TOUSA, INC.—WHAT IS A LENDER TO DO?

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To Our Clients and Friends:

On October 13, 2009, the United States Bankruptcy Court for the Southern District of Florida issued a decision in the Chapter 11 proceeding of Tousa, Inc. ("Tousa") that, among other things, voided as fraudulent conveyances the obligations of Tousa's subsidiaries under secured guarantees entered into in connection with an aggregate $500 million of first and second lien debt financing. In reaching this conclusion, the court rejected the lenders' contention that the "savings clauses" in the subsidiary guarantees prevented the subsidiaries from being rendered insolvent by their guarantee obligations and, therefore, shielded the guarantees from attack as fraudulent conveyances. In so doing, the court called into question the widespread use of these clauses in upstream and cross-stream guarantees.

BACKGROUND

Tousa and its subsidiaries are homebuilders operating in Florida, Las Vegas and certain other Southern markets. In 2005, Tousa Homes LP ("Homes LP"), a subsidiary of Tousa, entered into a joint venture to acquire certain properties from Transeastern Properties, Inc. The acquisition was funded by a loan which was not guaranteed by Tousa's other subsidiaries. The housing market deteriorated and so did the financial condition of the Transeastern joint venture. Litigation with the lenders to the Transeastern joint venture ensued, and in 2007, Tousa and Homes LP entered into a litigation settlement agreement with the lenders agreeing, among other things, to pay the lenders $420 million. At the time, Tousa had approximately $1 billion of unsecured debt outstanding which was guaranteed by its subsidiaries.

In July 2007, in order to fund the settlement, Tousa entered into a $200 million first lien credit agreement and a $300 million second lien credit agreement. Both facilities were guaranteed by Tousa's subsidiaries and secured by their assets. Within a short period of time, waivers were required in connection with the credit agreements and, within six months of closing, Tousa and its subsidiaries filed Chapter 11 petitions.

DECISION

In a very fact-specific and detailed opinion, the judge found that the Tousa subsidiaries were insolvent both before and after the July 2007 closings of the first and second lien credit agreements and that the subsidiaries were also inadequately capitalized. In addition, the court found that because only Tousa and Homes LP were liable with respect to the settlement payment made in connection with the Transeastern litigation, the subsidiaries did not receive

reasonably equivalent value in exchange for entering into guarantees of the first and second lien loans. The court dismissed the argument that the subsidiaries received substantial indirect benefits from the transactions.

Of potentially broader consequence, the court rejected the lenders' contention that the guarantees were protected from fraudulent conveyance attack by the "savings clauses" they contained. Like most subsidiary guarantees, the guarantees contained the following clause:

> "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 lending industry has long used "savings clauses" such as this in subsidiary guarantees to reduce contractually the amount of guaranteed obligations to an amount which would not render the guarantor insolvent, thus, hopefully, preventing the subsidiary guarantee from being deemed a fraudulent conveyance. These provisions are generally combined with provisions providing for a right of contribution among guarantors so that in the end each guarantor pays its *pro rata* share of the guaranteed obligations.

The court in the Tousa cases held that "saving clauses" are unenforceable because:

- savings clauses defeat a debtor's cause of action for a fraudulent transfer and thereby deprive a debtor of property of the estate based on its financial condition;
- savings clauses attempt to contract around core provisions of the Bankruptcy Code; and
- savings clauses attempt to amend contract terms without complying with the amendment terms of such contracts.

In addition, the court held that under the facts at hand, the terms of the savings clauses were inherently indeterminate and therefore unenforceable. In the court's view, the savings clauses in the guarantees of the first and second lien credit agreements each required one to determine the amount guaranteed pursuant to the other facility, resulting in a circular analysis.

It remains to be seen whether other courts will follow the legal analysis outlined by the Tousa court and certain of the problems identified by the court may be remedied through drafting modifications, at least in some instances. For example, the court's concern regarding the circularity of the clauses could be addressed by arranging for the guarantees of the first lien credit agreement to be delivered prior to those of the second lien credit agreement. Then the

savings clause in the guarantee of the first lien credit agreement could exclude from its calculation the debt under the second lien credit agreement. As such, the equity value remaining in the guarantors would be fully available for the first lien debt. The guarantees of the second lien credit agreement would be executed subsequently, and would take into account the guaranteed amount of the first lien debt. In other instances involving multiple guarantees—for instance, where there is a prior unsecured credit facility and a subsequent secured subsidiary guarantee (without reduction) would render the subsidiary insolvent—it would appear that drafting solutions, such as excluding the prior-in-time unsecured debt in the savings clause in the secured debt guarantee, would not effectively address the fraudulent transfer issues.

Whatever the long term implications of the court's analysis, the Tousa decision is a useful reminder that additional attention should be paid to the mechanics of savings clauses, particularly where there are multiple guarantees in place.

Please feel free to contact us with any questions.

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