

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF FLORIDA
FORT LAUDERDALE DIVISION

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In re:)	Chapter 11 Cases
)	
TOUSA, INC., <u>et al.</u> ,)	Case No. 08-10928-JKO
)	
Debtors.)	Jointly Administered
)	

OBJECTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF TOUSA, INC., ET AL., TO DEBTORS’ MOTION FOR ENTRY OF AN ORDER AUTHORIZING THE DEBTORS TO PAY CERTAIN LEGAL FEES AND COSTS RELATING TO SECURITIES INVESTIGATION TO CERTAIN OF THE DEBTORS’ DIRECTORS AND OFFICERS

The Official Committee of Unsecured Creditors (the “Committee”) of TOUSA, Inc., et al. (collectively, the “Debtors”), by and through its undersigned counsel, hereby files this objection (the “Objection”) to the Debtors’ Motion for Entry of an Order Authorizing the Debtors to Pay Certain Legal Fees and Costs Relating to Securities Investigation to Certain of the Debtors’ Directors and Officers [D.E. #1928] (the “Motion”). In support of this Objection, the Committee respectfully submits as follows:

OBJECTION

1. By the Motion, the Debtors request authority to pay prepetition unsecured claims of their former Chief Executive Officer¹ and current Chief Financial Officer (the “Officers”). Specifically, the Debtors seek permission to pay for legal fees (the “Legal Fees”) incurred by the Officers in connection with an investigation conducted by the Debtors’ audit committee and an

¹ By an order of this Court dated August 18, 2008 [D.E. #1648], the former CEO relinquished his position as of August 31, 2008 and agreed to continue solely in his capacity as Executive Vice-Chairman of the Board until the earlier of (i) December 31, 2008; (ii) the effective date of a plan of reorganization in the Debtors’ chapter 11 cases; and (iii) thirty days following the delivery of notice from either party of an intention to terminate the agreement

informal inquiry conducted by the Securities and Exchange Commission (the “SEC”). The Debtors’ obligations to indemnify the Officers, however, arise from prepetition indemnification agreements (the “Agreements”) and TOUSA, Inc.’s certificate of incorporation (the “Certificate”) and, thus, the indemnification claims are prepetition general unsecured claims that are not entitled to be paid outside of a plan of reorganization. Accordingly, the Motion must be denied.

2. The law is well settled that a debtor’s obligation to reimburse an officer or director for fees and expenses incurred postpetition pursuant to an indemnity agreement executed before the petition date creates a prepetition claim. *In re Mobley*, 377 B.R. 406, 408 (Bankr. M.D. Fla. 2007) (“when parties agree in advance that one party will indemnify the other party in the event of certain occurrences, there exists a right to payment, although contingent, upon signing the agreement.”); *In re Mid-American Waste Systems, Inc.*, 228 B.R. 816 (Bankr. D.Del. 1999) (finding that indemnification claims arising under a certificate of incorporation are not administrative expense claims). Expenses incurred after the petition date, but which will be indemnified under a prepetition agreement, are not elevated to postpetition claims by virtue of the date the applicable services are rendered. *In re Wilbur*, 237 B.R. 203, 209 (Bankr. M.D. Fla. 1999); *see also In re Peltz*, 55 B.R. 336, 338 (Bankr. M.D. Fla. 1985); *In re Yanks*, 49 B.R. 56 (Bankr. S.D. Fla. 1985) (where “all operative acts and legal relationships occurred prior to the commencement of the case” a postpetition judgment did not give rise to a postpetition administrative expense). As the indemnification claims arise from prepetition agreements that have not been assumed (*i.e.*, the Agreements and the Certificate), the Motion must be denied as a matter of law.

governing the former CEO’s retention. When the Legal Fees were incurred, both Officers were members of the Board of Directors and compensated as such.

3. The Debtors attempt to justify payment of the Legal Fees on “several legal theories” including, among others, (i) the Debtors’ business judgment and (ii) the doctrine of necessity. The Debtors’ reliance on these theories is legally misplaced and entirely devoid of any evidentiary support.²

4. The Debtors assert that their decision to pay the Legal Fees as administrative expenses is supported by their business judgment and Bankruptcy Code sections 1107(a), 1108, and 363(b). In support of this position, however, the Debtors only cite cases in which a debtor was authorized to make payments to non-insider creditors in order to facilitate its reorganization. *See, e.g., In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15 (Bankr. M.D. Fla. 2005) (discussing sound business justification, along with other elements that must be demonstrated to pay prepetition claims of “critical vendors”); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) (approving prepetition wage and medical benefit payments to active airline employees, but denying payment to striking employees); *Armstrong World Indus., Inc. v. James A Phillips, Inc.*, (*In re James A. Phillips, Inc.*), 29 B.R. 391, 397 (S.D.N.Y. 1983) (approving payments to unsecured creditors who would have had state law lien rights in the absence of payment). The Debtors have not cited to and cannot cite to any legal precedent for the specific relief they request.

