Structuring and Enforceability of Big Boy Letters and Non-Reliance Provisions in Private Investment Transactions

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Structuring and Enforceability of Big Boy Letters and Non-Reliance Provisions in Private Investment Transactions

Presented by
Brian S. Fraser and Paul B. Haskel

Date
February 19, 2015
What is a Big Boy Provision?

“[W]here the parties to an agreement have expressly allocated risks, the judiciary shall not intrude into their contractual relationship; party cannot complain of having been misled if “the substance of the disclaimer provisions tracks the substance of the alleged misrepresentations, notwithstanding semantical discrepancies. . . . It is not the role of the courts to relieve sophisticated parties from detailed, bargained-for contractual provisions that allocate risks between them, and to provide extra-contractual rights or obligations for one side or the other.”

The Legal Framework

- Securities
  - Regulatory framework is premised on public disclosure
- Non-securities Assets (e.g., loans, claims)
  - No public disclosure required and disclosure often prohibited by confidentiality obligations
Basic Elements of an Insider Trading Claim (Securities)

- In the U.S. markets, it is critically important to decide whether the asset to be traded is a security or not.
- Non-reliance provisions are much less effective in protecting against 10b-5 claims.
  - SEC does not need to prove reliance (See 17 C.F.R. § 240.10b5-1(b) (2000))
  - The antifraud provisions of the securities laws cannot be waived (See Section 29(a) of the Securities and Exchange Act, 15 U.S.C § 78cc (2005); AES Corp. v. Dow Chemical Co., 325 F.3d 174, 180 (3d Cir. 2003))
- While some courts have held that a non-reliance provision does not constitute a waiver of compliance with the Exchange Act, other have held that they are unenforceable as a matter of law.
- The main risk is the SEC or other regulators.
Basic Elements of a Fraud Claim

• Elements of a common law fraud claim
  1. material false representation (or fraudulent concealment with a duty to disclose)
  2. intent to defraud
  3. reasonable reliance
  4. loss arising as a result of reliance

• Where sophisticated parties are involved, the plaintiff must demonstrate that it conducted adequate due diligence to establish reasonable reliance.
Big Boy Provisions Address Two Distinct Elements of Fraud

- They undermine the allegation that there was a duty to disclose (Element #1)
- They aim to knock out plaintiff’s ability to plead the “reasonable reliance” element (Element #3)
The Duty to Disclose

• A duty to disclose (Element #1) arises from:
  • a fiduciary duty running from the non-disclosing party (arising from membership on a committee, for example);
  • when one party has made a partial or ambiguous statement and it would be misleading to omit the additional information; or
  • one party’s superior knowledge of material facts and make the failure to disclose “inherently unfair”
A Sophisticated Plaintiff Must Demonstrate Adequate Due Diligence to Prove Reasonable Reliance

“[I]f the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.”

*DDJ Mgmt., LLC v. Rhone Grp LLC, 15 N.Y.3d 147, 154. 905 N.Y.S.2d 118 (2010).*
Trends in the Case Law: The “Peculiar Knowledge” Doctrine

• Plaintiffs increasingly seek to overcome Big Boy provisions (or lack of reliance) by focusing on the “peculiar knowledge” doctrine
  • To survive a motion to dismiss, plaintiff must plausibly allege:
    • it conducted its own appropriate level of due diligence, and
    • the information was peculiarly within defendant’s control and could not be discovered by reasonable means
Trends in the Case Law: The “Peculiar Knowledge” Doctrine (con’t)

- Financial crisis cases involving MBS, CDO, and complex structured products (as opposed to loan or claims cases) may have affected courts’ attitude toward Big Boy framework.
- Complexity of assets and inability of buyer to diligence sponsor / arranger / originator information may have contributed to a recent shift in the cases.
Recent MBS/CDO Cases

- Examples of cases in which motions to dismiss were denied despite Big Boy provisions in the MBS/CDO context:
  
  
  
Pharos Capital Partners, L.P. v. Deloitte & Touche, L.L.P.

- Recent 6th Circuit Court of Appeals decision affirming summary judgment for defendant on the basis of a Big Boy agreement
- Three separate opinions in the Pharos case
Pharos – Summary of Facts

- Pharos purchased $12 million of National Century Series B Convertible Preferred stock. Defendant Credit Suisse was the placement agent. Four months later National Century filed for bankruptcy.
Pharos – Provisions of Big Boy

• From the District Court decision granting summary judgment:
  • “The language of the Letter Agreement is clear. It states that Pharos is a “sophisticated institutional investor” who was “relying exclusively” on its own due diligence investigation, its own sources of information, and its own credit analysis in deciding to invest in National Century preferred stock.”
  • “Indeed, Pharos represented in the Agreement that Credit Suisse’s information and advice was not ‘necessary or desired,’ that Credit Suisse had made no representations about National Century or the credit quality of the securities, and that any non-public information Credit Suisse possessed about National Century ‘need not be provided’ to Pharos.” 905 F. Supp. 2d at 824.
Pharos – District Court Decision
Denying Motion to Dismiss

• “The Court finds that the disclaimers in the offering materials and Participation Agreement do not preclude Plaintiffs from showing that they justifiably relied on Credit Suisse's alleged misrepresentations. . . . The issue of whether a party's reliance was justifiable is largely a question of fact inappropriate for resolution on a motion to dismiss.”

