Insolvency and Restructuring Update

TOUSA, Inc. – District Court Quashes Infamous Fraudulent Transfer Decision

On February 11, 2011, Judge Alan S. Gold of the U.S. District Court for the Southern District of Florida quashed a 2009 Bankruptcy Court decision that had ordered certain lenders (the "**Transeastern Lenders**") of Florida-based homebuilder TOUSA, Inc. ("**TOUSA**") to disgorge, as fraudulent transfers, as much as $480 million in debt repayments and interest.[1] This significant decision overrules many aspects of a highly controversial Bankruptcy Court decision that (among other things) imposed onerous due diligence obligations on lenders in respect of the repayment of undisputed antecedent claims.[2] It has also led to a dramatic increase in creative fraudulent transfer litigation as creditors' committees and other "out of the money" constituencies have sought to expand the reach of the Bankruptcy Court's ruling to fit other facts. As discussed below, these efforts to expand the reach of the Bankruptcy Court's decision may well subside in light of the District Court's comprehensive holding.

The Bankruptcy Court's ruling had avoided as fraudulent transfers the liens and underlying debt obligations incurred by certain of TOUSA's subsidiaries (the "**Conveying Subsidiaries**") in connection with $500 million of secured loans made six months prior to the bankruptcy filing of TOUSA and its subsidiaries (collectively, the "**Debtors**"). The proceeds of the loan facilities were used to repay the Transeastern Lenders for a loan that was not guaranteed by or secured by the assets of the Conveying Subsidiaries.

In overturning the Bankruptcy Court's ruling with respect to the Transeastern Lenders, the District Court found, *inter alia*, that (i) the Conveying Subsidiaries received "indirect economic benefits, constituting reasonably equivalent value, in exchange for their lien transfers,"[3] (ii) "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided to be short lived," can constitute "value" under the Bankruptcy Code,[4] (iii) "a *per se* rule, as applied by the Bankruptcy Court, that indirect benefits must be mathematically quantified is error"[5] and (iv) "the Transeastern Lenders, as recipients of a debt payment, had no reason or legal duty to conduct . . . extraordinary due diligence with respect to the provenance of the funds with which they were being repaid."[6]

The District Court's broadly applicable decision rectified what it characterized as "an unfair burden on creditors to investigate all aspects of their debtors and the affiliates of those debtors before agreeing to accept payments for valid debts owed."[7]

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[1] *See 3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re Tousa, Inc.)*, Case 0:10-cv-60017-ASG [Dkt. No. 131] (S.D. Fl. Feb. 11, 2011).

[2] The District Court's decision quashed the Bankruptcy Court's order as it relates to the liability of the Transeastern Lenders and rendered the Bankruptcy Court's imposition of remedies as to the Transeastern Lenders null and void. *See id.* at 112. For the avoidance of confusion, the District Court explained that its decision does not affect parallel appeal proceedings of the New Lenders currently pending before Judge Adalberto J. Jordan. *See id.* at 112 n.66.

[3] *Id.* at 64 (internal quotation marks omitted).

[4] *Id.* at 73.

[5] *Id.* at 84.

[6] *Id.* at 103-104.

[7] *Id.* at 107.

Notably, the District Court took the unusual step of reversing the Bankruptcy Court's decision without remand "due to the overwhelming evidence of indirect benefits to the Conveying Subsidiaries that directly linked their own survival as a going concern to that of TOUSA."[8] Moreover, the District Court found that reversal was further supported by "significant factual errors made by the Bankruptcy Court," as included in the Bankruptcy Court's "virtual *verbatim*" adoption of proposed findings of fact and conclusions of law submitted by the Committee.[9] In elaborating on this point, the District Court noted, based on "redline" comparisons submitted by the appellants, that of "the more than 53,000 words in the [Bankruptcy Court's decision], approximately 92% directly overlap with the [Committee's] Proposed Findings."[10]

Background

The Debtors designed, built and marketed detached single-family residences, town homes and condominiums. Since the late 1990s, they grew rapidly through a series of acquisitions. To finance this growth, TOUSA borrowed more than $1 billion in unsecured bond debt and maintained a $700 million[11] revolving credit facility, each of which was guaranteed by the Conveying Subsidiaries.

In July 2007, less than six months before the Debtors filed for bankruptcy, TOUSA and the Conveying Subsidiaries borrowed an aggregate of $500 million under first and second lien term loan facilities (together, the "**New Loans**") from certain lenders (collectively, the "**New Lenders**"), secured by substantially all of their assets. Approximately $420 million of the proceeds of the New Loans were used to fund the settlement of certain litigation (the "**Transeastern Litigation**") pending against TOUSA and its subsidiary Tousa Homes LP ("**Homes LP**"), which litigation arose from a default on a loan provided by the Transeastern Lenders to finance a failed joint venture between Homes LP and a third party.

