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## NY Court of Appeals Rules Lender Reliance on Borrower Financial Representations Without Independent Investigation is Not Unreasonable

An almost universal feature of commercial loan agreements is the inclusion of representations and warranties regarding the financial statements and condition of the borrower. A recent case examined whether under New York law, sophisticated lenders can reasonably rely upon such representations in asserting claims of fraud instead of being required to make an independent investigation into the books and records of the Borrower.

In *DDJ Management LLC, et al v. Rhone Group L.L.C., et al*<sup>1</sup>, the New York Court of Appeals held that Lenders may maintain claims against two groups of investment funds and their affiliates for fraud after the Plaintiffs<sup>2</sup>, the agent and lenders under a credit agreement lost a total of \$40 million in loans they made to a company controlled by such investment funds. The court held that lenders could reasonably rely upon representations and warranties contained in the loan documents, in which the borrower provided assurances that its financial statements were accurate and that nothing therein was materially misleading. The court found that by including such representations, the lenders made a “significant effort” to protect themselves against the possibility of false financial statements and therefore did not require that lenders independently investigate the financial condition of borrower. This came much to the relief of lenders who typically bargain for and rely upon such representations, as the appellate court overturned a lower court decision which would have required sophisticated lenders to independently investigate the books and records of their borrowers in order to sustain a fraud claim against them.

### Background

The borrower in DDJ was American Remanufacturers Holdings, Inc. (“ARI”), an auto parts remanufacturer that had been formed in spring 2003 through a merger of two separate companies owned by Rhone Group LLC and Quilvest S.A. and their respective affiliates (“Rhone” and “Quilvest” and together with certain employees thereof and of ARI, collectively, the “Defendants”). Not long after the merger, ARI sought to refinance certain obligations outstanding to General Electric Capital Corporation who had demanded repayment. In Fall 2003, ARI engaged an investment bank to arrange for loans to ARI and begun the process of courting the Plaintiffs as lenders.

The Plaintiffs assert that ARI and the Defendants had formulated a plan to obtain new financing and did so by making misrepresentations which painted a much rosier picture of the business affairs, management team, profitability and value of ARI’s assets than was reality and that in doing so, they committed fraud. The highlights of their numerous allegations include the following: (a) Plaintiffs were provided with 2004 unaudited financial statements of ARI which reported EBITDA as positive \$16.9 million when it was in fact a negative number; (b) inventory reserves were manipulated in the 2004 financial statements to achieve a higher EBITDA number and the reporting of such reserves were not in compliance with GAAP; (c) the CFO of ARI required the controller of ARI to make such changes in reserves after warnings by the controller that such behavior would be “unethical”; (d) various employees of Rhone were aware of and encouraged the manipulation of EBITDA; (e) the Defendants failed to disclose that their outside auditor, PricewaterhouseCoopers threatened to resign as ARI’s auditor prior to certifying the 2003 financial

<sup>1</sup> *DDJ Mgmt., LLC v. Rhone Group L.L.C.*, 2010 NY LEXIS 1182 (N.Y. 2010).

<sup>2</sup> The plaintiffs in the case are the agent DDJ Management LLC and lenders DDJ Total Return Loan Fund, L.P., GMAM Investment Funds Trust II and Arlie Opportunity Master Fund, LTD.

statements but was pressured by Rhone and Quilvest employees into continuing as auditor<sup>3</sup>; (f) that various management employees of ARI, including the chairman and CFO were being replaced because of their poor performance but this was deliberately not disclosed to the lenders until after the loans were completed; and that (g) the various representations and warranties made in the loan agreement relating to financial statements and information were not true when made<sup>4</sup>.

Within eight months of the closing of the loan in March 2005, ARI filed for bankruptcy.

**Intermediate Appellate Court Decision: Sophisticated investors have an affirmative duty to conduct independent appraisals in order to assert justifiable reliance**

The trial court initially dismissed the claims against the Defendants for fraud, and the Plaintiffs appealed. In March 2009, an intermediate appeals court<sup>5</sup> ruled that the dismissal of Plaintiff's claims of fraud were warranted and declared that sophisticated investors cannot claim "justifiable reliance" on alleged misrepresentations where they have not used "means of verification available to it." Finding that such investors have an "affirmative duty to exercise ordinary intelligence and conduct an independent appraisal of the risks they are assuming" the court went on to impose an unprecedented duty on lenders to do an independent review of the books and records of their borrowers.

