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INTRABANK CONFLICTS OF INTEREST

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I. INTRODUCTION

Courts and commentators have, since the 1970s, discussed potential conflicts of interest that may arise within a banking institution. In today's business climate, this discussion gains additional relevance and importance. The combination of the rapid growth and consolidation of banks, the continued expansion of the scope of services provided by banks, and the high level of merger and acquisition activity, generally, and among financial services providers in particular, increases the possibility of conflicts and heightens uncertainty about what banks can do to avoid conflict situations. As they become more prevalent, potential bank conflicts are being subjected to greater scrutiny.[1] This paper does not purport to provide

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1. *See, e.g.*, Christina Binkley, *Chase's Role in Patriot Bids is Questioned*, WALL ST. J., Feb. 12, 1999, at C1. According to the recent Wall Street Journal article, Chase Manhattan Corp is playing questionable three-way role in negotiations over financial restructuring of Patriot American Hospitality Inc; Chase is leading lender to Patriot and is advising Patriot as it weighs competing bids by Hilton Hotels and Apollo Real Estate Advisors, but Chase is also leading syndicate that would refinance Patriot if Apollo wins bidding. *See id.*

a comprehensive statement of all potential conflicts or to set out all protective measures that may be required by banking institutions. Rather, it seeks to highlight some potential conflict situations, suggest some steps banks may take to protect themselves from liability, and, primarily, to encourage banks and their legal counsel to increase their awareness of and focus on these issues.

This article describes several conflicts of interest that commercial banks may encounter. Section II examines conflicts involving the dissemination of confidential information. Part IIA addresses the potential conflict that arises when a bank disseminates nonpublic information within its commercial loan department and, more problematically, the conflict that ensues when such information is disclosed to certain third parties, such as an acquiring company. Part IIB discusses conflicts arising from the dissemination of confidential information to a separate bank department, such as the trust department, whose function it is to recommend particular investments to its clients. Part IIC outlines appropriate defensive strategies for preventing and resolving information based conflicts problems. Finally, Section III examines the potential conflict situations that arise out of a financial institution's dual role as lender and fiduciary under an indenture agreement. This section summarizes the legislative efforts in this area and assesses the effectiveness of the post-default conflict standard.

II. INFORMATIONAL CONFLICTS

Informational conflicts are often referred to as "conflicts of interest" between banks and their customers. They are more appropriately characterized, however, as conflicts between bank customers. The tension arises from the different interests of two or more customers of the banking institution's services. The bank's responsibility is to take these different interests into account when it determines how best to protect customer confidentiality and deliver financial services.

Perhaps the most visible conflict of interest presents itself when a borrower asks the bank to finance its acquisition of another bank customer. Similar concerns arise in the following situations: (1) the bank acts as lender for more than one bidder in an auction of a

corporation; (2) the bank acts as agent for a syndicated loan and underwrites a Rule 144A high-yield debt offering; and (3) the bank acts as senior lender and indenture trustee on a public bond issue. The same legal concerns confront the bank in each of these situations, and thus a similar analysis should apply. Though not discussed in this paper, banking institutions should also be aware of the potential conflicts that may arise under the Glass-Steagall Act.

A. *Intradepartment Conflicts*

As previously noted, a potential conflict situation arises when a bank has provided services for a target in the past and now proposes to provide financing for an acquirer of that target company. The bank may, as a result of its prior or continuing relationship with the target, have material, nonpublic information about the target. Although the courts have refused to place an absolute prohibition on the bank's ability to serve both corporate customers, they have placed limitations on the bank's ability to disseminate and use the nonpublic information it has about the target company.

In the first case to address the conflicts issue in the takeover context, *American Medicorp, Inc. v. Continental Illinois National Bank & Trust Co. of Chicago,*[2] a bank customer, American Medicorp, Inc. (American), sought to enjoin the bank from making a loan to Humana, Inc. (Humana), another bank customer that planned a takeover of American. Because of its prior commercial lending relationship with American, the bank had acquired a file of nonpublic financial and other information about American.[3] American first argued that providing financing to Humana would constitute a *per se* breach of a fiduciary obligation of the bank.[4] In addition, American argued that the bank had used some of plaintiff's confidential information in deciding whether to make the loan to Humana.[5]

The federal district court refused to impose a complete prohibition on a bank's ability to lend money to a company seeking to

2. American Medicorp, Inc. v. Continental Illinois National Bank & Trust Co. of Chicago, 475 F. Supp. 5 (N.D. Ill. 1977).
3. *See id.* at 7.
4. *See id.*
5. *See id.*

take over a bank customer that has previously provided nonpublic information to the bank.[6] Instead, the court focused on whether the bank had "used or relied upon" any of the confidential information that American had provided.[7] American produced evidence that one of the officers working on Humana's loan had seen and "flipped through" plaintiff's credit file, including a 13-page summary, and that another officer involved in Humana's loan had read the information in American's file several years earlier.[8] Finally, plaintiff contended that an informal meeting had occurred between two loan officers working on the Humana loan and two officers working on American's account in which the officers discussed the proposed acquisition and the amount of plaintiff's business the bank might lose as a result of the planned takeover.[9] The bank denied use of American's nonpublic information in making a decision about the Humana loan, and a bank officer testified that the decision to provide financing to Humana was based on Humana's financial capabilities and not on the financial condition of American.[10]

Emphasizing that there had been no disclosure to third parties, the court found that "[t]he fact that some of defendant's officers who were responsible for [Humana's] loan obtained, saw, touched, and to some extent used and interchanged information from the defendant's files on plaintiff . . . is not a *per se* violation of a trust."[11] The court also found that the evidence, taken as a whole, was not sufficient to prove that the bank used or relied on plaintiff's confidential information in deciding whether to make the loan to Humana.[12] If a bank "does not rely on the confidential information of its customers in its files," the court ruled "[it] is free to deal with any customer who comes to it."[13] Concluding that the plaintiff was unlikely to prevail on the merits of its claim, the court refused to enjoin the bank's loan to the potential acquirer.[14]

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6. *See id.*
7. *See id.*
8. *See id.* at 8.
9. *See id.* at 8-9.
10. *See id.* at 9.
11. *Id.*
12. *See id.*
13. *Id.* at 8.
14. *See id.* at 10.

