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Trustee Survives Judgment in Fraudulent-Conveyance Action Based on Novation Argument

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The Sixth Circuit recently ruled that a trustee's claim that a novation occurred upon the execution of amended and restated loan documents could not be dismissed under a Rule 12(b)(6) motion.[1] The Sixth Circuit remanded the case for further proceedings in the bankruptcy court. The case proceeded, and the U.S. Bankruptcy Court for the Northern District of Ohio ultimately recommended that the U.S. District Court for the Northern District of Ohio deny the lender's motion for summary judgment, thus allowing the matter to go forward to a jury trial.[2]

If the trustee was successful, he would be able to recover a payment of $16,999,927.09, made to a secured lender on July 20, 2007, under a fraudulent-conveyance theory. These rulings made it clear that attorneys should include specific language in amended and restated loan agreements and forbearance agreements that the agreements are not intended to be a novation to protect your clients from those types of arguments by trustees or others.

The Financing

In 2002, Fair Finance Co. was sold in a leveraged buyout to two Indiana businessmen.[3] Fair Holdings Inc. was formed as the parent of Fair Finance in order to accomplish the transaction.[4] To finance the transaction, on Jan. 7, 2002, Fair Holdings and Fair Finance entered into a loan and security agreement (the "2002 agreement") with Textron Financial Corp. and United Bank.[5] Pursuant to the terms of the 2002 agreement, Textron and United Bank agreed to make a $22 million loan available to Fair Finance and Fair Holdings in the form of a revolving line of credit.[6] Fair Holdings and Fair Finance pledged all of their present and future assets, including Fair Holdings' undiluted interest in Fair Finance, to secure the debt.[7] The 2002 agreement included the following provision regarding the scope of the security interest created thereunder:

> (c) It is [the] Borrower's express intention that this Agreement and the continuing security interest granted hereby, in addition to covering all present obligations of [the] Borrower to [the] Lenders and their respective Affiliates pursuant to the Obligations, *shall extend to all future obligations of [the] Borrower to [the] Lenders intended as replacements or substitutions for said Obligations, whether or not such Obligations are reduced or entirely extinguished and thereafter increased or reincurred*.[8]

On Jan. 6, 2004, Textron entered into a first amended and restated loan and security agreement (the "2004 agreement") with Fair Finance and Fair Holdings;[9] United Bank was not a party to this agreement. The amount that could be borrowed under the 2004 agreement was reduced from $22 million to $17.5 million. The 2004 agreement provided that the parties' "desire [was] to amend and restate the 2002 Agreement," acknowledging that the 2002 agreement granted a security interest in Fair Finance.[10] The 2004 agreement referred to an "effective date" rather than the "closing date" reference made in the 2002 agreement.[11] The 2004 agreement also contained, as an exhibit, an attorney opinion letter from Fair Finance's attorney, which included the following statement:

> Neither the making nor performance of the Loan Documents or the transactions contemplated thereby will adversely affect the validity or priority of the security interests granted to and obtained by Lender as a result of the making and performance of the [2002 agreement].[12]

In addition to executing the 2004 agreement, the parties executed a new promissory note for $17,500 (the "2004 note") and new personal guarantees.[13] The 2004 note stated that the "Promissory Note and the advances contemplated hereunder [were] made pursuant to the terms and provisions of that certain First Amended and Restated

1 *In re Fair Fin. Co.*, 834 F.3d 651 (6th Cir. 2016) (*Bash v. Textron Fin. Corp.*, A.P. No. 12-5101).
2 *In re Fair Fin. Co.*, 2018 WL 1069443 (Bankr. N.D. Ohio Feb. 23, 2018).
3 *In re Fair Fin. Co.*, 834 F.3d 651, 657 (6th Cir. 2016).
4 *Id.*
5 *Id.*
6 *Id.*
7 *Id.* at 658, 661.
8 *Id.* (emphasis added).
9 *Id.* at 661.
10 *Id.*
11 *Id.*
12 *In re Fair Fin. Co.*, 2018 WL 1069443, *12 (Bankr. N.D. Ohio 2018).
13 *In re Fair Fin. Co.*, 834 F.3d 651, 662 (6th Cir. 2016).

