THE TOUSA, INC. BANKRUPTCY DECISION: ANATOMY AND IMPLICATIONS OF A LANDMARK CREDITORS' RIGHTS CASE

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I. INTRODUCTION

A landmark Bankruptcy Court case involving TOUSA, Inc. ("TOUSA"), a Florida-based homebuilder, and several well-known banks, including, among many others, Citicorp North America, Inc. ("Citicorp") and Wells Fargo Bank, was recently decided in Florida's Southern District. The case's final outcome is still uncertain since an appeal is pending, but the implications of the Bankruptcy Court's unprecedented ruling setting aside the lenders' security for over $600 million in loans and ordering disgorgement of over $400 million from a prior lender may prove widespread. If upheld, the Court's ruling will profoundly impact underwriting and risk assessment practices of lenders, title insurers, and financial advisory firms alike. This article explores the key facts of the relevant transactions as found by the Bankruptcy Court, and highlights the most significant parts of the Court's opinion and their potential implications for the title and financial industries.

II. BRIEF FACTUAL BACKGROUND

A. The Formation and Expansion of TOUSA, Inc.

In June 2002, TOUSA, Inc. was formed by a merger between Engle Holdings Corp. and Technical Olympic, USA, wholly owned subsidiaries of a publicly-traded Greek development company, Technical Olympic, S.A. The merger created a unified homebuilding company, originally called Technical Olympic USA, Inc., but later renamed, TOUSA, Inc. Shortly after the merger, TOUSA undertook a plan of rapid expansion, acquiring regional home building companies across the country.[2] By 2004, Florida-based TOUSA was the 13th largest homebuilder in the United States and a publicly traded company on the New York Stock Exchange (the "NYSE"). TOUSA and its numerous subsidiary companies were primarily involved in the design, building and marketing of residential real estate, but TOUSA's subsidiaries were also involved in title insurance and mortgage brokerage services. TOUSA operated in numerous U.S. states, including Florida, Tennessee, Texas, Nevada, Colorado, Arizona, Maryland, Pennsylvania, Delaware and Virginia.

In June 2005, TOUSA announced plans to acquire a major competitor, Transeastern Properties, Inc. ("Transeastern"). The acquisition agreement was structured as a joint-venture between TOUSA Homes LP, a wholly owned TOUSA subsidiary ("Homes LP"), and other entities (the "Falcone Entities"), owned by Transeastern's two majority shareholders, Arthur and Edward Falcone. Homes LP was the joint venture's ("Transeastern JV") managing

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[2] The acquisitions were financed primarily through unsecured bonds, guaranteed by TOUSA subsidiaries.

member. After the August 1, 2005 Transeastern acquisition, TOUSA became the 11th largest homebuilder in the United States.

Deutsche Bank Trust Co. Americas ("Deutsche Bank"), as agent, and other mezzanine lenders (collectively "Transeastern Lenders"), funded TOUSA's acquisition of Transeastern by providing $675 million in financing.[3] The Transeastern JV secured the debt by pledging certain assets and ownership interests and making the debt non-recourse to TOUSA. The Transeastern Lenders also obtained Completion Guarantees from TOUSA and Homes LP and Carve-Out Guarantees from TOUSA, Homes LP and the Falcone Entities on the indebtedness.[4]

Initially, the Transeastern JV appeared a successful investment for TOUSA. The company's SEC Filings showed strong performance in the third quarter of 2005, and its annual financial results revealed continued growth. Just ten months later, however, in September 2006, TOUSA representatives reportedly met with the Transeastern Lenders and notified them that the rapid decline of the Florida housing market (which constituted the majority of the Transeastern JV's operations) had led to their decision to write off TOUSA's entire $143.6 million investment in the joint venture.

This massive write-off triggered a default in the Deutsche Bank financing, and the lenders threatened to exercise their remedies under the terms of the loan agreement.[5] TOUSA and Homes LP, disputing the Transeastern Lenders' claims of default, filed a declaratory relief action against Deutsche Bank in the U.S. District Court for the Southern District of Florida on November 28, 2006.[6] The next day Deutsche Bank sued TOUSA and Homes LP for breach of guaranty in a New York state court.