Subsequently, in *Washington Steel Corp. v. TW Corp.*,[15] the Third Circuit considered the same question of what limits, if any, the law imposes on a commercial bank that wants to make a loan to one client to facilitate that client's takeover of another bank client.[16] Several years prior to the takeover attempt, Chemical Bank (Chemical) had served as a participating lender (contributing 22.5% of the funds) in a $10 million line of credit for Washington Steel Corporation (Washington).[17] Chemical also served as one of two registrars for Washington's common stock.[18] In the course of participating in the loan, Chemical received certain nonpublic information about Washington, including financial statements and a study of cash flows and future earnings projections.[19]

Chemical had also previously served as lead lender on loans to Talley Industries, Inc., and its wholly owned subsidiary, TW Corporation (collectively, Talley). Talley decided to acquire Washington and sought financing from Chemical. The Chemical Corporate Banking Department discussed the potential conflict, but ultimately decided that the bank was not precluded from participating in the proposed loan to Talley. After performing a credit analysis of Talley, senior bank officers approved the loan.[20]

Washington subsequently filed suit, attempting to enjoin the loan and alleging that Chemical had violated its fiduciary duty by misusing confidential information obtained from Washington in deciding whether to finance Talley's tender offer.[21] Like the *American Medicorp* court, the Third Circuit concluded that the case law did not support imposition of a *per se* fiduciary duty on the bank based on its receipt of confidential information.[22] The Third Circuit added that a *per se* prohibition would be contrary to public policy by impeding the availability of funding for capital ventures.[23] The court explained that

15. Washington Steel Corp. v. TW Corp., 602 F.2d 594 (3d Cir. 1979).
16. *See id.* at 595.
17. *See id.* at 596.
18. *See id.*
19. *See id.*
20. *See id.*
21. *See id.* at 597.
22. *See id.* at 599-601 (characterizing the *per se* rule suggested by Washington as "wholly unprecedented" and criticizing Washington's attempt to "draw a fiduciary rabbit from a commercial loan agreement hat").
23. *See id.* at 601.

"[c]ompanies seeking to insulate themselves from takeovers, or even from ordinary competition, could simply arrange for a series of loans from most of the major banks, supplying those banks with the requisite non-public information," and thus those banks would be "foreclosed from financing competitors and potential acquirers of the borrowing firms."[24]

The *Washington Steel* court next examined Washington's claim that Chemical had misused the nonpublic information it had obtained from Washington. As in *American Medicorp*, the court first emphasized that there was no allegation that Chemical had relayed any nonpublic information to Talley.[25] Washington made two claims regarding misuse of information. First, Washington argued for a "presumption of use" based on an alleged need to examine Washington's financial situation in view of Talley's alleged financial weaknesses. Second, Washington argued actual use based on the silence of the Chemical officer in charge of the Washington account at a meeting regarding the proposed Talley loan. Washington based this argument on the theory that the officer's silence suggested to Talley that the target, Washington, was a good investment.[26] Rejecting both of these arguments, the court queried what the loan officer could have been expected to do other than to remain silent and pointed out that the bank had taken steps to keep the Washington files away from those personnel working on the Talley loan.[27]

Going beyond the *American Medicorp* decision, the court went on to state that, even assuming the bank had used the confidential information, "[w]e do not believe that a bank violates any duty it may owe to one of its borrowers when it uses information received from that borrower in deciding whether or not to make a loan to another prospective borrower."[28] The court explained that it is within the province of the legislature rather than the courts to establish rules limiting the dissemination of confidential information within a bank's loan department.[29] The court also expressed opposition to any such

24. *Id.*
25. *See id.* at 602.
26. *See id.*
27. *See id.* at 602-03.
28. *Id.* at 603.
29. *See id.*

rule on policy grounds, stating that a limitation on information available to banks for the purpose of making lending decisions would impede the free flow of funds by either: (1) causing banks to enter transactions without full information, thus resulting in potential violations of their duty to depositors; or (2) discouraging banks from lending money to corporations that expressed an interest in acquiring other bank customers.[30] The court limited the scope of its opinion, however, to the commercial loan department of the bank and did not express an opinion on whether, and to what extent, a bank can disseminate nonpublic information to other bank departments, such as the trust department, or to third parties.[31] The court did caution that such disclosures might constitute violations of section 10(b) of the Securities Exchange Act of 1934 and the corresponding SEC rule, Rule 10b-5.[32] The portion of the court's decision suggesting that use of nonpublic information within the bank is permissible on public policy grounds has been criticized. For example, one commentator asserts that prohibiting the bank from using nonpublic information internally does not disadvantage the bank, but merely puts it on equal ground with other banks that do not have access to such confidential information.[33]

After almost twenty years of judicial silence on this subject, a New York state trial court recently addressed this issue again, stating the question presented as "whether a commercial bank breaches a fiduciary duty by agreeing to finance the hostile takeover of one corporate customer by another."[34] As in the two previous cases, the court held that "a bank has no per se obligation to refrain from such

30. *See id.*

31. *See id.* at 603-04.

