The TOUSA Decision

A WARNING TO LENDERS

A recent bankruptcy court opinion from the southern district of Florida may have a major effect on lending practices in this recessionary environment.

In *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp N.A., Inc.*, the bankruptcy court set aside loan obligations incurred by subsidiaries of TOUSA, Inc., a real estate development company, under certain loan agreements and guaranties. The court based its decision mostly on fraudulent transfer and preference grounds, but in a curious—and possibly unwelcome—passage, the court held that a savings clause found in many upstream guarantees was invalid. The effect of the opinion, if not overturned on appeal, could both affect lending activity in the current marketplace and make lenders vulnerable to litigation from borrowers' or creditors' committees for similarly structured loans.

The facts of the TOUSA case are fairly unique and might explain the court's ruling. The TOUSA companies entered the recession with $675 million in debt owed to a number of lenders whose loans funded a failed joint venture project. TOUSA's lenders brought suit to collect on the outstanding debt. The case was settled by an agreement that TOUSA would immediately pay more than $421 million to the lenders. In order to finance the settlement, TOUSA's parent company entered into two term loans: a first-lien loan for $200 million and a second-lien loan for $300 million. To secure the financing, the TOUSA parent company caused several subsidiaries (which were not otherwise liable) to pay the settlement agreement.

The parent company and certain of its subsidiaries filed bankruptcy in January 2008. The creditors' committee filed suit to set aside the subsidiaries' obligations as fraudulent conveyances and preferences. The bankruptcy court ruled in favor of the committee, finding that the transfers, liens, and obligations were fraudulent conveyances. That portion of the ruling was neither surprising nor unusual.

What is unusual, and may have a dampening effect on future lending, is that the court held that some fairly standard savings clauses found in the loan documents could not be applied to defend the lenders. The savings clause at issue reads as follows:

> 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 times.

This "savings clause," or some variation of it, is fairly standard in many credit agreements and guaranties. Its intent is to automatically reduce the obligations incurred or the value of any liens given by an obligor or borrower to such a level that the debt incurred or lien provided would not render the obligor insolvent.

All the more surprising then that the court labeled the savings clauses "a frontal assault on the protections that [the Bankruptcy Code] provides to other creditors. They are, in short, entirely too cute to be enforced."

The TOUSA court's attack on savings clauses, if upheld on appeal or adopted by other courts, could have a negative effect on lending practices and the tenor of future bankruptcy cases. Lenders will have to be more careful in structuring loans to distressed companies that rely on upstream guaranties.

Bankruptcy, Insolvency + Restructuring
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