BANKRUPTING THE INSIDE JOB: ALTERNATIVES TO THE *WASHINGTON MUTUAL* APPROACH TO POLICING CREDITOR COMMITTEE INSIDER TRADING

MATT PORCELLI*

This article is an examination of the problem of insider trading by hedge funds sitting on creditors' committees in light of the Delaware Bankruptcy Court's decision in In re Washington Mutual, Inc.

* J.D. Candidate, 2013, New York University School of Law; B.A., 2006, Boston College. The author would like to thank Professor Troy McKenzie for providing invaluable guidance throughout the development of this note, including development of the issues and advising throughout the writing process; Brian Smith, Andrew Ellis, Grant Munyon, Ryan Rahman, Max Abend, and the rest of the Journal of Law & Business editors for their incredibly thorough editing and substantive comments; and Charles Reily and Rahul Sharma for providing feedback and useful suggestions early in the process. All errors are the author's own.

I.
OVERVIEW OF CREDITORS' COMMITTEE INSIDER TRADING

In the past few decades, hedge funds and other institutional investors have played an ever-increasing role in the bankruptcy reorganization process.[1] There is substantial empirical support for the proposition that hedge fund involvement has had a net positive impact on chapter 11 reorganizations, by both providing liquidity for distressed firms and playing an active role on creditors' committees.[2] Institutional investors are well suited to participate on creditors' committees on account of their expertise, resources, and familiarity and comfort with higher-risk investments.[3] At the same time, some critics note that hedge funds' focus on short-term returns might be incompatible with the chapter 11 goal of long-

1. *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 AM. BANKR. INST. J. 24 (2007).

2. *See, e.g.*, Jongha Lim, The Role of Activist Hedge Funds in Distressed Firms (Sept. 13, 2010) (unpublished student manuscript, Fisher College of Business, Ohio State University), http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.186.1385 (empirical study finding that hedge funds' presence as creditors in chapter 11 proceedings leads to effective restructuring through debt-equity swaps, prepackaged filings, and their capacity and willingness to inject new capital); Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. Fin. 513, 556 (2012), *available at* http://finance.sauder.ubc.ca/~kaili/jlw.pdf (empirical study concluding that hedge fund involvement positively impacts the probability of emergence from chapter 11 reorganization).

3. Robert C. Pozen, *Creditors' Committees and Insider Trading*, 828 PLI CORP. 7, 19-20 (1993).

term rehabilitation.[4] More troublingly, there is mounting empirical evidence that some hedge funds on creditors' committees misuse their access to confidential information by engaging in illegal insider trading in the securities of the distressed debtor.[5] On the basis of such concerns, the Securities and Exchange Commission ("SEC") has recently begun subjecting hedge funds involved in bankruptcy reorganizations to increased scrutiny.[6]

This issue was catapulted to the forefront of the bankruptcy world in the long-running Washington Mutual chapter 11 reorganization case *In re Washington Mutual, Inc.*[7] A group of deeply out-of-the-money stockholders (the "Equity Committee") asserted a claim that four hedge funds[8] traded on material nonpublic information obtained through their involvement in creditors' committee negotiations.[9] Specifically, the Equity Committee alleged that the hedge funds purchased deeply discounted securities of the debtor, including subordinated debt, based on their insider knowledge of the progress

4. *See, e.g.*, Mike Spector & Tom McGinty, *Bankruptcy Court is the Latest Battleground for Traders*, WALL ST. J., Sept. 7, 2010, *available at* http://online.wsj.com/article/SB10001424052748703309704575413643530508422.html ("'Now what happens is you have very sophisticated people whose primary objective is material gain,' says Harvey Miller, a veteran bankruptcy lawyer at Weil, Gotshal & Manges. 'You've changed [bankruptcy] from at least the semblance of a rehabilitative approach to a casino approach of 'how do I make more money?''").

5. Nadia Massoud et al., *Do Hedge Funds Trade on Private Information? Evidence from Syndicated Lending and Short-Selling*, J. OF FIN. ECON., *available at* http://www.sciencedirect.com/science/article/pii/S0304405X10002382; Gregory Zuckerman, *Hedge Fund Lending Draws Scrutiny*, WALL ST. J., July 3, 2010, http://online.wsj.com/article/SB10001424052748704699604575343273915683134.html.

6. Stephen Taub, *Hedge Fund Bankruptcy Role Seen Probed*, CFO.COM (Nov. 29, 2005), http://www.cfo.com/article.cfm/5244187/c_5242799?f=home_todayinfinance ("The [SEC] is investigating the increasing role played by hedge funds in bankruptcy proceedings and whether fund representatives are lying about the size of their stakes to gain critical, sensitive information . . . .").

7. *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011) *vacated in part*, 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

8. The accused hedge funds are Appaloosa Management, Aurelius Capital Management, Centerbridge Partners, and Owl Creek Asset Management. *Id.* at n.5.

9. The allegations were first raised at a confirmation hearing by a pro se individual investor, Nate Thoma. *Id.* at 239.

of restructuring negotiations.[10] After reviewing these claims, the bankruptcy judge denied confirmation of a proposed reorganization plan and granted standing to the Equity Committee to pursue their claim (contingent upon a prior attempt to resolve the dispute through mediation).[11] The judge justified putting the reorganization process on hold pending the resolution of this claim based on the Equity Committee's motion for the authority to prosecute an action to equitably disallow the claims of certain noteholders.[12] If the Equity Committee prevailed under this doctrine, the claims of the senior secured creditors could be altogether disallowed on the basis of the creditors' inequitable conduct.[13] Though the relevant part of the court's opinion was subsequently vacated as part of final plan confirmation in February 2012,[14] the court vacated this portion of its decision as a condition of the parties' settlement rather than on substantive grounds and appeared motivated by the desire to avoid further protracted litigation and termination of the settlement agreement.[15] Therefore, although these portions of the court's opinion no longer hold precedential value, the issues raised in the decision remain relevant in light of its direct consideration of insider trading issues in a bankruptcy reorganization context.

This note will argue that the court's equitable disallowance solution in *Washington Mutual*, though grounded on sound policy considerations, comes at an unacceptably high cost by too easily allowing for extensive delay of the reorganization process that undermines both goals of the Bankruptcy

---

10. Troy Racki, *Washington Mutual Reorganization Part 1: Fund Insider Trading Charges Prompt Mediation Order*, SEEKING ALPHA (Sept. 27 2011), http://seekingalpha.com/article/296151-washington-mutual-reorganization-part-1-fund-insider-trading-charges-prompt-mediation-order.

11. *In re* Wash. Mut., 461 B.R. at 267.

12. *Id.* at 267. Under the doctrine of equitable disallowance, a bankruptcy court may, in its equitable discretion, disallow the claims of certain noteholders who have acted "inequitably" so that any distribution to which they would have otherwise been entitled is redistributed to the other creditors and ultimately to shareholders. *See Id.* at 256-57.

13. *Id.* at 266-67.

14. *In re* Wash. Mut., No. 08-12229 (MFW), 2012 WL 1563880, at *31 (Bankr. D. Del. Feb. 24, 2012) (approving the Seventh Amended Joint Plan of Washington Mutual and its debtors and vacating its previous decision in part).

15. *Id.* at *30.

Code: debtor rehabilitation and creditor protection.[16] The remainder of Part I will provide background on insider trading and creditors' committees generally. Part II of this note will review the *Washington Mutual* decision. Part III will review and consider the doctrine of equitable disallowance, ultimately positing that this rarely invoked doctrine is an improper vehicle for introducing securities law into the bankruptcy process. Part IV provides a brief overview of private (i.e. non-SEC enforcement) insider trading claims, focusing particularly on the issue of standing. Finally, Part V will discuss alternatives to the *Washington Mutual* approach, including a potential legislative or judicial solution.

A. *Insider Trading and Hedge Funds*

Insider trading is the purchase or sale of a security in breach of a fiduciary duty while possessing material nonpublic information about the issuer of the security.[17] Corporate insiders are required to either abstain from trading in these securities or disclose any material nonpublic information in their possession prior to trading.[18] The primary rationale offered by the SEC for government regulation of insider trading is that the practice undermines investor faith in the fairness of securities markets and that the prohibition on the practice must be vigorously enforced to provide a "level playing field" for investors.[19] Investor confidence is critical to the stability and efficiency of the capital markets, particularly in the wake of the

---

16. *See* Miller, *infra* note 124.

17. *See* Chiarella v. United States, 445 U.S. 222, 227-29 (1980).

18. *See, e.g.*, Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. Docket 907, 1961 WL 60638 at *3 (Nov. 8, 1961) ("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. . .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 the transaction.").

