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## TOUSA: Do Lenders Have the Responsibility to Protect Borrowers from Their Own Bad Judgment?

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By now, most bankruptcy practitioners are aware that on Oct. 13, 2009, the U.S. Bankruptcy Court for the Southern District of Florida issued a 182-page opinion in the case of *Official Committee of Unsecured Creditors of TOUSA Inc. v. Citicorp N. Am. Inc.*,<sup>1</sup> in which the court found that obligations incurred and liens granted by certain subsidiaries of TOUSA Inc. were avoidable fraudulent transfers.



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The decision is notable for many reasons. The court itself recognized that the stakes were “enormous.”<sup>2</sup> Among other remedies, certain lenders were required to return more than \$400 million. Separate and apart from the sheer size of the amounts involved, the decision is notable for the fact that it invalidated so-called “savings clauses”—clauses that are designed to insulate lenders from fraudulent-transfer liability by limiting the amount of the liability of a guarantor to the largest amount at which the guarantor would still be solvent. However, what may be one of the most important take-aways from the decision (combined with two other recent decisions) is that lenders should be on notice that courts may now be examining past transactions with the benefit of 20/20 hindsight and the reality of the current economic climate, resulting in the view that the lenders’ actions should be held not only to greater

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scrutiny, but also to perhaps a lower standard to impose liability.

### Summary

TOUSA is a home-building company formed through the merger of many smaller companies. In 2005, a wholly-owned subsidiary of TOUSA and another entity entered into a joint venture referred to as the Transeastern joint

and the funds were used to satisfy the settlement with the Transeastern lenders.

Six months later, TOUSA and the conveying subsidiaries filed for chapter 11 on Jan. 29, 2008. The unsecured creditors’ committee sought to avoid the obligations incurred and liens granted by the conveying subsidiaries as fraudulent transfers. After a 13-day trial, the court granted the relief sought by the committee.

The court concluded that the conveying subsidiaries were insolvent before and after the closing of the financing transaction and were left with unreasonably small capital as a result of the transaction. The court also concluded that the conveying subsidiaries did not receive reasonably-equivalent value in

## Feature

venture (Transeastern). The joint venture was unsuccessful, and Transeastern defaulted on \$675 million of debt owed to its lenders (the Transeastern lenders). To settle the subsequent litigation (the Transeastern litigation), TOUSA agreed to pay the Transeastern lenders more than \$421 million.

The settlement of the Transeastern litigation was financed by a first-lien facility in the amount of \$200 million (provided by the first-lien lenders) and a second-lien facility in the amount of \$300 million (provided by the second-lien lenders). TOUSA and its subsidiaries (the conveying subsidiaries) were co-borrowers under the new loan facilities. The new financing was secured by a lien on substantially all assets of TOUSA and the conveying subsidiaries. The conveying subsidiaries were not defendants in the Transeastern litigation. The financing closed on July 31, 2007,

exchange for incurring the obligations and granting the liens. As previously noted, the court held that the savings clause was invalid and provided no protection for the first- and second-lien lenders. As a result, the court avoided the obligations incurred and liens granted by the conveying subsidiaries and required the Transeastern lenders to return more than \$400 million of the loan proceeds they had received in the settlement of the Transeastern litigation.

The court’s decision is very fact-intensive. The decision contains an extensive discussion of the expert testimony and the facts showing the deterioration of the real estate market in the months leading up to the closing. Of particular relevance to this article are the conclusions that the court made with respect to the conduct of Citi Corp., the administrative agent for the first-

<sup>1</sup> B.R. \_\_\_, 2009 WL 3519403 (Bankr. S.D. Fla. 2009).

