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The *TOUSA* Decision: Death of the Savings Clause?

In a recent case that sent shockwaves through the lending community, the United States Bankruptcy Court for the Southern District of Florida (the "Court") issued a 182-page decision in *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am., Inc.*,[1] setting aside obligations incurred and liens granted by subsidiaries of TOUSA, Inc. (the "Parent") under certain loan agreements and guarantees. While the Court addressed many issues relating to fraudulent conveyance and preference theories, its most notable holding was its unqualified rejection and invalidation of so-called "savings clauses"[2] in upstream guarantees.[3] If followed by other courts, the decision will have profound consequences for many lenders and debtors alike. Moreover, unless the decision is reversed on appeal, it is sure to open the floodgates to litigation against lenders who receive guarantees predicated upon savings clauses. We believe that neither the proper application of the Bankruptcy Code ("Code") nor a correct reading of the underlying documents supports the Court's conclusion regarding the invalidation of savings clauses and that the TOUSA decision does not advance any policy underlying fraudulent conveyance laws.

[1] Adv. Pro. No. 08-1435 (JKO) (Bankr. S.D. Fla. Oct. 30, 2009). The Court amended and replaced its prior decision given on October 13, 2009.

[2] A savings clause is a provision commonly used in loan documents that is intended to avoid a finding that the guarantor is insolvent for fraudulent conveyance analysis purposes. It is designed to limit the amount of the liability of, and liens granted by, the guarantor to the largest amount that would leave the guarantor solvent.

[3] The *TOUSA* court is the first court to rule on the enforceability of savings clauses in upstream guarantees.

Background

The Parent and its subsidiaries (collectively, the "Company") are a home-building company formed through the merger of several smaller home-builders. The recent economic downturn in the U.S. economy adversely affected the Company and other home-builders. Exacerbating the Company's problems was a $675 million debt that the Parent and one of its subsidiaries owed to certain lenders (the "Transeastern Lenders") whose loans funded a failed joint venture project. As the Company's economic situation worsened, the Transeastern Lenders pressured the Parent and the borrowing subsidiary to repay the loan, and ultimately commenced litigation (the "Transeastern Litigation") to recover on the loan. The Parent eventually executed a settlement with the Transeastern Lenders, which included the payment of more than $421 million (the "Transeastern Settlement"). In order to finance the Transeastern Settlement, in July 31, 2007, the Parent entered into a first lien term loan (in the original amount of approximately $200 million) (the "First Lien Term Loan") and a second lien term loan (in the original amount of $300 million) (the "Second Lien Term Loan" and, together with the First Lien Term Loan, the "Term Loans"). As a condition to entering into the Term Loans (the "Term Loan Transaction"), the lenders (the "Term Loan Lenders") required the Parent to cause certain of its subsidiaries (the "Conveying Subsidiaries"), which were not otherwise liable in connection with the Transeastern Settlement, to guarantee the Term Loans (the "Subsidiary Guarantees") and grant liens (the "Liens") on their assets to secure the Subsidiary Guarantees. The Term Loans contained savings clauses that were intended to prevent the Subsidiary Guarantees from being set aside as fraudulent conveyances in the event that any of the subsidiaries either was insolvent or would become insolvent.[4]

In January 2008, the Parent and certain of its subsidiaries (collectively, the "Debtors") filed for chapter 11 bankruptcy protection in the Southern District of Florida. The Official Committee of Unsecured Creditors (the "Creditors' Committee") filed a complaint in the bankruptcy cases seeking to set aside the obligations incurred, and liens granted, by the Conveying Subsidiaries as fraudulent transfers and preferences. After a thirteen-day trial, the Court found, among other things, that the Subsidiary Guarantees issued pursuant to the Term Loan Transaction constituted an avoidable fraudulent conveyance under both federal bankruptcy law and applicable state law[5] because the Conveying Subsidiaries (i) did not receive reasonably equivalent value in exchange for the Subsidiary Guarantees and Liens granted pursuant to the Term Loan Transaction, (ii) were insolvent both before and after the Term Loan Transaction, (iii) were unable to pay their debts as they became due as a result of the Term Loan Transaction, and (iv) were left with unreasonably small capital with which to operate their businesses as a result of the Term Loan Transaction.

