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IN RE TOUSA HIGHLIGHTS RISKS TO LENDERS RELYING ON AFTER-ACQUIRED COLLATERAL AND “SAVINGS CLAUSES” IN LOAN DOCUMENTS

The recent case of *In re Touse, Inc.* (Official Committee of Unsecured Creditors of Touse, Inc., v. Citicorp North America, Inc., Adv. Pro. No. 08-1435-JKO (Bankr. S.D. Fla., October 13, 2009)) has attracted considerable attention – and dread – in the banking and legal communities. No wonder, given the *Touse* court’s dramatic decision to require the debtor’s new lenders to sacrifice substantially all of the collateral supporting their \$500 million loan to the debtor, and order the debtor’s old lenders to disgorge the over \$420 million in cash they received through the new financing that the court rescinded. Much of the commentary about this case has focused on the fraudulent transfer components of the ruling, including the court’s invalidation of “savings clauses” and disregard of a third-party solvency opinion. Despite the publicity surrounding those aspects of the *Touse* decision (which will be summarized briefly below), another significant facet of the decision has largely “flown under the radar” and not garnered attention: namely, the risks that lenders face from a potential preference claim when they obtain a security interest in a debtor’s after-acquired property. The legal hazards presented by these pervasive preference and fraudulent transfer concerns are at the heart of any lender’s list of risks faced when extending credit during today’s difficult economic climate.

Factual Background: Many Borrowers, Few Beneficiaries of the Loan

Touse, Inc., was a holding company which, with its many subsidiaries, was a large residential land developer and homebuilder in the Southern United States. In mid-2007, the parent and many of its subsidiaries became obligated jointly and severally as borrowers under a new \$500 million loan facility (the “New Loan”) extended by a new lending group (the “New Lenders”). The purpose of the New Loan was to satisfy a \$420 million obligation of the parent and one subsidiary, Touse Homes, under a settlement agreement resolving the pair’s default under a loan from other lenders (the “Old Lenders”). Other than Touse Homes, none of Touse’s other subsidiaries was liable to the Old Lenders. Nevertheless, these other subsidiaries (the “Obligor Subs”) all became borrowers under the New Loan, and granted security interests in all of their assets to the New Lenders to support the New Loan; however, the proceeds of the New Loan were used solely to pay the parent’s and Touse Homes’s obligations to the Prior Lenders. Touse was hit particularly hard by the residential real estate downturn in Florida and the Gulf Coast region, and filed for bankruptcy in January 2008. In April 2008, Touse received a tax refund of approximately \$207 million relating to the 2007 tax year, which the New Lenders claimed as part of their collateral under an after-acquired property clause in their security agreement with Touse and the Obligor Subs. During the bankruptcy case, Touse’s unsecured creditors’ committee sued the New Lenders and the Old Lenders, seeking to invalidate \$500 million in liens that the Obligor Subs granted to the New Lenders, recover \$420 million that was paid to the Prior Lenders, and avoid the New Lenders’ \$207 million lien on Touse’s tax refund. The Committee won on all of its claims before the bankruptcy court. Although subject to a pending appeal, the decision to penalize the *Touse* lenders provides some broad lessons to the lending community.

Preference Risks in Liens on After-Acquired Property

The committee sought to set aside the New Lenders’ lien on Touse’s \$207 million tax refund as a preferential transfer under § 547 of the Bankruptcy Code. This statute – well known to most creditors – allows a debtor in bankruptcy to avoid and recover any transfer by the debtor of an interest in property, to or for the benefit of a pre-existing creditor of the debtor, made

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within 90 days before the debtor's bankruptcy (or within one year before bankruptcy if the transferee creditor was an insider of the debtor), if such transfer enabled the creditor to receive more than it would otherwise have received in a hypothetical liquidation of the debtor under Chapter 7 of the Bankruptcy Code. In *Tousa*, the New Lenders claimed that their lien on Tousa's tax refund was immune from a preference challenge because Tousa granted a lien on all of its then-existing and after-acquired property in mid-2007; thus, the New Lenders contended, because Tousa did not file bankruptcy until early 2008, the grant of a lien was well outside the 90-day "clawback" window under the preference statute.

The bankruptcy court noted that, under § 547 of the Bankruptcy Code, a transfer of property by the debtor "is not made until the debtor has acquired rights in the property transferred." (*Id.*, p. 164.) The date on which Tousa "acquired rights in" its federal income tax refund was January 1, 2008, the first day after the completion of its 2007 tax year, and thus the first day that Tousa had a right under federal tax law to claim a refund. Even though the New Lenders had been granted a lien on all after-acquired "general intangibles" (a category comprising tax refunds) in July 2007, the court ruled that January 1, 2008 was the first date on which Tousa could grant a lien on its tax refund, and was therefore the date on which the "transfer" of the tax refund to the New Lenders occurred, for purposes of the preference statute. Consequently, the court ruled that the transfer occurred within 90 days before Tousa's bankruptcy filing – i.e., within the preference avoidance period. Because the New Lenders' acquisition of an additional \$207 million lien in January 2008 enabled them to receive more than they would have received if the lien had not been granted, and since the New Lenders were undersecured, the New Lenders' after-acquired property clause in the 2007 loan agreement provided them with no protection from a preference challenge.

