

The Transactional Lawyer

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A Refinancing or Novation? Secured Creditors Beware

Jason M. Gray

The Sixth Circuit’s decision in *In re Fair Finance Co.*¹ creates fraudulent transfer risk for secured creditors that unwittingly enter into a novation when refinancing the secured obligation. Transactional lawyers involved in drafting such agreements need to be careful because almost any amendment to an agreement with a debtor could result in a novation.

The relevant facts of the case are relatively straightforward. Fair Holdings, Inc. (“FHI”) entered into a Loan and Security Agreement (“2002 Agreement”) with Textron and United in order to purchase the Debtor in a leveraged buyout.² Under the terms of the 2002 Agreement, Textron and United made a revolving line of credit available to FHI and Debtor in exchange for a security interest in all of Debtor’s assets. After the purchase was completed, FHI began operating Debtor as a front for a Ponzi scheme. Textron knew in early 2002 that FHI was utilizing Debtor to make insider loans and was engaging in other troubling business practices. Nevertheless, the business arrangement was very profitable for Textron and, as the original loan approached maturity, Textron bought out United’s interest in order to continue the business relationship with Debtor. As part of this deal, Textron entered into a First Amended and Restated Loan and Security Agreement (“2004 Agreement”) with Debtor and FHI. The 2004 Agreement provided Textron with a security interest in the same collateral as the 2002 Agreement.

The Ponzi scheme eventually collapsed approximately two years after Debtor and FHI had repaid

Textron. Debtor entered involuntary bankruptcy proceedings and the Chapter 7 Trustee sought to recover the payments made to Textron subsequent to entering into the 2004 Agreement as avoidable fraudulent transfers under the Ohio Uniform Fraudulent Transfer Act (“UFTA”).

Because the UFTA makes avoidable specified transfers of assets, but defines “asset” to exclude property “to the extent it is encumbered by a valid lien,”³ the payments were not avoidable unless the 2004 grant of the security interest to Textron was itself avoidable. But as to that issue, Textron claimed that because the collateral under the 2004 Agreement was the same as under the 2002 Agreement, there was no asset transfer in 2004 that could be avoided.

The district court agreed, concluding that the 2004 Agreement was a refinancing of the 2002 Agreement that did not affect the ongoing validity of the 2002 security interest. In other words, because the 2004 Agreement was a refinance and not a novation, the security interest established pursuant to the 2002 Agreement continued to encumber any assets or interests in assets that were conveyed after the 2004 Agreement was entered into. In reaching this conclusion, the district court focused on the terms of the 2004 Agreement that provided a security interest in the same collateral that was encumbered under the 2002 Agreement and actually reduced the total line of credit available to Debtor. In addition, the 2004 Agreement’s stated intent was to “amend and restate” the original agreement and the complaint itself referred to the “Textron Line of Credit” as lasting from 2002 until 2007 without interruption.

The Sixth Circuit reversed. Analyzing the text of the 2004 Agreement and, relying primarily on boilerplate terms,⁴ it determined that it was possible that the parties intended for the 2004 Agreement to operate as a novation. The Sixth Circuit also looked to extrinsic evidence in order to determine if the parties intended to have the 2004 Agreement operate as a novation.⁵ The Sixth Circuit therefore remanded the case for a determination of whether the parties had entered into a novation.

The Sixth Circuit’s decision is concerning on multiple levels. First and foremost, the court offered no explanation of why, even if the 2004 Agreement were a novation, that should matter. After all, even if that were true, the debtor’s assets went from being encumbered by the 2002 Agreement to being encumbered by the 2004 Agreement instantaneously, without any lapse. Thus, it

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is not at all clear how the transaction could have resulted in a transfer of unencumbered assets. Second, although the court was careful to emphasize that the standard of review on a motion to dismiss played a part in the decision, the court seemed to ignore language in the 2002 Agreement that the security interest created therein would extend to present obligations and “future obligations . . . intended as replacements or substitutions for said Obligations, whether or not such Obligations are reduced or entirely extinguished and thereafter increased or reincurred.”

The takeaway from a drafting standpoint is that any term in a refinancing agreement that could support the inference of a novation should be eliminated to ensure that the creditor’s security interest is uninterrupted. Thus, references to “superseding” the original agreement should be avoided.⁶ Instead, the refinancing agreement should expressly indicate that the original security interest “continues in full force and effect.”⁷ Such language should insulate the secured party from the fraudulent transfer risk that the Sixth Circuit’s decision imposes.

