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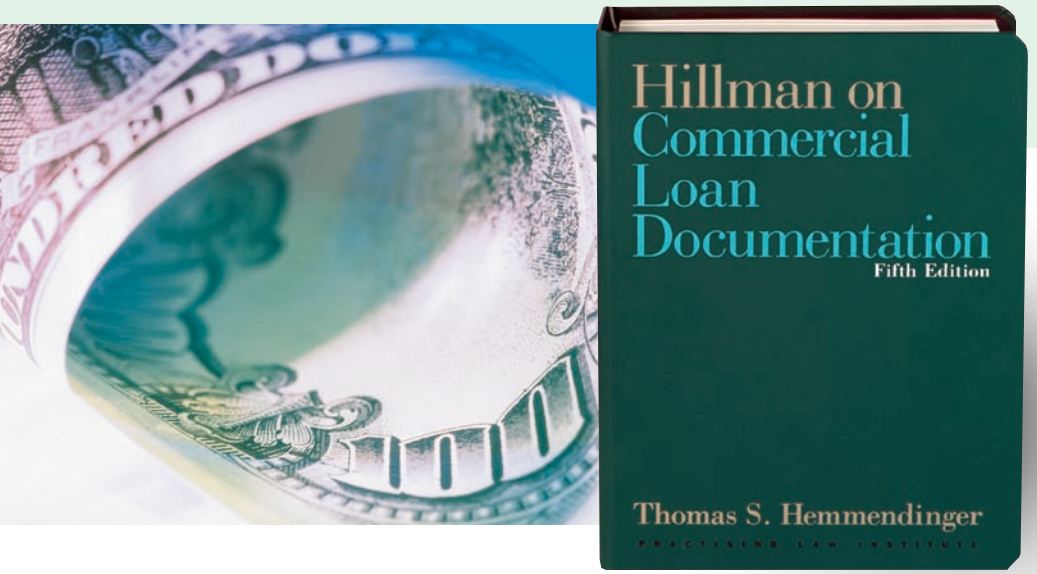

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Thomas S. Hemmendinger is of counsel to Brennan, Recupero, Cascione, Scungio & McAllister LLP, in Providence, Rhode Island. He specializes in commercial loan documentation, Uniform Commercial Code matters, and bankruptcy and insolvency litigation.

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Fifth Edition

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Form 8.1

Loan Agreement

Made as of this ____ day of _____, 20__, between **ANY LAWFUL BUSINESS, INC.** ("Borrower"), a Rhode Island corporation, and **LAST NATIONAL BANK** ("Lender"), a national banking association.

Recitals

(A) Borrower has requested Lender to extend credit to Borrower for business purposes.

(B) Lender is willing to extend such credit on the terms and conditions of this Agreement.

Agreement

1. Definitions and Certain Rules of Construction.

(a) Definitions. As used in this Agreement:

"Advance" and, collectively, "Advances," mean:

(1) any loans, advances or other extensions of credit to Borrower in an aggregate principal amount at any one time outstanding up to but not exceeding the maximum principal amount of the Line of Credit and the principal amount of the Term Loan, plus

(2) any funds Lender may advance or indebtedness Lender may incur in exercising its rights or remedies pursuant to the terms of any Loan Document.

"Affiliate" means a Person:

(1) that controls, is controlled by, or is under common control with another Person;

(2) that controls 10% or more of the outstanding voting power of another Person; or

(3) 10% or more of whose outstanding voting power is controlled by another Person.

For purposes this definition, "control" means the direct or indirect power to direct or cause the direction of the management, operations or policies of a Person through any means (including through legal or beneficial ownership of voting stock or other equity interests, through one or more intermediaries, or pursuant to contract, arrangement or understanding).

"Collateral" means all property described in any Security Document.

"Commitment" means the obligation of Lender to make Advances on the Line of Credit.

"Commonly Controlled Entity" means any entity under common control with Borrower under 26 U.S.C. § 414(b) or (c).

"Consolidated Cash Flow" means, for any period, the total of:

(1) Consolidated Net Income; plus

(2) amounts deducted in computing such Consolidated Net Income in respect of depreciation, amortization, interest on indebtedness (including payments in the nature of interest on capitalized leases), and taxes based upon or measured by income; minus

(3) capital expenditures.

"Consolidated Fixed Charges" means, for any period, the sum of:

(1) the aggregate amount of interest, including payment in the nature of interest under capitalized leases, paid or accrued by Borrower or any Subsidiary (whether such interest is reflected as an item of expense or capitalized) on indebtedness; plus

(2) the aggregate amount of all mandatory scheduled payments, prepayments and sinking fund payments, in each case with respect to principal paid or accrued by Borrower or a Subsidiary in respect of indebtedness for borrowed money, indebtedness evidenced by notes, debentures or similar instruments, indebtedness in respect of capitalized leases, indebtedness for the deferred purchase price of assets (other than normal trade accounts payable in the ordinary course of business), and indebtedness in respect of mandatory redemption, dividend or distribution rights on capital stock or other equity; plus

(3) any dividends or distributions paid or payable by Borrower or any Subsidiary (other than dividends or distributions paid or payable by a Subsidiary only to Borrower or to another Subsidiary).

"Consolidated Net Income" means the net income of Borrower and its Subsidiaries, determined in accordance with GAAP on a consolidated basis, excluding:

(1) income (or deficit) of any Person in which Borrower has an ownership interest, except for amounts actually received in cash, to the extent accrued during the time Borrower has an ownership interest in such Person;

(2) the aggregate amount of all investments, regardless of form, by Borrower in any such Person for the purpose of funding any deficit of such Person;

(3) all amounts included in computing net income (or deficit) in respect to write-up of any asset; and

(4) extraordinary and non-recurring gains.

"Covenant Compliance Certificate" means the certificate required by § 5(a)(3) hereof, in the form of Exhibit C hereto, or in such other form as is satisfactory to Lender.

"ERISA" means the Employee Retirement Income Security Act of 1974, as amended, and all regulations thereunder and published interpretations thereof. All terms defined in ERISA and used with capitalization in the ERISA provisions of this Agreement shall have the meanings specified in ERISA.

"Events of Default" are defined in § 6 of this Agreement.

"GAAP" means generally accepted accounting principles consistently applied throughout the periods involved, but for the purposes of the covenants in § 5 hereof and the related definitions, "GAAP" means such principles as in effect on _____, 20__ as applied by Borrower and its Subsidiaries in the preparation of the financial statements referred to in § 4(a)(4) hereof and consistently applied, without giving effect to any subsequent changes. Except as otherwise expressly stated herein, all computations required hereunder shall be made by the application of GAAP.

"Governmental Unit" means the United States, any State of the United States, the District of Columbia, Puerto Rico, any territory or insular possession subject to United States jurisdiction, any county, any municipality, any foreign state, any other domestic or foreign government, and any court, tribunal, department, agency or instrumentality of any of the foregoing.

"Guarantors" means, for the purposes of § 3(a) and § 4(a) of this Agreement, John Any, Samuel Some and ALB Realty LLC, and, for all other purposes, "Guarantors" includes not only such Persons, but

also all other Persons who may hereafter guaranty the payment or collection of, or become accommodation parties with respect to, any portion of the Obligations.

The term "indebtedness" includes every obligation of any kind to pay money or deliver value, whether on account of a loan, purchase, lease (whether or not capitalized), letter of credit, contingent obligation (such as a guaranty or reimbursement obligation), indemnity, funded or unfunded liability, or other undertaking.

"Law" and "Laws" mean all present and future laws, statutes, codes, rules, regulations, ordinances, rules of law, principles of law, orders, decrees, judgments, directives, or the equivalent.

"Line of Credit" means a demand line of credit loan in the maximum amount of Four Hundred Thousand Dollars ($400,000.00), evidenced by Borrower's note in substantially the form of Exhibit A hereto, with appropriate insertions (the "Line Note"), and/or by applications for issuance or confirmation of letters of credit.

"Loans" means the Line of Credit and the Term Loan.

"Loan Documents" means this Agreement, the Notes, the Security Documents, and all other agreements, instruments, guaranties, pledges, assignments, certificates, and other documents delivered by Borrower, any Guarantor or any other Person under or in connection with this Agreement or any Obligations, as the same may be amended, modified, restated or supplemented from time to time.

"Material Adverse Change" means a material adverse change in any one or more of the following:

(1) Borrower's, any Subsidiary's or any Guarantor's assets, operations, business or financial condition, or business or financial prospects;

(2) Borrower's ability to pay or perform the Obligations when due;

(3) any Collateral;

(4) the perfection or priority of Lender's Security Interest in any Collateral; or

(5) Lender's rights and remedies under any Loan Document.

"Notes" means the Term Note and the Line Note.

"Obligations" means all present and future indebtedness, obligations, covenants, undertakings and liabilities of Borrower to Lender of any kind whatsoever (including the Loans and other amounts due under the Loan Documents, including all principal, interest,

premiums, fees, charges, costs, expenses and other amounts), individually or with others, joint or several, direct or indirect, absolute or contingent, liquidated or disputed, due or to become due, however evidenced, however created (including directly, by assignment, transfer, pursuant to Law, or by operation of law), whether or not same are from time to time reduced or extinguished and thereafter increased or incurred, and whether or not presently contemplated by the parties on the date hereof.

"Person" includes any individual, partnership, joint venture, firm, association, trust, corporation, limited liability company or any other type of association or entity, including any Governmental Unit.

"PBGC" means the Pension Benefit Guaranty Corporation.

"Plan" means any employee benefit plan or other plan now or hereafter maintained for employees of Borrower, any Affiliate or any Subsidiary and covered by Title IV of ERISA.

The term "record" when used as a noun means information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form.

"Requirement" or "Requirements" mean all present and future terms, conditions and requirements of any license, permit, consent, approval, covenant, restriction, or easement.

"Security Documents" means all agreements, security agreements, mortgages, assignments, documents or instruments now or hereafter securing all or any part of the Obligations or of any indebtedness of any Guarantor, as the same may be amended, modified, restated or supplemented from time to time.

"Security Interest" includes any lien, charge, mortgage, pledge, assignment, encumbrance, retained title, purchase, or security interest, whether created or arising voluntarily, involuntarily or by operation of law.

"State" means the State of Rhode Island.

"Subsidiary" means a Person of which Borrower directly or indirectly owns or controls (including through ownership or control of intermediate entities) voting or other power sufficient under ordinary circumstances (not dependent upon the happening of a contingency) to elect or to control the actions of a majority of the directors, officers, trustees, managing partners, managers, or others under whose authority the power of such Person is exercised or under whose direction the business or affairs of such Person are managed.

