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Offshore Outsourcing For Financial Institutions: Minimizing Risks In Order To Maximize Rewards

Recent growth in outsourcing by banks and other financial institutions (hereinafter, "banks") has heightened interest in if and how such activities will be regulated, as well as in the risks and rewards associated with such activities. It is estimated that approximately 45 percent of all banks outsource. Increasingly, this outsourcing is moving overseas, which presents additional risks that recently have begun to come under the scrutiny of federal bank regulators. While there are many benefits to outsourcing, it is important for banks contemplating entering into outsourcing transactions to be aware of the risks regulators have identified so that they may take steps to minimize those risks.

THE BENEFITS OF BANK OUTSOURCING

The greatest benefit to banks from outsourcing is cost reduction. Third-parties may have economies of scale or specializations that allow them to offer certain services at a lower cost. Banks can also accommodate fluctuations in labor or equipment needs without having to pay full-time salaries or buying new equipment through outsourcing. Finally, outsourcing avoids the need to devote money to keeping up with rapidly changing technology.

The growth in outsourcing, both in the U.S. and overseas, also has been attributed to the desire for increased efficiency. Outsourcing helps banks become more efficient by improving company focus, freeing up resources for other projects, allowing banks to access resources not available internally, and reducing time to market for new products.

Finally, banks stay competitive by outsourcing. For example, banks can now continue their operations at off hours; this can help banks achieve compliance with certain regulatory requirements within specified time frames. Furthermore, banks can retain clients by offering more sophisticated products and by meeting clients' needs with shorter transaction processing times.

THE RISKS ASSOCIATED WITH BANK OUTSOURCING

The federal banking agencies have identified a number of risks that banks face when outsourcing activities, such as reputation risk, operational/transactional risk, compliance risk, strategic risk, credit risk, security risk, and risk associated with the outsourcing of activities outside of the U.S. (the practice of outsourcing outside of the U.S. is sometimes referred to as "offshoring"). Many would argue that offshoring presents the greatest risk. Offshoring has a much greater failure rate than domestic outsourcing; in fact, companies that have good domestic outsourcing track records have had failures overseas.

In recent guidance and bulletins, the federal banking agencies have identified the following risks as being of special concern in the case of offshoring:

Country Risk. Country risk includes the possibility that political, social or economic conditions in the foreign county could adversely affect the bank or its functions.

Compliance Risk. When evaluating whether or not to use a foreign service provider, banks must consider how such outsourcing will affect the bank's ability to comply with applicable laws and regulations, such as the Bank Secrecy Act and its records retention requirements.

Reputation Risk. Banks should be aware of any negative public opinion associated with a third party's inability to continue its level of service of customer relationships. Cultural and language bar-

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Seventh Circuit Enforces Subordination Agreement: Junior Lender Must Disgorge Payments, Pay Prejudgment Interest

In *PPM Finance, Inc. v. Norandal USA, Inc.*, 392 F.3d 889 (7th Cir. 2004), the Seventh Circuit recently upheld the enforceability of a subordination agreement that provided that a Junior Lender must disgorge approximately $3.8 million in subordinated note payments (the "Sub-Note Payments") it received from a debtor in default to a Senior Lender. (Lord Bissell & Brook LLP represented the Senior Lender.) The Court found that the subordination agreement required disgorgement, even though: (i) the Senior Lender did not give notice to the Junior Lender that the common debtor was in default; (ii) the Senior Lender could have stopped the debtor from making the payments to the Junior Lender; and (iii) the Senior Lender made revolving loan advances that allowed the debtor to make the to-be-disgorged payments to the Junior Lender. In addition, the Seventh Circuit upheld an award to the Senior Lender of approximately $684,000 in prejudgment interest on the disgorged payments.

The Subordination Agreement required the Junior Lender to disgorge any payments it received from a Common Debtor while the Common Debtor was in default to the Senior Lender. The Common Debtor ended up defaulting on its obligations to the Senior Lender. Despite these defaults, however, the Senior Lender continued to make loans to the Common Debtor under a revolving credit agreement, knowing that the Common Debtor used some of the funds to make Sub-Note Payments to the Junior Lender.

In November 2002, more than one year after the beginning of the Common Debtor's chapter 11 case, the Senior Lender sued the Junior Lender to recover the Sub-Note Payments. The district court granted the Senior Lender's motion for summary judgment, finding that the subordination agreement unambiguously required the Junior Lender to remit the Sub-Note Payments to the Senior Lender. The Seventh Circuit affirmed, rejecting the Junior Lender's largely equitable arguments as being contrary to the Subordination Agreement.

> "[T]he Seventh Circuit refused to "read in" additional terms into the Subordination Agreement that the parties had not written themselves.