<sup>2</sup> *Id.* at \*1.

and second-lien loans. For instance, the court stated that “Citi saw the proposed new financing as a highly attractive opportunity for fees.”<sup>3</sup> Of particular significance to the court was the fact that Citi structured the deal so that its maximum exposure on the loans would be less than the fees earned.<sup>4</sup> The court also noted that Citi agreed to amend an existing revolver so that TOUSA would avoid receiving a going-concern opinion from its auditors because such an opinion would endanger the fees to be earned on the new transaction.<sup>5</sup>

The court also criticized the due diligence conducted by Citi and noted that Citi failed to discover an internal TOUSA memo in which a TOUSA executive stated that the proposed financing would leave the company “over-leveraged” and at risk of “crashing and burning.”<sup>6</sup>

The court concluded that it was unreasonable for Citi to rely on the solvency opinion provided by the consultancy retained by TOUSA. The court criticized the opinion because it was provided on a contingent-fee basis and was based on projections provided by TOUSA’s management rather than independent projections.<sup>7</sup> The court stated that the opinion was nothing more than an engineered solution to the solvency problem.<sup>8</sup>

## Analysis

TOUSA provides a classic example of how bad facts make bad law. The court’s finding that upstream guaranties provided by the conveying subsidiaries were fraudulent transfers is actually not all that surprising. Upstream guaranties typically provide no consideration to the subsidiary providing the guaranty, and accordingly, it is easy to show that the subsidiary did not receive reasonably equivalent value in exchange for the transfer. That is precisely why lenders include savings clauses in the applicable loan documents and require the borrowing entities to obtain solvency opinions. What is significant is the extent to which the court focused on the fees earned in the transaction and conducted an after-the-fact criticism of the due diligence conducted by Citi.

What is surprising is the court’s view of a leveraged transaction that generated significant fees when such a transaction

was in line with the competitive lending market at the time the transaction was entered. With 20/20 hindsight, and through the scope of current economic challenges, it is clear that Hon. **John K. Olson** of the U.S. Bankruptcy Court for the Southern District of Florida thought that the lenders (and their professionals) made too much in fees off of the deal. It does not appear that the court thought the lenders took advantage of the borrower (who no doubt was a sophisticated financial player). Rather, what seems to be of great importance to the court is that now, in this economy, too much money was made off the deal—perhaps a “pigs get fat and hogs get slaughtered” approach. Also interesting is that the court noted that while TOUSA was already “dangerously overleveraged and in need of an infusion of capital,” it did not ascribe any culpability to the borrower for taking on an additional \$500 million in debt.<sup>9</sup> Additionally, it was established that the existing owner’s resistance to equity forced TOUSA to “take on excessive debt.”<sup>10</sup> The court then determined that Citi (as agent for the lending group) saw the proposed new financing as a “highly attractive opportunity for fees.”<sup>11</sup>

*Perhaps courts should revisit the concept that management and owners should be held accountable for their poor business judgment and that the lenders should not be saddled with the responsibility to protect borrowers from themselves.*

In the first instance, given the incredible overleverage of TOUSA and the dire prospects to borrow in the industry, are lenders not entitled to high fees to compensate for risk? Should lenders be penalized because the borrower, its owners and fiduciaries may not have executed good business judgment and incurred significant additional debt?

The court also took note that Citi knew the negative impact the transaction would have on the bondholders.<sup>12</sup> As a starting point, where was Citi’s fiduciary obligation to protect the bondholders?

The court acknowledged that Citi’s due diligence did not uncover the “crash and burn” risk held by some of senior management.<sup>13</sup> It is hard to see why this was Citi’s fault and why it would have mattered if Citi had known.

The court stated that Citi’s officers should have known that the housing market was spiraling downward in August 2007. Citi is a big organization with many resources at its disposal, but looking into a crystal ball is not one of them. Even if Citi could predict the future and see the handwriting on the wall in the housing market, again, why should Citi be held accountable for the borrowers’ (and owners’ and managers’) poor business judgment in taking on the new debt obligation? In fact, the court acknowledged that TOUSA’s CEO had a strong personal incentive to see the transaction consummated, which included, but was not limited to, a significant bonus.<sup>14</sup>