B. The July 31, 2007 Transaction

By Spring 2007, the parties to the dueling Transeastern JV litigations were involved in global settlement discussions. By June 29, 2007, TOUSA publicly announced it had entered into an agreement with Deutsche Bank and the other Transeastern Lenders to settle all

[3] The $675 million in financing consisted of: (1) $450 million of senior debt in the form of $335 million in term loans and a $115 million revolving loan commitment; (2) $137.5 million of senior mezzanine debt; and (3) $ 87.5 million of junior mezzanine debt. *In re TOUSA, Inc.*, United States Bankruptcy Court for the Southern District of Florida, Case No. 08-10928-JKO, Disclosure Statement filed by the Debtor, TOUSA, Inc. on October 13, 2008 ("TOUSA Disclosure Statement"), § V(A)(2)(a), p. 29.

[4] The Completion Guarantees made TOUSA and Homes LP liable to pay certain project costs of development already in process at the time of the acquisition, in the event the Transeastern JV failed to do so. Under this guarantee, TOUSA and Homes LP were also liable for satisfaction of any mechanics' liens. The Carve-Out guarantees, on the other hand, required TOUSA, Homes LP and the Falcone Entities to indemnify the lenders for any losses incurred due to fraud, material misrepresentation, misappropriation of funds, improper use of insurance proceeds, internal misconduct or waste with respect to the collateral and/or the borrowers' failure to maintain insurance or pay taxes. In the event the losses were a result of acts or omissions of TOUSA or Homes LP, TOUSA and Homes LP would also be required to indemnify the Falcone Entities.

[5] The write-off also constituted a "material adverse change" with respect to the revolving loan facility ("revolver"), for which Citicorp acted as the administrative agent. This material adverse change ultimately resulted in significant amendments to the revolver, including its securitization.

[6] TOUSA Disclosure Statement, § V(A)(2)(e), p. 32.

claims relating to the joint venture. TOUSA and Homes LP also entered into a settlement and mutual release agreement with the Falcone Entities, pursuant to which TOUSA was to become sole owner of the Transeastern JV, and would remain solely liable for its debt and indemnification obligations.

On July 31, 2007, TOUSA and the Transeastern Lenders finalized and executed their settlement agreement. In consideration for the dismissal of all the Transeastern JV related litigation, TOUSA agreed to pay a discounted sum of approximately $400 million[7] to the senior secured Transeastern Lenders, $137.5 million[8] to the senior mezzanine lenders and $16.25 million[9] to the junior mezzanine lenders. TOUSA also paid $50.2 million in cash to purchase land under existing land bank arrangements and $33.5 million in interest and other expenses.[10]

To finance this settlement, TOUSA amended its existing $800 million Citicorp revolver by reducing the available credit to $700 million, which enabled it to obtain two new secured term loans, one for $200 million, and the second for $300 million (the "New Term Loans"). The New Term Loans were used to finance the settlement.[11] In connection with the amended revolver and the New Term Loans, TOUSA and its subsidiary co-borrowers were required to pledge substantially all their assets as security, and they mortgaged substantially all their homebuilding assets in favor of Citicorp and the other lenders (collectively, the July 31, 2007 financing and settlement are referred to herein as the " July 31 Transaction"). While TOUSA's subsidiaries themselves had no liability to the Transeastern Lenders, all their assets were nonetheless pledged to secure the New Term Loans funding the settlement, a fact the Bankruptcy Court later found significant in setting aside their liens. Potentially significant to related creditor's rights issues is the fact that in connection with the July 31 Transaction, Citicorp obtained title insurance in the form of 1970 ALTA loan policies to insure the mortgages given to secure the loans.[12]

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[7] The $400 million was in cash. TOUSA Disclosure Statement, § V(A)(2), pp. 28-29.

[8] The $137.5 million consisted of: (1) $117.5 million in initial aggregate liquidation preference convertible preferred stock; and (2) $20 million in aggregate principal amount of 14.75% senior subordinated PIK election notes and 8% Series A convertible preferred PIK preferred stock. (TOUSA Disclosure Statement, § V(A)(2), pp. 28-29.)