AGREEMENT TO DISGORGE PAYMENTS ENFORCED

In a dispute about a subordination agreement, the first step under Illinois law is to determine whether the agreement is "subject to more than one reasonable interpretation." The Junior Lender, arguing that the Subordination Agreement was ambiguous, asked the Court to read additional obligations into the Subordination Agreement. Specifically, the Junior Lender

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riers can magnify this risk in cases of offshoring.

Credit Risk. Finally, there are credit risks involved if the third party fails to meet its obligations, or becomes insolvent. As with other risks associated with outsourcing, this risk can be greater when outsourcing services are performed offshore.

The federal banking agencies also have noted the increased privacy concerns associated with outsourcing, particularly when dealing with third party contracting arrangements overseas. The Gramm-Leach-Bliley Act establishes continuing obligations with respect to monitoring customer privacy and protecting customer personal information. The federal banking agencies have taken this to mean that banks also are obligated to monitor the activities of those service providers to which banks transfer customer information. Furthermore, the agencies recommend that banks that outsource data to vendors should also be aware when those vendors have in turn subcontracted with a third party.

WAYS TO MINIMIZE THE RISKS OF BANK OUTSOURCING

The federal banking agencies recommend that a bank perform adequate due diligence prior to entering into a contract with a third party service provider overseas. Moreover, banks are advised to pay close attention to contract provisions which govern choice of law and forum selection. Provisions regarding privacy and confidentiality of bank records should be included in offshoring contracts.

The federal banking agencies have indicated that they will examine an institution's outsourcing arrangement with foreign third party service providers if circumstances warrant. The agencies note that if the service provider is a regulated entity, then a regulator may arrange through the appropriate foreign supervisor to obtain information related to the services provided, and if significant issues emerge to examine those services.

The federal agencies also place responsibility on the bank's board of directors and management to ensure that the bank effectively oversees any relationships with foreign third party service providers. The agencies recommend, and in some instances require, ongoing oversight by the board of third party service providers.

While banks are increasingly looking to reap the rewards of outsourcing, it is important that banks stay abreast of (and take effective steps to address where appropriate) the legal and compliance risks associated with third party relationships, both in the U.S. and overseas.

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Sailing Beyond The Safe Harbor: Lender Risk Issues In Financing Brownfield Sites

A neighborhood family center and day care facility in Chicago's Lawndale community. Natural wetlands in tandem with a state-of-the-art technology park in coastal Virginia. Revitalized residential housing in suburban St. Louis. These are just a few of the brownfield success stories highlighted by the U.S. Environmental Protection Agency ("EPA"). Of course, none of these sites sounds like a "brownfield," although each of them at one time appeared to have a bleak future, as they sat unused and wasting. Lenders can play a pivotal role in changing the future for such sites, but they must ensure that they do not incur potential liability for cleanup cost and that risk is appropriately balanced. This two-part series will examine two ways that lenders can mitigate risk in credit facilities secured by properties that may be characterized as "brownfields." In Part I, we examine the role of the Site Assessment Report, and in Part II, we will discuss environmental insurance.

A "brownfield" is more specifically defined by the EPA as "abandoned, idled or underused industrial and commercial sites where expansion or redevelopment is complicated by real or perceived environmental contamination that can add cost, time or uncertainty to a redevelopment project." The abandoned gas station, the vacant lot where the steel mill once stood, the dump site behind the old auto repair shop—these properties also have the potential to be success stories.

However, there are no magic wands for turning derelict junk yards into sparkling new community centers. The liability risks in developing such properties pose a legitimate and substantial deterrent. In response, as state and local governments (and their constituents) recognize the value of revitalizing blighted properties, they have instituted certain protections for purchasers of brownfields, which in turn benefit private lenders financing the purchase. The federal government and a majority of states have enacted brownfields legislation. In 2002, Congress enacted the Small Business Liability Relief and Brownfields Revitalization Act, which, among other things, authorized funding for grants and loans, defined certain liability exemptions for purchasers, and established due diligence procedures for prospective purchasers.

Historically, lenders have had three primary concerns in financing blighted properties:

- Potential liability for cleanup costs and related damages stemming from contamination on the property ("Will we as lenders be on the hook for costs under CERCLA?")
- Uncertainty regarding a borrower's capacity to repay a loan if the borrower becomes overcommitted with cleanup costs ("How will the borrower repay us if the borrower is required to cover hundreds of thousands of dollars in cleanup costs?")
- Future value of the property ("How do we know this development will work? Will it *still* be an abandoned gas station $3 million later?")

Amendments to CERCLA in 1996 clarified safe harbor provisions for lenders. These amendments were made when Congress passed the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 and, essentially, they defined contours by which lenders could avoid CERCLA liability. While potential liability (albeit with a better defined ambit) remains a significant concern for lenders, the other concerns regarding the likelihood of repayment and future value of the property continue to shadow lenders considering financing brownfields projects. Nevertheless, there are other sources to which lenders can turn for comfort regarding the likelihood of repayment and an increased future value of the property.

