THE AFTERMATH OF "*WAMU*": A PROBLEM STILL IN SEARCH OF A SOLUTION

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INTRODUCTION

Even though *In re Washington Mutual, Inc.*[1] (the "*WaMu* decision") has been criticized and was vacated by the Delaware bankruptcy court as part of an overall resolution of the issues in dispute,[2] it nonetheless augurs a likely increase in insider-trading-related litigation in bankruptcy court. The potential implications of the *WaMu* decision, together with the current enforcement focus of the U.S. Securities & Exchange Commission (the "SEC") on insider trading by hedge funds, suggest that this issue should be of paramount concern to activist hedge funds. The *WaMu* decision brings into sharp relief the issue of how to fulfill the "level playing field" aspiration of the securities laws without unnecessarily chilling active hedge fund participation in the bankruptcy process. In Part I of this paper, we discuss the *WaMu* decision, explaining our view that, in its wake, we are likely to see more bankruptcy litigation involving claims of insider trading. In Part II, we survey and evaluate the different approaches that activist funds and other parties-in-interest have pursued in their efforts to minimize the risk of "*WaMu*-type" litigation. In Part III, we conclude that the most recent approaches, which seek judicial findings in advance that parties are not "temporary insiders" or will not be considered recipients of material non-public information, are misguided and expose hedge fund parties to substantial litigation and regulatory risk.

I. THE *WAMU* DECISION

On September 13, 2011, Judge Mary F. Walrath granted a motion by the WaMu equity committee for authority to pursue equitable subordination and disallowance of certain bondholder claims (the "Standing Motion") on the basis that a group of hedge fund bondholders involved in negotiations over WaMu's reorganization plan allegedly engaged in insider trading.[3] The court recognized that the rarely used remedy of "equitable disallowance" was available if it could be shown that the bondholders had traded in WaMu's securities while privy to nonpublic information gleaned through settlement negotiations with the WaMu debtors that "may have shifted towards the material end of the spectrum."[4]

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1 461 B.R. 200 (Bankr. D. Del. 2011).

2 *In re* Wash. Mut., Inc., No. 08-12229, 2012 WL 1563880, at *16 (Bankr. D. Del. Feb. 24, 2012).

3 *In re* Wash. Mut., Inc., 461 B.R. 200, 267 (Bankr. D. Del. 2011).

4 *Id.* at 263.

A. Factual Background

On September 25, 2008, the Office of Thrift Supervision closed Washington Mutual Bank and appointed the Federal Deposit Insurance Corporation (the "FDIC") as receiver.[5] On that same day, the FDIC sold nearly all of the bank's assets to JPMorgan in exchange for cash and the assumption of certain liabilities.[6] As receiver of the bank, the FDIC retained certain claims.[7] The very next day, WaMu and an affiliate commenced chapter 11 bankruptcy proceedings.[8]

In the wake of the September 2008 seizure and asset sale, which marked the largest bank failure in the nation's history, a multitude of disputes arose among the debtors, JPMorgan and the FDIC concerning ownership of certain assets and various claims that had been asserted.[9] Those disputes, potentially worth billions, were the subject of litigation in bankruptcy court and elsewhere.[10] It soon became clear that the outcome of WaMu's reorganization, and the extent to which creditors and shareholders would recover on their claims, depended upon resolution of these multi-billion-dollar disputes.[11]

In March 2010, a global settlement was announced that resolved the disputes among the debtors, JPMorgan and the FDIC.[12] The settlement was incorporated into the debtors' proposed plan of reorganization.[13] In January 2011, the bankruptcy court declared that the global settlement was fair and reasonable, but declined to confirm the plan for other reasons.[14]

The plan and settlement were subsequently modified to address certain concerns expressed by the court.[15] The hedge fund bondholders, as significant creditors holding large positions in the case, were invited to participate in the negotiations at times.[16] In March 2011, the debtors sought confirmation of the modified plan.[17] The modified plan had the support of major constituencies, including JPMorgan, the FDIC, the bondholders and the creditors' committee.[18]

The equity committee, however, opposed the modified plan.[19] According to the

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5 *Id.* at 211.
6 *Id.*
7 *Id.*
8 *Id.*
9 *Id.*
10 Eric B. Fisher & Katie L. Cooperman, *Bankruptcy Court Authorizes Insider Trading Claims Against Hedge Funds*, N.Y. L.J., Dec. 1, 2011, at 4.
11 *Id.*
12 *In re* Wash. Mut., Inc., 461 B.R. 200, 212 (Bankr. D. Del. 2011) ("On March 12, 2010, the parties announced that they had reached a global settlement agreement[.]").
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.* at 213.
19 *Id.*

equity committee, the formulation of WaMu's bankruptcy plan was:

