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In Re Touse: Implications For Solvency Opinion Providers

Law360, New York (December 07, 2009) -- On Oct. 13, 2009, the U.S. Bankruptcy Court for the Southern District of Florida entered a final judgment against the senior lenders of liquidating homebuilder TOUSA Inc., in a fraudulent transfer proceeding.

Pursuant to federal bankruptcy law (the code), and New York and Florida state law, the court ruled that money lent to Touse by a group of first and second lien lenders before Touse and certain of its affiliates filed for bankruptcy protection on Jan. 29, 2008, constituted a fraudulent transfer.

The court cited Section 548(a)(1)(B) of the code, which permits the avoidance of any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred within two years before the date of filing of the petition, if the debtor received less than reasonably equivalent value in exchange for such transfer or obligation and met one or more of the following conditions:

- Was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation
- Was engaged in a business or transaction, or was about to engage in a business or transaction that left the debtor with an unreasonably small capital
- Intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured

Background

On July 31, 2007, Touse entered into a \$200 million first lien loan and a \$300 million second lien loan arrangement with a group of lenders.

Pursuant to these loans the lenders received fees, principal and interest payments, and, as collateral, a \$207.3 million tax refund that Tousea received in June 2008. Tousea used these loans to settle litigation by creditors against Tousea and one of its subsidiaries.

This lawsuit arose when Tousea defaulted on loans used to finance a failed business venture called Transeastern Properties Inc.

The Court's Ruling

In its ruling, the court stated the following:

Tousea and its subsidiaries were already insolvent before taking on the \$500 million in secured loans. The lenders should have known that Tousea was insolvent.

The Tousea subsidiaries that pledged their assets in the 2007 loan transaction were left with unreasonably small capital, and Tousea and its subsidiaries did not receive reasonably equivalent value for the liens that the new debt placed on its assets.

By way of background, courts apply the "balance sheet" test of insolvency for purposes of section 548(a)(1)(B)(ii)(I), which requires proof that the sum of the debts of a conveying entity is greater than the fair value of that entity's assets.

According to the court, in order to determine if Tousea had "unreasonably small capital" the court must ask whether the company had sufficient capital to support its operations in the event that the company's performance turned out to be below its expectations.

Lastly, in defining "reasonably equivalent value" the court cited other decisions for the principle that "reasonably equivalent value" in the context of a fraudulent conveyance requires a determination of the value that was transferred against the value that was received.

Under the court's analysis, the value received was not limited to the amount of actual cash transferred.

In its ruling, the court avoided the lenders' liens on the assets securing Tousea and its subsidiaries' \$500 million debt.

Further, the court ordered disgorgement of all fees, principal and interest payments, and the \$207 million tax refund paid to the lenders and return of such amounts to the Tousea estates.

The lenders who were paid in the 2007 settlement of the Transeastern dispute were also ordered to pay \$403 million plus interest back to the Tousea estates. The court's opinion is likely, however, to be appealed.

The Solvency Opinion

As part of the 2007 loan transaction, counsel for Capital Research and Management Company, a large investor in Touse bonds, delivered a letter to Touse's board that was highly critical of the proposed settlement with Transeastern, stating that the transaction could render Touse insolvent if the housing slump became a protracted one.

Touse sent this letter to its lenders, which in turn demanded on April 27, 2007, that Touse provide a solvency opinion as a condition of closing to the 2007 loan transaction.

The Contingent Fee Arrangement

Touse engaged Alix Partners to render a solvency opinion for Touse on a consolidated basis.

Interestingly, Alix's fee arrangement for the solvency opinion was what the court described as a "contingent fee arrangement."

According to the court, Touse agreed to pay Alix \$2 million if Alix ultimately opined that Touse would be solvent immediately following the 2007 loan transaction.

If Alix did not render such opinion, however, Touse would pay Alix only its time charges and reimburse its costs, which the court stated ultimately amounted to approximately half of the \$2 million fee.

The court criticized the contingent fee arrangement as casting doubt on the solvency opinion's credibility.

Further, the court noted that Alix's retention was finalized on June 15, 2007, and by June 20, 2007, Alix had indicated that it expected to deliver a favorable opinion.

This arrangement to provide a solvency opinion on a contingent, or success fee, basis is not a standard fee arrangement for a solvency opinion provider and, if accurately described by the court, would seem to provide an inappropriate incentive to render a favorable solvency opinion.

It is unlikely that Alix intended to enter into a contingent fee arrangement, and this highlights the need for careful drafting at the outset of an engagement.

Alix's Experience

The court stated that the lender's commitment letter "required a solvency opinion from a 'nationally recognized, independent financial advisory firm that has substantial experience in providing solvency opinions in connection with transactions similar to the Transactions contemplated hereby.'"

The court further stated that "Alix had not provided a solvency opinion for a homebuilder since sometime before 2005" and thus that Alix had an "apparent lack of experience."

The court's opinion did not, however, address the following issues:

- Whether Alix had done work for homebuilders during that time period in areas other than solvency opinions
- Whether any solvency opinion providers had provided a solvency opinion to a homebuilder in that time period
- How many solvency opinions Alix had provided in that time period

Experience in a particular industry is one factor to be considered to determine if a financial advisor has relevant experience, but that should not be limited to providing solvency opinions (solvency opinions, fairness opinions and valuation opinions are all really just different financial valuation exercises) and in any event should not be dispositive, especially if the financial advisor has experience in tangential or related industries (for example, real estate can be considered similar to homebuilding in certain respects).

For the most part, solvency opinion providers do not limit their experience to a single industry and in fact their experience usually spans across virtually all industries.

The lack of experience in rendering solvency opinions in a particular industry should not render a firm unable to give a credible solvency opinion to companies in such industry, particularly when the financial advisor has experience in that industry outside of solvency opinions (for example, in lending or M&A transactions).

In addition, limiting the period to two years seems unnecessarily brief given that 2003 and 2004 could also be considered part of the U.S. economy's growth period that ended in 2007.

The Process by Which Alix Rendered its Opinion

The court criticized Alix for relying on the financial projections provided by Touse's management in its discounted cash flow analysis of Touse's business without conducting an independent review of how accurate management's projections had been in the past.

The court also stated that Alix should have conducted a "bottoms up" analysis of Touse's business, meaning that Alix should have sought input from the lower levels of Touse's management instead of relying on the projections provided by Touse's top managers.

It is a standard practice for solvency opinion providers to rely on the financial projections that management provides to them without independently verifying those projections.

Such providers do not have the capacity, nor do they get paid, to do due diligence on, or audit, a company's financial projections.

Instead they rely on management's statements that the financial projections are accurate, the company's auditors vetting of the numbers and, in the case of a public company, statements filed under penalty of law with the U.S. Securities and Exchange Commission that the company's numbers are accurate.

Further, it is not typically within the solvency opinion provider's scope of engagement to inquire with middle management about the accuracy of financial projections provided by top management.

Conclusion

The bankruptcy court's opinion exemplifies the second-guessing that can confront solvency opinion providers and highlights some of the issues that such providers should carefully vet with experienced legal counsel not only when they are prepared to render such opinions, but also when they are structuring their fee arrangement in the early stages of such engagements.

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Citigroup is a client of McDermott Will & Emery LLP.

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