

Real estate bust hits lenders

David Conaway writes from the USA on the state of the big players in the domestic housing market



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In the wake of the global credit crisis, the US housing market plummeted with values declining as much as 50% and home foreclosures at record highs. With lower asset values and frozen credit markets, it became difficult if not impossible for US homebuilders to continue business operations. Many US homebuilders, particularly those who operated on a highly leveraged basis, have been forced to liquidate assets to pay off lenders. Touse, Inc. (and its subsidiaries) is one of the largest US homebuilders to seek Chapter 11 protection. The Touse Bankruptcy Court's ruling on 13 October 2009 is one of the most significant lender liability cases in recent history. In its 182-page ruling, the United States Bankruptcy Court for the Southern District of Florida avoided as fraudulent conveyances secured obligations of almost \$500 million and the liens granted to secure such debts. The Court also

ordered the lenders, which include Bank of America, CIT Group, Citigroup and Wells Fargo, to *disgorge* such value for the benefit of the Touse Chapter 11 bankruptcy estate.

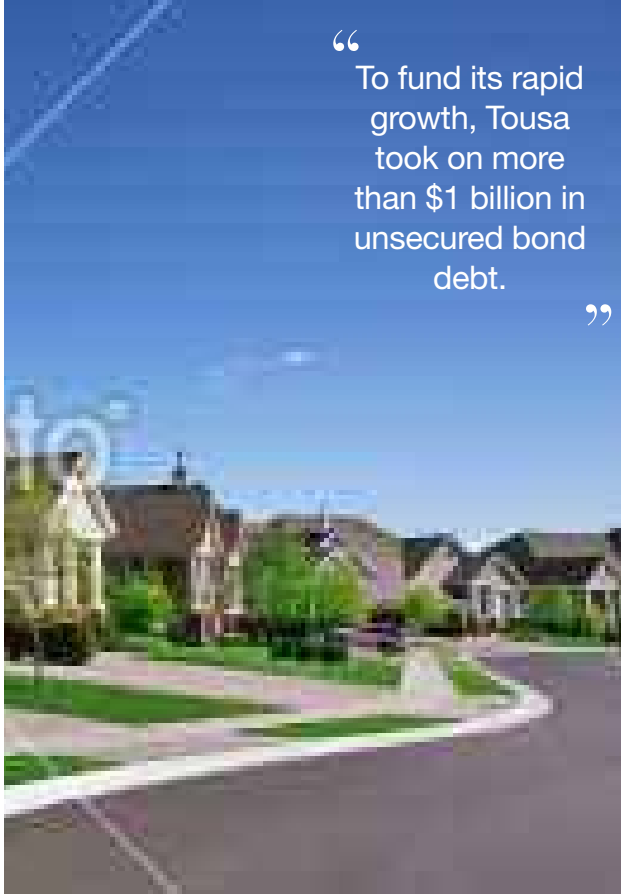
Touse, Inc. was a "roll-up" of US homebuilders in Florida, Maryland, Pennsylvania, Las Vegas and Denver, which Touse acquired from the late 1990's until the 2007 real estate bust. Touse conducted its operations through numerous US based subsidiaries.

To fund its rapid growth, Touse took on more than \$1 billion in unsecured bond debt. In addition, in June 2005, a Touse affiliate located in Florida borrowed \$675 million to fund acquisitions and operations. The administrative agents for these obligations included Citicorp North America, Inc. and Deutsche Bank Trust Company Americas. When the housing market crashed, Touse's Florida affiliate declared the loans in default. The parties

resolved the defaults by Touse agreeing to pay the lenders \$421 million in satisfaction of the 2005 Florida loans.

To pay for this settlement, in July 2007, Touse arranged for \$500 million of new debt, again with Citicorp as the initial administrative agent. The loan terms required that Touse subsidiaries with no connection to or involvement in the 2005 Florida loans be co-borrowers and to pledge their assets to the lenders as security for payment of the \$500 million debt. Of the \$500 million loan proceeds, the settlement required that approximately \$421 million be used to pay off the lenders involved in the 2005 Florida loans, and that the remainder of the loan proceeds be used to pay various fees, costs, and claims associated with the loan transactions.