After-acquired property clauses are critical in secured lending arrangements covering not only more discrete assets such as tax refunds, intellectual property, contract rights or equipment, but also constantly-changing collateral such as inventory or accounts receivable. Lenders must realize that, when relying on after-acquired property clauses to obtain a security interest in newly-acquired property of the debtor, the security interest will not become effective until the debtor obtains rights in the collateral in question. If the debtor files for bankruptcy within 90 days of its acquisition of new collateral, even if that collateral is covered by an after-acquired property clause in a previously-executed security agreement, the lender's lien on the new collateral may be subject to a preference claim. Furthermore, increases in a debtor's "floating" collateral base in inventory or accounts receivable during the 90-day pre-bankruptcy preference period, which improve the lender's undersecured position, can also result in the lender being exposed to a preference claim to the extent of the improvement in its position.

"Savings Clauses" in Loan Documents Cannot Save a Loan to an Insolvent Borrower from Fraudulent Transfer Risks

Although the topic has received significant attention from other commentators, the *Tousa* court's broad invalidation of "savings clauses" as a defense to lenders' fraudulent transfer liability is a legal milestone that warrants additional discussion. Fraudulent transfer laws allow the avoidance of any obligation or transfer made by a debtor (i) where the debtor is insolvent or rendered insolvent by the transfer or obligation; and (ii) that is made without the transferor or obligor receiving "reasonably equivalent value" in exchange. In *Tousa*, the Obligor Subs received no value under the New Loans, in exchange for their grants to the New Lenders of liens on substantially all of their property. In the face of evidence that the Obligor Subs were rendered insolvent by the New Loans, the New Lenders claimed that "savings clauses" in the loan documents insulated them from fraudulent transfer liability.

The savings clauses in *Tousa* were similar to those found in many loan documents, and provided for a supposed automatic reduction of each of the Obligor Subs' respective liability, such that each borrower's obligations would be "enforceable to the maximum extent" permitted by applicable law. (*Id.* at pp. 138-39.) The *Tousa* court essentially invalidated the savings clauses and held that they provided the New Lenders with no defense to fraudulent transfer liability, for several reasons. First, the court found that the Obligor Subs were already insolvent before they incurred their obligations to the New Lenders under the New Loans; because the New Lenders' claims could not be enforced at all, there was no "maximum extent" to which the New Loans might be lawful. (*Id.* at p. 139.) Second, the court found that the savings clauses were unenforceable under the anti-forfeiture provisions of § 541 of the Bankruptcy Code, which prohibits an automatic forfeiture of a debtor's interest in property that is conditioned on the debtor's insolvency or filing for bankruptcy. The *Tousa* court found that the savings clause, if effective upon bankruptcy, could result in the Obligor Subs' forfeiture of fraudulent transfer claims that constituted property of their respective bankruptcy estates.

Perhaps most importantly, the court held broadly, and explicitly, “The savings clauses are unenforceable for the additional reason that efforts to contract around the core provisions of the Bankruptcy Code are invalid.” (*Id.* at p. 140.) The court effectively invalidated the savings clauses as a matter of public policy, and inveighed harshly against lenders who, in the court’s view, sought to “saddle insolvent businesses with new obligations or liens.” (*Id.*) Finally, the court held that, even if the savings clauses were intended to be effective, the parties did not take any of the steps required by the loan documents to execute a written modification of the Obligor Subs’ respective loan obligations and reduce their exposure to an amount that would keep them solvent.

Conclusion: Conduct Greater Due Diligence During Troubled Economic Times and Maintain Realistic Expectations

It would be a mistake to blithely dismiss the *Tousa* decision as a case of “bad facts make bad law.” The case warns lenders that there is no substitute for thorough research and proper structuring at the outset of a loan transaction, or for continuing inquiry and monitoring of a debtor, its assets and the general status of a credit relationship throughout the loan. With respect to after-acquired property, it is critical for a lender to research and obtain a reliable valuation of its collateral package at the outset of a loan and to continue to appraise collateral value during a loan’s term. Any time a new asset is added to the collateral package for a pre-existing loan, the lender must be aware that the collateral may be subject to a preference risk for 90 days; the same risk applies to increases in the value of “floating” collateral such as inventory and accounts receivable that improve a lender’s undersecured position. Lenders must also remember that, when they are relying on a debtor’s tax refund to repay a loan, the debtor may not acquire rights in the tax refund until the end of its preceding tax year. That said, we would still advise lenders to accept additional after-acquired collateral, though lenders should temper their expectations with regard to such collateral until any applicable preference “clawback” period has expired. With respect to savings clauses, *Tousa* counsels that lenders must confront the substance of fraudulent transfer risks in due diligence and should not rely on savings clauses as an automatic defense. Lenders should undertake a thorough analysis of each debtor’s solvency and a clear tracing of the quantifiable financial benefits received by each debtor. The opinion serves as a continuing reminder that upstream and cross-stream guarantees and financing for leveraged buyouts and loans for dividend financing transactions may be challenged as fraudulent transfers and may not be insulated by a standard savings clause in loan documents.

Through the assistance of experienced legal counsel, lenders and other creditors can gain valuable guidance regarding due diligence and advice in structuring financial transactions to enhance their protection against avoidance claims and bankruptcy risks. The members of the Special Assets Team of Holme Roberts & Owen LLP who are listed on this Alert are experienced in analyzing the issues presented by potential creditors’ rights claims and insolvency risks in a wide variety of lending and bankruptcy scenarios. They work with clients to manage those risks practically and effectively and enable clients to achieve their financial goals. Please contact any of the lawyers on HRO’s Special Assets Team to discuss your particular situation or any questions about this Alert.

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