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ETHICAL IMPLICATIONS OF DELEGATING RECEIPT OF MATERIAL NONPUBLIC INFORMATION TO ATTORNEYS

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Ethical Implications of Delegating Receipt of Material Nonpublic Information to Attorneys

I. Dealing with the Restrictions Imposed by Material Nonpublic Information ("MNPI") – "Big Boy" Letters and Delegation to Legal Advisors

A. Becoming Restricted. Holders of bank or public debt of a distressed debtor often execute confidentiality agreements with the debtor in order to receive MNPI necessary to take an active role in a proposed restructuring of the debtor's finances and business. The confidentiality agreement usually requires the creditor to acknowledge that it may receive MNPI during the course of negotiations. Under federal securities laws, receipt of such MNPI may restrict the ability of the creditor to trade in the debtors' securities. See, e.g., Martin Bienenstock, *Advanced Distressed Debt Lesson: MNPI and NDAs: The Alphabet Soup of Getting Restricted*, DISTRESSED DEBT INVESTING (Feb. 21, 2013), http://www.distressed-debt-investing.com/2013/02/advanced-distressed-debt-lesson-mnpi.html (last visited July 31, 2013). Thus, absent the use of "big boy" letters as described below, becoming restricted can impede the creditor's ability to dispose of or add to its position.

B. "Big Boy" Letters.

1. One practice that has evolved to partially address the foregoing securities laws concerns is the execution of so-called "big boy" letters with the creditor's trading counterparty in any purchase or sale of the debtor's securities. *See* id. In a "big boy" letter, the counterparty acknowledges that the creditor has MNPI and has not shared it, disclaims the right to require that the MNPI be shared with it, and waives any claims for fraud. However, the SEC has not taken an official position approving or denouncing the use of "big boy" letters, rendering their effectiveness uncertain.

2. "Big boy" letters do not necessarily insulate persons trading in distressed debt while in the possession of MNPI from potential civil and criminal liability. For example, the letters may be ineffective against breach of contract or fiduciary claims arising from the purchase or sale of debt when the trader owes a duty of trust or confidence to the debtor. *See, e.g.*, SEC v. Barclays Bank PLC and Steven J. Landzberg, 07-CV-04427, Litigation Release No. 20132, 2007 WL 1559227 (S.D.N.Y. May 30, 2007) (announcing settlement of civil action arising from undisclosed trading by a member of official creditors' committee while in possession of MNPI, in some instances pursuant to "big boy" letters). In chapter 11 cases, potential liability arising from duties to the debtor and/or the creditors' committee may be addressed by a Bankruptcy Court "trading order" permitting trading by creditors' committee members in compliance with specified eithical wall require-

ments.

3. There is caselaw suggesting that well-drafted "big boy" letters may be an effective defense in a common-law fraud case, particularly where the plaintiff is a sophisticated party and the securities laws are not implicated. *See, e.g.*, Lazard Freres & Co. v. Protective Life Ins. Co., 108 F.3d 1531, 1542-43 (2d Cir.), cert. denied, 522 U.S. 864 (1997) (discussing the responsibilities of a sophisticated distressed debt purchaser).

4. A serious additional deficiency in any protection afforded by "big boy" letters is potential liablity to downstream purchasers. For example, Party A, who is in possession of MNPI, sells to Party B pursuant to a "big boy" letter. Party B, who does not have MNPI, promptly sells to Party C without a "big boy" letter and without informing Party C that Party B purchased from a seller who had MNPI. The investment performs poorly, and Party C sues Parties A and B for fraud. *See, e.g.*, R2 Investments LDC v. Salomon Smith Barney, Inc., 2005 WL 6194614 (S.D.N.Y. Jan. 13, 2005) (denying defendants' motion for summary judgment on federal securities law and state law claims in similar circumstances). This concern may be particularly acute where Party C is substantially less sophisticated than Parties A nd B. These issues may be addressed by contractual resale restrictions in the "big boy" letter.