5. Moreover, a debtor’s decision to make payments to insiders is subject to heightened scrutiny in order to protect creditors from potentially self-serving decisions. *See Matter of Multiponics, Inc.*, 622 F.2d 709, 714 (5th Cir. 1980) (with respect to payment of insider claims, the court must “sift through the circumstances surrounding the claim to see that injustice

² The Committee has indicated to the Debtors its intention to seek discovery in connection with the Debtors’ contentions, and the Debtors have confirmed that the hearing on January 9th will not be an evidentiary hearing. The Committee intends to take discovery prior to any evidentiary hearing.

or [u]nfairness is not done in administration of the bankruptcy estate”) (citations omitted); *In re Beverages Int’l Ltd.*, 50 B.R. 273, 281 (Bankr. D. Mass. 1985) (“Where a claimant is an insider or an affiliate of the debtor, or where the creditor exercises control over or domination of the debtor, his dealings with the debtor are subject to strict scrutiny”) (citing *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)). In the instant case, where unsecured creditors holding well over \$1 billion in unsecured claims will not receive a material recovery on their claims absent the successful prosecution of the Committee’s pending avoidance actions, payment of the Legal Fees would not only run afoul of the Debtors’ business judgment, it would be inequitable.

6. Similarly, the doctrine of necessity, which is rooted in the equitable provisions of Bankruptcy Code section 105(a) and typically applied where a debtor seeks to pay critical vendors, does not provide the Debtors with a basis to pay the Legal Fees. Courts generally hold that the payment of prepetition claims under section 105(a) (coupled with section 363) should only be allowed where there is evidence that a vendor would cease doing business with the debtor unless the vendor receives the payment at issue. The Third Circuit, in *In re Lehigh and New England Ry. Co.*, 657 F.2d 570, 581-82 (3rd Cir. 1981), set forth in detail the requirements of necessity:

[T]he *sine qua non* for the application of the “necessity of payment” doctrine is the possibility that the creditor will employ an immediate economic sanction, failing such payment. In such a circumstance, it is evident that the payment made under the “necessity of payment” rule is in the interest of all parties, including the mortgagees, because such payment will facilitate the continued operation of the [business].

7. The use of estate funds to pay in full the unsecured prepetition claims of insiders does not equate to the payment of a critical vendor claim under the doctrine of necessity. First,

the Officers have not threatened to withhold necessary services going forward.³ Indeed, as of January 1, 2009, the former CEO will provide no further services to the Debtors. Second, the doctrine of necessity contemplates that both a debtor and its creditors will be benefited by payments to a critical vendor in that the vendor will continue to provide the debtor with necessary services and/or goods. The payment of the Legal Fees does not, however, provide the Debtors or creditors of these estates with such a benefit.⁴

8. Accordingly, the Debtors' theories based on business judgment and the doctrine of necessity have no legal or factual support and must be rejected.

³ If the Debtors are seeking to pay the Legal Fees because such payment is essential to retention of the Officers, the Debtors must demonstrate that the payments meet the requirements of Bankruptcy Code section 503(c)(1). Specifically, the Bankruptcy Code requires the Debtors to show that the payment is essential because the employee (i) has an alternative job offer at equal or greater compensation, (ii) is essential to the Debtors' businesses, and (iii) that the payment is not disproportionate to payments made to similarly situated employees. 11 U.S.C. 503(c)(1). As the Debtors have not offered any evidence on these elements, the Legal Fees cannot be approved under Bankruptcy Code section 503(c)(1).

⁴ The Debtors argue that failure to pay the Legal Fees will create personal hardship for the Officers. Motion at ¶22. However, both Officers are well compensated. The CFO earns a base salary of \$750,000, with the potential for a bonus of 100% of his base salary. *See* TOUSA, Inc. Form 10-K filed August 12, 2008. In 2007, the former CEO earned in excess of \$2.8 million and, since his resignation as CEO, continues to receive \$300,000 annually for his service as a director. *See* TOUSA, Inc. Form 10-K filed August 12, 2008 and Debtors' Motion for Entry of an Order Pursuant to Section 363(b) of the Bankruptcy Code Authorizing the Debtors to Modify Certain Terms of the Executive Vice-Chairman Agreement [D.E. #1497].

CONCLUSION

WHEREFORE, for all the foregoing reasons, the Committee respectfully requests that this Court (i) deny the relief sought in the Motion; and (ii) grant the Committee such other and further relief as this Court deems just, proper, and equitable.

Dated: January 2, 2009

Respectfully submitted,

I hereby certify that I am admitted to the Bar of the United States District Court for the Southern District of Florida and I am in compliance with the additional qualifications to practice in this court set forth in Local Rule 2090-1(A).

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-and-

We hereby certify that the undersigned attorneys are appearing pro hac vice in this matter pursuant to Court orders dated February 27, 2008 and March 3, 2008.

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