

## Bullet Point ®

### Important Decision Concerning Trading by Hedge Funds on the Basis of Information Learned During Bankruptcy Proceedings<sup>1</sup>

*Many of our hedge fund clients participate in various capacities in bankruptcy proceedings involving companies whose securities they hold in their portfolios. The case discussed below highlights the restrictions which apply to their trading activities while serving in such capacities.*

A Bankruptcy Judge in the United States Bankruptcy Court for the District of Delaware issued an important recent decision concerning claims of insider trading against hedge funds who were alleged to have obtained material information relating to the bankruptcy. The decision was issued in the bankruptcy proceedings involving Washington Mutual, Inc. (“WaMu”).<sup>2</sup> The committee of equity holders (“Equity Committee”) of WaMu requested the Bankruptcy Judge to allow them to pursue a claim against four hedge funds which held senior subordinated notes and other securities of WaMu on the grounds that the hedge funds traded in securities of WaMu while in possession of information concerning negotiations to reach a global settlement agreement of litigation related to the WaMu bankruptcy (the “Settlement Negotiations”). The hedge funds were permitted to participate in the Settlement Negotiations because they held a large position of WaMu’s debt which enabled them to block approval of WaMu’s plan of reorganization.

The hedge funds entered into confidentiality agreements concerning information learned in the Settlement Negotiations. The nonpublic information which the Equity Committee alleged the hedge funds learned during the Settlement Negotiations included:

the knowledge that a settlement was being discussed and the relative stances the parties were taking in those negotiations. In particular, the Equity Committee and the TPS Group focus on the term sheets exchanged by the parties. According to the Equity Committee, the parties were conceding issues at a time when the public knew only

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<sup>1</sup> This memorandum provides general information on the subject matter described, should not be relied on for legal advice in any jurisdiction and may constitute attorney advertising.

<sup>2</sup> *In re Washington Mutual, Inc., et al.*, Case No. 08-12229 Slip Opinion (U.S.D.C., D. Del., Sept. 13, 2011) (Walrah, J.) (“Slip Op”).

that the Debtors, JPMC, and the FDIC were engaged in contentious litigation.<sup>3</sup>

The court held that the “ebb and flows” of settlement negotiations could constitute material nonpublic information especially where the parties to the negotiations signed confidentiality agreements and the existence of the negotiations were not publicly disclosed. The court did not accept the hedge funds’ argument that settlement negotiations only become material when there is an agreement in principle. Consequently, the court held that the Equity Committee stated a “colorable claim” that the information received was material. The Court also held that the Equity Committee had alleged sufficient facts to support a claim that the hedge fund participants in the Settlement Negotiations were either “temporary insiders” which imposed a fiduciary duty not to trade on the information or, alternatively, that the information constituted “misappropriated” information.

The Bankruptcy Judge did not decide the merits of the Equity Committee’s insider trading claims since the motion before the court was for authority to prosecute the claims. In allowing the claims to go forward, the Court held that if the Equity Committee’s claims were proven, there would be a basis to disallow the hedge fund’s claims under the bankruptcy plan “so that any distribution to which they would be entitled is redistributed to other creditors and ultimately to the shareholders.”<sup>4</sup> (The Court rejected the alternative form of relief of equitable subordination of the hedge fund’s claim because the Court held that there was no statutory basis for the Equity Committee to assert a claim of equitable subordination.) The hedge funds are appealing the Bankruptcy Judge’s decision to the District Court.

The decision is significant because many hedge funds serve on bankruptcy committees or otherwise have access to confidential information in connection with bankruptcy proceedings and are privy to confidential information in such capacities. Although the hedge funds in this case were not actual members of a committee, they were deemed to be sufficiently close to the bankruptcy process to have learned of material nonpublic information and, therefore, subject to a duty not to trade in the securities of the company. The court issued a cautionary warning to such participants: “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.”<sup>5</sup>

For more information about the case, please contact Ralph A. Siciliano (212 508-6718), a member of our firm who advises our fund and investment adviser clients on issues concerning trading in distressed securities.

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<sup>3</sup> Slip Op. at 119.

<sup>4</sup> Slip Op. at 112.

<sup>5</sup> Slip Op. at 137-8