In connection with the New Loans, the Conveying Subsidiaries, which were not defendants in the litigation and were not liable to the Transeastern Lenders, incurred liabilities and granted liens to secure the resolution of their parent's liabilities. The Official Committee of Unsecured Creditors (the "**Committee**") brought suit (on behalf of the Conveying Subsidiaries) against the New Lenders and the Transeastern Lenders in order to (i) avoid (A) the liens against the assets of the Conveying Subsidiaries and (B) the underlying obligations of the Conveying Subsidiaries, in each case as constructive fraudulent transfers and (ii) recover the $420 million paid to the Transeastern Lenders under the settlement.

The Bankruptcy Court ruled in favor of the Committee and avoided (i) the liens against the assets of the Conveying Subsidiaries and (ii) the obligations of the Conveying Subsidiaries. In so ruling, the Bankruptcy Court found that (A) the Conveying Subsidiaries received little or no benefit from the New Loans (and therefore did not receive reasonably equivalent value in exchange for incurring the obligations and granting the liens) and (B) due to the collapsing housing market the Conveying Subsidiaries were insolvent both prior to and after giving effect to the loan transaction, and were left with unreasonably small capital with which to operate their businesses as a result of the transaction.

According to the Bankruptcy Court, the remedies for the fraudulent transfers were to include (i) disgorgement by the Transeastern Lenders of the proceeds attributable to the Conveying Subsidiaries, (ii) reinstatement of the Transeastern Lenders' claims to the extent of the disgorgement, (iii) avoidance of the liens of the New Lenders against the assets of the Conveying Subsidiaries, (iv) deduction from the disgorged funds, for the benefit of the estate, of fees paid to the New Lenders and the amount of any diminution in the value of the Conveying Subsidiaries since the closing of the loan transaction (even

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[8] *Id.* at 86.
[9] *Id.* at 86.
[10] *Id.* at 43-44 (internal quotation marks omitted).
[11] The maximum credit available under the revolving credit facility was initially $800 million, but was reduced to $700 million in July 2007.

though this diminution was unrelated to the New Lenders) and (v) return of any balance of disgorged funds (after such deductions) to the New Lenders.

The Transeastern Lenders and a subset of the New Lenders appealed the Bankruptcy Court's ruling. A summary of certain key aspects of the District Court's decision follows in the paragraphs below.

Reasonably Equivalent Value

In short, the District Court found that the Conveying Subsidiaries received reasonably equivalent value in the form of indirect economic benefits in exchange for their transfers of liens to the New Lenders, and the Bankruptcy Court's holding to the contrary was reversible error.[12] The District Court ruled that the Bankruptcy Court, in arriving at its flawed holding, committed a number of other legal errors, including narrowly limiting the meaning of "value" as that term is used in the Bankruptcy Code.[13]

More specifically, the Bankruptcy Court erroneously relied—without citation to any case law—on the WEBSTER'S DICTIONARY definition of "property" in concluding that "the Conveying Subsidiaries could not have received 'property' unless they obtained some kind of enforceable entitlement to some tangible or intangible article" and, because avoidance of default and bankruptcy do not constitute property under this definition, they therefore cannot constitute value.[14] This was erroneous because a dictionary definition is not controlling and, under applicable legal authorities, prospective future economic benefits can constitute value for purposes of a fraudulent conveyance analysis.[15]

The District Court found that the Bankruptcy Court's ruling contravened well-established case law establishing that "indirect benefits may take many forms, both tangible and intangible."[16] Further, the Bankruptcy Court's narrow definition of value was flawed to the extent that it purported to exclude indirect economic benefits from being considered in determinations of whether a debtor has received value.[17]

Indeed, under controlling precedent, a debtor's reprieve from foreclosure and the attendant ability to continue operating as a going concern could confer an indirect economic benefit in trilateral transactions.[18] Accordingly, the District Court concluded that the Bankruptcy Court's decision was inconsistent with the weight of legal authority, which provides that an indirect, intangible, economic benefit may be considered in determining reasonably equivalent value.[19] "The touchstone," according to the District Court, is "whether the transaction conferred reasonable commercial value on the debtor."[20] Importantly, the District Court held that such value must be measured as of the time of the transfer and not with the benefit of hindsight.[21] As a result, it was of no moment that TOUSA was actually unable to avoid bankruptcy.

