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AN OVERVIEW OF LEGAL RISKS FOR DISTRESSED CLAIMS TRADERS

Claims traders inhabit a world driven by information flow. Missing a vital piece of information, or receiving it too late, may cost a trader's principals millions of dollars. Conversely, obtaining critical data before it becomes available to the market may enable the trader to realize a handsome return on the principals' capital. Certainly, the ability to sift through data is critical, as is the ability to analyze the data and make investment decisions based on the hypotheses that flow from the analysis. But a trader that does not receive information on a timely basis will not be a trader for long.

Locating valuable information, however, does not come without its perils. For instance, it is common knowledge that trading on "inside information" may have significant civil and criminal consequences. Other theories of liability abound. Yet there is remark-

ably little published that will help traders and their funds navigate through the thicket of issues that are presented when a trader proposes to trade in claims in a chapter 11 case. In this regard, while it is quite clear that the 1991 amendments to Bankruptcy Rule 3001(e) have sought to limit the bankruptcy court's involvement in policing claims trades,¹ the seeming lack of bankruptcy court oversight of the claims trading process should not be mistaken for a *laissez-faire* regulatory scheme. Indeed, traders who trade high-yield bonds of distressed issuers need to be cognizant of the federal securities laws' restrictions on insider trading. Moreover, even though bankruptcy courts' scrutiny of claims trades has been relatively lax for 15 years, various issues may arise in bankruptcy proceedings out of claims trading that could adversely affect the status of the claim at issue and lead to significant financial losses.

1. Prior to 1991, Bankruptcy Rule 3001(e)(2) required court approval of all claims transfers after notice and a hearing. As a result, prior to 1991, courts frequently used Rule 3001(e) to place significant restrictions on the claims trading process. The 1991 amendments to Rule 3001(e) removed the requirement of court approval of claims transfers, absent objection thereto. In its place, amended Rule 3001(e) requires only that the transferee file evidence of the claims transfer within 20 days of the transfer and provide notice of the transfer to the transferor.

This summary is intended to assist claims traders and funds in understanding when they should exercise caution in soliciting and using information, and some of the issues that arise when traders of distressed claims possess material nonpublic information.²

INSIDER TRADING UNDER THE FEDERAL SECURITIES LAWS

The federal securities laws will not apply to bankruptcy claims unless such claims are “securities.”³ Because the Supreme Court has refused to adopt a bright line test for what constitutes a “security” for purposes of the securities laws, and instead has focused on the specific context of an instrument, this issue is complex. Particularly problematic in the claims trading context is the fact that a company’s insolvency transforms, and creates a market in, its various obligations. Accordingly, although certain debt, such as publicly traded high-yield bonds, clearly qualifies as securities under the federal securities laws, the Bankruptcy Code requires that publicly traded bonds and traditional bank debt, trade claims, and judgments, which were not securities before the start of the bankruptcy case, be treated equally if they are of the same priority. In other words, they are all transformed into claims that have similar rights in the debtor’s estate.

As referenced above, certain debt, including traditional bank debt and trade debt, generally would not qualify as securi-

ties under current law. Nonetheless, despite the absence of reported cases on the point, it is conceivable that once such debt is transformed into a bankruptcy claim, a court could treat such claims as “securities” using the Supreme Court’s existing analytical framework. Moreover, trading in high-yield debt, even after such debt has been converted into a bankruptcy claim, will continue to be subject to the federal securities laws. In this regard, traders should consider existing laws restricting insider trading, given that violations of such laws could lead to severe civil or criminal penalties. In addition, it is not unrealistic to conceive of a bankruptcy court using principles of insider trading liability to punish claims traders who misuse confidential or other inside information.

In any event, traders should consult with counsel for assistance in determining whether the specific type(s) of claims trading in which they are engaged could implicate the securities laws, particularly if the trader is likely to receive confidential or other inside information.

Insider Trading. Section 10(b) of the Exchange Act proscribes “any manipulative or deceptive device or contrivance” in connection with “the purchase or sale of any security . . .,” at least to the extent that such a device or contrivance conflicts with rules and regulations prescribed by the U.S. Securities and Exchange Commission (the “SEC”). 15 U.S.C. § 78j(b). Rule 10b-5 similarly prohibits persons from employing a “device, scheme, or artifice” to defraud, making untrue statements of material fact (or omitting such facts), or engag-

2. Under the federal securities laws, information about an issuer of securities is “material” if it would be expected to affect the investment or voting decisions of a reasonable shareholder or investor, or if the disclosure of the information would be expected to alter significantly the total mix of the information in the marketplace about the company. In other words, material information is any type of information that could reasonably be expected to affect the market price of a security. Both positive and negative information may be material. While it is not possible to identify all information that would be deemed “material,” the following types of information ordinarily would be considered material:

- Financial performance, particularly quarterly and annual earnings announcements, and changes to financial forecasts or unforeseen liquidity issues.
- Potential mergers or other significant acquisitions or dispositions involving the issuer.
- Significant changes in senior management.
- New major contracts or customers, or the loss of a major customer.
- Capital-raising plans.
- Initiation or settlement of significant litigation.

