

Valuation Questions Raised by TOUSA

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Editor's Note: Please see the feature by Jo Ann J. Brighton on page 18 of the February 2010 Journal for an analysis of different aspects of the TOUSA case.

Lenders and their lawyers are trying to determine how best to deal with the bankruptcy court decision in the *TOUSA Inc.* case¹ that, among other things, stated that "savings clauses" commonly found in guarantees are not enforceable.² The debate that *TOUSA* has kicked off on that issue will not subside anytime soon, but in the meantime, the opinion also contains much that is of interest to the issue of business valuations in a bankruptcy case, and on how insolvency (or not) should be determined in a fraudulent-transfer case.

Insolvency Is a Key Element of a Fraudulent-Transfer Case



John C. "Kit" Weitnauer

At its simplest, a transfer (or the inurrence of an obligation) is "constructively fraudulent" if the debtor made the transfer (or incurred the obligation) without receiving a reasonably equivalent value in exchange for the transfer (or obligation) and the debtor was insolvent at that time. Insolvency is actually just one of three alternative conditions (the "financial condition tests") that will satisfy the statute. Specifically, §548(a) of the Bankruptcy Code provides:

The trustee may avoid any transfer...of an interest of the debtor in property...that was made...on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(B) (i) received less than a reasonably equivalent

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value in exchange for such transfer...; and (ii) (I) was insolvent on the date that such transfer was made...or became insolvent as a result of such transfer...;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was

similar provisions. In a fraudulent-transfer case brought under UFTA, UFTA provides that a "debtor who is generally not paying his [or her] debts as they become due is presumed to be insolvent." UFTA §2(b). However, there is no similar presumption when a fraudulent-transfer case is brought under §548. When a company files for bankruptcy, both state law and §548 can be relied on to avoid transfers as constructively fraudulent.

Factual Background of TOUSA

TOUSA and its subsidiaries were in the business of designing, constructing, marketing and selling residential real estate developments and the homes in them. In June 2005, Homes LP, a wholly-owned TOUSA subsidiary, formed a joint venture (JV) with a third party to acquire homebuilding assets in Florida, and the JV incurred debt to certain lenders (the Transeastern

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an *unreasonably small capital*; [or] (III) *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...*³

The Code generally defines "insolvent" to mean an entity's "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."⁴ This is often referred to as the "balance sheet test," even though the fair value of the entity's property, and its debts, will almost always bear little resemblance to the values shown on the balance sheet that is part of its financial statements. Most states have enacted a version of the Uniform Fraudulent Transfer Act (UFTA) that contains substantially

lenders). TOUSA and Homes LP executed certain guaranties in favor of the Transeastern lenders. On Oct. 30, 2006, demand was made on TOUSA and Homes LP under these guarantees. Various lawsuits were filed, but on July 31, 2007, a settlement was reached with the Transeastern lenders, and pursuant to that settlement, TOUSA paid more than \$421 million to the Transeastern lenders to satisfy their claims.

To make this payment, TOUSA borrowed \$500 million. Certain TOUSA subsidiaries (the conveying subsidiaries), none of which had been partners in the JV or guarantors of the JV's debt to the Transeastern lenders, became obligated for the payment of the new loans, and they granted liens on substantially all of their assets to secure performance of their obligations (collectively, the "July 31 transaction").

Just six months later, TOUSA and most of its subsidiaries, including all of the conveying subsidiaries, filed voluntary petitions for relief under the Bankruptcy Code. The unsecured creditors' committee sued the lenders that participated in the July 31 transaction, seeking (among other

¹ Official Comm. of Unsecured Creditors of TOUSA Inc. v. Citicorp N. Am. Inc. (In re TOUSA Inc.), No. 08-10928, 2009 WL 3261963 (Bankr. S.D. Fla. Oct. 13, 2009), amended, 2009 WL 3519403 (Bankr. S.D. Fla. Oct. 30, 2009).

² Savings clauses are designed to prevent upstream guarantees of a loan (and the liens on the guarantors' assets that are given to support the upstream guarantees) from being avoided as constructively fraudulent under state law or bankruptcy law by limiting the amount recoverable under the guarantee to an amount that would not render the guarantee constructively fraudulent.