Based on the foregoing, the District Court found that the settlement of the Transeastern Litigation conferred reasonably equivalent economic benefits on the Conveying Subsidiaries by enabling the Debtors' enterprise to avoid defaulting on over $1 billion in bond debt and revolving loan payments. As a result, the enterprise was able to make over $65 million in revolver payments after the settlement of the

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[12] *See id.* at 86.
[13] *See id.* at 65.
[14] *See id.* at 65-66. The District Court further noted that the Bankruptcy Code does not define the phrase "reasonably equivalent value," but rather, "defines the term 'value' for purposes of the fraudulent transfer provision as 'property, or satisfaction or securing of a present or antecedent debt of the debtor.'" *Id.* at 65 (quoting 11 U.S.C. § 548(d)(2)(A)).
[15] *See id.* at 66.
[16] *Id.* at 68.
[17] *See id.* at 69.
[18] *See id.* (citing *Gen. Elec. Credit Corp. v. Murphy* (*In re Duque Rodriguez*), 895 F.2d 725, 728 (11th Cir. 1990).
[19] *See id.* at 73.
[20] *Id.* at 73-74.
[21] See *id.* at 85.

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Transeastern Litigation, which in turn enabled the enterprise to continue operating as a going concern until the real estate industry subsequently collapsed in a manner unforeseen at the time of the settlement.[22] The District Court held that, under these circumstances, "no further proof of 'quantification' was required to establish reasonably equivalent value," as these were "precisely the kind of benefits that . . . are not susceptible to exact quantification but are nonetheless legally cognizable" under section 548 of the Bankruptcy Code.[23]

Extraordinary Due Diligence

The Bankruptcy Court also erred by imposing strict liability on the Transeastern Lenders under section 550(a) of the Bankruptcy Code[24] without determining whether they were "subsequent transferees" for purposes of the statute such that recovery would be precluded pursuant to section 550(b) of the Bankruptcy Code.[25] Section 550(b) of the Bankruptcy Code precludes recovery under section 550(a) from "(1) a transferee that takes for value, including satisfaction or securing of [an] antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or (2) any immediate or mediate good faith transferee of such transferee."[26] The District Court held that the Transeastern Lenders were a transferee that took for value (such value being the satisfaction of TOUSA's antecedent debt), and that the Committee had not established that the Transeastern Lenders had acted in bad faith or with knowledge of voidability (if any) of the lien transfer.[27]

Describing the due diligence standard established by Bankruptcy Court's decision as "patently unreasonable and unworkable,"[28] the District Court explained that, under the Bankruptcy Court's holding, it would be "'bad faith' for a creditor of someone *other than the debtor* to accept payment of a valid, tendered debt repayment outside of any preference period" without first investigating "the debtor's internal re-financing structure" and ensuring "that the debtor's subsidiaries had received fair value as part of the repayment, or that the debtor and its subsidiaries, in an enterprise, were not insolvent or precariously close to being insolvent."[29] The District Court held that holders of valid antecedent debts should not be held to such an investigatory duty.

Noting that "[c]ase law generally cautions against imposing exhaustive duties to investigate upon banks and other creditors," the District Court found that the net result of the Bankruptcy Court's decision was to impermissibly impose "extraordinary duties of due diligence on the part of creditors accepting repayment—duties that equal or exceed those imposed on lenders extending credit in the first place."[30]

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[22] *See id.* at 83.
[23] *Id.* at 84.
[24] Section 550(a) provides in pertinent part:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section . . . 548 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 552(a).
[25] *See In re Tousa* at 101.
[26] 11 U.S.C. § 550(b).
[27] *See In re Tousa* at 101-02.
[28] *Id.* at 103.
[29] *Id.* at 102.
[30] *Id.* at 103.

Future Implications

As noted by the District Court, the Bankruptcy Court's decision created enormous controversy from academia to the courthouse with respect to the law of fraudulent transfer. It has also emboldened creditors' committees and other "out of the money" constituencies in a variety of pending bankruptcy cases to assert increasingly creative theories against secured lenders in the hopes of extracting value not otherwise supported by economic realities. The District Court's thorough repudiation of many of the more controversial elements of the Bankruptcy Court's decision should seriously undermine the efficacy of such value extracting efforts in other cases. It remains to be seen as to the effect of the District Court's decision on the parallel appeal proceedings of the New Lenders currently pending before Judge Jordan (which appeal includes, *inter alia*, the Bankruptcy Court's controversial statements regarding the enforceability of market standard savings clauses), as well as any later appeal to the Eleventh Circuit.

- See a copy of the District Court's opinion

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