Secured Credit/Financial Advisors & Investment Banking

Legal and Practical Issues Involving Secured Creditors and the Retention of Financial Advisors

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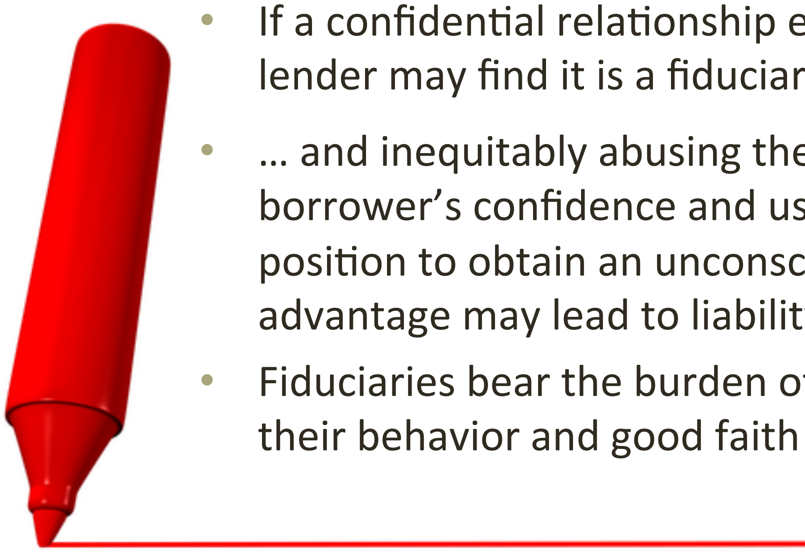
Caveat Fenerantis
Lender Beware

Lender Liability: A Refresher

- Excessive control v. reasonable enforcement
- Trust & confidence v. circumstances exceeding an ordinary commercial transaction
- Deep pockets make good targets

The Bottom Line:



- If a confidential relationship exists, the lender may find it is a fiduciary….
- … and inequitably abusing the borrower's confidence and using its position to obtain an unconscionable advantage may lead to liability
- Fiduciaries bear the burden of justifying their behavior and good faith

A Cautionary Tale

State National Bank v. Farrah Manufacturing

- Multimillion dollar judgement
- Why? Bad faith threats of contractual remedies to control borrower's management

Another Cautionary Tale

Lease & Rental Management

- By supervising payments, reducing the salary of the borrower's president, and causing the borrower to hire an accountant "chosen by the lender," the jury believed the lender had taken control of its borrower

Where Is The Line…?

- A lender may act in good faith to safeguard its interests…
- …is allowed a fair amount of latitude to do so.

How to Recommend or Retain a Financial Advisor

Financial Advisor Engaged by Debtor

- Lender "requests" it's borrower to hire a financial advisor due to underperformance or default

Practice Tips:

- A list of acceptable advisors may be *suggested* to the borrower, typically at least three
- Lender should not control the selection process
- Debtor conducts interviews and hires advisor

Loyalties

- Advisor's loyalty lies with the debtor
- The financial advisor is not the lenders spy
- Lender may rely on the work of the advisor

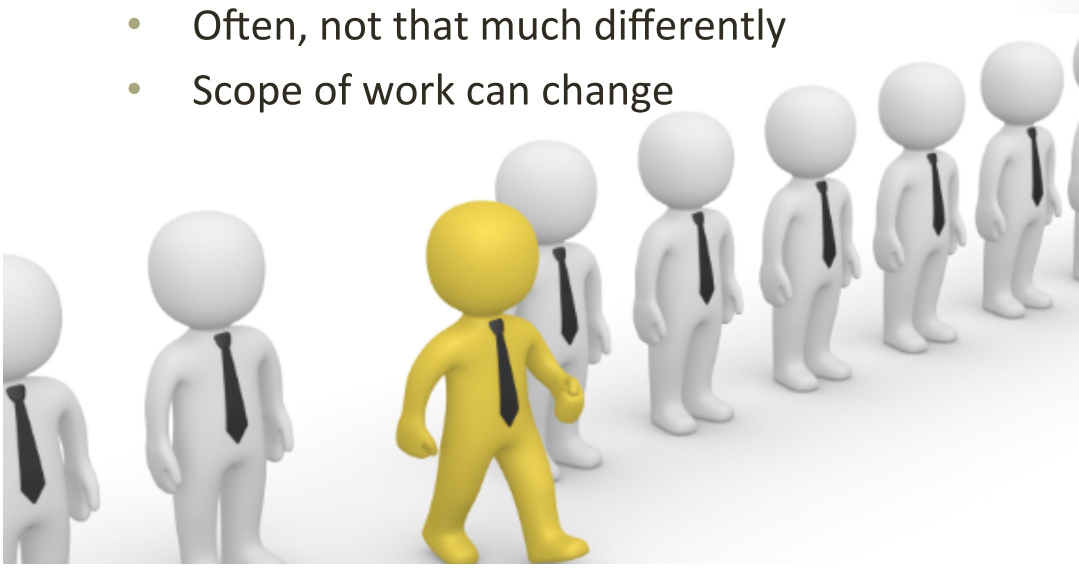
Financial Advisor Engaged by Lender

When Does a Lender Hire an Advisor?

- Concern about management integrity
- Goals diverge from the debtor’s
- Complex capital structures

How Does a Financial Advisor Operate Differently When Engaged By the Lender?

- Often, not that much differently
- Scope of work can change



What Financial Advisors Should Know:

- Who the client is
- Expectations
- Ethical responsibilities and loyalties

Employment by the Lender or Lender's Counsel?

- Working for counsel protects attorney-client and work product privileges
- Recommended when there is a bank group

Risks of Switching from Lender to Debtor's Advisor

- Disinterested?
- Conflict waivers?
- Challenges?

Legal Practice Pointers

The Basics:

- Attorney-client privilege
- Work product doctrine

The Fine Print…

- Work Product Doctrine
- Fed. R. Civ. P. Rule 26(b)
  - Trial Preparation: Materials
  - Trial Preparation: Experts

Preserving the Advisor's Privileged Status

- Manner in which advisors are retained
- Substance and nature of communications
- Expert witness testimony

Bankruptcy Considerations

- Documents created in anticipation of a case or proceeding
- Bankruptcy trustee succeeds to work product privilege

Special Scope Issues

- What is not protected?
  - Documents prepared in the ordinary course of the lender's business
  - Documents prepared to satisfy regulatory requirements
  - Factual summaries
- The common interest doctrine

Key Issues

- Waiver by disclosure / risk of disclosure to adversary
- The advisor as witness
- Memorializing the consulting advisor's dealings with debtor

Retention Arrangements

- Cost & Liability
- Confidentiality
- Control

Thank You

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Recommending or Retaining a Financial Advisor
Secured Creditor Considerations

Greg Charleston
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I. **Introduction.**

A. It has become accepted practice for a secured creditor to request or require a borrower to hire a financial advisor in situations of business underperformance and/or default

1. The secured creditor typically offers a list of financial advisors that are of acceptable and proven quality

2. The debtor interviews the advisors from the secured creditor's approved list

3. The debtor chooses the firm that is most suitable

4. The financial advisor is engaged by the debtor and performs services at the direction of the debtor

B. Under certain circumstances, the secured creditor may deem it necessary to hire a financial advisor

1. Financial advisor can be hired by the secured creditor directly or through the secured creditor's counsel

2. The financial advisor takes direction from the secured creditor or from the lender's counsel

C. In either scenario, it is important for the financial advisor to fully understand

1. Who the client is

2. The expectations that the client has for services that are to be provided

3. The ethical responsibilities and loyalties of the financial advisor can change based on whom is engaging the financial advisor and for what purpose the advisor is being engaged

