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District Court Quashes Controversial TOUSA Fraudulent Transfer Decision

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In a recent 113-page decision, Judge Alan S. Gold of the U.S. District Court for the Southern District of Florida quashed the TOUSA Bankruptcy Court's previous controversial fraudulent conveyance decision that required secured lenders (the "Transeastern Lenders") to disgorge approximately $480 million received in settlement of their claims against TOUSA. In a ruling with wide-ranging implications for the financing community, the District Court thoroughly rejected the Bankruptcy Court's reasoning and held that the TOUSA subsidiaries that guaranteed the new loans necessary to fund the settlement had in fact received "reasonably equivalent value" in exchange for their commitments by, among other things, preserving the value of the troubled homebuilder's entire corporate enterprise.

Factual Background

The Debtors designed, built and marketed detached single-family residences, town homes, and condominiums under various brand names. At one time, TOUSA and its subsidiaries operated the thirteenth largest home building business in the country with operations in Florida, Texas, the mid-Atlantic States and the western United States. In June 2005, TOUSA Homes LP (a wholly owned subsidiary of TOUSA) formed a joint venture with a third party for the purpose of acquiring certain real estate assets owned by Transeastern Properties, Inc., a leading developer in Florida. The Transeastern Lenders provided financing of $675 million (the "Transeastern Loan") for the joint venture. The joint venture financing was independent of the remainder of the TOUSA enterprise, although TOUSA—the corporate parent—was an obligor under the new credit facility.

As the housing market weakened, the joint venture failed and the Transeastern Lenders commenced litigation against TOUSA seeking immediate repayment of the outstanding amount of the $675 million loan plus interest. Success by the Transeastern Lenders in their litigation would not only mean that TOUSA would be obligated to pay amounts due and owing on the Transeastern Loan, such adverse ruling would also cause TOUSA and its subsidiaries to cross-default under the terms of their own $1 billion unsecured bond indebtedness (the “Bonds”), as well as their $700 million revolving credit facility (the “Revolver”).

In order to sustain its businesses and to avoid a default under the Bonds and the Revolver, TOUSA settled the litigation with the Transeastern Lenders. To fund the settlement, TOUSA undertook a series of transactions referred to as the “July 31 Transaction.” In the July 31 Transaction, TOUSA borrowed $500 million (the “New Loan”) on a secured basis from parties referred to as the “New Lenders.” Approximately $420 million of the proceeds of the New Loan was transferred to the Transeastern Lenders to settle the dispute. The obligations to the New Lenders were guaranteed by certain TOUSA subsidiaries referred to as the “Conveying Subsidiaries” despite the fact that these Conveying Subsidiaries had not independently guaranteed and were not independently liable for TOUSA’s obligations to the Transeastern Lenders.

The Fraudulent Conveyance Claim

During TOUSA’s subsequent bankruptcy case, the official committee of unsecured creditors (the “Creditors’ Committee”), on behalf of the Conveying Subsidiaries, brought suit against the New Lenders and the Transeastern Lenders to avoid the liens granted by the Conveying Subsidiaries to the New Lenders and to disgorge the $420 million settlement payment made to the Transeastern Lenders. The Creditors’ Committee argued that the entire July 31 Transaction was voidable pursuant to Bankruptcy Code Section 548, which provides, among other things, that a transfer is voidable if the debtor receives less than “reasonably equivalent value” in exchange for the transfer, and if the debtor was insolvent when the transfer occurred.

The Creditors’ Committee specifically argued that the Conveying Subsidiaries did not receive “reasonably equivalent value” in exchange for guaranteeing the obligations owed to the New Lenders because the Conveying Subsidiaries did not receive the proceeds of the New Loan or otherwise receive a benefit from the July 31 Transaction. The Creditors’ Committee also argued that the $420 million in settlement funds paid to the Transeastern Lenders could be disgorged under Bankruptcy Code Section 550 because the Transeastern Lenders were either direct transferees of the New Lenders’ financing, or were the parties “for whose benefit” the transfer of liens to the New Lenders occurred.

