BIG money

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NOVATION NEWS

Oral amendments can trump written agreements.

By Timothy A. Lambirth and Diane Bucka

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If the deal is important enough to be documented with a written agreement, post-breach agreements must be documented in writing as well. The pivotal issue in meeting the standard for novation is whether the new agreement simply alters, or actually extinguishes and replaces, the old one. By agreeing to and performing on terms that affect their security interest in property, defendants seal their fates.

Ninth Circuit Court decision offers lessons on requirement of performance for modification of written contracts and criteria for novation.

Clients rely upon counsel to ensure the validity, performance and enforceability of legal documents. Advocates polish, revise and modify contract language, then add the magic clauses at the end of the contract to the effect that they cannot be modified, except by a writing signed by the parties and that the agreement is the entire agreement. However clients, by engaging in post breach conduct, can undo all this effort. Clients must be instructed to seek legal advice after a breach and before they start working out some side deal with other parties.

If a written contract steadfastly specifies its finality, how and under what circumstances may future modifications be binding?
- Tim Lambirth -

Post-breach conduct can cost clients BIG Money

The Ninth Circuit, in a July 2005 decision involving a claim for breach of contract and promissory fraud, has provided reason for further evaluation of the potential for modification of written contracts. (*Fanucchi & Limi Farms v. United Agri Products*, 414 F. 3d 1075) Fanucchi & Limi Farms (Fanucchi) sued United Agri Products Financial Services, Inc. (United) for breach of contract and promissory fraud in connection with a loan for farming operations collateralized by future crop proceeds. The district court granted summary judgment to United, and Fanucchi appealed the summary judgment along with the associated grant of attorney's fees. The appellate court's partial reversal of the summary judgment based on a novation theory is the Big Money crux of the issue; if a written contract steadfastly specifies its finality, how and under what circumstances may future modifications be binding?

The Facts

Larry Fanucchi, Richard Limi, and Linda Limi, as general partners in Fanucchi & Limi Farms, entered into a loan contract to finance 1995 operating costs (1994 Loan). The 1994 Loan was memorialized in an Agricultural Loan Agreement, a Promissory Note, an Agricultural Security Agreement, personally executed Commercial Guarantees, and a Notice of Final Agreement. All of the loan terms and conditions were outlined in detail, including the circumstances under which the loan may be renewed in future years. The loan documents speak specifically to how parties may modify the agreement. Integration clauses in both the Loan and Security Agreements - and the Commercial Guarantees - state that they constitute the entire understanding and agreement of the parties, and that "no alteration of or amendment to this Agreement shall be effective unless given in writing and signed by the party or parties sought to be charged or bound by the alteration or amendment." Furthermore, the Notice of Final Agreement provides that (1) "the written loan agreement represents the final agreement between the parties," (2) "there are no unwritten oral agreements between the parties," and (3) "the written loan agreement may not be contradicted by evidence of any prior, contemporaneous, or subsequent oral agreements or understandings of the parties."

At various intervals during the course of 1995, United increased the amount of the note from $ 700,000 to what ultimately became $1,475,000. All increases were made in writing and provided that "the terms and conditions of [the original Promissory Note] will remain in full force and effect for this increase."

The failure of Fanucchi's 1995 crops resulted in Fanucchi being unable to repay the 1994 Loan, then valued at nearly $1.5 million. Fanucchi consulted with a United representative, Wayne Keese, and with bankruptcy counsel. According to the depositions, Keese persuaded Fanucchi not to file for bankruptcy, and orally promised to subordinate United's debt to new crop financing loans from other lenders for up to five years. Other terms were negotiated, including subordinated repayment of United's 1994 Loan from the crop proceeds available after new crop loans were paid off and a partial forgiveness of a remaining balance after the five-year period.

The agreement operated in this manner, with United's complicity, for the crop years 1996 and 1997. Things changed, however, when Keese's employment at United terminated in early 1998. United was no longer willing to perform in accordance with the oral agreement. Instead of subordinating to all of the lenders for the 1998 crop, United was willing to subordinate only to Southern California Cotton; United refused to subordinate to creditors who were family members of the borrowers.

The Legal Battles Ensues

In August 2000, Fanucchi sued United in California Superior Court for breach of contract and promissory fraud. Fanucchi claimed that United induced him not to declare bankruptcy by promising to change the terms of the 1994 Loan agreement as discussed. According to Fanucchi, United breached this new agreement in 1998 by refusing to subordinate its lien as it previously had, and by taking all of that year's excess crop proceeds for its own account.

United removed to federal district court based on diversity of citizenship. The district court granted summary judgment and attorneys' fees to United. Fanucchi appealed, requiring an assessment as to whether there were any genuine issues of material fact and whether the district court correctly applied California's substantive law.

Modification

Fanucchi made two breach of contract arguments, one for modification and one for novation. Fanucchi first argues that the 1994 Loan agreement was modified through subsequent oral agreements pursuant to California Civil Code §§ 1698(b) and (c), which provide:

(b) A contract in writing may be modified by an oral agreement to the extent that the oral agreement is *executed* by the parties (emphasis added).

(c) Unless the contract otherwise expressly provides, a contract in writing may be modified by an oral agreement supported by new consideration.

Both the district court and the appellate court rejected this argument based on the fact – as stipulated in Fanucchi's own argument – that the oral agreement was never fully executed, and therefore failed to conform to the terms of a modification.

Section 1698(c) allows oral modification of a written contract only if the written contract does not provide otherwise. Because the 1994 Loan specified that "the written loan agreement may not be contradicted by evidence of any prior, contemporaneous, or subsequent oral agreements or understandings of the parties," Fanucchi could not rely on § 1698(c) in support of its oral modification claim.

Novation

Fanucchi took another swing at the validation of the oral contract, this time stating the 1994 Loan agreement was novated. Novation, according to Cal. Civ. Code § 1530, is "substitute of a new obligation for an existing one" or "by the substitution of a new obligation between the same parties, with intent to extinguish the old obligation." Id. § 1531(1).

United did not dispute the novation argument based on the fact that the subsequent agreement was oral, arguing instead that the pleadings failed to demonstrate that the subsequent oral agreement did not fulfill the substantive requirements of novation under California law.

Based on an examination of the substantive changes between the old and new agreements, the perceived intent of the parties, and their conduct, the appellate court reversed the district court decision, citing the terms of Cal. Civ. Code § 1698(d):

> Nothing in this section precludes in an appropriate case the application of rules of law concerning estoppel, oral novation and substitution of a new agreement, rescission of a written contract by an oral agreement, waiver of a provision of a written contract, or oral independent collateral contracts.

Significant agreements should be documented in writing. For the same reasons, post-breach agreements must also be documents in writing. The central issue in meeting the standard for novation is whether the new agreement alters or replaces the old one. By performing on terms that affect their security interest in property, defendants extinguished their own defense.

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