Material information is “nonpublic” if it has not been widely disseminated to the public, for example, through major news services or web casts.

3. The Securities Exchange Act of 1934 (the “Exchange Act”) provides:

The term “security” means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement ... any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, ... or, in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10).

ing in a fraud or deceit in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5. Since the decision of the SEC in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), insider trading (*i.e.*, trading on the basis of material nonpublic information) by both corporate insiders (typically directors and executive officers) and their “tippees” has been viewed by the SEC and the courts as a violation of Rule 10b-5. This does not mean corporate insiders have a duty to disclose all material information to the public; rather, the duty is to disclose or to abstain from trading until disclosure has been made. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

The Supreme Court’s subsequent decisions in *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. SEC*, 463 U.S. 646 (1983), did not affect the liability for insider trading of true corporate insiders, or of certain kinds of tippees, but did restrict the scope of liability for insider trading somewhat. In *Chiarella*, an employee of a financial printer guessed, without being told by anyone, the names of certain takeover targets from documents being prepared at his place of employment. He was convicted of a criminal violation of Rule 10b-5 for having traded in the target company stocks prior to announcements of the takeovers, apparently on the theory that anyone in possession of material nonpublic information is prohibited from trading on it. 445 U.S. at 231. The Supreme Court, however, rejected this theory and overturned the conviction, ruling that only those who violate a specific duty by trading on material nonpublic information can be liable under Rule 10b-5. *Id.* at 232. Although not part of its holding, the Court noted that corporate insiders violate a fiduciary duty to shareholders when they trade on the basis of material nonpublic information, and that tippees of corporate insiders may be liable if they participate in an insider’s breach of duty. The Court expressly reserved for later decision the question whether misappropriation of information for purposes of insider trading in breach of a duty of an employer — or the corporation providing the information — could suffice for purposes of the imposition of insider trading liability under Rule 10b-5.

Chiarella itself did not involve a tippee; however, after *Chiarella*, it appeared that tippee liability under Rule 10b-5 would have to be based on either the tippee’s participation in a breach of fiduciary duty by a corporate insider in making a tip, or on the misappropriation or a violation of a duty by a tipping corporate insider. This was confirmed in *Dirks*,

which involved a securities analyst who was informed by corporate insiders of a major financial scandal involving a publicly traded company. The analyst, while making attempts to bring the information to the attention of the SEC and the press, informed some of his clients, who were able to sell the relevant securities before the scandal became public. The analyst was censured by the SEC. The Supreme Court, however, overturned the censure because the analyst received the nonpublic information about the company from corporate insiders who were attempting to expose a scandal rather than violating fiduciary duties to shareholders.

Misappropriation. In *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court addressed the question (unanswered by *Dirks* and expressly reserved by the Court in *Chiarella*) whether the misappropriation of information in order to trade in securities in violation of a duty of confidentiality to an employer or corporation could provide the basis for insider trading liability. In a highly publicized case, R. Foster Winans, a *Wall Street Journal* reporter and co-author of the “Heard on the Street” column, shared with others advance information on the stocks that would be discussed in upcoming columns. The recipients of the advance information then traded on this information and shared the profits with Winans. Because the information shared by Winans was not “inside” information of the companies whose shares were being traded, it could not be argued that Winans was trading on material nonpublic information *belonging to the companies about which he wrote*. The Supreme Court affirmed the Second Circuit’s decision in *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), which held that Winans had knowingly breached a duty of confidentiality by misappropriating information that had not yet been published and that was the property of the *Journal*, his employer.

The SEC subsequently sought to enhance its power to combat insider trading by promulgating Rule 14e-3 under section 14 of the Exchange Act. Rule 14e-3 governs insider trading in the context of tender offers and effectively abrogates *Chiarella*. Rule 14e-3 may apply before a tender offer is officially announced if anyone has taken “a substantial step or steps” to commence the offer. In *SEC v. Ginsburg*, 362 F.3d 1292, 1302-04 (11th Cir. 2004), for example, the court held that the formation of a due diligence team and execution of a confidentiality agreement was sufficient to trigger application of this rule. Congress also enacted, at the SEC’s behest, the

Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”). The ITSFEA added sections 20A and 21A to the Exchange Act, which authorized the SEC to seek, and federal courts to impose, a civil penalty of three times the illicit profit for insider trading violating any provision of the securities laws or the rules and regulations promulgated thereunder. The Supreme Court’s decisions on the issue, marked by a reluctance to define precisely the parameters of illegal insider trading, appeared to invite Congress to adopt a definition of insider trading that would or would not include misappropriation. In enacting the ITSFEA, however, Congress declined to resolve the question.

