

**COURT OF APPEALS OF NEW YORK CONFIRMS THAT LENDERS NEED NOT
PERFORM INDEPENDENT DILIGENCE IN CONNECTION WITH
REPRESENTATIONS GIVEN IN A CREDIT AGREEMENT**

In *DDJ Management, LLC v. Rhone Group L.L.C.*, No. 131, 2010 N.Y. LEXIS 1182 (June 24, 2010), the Court of Appeals of New York recently unanimously reversed the Appellate Division's ruling in *DDJ Management, LLC v. Rhone Group L.L.C.*, 60 A.D.3d 421, 875 N.Y.S.2d 17 (1st Dep't 2009). According to an amicus brief filed on behalf of the Loan Syndicate and Trading Association, the Commercial Finance Association and The Clearing House Association L.L.C., the Appellate Division's ruling would have threatened a "serious disruption to the vast amount of commercial lending that occurs in or is governed by the law of New York."

On March 22, 2005, a group of investment funds and their agent (the "Lenders") loaned \$40 million to American Remanufacturing Holdings, Inc. (the "Borrower") and its affiliated companies (the "Loan"). The Borrower was owned by certain funds of two private equity investors, the Quilvest Group ("Quilvest") and the Rhone Group ("Rhone" and collectively with Quilvest the "Sponsors"). Quilvest and Rhone each had two employees on the board of the Borrower, and one employee of each of the firms was assigned to assist in the Borrower's management. During the time period prior to the Loan, the finances of the Borrower began to deteriorate. The Sponsors knew that the Borrower was going to need financing, and according to the court, at the direction of the Sponsors' executives and employees who were managing the Borrower, the Borrower pursued a scheme to falsify its records, misrepresent its prospects and mislead the Lenders into making the Loan.

In accordance with the conditions of the Loan, the Lenders were provided with audited financial statements for 2003, together with unaudited and unfootnoted financial statements for 2004. In the loan agreement, the Borrower gave standard representations and warranties, including that there had not been a material adverse change, that the financial statements presented its financial position accurately in accordance with GAAS and that the loan agreement and financial statements contained no untrue statements or omissions of material facts. The record does not indicate that any such representations were made by the Sponsors. The 2004 financial statements indicated that EBITDA had dramatically increased compared to that shown in the 2003 financial statements. This increase was the result of a decision not to take reserves for inventory remaining unsold for one year, but rather for that remaining unsold for two years. The Lenders did not ask questions about the financial statements, nor did they ask to look at the Borrower's underlying records. On November 7, 2005, the Borrower filed for bankruptcy, eventually causing the Lenders to lose the entire principal amount of the Loan. The Lenders sued the Sponsors and the Borrower's accountants (claims against the accountants were eventually dismissed), alleging, among others things, fraud and negligent misrepresentation and claiming that the employees of the Sponsors and the Borrower had intentionally drafted the Borrower's financial statements to falsely report a positive financial outlook for the Borrower.

The Appellate Division, on March 5, 2009, dismissed the fraud claim against the Sponsors and held that a lender needs to conduct its own due diligence regarding the accuracy of a borrower's financial statements despite the borrower's representations and warranties in that regard. *DDJ Management, LLC v. Rhone Group L.L.C.*, 60 A.D.3d 421, 875 N.Y.S.2d 17 (1st Dep't 2009). The Appellate Division emphasized that since the Lenders had not made any effort to evaluate the Borrower's books and records to determine the accuracy of the financial statements, they could not properly allege reasonable reliance on the misrepresentations. In reversing, the Court of Appeals held that a lender is not required, as a matter of law, to conduct its own due diligence regarding a borrower's financial statements, but is entitled to rely on the representations and warranties of the borrower regarding the accuracy of those statements.

The Court of Appeals reversed the decision of the Appellate Division, ruling that because the plaintiffs had made a "significant effort to protect themselves against the possibility of false financial statements by requiring representations and warranties to the effect that nothing in the financial statements was materially misleading," they were not required to do more. The court stated that "where a plaintiff has gone to the trouble to insist on a written representation that certain facts are true, he will often be justified in accepting that representation rather than making his own inquiry." Furthermore, the court stated that even if hindsight suggests that it might have been possible to detect the fraud when it occurred, a plaintiff can recover in a lawsuit as long as it has taken reasonable steps to protect itself against deception.

It is important to note that the typical remedy for a lender in a situation in which a borrower's representations or warranties turn out to be false would be to declare an event of default and accelerate the loan, and this case does not appear to affect the ability of a lender to accelerate. As an aside, this case also serves as a reminder to sponsors whose employees serve as directors and officers of portfolio companies that they can be sued in connection with their participation in the preparation of the financial statements of those portfolio companies.

* * * * *

If you have any questions regarding this memorandum please contact William E. Hiller (212-728-8228, whiller@willkie.com), Mary K. Warren (212-728-8205, mwarren@willkie.com), Michael I. Zinder (212-728-8298, mzinder@willkie.com), Andrew T. Reardon (212-728-8824, areardon@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

July 16, 2010

Copyright © 2010 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.