> [T]he product of a disturbing process that operated, with the knowledge and complicity of the Debtors, for the benefit of a favored few – four powerful hedge fund managers who played pivotal roles in orchestrating both the Global Settlement Agreement and the Plan, and who, with the Debtors' express permission via the terms of confidentiality agreements, were enabled to engage in [insider trading.][20]

The bondholders opposed the equity committee's prosecution of "meritless" and "unprecedented" claims that are "uneconomic to pursue" where the debtors' estates suffered no harm.[21] In particular, the bondholders claimed that they acted in good faith as arm's length creditors, and were "relegated to discrete and intermittent roles in settlement negotiations and the plan process."[22] The bondholders rejected any implication that they dominated or controlled the debtors or had fiduciary duties to other creditors simply by joining an informal creditor group that collectively held a substantial position in a class of the debtors' securities.[23]

The portion of the *WaMu* decision that is the focus of this paper is the court's ruling on the equity committee's Standing Motion, which sought authority to prosecute claims for equitable subordination or disallowance of the noteholders' claims.[24] The issue before the court was whether the equity committee had stated a "colorable claim" for equitable subordination or disallowance.[25] As the court noted, the "threshold for stating a colorable claim is low and mirrors the standard applicable to a motion to dismiss for failure to state a claim."[26] Thus, the court's decision granting the Standing Motion was "merely a preliminary ruling . . . [i]n contrast to a ruling on the merits based upon a fully developed factual record after a full trial and discovery[.]"[27]

In granting the Standing Motion, the court was hospitable to the equity committee's contention that the bondholders had become temporary insiders of the debtors and had assumed fiduciary responsibilities to other stakeholders by virtue of

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[20] [Revised] Post-Hearing Brief of the Official Committee of Equity Security Holders in Opposition to Confirmation of the Debtors' Modified Sixth Amended Plan of Reorganization at 1, *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011) (No. 08-12229).

[21] Motion of Aurelius Capital Management, LP for Leave to Appeal Under 28 U.S.C. § 158(a) at 1–2, *In re* Wash. Mutual, Inc., 461 B.R. 200 (Bankr. D. Del. 2011) (No. 08-12229).

[22] *Id.* at 12.

[23] *Id.* at 6–7.

[24] *In re Wash. Mut., Inc.*, 461 B.R. 200, 267 (Bankr. D. Del. 2011).

[25] *Id.* at 254 (citing Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 566–67 (3d Cir. 2003)).

[26] *Id.* at 255 (citing *In re* Centaur, LLC, No. 10-10799, 2010 WL 4624910, at *4 (Bankr. D. Del. Nov. 5, 2010)).

[27] *In re* Wash. Mut., Inc., No. 08-12229, 2012 WL 1563880, at *19 (Bankr. D. Del. Feb. 24, 2012).

their involvement in the reorganization process.[28] The court was also receptive to the equity committee's contention that the substance of the bondholders' settlement discussions with the debtors constituted material nonpublic information that should have barred them from trading.[29] Finally, as a means of redress, the bankruptcy court appeared willing to breathe new life into the remedy of "equitable disallowance," a doctrine that is a creature of case law and not found in the Bankruptcy Code.[30]

B. Analysis of Insider Trading Claim

The court in *WaMu* relied on a broad interpretation of the Supreme Court's decision in *Dirks*[31] to hold that the bondholders may have become "temporary insiders" of the debtors when the debtors "gave them confidential information and allowed them to participate in" the global settlement negotiations with JPMorgan.[32] The court also found that the bondholders could be considered "non-statutory" insiders because of their status as members of an *ad hoc* group with "blocking positions" in certain classes of the debtors' securities.[33] Taken to its logical conclusion, *WaMu* implies that lone creditors, and certainly members of *ad hoc* committees, may fall under *Dirks*' definition of "temporary insider," depending upon their level of access to nonpublic information and participation in nonpublic negotiations.[34]

WaMu, in reliance on *Basic v. Levinson*, holds that mere knowledge of the occurrence of preliminary settlement negotiations (about which the trading public is unaware) may constitute material nonpublic information.[35] Judge Walrath rejected the bondholders' argument that information concerning preliminary, inconclusive or stale negotiations is immaterial as a matter of law and that a deal must be in place before settlement talks themselves become material.[36] *WaMu*, when read alongside *Basic*, implies that any creditor privy to confidential settlement discussions at any time during a bankruptcy case should remain restricted or walled off until the

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28 *In re Wash. Mut.*, 461 B.R. at 263–64.

