A Tussle with Tousa: Savings Clauses in Intercorporate Guaranties

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I. INTRODUCTION

In October, 2009, the bankruptcy court of the Southern District of Florida rendered its opinion in *Tousa*,[1] in which subsidiaries incurred upstream and cross-stream guaranty obligations, secured by their assets, while insolvent. The proceeds of the loan were used to pay the indebtedness to a third party of the parent and of one of the subsidiaries. The unsecured creditors of the other subsidiaries challenged the new obligations, the security interests and the payment to the third party, as fraudulent transfers. The court ruled in favour of the unsecured creditors and unwound the entire transaction. It strongly criticized the failure of the new lenders to investigate the insolvency of the guarantor debtors, interpreted narrowly the range of indirect benefits that would qualify as value, and declined to enforce the savings clauses in the loan agreements. Judge Olson remarked that "[t]he savings clauses are a frontal assault on the protection that section 548 provides to other creditors. They are, in short, entirely too cute to be enforced".

Some of Judge Olson's reasons for striking down the savings clauses apply beyond the facts of the case, and consequently have raised significant concerns in the legal and financial community.[2] For example, Shearman &

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1 *Official Committee of Unsecured Creditors of TOUSA, Inc.,* v. *Citicorp N. Am., Inc. (In re Tousa, Inc.)*, Adv. Pro. No. 08-1435 (JKO), 2009 WL 3261963 (Bankr. S.D.Fla. Oct. 30, 2009)(amended prior decision given on October 13, 2009). All references herein are to pages in the slip opinion. The defendants filed notice of appeal on October 20, 2009.

2 *Weathering the Storm. Savings Clauses: Fraudulent Transfer Issues in the TOUSA Bankruptcy Case*, Haynesboone Alert (October 21, 2009)("The judge seems to be implying that savings clauses are per se unenforceable"); James E. Hough, et al., *The In re Tousa, Inc. Fraudulent Transfer Decision: Impacts on Debt Trading, Derivatives*

Sterling's Client Publication issued on November 2, 2009, observed that the Court's "most notable holding was its unqualified rejection and invalidation of so-called 'savings clauses' in upstream guarantees . . . [U]nless the decision is reversed on appeal, it is sure to open the floodgates to litigation against lenders who receive guarantees predicated upon savings clauses".[3] The publication also warned that "[l]enders necessarily will become more circumspect in providing loans to distressed companies" and that the opinion "may well cause the already tight credit market to dry up even further".[4] The defendants in the case have filed a notice of appeal.

This paper reviews the opinion in *Tousa* and outlines its implications for savings clauses and intercorporate guarantees. In brief, the analysis suggests that savings clauses will offer little protection against avoidance proceedings if the lender acted in bad faith, by failing to investigate adequately the debtor's solvency. Conversely, a savings clause is more likely to be effective if the lender continues to monitor the solvency of the debtor during the term of the loan and to adjust periodically the amount of indebtedness in accordance with the clause. In any event, *Tousa* sets a precedent that threatens to increase the cost and decrease the availability of credit to distressed corporate groups. This may be bad news for these borrowers and the lenders, but its policy merits deserve closer evaluation. After all, fraudulent transfer laws themselves increase borrowing costs and reduce the availability of credit to distressed borrowers, and yet are generally regarded as socially beneficial because of the protection these laws provide to existing creditors. A closer look at the rationale behind multiple-entity enterprises and the policy behind fraudulent transfer doctrine is warranted, before rejecting the court's treatment of savings clauses. In brief, this essay suggests that the enforcement of savings clauses in intercorporate guaranties should mimic the predominant approach to similar clauses that purport to adjust interest rates to comply with usury laws. Consistent with the good faith defense in 548(c) of the *Bankruptcy Code*, the savings clause should be limited to

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Trading, and Commercial Lending, Morrison Foerster Legal Updates & News (October 2009)("near wholesale rejection of insolvency 'savings clauses'"); *Tousa, Inc.-Significant Fraudulent Transfer Decision*, Davis Polk Insolvency and Restructuring Update (October 15, 2009) ("surprisingly broad language . . . that savings clauses . . . are unenforceable");

3 *The TOUSA Decision: Death of the Savings Clause?*, Shearman & Sterling Client Publication 1 (November 2, 2009). The author is severely critical of the opinion, arguing that it is unsupported by either the Code or the policy underlying fraudulent conveyance laws. "[A] savings clause is an entirely appropriate contractual tool to mitigate the risks of an 'after the fact' insolvency analysis and potential avoidance of liens and obligations of lenders. The savings clause also benefits borrowers by reducing the risk that upstream guarantees will be voided as fraudulent conveyances, thereby encouraging lending supported by upstream guarantees at more beneficial pricing from a borrower's perspective." *Ibid.*., at 5.