19. *See, e.g.*, Robert Khuzami, Dir. of Div. of Enforcement, Sec. and Exch. Comm'n, Statement on the Application of Insider Trading Law to Trading by Members of Congress and their Staffs (Dec. 1, 2011), http://www.sec.gov/news/testimony/2011/ts120111rsk.htm ("Insider trading threatens the integrity of our markets, depriving investors of the fundamental fairness of a level playing field [. . .] [T]he detection and prosecution of [. . .] insider trading remains one of the [SEC]'s highest priorities.").

financial crisis.[20] Legal restrictions on insider trading are a crucial part of the securities regulatory regime; accordingly, insider trading enforcement actions have been a prominent part of the SEC's redoubled efforts in the past few years.[21] At the same time, growing sophistication in concealment techniques has made insider trading more difficult to detect, as evidenced in the recent high-profile Galleon case where wiretaps were key to the success of the investigation.[22]

Insider trading by hedge funds is particularly difficult to detect. Most hedge funds are private investment vehicles open only to a limited number of legally qualified investors.[23] As a result, in contrast to more heavily regulated mutual funds subject to extensive disclosure requirements, hedge funds are only lightly regulated by the SEC and other financial regulatory agencies.[24] Hedge funds generally market themselves as high-risk, high-return funds,[25] and, because of their incentive-

---

20. *See, e.g.*, *The Road to Investor Confidence*, Mary Schapiro, Chairman, Sec. & Exch. Comm'n (Oct. 27, 2009), *available at* http://www.sec.gov/news/speech/2009/spch102709mls.htm.

21. *See, e.g.*, Steve Eder, *SEC Chairman: Insider Trading is a 'Problem of Tremendous Magnitude,'* WALL ST. J. DEAL J. (Oct. 20, 2011 2:30 PM), http://blogs.wsj.com/deals/2011/10/20/sec-chairman-insider-trading-is-a-problem-of-tremendous-magnitude (explaining that the SEC responded by increasing insider trading investigations and expanding the scope of inspections and examinations of investment advisors).

22. Dennis K. Berman, *The Galleon Legacy: White-Collar Wiretaps*, WALL ST. J. (May 12, 2011), *available at* http://online.wsj.com/article/SB10001424052748704681904576317641529229136.html. In the recent prosecution of Rajat Gupta, Judge Jed Rakoff denied the defendant's motion to suppress wiretap evidence, explaining that "insider trading cannot often be detected, let alone successfully prosecuted, without the aid of wiretaps." United States v. Gupta, No. 11 Cr. 907, 2012 WL 1066817 at *3 (S.D.N.Y. Mar. 27, 2012).

23. *See* THOMAS P. LEMKE ET AL., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1:1 (2011). Hedge funds are only open to accredited investors, a regulatory term defined in 17 C.F.R. § 230.501 encompassing certain financial entities, businesses, and individual investors that meet minimum net worth or income levels. As a result, hedge funds are exempt from certain registration requirements under the Investment Company Act of 1940.

24. *See id.*

25. Thomas C. Pearson, When Hedge Funds Betray a Creditor Committee's Fiduciary Role: New Twists on Insider Trading in the International Financial Markets, 28 REV. BANKING & FIN. L. 165, 170 (2008). For example, many hedge fund managers are compensated based on a "two-and-twenty" scheme, under which they are paid a fixed two-percent fee for all assets under management, and an additional twenty percent of all profits in excess

based fee structure, they are under significant pressure to achieve outsized returns on a continuous basis, which makes them more likely to overstep legal boundaries in order to achieve an ongoing advantage in the market.[26]

Both the SEC and Congress have declined to provide a concrete definition of insider trading because they believed the definition would be too easy for bad actors to circumvent.[27] Given the lack of a statutory definition, it has fallen to the courts (with significant influence from the SEC and occasional guidance from Congress) to develop insider trading law. As will be discussed below, insider trading law has developed under two primary duty-based theories of liability: the "classical theory" and the "misappropriation theory."

While early SEC decisions in the modern line of insider trading cases provided a duty to "disclose or abstain" for any party in possession of material nonpublic information,[28] the Supreme Court subsequently rejected this broad conception of the doctrine in *Chiarella v. United States*.[29] There, the Court held that it was the existence of a fiduciary duty (e.g., between a corporate insider and the corporation), rather than the mere possession of inside information, that created the obligation to disclose or abstain.[30]

The Court next expanded the breadth of the fiduciary basis of duty in *Dirks v. SEC* to include tippees, holding that the recipients of material nonpublic information from corporate insiders could "inherit" the duty of the tipper, effectively creating a derivative duty to disclose or abstain.[31] In *Dirks*, the Court included a footnote explaining that, under certain circumstances, corporate "outsiders" (i.e. parties other than the employees or officers of the corporation) may become fiduciaries of a corporation's shareholders based on their entry into a

---

of a predetermined target rate of return. *See, e.g.*, Andrew R. Sorkin, Canadian Duo to Shake Up 'Two-and-Twenty', N.Y. TIMES, Jun. 8, 2010 ("[T]he so-called '2-and-20' structure . . . has been a rule of thumb for management fees in the hedge fund industry . . . .").

26. *Id.*

27. Robert A. Prentice, *Clinical Trial Results, Physicians, and Insider Trading*, 20 J. LEGAL MED. 195, 197 (1999).

28. *See, e.g.*, Cady, Roberts & Co., 40 S.E.C. Docket 907, at *3 (1961).

29. *See* Chiarella v. United States, 445 U.S. 222, 233-35 (1980).

30. *Id.* at 235.

31. 463 U.S. 646, 659-60 (1983).

"special confidential relationship in the conduct of the business of the enterprise" where they are "given access to information solely for corporate purposes."[32] This footnote was the origin of "temporary insider" status as a basis for the fiduciary duty to disclose or abstain from trading on material nonpublic information.[33] When a corporation provides confidential information to an outsider for corporate purposes with a reasonable expectation of confidentiality arising from the nature of the relationship, that outsider takes on the same duty to disclose or abstain that company insiders automatically owe.[34]

Separate from the preceding line of cases, which has come to be known as the "classical" theory of insider trading liability, the Supreme Court has more recently accepted the so-called "misappropriation" theory.[35] This theory supports a finding of liability where "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[36] The misappropriation theory is a significant expansion of insider trading doctrine; it premises liability on the appropriation of confidential information for an improper purpose and therefore does not depend on a formal fiduciary relationship with the original corporate insider or issuer.[37] Insider trading regulation thus now reaches so-called "outsider trading," which occurs when market participants who are not corporate insiders obtain and trade upon material nonpublic information.[38] As discussed in the following section, the two theories of insider trading liability may reach the conduct of members of creditors' committees in a bankruptcy reorganization in light of the duties that courts impose on these parties.

---

32. *Id.* at 655 n.14.

33. Robert A. Prentice, *Permanently Reviving the Temporary Insider*, 36 J. Corp. L. 343, 348-49 (2011).

34. *Id.* at 349.

35. *See generally* United States v. O'Hagan, 521 U.S. 642, 652 (1997).

36. *Id.*

37. *Id.* at 653.

38. *See, e.g.*, Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 Mich. L. Rev. 313, 358-408 (2002) (urging a laissez faire approach to outsider trading).

B. *Creditors' Committees and the Role of Institutional Investors*

Once a company has filed for reorganization under chapter 11, creditors' committees are formed to represent the interests of particular constituencies or groups of constituencies in a bankruptcy reorganization. Such committees may include both official committees, whose appointment is required under the bankruptcy code, and unofficial, or *ad hoc*, committees. The scope of a creditors' committee's fiduciary duties often depends in large part on whether the committee is official or unofficial.[39]

1. *Distinguishing Between Official and Unofficial Creditors' Committees*

Official creditors' committees are formed pursuant to 11 U.S.C. § 1102(a)(1), which directs the U.S. Trustee to appoint a committee of creditors holding unsecured claims as soon as practicable after the entry of an order for relief in a chapter 11 case.[40] These committees speak for and take positions on behalf of unsecured creditors or equity holders. Accordingly, official creditors' committees owe fiduciary duties to their class members and are obligated to protect their interests.[41] In order to fulfill their fiduciary duties, official creditors' committee members often must have access to material nonpublic information about the debtor.[42]

Unofficial, or *ad hoc*, committees are a means through which groups of creditors or equity holders "with a common

---

39. Rosenberg et al., *Ad Hoc Committees and Other (Unofficial) Creditor Groups: Management, Disclosure and Ethical Issues*, BUS. REORGANIZATION NEWSLETTER (Am. Bankr. Inst., Alexandria, VA), Apr. 2008, at 263 ("Unofficial committees . . . do not owe fiduciary duties to any body of constituents.").