29 *Id.* at 263.

30 *Id.* at 256–58.

31 Dirks v. S.E.C., 463 U.S. 646, 655 n.14 (1983).

32 *In re Wash. Mut.*, 461 B.R. at 263.

33 *Id.* at 264.

34 Fisher & Cooperman, *supra* note 10, at 9.

35 *See* Basic Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988) (articulating standard of materiality for purposes of insider trading as information a reasonable investor would consider important and noting "trading (and profit making) by insiders can serve as an indication of materiality") (emphasis omitted); *see also* Martin J. Bienenstock, et al., *The Alphabet Soup of Getting Restricted*, Law360 (Sept. 23, 2013) http://www.law360.com/articles/474098/the-alphabet-soup-of-getting-restricted ("Even mere knowledge of the existence of nonpublic restructuring discussions and negotiations between the company and certain creditors may constitute [material nonpublic information].").

36 *In re Wash. Mut.*, 461 B.R. at 260 (citing Basic v. Levinson, 485 U.S. 224, 237 (1988), wherein the "Supreme Court . . . expressly rejected the argument that there is no materiality to discussion until an agreement-in-principle has been reached.").

substance of the settlement discussions is publicly disclosed.[37] According to Judge Walrath, "a requirement to restrict trading or create an ethical wall in exchange for a seat at the negotiating table" is a fair price to pay by "creditors who wish to receive confidential information and give their input."[38]

C. Implications

In *WaMu*, Judge Walrath revived the theory of equitable disallowance adopted in the Supreme Court's 1939 decision in *Pepper v. Litton* as a viable remedy to eliminate the bondholders' claims against the debtors based on allegations of insider trading.[39] Even though Judge Walrath vacated her decision on September 24, 2012, the *WaMu* decision raises important, unresolved questions likely to recur in this era when hedge funds, and other alternative investment vehicles, play an increasingly important role in the restructuring process.[40] At least one bankruptcy judge has concurred with the vacated portion of Judge Walrath's decision, despite its vacatur, and creditors are well advised to proceed with caution.[41] Creditors who choose to

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[37] Fisher & Cooperman, *supra* note 10, at 9.

[38] *In re Wash. Mut.*, 461 B.R. at 266.

[39] Pepper v. Litton, 308 U.S. 295, 311 (1939).

[40] The Plan included, as a condition precedent to confirmation, the condition that the bankruptcy court vacate, for all purposes, (a) the September order to the extent it relates to the Standing Motion, and (b) those portions of Judge Walrath's opinion that relate to the Standing Motion (*i.e.*, section III(H) of the September 13, 2011 opinion, pages 108−39, and the first sentence on page 68, footnote 31 on page 70, and the last paragraph of section III(D) of the opinion, page 73). *In re* Wash. Mut., Inc., No. 08-12229, 2012 WL 1563880, at *16 (Bankr. D. Del. Feb. 24, 2012). Judge Walrath noted, among other things, that, "absent vacatur, the eight separate appeals of the September Opinion will proceed in at least one appellate court, if not more, which appellate process could last for years, imposing significant costs on the parties and the judicial system," that the portions of the order and opinion that are being vacated "are fact-specific, unique to this bankruptcy, and are non-binding on other courts," and that partially vacating her decision in furtherance of the settlement "will avoid further protracted litigation in this Court, in the Delaware District Court, and in the Third Circuit[.]" *Id.* at *18. Judge Walrath went on to find that:

> [T]he Court's determination . . . that the Equity Committee has standing to pursue certain equitable disallowance claims was merely a preliminary ruling. In contrast to a ruling on the merits based upon a fully developed factual record after a full trial and discovery, the precedential value of the portions of the September Opinion and September Order that are related to the Standing Motion therefore is not high. On the other hand, the resolution of the Chapter 11 Cases pursuant to the Plan and the compromises and settlements embodied therein preserves estate resources, conserves judicial resources, and ensures that billions of dollars in distributions can be made to creditors and holders of equity interests who have waited over three years for any recovery. This Court thus concludes that the Debtors have demonstrated the presence of "exceptional circumstances" warranting the requested vacatur and that the requested vacatur will serve the public interest.

Id. at *19.

