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IN RE TOUSA, INC.–A CAUTIONARY TALE FOR CANADIAN LENDERS

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Canada-U.S. Cross-Border

On October 13, 2009, a U.S. Bankruptcy Court in Florida issued an opinion invalidating, under U.S. fraudulent conveyance law, guaranties and security interests given by certain subsidiaries to secure the $200 million first lien and $300 million second lien credit facilities made to the subsidiaries' parent corporation, TOUSA, Inc. (*In re* TOUSA, Inc., 2009 WL 3519403, at *1 (Bankr. S.D. Fla. 2009). The court in Tousa also required the lenders that made the loans to disgorge all principal, interest, fees, and expenses they had received in connection with the loans, and required certain other parties who received most of the proceeds of the loans to disgorge $403 million (plus interest at 9%).

Tousa has received a lot of attention in the United States because of the huge dollar amounts involved and because of the holdings of the case, particularly the court's controversial holding invalidating the "savings clause" in the subsidiaries' guaranties. Savings clauses are found in many U.S. guaranties and are frequently seen in cross-border financings where the U.S. subsidiaries and affiliates of a Canadian borrower guarantee repayment of the borrower's loans.

The lenders have appealed the decision in *Tousa*, but whether or not all of the holdings of this case stand, *Tousa* serves as a serious reminder to Canadian lenders that they need sound legal guidance before relying on "upstream" or "cross-stream" U.S. guaranties and security interests.

Key Facts. The most important facts are that (1) the subsidiaries were jointly and severally liable on the loans (effectively guarantied the loans), (2) the subsidiaries' assets secured repayment of the loans, (3) the loans were principally made to finance the settlement of a lawsuit against the parent for which the subsidiaries had no liability, and (4) the loans were made during the time that the financial condition of the parent and the subsidiaries (and in particular the value of their housing stock) was rapidly deteriorating due to the U.S. housing crisis. These are the facts that led to the challenge by the Unsecured Creditors' Committee, under fraudulent conveyance law, of the subsidiaries' liability for the loans and the security interests given by the subsidiaries. The committee represented in large part the interests of the holders of more than $1 billion of unsecured bond indebtedness of the parent and its subsidiaries. These bondholders had a very strong incentive to challenge the lenders' claims against the subsidiaries. On the day after the decision in *Tousa* was issued, Bloomberg.com reported that the value of these bonds “soared 42.5 cents to 53.5 cents on the dollar.”

Fraudulent Conveyance Law. Under U.S. bankruptcy law, and under similar state law provisions, a transfer or the incurring of an obligation by the debtor, such as the giving of a security interest or a guaranty, is subject to being avoided (invalidated) if both of two elements of a fraudulent conveyance are satisfied, *even when there is no actual intent to defraud creditors*. Stated in very simplified terms, the first element is that the debtor is insolvent at the time of or after giving effect to the transfer or incurring of the obligation, and the second element is that the debtor did not receive reasonably equivalent value in return for the transfer or incurring of the obligation. If the debtor received reasonably equivalent value, then third parties are not harmed by the transfer or incurring of the obligation even if the debtor is insolvent, and there is no fraudulent conveyance.

Solvency. Before making the loans, the lenders obtained a “solvency opinion” from an expert to establish that the subsidiaries were solvent, and that therefore the incurring of the joint and several liability by the subsidiaries and the security interests given by the subsidiaries were not fraudulent conveyances. The court did not find this solvency opinion credible, because the opinion relied heavily without investigation on the information obtained from the borrower and on assumptions that the court found questionable in light of the parent’s obviously deteriorating financial condition in the context of the housing crisis. The court also questioned the objectivity of the lenders’ solvency expert because its $2 million fee was contingent on the expert giving an opinion that the subsidiaries were solvent. Most importantly, the court made it clear that solvency cannot be examined on a consolidated or “common enterprise” basis. Solvency must be examined on an entity by entity basis—the solvency of each subsidiary must be determined alone.

Reasonably Equivalent Value. It was difficult for the lenders to argue that the subsidiaries received reasonably equivalent value from the loans because the subsidiaries did not receive any proceeds of the loans and were not themselves liable on the lawsuit settled with the proceeds of the loans. Nevertheless, the lenders argued that the subsidiaries received reasonably equivalent value from a series of other benefits. For example, the lenders claimed that the subsidiaries received tax benefits, the benefit of the bankruptcy of the parent being forestalled, the benefit of increased availability under their revolving credit facility, and the benefit of avoiding certain cross defaults on other indebtedness. The court concluded, however, that certain of the argued benefits did not in fact result from the loans, or if they did result, that the benefits had a minimal value that could not be quantified and was clearly less than reasonably equivalent. Moreover, the court rejected the consideration of reasonably equivalent value on a consolidated basis. Reasonably equivalent value like solvency must be analyzed for each subsidiary on a stand-alone basis.

