

Bankruptcy Court Issues Significant Fraudulent Transfer Ruling in the TOUSA Bankruptcy Case

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On October 13, 2009, the United States Bankruptcy Court for the Southern District of Florida issued an important ruling in the Chapter 11 liquidation proceedings of TOUSA, Inc. and its subsidiaries, voiding as fraudulent transfers approximately \$500 million dollars in obligations and transfers by TOUSA. As this decision involves a fairly common type of financing transaction, this mailing provides a brief overview of the transactions, the ensuing litigation, and some key take-aways from the ruling. It should be noted, however, that the TOUSA decision — like all fraudulent transfer decisions — turns on its specific facts and circumstances. Accordingly, it is not clear the extent to which the decision will impact the structuring of leveraged finance transactions in the future, nor will it necessarily dictate the outcome in other litigation challenging such transactions.

Overview of the TOUSA Transactions and Litigation

TOUSA, Inc., the ultimate parent company of the TOUSA corporate family, was obligated, as a guarantor, on a significant unsecured debt obligation owed by one of its joint ventures to various lenders. After the debt went into default, the parent company, the joint venture and the lenders brought litigation against one another over the terms of the debt. The parent and the joint venture ultimately agreed to settle the litigation through a payment to the lenders of approximately \$420 million.

To finance this payment, the parent company borrowed, and caused many of its subsidiaries to become obligated for, \$500 million in debt. The debt was secured by the subsidiaries' assets. However, the subsidiaries were not obligors on the joint venture debt, were not defendants in the litigation being settled, and they received *none* of the proceeds of the secured loans. Rather, the proceeds of the secured loans were utilized entirely to pay for the settlement and for the corporate purposes of other members of the TOUSA family.

TOUSA and its subsidiaries filed for bankruptcy six months later. Representatives of TOUSA's bankruptcy estate sued to avoid the transactions as fraudulent transfers. After a lengthy, contested trial, the Bankruptcy Court issued a 182-page decision in which it avoided the transactions. In particular, the Bankruptcy Court "unwound" the transactions by ordering the joint venture lenders to pay back to the subsidiaries' bankruptcy estates \$403 million — which was the amount of the joint venture loan repayment attributable to the subsidiaries. The joint venture lenders' unsecured claims were then reinstated to that extent. The court ordered that the returned funds were to be paid back to the secured lenders — but net of fees and expenses incurred by TOUSA in the transaction and the litigation, and net of the decrease in the value of the subsidiaries' assets between the date of the transactions and their avoidance.

In arriving at this decision, the Bankruptcy Court found that the subsidiaries were insolvent both before and after they incurred the obligations on the secured loans. It also found that the subsidiaries did not receive reasonably equivalent value in exchange for their agreement to incur the obligations and grant liens on their assets, as the obligations only benefited the subsidiaries' parent, not the subsidiaries themselves.

Key Take-Aways From the TOUSA Litigation

Lender diligence; good faith. Lenders must take care in conducting their diligence of a borrower, including by not relying exclusively on management projections. The Bankruptcy Court's ruling was critical of the secured lenders for what the court viewed as a lack of diligence in making a risky loan to a borrower in a deteriorating market (home-building) in exchange for receipt of significant fees. Due to this lack of diligence, the court declined to accept the secured lenders' and joint venture lenders' defense that they entered into the transactions in good faith. Indeed, the court said that the joint venture lenders had a duty to investigate the subsidiaries' ability to shoulder the new secured debt load. Of course, third-party recipients of loan proceeds are not often in a position to conduct such diligence and/or are more inclined to accept the proceeds and take the risk of later avoidance. Accordingly, it is unclear what practical impact this aspect of the decision will have.

Solvency opinions; contingency fees. Delivery of a solvency opinion at the time of a transaction does not mean that the transaction is immune from later fraudulent transfer attack. The Bankruptcy Court was especially critical of a solvency opinion delivered in the TOUSA matter because it was based on a valuation methodology that relied on EBITDA — a methodology that all other experts in the case believed was inappropriate in the home-building industry. The court was also critical of the opinion because it was based on dated projections that were not updated or verified by management or the opinion-giver. Moreover, the opinion-giver's fee was contingent on delivering an opinion that concluded that the subsidiaries were, in fact, solvent at the time of closing.

Fraudulent transfer savings clauses. Many guarantees contain so-called "savings clauses" that provide, in effect, that the obligations of a guarantor will be reduced to the extent necessary to prevent the guarantor's insolvency in the event its guarantee is attacked as a fraudulent transfer. In a first, the Bankruptcy Court held that the savings clause was an unenforceable effort by the lenders to defeat the subsidiaries' fraudulent transfer action. "The savings clauses are a frontal assault on the protections that [the fraudulent transfer laws] provide to other creditors. They are, in short, entirely too cute to be enforced." This ruling could impact the way lenders view upstream guarantees, especially in highly leveraged transactions.

Parent/subsidiary relationships. Whether a transfer is fraudulent must be analyzed on an entity-by-entity basis. That a corporate family may be solvent as a whole is not relevant. And the mere fact that corporate entities may be part of a larger corporate family does not mean that a transaction that benefits one of them automatically benefits them all. This may be especially true where a subsidiary incurs obligations for the benefit of a parent. While the court recognized that indirect as well as direct benefits are probative, it refused to credit the argument that the subsidiaries indirectly benefited from the parent's having eliminated the "overhang" of the settled litigation. The court also noted that any benefits derived by the subsidiaries from the parent (such as management service, synergies, etc.) must be quantified in a sufficiently detailed manner in order to conclude that such benefits constitute "reasonably equivalent value" to the subsidiaries.

Expert valuations and methodology. The Bankruptcy Court’s ruling underscores the importance of careful vetting of experts before they are called to testify. The court was highly critical of certain experts for what the court viewed as biased, inaccurate, expert opinion testimony and opinion testimony that relied more on general assumptions rather than on detailed, “bottoms-up” analyses. The court’s ruling also represents one of the first published rulings in the bankruptcy context in which a court endorsed a method for valuing a troubled company based on the distressed trading prices of the company’s bond and equity securities. However, the ruling is largely consistent with rulings from other courts that have held that the market in a company’s public securities is highly probative evidence of solvency or insolvency.

The lenders have vowed to appeal the Bankruptcy Court’s ruling. Skadden will be certain to provide updates on the TOUSA decision if there are any significant developments.