Pharos – District Court Ruling Granting Summary Judgment

• “To allow Pharos to proceed any further with its fraud and negligent misrepresentation claims would upset the risk allocation the parties bargained for. Pharos agreed that it was relying exclusively on its own investigation and analysis and that it would bear, as to Credit Suisse, 100% of the risk of loss.” 905 F. Supp. 2d at 825.
• “Finally, the district court correctly held that Pharos could not justifiably rely on any statement by Credit Suisse because Pharos was a sophisticated investor, had substantial adverse information about National Century, and, most critically, signed an agreement disclaiming reliance on any statement by Credit Suisse. On appeal, Pharos argues that Credit Suisse had knowledge of material information about National Century’s fraud that outside investors—like Pharos—could not discover. Even assuming that this scenario could make Pharos’s reliance justifiable, Pharos has not demonstrated that any material information was truly unavailable to a sophisticated investor like Pharos.” 2013 U.S. App. LEXIS 21912 at *5.
Pharos – Takeaways

• While the Big Boy provision in *Pharos* was ultimately enforced, it was not until 11 years after the transaction at issue.

• The value of a Big Boy is significantly undermined if it does not result in dismissal at an early stage.

• Both the District Court and the Court of Appeals found that Credit Suisse did not have “peculiar knowledge,” 905 F. Supp. 2d at 826; 2013 U.S. App. LEXIS 21912 at *5.

• The Court of Appeals held that “*Pharos* has not demonstrated that any material information was truly unavailable to a sophisticated investor like *Pharos*.”
Conclusions From The Case Law

- A non-reliance provision may be helpful in defending a private civil securities fraud case but probably will be of little use in defending a regulatory proceeding.
- A NRP will be most useful when the parties are sophisticated, the provision is specific and the plaintiff has had the opportunity to conduct due diligence.
- Even a successful defense can take a long time and be very expensive.
Sample Big Boy Provision

- Both Seller and Buyer confirm they:
  - are sophisticated
  - have access to information sufficient to make an investment decision and have conducted their own due diligence
  - have made any such investment decision without reliance upon the other,
  - have not relied on the other to furnish or make available [certain enumerated types]* of material information
  - waive and release any claims arising from non-disclosure of asymmetrical information

*insert “enhanced” big boy language if applicable
“Enhanced” Big Boy Language

- Provisions should be the product of negotiation between sophisticated parties (Not a form!)
- Describe the specific type and quality of information being withheld in terms that are tailored to the trade
- Include specific acknowledgement that party has voluntarily entered into the transaction notwithstanding the non-disclosure of the MNPI
The Loan Syndications and Trading Association, Inc. ("LSTA") guidelines build on case law and create a pragmatic, user-friendly approach.

- "Syndicate Information" – confidential borrower information available to lenders or potential lenders
- "Borrower Restricted Information" – confidential borrower information not available to all lenders
LSTA Big Boy Framework (Loans)

- Two general LSTA philosophies:
  - LSTA Big boy provisions will protect against information asymmetry created by possessing Syndicate Information
  - LSTA Big boy provisions may **not** protect against information asymmetry created by possessing Borrower Restricted Information
Syndicate Information

- “Syndicate Information”
  - Subject to the confidentiality provisions of the loan agreement
  - Disclosure to prospective buyers is necessary, and is permitted under most confidentiality provisions
- Lenders can trade loans even if they possess Syndicate Level Information, provided they disclose to counterparty the information or that they possess such information (LSTA standard “big boy” provisions)
- MNPI exposure will restrict trading of securities of the borrower
  - Challenging to evaluate materiality of information
Borrower Restricted Information

• “Borrower Restricted Information”
  • Information above and beyond Syndicate Level Information
  • Trading bank loans while in possession of Borrower Level Information more likely to give rise to allegations of fraud
  • LSTA: if you are in possession of advisory level information, then don’t trade on unless you can share it – exceptions may be made “according to internal policies, consistent with general standards of professional integrity and fair dealing that promote confidence in the fairness of the loan market.”
  • Widely believed to refer to the use of “big boy” provisions.
Borrower Restricted Information (con’t)

• Sources of Borrower Restricted Information
  • Committees (Formal or Ad Hoc)
  • Discussions with Management
  • Trade counterparties
  • Consultants who do not abide by confidentiality duties (should be precluding use through screening)
Loan Market Practice

- Market resistance to “enhanced big boy” provisions may impact pricing
- As an alternative to transacting on a Big Boy:
  - Provide counterparty with “leveling” information or “access” to that information
  - But, market resistance to receiving Borrower Restricted Information
  - So: using dealers to find counterparties who already have access
Loan Market Practice (con’t)