32. *See id.*

33. *See* Thomas M. Millhiser, *Conflicts of Interest: The Chinese Wall and Bank Financing of Hostile Tender Offers*, 37 WASH. & LEE L. REV. 953, 958 (1980); *see also* Mary S. Butch, Case Comment, *Bank Use of Confidential Information to Evaluate Applications for Financing of Tender Offers*: Washington Steel Corp. v. TW Corp., 61 B.U. L. REV. 245, 260 (1981) (stating that restricting the use of nonpublic information means that "[t]he bank is in the same position as any other bank evaluating a proposed loan" and that "allowing the bank to use the confidential information would give it an unfair advantage over other banks which might finance the tender offer by reducing the known risk the bank undertakes when it advances funds to . . . borrower[s]").

34. ADT Operations, Inc. v. Chase Manhattan Bank, N.A., 662 N.Y.S.2d 190, 191 (Sup. Ct. 1997).

participation."[35] Making the same factual distinction as the *American Medicorp* and *Washington Steel* courts, the *ADT* court emphasized that the plaintiff might have an actionable claim if the bank had disseminated nonpublic information directly to the acquiring company.[36] The *ADT* court, however, took a more restrictive view on the bank's use of confidential information than the *Washington Steel* court by adding that the complaint would state a claim if nonpublic information were "used by the bank in advising the acquirer."[37]

In 1993, ADT Operations, Inc. (ADT), entered into a $500 million credit facility with a syndicate of banks that was co-managed by Chase Manhattan Bank (Chase).[38] In its complaint, ADT alleged that during the course of arranging the financing, "Chase assumed the role of a financial advisor and encouraged ADT Operations to confide in the bank with respect to every facet of its business and operations."[39] In the course of its dealings with Chase, ADT provided Chase with numerous nonpublic financial documents. According to ADT, it provided such information based on the "express understanding that it would remain confidential and that Chase would use it only for the purposes relating to the credit loan facilities and for providing financial advice to ADT."[40] In addition, ADT asserted that Chase had signed a confidentiality agreement to that same effect.[41] Finally, ADT claimed that Chase personnel had represented that it was bank policy "not to finance or otherwise assist in the hostile takeover of a bank customer without the customer's consent."[42] In 1996, ADT discovered that Chase planned to finance the hostile takeover of ADT by Western Resources, Inc. (Western).[43] According to ADT, in the course of the takeover financing, Chase supplied Western with certain

35. *Id.*

36. *See id.*

37. *Id. Compare id., with Washington Steel*, 602 F.2d at 603 (stating that "[w]e do not believe that a bank violates any duty it may owe to one of its borrowers when it uses information received from that borrower in deciding whether or not to make a loan to another prospective borrower.")

38. *See ADT Operations*, 662 N.Y.S.2d at 191.

39. *Id.*

40. *Id.* at 192.

41. *See id.*

42. *Id.*

43. *See id.*

nonpublic information it had acquired from ADT.[44]

In its analysis, the court first recognized that, in general, the legal relationship between a bank and its customer is "an arm's-length, debtor-creditor relationship that does not, without more, create a fiduciary relationship."[45] As in *American Medicorp* and *Washington Steel*, the court rejected a *per se* rule forbidding the dual representation and stated that "a fiduciary duty is not created by the mere communication of confidential information from the customer to the bank . . . ."[46] The court added that a customer's "unilateral placement" of trust in a bank does not, by itself, create a fiduciary obligation.[47] Following that affirmation of precedent, however, the *ADT* court held that "[a] fiduciary relationship may arise between a bank and its customer where the bank assumes control and responsibility over the customer's assets and operations, or where the customer places special trust and confidence in the bank and thereby becomes dependent on it."[48]

Because ADT had, in the court's view, failed to produce any evidence, other than conclusory statements, of Chase's assumption of any duty to provide it with advice or counsel, the court dismissed the claims based on breach of fiduciary duty.[49] The court explained that there was no evidence that the bank had agreed to become ADT's advisor or agent with respect to the financing of hostile takeovers. In dicta, the court stated that the "bank's mere receipt and internal use of confidential information in making its financing decisions does not create a fiduciary duty . . . ."[50]

The court recognized, however, that ADT might have a cognizable claim based on breach of the written confidentiality agreement that forbade Chase from using certain nonpublic information "other than in connection with [Chase's] engagement under the Engagement Agreement."[51] Any such claim would not extend to information received outside the Engagement Agreement and

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44. *See id.*
45. *Id.* at 192-93 (citing a line of New York cases).
46. *Id.* at 195.
47. *See id.*
48. *Id.* at 193.
49. *See id.* at 195-96.
50. *Id.* at 196
51. *Id.*

would not cover publicly available information.[52]

As in the two previous cases, the court cautioned against dissemination of nonpublic information to third parties; however, the court interpreted this prohibition more broadly than prior courts by implying that this obligation could be violated by a breach of the bank's Chinese Wall.[53] Although acknowledging that not every breach of a Chinese Wall is material, the court stated that "any breach which directly assists [the acquirer] or gives it an unfair advantage in its takeover efforts [is] actionable."[54] Although the *ADT* case has not been followed by any other court and has spawned only very limited commentary, one practical effect is that corporations may avoid obtaining financing from a certain bank, even one of their primary relationship banks, if they know that the bank has a relationship with their potential acquisition targets.[55]