40. 11 U.S.C. § 1102(a)(1) (2005). The statute provides specific direction for the US Trustee's selection of the committee members: the committee "shall ordinarily consist" of the seven largest creditors willing to serve or, alternatively, of the members of a creditors' committee organized before the filing of the case, "if such committee was fairly chosen and is representative of the different kinds of claims to be represented." § 1102(b)(1). *See also* Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 MARQ. L. REV. 581, 582-83 (1990).

41. Susan M. Freeman, Are DIP and Committee Counsel Fiduciaries for Their Clients' Constituents or the Bankruptcy Estate? What is a Fiduciary, Anyway?, 17 AM. BANKR. INST. L. REV. 291, 310-13 (2009).

42. *See id.*

agenda can join together on an informal basis to advance their interests in the reorganization process."[43] Though the Bankruptcy Code is silent on unofficial committees, courts generally recognize and consider the views of an unofficial committee where it plays an active role in the case.[44] In contrast to official committee members, unofficial committee members cannot represent the rights of any party who is not a member of the group.[45] As such, unofficial creditors' committee members are not restricted from acting in their own self-interest. Moreover, unlike official creditors' committee members, unofficial creditors' committee members are not automatically subject to trading restrictions unless they elect to receive confidential information.[46] Even though unofficial committee members do not owe formal fiduciary duties to any constituent class, they nonetheless may be subject to certain disclosure requirements. Under recent amendments, the Federal Rules of Bankruptcy Procedure require disclosure of economic interests by "every group or committee that consists of or represents, and every entity that represents [multiple creditors or shareholders] . . . acting in concert to advance their common interests."[47] Of course, members of all creditors' committees including informal ones remain subject to the full range of the securities laws, including the prohibition on insider trading.

2. *Creditors' Committees, Inside Information, and Trading*

The responsibilities of any creditors' committee typically include conducting due diligence investigations of the debtor's business operations and financial condition, forming and negotiating a proposed reorganization plan for the com-

43. Rosenberg et al., *supra* note 39, at 263.

44. 5 William L. Norton, Norton Bankruptcy Law and Practice § 98:8 (3d ed. 2012).

45. *See* Evan D. Flaschen & Kurt A. Mayr, *Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds*, 26 AM. BANKR. INST. J., 16, 45 (2007).

46. *See* Rosenberg et al., *supra* note 39, at 263.

47. FED. R. BANKR. P. 2019(b)(1). What constitutes a "committee" for purposes of Rule 2019 is often the subject of dispute. *Compare In re* Washington Mut., Inc., 419 B.R. 271, 275, (Bankr. D. Del. 2009) (holding that informal noteholder group was a "committee" for the purposes of Rule 2019 disclosure requirements even though "committee" could not bind any member), *with In re* Phila. Newspapers, LLC, 422 B.R. 553, 567, (Bankr. E.D. Pa. 2010) (holding that a self-appointed committee was not recognized as an informal "committee").

pany, and other services required by constituent creditors and/or members.[48] Members of these committees typically receive confidential information through their involvement in reorganization negotiations, including internal financial projections and information on the progress and likely outcomes of the negotiations themselves.[49] Through their influence on the process and engagement with management, members of creditors' committees have access to information regarding the uncertainty and time frame of the reorganization process.[50] As a result, there are opportunities to make substantial profits by trading based on this information.

When hedge funds become involved on an official creditors' committee (or, alternatively, if they become involved on an unofficial committee and gain access to material nonpublic information), they are effectively made constructive insiders for insider trading purposes and thus are subject to a duty to disclose or abstain from trading in the debtor's securities.[51] This duty can be understood under either the classical or misappropriation theories of insider trading liability.[52] Under the classical theory, members of creditors' committees are made temporary insiders of the debtor. Under the misappropriation theory, use of confidential information for self-serving purposes other than those for which the information was provided is a breach of duty.[53]

Committees owe fiduciary duties to the constituent creditors or shareholders that they represent.[54] Unlike the debtor-in-possession (DIP), which owes fiduciary duties to the bank-

48. Pearson, *supra* note 25, at 183-84.

49. *See id.*

50. *See id.*

51. *Id.* at 172.

52. Though the temporary insider theory and misappropriation theories "intertwine and overlap," the two are distinguishable. *See* Prentice, *supra* note 27, at 351-53.

53. The SEC defined the "duties of trust or confidence" that give rise to potential misappropriation liability in Rule 10b5-2; in the context of a creditors' committee, such duty would arise either expressly through confidentiality agreements or implicitly through "a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality[.]" 17 C.F.R. § 240.10b5-2(b) (2011).

54. Freeman, *supra* note 41 at 310.

ruptcy estate's creditors,[55] committees are not fiduciaries for the debtor or the estate in general.[56] Nonetheless, members of official creditors' committees are obligated pursuant to a fiduciary duty of care to their constituents to preserve the confidentiality of information obtained in committee service. Members of all creditors' committees, whether formal or informal, must also comply with confidentiality obligations imposed under the securities laws.[57] At the same time, institutional investors participating on creditors' committees must balance their committee-related obligations with their responsibilities to their investors, and thus must be free to buy and sell the debtor's securities in response to changes in market conditions or client objectives.

Given this dual responsibility and the ever-increasing involvement of institutional investors in corporate bankruptcy proceedings,[58] it is necessary for the law to allow funds to continue trading—subject to certain controls and limitations—in the securities of the bankrupt entities on whose creditors' committees they sit. In order to enable this legitimate need to be met, courts have sanctioned committee members' engaging in such trading without running afoul of the securities and bankruptcy laws under limited circumstances. A committee member that wishes to trade in the debtor's securities must establish, implement, and maintain procedures to prevent the communication of material nonpublic information between the member's personnel participating on the creditors' committee and other personnel involved in day-to-day trading and investment decisions.[59] In 2000, the SEC explicitly approved these information barriers, also known as ethical or "Chinese" walls.[60] Some hedge funds, however, may be too small in terms

55. *See, e.g.*, Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) ("[DIP] directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee.") (citing Wolf v. Weinstein, 372 U.S. 633, 649-52 (1963)).

56. *See* Freeman, *supra* note 41, at 310-11.

57. Freeman, *supra* note 41, at 312 (citing *In re* Refco Inc., 336 B.R. 187, 196-97 (Bankr. S.D.N.Y. 2006)).

58. *See* Fisher & Buck, *supra* note 1.

59. Pozen, *supra* note 3 at 12.

60. *See* Robert J. Benjamin, Fiduciary Responsibilities of Creditors' Committees with Respect to Securities and Commodities Transactions, 10 AM. BANKR. INST. L. REV. 493, 498 (2002).

of personnel to erect an effective ethical wall;[61] in light of their increasingly prominent role in the distressed debt market and their function as an important liquidity provider, excluding a subset of hedge funds could be problematic.[62]

3. *Recent History of Creditors' Committee Insider Trading*

Notwithstanding the ethical wall safe harbor, illegal insider trading has been an ongoing problem in the context of creditors committees. Beginning in the early 90's, concerns over widespread insider trading by members of creditors committees first arose.[63] A number of recent empirical studies have provided support for the extent and scope of this problem.[64] This concern was the driving force behind a major portion of the recent Delaware Bankruptcy Court decision rejecting the reorganization plan of Washington Mutual.[65]

In an analogous 2003 case, Barclays Capital initially sat on an unsecured creditors committee of a bankrupt textile manufacturer, then withdrew after a year and joined a secured creditors committee in the same reorganization.[66] The members of the unsecured creditors committee brought suit against Barclays for engaging in illegal insider trading based on information obtained in the course of the bank's year on the unsecured committee.[67] In their complaint, the plaintiffs sought equitable subordination of Barclays' claims, damages, and disgorgement of all profits based on Barclays' breach of its fiduci-

61. *See* Daniel Sullivan, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533, 559 (2008).

62. *See* Fisher et al., *supra* note 1 (discussing the increased role of hedge funds in the distressed debt markets).

63. See Mark J. Krudys, Insider Trading by Members of Creditors' Committees – Actionable!, 44 DEPAUL L. REV. 99, 102 (1994).

64. *See, e.g.*, Massoud et al., *supra* note 5 (finding evidence of a significant increase in short-selling of the equity of companies that secure additional debt financing shortly prior to the announcement of such financings).