It is hard to see why Citi should be penalized for the CEO acting in his own best interest. The CEO specifically noted that the covenants proposed by Citi would “surely limit [its] ability to grow the business in the future” but concluded that the borrower did “not have a lot of choice” in the matter.<sup>15</sup> Of course, Citi proposed stringent covenants. Given the leveraged nature of the borrower, it is not surprising that it would do everything possible to protect its own interest and maximize its recovery—a concept that courts have specifically found does not rise to the level of any inequitable conduct.<sup>16</sup> The court did note that whether management was appropriately candid with its board, and whether the board exercised due care, were questions that went “well beyond the scope of what [he] was called to decide.”<sup>17</sup>

As the opinion continues, the court strongly criticized the lenders’ failure to challenge the continuing validity of TOUSA’s projections. In fact, the court stated that it was either “gross negligence or a willful decision—motivated by a desire to generate fee income—to turn a blind eye toward the obvious reality that TOUSA was in a death spiral.”<sup>18</sup> The court also determined that TOUSA did not provide Citi with an honest assessment of its prospects.<sup>19</sup>

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at \*13.

<sup>15</sup> *Id.* at \*14.

<sup>16</sup> See, e.g., *In re Three Flint Hill Ltd. Partnership*, 212 B.R. 292, 301 (D. Md. 1997) (“[I]t is now well settled that a creditor does not act in bad faith simply by pursuing its own self interest.”).

<sup>17</sup> *Id.* at \*51 n. 34.

<sup>18</sup> *Id.* at \*54.

<sup>19</sup> *Id.* at \*54-55.

<sup>3</sup> *Id.* at \*11.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 52-53.

<sup>8</sup> *Id.* at 80 n. 56.

<sup>9</sup> TOUSA, 2009 WL 3519403, at \*6.

<sup>10</sup> *Id.* at \*8.

<sup>11</sup> *Id.* at \*11.

<sup>12</sup> *Id.*

What the court ultimately concluded was that the lenders did not act in good faith and were grossly negligent.<sup>20</sup> The court noted that the lenders had “ample reason” to acknowledge that TOUSA was in a “difficult position” and that “every...lender had ample reason to suspect that TOUSA has been drifting towards the edge of insolvency for months.”<sup>21</sup> It was the court’s opinion that “nonetheless, Citi proceeded with the transaction, which generated very substantial fee income for Citi.”<sup>22</sup> On the other hand, the court noted that the borrower was overleveraged at the time of the closing and faced considerable risk of failure as a result of the transaction.<sup>23</sup>

The court did note that when Citi became aware of the possible fraudulent-transfer concerns via bondholders’ warnings, Citi demanded that the borrowers obtain a solvency opinion.<sup>24</sup> However, the court’s view of Citi’s diligence was that the “solution attempted to be engineered through the...solvency opinion reflects excessive cleverness rather than hard-headed, honest analysis of the economic reality” of the transaction.<sup>25</sup>

It appears that the court thought Citi knew or should have known factors that should have led them to not make the loan and to protect the borrowers from themselves. However, given the sophistication of the borrower, as well as the desperation that led to the desire to place even more debt into an already overleveraged situation, should the lenders have been the ones to make the call and attempt to protect the borrower from its poor business judgment? Fraudulent-transfer law aside, was it the lenders’ responsibility not to loan? In fact, the lenders are the ones who gave the borrower one last shot at even the prospect of turnaround. Should they now, in 20/20 hindsight of the failure of TOUSA to recover, coupled with the economic realities of the current market environment, be deemed to have been grossly negligent and have acted in bad faith? What was inherently wrong with making a very risky loan that a sophisticated borrower asked for, provided support for possible viability and even a picture that was definitely more rosy than realistic to support?

The trend toward the 20/20 look-back in light of current economic reality

<sup>20</sup> *Id.* at \* 63.

<sup>21</sup> *Id.* at \* 64.

<sup>22</sup> *Id.* at \* 67.

<sup>23</sup> *Id.* at \* 74.

<sup>24</sup> *Id.* at \* 80 n. 56.

