C A D W A L A D E R

Beyond the Boilerplate

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The term “boilerplate” originates from the printing industry, where “boilerplate” referred to metal plates with standardized text used for newspapers and other publications. In legal documents and contracts, boilerplate refers to standard clauses or sections that are common to most agreements and address general terms and conditions, such as dispute resolution, commencement, venue, choice of law, confidentiality, indemnification, etc.

When thinking about topics for *Fund Finance Friday*, the best source of content is most often the questions and issues that arise in day-to-day discussions and negotiations. The idea for this article popped up recently during a negotiation of a credit agreement and impacted a boilerplate section that doesn’t get discussed as often as some others. In this situation, the borrower was particularly concerned about the lender directly contacting their investors in the normal course (i.e., other than during an enforcement scenario). The usual assurances that the lender would not randomly contact investors during non-enforcement failed to alleviate the borrower’s concerns.

As a result, the lender agreed to modify the typical standstill and power of attorney language to specifically state that the lender would not contact investors outside of enforcement. Issue resolved? We thought so. However, as drafts were exchanged, it became clear that the borrower sought to not only have the lender affirmatively state that it would not contact its investors, but also wanted recourse against the lender should the no-contact agreement be violated – regardless of the circumstance.

Damages (or lack thereof) issues aside for an unintentional contact, the lender had agreed early on to insert to be determined no-contact language (aside from during an enforcement scenario). As the understanding moved from concept to drafting, the core issue moved past the lender agreeing to the concept. Instead, the issue was whether, and to what extent, the lender was comfortable carving out the no-contact promise from the indemnification protections. A modification of that protection would open the lender up to potential liability, depending upon the standard to apply to a breach of that promise by the lender. Stated differently, would an “honest mistake,” such as an analyst for some (unlikely) reason calling an investor regarding an incomplete subscription agreement result in liability? Further, what level of “mistake,” if any, would or should result in liability for the lender? For that analysis, a review of a certain “boilerplate” - standard section common to most agreements” was required – in this case, the indemnification section.

<u>Lender Liability and Indemnification</u>

The LSTA’s Complete Credit Agreement Guide states: “It is customary for lenders to obtain from the borrower a general indemnification against loss or liability suffered by the lenders in connection with the credit agreement.”

Inclusion of a general indemnification clause was not always boilerplate in loan documents. Indemnification sections started to make their way into loan agreements in the mid-1980s as a result of the fallout from lender liability cases arising in that decade and the decade prior. In a nutshell, lender liability refers to a body of liability theories based in contract, tort, other common law and statutes, with the common thread being they are asserted against lenders. The causes of action under these theories involve actions taken (or not taken) by the lender in connection with a loan that directly or indirectly results in losses to the borrower or a third party. For example, lenders found themselves being sued by the targets of hostile takeovers (e.g., for not funding), and wanted protection from borrowers for any damages awarded in connection with (and any costs incurred in defending) such claims. This specter of potential lender liability gave rise to the broad indemnification and hold harmless language that now appears in the boilerplate section of most credit agreements.

One quick point on "Indemnify" versus "Hold Harmless." Although the concepts are used somewhat interchangeably, as a technical matter, indemnification is the borrower's obligation to reimburse the lender(s) in connection with claims brought by third parties. Whereas, "hold harmless" is the borrower's agreement not to sue the lender(s) for claims arising under the credit agreement.

At the end of the day, the standard boilerplate language protects the lender from a wide variety of "losses, claims, damages, liabilities, and related expenses" incurred in connection with the credit facility, whether in the context of claims brought by third parties or by the borrower itself. As a junior lawyer, the latter concept was a bit difficult to comprehend – if the lender does something wrong, vis-a-vis the borrower and the borrower sues the lender for damages and wins, the borrower would need to indemnify the lender for the damages the lender paid the borrower? This hit me similar to: "I know I damaged your car, but it is your fault for loaning it to me. If you hadn't asked me to help, none of this would have happened."

As explained to me in layman's terms years ago by a senior lawyer: "Banks loan money to customers to make money, via fees and interest and ultimately to get their money back – they aren't in the business of getting sued as a result of the service they are providing."

<u>Exceptions to Rule, but an Understandably High Bar</u>

In our example, the borrower initially sought to exclude indemnification coverage for any violation of the no-contact agreement by the lender. For the lender, the likelihood of mistakenly contacting an investor was low, since that was not something that would occur in the normal course and depending on the fact pattern, actual damages resulting from a breach seemed unlikely. However, almost all lenders have multiple touch points with their borrower clients. In addition to a "regular banker" there most likely is a banker who monitors the credit, manages the cash, opens new accounts, provides swap services, etc. In a nutshell, regardless of the issue and the best efforts of everyone involved to provide the best service to their clients, things happen. Perhaps the best summary is to use a time-honored borrower statement – "We can't be in default for a simple "foot fault."

The reality is mistakes sometimes happen. Combine that with the fact that lenders aren't in the business of getting sued as a result of the service they are providing to the borrower, while the standard boilerplate does contain indemnity exclusions, the "mistake" needs to exceed a high threshold to relieve the borrower from its indemnification obligation. In the indemnification context, the high bar exclusions usually include gross negligence and willful misconduct – meaning, the gross negligence or willful misconduct of the lender (indemnitee) excludes indemnification coverage, such that the borrower (indemnitor) isn't obligated to cover losses arising from such severe or intentional wrongdoing by the lender.

The definitions of gross negligence and willful misconduct vary by state, but under New York law, gross negligence is more than just heightened negligence. Rather, it is closer to willful misconduct, and, thus, it is different in kind, not just degree, from claims of ordinary negligence. Gross negligence is "conduct that evinces a reckless disregard for the rights of others or 'smacks' of intentional wrongdoing." Stated differently, gross negligence is not simply a worse form of negligence, but akin to intentional wrongdoing.

With respect to willful misconduct, under New York law, it generally refers to intentional actions or deliberate failures to act, taken with the knowledge that such conduct will likely result in harm or damage, indicating a reckless disregard for the rights of others. While the willful misconduct standard is similar to the gross negligence standard, willful misconduct focuses more on the harm that a party's action or inaction caused. In summary, willful misconduct and gross negligence involve a higher level of intent or awareness of the risks involved compared to ordinary negligence.

<u>Conclusion</u>

if the borrower breaches any of the litany of covenants in the credit agreement, the lender may (depending on the exact circumstances) have all sorts of remedies at its disposal. Meanwhile, the lender is absolved of liability for anything short of gross negligence or willful misconduct.

You might be thinking that the remedies available to the borrower and the lender under a typical credit agreement seem quite asymmetrical—and you would be correct. So is that fair?

The answer (perhaps unsurprisingly) is yes. Asymmetrical remedies make sense in view of the asymmetrical risks of the lender versus the borrower. The lender is lending the money and assuming the risk of nonpayment. The lender would not be in a position of any liability but for its agreement to make the loan the borrower is requesting. That isn't to say that the lender is completely isolated from its mistakes or actions. However, to the extent that the lender's mistake or action doesn't rise to the level of gross negligence or willful misconduct, the lender did not bargain for the additional assumption of liability to the borrower or any third party as a result of its agreement to provide the service requested by the borrower (and the borrower should have to reimburse the lender if borrower or someone else does).