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II. **Financial Advisor Engaged by the Debtor**

A. Most commonly, the financial advisor is engaged by the debtor

B. These circumstances generally arise when the debtor has performed below expectations and the secured creditor is beginning to lose confidence in management

C. Generally, the expectation is that a financial advisor will assist the debtor to develop and implement a plan to improve the financial performance of the business

D. The financial advisor is engaged by the debtor and is loyalty lies specifically with the debtor

E. The financial advisor is not expected to be a "spy" for the secured creditor nor would it be appropriate for the financial advisor to make recommendations to the debtor that were not truly in the interests of equity of the debtor or in the interest of all stakeholders of the debtor

F. Generally, what is good for the debtor is also good for the secured creditor

G. The financial advisor typically helps the debtor to restore the secured creditor's confidence and creates a "win-win" outcome

H. In most circumstances, the secured creditor relies on the work of the debtor's financial advisor

III. **Financial Advisor Engaged by Secured Creditor.**

A. When does a secured creditor hire an advisor?

1. Debtor does not have an advisor and refuses to hire one

2. Secured creditor becomes concerned about management integrity

3. Auto deals – three way agreements (Company > Bank > OEM) – lender needs a financial advocate

4. Circumstances where secured creditor's goals diverge from the debtor's goals

5. Debtor with complex capital structures

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B. How does a financial advisor operate differently when engaged by the secured creditor?

1. Often, not that much differently – the mutually beneficial goals are still the same –

2. When debtor's goals and secured creditor's goals begin to diverge, financial advisor's focus becomes assisting the secured creditor to protect collateral position

3. Can't make decisions for the company – must be careful about telling the debtor what to do or advising them

4. Scope of work can change

a. Evaluate projections and liquidity

b. Ask hard questions about cost cutting and selling non-core assets

c. Assist in analysis and negotiation of agreements with customers

d. Dig deeper and spend some time understanding company's turnaround plan

e. Evaluating value of collateral in a liquidation

f. Evaluate cost/benefit of pursuing a turnaround or restructuring plan v. liquidating

g. Advice to counsel re cash collateral, DIP Financing 363 sale process and plan process may be important

h. Expert testimony may become necessary, requiring an attempt to segregate the advisor's work as a consultant from its work as an expert.

C. Should the advisor be hired by the secured lender or through secured lender's counsel?

1. Working for counsel is better for protecting attorney-client and work product privileges

a. Recommended in adversarial situations

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b. Especially where litigation is a a reasonable possibility

2. Recommended when there is a bank group

a. Attorney can provide structure for the relationship between the financial advisor and bank group

b. Can take pressure off the financial advisor

c. Helps eliminate conflicting direction from bank group members

IV. **Switching from Advisor to Secured Creditor to Advisor to the Debtor**

A. Why would this happen?

1. This is not uncommon

a. Often, the advisor works first for the secured creditor

b. The debtor then agrees to hire its own advisor or CRO

2. The debtor has grown comfortable and confident in the secured creditor's advisor and agrees to waive a conflict of interest in order to hire the advisor directly

3. It is often more efficient to use the secured creditor's advisor rather than bring a new firm to start over from scratch

B. Risks of Switching

1. If debtor later files bankruptcy, advisor's role may be challenged in court

a. Disinterestedness test in bankruptcy

b. Other creditors or stakeholders may not be comfortable with the relationship

2. Even if debtor waives the conflict, another party could later challenge the relationship

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Practical and Legal Aspects of Retaining a Financial Advisor By Secured Creditor's Counsel

J. Mark Fisher and Michael W. Ott
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I. Introduction.

A. Financial advisors are often critical members of the secured creditor's team of advisors, providing necessary advice and financial modeling to assess and develop legal strategies devised by the secured creditor's attorneys during any workout or bankruptcy process.

B. Courts recognize the importance of financial advisors (and other technical and consulting experts) and allow parties to protect certain communications with financial advisors by extension of the attorney-client privilege and protect the output of the financial advisor under the work product privilege.

C. However, to preserve a financial advisor's privileged status, secured creditors must be mindful of the manner in which they retain the financial advisor, and the substance and nature of any communications with the financial advisor, especially if they expect the financial advisor to provide expert witness testimony.

II. Possible Retention Arrangements for Financial Advisors benefitting Secured Creditor.

A. **Factors to Consider.** There are three principal factors to consider when determining the best way to retain a financial advisor: cost, confidentiality and control. The predominance of any specific factor will inform the manner in which the secured creditor should retain a financial advisor.

B. **Reliance upon the Debtor's Financial Advisor**. If cost is the predominant concern—especially in cases where the secured creditor will not ultimately be responsible for paying all of the debtor's administrative expenses—it may make sense to rely upon the modeling and reports prepared by the debtor's financial advisor and forego retaining an independent financial advisor. However, what the secured creditor might save in cost, it will certainly lose in control over the financial advisor and the information provided. Additionally, it will be difficult to preserve the confidentiality of communications with the financial advisor except in the very rare case where the secured creditor's interests are completely aligned with those of the debtor, in which case the secured creditor and the debtor may be able to invoke the common interest doctrine, which is discussed below.

C. **Advisor Employed or Retained Directly by Secured Creditor.** If the secured creditor requires an independent financial advisor but cost remains a principal concern, it may rely upon financial modeling and advice provided by its own employees or its existing accountants or financial advisors without destroying the privileged nature of the advisor's communications and work product.[1] However, it may be more difficult to preserve the confidentiality of the financial advisor's work if he or she is also providing

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ordinary course of business advice to the secured creditor with respect to the debtor or other matters.

D. **Advisor Retained Indirectly through Secured Creditor's Counsel**. If the secured creditor needs an independent financial advisor and there are no significant cost savings associated with using an advisor already employed or retained directly by the secured creditor, the safest way to preserve the confidentiality of the financial advisor's work product and communications with the secured creditor and its attorneys is for the secured creditor's attorneys to retain the advisor.

III. **Work Product Doctrine & Rule 26(b)(3) of Federal Rules of Civil Procedure Generally**.[2]

A. **General.** The work product doctrine is a qualified privilege that protects the tangible work product created by a representative of a secured creditor that was prepared in anticipation of litigation. While the work product of a financial advisor employed or directly retained by the secured creditor is potentially covered, broader protection inures to the work product of a financial advisor retained as a consultant to counsel for the secured creditor.

1. The privilege has its origin and supports the policy of protecting the theories and mental impressions of counsel in order to foster the adversary system by promoting attorney preparation by all parties and avoiding undue interference by the threat of disclosure. Hence, the doctrine most strongly protects the thought processes, strategies and direction of counsel that is reflected in the work product.

2. Financial advisors working as consultants to, and under the direction of, a secured creditor's counsel most clearly implicate these policies and are protected. The work product privilege is limited and does not protect underlying facts, analysis created in the ordinary course of business or work product of testifying experts. It is qualified because an adversary can obtain much of the work product upon a showing of undue hardship in obtaining the same information by other means. These features are discussed below.

B. **Origins of the Work Product Doctrine**.

1. The United States Supreme Court first expressed the work product doctrine in *Hickman v. Taylor*[3], which is still viewed as providing policy guidance regarding the work product doctrine now mostly codified in Rule 26 (b)(3) of the Federal Rules of Civil Procedure (the "Rules") and state civil procedure rules and decisions.[4] In particular, *Hickman* provides additional support beyond Rule 26 (b)(3) for the special protection of attorneys' mental impressions and thought processes embodied in work product.

