiations with JPMC[.]").

[14] *Id.* at 267.

[15] *Id.* at 256.

though all of the information thought to be material had been publicly disclosed at the conclusion of the negotiations.[16]

The bankruptcy court found that proposed claims against the note holders were at least colorable under a number of legal theories, including a classic theory of trading with material non-public information and another based on the alleged misappropriation of confidential information.[17] The Court believed that the note holders qualified as temporary insiders or non-statutory insiders and granted the equity committee standing to sue the note holders.[18] The committee was given the authority to seek equitable disallowance of claims, a rarely invoked remedy.[19] I recognize, however, that no matter how strong the defenses and how hard it may be to prove such claims, the right to assert claims of this sort, regardless of merit, means that they have both nuisance value and settlement value.

The decision also mentioned that creditors who want to participate in settlement discussions in which they receive MNPI need to either restrict their trading or establish an ethical wall.[20] In that respect, the decision broke no new ground. Abstaining from trading is the simplest form of protection from claims predicated on improper trading, but the severe penalty (not being able to trade without incurring some risk including regulatory scrutiny) may be unacceptable, especially in volatile markets. The second alternative, an ethical wall, is an option that may work in large organizations but may be burdensome, impractical or simply too costly to implement in smaller investment firms.

As it turns out, no actual claims were ever litigated against the funds that were the target of the equity committee's motion, but the potential exposure identified in *WaMu* was enough to send out shock waves and strong warnings to market participants and to raise serious concerns within the hedge fund community. Although the *WaMu* decision has since been amended to remove all references to these potential causes of action, the implicit threat embedded in the legal analysis is persistent, and appears to have been internalized in the risk management practices of many funds and their advisors.

Even though the decision does not measurably change the risk profile, it has added urgency to the subject of plan negotiations followed by purchases and sales of securities. *WaMu* has caused certain sophisticated market participants to conclude that it is not safe to even engage in settlement negotiations, with or without a mediator, if doing so would increase exposure, however remote that risk might be, to adverse claims or potentially be grounds to restrain the ability to trade

[16] *Id.* ("The Equity Committee argues that equitable disallowance of the Settlement Noteholders' claims is warranted in this case because they traded on insider information obtained while they participated in settlement negotiations with the Debtor and JPMC.").

[17] *Id.* at 258 ("The Supreme Court has recognized two theories of insider trading under section 10(b): the 'classical theory' and the 'misappropriation theory.'").

[18] *Id.* at 264.

[19] *Id.* at 257.

[20] *Id.* at 266 (stating "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.").

securities of the debtor. *WaMu*, thus, seems to have spawned a new normal in plan negotiations in which investment funds are reluctant—even unwilling—to take part in negotiations without first obtaining some protection from the risks represented by these colorable claims.

That is the current mindset of distressed funds, and that is what I confronted in *ResCap*. Early in the mediation, I learned that institutional holders of Junior Secured Notes would not participate directly in discussions relating to plan treatment unless acceptable procedures were adopted to deal with these insider trading issues. For the first six months of the mediation, all of my communications were with professionals retained by the ad hoc committee of note holders. That was helpful, but not entirely satisfactory.

Counsel lacked the ability to bind their clients or even negotiate as surrogates for their clients, but could discuss plan issues in the most general terms. Their clients were aware of public information and were unrestricted; they would not agree to become restricted and participate directly in negotiations unless the court entered an order modeled after one that had been entered under similar circumstances by a Texas bankruptcy court in the *Vitro* case.[21] That order was entered on January 26, 2012 to deal with the chilling impact of *WaMu*.[22] I understand that the order was intended to reduce the perceived risks of taking part in settlement negotiations. That order has since taken on secondary meaning, and the term "*Vitro* Order" has become a buzz word for a comfort order entered in advance of and as a condition to plan negotiations providing that participants will be protected from specified future claims of the sort raised in *WaMu*. Such an order seems to have become an industry standard presumed antidote for the *WaMu* effect.

