FLORIDA BANKRUPTCY COURT CALLS INTO QUESTION ENFORCEABILITY OF "SAVINGS CLAUSES" IN UPSTREAM GUARANTY AGREEMENTS

On October 13, 2009, the United States Bankruptcy Court for the Southern District of Florida (the "Bankruptcy Court") held that the granting of liens and incurrence of guaranty obligations by certain subsidiaries (the "Conveying Subsidiaries") of TOUSA, Inc. ("TOUSA") in favor of TOUSA's lenders constituted avoidable fraudulent transfers.[1] In so holding, the Bankruptcy Court rejected the lenders' contention that the customary "savings clauses" included in the loan documentation prevented avoidance of the liens and guaranty obligations by automatically reducing the value of the Conveying Subsidiaries' liens and guaranty obligations to the extent necessary to prevent their insolvency. The Bankruptcy Court's decision represents the most aggressive judicial attack to date on the use of such provisions.

Background

The TOUSA fraudulent transfer litigation arose from TOUSA's decision to borrow, and cause the Conveying Subsidiaries to borrow, $500 million in first and second lien bank debt and issue $20 million in payment-in-kind notes (the "Financing"), the proceeds of which were used to settle litigation between TOUSA and its subsidiary, TOUSA Homes LP, on the one hand, and lenders to a joint venture in which TOUSA Homes LP was the managing member, on the other. TOUSA's obligations under these credit facilities were supported by guaranties from the Conveying Subsidiaries and secured by the Conveying Subsidiaries' assets, despite the fact that none of the Conveying Subsidiaries was a party to the joint venture litigation or liable on the joint venture debt.

In January 2008, TOUSA and the Conveying Subsidiaries filed petitions for relief under chapter 11 of the Bankruptcy Code. The official creditors' committee appointed in TOUSA's bankruptcy cases, whose primary constituency was a group of bondholders of the Conveying Subsidiaries, commenced an adversary proceeding seeking to avoid as fraudulent transfers the liens granted and guaranty obligations incurred by the Conveying Subsidiaries in connection with the Financing.

[1] Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc. (In re TOUSA, Inc.), Case No. 08-10928-JKO, Adv. Pro. No. 08-1435-JKO (Bankr. S.D. Fla. Oct. 13, 2009).

Decision

The bulk of the Bankruptcy Court's 182-page opinion was devoted to weighing and analyzing the evidence of the Conveying Subsidiaries' solvency that had been presented at trial. Upon considering such evidence, the Bankruptcy Court concluded that the Conveying Subsidiaries were insolvent both prior to and following the Financing (on an individual and consolidated basis), and that the Financing: (i) rendered the Conveying Subsidiaries even less solvent; (ii) left the Conveying Subsidiaries with unreasonably small capital; and (iii) left the Conveying Subsidiaries unable to pay their debts as they matured. Moreover, the Bankruptcy Court found that the Conveying Subsidiaries did not receive "reasonably equivalent value" in exchange for the liens they granted and guaranty obligations they incurred in connection with the Financing, as the Conveying Subsidiaries received no direct benefit from settlement of the joint venture litigation, and received, at best, minimal indirect benefits from the Financing.

The Bankruptcy Court also dismissed the lenders' argument that the customary savings clauses contained in the first and second lien credit agreements automatically reduced the obligations incurred and liens granted by the Conveying Subsidiaries to the extent necessary to prevent the Conveying Subsidiaries' insolvency, thereby precluding avoidance of the liens and obligations. Each of the first lien and second lien credit agreements relating to the Financing contained the following provision:

> Each Borrower agrees if such Borrower's joint and several liability hereunder, or if any Liens securing such joint and several liability would, but for the application of this sentence, be unenforceable under applicable law, such joint and several liability and each such Lien shall be valid and enforceable to the maximum extent that would not cause such joint and several liability or such Lien to be unenforceable under applicable law, and such joint and several liability and such Lien shall be deemed to have been automatically amended accordingly at all relevant times.[2]

The Bankruptcy Court held these savings clauses unenforceable for a variety of reasons. For example, the Bankruptcy Court found that the savings clauses ran afoul of section 541(c)(1)(B) of the Bankruptcy Code, which voids any provision in an agreement, conditioned on the insolvency of the debtor, that "effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property."[3] The Bankruptcy Court noted that the savings clauses, if given effect, would defeat the Conveying Subsidiaries' cause of action for a fraudulent transfer. Because that cause of action constituted a property interest of each of the Conveying Subsidiaries, the Bankruptcy Court found that the savings clauses "effect[ed] a forfeiture, modification, or termination" of a property interest, and were therefore void. The contrary view, of course, is that the debtor is not deprived of a fraudulent transfer action because the savings clause precludes such a cause of action from arising at all.

---

2 Id. at 138, n.47.

3 11 U.S.C. § 541(c)(1)(B).