³ 11 U.S.C. §548(a) (emphasis added). Transfers and obligations can also be avoided under fraudulent-transfer law when they are made with "actual intent to hinder, delay or defraud." Id. Whether or not the debtor was insolvent at the time of such a transfer is relevant circumstantial evidence in determining actual intent. See, e.g., Unif. Fraudulent Transfer Act §4(b)(9), 7A Pt. 2 U.L.A.2.

⁴ 11 U.S.C. §101(32). The definition contains certain exclusions, and provides different definitions that are applicable to partnerships and municipalities.

things) to avoid the liens granted by the conveying subsidiaries as constructively fraudulent and recover the proceeds paid to the Transeastern lenders.⁵ The bankruptcy court found that: (1) the conveying subsidiaries were insolvent prior to the July 31 transaction; (2) the July 31 transaction left the conveying subsidiaries with “unreasonably small capital;” and (3) the “inability to pay debts” prong of §548 was satisfied.

Balance-Sheet Test of Insolvency

Much of what the court stated about the principles of valuation was in no way out of the ordinary. The bankruptcy court focused on the “fair valuation” of the assets⁶ of the conveying subsidiaries, concluding in that regard that “fair valuation” is the same concept as “fair-market value.”⁷ Further, the court found that “fair-market value is the price that a hypothetical, fully-informed, willing buyer would have paid a willing seller on the valuation date, assuming a reasonable time to sell the property and no undue pressure on either party.”⁸ Said another way, “[w]hat would a buyer be willing to pay for the debtor’s entire package of assets and liabilities[?] If the price is positive, the firm is solvent; if negative, insolvent.”⁹

The court rejected the defendants’ argument that it was “inappropriate or impossible to determine the solvency of individual Conveying Subsidiaries because TOUSA and its subsidiaries collectively operated as a ‘common enterprise’...[and] that this common enterprise should be examined on a consolidated basis.”¹⁰ The court correctly pointed out that the statute “requires consideration of whether ‘the debtor’ was insolvent and, because each of the Conveying Subsidiaries is a separate and distinct ‘debtor,’ each must be considered separately.”¹¹

The court adopted the valuation opinion of the plaintiff’s expert, and, regarding the valuation of each of the conveying subsidiaries, the court approved a valuation of each subsidiary “as a going-concern that would be sold to a buyer of a business or a portion of a business, rather than the value of individual assets that would be sold at retail through a potentially lengthy

wind-down process.”¹² In its findings, the court reviewed in detail the steps of each expert’s analysis.¹³ One point repeatedly made by the court was that the experts limited themselves to information known as of July 31, 2007, which, as a general rule, is the proper methodology to avoid the improper influence of “hindsight” when offering a valuation opinion some time in the past.¹⁴

Methods of Valuation

More interesting, however, was the court’s approval of valuation methods. The court found that one of the plaintiff’s business-valuation experts demonstrated insolvency under three valuation methods: (1) “Observable Market Value;” (2) “comparable companies;” and (3) discounted cash flow.¹⁵ The last two methods are well-established valuation methods, the details of which can be found elucidated in-depth in universally-recognized treatises on valuation¹⁶ and have been accepted by bankruptcy and other courts for decades.¹⁷

The first method is not well established—yet, anyway. Indeed, it had been the subject of a *Daubert*¹⁸ motion in the *TOUSA* case, which the court denied without much in the way of explanation in this opinion (the court did declare that it was “commonly used” and did note that experts for both sides used the method). As an initial matter, the court’s reliance on this valuation method is puzzling because it had *rejected* the defendant’s argument that the valuation should be performed on a common-enterprise basis, and here the observable market value method could *only* give an indication of value at the parent level—

thus, on a common-enterprise basis. As the court explained, “[t]he Observable Market Value method calculates a public company’s TEV [total enterprise value] on a certain date by adding the market value of the company’s publicly traded debt and equity securities on that date and subtracting its cash.”¹⁹ Then, “the face value of the debt [less]...cash (which could be used to pay off that debt)”²⁰ is subtracted from TEV: If the result is positive, the company is solvent; if not, it is insolvent. Given the court’s decision that the only question before it was whether *each* subsidiary, as a transferring debtor, met the financial condition tests, even if this method met the relevant tests for admissibility, there would appear to be no reason to consider it.

