WaMu Confirmation Denied: Interest Rates, Equitable Disallowance, and Insider Trading

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In *In re Washington Mutual, Inc.*, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011), Judge Mary F. Walrath of the U.S. Bankruptcy Court for the District of Delaware denied confirmation of the debtors' proposed chapter 11 plan and instead referred the litigants to mediation in order to move the case toward a confirmable resolution. The lengthy opinion denying confirmation covers issues ranging from the award of interest in a chapter 11 plan to equitable claims disallowance and insider trading. While some of the topics discussed in the opinion are relatively straightforward, other issues examined in the ruling have divided bankruptcy courts throughout the nation. As a consequence, the decision is a must-read for restructuring professionals, particularly those in the distressed investing field.

Washington Mutual's Confirmation Process

Washington Mutual, Inc., was the bank holding company that formerly owned Washington Mutual Bank ("WaMu"). WaMu was the nation's largest savings and loan association. In 2007, as with many other large financial institutions at that time, WaMu's revenues and earnings began to decline. By September 2008, the rating agencies had significantly downgraded the credit ratings of both the bank and the holding company. A run on the bank ensued.

On September 25, 2008, the U.S. Office of Thrift Supervision seized WaMu and appointed the Federal Deposit Insurance Corporation (the “FDIC”) as receiver. The takeover of WaMu by the FDIC represented the largest bank failure in this country’s history. On the day of the takeover, the FDIC sold substantially all of WaMu’s assets to JPMorgan Chase Bank, N.A. (“JPMorgan”). A day later, Washington Mutual, Inc., and affiliate WM Investment Corp. (the “debtors”) filed for chapter 11 protection in Delaware.

On March 26, 2010, the debtors proposed a sixth amended chapter 11 plan, which was modified various times thereafter. The sixth amended plan incorporated a global settlement agreement among the debtors, JPMorgan, the FDIC, and certain other stakeholders regarding ownership of certain assets and various claims that the parties asserted against each other. In a January 7, 2011, opinion, the bankruptcy court approved the global settlement agreement but denied confirmation of the plan for other reasons.

The debtors subsequently revised the plan and again sought confirmation. The debtors, JPMorgan, the FDIC, the official committee of creditors, a group of senior noteholders, the indenture trustees for the debtors’ senior notes and senior subordinated notes, and certain other parties in interest all supported confirmation of the revised plan. Others, including the official equity committee and certain putative holders of “trust preferred securities,” opposed it.

Confirmation Issues

As is common in many large chapter 11 cases, the plan objectors disputed the debtors’ proffered valuation of the reorganized company. They argued that, as a result of this low valuation, creditors receiving stock in the reorganized company were receiving too much on account of the expense of their claims at equity. After hearing expert testimony from both sides, the court determined that, although the debtors' valuation was in fact too low, the plan objectors' competing valuation was too high. The court then valued the company at an amount between the two proposed valuations.

The plan opponents also attacked the global settlement agreement as unreasonable. In its prior decision denying confirmation, the court had already passed on the global settlement and determined that it met the applicable legal standards for approval. However, certain objectors argued that the court was not bound by its prior decision, some maintaining that subsequent case law justified a departure from the previous determination. The court rejected these arguments, ruling that it had already decided the issue and no intervening change in law or fact warranted reconsideration of its prior determination.

Next, the plan objectors argued that the plan's award of postbankruptcy interest was too rich. Typically, unsecured creditors may not recover postpetition interest on their claims. However, courts have awarded such interest in rare cases where the estate is solvent. One rationale for doing so is based upon a combined reading of sections 726 and 1129(a)(7) of the Bankruptcy Code. Section 726 provides that, in a chapter 7 liquidation, postpetition interest at the "legal rate" shall be paid on unsecured claims before any distribution to equity holders. Courts have imported section 726's priority scheme into chapter 11 cases on the basis of the "best interests" test in section 1129(a)(7), which requires that in order to confirm a chapter 11 plan, a dissenting creditor or interest holder must receive at least as much under a chapter 11 plan as it would in a chapter 7 liquidation.

Although most courts agree that interest should be awarded to unsecured creditors in a solvent estate, courts are split on the permissible rate of interest and the meaning of the term "legal rate" in section 726. In *Washington Mutual*, the court concluded that "legal rate" means the federal judgment rate at the time of the bankruptcy filing. In a prior decision in the case, the court noted authorities for the proposition that the term "legal rate" establishes a rebuttable presumption in favor of the contract rate, which can be overcome only by the equities of the case. Among these authorities was Judge Walrath's own earlier opinion in *In re Coram Healthcare Corp.*, 271 B.R. 228 (Bankr. D. Del. 2001), wherein the judge applied the federal judgment rate only after determining that the equities in that case did not favor application of the contract rate. Accordingly, *Washington Mutual* would appear to represent a shift in the court's position on this issue.