Moreover, uncertainty remained with respect to Rule 10b-5’s application to persons who came into possession of material nonpublic information legitimately, such as accountants, lawyers and investment bankers, but then used the information to trade. Some circuit courts, including the Second Circuit, resolved this issue by recognizing the “misappropriation theory.” Other circuits, however, rejected this basis for insider trading liability. The conflict among the circuits was finally resolved by the Supreme Court’s decision in *United States v. O’Hagan*, 521 U.S. 642 (1997). *O’Hagan* involved trading by a lawyer in a large law firm who became aware that one of his firm’s clients, Grand Metropolitan PLC, was planning a tender offer for Pillsbury Company. Using this information, O’Hagan purchased Pillsbury call options and common stock and, when the tender offer was subsequently announced, O’Hagan sold the options and stock for over \$4 million in profit. The Eighth Circuit reversed O’Hagan’s criminal securities law convictions on the grounds that (1) he was not guilty of securities fraud because trading on the basis of misappropriated material nonpublic information in securities of a company to which O’Hagan owed no fiduciary duty did not violate section 10(b) or Rule 10b-5; and (2) O’Hagan could not be guilty of violating Rule 14e-3 under the Exchange Act (the SEC rule that prohibits trading on material nonpublic information relating to a tender offer, without regard to whether fraud was committed) because the SEC had exceeded its authority when promulgating that rule.

The Supreme Court reversed the Eighth Circuit on both grounds, holding that criminal liability under section 10(b) could be based on the misappropriation theory. The Supreme Court explained that trading on misappropriated confidential information is deceptive under section 10(b) because

the fiduciary-turned-trader deceives those who entrust him with access to confidential information and defrauds them of the exclusive use of the information. The *O’Hagan* Court distinguished the theory upon which the SEC’s charges were based as follows:

The classical theory targets a corporate insider’s breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate “outsider” in breach of a duty owed not to a trading party, but to the source of the information.

Id. at 653. The Court did concede that “[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the information’s source, if the fiduciary discloses to the source that he plans to trade on the information, there is no ‘deceptive device’ and thus no § 10(b) violation.” *Id.* at 643. In this case, however, O’Hagan made no such disclosure upon receipt of the material nonpublic information, and he breached his duty of loyalty to his law firm and its client when he traded on the basis of that information. Importantly, the deceived or defrauded party need not be a party to the trade in question in order for the deception to be “in connection” with the trade; rather, the information only must be used as a basis for the trade.

The *O’Hagan* Court also disagreed with the Eighth Circuit’s other ground for reversing O’Hagan’s conviction. In *O’Hagan*, the Court held that, as applied in this case, the SEC properly exercised its rulemaking authority with respect to Exchange Act Rule 14e-3 (the rule prohibiting trading on the basis of any material nonpublic information that relates to a tender offer and imposes a duty on persons with such information to disclose such information or refrain from trading). Under the rule in question, this duty is imposed even if the trader owes no fiduciary duty of loyalty or confidentiality, as the Supreme Court recognized that section 14(e) of the Exchange Act empowered the SEC to take preventive measures designed to prevent fraudulent trading and that in this case the SEC had not exceeded its authority.

Before the *O’Hagan* decision, the Second Circuit had extended the scope of the misappropriation theory by holding that liability under the theory would attach whenever a defendant engaged in a securities transaction based on information acquired in a “breach of a fiduciary duty or simi-

lar relationship of trust and confidence.” See *United States v. Mylett*, 97 F.3d 663, 667 (2d Cir. 1996). In doing so, the court implicitly approved the holdings of some prior cases that had extended the misappropriation theory outside the employer/advisor context, and *O’Hagan* appears to support this extension of the misappropriation theory.

Recent SEC Rulemaking Initiatives. Rule 10b5-2 under the Exchange Act was promulgated by the SEC in August 2000 as part of the SEC’s attempt to clarify when “certain non-business relationships, such as family and personal relationships, may provide the duty of trust or confidence required under the misappropriation theory.” Selective Disclosure and Insider Trading, Exchange Act Release No. 43154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,695 (Aug. 15, 2000) [hereinafter Selective Disclosure Release]. This rule provides that “a duty of trust or confidence exists whenever a person agrees to maintain information in confidence.” 17 C.F.R. § 240.10b5-2(b)(1). It then provides that a “duty of trust or confidence exists when two people have 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)(2). Finally, Rule 10b5-2 adopts a bright line test that provides that a duty of trust or confidence exists when a person receives or obtains material nonpublic information from certain enumerated close family members, although the recipient of the information has an affirmative defense if that person can demonstrate that no duty of trust or confidence exists. See Selective Disclosure Release, at 83,696.

