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DISPATCHES FROM THE TRENCHES

TOUSA, Inc.: Upstream Guaranties, Fraudulent Transfers and “cute” Savings Clauses

As noted in previous editions of Dispatches from the Trenches, guaranties have traditionally been subject to as more judicially-created defenses than any other finance document. Judges have, for example, required lawsuits to be brought against the primary obligor *prior to* suing the guarantor (the dreaded “guaranty of collection” instead of “guaranty of payment and performance”). Judges have also releases guarantors as a result of differences in the underlying obligation than what was originally contemplated. *See e.g. Ace Leasing, Inc. v. Boustead*, 55 P.3d 371 (Mt., 2002)(Court held that the lessor’s failure to properly perfect a security interest in the leased equipment materially altered the risk born by guarantor and exonerated guarantor from its obligations). Special required notices to guarantors and other byzantine defenses help explain why so many guaranties are practically unreadable and why many are loathe to make changes to such documents.

One classic risk area of guaranties is that of the “upstream” guaranty which differs from the more classic “downstream” guaranty. The crucial conceptual difference is one of consideration— what benefit does the guarantor receive for having provided the guaranty. In the classic “downstream” guaranty, the consideration is obvious: the value of the stock or interest of the parent/owner is increased by the infusion of capital. In upstream guaranties, however, the subsidiary guaranties the obligations of the parent and the benefit to the guarantor is often much less direct. Cross stream guaranties, in which a brother-sister company relationship exists, such as two corporations owned by the same parent company, can raise a similar issue. Under these situations, it is particularly important to be able to show benefit to the guarantor.

Matters are made worse by various federal and state insolvency laws which can raise the standard necessary for one of these guaranties to pass muster. Simply put, where the execution of the guaranty causes the guarantor to be insolvent as an accounting matter, such as where the book value of its assets is so low that the contingent liability of the guaranty or other obligations can cause it to be technically insolvent, the consideration must be “reasonably equivalent value”. If it is not, the transaction can be deemed a “fraudulent transfer”.

A strong example of this risk is *In re: TOUSA, Inc. et al.*, 422 B.R. 783 (S. Distr. FL, 2009). In that case, TOUSA, Inc. (the "Parent") was the ultimate owner of multiple business entities comprising the TOUSA corporate family whose business focused on designing, building and marketing single-family residences, town homes and condominiums. One of the Parent's subsidiaries entered into a joint venture relationship to acquire homebuilding assets in Florida. As a condition to financing obtained by that joint venture (the "Joint Venture Financing"), the Parent guaranteed the obligations of the joint venture.

When the joint venture defaulted on its obligations, the existing lenders sought to enforce the guaranty of the Parent, which was a classic down-stream guaranty. The Parent eventually reached a settlement with the existing lenders which required a payment of approximately \$420 million. In order to obtain the necessary funds, the Parent borrowed approximately \$500 million pursuant to a first lien term loan and a second lien term loan (collectively, the "Subsequent Financing") which required the proceeds to be used to repay the settlement obligations relating to the Joint Venture Financing. As a condition to the Subsequent Financing, various subsidiaries that were not party to the Joint Venture Financing (the "Subsidiaries") guaranteed the obligations of the Parent and pledged substantially all of their assets as collateral for their guaranty obligations.

The guaranty by the Subsidiaries was a classic upstream guaranty and was tested in bankruptcy six months after consummation of the Subsequent Financing. The Official Committee of Unsecured Creditors, acting on behalf of approximately \$1 billion owed to unsecured bond holders (the "Creditors' Committee") sought to set aside the guaranties granted and liens pledged by the Subsidiaries as fraudulent transfers under Florida, New York and federal bankruptcy laws. The Court held in favor of the Creditors' Committee and unwound the Subsequent Financing, forcing the prior lenders to pay the amounts they had received back into the bankruptcy estate.