[4] The savings clauses at issue stated that "[e]ach 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 times."

[5] The Court found that there was no material difference, under the facts of the case, between Florida fraudulent conveyance law and section 548 of the Code. It, therefore, analyzed the fraudulent conveyance issue under section 548 of the Code. Section 548 provides essentially that a bankruptcy trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by a debtor, that was made or incurred on or within two years before the date of the filing of a bankruptcy petition, if the debtor voluntarily or involuntarily received less than a reasonable equivalent value in exchange for such transfer or obligation and (i) was insolvent on the date that the transfer was made or the obligation was incurred, or became insolvent as a result of the transfer or obligation, (ii) was left with unreasonably small capital as a result of the transfer or obligation, (iii) intended to incur debts beyond its ability to pay as they matured, or (iv) made the transfer to or for the benefit of an insider outside the ordinary course of business.

Most significantly, the Court held in sweeping terms that savings clauses (which have become very common in lending transactions) are unenforceable in general, and particularly under the facts of the *TOUSA* case. Without the benefit of the savings clauses, the Term Loan Lenders could not show that the Conveying Subsidiaries were solvent at the time they entered into the Subsidiary Guarantees. Accordingly, the Court concluded that the Term Loan Transaction amounted to a fraudulent conveyance. Moreover, the Court granted very extreme remedies in favor of the Creditors' Committee, including, without limitation, (i) avoiding the claims and liens of the Term Loan Lenders insofar as they related to the Conveying Subsidiaries, (ii) directing the Term Loan Lenders to disgorge to the Conveying Subsidiaries' estates any and all principal, interest, costs, expenses and other fees or amounts paid to the Term Loan Lenders in respect of claims or obligations against the Conveying Subsidiaries' estates, (iii) directing the Transeastern Lenders to disgorge the funds paid in the Transeastern Settlement, plus prejudgment interest, (iv) allowing the Conveying Subsidiaries to recover the diminution in the value of property encumbered by the Liens since the time of the transfer, (v) awarding fees and costs to the Creditors' Committee, and (vi) directing the disgorgement of all fees paid by the Debtors to the professionals that represented the Term Loan Lenders.

Savings Clause Conclusions by the Court

The Court rejected the argument that the savings clause provisions of the Term Loans obviated a finding of insolvency for fraudulent conveyance purposes. The Court based its holding on the following five determinations:

First, because the Court concluded, based upon the evidence, that the Conveying Subsidiaries were insolvent even before the Term Loan Transaction and received no value from that transaction, it held that even if the savings clauses were enforceable, they would have no impact on a finding of insolvency. In other words, reducing the liability of, and liens against, the Conveying Subsidiaries under the Term Loans would not alter the fact that they already were otherwise insolvent. Any liability imposed on a Conveying Subsidiary, and any lien securing that liability, therefore would be avoidable under Section 548.[6]

Second, the Court concluded that even if the Conveying Subsidiaries were solvent before the Term Loan Transaction, the savings clauses were unenforceable under section 541(c)(1)(B) of the Code. Section 541(c)(1)(B) of the Code, as quoted by the Court, "provides that an interest of the debtor in property becomes property of the estate, notwithstanding any 'provision in an agreement' that is 'conditioned on the insolvency or financial condition of the debtor' that 'effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.'"[7] Based upon this provision, the Court concluded that the Code effectively invalidates such contractual provisions, commonly known as *ipso facto* clauses. The Court held that the applicable savings clauses were, on their face, "provision[s] in an agreement," that were "conditioned on the insolvency or financial condition of the debtor," and that "effect[ed] forfeiture, modification, or termination of the debtor's interest in property."[8] Accordingly, the Court held that the savings clauses could not be enforced.