Another controversial question in the insider trading context is what constitutes trading “on the basis of” material nonpublic information for purposes of section 10 and Rule 10b-5. Although few courts have specifically addressed whether these provisions require a causal connection between the material nonpublic information and the insider’s trading, or whether knowing possession of that information, while trading, is sufficient for the imposition of liability, the Second Circuit has held that “knowing possession” of material nonpublic information is sufficient. *United States v. Cusimano*, 123 F.3d 83, 87 (2d Cir. 1997). In contrast, the Eleventh Circuit has ruled that *Chiarella*, *Dirks*, and *O’Hagan* suggest that there is no securities law violation in the absence of a stron-

ger causal connection. See *SEC v. Adler*, 137 F.3d 1325, 1332 (11th Cir. 1998). Accordingly, the *Adler* court held that insider trading while in knowing possession of material nonpublic information is not a *per se* violation; rather, such activity raises a strong inference that the insider intended to use the information in trading, an inference that the insider can attempt to rebut. *Id.* at 1337. The Ninth Circuit also rejected the knowing possession standard in favor of a use standard, noting that “[i]t is the insider’s use, not his possession, that gives rise to an informational advantage and the requisite intent to defraud.” *United States v. Smith*, 155 F.3d 1051, 1068 (9th Cir. 1998).

In August 2000, the SEC promulgated Rule 10b5-1 under the Exchange Act in an attempt to end the use/possession debate. Under the new rule, a “purchase or sale of a security of an issuer is ‘on the basis of’ material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.” 17 C.F.R. § 240.10b5-1. The SEC resolved the debate by adopting a standard similar to the “knowing possession” test, mitigated by specific affirmative defenses. The most important affirmative defense, available to both individuals and entities, provides exclusions for certain situations in which a trade resulted from a pre-existing plan, contract, or instruction that was made in good faith. This defense covers “situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision.” Selective Disclosure Release, at 83,694. An additional defense is available to entities alone, which can avoid liability if the entity can demonstrate that the person making investment decisions for the entity was not aware of the information, and that the entity had implemented reasonable policies and procedures to prevent insider trading.

Penalties for Insider Trading. For the individual trader who has engaged in insider trading, the consequences can be significant. First, the SEC may pursue criminal or civil remedies. Depending on its investigation, the SEC may refer a matter to the Department of Justice for prosecution as a criminal matter. 15 U.S.C. § 77t(b). Criminal liability can be visited both upon the principal and on his or her aidors and abettors. Maximum criminal penalties run in the range of significant fines (to \$5 million for individuals and \$25 million for organizations) and extended prison terms (up to 20 years).

On the civil side, various enforcement actions frequently follow, ranging from fines and penalties and cease and desist orders to orders barring individuals from serving as officers or directors of any reporting company. *See generally* 15 U.S.C. §§ 77t-78t.

Often, management will take all reasonable actions to ensure that its traders act legally and without resort to confidential information. Yet the pressure on traders can be intense and, notwithstanding management's exemplary efforts, a rogue trader may still resort to inside sources. Does management remain liable? Section 20 of the Exchange Act governs liability of "controlling persons," as well as "persons who aid and abet violations" of the securities laws. 15 U.S.C. § 78t. That section provides that every organization "who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person . . ." 15 U.S.C. § 78t(a). Section 21A(b) of the Exchange Act, however, provides that no penalty may be imposed on a "controlling person" unless the SEC establishes that:

- [1] such controlling person knew or recklessly disregarded the fact that [those under its control were] likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or
- [2] such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under [section 15(f) or section 204A of the Investment Advisers Act of 1940] and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.

15 U.S.C. § 78u-1(b)(1). In principle, then, a conscientious organization that is victimized by its own employee/trader need not suffer liability for the trader's unauthorized activity – provided that it has taken appropriate action to foreclose the possibility of such activities.

In addition to the remedies available to the SEC and associated enforcement agencies, private parties may seek relief from traders directly for violating federal securities laws, breaching contracts (*e.g.*, breach of confidentiality obligations), or otherwise running afoul of state law (*e.g.*, breach

of fiduciary duty). Although the laws vary from jurisdiction to jurisdiction, some also recognize claims for aiding and abetting the foregoing or entering into a conspiracy to accomplish them. The damages associated with such claims for relief are unpredictable and, depending on the circumstances, could be significant.

CLAIMS TRADING UNDER THE BANKRUPTCY CODE

As discussed above, the amendments to Bankruptcy Rule 3001(e) have left claims trading largely unregulated by bankruptcy courts. *See, e.g., In re Lynn*, 285 B.R. 858, 859 (Bankr. S.D.N.Y. 2002) (denying a debtor's motion to invalidate a claims transfer "[b]ecause Rule 3001(e), which governs the assignment of bankruptcy claims, does not confer standing on the Debtor to object to the assignment" and because the intent of the 1991 amendments was to "curtail judicial oversight of the claim assignment process"). In this regard, some courts have refused to invalidate claims transfers even in cases where claims purchasers have used misinformation to purchase claims. *See In re Olson*, 120 F.3d 98 (8th Cir. 1997). In *Olson*, the Eighth Circuit reversed a bankruptcy court's disallowance of claims transfers because the transferors did not object and, therefore, the bankruptcy court lacked the authority under Rule 3001(e) to rule on the matter.