As the court stated, Plaintiffs "could have insisted on reviewing the books and records of ARI itself but did not, and as a result, Plaintiffs "failed to make any such effort to evaluate the risk for themselves, they cannot now properly allege reasonable reliance." Understandably, this case was troubling to the lending industry, calling into question an industry-wide practice of relying on representations and company-certified financial statements and potentially requiring that lenders undertake the burden of independently auditing the books of their borrowers each time they make a loan.

Upon appeal, an amicus brief was filed by industry groups such as the Loan Syndications and Trading Association and the Commercial Finance Association warning of the burden this would place on the credit markets<sup>6</sup>. The amicus brief describes this ruling as threatening "serious disruption to the vast amount of commercial lending that occurs in or is governed in New York" and goes on to state that "the courts rule upsets lenders' settled expectations in countless existing loan obligations...at a time when commercial lending is already painfully restricted."

<sup>3</sup> The Plaintiffs alleged that the 2003 financial statements should have contained a going concern qualification because the auditor was aware of the 2004 unaudited financial statements and condition of the company prior to the date upon which the 2003 statements were certified. Nonetheless, various claims by the Plaintiff against PricewaterhouseCoopers relating to the 2003 financial statements, were dismissed because among other things, Plaintiffs had not established that the auditor's conduct had been the "proximate cause of injury" to Plaintiffs.

<sup>4</sup> The representations and warranties contained in the loan documents covered the typical panoply of representations as to accuracy of financial statements and information, and included the following: (a) the 2004 financial statements "present fairly in all material respects the financial position of ARI as at December 31, 2004 and the results of ARI's operations and cash flows for the period then ended"; (b) that the statements were prepared in accordance with GAAP; (c) that between December 31, 2003 and March 22, 2005, "no event has occurred which alone or together with other events, could reasonably be expected to have a Material Adverse Effect" on ARI's "business, assets operations, prospects or ability to repay the loans and (d) no information contained in the loan agreement, other loan documents or the financial statements furnished to Plaintiffs contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained therein not misleading in light of the circumstances under which they were made."

<sup>5</sup> See 875 N.Y.S.2d 17 (App. Div. 2009).

<sup>6</sup> The amicus brief can be found [here](#).

**Court of Appeals Decision: Justifiable reliance can be established by bargained for representations and warranties**

The Court of Appeals acknowledged the rule that a party claiming to be defrauded must have justifiably relied on the fraudulent conduct as an important balance preventing hypocritical claims by sophisticated parties. However, the Court of Appeals reversed the lower court's decision, stating that "where a Plaintiff has taken reasonable steps to protect itself against deception, it should not be denied recovery merely because hindsight suggests it might be possible to detect the fraud when it occurred."

The court did acknowledge that there was no evidence that Plaintiffs asked to look at ARI's underlying books and records and that there may have been "hints from which Plaintiffs might have been put on guard." Nonetheless, the court recognized that the lenders bargained for extensive representations regarding the financial information upon which it based its credit decisions and held that "where a plaintiff has gone to the trouble of insisting upon a written representation that certain facts are true, it will often be justified in accepting that representation rather than making its own inquiry." The court also focused on the facts of a case applying New York law, *Merrill Lynch & Co v. Allegheny Energy Inc.*<sup>7</sup>, where the Second Circuit Court of Appeals reached a similar result, finding that in exacting written representations and warranties as to the accuracy of financial information, a sophisticated party satisfied its requisite due diligence requirements.

**The Impact of DDJ**

The ruling by the Court of Appeals was a significant confirmation for commercial lenders in New York. It affirms the current practice of commercial lenders, who in many cases rely upon interim unaudited financial statements provided by borrowers and perhaps other limited public information, supported by written assurances in their loan documents regarding the quality and accuracy of such information provided by borrowers. By overturning the lower court decision, the Court of Appeals provided that such reliance was reasonable without placing the heavy burden upon lenders to independently verify financial statements prepared by borrowers through independent examination of their books and records. This additional burden would have been disruptive to the financial markets and to borrowers given that independent verification of financial information is a lengthy and expensive process and generally only occurs once per year when audited yearly financial statements are completed.

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<sup>7</sup> 500 F.3d 171 (2d Cir. 2007).