The *ADT* court's emphasis on the bank's role and assumption of specific fiduciary obligations is consistent with a prior federal district court decision. Unlike in the traditional debtor-creditor context, courts may be more willing to find the existence of a fiduciary relationship between "financial advisors" and their clients. For example, in *General Acquisition, Inc. v. GenCorp Inc.*,[56] GenCorp Inc. (GenCorp) claimed that Shearson Lehman Hutton, Inc. and its subsidiary, Shearson Lehman Brothers Holdings, Inc. (collectively, Shearson), had breached its fiduciary duty to GenCorp. Shearson had acted as the investment and financial advisor for GenCorp in connection with two GenCorp financial matters, performing a financial analysis of a potential leveraged buyout of one of GenCorp's subsidiaries and advising GenCorp in connection with its decision whether to pursue an acquisition of Goodyear Aerospace.[57] In connection with these two transactions, GenCorp provided

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52. *See id.*

53. *See id.* (stating that the bank's internal policies should forbid disclosure to third parties and should "create a 'Chinese Wall' between its corporate loan department and its mergers and acquisitions division.").

54. *Id.*

55. *See It's Who You Don't Know; Union Pacific Avoids Relationship Banks in Hostile Bid for Pennzoil*, BANK LETTER, June 30, 1997, at 1 (discussing Union Pacific Resources' decision to use Credit Suisse First Boston rather than one of its top three relationship banks because of those banks' close ties to its potential target).

56. General Acquisition, Inc. v. GenCorp Inc., 766 F. Supp. 1460 (S.D. Ohio 1990).

57. *See id.* at 1466.

nonpublic information to Shearson, including internal projections and forecasts, GenCorp's cost of capital, and its ability and willingness to obtain financing and utilize its existing resources.[58] Following GenCorp's decision not to pursue the acquisition of Goodyear Aerospace, Shearson sent a letter to GenCorp stating that "[w]e would like to . . . develop a relationship with you whereby we can offer meaningful ideas and suggestions for implementation of your strategy."[59]

While it was working with GenCorp, Shearson was also serving as an advisor to Wagner & Brown with regard to potential acquisition candidates.[60] During these engagements, Shearson also purchased more than 600,000 shares of GenCorp stock.[61] When Shearson presented a list of acquisition candidates to Wagner & Brown, it named GenCorp as the most attractive candidate.[62] Shearson then submitted a written report to Wagner & Brown that included a discussion of some of the nonpublic information that Shearson had obtained as a result of its relationship with GenCorp.[63] In addition to recommending GenCorp as the most desirable target, Shearson also provided, through its affiliate, $1.25 billion in financing for the acquisition.[64] Although Wagner & Brown eventually abandoned its attempted tender offer, GenCorp brought suit against Shearson for breach of fiduciary duty.[65] GenCorp based its fiduciary duty claim on three different grounds: (1) an agency relationship; (2) a *de facto* fiduciary relationship; and (3) a "prospective agency."[66]

Although finding that Shearson acted as an independent contractor in its role as financial advisor, the court held that a principal-agent relationship, and thus a fiduciary relationship, existed between Shearson and GenCorp.[67] According to the court, an agency

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58. *See id.*

59. *Id.* at 1467.

60. *See id.*

61. *See id.*

62. *See id.*

63. *See id.* For example, the report discussed GenCorp's consideration and rejection of a plan to acquire Goodyear Aerospace and some of the reasons for its decision. *See id.*

64. *See id.* at 1468.

65. *See id.*

66. *See id.*

67. *See id.* at 1470-71.

relationship existed based on GenCorp's "control" over Shearson, more specifically: (1) GenCorp's acceptance of Shearson's offer to provide financial advice with regard to the proposed acquisition; (2) GenCorp's retention of the right to terminate the relationship with Shearson; and (3) GenCorp's ability to control the degree of Shearson's participation in the contemplated transactions.[68] Finally, the court pointed out that Shearson's actions were "directed toward the attainment of GenCorp's interests."[69] Although this was not the type of analysis applied by the *ADT* court, banking institutions should be aware that a court could apply an agency analysis to banks' relationships with their customers in determining whether a fiduciary duty exists. Thus, as banks move away from the traditional debtor-creditor relationship and become more involved in advising and counseling clients, there is a growing danger that a court could characterize them as fiduciaries of the client, and thus hold them liable for any breach of that duty.

The court next examined the question of whether a *de facto* fiduciary relationship existed between Shearson and GenCorp. Although acknowledging that a fiduciary relationship does not arise from an arm's-length transaction, the court stated that a *de facto* fiduciary relationship is created "where both parties understand that a special trust or confidence has been reposed."[70] The court explained that a "financial advisor [does not] always assume a fiduciary duty by providing advice to an entity or individual,"[71] but imposed a *de facto* fiduciary duty based on the specific facts of the Shearson relationship.[72] Because of the "nature of the relationship" between GenCorp and Shearson and the confidential information that GenCorp provided to Shearson, the court held, both parties "must have understood that a special trust or confidence had been reposed in Shearson not to disclose this confidential information to third parties."[73] Because of its imposition of a fiduciary duty on other

68. *See id.* at 1471.
69. *Id.*
70. *Id.* (quoting Stone v. Davis, 419 N.E.2d 1094 (Ohio 1981)).
71. *Id.* at 1473.
72. *See id.*
73. *Id.*

grounds, the court did not discuss "prospective agency,"[74] the third ground alleged by GenCorp.