65. *In re* Wash. Mut., Inc., 461 B.R. 200, 266-67 (Bankr. D. Del. 2011) *vacated in part*, 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

66. Michael P. Richman & Jonathan E. Aberman, *Creditors' Committees Under the Microscope: Recent Developments Highlight Hazards of Self-Dealing*, 26 AM. BANKR. INST. J. 22, 60-61 (2007) (citing Complaint, Galey & Lord Inc. v. Barclays Bank Plc., No. 03-92683 (S.D.N.Y. Nov. 6, 2003)).

67. *Id.*

ary duties to the committee and to all creditors.[68] The U.S. Trustee also filed a motion to intervene, seeking an injunction requiring Barclays to implement (and maintain for future creditors' committee proceedings) internal protective measures to prevent future misuse of confidential committee information and to refrain from future use of any confidential committee information to further its own pecuniary interest.[69] Ultimately, Barclays settled with the unsecured creditors for $2.08 million in cash without admitting the allegations in the complaint and represented to the U.S. Trustee that it had implemented policies designed to prevent the future misuse of confidential information.[70]

Subsequently, the SEC conducted an insider trading investigation of Barclays in connection with its involvement on numerous official and unofficial bankruptcy creditors' committees.[71] The SEC eventually filed a complaint in the U.S. District Court for the Southern District of New York, bringing insider trading charges against Barclays and Steven J. Landzberg, a former proprietary trader who served as Barclays' representative on numerous creditors' committees.[72] Barclays and Landzberg settled the complaint out of court without admitting or denying the allegation, with the bank agreeing to pay $10.94 million to the Commission.[73] The Barclays case put the institutional investing world on notice that both the courts and the SEC were willing and able to police creditors' committees in order to protect the integrity of the bankruptcy reorganization process.[74]

---

68. *Id.* at 61 (citing complaint, ¶ 40-49).

69. *Id.* (citing Motion by the U.S. Tr. to (A) Intervene Pursuant 11 U.S.C. § 307 or, in the Alternative, Fed. R. Civ. P. 24(b) and Bankruptcy Rule 7024 and (B) Amend Complaint Pursuant to Fed. R. Civ. P. 15 and Bankr. Rule 7015 by Adding Herself as a Plaintiff to the Action and Including an Additional Claim for Injunctive Relief, No. 03-92683 (Jan. 13, 2004)).

70. *Id.*

71. *Id.*

72. *Id.* (citing Complaint, SEC v. Barclays Bank PLC, No. 07-CV-4427 (S.D.N.Y. 2007)).

73. SEC v. Barclays Bank PLC, Litig. Release No. 20,132, 90 SEC Docket 1999, (May 30, 2007).

74. *See, e.g.*, Karl Groskaufmanis et al., Revisiting Insider Trading in the Debt Markets: Lessons For Debt Investors and Members of Committees in Bankruptcy Cases, (PLI Corp. Practice, COURSE Handbook Ser. No. 1687,

II.
THE WASHINGTON MUTUAL CASE

A. *Background*

Washington Mutual, Inc. was a savings and loan institution with over $300 billion in assets as of June 2008. After a credit rating agency downgrade led to a bank run in September 2008, the Office of Thrift Supervision seized the bank and placed it into the receivership of the Federal Deposit Insurance Corporation ("FDIC"). Prior to the decision in *Washington Mutual*,[75] after a three-year reorganization process most of the parties to the reorganization (including the debtor, most large creditors, the FDIC, and others—collectively the "Settlement Noteholders") reached a Global Settlement Agreement and presented a Sixth Amended Plan (the "Modified Plan") of reorganization to the bankruptcy court for approval.[76] At the initial confirmation hearings, a pro se owner of one class of the company's preferred stock securities raised allegations of insider trading on the part of several Settlement Noteholders: specifically, four hedge funds who had been actively involved on a creditors' committee during negotiations.[77] The Equity Committee joined in limited discovery on the issue and subsequently objected to the Modified Plan on the basis of the creditors' inequitable conduct.[78] Specifically, the Equity Committee alleged that the creditors not only traded based on material nonpublic information, but also used this information to gain a blocking position for voting purposes in the various creditor classes to ensure that their claims were paid while shareholders received nothing.[79]

On the basis of these allegations, the Equity Committee sought to prosecute an insider trading action that would equi-

---

2007) (reviewing the Barclays case and opining on the state of committee practice after the case).

75. 461 B.R. 200 (Bankr. D. Del. 2011) *vacated in part*, 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

76. *Id.* at 211-12.

77. *Id.* at 237.

78. *Id.*

79. *Id.* at 239. The latter part of the shareholders' claim was partially based on the structure of the Modified Plan, which at the time of the court's decision came $40 million short of making any payment to equity in an estate worth over $8 billion. In other words, the shareholders were left just 0.5% out of the money.

tably subordinate or disallow the Settlement Noteholders' claims.[80] The Equity Committee asserted this claim by standing in the shoes of the debtor and claiming that the bankruptcy estate unjustifiably refused to pursue the insider trading claim.[81] The bankruptcy court denied standing for the purpose of equitable subordination since precedents held that equitable subordination only permitted the subordination of claims to other claims.[82] The stockholders would thus effectively be in the same position even if subordination were granted, since the equitably subordinated noteholders would still be paid ahead of equity; therefore, there was no chance that the stockholders' injury would be redressed by subordination.[83]

The court did, however, find that the stockholders' claims could be remedied by the doctrine of equitable disallowance: if the Equity Committee prevailed, the bankruptcy court could, in its equitable discretion, disallow the Settlement Noteholders' claims "so that any distribution to which they would be entitled [would be] redistributed to the other creditors and ultimately to the shareholders."[84] After a lengthy review of equitable disallowance, the court concluded that disallowance continues to be an available remedy after the enactment of the Bankruptcy Code, which did not expressly authorize it.[85]

B. *Insider Trading Analysis*

Having found equitable disallowance to be a viable basis for relief, the court evaluated the case for insider trading liability both under the classical and misappropriation theories, considering whether the Equity Committee had raised a "colorable claim" that each element of liability was met.[86] In se-

80. *Id.* at 254.
81. *Id.*
82. *Id.* at 255-56.
83. *See id.* at 256.
84. *Id.*
85. *Id.* at 257 ("Here, the Court. . . concludes that it does have the authority to disallow a claim on equitable grounds . . . ."). *See also infra* Part III.
86. *In re* Wash. Mut., Inc., 461 B.R. 200, 258 (Bankr. D. Del. 2011) ("Under the classical theory, section 10(b) and Rule 10b–5 are violated when a corporate insider (i) trades in the securities of his corporation (ii) on the basis of (iii) material nonpublic information (iv) in violation of the fiduciary duty owed to his shareholders. Under the misappropriation theory,

quence, the court reviewed the elements of materiality, scienter, and insider status. On the element of materiality, the court determined that the Equity Committee had raised a colorable claim that nonpublic information concerning the progress of the settlement negotiations and the stances of the parties to those negotiations could be considered material.[87] In reviewing the "knowledge" (scienter) prong, the court found a colorable claim that the Settlement Noteholders acted recklessly in their use of material nonpublic information.[88]

With respect to "insider status" or the requirement of an underlying fiduciary duty, the court found a colorable claim that the Settlement Noteholders became "temporary insiders" of the corporation by virtue of both their involvement on the creditors' committee and the information received therein for the "common corporate purpose" of reorganization.[89] As an alternative basis of duty, because the Settlement Noteholders held blocking positions in two classes of the Debtor's debt structure, the court also accepted a broader argument that they might have "owed duties as non-statutory insiders under bankruptcy law."[90] On this second basis, the court was somewhat cryptic, reciting a list of cases in which the members of creditors' committees were variously found to owe duties to all parties, the debtor, other class members, or some combination thereof.[91] The court then explained that on the basis of their blocking position, the Settlement Noteholders could be considered insiders of the debtors and therefore might owe duties to the other members of those two classes.[92] The court did not explain, and it remains unclear, how such a potential duty to fellow creditors could be relevant to a private insider trading claim brought by the shareholders on behalf of the debtor

by contrast, a corporate 'outsider' violates section 10(b) and Rule 10b–5 'when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information' rather than a duty owed to the persons with whom he trades.") (internal citations omitted). Knowledge, or scienter, is an additional element not cited by the court here but addressed later. *See id.* at 265.

87. *Id.* at 259-64.

88. *Id.* at 265.

89. *Id.* at 263.

90. *Id.* at 264.

91. *Id.*

92. *Id.*

(i.e., the Equity Committee is suing the Settlement Noteholders by standing in the position of the debtor).