The Bankruptcy Court also held that the savings clauses were unenforceable attempts to contract around the core provisions of the Bankruptcy Code. In the Bankruptcy Court's view, the only purpose of savings clauses is to ensure that the lenders/transferees can preserve their claims "to every last penny of the debtor's remaining assets without providing reasonably equivalent value." As such, the Bankruptcy Court continued, savings clauses represent a "frontal assault" on the protections of section 548, including section 548(a)(1)(B)(I), which provides for avoidance of transfers by insolvent transferors receiving less than reasonably equivalent value, and section 548(c), which limits the right of a good faith transferee to retain property transferred to the extent that the transferee gave value to the debtor in exchange for the transfer. In a footnote, the Bankruptcy Court took a potshot at the legal community, expressing its opinion that "[t]here is something inherently distasteful about really clever lawyers overreaching" and noting that "[s]ome problems cannot be drafted around."[4]

The Bankruptcy Court's view that savings clauses conflict with the Bankruptcy Code is undermined by the language of the Bankruptcy Code itself. Section 548(a) of the Bankruptcy Code seems to invite application of a "fraudulent transfer cap" on a debtor's obligations. Section 548 does not provide for avoidance of all transfers for less than reasonably equivalent value; rather, it prescribes avoidance only where such a transfer has been made <u>and</u> one of the conditions set forth in section 548(a)(1)(B)(ii) is present (<u>e.g.</u>, the debtor was insolvent at the time of the transaction or rendered insolvent thereby). In addition, section 548(c) of the Bankruptcy Code expressly provides that liens granted and obligations incurred in good faith will be upheld "to the extent" value is given in exchange therefor. By expressly permitting a debtor to incur an obligation in exchange for less than reasonably equivalent value so long as the debtor is not insolvent after incurring such obligation, section 548 seems to encourage the use of contractual provisions limiting the value of a debtor's obligations to the extent necessary to avoid insolvency. In other words, the savings clauses are meant to ensure compliance with the Bankruptcy Code, not to subvert it.

In addition to concluding that the savings clauses conflicted with the Bankruptcy Code, the Bankruptcy Court found that the savings clauses contravened the amendment provisions of the loan documents, which required a signed writing to amend the credit agreements. Consequently, the Bankruptcy Court declined to give effect to the purported "amendments" to the loan documents effected by operation of the savings clauses. Assuming that the Bankruptcy Court's view is correct, the simple solution to this problem is to clearly provide in the amendment provision of the loan documents that a formal amendment is not required. Lenders should consider, in connection with most favored nation ("<u>MFN</u>") provisions, the Bankruptcy Court's approach to interpreting the amendment provisions of the loan documents. Sometimes the MFN provisions state that the loan documents are "deemed amended" to include provisions in third-party loan documents between the borrower and third-party lenders that contain provisions more favorable to third-party lenders than those contained in the loan documents. Under the Bankruptcy Court's approach, the MFN provisions might not actually become operative unless a formal amendment is signed, a result clearly not intended in the case of MFN provisions.

---

[4] <u>Id.</u> at 140, n.49.

The Bankruptcy Court also observed that giving effect to the savings clauses contained in each of the first lien and second lien credit agreements rendered the Conveying Subsidiaries' obligations under each facility "inherently indeterminate." Because each savings clause purported to reduce each guarantor's obligations under the applicable facility after accounting for all of the guarantor's other obligations, which necessarily included the guarantor's obligations under the other facility that were subject to an identical savings clause, the Bankruptcy Court concluded that it was impossible to determine what obligations remained after application of the various savings clauses. Thus, the Bankruptcy Court found that the savings clauses created a "circular problem [having] no answer," and were unenforceable as a matter of contract law.

Where a guarantor has extended multiple guaranties, each subject to a savings clause, the "circular problem" that the Bankruptcy Court identified can be avoided by careful drafting. In most loan transactions, the lenders obtain at the time of the closing of the transaction a solvency representation, certificate or opinion stating, in effect, that the borrower and guarantors, when taken as a whole, satisfy the various solvency tests under applicable fraudulent transfer laws. If that conclusion is, in fact, correct, there should not be the circularity issue perceived by the Bankruptcy Court, since the claims under ***all*** of the multiple guaranties can be taken into account without the need to reduce the amount of obligations guarantied under the fraudulent transfer cap. However, lenders may wish to be more cautious and may desire to confront the possibility that the solvency representation or opinion might, with hindsight, be found to be incorrect. Consider, for example, a first lien/second lien financing in which the first and second lien lenders seek to be certain that the maximum amount of guaranties can be incurred by the guarantors to support the first and second lien loans. The first lien lenders might mitigate the problem perceived by the Bankruptcy Court by providing in the guaranties of the first lien loan that the cap is computed without taking into account the second lien obligations and requiring that the cap in the second lien obligations be computed by taking into account, so long as the first lien obligations are outstanding, the amount of first lien obligations. The second lien lenders may object to this approach on the grounds that, to a certain extent, it has the effect of subordinating the claim (as compared to the lien) of the second lien lenders at least insofar as guaranty obligations are concerned.

The Bankruptcy Court's decision in TOUSA has been appealed, and it is not yet clear whether the Bankruptcy Court's analysis will command support among other courts and commentators, but it is likely to be given careful scrutiny. We believe that the circularity issue, arising where a guarantor's obligations under multiple guaranties are subject to separate savings clauses, might be resolved through the drafting process. For the time being, lenders should be aware of the TOUSA decision, and may wish to scrutinize solvency issues with even greater vigor, but should not assume that the ruling represents the "death" of savings clauses.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Marc Abrams (212-728-8200, mabrams@willkie.com), William E. Hiller (212-728-8228, whiller@willkie.com), Michael I. Zinder (212-728-8298, mzinder@willkie.com), Andrew D. Sorkin (212-728-8818, asorkin@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

November 25, 2009

Copyright © 2009 by Willkie Farr & Gallagher LLP.
All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.