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The *In re Tousa, Inc.* Fraudulent Transfer Decision: Impacts on Debt Trading, Derivatives Trading, and Commercial Lending

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A recent decision in the U.S. Bankruptcy Court for the Southern District of Florida, *In re Tousa*,[1] has received widespread attention for its near wholesale rejection of insolvency "savings clauses," and the resulting order requiring lenders to disgorge hundreds of millions of dollars. The decision raises numerous practical problems for participants in the secondary loan and derivatives markets, and more generally for commercial lenders and borrowers.

Background

In 2005, homebuilder Tousa, Inc. ("TOUSA") and Transeastern Properties, Inc. entered into a joint venture funded by certain lenders (the "Transeastern Lenders"). The joint venture was described by the Bankruptcy Court as "disastrous," ultimately leading to litigation between TOUSA and the Transeastern Lenders. In July 2007, TOUSA settled the litigation with a payment of about $420 million to the Transeastern Lenders. TOUSA financed the settlement with new loans totaling $500 million (the "2007 Financing"), which were secured by liens on substantially all of the previously unencumbered assets of certain subsidiaries (the "Conveying Subsidiaries"). Significantly, the Conveying Subsidiaries were not obligated to the Transeastern Lenders in connection with the original joint venture financing, and were not parties to the litigation or the settlement.

Shortly after the 2007 Financing, TOUSA and the Conveying Subsidiaries filed for bankruptcy. The Official Committee of Unsecured Creditors commenced an adversary proceeding to avoid the liens granted by the Conveying Subsidiaries as part of the 2007 Financing, and recover the approximately $420 million paid to the Transeastern Lenders. In a detailed 182 page ruling, the Bankruptcy Court found that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the liens they granted as part of the 2007 Financing, were left insolvent by the 2007 Financing, and had unreasonably small capital to operate as a result of the 2007 Financing. The Bankruptcy Court avoided the liens, ordered the Transeastern Lenders to disgorge $403 million of proceeds received as part of the settlement, and ordered the disgorgement of principal, interest, and fees paid in connection with the 2007 Financing.

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Market Impact

In re Tousa presents a host of issues for parties in the secondary loan, derivatives, and commercial lending markets. First, the disgorgement order is directed to the lenders of record, but, as a practical matter, the owners of the debt, and the actual beneficiaries of the payments now ordered to be disgorged, may be different entities. This situation primarily arises where a lender of record sold a portion of the debt in a transaction that settled on the proceeds of the loan pursuant to the terms of a proceeds letter, as described below. Second, further complexity arises where a lender of record, upstream seller, or trade or swap counterparty (i) is in bankruptcy; (ii) has merged into another company; or (iii) has been liquidated or is in the process of being liquidated. In all of these situations the lender of record may be required to disgorge funds it received but did not retain.

Many of the parties that settled outstanding loan trades after the closing of the 2007 Financing used proceeds letters, which are typically used by loan trading counterparties to satisfy their respective rights and obligations under their trade confirmation(s) after a credit has been repaid (usually after a debtor's emergence from bankruptcy). Although many of these proceeds letters contained express disgorgement provisions, many lacked such provisions. In addition, not all proceeds letters contained express indemnification clauses, which would serve to clarify the parties' respective obligations to cover litigation costs (including the cost of any *supersedeas* bond) in connection with the *In re Tousa* appeal.

Parallel concerns arise in connection with total return swaps and other derivative products intended to pass the economic costs and benefits of the loans held by the Transeastern Lenders between parties. As in the case of loan trades that settled on proceeds letters, the total return swap documents may not have disgorgement or indemnity provisions that adequately address the *In re Tousa* ruling.

If upheld, *In re Tousa* will also present challenges for the commercial lending market, especially to the extent lenders have historically relied on insolvency "savings clauses" designed to limit the ability to challenge liens and guarantees used to secure debt. The *In re Tousa* decision rejected the lenders' arguments that the "savings clauses" contained in the 2007 Financing documents prevented the transfers from being fraudulent, even though such clauses, on their face, purported to reduce the obligations incurred and liens granted by the Conveying Subsidiaries to the extent necessary to prevent their insolvency. The Bankruptcy Court's rejection of the "savings clauses" went beyond the specific facts of the case and, instead, held that "savings clauses" in general "are a frontal assault on the protections that section 548 [of the Bankruptcy Code] provides to other creditors" and are "entirely too cute to be enforced."[2]

The Bankruptcy Court also rejected claims that the lenders acted in good faith and without knowledge of the Conveying Subsidiaries' insolvency. A solvency opinion issued at the time of the 2007 Financing was held insufficient because (i) the opinion was issued on a consolidated basis, and did not offer an opinion on the solvency of the individual Conveying Subsidiaries; (ii) only one financial advisor was consulted and retained; (iii) the solvency opinion resulted from a contingency fee arrangement; and (iv) the opinion relied on projections provided entirely by TOUSA management, including assumptions that were not revised despite the continuing decline in the housing market.[3]

We will continue tracking the *In re Tousa* appeal and keep clients abreast of key developments. In the meantime, please contact us about the issues raised here and any additional questions you may have.

Footnotes

[1] *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc. (In re Tousa, Inc.)*, Adv. Pro. No. 08-1435 (JKO), 2009 WL 3261963 (Bankr. S.D. Fla. Oct. 13, 2009).

[2] *Id.* at *76 ("If given effect, the only purpose served by the savings clauses 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.").

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[3] *See id.* at *51 - *56 (noting Bankruptcy Court's reasons why solvency opinion was not persuasive).

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