

Managing Litigation and Regulatory Risks in Loan Facility Restructurings

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The process of restructuring a loan facility—if not handled properly—creates significant litigation and regulatory risks for lenders. While the degree and scope of risk depends on the specifics of each restructuring, a series of analytical steps must be taken to assess and manage these risk elements.

Loan Facility Restructuring Risks

In the typical case, once a borrower defaults on its loan facility, a restructuring unfolds on two separate tracks. The borrower and the agent for the loan syndicate start discussions to re-negotiate terms of the underlying loan, including adjusting operational and financial covenants. At the same time—and more problematic—are the discussions between the agent for the loan syndicate and its counsel, on the one hand, and with members of the loan syndicate, on the other hand. These loan group discussions include analysis of confidential information provided by the borrower about its business operations and financial results, as well the group's legal options and strategies, including litigation, foreclosure and bankruptcy.

The primary risks inherent in these restructurings fall into two broad categories: litigation and insider trading/regulatory risks. With regard to the litigation risk element, the lender group must make sure that its discussions are covered by the "common interest" privilege and are protected from disclosure. Second, the lenders need to avoid regulatory liability that may arise because, the borrower has disclosed confidential information to the agent, and in some instances, to members of the loan syndicate, in order to analyze the borrower's creditworthiness and future prospects in the course of the restructuring and in the initial loan diligence. It becomes more complicated—and presents greater risk for lenders—when the borrower's stock or debt is publicly traded, especially when lenders are part of larger financial institutions or investment funds that take positions or make investments at all levels of the borrower's capital structure.

Common Interest Privilege

Conventional wisdom has been that discussions between members of the loan syndicate are shielded from disclosure by the "common interest" privilege, a legal doctrine based on the attorney-client privilege which protects communications to the extent that there is an "ongoing common enterprise." In essence, the "common interest" privilege expands the attorney-client privilege to protect communications with non-clients who have an expectation of confidentiality because they share common problems or issues in pending or threatened civil litigation, so long as the nature of their legal interest is identical.

A recent case, *HSH Nordbank AG New York Branch v. Swerdlow*,¹ illustrates the inherent risks in these multi-party negotiations and the importance of managing the restructuring and communication process among the lender group, and between the lender group and the agent. In that case, in the course of failed loan renegotiations, the agent bank's attorney communicated directly with other lenders in the syndicate and not through their legal counsel. During discovery, the lender inadvertently produced documents that it claimed were covered by the attorney-client privilege. Although the parties had a claw-back agreement in place to protect against inadvertent disclosures of this nature, the borrower used the disclosures as leverage and challenged the assertion of privilege by arguing that the communications—made directly to the non-party lenders rather than to their counsel—were not covered by the common interest privilege.

The court, however, agreed with the lenders' position and held the discussions were protected by the common interest privilege. In reaching this conclusion, the court placed considerable emphasis on three factors. *First*, the loan agreement identified the agent bank as the only party capable of enforcing or exercising rights or remedies upon a default and contemplated that agent's counsel would represent the interests of the various lenders which, as the Court noted, "are presumed to be identical." *Second*, the lender group entered into a written common interest agreement signed by all lenders, which the court said illustrated the shared expectation of all lenders that their communications would be kept confidential. *Third*, the lenders' communications focused on their legal rights and remedies including the development and implementation of an "appropriate legal strategy for obtaining relief," even though there was some overlapping discussion of the lenders' business interests.

As was made clear by the court in *HSH Nordbank AG New York Branch*, lenders can take certain steps to manage this risk and optimize their position to successfully invoke the common interest privilege. Before doing so, however, lenders and their counsel should consider the following:

- Is there a disparity in interests between or among members of the loan syndicate so much so that there is no common interest? Senior lenders are often at odds with more junior lenders or revolving lenders given the priority of their respective security interest in the borrower's collateral. Are there safeguards in place when lender groups have disparate interests?
- Consider what happens if any party becomes a subject or target in a government investigation and the implications if the common interest agreement becomes subject to a discovery or disclosure request.
- Determine the degree to which the information the group receives can be shared by members later added to the common interest group, and whether this creates any potential conflicts (*e.g.*, do lenders want to be hostage to a requirement that the group cannot be expanded?);
- Before adding a new lender to the common interest group, determine whether the new lender shares an identity of legal interest with the group, or if instead a new lender should be represented by separate counsel and not share in the group's communications;
- Understand the effect the common interest agreement will have on future investment or divestment of interests in the borrower, and determine if it is consistent with the lender's investment objectives (*e.g.*, is a lender willing to be frozen in its position if the agreement requires that all trading cease?);

- Decide on a clear end point for obligations under the agreement (*e.g.*, how long do the lenders want their discussions and advice to remain confidential, especially if the group becomes ineffective?)

In practice, most lenders and their counsel rely upon an oral common interest understanding. It is the exception, such as in *HSH Nordbank AG New York Branch*, when parties put these in writing. While each circumstance is fact specific, as is the decision to function with an oral or written common interest agreement, lender groups generally do not use written agreements of this type to preserve the broadest flexibility and expectations of confidentiality.

Confidential Information and Regulatory Risk

The same confidential information provided to the lenders by the borrower about its business creates the potential for substantial regulatory exposure as well, and, in fact, is a dangerous double-edged sword. On the one hand, in order to perform diligence and evaluate the borrower's creditworthiness and future prospects, whether as part of the initial loan commitment or the restructuring, lenders need access to nonpublic information about the borrower and its business operations. The same information, if not properly managed, might also serve as the foundation for charges of insider trading or fraud.

The level and detail of borrower information provided to members of the loan syndicate varies based on the borrower's public equity or debt and the extent to which individual lenders, or their affiliates, have other positions in the borrower's capital structure.

In the context of a restructuring, however, where the loan facility is already in default and the lenders' risks are substantially higher, the lenders' need for more detailed borrower information is heightened. That said, even with a greater need for more granular borrower information, lenders and their counsel should consider the following:

- Make sure they understand the limitations created by all confidentiality arrangements in place with the borrower—whether in connection with the initial loan commitment or restructuring—and how they will be impacted by the attorney's contacts (*e.g.*, will the group be exposed to borrower level information and subject to different rules during a restructuring process?);
- Give clear direction to counsel (and the agent's counsel) about the information they want the attorney to obtain on their behalf (*e.g.*, do not let the attorney expand their mandate and create new limitations on a lender's ability to share non-privileged information or trade after such disclosure);
- Reconsider compliance safeguards, including whether "lock boxing" higher level borrower information is necessary to guard against insider trading exposure;
- Decide whether participation in the group is worthwhile given the level of information that may be received (*e.g.*, what seems like a great idea may simply be too limiting), and if participation is worthwhile, ensure that an effective process is put in place for group conversations.

The challenge in these circumstances is to create a process that encourages candid

discussion and analysis by the lender group but that also manages the inherent litigation and regulatory risks. There is, unfortunately, no "one-size-fits-all" process to cover all of these risk elements, rather the unique facts and circumstances of each restructuring and the composition and interests of the lender group are the governing elements. While the primary litigation and regulatory risks are highlighted here, a methodical privilege and regulatory analysis is required to design an effective process to minimize these risk factors.

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