Bankruptcy ADVISORY

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TOUSA Redux: The Eleventh Circuit Court of Appeals Affirms Bankruptcy Court's Avoidance of Constructively Fraudulent Transfers and Reverses the District Court

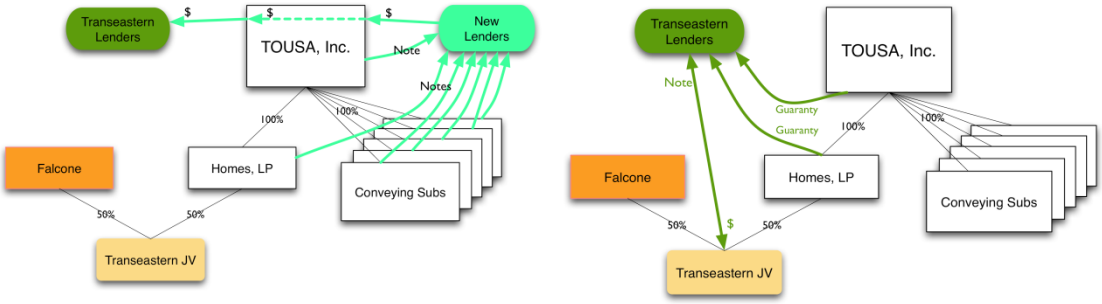
The outcome of the *TOUSA* appeal has been much anticipated and closely watched by the lending community, their counsel and advisors, and legal scholars. On May 15, 2012, the Eleventh Circuit Court of Appeals issued its opinion (found here), reversing the District Court for the Southern District of Florida and affirming the Bankruptcy Court for the Southern District of Florida, at least insofar as to the bankruptcy court's factual findings, but not remedies. The appellate court held that the bankruptcy court got it right when (a) it avoided as fraudulent transfers the liens granted by certain TOUSA subsidiaries (the "Conveying Subsidiaries") to TOUSA's new lenders and (b) required disgorgement of the $403 million in loan proceeds paid to certain lenders (the "Transeastern Lenders"). "We hold that bankruptcy court did not clearly err when it found that the Conveying Subsidiaries did not receive reasonably equivalent value for the liens and that the bankruptcy court correctly ruled that the Transeastern Lenders were entities 'for whose benefit' the liens were transferred."

Brief Background:

TOUSA and its subsidiaries were in the business of designing, constructing, marketing and selling detached single-family residences, town homes and condominiums.

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 the Transeastern Lenders. TOUSA and Homes LP executed certain guaranties in favor of the Transeastern Lenders. On October 30, 2006, demand was made upon 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 over $421 million to the Transeastern Lenders to satisfy their claims.

To make this payment, TOUSA borrowed $200 million under a first-lien term loan facility and $300 million pursuant to a second-lien term loan facility. To obtain these new loans, 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 these new loans and granted liens on substantially all of their assets to secure performance of their obligations (collectively, the "July 31 Transaction"). A chart illustrating the July 31 transaction follows:



Just six months later, on January 29, 2008, TOUSA and most of its subsidiaries, including all of the Conveying Subsidiaries, filed voluntary petitions for relief under the Bankruptcy Code. The United States Trustee appointed the Official Committee of Unsecured Creditors (the "Committee") to represent the interests of unsecured creditors (primarily bondholders owed slightly more than $1 billion). The Committee sued all of the lenders who participated in the July 31 Transaction, including the agent bank, Citicorp North America, Inc. ("Citi") (the "New Money Lenders"), seeking to (i) avoid (a) the liens against the Conveying Subsidiaries' assets and (b) the underlying obligations of the Conveying Subsidiaries to the New Money Lenders and (ii) recover the approximately $420 million paid to the Transeastern Lenders. The Eleventh Circuit's opinion further chronicles in great detail the events leading to TOUSA's demise.

Bankruptcy Court Ruling:

After TOUSA and the Conveying Subsidiaries filed bankruptcy, the Committee filed an adversary proceeding against the New Money Lenders and the Transeastern Lenders to avoid as a fraudulent transfer the transfer of the liens to the New Money Lenders and recover the value of the liens from the Transeastern Lenders. On October 13, 2009, the Bankruptcy Court issued its opinion, which (a) avoided the Conveying Subsidiaries' obligations to the New Money Lenders and the liens to secure such obligations, (b) held that the Transeastern Lenders were liable as entities "for whose benefit" the lien transfers were made and (c) held that the Transeastern Lenders were direct transferees of the $421 million from the proceeds of the New Money Lenders' loans.