[9] The $16.25 million consisted of common stock warrants, the values of which were estimated at the time of issuance based on the Black-Scholes option pricing model and other agreed upon inputs. (TOUSA Disclosure Statement, § V(A)(2)(a), pp. 29-30.)

[10] *Id*.

[11] Citicorp was the Administrative Agent and Citigroup Global Markets, Inc. ("Citigroup") was the Sole Lead Arranger and Book Running Manager on the Amended Revolver and New Term Loans. Wells Fargo later became the successor Administrative Agent with respect to the $300M Second Lien Term Loan.

[12] This fact is significant because the fallout from the July 31 Transaction implicates several creditors' rights issues, and unlike later policy versions, pre-1990 ALTA policies do not contain an express creditors' rights exclusion. ALTA's decision to amend its standard policies (in 1990, again in 1992, and most recently in 2006) to include the express creditors' rights exclusion was reportedly to make clear that title insurers do not (and did not), as a matter of course, intend to insure against "an insolvency created by the insured transaction." (See Barlow & Burke, Law of Title Insurance, § 4.10[B], p. 4-101 (2007).) Therefore, while it appears ALTA's insertion of a creditors' rights exclusion was to make clear that creditors' rights coverage was never meant to be part of the standard insuring clauses in pre-1990 ALTA policies, the question of creditors' rights coverage remains less clear without an express exclusion in the 1970 ALTA policies.

With settlement of the Transeastern JV lawsuits, TOUSA expressed hope it could move toward refocusing its resources on its core homebuilding business. By the second half of 2007, however, the general economy was already in decline, and TOUSA's precarious financial condition continued to worsen. In the third quarter of 2007, TOUSA was unable to warrant its solvency as required under the amended revolver's terms. On November 15, 2007, the NYSE notified TOUSA that its common stock would be suspended immediately due to the company's failure to maintain common stock standard listing requirements, and on February 15, 2008, the NYSE affirmed its decision to de-list TOUSA's stock. TOUSA was also still defending class action litigation filed in December 2006 by TOUSA shareholders claiming violations of securities laws in connection with the Transeastern JV acquisition.

C. The Bankruptcy Filing and Adversary Proceeding

Ultimately, on January 28, 2008, TOUSA and most of its subsidiaries, including its co-borrower subsidiaries,[13] filed for Chapter 11 relief in the U.S. Bankruptcy Court for the Southern District of Florida.[14]

On July 14, 2008, a committee appointed by the Bankruptcy Court to represent TOUSA's unsecured creditors filed an adversary proceeding. This Committee of Unsecured Creditors of TOUSA, Inc. (the "Committee") represented mainly the unsecured bondholders.[15] The Committee sought, in pertinent part, to: (1) recover as a fraudulent transfer $421 million that had been paid to the Transeastern Lenders; (2) set aside as fraudulent transfers the payment obligations of and liens granted by the TOUSA subsidiaries to secure the New Term Loans that funded the settlement; (3) set aside as a preferential transfer a security interest in a $207 million tax refund granted to the New Term loan lenders; and (4) recover all fees and expenses paid or reimbursed to the lenders in connection with the July 31 Transaction.[16]

The case was tried over 13 days in July and August 2009. Nearly fifty percipient witness deposition transcripts, numerous expert witness deposition transcripts, and thousands of pages of exhibits were submitted to the Court. With over a billion dollars assertedly at stake, all reports paint the picture of an intense battle in the courtroom.[17] On October 13, 2009, Bankruptcy Judge John K. Olson issued a much-anticipated 182-page opinion (the "Opinion") sustaining substantially all the Committee's claims against Citicorp and the other New Term Loan lenders.

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[13] Not all of TOUSA's subsidiaries were co-borrowers under the revolver and New Term Loans. Some TOUSA subsidiaries who were not co-borrowers were not involved in the bankruptcy proceedings.

[14] *In re TOUSA, Inc.*, U.S. Bankruptcy Court for the Southern District of Florida, Fort Lauderdale Division, Case No. 08-10928-JKO.

[15] *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc., et al.*, Findings of Fact and Conclusions of Law and Order signed by Judge John K. Olson, and filed 10/13/09 ("Opinion"), p. 2.

