TO OUR FRIENDS AND CLIENTS

Memorandum

June 19, 2007

Revisiting Insider Trading in the Debt Markets: Lessons For Debt Investors and Members of Committees in Bankruptcy Cases

For some participants in the debt and credit markets, insider trading risks seem like a problem for someone else. There is some statistical basis for that assumption; the law of insider trading has been developed largely through cases involving the equity markets. There is no basis, however, for a sense of immunity. The Securities and Exchange Commission’s recent settlement involving Barclays Bank PLC and Steven J. Landzberg, a former proprietary trader for Barclays’ U.S. Distressed Debt Desk, sends a signal that the SEC is prepared to bring even novel insider trading cases in the debt markets. See SEC v. Barclays Bank PLC, Litig. Release No. 20,132 (May 30, 2007) (the “Settlement”). While the Settlement involves important lessons for holders of debt securities, such investors should particularly take these lessons into account when considering joining a creditors’ committee.

The SEC’s complaint that resulted in the Settlement is not focused on an isolated incident. Instead, the Commission contends that, through Barclays’ participation on a half dozen official and unofficial creditors’ committees, the firm received material, nonpublic information about the debt issuers involved. While serving on these committees, Barclays allegedly received material information concerning the financial

1 The trades in question allegedly occurred while Barclays was (i) a member of the Official Unsecured Creditors’ Committee of Galey & Lord, Inc., (ii) co-chair of the Official Committee of Unsecured Creditors of Pueblo Xtra International, Inc., (iii) chair of the Official Committee of Unsecured Creditors of Desa International, Inc., (iv) a member of the unofficial pre-bankruptcy bondholder committee for Archibald Candy Corporation, (v) a member of the unofficial pre-bankruptcy bondholder committee for Conseco, Inc. and (vi) a member of an unofficial Air 2 US committee, a leasing company related to United Airlines parent UAL Corp.
condition and prospects of the issuers, their most recent business plans, detailed management projections, contemplated financing alternatives, proprietary advisor analyses, and the timing and terms of proposed plans of reorganization. The SEC alleges that between March 2002 and September 2003, Barclays “purchased and sold millions of dollars of securities while aware of material nonpublic information . . . .”

None of the legal issues implicated in the Settlement will be tested in the courts. Barclays and Landzberg settled the proceedings for payments, respectively, of $10.9 million and $750,000. Landzberg also consented to a bar from service on any creditors’ committee in a federal bankruptcy case involving an issuer of securities.

The Settlement coincides with significant change in the debt and credit markets. Once dominated by banks and multi-service securities firms, these markets have seen an influx of new participants, including hedge funds and other “buy side” investors. For this marketplace, the Settlement signals four important lessons.

**First, through the Settlement, the SEC sounds a blunt warning for debt investors in general, and particularly for those serving as members of committees in bankruptcy cases.** The warning regarding the ability to trade while aware of material, nonpublic information involving debt securities is not new; the SEC has prosecuted insider trading cases in the debt markets since 1943. What is distinctive about the Commission’s action is the breadth of the trading activity covered. The complaint alleges that 143 separate transactions in the debt securities of six issuers were effected while Barclays had material, nonpublic information regarding the relevant issuer; the complaint fails to address the specific details of any one trade. By contrast, in another settled insider trading case announced just days before the Settlement involving the equity markets, the SEC’s pleadings addressed the specific nature of the nonpublic information involved (a corporate takeover), the materiality of the information (the target

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company’s stock price increased 34 percent after the transaction was announced) and the allegedly improper profits garnered ($3,785 by one defendant; $2,897 by the other).⁴

Members of committees in bankruptcy cases should take particular note of the Commission’s allegation that Barclays’ trading breached fiduciary and other duties of trust or confidence. In addition, the SEC complaint expressed concern that Barclays and Landzberg allegedly failed to disclose their trades to the sources of the material, nonpublic information – the creditors’ committees and issuers – or to the U.S. Trustee, U.S. Bankruptcy Courts or trading counterparties.

In a settled proceeding, the SEC is not compelled to prove each element of an insider trading violation. By looking at the final product of a settlement negotiation, it also is not possible to determine what pressures affected the outcome. Nonetheless, the broad scope of trading addressed in the Settlement could be read to mean that one principal concern for the Commission in this case was an overall failure to maintain adequate ongoing control over material information received in Barclays’ capacity as a committee member.