District Court Ruling:

On appeal, the district court quashed the bankruptcy court's ruling regarding the liability of the Transeastern Lenders, holding that the bankruptcy court had, as a matter of law, too narrowly defined "value."[1] The district court concluded that indirect benefits, such as the ability to avoid bankruptcy, could constitute "value" under section 548(a). Specifically, the Transeastern Lenders and New Money Lenders asserted that the July 31 Transaction gave the Conveying Subsidiaries the opportunity to avoid bankruptcy, continue as going concerns and make further payments to their creditors. The district court held that these benefits did not need to be quantified to establish reasonably equivalent value. "Inherently, these benefits have immense economic value that ensure the debtor's net worth has been preserved, and, based on the entirety of this record, were not disproportionate between what was given up and what was received."[2] Further, the district court was concerned that the bankruptcy court's narrow definition of value may potentially be "inhibitory of contemporary financing practices."

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1 The Eleventh Circuit's decision relates to the appeal by the Transeastern Lenders. The appeal by the New Money Lenders to the district court was stayed pending the decision of the Eleventh Circuit.

2 *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc.,* 444 B.R. 613, 666 (S.D. Fla. 2011).

Eleventh Circuit Ruling:

In affirming the bankruptcy court and reversing the district court, the Eleventh Circuit focused on two primary issues: (1) whether the bankruptcy court clearly erred in finding that the Conveying Subsidiaries did not receive reasonably equivalent value for the liens granted to the New Money Lenders in the July 31 Transaction and (2) whether the Transeastern Lenders were entities for whose benefit the liens were transferred within the purview of section 550 of the Bankruptcy Code. The Eleventh Circuit did not consider challenges to the remedies imposed by the bankruptcy court and, instead, remanded that issue back to the District Court

Reasonably Equivalent Value:

The Eleventh Circuit did not address the differing opinions of the bankruptcy court and the district court on the proper definition and breadth of the term "value" as set forth in section 548. Rather, the Eleventh Circuit held that the bankruptcy court had properly found as a factual matter that, even if all the purported benefits of the July 31 Transaction proffered by the New Money Lenders were legally cognizable, they still did not confer reasonably equivalent value to the Conveying Subsidiaries. The Eleventh Circuit stated, "[t]he record supports the finding by the bankruptcy court that, for the Conveying Subsidiaries, the almost certain costs of the transaction of July 31 far outweigh any perceived benefits."

The Transeastern Lenders and the New Money Lenders had asserted that an adverse judgment against TOUSA in the Transeastern litigation would have caused TOUSA to immediately file for bankruptcy, the Conveying Subsidiaries' access to revolving loan to be cut off and the Conveying subsidiaries to become immediately liable for $1.3 billion to revolving loan lenders and the bondholders. The lenders further alleged that the bankruptcy court clearly erred when it found the Conveying Subsidiaries could have survived a TOUSA bankruptcy because there was no way the Conveying Subsidiaries could have obtained independent financing in sufficient time due to the fact that their books and records were a "huge pile of tangled spaghetti." The Eleventh Circuit nonetheless deferred to the bankruptcy court's finding that the July 31 Transaction "was still the more harmful option," and at most, "delayed the inevitable."

Moreover, the Transeastern Lenders and the New Money Lenders asserted that they should not be held liable for not foreseeing the unforeseeable, citing Warren Buffet and Alan Greenspan that the past recession was a an "economic Pearl Harbor" and a "credit tsunami." The Eleventh Circuit disagreed with the lenders using a metaphor of its own: "The record supports a determination that the bankruptcy of TOUSA was far more like a slow-moving category 5 hurricane than an unforeseen tsunami." Based on the evidence presented to the bankruptcy court in over 1800 exhibits presented in a 13-day trial, which included evidence of TOUSA insiders forecasting the free-fall in the housing market and their doubts about the ability of the July 31 Transaction to keep TOUSA out of bankruptcy, the Eleventh Circuit held that TOUSA's demise was, in contrast to Pearl Harbor, "as foreseeable as the bombing of Nagasaki after President Truman's ultimatum." The court concluded that "[t]he opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden" and affirmed the bankruptcy court's decision that the liens given to the New Money Lenders were avoidable.