The court next discussed whether Shearson had breached its fiduciary duty to GenCorp. GenCorp alleged a breach of fiduciary duty on three different bases: (1) Shearson's disclosure of confidential information to Wagner & Brown; (2) Shearson's failure to disclose to GenCorp its simultaneous relationship with Wagner & Brown; and (3) Shearson's purchase of GenCorp stock for its own account.[75] Citing the rule that "a fiduciary is under a duty not to disclose or use for his own benefit confidential information acquired in the course of its fiduciary relationship,"[76] the court refused to dismiss GenCorp's first breach claim.[77] On the second ground, the court found that Shearson's dual role presented an "inherent conflict of interest" and concluded that, given Shearson's knowledge of Wagner & Brown's interest in acquiring a company similar to GenCorp, it was "essential" for Shearson to inform GenCorp of its relationship with Wagner & Brown.[78] With regard to GenCorp's third claim based on insider trading, the court stated "[h]aving found that Shearson owed GenCorp fiduciary duties, the Court further holds that a breach of this duty may have occurred if Shearson did purchase GenCorp stock on the basis of confidential information acquired in the course of their fiduciary relationship."[79]

One could argue that this case does not add to or change the law expressed in the three bank cases discussed above. The *GenCorp* case is factually distinguishable from the other cases because it involves a clear disclosure of material, nonpublic information to a third party. It is difficult to determine how much this disclosure

74. Under the theory of "prospective agency", a prospective agent is vested with fiduciary responsibilities and duties towards a prospective principal or employer. *See id.* In other words, "[a] person who . . . invites a confidence or permits the prospective principal to reveal confidential information to him, is subject to the same duties with respect to such information as if, at the time the confidence was given, he were in fact an agent." *Id.*

75. *See id.* at 1474-75.

76. *Id.* at 1475.

77. *See id.*

78. *See id.* at 1476. It is unclear how Shearson could have made a meaningful disclosure of such information to GenCorp without alerting GenCorp to Wagner & Brown's consideration of the company as a potential takeover target, and thus potentially breaching a duty to Wagner & Brown.

79. *Id.* at 1477.

contributed to the court's analysis, and the same court may have been unwilling to impose a fiduciary duty or to find a breach of such duty if the facts of the case had been different.

Even though the *GenCorp* case involved a disclosure to a third party, the case may be interpreted to mean that some courts will impose a fiduciary duty on a bank if it steps out of the traditional debtor-creditor role and into the role of "advisor." For example, if a bank acts as advisor to a company that is bidding on another corporation, it is possible that a court would impose a fiduciary duty on that relationship and find a violation of that duty if the bank also engaged in advising another bidder for the same corporation. In addition, if a bank accepted the role of advisor to a potential acquirer in a takeover bid and then loaned money to the target in a defensive recapitalization transaction, the bank might have breached a duty to the acquirer. A bank that encounters this type of situation should closely examine the terms of its engagement letter with the first client. If the bank has agreed to act as advisor to a potential acquirer, the bank may not want to finance the target's defensive recapitalization. At a minimum, the bank should advise the acquirer up front that the bank might be contractually obligated from an earlier agreement to lend money to the target.[80] As banks move away from their traditional roles and continue to expand the range of services they offer, they move into more dangerous territory.

There are few certainties in the existing case law; however, it appears that courts will not impose *per se* fiduciary duties on traditional debtor-creditor relationships. At the opposite end of the spectrum, it is clear that banks should not disclose any nonpublic information to third parties, especially if a confidentiality agreement would prohibit such disclosure. Between these two poles, the courts have provided little guidance to banks. Because of the limited case law available, the most important step for banks is to increase their awareness of the potential conflicts involved in playing dual roles or in serving customers with competing interests.

Assuming that a bank has a duty to refrain from using

80. For a more complete discussion of this issue, see Dan C. Aardal, *Securities Related Activities of Banks and Bank Holding Companies*, *in* INSTITUTE OF BANKING LAW AND REGULATION 1989, at 757, 786-96 (PLI Com. Law & Practice Course Handbook Series No. A4-4273, 1989).

nonpublic information in deciding whether to finance the takeover of a bank customer, the question remains how a bank can satisfy that duty, and just as important, how the duty will be enforced. If a bank customer brings suit based on misuse of confidential information, it is not clear who has the burden of proving either misuse or nonuse. Placing the burden of proving misuse on the plaintiff practically requires the plaintiff to have a bank employee testify that the bank used the confidential information or to produce a writing of the bank indicating use of the nonpublic material. The burden becomes more onerous if, as suggested by the *American Medicorp* court, the plaintiff must also show reliance by the bank.[81] Placing the burden of proving non-use on the bank, however, would require the bank to perform the nearly impossible task of proving a negative proposition. Unless the bank can prove non-use by producing evidence of the existence and use of a Chinese Wall, as described in more detail below, it would be difficult, if not impossible, for the bank to meet its burden of proof.[82]

B. Interdepartment Conflicts

Commercial banks also face the problem of conflicts of interest resulting from the capabilities of their various departments to serve in multiple roles. Like the intradepartment conflicts described above, these conflicts can also be characterized as "informational conflicts" - conflicts created by the potential for information to flow between various areas of the bank. As discussed above, these types of informational conflicts do not prevent the bank from participating in multiple roles. Rather, the bank must take precautionary measures to stop the improper flow of information.