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2. Fed. R.Civ.P. 26(b)(3) and (4)(B) and (C) provide:

(3) ***Trial Preparation: Materials***.

(A) *Documents and Tangible Things*. Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:

(i) they are otherwise discoverable under Rule 26(b)(1); and

(ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

(B) *Protection Against Disclosure*. If the court orders discovery of those materials, it must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation.

[…]

(4) Trial Preparation: Experts.

(A) *Deposition of an Expert Who May Testify*. A party may depose any person who has been identified as an expert whose opinions may be presented at trial. If Rule 26(a)(2)(B) requires a report from the expert, the deposition may be conducted only after the report is provided.

(B) *Trial-Preparation Protection for Draft Reports or Disclosures*. Rules 26(b)(3)(A) and (B) protect drafts of any report or disclosure required under Rule 26(a)(2), regardless of the form in which the draft is recorded.

(C) *Trial-Preparation Protection for Communications Between a Party's Attorney and Expert Witnesses*. Rules 26(b)(3)(A) and (B) protect communications between the party's attorney and any witness required to provide a report under Rule 26(a)(2)(B), regardless of the form of the communications, except to the extent that the communications:

(i) relate to compensation for the expert's study or testimony;

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(ii) identify facts or data that the party's attorney provided and that the expert considered in forming the opinions to be expressed; or

(iii) identify assumptions that the party's attorney provided and that the expert relied on in forming the opinions to be expressed.

(D) *Expert Employed Only for Trial Preparation*. Ordinarily, a party may not, by interrogatories or deposition, discover facts known or opinions held by an expert who has been retained or specially employed by another party in anticipation of litigation or to prepare for trial and who is not expected to be called as a witness at trial. But a party may do so only:

(i) as provided in Rule 35(b); or

(ii) on showing exceptional circumstances under which it is impracticable for the party to obtain facts or opinions on the same subject by other means.

C. **Applicability re Bankruptcy.**

1. <u>Documents created in anticipation</u> of a bankruptcy case[5] or adversary proceeding may be protected by the work product doctrine because bankruptcy is one form of "litigation".

2. <u>Fed. R. Civ.P. 26(b)(3) is applicable in bankruptcy</u> adversary proceedings under Bankruptcy Rule 7026 and contested matters under Bankruptcy Rule 9014.[6]

3. <u>The bankruptcy trustee succeeds</u> to the right of the debtor to assert the work product privilege (similar to his standing to assert the attorney-client privilege)[7].

D. **Anticipation of Litigation vs. Ordinary Course of Business.** Whether documents were "prepared in anticipation of litigation" is the biggest determinant of protection under the work product privilege. The privilege arises at a time when there is a special interest in attorney privacy in preparing a case in the U.S. adversarial system of justice.

1. Discovery by an adversary is a legitimate concern for materials prepared when litigation could arise by or against the party, and, hence, a special need arises to protect work product from disclosure to an adversary. Litigation need not be commenced or even threatened so long as it is a contingency.[8] However, litigation can't be speculative or merely a remote or an abstract possibility.[9]

2. If the document has a dual purpose (litigation and otherwise), work product protection only arises if the prospect of litigation was a substantial factor motivating the document's preparation and the document reflects attorney mental impressions.[10] On the other hand, "ordinary course of business"

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documents are not protected because they would have been created whether or not litigation was anticipated or arose.

3. Courts balance the imminence of litigation and the degree to which attorney mental impressions are involved. Several factors might be helpful to assess whether litigation was "anticipated" at the time of preparation: (a) was the document prepared after or shortly before the filing of a lawsuit, (b) does the document identified legal issues and parties relevant to the lawsuit, (c) do contemporaneous documents indicate that the client anticipated litigation, (d) was an attorney involved in the creation or directing the creation of the document, (e) was the dominant motive for creation of the document business management, regulatory requirements or defense of litigation, (f) how closely related is the subject matter of the document to the litigation, and (g) would an attorney's mental impressions or trial preparation strategies be revealed by disclosure.

E. **Burden and Scope of Protection.** The burden of asserting work product protection lies with the proponent, who must establish each required element. The privilege is waived if the party fails to assert it in a timely manner.[11]

1. What is Protected? The work product doctrine protects documents and tangible items such as the analysis of facts, reports, lists of key witnesses or issues to be evaluated or witness statements prepared by a party representative at the direction of counsel, investigators notes,[12] charts and summaries,[13] billing records that would reflect attorney strategy,[14] drafts of reports reflecting counsel's comments,[15] spreadsheets prepared at the request of counsel,[16] documents reflecting the methodology used to evaluate data,[17] and the selection of a few documents or facts (out of many that might otherwise be discoverable) pursuant to counsel's trial strategy. Facts referred to in work product may be discoverable unless they are independently privileged (e.g., attorney-client communication), but counsel's selections of facts or analysis is protected by virtue of its relationship to trial strategy.

2. What is Not Protected? Various types of documents are not protected: purely factual summaries (particularly if they do not reflect counsel's strategy or direction), documents prepared in the ordinary course of the secured creditor's business[18] (such as internally generated financial statement "spreads" and summaries), and documents prepared to satisfy regulatory requirements regardless of whether litigation was anticipated.

   a. Factual summaries are not protected merely because they are marked "work product."[19] Email attachments are not protected merely because they are attached to a privileged document.[20]

   b. Materials prepared by, or provided to a party's testifying expert are outside the scope of work product protection.[21] Testifying experts cannot generate privileged work product because they are independent

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of a party. However, non-testifying consultants can generate privileged work product during and in anticipation of litigation.[22] The purpose of the document, rather than its title or the label of the preparer, is controlling on the issue of work product protection. To avoid close questions and heightened scrutiny, it is clearly better for a consultant's work product to be generated under the direction of attorneys for the party in litigation or anticipating litigation.[23]

c. Nonprivileged documents do not become protected merely because they are turned over to counsel or because an attorney is supervising an overall investigation.[24]

3. Special Scope Issues

a. "Opinion" work product with embedded attorney "mental impressions" receives special protection because it "shall be protected" from discovery under Fed. R. Civ. P. 26(b)(3). This could apply to the directions given for a financial advisor's investigation or the responsive report.[25] Work product containing attorney mental impressions is afforded near absolute protection.[26] This material can only be produced if there is an overriding showing of substantial need or undue hardship.

(i) Substantial need may include the need to access essential facts needed to prove the prima facie case of the requesting party and the absence of alternative sources of the information (e.g., test results that cannot be replicated, contemporaneous statements from witnesses that have died or that provide an immediate contemporaneous impression). The desire to obtain merely corroborating information is insufficient to establish substantial need or undue hardship.[27] Courts do not allow one adversary to avoid doing its own work by merely discovering its opponent's work product.

(ii) Special protection of "opinion" work product does not apply to (a) opinions used to commit fraud or a crime, (b) materials containing advice of counsel that itself is placed at issue by asserting that advice as a defense to claim (e.g., good faith reliance on counsel), (c) opinions that are more like ordinary work product because they only may be inferred from materials rather than expressly stated therein, and (d) the opinions are intentionally shown to a testifying expert.

b. Non-attorney work product mixed with legal advice can present a particular problem. In-house counsel may need to take special care because of the business-related role that they play for the secured creditor.[28] They and non-attorney consultants need to exercise care in

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preparing work product to make sure that the "anticipation of litigation" requirement is met[29] and documented, and any reference to the direction of counsel and counsel's mental impressions as noted.[30]

c. Absent "exceptional circumstances", the identity of a non-testifying consultant is protected under Rule 26(b)(4)(D) if that person is not expected to be called as a witness at trial. However, most engagements of financial advisors in bankruptcy cases expose the identity of the advisor merely because they receive information on-site or with knowledge of other parties.

