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Recent Developments

RESTRUCTURING AND FINANCE DEVELOPMENTS

Bankruptcy Court Voids Subsidiary Guaranties and Liens as Fraudulent Transfers

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In a troubling decision for lenders, Judge John K. Olson of the Bankruptcy Court for the Southern District of Florida recently unwound a secured loan transaction on fraudulent transfer grounds, voiding the upstream guaranties and liens granted by the debtor subsidiaries in a loan transaction entered into six months prior to bankruptcy. *In re TOUSA, Inc.*, No. 08-1435, 2009 WL 3261963 (Bankr. S.D. Fla. Oct. 13, 2009).

In the challenged loan transaction, the parent debtor (TOUSA, Inc.) caused its key home building subsidiaries (referred to in the opinion as the "Conveying Subsidiaries") to incur liens and guaranties on $500 million in new secured debt, and used the bulk of the loan proceeds to settle litigation with a prior unsecured lender group, whose obligors had included the parent but not the Conveying Subsidiaries. Ruling in favor of the plaintiff unsecured creditors' committee, which principally represented the interests of more than $1 billion in bond debt that had been incurred several years before the secured loan, the bankruptcy court ordered a broad array of remedies that the court concluded were necessary to restore the Conveying Subsidiaries to the financial condition they would have enjoyed had the transaction never occurred. Those remedies included: disgorgement of over $400 million of loan proceeds paid to the old lenders that were attributable to the Conveying Subsidiaries; disallowance of the new lenders' liens and claims against the Conveying Subsidiaries; disgorgement of all principal, interest and fees received by the new lenders, including the fees of their advisors; payment of all fees and costs of prosecuting the adversary proceeding; and prejudgment interest of 9% per annum since the date of the transaction. In addition, the bankruptcy court held the new lenders liable for any diminution in the value of the Conveying Subsidiaries' property securing the new loans since the transaction date. Finally, the court avoided as a preferential transfer a lien on a $207 million tax refund granted by the parent to secure the new loan.

The *TOUSA* decision is significant in several respects. First, the court placed a substantial burden of due diligence and inquiry notice on the new lenders. The court extensively relied on selected evidence of financial distress from before, at the time of, and following the transaction to conclude that the new lenders should have known that the debtors were insolvent and inadequately capitalized at the time of the transaction. Much of the negative evidence cited by the bankruptcy court, however, was based on internal TOUSA emails and documents that were not contemporaneously available to the lenders, and "were considerably more pessimistic than TOUSA's projections" provided to the lenders to support the transaction. The court stated repeatedly that it was using evidence contemporary to the challenged loan transaction, but arguably took into consideration that it was now presiding over a chapter 11 case of homebuilders that "are grossly insolvent and are in a phased wind-down of their operations, heading to a liquidating Chapter 11 plan."

Second, the court held that the solvency opinion obtained to support the transaction was unreliable and inadequate to demonstrate the debtors' solvency. The court strongly criticized (i) the contingent fee arrangement whereby the compensation paid to the provider of the solvency opinion was dependent in substantial part on reaching the conclusion that the debtors were solvent, and (ii) the inclusion of customary disclaimers in the opinion noting that the provider had accepted and relied on management's projections without significant independent scrutiny or due diligence.

Third, the court found that contractual "savings

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clauses," a common protection in guaranties limiting the guarantor's liability to a level that will not result in insolvency, were invalid. The court found that because the Conveying Subsidiaries were insolvent before the transaction, any new lien or obligation was avoidable as a fraudulent transfer, and hence the savings clauses had no effect. In *dictum*, the court went on to rule, among other things, that even if the Conveying Subsidiaries had become insolvent after the transaction, the savings clauses would remain unenforceable because their effect would be to defeat the cause of action for fraudulent transfer, which constituted estate property: "[E]fforts to contract around the core provisions of the Bankruptcy Code are invalid." Going still further, the court found that the existence of multiple savings clauses, each of which purported to reduce obligations after accounting for other obligations, rendered them "circular," "*inherently* indeterminate," and thus "unenforceable as a matter of contract law."

Fourth, in ruling that the tax refund constituted a preferential payment, the court disregarded the fact that the lien on the tax refund had been granted well prior to the 90-day preference period. Instead, the court looked to the date that the tax refund accrued in order to avoid the payment as a preference. If followed by other courts, this could have negative implications for secured financings relying on liens against after-acquired collateral.

Fifth, the court held the new lenders liable for the diminution in value of the collateral securing their liens following the date of the transaction, theorizing that the estate had been deprived of the opportunity to dispose of the Conveying Subsidiaries' property prior to its depreciation. In doing so, the court effectively imposed consequential damages on the new lenders as a remedy for fraudulent transfer, which would represent a significant expansion of prior case law interpretations of the relevant statutory provisions imposing liability on transferees of fraudulent transfers.

Sixth, and finally, in determining the debtors' enterprise value to assess solvency, the bankruptcy court placed significant weight on what it termed the "Observable Market Value" method. Under this valuation approach, the court found that the sum of the market values of the company's actively traded debt and equity securities was the "textbook definition of enterprise value." In so finding, the court further extended a growing trend among the federal courts in relying on the trading values of securities of public companies to establish fair market value for purposes of determining solvency. See our earlier memo, Third Circuit Endorses Use of Market Evidence in Rejecting Challenge to Leveraged Spin-Off.

Unsurprisingly, the defendants in the *TOUSA* case have filed notices of appeal. The appellate decisions in the case are likely to provide important precedent in the law of fraudulent transfers and preferences.

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