

# WHEN THE BORROWER SAYS “NO” TO A LENDER’S REQUEST FOR A LEGAL OPINION

*by Gary Samson*



It is common in commercial lending transactions for the lender to require the borrower to make various representations and warranties in the loan agreement. Some representations relate to the borrower’s legal status, its authority to enter into the loan and to pledge the collateral, whether entering into and performing the loan violates any of the borrower’s organizational documents or material contracts, and whether the borrowing is otherwise in violation of federal or state law. The lender also asks if there are any lawsuits or administrative procedures pending against the borrower. If so, they could have a material adverse effect. Discovering untrue representations after the loan has been made may well lead to adverse consequences. Example: if a borrower in a regulated industry requires the authority of a governmental agency, the granting of a security interest by that borrower, the lender may be unable to cure this defect after the loan is made.

Unfortunately, borrowers sometimes, knowingly or unknowingly, misstate the accuracy of the representations and warranties. Rather than relying on the borrower’s representations and warranties and on the documentation prepared by the lender’s counsel, the lender and the lender’s counsel typically want an opinion from the borrower’s counsel that certain legal matters covered by the borrower’s representations and warranties are accurate.

The opinion should also address the validity and perfection of the security interest granted the lender by the borrower. While primary responsibility for assuring

perfection rests on the shoulders of the lender's counsel, a second set of eyes should review the security documents to make sure that the lender has a perfected security interest in the lender's collateral for the loan. The perfection opinion is typically limited on security interests perfected by the filing of a financing statement.

The legal opinion of the borrower's counsel is important in the loan documentation process for at least three additional reasons. First, the lender and its counsel have limited information about the borrower. Certain information can be obtained from public records, but much of the information covered by the legal opinion is not otherwise available to the lender or its counsel.

Second, if a representation is misstated by a borrower, the only practical consequence is to declare an event of default. The lender cannot necessarily cure or fix the effect on its loan or security interest of a borrower's misrepresentation discovered after the loan closes. Had the lender obtained a legal opinion (or insurance), the due diligence that would have been conducted by borrower's counsel or the insurer may have revealed the borrower's misstated representation before the funding of the loan.

Third, if there is an error in the legal opinion which results in the lender being damaged, the lender may be entitled to payment of its monetary damages by the issuer of the opinion. If the lender has insurance coverage for the claim, the lender can assert the claim under the terms of the policy.

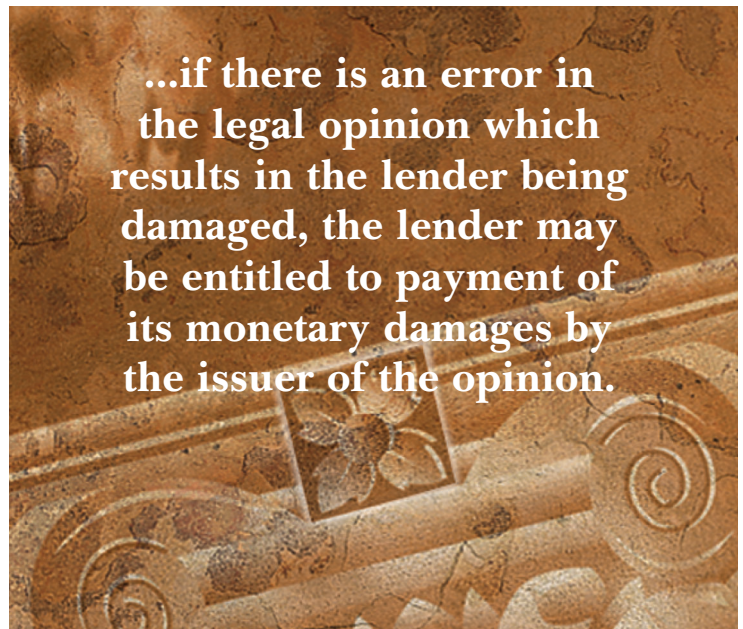
### **What does the legal opinion typically cover?**

The provisions described below are generally requested by lenders in legal opinions delivered in the nonagented, nonmulti-state loans (most of these provisions are included in larger lending transactions with additional provisions to account for the complexity of the transaction). The terminology below refers to a corporate borrower, but equivalent language would be used for a limited liability company or partnership. The following provisions will be referred to in this article as the "Borrower's Opinion Provisions".