[16] *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc., et al.*, Amended Complaint, filed 10/22/08, Counts I-XX, ¶¶ 45-193, and Prayer for Relief.

[17] As one may imagine, by all accounts, this litigation was also extremely expensive. Based on one attorney's estimation, more than $50 million in fees had been expended by the time the Opinion was issued. These fees were incurred by more than 15 law and accounting firms, who represented competing interests in the case. Many more firms in secondary roles monitored the litigation and represented smaller players. (Brinkmann, *TOUSA Case Fees Eat Up More Than $50M*, South Florida Business Journal (October 23, 2009).)

III. THE OCTOBER 13, 2009 OPINION

Judge Olson's lengthy Opinion finds certain of the debtors - and in particular TOUSA's subsidiaries: (1) did not receive reasonably equivalent value in exchange for the liens they granted; (2) were insolvent both before and after the July 31 Transaction; and (3) were left with unreasonably small capital with which to operate their businesses as a result of the July 31 Transaction. Accordingly, the Court ruled the liens would be avoided as fraudulent transfers, and the value of the property conveyed (i.e., the mortgage liens) would be recovered for the benefit of the bankruptcy estate.[18]

The Court went on to opine at length that the interest in the tax refund pledged as security for one of the New Term Loans was perfected within the "preference period," and that permitting the New Term Loan lenders to retain the security interest would enable them to receive more than they would otherwise have received in a liquidation. The Court therefore ruled the security interest in the tax refund would also be avoided and recovered for the benefit of the bankruptcy estate.[19]

The Court found that that the New Term Loan lenders "did not act in good faith and were grossly negligent."[20] Citing to several factors, including TOUSA's "plummeting bond and stock prices,"[21] its falling numbers as reported in its SEC filings, and its credit rating downgrades,[22] the Court concluded that every single lender in the syndicate had "ample reason" to suspect TOUSA had been "skirting the edge of insolvency for months," and had reason to know the security pledged in connection with the July 31 Transaction could be an avoidable transfer by TOUSA's co-borrower subsidiaries.[23] The Court noted that "objective, publicly available information" provided sufficient notice of TOUSA's insolvency to all lenders. It explained that the best evidence was discovered in emails and testimony from key personnel at Citicorp and TOUSA, which the Court determined made it "clear that [Citicorp] had actual knowledge of the facts" that TOUSA was insolvent, and TOUSA's "Conveying Subsidiaries would not receive reasonably equivalent value at the time of the [July 31 Transaction]."[24]

The Court's Opinion rejected the lenders' attempts to enforce certain "savings clauses" contained in the New Term Loans. The Court reasoned that these "savings clauses"

[18] Opinion, pp. 2; 129-182. Under Federal Bankruptcy law, a fraudulent transfer is any transfer of a debtor's interest in property, or any obligation incurred by a debtor within two years before filing a bankruptcy petition, if the debtor received less than reasonably equivalent value and the debtor was insolvent on the date of the transfer or was rendered insolvent by the transfer, or was left with unreasonably small working capital, or the debtor intended to incur or believed that it would incur debts that would be beyond the debtor's ability to pay. (11 U.S.C. § 548.)

[19] Opinion, p. 2. A "preference" allows a bankruptcy court to set aside a transfer if: (1) the transfer was made on account of an antecedent debt; (2) the transfer was made while the debtor was insolvent; and (3) the transfer permitted the creditor to receive more than the creditor would have in the bankruptcy proceeding. (11 U.S.C. § 547.) Under section 547, a bankruptcy debtor is also presumed to be insolvent during the 90 days preceding the debtor's bankruptcy filing.

[20] Opinion, p. 115.

[21] Opinion, p. 117.

[22] Opinion, p. 118.

[23] Opinion, pp. 115; 123-124. In the Opinion, the Court referred to TOUSA's co-borrower subsidiaries as the "Conveying Subsidiaries."