C. *Elements Not Discussed in the Opinion*

As the accused hedge funds pointed out in their briefs requesting an appeal, notably missing from the court's analysis was any consideration of a number of key issues pertaining to the private nature of the underlying insider trading claim.[93] First, in requiring only that the Equity Committee present a "colorable claim," which the court referred to as a low threshold that "mirrors the standard applicable for a motion to dismiss for failure to state a claim,"[94] the court did not take into account the heightened pleading requirements mandated under the Private Securities Litigation Reform Act of 1995.[95]

A second (and perhaps more significant) overlooked issue is the so-called standing requirement. Since the underlying insider trading claim is a private one, the plaintiffs are required to show that the debtor traded contemporaneously with the defendants in order to have standing to bring a claim.[96] In fact, as will be discussed further in Part IV below, this threshold standing requirement for private insider trading litigation potentially precludes the vast majority of such lawsuits in the context of bankruptcy reorganization. Finally, the Equity Committee made no showing of either harm to the debtor or illicit profits by the Settlement Noteholders; in fact, the Noteholders were shown to have lost money on the trades.[97] This is significant because the recovery amount in a private insider trading action is limited to the amount of illicit

---

93. *See* Joint Memorandum of Law of Appaloosa Management L.P., Centerbridge Partners, L.P. and Owl Creek Asset Management, L.P. in Support of Motion for Leave to Appeal from the Decision of the Bankruptcy Court or, alternatively, *see* Issuance of a Writ of Mandamus, Case No. 08-12229 (MFW), Sept. 27, 2011, *available at* http://www.scribd.com/doc/66735561/Motion-of-Appeal-by-Appaloosa-Centerbridge-and-Owl-Creek.

94. *In re* Wash. Mut., 461 B.R. at 255.

95. Public Securities Litigation Reform Act of 1995, Pub. L. No. 104-167, § 101(b), 109 Stat. 737 (codified as amended at 15 U.S.C. § 78u-4(b)(2) (1995)) (Claims for insider trading must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

96. See *infra* Part IV.

97. *In re* Wash. Mut., 461 B.R. at 262.

profits made or losses avoided.[98] The court nonetheless made no mention of these issues and allowed the claim to proceed, raising further questions as to the merits of the underlying claim.

D. *Rejection of the Plan*

In light of its findings, the court rejected the reorganization plan and granted but stayed the Equity Committee's standing motion to bring an insider trading action.[99] Citing concerns over a potential "litigation morass" that would further deplete the value of the estate, the court ordered the parties to go to mediation before the Equity Committee pursued its claim any further.[100]

Near the end of the opinion, the court provided the underlying policy rationale for its decision. Responding to the Settlement Noteholders' contention that a finding of insider trading under these circumstances would chill creditor participation in the bankruptcy process, Judge Walrath disagreed:

> 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. These types of restrictions are common in bankruptcy cases. Members of creditors' committees and equity committees are always subject to these restrictions . . . . 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.[101]

While Judge Walrath's statement of policy is sensible and superficially compelling, it is a separate question whether the mechanism of equitable disallowance in the midst of a chapter 11 reorganization is the optimal method to pursue this out-

98. 15 U.S.C. § 78t-1(b)(1) (1988).
99. *In re* Wash. Mut., 461 B.R. at 267.
100. *Id.*
101. *Id.* at 266 (citation omitted).

come. This is particularly so where disallowance is contingent on an insider trading claim of questionable validity. As the next section will show, equitable disallowance is an extreme remedy whose very existence is in doubt. Moreover, freezing a reorganization process in order to allow a securities law claim potentially supporting grounds for equitable disallowance may be a speculative and attenuated method of addressing the underlying problem of insider trading. This approach imposes too great a burden on the bankruptcy estate, the value of which will be continually eroded as litigation draws on.

III.
Equitable Disallowance

A. *Overview, History of the Doctrine, and Current State of the Law*

The doctrine of equitable disallowance invoked by Judge Walrath is rarely discussed and almost never applied by courts; in fact, there is a circuit split on whether or not the remedy even continues to exist after the enactment of the Bankruptcy Code.[102] The remedy of equitable disallowance is not expressly provided for in the Code. Section 510(c) expressly permits equitable subordination but makes no mention of the disallowance of claims.[103] Section 502(b) provides that a bankruptcy court "shall allow" a claim to proceed unless it falls within a list of nine conditions warranting disallowance, none of which seem to represent "equitable" disallowance.[104]

102. Philip D. Anker, Commercial Bankr. Litig. § 9:55 (Jonathan P. Friedland ed., 2d ed. 2012).

103. *See* 11 U.S.C. § 510(c) (1978) (A court may, after notice and a hearing, "subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . . .").

104. 11 U.S.C. § 502(b) provides in relevant part that claims may be disallowed where "(1) such claim is unenforceable against the debtor . . . under any agreement or applicable law; (2) such claim is for unmatured interest; (3) if such claim is for [property tax that] exceeds the value of the [estate's] interest in the property; (4) if such claim is for services of an insider or attorney of the debtor [and] exceeds the reasonable value of such services; (5) such claim is for unmatured debt on certain alimony and child support obligations; (6 [and 7]) if such claim [is for certain] damages resulting from the termination of a lease [or employment contract]; (8) such claim results from a reduction, due to late payment, in the amount of . . . credit available to the debtor in connection with an employment tax on wages, salaries, or

The Fifth Circuit has rejected the doctrine outright, holding that "equitable considerations can justify only the subordination of claims, not their disallowance."[105] In a corresponding footnote, the court explained:

> Disallowance of claims on equitable grounds would add nothing to the protection against unfairness already afforded the bankrupt and its creditors. If the claimant's inequitable conduct is directed against the creditors, they are fully protected by subordination. If the misconduct directed against the bankrupt is so extreme that disallowance might appear to be warranted, then surely the claim is either invalid or the bankrupt possesses a clear defense against it . . . . Thus, where the bankrupt is the victim it has an adequate remedy at law. It follows that disallowance of a wrongdoer's claim on nonstatutory grounds would be an inappropriate form of equitable relief.[106]

In addition, the Supreme Court recently seemed to approve of an *expressio unius* view of the disallowance of claims, holding that the Bankruptcy Code did not bar a contractual claim for attorneys' fees since this was not one of the nine expressly specified disallowance exceptions in § 502(b).[107] The Court implied that non-enumerated grounds for disallowance were not permissible and made no mention of bankruptcy courts' authority to equitably disallow claims.[108] At least one district court has cited this case to dismiss an equitable disallowance claim on grounds that the remedy is not authorized under the Bankruptcy Code.[109]

In recent years, other courts have somewhat tentatively rejected the position that equitable disallowance is no longer viable, either finding that the remedy may apply in certain lim-

---

commissions earned from the debtor; or (9) proof of such claim is not timely filed."

105. *In re* Mobile Steel Co., 563 F.2d 692, 699 (5th Cir. 1977).

106. *Id.* at n.10. The Fifth Circuit did not consider a situation in which shareholders were the "victims," presumably because that situation was not before the court.

107. *See* Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 449–50 (2007).

108. *Id.*

109. Grede v. Bank of N.Y., No. 08 C 2582, 2009 WL 188460, at *8 (N.D. Ill. Jan. 27, 2009).

ited circumstances or at least declining to hold that the doctrine no longer exists. The modern basis of support for the doctrine is found in *Pepper v. Litton*, a 1939 Supreme Court decision affirming a district court's disallowance of the claim of Litton, a debtor's controlling stockholder, based on inequitable conduct.[110] In *Washington Mutual*, Judge Walrath cited the *Pepper* court's holding that the claim of an insider who traded on inside information was properly subordinated on equitable principles.[111] The Supreme Court discussed the equitable powers of bankruptcy courts:

> [T]his Court has held that a bankruptcy court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence . . . . That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it *pari passu* treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence.[112]

Citing *Pepper*, the Third Circuit expressly rejected a lower court's conclusion that equitable subordination authorized under §510(c) is the only equitable remedy available for a bankruptcy court and that equitable disallowance is beyond the court's authority.[113] Acknowledging that *Pepper* suggests that equitable disallowance was permissible under the law before the enactment of the Bankruptcy Code, the court declined to decide whether or not the remedy remains availa-

---

110. 308 U.S. 295.

111. 461 B.R. 200, 258 (Bankr. D. Del. 2011) (citing Pepper, 308 U.S. at 311).

