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Restructuring Lessons Learned Alert – Preemptive Revolver Draws

This memorandum was prepared as part of our continuing internal focus to facilitate the collective sharing of best practices and lessons learned in the financial restructuring areas. If you have any questions or comments regarding this alert, or would like to discuss the issues raised in this alert, please contact us at Noble Law PLLC.

Borrowers may seek to draw the remaining amount of an unused revolver commitment in anticipation of reporting deteriorating financial performance resulting from then existing adverse economic factors. As a condition precedent to such borrowings, the applicable credit agreement may require that a responsible officer of the borrower certify that no material adverse event has occurred and/or that the borrower is solvent.¹

In some instances, the administrative agent may have a reasonable, good faith belief that a material adverse event has occurred or that the borrower is no longer solvent, but still finds itself unwilling to decline to fund a borrowing request because of the potential risk to it of litigation or lender liability. In such a situation, the administrative agent may want to consider a strategy under which all parties may benefit from the responsible officer having an accurate understanding of the potential personal liability that he or she may incur from making an untrue certification, and thereby reduce the likelihood that the responsible officer will act imprudently where he or she may also have doubts as to whether or not a material adverse event has occurred or the borrower is solvent.

Towards that end, and as discussed below, the administrative agent may (i) undertake a further review of the applicable conditions precedent in light of known and communicated facts and circumstances surrounding specific borrowers and (ii) clearly communicate with the appropriate responsible officers of the borrowers regarding the potential personal liability (civil

¹ Note: Although credit agreements vary, a borrower may be required to satisfy a material adverse event representation as a condition precedent to a borrowing and a solvency representation at all times.



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and criminal) that he or she may incur by making a certification (even though acting in a representative capacity) to the administrative agent in connection with a borrowing request that the officer knows, or reasonably should know, is false.

1. Credit Agreement Provisions.

Credit agreements will typically require, as a condition precedent to a borrowing, that a responsible officer of the borrower execute and submit a borrowing request certifying that the applicable representations and warranties contained in the credit agreement are true and correct as of the date of the borrowing request. Those representations and warranties may include, among other things, that no material adverse event has occurred and/or that the borrower is solvent.²

The material adverse effect representations may require a responsible officer to certify that no material adverse effect has occurred since a specified date with respect to the borrower's business, assets, property or ability to perform under the credit agreement, although the language with respect to the actual representations may contain certain variations. Those representations, and case law interpreting the relevant language, are generally not well developed. Such provisions do not customarily define a material adverse event in objective terms, but instead rely on a judicial assessment of the facts and circumstances existing as of the date of an alleged material adverse effect. Case law interpreting these provisions does not contain a standard test for evaluating an alleged material adverse effect, although courts tend to focus on (i) whether the challenged effect was foreseeable at the time the credit agreement was entered into and (ii) material to the amount of any likely loss with respect to the financing at issue.

The solvency representations may require a responsible officer to certify that the borrower is solvent at the time of the borrowing, although the language with respect to the actual representations may contain certain variations. These solvency representations, along with case law interpreting the relevant language, are generally well developed and largely track equivalent provisions in fraudulent transfer and similar statutes. We note that solvency determinations are made based on the facts and circumstances existing as of the date of the challenged borrowing or certification, generally with the benefit of judicial hindsight. We also note that a borrower may be insolvent even though it has sufficient value to satisfy obligations under the revolving credit facility where its value is nonetheless insufficient to satisfy the junior debt facilities, including any mezzanine and second lien facilities.

² The officer's ability to obtain indemnification for such liability, incurred while acting within the scope of his employment, may be impaired (i) under any otherwise available D&O policy, to the extent of any fraud exclusion customarily contained in such policies, and (ii) for any recovery from the borrower to the extent otherwise taken within the scope of his or her employment, since such claims are generally unsecured.



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2. Responsible Officer Personal Liability.