4 *Ibid.*, at 4.

protecting lenders against honest mistakes in assessing the solvency of the debtor or the benefit it derives from the financing arrangement.

Part II summarizes the treatment of intercorporate guaranties under fraudulent transfer laws and Part III discusses in some depth the reasoning in Judge Olson's opinion in *Tousa*. Part IV evaluates his reasons for declining to enforce the savings clause and proposes a standard that courts may use in future cases, based on the conduct of the lender before, during and after the transaction. Part V concludes.

II. INTERCORPORATE GUARANTIES AND FRAUDULENT TRANSFER LAWS

Fraudulent transfer laws are a constant threat to intercorporate guaranties. An obligation incurred by a debtor or a transfer of an interest of the debtor in property may be avoided if the debtor receives less than reasonably equivalent value in exchange, and the debtor is distressed in any of the following ways: (a) the debtor was or became insolvent as a result of the obligation or transfer, (b) the debtor was engaged in business with unreasonably small capital, or (c) the debtor intended to or believed that it would incur debts beyond the ability to pay as they matured.[5] Therefore, when a debtor incurs an obligation as guarantor or co-borrower to enable a loan to an affiliate, and receives none of the proceeds, the obligation might be avoided subsequently if the debtor is insolvent or undercapitalized at the time of the transaction. If the debtor also grants an interest in its assets to secure its obligation or the debt of the affiliate, this transfer may also be avoided.

Upstream guaranties (guaranties by subsidiaries of parent's debts) or cross-stream guaranties (between subsidiaries) are more susceptible to challenges than guaranties by parents of their subsidiaries' obligations. Upstream and cross-stream guaranties are presumptively not made in exchange for reasonably equivalent value.[6] Therefore, if they are made by insolvent or undercapitalized subsidiaries, they are presumptively fraudulent.[7]

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5 *Bankruptcy Code* §548(a)(1)(B). Similar provisions are found in state legislation, based on either the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act. The trustee may move to avoid a transfer or obligation under state law, by virtue of *Bankruptcy Code* §544(b).

6 See,e.g., *Rubin* v. *Manufacturers Hanover Trust Co.*, 661 F.2d 979, 989 (2d Cir. 1981); *Marquis Products, Inc.* v. *Conquest Mills Inc. (In re marquis Products, Inc.)*, 150 B.R. 487, 491 (Bankr. D. Me. 1993).

7 A considerable body of literature discusses the application of fraudulent transfers to intercorporate guaranties. See, e.g., Phillip I. Blumberg, *Intragroup (Upstream, Cross-Stream, and Downstream) Guarantees Under the Uniform Fraudulent Transfer Act*, 9 Cardozo L. Rev. 685 (1987); Barry L. Zaretsky, *Fraudulent Transfer Law as the*

In practice, however, intercorporate guaranties are important to the financing of corporate groups.[8] The language of fraudulent transfer provisions would make it very difficult for an insolvent or undercapitalized entity to guaranty the debt of its affiliate. In particular, the *Code* defines "value" in §548(a)(1)(B(I), as "*property*, or satisfaction or securing of a present or antecedent debt of the debtor, but [it] does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor"(emphasis added). Moreover, that property must be received by the debtor entity "in exchange" for its guaranty obligation. Acknowledging the widespread practice of intercorporate guaranties, the courts have relaxed the definition of reasonably equivalent value to allow for indirect benefits, particularly when the guaranty is the result of arm's length bargaining. They recognize that the guarantor is part of an enterprise and therefore can participate in benefits accruing to the corporate group as a whole.[9] For example, new financing may enhance the public image and goodwill of the group, or its access to credit. The financial health of the enterprise is important to the continuation of supplies from and sales to affiliate companies within the group.[10] Rather than focus exclusively on "property" as the source of value, courts have been willing to look at the impact of the

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Arbiter of Unreasonable Risk, 46 S.C.L. Rev. 1165 (1995); Scott F. Norberg, *Comment, Avoidability of Intercorporate Guarantees under Sections 548(b) and 544(b) of the Bankruptcy Code*, 64 N.C.L.Rev. 1099 (1986); Brad R. Godshall and Robert A. Klyman, *Wading 'Upstream' in Leveraged Transactions: Traditional Guarantees* v. *'Net Worth' Guarantees*, 46 Bus. Law 391 (1991).

