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How to Turn a Bankruptcy Reorganization Into an Insider Trading Charge

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In ***In re Washington Mutual, Inc.*****,** No. 08-12229 (MFW), 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011), the United States Bankruptcy Court for the District of Delaware denied confirmation of debtor Washington Mutual, Inc.'s ("WaMu") plan of reorganization. Standing in the way of confirmation was the equity committee's motion for leave to file an adversary proceeding against four noteholding hedge funds because of **insider trading.** The bankruptcy court, in granting the motion, provided guidance to participants in bankruptcy proceedings who might be inclined to purchase or sell stock on information gleaned through the bankruptcy process.

In the *WaMu* case, litigation in several courts among debtor, creditors, new asset owner JP Morgan Chase and the FDIC receiver had been resolved in a global deal. The deal anchored the reorganization plan. But standing in the way of confirmation was the equity committee's motion that could lead to disallowing the claims of four hedge fund based upon their alleged violations of federal insider trading laws. Evidence was taken, the motion was argued and was successful.

At the heart of the dispute were the **duties of the hedge funds (which were noteholders) in dealing with confidential information** they had received in settlement negotiations. The hedge funds maintained that their trading procedures did not exploit the confidentiality periods. The equity committee contended that the existence, status and terms of the negotiations was material non-public information, on which the hedge funds had traded outside of the confidentiality periods.

The bankruptcy judge's decision contains a **detailed analysis of both classical and misappropriation theories of insider trading under Section 10(b) of the Securities Exchange Act of 1934**, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. The court found that there was a colorable claim under one or both theories against the four hedge funds. The entire decision is worth reading for its application of insider trading doctrines to bankruptcy negotiations. Of particular note is the following:

1. Negotiations can be material non-public information, despite the uncertainty of a final result
2. Do not rely upon the debtor's view of what is material. Each noteholder had an obligation to obey the securities laws and cannot use the debtor's view as a shield.

3. Negotiating creditors may become insiders, at least temporarily, by their in-depth participation in discussions and receipt of confidential information.

4. There is no guarantee that engaging outside counsel with attorneys'-eyes-only agreements will be accepted at face value.

5. If you want to sit at the negotiating table, then it's not asking too much to restrict trading or construct an ethical wall between traders and negotiators.

Among the lessons to be learned from the *WaMu* decision are that insider trading rules apply in bankruptcy, that creditors and debtors have independent obligations and that not even confidentiality agreements with "cleansing" provisions will guarantee the elimination of exposure. The risks include disallowance of claims, but also the serious sanctions, fines and penalties of insider trading claims. (And there's still no approved reorganization plan, after three years in the courts.)

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