

NY Court of Appeals Addresses Lender's Right to Rely on Borrower Representations

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On June 24, 2010, the Court of Appeals of New York unanimously reversed an intermediate court's ruling that would have limited a lender's ability to rely on a borrower's representations and warranties regarding its financial statements.

In *DDJ Management, LLC, et al. v. Rhone Group L.L.C., et al.*, a group of lenders that had loaned \$40 million to American Remanufacturers Holdings, Inc. ("ARI"), sued ARI (now bankrupt), ARI's owners, and certain of their affiliates for fraud. The complaint alleged that ARI's representations in the credit agreement as to its unaudited financial statements (prepared in accordance with GAAP; fairly presented the financial condition of borrower) were false and materially misleading because they "grossly inflated EBITDA, in significant part through a manipulation of ARI's inventory reserves." The lenders alleged that ARI and its investment banker had intentionally drafted the financial statements falsely to inflate EBITDA in order to induce the lenders to make the \$40 million loan to ARI. In response, and pursuant to its motion to dismiss the claim, ARI argued that the lenders should have been alerted to the falseness of the financial statements, particularly the sudden improvement in profitability in the last month of the year, and because the lenders did not conduct sufficient due diligence into the accuracy of the financial statements (for example, by undertaking a review of the borrower's books and records), they were precluded, as a matter of law, from reasonably relying on such financials.

The Supreme Court denied the motion to dismiss the fraud claim, but the intermediate Appellate Division reversed, holding that since the lenders "never looked at ARI's books and records," the lenders "cannot now properly allege reasonable reliance on the purported misrepresentations" which is a requirement for the prosecution of a fraud claim. The Court of Appeals reversed the Appellate Division's decision and reinstated the fraud claim.

Recognizing that “there were hints from which plaintiffs might have been put on their guard in this transaction,” and that certain aspects of the unaudited financial statements “might have seemed too good to be true,” the Court of Appeals wrote

“But plaintiffs made a significant effort to protect themselves against the possibility of false financial statements; they obtained representations and warranties to the effect that nothing in the financials was materially misleading. We decline to hold as a matter of law that plaintiffs were required to do more – either to conduct their own audit or to subject the preparers of the financial statements to detailed questioning.”

The Court of Appeals’ decision, therefore, provides comfort to lenders insofar as it reflects current lender practices in the marketplace with respect to loan negotiation and the obtaining of a borrower’s latest audited financial statements and unaudited statements subsequent thereto. It should be borne in mind that while the Court of Appeals’ holding means that a lender’s fraud claim in a like situation cannot be dismissed at the pleading stage, the issue of justifiable reliance remains a question of fact to be adjudicated at trial. Additional lender due diligence would continue to be appropriate in situations where there is an absence of representations and warranties of the type presented here or where a lender has information, independent of that in the financial statements, which materially and adversely impacts borrower creditworthiness in a manner which cannot be adequately addressed by representations and warranties. In addition to obtaining representations on these matters, lenders should obtain parallel warranties, as the courts have upheld the right to bring a claim based on a warranty as a contractual allocation of risk, even if the recipient of the warranty has “doubts” about it. *CBS Inc. v. Ziff-Davis Publishing Co.*, 75 N.Y.2d 496; 553 N.E.2d 997; 554 N.Y.S.2d 449 (NY 1990).

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