"Tangible Net Worth" means the result of subtracting the following from the aggregate of the issued share capital, surplus, reserves, and retained earnings account on a balance sheet of Borrower and its Subsidiaries: any capitalized leaseholds; share capital discount and expense; unamortized discount and expense on indebtedness; write-up of assets; any excess of cost over market value of investments; development, pre-operating, preproduction, and start-up expenses; the Loans; deferred expenses; notes, accounts receivable or other sums due from any Subsidiary, Affiliate or Guarantor or from any officer, director, manager, or direct or indirect owner of any equity interest in Borrower; goodwill; and all other intangible assets to the extent included in such balance sheet of Borrower and its Subsidiaries.

"Term Loan" means a term loan in the principal amount of Six Hundred Thousand Dollars ($600,000.00), evidenced by Borrower's note in substantially the form of Exhibit B hereto, with appropriate insertions (the "Term Note").

"UCC" means the Uniform Commercial Code as now or hereafter in effect in the State.

(b) Miscellaneous. The captions and headings in this Agreement are for convenience only and are not to be used to interpret or define the provisions of this Agreement. Any references to any Person shall be construed in the masculine, feminine or neuter, singular or plural, as the context may require. The terms "includes" and "including" are not exclusive.

2. Advances and Manner of Borrowing.

(a) Advances. Lender agrees, on the terms and conditions of this Agreement, to make the Advances on the Loans. Within the limit of the Line of Credit, Borrower may borrow, repay, and re-borrow at any time or from time to time from the date hereof to and including _____, 20__, or the termination of Lender's Commitment, whichever is earlier; Provided, however, that all sums due under the Line of Credit shall be paid in full during not less than thirty (30) consecutive days annually.

(b) Letters of Credit. If Lender issues or confirms letters of credit for Borrower, then the face amount of any such letters of credit shall constitute outstanding and unpaid Advances under the Line of Credit for so long as such letters of credit remain outstanding and Borrower's reimbursement obligation with respect thereto remains unsatisfied. Nothing herein shall constitute Lender's approval of any request for issuance or confirmation of letters of credit.

(c) Manner of Borrowing. Prior to or concurrently with the execution hereof, Borrower shall certify to Lender the officer or officers of Borrower authorized to request Advances, together with true signatures of such officer or officers, and Lender may conclusively rely on such certification until it receives notice in writing to the contrary. Upon Lender's approval of a request for a cash Advance, Lender may in its discretion make all or part of such Advance by (1) depositing same into Borrower's general deposit account with Lender or (2) (if any part of the Advance is to provide purchase money) disbursing same to the vendor.

(d) Notice of Borrowing. Borrower shall give Lender at least three (3) business days' written notice (effective upon receipt) specifying the amount and date of each request for an Advance under the Line of Credit.

3. Conditions Precedent.

(a) Initial Advance. The obligation of Lender to make the initial Advance is subject to the following conditions precedent:

(1) Lender shall have received a certified copy of all action taken by Borrower to authorize the execution, delivery, and performance of this Agreement and the other Loan Documents required by this Section and the borrowing by it hereunder, and such other records as Lender shall reasonably require.

(2) Lender shall have received an opinion of counsel to Borrower, in form and substance satisfactory to Lender and to Lender's counsel.

(3) Borrower shall have paid the Lender all of Lender's costs and expenses (including Lender's appraisal and attorneys' fees) incurred in connection with the negotiation, preparation and execution of the Loan Documents and the satisfaction of the conditions precedent.

(4) Borrower shall have granted to Lender a perfected first-priority security interest in all of its presently owned and hereafter acquired personal property and fixtures, including all equipment, fixtures, inventory, accounts, general intangibles, chattel paper, documents, instruments, deposit accounts, letter-of-credit rights, and investment property, and all proceeds of the foregoing (each as defined in the UCC), upon the terms and conditions set forth in a security agreement with terms and conditions satisfactory to Lender.

(5) Lender shall have received from ALB Realty LLC, a landlord's waiver in form satisfactory to Lender.

(6) Each Guarantor shall have executed and delivered to Lender its guaranty of all Obligations, with terms and conditions satisfactory to Lender.

(7) John Any and Samuel Some shall have subordinated to the Obligations all indebtedness of Borrower to him/them and shall have pledged same to Lender.

(8) Borrower shall have paid to Lender a non-refundable origination fee of $_____.

(9) [OMITTED]

(b) Each Advance. The obligation of Lender to make each Advance (including the initial Advance) is subject to the following conditions precedent:

(1) All of the conditions in the preceding subsection remain satisfied, and all instruments and agreements referred to therein remain in full force and effect.

(2) No Event of Default and no event that with notice, lapse of time or otherwise would become an Event of Default shall have occurred and be continuing.

(3) Borrower's representations and warranties to Lender shall be true on and as of the date such Advance is to be made with the same force and effect as if made on and as of such date.

(4) There shall not have occurred any Material Adverse Change.

(5) All legal matters incident to the transactions hereby contemplated shall be satisfactory to Lender.

(6) Lender is the principal bank of account of Borrower.

(7) [OMITTED]

(c) Conditions for Lender's Benefit. These conditions precedent exist solely for Lender's benefit, and Lender in its sole discretion shall determine if they have been satisfied.

4. Representations and Warranties.

(a) To induce Lender to enter into this Agreement and make the Advances, Borrower hereby represents and warrants to Lender that:

(1) Corporate Existence, Power and Authority. Borrower is a corporation duly incorporated, validly existing, and in good standing under the Laws of the jurisdiction identified at the beginning of this Agreement and is duly qualified to transact business or own real property in each state or other jurisdiction in which any material part of its assets are located or in which it conducts any important or material part of its business. Borrower has corporate power to make this Agreement and to borrow hereunder. The making and performance by Borrower of the Loan Documents have been duly authorized by all necessary corporate action.

(2) Obligations Absolute. The Loan Documents are the legal, valid and binding obligations of Borrower, enforceable against Borrower in accordance with their respective terms. Borrower's obligation to repay the Loans, together with all interest accrued thereon and other charges, is absolute and unconditional, and there exists no right of set-off or recoupment, counterclaim, cross-claim or defense of any nature whatsoever to payment or performance of the Obligations.

(3) No Violation. Borrower's execution, delivery and performance of the Loan Documents do not and shall not (A) violate any Law or Requirement to which Borrower is subject, (B) conflict with or result in a breach of Borrower's Articles of Organization or Bylaws or any agreement or instrument to which Borrower is party or by which it or its assets are bound, or (C) result in the creation or imposition of any Security Interest upon any of Borrower's present or future assets, other than Security Interests in favor of Lender.

(4) Financial Condition. The financial statements (including balance sheets, statements of income and retained earnings, statements of cash flows, and, with respect to individuals, personal financial statements) of Borrower, its Subsidiaries, and the Guarantors that have been furnished to Lender are complete and correct and fairly represent the financial condition of Borrower, its Subsidiaries and the Guarantors as at the dates of said financial statements and the results of their operations and financial activities for the periods ending on said dates. There is no material indebtedness not disclosed by, or reserved against in said financial statements. At the present time there are no material unrealized or anticipated losses from any unfavorable commitments of Borrower, any Subsidiary or any Guarantor. Except with respect to individuals, said financial statements were prepared in

accordance with GAAP. Since the date of the latest of such financial statements there has been no Material Adverse Change.

(5) Litigation. There are no suits or proceedings pending or (to Borrower's knowledge) threatened against or affecting Borrower, any Subsidiary or any Guarantor that, if adversely determined, would directly or indirectly cause a Material Adverse Change. There are no proceedings by or before any Governmental Unit pending or (to Borrower's knowledge) threatened against Borrower, any Subsidiary or any Guarantor.

(6) Security Systems. Borrower follows and shall continue to follow sound business practices to maintain the safety and security of its assets and business operations, including the accuracy, integrity and security of its records and the efficient and secure operation of its business and of its information and data systems. Without limiting the scope of the foregoing, the following are true and shall continue to be true:

(A) Borrower performs regular daily backups of its computer-based systems, and Borrower retains backup recording media in a secure off-site location.

(B) Borrower has and maintains on a regular basis appropriate antivirus and firewall systems.

(C) Borrower has adequate contingency plans for security and preservation of its assets and business operations in case of natural or manmade disaster, act of war, act of terrorism or other emergency.

(D) Borrower has valid licenses to use all software used in the conduct of its business, and Borrower is in compliance with its license obligations.

(E) Borrower maintains and upgrades its hardware and software in a manner appropriate for the conduct of its business.

(F) Borrower's computer-based systems have user interfaces, date data fields, processing logic and output that correctly recognize, process, reflect and otherwise support date data for all dates.

(7) ERISA Compliance.

(A) Borrower and its Subsidiaries are in compliance in all material respects with ERISA and the Internal Revenue Code.

(B) No Reportable Event or Prohibited Transaction has occurred or is continuing with respect to any Plan.

(C) No circumstances exist which would entitle the PBGC to institute proceedings to terminate or appoint a trustee to administer a Plan, and the PBGC has instituted no such proceedings.

(D) Neither Borrower nor any Commonly Controlled Entity has completely or partially withdrawn from a Multi-employer Plan.

(E) Borrower and each Commonly Controlled Entity have met their respective minimum funding requirements under ERISA and other applicable Laws, and the present value of all vested benefits under each Plan does not exceed the fair market value of all Plan assets allocable to such benefits, as determined on the most recent valuation date in accordance with ERISA.

(F) Neither Borrower nor any Commonly Controlled Entity has incurred any liability to the PBGC.

(b) Reaffirmation and Continuing Nature of Representations and Warranties. These representations and warranties are of a continuing nature and shall survive the termination of this Agreement and full payment and performance of the Obligations. They shall also be deemed to be repeated whenever Borrower requests an Advance.

