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WEATHERING THE STORM

Savings Clauses: Fraudulent Transfer Issues in the TOUSA Bankruptcy Case

On October 13, 2009, a Florida bankruptcy judge in the TOUSA, Inc. bankruptcy cases ordered, among other things, (i) the avoidance of obligations, including liens, incurred by certain of the TOUSA subsidiaries (the "Conveying Subsidiaries") under a \$200 million first lien facility (the "First Lien Facility") and a \$300 million second lien facility (the "Second Lien Facility"); (ii) the disgorgement by certain lenders of \$403 million received in connection with the transaction and (iii) the disgorgement of principal, interest and fees paid to the lenders under the First Lien Facility and the Second Lien Facility. The judge's ruling raises a number of troubling issues for commercial lenders, including but not limited to, the judge calling into question the enforceability of fraudulent conveyance "savings clauses," common in commercial loan agreements.

TOUSA, Inc. and its subsidiaries are homebuilders marketing homes under a variety of brand names. In June 2005, TOUSA entered into a joint venture to acquire certain properties owned by Transeastern Properties, Inc. in Florida. To fund the purchase of the Transeastern Properties, TOUSA and its joint venture subsidiary entered into a credit agreement (the "Transeastern Loan") for third party funding with certain lenders (the "Transeastern Lenders"). The Conveying Subsidiaries were not parties to the Transeastern Loan nor did they execute guarantees for the benefit of or pledge collateral to the Transeastern Lenders. With the turn in the housing market, the joint venture ran into hard times, and litigation ensued between TOUSA and the Transeastern Lenders.

On July 31, 2007, TOUSA entered into a settlement agreement with, among others, the Transeastern Lenders by which TOUSA agreed to pay approximately \$420 million to the Transeastern Lenders (the "Transeastern Settlement"). In connection with the Transeastern Settlement, TOUSA and the Conveying Subsidiaries, as borrowers, entered into the First Lien Facility and the Second Lien Facility (collectively, the "July 31 Transaction").¹ Using the proceeds of the new financing, TOUSA and the Conveying Subsidiaries (although not obligated under the Transeastern Loan) paid approximately \$420 million to the Transeastern Lenders. The Conveying Subsidiaries pledged substantially all of their, previously unencumbered, assets to secure repayment of the loans advanced pursuant to the July 31 Transaction. The Conveying Subsidiaries did not retain any of the proceeds advanced under the July 31 Transaction.

On January 28, 2008, TOUSA and the Conveying Subsidiaries filed for bankruptcy protection, and the creditors committee commenced an adversary proceeding seeking to unwind the Conveying Subsidiaries' obligations under the July 31 Transaction to recover the \$420 million paid to the Transeastern Lenders. In a 182-page opinion, the judge found, among other things, that the Conveying Subsidiaries were insolvent at the time of or rendered insolvent by the July 31 Transaction, that the Conveying Subsidiaries were left with unreasonably small capital as a result of the July 31 Transaction and that the July 31 Transaction could be avoided as a fraudulent transfer because the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the obligations incurred and liens granted by the Conveying Subsidiaries under the July 31 Transaction.

The judge dismissed each of the defenses raised by the defendants including the argument that the fraudulent conveyance "savings clauses" in the First Lien Facility and the Second Lien Facility prohibited the avoidance of the July 31 Transaction. Like most commercial loan agreements involving multiple borrowers or guarantors, the First Lien Facility and Second Lien Facility contained a fraudulent conveyance "savings clause" that provided:

¹ Additionally, TOUSA refinanced its revolver, but such refinancing is not at issue for this article.

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.

The defendants argued that TOUSA and the Conveying Subsidiaries, as sophisticated parties, had agreed to limit the ability of TOUSA and the Conveying Subsidiaries to later avoid the July 31 Transaction as a fraudulent transfer under the Bankruptcy Code. The Court disagreed and found that the fraudulent conveyance savings clauses were unenforceable for the following reasons:

1. The Conveying Subsidiaries received **no** benefit under the Transeastern Settlement and the corresponding July 31 Transaction since the proceeds were used to repay the Transeastern Lenders under a debt they had no obligation to repay;
2. The savings clauses contained inherently indefinite contract terms since the enforceability of each facility was circularly dependent upon the enforceability of the other facility (*i.e.*, the judge could not make heads or tails of the fraudulent conveyance savings clauses);
3. The fraudulent conveyance savings clauses would effectuate amendments to the credit facilities, and the defendants had failed to take the necessary steps under the loan agreements to affect the required amendments;
4. The right to avoid a fraudulent transfer is property of the debtor and contract provisions conditioned on the insolvency or financial condition of the debtor that affect a forfeiture of a debtor's interest in property violate the Bankruptcy Code; and
5. Enforcement of the fraudulent conveyance savings clauses would violate public policy as an attempt to contract around core provisions of the Bankruptcy Code.²

The judge's reasoning under #1 and #2 above is fact-specific and will vary in each case. More problematic is his reasoning under #3 through #5 because they are applicable to most fraudulent conveyance savings clauses. The judge seems to be implying that savings clauses are *per se* unenforceable and that reliance by lenders on fraudulent conveyance savings clauses may be misplaced.

Also worth noting, the judge concluded that the lenders knew, or should have known, that their borrowers, the Conveying Subsidiaries, were insolvent, or would be rendered insolvent, by the Transeastern Settlement and the July 31 Transaction. With the enforceability of fraudulent conveyance savings clauses possibly in doubt, commercial lenders should focus more heavily on the solvency of their borrowers as a proactive measure to avoid the unfavorable outcome presented in the TOUSA bankruptcy cases. Haynes and Boone stands ready to assist lenders with all issues involving fraudulent transfers both common and uncommon in the commercial lending market.

² The judge noted that "some problems cannot be drafted around" even by overreaching "really clever lawyers."

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