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Notes:

1. 834 F.3d 651 (6th Cir. 2016), *reh'g denied*, (Sept. 23, 2016).
2. Textron and United filed a UCC Financing Statement in order to perfect the security interest created by the 2002 Agreement.
3. Ohio Rev. Code Ann. § 1336.01(B)(1).
4. These terms included a standard merger clause and consideration clause.
5. The extrinsic evidence that the court relied on to support its conclusion that a novation may have occurred consisted of the date of the amended agreement (which was the maturity date of the original agreement), a new promissory note and personal guarantees from the owners of FHI, and the fact that the amended agreement contained “significant new terms.” However, the court did not explain how the extrinsic evidence had any meaningful relevance to the issue of whether the parties intended for a novation to occur.
6. The 2004 Agreement contained such a statement.
7. *See In re TOUSA, Inc.*, 2011 WL 1627129 (S.D. Fla. Mar. 4, 2011), ruling that a refinancing was not a novation because even though the new agreement purported to “supersede” the earlier agreement, it also

provided that “it was the ‘intent of the parties . . . that the security interests and [l]iens granted in the [c]ollateral under and pursuant to the [o]riginal [s]ecurity [a]greement shall continue in full force and effect,” and the specific statement governs the general statement.



So Let It Be Written: When to Use the Passive Voice in Contract Documents

Stephen L. Sepinuck

Two recent cases provide cautionary tales about the use of the passive voice in written agreements. In the first, *East Texas Copy Systems, Inc. v. Player*,¹ an asset purchase agreement for the sale of a business contained clauses providing for the buyer to employ the seller for four years and prohibiting the seller from engaging in a competing business. The agreement also provided that the restriction on competition would cease to be binding if the seller’s “employment with Buyer is terminated” less than two years after the date of the agreement for any reason other than cause. The day before the two-year period was to expire, the seller quit. He then brought an action seeking a declaratory judgment that the non-compete clause was no longer enforceable. The court agreed, concluding that the passive language indicated that termination could be by either party.

In the second, *Keltner v. Estate of Simpkins*,² a real estate purchase agreement purported to give the buyers an option to purchase adjoining tracts of land. The agreement provided, “[s]hould Buyer exercise said option to purchase, a fair and equitable price for said property will be established at a later date.” The trial court ruled that the option was unenforceable because it was too vague with respect to price. The appellate court affirmed after noting that the price term was expressed in the passive voice, making it unclear how the price was to be determined.

Although the asset purchase agreement in *Player* contained other terms that the court drew upon to support its conclusion, the parties’ use of the passive voice almost assuredly frustrated the expectations of the buyer. In *Keltner*, the effect was even more disruptive: the complete invalidity of one of the dickered terms of the agreement.

Collectively, these cases serve as a reminder to use the passive voice with care. But it would be a mistake to infer from these cases that the passive voice is always undesirable in contracts.

A BRIEF DIGRESSION

Imagine the following covenant in a residential lease:

The Premises shall be kept in good repair.

Does this impose an obligation on the landlord or on the tenant? A judge could reasonably interpret it either way. Of course, context might provide guidance. If the clause were in a section of the lease delineating the tenant's duties, or under a heading identifying it as one of the tenant's duties, that placement would suggest that the tenant is the party obligated by this statement. Usage of trade might also provide guidance. However, in the absence of such context or usage of trade, there is really no reliable way to know who is obligated under this clause.

Similarly, consider the recent case of an account debtor that, in connection with a loan to the debtor, entered into a consent agreement that provided as follows:

The Secured Obligations may be refinanced, renewed or replaced from time to time, and [account debtor] agrees that this Agreement will remain in full force and effect and continue to apply in favor of the Collateral Agent.

Refinanced, renewed or replaced by whom? If a new lender provides funding to pay off the secured obligation, so that the original secured creditors and the Collateral Agent no longer have any skin in the game, is the account debtor still bound by the consent agreement?³

In each of the last two examples, the use of the passive voice – coupled with the failure of the clause to identify the actor – rendered the clause ambiguous.³ In some situations, the passive voice can significantly broaden or narrow the meaning of a statement. Consider, for example, the difference between the following two representations or warranties, which might appear in an agreement for sale:

The car has been driven fewer than 60,000 miles.