5. Covenants.

So long as the Commitment is outstanding and until the full payment and performance of all Obligations, Borrower agrees that, unless Lender shall otherwise consent in writing:

(a) Financial and Other Information. Borrower shall furnish Lender:

(1) within one hundred twenty (120) days after the end of each fiscal year of Borrower, copies of balance sheets of Borrower and its Subsidiaries, as at the close of such fiscal year, and statements of income and retained earnings and statements of cash flows of Borrower and its Subsidiaries for such year, certified by independent certified public accountants selected by Borrower and satisfactory to Lender;

(2) within thirty (30) days after the end of each of the first three quarters of each fiscal year of Borrower, copies of balance

sheets of Borrower and its Subsidiaries as at the end of such quarter, and statements of income and retained earnings and statements of cash flows of Borrower and its Subsidiaries for the period from the beginning of the fiscal year to the end of such quarter, in each case certified by an authorized financial or accounting officer of Borrower;

(3) within one hundred twenty (120) days after the end of each fiscal year of Borrower, a certificate of such independent public accountants, and within thirty (30) days after the end of each quarter of each fiscal year a certificate of an authorized financial or accounting officer of Borrower, in each case stating whether Borrower is in compliance with the financial covenants set forth in § § 5(b) through (g) hereof, and whether any Event of Default or any event that with notice, lapse of time or otherwise would become an Event of Default has continued or is continuing;

(4) within ten (10) days after the end of each calendar month, each of the following, certified by an authorized financial or accounting officer of Borrower:

(A) an aged analysis of all accounts receivable of Borrower current as of the close of business on the last day of such period, with such supporting data as Lender may reasonably require,

(B) an aged analysis of all accounts payable of Borrower current as of the close of business on the last day of such period, with such supporting data as Lender may reasonably require, and

(C) a schedule containing a breakdown of Borrower's inventory by amount and valued at cost and identified by warehouse and production facility location, current as of the close of business on the last day of such period, and with such supporting data as Lender may reasonably require;

(5) within one hundred twenty (120) days after the end of each tax year, copies of Borrower's and each Subsidiary's federal income tax return for such tax year, with all schedules;

(6) within one hundred twenty (120) days after the end of each tax year, copies of each Guarantor's federal income tax return for such tax year, with all schedules;

(7) within one hundred twenty (120) days after the end of each calendar year, signed personal financial statements of

each individual Guarantor, current as of a date no more than thirty (30) days prior to Lender's receipt of such statements; and

(8) from time to time, such further information regarding the assets, business, affairs, and financial condition of Borrower, its Subsidiaries, its Affiliates, and the Guarantors as Lender may reasonably request.

All financial statements (other than with respect to individuals) shall be prepared in accordance with GAAP.

(b) Debt Service Coverage. On the last day of each fiscal quarter of Borrower, the ratio of Consolidated Cash Flow for the period of four consecutive fiscal quarters then ending to Consolidated Fixed Charges for such period shall exceed _____ to one (___ to 1).

(c) Working Capital. Borrower shall at all times maintain current assets of Borrower and its Subsidiaries in excess of their consolidated current liabilities (including the Notes) by at least _____ Dollars ($_____).

(d) Current Assets. Borrower shall not at any time permit the current assets of Borrower and its Subsidiaries to be less than _____ Dollars ($_____).

(e) Current Ratio. Borrower shall at all times maintain the ratio of current assets of Borrower and its Subsidiaries to their current liabilities (including the Notes) of not less than _____ to one (___ to 1).

(f) Tangible Net Worth. Borrower shall at all times maintain its Tangible Net Worth in an amount not less than _____ Dollars ($_____).

(g) Debt to Tangible Net Worth. Borrower shall not at any time permit the ratio of the total indebtedness of Borrower and its Subsidiaries to the Tangible Net Worth of Borrower and its Subsidiaries to exceed _____ to one (___ to 1).

(h) Limitation on Indebtedness. Borrower shall not, and shall not permit any Subsidiary to, have any indebtedness except for:

(1) indebtedness to Lender;

(2) current accounts payable accrued or incurred in the ordinary course of business, so long as the same are either paid when due in accordance with customary trade terms or contested in good faith by appropriate proceedings with adequate reserves;

(3) current taxes, levies and assessments (other than under ERISA or any Law or Requirement relating to the environment, human health, or animal health), so long as the same are either paid when due or contested in good faith by appropriate proceedings with adequate reserves;

(4) purchase-money financing and equipment leases, subject to the following limits: (A) the aggregate of such indebtedness shall be no more than _____ Dollars ($_____); and (B) the indebtedness relating to any one item shall be no more than _____ percent (__%) of the lesser of cost or the fair market value of such item;

(5) indebtedness for money borrowed by Borrower from banks payable on demand or less than one (1) year after the date of the creation thereof up to but not exceeding _____ Dollars ($_____) in aggregate principal amount at any one time outstanding, so long as Borrower is free from all such indebtedness in excess of _____ Dollars ($_____) for at least sixty (60) consecutive days in each fiscal year of Borrower; and

(6) up to an aggregate of _____ Dollars ($_____) in other indebtedness at any one time outstanding, which may include a sub-limit of up to _____ Dollars ($_____) in guaranties and other contingent obligations with respect to Persons other than Subsidiaries.

(i) Security Interests. Borrower shall not, nor shall it permit any Subsidiary to, create, incur, or suffer any Security Interest upon any of its present or future assets, except:

(1) Security Interests to Lender;

(2) liens or claims of materialmen, mechanics, carriers, warehousemen, or processors arising by operation of law in the ordinary course of business and securing obligations that are either paid when due or contested in good faith by appropriate proceedings with adequate reserves;

(3) liens arising by operation of law for indebtedness permitted by clause (3) of the preceding subsection;

(4) purchase-money security interests and equipment leases securing indebtedness permitted by clause (4) of the preceding subsection, so long as no security interest extends to any other property; and

(5) other security interests having an aggregate value that shall not exceed _____ Dollars ($_____) (computed at the lower of book or fair market value) securing any indebtedness permitted by clauses (5) and (6) of the preceding subsection.

(j) Reports and Returns. Borrower shall, and shall cause each Subsidiary to, file with the appropriate Governmental Unit every report and notice required by applicable Law or Requirements (including every return for taxes, levies, and assessments of whatever description and every informational return) on or before the initial due date (or the extended due date, if there exists a valid extension for filing without interest or penalties).

(k) Dividends. Borrower shall not declare any dividends or authorize any other distribution on any present or future equity interest in Borrower, or make any payment on account of the purchase, acquisition, redemption, or other retirement of any such interest.

(l) Required Notice to Lender. Borrower shall, and shall cause each Subsidiary to, promptly (but in any event within fifteen (15) days) give Lender written notice of:

(1) the commencement of litigation or a receipt of a threat of any litigation (including arbitration) or of any proceedings before a Governmental Unit, which might result in a Material Adverse Change, or where the amount involved is $50,000.00 or more;

(2) any material loss or unusual depreciation in any material asset and the amount of same;

(3) any material dispute that may arise between Borrower or any Subsidiary and any Governmental Unit;

(4) any labor controversy resulting or likely to result in a strike or work stoppage against Borrower or any Subsidiary;

(5) any proposal by any Governmental Unit to acquire all or any part of Borrower's or any Subsidiary's assets or business;

(6) any change in its place of business or the location of any fixtures or other assets; and

(7) any other matter which has resulted or is reasonably likely to result in a Material Adverse Change.

(m) Insurance. Borrower shall, and shall cause each of its Subsidiaries to, maintain insurance in responsible companies in such amounts and against such risks as is satisfactory to Lender, and, in any event, as are ordinarily carried by similar businesses. Borrower shall deposit such policies and certificates thereof with Lender. All policies insuring any Collateral shall also comply with the requirements of the applicable Security Document. All policies shall provide that the insurance cannot be canceled or decreased without thirty (30) days' prior written notice to Lender.

(n) Inspection. At Borrower's cost and at any reasonable time and from time to time, Borrower shall permit Lender to enter Borrower's places of business and inspect and appraise any of Borrower's assets, examine and make copies or extracts of Borrower's records, and discuss Borrower's assets and affairs with Borrower, its accountants, and other consultants.

(o) Deposit Accounts. Borrower shall maintain Lender as its principal bank of account.

(p) Debit Authorization. Borrower irrevocably authorizes Lender to charge any account of Borrower with Lender for:

(1) installments of principal and/or interest due under the Notes;

(2) costs or expenses incurred by Lender for which Borrower is responsible under any Loan Document; and

(3) any other Obligations, to the extent not paid when due.

(q) ERISA Compliance. Borrower shall:

(1) promptly comply with all applicable provisions of ERISA and other Laws relating to the compensation of employees and the funding of Plans;

(2) not permit the occurrence of any Reportable Event or other fact which might constitute grounds for PBGC to terminate any Plan, seek the appointment of a trustee or administrator for any Plan, and/or impose any withdrawal liability upon Borrower or any Commonly Controlled Entity; and

(3) provide to Lender at the time of filing all reports, returns and other communications with respect to such Plans, plus such other information and documents regarding any Plan as Lender may reasonably request.

(r) Capital Expenditures. Borrower shall not make capital expenditures by lease, purchase, or otherwise, greater than the prior year's depreciation.

(s) Miscellaneous. Borrower shall not, and shall not permit any Subsidiary to:

(1) dissolve, merge or consolidate with or into any Person;

(2) convert into any other type of Person;

(3) form or dispose of any Subsidiary or Affiliate;

(4) sell, lease, transfer, or otherwise dispose of all or any substantial part of its present or future assets (except inventory in the ordinary course of business);

(5) change its entity name;

(6) make any significant change in its management without a minimum thirty (30) days' prior written notice to Lender;

(7) permit a transfer of any legal or equitable interest in any equity interest in Borrower to others than the present holders thereof as previously disclosed to Lender (including the issuance, sale, redemption or repurchase of any such interest, the distribution of treasury stock, or the payment of any indebtedness owed to Borrower by any managers, Subsidiaries, Affiliates, or owners of equity interests or debentures);

(8) make or consent to a material change in its method of accounting (including the basis of application of GAAP) or in its tax elections under any Law;

(9) create, incur, assume, or suffer to exist any lease obligation other than lease obligations incurred in the ordinary course of business;

(10) purchase or acquire obligations owed by others;

(11) enter into, or be a party to, any transaction with any Subsidiary or Affiliate (including transactions involving the purchase, sale or exchange of property, the rendering of services or the sale of stock) except in the ordinary course of business pursuant to its own reasonable requirements and upon fair and reasonable terms no less favorable to itself than it would obtain in a comparable arm's-length transaction with a Person other than a Subsidiary or an Affiliate; or

(12) make any payment on any indebtedness in violation of any subordination agreement made by the holder of any indebtedness.

(t) Further Assurances. At Borrower's cost, Borrower shall execute such documents and take such actions as Lender may request to implement the provisions of any Loan Document or to perfect and protect Lender's Security Interests.