*Due incorporation and qualification:* Borrower's counsel opines on whether the borrower is duly incorporated and validly existing under the laws of the state of its incorporation. The opinion often covers the borrower's qualification in other jurisdictions where it is doing business (counsel may refuse to give this opinion if the counsel is not licensed to practice law in these other jurisdictions).

*Power and authority:* The lender wants to know that the borrower has the power and authority to borrow the money and to enter into and perform the loan documents. This requires, among other things, that borrower's counsel determine that necessary director (and sometimes shareholder) approval has been obtained.

*No conflict:* Borrower's counsel is asked to confirm that entering into and performing the loan documents will not



conflict with or cause a default under any other agreement or document by which the borrower is bound. This opinion is typically limited to the governing documents and a specific (and usually short) list of contracts entered into between the borrower and third parties.

*Binding effect:* The opinion states that the loan documents are binding and enforceable against the borrower subject, to multiple exceptions. These include bankruptcy and insolvency proceedings, equitable remedies and exceptions geared to particular state law. These exceptions are often so numerous that the lender may get little comfort from this portion of the opinion.

*No litigation:* The borrower's counsel will generally opine that, to the best knowledge of the lawyers in the borrower's counsel's firm, the borrower is not subject to any litigation except as noted. The opinion may rely on specific litigation searches. Generally, no opinion is given on the merits of litigation or on the expected outcome.

*No governmental consent:* The lender requires the borrower's counsel to opine that the performance of the loan documents does not require governmental consent under federal or state law. It is uncommon for such consent to be required.

*No stamp, recording or similar taxes required to be paid:* This provision addresses the issue of whether a tax is assessed by a governmental agency in the filing of a financing statement beyond the normal filing fees. While at least two jurisdictions, Florida and Tennessee, do have a tax on UCC financing statements, most states do not. Most of the UCC filing services are very familiar with these taxes and can advise a lender of their applicability.

*Perfection of the security interest:* Borrower's counsel is usually required to opine that the financing statements are in proper form and either have been filed in the appropriate jurisdiction under the UCC or, when filed in the appropriate

TYPICAL LEGAL OPINION COVERAGE	UCC INSURANCE WITH A STATUS ENDORSEMENT® (the Policy)
Borrower is a corporation duly incorporated, validly existing, and in good standing under the laws of the state of its incorporation.	<b>Covered.</b> The Policy insures against the failure of the debtor to be a corporation which is validity existing and in good standing under the laws of the state of its incorporation.
Borrower is qualified to do business in the states listed in a schedule attached to the opinion.	<b>Covered.</b> The Policy insures against the failure to be qualified in the jurisdictions identified by the lender for coverage.
Borrower has the corporate power and authority to execute and deliver the loan documents and perform its obligations under, to own and operate its properties and assets, and to carry on its business.	<b>Covered as to the Loan Agreement only.</b> The Policy covers the failure of the borrower to have the power and authority to enter into the loan documents granting the security interest (hereinafter referred to as the Loan Agreement) <sup>1</sup> or the power or authority to execute and deliver the Loan Agreement. The Policy does not address corporate authority beyond the scope of the Loan Agreement.
The execution, delivery, and performance of the loan documents have been duly authorized by all necessary corporate actions on the part of borrower. Each loan document has been duly executed and delivered by borrower.	<b>Substantially covered.</b> The Policy covers the failure of the borrower to have duly authorized and approved the execution and delivery of the Loan Agreement. The Policy also insures that the Loan Agreement has been duly executed and delivered.
The loan documents constitute the legal, valid, and binding obligations of borrower, enforceable against borrower in accordance with their respective terms.	<b>Partially covered.</b> The legality, validity and binding nature of the Loan Agreement is covered by the Policy.
The execution, delivery, and performance of the loan documents by borrower, the compliance with the terms and conditions thereof, and the consummation of the transactions contemplated thereby, do not and will not (1) conflict with, result in a breach of, or constitute a default under, any of the terms, conditions, or provisions of (a) any present statute, rule, or regulation applicable to borrower, (b) the articles of incorporation or bylaws of borrower, (c) to our knowledge, after due inquiry, any term of any agreement, contract, undertaking, indenture, or instrument by which borrower or the properties or assets of borrower are bound, or (d) any order, judgment, or decree of any domestic court or other agency of domestic government, known to borrower's counsel, after due inquiry, that is binding on borrower, or (2) result in the creation of any lien, mortgage, pledge, charge, security interest, or other encumbrance upon any of the properties or assets of borrower other than as granted to the lender.	<b>Partially covered.</b> The Policy covers item (1)(a) with regard to the loan documents granting the security interest. Items (1) (c) and (d) and item (2) are not covered and while important in larger loans, are typically not a problem in smaller lending transactions.