F. **Preservation of Work Product Among Parties with a Common Interest.**

1. Disclosure or exchange of one party's work product to others with a common interest is not a waiver of protection.[31] Hence, work product disclosed by a creditor to a creditors' committee in a bankruptcy case[32], an ad hoc committee of bondholders or noteholders, a litigation support firm[33] or an accountant[34] or third party litigation funders[35] may remain protected. However, the shared materials must be work product to begin with and the sharing must occur in preparation for litigation.

2. No formal common interest agreement is required[36]; but it is a best practice to prepare and execute same so that the parties formally agree upon duties of confidentiality, the inability for any receiving party to unilaterally waive protection, and procedures for the return or destruction of work product when a receiving party settles or no longer has a common interest.

G. **Differences from Attorney-Client Privilege.**

1. Work Product vs. Privileged Communication. The attorney-client privilege protects confidential communications to and from an attorney in connection with rendering legal advice. While the work product privilege provides overlapping protection of advice given in anticipation of litigation, it also protects the analysis underlying that advice and covers documents that need not be communicated at all. In terms of the attorney-client privilege, the content of communications between the financial advisor and counsel or the secured creditor is more relevant than who retained the financial advisor. Only communications that are connected with the furnishing of legal advice or informing counsel to render that advice would be protected by the attorney-client privilege.

2. Whose privilege? Both client and attorney[37] can assert the work product privilege; but client's direction overrides so that the attorney cannot deny access to work product by the client.[38]

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IV. **Certain Key Issues.**

A. **Waiver by Disclosure to or Increased Risk of Disclosure to Adversary.**

1. Work product may be disseminated beyond the client or a control group thereof without losing the privilege. Hence, it can be disclosed to third parties without risk of an "implied waiver", so long as they are not adversaries in the litigation or the risk of disclosing it to litigation adversaries is not materially increased.[39]

2. Inadvertent disclosure is not an implied waiver of the work product privilege pursuant to Rule 502 of the Federal Rules of Evidence so long as the holder of the privilege took reasonable steps to prevent disclosure, the disclosure was inadvertent and the disclosing party took reasonable steps to rectify the error.[40]

3. “At issue” waiver of the work product privilege can occur if a party affirmatively injects an issue into a case, such as by raising the defense of good faith reliance on advice of counsel, and seeks to withhold work product of that counsel.[41]

4. Disclosure to a party bound by a confidentiality agreement is not a waiver.[42] However, reasonable expectations of confidentiality in reliance on confidentiality agreements with one adversary cannot prevent waiver of the privilege as to all adversaries in the litigation.[43] Thus, disclosure of work product to an adversary in settlement negotiations is a waiver of the privilege because there is no “common interest” among adversaries. [44]

5. Subject matter waiver is a possibility if certain work product on a subject is disclosed, depending on the court’s evaluation of fairness concerns that may require disclosure of all work product on that subject. Disclosure of certain work product generally is not a subject matter waiver for other documents unless the party uses the substance of the documents and testimony on a selective basis. [45] If selective disclosure of work product leads to ambiguity or misrepresents the subject, then other disclosure may be required.[46] Subject matter waiver is more likely to occur with ordinary work product (as opposed to more highly protected “opinion” work product).

B. **Financial Advisor Designated as Witness**.

1. Expert Witnesses. The work product privilege cannot exist with respect to information provided to an expert witness or the expert’s report.[47] Rule 26(b)(3) is expressly made "subject to" the ability to take discovery of experts under Rule 26(b)(4), although the latter rule was amended in 2010 to protect the exchange of drafts of the report and other communications between a party's attorney and an expert. In some instances, materials “inadvertently” disclosed to an expert will be protected, based on whether the disclosure was due to excusable neglect, the ability to provide relief from the disclosure, whether there is a serious prospect of harm to the opponent, or in the interests of justice.[48]

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2. A "Dual Hat" Financial Advisor that is a testifying expert on some issues and a consultant on other issues does not have to disclose materials reviewed solely as a consultant[49]; but policy favors disclosure if the dual consultant/expert role is blurred. Preservation of materials used in the consulting role will be evaluated based on whether they are of the same subject as the expert testimony; if so, a subject matter waiver analysis may require disclosure.[50] Using a consultant as a witness clearly creates the risk of exposure based on the court's determination of the breadth of the subject matter(s) of the consulting and expert assignments and if they overlap.

C. **Documents Memorializing the Consulting Financial Advisor's dealings with Debtor** likely would not be protected work product because of the adversarial posture of the secured creditor and debtor in a bankruptcy and because they would not likely contain attorney mental impressions, but rather only ordinary course of business activities. This would apply to (1) emails between a consultant for the secured creditor's counsel and the debtor, (2) oral discussions between the consulting financial advisor and the debtor on financial or business issues, (3) workout or settlement meetings between the debtor and secured creditor, and (4) analysis of business issues unrelated to litigation or instructions of counsel.

D. **Documents Memorializing the Consulting Financial Advisor's** meetings with the secured creditor without the presence of counsel during, or in anticipation of a bankruptcy may be protected if they related to the instructions of counsel. A similar result would apply to meetings with similarly situated secured parties who agreed to keep the communications "confidential" and not disclose them to third parties, such as the debtor. A joint interest agreement providing for confidentiality would be helpful.

1. Retention of a consulting financial advisor by counsel to the Agent of the Bank Group may have other benefits. Members of the bank group are less likely to press a consulting financial advisor for independent information at the meetings when counsel is not present or in one or more informal inquiries.

V. **Practice Pointers.**

A. **Documented Anticipation of Litigation**. Since the work product privilege is dependent upon "anticipation of litigation", the pendency or prospect of a bankruptcy case or creditors' rights litigation should be expressly mentioned as the principal motivation for the engagement and the scope of services.

B. **Conflict Check.** The financial advisor must perform a conflict check regarding the debtor(s), their affiliates, any major unsecured creditors identified by the secured creditor and any known potential buyers of the debtor.

C. **Description of Scope of Services**. A well-defined scope of work is very important to assure the financial advisor is performing services that tie into the anticipated litigation. Indeed, to enhance the work product protection regardless of whether the financial adviser is retained by counsel, it should perform only those services directed by the

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secured creditor's attorney. Hence, the financial advisor will be generating protected work product based on the attorney's mental impressions and advice. Since other services beyond the initial scope of work may not be protected, it is important to have open-ended coverage for "other work requested from time to time by counsel orally or in writing". Of course, a well-crafted scope of work also will avoid billing disputes for unrequested work when the secured creditor gets the bill

D. **Anticipation of Dual Status and Organization of Work Product with View to Potential Testimony**. At the outset of the engagement, it is important to determine which subject matter(s) within the scope of the financial advisor's duties will be the subject of mere consultancy or expert testimony. There is also the potential that a consultancy will turn into expert testimony. In any event, if the work product for the consultancy is not separately defined and then carefully segregated, the presumption in favor of disclosing a testifying expert's work product will likely lead to the waiver of the work product privilege on the consulting subjects.