6. Default.

(a) Events of Default. The occurrence of any one or more of the following constitutes an "Event of Default" (collectively, "Events of Default"):

(1) any statement, representation or warranty made by Borrower to Lender shall prove to have been incorrect or misleading in any material respect;

(2) Borrower shall default in the payment, when due, of any part of the Obligations;

(3) Borrower shall default in the performance of any other covenant, condition or undertaking contained in any Loan Document, or in any other existing or future agreement with Lender;

(4) any indebtedness for money borrowed, for which Borrower or any Subsidiary or any Guarantor is liable (as principal obligor, guarantor or otherwise) is not paid at its stated maturity or is declared or otherwise becomes due and payable prior to its stated maturity, or there shall occur any event or condition that permits any holder of any such indebtedness to declare such indebtedness due and payable prior to its stated maturity;

(5) any demand by Lender, in the case of any Obligations due and payable on demand;

(6) any Guarantor shall terminate or revoke its guaranty or shall take any action to terminate or revoke same;

(7) any individual Guarantor shall die or become incompetent;

(8) Borrower or any of its Subsidiaries or any Guarantor shall:

(A) terminate or suspend the operation of any portion of its business as presently conducted;

(B) become the debtor, alleged debtor, respondent or other subject of a case or other proceeding relating to it under any bankruptcy, reorganization, arrangement, readjustment, insolvency, receivership, dissolution, liquidation or similar Law;

(C) apply for or suffer the appointment of a receiver, trustee, or other fiduciary of itself, or of all or a substantial part of its assets;

(D) be unable to pay its debts as they fall due;

(E) make a general assignment or other transfer for the benefit of its creditors; or

(F) take any action for the purpose of effecting any of the foregoing;

(9) the entry of a judgment or judgments for the payment of money against Borrower, any Subsidiary or any Guarantor, and any such judgment shall remain unsatisfied and in effect for any period of twenty (20) consecutive days without a stay of execution;

(10) the occurrence of any Material Adverse Change;

(11) Borrower shall in any material respect fail to comply with any Law or any material Requirement regarding Borrower or its premises or assets; or

(12) Lender shall believe that the prospect of payment of the Loans or the performance of any of Borrower's obligations under this or any other agreement with Lender is impaired.

(b) Lender's Remedies. Upon the occurrence of any one or more Events of Default, Lender may at any time, without any demand, presentment, protest or notice (all of which Borrower hereby waives):

(1) declare the principal of and interest accrued on the Term Note to be forthwith due and payable, whereupon the same shall become forthwith due and payable; and/or

(2) terminate its Commitment and/or declare the principal of and interest accrued on the Line Note to be forthwith due and payable, whereupon the same shall become forthwith due and payable.

7. Miscellaneous.

(a) Notices. All notices, requests, and demands shall be in writing and be given to or made upon the respective parties hereto as follows:

Borrower: [OMITTED]

Lender: [OMITTED]

or to such other address as either party shall designate for itself in writing to the other party.

(b) Preservation of Lender's Rights. Notwithstanding any course of dealing or course of performance:

(1) neither failure nor delay on the part of Lender to exercise any right, remedy, power, or privilege under any Loan Document or applicable Law shall operate as a waiver thereof;

(2) no single or partial exercise of any right, remedy, power, or privilege under any Loan Document or applicable Law shall preclude any other or further exercise thereof or the exercise of any other right, remedy, power, or privilege, whether singularly, alternatively, successively or concurrently at such time or times as Lender deems expedient;

(3) no notice or demand by Lender shall be deemed to be a waiver of the obligation of Borrower or of the right of Lender to take further action without notice or demand; and

(4) no amendment, modification, rescission, waiver or release of any provision of this Agreement shall be effective unless the same shall be in writing and signed by a duly-authorized officer of Lender.

(c) Time of the Essence. Time is of the essence with respect to each and every covenant, agreement and obligation of Borrower under the Loan Documents.

(d) Lender's Right to Cure. Lender has the right but not the duty to take such steps and incur such expenses as it deems necessary to protect its interests, rights and remedies, without waiving any rights or remedies upon the occurrence of any Events of Default. Any expenses that Lender incurs constitute additional Advances to Borrower, payable on demand.

(e) Consultation with Advisors. Borrower acknowledges that it has consulted with counsel and with such other experts and advisors

as it has deemed necessary in connection with the negotiation, execution and delivery of the Loan Documents.

(f) Benefit of Agreement. This Agreement shall be binding upon Borrower, its successors and assigns, and inure to the benefit of Lender, its successors and assigns. No other Person shall be entitled to claim any right or benefit under this Agreement, as third-party beneficiary or otherwise.

(g) Construction. Borrower's representations, warranties, covenants, and other undertakings in the Loan Documents shall be liberally construed for Lender's benefit. If the terms of this Agreement shall conflict with the provisions of any other Loan Document, the terms imposing the greater obligation upon Borrower or affording the greater rights to Lender shall govern. Each Loan Document shall be construed without regard to any presumption or rule requiring that it be construed against the party causing such Loan Document or any part thereof to be drafted.

(h) Severability. If any provision of any Loan Document is held invalid or unenforceable in whole or in part in any jurisdiction, such provision shall, as to such jurisdiction, be ineffective to the extent of such invalidity or unenforceability without in any manner affecting the validity or enforceability of such provision in any other jurisdiction or the remaining provisions of such Loan Document in any jurisdiction.

(i) Governing Law. Except as otherwise specifically set forth in a particular Loan Document, the Loan Documents shall be governed by and construed in accordance with the Laws of the State (without giving effect to the State's conflicts of law principles).

(j) Lender's Fees and Expenses. Borrower shall pay, whether or not any Advance is made, all costs, expenses and fees (including appraisals, audits, field examinations, environmental site assessments and reasonable attorneys' fees) incurred by Lender in connection with: (1) the preparation, execution, and delivery of the Loan Documents and the making of Advances; (2) the administration of the Loan Documents and any matters arising thereunder or of any amendment of, or granting of any waiver or consent under, any Loan Document; (3) collection, in case any Event of Default occurs; (4) enforcement of payment or performance of any Obligations (including by any action or participation in, or in connection with, a case or proceeding under any Chapter of the Bankruptcy Code, or any successor statute thereto); and/or (5) any dispute between the parties, whether incurred before or after the Obligations are paid in full.

(k) Counterparts and Facsimile Signatures. This Agreement may be executed in two or more counterparts, each of which shall be an original, but all of which shall constitute but one agreement. Any signature to this Agreement delivered by electronic transmission is deemed to be an original signature.

(l) Participation. Lender reserves the rights, without notice to Borrower or any Guarantor and without Borrower's or any Guarantor's consent, to participate out all or any portion of any Loan to other lenders or to assign all or any portion of any Loan, and give potential assignees and participants such information on Borrower and Guarantors as they may request.

(m) Complete Agreement. This Agreement, together with the other Loan Documents executed in connection herewith, constitutes the entire agreement and understanding among the parties relating to the subject matter hereof, and supersedes all prior proposals, negotiations, agreements and understandings relating to such subject matter. In entering into this Agreement, Borrower acknowledges that, except as expressly set forth in this Agreement, Borrower is not relying on any statement, representation, warranty, covenant or agreement of any kind by Lender or by any Person acting on Lender's behalf.

(n) Jurisdiction and Venue. Borrower irrevocably consents to non-exclusive jurisdiction and venue for legal proceedings related to all claims and disputes involving Borrower and Lender in the federal or state courts in the State. Borrower irrevocably consents to the commencement and transfer of all legal proceedings to such courts. Borrower irrevocably waives all defenses based on inconvenience of forum in all actions commenced in, or transferred to, such courts.

(o) **WAIVER OF RIGHT TO TRIAL BY JURY**. **Borrower and Lender each hereby unconditionally and irrevocably waive any right to trial by jury in any action, suit, counterclaim or cross-claim or third-party claim arising in connection with, out of or otherwise relating to any Loan Document, any Obligations, any Collateral, or any transaction arising therefrom or related thereto.**

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed under seal, all as of the day and year first above written.

(signatures)

Form 8.2

Covenant Compliance Certificate

ANY LAWFUL BUSINESS, INC.
123 Main Street
West Providence, RI 02900

COVENANT COMPLIANCE CERTIFICATE

_____, 20___

LAST NATIONAL BANK ("Lender")
LNB Plaza
Providence, RI 02903

Attn: Commercial Lending

Ladies and Gentlemen:

Reference is made to the Loan Agreement (the "Loan Agreement"), dated as of _____, 20___ between Borrower and Lender. Capitalized terms used herein without definition shall have the meanings set forth in the Loan Agreement.

Pursuant to § 5 of the Loan Agreement, Borrower and the undersigned officer of Borrower (who has reviewed the Loan Documents) hereby certifies as follows:

1. Accuracy of Information. The information furnished below in this certificate is true and correct as of _____, 20___.

2. No Default. As of the date hereof, no Event of Default has occurred, and no event which with the passage of time, the giving of notice or otherwise would constitute an Event of Default has occurred.

3. GAAP. The financial statements delivered herewith were prepared in accordance with GAAP.

4. Reaffirmation of Representations and Warranties. Except as specified in the attached schedule, if any, the representations and warranties set forth in § 4 of the Loan Agreement are true and correct in all material respects as of the date hereof; provided, however, that

the representations and warranties set forth in § 4(a)(4) of the Loan Agreement shall be deemed to be made with respect to the financial statements of Borrower most recently delivered to Lender pursuant to § 5(a) of the Loan Agreement.

5. Period Covered by this Certificate. The calculations stated below relate to the _____-month period ending _____, 20___.

6. Debt Service Coverage Ratio (for minimum ratio required, see § 5(b) of the Loan Agreement):

Ratio for this period:

Consolidated Cash Flow:	
Consolidated Net Income this period:	$_____
Plus depreciation this period:	$_____
Plus amortization this period:	$_____
Plus interest on indebtedness this period:	$_____
Plus income taxes this period:	$_____
Less capital expenditures this period:	($_____)
(1) Sum of the above items:	$_____
Consolidated Fixed Charges:	
Interest on indebtedness this period:	$_____
Plus mandatory scheduled payments, prepayments, and sinking fund payments this period:	$_____
Plus dividends and distributions this period:	$_____
(2) Sum of the above items:	$_____
(3) Ratio of (1) to (2):	____ to 1
Minimum ratio required for this period:	____ to 1

7. Working Capital (for minimum amount required, see § 5(c) of the Loan Agreement):

Amount this period:

(1) Current assets as of the end of this period:	$_____

(2) Less current liabilities as of the end of this period: ($_____)

(3) Difference between (1) and (2): $_____

Required minimum amount as of the end of this period: $_____

8. Current Assets (for minimum amount required, see § 5(d) of the Loan Agreement):

Current assets as of the end of this period: $_____

Required minimum current assets as of the end of this period: $_____

9. Current Ratio (for minimum ratio required, see § 5(e) of the Loan Agreement):

Ratio for this period:

(1) Current assets as of the end of this period: $_____

(2) Current liabilities as of the end of this period: $_____

(3) Ratio of (1) to (2): ____ to 1

Minimum ratio required for this period: ____ to 1

10. Tangible Net Worth (for minimum amount required, see § 5(f) of the Loan Agreement):

Tangible Net Worth at the end of this period: $_____

Minimum required Tangible Net Worth at the end of this period: $_____

11. Total Liabilities to Tangible Net Worth (for maximum ratio permitted, see § 5(g) of the Loan Agreement):

Ratio this period:

(1) Total liabilities at end of this period: $_____

(2) Tangible Net Worth at end of this period: $_____

(3) Ratio of (1) to (2): _____ to 1

Maximum ratio permitted this period: _____ to 1

IN WITNESS WHEREOF, the undersigned has executed this certificate on this ____ day of _____, 20___.