As the *ResCap* mediator and as a sitting bankruptcy judge, I must admit that I was generally unsympathetic to the request that our bankruptcy court enter a "*Vitro* Order" and provide such prospective aid and comfort as a condition to the start of negotiations, especially in adopting a proposed form of an order that I found to be impenetrably dense and hard to comprehend and interpret. We were at an impasse over this procedural precondition for many months but eventually the parties, with encouragement and even some drafting tips from me, reached an accord regarding a motion for entry of an acceptable form of order in aid of mediation. That order was entered on July 29, 2013.

I believe that this *ResCap* Order is the new gold standard for comfort orders of this type. In approving an uncontested motion for entry of this order, Judge Glenn made bench rulings relying on the broad language of section 105(a) and Bankruptcy Rule 7016(c)(2)(L) allowing for the adoption of special procedures for managing difficult or complex issues.[23] His comments provide useful context for the order itself. As Judge Glenn stated in his ruling, "[t]he proposed order is intended to

[21] *See id.* at 37 (stating that proposed order was to be modeled after the *Vitro* Order).
[22] *See id.* at 45.
[23] *Id.* at 44–45.

clarify the status of mediation participants with respect to the debtors and other parties in interest as a consequence of participating in the mediation."[24]

Specifically, the proposed order determines that no mediation parties shall become an insider or temporary insider of the debtor parties, shall not be deemed to owe any duty to any of the debtor parties and do not undertake any duty to any party in interest.[25] Additionally, the proposed order specifies that parties who take part in the mediation are not deemed to misappropriate any information.[26] Judge Glenn also clarifies that the junior secured note holders are not insiders of the debtors under any traditional standard, nor do they owe any fiduciary obligations to others because they are simply creditors seeking to engage in arm's-length negotiations to further their own economic self-interest.[27]

The holding states the proposed order "serves to foster the policies in favor of mediation and encouraging creditor participation in chapter 11 cases by allowing principals from the junior secured noteholders to participate in mediation and settlement negotiations, without the risk that such participation would subject such junior secured noteholders to liability."[28] Judge Glenn's bench ruling is notable precedent, not only as it relates to *ResCap*, but as it may be applied to encourage negotiations in other complex bankruptcy cases. Importantly, given the eagerness of market participants for a remedy, it declares that the bankruptcy court has the authority to protect parties in advance of prospective negotiations: the act of negotiating will not be a source of incremental liability for parties who engage in settlement negotiations with or without a mediator.[29]

The ruling in *ResCap* can be adapted and applied to other settings. Parties may want to think about whether it would be desirable to seek entry of an order of this sort as a "first day" order in chapter 11 cases where active plan negotiations with funds are contemplated at the outset. Alternatively, a motion for entry of an order comparable to the one used in *ResCap* may be filed whenever it becomes ripe to do so. The *ResCap* form of order is not foolproof, but it does represent a giant step forward in encouraging parties to negotiate. My own experience confirms that the junior secured note holders were willing to meet immediately after entry of this order. This shows that the at least one group of funds was satisfied with the order and indicates that others may be similarly comforted.

---

[24] *Id.* at 45.
[25] *Id.*
[26] *Id.*
[27] *Id.* at 46.
[28] *Id.*
[29] *Id.* at 46–47 ("Without entry of the proposed order, the junior secured noteholders' principal will be unable to participate in the mediation under the construct demanded by the debtors and creditors' committee.").

CONCLUSION

The basic takeaways here are: First, the bankruptcy court has the authority to aid mediation and settlement discussions in appropriately complex cases where obtaining and later disclosing MNPI can present concerns to the parties. Second, the relief afforded by the order is not a universal antidote and does not protect against SEC or other regulatory enforcement actions, nor does it offer the comfort of forward looking exculpation for inadequate disclosure, market manipulation and misconduct. In short, it does not pardon wrongful actions. Finally, orders such as the *ResCap* order are helpful in granting a prophylactic judicial characterization of legal status that may preempt theoretical exposure to claims associated with plan negotiations. In that respect, *ResCap* orders may encourage the kind of conduct that mediators like to see: constructive settlement talks that can lead to the consensual resolution of complex bankruptcy problems.