For example, a commercial bank faces conflict of interest and potential insider trading problems if nonpublic information flows between its commercial lending department and its trust department. More specifically, the lending department may have obtained confidential information about a public corporation as a result of a lending negotiation or transaction. Simultaneously, the trust department may be recommending or consummating transactions in

81. *See* American Medicorp, Inc. v. Continental Illinois National Bank & Trust Co. of Chicago, 475 F. Supp. 5, 8-9 (N.D. Ill. 1977).

82. *See* Millhiser, *supra* note 33, at 959 n.47.

the same corporation's securities for customer accounts. Because the bank as trustee has a duty to maximize the return on its trusts, there is an incentive to use any information it obtains as an aid in investing trust assets. Therefore, the bank must have a procedure to prevent confidential information obtained by the loan department from being disseminated to those persons making investments for the trust department.[83] Another situation in which the same problem arises, and thus the same analysis applies, is when a bank serves as fiduciary to an employee benefit plan and has nonpublic information about the issuer of a security that is held by that plan.[84]

Other ways in which a commercial bank may obtain confidential information that must not be disclosed to its trust department include: (1) from the bank's municipal bond department that underwrites municipal securities which are traded in public secondary markets; (2) as a result of its role as advisor to a public corporation engaged in a private placement of its securities; and (3) through its participation in the financing of tender offers for public corporations.[85] In all of these situations, the bank must prevent disclosure of nonpublic information to the trust department through construction of Chinese Walls.

Although a Chinese Wall appears to be the logical solution to this interdepartment informational conflict, a problem arises if the Wall impedes the intrabank exchange of relevant public information,[86] thus exposing the bank to liability for any resulting harm to the trust beneficiaries.[87] For example, a bank loan department may have substantial information, some confidential and some public, about a client. In the trust department, even if a trustee fails to conduct a reasonable investigation, the trustee is deemed to have constructive knowledge of all "readily ascertainable, relevant facts." Thus, the public knowledge the loan department has needs to be transferred to

83. *See* Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783, 1803 (1994).

84. For an in-depth discussion of this topic, see Allan Horwich, *Bank Fiduciaries with Material Inside Information: Responsibilities and Risks*, 113 BANKING L.J. 4 (1996).

85. *See id.*

86. *See* David L. Abney & Mark A. Nadeau, *National Banks, the Impassable "Chinese Wall," and Breach of Trust: Shaping a Solution*, 107 BANKING L.J. 251, 258 (1990).

87. *See id.* at 251.

the trust department.[88] Because the only other options are divestiture of the trust department or a bank policy prohibiting trust investments that relate to any corporate clients of the bank, the Chinese Wall, though imperfect, is the most realistic solution.

Some have suggested replacement of the traditional Chinese Wall that blocks the flow of all information to the trust department with a "permeable" wall that allows the flow of selected information. Developing an accurate and effective filtering device would be extremely difficult, however. Implementation of an effective permeable wall would require an independent party or committee to evaluate all information and determine whether it should be allowed to flow through the wall.[89] Complete independence of the party or committee would be required because of the ability to "straddle the wall." If a permeable wall is adopted, only publicly accessible information should be permitted to pass through the wall, and all information passed to the trust department should be documented in order to refute potential claims of insider trading.[90] Because this option involves discretionary decisionmaking, it is more susceptible to challenge by third parties than the more traditional Chinese Wall. In spite of its drawback, the permeable wall may be the most viable alternative now available for some banks.

C. *Chinese Walls as Defensive Measures*

For both intrabank and interbank conflict situations, a bank's only real defense against charges that it has wrongfully disseminated or misused confidential information is the construction of a Chinese Wall. At a minimum, construction of a Chinese Wall may shift the burden of proof to a party challenging the bank's actions. For example, existence of a Chinese Wall could serve as *prima facie* evidence that the bank has not misused or wrongfully disseminated confidential information. Although in a slightly different factual context, at least one court has held that breach of a Chinese Wall must be proven by a preponderance of the evidence, thus placing the burden

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88. *See id.* at 253.
89. *See id.* at 259-60.
90. *See id.*

of proof on the plaintiff.[91]

The primary purpose of a Chinese Wall is to prevent the flow of nonpublic information to conflicting parties. In the acquisition context, the Wall should prevent both the potential acquirer and the bank personnel (including credit approval committees) involved in its takeover financing from obtaining confidential information about the target corporation. This purpose can be achieved in a variety of ways.

One article aptly describes a Chinese Wall as "a statement by a bank that it is the bank's policy to safeguard confidential customer information and that it has established and has followed procedures and safeguards to carry out this policy."[92] For example, the statement may be set out as part of the bank's Code of Conduct, in a Statement of Policy and Procedures or in some other compliance manual that is provided to all bank personnel. Another important preliminary step is to create programs to educate all bank personnel on such policies and procedures.

Depending on the factual situation, various additional measures will be required. For example, one article suggests that banks adopt appropriate combinations of the following: (1) physical separation of departments in different buildings or different parts of the same building; (2) maintenance of separate records, accounting systems and staff; (3) adoption of methods for identifying confidential documents; (4) use of secure filing systems; (5) restricting access in departments where confidentiality concerns exist; (6) restricting transfer of personnel between departments; and (7) using code names for sensitive projects.[93] Effectively restricting access to certain areas of the bank might require restricting physical access to the department, limiting physical access to files and restricting computer access to various files and information.