The Bankruptcy Code, however, provides for various "equitable" remedies where the holder of a claim is alleged to have committed some form of misconduct. Chief among these remedies is equitable subordination pursuant to section 510(c) of the Bankruptcy Code. The Bankruptcy Code itself is silent as to what, exactly, constitutes grounds for subordination; rather, it simply allows subordination, in somewhat circular fashion, "under principles of equitable subordination." 11 U.S.C. § 510(c)(1). Commentators agree that in using this language Congress intended that the existing law on equitable subordination thus would be endorsed in statute. The general requirements for subordination were set forth by the Fifth Circuit in the seminal case of *Benjamin v. Diamond (In re Mobile Steel Corp.)*, 563 F.2d 692 (5th Cir. 1977). They are as follows: (1) the claimant engaged in inequitable conduct; (2) the inequitable conduct resulted in injury to creditors, or conferred an unfair advantage on the claimant; and (3) subordination is consistent with other provisions of the Bankruptcy

Code. *Id.* at 700. In reviewing the case law, one respected commentator observed that equitable subordination cases tend to be limited to instances in which a claimant with fiduciary obligations abuses its position to the disadvantage of other creditors or commits a fraud as against other creditors. *Collier on Bankruptcy*, ¶1510.05[1] at 510-15 (15th ed. rev. 2006).

Unfortunately for those who seek certainty in transactions, “inequitable conduct” is all too frequently in the eye of the beholder. More specifically, could trading on confidential information be deemed inequitable conduct that damaged other creditors? Arguably so, particularly if the trading can be causally linked to events that either caused the estate damage or that otherwise reduced distributions to unsecured creditors. In this regard, traders need to be cognizant of these principles and recognize that courts continue to police claims trading in certain circumstances. Importantly, under the Bankruptcy Code, the transferor has standing to object to the transfer, and bankruptcy courts’ focus remains on protecting sellers of claims from overreaching buyers. As discussed below, bankruptcy courts have used their equitable powers to fashion remedies when claims trading strategies involve questionable conduct or the misuse of inside information.

Limitations on Acquiring Claims for Voting Purposes. In *Citicorp Venture Capital, Ltd. v. Committee of Creditors*, 160 F.3d 982 (3d Cir. 1998), the Third Circuit upheld the bankruptcy court’s use of its equitable powers to police an insider’s purchase of claims. Citicorp Venture Capital, Ltd. (“Citicorp”) was found to be an insider of the debtor because it held a 28 percent ownership stake in the debtor. Citicorp obtained a blocking position by purchasing a block of unsecured claims at a significant discount. Citicorp then used its blocking position to oppose the debtor’s plan and offer a competing plan. In response to the court’s criticism of Citicorp’s covert claim purchases and blocking strategy, Citicorp decided not to vote its purchased claims. Nonetheless, the bankruptcy court reduced Citicorp’s purchased claims to the amount of the discounted purchase price. Although the Third Circuit disagreed with portions of the bankruptcy court’s ruling, it agreed that the appropriate remedy was to limit Citicorp’s recovery to the purchase price of the claims so that Citicorp would not be allowed to profit from its inequitable conduct.

In a pre-1991 case, *In re Allegheny Int’l, Inc.*, 100 B.R. 241 (Bankr. W.D. Pa. 1988), the bankruptcy court held that the circumstances surrounding a creditor’s acquisition of claims for the purpose of obtaining a blocking position to defeat plan confirmation amounted to bad faith and supported the designation of those claims. As a result, the bankruptcy court disallowed the votes of a claim purchaser who acquired and voted claims to reject the plan as having been cast in bad faith. In reaching its decision, the court made several key findings. First, the court found that, notwithstanding the claim purchaser’s longstanding interest in acquiring the debtor, it did not acquire significant claims until the vote solicitation period and did not file a competing plan “until the eleventh hour.” Second, the bankruptcy court found that the pattern of the claims purchases showed an intent to acquire a blocking position, *i.e.*, just enough claims to defeat the debtor’s plan. Third, the bankruptcy court found that the purchaser’s willingness to pay an increasing price for claims until a blocking position was attained illustrated an “ulterior motive” to defeat the plan. Fourth, the bankruptcy court noted that the purchaser improperly solicited creditors both before and after the purchaser’s disclosure statement was approved. Finally, the bankruptcy court held that because the claim purchaser held significant inside information, it could be deemed an insider with fiduciary duties to all creditors. *But see Figter Ltd. v. Teachers Ins. and Annuity Assn. (In re Figter)*, 118 F.3d 635 (9th Cir. 1997) (holding on different facts that secured creditor purchasing unsecured claims to block plan “acted in a good faith attempt to protect its interests and not with some ulterior motive”).

Confidentiality Issues. One of the issues that large claims purchasers must address is whether it is in their interests to agree to be bound by confidentiality provisions in order to gain access to inside information that will allow them to (1) meaningfully participate in decisions facing the debtors in the management of their chapter 11 cases and their operations, (2) serve as a member of a bank group or creditors’ committee, or (3) enter into negotiations for the purchase of some or substantially all of the debtor’s assets. Once a purchaser has received inside information about the debtor, it must be careful when both acquiring additional claims against the debtor and selling its claims. *See, e.g., Citicorp Venture Capital, Ltd. v. Committee of Creditors, supra* (reducing claim to amount of purchase price because purchaser did not disclose insider status to claim sellers).