The court characterizes this method as a “balance sheet test”²¹ but admits that the market values of the company’s securities represent only a “proxy”²² for the “fair value of the assets.” This acknowledgement alone casts doubt on the propriety of using this method when the Bankruptcy Code requires a “fair valuation” of an entity’s property.²³

It is also not clear whether the court applied the proper test when determining to allow this method as part of the valuation evidence. While the court characterized the TEV as “a commonly used concept,” the Supreme Court in *Daubert* ruled that the long-standing “general acceptance” test for expert testimony was displaced with Federal Rule of Evidence 702.²⁴ For scientific evidence, at least, the Supreme Court set out two questions that should be answered: (1) Can the technique be (and has it been) tested; and (2) has the technique been subject to peer review and publication? The Court also stated that a court should consider the technique’s known or potential rate of error. Finally, the Court also acknowledged that the degree of “general acceptance” of a technique can have a bearing on the question of admissibility.²⁵ Clearly, finding only that a method is “commonly used” does not match the standards imposed by the Supreme Court.

One of the defendants’ responses to the observable market method was that

⁵ The committee also sought to avoid as a preference the grant of a security interest in a \$207 million federal-income tax refund, which lien was contemplated by the July 31 transaction, but not perfected until 2008.

⁶ In ordinary cases, debts do not need to be valued, but sometimes this is not true for contingent or disputed debts.

⁷ 2009 WL 3519403, at *70.

⁸ *Id.*

⁹ *Id.* at *72 (quoting *Covey v. Commercial Nat’l Bank of Peoria*, 960 F.2d 657, 660 (7th Cir.1992)).

¹⁰ *Id.* at *73.

¹¹ *Id.*

¹² *Id.* at *72.

¹³ The details of the steps of the experts’ opinions are beyond the scope of this article.

¹⁴ There are exceptions to the “no hindsight” rule. See Ian Ratner, Grant T. Stein and John C. Weitnauer, *Business Valuation and Bankruptcy*, at p. 136, *et seq.*

¹⁵ 2009 WL 3261963 at *71.

¹⁶ See, e.g., Shannon P. Pratt, *Valuing a Business* (5th Ed. 2008).

¹⁷ See, e.g., *In re Med Diversified Inc.*, 334 B.R. 89 (Bankr. E.D.N.Y. 2005) (discusses three long-accepted valuation methods and importance of using accepted valuation methods). This case and others put the discounted cash-flow method at the center of accepted valuation methods in bankruptcy matters. See also *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510, 526 (1941):

As Mr. Justice Holmes said...“the commercial value of property consists in the expectation of income from it...” It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity. The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster... Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances [that] indicate whether or not that record is a reliable criterion of future performance.

¹⁸ *Daubert v. Merrell Dow Pharms. Inc.*, 509 U.S. 579, 589 (1993) (“the trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable”).

¹⁹ 2009 WL 3519403 at *38.

²⁰ *Id.*

²¹ *Id.* at *37.

²² *Id.*

²³ 11 U.S.C. §101(32).

²⁴ 509 U.S. at 593-94.

²⁵ *Id.*

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“TOUSA’s positive market cap (the total value of outstanding public and private shares)—which was \$170.5 million...cuts against [the TEV] opinion that TOUSA was insolvent.”²⁶ Indeed, other courts have relied heavily on a positive market cap when finding that a company was solvent at the time of a transfer that is later challenged as a fraudulent transfer.²⁷ In this case, however, the court found that market value of common stock is almost completely unreliable as a measure of value when a company is perceived to be in financial distress (“[e]conomic rationality appears to play little role in

such matters”).²⁸ While it was argued that the market for debt instruments might not be “efficient” (and therefore, not a reliable indication of value in this method), the court found that there was no evidence the depressed trading prices for TOUSA’s bonds “resulted from any factors other than the market’s perception of the depressed fair value of TOUSA’s assets.”²⁹ Given the many contrasting views on the importance—or lack thereof—of market prices of various securities on a determination of value, it may be premature to declare the observable-market method a sufficiently reliable method of valuation.

