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Bankruptcy Court Denies Confirmation of WaMu's Plan of Reorganization

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Sending the debtors back to the drawing board after almost three years in bankruptcy, the bankruptcy court has for the second time denied confirmation of the Plan of Reorganization for Washington Mutual, Inc. ("WaMu"). It is hard to recall a bankruptcy case of a similar magnitude to that of WaMu being denied confirmation, let alone twice, but that was just the beginning. The bankruptcy court's 139-page opinion has caused a fair degree of consternation (indeed, it has been something akin to a shot heard around the bankruptcy world) among financial institutions by ruling that:

- Bondholders and lenders that receive material non-public information from a debtor in settlement negotiations as part of the process to agree on a consensual plan of reorganization must either not trade, or must have established a "wall" between the individuals receiving the information and those trading claims; and
- Bondholders and other unsecured creditors in a solvent estate are never entitled to postpetition accrued interest at the coupon or contract rate, and, instead, can only receive interest on their claims at the federal judgment rate.

As if those blockbuster rulings were not enough, in denying confirmation, the bankruptcy court also determined that an equityholders' committee had stated "colorable claims" of insider trading by certain noteholders during the bankruptcy case, and, as a result, the claims of those noteholders against WaMu could be subject to "equitable disallowance" of their entire claims, and not just disgorgement of any profits obtained as a result of any insider trading. In other words, noteholders would face claims that could mean they would receive a zero recovery on their claims in favor of lower priority common stockholders. Among other things, this would constitute a far harsher penalty for insider trading than would be faced by someone who had engaged in insider trading of a security not in bankruptcy.

The bankruptcy court directed the parties to engage in mediation to see if they could reach a settlement on these thorny issues and thereby avoid a "litigation morass." The noteholders, along with WaMu and its creditors committee, have all sought leave to appeal the bankruptcy court's ruling.

The court also provided significant insight into issues surrounding a bankruptcy court's claim settlement jurisdiction in the wake of the Supreme Court's decision in *Stern v. Marshall*, including whether a plan may be confirmed despite pending appeals on issues that will be mooted by such confirmation.

Background

WaMu filed for bankruptcy on Sept. 26, 2008, the day after its banking unit was seized by the FDIC and sold to JPMorgan Chase. The seizure by the FDIC represented the largest of a savings bank in U.S. history. Early in the bankruptcy case, disputes arose among the debtors, the FDIC, and JPMorgan regarding ownership of certain assets and various claims that the parties asserted against each other.

Although we have certainly entered the era where the vast majority of complex Chapter 11 bankruptcy cases are "pre-negotiated" between a debtor and its significant creditor constituencies, WaMu represents a throwback to the days gone by of a classic "hard landing" into bankruptcy. The precipitous filing by WaMu, a bank holding corporation, was the result of the seizure by the FDIC of its subsidiary, Washington Mutual Savings Bank. As a result, the debtor and its significant creditors engaged in postpetition discussions to formulate a consensual plan of reorganization, and some of those discussions were with a group of noteholders who became known in subsequent litigation as the "Settlement Noteholders."

As is customary, the Settlement Noteholders agreed that their settlement discussions with WaMu and other creditors would be subject to a confidentiality agreement. In addition, the Settlement Noteholders understood that while they were engaging in settlement negotiations they would be "restricted," effectively meaning that Settlement Noteholders could not trade their WaMu holdings unless they erected an "ethical wall" between those trading and those receiving the confidential information. However, as has become accepted practice, WaMu agreed with the Settlement Noteholders that any confidential information from the settlement negotiations would subsequently be disclosed so that the Settlement Noteholders would, as the practice is known, be "cleansed" and therefore the Settlement Noteholders would be able to trade free of any restrictions and seemingly free of any concerns about insider trading.

The Cleansing Process

Although not frequently written about, the cleansing process used in WaMu, where the use of subsequent disclosures — often in the Form 8-Ks filed by the debtor, to allow restricted creditors that have engaged in restructuring negotiations to become unrestricted and trade — has become standard practice. While ethical walls remain in use, many institutions experience difficulty in erecting them, as there may only be a few individuals involved in researching a debt issue and either they themselves or the person sitting only a few feet away from them on a trading floor are involved in trading that same debt issue. So-called trading orders, where firms agreed to isolate their analysts from their traders to the point where the analysts did not even know whether their own firm still held the securities at issue, have fallen out of favor.

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Settlement discussions between WaMu and the Settlement Noteholders took place over time, but became particularly significant in two periods. During the first period, one of the Settlement Noteholders established an ethical wall to allow for trading, whereas other Settlement Noteholders simply restricted their trading. Those negotiations were unsuccessful and, with the apparent blessing of WaMu, the Settlement Noteholders engaged in unrestricted trading. During a second negotiation period, the Settlement Noteholders once again became restricted and received certain information from WaMu. Those negotiations were also unsuccessful, and WaMu agreed to "cleanse" the Settlement Noteholders by publicly disclosing the information that had been previously disclosed on a private basis to the Settlement Noteholders. In addition, certain Settlement Noteholders asked WaMu to confirm expressly they were no longer restricted and were allowed to trade, which WaMu did.