The Court held that there were no material differences between the legal standards governing the claim brought by Creditors' Committees under Florida, New York or federal law and therefore focused on claims under the provisions of the Bankruptcy Code. As the Court outlined, the Bankruptcy Code "permits the avoidance of any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred within 2 years before the date of filing of the [bankruptcy] petition, if the debtor voluntarily or involuntarily received less than a reasonably equivalent value in exchange for such transfer or obligation and (A) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation, (B) was engaged in a business or transaction, or was about to engage in a business or transaction, for which any property remaining with the debtor was an unreasonably small capital; or (C) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured. *Id.* at 858 (citing 11 U.S.C. § 548(a)(1)(B)).

This test could be viewed as having three main components. First, the debtor must have incurred obligations or granted interests in property within two years of the petition. Second, the debtor must have received less than reasonably equivalent value (the "Reasonably Equivalent Value Criteria"). Third, the debtor must satisfy one of the

enumerated insolvency-type criteria set forth in subsections (A) through (C) above (the "Insolvency Criteria").

The first component of the test was easily satisfied since the Subsidiaries incurred the guaranty obligations and granted liens on their assets, constituting a "transfer of an interest in their property," within two years of the petition.

In analyzing whether the second component of the test was also satisfied, the Court noted that "there are two types of benefits to be considered in analyzing reasonably equivalent value: benefits that the debtor receives directly ("direct benefits") and those it receives indirectly ("indirect benefits")." *Id.* at 866.

According to the Court, the Subsidiaries received neither. Of note was the fact that: (1) the Subsidiaries received none of the proceeds of the loans they became obligated to repay, (2) the majority of the loan proceeds were utilized to satisfy the settlement reached with respect to the Joint Venture Financing as expressly required by the terms of the Subsequent Financing; (3) the remaining proceeds were used for general corporate purposes of the Parent and parties other than the Subsidiaries; (4) the Subsidiaries received no value in the form of debt relief since they were not in any way obligated with respect to the Joint Venture Financing; (5) the Subsidiaries did not receive any homebuilding inventory or other property in exchange for their role in the Subsequent Financing; and (6) the Subsidiaries received no value in the form of tax benefits. *Id.* at 844-845.

The Court also rejected claims that the indirect benefits that were claimed to be received by the Subsidiaries were sufficient to satisfy the Reasonable Value Criteria. The Court noted that: (1) the applicable Bankruptcy Code Section requires reasonably equivalent "value" rather than "benefits" and "includes a precise definition of "value" that encompasses only "property" and "satisfaction or securing of a present or antecedent debt of the debtor"; (2) value must be given "in exchange" for the Subsidiaries' participation in the Subsequent Financing; and (3) the value must be received by the Subsidiaries. *Id.* at 868.

Based on the foregoing analysis, the Court rejected arguments that the Reasonable Value Criteria could be satisfied by the asserted presence of "business synergies" between the Parent and the Subsidiaries, the fact that the Parent provided management services to the Subsidiaries or the fact that satisfying the settlement obligations of the Parent with respect to the Joint Venture Financing would avoid default and bankruptcy by the Subsidiaries and eliminate the adverse business overhang of the defaulted Joint Venture Financing. As summarized by the Court, none of these claimed benefits "constitutes (1) property (2) received by the debtor (3) in exchange for the obligation or transfer." *Id.* at 869.

Although only one of the Insolvency Criteria was required to support a holding of a fraudulent transfer, the Court held that the Subsidiaries were insolvent under each of three specified criteria. Although the Court used detailed analysis, including a balance sheet test, it does not take an appraiser, accountant or rocket scientist to understand that

the Guaranty by a Subsidiary of a debt of their substantially larger Parent without any value in return could easily render the Subsidiary insolvent.

One last point of interest, and one of the most frequently written about aspects of this case, is the Court's rejection of the fraudulent transfer savings clause. Like many guaranties, the guaranties executed by the Subsidiaries contained a savings clause which provided that the obligations of the guarantors were deemed to be automatically reduced to the extent necessary to prevent the guarantors' insolvency for purposes of fraudulent transfer analysis. The Court held such clauses to be invalid as an ipso facto clause, stating that such savings clauses are "a frontal assault on the protections that section 548 [of the Bankruptcy Code] provides to other creditors [and are] in short, entirely too cute to be enforced." *Id.* at 864.

The message is clear, lenders and lessors taking upstream guaranties should proceed carefully.

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