E. **Work Plan and Budget**. Surprise billing and extraneous work can be avoided if the financial advisor prepares and adheres to a work plan with regular checkpoints for communication of status and results to the secured creditor and its counsel. Regular communication will also limit ad hoc requests for work and results from members of a bank group or ad hoc committee that can run up the bill and cause the financial advisor's work to deviate from the plan devised by counsel and potentially impair work product protection.

F. **Limitation on Disclosure of Work Product**. It is important for the financial advisor to agree to preserve the confidentiality of the instructions received from the attorney and the work product generated. Otherwise, the work product privilege may be waived by any disclosure that materially increases the likelihood of disclosure to the debtor or another adversary of the secured creditor. Alternatively, the financial advisor's work product will not be protected because it does not reflect the attorney's instructions. Direct communications between a financial advisor and members of a bank group or members of an ad hoc committee of bondholders or noteholders should be limited or at least be defined to protect the work product privilege as well as prudent control of the fruits of investigation, group dynamics and control of the fees and costs of the financial advisor. All parties receiving the financial advisor's work product must be cautioned to avoid steps that may allow adversaries to obtain it.

G. **Communication and Interaction with Debtor and Other Parties in Interest**. The financial advisor working on site must take care not to inject himself or herself too deeply in the debtor's business activities or financial reporting. This activity lies outside the work product protection and is discoverable. More importantly, it exposes the secured creditor to liability possible for control of the debtor and damages if the subject decisions are faulty.

H. **Confidentiality of Debtor's Records**. It is important for the financial advisor to agree to preserve the confidentiality of the debtor's records. Otherwise, the secured creditor

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may be violating its duty to preserve the confidentiality of debtor's records under its loan agreements or under state or federal law or regulations.

I. **Modification of Financial Advisor's Form Engagement Letter.** When counsel for the secured creditor receives the draft engagement letter for counsel's retention of the financial advisor as a consultant it often must revise a document normally used when the financial advisor is retained by the secured party or debtor. Close review may be required to revise the draft to implement the foregoing Practice Pointers and the following:

1. Disclosure of Secured Creditor as Principal Solely Obligated to Pay. Since most form engagement letters assume that the firm retaining the financial advisor will be paying the financial advisor's bills, they must be revised when the retention is by the attorney for the secured creditor. The secured creditor must be disclosed as the secured creditor that will be solely responsible to pay the invoices of the financial advisor. The financial advisor may wish to obtain a separate letter from the secured creditor acknowledging its obligation to pay the invoices for the engagement.

2. Submission and Payment of Advisor's Invoices to Secured Creditor. The engagement letter should also provide that the financial advisor's invoices will be submitted directly to the secured creditor, with a copy to the attorney. This will not waive any work product but will make it clear that the attorney is not liable for the invoices.

3. Indemnification by Secured Creditor vs. Exculpation. The financial advisor's form engagement letter frequently includes a broad indemnification. While such an indemnification makes sense in connection with the retention of financial advisors by the debtor, it is less appropriate when the financial advisor is representing the secured creditor or its counsel. The financial advisor should not be engaging in activities that might amount to "control" of the debtor or that would otherwise expose the financial advisor to liability to third parties. It is never appropriate for the attorney for the secured creditor to indemnify the financial advisor. However, an exculpation of the financial advisor and its employees and officers from liability to the secured creditor, members of the bank group or any ad hoc committee of noteholders or bondholders would be appropriate, provided that there are carveouts for fraud, gross negligence or intentional misconduct.

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Endnotes

[1] *See, e.g.*, *In re Hardwood P-G, Inc.*, 403 B.R. 445, 458-59 (Bankr. W.D. Tex. 2009) (rejecting argument that financial advisor's report cannot be privileged if the financial advisor was hired by the debtors and not their counsel); *In re FiberMark, Inc.*, 330 B.R. 480, 499 (Bankr. D. Vt. 2005) (citing *In re Kovel*, 296 F.2d 918, 922 (2d Cir. 1961)); *In re Tri State Outdoor Media Grp., Inc.*, 283 B.R. 358, 362-63 (Bankr. M.D. Ga. 2002).
[2] Several sets of materials discuss the work product privilege, which is not often the subject of decisions of courts in bankruptcy matters. See, J.W. Gergacz, ATTORNEY-CORPORATE CLIENT PRIVILEGE 3D (Fall 2005 Ed.) §§ 4:35-4:36, 7:1-7:88;WRIGHT, MILLER, MARCUS, FEDERAL PRACTICE AND PROCEDURE (3D ED.2015) §§2020-2028.
[3] 329 U.S. 495, 67 S. Ct. 385 (1947).
[4] For example, most states, including Delaware, have adopted procedures modeled after the Federal Rules of Civil Procedure but may invoke a different test for the application of the work product doctrine. E.g., *Gonzalez v. Caraballo, 2008 WL 4902686 (Del. Super. Ct. 2008).* Illinois state rules only protect attorney opinion work product. *Depositors Ins. Co. v. Canal Ins. Co.*, No. 2-12-1410, 2013 WL 5509108 at *3 (Ill. App. Ct. 2d Dist., Oct. 1, 2013). New York state rules absolutely protects attorney work product but provides only qualified protection for the work product of non-attorneys. CPLR 3101 (C), (D); *Bloss v. Ford Motor Company*, 126 A.D.2d 804, 510 N.Y.S.2d 304 (3d Dept. 1987).
[5] E.g., *In re Superior Nat. Ins. Gr.*, 518 B.R. 562 (Bankr. C.D. Cal. 2014); *In re McDowell, 483 B.R. 471 (Bankr. S.D. Tex. 2012); cf. Coyle v. Coyle*, 538 B.R. 753 (C.D. Ill. 2015) (worksheets for bankruptcy schedules).
[6] Fed. R. Bankr. P. 7026, 9014.
[7] *In re Hardwood P-G, Inc.*, 403 B.R. 445 (Bankr. W. D. Tex. 2009); *In re Equaphor Inc.*, 2012 WL 1682583 (Bankr. E.D. Va. 2012).
[8] *United States v. Aldman,* 134 F.3d 1194 (2d Cir. 1998) (protects counsel's evaluation of litigation that might arise from closing a business transaction).
[9] *In re Grand Jury Proceedings*, 604 F.2d 798 (3d Cir. 1979) (some prospect of litigation is sufficient); *Burlington Industries v. Exxon Corp.*, 65 F.R.D. 26 (D.M.D. 1974) (litigation is a contingency). Some courts require a more imminent or identifiable prospect of litigation.
[10] *Burlington Indus.,* 65 F.R.D. at 42.
[11] *Toledo Edison Co. v. G.A. Technologies, Inc.,* 847 F.2d 335 (6th Cir. 1988).
[12] *F.T.C. v. Hope Now Modifications, LLC*, 2011 WL 2634029 (D.N.J. 2011).
[13] *Johnson v. Teledyne Industries, Inc*., 1996 WL 507282 (N.D. Ill. 1996).
[14] *Nesse v. Pittman*, 202 F.R.D. 344 (D.D.C. 2001).
[15] *Id*.
[16] *Sher v. Barclays Capital Inc*., 2013 WL 3279801 (D.Md. 2013).
[17] *U.S. v. Duke Energy Corp.,* 208 F.R.D. 553 (M.D.N.C. 2002).
[18] *U.S. v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982); *Thomas Organ Co. v. Jadroanska Sloboda Plovida,* 54 F.R.D. 367 (N. D. Ill. 1972) (investigator's reports prepared by a non-attorney that have not been requested by counsel or prepared for counsel and do not reflect counsel's legal expertise are conclusively unprotected); *contra, Spalding v. Denton*, 608 F.R.D. 342 (D. Del. 1975) (non-attorney's work product created in anticipation of litigation is protected without any involvement by counsel).
[19] *Coltec Industries, Inc. v. American Motorists Ins. Co.,* 197 F.R.D. 368, 373 (N.D. Ill. 2000).
[20] *Mold-Masters Ltd. v. Husky Injection Molding Systems Ltd*., 2001 WL 1558303 (N.D. Ill. 2001).
[21] *Republic of Ecuador v. MacKay*, 742 F.3d 860 (9th Cir. 2014); Fed. R. Civ. P. 26(b)(3).
[22] *American Buildings Co. v. Kokomo Grain Co., Inc.*, 506 N.E.2d 56 (Ind. Ct. App. 1987).
[23] *Largan Precision Co., Ltd. v. Genius Electronic Optical Co., Ltd.,* 2015 WL 124557 (N.D. Cal. 2015).
[24] *Allied Irish Banks v. Bank of America, N.A.*, 240 F.R.D. 96 (S.D.N.Y. 2007); *Urban Box Office Network, Inc. v. Interfase Managers, L.P.*, No. 01 CIV. 8854 LTS/THK, 2006 WL 1004472, at *3 (S.D.N.Y. Apr. 18, 2006) (containing an excellent discussion of various documents that are and are not protected).
[25] See, e.g., *In re Cendant Corp. Securities Litigation*, 343 F.3d 658 (3d Cir. 2003) (litigation consultant's advice was based on information disclosed in private mediations between client, client's litigation attorney and consultant).
[26] *In re Seagate Tech., LLC*, 497 F.3d 1360, 1375 (Fed. Cir. 2007).