ANY LAWFUL BUSINESS,
INC. ("Borrower")

By _____

Name:

Title:

Negotiating Commercial Loan Representations, Warranties and Covenants
Strafford Publications Webinar October 6, 2010

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Raiffa, Howard, The Art and Science of Negotiation, Harvard University Press, 2003

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LEXSEE 15 NY3D 147

Analysis
As of: Sep 24, 2010

[*1] **DDJ Management, LLC, et al., Appellants, v Rhone Group L.L.C., et al., Respondents, Larry A. Pavey, et al., Defendants.**

No. 131

COURT OF APPEALS OF NEW YORK

2010 NY Slip Op 5603; 15 N.Y.3d 147; 931 N.E.2d 87; 905 N.Y.S.2d 118; 2010 N.Y. LEXIS 1182

June 24, 2010, Decided

NOTICE:

THE LEXIS PAGINATION OF THIS DOCUMENT IS SUBJECT TO CHANGE PENDING RELEASE OF THE FINAL PUBLISHED VERSION. THIS OPINION IS UNCORRECTED AND SUBJECT TO REVISION BEFORE PUBLICATION IN THE OFFICIAL REPORTS.

PRIOR HISTORY: *DDJ Mgt., LLC v. Rhone Group L.L.C., 60 A.D.3d 421, 875 N.Y.S.2d 17, 2009 N.Y. App. Div. LEXIS 1542 (N.Y. App. Div. 1st Dep't, 2009)*

DISPOSITION: Order, insofar as appealed from, reversed, with costs, and case remitted to the Appellate Division, First Department, for consideration of issues raised but not determined on the appeal to that court.

CASE SUMMARY:

PROCEDURAL POSTURE: Plaintiff creditors sued defendants, shareholders of the debtor, their corporate affiliates, and individuals acting on their behalf, alleging, inter alia, that defendants defrauded plaintiffs. On motions pursuant to *CPLR 3211*, the trial court dismissed all but the fraud claim. An appeal followed; the New York Appellate Division, First Department, modified the trial court's decision and dismissed the fraud claim. Plaintiffs appealed.

OVERVIEW: Plaintiffs alleged that defendants defrauded them into making loans to the debtor by presenting them with the debtor's financial statements that were false and misleading. Defendants argued that plaintiffs failed to make a reasonable inquiry into the truth of what defendants said, and thus did not reasonably rely on any allegedly false representations. The intermediate appellate court held that as plaintiffs never looked at the debtor's books and records, they could not properly allege reasonable reliance on the purported misrepresentations. The high court disagreed. Plaintiffs made a significant effort to protect themselves against the possibility of false financial statements; they obtained representations and warranties from the debtor to the effect that nothing in the financials was materially misleading. As a matter of law they were not required to do more--either to conduct their own audit or to subject the preparers of the financial statements to detailed questioning. If plaintiffs could prove the allegations in the complaint, whether they were justified in relying on the warranties they received was a question to be resolved by the trier of fact.

OUTCOME: The order of the intermediate appellate court was reversed and the case was remitted to that court for consideration of questions raised but not determined on the appeal to that court.

LexisNexis(R) Headnotes

Torts > Business Torts > Fraud & Misrepresentation > Actual Fraud > Defenses
Torts > Business Torts > Fraud & Misrepresentation > Actual Fraud > Elements
[HN1] If the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations. This rule rejects the claims of plaintiffs who have been so lax in protecting themselves that they cannot fairly ask for the law's protection. Where, however, a plaintiff has taken reasonable steps to protect itself against deception, he should not be denied recovery merely because hindsight suggests that it might have been possible to detect the fraud when it occurred. In particular, 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. The question of what constitutes reasonable reliance is always nettlesome because it is so fact-intensive.

COUNSEL: Arnold M. Weiner, for appellants.

Herbert M. Wachtell, for respondents Rhone Group L.L.C. et al.

Christopher M. Mason, for respondents Quilvest S.A. et al.

Juan C. Basombrio, for respondent Duncan.

Loan Syndications and Trading Association; Commercial Finance Association; The Clearing House, amici curiae.

JUDGES: Opinion by Judge Smith. Chief Judge Lippman and Judges Ciparick, Graffeo, Read, Pigott and Jones concur.

OPINION BY: SMITH

OPINION

[**151] [***89] SMITH, J.:

We hold that plaintiffs in this action for fraud have alleged facts from which a jury could find that they were justified in relying on the representations defendants made to them.

[*2] **I**

Plaintiffs are four companies that loaned a total of $ 40 million dollars in March of 2005 to American Remanufacturers Holdings, Inc. and affiliated companies (ARI). ARI was a remanufacturer of automobile parts; it purchased used parts, broke them down into their components, and used the components to make new parts. ARI's stock was owned 45 percent by entities affiliated with Rhone Group L.L.C., and 55 percent by entities affiliated with Quilvest S.A.

After ARI failed to repay the loan, plaintiffs brought a number of claims against Rhone, Quilvest, companies and individuals associated with them, members of ARI management, and ARI's outside accountants. Only the first claim is in issue here. It asserts in essence that Rhone and Quilvest, their corporate affiliates and individuals acting on their behalf (hereafter defendants) defrauded plaintiffs into making the loans.

Plaintiffs allege, among other things, that defendants presented them with ARI financial statements that were false and misleading. More specifically, they allege that the financial statements were designed to inflate the number with which plaintiffs were most concerned -- ARI's earnings before interest, taxes, depreciation and amortization (EBITDA). The allegations on this subject are lengthy, and include some striking details. An e-mail sent to one of the defendants by an ARI executive about two months before the loan closing says: "I understand the financial reason to manipulate earnings." Another e-mail, sent some three weeks later by the same officer to the same recipient says: "I realize we needed to make EBITDA for banks but we should understand . . . what our true EBITDA is."

We need not describe defendants' alleged misconduct fully; we may assume, for purposes of this appeal, that the complaint [**152] adequately alleges that defendants made material misrepresentations. The question for us is whether, if the complaint's allegations are true, a jury could find that plaintiffs justifiably relied on those misrepresentations. Defendants argue that plaintiffs failed to make a reasonable inquiry into the truth of what defendants said, and we will describe in more detail the alleged facts that are relevant to that argument.

The complaint alleges that plaintiffs were first solicited to loan money to ARI in July 2004, and that over the next several months they received a number of written presentations by ARI's investment banker, containing financial and other information that later proved to be false or misleading. At the time of the solicitation -- and indeed until the day the loan closed -- ARI's outside auditors had not completed their audit for the year ending December 31, 2003, and it was part of the original proposal that the loans would be "conditioned upon, and made after, the borrower had provided the lenders" with

audited financial statements for 2003. It was later agreed that unaudited financial statements for 2004 would also be provided.

During the months before those financial statements were completed, plaintiffs [*3] had several conversations with ARI representatives in which they were given reassuring information, and made two calls to participants in the industry to get information about ARI's management, which [***90] was also reassuring. In December 2004 and January 2005, plaintiffs were sent drafts of the audit report for 2003, and on March 2, 2005 they were sent the unaudited financial statements for 2004. The final version of the 2003 audit report was provided on March 22, 2005, and the loan closed on the same day.

ARI's unaudited 2004 statements, plaintiffs allege, grossly inflated EBITDA, in significant part through a manipulation of ARI's inventory reserves. Plaintiffs say that they could not have detected this, but, as defendants point out, the 2004 statements contained some features that might have aroused concern in a skeptical reader who examined them carefully. They showed a significant increase in the value of ARI's inventory over the previous year; a modest amount of cash on hand, equal to the amount of ARI's bank overdraft; and a remarkable increase in the company's apparent profitability in the last month of the year. Though December 2004 revenues were below the year's monthly average, gross profit was higher than average, and gross margin was shown as 17.9 percent for the month, compared to 13.5 percent for the year as a whole.

[**153] The complaint does not allege that plaintiffs asked questions about these or other aspects of the financial statements, or that they asked to look at ARI's underlying records. Plaintiffs did, however, insist that ARI represent and warrant, in substance, that the financial statements were accurate. Specifically, ARI represented and warranted in the loan agreement (as summarized in the complaint) that 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"; that the statements were prepared in accordance with generally accepted accounting principles; that "between December 31, 2003 and March 22, 2005 [the closing date], 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 or prospects or its ability to repay the loans; and that "no information contained in the loan agreement, the other loan documents or the financial statements being furnished to the 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." All of these representations and warranties, plaintiffs say, later proved to be false.

The loan agreement, as defendants emphasize, also provided for a high interest rate: ARI agreed to pay plaintiffs the lower of 10 percent above the LIBOR rate or 9 percent above an index rate derived from the "base rate" charged by United States banks to corporate borrowers.

[*4] As we mentioned above, plaintiffs' claim for fraud against defendants was one of several in the complaint. On motions pursuant to *CPLR 3211*, Supreme Court dismissed all the others, but allowed this claim to stand. The Appellate Division modified Supreme Court's decision and dismissed the claim, emphasizing that "plaintiffs never looked at ARI's books and records" and concluding that, having failed to do so, they "cannot now properly allege reasonable reliance on the purported misrepresentations" (*DDJ Mgt., LLC v Rhone Group L.L.C., 60 AD3d 421, 424, 875 N.Y.S.2d 17 [1st Dept 2009])*. We granted leave to appeal, and now reverse.

[***91] **II**

The rule defendants rely on was stated more than a century ago in *Schumaker v Mather (133 NY 590, 596, 30 N.E. 755, 4 Silv. A. 224 [1892])*:

> [**154] [HN1] "[I]f the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations."

See also Danann Realty Corp. v Harris (5 NY2d 317, 322, 157 N.E.2d 597, 184 N.Y.S.2d 599 [1959]).