For example, in *Washington Steel*, Chemical erected a Chinese Wall around Washington Steel's files and the personnel working on the Washington Steel account. Chemical prohibited the personnel

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91. *See* Harnischfeger Corp. v. Paccar, Inc., 474 F. Supp. 1151, 1153 (E.D. Wis. 1979), *aff'd*, 624 F.2d 1103 (7th Cir. 1979) (rejecting allegations of breach of fiduciary duty on part of defendant bank, but granting a preliminary injunction against corporate acquisition on antitrust grounds).

92. Aardal, *supra* note 80, at 789-95.

93. *See* Steinberg & Fletcher, *supra* note 83, at 1804.

working on the Talley account from communicating with those persons working on the Washington Steel account. In addition, the officer in charge of the Washington Steel account personally secured all of the files relating to that account.[94]

One common method used primarily for intradepartment conflicts is a team-based assignment approach. In other words, banks will compartmentalize projects and create small teams to work on sensitive projects. All confidential information derived from the project is then confined to that team. The first important step in a team-based approach is selection of the appropriate team members. No team member should have any nonpublic information about another bank client (i.e., a takeover target) that has conflicting interests with those of the team's client (i.e., a bidder). This is essential to avoid any accusation that a team member with confidential information is sharing that information with the other members of the team or with the team's customer. One way of managing team selection is to have a coordinator or manager who assigns people to various teams as new projects come in. The team coordinator must be aware of all transactions coming into the bank that might result in conflicts between the bank's customers and must track what teams different individuals are assigned to in order to avoid placing them on teams with potential conflicts. Thus, the bank will need to implement a "clearinghouse procedure."[95]

For conflicts such as the acquirer/target situation described above, the bank may want to implement special procedures. For example, a request for financing of a tender offer could bypass "normal" lending channels and move directly to a more senior officer level where the matter could be contained. Because of the large dollar amounts involved in takeover transactions, it is reasonable to have more senior officials in charge of making these financing decisions.[96] A Securities Exchange Commission (SEC) proposal from the late 1970s included various other suggestions directed toward the conflicts resulting from the takeover context. For example, the SEC proposed: (1) requiring disclosure of the lending bank's identity if it had a "prior

94. *See* Washington Steel Corp. v. TW Corp, 602 F.2d 594, 603 (3d Cir. 1979).

95. Aardal, *supra*, note 80, at 789-95.

96. See Butch, *supra* note 33, at 268 & n.126.

or present commercial relationship" with the target company,[97] (2) prohibiting the bank from disclosing any nonpublic information to the acquirer; and (3) enacting a provision that would "clarify the SEC's authority to promulgate rules governing the use by banks and other financial intermediaries of material, nonpublic information concerning a subject company in connection with planning, financing or otherwise participating in or rendering advice in connection with, a tender offer."[98] Approximately twenty years later, these proposals have not been enacted, and the SEC has not promulgated rules directly on this subject. Case law and the federal securities laws, however, would prohibit disclosure of nonpublic information to the acquiring company.

In most cases, a combination of the above measures will be required. For example, one financial institution has implemented a Chinese Wall conflicts policy that includes the following guidelines:

> (1) Prior to accepting any engagement with a new client or a new engagement for an existing client, the senior banker on the team must determine the scope and nature of any prior or existing relationship between the bank and that company;
> (2) For any type of nonpublic engagement, all information must be kept on a "need to know" basis. "Need to know basis" means that information must not be shared with any nonbank personnel and should be shared only with bank personnel that have a "need to know" the information. That is, disclosure should be made only in furtherance of the project to those working on the project. All recipients of information must be instructed that the information is to remain confidential. Even within a department or business group, information should only be disclosed in furtherance of the project in order to prevent personnel from being foreclosed from participating on other

97. The scope and object of this disclosure is not clear from the SEC proposal.

98. L. RICHARD FISCHER, BANK USE AND PROTECTION OF CONFIDENTIAL INFORMATION, ¶ 7.03 (discussing the Memorandum of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs on Bank Financing of Tender Offers, at 27 (undated)).

> teams or projects. For example, if nonpublic information about a client that is a bidder in a corporate auction situation is disclosed to a bank official even though that official has no need to receive that information, then that official would needlessly be foreclosed from participating on a team organized to serve another bidder in the same auction.
> (3) For the same reasons as discussed above, the bank policy also cautions against sharing information between different business groups within the same department unless client consent is first obtained.

The policy provides additional specific rules that are directed to the acquisition conflicts described above:

> (1) The involved bankers must ask whether the client's target is an existing client. If the target is a client of one of the bankers, that banker must immediately withdraw from the engagement. The acquiring client should simply be notified that the banker has a "personal conflict" and will be replaced. The bank can then continue with the transaction. Even if the target is not a client of any of the bankers assigned to the new engagement, if the target is a client of the bank, then the bank must determine whether, based on policy reasons, it wants to accept the acquirer's engagement proposal. The risk should be discussed with senior management, compliance and legal. Separate deal teams must be established.
> (2) A conflict may also arise if there are multiple bidders for a target. If such a conflict exists, management, in consultation with legal and compliance, must determine whether to proceed. If the bank decides to proceed, it must create completely separate deal teams all the way through senior management. No information may be shared between teams.
> (3) In all conflict situations, the engagement letter

> should contain provisions that: (a) disclose potential conflicts; (b) notify clients that the bank is a common carrier that finances many competing interests; and (c) provide appropriate indemnities. Counsel should participate in the preparation of any such letter.
> (4) All engagements with potential conflicts must be assigned a code name by the time the client makes the decision to proceed. The compliance department must be given the code name. The code name must be used in all communications among team members and with client representatives.