• Dealers who flow trade
  • R2 case – settled w/o decision – a securities case
  • Contract protections adopted in response to R2 case
    • Dealer modifies downstream big boy to disclose sourcing from seller with MNPI and text of upstream big boy
    • Downstream buyer covenants to make similar disclosure to any future transferees
Limits of the Big Boy Framework

- Will not protect a counterparty that fails to disclose “blockbuster” information that goes to the essential fairness of the transaction
- Will not protect where the Court detects intentional fraud
- Not to be used in transactions involving securities
- Does not protect against a claim of breach of fiduciary duty, because reliance is not an element of a claim of breach of fiduciary duty
- Courts are calling “balls and strikes”
- The issue of “peculiar knowledge” is outcome determinative
LMA Conventions and UK Market Practice

• European loan market is generally private – little to no public disclosure.
• Therefore, difficult to be purely “public” while trading loans: even loan agreements are confidential.
• Financial Conduct Authority (FCA):
  • Principal No. 1: A firm must conduct its business with integrity
  • Principal No. 5: A firm must observe proper standards of market conduct
LMA Transparency Guidelines: Best Practice (2011)

• Syndicate Confidential Information
• Borrower Confidential Information
• LMA Best Practices:
  • Can trade on Syndicate Confidential Information
  • Should not trade on Borrower Confidential Information, except where the trade (i) is consistent with “appropriate standards of professional integrity and fair dealings”, (ii) is with another person who possesses the same information, and (iii) will not adversely affect other members of the syndicate/market
LMA Transparency Guidelines (con’t)

- No trading with any disparity of information.
- No room for trading a big boy.
- Stricter standard than the LSTA’s standard.
- Surprise to the market – created uncertainty.
- Even if both parties have same Borrower Confidential Information, trading permitted only in narrow safe-harbor.
AIMA Statements (2012)

- AIMA expressed disagreement that LMA’s position was “best practice”
- LMA position does “not” reflect current secondary market practice.
- Equality of information is not possible in a private market.
- Market participants are sophisticated and trading on big boys not inconsistent with maintaining standards of integrity.
Current State of the LMA Market

- Uncertainty as to current best practices
- Anecdotally – some hesitation to sit on creditors' committees
- Tailored big boy agreements are still in use
Brian S. Fraser represents and advises clients in complex commercial and financial matters. In financial litigation, Mr. Fraser represents clients in capital markets, derivatives, securities, including asset-backed securities, distressed loans, corporate governance and insurance litigation. Mr. Fraser represents hedge funds, fund managers, institutional investors, insurers, investment banks, and other clients involved in disputes arising from transactions or investments in the equity, debt, structured finance and derivatives markets.

In commercial litigation, Mr. Fraser has extensive experience representing manufacturing and other commercial clients in mass tort, antitrust, breach of contract and intellectual property matters. Mr. Fraser has successfully represented plaintiffs and defendants in state and federal courts across the country and in arbitrations and mediations.

He also frequently advises clients on litigation risk and avoidance in connection with transactions and has often been called upon to evaluate likely litigation outcomes. Illustrative representations include:

- An interdealer broker in two class actions alleging violations of the antitrust laws and the Commodities Exchange Act in connection with alleged efforts to manipulate USD LIBOR, Yen LIBOR and Euroyen TIBOR
- A major investment bank that is a senior noteholder of a CDO backed by CMBS in litigation with the indenture trustee over the proper interpretation of the indenture
- The Boeing Company in wrongful death and tens of billions of dollars in property damage claims arising from the terrorist attacks on September 11, 2001
- Financial Guaranty Insurance Company in numerous lawsuits with municipalities throughout the United States arising from the insurer’s credit ratings downgrade during the financial crisis;
- Institutional investors including a university endowment in an involuntary winding up proceeding against a hedge fund in the Cayman Islands;
- A major investment bank in substantial broken debt trade litigation against a foreign bank.
Paul B. Haskel specializes in high-yield and distressed debt transactions. He represents investment banks, broker-dealers, hedge funds and other financial institutions in connection with the purchase and sale of various U.S. and international distressed assets (including domestic and foreign bank loans, high-yield bonds, bankruptcy claims, options and related credit derivatives). Mr. Haskel regularly provides advice to clients on bankruptcy and reorganization matters and has extensive experience in special situation investments and loan restructurings. In addition, Mr. Haskel regularly advises clients on issues arising from the receipt of confidential information by virtue of investment in bank loans, including issues arising under U.S. securities law and state law. In the last several years, Mr. Haskel and the firm’s debt trading group have advised clients in connection with thousands of transactions in bank loans, trade claims and credit derivatives relating to both distressed and par borrowers, including MF Global, Lehman Brothers, Tribune, General Motors, Boston Generating and American Airlines.

Mr. Haskel is an active participant in the Loan Syndications and Trading Association, Inc. and is an active participant in its Trade Practices and Forms Committee which seeks to update and add to its suite of market standard documentation.

Mr. Haskel, in addition to providing advice on specific transactions, is a regular speaker at industry events, including the LSTA and the American Bar Association and is regularly engaged to provide training to clients in many of these areas.
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