C. Becoming Unrestricted. After receiving MNPI, a creditor can become unrestricted from trading the debt if the MNPI becomes public. Otherwise, the creditor may have to wait until the MNPI becomes stale. Thus, in the course of negotiating the confidentiality agreement, a creditor may include provisions requiring the debtor to publicly disclose the information by a specified deadline through a press release or SEC filing. If the creditor determines that the debtor has failed to sufficiently disclose all necessary information, the confidentiality agreement may include a self-help remedy permitting the creditor to disclose the information itself. *See, e.g.,* Martin Bienenstock, *Advanced Distressed Debt Lesson: MNPI and NDAs: The Alphabet Soup of Getting Restricted*, DISTRESSED DEBT INVESTING (Feb. 21, 2013), http://www.distressed-debt-investing.com/2013/02/advanced-distressed-debt-lesson-mnpi.html (last visited July 31, 2013). The debtor may have legitimate reasons for deferring disclosure of the MNPI, so provisions of this sort can be the subject of spirited negotiation.

D. The Advisor Alternative. Rather than resorting to "big boy" letters, creditors may avoid or defer becoming restricted by delegating the receipt of MNPI to their attorneys and/or financial advisors. *See, e.g.,* Glenn E. Siegel & Davin J. Hall, *Confidentiality and Disclosure in Distressed Investing*, 24 REV. OF BANKING AND FIN. SERVICES 1, 1 (2008). Creditors can decide how early or late they wish to receive the information from their legal or financial advisors during the course of an out-of-court restructuring or bankruptcy case: immediately, when substantive negotiations are to commence, shortly before a deal is agreed upon, or some other time. If receipt of MNPI is deferred, they generally rely on their lawyers or finan-

cial advisors to tell them when the agreed stage of information sharing, discussions or negotiations has been reached. This practice of appointing the legal advisor to become restricted is particularly common among members of *ad hoc* committees. *See Finance Fundamentals: Ad Hoc Committees v. Official Committees*, PRACTICAL LAW CO., http://us.practicallaw.com/5-518-6632?q=&qp=&qo=&qe (last visited July 29, 2013).

II. Ethical Implications of Attorney's Possession of MNPI on Behalf of the Client

A. Important Ethical Duties. Most attorneys take for granted that they must share material information with their clients, and look to their clients to make all significant substantive decisions. This is sometimes expressed as the difference between "legal decisions" to be decided by the lawyer and "business decisions" to be decided by the client. An arrangement whereby an attorney receives but does not share MNPI with his client runs counter to the usual rules, and is particularly unusual when the attorney is expected to make decisions that bind the client without meaningful current input from the client. Such an arrangement potentially implicates the attorney's ethical duties under the New York Rules of Professional Conduct (the "Rules"). In particular, Rule 1.2 ("Scope of Representation and Allocation of Authority Betweem Client and Lawyer") and Rule 1.4 ("Communication") may be relevant. Consequently, the attorney should have a clear, preferably written, understanding of what is required when representing clients in these arrangements. As discussed below, such an understanding may protect the client as well as the lawyer.

B. Scope of Representation. Rule 1.2(a) states in part: "Subject to the provisions herein, a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to settle a matter. . . ."

1. Rule 1.2(a) gives the client the authority to define the scope of representation and purposes to be served, subject to the limits of the law and the attorney's obligations under the Rules. *See* N.Y. STATE BAR ASS'N, RULES OF PROF. CONDUCT 13 (2012). To fully understand and best meet the client's needs, the attorney must consult with the client and discuss the means by which any objectives should be pursued. Id. at 14. Importantly, as the New York State Bar Association notes in comment three, "[a]t the outset of a representation, the client may authorize the lawyer to take specific action on the client's behalf without further consulation. Absent a material change in circumstances and subject to Rule 1.4, a lawyer may rely on such advance authorization. The client, however, may revoke such authority at any time." Id.

2. Thus, as the rule and New York State Bar Association commentary indicate, clients have the right to delegate attorneys to take specified actions on their behalf and to receive MNPI on their behalf. However, Rule 1.2(a) is

qualified by Rule 1.4, which contains requirements as to communications with the client. This requirement is important when considering a creditor's desire *not* to be informed of certain information lest they become restricted from trading the debtor's securities.