Third, the Court held that the Term Loan Lenders' efforts to use the savings clauses to contract around the Code were invalid. According to the Court, if the savings clauses were enforced, they would have the effect of nullifying the protection provided by section 548(a)(1)(B) of the Code and the limits that section 548(c) of the Code

[6] A similar argument was previously employed to successfully defeat a motion to dismiss in *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Tech.),* 299 B.R. 732 (Bankr. D. Del. 2003).

[7] *Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am., Inc.*, Adv. Pro. No. 08-1435 (JKO) (Bankr. S.D. Fla. Oct. 30, 2009) at *139.

[8] The property at issue was the debtors' right to pursue a fraudulent conveyance action against the Term Loan Lenders.

place on the ability of transferees to retain property.[9] If given effect, therefore, the only purpose the savings clauses served would be to ensure that the transferee could preserve its claim "to every last penny of the debtor's remaining assets without providing reasonably equivalent value" to the detriment of other creditors in the case who would otherwise receive a greater distribution in the bankruptcy.[10] According to the Court, savings clauses are "a frontal assault on the protections that section 548 [of the Code] provides to other creditors. They are, in short, entirely too cute to be enforced."[11]

Fourth, the Court decided that savings clauses were unenforceable as a matter of contract law under the specific facts of *TOUSA*. The Court concluded that the existence of multiple savings clauses entered into simultaneously, "each of which purport[ed] to reduce obligations after accounting for all other obligations," rendered the task of determining the obligations that result from the application of any particular savings clause impossible.[12] For example, whether liabilities should be reduced pursuant to the savings clause in a first lien term loan, and if so, by how much, could only be determined after a determination of liabilities under a second lien term loan, and likewise in respect of the second lien term loan. Accordingly, "the value of *A* can be determined only after knowing the value of *B*; but the value of *B* can be determined only after knowing the value of *A*."[13] The simultaneous entry of multiple loan agreements each incorporating savings clauses created a circular problem that had no answer; and the Court held that inherently indefinite contract terms are unenforceable as a matter of contract law.

Finally, the Court concluded that the parties to the Term Loans did not take the steps required by the Term Loan agreements to give effect to any modification of the Conveying Subsidiaries' obligations and liens. The Court observed that the Term Loans provided that no amendment would be effective unless, among other things, the amendment was in writing and signed by the requisite lenders under the Term Loans. More specifically, the Court indicated that an executed document was explicitly required for any amendment that would "reduce the principal amount of any [t]erm loan" or that would "release any Borrower from its payment obligation."[14]

The Impact of the *TOUSA* Decision

The Court's wholesale invalidation of the savings clauses, if upheld or widely followed by other courts, would likely have enormous consequences both on lending transactions throughout the country and on the dynamics of bankruptcy cases. If lenders cannot get the benefit of savings clauses, it may well cause the already tight credit market to dry up even further. Borrowers may have a harder time obtaining the financing needed to sustain their businesses and reorganization efforts. Lenders necessarily will become more circumspect in providing loans to distressed companies, because not only will the credit enhancement afforded by subsidiary guarantors be less reliable, but lenders will also need to be concerned that parties in bankruptcy cases will commence litigation against them in order to recover funds or otherwise create bargaining leverage.

The full impact of the *TOUSA* decision is not yet known. The decision does not bind other bankruptcy courts, and it remains to be seen whether any courts will adopt the logic of *TOUSA*. Moreover, certain parties in the *TOUSA* litigation have filed appeals from the decision. Until the dust settles, lenders will not be able to take comfort in

[9] Section 548(c) of the Code permits a transferee or obligee that takes for value and in good faith to retain any interest transferred, but only "to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation." 11 U.S.C. §548(c) (2009).

[10] *Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am., Inc.*, Adv. Pro. No. 08-1435 (JKO) (Bankr. S.D. Fla. Oct. 30, 2009) at *140.

[11] *Id*. at *141.

[12] *Id.*

[13] *Id*.

[14] *Id.* at *143.

being able to predict how any court may rule on the enforceability of savings clauses.