112. Pepper, 308 U.S. at 305-06.

113. Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982 (3d Cir. 1998).

ble.[114] A few other lower courts have reached similar conclusions.[115]

In the 2007 Adelphia bankruptcy case, the Southern District of New York reviewed the bankruptcy court's determination that, in light of *Pepper* and the legislative history of the bankruptcy code, equitable disallowance remains a permissible remedy.[116] Examining the legislative history even more extensively than the court below, the district court affirmed this portion of the bankruptcy court's holding.[117] The plaintiffs in that case pointed to a House Judiciary Committee Report on a preliminary version of §510(b) of the Code, which codified the doctrine of equitable subordination.[118] However, the court noted that this report did not reflect subsequent compromises in the run-up to the passage of the Code and that "the committees in charge of evaluating § 510 did not prepare a final report on the section."[119] Nevertheless, the court cited the Supreme Court's rule of statutory construction: "if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications."[120] Based on this canon, the Southern District held that equitable disallowance remained permissible under *Pepper*.[121]

114. *Id.* at n.7.

115. *See, e.g.*, Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 498 (S.D.N.Y. 1994) ("It is well settled that bankruptcy courts possess a broad range of equitable powers, including the authority to disallow or subordinate the claims of any creditor who attempts to take unfair advantage of the debtor or other creditors."); *In re* Outdoor Sports Headquarters, Inc., 168 B.R. 177, 182 (Bankr. S.D. Ohio 1994) ("[A]uthority exists which would authorize the court to disallow a claim based upon equitable principles.").

116. *In re* Adelphia Commc'ns Corp., 365 B.R. 24, 70-73 (Bankr. S.D.N.Y. 2007).

117. Adelphia Recovery Trust v. Bank of Am., N.A., 390 B.R. 64, 76 (S.D.N.Y. 2008), *adhered to on reconsideration*, No. 05 CIV. 9050 (LMM), 2008 WL 1959542 (S.D.N.Y. May 5, 2008).

118. *Id.* at 74-75 (quoting legislative history) ("Nor does this subsection preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances." (citing Pepper, 308 U.S. 295 (1939))).

119. *Id.* at 75 (quoting *In re* Virtual Network Servs. Corp., 902 F.2d 1246, 1248 (7th Cir. 1990)).

120. *Id.* at 76 (quoting Midlantic Nat'l Bank v. N.J. Dept. of Envtl. Prot., 474 U.S. 494, 501 (1986)) (citation omitted).

121. *Id.*

In *Washington Mutual*, Judge Walrath was persuaded by the analysis of *Adelphia* and concluded that the court "does have the authority to disallow a claim on equitable grounds 'in those extreme instances—perhaps very rare—where it is necessary as a remedy.'"[122] Though it appears unsettled whether equitable disallowance remains an available remedy, particularly in light of the Supreme Court's decision in *Travelers*,[123] the application of the doctrine in the specific context of an insider trading action within a bankruptcy reorganization presents additional problems.

B. *The Inconsistency Between Disallowance in This Context and the Two Primary Goals of the Bankruptcy Code*

In the modern era of bankruptcy reorganization, particularly in light of the increased role of institutional investors, the two primary goals of the chapter 11 reorganization process are the rehabilitation of the debtor and the protection of creditors.[124] Both of these goals are substantially undermined by permitting a plan to be indefinitely suspended based on a doubly attenuated cause of action. First, since the bankruptcy court only required the showing of a "colorable claim"[125] of insider trading (and in so doing gave no express consideration to the heightened pleading requirements for § 10b-5 actions enacted in the Private Securities Litigation Reform Act and reflected in Rule 9(b) of the Federal Rules of Civil Procedure),[126] the outcome of the securities law action is highly un-

122. *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011) *vacated in part*, 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

123. Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 449–50 (2007).

124. *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2016 (2002) ("Reorganization has evolved from a primarily rehabilitative process to a dual process that stresses, in addition to rehabilitation, enhancing creditors' recoveries.").

125. According to the court, "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." *In re* Wash. Mut., 461 B.R. at 255 (citing *In re* Centaur, LLC, No. 10–10799, 2010 WL 4624910, at *4 (Bankr. D. Del. Nov. 5, 2010)); *see also In re* Adelphia Commc'ns Corp., 330 B.R. 364, 376 (Bankr. S.D.N.Y. 2005) ("Caselaw construing requirements for 'colorable' claims has made it clear that the required showing is a relatively easy one to make.").

126. Public Securities Litigation Reform Act of 1995, Pub. L. No. 104-167, § 101(b), 109 Stat. 737 (codified as amended as 15 U.S.C. § 78u-4(b)(1)

certain. The absence of any analysis on the issue of standing leaves the merits of the claim even more in doubt. Second, since it is clear that equitable disallowance applies, if at all, "only in the most extreme instances—perhaps very rare—where it is necessary as a remedy,"[127] even if the Equity Committee prevails at trial it is unclear, even doubtful, that disallowance would actually apply. In their appeal against Judge Walrath's ruling, a group of hedge funds led by Aurelius Capital Management noted "the absence of a single reported case applying the doctrine of equitable disallowance," and added that, even if the doctrine remained theoretically available, the possibility for relief under the securities laws or through an SEC enforcement action mean that the draconian remedy of equitable disallowance is not necessary under the circumstances.[128]

Furthermore, as Judge Walrath acknowledged in her opinion, in considering whether to allow a claim such as this one to go forward, the bankruptcy court is obligated to consider not only whether the claim is colorable, but also whether the costs of pursuing the claim are justifiable.[129] While Judge Walrath briefly considered the burden on the estate, she conducted no cost-benefit analysis or assessment of the probability of success of the claim and instead only directed the parties to

(1995)) ("[T]he complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."); Fed. R. Civ. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake . . . ."). By its terms, this statute applies to insider trading actions, since these claims are brought under the fraud statute, § 10(b) of the Securities Exchange Act of 1934.

127. *In re* Wash. Mut., 461 B.R. at 257 (Bankr. D. Del. 2011) (citing Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 64, 76 (S.D.N.Y. 2008)).

128. Motion of Aurelius Capital Mgmt., LP for Leave to Appeal Under 28 U.S.C. § 158(a) at ¶ 47-49, *In re* Wash. Mut., 461 B.R. 200 (Bankr. D. Del. 2011) (No. 08-12229) (MFW)), *available at* http://www.scribd.com/doc/66736295/Motion-of-Appeal-by-Aurelius-Capital.

129. *In re* Wash. Mut., 461 B.R. at 254-55 (Bankr. D. Del. 2011) ("[T]he court must balance the probability of success against the financial burden the suit would have on the estate." (citing *In re* STN Enters., 779 F.2d 901, 905 (2d Cir. 1985))).

go to mediation on the issue.[130] Had mediation failed, it would only have further delayed the onset of the securities litigation, which itself would have again delayed a reorganization that had already drawn on for over three years.

Equitable subordination rests on much sounder ground since it is expressly authorized under the Code and there is a far more developed body of case law supporting its application.[131] However, as was observed in *Washington Mutual*, subordination would never protect the interests of stockholders in a bankruptcy proceeding.[132] Because debtor claims can only be subordinated to other debtor claims and not to residual equity claims, equity holders would be in the same economic position regardless of any change in priority amongst creditors.[133]

Another alternative to the equitable disallowance approach is to allow the reorganization to proceed while simultaneously allowing a separate insider trading action to proceed outside of the bankruptcy courts. The bankruptcy judge could pass on the validity of the claim in an adversary proceeding connected to the reorganization case and submit the court's findings of fact and conclusions of law to the district court, which would be permitted to review *de novo* any matter to which a party objects.[134] This approach would address the underlying problem by deterring insider trading by members of creditors' committees in a bankruptcy reorganization while at the same time ensuring that the debtor can be effectively rehabilitated in a timely manner and that creditors are protected. Because of the threshold standing requirement—a judicially developed limitation on private insider trading actions—under normal circumstances it could be difficult or impossible for parties to a bankruptcy reorganization to successfully bring insider trading actions against fellow parties. Therefore, any solution must take into account the issue of standing.

130. *Id.*
131. 11 U.S.C. § 510(c) (2006).
132. *See In re* Wash. Mut., 461 B.R. at 255-56.
133. *See id.*
134. *See* Stern v. Marshall, 131 S. Ct. 2594, 2604 (2011).

IV.
Issue of Standing

A. *Standing for Private Insider Trading Actions*

The Insider Trading and Securities Fraud Enforcement Act of 1988[135] created § 20A of the Exchange Act, which expressly establishes a right of action for parties trading contemporaneously with alleged insider traders.[136] Thus, apart from proving the standard elements of insider trading,[137] 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.[138] While courts have not defined contemporaneousness with a precise time range, the Ninth Circuit indicated that a two-month range is too long and would "gut the contemporaneous trading rule's premise,"[139] while some other courts have held plaintiffs may not sue if their trades occurred even a few days after the alleged insider trades.[140]

The purpose of the standing requirement is "to filter out plaintiffs who could not possibly have traded with the insider, given the manner in which public trades are transacted."[141] Since it is more difficult to imagine the individual plaintiff (as opposed to the SEC) standing in for the interests of the broader investing public, the contemporaneousness requirement relates to the loss causation element of insider trading and attempts to loosely connect the harm to the plaintiff with the actions of the defendant. The rule is an accommodation intended to allow a plaintiff to recover even though their

135. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

136. 15 U.S.C. § 78t-1(a) (2006) ("Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information shall be liable . . . to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class.")

