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The *TOUSA* Decision: A Lender's Nightmare?

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This article provides a brief summary of the relevant facts of the recent TOUSA decision, the implications of the decision and the lessons to be learned from the case.

The nightmare: $500 million in secured loans challenged in bankruptcy court; all claims by lender against borrower and all liens avoided; all principal, interest, costs, expenses and other fees, including all professional fees paid to lender in connection with the loan, disgorged; $403 million, plus nine percent pre-judgment interest, disgorged; all loan transaction costs, litigation costs (including attorney fees, advisor fees and expert fees) and diminution of value in property incurred by borrower to be paid by lender; a lien on a $207.3 million federal tax refund avoided and all funds paid from such tax refund disgorged with nine percent interest.

This laundry list of woes was the painful reality for the lenders in *In re TOUSA, Inc.* (the "*TOUSA* decision"). The *TOUSA* decision is a 182 page ruling by the U.S. Bankruptcy Court for the Southern District of Florida (the "court") finding that the loans made by the secured lenders in that case were constructively fraudulent transfers.

This article provides a brief summary of the relevant facts, the implications of the decision and the lessons to be learned from the case. Of particu-

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lar note is that the court (1) dismissed the savings clauses contained in the loan documents as unreasonable and unenforceable devices; (2) found the solvency opinion relied upon by the lenders to be ineffective; and (3) as part of its remedy, ordered the lenders to pay the borrower for the diminution of value in its property from the time of the granting of the liens to the date of the decision of the court.

BACKGROUND

TOUSA, Inc. ("TOUSA") and its subsidiaries were in the business of designing, building and marketing detached single family residences, town homes and condominiums. The case involved an "upstream guarantee" by certain subsidiaries of TOUSA (the "Conveying Subsidiaries") pledging their assets as collateral to secure the obligations of TOUSA to repay roughly $500 million in first and second lien term loans (collectively, the "Term Loans"). The proceeds of the Term Loans were used to settle litigation against TOUSA and one of its subsidiaries ("Homes LP"). That litigation arose from a default on separate debt incurred to finance a failed joint venture enterprise. Notably, none of the Conveying Subsidiaries was a party to the lawsuit brought by the entities that financed the failed joint venture enterprise (the "Transeastern Lenders") for which the settlement funds were being paid. However, the Conveying Subsidiaries granted liens on the majority of their assets to secure the funds borrowed to settle this litigation. TOUSA, Homes LP and the Conveying Subsidiaries declared bankruptcy six months after the loans were made by the Term Loan lenders. TOUSA's official committee of unsecured creditors, representing approximately $1 billion in unsecured bond debt, brought suit to avoid the Term Loans' and the Transeastern Lenders' settlement as fraudulent conveyances.

FRAUDULENT CONVEYANCES

Section 548(a)(1)(B) of the U.S. Bankruptcy Code permits the avoidance of any transfer of interest in debtor property, or any obligation incurred by a debtor, that was made or incurred within two years before the date of filing a bankruptcy petition if the debtor voluntarily or involuntarily received less than reasonably equivalent value in exchange for such transfer or obligation and (1) was insolvent on the date the transfer or obligation was incurred, or became insolvent as a result of such transfer or obligation; (2) was engaged in a business or transaction, or was about to engage in a business or transaction, for which any property remaining is unreasonably small capital; or (3) 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. No actual fraud or intent to deceive is required.

The court reasoned that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the Term Loans because they received neither direct nor indirect benefits from the Term Loans. With respect to direct benefits, the Conveying Subsidiaries were not parties to the litigation that was being settled, and they received no proceeds from the Term Loans, no debt relief and no tax benefits. With respect to indirect benefits, the court stated that indirect benefits are cognizable only if (1) the benefits are actually received by the individual subsidiary, (2) the benefits are limited to cognizable "value" and (3) the property is received by the subsidiary "in exchange for" the transfer obligation. Based on these criteria the court dismissed the defendants' assertions that corporate office services, business "synergies" and "avoiding default" constituted the cognizable indirect benefits of a common business enterprise.

After a very lengthy analysis, the court also determined that each Conveying Subsidiary (1) was insolvent both before and after the loan transaction — "[t]o decide whether a firm is insolvent…a court should ask: What would *a* buyer be willing to pay for the debtor's *entire package* of assets and liabilities. If the price is positive, the firm is solvent; if negative, insolvent;" (2) had unreasonably small capital after the transaction — "[the] standard asks whether a company has sufficient capital to support operations in the event that performance is below expectations…[b]alance sheet insolvency is also proof that the Conveying Subsidiaries had unreasonably small capital;" and (3) was unable to pay its debts as they became due — they actually were unable to meet their financial obligations after the transaction.

