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VICTORY FOR LENDERS: DISTRICT COURT QUASHES *TOUSA* FRAUDULENT TRANSFER OPINION

Secured lenders who provide financing to distressed companies were understandably concerned when the bankruptcy court presiding over the case of homebuilder Tousa, Inc. ("Tousa") avoided certain liens of the debtors' pre-petition rescue lenders and ordered the disgorgement of over $400 million from certain other pre-petition lenders (the "Transeastern Lenders") receiving the proceeds of such rescue financing.

In a scathing 113-page opinion highly critical of the bankruptcy court's decision, the United States District Court for the Southern District of Florida, Judge Alan S. Gold, "quashed" the bankruptcy court's opinion holding the Transeastern Lenders liable for approximately $403 million, plus interest, in fraudulent transfers relating to pre-petition rescue financing used to repay the Transeastern Lenders.[1] In quashing the bankruptcy court's opinion, as opposed to remanding the issue to the lower court (a decision that speaks volumes in itself), Judge Gold provided a measure of comfort to lenders that payments made to such lenders from the proceeds of typical rescue financings for corporate enterprises would not be set aside as fraudulent and that no extraordinary duties of due diligence on the part of lenders accepting repayment would be imposed.

Background of the *Tousa* Case

In 2005, a wholly-owned subsidiary of Tousa and another entity entered into a joint venture referred to as the Transeastern joint venture ("Transeastern"). The joint venture was unsuccessful, and Transeastern defaulted on $675 million of debt owed to the Transeastern Lenders. To settle the subsequent litigation, Tousa agreed to pay the Transeastern Lenders more than $421 million (the "Settlement"). The Settlement was financed by a first-lien credit facility in the amount of $200 million and a second-lien facility in the amount of $300 million (the "July Financing"). Tousa and its subsidiaries (the "Conveying Subsidiaries") were co-borrowers under the July Financing. This financing was secured by a lien on substantially all assets of Tousa and the Conveying Subsidiaries, and the proceeds of this financing were used to satisfy the Settlement with the Transeastern Lenders.

Six months later, Tousa and the Conveying Subsidiaries filed for relief under chapter 11 of the Bankruptcy Code. The official committee of unsecured creditors (the "Committee") appointed in the Tousa case then sought to avoid the obligations incurred and liens granted by the Conveying Subsidiaries under the July Financing as fraudulent transfers pursuant to section 548 of the Bankruptcy Code. After a 13-day trial, the bankruptcy court granted the relief sought by the Committee. The bankruptcy court concluded that the Conveying Subsidiaries were insolvent before and after the closing of the July Financing and were left with unreasonably small capital to operate their businesses as a result of the transaction. The bankruptcy court also held that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for incurring such obligations and granting such liens to the new lenders. Accordingly, the bankruptcy court avoided the obligations incurred and liens granted by the Conveying Subsidiaries in connection with the July Financing and required the Transeastern Lenders to disgorge more than $400 million of the loan proceeds they had received in connection with the Settlement of the Transeastern litigation.

The Bankruptcy Court's "Direct Transferee" Theory of the Transeastern Lenders' Liability was Legally Incorrect

As an initial threshold matter, the District Court noted that the Bankruptcy Code allows for the avoidance of only those transfers "of an interest of <u>the debtor</u> in property." Under applicable Eleventh Circuit case law, whether a debtor had possession of property allegedly avoidable is determined by a "control test" encompassing two elements: (i) the power to designate which party will receive the funds; and (ii) the power to actually disburse the funds at issue to that party.[2] The Transeastern Lenders argued on appeal that the Conveying Subsidiaries never had any property interest in the proceeds of the July Financing and thus transferred nothing to the Transeastern Lenders. The District Court agreed that the Conveying Subsidiaries did not receive the proceeds of the loan nor did they have the power to designate who would receive the loan proceeds.[3] The District Court thus ruled that the Conveying Subsidiaries lacked the requisite control over the property transferred, given that Tousa, as the primary borrower, was the only party with actual authority under the July Financing documents to control the loan proceeds' distribution. Furthermore, the July Financing documents were clear that the loan proceeds were to be used in satisfying the Transeastern Settlement.[4]