8 See *Telefest, Inc.* v. *VU-TV Inc.*, 591 F.Supp. 1368, 1379 (D.N.J., 1984) ("cross-guaranties are often needed because of the unequal abilities of interrelated corporate entities to collateralize loans").

9 See, e.g., Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 Cardozo L.Rev. 1403, 1438 (1994); Robert Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. Pa. L. Rev. 235, 245-6 (1976).

10 See, e.g., *Telefast, Inc.* v. *VU-TV*, 591 F.Supp. 1368, 1379-81 (D.N.J., 1984)(safeguard an important source of supply or important customer); *In re Fairchild Aircraft Corp.*, 6 F.3d 1119, 1127 (5th Cir., 1993)(indirect benefit from continued operation of affiliates); *Marquis Products. Inc.,* v. *Conquest Carpet Mills, Inc.*, 150 B.R. 487, 491 (1993)(improved funding prospects from parent); *Mellon Bank, N.A,* v. *Metro Communications, Inc.*, 945 F.2d 635, 646-8 (3d Cir., 1991); cert. denied sub nom. *Committee of Unsecured Creditors* v. *Mellon Bank, N.A.*, 503 U.S. 937, 112 S.Ct. 1476 (1992) (increase the strength of corporate group as a whole, raise goodwill and other intangibles, enhance ability to borrow working capital); *Cordes & Co., LLC* v. *Mitchell Companies, LLC*, 605 F.Supp.2d 1015, 1022 (N.D.Ill., 2009)(benefits from goodwill, increased ability to borrow working capital, retention of important source of supply).

transaction in question on the debtor's net worth or cash flow, given that this determines whether its unsecured creditors are impaired.[11]

In cases of upstream or cross-stream guaranties, the burden to demonstrate reasonably equivalent value lies with the defendant transferees or obligees.[12] To minimize the risk that the court will avoid the transfer or obligation, parties may take various precautions at the time of the transaction. They engage experts to verify the solvency of each debtor and the expected receipt by each debtor of reasonably equivalent value, as required in the statute. Of course, these opinions are not conclusive evidence in future avoidance proceedings, and the court will reach its own finding of fact. However, the opinions provide critical evidence of due diligence, so as to justify a finding that the lender acted in good faith. Under §584(c), a transferee or obligee that takes for value and in good faith, may retain the interest transferred or enforce the obligation, to the extent that party gave value in exchange for the transfer or obligation. This protects against the risk that, in hindsight, a court might find that a debtor was insolvent following the loan in question.

The good faith defense is itself uncertain. So, a complementary strategy is to limit the liability of the debtor in order to avoid triggering the financial condition of insolvency, and thereby the avoidability of the obligation or transfer. Commercial loan agreements involving multiple borrowers and guarantors commonly include clauses limiting, on an ongoing basis, the guaranty to the amount, or some fraction of, the guarantor's net worth. Alternatively, the agreements might provide for the right of contribution from other entities in the event that the guaranty is paid. These provisions are imperfect solutions. For instance, the net worth guaranty will not save the transaction if a court finds that the business was undercapitalized or that the debtor should have known that it would be unable to pay its debts as they matured. A more generally drafted savings clause might provide broader coverage: to limit the guaranty obligation to the extent necessary to avoid triggering the judicial finding of a fraudulent transfer.

III. IN *RE TOUSA*

Tousa is a Florida homebuilder that operates through a number of subsidiaries. The parent company (Tousa Inc.) and one of its subsidiaries (Tousa Homes) entered into a joint venture to purchase and develop property, and the joint venture was funded by an unsecured loan from a group of lenders (the "Transeastern Lenders"). When the venture failed, litigation arose between the

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11 See *In re Image Worldwide Ltd., David P. Leibowitz, Trustee* v. *Parkway Bank &Trust Co.*, 139 F.3d 574 (1998).

12 *Clark* v. *Sec.Pac. Bus. Credit (In re Wes Dor, Inc.)*, 996 F.2d 237, 243 (10th Cir. 1993).

Tousa debtors and these lenders. The parties subsequently reached a settlement under which Tousa Inc. and Tousa Homes agreed to pay the Transeastern lenders over $420 million.

On July 31, 2007, Tousa borrowed $500 million from a group of lenders (the "New Lenders") to fund the payment of the settlement amount. The new credit came in the form of a $200 million first-lien term facility and a $300 million second-lien term facility. Over $420 million of the loan proceeds were paid to the Transeastern Lenders.