C. Communication. Rule 1.4 states: "(a) A lawyer shall: (1) promptly inform the client of: (i) any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(j), is required by these Rules; (ii) any information required by court rule or other law to be communicated to a client; and (iii) material developments in the matter including settlement or plea offers; (2) reasonably consult with the client about the means by which the client's objectives are to be accomplished; (3) keep the client reasonably informed about the status of the matter; (4) promptly comply with a client's reasonable requests for information; and (5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by these Rules or other law. (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

1. Notably, Rule 1.4(a)(2) requires an attorney to consult with the client about how the attorney will attempt to achieve the client's objectives, and Rule 1.4(a)(3) requires an attorney to keep the client updated about the matter. However, the Rules do not seem to contemplate the situation where there is an understanding that certain information will be withheld by the attorney and the client clearly benefits from the arrangement, such as when the client is able to trade in the securities of a third-party because the attorney has not passed along MNPI about the third-party to client. Comment seven to Rule 1.4 discusses circumstances in which a lawyer may be justified in delaying transmission of relevant information, but those circumstances are not relevant here. The Rule does not even expressly state that it can be waived. Thus, considerable care must be taken when entering into such arrangements so as not to breach the ethical duties by which an attorney is bound.

2. Given the absence of clarity in the Rules, attorneys may wish to turn to analogous bodies of law for guidance. In his article *Lawyers' Professional Responsibilities and Liabilities in Negotiations*, Douglas Richmond looks to the agency aspect of the attorney-client relationship and concludes that a client and attorney can, without running afoul of Rule 1.4 of the American Bar Association's Model Rules of Professional Conduct (which is similar to the New York Rules), agree to limit the attorney's communication with the client. Douglas R. Richmond, *Lawyers' Professional Responsibilities and Liabilities in Negotiations*, 22 GEO. J. LEGAL ETHICS 249, 253 (2009). "Regardless of the specific obligation imposed under Rule 1.4(a), and consistent with the reasonableness requirement inherent in the rule, lawyers' duty to communicate with clients is necessarily contextual." Id. Richmond goes on to assert that "the attorney-client relationship is an agency relationship, and a principal and agent may agree to limit the agent's duty to com-

municate." Id. *See, e.g.,* Jackson Nat'l Life Ins. Co. v. Gofen & Glossberg, Inc., 882 F. Supp. 713, 720-21 (ND. Ill. 2005) (declining to find agent liable to principal for failure to communicate information because parties agreed in written contract that agent would have no such obligation). Though Richmond does not specifically discuss the delegation of receiving MNPI to the attorney and the attendant communication limitations, he does state that "sparse communication between a lawyer and a client may be reasonable if . . . the client has granted the lawyer broad discretion in carrying out the representation." *Richmond* at 253.

3. Note that Rule 1.4(a)(1)(iii) expressly requires an attorney to inform the client of any material developments such as a settlement offer. Again, there is no express waiver provision in the Rules, and no help from the Comments. If the client is a creditor in a workout situation or bankruptcy case and has instructed the attorney to undertake negotiations while in possession of MNPI, then there is the possibility that the attorney may receive a settlement offer while the creditor is still unrestricted and not in possession of MNPI. Depending on the circumstances, if the attorney merely informs the client of the terms of the settlement offer, the client may become restricted (which the client may or may not want to occur). If the scope of the attorney's role is such as to afford the attorney discretion to withhold the settlement offer from the client, the circumstances in which the attorney is expected to do so should be clearly understood.

D. Suggested Actions. Where the client wishes to limit the content and frequency of the communication, as is the case when a creditor wishes to delegate receipt of MNPI to its legal counsel, the attorney and client should have a clear understanding and should consider memorializing the mandate in writing. Such writingmay include:

1. An express instruction from the client to the attorney to withhold information that the attorney believes in good faith to be MNPI;

2. The understanding as to when the attorney should share MNPI with the client (*e.g.* a specific date, when a particular event occurs or condition exists and/or in the discretion of the attorney); and

3. The discretion (particularly as to any negotiations that may bind the client) delegated by the client to the attorney before the client obtains MNPI.

A written understanding not only ensures that both the client and attorney have a clear understanding of what is expected of the attorney and what the attorney agrees to do, but it may also provide evidence that there was an understanding that the client was not to be in possession of MNPI. Otherwise, a court or regulators may assume that the client was in possession of any MNPI in the attorney's possession. These precautionary measures do not guarantee that the arrangement between the client and attorney will not face scrutiny, but they do demonstrate that

the attorney is mindful of his or her obligations under the Rules and may reduce risks to the attorney and client.