“Time of Transaction” Solvency Opinion was Unreliable

There is at least one additional valuation issue in the *TOUSA* opinion that is especially noteworthy. Lenders often obtain “solvency opinions” from outside experts in connection with loans to corporate groups. This happened here, but it did not help. In connection with the July 31 transaction, a nationally recognized firm was retained to provide a solvency opinion. The court discounted this opinion in its entirety for several reasons.³⁰

First, the firm was compensated on a contingency-fee basis: The firm could earn a \$2 million “premium” only upon the issuance of an opinion finding solvency, which dwarfed the amounts payable to the firm on a time and expense basis if it were unable to give an opinion of solvency. Second, the firm relied entirely on projections provided by TOUSA’s management and never examined individual divisions or community-level projects. Third, TOUSA failed to revise these projections

to account for the collapse in the housing market, of which TOUSA management was well aware, as demonstrated by numerous internal discussions and memoranda. Fourth, the projections were far more optimistic than those that TOUSA was utilizing internally, with the “base case” provided to the firm allowing for far higher growth in TOUSA’s business than the “best case” presented to the board of directors in a presentation occurring just four days after the July 31 transaction closed. Fifth, the firm based its valuation on EBITDA multiples, which experts for both the plaintiffs and the defendants agreed was inappropriate and unreliable given TOUSA’s business.

Conclusion

The *TOUSA* opinion got at least one issue right: An expert’s “opinion” is worth little or nothing if the expert is conflicted. Experts are entitled to get paid for their work, but when they get paid more for a particular answer, courts usually conclude that such an opinion lacks credibility. “Papering the file” will not help a lender’s argument regarding solvency at the time of the transaction, or the lender’s good-faith defense, when the “paper” can be dismissed out of hand as biased or lacking credibility. Otherwise, however, a well-reasoned and supported solvency opinion may be a worthwhile step to take as part of the underwriting of a loan.

It is not as clear whether the *TOUSA* opinion was justified in approving the observable-market method as a reliable methodology to prove value. Given other language in the opinion, it may be correct to characterize it as *dicta*. Even so, this court has approved it, and as such, it can be expected that it will be the subject of testimony—or *Daubert* challenges—for some time to come. ■

²⁶ 2009 WL 3519403 at *39.

²⁷ See, e.g., *Statutory Committee of Unsecured Creditors v. Motorola Inc. (In re Iridium Operating LLC)*, 373 B.R. 283, 346-47 (Bankr. S.D.N.Y. 2007).

This Court considered contemporaneous valuations of Iridium, notably evidence of Iridium’s stock price and the assessments of market analysts. A company’s stock price is an “ideal datapoint” for determining value. *VFB LLC v. Campbell Soup Co.*, No. Civ. A. 02-137, 2005 WL 2234606, at *22 (D. Del. Sept.13, 2005). The Court in *VFB* recognized the advantage of contemporaneous market evidence as being “untainted by hindsight or post-hoc litigation interests” and found it important to consider the company’s stock price and the opinions regarding value of other contemporaneous market participants. *Id.*

The Third Circuit, in *VFB*, affirmed the district court’s “primary” reliance on the stock price and market-based valuations as a measure of value. *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 at 631. The Court reasoned that “[e]quity markets allow participants to voluntarily take on or transfer among themselves the risk that their projections will be inaccurate.” *Id.* The Court further noted that market capitalization reflects all the information that is publicly available about a company at the relevant time of valuation. *Id.* (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 245, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988)).

Absent some reason to distrust it, the market price is “a more reliable measure of the stock’s value than the subjective estimates of one or two expert witnesses.” *VFB*, 482 F.3d at 633; *In re Prince*, 85 F.3d 314, 320 (7th Cir.1996); see also *In re Hechinger Investment Co. of Del.*, 327 B.R. 537, 548 (D. Del. 2005); *Peltz v. Hatten*, 279 B.R. 710, 738 (D. Del. 2002); *Metlyn Realty Corp. v. Esmark Inc.*, 763 F.2d 826, 835 (7th Cir.1985) (“[T]he price of stock in a liquid market is presumptively the one to use in judicial proceedings.”).

The Supreme Court in *Basic v. Levinson*, 485 U.S. at 244, 108 S.Ct. 978, explained the importance of market price in determining value:

“With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.”

²⁸ 2009 WL 3519403, at *39.

²⁹ *Id.*

³⁰ 2009 WL 3519403, at *52.

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