SITE ASSESSMENT REPORTS

The adage "knowledge is power" rings especially true here. The more a lender knows about the property, the better a decision it can make regarding the risk (and benefits) of financing a project. Lenders should, as a matter of practice, require the purchaser/borrower to provide the lender with current site assessment reports ("SARs") at the purchaser's expense. SARs provide information regarding the nature and extent of environmental contamination, if any exists. SARs are available in a standardized format, as issued by the American Society for Testing and Materials ("ASTM"). The ASTM standard should at least be consulted, if not used, by an independent and reputable environmental consulting firm.

All parties involved in the transaction should have sufficient time to digest and understand the SAR. Simply noting receipt of a SAR and never understanding it are as worthwhile as never having had the SAR done in the first place. While large financial institutions often have their own in-house environmental risk specialists to explain these sorts of reports, it would not be unreasonable to engage an outside consultant to assist in communicating the results of the SAR—and also ensuring that the underlying work is thorough and reliable.

While understanding the SAR is critical, a lender also should appreciate that

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the SAR may not be the only evaluation required. Some issues may be unresolved, and some new questions may arise from information revealed in the SAR. In addition, the lender or its consultant may have good cause to believe that the SAR did not address certain key issues; it is not uncommon for consultants to occasionally disagree about what is necessary to complete an evaluation. Perhaps the SAR did not cover groundwater contamination for adjacent lots. If the lender is uncomfortable financing the risk without the information, the lender may require additional evaluation.

In the next issue of the Lord Bissell & Brook *Banking & Bankruptcy Law* Newsletter, we will take a look at environmental insurance, another method by which lenders can mitigate the risk of loans related to brownfield sites.

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asserted that the Senior Lender was under an obligation to notify the Junior Lender of the Common Debtor's default. Because the Senior Lender failed to give such notice, the Junior Lender argued, the Senior Lender was barred from recovering the Sub-Note Payments under the Subordination Agreement.

Finding the Subordination Agreement unambiguous, the Seventh Circuit refused to "read in" additional terms into the Subordination Agreement that the parties had not written in themselves. Notably absent from the Subordination Agreement was a senior default notice provision. In fact, the Court found that "nothing in the subordination agreement required [the Senior Lender] to notify [the Junior Lender] of [the Common Debtor]'s default." 392 F.3d at 893. Because the Senior Lender had no obligation to notify the Junior Lender of the default, and the Subordination Agreement also clearly provided that the senior debt must be paid in full before payments could be made on the subordinated debt, the Senior Lender had a right to recover the Sub-Note Payments from the Junior Lender.

RIGHT TO DISGORGE NOT WAIVED

The Junior Lender also argued that the Senior Lender waived its right to disgorge payments from the Junior Lender by providing post-default loans to the Common Debtor, part of which the Common Debtor, in turn, used to pay the Junior Lender, even though the Common Debtor had defaulted under its Credit Agreement with the Senior Lender

The Seventh Circuit concluded that the Senior Lender's issuance of the post-default loans to the Common Debtor did not constitute a waiver of its right to disgorge the Sub-Note Payments from the Junior Lender for two reasons. First, the Subordination Agreement contained a broad anti-waiver provision that required any waiver to be in writing and signed by the parties. Finding the anti-waiver provision enforceable, and that the parties had not entered into a written waiver, the Court rejected the Junior Lender's waiver argument.

Second, the Court found that "[the Senior Lender]'s post-default loans to [the Common Debtor] were not inconsistent with its later efforts to recoup that money [from the Junior Lender] pursuant to the agreement." *Id.* at 895. The Court relied on a section of the subordination agreement that explicitly authorized the Senior Lender to make additional loans without affecting either party's obligations under the Agreement.

PREJUDGMENT INTEREST AWARDED

The Illinois Interest Act provides that a creditor shall be awarded interest at the rate of five percent per year for all moneys after they become due on any "instrument of writing." 815 ILCS 205/2 (2002). Finding the Subordination Agreement to be an "instrument of writing," the Seventh Circuit upheld the district court's award of approximately $684,000 in prejudgment interest to the Senior Lender.

CONCLUSION

When negotiating and drafting a subordination agreement, senior lenders should pay heed to the Seventh Circuit's helpful guidelines and:

- Identify all substantive rights and duties of the parties clearly in the subordination agreement.
- Include a broad anti-waiver provision.
- Provide that advancing additional loans to a debtor, even a debtor in default, does not alter the respective rights or obligations of the senior and subordinated creditor.
- Be aware of state statutes that award prejudgment interest.

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