Loan and Security Agreement."[14] On July 20, 2007, Fair Financial paid Textron the balance of $16,999,927.09 in full through an asset-sale transaction.[15]

The Adversary Proceeding

On Feb. 8, 2010, an involuntary bankruptcy proceeding was filed against Fair Financial because it was alleged that Fair Financial was operated as a Ponzi scheme.[16] **Brian A. Bash** (BakerHostetler; Cleveland) was appointed as a chapter 7 trustee, and he initiated several adversary proceedings, including the adversary proceeding against Textron.[17] Among other things, the chapter 7 trustee alleged that the 2004 agreement was a novation of the 2002 agreement, and that the avoidance of the 2004 agreement would render the 2002 agreement a legal nullity, thereby avoiding the original secured interest.[18] The trustee argued that three grounds existed that would invalidate the 2002 agreement.[19]

First, the 2004 agreement was a novation, which extinguished the prior agreements, including the security interest granted thereunder.[20] Second, the 2004 agreement was entered into to purposefully defraud creditors. Finally, the court could use its equitable powers to subordinate Textron's lien.[21] If the trustee could establish that the 2004 agreement extinguished the security interests granted under the 2002 agreement, and that the security interest granted in the 2004 agreement was a fraudulent conveyance, then he could recover the $16,999,927.09 payment to Textron under a fraudulent-conveyance theory.

Textron filed a motion to dismiss under Rule 12(b)(6), but the U.S. Bankruptcy Court for the Southern District of Ohio recommended denying the motion, stating that the chapter 7 trustee had sufficiently alleged the elements of the claim.[22] The district court rejected the bankruptcy court's recommendation and granted Textron's motion to dismiss, stating as a matter of law that the 2004 agreement was not a novation of the 2002 agreement.[23] The district court also dismissed the constructive fraudulent-conveyance claim because it was barred by the applicable statute of limitations.[24]

In the chapter 7 trustee's appeal to the Sixth Circuit, he argued that under Ohio law, the 2004 agreement constituted a novation of the 2002 agreement.[25] Thus, the chapter 7 trustee contended that upon execution of the 2004 agreement, the 2002 agreement, along with its underlying security interest, was extinguished.[26] As a result, the chapter 7 trustee asserted that the debtor's assets were not encumbered by a preexisting lien, and that the security interest granted and the payments made pursuant to the 2004 agreement were fraudulent transfers.[27] The Sixth Circuit described a contract of novation as follows:

> A contract of novation is created where a previous valid obligation is extinguished by a new valid contract, accomplished by substitution of parties or of the undertaking, with the consent of all the parties, and based on valid consideration.[28] The Ohio Court of Appeals has explained that "[i]ntent, knowledge and consent are the essential elements in determining whether a purported novation has been accepted." [cites omitted] A party's knowledge of and consent to the terms of a novation need not be express, but may be implied from circumstances or conduct. [T]he evidence of such knowledge and consent, however, "*must be clear and definite*, since a novation is never presumed."[29]

The Sixth Circuit pointed to several provisions in the 2004 agreement that they believed could be seen to be evidence of an intent for a novation.[30] The Sixth Circuit believed that the language stating that the parties "desired that the 2004 Agreement supersede any and all prior oral or written agreements related to this subject matter" might be read to indicate an intent for a novation.[31] Likewise, the integration clause was viewed as potential evidence of an intent that the 2004 agreement was a novation.[32] The 2004 agreement states that valuable consideration exchanged hands.[33] The Sixth Circuit stated, "Read together, these provisions support a finding that the parties demonstrated their intent to extinguish their obligations under the prior agreement and be bound anew under the terms of the 2004 Agreement."[34] The Sixth Circuit also pointed to additional factors outside the language of the 2004 agreement that could also support a finding that the 2004 agreement was a novation of the 2002 agreement: (1) The parties entered into the 2004 agreement on the maturity date of the 2002 agreement; (2) the parties replaced the promissory note and got new personal guarantees; (3) the 2004 agreement imposed significant new terms, such as new interest rate and fees, an increased financial commitment from Textron and others; and (4) United Bank was removed as a lender.[35]

The Sixth Circuit held that these factors demonstrated an ambiguity on whether or not the parties' intended the 2004 agreement to be a novation, and thus ruled that the motion to dismiss should not have been granted by the district court.[36] They reversed the district court decision and sent it back to the bankruptcy court for further proceedings.[37] The Sixth Circuit stated that the district court failed to examine extensive evidence that supported the trustee's contention, making it inappropriate to determine the parties' intent at the motion-to-dismiss stage.

The proceeding continued in the bankruptcy court, and eventually both Textron and the chapter 7 trustee filed motions for summary judgment. The bankruptcy court

14 *Id.*
15 *Id.* at 663.
16 *In re Fair Fin. Co.*, 2018 WL 1069443, *3 (Bankr. N.D. Ohio 2018).
17 *Id.* at *2.
18 *In re Fair Fin. Co.*, 834 F.3d 651, 665 (6th Cir. 2016).
19 *Id.*
20 *Id.*
21 *Id.*
22 *Id.* at 664.
23 *Id.*
24 *Id.* at 665.
25 *Id.* at 667.
26 *Id.*
27 *Id.*
28 *McGlothin v. Huffman*, 94 Ohio App. 3d 240, 640 N.E.2d 598, 601 (1994).
29 *Id.*
30 *Id.* at 668.
31 *Id.*
32 *Id.*
33 *Id.*
34 *Id.*
35 *Id.* at 669.
36 *Id.* at 668, 670.
37 *Id.*

continued on page 37

from page 31

tendered an order to the district court recommending the denial of Textron's motion for summary judgment on the novation issue, which the district court adopted on Feb. 23, 2018.[38] The bankruptcy court framed the issue facing the court as being whether the lien created by the 2002 agreement was extinguished with the execution of the 2004 agreement.[39]