[41] In upholding the remedy of equitable disallowance, Judge Gerber quoted Judge Walrath's opinion in *WaMu* but noted that the language "may not appear if you shepherdize Judge Walrath's Washington Mutual decision the traditional way [because] she later vacated her decision when parties made a deal in the case." Judge Gerber went on to question the propriety, stating that the *WaMu* decision "reflects thinking on this

play an active role in the negotiation process may be regarded as insiders of a debtor, by virtue of their participation in nonpublic negotiations, and may unwittingly assume the attendant obligations and restrictions.[42] Under *WaMu*, creditors who buy or sell securities of financially distressed companies based upon nonpublic information learned through participation in the bankruptcy process risk subordination or disallowance of their claims in full.[43]

Because the barriers to stating viable claims for equitable subordination are substantially lower than those under the federal securities laws, we expect an uptick in insider trading-related litigation in bankruptcy court. It is potentially far easier for a plaintiff to assert a viable claim in bankruptcy court for equitable subordination or disallowance based upon insider trading than it would be for that same party to assert a claim under the federal securities laws. The requirements for equitable subordination or disallowance of creditor claims based upon theories of insider trading are not equivalent to those necessary to state a claim under the federal securities laws. The former are more lax. For example, to state the most obvious difference, equitable subordination requires a showing that the defendant behaved inequitably;[44] on the other hand, to state a claim under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, a plaintiff must ultimately prove scienter—a standard that is much tougher to satisfy than mere inequitable conduct.[45] In addition, claims under the federal securities laws are subject to the stringent pleading requirements imposed by the Private Securities Litigation Reform Act of 1995 (the "PSLRA").[46] Equitable subordination or disallowance claims based upon insider trading, in contrast, are arguably not fraud claims at all and thus may not even be subject to the pleading-with-particularity

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exact issue by a very respected Judge and frankly I have my reservations as to the extent to which judicial thinking could be vacated and made irrelevant by the decision of parties to make a deal after the decision was issued at least on matters of law as compared and contrasted to disputed issues of fact." Transcript of Hearing re: Debtors' Objection to Proof of Claim at 12–13, *In re* Motors Liquidation Co., (2012) (No. 09-50026). Similarly, on July 17, 2012, Judge Gerber again expressed his agreement with Judge Walrath's analysis in *WaMu* and stated that he was "not impressed by arguments that, like one of those three monkeys, I should close my eyes and ears to the benefits of her thinking on this subject, simply because incident to a settlement, there was a partial vacatur of the opinion in which her thinking was revealed." Audio of Hearing Regarding Noteholders' Motion In Limine To Preclude Certain Evidence Or, In The Alternative, To Adjourn The Trial Date at 57:00, *In re* Gen. Motors Corp, No. 09-50026 (Bankr. S.D.N.Y. 2012).

[42] Fisher & Cooperman, *supra* note 10, at 9.

[43] *Id.*

[44] *See generally* Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977); *In re* Adelphia Commc'ns Corp., 365 B.R. 24, 68 (Bankr. S.D.N.Y. 2007).

[45] *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Inc., 551 U.S. 308, 324 (2007) (stating "inference of scienter must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations.").

[46] The PSLRA imposes heightened pleading requirements for any private claim. *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 81–82 (2006). Claims for insider trading must be pled with particularity and allege a strong inference of fraud. *Tellabs*, 551 U.S. at 321. The pleading requirements of the PSLRA require a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" with respect to "each act or omission alleged to violate" the federal securities laws. 15 U.S.C. § 78u-4(b)(2) (2006).

requirements of Rule 9(b) of the Federal Rules of Civil Procedure.[47] Further, there are fewer hurdles to establish standing to assert an equitable subordination claim as compared to a claim for insider trading under the federal securities laws.[48]

In addition to the explicit risk of the subordination or disallowance of claims by funds named as defendants in equitable subordination/disallowance lawsuits, the potential proliferation of such litigation poses substantial, unquantifiable regulatory risk as well. Particularly in this period when enforcement efforts by the SEC and United States Attorney's Office ("USAO") are focused on insider trading by hedge funds, private litigation about insider trading in bankruptcy court poses the added risk of attracting SEC and USAO scrutiny.[49]

II. DIFFERENT APPROACHES TO MANAGING *WAMU* LITIGATION RISK

Activist funds and other parties-in-interest have pursued different approaches in their efforts to minimize the risk of "*WaMu*-type" litigation. There are three basic approaches: restrict or disclose; ethical walls; and the more recent effort to develop prophylactic measures.