The seller has driven the car fewer than 60,000 miles.

The former is passive but is certainly preferable from the buyer's standpoint because it is broader: it deals with how far the car has traveled, not merely how far the seller has driven it, and thus includes mileage racked up by former owners and others in the seller's household. This example illustrates that the passive voice can be both appropriate and desirable.

So where does this leave us? Those who advise transactional lawyers to always avoid the passive voice are wrong.⁴ Instead, the better approach is to use the passive voice only when the action, not the actor, is what matters. This more-nuanced approach is what each of the leading authorities on contract drafting recommends.⁵ The goal of the remainder of this article is to offer transactional lawyers some guidance on when the action, not the actor, is what matters, and hence on when to use – and when to avoid – the passive voice.

ACTORS VS. ACTIONS

In general, contract terms should focus on an action, rather than the actor, when the actor is unknown, unknowable, or irrelevant.

Consider the following two terms in a Nondisclosure Agreement:

A. Receiving Party shall restrict access to Confidential Information to employees who reasonably need the Confidential Information for Receiving Party to satisfy its obligations under [specified agreement], and shall, before disclosing any Confidential Information to an employee, require the employee to agree in a signed writing to restrictions on disclosing Confidential Information at least as protective as those in this Agreement.

B. If Receiving Party is requested or required (by deposition, interrogatory, request for documents, subpoena, or similar process) to disclose any Confidential Information, Receiving Party shall notify Disclosing Party promptly so that Disclosing Party may seek an appropriate protective order or take other appropriate action.

Term A is entirely in the active voice. That is appropriate because the actors (principally, Receiving Party) are known and specified. In contrast, Term B begins with the passive voice (“is requested or required”) and then employs the active voice (“shall notify”). That too is appropriate. In the first clause of Term B (the language

in blue), the actor who requests or requires disclosure is neither known at the time the Agreement is made nor relevant. The parties do not care who makes the request; the point is to impose a duty if a request is made, regardless of who makes it. In contrast, the actor in the second clause of Term B is known: it is Receiving Party.

TYPES OF CONTRACT TERMS

It is important to note that the examples above involve different types of contract terms. The first example – about maintaining the premises – is a covenant. The second example, concerning the account debtor’s consent agreement, is a grant of discretionary authority: the right to refinance the secured obligation without affecting the consent. The third example, dealing with the mileage on a car, involves a representation or warranty. The final example – the two terms in a Nondisclosure Agreement – contain covenants and a condition.

These distinctions suggest some presumptions to follow when determining whether the action or the actor is what matters. In a covenant, the passive voice can create ambiguity by failing to identify which party is obligated, and is almost never appropriate.⁶ The same is true with respect to a grant of discretionary authority.

In contrast, the passive voice is often desirable in a condition.⁷ For example, a merger or acquisition conditioned on the absence of a “material adverse change” before closing should describe that condition in the passive voice. After all, the buyer or acquirer wants out of the deal if such a change occurs, regardless of whether the seller caused the change. Similarly, a loan agreement should refer to the condition of default in the passive voice (*e.g.*, “if a default occurs and has not been cured” or “upon default”) rather than in the active voice (“if Borrower defaults”) if, as is likely, default is defined to include things that require no action by the borrower: an undesirable change in the loan-to-value ratio, a casualty to all or some of the collateral, or any of the collateral becoming encumbered by another lien.

This is not to say that the passive voice is always appropriate in a condition. In one recently litigated case,⁸ language in a lease required the landlord to release its security interest in the tenant’s equipment unless, prior to a specified date, the tenant “was found to be in default.” The court ruled that this required a judicial finding of default even though the security agreement otherwise permitted the landlord to declare a default in its sole discretion. It is likely that the passive voice in that clause operated against the party that drafted the agreement.⁹ Nevertheless, the passive voice is likely to be least objectionable and most appropriate in a condition.

Somewhere in between covenants and discretionary authority, on the one hand, and conditions on the other, lie declarations, representations, and warranties. In each of these types of contract term, the passive voice will occasionally be appropriate. The issue, as in every case, is whether the action or the actor is what matters.