**Second, the Settlement underscores the critical significance of receiving material information under a confidentiality agreement.** Insider trading is a fraud-based violation. On a number of occasions, the Supreme Court has emphasized that simply receiving material, nonpublic information does not make it fraudulent (and illegal) to trade on the basis of that information.⁵ Under the misappropriation doctrine of insider trading liability, a trader commits securities fraud when he misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of that information. In endorsing this doctrine, the Court emphasized that “a fiduciary’s undisclosed, self serving use of a principal’s information to purchase or sell securities, in

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⁵ See Chiarella v. United States, 445 U.S. 222, 235 (1980) (“We hold that a duty to disclose under [Section] 10(b) does not arise from the mere possession of nonpublic market information.”); Dirks v. SEC, 463 U.S. 646, 658 (1983) (“Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.”).
breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.”

The SEC complaint and the Settlement were brought squarely under the misappropriation doctrine. The SEC’s complaint alleges that, in connection with its service on the six creditors’ committees, Barclays executed either agreements or bylaws that included confidentiality commitments. The purported material, nonpublic information allegedly was used in breach of the duties assumed by Barclays by virtue of its membership in each of these committees.

The challenge presented in the Settlement – managing the receipt of information under a confidentiality agreement – is one that appears repeatedly in the debt and credit markets (and not solely through involvement with official and unofficial creditors’ committees). A credit agreement often affords lenders access to operating information beyond that which the company has disclosed publicly; such a credit agreement routinely requires the lender to keep this information confidential. In a number of contexts, distressed issuers will wish to share material information with investors and will press to do so under a confidentiality agreement.

The Settlement reinforces that all investment staff must appreciate that, given the breadth of the misappropriation doctrine, receiving material information under a confidentiality agreement effectively restricts securities trading (unless effective procedures shield the person making the investment decision from access to the material information and, if the investor serves on a creditors’ committee, such procedures are not inconsistent with any applicable bankruptcy court trading orders). That risk can be assumed even with an oral confidentiality agreement; it need not be a formal non-disclosure agreement. The key point is that the legal risk changes dramatically when the material information is subject to any form of confidentiality agreement.

The Settlement also serves as a reminder that in bankruptcy cases, “trading orders” entered into by committee members which prohibit the sale of securities by committee members must be obeyed. For example, in connection with Barclays’ service on the Galey & Lord, Inc. Official Unsecured Creditors’ Committee, Barclays certified to the U.S. Trustee that it would not trade while serving on the committee by submitting a Creditors’ Committee Acceptance Form in that case.

*Third, the Settlement muddies the legal standing of so-called “big boy” letters in securities markets.* Big boy letters are agreements under which market participants make a business decision to move forward with a transaction with advance knowledge that one party may have undisclosed material information. In its various forms, the big boy letter typically includes an acknowledgement, among others, that: (a) the parties are sophisticated institutional investors (thus “big boys”); (b) one party may have access to material, nonpublic information that will not be shared with the other party; and (c) the counterparty is prepared to proceed with the transaction and will assert no claims relating to the counterparty’s failure to disclose the material information. The use of big boy language has evolved with little direct guidance from the courts or the SEC.

Both the SEC complaint and the related SEC Litigation Release note that, “in a few instances,” Barclays executed transactions pursuant to big boy letters. The Commission added, however, that “in no instance did Defendants disclose the material nonpublic information they received through official creditors’ committees to their bond trading counterparties.” While the SEC’s discussion is limited to one compact paragraph, two points can be drawn from this discussion: (a) the Commission and its staff structured the Settlement to address the use of big boy letters; and (b) the few transactions in which big boy letters were utilized were not excluded from those included in the SEC fraud charges.

Big boy letters should be a useful tool in enhancing marketplace liquidity. In the absence of authority directly on point, marketplace participants have operated on two common sense notions. The first is that sophisticated investors are not defrauded when they are told information will not be shared with them and proceed with the transaction
nonetheless. In fact, there are reported analogous decisions that dismiss securities fraud claims by sellers who were on notice that the purchasers would not disclose certain information.\(^7\) Second, while Section 29(a) of the Exchange Act limits contractual provisions that waive compliance with the federal securities laws,\(^8\) when a big boy letter is entered into by similarly-situated parties, it provides a contemporaneous record that should allow a regulator or a trier of fact to determine that there is no basis to conclude that anyone was defrauded in the first place.\(^9\)

It is likely that, after this Settlement, big boy agreements will continue to be used by institutional investors, particularly in credit markets involving transactions that do not involve securities. The Settlement provides scarcely any detail regarding the context surrounding those “few instances” which Barclays utilized big boy letters. Certainty is vital to securities markets; the Settlement does not enhance the certainty regarding the use of big boy letters in those markets.

