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Insights

An Amended and Restated Loan & Security Agreement Should Expressly So State If It Is Not Intended As a Novation

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The United States Court of Appeals for the Sixth Circuit (the "6th Circuit") in *Bash v. Textron Fin. Corp. (In re: Fair Fin. Co.),* 834 F.3d 651 (6th Cir. 2016), held that an amended and restated loan and security agreement ("Amended Loan Agreement") may have been a novation of the original loan and security agreement resulting in the loss of the lender's security interest and making payments fraudulent transfers. Upon remand and after cross motions for summary judgment, the federal district court, in light of evidence brought to its attention that the parties did not intend to extinguish the earlier lien by amending and restating the agreement, concluded that the issue was one for a jury.

This case is noteworthy because the Amended Loan Agreement at issue contained provisions commonly used by many lenders. The practical takeaway is that an amended and restated agreement should expressly state the intent of the parties that the security interest and liens in the collateral under the original security agreement continue in full force and effect and that the amended and restated agreement is not intended to be a novation.

This Alert discusses only that portion of the legal proceedings involving the issue of whether the Amended Loan Agreement constituted a novation.

Fair Finance Company ("Debtor") and its holding company, Fair Holdings, Inc. ("FHI") received a $22 million revolving credit line under the terms of a loan and security agreement in 2002 ("2002 Loan Agreement") with Textron Financial Corporation ("Textron") and United Bank.

As security for the loan, FHI pledged all of its present and future assets. The security interest created under the 2002 Loan Agreement extended to all future obligations of FHI, including obligations intended as replacements or substitutions for those existing under the 2002 Loan Agreement.

As the 2004 maturity date for the 2002 Loan Agreement approached, all parties involved began discussions on whether to renew the loan. Textron bought out United Bank's position and entered into an amended and restated loan and security agreement ("2004 Amended Loan Agreement") with Debtor and FHI.

The terms of the 2004 Amended Loan Agreement included:

- Recitals that the parties intended to amend and restate the original agreement to reduce the amount and modify certain terms and conditions.
- A new interest rate, new fee schedule, new covenants, new events of default and new conditions precedent.

- The requirement that the Debtor and FHI give Textron 50% of the amount required to obtain United Bank's release from the 2002 Loan Agreement as well as all accrued interest, fees and expenses owing under the 2002 Loan Agreement.
- A provision that it was intended to be the final, complete and exclusive expression of agreement between the parties, and that it superseded all prior agreements.
- A grant of security interest.

Textron did not file a UCC financing statement upon execution of the 2004 Amended Loan Agreement, but did file a UCC financing statement amendment.

In 2007, the Debtor and FHI used part of the proceeds from an asset sale transaction to pay the remaining balance to Textron under the 2004 Amended Loan Agreement. This payment ended Textron's relationship with the Debtor and FHI, and Textron released all of its liens.

In 2009, the FBI raided the Debtor's headquarters. After the Debtor's operations collapsed, a petition for involuntary bankruptcy was filed against the Debtor. Among other claims, the bankruptcy trustee filed a number of adversary proceedings against Textron (and other defendants) in the bankruptcy court which included a claim to avoid and recover fraudulent transfers.

Textron moved to dismiss the trustee's claims, and the district court granted Textron's motion. As to the trustee's fraudulent transfer claim, the district court concluded as a matter of law that the 2004 Amended Loan Agreement was not a novation and, as a result, the security interest conveyed pursuant to the 2002 Loan Agreement continued in full force. Accordingly, neither the 2004 Amended Loan Agreement, nor the payments made under it, could qualify as transfers for the purposes of a fraudulent transfer claim.

On appeal the trustee asserted, pursuant to the Ohio Uniform Fraudulent Transfer Act ("UFTA"), that the Debtor could avoid the obligations incurred and payments made under the 2004 Amended Loan Agreement because the security interest conveyed, and payments made, by the Debtor in accordance with the 2004 Amended Loan Agreement qualified as fraudulent transfers. The trustee argued that the lien granted under the 2002 Loan Agreement was nullified because the 2004 Amended Loan Agreement was a novation of the 2002 Loan Agreement, and that when the 2002 Loan Agreement was extinguished, so was the security interest granted under the 2002 Loan Agreement.

To state a claim for relief under the Ohio UFTA, the 6th Circuit said that the trustee must allege facts plausibly suggesting that the assets or interest in assets conveyed by the Debtor pursuant to the 2004 Amended Loan Agreement were not already encumbered by a valid lien. The 6th Circuit then examined the elements of intent, knowledge and consent to determine if there had been a novation of the 2002 Loan Agreement. The 6th Circuit found support for a novation in: (1) the text of the 2004 Amended Loan Agreement, where several provisions evidenced the intent of the parties for the 2004 Amended Loan Agreement to extinguish and wholly replace the 2002 Loan Agreement; (2) circumstantial evidence, such as the timing of the entering into the 2004 Amended Loan Agreement, which occurred at the maturity of the 2002 Loan Agreement, new promissory notes and guaranties were issued, United Bank ceased to be a lender; and (3) new terms in the 2004 Amended Loan Agreement, all of which the 6th Circuit said signified the intent to extinguish the 2002 Loan Agreement.

The 6th Circuit discussed and distinguished *Official Comm. of Unsecured Creditors of Tousa, Inc. v. Citicorp N. Am., Inc. (In re TOUSA, Inc.),* 630 F.3d 1298 (11th Cir. 2012), where the loan agreement included express language that the security interest continued in full force.

When all the facts were examined together, the 6th Circuit found there existed an ambiguity as to whether the parties intended the 2004 Amended Loan Agreement to extinguish the 2002 Loan Agreement.

Thus, the 6th Circuit concluded that the district court erred in determining as a matter of law that the parties did not intend the 2004 Amended Loan Agreement as a novation of the 2002 Loan Agreement, and reversed and remanded the case for further proceedings.

The case is on remand to the district court where a motion for partial summary judgment is in the briefing stage as of this date of this Alert.

If you would like additional information, please contact **Lori Jean** at **ljean@kdlegal.com** or (574) 485-2011 or another attorney in the Firm's **Commercial and Real Estate Lending Practice Group**.