[24] Opinion, p. 22-24; 104-115.

were unenforceable because it considered such clauses "efforts to contract around the 'core provisions' of the Bankruptcy Code," and such tactics, the Court instructed, "are invalid."[25] Revealing apparent frustration with the use of these so-called "savings clauses," Judge Olson wrote "[t]he savings clauses are a frontal assault on the protections that section 548 provides," and "they are, in short, entirely too cute to be enforced."[26] The Court went on to state "there is something inherently distasteful about really clever lawyers overreaching. Some problems cannot be drafted around."[27] Accordingly, the Court set aside all liens granted by TOUSA's co-borrower subsidiaries as collateral for the New Term Loans.

In reaching its legal conclusions, the Court referenced certain key facts and evidence influencing its determinations. For example, Judge Olson determined the July 31 Transaction closed despite the knowledge of TOUSA's insolvency by the lenders, in part because of the fact that TOUSA's management, advisors and lenders were expected to be paid very large fees if - and only if - the July 31 Transaction was consummated.[28]

The Court found similarly disconcerting the payment structure of the "solvency opinion"[29] provided by an advisory firm, AlixPartners, which warranted TOUSA's solvency prior to the close of the July 31 Transaction.[30] The lenders reportedly relied upon this opinion in agreeing to finance the July 31 Transaction settlement. The Court found the solvency opinion was not credible because, among other things, TOUSA had agreed to pay AlixPartners a $2 million fee for the opinion if it reached a conclusion of solvency, but only its hourly rates and costs, which would have been less than half that amount, if it concluded TOUSA was insolvent.[31]

Additionally, the Court observed that the syndicated New Term Loans included some Transeastern Lenders, who had apparently re-positioned themselves from being unsecured creditors of the failing Transeastern JV to being secured creditors of TOUSA and its subsidiaries. The Court believed this factor also supported a conclusion that TOUSA was insolvent both before and after the July 31 Transaction.[32]

In total, Judge Olson ordered $403 million (plus interest and fees) of the $421 million paid to the Transeastern Lenders in connection with the July 31 Transaction set aside as a fraudulent transfer and disgorged. He ordered the pledge of the $207 million tax refund invalidated as a preference and the fees and expenses paid in connection with the Settlement disgorged. He further ordered the lenders to pay the Committee's attorneys' fees and expenses

[25] Opinion, p. 140. The "savings clause" was found in section 10.20(d) of both the New Term Loans and states: "Each Borrower agrees if such Borrower's joint and several liability hereunder, or if any Liens securing such joint and several liability, would, but for the application of this sentence, be unenforceable under applicable law, such joint and several liability and each such Lien shall be valid and enforceable to the maximum extent that would not cause such joint and several liability or such Lien to be unenforceable under applicable law, and such joint and several liability and such Lien shall be deemed to have been automatically amended accordingly at all relevant times."
[26] Opinion, p. 140.
[27] Opinion, p. 140, fn. 49.
[28] Opinion, pp. 7-8, fn 1; 20-21; 24-25; 96; 123.
[29] This so-called "solvency opinion," prepared by AlixPartners, warranted that TOUSA (together with its subsidiaries) was solvent before, and would be solvent after, the July 31 Transaction.
[30] Opinion, p. 95.
[31] Opinion, pp. 25; 96.
[32] Opinion, p. 22.

and the debtors' estate "reimbursed" for the decline in value of the assets upon which the avoided liens had been granted.[33]

Not surprisingly, given the enormous amounts at stake, the lenders (led by Citicorp), have appealed Judge Olson's decision, challenging virtually all the factual and legal conclusions reached in his Opinion.[34]

IV. IMPLICATIONS

The Bankruptcy Court's decision is a striking example of the painful fallout that has resulted from the recent severe economic downturn, dubbed by many as the "Great Recession."[35] It teaches that lenders must expect to be charged with a duty of diligence and due care in assessing the solvency of their prospective borrowers. Specifically, the Court focused on the lender's duty to assess risk based not only on objective and publicly available information (e.g., SEC filings, stock prices, industry reports), but also on internal information from their prospective borrowers (e.g., emails, internal memoranda, Board presentations). The Court also makes clear that solvency opinions are not a "silver bullet" protecting against fraudulent transfer challenges, particularly when the expert receives what may appear to be an exorbitant fee contingent on an opinion warranting solvency.