A person in possession of material nonpublic information will be restricted from trading in the securities of an issuer under applicable securities laws until either (i) the information becomes stale and no longer material or (ii) the information is made public.[50] As first articulated in *Cady, Roberts*, a party to a

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[47] *See* FED. R. CIV. P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

[48] In order to have standing to bring a private insider trading action, a private litigant must show that it traded in the securities contemporaneously with the defendant. Matt Porcelli, *Bankrupting the Inside Job: Alternatives to the Washington Mutual Approach to Policing Creditor Committee Insider Trading*, 9 N.Y.U. J. L. & BUS. 295, 312 (2012). On the other hand, a debtor, creditors' committee or other party in interest, may have, or obtain, standing to assert a claim for equitable subordination.

[49] *See, e.g.*, Greg Farrell, *Cohen, SAC Capital Sought 'Edge,' Prosecutors Say*, BLOOMBERG NEWS, July 26, 2013, http://www.bloomberg.com/news/2013-07-27/cohen-sac-capital-sought-edge-prosecutors-say.html (discussing SAC indictment and noting 2009 arrest and insider trading charges filed against Galleon Group's Raj Rajaratnam "put Wall Street on notice that the U.S. attorney's office had a major effort going to punish insider trading"); Julie Creswell, *A Relentless Prosecutor's Crowing Case*, N.Y. TIMES DEALBOOK, July 25, 2013, http://dealbook.nytimes.com/2013/07/25/a-relentless-prosecutors-crowning-case/ (noting Preet Bharara, "the new sheriff of Wall Street" who oversaw insider trading convictions of Raj Rajaratnam and former Goldman Sachs board member Rajat K. Gupta, "has taken an aggressive stance" by pursuing entire SAC firm); Lorenzo Casavecchia, *A Hedge on the Edge: SAC Capital's Insider Trading Scandal*, THE CONVERSATION, July 25, 2013, http://theconversation.com/a-hedge-on-the-edge-sac-capitals-insider-trading-scandal-16276 ("In the 2012 fiscal year, the SEC brought 58 insider trading actions against 131 managers and entities accused of gaining profits – or avoiding losses" and between 2010 and 2012 "the SEC has filed more insider trading actions – a total of 168 cases against nearly 400 individuals and entities – than in any three-year period in the SEC's history"); Alexandra Stevenson, *After SAC Plea, Fellow Funds May Pay*, THE NEW YORK TIMES DEALBOOK, November 5, 2013, http://dealbook.nytimes.com/2013/11/05/after-sac-plea-fellow-funds-may-pay/?_r=0 (according to Preet Bharara, no hedge fund "should consider itself 'too big to jail'").

[50] ADAM C. HARRIS & HOWARD GODNICK, INSIDER TRADING LAW AND COMPLIANCE ANSWER BOOK 2011-12: OUT-OF-COURT RESTRUCTURINGS, THE BANKRUPTCY CONTEXT, AND CREDITORS' COMMITTEES, 434 (Harry S. Davis 2011).

securities transaction who possesses material nonpublic information must either disclose such information or "forego [*sic*] the transaction."[51] This proposition has come to be known as the "disclose or abstain" rule. The underlying principle is that "[i]ntimacy demands restraint lest the uninformed be exploited."[52]

Recipients of material nonpublic information often seek to limit the period during which they will be restricted from trading.[53] As a result, confidentiality agreements negotiated with the debtor in a bankruptcy context typically contain a provision stating that the debtor will make public the material nonpublic information provided by a certain date.[54] After that date, the counterparty is free to trade. A similar solution is to agree to the disclosure of the results of failed settlement discussions at the conclusion of such discussions.[55] For example, a confidentiality agreement may require the public disclosure after the expiration of a certain period of the fact that confidential discussions were underway as well as certain confidential information that was shared in the discussions.[56] Under certain orders, creditors are free to disclose information if they are not satisfied with the debtor's disclosure or if the debtor fails to timely disclose.[57] One obvious problem with agreements to disclose the contents of settlement discussions is that the specter of public disclosure discourages the candid exchange of positions that is often critical to a successful negotiation or meditation.

Creditors who are unwilling to restrict their trading and who receive material nonpublic information may still trade in the debtor's securities without exposing

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[51] In the Matter of Cady, Roberts & Co., Exch. Act, No. 6668, 1961 WL 60638 at *3 (Nov. 8, 1961). As stated by the SEC:

> We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego [*sic*] the transaction.

Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907, 1961 WL 60638 at *3 (Nov. 8, 1961).

[52] *Id.* at *4. It should be noted that the breadth of the "disclose or abstain rule" articulated in *Cady, Roberts* was later narrowed by the Supreme Court in *Chiarella*, which held that it was the existence of a specific relationship, rather than simply the possession of inside information, that created the obligation to disclose or abstain. Porcelli, *supra* note 48 at 301; *see also Chiarella v. United States*, 445 U.S. 222, 233 (1980) (refusing to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information" because such a broad duty "departs radically from the established doctrine that duty arises from a specific relationship between two parties[.]").

[53] Harris & Godnick, *supra* note 50 at 434.

[54] *Id.*

[55] *See, e.g.*, *Energy Future Holdings Corp*., *Current Report, Form 8-K*, UNITED STATES SECURITY AND EXCHANGE COMMISSION (Aug. 2, 2013).

[56] *Id.*

[57] Harris & Godnick, *supra* note 50 at 434–35. The *WaMu* decision did not allow creditors to simply rely on the debtor's disclosure of material nonpublic information, imposing an independent obligation upon the creditors to ensure that all material nonpublic information had truly been publicly disclosed before trading restrictions could properly be lifted. *In re* Wash. Mut., Inc., 461 B.R. 200, 264–65 (Bankr. D. Del. 2011).

themselves to liability, provided that they implement appropriate and effective information blocking procedures to screen the material nonpublic information received from the trading arm of the institution.[58] These screening procedures, also known as ethical walls, are designed to separate an entity's trading personnel from the restricted individual and any material nonpublic information.[59] Courts have expressly permitted reliance on a proper ethical wall[60] and have outlined the elements of an effective wall, including: (i) requiring that members who have access to nonpublic information in the bankruptcy proceeding acknowledge that they may receive material nonpublic information and that they are aware of the information screening procedures; (ii) prohibiting the sharing of nonpublic information with other employees; (iii) requiring that individuals keep all files containing nonpublic information in areas inaccessible to other employees; (iv) prohibiting the restricted individual's receipt of information about its firm's trades related to the debtor in advance of the trades; and (v) requiring that the firm's compliance department review the trades in a debtor's securities to confirm they comply with the information screening procedures.[61] It should be noted that the

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[58] Harris & Godnick, *supra* note 50 at 426.

[59] *Id.* at 431.

[60] In the General Motors bankruptcy case, the Bankruptcy Court entered an order in advance of mediation that permitted a mediation party to designate a representative to participate in the mediation. The order further provided that the receipt of any confidential information by the representative would not be deemed receipt by the mediation party so long as, prior to the receipt of any such information, the mediation party established and maintained screening procedures to prevent the transmission to members of the firm who may be involved in trading the securities of any mediation party. *See, e.g.*, Stipulation and Agreed Order Appointing Mediator at 6, *In re* Motors Liquidation Co., No. 09-50026 (Bankr. S.D.N.Y. June 27, 2013) (ECF No. 241). Before the order was entered, counsel for one of the mediation parties informed the bankruptcy court that there was "an agreement among the parties as to respective individuals at firms being able to put in place screening procedures, so that individuals could participate actively in the mediation process while at the same time not restricting others within the firm provided the screen procedures were adhered to." The bankruptcy court responded that it was not "offended by trading being ongoing while this [mediation] goes on but I will, of course, insist on an ironclad ethical wall." The bankruptcy court went on to emphasize that the parties must embody their agreement in a court order and "that if they trade in violation of the restrictions, it's not just a breach of contract but it's a contempt of court or capable of being a contempt of court." Transcript of Hearing re: Telephone Conference in Connection with the Paulson Noteholders Letter Requested Court-Ordered Mediation at 20–21, *In re* Motors Liquidation Co., No. 09-50026 (Bankr. S.D.N.Y. June 11, 2013).