137. *See supra* note 69.

138. *See, e.g.*, Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1002 (9th Cir. 2002).

139. *Id.*

140. *See, e.g.*, Alfus v. Pyramid Tech. Corp., 745 F. Supp. 1511, 1522 (N.D. Cal. 1990).

141. Brody, 280 F.3d at 1002.

trades were made anonymously through the securities markets—that is, absent the face-to-face transaction between the defendant and a counterparty required under the common law conception of fraud.[142] At the same time, the provision protects defendants from grossly disproportionate liability by limiting damages to the insider trader's total profit gained or loss avoided through the transactions that are the subject of the violation.[143]

The standing requirement would likely bar most parties to a chapter 11 reorganization from suing other participants in the reorganization process for insider trading violations, since each of those parties is similarly situated with access to confidential information on the debtor. In a bankruptcy context, it is difficult to satisfy the contemporaneous trading requirement because all members of committees in bankruptcy reorganizations routinely have access to material nonpublic information. In effect, unless these parties themselves either traded based on material nonpublic information or excluded themselves from any confidential information and then traded, they would be barred from bringing a private insider trading action against other committee members. This result stems from an incongruity arising from the application of insider trading laws in a bankruptcy reorganization context. Typical insider trading actions are brought in connection with the trading of securities in the broader context of the global securities markets, where insider trading law protects the vast constituency of the entire investing public. The standing requirement is therefore necessary to protect defendants from facing potentially unlimited causes of action. Moreover, because the limitation of dam-

142. *C.f., e.g.*, Neubronner v. Milken, 6 F.3d 666, 669 (9th Cir. 1993) ("[N]oncontemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information.").

143. 15 U.S.C. § 78t-1(b)(1)(1988). For enforcement actions brought by the SEC, the penalty amount to be imposed is limited to three times the profit gained or loss avoided as a result of the unlawful action. 15 U.S.C. § 78u-1(a)(2) (1988). Of course, in appropriate cases criminal sanctions may also be pursued in conjunction with civil enforcement remedies—even where the illegal trades turned out to be unprofitable. *See, e.g., In re* Wash. Mut. Inc., 461 B.R. 200, 262, 265 (Bankr. D. Del. 2011) (citing SEC v. Thrasher, 152 F.Supp 2d 291, 301 (S.D.N.Y. 2001); United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993)) *vacated in part*, 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).

ages to the amount of profits or losses avoided by the defendant means that the potential recovery is small relative to the large number of potential plaintiffs, these lawsuits are rare.[144]

In contrast, bankruptcy reorganizations necessarily involve a much narrower universe of creditors and shareholders, and the interests implicated by insider trading in this context more directly affect parties to the reorganization. This is particularly true in light of the availability of the creditor committee mechanism, which consolidates the interests of disparate security holders for the more efficient resolution of a chapter 11 case.[145] Confidential information shared by the debtor and amongst the various committees is being misused or misappropriated for self-interested pecuniary gain, often at the direct expense of the other parties to the reorganization (as was allegedly the case in *Washington Mutual*, where the hedge funds' alleged insider trading helped them to profitably take on a blocking position in multiple classes of the parent company's debt).[146] Because of this, the standing requirement for an insider trading private right of action should be relaxed when such an action arises in the context of a chapter 11 reorganization. Automatic standing should be granted to the debtor and its creditors and stockholders—that is, the contemporaneous trading requirement should be waived for these parties. The remaining elements of insider trading liability, including the existence of a duty, materiality, and scienter, would ensure that frivolous claims do not survive the motion to dismiss phase of litigation, particularly in light of the applicable heightened pleading requirements for insider trading actions under Fed. R. Civ. P. 9(b).

Though concerned not with insider trading standing but with out-of-the-money creditors' standing to appeal a decision

---

144. *See* Richard A. Booth, *Class Conflict in Securities Litigation*, 14 U. PA. J. BUS. L. 701, 744 n.75 (2012) ("[A] standalone claim for contemporaneous trading holds little value for investors . . . . [I]n most cases, the large number of investors who happen to buy at about the same time that insiders sell will so dilute the recovery of individual buyers that many would likely not even bother to claim their share of a settlement. Thus, it is not surprising that there are very few reported cases involving a claim for contemporaneous trading.").

145. *See, e.g.*, Klee & Shaffer, Creditors' Committees Under Chapter 11 of the Bankruptcy Code, 44 S.C. L. REV. 995, 997-1001 (Summer 1993).

146. *In re* Wash. Mut., 461 B.R. at 239.

of a bankruptcy court before the district court, a recent Second Circuit decision provides supporting principles for the proposal of more liberal standing requirements for insider trading actions in the context of bankruptcy reorganization.

B. *Applying Standing in Bankruptcy Court to Insider Trading Actions*

In *In re DBSD North America, Inc.* (the "DISH Case"),[147] the Second Circuit considered whether creditors whose claims were substantially underwater based on the bankruptcy court's valuation of the estate had standing to appeal the confirmation of the reorganization plan. The parties opposing standing argued that confirmation could not have harmed the unsecured creditors' interests because those interests were already worthless. Even though the court accepted the bankruptcy court's valuation and therefore assumed that the unsecured creditors' claim was worthless, the court still granted standing, noting that "[w]e have never demanded more to accord a creditor standing than that it has a valid and impaired claim."[148] The Second Circuit panel noted that to bar out-of-the-money creditors from raising appeals would prevent many creditors in bankruptcy court from ever reaching the district court, however meritorious their appeals might be, which would "disserve the protection of the parties' rights and the development of the law."[149] The court rationalized its decision by explaining that "[w]e should not raise the standing bar so high, especially when it is a bar of our own creation and not one required by the language of the Code . . . ."[150]

This same principle of more liberalized standing in the bankruptcy context can be readily applied to support the notion that standing for insider trading actions connected to bankruptcy reorganizations should also be liberalized. Such liberalization would help to bring meritorious claims before the courts and protect the interests of both private parties to the reorganization and the broader investment public by deterring insider trading based on confidential information obtained through creditors' committee participation. Further-

147. 634 F.3d 79 (2011).
148. *Id.* at 90.
149. *Id.* at 91.
150. *Id.*

more, although the contemporaneous trading requirement is reflected in § 20A of the Securities Exchange Act, the doctrine is in fact a bar of courts' own creation in two respects. First, the 1988 legislation was an attempt to partially codify the decisions of the courts; to that end, the committee report on the bill refers to the principal cases dealing with the issue without commentary.[151] And second, by declining to provide any guidance as to the meaning of "contemporaneous," Congress signaled its intention to allow the courts to continue to develop this judicially-created doctrine as they saw fit. Therefore, an expansion of the definition to give standing to parties to a bankruptcy reorganization is consistent with the statutory text, the legislative purpose of the 1988 Act, and the principles cited in the DISH case.

C. *Counterarguments to Relaxing the Standing Requirement*

Perhaps the most immediate criticism of a relaxation of the standing requirement is that eliminating the contemporaneous trading requirement removes an important litigation filter, potentially allowing too many frivolous lawsuits to go forward. Since any party to the bankruptcy reorganization would be able to raise a claim, it follows that out-of-the-money constituencies, with nothing to lose, would in all cases at least attempt to bring an insider trading suit in order to extract some benefits from the senior creditors. While this is a valid concern, three considerations mitigate the potential problem. First, a recent extensive empirical study of securities class action lawsuits involving bankrupt companies has provided support for the theory that securities litigation in connection with bankruptcy tends to be more meritorious than non-bankruptcy cases.[152] Second, because any potential recovery remains limited by statute to the amount of profits or losses

---

151. *See* H.R REP. NO. 100-910, at 27 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6064 ("The bill does not define the term 'contemporaneous,' which has developed through case law.").