This rule has been frequently applied in recent years where the plaintiff is a sophisticated business person or entity that claims to have been taken in. In some cases, the rule serves to rid the courts of cases in which the claim of reliance is likely to be hypocritical. Thus in *Global Mins. & Metals Corp. v Holme (35 AD3d 93, 824 N.Y.S.2d 210 [1st Dept 2006])*, the plaintiff had fired an officer whom it found to be untrustworthy, and given him a general release. Later, it claimed to have trusted, without verifying, the officer's assurances as to the innocent nature of a particular transaction. The Appellate

Division held such trust to be unjustified. In other cases, the rule rejects the claims of plaintiffs who have been so lax in protecting themselves that they cannot fairly ask for the law's protection. In *Lampert v Mahoney, Cohen & Co. (218 AD2d 580, 582, 630 N.Y.S.2d 733 [1st Dept 1995])*, the Appellate Division dismissed the claim of a plaintiff who said "that he loaned some $ 3 million to a corporate entity and its principal without ever investigating the financial condition of the business beyond obtaining some vague verbal assurances from its accountant." In cases like *Global Minerals* and *Lampert*, the plaintiff "may truly be said to have willingly assumed the business risk that the facts may not be as represented" (*Rodas v Manitaras, 159 AD2d 341, 343, 552 N.Y.S.2d 618 [1st Dept 1990])*.

Where, however, a plaintiff has taken reasonable steps to protect itself against deception, it should not be denied recovery merely because hindsight suggests that it might have been possible to detect the fraud when it occurred. In particular, where a plaintiff has gone to the [*5] trouble to insist on a written representation that certain facts are true, it will often be justified in accepting that representation rather than making its own inquiry. Indeed, there are many cases in which the plaintiff's *failure* to obtain a specific, written representation is given as a reason for finding reliance to be unjustified (*see e.g. Curran, Cooney, Penney v Young & Koomans, 183 AD2d 742, 743-744, 583 N.Y.S.2d 478* [**155] *[2d Dept 1992]*; *Rodas v Manitaras, 159 AD2d at 343*; *Emergent Capital Investment Management, LLC v Stonepath Group, Inc., 343 F3d 189, 196 [2d Cir 2003]* [applying New York law]). It is harder to find cases holding that a plaintiff who did obtain such a representation could not justifiably rely on it; one such case is *Ponzini v Gatz (155 AD2d 590, 548 N.Y.S.2d 36 [2d Dept 1989])*, in which the plaintiff's attorney actually knew that the warranty in question was false. In *National Conversion Corp. v Cedar Bldg. Corp. (23 NY2d 621, 246 N.E.2d 351, 298 N.Y.S.2d 499 [1969])* -- a case admittedly much different in its facts from this one -- we held that it was reasonable for the plaintiff to rely on a written representation as a substitute for making an investigation of the facts represented.

"The question of what constitutes reasonable reliance is always nettlesome because [***92] it is so fact-intensive" (*Schlaifer Nance & Co. v Estate of Warhol, 119 F3d 91, 98 [2d Cir 1997])*. No two cases are alike in all relevant ways. However, several federal cases applying New York law bear a noticeable resemblance to this one -- and all of them hold that the plaintiffs' claims of justifiable reliance were legally sufficient (*Merrill Lynch & Co. v Allegheny Energy, Inc., 500 F3d 171, 181-182 [2d Cir 2007]*; *Barron Partners, LP v Lab123, Inc., 2008 WL 2902187, 2008 US Dist LEXIS 56899 [SD NY 2008]*; *JP Morgan Chase Bank v Winnick, 350 F Supp 2d 393 [SD NY 2004]*; *Faller Group, Inc. v Jaffe, 564 F Supp 1177 [SD NY 1983])*.

JP Morgan is perhaps the case most similar to ours. Plaintiffs there were banks that had extended credit to Global Crossing, Ltd. (GC). After it became insolvent, the banks sued GC's officers, directors and employees for fraud. The district court denied defendants' motion for summary judgment on the fraud claims, rejecting the argument "that the plaintiffs cannot demonstrate reliance on the alleged misrepresentations" (*350 F Supp 2d at 404*). The court emphasized that plaintiffs had bargained for a provision in their credit agreement with GC to the effect that "each loan request was 'deemed' a 'representation and warranty' by GC that no 'event of default' had occurred" (*id. at 396*). Examining the facts of several state and federal cases applying New York law, the court concluded that they "do not support the interpretation that a duty to inquire is necessarily triggered as soon as a plaintiff has the slightest 'hints' of any 'possibility' of falsehood" (*id. at 408*). The court said:

> "It is undisputed that the Banks expressly bargained [**156] not only for the right to examine GC's books and records, but also for the provision of the Agreement deeming each borrowing request to be a representation that GC remained in compliance with its debt [*6] covenants at the time the request was made. Under these circumstances, it cannot be argued that the Banks failed to bargain for adequate safeguards to establish, at least initially, the basis for their reliance on the defendants' representations"

(*id. at 409*).

Noting the defendants' argument "that GC's . . . financial statements . . . were so transparently false -- or at least, that the assumptions on which they were based were so apparently questionable -- that no reasonable banker would have lent GC a penny without conducting further inquiry into their accuracy" (*id.*), the court found that the question it presented was for the jury. The court was unable to say as a matter of law that "a reasonable lender of equivalent experience should have inquired further" into GC's financial statements (*id. at 411*).

We reach a similar conclusion here. It is fair to say that there were hints from which plaintiffs might have been put on their guard in this transaction. Some aspects of the 2004 financial statements -- particularly the sudden improvement in profitability in the last month of the year -- might have seemed too good to be true; the fact

that it took an auditor until March of 2005 to complete an examination of the 2003 financial statements was hardly encouraging; and the high interest rate itself demonstrates that plaintiffs knew the transaction carried considerable risk. 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 [***93] own audit or to subject the preparers of the financial statements to detailed questioning. If plaintiffs can prove the allegations in the complaint, whether they were justified in relying on the warranties they received is a question to be resolved by the trier of fact.

Defendants emphasize that the warranties were given only by ARI, and suggest that they cannot support a claim against Rhone, Quilvest and others. But this argument blurs the distinction between claims for breach of warranty and claims [**157] for fraud. It is true that, as a contractual matter, the only rights plaintiffs acquired under the warranties were against ARI. If plaintiffs prove only that the warranties were false, they cannot recover against Rhone and Quilvest. But if they can prove that Rhone and Quilvest knew the facts represented and warranted were false -- in other words, that Rhone and Quilvest knew the financial statements gave an untrue picture of ARI's financial condition -- the case is different. It can be inferred from the allegations of the complaint that plaintiffs believed Rhone and Quilvest would not knowingly cause a company they controlled to make false representations in a loan agreement as to the [*7] accuracy of financial statements. We cannot say as a matter of law that this was an unjustifiable belief.

Accordingly, the order of the Appellate Division, insofar as appealed from, should be reversed with costs, and the case remitted to the Appellate Division for consideration of questions raised but not determined on the appeal to that court.

* * * *

Order, insofar as appealed from, reversed, with costs, and case remitted to the Appellate Division, First Department, for consideration of issues raised but not determined on the appeal to that court. Opinion by Judge Smith. Chief Judge Lippman and Judges Ciparick, Graffeo, Read, Pigott and Jones concur.

Decided June 24, 2010

CORPORATE CREDIT

A CFO's Guide to Bank Debt and Loan Agreements

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Chapter 9

Representations and Warranties

A lender needs to know something about your company in order to feel comfortable loaning you millions of dollars. The lender will conduct some due diligence before making the loan, of course, but it will also want you to make statements about the nature of your business and its assets. These statements will appear in the "Representations and Warranties" section of your loan agreement. Representations and warranties are a means of risk allocation. Since you know more about your company than the lender does, the risk that a statement is untrue is allocated to you by having you make the representation.

The representations and warranties are usually made as of the closing date (the date you sign the agreement) and as of the date any funds are advanced. For a term loan, these two dates are often the same—or very close together. For a revolving line of credit, you might borrow many times during the course of a year, and each time you draw funds the representations are deemed to be made again. This means you need to make sure that you are in compliance with the representations pretty much all the time, if you want to keep borrowing money. (On a related note, take a close look at the monthly or quarterly compliance certificates you are expected to deliver with your financial statements. Sometimes they include a statement that the representations and warranties are true as of the date of the certificate, regardless of whether any borrowings were made on that day.) The bottom line is that your representations and warranties aren't necessarily over and done with as of the closing.

The representations and warranties should generally be statements that you, as a corporate officer, would fairly readily know to be true. You'll want to carefully review them and make sure they are indeed true in every respect.

Many of the representations are qualified by schedules that are attached at the back of the agreement. For example, you might make a representation that "as of the Closing Date, all of the subsidiaries of the Company are listed on Schedule 5.1 hereto" and then at the back of the agreement, Schedule 5.1 would contain a list of all of your subsidiaries. Or, the representation might refer to the schedule for a list of exceptions to the representation (for example, "except as set forth on Schedule 5.5 hereto, each Material Agreement is in full force and effect"; in that case, Schedule 5.5 might just say "None" on it if there were no reason to think any of the agreements had been terminated).

Many times, preparation of the schedules is one of the most time-consuming tasks the company encounters in connection with getting the loan. There will be schedules for the representations and warranties as described here, and then a separate set of schedules relating to the security interest in the collateral. If the schedule requirements seem too burdensome, it may be possible to reword some of the requirements to limit them to "material" items rather than "all" items in a category. Some schedules might be eliminated altogether, depending on the relative importance of the content. These are points for negotiation.

The representations will cover several things about your company, like corporate existence, ERISA (Employee Retirement Income Security Act) benefit plans, environmental issues, litigation, real property, taxes, and other things.

Corporate Existence, Powers, Qualification

You will be required to state that your company is a corporation (or partnership, etc.), that is duly organized and validly existing under the laws of its state of incorporation, and that it is in good standing under that state's laws. You'll also be asked to state that

the company has the required power and authority to carry on its business and to enter into and perform its obligations under the credit agreement and related documents. You might also be asked to represent that the company and its subsidiaries are properly qualified to do business in each state where they operate, and that they are in good standing in each of those states as well.

Subsidiaries

If the company has subsidiaries, you'll be asked to make representations about the ownership of their equity interests (does the company own 100% of the equity, or are there other stockholders?), and you'll need to make the same representations as to existence, good standing, and corporate power and authority of each subsidiary as the ones made about the company.

No Conflict

This representation is about conflicts between the loan agreement and other documents. You'll be asked to state that the execution, delivery, and performance of the loan documents won't conflict with your articles of incorporation or bylaws, any court decrees or government rules or regulations applicable to your business, or any material agreements you are already a party to. You will also represent that entering into the loan agreement will not trigger imposition of a lien on any of your assets (other than liens in favor of this lender) or require consent of third parties, other than consents that have been obtained at the time of closing.