Within about six months after closing the July 2007 loan transactions, Touse filed Chapter



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11 in January 2008 in response to the real estate market crash, plummeting real estate values, and a freeze of the credit markets. In the Chapter 11 proceeding, the unsecured creditors' committee (comprised mainly of Touse's unsecured bondholders) filed an adversary proceeding against the lenders involved in the July 2007 loan transactions and also the lenders involved in the 2005 Florida loans who were paid off from the proceeds of the July 2007 loan transaction.

The essence of the lawsuit was that the loans and liens of the July 2007 transactions and payments to satisfy the lenders of the 2005 Florida loans were fraudulent conveyances under Section 548 of the Bankruptcy Code, which allows a debtor to avoid obligations incurred and transfers or pledges of property if:

1. Debtor “receives less than a reasonably equivalent value in exchange for such transfer or obligation,”

2. Debtor was insolvent at the time of the transfers or the obligations are incurred,
3. Debtor was left with “unreasonably small capital,” and
4. Debtor was unable to pay its debts as they came due in the ordinary course of business.

In the Touse case, the unsecured creditors' committee asserted that when the unrelated Touse subsidiaries took on \$500 million of debt obligations, such subsidiaries received virtually no value or consideration for such debt. Rather, the loan proceeds were used primarily to pay off prior debts of other entities. Moreover, at the time and as a result of the new debt, the subsidiaries were rendered insolvent, were left with insufficient working capital, and were unable to pay their debts in the ordinary course of business. In its ruling, the Bankruptcy Court found that the creditors' committee had satisfied all of the elements of Section 548

relating to fraudulent conveyances.

In reaching this conclusion, the Court noted the following:

1. Touse's stock price had fallen from \$23 per share in 2006 to below \$4 per share in April 2007.
2. The evidence showed that Touse's management, material stock owners and the new debt lenders knew about Touse's dire financial condition but that Citigroup and other participants were motivated in part by fees generated by the July, 2007 loan transactions including \$15 million of loan and advisory fees for Citigroup and \$6.4 million for transaction and advisory fees for Lehman Brothers.
3. The July, 2007 loans caused Touse to have a seventy (70) to thirty (30) debt to equity ratio when a 45% to 55% debt cap had been recommended as the maximum sustainable debt level.
4. Touse's CEO was due an incentive bonus of \$2.25 million as a result of a successful closing the July 2007 loan.
5. Touse agreed to pay its financial consultant Alix Partners \$2 million for a solvency opinion regarding Touse to be used as support for the July 2007 transaction, which the Court found to be “seriously flawed”. A solvency opinion is common in loan transactions as an attempt to avoid a later claim that the loan caused the Debtor(s) to be insolvent.
6. The July 2007 debt crippled the Touse subsidiaries in that they became more deeply insolvent, unable to pay their debts in the ordinary course of business, and significantly undercapitalised.

The defending lenders raised several defenses to the fraudulent conveyance claims, mainly arguing that the loans were made in good faith and that the Touse subsidiaries did receive material value for the loans. In addition, the lenders argued that the savings clauses in the loan agreements prohibited avoidance of the loans.

savings clauses are common in commercial loan agreements, and generally provide for an automatic reduction of obligations and liens to the point where they do not trigger the elements of a Section 548 fraudulent conveyance. The Bankruptcy Court rejected these arguments, stating that such savings clauses violate the policy of the Bankruptcy Code as well as public policy as an attempt to nullify Section 548.

In a footnote to the opinion, the Bankruptcy Court observed: *“There 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. In any event, Citi and the rest of the Defendants assumed the risk that the Transaction would be regarded by a reviewing court as a fraudulent transfer.”*

It is significant that the court avoided as fraudulent conveyances the July 2007 loan transactions **and** the pay-off of the prior debt with the proceeds of the July 2007 loan transactions. After concluding that the obligations and liens were avoided, the court ordered that almost \$500 million in value be disgorged from the lenders in the July 2007 loan transaction and also from the lenders who were paid off.

We note that the lenders have appealed the Bankruptcy Court's ruling, thus there may be future appeals court rulings in the Touse case. The lender liability ruling in Touse will provide guidance to other US Bankruptcy Courts in scrutinising loans as the US real estate market restructures, often in a Chapter 11 proceeding.