152. James J. Park, *Securities Class Actions and Bankrupt Companies* (Brooklyn Law Sch. Legal Studies Working Paper Series, Research Paper No. 241, 2012), *available at* http://ssrn.com/abstract=1892229. The study examined 1,466 class actions, including 236 that arose in connection with a bankrupt company, measuring the "merit" of each claim based on indicia of merit (e.g., restated financial statements, parallel SEC proceedings) and litigation results.

avoided,[153] the cost of litigation should ensure that only substantial, meritorious claims will be brought. Third, the PSLRA provides for a stay of discovery until any motion to dismiss has been ruled upon. This essentially inserts courts as gatekeepers, as prospective plaintiffs must succeed on a motion to lift the discovery stay in order to engage in any early discovery.[154]

Apart from concerns about frivolous litigation, a separate counterargument to any proposed relaxation of the standing requirement is that such a change could be seen to decouple the basis for insider trading liability from its underlying rationale. Prior to the enactment of the Insider Trading Act of 1988, the Second Circuit declined to allow private plaintiffs to sue based on the misappropriation doctrine, citing concerns that allowing a plaintiff to recover on this basis would "grant him a windfall recovery simply to discourage tortious conduct by securities purchasers."[155] The court continued to explain that the securities laws protect investors only "against *fraud*; they do not remedy every instance of undesirable conduct involving securities."[156] While Congress's action in 1988[157] combined with the *O'Hagan* decision[158] have effectively reversed this decision and permitted private lawsuits based on the misappropriation doctrine, the principles cited by the Second Circuit remain relevant.

Nevertheless, because of the uniqueness of the creditors' committee context and the narrowness of the proposed exception, the expansion of scope of the rationale would be limited. Moreover, insider trading in a bankruptcy context implicates not only the interests of the investing public and the truly contemporaneous trading counterparties, but the interests of the other parties to the bankruptcy reorganization as well. This was apparent in the *Washington Mutual* case, where the Settle-

153. 15 U.S.C. § 78t-1(b)(1).

154. Public Securities Litigation Reform Act of 1995, Pub. L. No. 104-167, § 101(b), 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (1995)) (discovery shall be stayed during the pendency of any motion to dismiss "unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.").

155. Moss v. Morgan Stanley Inc., 719 F.2d 5, 16 (2d Cir. 1983).

156. *Id.*

157. 15 U.S.C. § 78t-1.

158. *See* O'Hagan, *supra* note 36.

ment Noteholders allegedly used insider information to obtain a blocking position in the debtor's capital structure.[159] Therefore, a somewhat broader conception of the insider trading rationale should apply in order to vindicate the interest of these parties, which is not a factor in insider trading cases outside of bankruptcy proceedings.

V.
SOLUTIONS

There are at least three potential avenues through which the policy arguments advanced by Judge Walrath in *Washington Mutual* can be more effectively implemented. First, private parties can attempt to rely on the SEC in order to vindicate the public's interest in preventing insider trading while sharing in disgorgement proceeds through the agency's new whistleblower program, implemented under the recent Dodd-Frank Act.[160] Second, the courts themselves can implement the relaxation of the standing requirement in the bankruptcy context. Third, a legislative solution that both relaxes standing requirements and expressly provides safe harbors to protect creditors from frivolous lawsuits can be adopted.

A. *SEC Enforcement Actions*

The first possibility, which would require no legislative or judicial action, is that private parties could collaborate with the SEC in order to hold creditors' committee insider traders accountable for their illegal conduct and disgorge them of their profits. Though it has never been a major area of focus, the agency has successfully prosecuted such actions in the past, most recently recovering $11.7 million from Barclays Bank and its former head of distressed debt trading to settle charges of insider trading based on information received in connection with the bank's participation on six creditors' committees.[161]

The new whistleblower rule adopted under § 922 of the Dodd-Frank Act[162] could incentivize private parties to bring ac-

---

159. *In re* Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011) *vacated in part*, 08-12229 (MFW), 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012).
160. *See* 15 U.S.C. § 78u-6.
161. SEC v. Barclays Bank PLC, Litigation Release No. 20132, 90 SEC Docket 1999 (May 30, 2007). *See supra* Part I-B.
162. 15 U.S.C. § 78u-6 (2010).

tions before the SEC. Under rules adopted in 2012, any party that voluntarily provides the SEC with original information that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains sanctions totaling more than $1 million is eligible to receive a whistleblower reward of ten to thirty percent of the amount recovered by the Commission.[163] In light of the SEC's limited resources, it is unclear that the agency would be willing or able to accommodate many of even the more meritorious claims of private parties. However, this approach does have the advantage of more directly vindicating the public interest while also enabling private parties to collaborate with the SEC for more effective enforcement.

B. *Judicial Relaxation of the Standing Requirement*

As discussed above, courts could rely on the DISH case and develop the equivalent of a bankruptcy exception to the contemporaneous standing requirement for private insider trading actions, effectively granting automatic standing by assuming that all parties to a reorganization meet the contemporaneousness requirement. Congress intentionally left the substantive details of § 20A of the Exchange Act to be developed by the courts, declining to provide any guidance for the meaning of "contemporaneously."[164] In light of this intentional delegation to the judiciary and the stated purpose of the Act—"to improve the procedures and remedies for the prevention of insider trading"[165]—courts could defensibly expand the definition of a "contemporaneous trader" in this narrow context.

The advantage to this approach is that insider trading law in general, and the contemporaneous trading standing requirement in particular, are primarily judicially developed concepts, meaning that courts are best suited to continue to develop the law in this area on a case-by-case basis. The chief disadvantage is that relaxation of the requirement without any countervailing policy such as a safe harbor could potentially

163. *Id.* at § (a)-(b).

164. 15 U.S.C. § 78t-1(a) (1988); *see also* H.R REP. NO. 100-910, at 27 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6064 ("The bill does not define the term 'contemporaneous,' which has developed through case law.").

165. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (preamble).

spur an outsized increase in frivolous litigation, the mere threat of which might alter the balance of power in reorganization negotiations. Indeed, in *Washington Mutual* the shareholders who were deeply out of the money in the capital structure were ultimately able to secure a settlement payment out of court from the secured creditors to resolve the claim.[166] Further difficulties arise in light of the intersection of the federal insider trading securities law and the bankruptcy code, since there is limited case law addressing the overlap of the two fields.

C. *Legislative Solutions*

A legislative solution could provide a more nuanced and thorough response to the problem than a judicial fix. Such a solution would have the advantage of being able to both relax the standing requirements for private insider trading rights of action while also accounting for the threat of increased frivolous litigation by providing a safe harbor provision. Such a provision could bring Judge Walrath's policy preferences to bear more directly by providing at least two safe harbors for members of a creditors' committee in a chapter 11 reorganization. First, any party that agrees to restrict or entirely prohibit trading in the securities of an entity on whose creditors' committee it participates would be protected from insider trading allegations. Second, in the alternative, any party that puts in place an adequate ethical wall separating the inside information from trading personnel would also be protected. This approach would strike an effective balance by ensuring that meritorious claims could still be brought while also protecting members of creditors' committees from groundless lawsuits that might deter their participation altogether. The precise contours of the safe harbor provision would draw on industry practices already widely implemented at many hedge funds.[167]

---

166. Sakthi Prassad, *WaMu Settles Dispute, Eyes Bankruptcy Exit*, REUTERS (Dec. 13, 2011), *available at* http://www.reuters.com/article/2011/12/13/us-wamu-settlement-idUSTRE7BC0CI20111213.

167. *See, e.g.*, Sullivan, *supra* note 61.

VI.
CONCLUSION

By invoking the doctrine of equitable disallowance, the Delaware bankruptcy court attempted to balance two competing objectives. On one hand, the court sought to keep a complex chapter 11 reorganization case moving forward; on the other hand, the court also wanted to ensure that adequately substantiated claims of inequitable insider trading on the part of creditors are not ignored. Practically, the court appears to have succeeded in this objective: shortly after the court's decision, the parties reached a settlement that allowed the seventh reorganization plan to move forward with court approval in February 2012.[168]

Despite this result, the issues raised in the case remain relevant in light of the evidence of widespread insider trading by members of creditors' committees.[169] In light of the questionable legal support for equitable disallowance and its incompatibility with the goals of the bankruptcy code, courts should decline to follow this approach in future cases. Instead, policymakers should rely on the SEC in tandem with whistleblowers from the private sector to police insider trading through enforcement actions. As a complement to this approach, particularly if the limited resources of the SEC prove to be a constraint to effective enforcement, courts and legislatures should take steps to promote deterrence of creditor committee insider trading through private litigation by liberalizing the standing requirement in the bankruptcy context.

---

168. *WaMu Exits Bankruptcy, on Heels of Lehman*, REUTERS, Mar. 19, 2012, *available at* http://www.reuters.com/article/2012/03/19/us-washingtonmutual-idUSBRE82I15S20120319.

169. *See, e.g.*, Massoud et al., *supra* note 5.