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[27] *Director, Office of Thrift Supervision v. Vinson & Elkins, LLP*, 124 F.3d 1304 (D.C. Cir. 1997).
[28] *Anastasi v. Fidelity National Title Insurance Co*., 341 P.3d 1200 (Hawaii Ct. App. 2014).
[29] *Canel v. Lincoln National Bank,* 179 F.R.D. 224 (N.D. Ill. 1998).
[30] *Sandberg v. Virginia Bancshares, Inc.,* 979 F. 2d 332, 356 (4th Cir. 1992) (in-house counsel's notes of a board meeting).
[31] *Castle v. Sangamo Weston, Inc*., 744 F.2d 1646 (11th Cir. 1984).
[32] *In re Superior Nat. Ins. Gr.*, 518 B.R. 562 (Bankr. C.D. Cal. 2014).
[33] *Compulit v. Banctec, Inc.,* 177 F.R.D. 410 (W.D. Mich. 1997).
[34] *In re Latin Inv. Corp.* 160 B.R. 562 (Bankr D.D.C. 1993).
[35] *Grochocinski v. Mayer Brown Rowe & Maw LLP,* 251 F.R.D. 316 (N.D. Ill. 2008).
[36] *Chamberlain Mfg. Corp. v. Maremont Corp*., 1993 WL 625511 (N.D. Ill. 1993).
[37] *In re Grand Jury Proceedings*, 604 F.2d 798 (3d Cir. 1979).
[38] *Polin v. Wisehart & Koch*, 2002 WL 1033807 (S.D.N.Y. 2002).
[39] *Coyle v. Coyle*, 538 B.R. 753 (C.D. Ill. 2015) (individual chapter 7 debtor and counsel waived work product and attorney-client privilege by producing, without redaction or disclosure restriction, worksheets for bankruptcy schedules and detailed attorney billing records to chapter 7 trustee, who disclosed them to plaintiff in discharge litigation).
[40] Fed. R. Evid. 502.
[41] *Colan v. Cutler-Hammer, Inc.,* 1983 U.S. Dist LEXIS 13523 (N.D. Ill. 1983); *Panter v. Marshall Field & Co*., 80 F.R.D. 718 (N.D. Ill. 1978).
[42] *Cellco Partnership d/b/a/ Verizon Wireless v. Nextel Communications, Inc.,* 2004 WL 1542259 (S.D.N.Y. 2004).
[43] *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414 (3d Cir. 1991).
[44] *In re Grand Jury Subpoenas Dated December 18, 1981,* 561 F. Supp. 1247 (E.D.N.Y. 1982).
[45] *Remington Arms Co. v. Liberty Mutual Insurance Co.*, 142 F.R.D. 408 (D. Del. 1992).
[46] *Hartz Mountain Indus., Inc. v C.I.R.,* 1989 WL 128568 (1989) (subject matter waiver found); *In re Hechinger Inv. Co. of Delaware,* 303 B.R. 18 (D. Del. 2003) (no waiver from inadvertent disclosure because no unfairness).
[47] *In re Tri State Outdoor Media Grp., Inc.*, 283 B.R. at 365.
[48] *Simon Property Group L.P. v. mySimon*, 194 F.R.D. 644 (S.D. Ind. 2000).
[49] *Yeda Research and Dev. Co., Inc. v Abbott GmbH & Co.KG,* 929 F.R.D. 97 (D.D.C. 2013) (dual-role expert must produce all materials except those uniquely tied to consulting role).
[50] *S.E.C. v. Reyes*, 2007 WL 963422 (N.D. Cal. 2007).

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Legal and Practical Issues Involving Secured Creditors and the Retention of Financial Advisors

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I. LENDER LIABILITY PRINCIPLES APPLICABLE TO ENGAGEMENT OF FINANCIAL ADVISORS

A. Lender liability can result from a lender's breach of common law. One such scenario is where a lender exercises "excessive control" over its borrower's affairs, in which case it may be held liable to the borrower or third parties for damages and/or could find its claims subject to disallowance, equitable subordination, or avoidance.

B. "Control" is more than negotiating leverage, whether that leverage is economic (*e.g.,* the lender will not provide financing unless the debtor engages an advisor) or embodied in provisions of the loan documents (*e.g.,* provisions requiring a debtor to hire an advisor in the event of default).[1] A lender will likely be exonerated if acting strictly within the terms of its loan agreement—as long as its actions are "reasonable." It is the lender's actions with respect to the loan agreement's provisions and remedies—not their mere existence—that may form a basis for liability.[2]

C. Ordinarily the relationship between a bank and its borrower is one of creditor/debtor, subject to a duty of reasonable care and simple negligence standards. However, if there is a relationship of "trust and confidence" between bank and customer, a fiduciary obligation may be imposed.[3]

D. When is such a "confidential" relationship created? When the borrower places trust in the lender, with resulting superiority and influence being exercised by the lender over its borrower.[4] Put differently, does the lender have reason to know that its customer

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1 *See Cosoff v. Rodman (In re W.T. Grant Co.),* 699 F.2d 599, 609-10 (2d Cir. 1983) (within the parameters of preference and fraudulent transfer laws, "there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims").

2 For an extensive discussion of how courts have viewed the lender's obligation of good faith and fair dealing and how relatively infrequently they have imposed liability based on its breach, *see* A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 Fordham L. Rev. 963 (1993).

3 *See, e.g., Bear Stearns & Co. v. Daisy Sys. Corp. (In re Daisy Sys. Corp.),* 97 F.3d 1171, 1177-79 (9th Cir. 1996); *Kottler v. Deutsche Bank AG*, 607 F. Supp. 2d 447, 465 (S.D.N.Y. 2009) ("In determining when a fiduciary relationship exists, 'New York courts conduct a fact-specific inquiry into whether a party reposed confidence in another and reasonably relied on the other's superior expertise or knowledge.'" (citation omitted)).

