Hypothetical for WGLO Ethics Panel, October 31, 2017

Weevil Assurance Co. is a broker that contracts with insurers to provide insurance policies to farmers to protect against crop failure. Weevil enters into a Loan Agreement with financier Diamond Hat Lenders. Diamond Hat is to provide a $5 million revolving loan to Weevil, collateralized by all of Weevil’s assets. Weevil’s assets are primarily the commissions it receives on the policies, which Weevil’s insurance agents are to send directly to a lockbox account that Diamond Hat could foreclose upon in the event of a default. In the event any agent remits a commission payment to Weevil other than to the lockbox account, the Loan Agreement obligates Weevil to transfer the payment promptly to the lockbox account.

As a condition of the Loan Agreement, Diamond Hat requires a closing opinion from Weevil’s outside law firm, Quartz & Bronze LLC. Ralph is a partner in Quartz’s New York office with primary responsibility for the lending transaction, which is to be governed by New York law. Quartz’s opinion, which is addressed to Diamond Hat, provides in part, “To our knowledge there is no lawsuit pending or threatened against Weevil that might adversely affect the validity or enforceability of any loan document.” It further provides that “We are aware of nothing that causes us to believe that the Loan Agreement contains an untrue statement of material fact or omits to state a material fact necessary in order to make the statements therein, in the light of the circumstances under which they are made, not misleading.” It expressly defines “knowledge” or “awareness” as the actual knowledge of the Quartz & Bronze LLC lawyers who worked on the lending transaction.

Step 1:

Prior to delivering the opinion, Ralph discusses the no-litigation confirmation with Weevil’s general counsel, Thelma. Thelma tells Ralph that there are two active lawsuits against Weevil. The first is an employment discrimination lawsuit seeking nominal damages in which a former executive of Weevil claims that the company has consistently refused to admit women to senior management positions. Thelma tells Ralph that she views the lawsuit as frivolous—not least because Thelma herself is a member of senior management—and immaterial in any event. The second is a lawsuit that was recently filed under seal in federal court, in which a putative class of farmers alleges that Weevil engaged in a nationwide scheme to defraud farmers and obtain excessive commissions on the insurance policies. Plaintiffs seek treble damages amounting to tens of millions of dollars, far more than Weevil’s net worth. Thelma tells Ralph she thinks the lawsuit is meritless and will likely be dismissed. Thelma also says she does not want to tell Diamond Hat about the class action lawsuit, for fear that they may blow it out of proportion.

Ralph discusses both lawsuits with his litigation partner, Edward, who is the firm’s relationship partner for Weevil and is handling both cases. Edward agrees with Thelma’s assessment of their merits. By the way, Edward is married to Thelma.

Ralph concludes that he can give the opinion without further qualification or disclosure. He thinks there is nothing about the discrimination suit that has any bearing on the opinion or the transaction, and it is frivolous anyway. The second lawsuit, he thinks, does not bear on the “validity or enforceability” of the loan documents; therefore it would not render the opinion inaccurate.

Can Ralph give the opinion? What ethics rules may be pertinent?

Step 2:

Shortly before the transaction is scheduled to close, Edward calls Ralph and tells him that Weevil has been threatened with another lawsuit. Edward says he is under strict instructions from Thelma not to discuss this lawsuit with anyone, not even his partners, but Edward felt that he had to tell Ralph since he knows the lending transaction is imminent, even though Edward is not working on the transaction. Ralph calls Thelma, who tells him (a) that she is going to kill Edward (Ralph thinks she is speaking figuratively), and (b) that she prefers not to tell Ralph what the lawsuit is about, but Diamond Hat knows all about the lawsuit because it would be a codefendant and has received the same threat.

Assume that the threatened lawsuit, whatever it is, actually would impair the validity of the loan documents; but Ralph of course doesn’t know that. Can Ralph give the opinion to Diamond Hat? Does the “knowledge” definition in the opinion matter? Does it matter that Diamond Hat already knows about the threatened lawsuit?

Step 3:

The Loan Agreement separately requires Weevil to disclose to Diamond Hat any “contracts that would materially affect the Collateral.” “Collateral” is defined to include all of Weevil’s assets, including specifically its right to the commissions, which are supposed to be deposited into the lockbox account. Weevil lists certain contracts on a Borrower’s Disclosure Schedule, appended to the Loan Agreement. The Schedule does not disclose that some of these agreements were modified to permit insurance agents to send commission payments directly to Weevil’s operating account instead of to the Lockbox Account. Ralph and Thelma discuss this. Thelma explains that in her view, the modification agreements do not “affect the Collateral” because Weevil is obliged to remit the payments to the lockbox anyway. Ralph agrees, but, to be on the safe side, he amends the Quartz & Bronze opinion to insert the following language at the end of the negative assurance sentence: “(except for the contents of the Borrower’s Disclosure Schedule, as to which we express no opinion).” Diamond Hat accepts the opinion with that exclusion.

Any problem for Ralph if he adds the new language? What if he doesn’t add it?

Step 4:

As you may have guessed, since this is one of our hypotheticals, everything is not really on the up and up at Weevil. A few months after the lending transaction closes, Edward tells Ralph that Thelma has confided to him that Weevil has been instructing all of the insurance agents to send payments directly to its operating account, and not to the lockbox. Weevil has not forwarded those payments to the lockbox but rather has distributed the funds to its executives in the form of bonuses. Edward has implored Thelma to put a stop to this. In the meantime he invites Ralph to continue their discussion on his new sailboat.

What are Ralph’s obligations?