**Fourth, this Settlement reminds participants in the debt and credit markets that “information barriers” must be demonstrably effective.** An information barrier allows an entity to segregate material, nonpublic information in its possession in part of its business. This segregation allows traders on the other side of the “wall” to continue to trade the securities on the premise that these procedures block those individuals making trading decisions from acting on the basis of material, nonpublic information. SEC rulemaking has sanctioned the information barrier as a defense against liability under Section 10(b) of the Exchange Act.\(^10\) Similarly, bankruptcy courts often mandate

\(^7\) See, e.g., *Jensen v. Kimble*, 1 F.3d 1073, 1077-79 (10th Cir. 1993).

\(^8\) Section 29(a) of the Exchange Act provides that “[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.” 15 U.S.C. § 78cc(a) (2007).

\(^9\) See, e.g., *Harsco Corp. v. MHC Holdings Corp.*, 91 F.3d 337, 343-44 (2d Cir. 1996).

\(^10\) See Rule 10b5-1(c)(2) (providing that an entity may demonstrate that a purchase or sale of securities was not made on the basis of material, nonpublic information if the entity demonstrates that: (i) the individual making the investment decision was not aware of the information and (ii) the entity “had implemented reasonable policies and procedures . . . to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information”). 17 C.F.R. § 240.10b5-1(c)(2) (2007).
that entities represented on creditors’ committees attest to having effective information barriers in order to preserve their capacity to continue trading the company’s securities.\textsuperscript{11} The SEC’s complaint contends that “[t]he illicit course of conduct occurred under the watch of Barclays’ senior management and Compliance Department.” That allegation is mirrored, in greater detail, in the Commission’s 2005 proceeding involving Van D. Greenfield and Blue River Capital.\textsuperscript{12} In \textit{Blue River}, the Commission alleged that a broker-dealer failed to take adequate steps to sequester information associated with service on three creditors’ committees. Specifically, the Commission claimed that an oral direction to delegate trading to another employee within a small firm with shared space did not constitute reasonable procedures to prevent the illegal use of material, nonpublic information.

As the scope of activity in the debt and credit markets widens, there is a growing circle of entities with access to market-sensitive information. The outcomes in the Settlement and the \textit{Blue River} proceeding underscore the need for every organization to be able to: (1) ensure that the institution is aware when part of the organization is receiving material, nonpublic information from a public company; (2) restrict trading while the firm is aware of this information; or, in the alternative (3) maintain and document procedures that separate the information from individuals who are charged with investment decisions; and (4) develop systems to ensure compliance with applicable bankruptcy court orders. Both settlements also provide a reminder for entities to assess how they can demonstrate that these procedures were in place and were implemented.

The law of insider trading was developed predominantly in the equity markets. The constant surveillance of equity markets makes it likely that the principal focus of future insider trading developments will be in those markets. At the same time, the Settlement

\textsuperscript{11} See, e.g., \textit{In re Refco, Inc.}, 336 B.R. 187, 196-97 (Bankr. S.D.N.Y. 2006) (discussing the underlying concern of a breach of a committee members’ fiduciary duties of loyalty and care to all unsecured creditors by profiting from, or enabling selected creditors to profit from, nonpublic information obtained as a result of committee membership), citing \textit{In re Federated Dep’t Stores}, 1991 Bankr. LEXIS 288, 1991 WL 79143 (Bankr. S.D. Ohio 1991) (recognizing ability of creditors’ committee members to trade in the debtor’s securities so long as such members institute procedures for screening personnel engaged in trading from personnel involved in committee work).

\textsuperscript{12} \textit{In re Van D. Greenfield and Blue River Capital LLC}, Exchange Act Release No. 52,744 (Nov. 7, 2005) (“\textit{Blue River}”).
demonstrates that the SEC remains committed to exporting its insider trading principles to the markets for other securities.

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