Finally, there were settlement negotiations that ultimately resulted in a global settlement that was incorporated in the proposed Plan of Reorganization. Certain parties who will receive little or nothing under the proposed plan objected to confirmation on multiple grounds. Among those objectors was a pro se individual who complained that there appeared to him to have been insider trading by the Settlement Noteholders. The bankruptcy court indicated its interest in determining whether such insider trading had occurred and an investigation by an official committee of equity holders ensured. As a result, a great deal of the contested confirmation hearing with respect to WaMu's Plan of Reorganization concerned the activities of the Settlement Noteholders and whether they had engaged in insider trading.

Information from Settlement Discussions May Create Insider Trading Liability

The bankruptcy court ruled that a creditor who receives non-public material information from a debtor must either not trade or must have established a "wall" between the individuals receiving the inside information and those trading claims. A creditor that engages in trading while in possession of non-public information does so at its peril, and the penalty could be the complete disallowance of that creditor's claims. This may well result in the resumption of trading orders and other methods used in the past to allow institutions to both trade and receive inside information.

The bankruptcy court found that a creditor trading on inside information received from a debtor could result in "equitable disallowance" of the creditor's claim in addition to other remedies such as subordination or disallowance of a claim.

The plan objectors asserted that certain noteholders, while continuing to engage in settlement discussions surrounding their claims and receive material information regarding the debtors in the context of such settlement discussions, engaged in trading activity and, accordingly, engaged in insider trading. The bankruptcy court found that the plan objectors had established "colorable claims" that insider trading had occurred.

Creditors should be aware that under the bankruptcy court's analysis, almost any settlement discussions with debtors could be considered material non-public information and therefore any trading should either be restricted or an ethical wall between analysts and traders established. Creditors also cannot rely upon the defense that debtors agreed to "cleanse" the creditors who are party to settlement discussions by periodically disclosing any material non-public information. While the WaMu debtors agreed to disclose any material non-public information at the end of each confidentiality period, the bankruptcy court ruled that the noteholders could not rely on such assurances to insulate them from insider trading liability. Indeed, the bankruptcy court seemed to flatly reject the notion that a debtor such as WaMu could determine when and under what circumstances there could be trading after information had been disclosed as part of settlement negotiations to formulate a consensual Plan of Reorganization.

The bankruptcy court found that where possible insider trading by a creditor has occurred, which would establish equitable grounds for the disallowance of the creditor's claim, a plan cannot be confirmed without resolution of such insider trading issues, reservation of funds with respect to such claims until resolution of such insider trading issues and/or temporary allowance of such claims with the ability to "claw back" funds paid out on account of such claims depending on the ultimate resolution of insider trading issues. The bankruptcy court has ordered the parties to mediation in an attempt to avoid "a litigation morass" over insider trading allegations.

Correct Postpetition Interest Rate Is Federal Judgment Rate and Not Contract Rate

Another significant part of the bankruptcy court's ruling is that the correct postpetition interest rate paid on unsecured claims in solvent estates, including bondholder claims, is the federal judgment rate and not the rate that may have been agreed to in any contract a debtor had entered into prior to filing for bankruptcy. The effect of this ruling on banks and financial institutions that have significant unsecured claims in other bankruptcy cases could be substantial. There has been wide disagreement on which interest rate applies because the bankruptcy code simply states that unsecured creditors are entitled to postpetition interest under a plan at the "legal rate" where the debtor is solvent. Some courts have held that "legal rate" refers to the contract rate and some courts have held that it means only the federal judgment rate. Still other courts have opined that "legal rate" could refer to the state judgment rate. The bankruptcy court in WaMu found that the federal judgment rate of interest was the appropriate rate of interest in all circumstances and that "legal rate" referred only to the federal judgment rate.

In addition, the bankruptcy court held that the federal judgment rate of interest should be calculated as of the petition date. The bankruptcy court overruled the plan objectors who had asserted that interest should only be paid after confirmation of the plan. The bankruptcy court further held that creditors were not entitled to compounded interest (whether or not contractually required).

Although the bankruptcy court's ruling on use of the federal judgment rate may have profound effects, it may not have much negative effect on the claims of senior noteholders in WaMu, as the bankruptcy court also ruled that junior noteholders were contractually subordinated and required to pay all interest at the contract rate to the senior noteholders before receiving any recovery on their subordinated claims.

Jurisdictional Issues Following *Stern v. Marshall*

The plan objectors argued that the settlement of non-bankruptcy claims must be decided by the district court as a result of the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011). Because the bankruptcy court was only determining whether the settlement was reasonable and did not have to rule on the underlying merits of such claims, the bankruptcy court ruled that it had jurisdiction. As a practical matter, it appears that bankruptcy courts will continue to assert jurisdiction over the approval of such settlements.