Several of Tousa's subsidiaries (the "Conveying Subsidiaries") became jointly liable with Tousa Inc. and Tousa Homes on the $500 million loans, and they secured these obligations by granting liens to the New Lenders on substantially all of their assets. The Conveying Subsidiaries were never indebted to the Transeastern Lenders, and they were neither defendants in the litigation nor parties to the settlement. Their secured obligations to the New Lenders were equivalent to upstream guaranties of Tousa Inc.'s obligations, and cross-stream guaranties of subsidiary Tousa Homes' obligations. Tousa Inc. and Tousa Homes were the direct beneficiaries of the loan proceeds.

Less than six months after the $500 million loans, Tousa and most of its subsidiaries filed for bankruptcy. The Official Committee of Unsecured Creditors brought a motion to avoid under the fraudulent transfer provision of the *Bankruptcy Code*, (a) the claims and liens of the New Lenders against the Conveying Subsidiaries and (b) the payment of the loan proceeds to the Transeastern Lenders. They succeeded on both counts. The Court found that the Conveying Subsidiaries were insolvent at the time of the transaction and held that they had in each case incurred an obligation or made a transfer for less than reasonably equivalent value. The Court rejected the good faith defense of 548(c) because, in light of the ample public information indicating that the subsidiaries were insolvent, neither the New Lenders nor the Transeastern Lenders exercised sufficient diligence in investigating the solvency of the debtors. Moreover, 548(c) protects the good faith transferee or obligee only "to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation." The Court found that the defendants had failed to establish that the Conveying Subsidiaries had received any concrete, economic value in exchange for the transfers and obligations.

Judge Olson's remedy was far-reaching. He ordered the unwinding of the transaction, with the express objective of restoring the debtor to the financial condition that would have existed had the transfer never occurred.[13] He attributed to the Conveying Subsidiaries approximately $403 million of the secured obligation incurred by the Tousa enterprise to the New Lenders. Accordingly he ordered the Transeastern Lenders to disgorge $403 million, plus prejudgment interest from the date of the transaction. He reinstated their unsecured claim against Tousa Inc. and Tousa Homes. The New Lenders' claims and liens against

13 Slip Opinion, *supra*, at 171.

the Conveying Subsidiaries (but not against Tousa Inc. or Tousa Homes) were eliminated. The New Lenders were entitled to receive the disgorged sum from the Transeastern Lenders, but only after the Conveying Subsidiaries were compensated from that amount for all the expenses and losses they incurred due to the transaction.

The compensation of the Conveying Subsidiaries was comprehensive. The Conveying Subsidiaries would be reimbursed for all fees and expenses they incurred in the transaction, as well as in bankruptcy proceedings related to the interest of the New Lenders (such as cash collateral hearing). For example, the administrative agent for the New Lenders, Citicorp, withheld $14.8 million of the loan proceeds as fees for the financing, loan syndication and restructuring, $3.7 million for legal, advisory and other professional fees, and $5 million as an Original Issue Discount. These would all be reimbursed. In addition, the Conveying Subsidiaries would collect all costs and expenses incurred in the avoidance litigation.

The court also entitled the Conveying Subsidiaries to recover the diminution in value of the collateral given to secure the new loans, that had occurred since the transfer: that is, "the difference between the value of the liens at the time of the transaction (i.e., the amount of the loan obligations) and the value of those liens today (i.e., the current fair market value of the Conveying Subsidiaries' property)."[14] Quoting approvingly from the opinion in *Feltman* v. *Warmus*, Judge Olson stated that "if the property has declined in value, the estate will have lost the opportunity to dispose of the property prior to its depreciation".[15] If the property had appreciated after the loan, of course, the debtors would have enjoyed the upside. Effectively, then, the New Lenders were compelled to insure the borrower against market declines in the value of their assets. In this respect at least, the court's remedy was punitive in that it left the debtor better off than if the avoidable transaction had not occurred.

Over half of the court's opinion in *Tousa* is devoted to evaluating the evidence of insolvency and undercapitalization of the Conveying Subsidiaries. Judge Olson found that there was ample public information revealing that the subsidiaries were insolvent at the time of the transaction, including a severe downgrade by Moody's indicating that the senior subordinated bonds were likely in or very near default. The lenders also knew that the Conveying Subsidiaries were not liable under the settlement and therefore would not receive a direct benefit from the payment to the Transeastern Lenders. The existence of this information raised the burden on the lenders to conduct their independent investigation of the debtors before proceeding with the transaction, in order to avail themselves of the good faith defense in §548(c).

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14 *Ibid.*, at 178.