Certain of the holdings by the *TOUSA* court are difficult to support. For example, the Court's *ipso facto* analysis is curious. In quoting section 541(c)(1)(B), the Court inexplicably omitted seemingly critical language, which makes it clear that the section only applies to provisions that are conditioned on the insolvency or financial condition of the debtor "on the commencement of the case under [title 11]."[15] It does not appear that the savings clauses in question were triggered by the commencement of the debtors' chapter 11 cases, and therefore, section 541(c)(1)(B) arguably is inapplicable. Furthermore, the Court's holding that the use of a savings clause is an invalid attempt to "contract around" the Code seems analytically incorrect. There is no provision of the Bankruptcy Code that purports to preclude lenders and borrowers from agreeing to *reduce* the maximum liability under guarantees issued in support of a loan if it turns out that the guarantors are in a distressed condition. That is a matter of commercial negotiation that a bankruptcy court should not regulate after the fact on policy-making grounds. Additionally, the Court's holding that the savings clauses were unenforceable because "the liabilities under the term loans are *inherently* indeterminate" as a result of the "interaction between the two savings clauses,"[16] is highly questionable. It is unclear why the Court, which spent a significant portion of its lengthy decision attempting to arrive at a "fair value" of the Conveying Subsidiaries' assets and liabilities based upon reasonable estimation and equitable allocation among the various Debtor entities, could not perform the same type of analysis with respect to the effect of the savings clauses.[17] It would seem more equitable to arrive at a fair estimate of the impact of the "competing" savings clauses than to deny the lenders the benefit of their bargain entirely. Finally, the Court's holding that the savings clauses were ineffective because the parties did not take the steps required to effectuate a modification of the Term Loans also seems incorrect. The savings clause does not reduce the principal amount of any loan nor does it release any borrower from its payment obligations under any loan. Further, the loan documentation provided that the savings clauses were to take effect automatically. Thus, no amendment of the Term Loans was needed.

Moreover, the tone of the *TOUSA* opinion makes clear that the Court was particularly disturbed about certain facts that it found egregious.[18] It is difficult to know whether the Court would have held differently under a different set of facts and whether other courts will do so.

Our view is that notwithstanding the decision in *TOUSA*, a savings clause is an entirely appropriate contractual tool to mitigate the risks of an "after the fact" insolvency analysis and potential avoidance of liens and obligations of lenders. The savings clause also benefits borrowers by reducing the risk that upstream guarantees will be voided as fraudulent conveyances, thereby encouraging lending supported by upstream guarantees at more beneficial pricing from a borrower's perspective.

To the extent, however, that other courts follow *TOUSA*, lenders may have to alter the way they structure their loans, because they will no longer be able to rely on the enforceability of savings clauses. They will need to reexamine their existing loan portfolios to ascertain situations in which subsidiary guarantors might be rendered insolvent as a consequence of granting guarantees. Moreover, when extending new loans, lenders will need to take a more rigorous look at each subsidiary guarantor's financial condition. In many

15 11 U.S.C. § 541(c)(1)(B) (2009).

16 Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am., Inc., Adv. Pro. No. 08-1435 (JKO) (Bankr. S.D. Fla. Oct. 30, 2009) at *141.

17 The Court stated that "[t]he problem from a mathematical standpoint is that each savings clause is to be implemented only after all other liabilities have been determined." *Id.* at *141, n. 50.

18 Among other things, the Court found that employees, officers, directors and advisors of the Parent and the Term Loan Lenders knew or should have known that the Parent's economic situation was dire, that the Parent and the Conveying Subsidiaries were insolvent prior to the Term Loan Transaction, and that various parties nevertheless pursued the Term Loan Transaction in order to reap outsized fees and bonuses.

cases, this may mean limiting the maximum liability under the guaranty to a conservative dollar amount and thereby forgoing the benefit of a subsidiary's increases in net worth.

For questions regarding savings clauses in loan documentation, please contact any of the attorneys listed below.

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