

Tousa Update

We reported to you in detail about the Tousa Bankruptcy Court decision in November, 2009 (copy attached) which found payments to lenders and the grant of associated liens were avoidable as fraudulent conveyances. The impacted Tousa lenders appealed the Bankruptcy Court's decision to the United States District Court, which reversed the Bankruptcy Court's decision. The Tousa estate then appealed the District Court's reversal to the U.S. Court of Appeals for the 11th Circuit, which AFFIRMED the Bankruptcy Court's decision. The 11th Circuit ruled that:

(1) certain secured obligations Tousa, Inc. and its subsidiaries incurred to payoff a prior lender, and the associated liens on the subsidiaries' assets, can be avoided as fraudulent conveyances; and (2) the prior lender who received the payoff must return the value it received to the bankruptcy estate.

The legal issue in Tousa was whether payments made and liens granted to lenders were fraudulent conveyances under Section 548 of the Bankruptcy Code. This determination hinges on whether particular Tousa subsidiaries received "reasonably equivalent value" in exchange for the payments made and liens granted to the lenders. The District Court found the payoff of certain Tousa's debt provided the subsidiaries an opportunity to avoid bankruptcy and continue operating as going concerns, which constituted sufficient value.

Accordingly, the court held the "conveyances" were not fraudulent and not avoidable.

The 11th Circuit Court of Appeals disagreed with the District Court, finding that every transfer that decreases the likelihood of bankruptcy does not necessarily provide value, noting "a corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." The court further observed that the payoff of the prior creditor simply delayed the inevitable – the issue was not *whether* Tousa and its subsidiaries would file bankruptcy, it was *when* they would file. The Tousa subsidiaries, therefore, received no reasonably equivalent value for the payments and lien transfers, rendering them fraudulent conveyances.

In addressing concerns about the impact its ruling might have on the credit industry, the court stated, "every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor." The 11th Circuit thus found that the loan proceeds were properly disgorged from the prior lender.

We hope you have found this article informative and useful. Please let us know if you have any comments or questions.

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U.S. REAL ESTATE BUST HITS LENDERS

In the wake of the global credit crisis, the U.S. 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 U.S. homebuilders to continue business operations. Many U.S. 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 U.S. homebuilders to seek Chapter 11 protection. The Touse Bankruptcy Court's ruling on October 13, 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 U.S. 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 U.S. 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 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 Tousa'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 Tousa case, the unsecured creditors' committee asserted that when the unrelated Tousa 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. Tousa's stock price had fallen from \$23 per share in 2006 to below \$4 per share in April, 2007.
2. The evidence showed that Tousa's management, material stock owners and the new debt lenders knew about Tousa'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 Tousa 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. Tousa's CEO was due an incentive bonus of \$2.25 million as a result of a successful closing the July, 2007 loan.
5. Tousa agreed to pay its financial consultant Alix Partners \$2 million for a solvency opinion regarding Tousa 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 Tousa subsidiaries in that they became more deeply insolvent, unable to pay their debts in the ordinary course of business, and significantly undercapitalized.

The defending lenders raised several defenses to the fraudulent conveyance claims, mainly arguing that the loans were made in good faith and that the Tousa 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 Tousa case. The lender liability ruling in Tousa will provide guidance to other U.S. Bankruptcy Courts in scrutinizing loans as the U.S. real estate market restructures, often in a Chapter 11 proceeding.

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