[61] Harris & Godnick, *supra* note 50 at 426–27; *see In re* Federated Dep't Stores, Inc., No. 1-90-00130, 1991 Bankr. LEXIS 288, *2–*4 (Bankr. S.D. Ohio Mar. 7, 1991) (outlining "Chinese Wall" implementation procedures). Courts in other cases have subsequently followed the procedures outlined in *Federated*. *See* Outline of Topics/Issues to be Addressed at 9th Annual NYC Bankruptcy Conference By Panelists on: Bankruptcy/Securities Law Intersection, at 11, http://www.abiworld.org/committees/newsletters/publicComp/Vol4Num2/PubCompVol4Num2.pdf (noting *Federated* procedures have been followed in *In re* Calpine Corp., *In re* Foamex Int'l, *In re* Pliant Corp. and *In re* The Finova Group, Inc.). Funds have gone to great lengths to establish effective walls, and those efforts still have not insulated them from allegations of insider trading. Aurelius, a firm accused of insider trading in the *WaMu* case, spent $150,000 to sound proof an office in connection with its implementation of screening procedures. Mr. Gropper of Aurelius described the procedures Aurelius followed in order to maintain the ethical wall in the *WaMu* case during a particular confidentiality period as follows:

implementation of information blocking procedures is not always a feasible option and may not be possible at a small institution.[62]

Recently, venturing beyond the traditional approaches of restricting or establishing a wall, parties to settlement discussions have sought comfort regarding insider status, fiduciary duties and the potential receipt of material nonpublic information in the form of advance court orders. For example, at least two courts have entered orders clarifying that parties who engage in settlement discussions are not imputed with special status or duties as a consequence of engaging in such discussions.[63] In *In re Vitro*, the bankruptcy court entered an order providing that (i) settlement proposals shall not constitute material nonpublic information; (ii) no party participating in the settlement negotiations shall (a) be or become an insider or fiduciary of the debtor, (b) undertake any duty to any party in interest, or (c) be limited in its ability to trade any security, regardless of whether a confidentiality agreement exists.[64] The order further provided that no party in interest shall have any claim, defense, objection or cause of action of any nature, including but not limited to any objection to a claim or any other basis to withhold, subordinate or

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> The idea behind our ethical wall is that there be no communication whatsoever, with very limited exceptions . . . of information, public or private, across the ethical wall. It requires that all information that is received during the pendency of the wall be kept in locked cabinets, for which I'm the only one who has the key. Additionally, all of our computers time out very quickly, so no one can walk by a screen and see something inadvertently. It requires that no conversations take place on speakerphone, so no one could hear beyond the walls of our office. I happen to sit in a closed office. Actually, when I took calls on Washington Mutual when this ethical wall was up, I actually went to an office thirty feet away from our trading desk to make sure that no one could overhear any conversations that I was having.
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> Subsequent to our having this wall in place in Washington Mutual, we spent 150,000 dollars to fully soundproof my office. We've extended the walls up to the concrete barrier of the floor above. We've installed double-pane glass with sound deadening g[l]as[s] between the panes, and we've put rubber seals around all four surfaces of my door. And we then had sound engineers . . . come into our office and check to make sure there was no sound leakage outside the office. We take our compliance with the securities laws and the ethical walls deadly seriously, and we are absolutely compulsive about this compliance.

Transcript of Hearing at 57–58, *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011) (No. 08-12229).

[62] *See* Harris & Godnick, *supra* note 50 at 431 (stating "trading walls may not be feasible at smaller firms where one person may serve a variety of roles, and it may be impractical or impossible to assure that the material nonpublic information has not been available to the person responsible for trading.").

[63] *See, e.g.*, Order in Aid of Settlement Discussions at 2, *In re* Vitro, S.A.B. de C.V., 473 B.R. 117 (Bankr. N.D. Tex. 2012) (No. 11-33335-hdh-15) (explaining that among other negotiation discussions, settlement proposals are not material nonpublic information); s*ee also* Order in Aid of Mediation and Settlement at 2, *In re* Residential Capital, LLC, 2013 WL 1618327 (S.D.N.Y. Apr. 12, 2013) (listing duties and obligations not owed to debtors during mediation and settlement).

[64] Order in Aid of Settlement Discussions at 2, *In re* Vitro, S.A.B. de C.V., 473 B.R. 117 (Bankr. N.D. Tex. 2012) (No. 11-33335-hdh-15).

disallow a claim.[65] The order makes clear, however, that it is not binding on a governmental entity with jurisdiction to enforce securities laws.[66]

Similarly, in *In re Residential Capital* ("*ResCap*"), the bankruptcy court entered an order providing that no mediation party shall (i) be or become a temporary insider or fiduciary of any debtor or their affiliates, (ii) be deemed to owe any duty to any of the debtors, and (iii) undertake any duty to any party in interest.[67] The order further stated that no party in interest "shall have any claim, defense, objection or cause of action of any nature against any [m]ediation [p]arty or any other basis to withhold, subordinate or disallow" a claim on account of a claim based on such mediation party's trading in the debtor's securities and participating in settlement discussions.[68] Further, according to the order, the mediation party shall have no duty of confidentiality or otherwise with respect to material nonpublic information except as set forth in a confidentiality agreement.[69] Like the *Vitro* order, this order makes clear that it is not binding on a governmental entity seeking to enforce securities laws.[70] However, unlike the *Vitro* order, the order in *ResCap* does not expressly permit a participating party to trade in any security, including securities of the debtor.