Although an officer of the borrower does not have personal liability for the debts of the borrower, he or she does have (i) personal civil liability for damages suffered by a lender with respect to any misrepresentation that the officer makes, with the expectation that the lender rely on it in advancing funds, that the officer knows or reasonably should know is false and (ii) personal criminal liability to the extent the officer makes such a representation to a regulated financial institution.³

Courts have consistently imposed personal civil liability on corporate officers with respect to tortious conduct if they participate in a misrepresentation or authorize or direct that it be made. For example, in DDJ Management, LLC v. Rhone Group L.L.C., a lender sued the borrower and its responsible officers for misrepresentation after the borrower presented financial statements that were false and misleading, and designed to inflate EBITDA. In denying the borrower's motion to dismiss, the court stated that even though the claims were connected with a breach of representations provided on behalf of the borrower, the claims against the responsible officers could survive if the officers "knew the facts represented and warranted were false—in other words, that [the responsible officers] knew the financial statements gave an untrue picture of [the borrower's] financial condition."⁴

Similarly, a corporate officer is subject to personal criminal liability to the extent he or she makes a representation to a regulated financial institution knowing, or reasonably knowing, that it is false in order to obtain funds from such institution.⁵ While such criminal liability, and the ability

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⁴ DDJ Management, LLC v. Rhone Group L.L.C., 15 N.Y.3d 147, 156-57 (2010) (applying New York law). See also, e.g., Gore v. Scotland Golf, Inc., 136 S.W.3d 26, 32 (Tex.App.2003) ("The law is well-settled that a corporate agent can be held individually liable for fraudulent statements or knowing misrepresentations even when they are made in the capacity of a representative of the corporation."); Roberts v. United New Mexico Bank at Roswell, 14 F.3d 1076, 1078 (5th Cir.1994) (Under Texas law, to recover for fraud, the plaintiff must establish that: (1) a material representation was made; (2) it was false when made; (3) the speaker knew it was false, or made it recklessly without knowledge of its truth and as a positive assertion; (4) the speaker made it with the intent that it should be acted upon; and (5) the party acted in reliance and suffered injury as a result.); cf. MTA v. Triumph Adver. Prods., Inc., 116 A.D.2d 526, 497 N.Y.S.2d 673, 675 (App.Div.1986). ("To maintain a claim of fraud in such a situation, a plaintiff must either: (i) demonstrate a legal duty separate from the duty to perform under the contract; (ii) demonstrate a fraudulent misrepresentation collateral or extraneous to the contract; or (iii) seek special damages that are caused by the misrepresentation and unrecoverable as contract damages.").

⁵ 18 U.S.C. § 1344 ("Whoever knowingly executes, or attempts to execute, a scheme or artifice – (1) to defraud



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to seek a criminal referral for bank fraud, does not result in an affirmative recovery for the lenders, it may have a significant impact on creating appropriate dynamics to actively shift the risk of liability with request to an untrue borrowing certification to the responsible officer of the borrower.⁶

3. Potential Responsive Steps.

While the particulars of each situation will have a material bearing on whether or not an administrative agent will fund or decline to fund a borrowing request, we believe that the risk management considerations discussed above may result in improved outcomes. In anticipation of anticipated potential preemptive revolver draws, it may be useful to have a discussion of the legal standards to be applied to the facts and circumstances at hand to the determination of the occurrence of a material adverse effect or borrower insolvency, as well as appropriate means of communicating to responsible officers with respect to the potential personal liability that they may incur in signing an incorrect borrowing certificate. We also note that, in advance of receiving a preemptive borrowing request, it may be prudent for the administrative agent to notify its “back office” that future borrowing requests over a specified dollar amount should be promptly cleared with the responsible loan officer.

Finally, we note that, with respect to any prior borrowing notices, the administrative agent may seek to ensure that potential claims against the responsible officers with respect to any misrepresentations are not released (and are expressly preserved) in connection with any subsequent amendments or forbearance agreements, and that secondary sources of recovery (such as the borrower’s liability insurance policies) are identified and preserved.

If you have any questions or comments regarding this alert, or would like to discuss the issues raise in this alert, please feel free to contact us at Noble Law PLLC.

Kenneth Noble

Noble Law PLLC
1185 Avenue of the Americas, 3rd Floor
New York, New York 10036-6805
M: +1 917 689 5897
E: knoble@noblepllc.com

a federally chartered or insured financial institution; or (2) to obtain any of the moneys, funds, credits, assets, securities or other property owned by or under the custody or control of a federally chartered or insured financial institution by means of false or fraudulent pretenses, representations, or promises; shall be fined not more than \$1,000,000 or imprisoned not more than 30 years, or both.”).

⁶ E.g., United States v. Rigas, et al., 490 F.3d 208 (2d Cir. 2007) (affirming conviction for bank fraud based on false statements made in connection with borrowing base certificate).