One way to protect against the risk of buying and selling claims while holding inside information is the use of “Big Boy” letters, which contain acknowledgments by the buyer and seller that each has relied solely on its own investigation in deciding to enter into the transaction, and that each understands that the other party may have material nonpublic information. These letters further provide that the parties waive any recourse for the other party’s failure to disclose such information. *See Banco Espanol de Credito v. Sec. Pac. Nat’l Bank*, 973 F.2d 51, 56 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) (“The waiver provision in the MPA’s signed by the loan participants specifically absolved Security Pacific of any responsibility to disclose information relating to Integrated’s financial condition.”).

Claim Impairment. One of the greatest inherent risks facing claims purchasers is that the transferred claim will be disallowed or otherwise impaired as a result of any number of factors beyond the purchaser’s control, including events that occurred long before the actual transfer. For example, in *Enron Corp. v. Third Avenue Special Situations Fund II, LP*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005), the bankruptcy court held that a transferred claim can be equitably subordinated based upon the transferor’s conduct, even though the transferee is blameless and the transferor’s conduct justifying equitable subordination does not relate to the transferred claim. In a later related decision, the same bankruptcy court recently held that a transferred claim should be disallowed temporarily under section 502(d) of the Bankruptcy Code unless and until the transferor returns payments to the estate that are subject to a preference action. *See In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

To protect against this risk, savvy claims purchasers will try to shift the risk of impairment back to the transferor in the transfer agreement. Claim transfer agreements typically include impairment provisions that require the seller to repurchase the impaired claim or, if the claim is only partially impaired, the impaired portion of the claim. The buyer will attempt to define impairment as broadly as possible to give the buyer a remedy in the event of any impairment of the claim, such as the filing of an objection or a preference action affecting the allowance of the claim. The seller, on the other hand, will seek to limit the scope of impairment such that the buyer will have no remedy until an objection is sustained or an alleged preference is reduced to judgment.

OTHER THEORIES OF LIABILITY

There are a number of theories of liability that could apply to claims trading regardless of whether the underlying claim is a security, mostly arising under applicable state laws for which the nature of the underlying claim is immaterial. Some arise out of contract or contract-like obligations, for example, violation of confidentiality or nondisclosure agreements. Others arise out of the relationship between the trader and the holder of the material nonpublic information, such as officers, agents, or fiduciaries. In each case, the injured party (*e.g.*, the corporation, a creditors’ committee or, arguably, the counterparty to a claim transfer agreement) may be able to state a cause of action for breach of contract, breach of fiduciary duty, or misrepresentation to the extent that it seeks relief for alleged misuse of confidential information.

While the most likely claims for relief are set forth above, the theories that an aggrieved litigant might raise are limited only by the creativity of the plaintiff’s attorney or prosecutor. Derivative theories such as conspiracy or aiding and abetting might be alleged wherever the trader could be construed as part of a larger scheme in which a third party is otherwise accused of misconduct. State law causes of action like fraud can be federalized into mail or wire fraud. Such theories underscore the importance of careful consideration of trading policies and implementation of appropriate procedures to minimize a trader’s legal exposure.

WHEN SHOULD TRADERS EXERCISE CAUTION?

When should information proffered by a source be refused, or at least handled with care? Although the securities laws focus on material nonpublic information, bankruptcy cases have focused on trading while in possession of material *confidential* information. In a chapter 11 case, who has access to confidential information?

Corporate Insiders. Corporate insiders are the classic providers of inside information and, when the information is material and nonpublic, liability for trading on such information is likely to arise. Certain disclosures are clearly public – *e.g.*, press releases and investor conference calls open to the public. Others, however, must be approached with caution: The fact that an insider makes material nonpublic

disclosures inadvertently when discussing otherwise routine matters with an investor – with no expectation of personal benefit – *is* exculpatory. See *Dirks, supra*, 463 U.S. at 662. However, determining whether there was any “personal benefit” is determined in retrospect and can be inferred from circumstantial evidence. For example, liability was found in one case where the benefit to the tippee was inferred from “an affair involving incessant telephone conversations” and subsequent, successful trading activity by the tipper. See *United States v. McDermott*, 245 F.3d 133 (2d Cir. 2001). Indeed, a “gift” of information, even if it appears gratuitous, has been held to give rise to liability. See, e.g., *SEC v. Ward*, 151 F.3d 42 (2d Cir. 1998). Accordingly, traders researching a potential investment should view information from corporate insiders with skepticism, as anything out of the ordinary might, with the benefit of hindsight, appear to suggest that the insider was knowingly providing material nonpublic information – even if it is not immediately apparent *why* the corporate insider is choosing to do so.