Binding Obligation

This one always sounds a little odd, but you are asked to represent that the loan documents are valid and binding obligations, enforceable against you in accordance with their terms, except where bankruptcy or other similar laws would limit enforceability. Usually, your counsel will be asked to give a legal opinion on this topic as well, and there are standard conventions among legal counsel for how this is addressed.

Financial Condition

The agreement will include a representation that the latest set of financial statements you delivered to the lender was prepared in accordance with generally accepted accounting principles (commonly known as "GAAP") and "fairly present, in all material respects, the financial position of the company for the period then ended." This is standard language and is meant to protect the lender in case your financial statements turn out to have been faulty or need to be restated later. The lender relies heavily on your financial statements in making its credit decision, so this is an important representation.

No Material Adverse Change

This representation will say that since the date of the audited financial statements mentioned in the financial condition representation, no event has occurred that has resulted in a material adverse effect. All well and good, but what's a material adverse effect? The definition varies (and sometimes gets negotiated), but it usually says something like the following:

> (a) a material adverse effect on the business, operations, properties, assets or condition (financial or otherwise) of the company and its subsidiaries taken as a whole, or
>
> (b) impairment of the company's ability to perform, or of the lender to enforce, the obligations under the loan agreement.

Title to Properties; Assets

You'll be asked to make representations about your assets. These sometimes take different forms, depending on how the loan agreement is drafted. Sometimes these representations will appear in the security agreement rather than here, or they will be in a separate section of the loan agreement that relates to the security interest. But

generally there will be a representation that you own your assets and that they are kept in proper working order for use in your business.

Materiality

The content of the representations and warranties section is subject to significant negotiation between the borrower and lender. The borrower will usually want to try to include materiality carve outs in the representations in as many places as possible—so, for example, it's not just "there is no litigation pending against the company" but rather "there is no litigation pending against the company that could reasonably be expected to have a material adverse effect." The lender will often accept these kinds of changes as to certain types of representations, but not as to all of them. Some representations are so often qualified by materiality that the lender's loan agreement form may already have this built in (as is often the case with a litigation representation, for example).

Materiality standards are necessary in some cases just to eliminate things that the lender doesn't care much about but that would be burdensome for the borrower to determine. For example, a representation that says that "the company has no intellectual property other than as listed on Schedule 5.9 to the loan agreement" would result in someone at the company spending countless hours trying to prepare a complete schedule. This wouldn't be a good use of anyone's time. The lender likely only cares about material intellectual property anyway. For most companies, material intellectual property would consist of patents, copyrights, or trademarks that are formally registered at the Patent and Trademark Office or the Copyright Office in Washington, D.C. A representation like this could be modified to read "the company has no material intellectual property [or no registered patents, trademarks, or copyrights, or applications for registration] other than as listed on Schedule 5.9." It's often important that the time and effort required to make representations be considered and addressed by both parties to the agreement.

Chapter 12
Affirmative Covenants

Covenants are divided into two types: affirmative covenants, meaning things you have to do "affirmatively," and negative covenants, which are things you can't do. (Financial covenants are frequently included in the negative covenant section of the loan agreement, though they also can stand alone in their own category.) Almost any requirement can be worded as a positive "you must do this" or as a negative "you must not fail or neglect to do this," and so some of the things that appear in the category of an affirmative or negative covenant could probably just as easily have been put in the other category. There isn't always a strong logic as to why something is in one section or the other, but there is a common practice for what types of things go in each place. We'll address the topics in the sections in which they would normally appear in a loan agreement, based on market convention.

Notices and Deliveries

As mentioned above, the reporting requirements might appear in their own separate section of the loan agreement, or they might appear as the first few items in the list of affirmative covenants. Since we've already discussed all of these in the previous chapter, we won't get into the details again here.

Corporate Existence

There will be a requirement that you maintain your company's existence and its good standing in the states where you're doing

business. This covenant might also include a requirement to maintain all material rights and franchises that are important for the business. The lender wants to know that the company will still exist (no surprise there) and that it is continuing to operate as expected.

Payment of Taxes

Your lender will want to know that you are staying current on tax payments, because the government can take a lien on your assets for the amount of the tax if you fail to pay. So, there is usually a requirement that you will pay all your corporate taxes on time, except for amounts that you are disputing in good faith and have taken reserves for in your financial statements.

Maintenance of Properties, Insurance, Etc.

In a secured loan, it is common to have covenants relating to your assets. The lender wants you to continue to own all the assets you need in order to run the business, and will often require the assets to be "in good repair" or "in working order" to make sure that you can use the assets to continue to produce revenue. There may also be a specific covenant about undertaking appropriate repairs and maintenance for these assets.

In addition, the lender will want to know that you are maintaining appropriate insurance coverage for the business. This applies not just to your assets (insurance against casualty events like fire, flood, or other destruction of the assets) but also to liability insurance and business interruption insurance. Sometimes the lender will also require a "key person" policy (formerly known as a "key man" policy) be obtained on the life of one or more of the managers who are critical to the company's business. In that case, the policy will usually be assigned directly to the lender. You will be required to give the lender certificates evidencing your insurance coverage both at closing and at regular intervals (usually annually) during the term of the loan. Asset-based loans will often include stricter requirements for insurance than cash-flow loans.

Inspection and Visitation Rights

The lender will want the right to visit your offices from time to time. In an asset-based loan, the lender will require you to permit regular visits and appraisals of the assets, with a team on site at your various locations. Even cash-flow lenders will usually require you to agree to let them inspect your books and records regularly. The topic most at issue in this covenant will be how many visits are to be paid for by the borrower versus those conducted at the lender's own cost. The borrower usually does not have concerns about allowing the lender to visit for a reasonable number of times, but it does not want to pay for the costs of duplicate visits. Note, however, that if the borrower is in default, it is customary to permit any number of visits and inspections at the borrower's cost. Visits to your business locations usually require reasonable advance notice. You can also require that visits be conducted during your normal business hours, and that authorized company representatives be present for any discussions with outside auditors and customers.

Environmental Issues

There will usually be a rather lengthy covenant about environmental issues. The lender will want the borrower to deliver copies of any notices or communications relating to environmental concerns, and copies of environmental audits. The borrower will also be required to maintain environmental review programs and take other actions necessary to abide by regulatory requirements. Some credit facilities will require environmental audits to be undertaken, and this is most common where there is a known environmental problem at one of the borrower's locations. Loans secured by real estate will have additional environmental provisions, as this is an area where potential liability can be very significant. The liability can, in some cases, be asserted by the injured party directly against the lender as well as against the borrower. Because of the potential for liability, lenders are often concerned about this area and will request more detailed representations than for other topics.

Subsidiaries

If the company forms or acquires new subsidiaries after the closing, the company may be required to have them sign guarantees, in order to add them as guarantors of the loan. If the loan is secured, the borrower may also need to have them execute counterparts to the security agreement, in order to grant liens on all their assets. The borrower (the parent company, in this case) will also need to pledge the stock of each of its subsidiaries as collateral for the loan.

Having a subsidiary guarantee the loan and pledge its assets in support of the loan gives the lender additional collateral and additional means for repayment of its loan. This also gives the borrower additional flexibility because the borrower is usually permitted to transfer assets and to make intercompany investments (including loans) between subsidiaries that are guarantors of the loan—but would be restricted from doing so with non-guarantor subsidiaries. As long as the lender has a lien on all the assets and a guarantee from all the companies, the lender is unlikely to be concerned about which company is holding those assets at any particular time.

These terms requiring subsidiaries to provide guarantees and to grant security interests in their assets often will not apply to foreign subsidiaries. This is because of a tax rule that, under certain conditions, could require the U.S.-based parent company to treat the amount of a guarantee provided by its foreign subsidiary as a dividend payment—just as if the subsidiary had sent a cash dividend to the parent in this amount. Of course, no cash would be changing hands here, so having the parent company owe taxes on this amount is undesirable, to say the least! Most lenders will agree to eliminate these requirements as to foreign subsidiaries so that the company will not incur this extra tax burden. It is generally permissible to pledge up to 65% of the subsidiary's stock in support of the loan without creating a tax issue, so many credit agreements do include a limited stock pledge requirement for up to 65% of the foreign subsidiary's stock. If you have foreign subsidiaries, make sure to check with a tax lawyer to see which of the rules apply to you and what the impact could be for your company. If a significant amount of

your company's value is in a foreign subsidiary, you will need additional guidance as to how a loan could be structured to work in that situation.

Hedging

If you have a large syndicated term loan, you might be required to purchase an interest rate hedge as to 50% or more of the loan amount. The purpose of the hedge is to protect the company against large fluctuations in the interest rate, to make sure the company doesn't suddenly get overburdened by very large interest payments as a result of market conditions. You can theoretically get an interest rate hedge or swap contract from any swap provider, but since most providers will require collateral, it is easiest to get the hedge or swap from one of the lenders under the credit facility. The security agreement will usually provide for swap or hedging arrangements provided by a lender under the credit facility (or one of its affiliates) to be secured by the collateral right along with any loans that are made, so the collateral issue is already taken care of for any such lender.

Deposit Accounts

If you have a loan from a single lender (not a syndicated deal) and the lender is a bank that typically provides treasury services and maintains deposit accounts, the lender may require you to maintain your primary banking relationship at its institution. This makes loan and payment processing easier, but it also gives the lender a quicker means for controlling your cash if you go into default. Indeed, it is common in asset-based loans for the lender to require you to process all of your accounts receivable through a lockbox account that the lender controls.

In any type of loan agreement for a secured loan, you will usually be required to provide the lender with control agreements for each of your deposit accounts. A control agreement is a three-way agreement between the borrower (depositor), the lender (secured party), and the depositary institution (the bank where the account is

held, which in some cases could be the same as the lender). Unless the account is held at the lending institution, this agreement will be necessary in order for the lender to perfect its security interest in the account. It gives the lender the ability to take control of the account if the borrower goes into default. Practically speaking, most lenders wouldn't immediately seize the borrower's bank accounts if the borrower missed a reporting deadline or failed to meet a financial covenant for one quarter, but the lender has this right and can be expected to use it if there's a significant default—especially if there is concern about your ability to repay the loan otherwise. A typical control agreement does not give the lender the ability to control the account outside of a default situation, except as to an account that is intended to function as a lockbox (with the lender having control of the account from day one, typical for an asset-based loan).

The requirement for control agreements may appear in the security agreement, but it is more commonly found in the affirmative covenants section of the loan agreement itself.

Chapter 13

Negative Covenants

Okay, now we've reached the real heart of your agreement. Most of the questions I get about loan terms are about the content of the negative covenants. That's probably because this section has all the "thou shalt not" limitations in it. All those questions about what you can do, and what you can't do, get answered here.