Further, Judge Olson's Opinion serves as a reminder that "upstream" loan transactions[36] are riskier endeavors than other kinds of financing structures, and may be more likely than other structures to be susceptible to fraudulent transfer challenges which could result in substantial losses.

The Opinion also calls into question the protection afforded by commonly used "savings clauses" in the loan documents. If this portion of the Opinion is upheld on appeal, it is possible that these clauses will offer little to no protection in the event of a fraudulent transfer challenge to a security interest.

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[33] Opinion, pp. 149-150. This part of the ruling impacted the New Term Loan lenders, who may have been entitled to a return of the $403 million under U.S.C. § 548(c). The Court, however, found that the valuation in fraudulent transfer litigation is made in hindsight, and that lenders who do not act in good faith bear the risk of decreases in asset values that follow the transfer. This part of the ruling has the practical result of reducing, dollar for dollar, the $403 million that would otherwise have gone back to the New Term Loan lenders. Further, given the rapid and severe decline in value during the relevant period of the undeveloped land pledged as collateral to the New Term Loan lenders, the amount ultimately ordered to be reimbursed to the debtors' estate is likely to be substantial.

[34] *Citicorp North America, Inc. v. TOUSA, Inc., et. al.*, United States Bankruptcy Court Southern District of Florida Fort Lauderdale Division, Case No. 08-1435-JKO, Statement of Issues on Appeal, Filed 11/06/09.

[35] Isidore, *The Great Recession*, CNNMoney.com (March 25, 2009); Reuters, *U.S. Economy Data Mixed But Stronger Rebound Seen*, The New York Times (August 20, 2009); Gross, *The Recession Is…Over?* Newsweek (July 14, 2009).

[36] Upstream transactions occur where at least some of the money loaned by the lender goes upstream to the owners of the borrower. In this case, TOUSA's subsidiaries were co-borrowers, but the Opinion found that the money loaned to the subsidiaries was actually all for the benefit of TOUSA, the parent company.

Moreover, the Opinion reminds all who participate in complex financing transactions – including lenders, borrowers, financial advisors, and title insurers – to pay close attention to the tone and content of internal emails and other memoranda, which will be discoverable, and may prove damaging in ensuing Bankruptcy litigation.

Finally, this case serves as a cautionary tale to title insurers, who frequently encounter lenders' requests to insure "upstream" financings structured similarly to TOUSA's July 31 Transaction. Such requests may also include the specific request to eliminate the creditors' rights exclusion in states where those endorsements are available.[37] Because of restrictions on access to information (and often on time), and the different type of underwriting required for such coverage, title insurers may find themselves in the position of relying heavily on the representations of the insured lenders.[38] Under such circumstances, it is possible the insurer will not be in a position to fully comprehend the risks associated with a complex financing transaction. Given that California permits title insurers to offer endorsements for creditors' rights coverage, California title insurers will be wise to keep the outcome of this case in mind when contemplating the provision of such coverage.

V. **CONCLUSION**

This complex and important case has far reaching implications which may be significant enough to alter title insurance and lending practices nationwide. While the final outcome remains uncertain given the pending appeal, the Opinion's findings of fact and conclusions of law serve as a stark reminder that when the worst economic case scenario occurs, the fallout may be more painful and costly than anticipated.[39]

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[37] While this is not the case in all states, creditors' rights coverage is currently permitted in California. While the standard ALTA policies contain an express creditors' rights exclusion, ALTA standard Endorsement 21 and 21-06, and the corresponding CLTA Endorsement 131 and 131-06, eliminates the exclusion and provides coverage for losses resulting from an impairment of the insured interest due to an occurrence, on or before the policy date, of either a fraudulent transfer or a preference under bankruptcy, state insolvency or other creditors' rights laws.

[38] As Judge Olson's opinion in this case demonstrates, the lenders may themselves have limited access to the necessary risk-assessing information, or may be under outside pressures to close the financing despite evident risks.

[39] For those interested in further detail, the entirety of Judge Olson's Opinion may be accessed at the following URL: http://www.kccllc.net/documents/0810928/0810928091014000000000003.pdf