15 *Feltman* v. *Warmus (In re Am. Way Serv. Corp.)*, 229 B.R. 496, 532 (Bankr. S.D. Fla., 1999).

The Transeastern Lenders appeared to have relied on the due diligence of the administrative agent for the New Lenders, Citicorp, and other third party professionals in the transaction. Citicorp had requested that Tousa provide a solvency opinion as a condition of closing, but Judge Olson found that the opinion was patently flawed in several respects. He commented that "like the ineffective savings clauses, the 'solution' attempted to be engineered through the Alix solvency opinion reflects excessive cleverness rather than a hard-headed, honest analysis of the economic reality of the Transaction."[16] In particular, Judge Olson noted that the opinion did not examine the entities individually, but rather reported on the consolidated enterprise. He held that the solvency of the enterprise was relevant only if the conditions for invoking the doctrines of substantive consolidation or veil piercing were present.[17] He also held that the opinion relied blindly and excessively on inaccurate projections and assumptions provided entirely by the Tousa management. In addition, Judge Olson observed that the expert, AlixPartners, was compensated under a contingent fee arrangement that paid $2 million if Alix opined that Tousa would be solvent immediately after the transaction, and only time and expenses (less than $1 million) if it did not.

Given that the Conveying Subsidiaries were insolvent after, and probably before, the transaction, the obligation incurred to the New Lenders and the transfer of security interest to them were constructively fraudulent unless the subsidiaries received reasonably equivalent value in exchange. As observed earlier, the caselaw recognizes that this requirement may be met in cases of intercorporate guaranties if the defendants establish that the debtor/transferor received an indirect benefit, and that its net worth was undiminished as a result of the transaction. The defendants pointed to a number of indirect benefits: they asserted that the litigation settlement removed the distraction and reputational harm to the enterprise from ongoing litigation and, by saving the parent from bankruptcy, assured the subsidiaries of continued corporate services from the parent (such as centralized cash management, purchasing, payroll and benefits administration). Judge Olson was unpersuaded and declined to recognize benefits that the defendants had not purported to quantify. He also interpreted the meaning of "value" more narrowly than other courts and more closely in line with the, definition. He required some property element—that is, "some enforceable entitlement to some tangible or intangible article".[18]

Given the insolvency of the Conveying Subsidiaries, the unsecured creditors challenged the payments to the Transeastern Lenders on two grounds. First, by receiving payment from the loan proceeds, the Transeastern Lenders were beneficiaries of the fraudulent obligation and transfer to the New Lenders. Second, the payment was a transfer from the debtor, because the loan proceeds

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16 Slip Opinion, *supra*, note 56 at 150.

17 *Ibid.*, at 136.

18 *Ibid.*, at 148, n55.

otherwise would have been property of the debtors' estates. In other words, as co-borrowers, each of the subsidiaries had a property interest in the funds. Judge Olson squared this argument with the apparent conflicting claim that the subsidiaries did not receive value in return for their obligation and transfers to the New Lenders, as follows:

> "There is no inconsistency in the Committee's claim that the Conveying Subsidiaries had a property interest in the proceeds of the term loans and the Committee's simultaneous claim that the Conveying Subsidiaries did not receive reasonably equivalent value from the First and Second Lien Lenders. The Conveying Subsidiaries had a property interest in the loan proceeds . . . but the value of that property interest to the Conveying Subsidiaries was minimal because they had been forced to enter into a contractual commitment that the borrowed funds would be paid to . . . the Transeastern Lenders."[19]

In essence, Judge Olson collapsed the extension of credit to the Conveying Subsidiaries and the payment to Transeastern for the purpose of avoiding the obligation and transfer to the New Lenders, but kept the loan and the payment as distinct transfers for the purpose of the avoidance action against Transeastern.

IV. SAVINGS CLAUSES UNDER TOUSA

Section 10.20(d) of both first and second lien loans 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."

The defendants argued that the savings clause reduced the obligations incurred and liens granted by the Conveying Subsidiaries to the extent necessary to prevent their insolvency.

Judge Olson rejected the defense for five reasons. Two of them are specific to the facts of the case. First, the loan agreements provided that any amendment must be in writing and signed by the lenders, particularly if the amendment would reduce the principal amount of either loan or would release the borrower from its payment obligation. Judge Olson found that the savings clause could not alter the amount owing without complying with this require-

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19 *Ibid*,. at 156.

ment, and no written agreement had been signed. This justification for the ruling seems to be the weakest because the adjustment in liability would occur according to the terms of the initial agreement, not pursuant to an amendment.