4 *See, e.g., Sallee v. Fort Knox Nat'l Bank, N.A. (In re Sallee)*, 286 F.3d 878, 892-93 (6th Cir. 2002); *Am. Bank Ctr. v. Wiest*, 793 N.W.2d 172, 183 (N.D. 2010) ("a fiduciary relationship may arise under circumstances which reflect a borrower's reposing of faith, confidence and trust in a bank with a resulting domination, control or influence exercised by the bank over the borrower's affairs" (internal quotation marks and citations omitted)).

has placed its trust and confidence in the bank under "circumstances exceeding an ordinary commercial transaction"?[5]

E. If a confidential relationship exists between lender and borrower, the lender may find itself in the position of a fiduciary.[6] That alone will not create liability.

1. The lender may be found liable, however, for breaching its fiduciary duty—such as by inequitably abusing the borrower's confidence and wrongfully using its position of superiority in order to obtain an unconscionable advantage over the borrower.[7]

2. A lender may also held liable to a borrower or third party even if it does not take advantage of a confidential relationship. A lender's actions that result in harm to the borrower or its creditors, coupled with a finding that the lender controlled or dominated the borrower, may lead to a finding of lender liability.[8]

II. TRUST AND CONFIDENCE: THE SELECTION OF ADVISORS

A. Applying these basic principles to the employment of financial advisors and appointment of a Chief Restructuring Officer, one can easily see the dangers. A lender that takes control of management—perhaps by threatening to enforce remedies or declining to enter into a forbearance agreement unless an "acceptable" CRO or financial advisor is appointed—risks exposure to causes of action for damages resulting from its exercise of control.

B. For example, in *State Nat'l Bank v. Farah Mfg. Co.,* a loan agreement provided that a change in management would constitute an event of default if the lender considered the change to be adverse to its interests. That clause alone did not give rise to liability. Rather, liability was found based on evidence presented at trial demonstrating that the lender caused its borrower to believe that it would accelerate the loan and force the company into bankruptcy if management unacceptable to the lender was installed. Once a CEO acceptable to the lender was installed, the CEO and lender-approved board proceeded to auction off the borrower's assets. When the former CEO regained control of the company following the auction, the company successfully claimed that the lender had installed incompetent management, prevented the election of competent management, and caused losses and damage to the borrower's business, resulting in a multimillion dollar judgment against the lender. What tripped this lender up? Bad faith

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5 *Jaffe v. Bank of Am., N.A.*, 667 F. Supp. 2d 1299, 1319 (S.D. Fla. 2009), *aff'd,* 395 F. App'x 583 (11th Cir. 2010).

6 See William H. Lawrence, *Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing*, 62 S. Cal. L. Rev. 1387, 1426-30 (1989), for a discussion of the nature of control exercised by so-called "relational" lenders (those whose relationship with their borrowers is highly interactive) and the inherent fiduciary obligations.

7 *See Hoffman v. Lincoln Nat'l Bank & Trust Co*., 636 N.E.2d 185, 188 (Ind. Ct. App. 1994).

8 *See* Richard E. Kaye, *Lender Liability Litigation: Undue Control,* 139 Am. Jur. Trials 103 (2015).

threats to exercise contractual remedies in order to control the borrower's management.[9]

C. In *Melamed v. Lake County Nat'l Bank*, the lender was found liable both to the borrower for losses it suffered and to the borrower's customer for misrepresenting the borrower's financial condition. How? By supervising payments, reducing the salary of the borrower's president, and causing the borrower to hire an accountant "chosen by the lender," all of which, in the eyes of the jury, meant that the lender had taken control of its borrower.[10]

III. LENDER LIABILITY POST-BANKRUPTCY

A. After the borrower files for bankruptcy, the risks to a lender exercising "domination and control" increase exponentially.

B. First, prepetition paydowns on the loan—reaching back four years or more—may be found to be fraudulent transfers made with actual intent to defraud, with the lender's intent imputed to the debtor.[11] The New York district court *In re Adler, Coleman Clearing Corp.* identified four scenarios where the transferee/lender's position to dominate or control is such that imputation of intent may be appropriate, one of which is when the transferee is the debtor's fiduciary.[12] Importantly, the lender's superior bargaining position alone does not justify imputation of its intent to the debtor; there must also be tangible evidence of domination and control.[13]

C. Second, the lender may be deemed an insider for purposes of extending the preference reach-back to one year.[14] Section 101(31)(B) defines "insider" to include a "person in control of the debtor." In determining whether a lender had the requisite level of control to be considered an insider, courts examine "whether the creditor had more ability to assert control than the other creditors, whether the creditor made

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9 678 S.W.2d 661 (Tex. Ct. App. 1984) (writ granted, judgment set aside, cause dismissed); *see also Credit Managers Ass'n v. Superior Court*, 124 Cal. Rptr. 242, 246-47 (Cal. Ct. App. 1975) (complaint adequately pled breach of fiduciary duty where it alleged bank compelled debtor to hire business consulting company that grossly mismanaged debtor, leading to its insolvency).

10 727 F.2d 1399, 1403-04 (6th Cir. 1984); *see also Cent. States Stamping Co. v. Terminal Equip. Co*., 727 F2d. 1405 (6th Cir. 1984) (after bank provided information regarding debtor's creditworthiness to creditor/purchaser who relied on it, bank held liable for failure to disclose debtor's financial instability).

11 *See* Bankruptcy Code Sections 548(a)(1)(A) & 544(b) and state law fraudulent transfer laws.

12 *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.),* 263 B.R. 406, 447-48 (S.D.N.Y. 2001).

13 *See e.g., Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings Inc.),* 541 B.R. 551, 576 (S.D.N.Y. 2015) (bank's "strong financial leverage" over debtor held insufficient to establish domination/control for purposes of imputing intent; showing of "*actual control"* required (emphasis in original)); *Andrew Velez Constr., Inc. v. Consol. Edison Co. (In re Andrew Velez Constr., Inc.),* 373 B.R. 262, 269-70 (Bankr. S.D.N.Y. 2007) (creditor's "economic stranglehold" over debtor did not justify imputation, where creditor and debtor at all times maintained arms-length relationship).

14 *See* Bankruptcy Code Section 547(b)(4)(B).

management decisions for the debtor, directed work performance, and directed payment of the debtor's expenses."[15]

D. Third, the lender may be deemed an insider for purposes of determining whether its claim should be equitably subordinated. One prerequisite to equitable subordination is a showing that the creditor engaged in "inequitable conduct."[16] Notably, the courts' "scrutiny for presence of inequitable conduct is more stringent with respect to creditors who are insiders of the debtor, . . . as opposed to ordinary creditors. In such cases, a breach of fiduciary duty or even mere engagement in conduct that is 'somehow unfair' on the part of the insider may constitute inequitable conduct."[17]

E. In determining whether a creditor is an "insider" for purposes of equitable subordination, courts have considered wide ranging factors, including whether the creditor: (i) received information from the debtor not available to other creditors, shareholders and the public; (ii) attempted to influence decisions made by the debtor; (iii) selected new management for the debtor; (v) had special access to the debtor's premises and personnel; (v) was the debtor's sole source of financial support; and (vi) generally acted as a joint venturer or prospective partner with the debtor rather than an arms-length creditor.[18]

F. Here again, a strong showing of domination and control has been held necessary. Courts have ruled that, to be an insider, the lender must "exercise sufficient authority over the corporate debtor so as to unqualifiably dictate corporate policy and the disposition of assets."[19] In *In re Clark Pipe & Supply Co.*, for example, the Fifth Circuit held that the lender was not an insider – even though it exercised "potent leverage" over the debtor – where it did not have "total control" over the debtor's activities.[20]

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[15] *Shubert v. Lucent Techs. Inc. (In re Winstar Commc'ns, Inc.)*, 348 B.R. 234, 279 (Bankr. D. Del. 2005) ("*There must be day-to-day control, rather than some monitoring or exertion of influence regarding financial transactions in which the creditor has a direct stake.*" (emphasis in original)) (citing cases), *aff'd,* No. 01 01063 KJC, 2007 WL 1232185 (D. Del. Apr. 26, 2007), *aff'd in part, modified in part,* 554 F.3d 382 (3d Cir. 2009).