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Notes:

1. [2016 WL 6638865](#) (Tex. Ct. App. 2016).
2. [2016 WL 1247704](#) (Tenn. Ct. App. 2016).
3. *See* Wellons, Inc. v. Eagle Valley Clean Energy, LLC, [2017 WL 897840](#) (D. Colo. 2017). The debtor in the case was seeking to hold the account debtor to a liquidated damages clause in the consent agreement.
3. Ambiguity can be created by omitting the subject even without using the passive voice. A written agreement signed by my wife for the purchase of a Australian Shepherd puppy obligated the breeder to refund the purchase price “[u]pon verification of genetic eye disease or hip dysplasia.” That prepositional phrase is not in the passive voice but nevertheless is ambiguous as to who must provide the verification: my wife, the breeder, or a licensed veterinarian. This problem is probably attributable to improper nominalization: turning the verb “to verify” into a noun.
4. *See, e.g.*, GEORGE W. KUNEY, *THE ELEMENTS OF CONTRACT DRAFTING* 35 (2d ed. 2006). *See also* REED DICKERSON, *THE FUNDAMENTALS OF LEGAL DRAFTING* § 8.18 (1986) (generally recommending the passive voice, particularly in provisions “conferring powers or privileges or imposing duties”).
5. *See, e.g.*, KENNETH A. ADAMS, *A MANUAL OF STYLE FOR CONTRACT DRAFTING* §§ 3.12–3.13 (3d ed. 2013); SCOTT J. BURNHAM, *DRAFTING AND ANALYZING CONTRACTS* § 17.3 (4th ed. 2016); TINA L. STARK, *DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO* § 8.3.2 (2d ed. 2014).

Note that the textual sentence culminating in this footnote is in the passive voice. That was intentional; it was designed to maintain the focus – established in the prior sentence – on the approach, rather than on who recommended it. That makes the connection between the sentences more obvious and improves the flow from one to the next. In contract drafting, such stylistic considerations should take a back seat to clarity and precision.

6. See TINA L. STARK, DRAFTING CONTRACTS, *supra* note 5, at § 10.2.8. For an example of a case in which drafting a covenant in the passive voice created a problem, see *Chemical Bank v. Long’s Tri-County Mobile Homes*, [2011 WL 521158](#) (Mich. Ct. App. 2011), in which one of the issues was whether a creditor that had loaned funds to a mobile home dealer had breached the loan agreement. The agreement included the statement: “Manufacturers [sic] buyback agreement required.” Each party claimed that the other had the duty to obtain the buyback agreements. The court ruled for the debtor, concluding that the creditor had that duty, a conclusion likely to be contrary to normal commercial practices and expectations. See also *Good v. Howmedica Osteonics Corp.*, [2015 WL 8175256](#) (E.D. Mich. 2015) (informed consent agreement in connection with clinical trials for a medical implant, which provided that “[m]edical treatment will be offered if you experience a complication or injury as a result of your participation in the clinical study” – did not impose a duty on the manufacturer to provide or pay for medical treatment in part because the clause was written in the passive voice).

7. See TINA L. STARK, DRAFTING CONTRACTS, *supra* note 5, at § 11.4.1.

8. *Moniuszko v. Karuntzos*, [2014 WL 4657134](#) (Ill. Ct. App. 2014).

9. Another recent case, *Ott v. Fred Alger Management, Inc.*, [2016 WL 5407663](#) (S.D.N.Y. 2016), involved an employment agreement that included a clause forfeiting deferred compensation “[i]n the event that a Participant incurs a Termination.” The court concluded that this clause applied regardless of whether the employee was terminated or resigned. That result favored the employer, who no doubt drafted agreement. However, better drafting would have avoided the ambiguity resulting from the use of the passive voice.



Recent Cases

SECURED TRANSACTIONS

In re TSAWD Holdings, Inc.,

[2017 WL 892329](#) (Bankr. D. Del. 2017)

Because there was a factual issue about whether a retailer was generally known by its creditors to be substantially engaged in selling the goods of others, summary judgment was not appropriate on whether a transaction by

which sporting goods were delivered to a retailer for sale was a “consignment” within the meaning of Article 9, and therefore whether the retailer had the power to grant a security interest in the sporting goods. Although the security agreement purported to cover only property owned by the retailer, that limited language would not necessarily prevent the security interest from attaching if the consignment was an Article 9 transaction.

In re Voboril,

[2017 WL 1048041](#) (Bankr. E.D. Wis. 2017)

A financing statement that listed the name for an individual debtor in the box for an organizational debtor was ineffective to perfect a security interest in an instrument because a search under the debtor’s name would not disclose the filing.