Committee Members. In the context of distressed investing, creditors’ committees including investors are routinely appointed in chapter 11 cases, while *ad hoc* committees of bondholders are frequently assembled by a debtor long before the filing decision is ever made. These committees typically are contractually bound to maintain the debtor’s confidences and, having made their commitments, are thereafter provided with confidential information essential to fulfilling their advisory roles. In this regard, under the misappropriation theory discussed above, the fundamental focus of the inquiry is on the misuse of *any* material nonpublic information. In the context of chapter 11 practice, it is not difficult to conceive of circumstances that could give rise to misappropriation liability, particularly in the context of creditors’ committee deliberations. For example, liability could attach to the extent that a trader traded in advance of the market upon learning of a decision to break off promising plan negotiations and pursue a riskier litigation strategy or, conversely, to accept a confidential proposal from a plan sponsor that would result in returns above the existing market for claims against the debtor.

Although the circumstances under which a corporate insider would choose to knowingly share material nonpublic information are presumably few, the exposure to a trader receiving information from a committee member is much more

significant. It is common practice among traders to share information amongst themselves. A plaintiff or prosecutor investigating questionable trading patterns that determine that a committee member is speaking too freely (*i.e.*, in violation of its confidentiality obligations) will almost reflexively argue that the sharing of such information with a friendly trader was part of an established *quid pro quo* between the traders in which “hot” tips were freely exchanged between themselves. See, e.g., *SEC v. Yun*, 327 F.3d 1263, 1280 (11th Cir. 2003) (holding that evidence was sufficient for jury to conclude that wife of executive officer expected to benefit from tipping “by maintaining a good relationship between a friend and a frequent partner in real estate deals”); *cf. SEC v. Maxwell*, 341 F. Supp. 2d 941, 949 (S.D. Ohio 2004) (holding that no evidence was presented that executive expected to benefit from disclosure to barber where court was “unable to discern why having a good relationship with his barber would be of consequence to [d]efendant”).

Private Actors. The focus on “confidential” information, rather than “inside” information, directs attention to the fact that traders relying on material nonpublic information could have exposure even when the company itself is ignorant of the information. The archetypal fact situation arises where a third party prepares a tender offer and, before the offer is announced, a trader is leaked the information. Indeed, this was exactly the context in which criminal liability was affirmed in the *O’Hagan* case discussed above. Analogues in the distressed company area abound: private equity players who surreptitiously begin to acquire trade or bank debt in furtherance of a plan to take a controlling position in the debtor’s case; a major lender’s decision to forego further plan negotiations and seek relief from stay to foreclose; or a third-party purchaser’s discovery of previously undisclosed circumstances that will cause it to significantly reduce (or withdraw) its purchase proposal. A trader who learns of any of these circumstances, and trades on them without authorization, may find itself the target of an action for misappropriation under the federal securities laws.

Although traders must exercise caution in such circumstances, it should be noted that the extension of the misappropriation theory to such circumstances has raised a number of difficult questions about when liability will attach. For instance, the language of the Supreme Court’s *O’Hagan* decision – which focused upon section 10(b)’s “deceptive

device or contrivance” language – suggested that *openly* misappropriating the information from a confidential source might not create liability; so-called “brazen misappropriators” might not have liability so long as they openly avowed to their source their intention to trade. (Of course, this seems counterintuitive; *O’Hagan* notwithstanding and in light of Rule 10b5-2, traders should consider whether it is worth being the test case in such circumstances.) Moreover, the very notion of misappropriation presumes the source has not consented to the use of confidential information. In the real world, however, lines of authority and consent are often undefined or fluid concepts and, in these gray areas, traders must tread with extreme caution.

Tippees. Misuse of information received from any of the preceding sources can give rise to liability. Critically, the information need not come *directly* from any of these proscribed sources. Such a source, a “tipper,” may set in motion a chain of disclosures among subsequent tippees, each of whom may be liable under applicable statutes. A recent example of a tippee’s exposure for insider trading is Martha Stewart’s travails after allegedly trading based on information received from a broker who may have received inside information from a corporate officer of ImClone in 2003. (It should be cold comfort to concerned traders that, while Ms. Stewart ultimately was not convicted of any crimes under the federal securities laws, she was convicted of conspiracy, obstruction of justice, and two counts of making false statements – all charges arising out of the investigation of the allegations of insider trading.)

For a tippee to incur liability, a required finding is that the tippee “knows or should know that there has been a breach” of a duty not to disclose material nonpublic information. *Dirks*, 463 U.S. at 660. Though there is limited case law on the topic, common sense dictates that a trader is not insulated from liability by ignorance of the exact circumstances under which proscribed information has reached the trader; it is enough to show that the tippee knows or has reason to know that the information has been improperly communicated. *See, e.g., United States v. Chestman*, 947 F.2d 551, 563 (2d Cir. 1991). Conversely, unsubstantiated rumors should not give rise to liability. In between is a massive gray area in which the trader may have a sick feeling, but no explicit grounds upon which to believe, that critical information has been procured inappropriately.

WHAT SHOULD TRADERS DO TO PROTECT THEMSELVES?