The plan objectors also argued that the plan violated section 1129(a)(3) of the Bankruptcy Code because it was not proposed in good faith. The objectors complained of alleged misconduct on the part of certain of the noteholders that were party to the global settlement agreement (the "settlement noteholders"). In particular, the equity committee complained that the settlement noteholders "hijacked" the settlement-negotiation process and engaged in wrongful conduct, including insider trading.

In rejecting this argument, the court determined that the settlement noteholders' conduct neither negatively impacted the chapter 11 plan nor tainted negotiation of the global settlement. According to the court, the settlement noteholders' conduct appeared to have assisted in augmenting the debtors' estates by encouraging a more aggressive settlement with JPMorgan. The court therefore held that, although it was not suggesting that the settlement noteholders' conduct was commendable, any harm caused by their conduct could be remedied in other ways.

Insider Trading and the Doctrine of Equitable Disallowance

Relatedly, after explaining that confirmation must be denied, the court granted a motion of the equity committee for standing to pursue equitable disallowance of the settlement noteholders' claims.

The continued vitality of the doctrine of equitable disallowance has been a controversial topic in recent years. Some courts have held that the doctrine did not survive the enactment of the Bankruptcy Code. Other courts, however, continue to recognize its existence. The *Washington Mutual* court aligned itself with the latter group.

The court next considered whether the equity committee had articulated a colorable claim for equitable disallowance based on alleged insider trading on the part of certain of the settlement noteholders. The court began by identifying two types of insider trading under section 10(b) of the Securities Exchange Act of 1934: the "classical theory" and the "misappropriation theory." The classical theory of insider trading applies where a corporate insider (i) trades in the securities of the corporation, (ii) on the basis of (iii) material nonpublic information, (iv) in violation of a fiduciary duty owed to shareholders.

The equity committee alleged that the classical theory of insider trading applied. According to the equity committee: (a) the settlement noteholders had knowledge of the global settlement negotiations and the parties' position therein; (b) such knowledge constituted material nonpublic information; (c) the noteholders actively traded in the debtors' securities after the expiration of certain restriction periods; and (d) such noteholders became "temporary insiders" of the debtors when they were given material nonpublic information creating a fiduciary duty on their part to other creditors and shareholders.

With respect to the question of whether the information at issue was material, the settlement noteholders argued that their knowledge of the negotiations and the parties' positions during the negotiations could not be considered material because the parties neither reached an agreement in principle nor came close to reaching a deal. The court rejected this argument and concluded, on the basis of the evidence presented, that it appeared that the "settlement negotiations may have shifted towards the material end of the spectrum" and that the settlement noteholders may have traded on information that was nonpublic.

The court also determined that the settlement noteholders could have become "temporary insiders" or "non-statutory insiders" of the debtors. According to the court, the settlement noteholders could colorably be temporary insiders due to the fact that the debtors provided them with confidential information to allow them to participate in negotiating the global settlement agreement and plan. Also, the court explained, the settlement noteholders could be considered non-statutory insiders of the debtors because they held blocking positions in two classes of the debtors' debt structure. As such, the court concluded that it could find that these noteholders owed a duty to the other members of the affected classes.

The court also rejected the settlement noteholders' argument that they lacked the requisite "scienter" for insider trading. Specifically, the settlement noteholders argued that, even assuming the information obtained was material nonpublic information, they did not know this was the case because the debtors had agreed to disclose all material nonpublic information at the end of each confidentiality period. The equity committee responded that good-faith reliance on assurances of a third party to disclose all material information to the public cannot be a defense to insider trading. The bankruptcy court agreed.

Accordingly, the court determined that the equity committee stated a colorable claim for insider trading under the classical theory (and, for similar reasons, the misappropriation theory) and, hence, a claim for equitable disallowance. It therefore conferred derivative standing upon the equity committee to pursue the claim. However, the court stayed prosecution of the action pending mediation.

Analysis

Washington Mutual covers a broad waterfront of issues pertinent to distressed investors and other bankruptcy stakeholders. The court's analysis of the valuation dispute and the proposed global settlement in the case addresses topics that frequently arise in contested chapter 11 plan cases.

The court also had occasion to address matters that arise less frequently, such as the appropriate interest rate payable under a chapter 11 plan on unsecured claims when a debtor is insolvent, as well as the vitality and contours of the doctrine of equitable disallowance of claims.

Finally, distressed investors that regularly trade claims in bankruptcy cases would be well advised to consider the court's analysis of the insider-trading allegations in *Washington Mutual*. Of particular note is the court's determination that the noteholders' participation in the settlement negotiations potentially provided them with material nonpublic information. In addition, the court made important rulings regarding the noteholders' blocking positions and the consequences thereof to the noteholders' insider status.