Savings Clause. The loan agreements for the first and second lien financings had savings clauses that provided: “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.” Since the subsidiaries as “Borrowers” were each jointly and severally liable for the entire $500 million of the loans, the purpose of the savings clause was to reduce the amount of that liability to a lesser amount if an obligation of a lesser amount would not be a fraudulent conveyance and would be enforceable. For example, if a subsidiary would not be insolvent if it were liable for $1 million of the loans rather than $500 million, then the amount of that subsidiary's obligation (and the lien securing such obligation) would be reduced to $1 million. This type of savings clause is found in many U.S. guaranties.

In a very troubling and poorly reasoned portion of the case, the court found the savings clauses in the first and second lien loan agreements to be unenforceable. The court found that the savings clauses were an impermissible evasion of the protections afforded by the Federal Bankruptcy Code, and that they were ipso facto clauses, which were invalidated under the Federal Bankruptcy Code. An ipso facto clause is a clause that deprives the debtor of a property right due to the debtor's insolvency or financial condition. A savings clause reduces a liability and does not deprive the debtor of any right so the court's reasoning is questionable. In addition, the court more understandably found the legal effect of the savings clause undeterminable because the first and second lien loan agreements were signed and delivered simultaneously and both had savings clauses. The determination of the maximum enforceable liability under the first lien loan agreement depended on the maximum enforceable liability under the second lien loan agreement, and vice versa, which results in circularity. The court also reached the very questionable conclusion that each savings clause's automatic amendment of a subsidiary's liability was inconsistent with the provision in each loan agreement requiring amendments to be in writing.

Remedies. For the reasons described above and others, the court found that the subsidiaries' joint and several liability to the lenders and the liens granted to secure such liability to be fraudulent conveyances and ordered a series of very complex and potentially duplicative remedies. Importantly, the court did not limit itself to invalidating the subsidiaries' joint and several liability and the liens given by the subsidiaries. Among other remedies, the court found the subsidiaries were entitled to receive costs that the subsidiaries had incurred as a result of the fraudulent conveyances, including transaction costs in connection with the closing of the loans, legal and other professional fees incurred in connection with the adversary proceedings, and the very substantial decrease in value of the pledged assets between the transaction date and the court's decision date. The court ordered these amounts to be paid to the subsidiaries off the top from the disgorged loan proceeds, with the balance of such proceeds to be paid to the lenders.

The practice has frequently been for a lender to take a guaranty or security interest from a subsidiary or affiliate of the borrower for "what it is worth," not concerning itself as to whether or not they were fraudulent conveyances, on the theory that, worst case, the lender would lose the benefit of the guaranty and security interest if they were determined to be fraudulent conveyances. *Tousa* may cast some doubt on that strategy because it raises the specter of a potential claim against the lender for diminution in value of the pledged assets. However, the basis for the court awarding this remedy has been questioned, and this remedy very well may not stand.

Recommendations for Canadian Lenders

In those cases where a Canadian lender is relying on guaranties (or the joint and several liability) or security interests from U.S. subsidiaries or affiliates of the borrower, a U.S. fraudulent conveyance law analysis is required to determine whether that reliance is misplaced. If the U.S. entity has not received reasonably equivalent value and is insolvent, then its guaranty and security interest may be unenforceable. Here are a few important reminders and recommendations for Canadian lenders:

- If a guarantor is not receiving a quantifiable benefit from the financing but is receiving certain less tangible benefits, a court may very well conclude the guarantor has not received reasonably equivalent value.

- In analyzing solvency, do not rely, or permit any expert to rely, without scrutiny on the projections and other financial information, and any underlying assumptions, that the borrower provides. In a deteriorating market, or if there is a history of poor performance, the risks are great that a determination of solvency will be questioned by a court. A solvency opinion is no magic bullet. If an expert opinion is sought, do not agree to a fee that provides a financial incentive for the expert to give an opinion of solvency.
- In analyzing solvency and reasonably equivalent value, avoid doing so on a consolidated or common enterprise basis. The analysis should be on an entity by entity basis. There is no obvious statutory basis for such a consolidation, and there is a material risk that a court won't respect an analysis on a common enterprise or consolidated basis.
- When there are multiple financings each with savings clauses, a priority of closings should take place (e.g., first lien documents are executed and delivered before the second lien loan documents) to avoid the circularity that concerned the court in *Tousa*.
- Avoid altogether using terms such as "amendment" in a savings clause. Such language is not needed to describe any reduction in the maximum enforceable amount that occurs under the terms of a savings clause.
- Continue to use savings clauses in loan documents. The savings clause aspect of the opinion may very well not stand or be followed by other courts. The use of savings clauses may have to be revisited, but for now we recommend their continued use.
- Not all of the remedies awarded by the court in *Tousa* may stand or be awarded by other courts. If taking a guaranty and security interest from a subsidiary or affiliate of the borrower for "what it's worth," understand that *Tousa* suggests the potential for a claim against the lender for costs, including diminution in value of the pledged assets.

For more information, please contact