The bankruptcy court said that the chapter 7 trustee had to do more, under his novation theory, than show evidence of intention to create a new agreement; the trustee must also establish that the parties intended to extinguish the 2002 lien.[40] If the trustee could do that, then the payments made pursuant to the 2004 agreement, including the payoff of nearly $17 million, could be classified as fraudulent conveyances.[41] To support its position that the 2004 agreement was not a novation, Textron relied heavily on the attorney's opinion that stated that the execution of the 2004 agreement did not affect the validity of the liens created by the 2002 agreement.[42] This piece of documentation and evidence was apparently not raised in the appeal to the Sixth Circuit, although it was part of the record.[43]

The bankruptcy court focused its analysis on the Sixth Circuit's previous decision in this case and *In re TOUSA Inc.*,[44] which was also relied upon by the Sixth Circuit. In *TOUSA*, the U.S. Bankruptcy Court for the Southern District of Florida granted a motion to dismiss based on a similar argument that a refinancing acted as a novation. The bankruptcy court stated:

> The preexisting liens, which were granted in the October 2006 revolver, as amended in January 2007, carried forward, and to the extent that the collateral was granted under those prior agreements carried forward under the July amendments, I find that there was no new transfer that's subject to avoidance as a fraudulent transfer under [11 U.S.C. §] 548….[45]

The U.S. Bankruptcy Court for the Southern District of Ohio acknowledged that nothing in the Sixth Circuit's decision in this case disputes or undermines the reasoning in *TOUSA*.[46] Instead, the Sixth Circuit distinguished this matter from *TOUSA* by stating that in *Fair Finance*, the 2004 agreement lacked the language explicitly stating "that it was the parties' intent that the liens granted under the original security agreement shall continue in full force and effect."[47] The bankruptcy court went on to state:

> As noted earlier, Textron makes a compelling case that no reasonable jury could find that the parties intended the 2004 Agreement to extinguish the valid 2002 lien. The opinion letter, incorporated into the 2004 Agreement, contains language almost as explicit as the language in the "Second Amended and Restated Revolving Credit Agreement" in *TOUSA*, which shows that it was the parties' intent that the liens granted under the original security agreement shall continue in full force and effect [cites omitted]. Nor was a release of the lien ever filed until the debtor and Textron ended their relationship in 2007.
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> Indeed, were it not for language in the Sixth Circuit's decision, the undersigned judge would likely recommend that the district court grant Textron's motion for summary judgment with respect to the Trustee's theory for actual fraudulent transfer based on novation.
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> The language in the Sixth Circuit's decision cannot be ignored. When the Sixth Circuit refers to documents incorporated in the Trustee's first amended complaint and indicates that there is "extensive evidence" that supports the Trustee's contention that the parties intended to "replace and extinguish" the 2002 Agreement, the lower court must exercise care before choosing to disregard such language. True, the Sixth Circuit's statement was in the context of a Rule 12(b)(6) motion to dismiss. But the "extensive evidence" did not go away. Rather, Textron has simply brought to the court's attention other evidence that the parties never intended the 2004 Agreement to extinguish the valid 2002 lien. Whether this other evidence proves to be more persuasive that the "extensive evidence" identified by the Sixth Circuit is ultimately a question for the jury....[48]

Conclusion

It seems that the bankruptcy court placed too much emphasis on the attorney's opinion letter, which stated that the amended and restated credit agreement did not affect the validity of the liens. Even though the opinion letter was incorporated into the loan documents, it does not show the parties' agreement or intent, but rather is a legal opinion of borrower's attorney. Nor was it specifically executed by the parties.

The language relied upon by the Sixth Circuit to find potential intent for a novation is problematic. The language cited by the Sixth Circuit is found in virtually all amended and restated agreements. Such a finding should force attorneys back to the drawing board for drafting such amended and restated agreements. It seems clear from these decisions that a specific provision must be included in all amended and restated agreements and forbearance agreements stating that the parties agree that the amended and restated agreement or forbearance is not a novation and that any existing security interests continue in effect. abi

38 *Id.* at *16.
39 *Id.* at *7.
40 *Id.* at *12.
41 *Id.*
42 *Id.*
43 *Id.*
44 680 F.3d 1298 (11th Cir. 2002).
45 *Id.* at *13-14.
46 *Id.* at *14.
47 *Id.*
48 *Id.* at *15-16.