Jipping v. First National Bank Alaska,

[2017 WL 927987](#) (D. Alaska 2017)

Although the debtor’s first security agreement with a bank granted the bank a security interest in the debtor’s deposit accounts and expressly stated that the security interest would “continue in effect even though all or any part of the Indebtedness is paid in full,” because that secured obligation was paid off and the debtor’s subsequent security agreement with the bank did not list deposit accounts as collateral and expressly stated that it, “together with Related Documents, constitutes the entire understanding and agreement” of the parties, the bank’s later loan was not secured by deposit accounts. The original security agreement was not a Related Document because it was not executed in connection with the subsequent loan.

BANKRUPTCY

In re Rocky Aspen, LLC,

[2017 WL 977813](#) (D. Colo. 2017)

Although a lender to a limited liability company had, pursuant to its security agreement with the members, the right to vote their membership interests after default, because the company was managed by managers, the managers retained the authority to file a bankruptcy petition on behalf of the company.

LENDING & CONTRACTING

In re Designline Corp.,

[2017 WL 279488](#) (Bankr. W.D.N.C. 2017)

A transaction by which a bankruptcy trustee sought to obtain financing for three adversary proceedings by selling 25% of the net litigation proceeds constitutes

champerty and would therefore not be approved because: (i) it does not require the financier to make any advances and instead requires the trustee to request advances quarterly; (ii) requires the trustee to seek the financier's input and approval of strategic decisions; and (iii) if the trustee's counsel withdraw, it requires the trustee to consult with the financier regarding substitute counsel.

Rincon EV Realty LLC v. CP III Rincon Towers, Inc.,
[2017 WL 429267](#) (Cal. Ct. App. 2017)

Even though a loan agreement selected New York law as the governing law, and a contractual clause waiving the right to a jury is enforceable in New York, the agreement's jury waiver clause was unenforceable in California litigation because it violates fundamental policy of the state and California has a materially greater interest in the matter than does New York.

Madden v. Midland Funding, LLC,
[2017 WL 758518](#) (S.D.N.Y. 2017)

Application of Delaware law pursuant to a choice-of-law clause in the parties' credit card agreement would violate a fundamental public policy of New York because Delaware does not cap the interest rate that parties may agree to whereas New York has a criminal usury statute.

Transit Funding Assocs., LLC v. Capital One Equipment Fin. Corp., [2017 WL 754335](#) (N.Y. Sup. Ct. 2017)

Because a loan agreement expressly provided that the lender could deny any funding request "in its sole and absolute discretion," the borrower had no claim against the lender for breach of contract or breach of the duty of good faith arising from the lender's refusal to make requested advances, even though the refusal might have put the borrower out of business and might have been motivated by the lender's relationship with a competitor of the borrower.

Western Surety Co. v. La Cumbre Office Partners, LLC,
[2017 WL 445408](#) (Cal. Ct. App. 2017)

Because the official capacity of a person signing an agreement on behalf of a limited liability company does not need to be indicated, an LLC was bound by an indemnity agreement signed by the managing member of its manager, even though the agreement mistakenly identified him as the LLC's managing member.

U.S. Bank v. T.D. Bank,
[2017 WL 436508](#) (S.D.N.Y. 2017)

Because the Rule of Explicitness is part of the non-bankruptcy law of New York and applies in disputes outside of bankruptcy court, if a lender is to be entitled to postpetition interest before the principal owed to a different lender, the intercreditor agreement must so state clearly. Nevertheless, by providing that the lenders were "entitled to receive post-petition interest . . . to the fullest extent permitted by law," the intercreditor agreement in this case was sufficiently explicit that both the senior and junior lenders were entitled to postpetition interest before the principal of either the senior or junior debt is paid. It did not matter that post-petition interest would not have been available in the bankruptcy proceeding because this was not a bankruptcy case and, in any event, the agreement defined "Obligations" to include "interest and fees that accrue after the commencement . . . of any Insolvency or Liquidation Proceeding . . . regardless of whether such interest and fees are allowed claims in such proceeding."

SK Food Corp. v. Firstbank,
[2017 WL 776116](#) (Tenn. Ct. App. 2017)

A prospective borrower's promise in a loan commitment letter to pay the bank's expenses, including reasonable attorney's fees, "incurred in the preparation and negotiation of documentation," did not cover the attorney's fees the bank incurred in successfully defending against the prospective borrower's claim for breach by refusing to lend.



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