Second, even if enforceable, the savings clause in the new loan agreements would leave the New Lenders with no claim. The clause does not affect the finding that the subsidiaries were insolvent before the transaction and that they did not receive reasonably equivalent value. Therefore, any obligation or lien would be avoidable. By its operation, therefore, the savings clause would reduce the liability to zero - the same result as if there were no such clause. Ironically, the savings clause might have protected the Transeastern Lenders from being ordered to disgorge the payment from the loan proceeds and thereby produced a worse outcome for the New Lenders than under Judge Olson's remedy.

Judge Olson provided three other reasons for rejecting the savings clause, which might be applicable beyond the facts of *Tousa*, and are potentially the source of concern in future loans to distressed enterprises. First, Judge Olson cited *Bankruptcy Code* §541(c)(1)(B), which provides that an interest of the debtor in property becomes property of the estate, notwithstanding any contractual or legal provision that is conditioned on the insolvency or financial condition of the debtor that terminates, modifies or forfeits the interest. Judge Olson held that the debtor's cause of action to avoid a fraudulent transfer is property of the debtor, and a savings clause purports to modify this right when the debtor's financial condition deteriorates sufficiently to trigger the avoidance. This is an interesting application of the statute that bears further consideration. As a technical matter, the estate – not the debtor – has the right to avoid under §548, so the anti-ipso-facto provision in §541 does not protect this right. The question instead, as discussed below, is whether the savings clause may modify the avoidance provision in §548 at all. Judge Olson's reading of §541(c)(1)(B) might limit the effect of the savings clause on the debtor's cause of action under state fraudulent transfer laws, which the debtor could assert before bankruptcy. More fundamentally, however, it is the property interest itself – the cause of action – that is conditioned on the financial condition of the debtor (i.e. insolvency). In essence, then, what the fraudulent transfer laws giveth, the savings clause taketh away, leaving the debtor in no worse position than if there were no insolvency.

Second, as a matter of contract law, a court may decline to enforce an agreement that is indefinite. Judge Olson found that the joint operation of the savings clauses in the two loans was indefinite because the adjustment of liability under the savings clause of the first lien would determine the necessary adjustment on the other, and vice-versa. Thus, "[t]he savings clauses create a circular problem that has no answer. . . . Because of the interaction between the two savings clauses, liabilities under the term loans are *inherently* indeterminate" (emphasis in original).[20] Judge Olson concluded that the savings clauses are therefore unenforceable.

Courts vary in the degree to which they are prepared to enforce a contract with an underspecified core provision, such as the amount of an obligation to pay. Although inapplicable to loan agreements, §2-204(3) of the Uniform Commercial Code exemplifies a common liberal approach: "Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy". There is no question in New Lender contracts about the intent to agree. The parties failed to anticipate the difficulty in the joint enforcement of the savings clauses with different groups of lenders. However, courts have been willing to supplement expressed terms with implied ones that are reasonable and reflect the likely intent of the parties. In enforcing the savings clauses in *Tousa*, for example, a court might order an equal *pro rata* adjustment to each obligation in order to preserve the solvency of the debtor. Of course, there may be a concern about imposing the burden of this gap-filling task on courts. However, in light of the countless occasions on which courts are called upon to construe what is "reasonable" or "good faith" under the circumstances, the determination of the amount of indebtedness under savings clauses is hardly an extraordinary burden. In future agreements, of course, parties may wish to make savings clauses more precise and to anticipate the joint operation of such clauses across multiple agreements.

Ultimately, the most significant threat to the enforceability of savings clauses stems from the court's policy concerns. After noting that the core provisions of the *Bankruptcy Code* may not be modified or varied by contract, Judge Olson stated that:

> "If given effect, the only purpose served by the savings clause is to ensure that the transferee can preserve its claim to every last penny of the debtor's remaining assets without providing reasonably equivalent value. The savings clauses are a frontal assault on the protection that section 548 provides to other creditors. They are, in short, entirely too cute to be enforced."[21]

In a footnote, he added that "[t]here is something inherently distasteful about really clever lawyers overreaching. Some problems cannot be drafted around. The fact that this sort of drafting was felt necessary by Citi ought to have given it pause that maybe this deal was not possible."[22]

The sanctions of fraudulent transfer laws are punitive (unlike those of avoidable preferences). In the absence of good faith, the obligee or transferee forfeits the obligation or transfer. Even if that party has given value for the

20 *Ibid.*, at 141.
21 *Ibid.*, at 140-1.
22 *Ibid.*, at 141 n. 51.