III. CRITIQUE OF RECENT APPROACHES

The most recent approaches adopted in *Vitro* and *ResCap*, which seek judicial findings in advance of mediation that parties are not "temporary insiders" or will not be considered recipients of material nonpublic information, are misguided and expose hedge fund parties to substantial litigation and regulatory risk. As an initial matter, such orders clearly are not binding on the SEC, and thus parties relying on the orders may still be subject to SEC enforcement action and other governmental action.

Further, issues such as insider status and the materiality of information turn on the specific facts and context, and thus are not properly susceptible to abstract, advance judicial determination. For example, whether a party does or does not become a temporary insider within the meaning of footnote 14 of *Dirks* would depend on the circumstances and the purpose for which the debtor shares the confidential information with the creditor party.[71] Moreover, even if a party could

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65 *Id.* at 4.

66 *Id.*

67 Order in Aid of Mediation and Settlement at 2, *In re* Residential Capital, LLC, 2013 WL 1618327 (2013) (No. 12-12020).

68 *Id.* at 3.

69 *Id.* at 2.

70 *Id.* at 5.

71 Dirks v. S.E.C., 463 U.S. 646, 655 n.14 (1983) ("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

properly obtain *ex ante* protection against being deemed a temporary insider, there still would be potential insider-trading risk under the misappropriation theory, which does not require insider status.[72] *Basic v. Levinson*'s "total mix" of information standard renders issues of materiality even more fact-dependent than the issue of temporary insider status.[73] For these reasons, it is our view that orders, like those entered in *Vitro* or *ResCap*, are potentially vulnerable on appeal, chiefly because the orders turn on advisory determinations of fact by the bankruptcy court untethered to any factual record. Thus, in addition to the unmitigated regulatory risk, even in the context of inter-creditor litigation, these orders may not offer the protection that they superficially seem to promise.

Finally, to ensure that our criticism of the *Vitro*/*ResCap* approach serves a constructive purpose, we would like to suggest a shift in focus by parties understandably seeking to manage *WaMu*-type litigation risk. All good faith participants in the bankruptcy process, including many hedge funds that confer substantial benefits on that process, have a shared interest in both the perception and reality that no party-in-interest has an unfair ability to profit from material nonpublic information through the bankruptcy process. Over the longer term, it would be corrosive to the integrity of the bankruptcy process and harmful to the reputations of hedge fund participants, if such participants actually had, or even were perceived to have, a "free pass" to profit from material nonpublic information. Thus, neither hedge fund participants nor the bankruptcy system as a whole are well served by imperfect, prophylactic orders that risk promoting the trading of securities while parties are in possession of material nonpublic information learned through a mediation or settlement process. Instead, parties who care about the bankruptcy process, including the potentially important role played by many hedge funds, should consider taking more careful aim to curb the conduct of those potential litigants who might seek to abuse the principles behind the *WaMu* decision and carelessly pursue claims based on insider trading that are not well supported. For example, through case law developments, and possibly even through amendments to the Federal Rules of Bankruptcy Procedure, litigants seeking equitable relief based upon claims of insider trading could be subject to the more rigorous pleading and proof requirements that are central to private securities litigation in federal court discussed briefly towards the end of Part I above. The main purpose of these developments in federal securities litigation is to ensure that claims of securities fraud are tested at the very threshold to weed out weak claims before they cause serious reputational harm or impose substantial litigation expense.[74] By similarly shifting the focus away from advisory orders and towards the important task of

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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.").

[72] S.E.C. v. Obus, 693 F.3d 276, 284 (2d Cir. 2012).

[73] *See* Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321 (2011) (explaining "total mix" inquiries involve determining whether reasonable investors would view non-disclosed information as significantly altering disclosed and available information).

[74] Rombach v. Chang, 355 F.3d 164, 171 (2d Cir. 2004).

curbing abusive litigation tactics in bankruptcy court, parties would be able to more responsibly manage *WaMu*-type litigation risk without disturbing the core principle that no party should profit from trading on the basis of material nonpublic information.