A bank's duty does not end with the creation of a Chinese Wall. Rather, it should effectuate a compliance program to ensure that personnel are following the policies and procedures of the Chinese Wall.[99] For example, a bank may have continuing education programs regarding such policies and procedures. In addition, the bank may want to establish an internal auditing system. For the problem of information flow from various bank departments to the trust department, specific measures such as watch lists may also be used.[100] A watch list is a device used to monitor employee and customer transactions and research in the securities of corporations for which the bank has obtained, or is likely to obtain, nonpublic information. The purpose is to detect potential breaches of the bank's Chinese Wall policies and procedures. The contents of the watch list are known only by a limited number of selected members of the compliance department and upper-level management. Regardless of the procedures selected by the bank, all personnel should be encouraged to discuss all conflict concerns and questions with a member of the compliance department or with legal counsel.

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99. *See* Steinberg & Fletcher, *supra* note 83, at 1804.
100. *See id.* at 1805.

III. CONFLICTS ARISING FROM DUAL ROLES

The potential for a conflict of interest also arises when a bank serves both as principal lender to and indenture trustee for a corporation issuing public debt. Although a bank acting in this dual-role has a potential conflict between its interest as a lending bank and its interest as a fiduciary for bondholders, this arrangement is quite common. Unlike the other potential conflict situations discussed in Section I above, the legislature has developed specific rules to provide guidance in this area. Prior to the enactment of the Trust Indenture Reform Act of 1990 (TIRA), the Trust Indenture Act of 1939 (TIA) provided statutory conflict of interest guidelines for indenture trustees. Neither the TIA nor the TIRA imposed a prohibition on the bank's ability to act in both roles. Rather, the statutes attempted to minimize the potential for conflicts of interest.

The TIA set forth nine different situations in which a conflict of interest arose. If one of the described situations occurred at any time when the securities were outstanding, a conflict of interest arose, and certain relationships were prohibited. Over time, and primarily as a result of increased syndications, the TIA rules became burdensome. In the course of reevaluating the TIA and enacting the TIRA, Congress determined that, because of the ministerial nature of trustee duties prior to default, there was no danger of abuse and thus no real potential for conflict prior to default.

Accordingly, in 1990 Congress enacted the TIRA, which emphasizes a post-default conflict of interest standard. A conflict of interest arises after default because both the bank, in its role as lender, and the bondholders (to which the indenture trustee owes a fiduciary duty) want to be paid, and there is only one sum of money from which payment can occur. Under the TIRA regime, there is a 90-day period in which a default must be cured, or the conflict of interest eliminated. If either the default or the conflict exists at the end of the 90-day period, then the trustee must resign and a successor will be appointed in the manner set forth in the indenture.[101] In addition, upon default, a

101. *See* 15 U.S.C. § 77jjj(b) (1994); *see also* Joseph F. Kelley, Jr., *The Indenture Trustee and Conflict of Interest Concerns*, *in* PROBLEMS OF INDENTURE TRUSTEES AND BONDHOLDERS 1992: DEFAULTED BONDS & BANKRUPTCY, at 197 (PLI Real Est. L. & Practice Course Handbook Series No. N4-4561, 1992).

creditor relationship becomes an explicit and prohibited conflict of interest.[102]

One commentator has suggested that the adoption of a post-default conflict standard does not completely eliminate pre-default conflict of interest risk. According to this commentator, the TIRA cannot eliminate "true conflicts" such as the following: "if a lending bank improves the nature and value of the collateral for its loan knowing that the borrower is in financial extremis, it is by no means clear that it can put its head in the sand as the borrower moves toward a default on the debentures for which the banking institution acts as a fiduciary indenture trustee."[103] A minor syndicate member, however, with no substantive role in due diligence would not be subject to the same level of scrutiny as the lead lenders.[104] Therefore, although the TIRA provides more guidance for indenture trustees than the TIA provided, the continuing possibility of potential conflicts of interest "should continue to make corporate trust departments uncomfortable."[105] As with the other conflict situations discussed above, this is an area where banks must continue to think about the possibility of conflicts and how best to address them in an evolving banking environment.

Conflicts of interest are of growing concern and significance in a rapidly expanding banking industry. As a result of these changes, banks will need to anticipate potential conflicts in new contexts. For instance, as banks shift the focus of their customer relationships from traditional debtor-creditor to advisory in nature, their use of nonpublic information becomes more suspect, and thus must be more closely monitored. Whether a potential conflict is based on the dissemination of confidential information or performing the dual role of lender and fiduciary under an indenture agreement, banks must be prepared to develop and employ effective defensive strategies. If banks fail to innovate, they may find themselves responsible for breaches of

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102. *See* 15 U.S.C. § 77jjj(b)(10).

103. Kelley, *supra* note 101, at 205.

104. *See id.*

105. *Id.*, at 208 (concluding that "the increased activism of corporate debtholders, the obvious flood of contentious litigation, the manifest interest of the court and public in the role of banks and others in highly leveraged transactions, and perhaps even common sense, all raise difficult questions about the indenture trustee's role in modern corporate financing).

unforeseen fiduciary obligations. At a minimum, until banks provide stronger assurances of confidentiality, these "complicated relationship issues" may cost them customers.