obligation or transfer, it cannot retain any portion of its interest or obligation unless it acted in good faith; §550(a), 548(c). If savings clauses purport to operate irrespective of good faith, they undermine the operation of the good faith defense and the punitive sanction on fraudulent transfers. In this sense, Judge Olson is correct in characterizing these clauses as attempts to contract around a core provision of the *Code* (and state debtor-creditor law). The circumvented provision, however, is the sanction for the failure to act in good faith, including the judicially-imposed requirement that the lender exercise due care in investigating the solvency of the debtor. In a case involving an intercorporate guaranty such as *Tousa*, the savings clause essentially replaces the statutory forfeiture of a secured claim with the lighter sanction of a write-down in the obligation. In turn, this dilutes the lender's incentive to screen for the borrower's solvency.

It is common for the law to impose liability on innocent parties when the guilty ones are likely to be judgment proof. Where a thief sells stolen property to a buyer, the true owner can usually recover it, leaving the innocent buyer to bear the loss of his payment to the thief. In the commercial context, lenders may be liable for the regulatory infractions of their borrowers (for example, a mortgagee may be liable for the clean-up of its borrower's toxic spill). The buyer and lender, respectively, are effectively gatekeepers who can reduce the risk of harm by deterring the misbehaviour in question.

Many bankruptcy courts are willing to avoid the transfer of security interests received by lenders who finance leveraged buyouts of insolvent firms. These courts typically collapse into one transaction the secured loan, the payment of loan proceeds to the selling shareholders, and the delivery of stock to the buyers. In this frame, the insolvent target appears to be conveying a property interest and incurring an obligation without receiving reasonably equivalent value.[23] Lenders thereby become gatekeepers who are charged with the responsibility of refusing financing for buyouts that would leave the target in an insolvent or undercapitalized state, at the expense of existing creditors. Lenders play a similar role when they assist the cross-financing of entities within a corporate group. In these cases, the incentives on lenders to police these transactions depends on the severity of the sanctions. By softening the sanction to a write-down of the obligation, savings clauses dilute the incentive of lenders to investigate the solvency of the individual borrowers. Specifically, the added sanction imposed by the *Code* may be necessary to offset the prospect of underenforcement: those cases in which an avoidance action is not brought or the courts err in finding that the lender had reasonable grounds to believe the borrower was solvent.

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23 E.g., *U.S.* v. *Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), affirming *U.S.* v. *Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D.Pa., 1983), cert. denied, 483 U.S. 1005 (1987)

Contracting parties may have another motivation for including savings clauses. The defense provided by the *Code* relies on a judicial finding that the lender acted in good faith. This is a costly and uncertain assessment that the parties may wish to avoid by including a savings clause. As discussed above, the construction and application of the savings clause in *Tousa* is also likely to be costly and uncertain. However, the savings provision narrows the stakes and thereby reduces the cost of uncertainty. The assessment of good faith determines whether the lender has a claim for all or none of the amount of the loan; in applying the savings clause, a court chooses instead among fractions of the loan amount.

The judicial treatment of savings clauses in usury cases provides an instructive analogy.[24] Such clauses purport to reduce interest charges that would otherwise be held to violate usury laws, to the maximum permissible rates under law. In construing savings clauses, courts look to the intent of the parties, as evidenced in the agreement as a whole and the surrounding circumstances.[25] Thus, a savings clause is ineffective if it directly contradicts the explicit terms of the contract.[26] It may be effective, however, in correcting a mistake, particularly in complex transactions or agreements in which calculations are complicated.[27] The clause may also save transactions if a legal rate becomes usurious because of a contingency occurring after the contract.[28] The conduct after the contract may be relevant, particularly whether the lender in fact attempted to

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24 Clauses with a similar motivation exist in many other contexts, including non-compete covenants and severability clauses, as well as in legislation vulnerable to constitutional challenge. See Omri Ben-Shahar, How to Repair Unconscionable Contracts (Draft, Summer 2009).

25 For example, *Video Trax, Inc.* v. *Nationsbank*, *N.A.*, 33 F.Supp.2d 1041 (S.D.Fla., 1998)(holding that the savings clause is one factor in determining whether the lender intended to charge a usurious rate); *In Re Dominguez*, 995 F.2d 883, 886-7 (9th Cir., 1993)(agreement not usurious because savings clause was clearly written to override the regular interest provision, and this was consistent with the extrinsic evidence of intent); *FDIC* v. *Claycomb*, 945 F.2d853 (5th Cir., 1991)(court held that savings clause was consistent with intent to structure transaction to avoid usurious interest).