[16] *Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692, 700 (5th Cir. 1977).

[17] *Official Comm. of Unsecured Creditors v. Blomen (In re Hydrogen, LLC),* 431 B.R. 337, 361 (Bankr. S.D.N.Y. 2010) (citations omitted).

[18] *See Pan Am Corp. v. Delta Air lines, Inc.,* 175 B.R. 438, 500 (S.D.N.Y. 1994) (collecting cases); *see, e.g., Nisselson v. Softbank AM Corp. (In re MarketXT Holdings Corp.)*, 361 B.R. 369, 387-88 (Bankr. S.D.N.Y. 2007) (trustee stated viable claim for equitable subordination by alleging that defendant/bank held two seats on debtor's board, controlled board's ability to obtain quorum, had significant rights as preferred stockholder, and used these powers to its advantage and to the disadvantage of other creditors).

[19] *Official Unsecured Creditors Comm. v. Citicorp N. Am., Inc. (In re Aluminum Mills Corp.),* 132 B.R. 869, 894 (Bankr. N.D. Ill. 1991); *see also Lehman,* 541 B.R. at 582.

[20] 893 F.2d 693,702 (5th Cir. 1990) ("At all material times [debtor] Clark had the power to act autonomously and, if it chose, to disregard the advice of [lender] Associates; for example, Clark was free to shut its doors at any time it chose to do so and to file for bankruptcy."); *see also Badger Freightways, Inc. v. Cont'l Ill. Nat'l Bank (In re Badger Freightways, Inc.),* 106 B.R. 971, 977 (Bankr. N.D. Ill. 1989) ("If the lending institution usurps the power to make business decisions from the customer's board of directors and officers, then it must also undertake the fiduciary obligation that the officers and directors owe the corporation (and its creditors). This

IV. WHAT CAN A LENDER DO TO SAFEGUARD ITS INTEREST?

A. Courts generally will not impute control of a borrower, or impose liability, where a lender has merely acted in good faith to safeguard its interests. And lenders should be allowed a fair amount of latitude to do so.[21]

B. While this is good news for a lender, there is no bright line test that can be applied. Whether the relationship between the lender and debtor is one of trust and confidence, and whether the lender exercised control over its borrower in a way that abused such trust and confidence, are uniquely fact specific issues that must be decided based on the totality of circumstances.

C. Against that backdrop, it is common practice for lenders to require that a debtor engage a financial advisor, or perhaps appoint a Chief Restructuring Officer, in an effort to safeguard their interests and as a precondition to providing financing or agreeing to forebear in the enforcement of remedies. A lender may go so far as to provide a list of financial advisors or CROs that would be acceptable, and to "suggest" that the borrower interview those firms. Requiring that the borrower hire a specific firm, or be limited to that list, is clearly asking for trouble. Making "suggestions"—as opposed to "demands"—may not be enough to avoid liability either. Everything must be considered in context.

V. ISSUES ARISING WHEN A FINANCIAL ADVISOR "FLIPS" FROM RETENTION BY THE SECURED CREDITOR TO RETENTION BY THE DEBTOR

A. If a lender benefits from misrepresentations it made to a borrower, it may be held liable on a constructive fraud theory. It may even be held liable for a failure to disclose information or for negligently representing inaccurate facts. These cases are based on the lender's relationship to the borrower and again arise where there is trust and confidence. And while a lender may not have a duty to disclose information, once it does so with knowledge that the borrower will rely on that information, it must represent the facts accurately. With that in mind, another question that a lender must ask itself is whether, if the borrower hires the lender's financial advisor, it has created a relationship of trust and confidence such that the lender will become responsible for the information that its former financial advisor provides to the borrower, and/or responsible to provide additional information to the borrower?

B. Choosing Sides: Thorny Issues of Disinterestedness.

1. Lenders should also carefully think through their end game, as the Bankruptcy Code does not welcome team changes. The debtor may employ a financial advisor under Section 327(a) only if the advisor does not hold or represent an

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reasoning also dictates the scope of the term 'control.' What is required is operating control of the debtor's business, because only in that situation does a creditor assume the fiduciary duty owed by the officers and directors.").

[21] *See, e.g., W.T. Grant,* 699 F.2d at 610 (lender entitled to keep "careful watch" over borrower).

interest adverse to the estate, and is a "disinterested person." Section 101(14) defines a "disinterested person" as one who "is not and was not, within two years before the date of the filing of the petition, a director, officer or employee of the debtor." Thus, for example, a Chief Executive Officer appointed pre-filing at the behest of the lender cannot be retained as the postpetition CRO under Section 327(a) because he is not disinterested. Neither would he likely qualify for employment under Section 327(b) because a CRO may not be seen to be "regularly employed."

2. One solution is to employ the CRO himself under Section 363, with the CRO's firm employed under Section 327.[22] There remains, however, an uneasy and possibly fragile tension between the use of Section 363 as a work around and the obligation to comply with the provisions of Section 327(a) and 101(14).[23]

3. Another question that can arise is whether a CRO can, in good faith, carry out the fiduciary responsibilities of a trustee—which include the avoidance of conflicts of interest and the appearance of impropriety, and the obligation to treat all parties fairly and maximize estate value—when formulating a Chapter 11 plan. In *In re Coram Healthcare Corp.*, for example, a Delaware bankruptcy court held that because the debtor's chief executive officer was also being paid as a consultant by one of its largest creditors, the resulting conflict of interest meant that the debtor could not satisfy the Bankruptcy Code's "good faith" requirement for confirmation of its plan.[24]

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[22] The procedure of employing a CRO under Section 363 is often referred to as the "Jay Alix Protocol," after an agreement between the U.S. Trustee for Region 3 and Jay Alix & Associates in the *Safety-Kleen Corp.* bankruptcy case. One of the protocol's provisions requires the CRO to make disclosures akin to those required under Fed. R. Bankr. P. 2014(a) (listing all connections to debtor, creditors, other parties in interest) as a condition of the engagement and to continue to supplement such disclosures.

[23] *See, e.g., In re Blue Stone Real Estate, Constr. & Dev. Corp.,* 392 B.R. 897 (Bankr. M.D. Fla. 2008) (refusing to authorize employment of CRO under Section 363 where CRO, certified public accountant, was a "professional" within the meaning of Section 327(a)) ("The two main purposes of section 327 are to permit the Court to control administrative expenses in the form of professionals' compensation and ensure that the professional is conflict free and impartial. Absent such judicial oversight and the opportunity for continuing party-in-interest scrutiny of both a professional's retention and compensation, these important goals of the Bankruptcy Code cannot be met."); *compare In re Copenhaver, Inc.,* 506 B.R. 757, 765 (Bankr. C.D. Ill. 2014) (authorizing employment of debtor's former president as its CRO under Section 363(b) based on "unique and compelling circumstances").

[24] 315 B.R. 321, 327 (Bankr. D. Del. 2004).