<p style="text-align: center;"><b>TYPICAL LEGAL OPINION COVERAGE</b> Continued</p>	<p style="text-align: center;"><b>UCC INSURANCE WITH A STATUS ENDORSEMENT® (the Policy)</b> Continued</p>
<p>The security interest granted in the loan documents has been duly perfected to the extent the collateral can be perfected by the filing of a financing statement. Opinion assumes that the borrower has rights in the collateral and that the lender has given the borrower value.</p>	<p><b>Substantially covered and adds priority of the security interest.</b> These provisions are covered by the Policy. The Policy also insures against the failure of the security interest to attach, to be perfected, or to have priority as provided in the Policy and adds coverage for perfection of security interests by possession or control (such as bank accounts and stock certificates held in a brokerage account).</p>
<p>There are no stamp, recording, or similar taxes required to be paid in connection with the execution, delivery, or filing of the financing statements to be filed with the filing offices, except for the standard filing fees collected by such filing offices.</p>	<p><b>Not covered but issue is limited to only a few jurisdictions.</b> Usually these taxes are not a problem unless financing statements are filed in those few jurisdictions which impose a tax on personal property security interests (Florida is an example.) Most search services are familiar with these taxes and can advise the lender in advance of any requirements.</p>
<p>No governmental consents or approvals are required in connection with the extensions of credit under the loan documents or other consummation of the transactions contemplated by the loan documents, except for filings required for the perfection of lender's security interests.</p>	<p><b>Substantially covered.</b> The Policy insures against the failure to obtain any required governmental consent for the execution or performance of the Loan Agreement.</p>
<p>The making of the loans, advances, and extensions of credit to borrower pursuant to the loan agreement and the loan documents and the application of the proceeds of the advances there under do not violate Regulations T, U, or X of the Federal Reserve System.</p>	<p><b>Not covered.</b> This provision is not covered by the Policy; however the lack of such coverage is usually not a material issue unless the loan proceeds are being used to purchase or carry marketable securities.</p>
<p>To the knowledge of borrower's counsel, the borrower is not subject to any litigation except as noted in the opinion.</p>	<p><b>Can be substantially covered.</b> The Policy, with an additional endorsement, will identify litigation matters revealed in a litigation search in jurisdictions requested by the lender. Typically, many legal opinions are also limited to specific litigation searches. The Policy will not cover any pending claims which are not yet of public record.</p>

jurisdiction, will perfect a security interest in those assets which can be perfected by the filing of a financing statement. Other elements of perfection, including the borrower's execution of a security agreement, the borrower having rights in the collateral and the lender giving value, are assumed in the opinion and not opined on by counsel. Counsel virtually never opines on whether the borrower has title to the collateral.

*Priority of the security interest:* With rare exception, borrower's counsel does not opine on the priority of the lender's security interest. If such an opinion were given, it would be subject to a multitude of exceptions and limitations. The borrower's counsel would undoubtedly also require a premium fee to give such an opinion.

*No violations of regulations T, U or X of the Board of Governors of the Federal Reserve System:* While these opinions are typically requested, they only apply to the purchase of margin securities and are not an issue in most commercial loans. Sometimes borrower's counsel is unfamiliar with these regulations and may refuse to give the opinion.