SAVINGS CLAUSES INVALID

The loan agreements for each of the Term Loans contained savings clauses that the court found to be ineffective. The savings clauses in question purported to amend the liabilities and liens to the degree necessary to make them "enforceable to the maximum extent" permitted by law. The court determined that those clauses were unenforceable, stating, "[t]here is something inherently distasteful about really clever lawyers overreaching…[s]ome problems cannot be drafted around…." "[The savings clauses] are, in short, entirely too cute to be enforced."

The court stated that because the Conveying Subsidiaries were insolvent even before the transaction and received no value, the liabilities and liens could not be enforced at all. Any liabilities imposed and any liens securing those liabilities were avoidable. The court went on to say that even if the Conveying Subsidiaries had become insolvent after the transaction, the savings clauses would be unenforceable under 11 U.S.C. 541(c)(1)(B), which says that an interest of the debtor in property becomes property of the estate, notwithstanding any "provision in an agreement" that is "conditioned on the insolvency or financial condition of the debtor" that "affects or gives an option to effect a forfeiture, modification or termination of the debtor's interest in property." The court held that these savings clauses were just the type of provisions that the U.S. Bankruptcy Code protects against. If the clauses were given effect, they would defeat the debtors' cause of action for a fraudulent transfer "and a cause of action is unquestionably property of the debtor." The court believed that these savings clauses were unenforceable provisions that attempted to contract around the core provisions of the U.S. Bankruptcy Code and were invalid.

Finally, an important factor in the court's decision to reject these clauses was that both Term Loans contained identical savings clauses, which stated that the secured obligations to be preserved could not be determined under either loan until the liabilities had been determined under the other loan. The court found that this circular cross-reference scheme made the liabilities inherently indeterminable and therefore impossible to enforce.

SOLVENCY OPINION UNRELIABLE

As part of their underwriting process, the Term Loan lenders required a solvency opinion. However, the court found that the solvency opinion lacked credibility and that the lenders should not have relied upon it because:

(1) most importantly, the fee to be paid to the firm rendering the opinion was contingent on the conclusion — if the opinion showed solvency, the fee was $2 million; if insolvency, the firm would only be paid for its time and reimbursable expenses;

(2) the firm lacked recent experience in providing such opinions — it had not prepared one in more than two years;

(3) the borrower did not consider any other firm to provide the opinion;

(4) the opinion was delivered in a suspiciously hurried manner — the firm was retained on June 15, informed TOUSA that the result would be favorable on June 20 and a draft solvency opinion was in circulation by June 27; and

(5) the opinion relied on projections provided entirely by TOUSA's management and was not a "bottoms up" analysis.

The engagement letter stated that the firm "would not take any action to verify accuracy or completeness" of the information provided, the firm did not ask management how good the projections had been historically, the information was not provided by operational-level management and, even though TOUSA acknowledged that due to the decline in the economy its projections were outdated and overly optimistic, it never revised its assumptions. The court concluded that because the firm blindly relied upon TOUSA's unsupportable financial projections, its opinion that TOUSA was solvent as of July 31, 2007 was not credible.

DIMINUTION OF VALUE RECOVERABLE

In this case the timing is particularly interesting. The transaction was concluded in July 2007 — just ahead of the major events of the recent financial meltdown. No one could have clearly foreseen the length and extent of the resulting economic collapse at that time. When the Term Loans were made, the value of the Conveying Subsidiaries' assets appeared to be greater than the obligations secured. However, by the time of the *TOUSA* decision, the value of those assets had greatly decreased below the value of the loans. The court, in an effort "to restore the estate to the financial condition that would have existed had the transfer never occurred," employed its broad equitable powers to order the lenders to also reimburse to the Conveying Subsidiaries the difference in the value of their assets from the time of the granting of the liens and the time the decision was delivered (October 13, 2009). This diminution in value amount (which had not yet been calculated at the time of the ruling) will undoubtedly result in a significant additional liability for the lenders that they had not anticipated at the time of loan origination.

SUMMARY AND LESSONS

While the *TOUSA* decision highlights the risks of using the assets of subsidiaries to secure parent-level debt, most of its lessons are not new. Nevertheless, these lessons need to be learned again with each turn of the business cycle. Notwithstanding the result of pending appeals, lenders would do well to keep the following in mind:

- Be cautious of upstream guarantees, mortgages and other security interests and make sure that at least some value is given to the security-granting subsidiary entities.
- Conduct independent financial analysis of each individual debtor and subsidiary guarantor (rather than on a consolidated or "common enterprise" basis).
- Conduct careful due diligence and make sure you are aware of all market conditions and all public filings and notices relating to each debtor.
- Do not rely on savings clauses.
- Make sure solvency opinions are not contingency based and, if possible, make sure the underlying information used to make the determination of the opinion is independently obtained and examined. If, practical, a lender must rely on information provided by the debtor, the lender must question all assumptions made by the debtor and the validity of the information provided. Also, the lender must make sure it has the most up-to-date and accurate financial information available.