The Transeastern Lenders Were "Entities for Whose Benefit" the Transfers Were Made:

The Bankruptcy Code contains two aspects of a debtor or trustee's avoiding powers—avoidance and recovery. In TOUSA, the Committee sought to recover the loan proceeds from the July 31 Transaction from the Transeastern Lenders. The Transeastern Lenders asserted that although the liens of the Conveying Subsidiaries were

transferred to secure loans to pay the Transeastern Lenders off, the Committee could not, as a matter of law, recover the loan proceeds from them because they were not an "entity for whose benefit the transfer [that is, the granting of the liens] was made" under section 550 of the Bankruptcy Code. The Transeastern Lenders argued that they were subsequent transferees, not entities that benefitted from the initial transfer, based on the fact that the loan proceeds passed through a wholly owned subsidiary of TOUSA.

The import of qualifying as a subsequent transferee under section 550(a)(2) as opposed to an initial transferee under section 550(a)(1) is that a subsequent transferee may use the defense in section 550(b)(1), whereas an initial transferee may not. The defense under section 550(b)(1) prohibits recovery by a trustee (or, as in *TOUSA*, a creditors' committee) if the transferee takes for value, including satisfaction or securing of a present or antecedent debt, in good faith and without knowledge of the voidability of the transferee avoided.

The bankruptcy court held they were "entities for whose benefit the transfer was made," meaning that the Transeastern Lenders were not subsequent transferees. The district court reversed. The Eleventh Circuit again sided with the bankruptcy court, concluding that the Transeastern Lenders were entities for whose benefit the Conveying Subsidiaries transferred their liens. The Eleventh Circuit found it compelling that the New Money Lenders' loan agreements required the loan proceeds to pay the Transeastern Lenders, and the Transeastern settlement expressly depended on the new loans. The appellate court also reasoned that the Transeastern Lenders were not subsequent transferees just because a TOUSA subsidiary first received the wire. According to the appellate court, that TOUSA subsidiary lacked control over the funds and was disregarded for purposes of section 550.

The Transeastern Lenders argued that such a reading of section 550(a) would drastically expand the potential pool of entities that could be liable for any transaction and would impose "extraordinary" duties of due diligence on the part of creditors accepting repayment. The Eleventh Circuit reasoned that the lenders' fears were unsubstantiated and, in any event, "every creditor must exercise some diligence when receiving payment from a struggling debtor," including those creditors being repaid hundreds of millions of dollars by someone other than its debtor. Accordingly, the Eleventh Circuit affirmed the bankruptcy court's ruling that the Transeastern Lenders are "entities for whose such benefit" the New Money Lender liens were made under section 550(a)(1) of the Bankruptcy Code.

Implications and Take-Away:

Much of the Eleventh Circuit's opinion must be viewed through the deference the court granted to the bankruptcy court's findings of fact under the "clearly erroneous" standard of appellate review. Under this standard, unless the appellate court is "left with a definite and firm conviction that a mistake has been made," the findings of fact are not clearly erroneous. The appellate court cannot make independent factual findings.

Despite these legalities, practically, the *TOUSA* decision has important implications for both lenders and borrowers. "Each time history repeats itself, the price goes up."[3] Indeed, borrowers may face a higher cost of borrowing as higher transaction costs are imposed on lenders in the form of additional diligence that *TOUSA* may require, particularly in ensuring solvency of upstream guarantors. Increased diligence may also be required when borrowers have complicated corporate structures.

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[3] Ronald White: A Short History of Progress (2005).

Many hailed the district court's opinion as reaffirming that indirect benefits realized by affiliates through transactions that bolster enterprise value constitute reasonably equivalent value. The Eleventh Circuit's decision may embolden trustees and unsecured creditors' committees to test the scope of *TOUSA*. The difference in *TOUSA* from other cases in this area, however, is that courts that find reasonably equivalent value for upstream guarantees do so when enterprise value is strengthened, whereas in *TOUSA*, the Eleventh Circuit deferred to the bankruptcy court's finding that there was no benefit. According to the bankruptcy court, based on the circumstances that existed at the time the transaction was contemplated, there was not any chance that the transaction would generate a positive return for *TOUSA*; the July 31 Transaction merely delayed the inevitable.

It remains to be seen what will happen with other controversial decisions of the bankruptcy court, including the validity of savings clauses and the efficacy of solvency opinions. At issue for lenders is the realization that favorable solvency opinions may not end the inquiry, and savings clauses may not be enforceable, requiring lenders to search for other forms of credit enhancement. The Eleventh Circuit did not address these important issues.

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