LOWENSTEIN SANDLER PC CLIENT ALERT

BANKRUPTCY, FINANCIAL REORGANIZATION & CREDITORS' RIGHTS

Attorney Advertising

"BIG BOY" LETTERS RAISE INSIDER TRADING CONCERNS IN AND OUT OF BANKRUPTCY

By: John D. Hogoboom, Esq., Sharon L. Levine, Esq. and S. Jason Teele, Esq.

June 2007

In SEC v. Barclays Bank PLC and Steven J. Landzberg, Case No. 07-04427 (S.D.N.Y.), the SEC accused Barclays Bank PLC and one of its traders of illegally trading millions of dollars of bond securities based on material non-public information obtained through Barclays' service on several different official and unofficial committees of unsecured creditors in various chapter 11 cases. The defendants recently settled the action for $10.9 million plus the defendants' consent to the entry of permanent injunctions prohibiting further violations of the Securities Act of 1933 and the Securities and Exchange Act of 1934. Barclays' use of so-called "big boy" letters did not shield it or the individual trader from insider trading charges. This enforcement action should serve as an alarm bell to all who rely on big boy letters to trade on material nonpublic information.

Although enforcement actions by the SEC against creditor committee members are rare — the first such action was brought in 1993 — the *Barclays* enforcement action calls into doubt the prophylactic benefits of the big boy letter. The SEC recognized that Barclays and the trader used big boy letters in many of the allegedly illegal transactions, but nevertheless accused the defendants of multiple Rule 10b-5 violations for failing to disclose the material nonpublic information to which they were privy prior to engaging in the trades. By implication, only the disclosure of the material nonpublic information by the defendants, a disclosure prohibited by the defendants' confidentiality agreements with the debtors, could have rendered the trades compliant with Rule 10b-5.

The Rise of Big Boy Letters

Big boy letters are agreements between buyers and sellers of securities pursuant to which one party (usually the seller) discloses that it has better information than the other party, and the parties agree to go forward with the transaction despite this information disparity and the potential impact on the value of the securities being traded. Such agreements are typically used in transactions where the seller is prohibited by fiduciary duties or confidentiality agreements from disclosing actual material nonpublic information to the other party. Big boy letters, as a means of avoiding insider trading liability, springs from the United States Supreme Court's recognition of the misappropriation theory of insider trading in its landmark ruling in *U.S. v. O'Hagan*, 521 U.S. 642 (1997). Prior to *O'Hagan*, courts recognized only the classical theory of insider trading. The classical theory of insider trading requires that before a duty to disclose arises, there must be a fiduciary duty owed by the insider to the counterparty to the trade. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). The misappropriation theory expands the classical theory by extending insider trading liability to non-insiders without any fiduciary duty owing to their trading counterpart, but with a fiduciary duty owing to another third-

Lowenstein Sandler

ATTORNEYS AT LAW

party. *See SEC v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991)("The misappropriation theory focuses not on he insider's fiduciary duty to the issuing company … but on whether the insider breached a fiduciary duty to any lawful possessor of material non-public information.").

In recognizing the misappropriation theory, the Supreme Court shifted traders' disclosure obligations away from their trading partners and toward the issuers. But an exception to the misappropriation theory renders less than all trading on material nonpublic information a violation of Rule 10b-5. In *O'Hagan*, the Supreme Court implied that a person in possession of material nonpublic information may avoid liability by disclosing his intent to trade to the company without disclosing the actual information to the trading partner. Thus the rise of big boy letters as a means to limit insider trading liability.

Committee Member Insider Trading Liability

Creditor committee members run the risk of incurring insider trading liability under the misappropriation theory. Since committee members often obtain access to confidential information regarding the details of a debtor's operations, business plans, and reorganization plans, most debtors require committee members to sign confidentiality agreements at the outset of the case and before any information is exchanged. Additionally, most creditor committee by-laws, which each member signs, provide that committee deliberations and information are confidential. Moreover, creditor committee members owe fiduciary duties to other similarly situated creditors. *See Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438, 514 (S.D.N.Y.1994); *In re First Republicbank Corp.*, 95 B.R. 58, 61 (Bankr. N.D. Tex. 1988)("A member of a creditor's committee owes a fiduciary duty to represent the interest of all creditors… ."). Clearly, committee members occupy positions of trust and confidence.

Committee members who misappropriate material nonpublic information may therefore be found to have breached their duties to the debtor as well as their fellow committee members and similarly situated creditors. *See In re Tucker Freight Lines, Inc.*, 62 B.R. 213 (Bankr. W.D. Mich. 1986)(finding that committee members violated their duties to similarly situated creditors); *SEC v. Baker*, Case No. 93-7398 (S.D.N.Y.)(charging committee member with breach of duty to the committee member's shareholders and the committee itself). To minimize the risk of such liability, many committee members rely on big boy letters when they trade in the debtor's securities.

Committee Members' Use of Big Boy Letters

To satisfy their duties, committee members seeking to trade in securities of the debtor often enter into big boy letters with their trading partners only after disclosing their intent to trade to the debtor. Trading restrictions imposed by bankruptcy courts, in many chapter 11 cases involving public companies, often provide a procedure for providing notice of intent to trade and an opportunity for the debtor to object to certain trading.

Conclusion

The jurisprudence of big boy letters will soon change again as the first case involving these agreements is set to go to trial in Texas. Nevertheless, in light of the *Barclays* enforcement action, those who use big boy letters to trade on material nonpublic information must take an even more cautious approach, after consulting with legal counsel, to ensure that their trading activity complies with all applicable trading laws, rules and other requirements, both before deciding to trade, and as the trade is being documented. ■

John D. Hogoboom *is a member of Lowenstein Sandler PC and a founding member of the Lowenstein Sandler Specialty Finance Group.*

Sharon L. Levine *is a member and* ***S. Jason Teele*** *is an associate of Lowenstein Sandler PC practicing in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Department.*

They may be reached by calling 973.597.2500 or via e-mail at jhogoboom@lowenstein.com, slevine@lowenstein.com, or steele@lowenstein.com.