At an individual level, some rules are basic. First, traders must understand the legal regime; one cannot protect oneself against legal exposure without at least a rudimentary understanding of the statutes and theories that apply. Second, diligence should be exercised when dealing with persons with access to confidential information, whether company insiders, committee members, or others actively engaged with a debtor. Where valuable information is disclosed, ask the obvious questions: Is this information publicly available? If not, why is it being shared with me, now? If a trader has an uneasy feeling about such disclosures, he or she should discuss them with management or counsel; unfortunately, in light of lingering uncertainties in the applicable laws, the ultimate decision will frequently turn not on whether a proposed trade is legal or illegal, but rather how much risk the trader is willing to take that the trade or trades would be challenged with the benefit of hindsight.

Even the most attentive, disciplined trader is not immune from allegations of improper trading. For an institution, a nightmare scenario arises where the trader inadvertently fixes upon a trading strategy simultaneously with the disclosure of material nonpublic information to another person in his or her institution. Even if the two individuals were wholly unaware of the other’s interest in the subject company, circumstantial evidence is admissible to prove insider trading and the coincidence could be cited as “proof” that the trader is a tippee. How does the institution protect itself?

In a closely analogous circumstance, the SEC has offered some guidance. Insider trading is specifically prohibited in connection with tender offers, which must be conducted in accordance with rules promulgated by the SEC. In this regard, Exchange Act Rule 14e-3 provides a safe harbor that protects traders from illegal insider trading allegations simply by virtue of the fact that the traders’ organization – without their knowledge – is preparing a tender offer. To invoke the safe harbor, an organization must demonstrate that it:

implemented . . . policies and procedures, reasonable under the circumstances, taking into consideration the nature of the [organization]’s business, to ensure that individual(s) making investment decision(s) would not violate [Rule 14e-3(a)], which policies and procedures

may include . . . those which prevent such individual(s) from knowing such [material nonpublic] information.

17 C.F.R. § 240.14e-3(b)(2). In addition, the organization must demonstrate that, as a matter of fact, the employees “making the investment decision” on its behalf “did not know the material, nonpublic information.” 17 C.F.R. § 240.14c-3(b)(1).

In the industry, that set of policies and procedures intended to insulate a trading organization from accusations of insider trading is usually referred to as an “ethical wall.” The SEC, while generally declining to set forth conclusively the adequacy of an ethical wall, has published a report entitled “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information.”⁴ In that report, the SEC identified the “necessary elements” of an adequate ethical wall: “These minimum elements include review of employee and proprietary trading, memorialization and documentation of firm procedures, substantive supervision of interdepartmental communication by the firm’s compliance department, and procedures concerning proprietary trading when the firm is in possession of material, nonpublic information.” Put somewhat more colloquially, the SEC has advised that the “pure heart, empty head” defense will not find favor with it; if a trader seeks to invoke an ethical wall as a defense to the allegation that it took advantage of material nonpublic information in the possession of his or her employer, the institution must have put into place a comprehensive program including education, monitoring, and compliance to preclude a foreseeable misuse of proprietary information.

Ethical walls are nothing new, and substantial literature on the subject exists. See, e.g., Pozen & Mencher, “Chinese Walls for Creditors’ Committees,” 48 *Bus. Law.* 747 (Feb. 1993). Generally, the literature does not discuss in depth the

distressed debt and chapter 11 markets, but the principles should still adhere. Indeed, it is now common in large chapter 11 cases for the debtors or the committees to seek and obtain “trading orders” that permit committee members to trade in the debtor’s debt securities notwithstanding their access to material nonpublic information. *In re Dana Corp.*, No. 06-10354 (Bankr. S.D.N.Y. Aug. 9, 2006); *In re Federated Dep’t Stores, Inc.*, No. 90-00130, 1991 WL 79143 (Bankr. S.D. Ohio Mar. 7, 1991) (Order Permitting Securities Trading in Certain Circumstances). The effect of such orders, however, should not be overstated; while liability will not be imposed merely because a committee member trades in a debtor’s securities, these orders are premised on the assumptions that (1) the committee member honors its confidentiality obligations and (2) the ethical wall is in force and effective. The trading order only protects the honest trader from exposure for allegations based solely on circumstantial evidence.

CONCLUSION

Trading in distressed debt and chapter 11 claims is, by all estimates, a multibillion dollar a year industry that provides tremendous liquidity to the markets. It also promises significant opportunity to those sophisticated enough to understand the restructuring process and with sufficient access to information to take appropriate risks. One risk that a trader can minimize through awareness and appropriate prophylactic measures is the risk that an enforcement agency or private party will accuse the trader of unauthorized trading based on proprietary information. By understanding the legal regime, acting cautiously when potentially compromising sources offer information, and protecting the institution from rogue traders who seek to profit even on inappropriate or unlawful strategies, traders can focus their efforts on making money in the markets, not risking it in the courts.

4. Available at <http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf>. See also Practising Law Institute, Insider Trading § 13:5.3, *Broker-Dealer Policies and Procedures: Chinese Walls and Their Minimum Elements* (2d ed. 2005) (relying entirely on the 1990 SEC report as basis for the “minimum elements” of an effective ethical wall).

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