### **Why borrowers refuse a lender's request for an opinion**

While not usually a problem in larger lending transactions, in the nonagented, nonmulti-state lending transactions in the range up to \$10,000,000, the borrower may object to the requirement that the borrower's counsel issue an opinion. These objections are typically based on one or more of the following:

- The borrower does not have regular outside counsel, does not use counsel in the conduct of its business and objects to the lender requiring the borrower to hire counsel.
- The borrower has regular outside counsel, but does not want to pay counsel to read the loan documents or to issue the opinion. Since an opinion carries with it a certain amount of legal risk, lawyers want to be compensated for that risk.
- The borrower's counsel may have little or no background or expertise in commercial lending and is unable or unwilling to give an opinion.

### **Lender's alternatives to a refusal of borrower to give the lender an opinion**

When the borrower resists permitting or directing its counsel to give a legal opinion to a lender, or where the transaction size does not justify the borrower hiring counsel to give the opinion requested by the lender, the lender has two principal alternatives.

The lender may waive the opinion and rely on the representations and warranties of the borrower set forth in the loan documents. Of course, representations and warranties are only reliable if they are true and correct. Some borrowers intentionally misrepresent matters to lenders and other borrowers may simply misrepresent matters out of negligence or lack of knowledge. If a representation proves to be incorrect, generally the lender's only alternative is to declare a default.

Lenders will often waive the opinion because of the desire to close the transaction. The danger: the expediency of closing a transaction may be offset by problems for the lender arising in a workout or bankruptcy proceeding

which could have been avoided had an opinion been obtained. And the once-friendly borrower may no longer be willing to cooperate now that it has the money. Even if the defect in the loan documentation is defensible, it can cost the lender hundreds of thousands of dollars to litigate.

The second alternative is for the lender to purchase UCC insurance. While a certain degree of due diligence is conducted by the back office of the insurer issuing the policy, UCC insurance is not a legal opinion. It does, however, offer indemnity coverage to the lender. But does UCC insurance give the lender protection it would receive from a legal opinion?

### **A new endorsement to UCC insurance may be the best alternative**

Most lenders are familiar with UCC title insurance offered by several land title companies. UCC insurance is similar to the title insurance offered on real estate and insures the lender that it has a perfected and prior security interest in its collateral in accordance with the terms of the policy. The First American Title Company now offers the Status Endorsement,<sup>™</sup> the purpose of which is to bridge the gap between the coverage typically offered in a UCC insurance policy and the provisions of the legal opinion usually required by lenders in nonagented and nonmulti-state loans. While the UCC insurance and the Status Endorsement<sup>™</sup> are not legal opinions (insurance companies do not render legal advice and do not practice law), UCC insurance and this endorsement offer the lender insurance coverage for many of the same matters lawyers are asked to cover in their legal opinions to lenders. In some cases, the insurance gives the lender greater protection than from an opinion letter.

The following chart compares a typical legal opinion required in the smaller lending transactions with UCC insurance coupled with the Status Endorsement<sup>™</sup>. As noted



above, while the following is geared to a corporate borrower, similar provisions and coverage are available for a borrower that is a limited liability company or a partnership.

When a lender is faced with the dilemma of either insisting upon the delivery of a legal opinion over the borrower's objection or waiving that opinion, the UCC insurance coupled with a Status Endorsement™ represents a new and valuable alternative to the lender. The scope of the Policy may actually give a lender greater coverage than would be obtained from an opinion letter. An additional advantage over an opinion letter is that with a Policy, the lender has actual "insurance," and a mechanism for asserting a claim covered by the Policy. Opinion letters are not insurance and there is no easy method for recovering damages on a claim against the issuer of an opinion. While legal opinions will continue to play an important role in the documentation of commercial loans, an insurance policy can be a recommended alternative in those transactions where obtaining a legal opinion is not feasible. •

## Endnote

<sup>1</sup> It is customary in less complex lending transactions for the credit agreement and the security agreement (which is the document granting the liens) to be combined into one document. References in this article to the Loan Agreement refers to the security agreement. If the security agreement is combined with the credit agreement, references to the Loan Agreement refer to that portion of the agreement covering the grant of the security interest.



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