The Bankruptcy Court Committed Clear Error in Finding No Reasonably Equivalent Value for Any Transfer

The Bankruptcy Code allows for avoidance of any transfer made of an interest of the debtor in property if the debtor did not receive "reasonably equivalent value." The bankruptcy court held that the minimal value received by the Conveying Subsidiaries paled in comparison to the $403 million in obligations they collectively incurred. The District Court, however, found the bankruptcy court's comparison of the property transferred and value received faulty - "if the value of the property interest transferred from the Conveying Subsidiaries to the Transeastern Lenders was 'minimal', then the measure of reasonably equivalent value must be whether the Conveying Subsidiaries received 'minimal' value in return."[5]

Next, the District Court held that the bankruptcy court committed legal error in holding that the indirect benefits received by the Conveying Subsidiaries was, as a matter of law, not property cognizable as "value" under fraudulent conveyance law. Rather, the District Court held that the "mere 'opportunity' to receive an economic benefit in the future constitutes 'value' under the Code."[6] Further, the District Court noted that "[w]hat is key in determining reasonably equivalent value then is whether, in exchange for the transfer, the debtor received in return the continued opportunity to financially survive, where, without the transfer, its financial demise would [have] been all but certain."[7]

In this regard, the bankruptcy court ignored the indirect benefits to the larger integrated corporate enterprise and ignored the reality that the transfers made in accordance with the Settlement prevented an adverse judgment in the Transeastern litigation that would have been catastrophic to the Tousa enterprise as a whole. In short, the totality of the circumstances established a direct link between the financial net worth of the Conveying Subsidiaries and the fate of the Tousa parent, and therefore there were indirect benefits that constituted sufficient "value."[8]

The Bankruptcy Court Erroneously Compelled the Transeastern Lenders to Disgorge the Value of the Liens as Parties "For Whose Benefit" the July Financing was Made

Even assuming that the bankruptcy court's findings regarding "reasonably equivalent value" could be sustained, the District Court held that the Conveying Subsidiaries could not recover such avoided transfers from the Transeastern Lenders, because the Transeastern Lenders did not act in "bad faith." The District Court refused to accept the bankruptcy court's holding that it is bad faith for a lender to accept payment of a valid pre-existing debt if such lender does not first investigate the debtor's internal refinancing structure and ensure 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.[9] As the District Court observed:

> The net result of the bankruptcy court's improper finding is to 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[10].

Conclusion

The District Court's opinion in *Tousa* provides a measure of comfort to lenders that reviewing courts should look to the totality of the circumstances and both direct and indirect benefits of a financing transaction (including upstream guaranties) when analyzing fraudulent transfers.

Moreover, while a trend has developed where some bankruptcy courts have used hindsight to analyze the avoidability of certain transfers, the District Court's opinion in *Tousa* makes clear that whether "reasonably equivalent value" was provided in exchange for the alleged avoidable transfer is an issue that must be analyzed based upon the facts as they existed at the time of the loan/repayment (*i.e.*, when the "rescue" was needed), not using 20/20 hindsight.

Finally, a major takeaway from the District Court's opinion in *Tousa* is that a bankruptcy court may not impose extraordinary duties of due diligence on the part of lenders accepting repayment of pre-petition debt that exceed those imposed upon lenders extending credit in the first place.

Separate appeals of the bankruptcy court's opinion by the July Financing lenders relating to the avoidance of the transfers made in connection with the July Financing are currently pending. Although the District Court's opinion is not binding in these appeals, it is certainly positive news for the lenders involved in those appeals.

Please feel free to contact any of the attorneys listed below if you would like to discuss this matter.

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[1] *In re Tousa, Inc.*, Slip Op., Case No. 10-60017 (Gold, J.) (S.D. Fla. Feb. 11, 2011); *rev'g in part Official Comm. of Unsecured Creditors v. Citicorp (In re Tousa, Inc.),* 422 B.R. 783 (Bankr. S.D. Fla. 2009).
[2] *Id.* at 51.
[3] *Id.* at 49.
[4] *Id.* at 52.
[5] *Id.* at 59.
[6] *Id.* at 66.
[7] *Id.* at 74.
[8] *Id.* at 81.
[9] *Id.* at 102-103.
[10] *Id.* at 103-104.