26 For example, *Mims* v. *Fidelity Funding, Inc*., 307 B.R. 849 (N.D.Tex., 2002) (holding that the savings clause was ineffective because the loan agreement was usurious on its face, despite reciting that the parties intend to comply with the applicable usury law); *First State Bank* v. *Dorst*, 843 S.W.2d 790, 792 (Tex. Ct. App., 1992) (court rejected savings clause because it would have allowed lender to effectively disclaim 'that which under his contract he has plainly done').

27 For example, *Federal Sav. & Loan Ins.* v. *Kralj*, 968 F.2d 500 (5th Cir., 1992) (savings clause corrects contractual mistake in setting daily rate of interest based on a 360-day year)

28 *Jersey Palm-Gross, Inc.* v. *Paper*, 658 So.2d 531, 535 (Fla., 1995). The Florida Supreme Court stated

effectuate the reduction contemplated in the savings clause.[29] The policy considerations were summarized by the Florida Supreme Court in *Jersey Palm-Gross, Inc.* v. *Paper*, 658 So.2d 5310, 535 (Fla. 1995):

> "[A] usury savings clause is one factor to be considered in the overall determination of whether the lender intended to exact a usurious interest rate. Such a standard strikes a balance between the legislative policy of protecting borrowers from overreaching creditors and the need to preserve otherwise good faith, albeit complex, transactions which may inadvertently exact an unlawful interest rate."[30]

As in usury cases, bankruptcy courts might condition their treatment of savings clauses in intercorporate guaranties by insolvent subsidiaries, on the apparent motivation of the parties. In particular, if the savings clause appears to be designed to avoid the good faith obligation to exercise due diligence under §548, the court should decline to give it effect (as Judge Olson did in *Tousa*). The court should be relatively more willing to enforce the clause if the motivation appears to be to reduce the cost and uncertainty of the judicial determination of good faith in future avoidance proceedings. As in the usury cases, the lender might present evidence that the solvency of the debtor was ambiguous, or difficult to determine at the time of the contract. The court should apply a more lenient standard if the debtor became solvent or undercapitalized only after the transaction. The court should also inquire whether the lender was proactive in investigating the debtor's financial condition during the term of the loan and making periodic adjustments of the debtor's liability under the savings clause before the debtor's bankruptcy filing.

Before closing, and at the risk of further complicating the issue, it is worth noting that the efficiency of intercorporate guaranties is context-dependent in another respect. They occur in corporate structures that (usually) deliberately separate ventures or asset groups into distinct legal entities. There are many motivations for doing so. One of them, however, is to instill the discipline of having each (venture) tub on its own bottom. Cross-financing arrangements undermine this objective. So, in this limited sense, fraudulent transfer laws support the precommitment of corporate structures not to cross-subsidize their ventures. As commentators have noted in the wake of *Tousa,* the court's reluctance to enforce savings clauses may chill the availability of cross-financing in distressed corporate groups. This would reinforce, however, the fiscal discipline that may have prompted the corporate structure in the first place. In contrast, if

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29 For example*., FCE Techmologies, Inc.* v. *Cherrington Corp.*, 168 F.3d 201 (5th Cir., 1999)(savings clauses are ineffective if usurious interest was in fact received); *Armstrong* v. *Steppes Apartments, Ltd.*, 57 S.W.3d 37 (Tex.App. Ft.Worth, 2001) (notes were usurious on their faces and no evidence that lender attempted to effectuate clause).

30 *Jersey Palm-Gross*, 658 So.2d at 535.

the motivation for separate entities is regulatory compliance or tax-avoidance, then cross-financing is consistent with such motivation and legal impediments increase the cost of multiple-entity structures.

V. CONCLUSION

The upshot of *Tousa* is to put a more onerous burden on lenders (and third party recipients of the loan proceeds) to investigate the solvency of each guarantor, as well as the benefit from the transaction to each guarantor. The court warned, for instance, that lenders cannot rely exclusively on managerial projections and assumptions in assessing the borrower's solvency and, in establishing the presence of reasonably equivalent value, they should proceed to quantify the purported indirect benefits. The prospect that other courts might share Judge Olson's distaste for savings clauses cautions lenders against relying on them as insurance against careless diligence. His opinion should also prompt a rethinking and redrafting of such clauses. In light of the facts in this case, the appellate court is unlikely to disturb the bankruptcy court's finding of insolvency. It might relax Judge Olson's strict approach to indirect benefits. The appeal's most important and interesting analysis, however, will focus on the enforceability of the savings clauses. This paper offers a framework and some implications to consider on appeal.