Other Debt

A lender likes to have limitations on the amount of debt a company can take on. This is partly addressed in the leverage test in the financial covenants section described earlier, but that's just a general test of overall leverage. It usually is too general for these purposes, and it probably includes too much cushion to serve as the only limitation. The loan agreement will likely contain a strongly worded prohibition on taking on other debt, and then will list certain types of debt that are permitted exceptions to the rule.

Though large amounts of existing debt will probably need to be repaid and terminated when this new loan goes into effect, it is common to permit the continued existence of reasonably small amounts of other debt already in place, reasonable amounts of specialized forms of debt (like equipment financings), and junior debt that is being entered into at the same time as this loan agreement. This existing debt will usually be listed on a schedule at the back of the loan agreement. Permission to maintain this debt will include any refinancings as well, with the principal amount capped. The company

will usually be permitted to have some equipment financings, as long as the only security interest that the finance provider obtains is a lien on the equipment itself. Often there will also be a cap on the overall amount of this type of debt. The company may also be permitted to have intercompany debt between itself and its subsidiaries, which may be unlimited in amount if the subsidiaries have guaranteed the loan and granted liens on their assets, as explained previously, or up to a capped amount if the subsidiaries have not guaranteed the loan. It is also not unusual to permit the company to be liable for indebtedness that it assumes in connection with the purchase of an asset, so long as the purchase itself was permitted under the loan agreement (subject to certain other conditions).

Permission to have and incur other types of debt is often negotiated on a case-by-case basis, depending on the type of business the company is in and its anticipated needs.

Other Liens

Like the debt covenant, the company will usually be prohibited from granting any liens on its property, with a few narrow exceptions.

There will nearly always be exceptions for immaterial liens that commonly arise by operation of law, such as materialmen's or warehousemen's liens, liens for certain types of easements or minor encroachments, statutory liens arising in favor of landlords and banks, deposits for worker's compensation or unemployment insurance, license or subleases of property, and other similar things. Lenders understand that these types of liens arise in the normal course of business for most companies and are not overly concerned about this.

Similar to the debt covenant, it is fairly common to permit reasonable liens in existence as of the closing date, and liens on assets acquired after the closing, based on certain conditions. It is not typical for a lender to permit any significant other liens to be granted, especially liens with respect to other indebtedness, though larger companies can often negotiate a basket for a relatively small amount of indebtedness that can be secured by liens.

What Is a Negative Pledge?

A prohibition on liens is more restrictive than a negative pledge, so that is usually the preferred method a lender would use to protect its secured position. But, you might have an agreement that has a negative pledge instead of—or in addition to—a lien covenant.

The negative pledge provision will work in favor of the lender and will provide that, although the lender is going to be unsecured as to this loan, if any other debt of the company is secured (whether now or at a later date), then this loan must also be secured on the same basis as that other debt. This is common in high-end investment grade credits. In this case, the lender is okay with having its loan be unsecured only as long as all the other major creditors of this borrower are going to be in the same boat. If somebody else tries to jump ahead and get secured, this lender will also be secured—or there will be a default under the loan agreement.

It's also typical to include a term that says that the company can't have other agreements that contain restrictions on liens (other than, of course, the lender's own loan agreement here). The lender does not want the restriction on liens in this agreement to trigger a default under any of the company's other agreements—nor, usually, does the company.

Investments and Acquisitions

The company will usually be restricted from investing its cash in other companies, whether via making a loan or making an equity investment. The company will also be restricted from making acquisitions. As usual, there will be a few exceptions to these limitations.

First, there will typically be a list of existing investments that the company can continue to maintain, and this will appear on a schedule at the back of the agreement. Second, the company will usually be allowed to own "cash equivalents," which are defined as treasury bonds or other highly rated securities. Intercompany investments will be permitted, as mentioned in the debt covenant section, and will be uncapped if all the subsidiaries are guarantors of the loan,

and subject to a cap if the subsidiaries are not guarantors. The company may also be permitted to acquire securities or other non-cash consideration in exchange for settling an obligation owed to it, or as partial payment for an asset sale.

The company might also be permitted to do acquisitions within certain guidelines, but this is typically reserved for larger companies with strong financial results. If the company is permitted to make acquisitions without prior consent from the lender, the acquisitions usually have to fit within a dollar limit as to the purchase price. Also, the acquisition usually can't be a hostile takeover, can't result in a breach of any other term of the loan agreement, must result in compliance with the financial covenants (calculated on a pro forma basis, as if the acquisition had taken place at the start of the accounting period), must include advance notice and certifications made to the lender, and a long list of other conditions must be met. Frequently, even when certain acquisitions are permitted, the company ends up needing to ask the lender for permission anyway, as one or more of these conditions will not be met.

Guarantees and Other Contingent Obligations

For this covenant to make any sense, you'll first have to look at the definition of "indebtedness" in your loan agreement to see if it includes guarantees and contingent liabilities or not. Many times, the debt covenant restricts not just debt, but contingent obligations as well. If it doesn't, there will be a separate provision relating to contingent obligations. Similar to the debt covenant, this covenant will prohibit all but a few common types of guarantees and contingent payments, including those in existence on the closing date, contingent obligations in connection with interest rate hedges (especially if hedging of the term loan is required in the affirmative covenants section), ordinary course guarantees of obligations of suppliers, franchisees and licensees, and perhaps additional guarantees or other obligations within a dollar cap.

Payment of Dividends and Subordinated Debt

A senior lender usually does not want other debt to be paid before its own loan is paid. Even more important, the lender will not want equity holders to be paid before its loan is paid. Why is this? Well, first of all, equity holders generally stand to receive a higher rate of return than debt holders. The ultimate value of the company belongs to them. Debt holders have the benefit of priority of repayment (even in a bankruptcy proceeding, debt holders are paid in full before the equity holders receive anything) so they usually have a lower rate of return, meaning that the interest rate on the debt is lower than the dividend rate a preferred stockholder would receive. Because of the priorities given under the bankruptcy code, there is a strong desire to keep the equity owners from taking anything out of the company or receiving any significant return on their investment while the debt is still unpaid and the lender's commitments remain in effect.

With this in mind, it is easier to understand why a lender would include covenants restricting payments of dividends and subordinated debt. These covenants are sometimes found under the heading "Restricted Junior Payments," as they all relate to payments of obligations that are junior in priority to the loan. The payments prohibited in this covenant will be dividends, repurchases of stock or stock redemptions, exercise of redemption rights under bond offerings, and prepayment of any subordinated debt from a junior creditor (though not payment at maturity, unless the subordinated lender has agreed to these restrictions in an intercreditor or subordination agreement). Payment of interest on other debt may be permitted—and indeed often is—though it depends on the nature of the deal.

If the borrower is a subsidiary of a holding company, the lender may permit some cash to be distributed up to the holding company for limited purposes. Payments for tax liabilities relating to the operations of the company, and for administrative costs and expenses that are attributable to the company, are usually permitted, as these may have been borne by the borrower itself absent the holding company's existence.

Fundamental Changes

The company will be required to agree not to change its corporate structure, or "merge, consolidate, liquidate, wind-up," or otherwise dissolve itself. It seems obvious why this would be important. The company needs to continue its existence during the term of the loan. That said, it's fairly common for an internal merger (between subsidiaries) or consolidation to be permitted as long as the company is the surviving entity from that merger. So, for example, the company could merge one of its subsidiaries into itself, and this would pose no problem at all. Acquiring a new company via merger would of course require the company to meet the terms of the other negative covenant that prohibits acquisitions, in addition to meeting the requirements of this covenant.

Asset Sales

I tend to get a lot of questions about asset sales. The company will be planning to get rid of some old equipment that it isn't using anymore, or will have an opportunity to sell a portion of its business for a good price. The question will be whether this can be done without lender consent—and if you do it, what do you have to do with the proceeds?

Here's the answer. First, take a look at the negative covenants in your loan agreement. The company is usually prohibited from disposing of assets, but (you guessed it) with a few exceptions. There will be an exception for sales of assets that are worth only small dollar amounts. And, there will usually be exceptions permitting disposal of obsolete, worn-out, or surplus property, and for discounting accounts receivable in the ordinary course of business (other than in an asset-based loan). Certainly, sales of inventory in the ordinary course of business will always be permitted.

The wording of the exceptions matters. Sometimes you will only be allowed to dispose of worn-out equipment, but not surplus equipment, or perhaps only equipment and not other types of assets. Doing anything that isn't expressly permitted will require consent from the lender. This is something to consider when negotiating the

loan agreement. If you frequently dispose of certain kinds of items, you would want to bring this up and see whether the lender is willing to permit at least some of those dispositions up front, without your having to go back and ask for consent each time.

The other thing to be aware of when doing an asset sale is that it's common for an asset sale to be a trigger for a mandatory prepayment. Take a look at the mandatory prepayment section (back near the beginning of the agreement) to see if this is the case in your deal. Often there will be some kind of threshold established (i.e., you only have to prepay the loan if you receive more than $100,000 in any calendar year from permitted asset sales), so that not every dollar needs to be applied to prepay the loan. Also, check the timing, because some loan agreements require "immediate" prepayment, while others give you a few days to send in the money. This is often a negotiated point in the agreement.

Transactions with Affiliates

Usually, the loan agreement will include a covenant restricting dealings with shareholders and other affiliates. Unless the terms of those dealings are equivalent to what the company would get from a third party—also known as "arm's length" terms—the lender will want these types of deals to be prohibited. The lender won't want the company to be making sweetheart deals with its shareholders or officers, where they get paid more than they would otherwise get, since that would be another way for the equity owners or affiliates to get money out of the company sooner. (We already know that lenders don't like that idea.)

Exceptions to the rule here will include permission for the company to engage in transactions with its own subsidiaries or parent company (to the extent permitted elsewhere under the other covenants), payment of customary fees to board members for their service on the board of directors, reimbursement of customary costs and expenses of officers and employees, and other customary types of payments. There may also be a schedule listing existing arrangements that the lender will decide to approve as of the closing date.

For example, it is not unusual for a small company to lease its office space from one of its shareholders (or another company owned by the shareholder), and the lender will permit this to continue if the lease is favorable—or at least not unfavorable—to the company.

For companies owned by private equity sponsors, the lender may permit some management fees to be paid to the sponsor, and may permit costs and expenses to be reimbursed pursuant to the terms of an existing management agreement. The lender may wish to put a cap on the amount that can be paid, and may require that the company meet certain leverage tests before making management fee payments. This is in keeping with the principle that equity is paid after debt. Payment of management fees may be well-deserved, or may on occasion be viewed by the lender as a potential end-run around the restriction on payment of dividends.