EQUIPMENT Leasing & Finance

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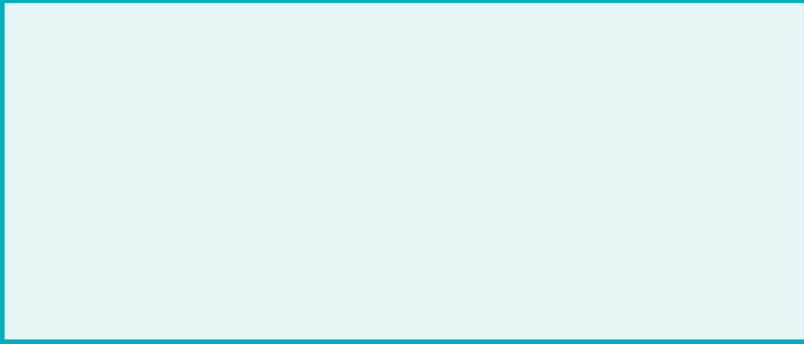
Not Your Grandparent's Captive

Economic, technological and regulatory trends reinvent captive equipment finance firms



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ELFA
EQUIPMENT LEASING AND FINANCE ASSOCIATION

By Stephen T. Whelan

Fair Finance: Boiled by Boilerplate

IT USED TO BE SO EASY. The borrower and lender would enter into a loan and security agreement, fund the loan and perfect the security interest in the collateral. A year or two later the borrower might want an additional funding, perhaps providing supplemental collateral, and the parties would enter into an amended and restated loan and security agreement. This simplified the documentation and saved on legal fees.

Not so fast. A federal court of appeals decision, *In re: Fair Finance Company,* declared that the borrower's bankruptcy trustee had established that refinancing loan documents were ambiguous as to whether the parties clearly intended an amended and restated loan agreement to extinguish the original loan agreement and the security interest that it had created. The lender hence was forced to litigate whether it had lost its security interest in the collateral. This article will discuss how lenders and finance lessors can cope with this judicial decision.

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The Original Transaction

The debtor was founded to provide accounts receivable financing. It financed its factoring operations by issuing notes in private placements and had never defaulted on any notes. In 2002 the company was sold in a leveraged buyout, financed via a loan and security agreement between Textron Financial Corporation and United Bank, as lenders, and FHI, the acquisition entity that purchased ownership of the company and that was controlled by Durham and Cochran. FHI pledged all of its present and future assets to the lenders as collateral for "all present obligations of Borrower to Lenders [and] all future obligations of Borrower to Lenders intended as replacements or substitutions for said Obligations, whether or not such Obligations are reduced or entirely extinguished and thereafter increased or reincurred." The Lenders filed a UCC financing statement to perfect their security interest (including FHI's equity in Fair Finance).

The new owners arranged for the company to issue substantially larger amounts of notes, lending the proceeds to FHI, which then would relent the monies to entities controlled by Durham or Cochran. According to the trial court record, whenever "an insider loan approached default, Durham would…prevent the [company] from enforcing its rights and/or collecting amounts due."

The Refinancing

In January 2004, Textron, the company, and FHI entered into the First Amended and Restated Loan and Security Agreement, which repaid United Bank and contained a granting clause identical to the 2002 language quoted above. The A&R agreement contained new financial terms, covenants and events of default. Most importantly, it contained "boilerplate" clauses that it was "intended by the Borrowers and Lender to be the final, complete and exclusive expression of the agreement between them" and that the 2004 agreement *"supersedes all prior oral or written agreements related to the subject matter hereof"* (emphasis added). Textron neglected to file a new financing statement but in 2006 filed a continuation statement purporting to continue perfection of the security interest established in January 2002. From 2004 until FHI repaid Textron in 2007, FHI used three different accounting firms and signed 10 amendments (with Textron providing numerous other waivers) to the A&R agreement, providing Textron with aggregate amendment and waiver fees well in excess of $100,000.

The FBI Raid

In 2009, the FBI raided the company's headquarters, seizing its documents and computers. In 2011, Durham, Cochran, and the company's CFO were indicted for wire fraud, securities fraud and conspiracy. All three were convicted, receiving prison sentences ranging from 10 to 50 years. After the FBI raid, certain company noteholders filed an involuntary petition in bankruptcy against the company; its trustee in bankruptcy sued Textron, among others, to recover fraudulent transfers (for moneys received while Fair Finance and FHI were insolvent).

Textron asked the trial court to dismiss the trustee's claims. The trial court referred the issues to the bankruptcy court, whose report concluded that the trustee had sufficiently claimed that the A&R agreement constituted a novation. Nevertheless, the trial court ruled that the A&R agreement

was not a novation of the original agreement, that Textron's security interest remained in effect, and hence that payments received by Textron under the A&R agreement were not fraudulent transfers.

What Is a Novation?

Black's Law Dictionary defines a novation as "substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party." If the A&R agreement constituted a novation, then Textron's 2002 perfected security interest would have been extinguished and monies received—whether as amendment fees or the 2007 payoff amount—after 2004 would be fraudulent transfers. The Court of Appeals reversed the trial court's ruling that the A&R agreement was not a novation, and further ruled that the bankruptcy trustee "has stated a plausible claim…that all payments made by the [company]…under the [A&R agreement] amount to fraudulent transfers…because each transaction was undertaken in an effort to perpetuate a Ponzi scheme…made with the actual intent to hinder, delay or defraud creditors as a matter of law." Textron was forced to litigate further whether a novation had occurred and it had lost its security interest.

What Can You Do?

Lenders and lessors can protect themselves by 1) filing a financing statement even if the circumstances do not appear to require it; 2) avoiding the "extend and pretend" game of ignoring warning signs, such as resignation of accountants and abuse of corporate formalities of operating subsidiaries; and 3) including language in amended and restated agreements to preclude treatment as a novation. This language could include wording such as "this amended and restated agreement a) continues, as amended hereby, the original agreement, b) does not extinguish or otherwise reduce the obligations created thereby, c) does not constitute a novation, d) reconfirms the grant of a security interest in all collateral, and e) continues in full force and effect the original agreement except as expressly set forth in this agreement." There is no surefire remedy, but there are steps that you can take—to avoid being boiled by boilerplate. ■

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