<sup>25</sup> *Id.*

and lack of sympathy for lenders can also be seen in two other recent decisions—*In re Yellowstone Mountain Club LLC* and *ION Media Networks Inc.*<sup>26</sup> In *Yellowstone*, the court equitably subordinated the lenders’ claims and referred to the “naked greed” of the lenders and the fees charged.<sup>27</sup> In this regard, the decision represents another case where the outcome was driven, at least in part, by a court’s conclusion that a lender was improperly motivated by the prospect of generating substantial fees. In another very recent decision, *Ion Media*,<sup>28</sup> Hon. **James M. Peck** of the U.S. Bankruptcy Court for the Southern District of New York enforced an intercreditor agreement in its entirety against a hedge fund second-lien lender who purchased the debt for “pennies on the dollar.” In denying the second-lien lender’s standing to object even as an unsecured creditor, Judge Peck made it abundantly clear that in this economy the lender who purchased the debt at a discount should not seek supersize returns.<sup>29</sup> In fact, in one hearing, Judge Peck stated: “So you’re looking at a free shot to continue your *terrorism* in this case and different levels of the federal system?”<sup>30</sup> Strong words directed at a lender advancing what it perceives as its contractual rights in the bankruptcy case and the author thinks it would be very difficult to hear similar words spoken against a debtor’s attempts to make a last ditch effort to save its business.

## Conclusion

In the end, it is impossible to tell whether the result in TOUSA would have been any different had the fees been any less. Based on the court’s decision, it does appear that there was sufficient evidence to find that the conveying subsidiaries were insolvent at the time of the transfers. As previously noted, the holding that a subsidiary providing an upstream guaranty does not receive reasonably-equivalent value is not a new or novel concept. Nevertheless, the fees were an important factor in the court’s analysis and it is clear that the court thinks the lenders should not have made the loans (separate and apart from the fraudulent-transfer issues) because

<sup>26</sup> *In re Yellowstone Mountain Club LLC*, -- B.R. --, 2009 WL 3094930 (Bankr. D. Mont.), and Case No. 08-61570 (Bankr. D. Mont.).

<sup>27</sup> *Yellowstone*, 2009 W.L. 3094930 at \*9. Decision was ultimately withdrawn as part of settlement between the parties. See full discussion of the case at Brighton, Jo Ann and Parrish, Felton, “*Yellowstone*: New Standards for Lender Liability in Today’s Economic Climate,” *Am. Bankr. Inst. J. Vol. XXVIII*, No. 7 (September 2009).

<sup>28</sup> *ION Media*, 2009, WL 4047995 at \*1.

<sup>29</sup> *Id.*

<sup>30</sup> *In re ION Media Networks Inc.*, Case No. 09-13125 (Bankr. S.D.N.Y.) (Dec. 3, 2009 Hr’g Tr. at 13:1-3; 47:4-13) (emphasis added).

they knew or should have known that TOUSA could not repay them. Why was it the lender’s responsibility to protect the borrower from itself?

One irony of the *TOUSA* decision is that if it is upheld on appeal, it will cause borrowers to incur even greater fees and higher borrowing costs. Prudent lenders will no longer rely on management projections and will instead require solvency opinions based on projections prepared by independent consultants. Lenders will request more information in due diligence. The increased work that lenders will be forced to do to review a potential transaction will inevitably result in higher fees to borrowers.

The author suggests that while *TOUSA* will be discussed for the detailed fraudulent-transfer analysis that it contains, the finding that savings clauses are never enforceable and the merit of solvency opinions (and how the fees are structured), perhaps *TOUSA* may also be read as the beginning of a sea change that when bankruptcy judges now go back and review leveraged transactions under the bright lights of the current economic scrutiny (think TARP funds and the resultant scrutiny), it is the lenders with the deep pockets that are likely to come out on the losing end. Perhaps courts should revisit the concept that management and owners should be held accountable for their poor business judgment and that the lenders should not be saddled with the responsibility to protect borrowers from themselves. ■

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