The Bankruptcy Court’s Decision

In a October 2009 opinion, the Bankruptcy Court ruled in favor of the Creditors’ Committee, holding that the July 31 Transaction constituted a fraudulent conveyance under Section 548 of the Bankruptcy Code. The Bankruptcy Court reasoned that the Conveying Subsidiaries did not receive “reasonably equivalent value” in exchange for the liens they granted to the New Lenders. As such, the Bankruptcy Court ordered that (i) the liens and obligations granted by the Conveying Subsidiaries to the New Lenders would be avoided pursuant to Section 548 of the Bankruptcy Code and (ii) the proceeds of the New Loan transferred to the Transeastern Lenders (totaling $480 million after accounting for interest) would be disgorged and returned to the estates. The Bankruptcy Court adopted other allegations prepared by the Creditors’ Committee, including that the Transeastern Lenders acted in bad faith by engaging in the transfer when “they knew of or should have known on the basis of publicly available information that TOUSA and the Conveying Subsidiaries were insolvent on July 31, 2007, or were precariously close to insolvency.”

The Appellate Decision

On February 11, 2011, the District Court overturned (and roundly criticized) the Bankruptcy Court’s ruling with respect to the portion of the order disgorging the settlement payments to the Transeastern Lenders. (A separate portion of the Bankruptcy Court’s decision concerning the validity of the New Lenders’ security interests, as well as its controversial ruling on savings clauses, is before a different judge in a related appeal.) Specifically, Judge Gold found that the Bankruptcy Court committed “clear legal error” in simply adopting the Creditors' Committee's narrow interpretation of "reasonably equivalent value" under Section 548 of the Bankruptcy Code.

Judge Gold rejected the Bankruptcy Court's conclusion that in order to receive any "value" under Section 548, the Conveying Subsidiaries had to receive either actual "property"—i.e., some kind of enforceable entitlement to some tangible or intangible article—or indirect benefits susceptible to "mathematical quantification." To the contrary, Judge Gold reaffirmed well-established law that "value" may encompass both direct or indirect benefits and that "indirect benefits may take many forms, both tangible and intangible." The District Court determined that the Conveying Subsidiaries received "value" in the July 31 Transaction, including avoiding immediate default on the Bonds and Revolver, maintaining the viability of their corporate parent, and preserving the net worth, synergies and going concern value of TOUSA's entire corporate enterprise.

In addition, while it is customary for an appellate court to remand proceedings when the lower court misapplies a legal standard, Judge Gold decided instead to "quash" the Bankruptcy Court's ruling—which he disparaged for tracking the Creditors' Committee's post-trial submissions nearly verbatim—and resolve the dispute in its entirety on appeal.

In assessing the facts on the record, Judge Gold first noted that it was necessary to consider the "totality of the circumstances" when determining if reasonably equivalent value had been received on account of a transfer. In the case at hand, Judge Gold concluded that "eliminating the threat of [the Transeastern Lenders'] claims against the Conveying Subsidiaries' parent, and indirectly against each of them, constituted an enormous economic benefit to these subsidiaries in terms of their viability as going concerns and their continued access to financing through the TOUSA parent, which, in turn, allowed them, for a period of time, to continue to pay interest to the bondholders, the very creditors at issue." Accordingly, he found that "no further proof of 'quantification' was required to establish reasonably equivalent value" because 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.

Although the District Court's decision with respect to Section 548 was sufficient to undo the disgorgement of the settlement payment from the Transeastern Lenders, the District Court also addressed and rejected the Bankruptcy Court's reasoning with respect to Section 550 of the Bankruptcy Code. Specifically, the District Court found that the Bankruptcy Court committed clear error in holding that as the ultimate recipients of the proceeds of the new loans, the Transeastern Lenders constituted parties "for whose benefit" the Conveying Subsidiaries undertook their guarantees with respect to July 31 Transaction. To the contrary, the District Court found that the TOUSA corporate enterprise, which resolved its liability to the Transeastern Lenders, was "for whose benefit" the guarantees were made. In so ruling, the District Court reaffirmed settled law that Section 550's disgorgement power "does not apply where the 'benefit' is not the immediate and necessary consequence of the initial transfer but flows from the manner in which the initial transfer is used by its recipient."

Implications for Future Secured Lending Disputes

While the District Court's decision addresses numerous legal issues, four (4) are of particular importance to the financing community. Specifically, the ruling reaffirms and strengthens protections with respect to (i) loans to borrowers with complex corporate structures in which subsidiaries guarantee the debt obligations, (ii) a lender's due diligence obligations when accepting satisfaction of a loan, (iii) loans to distressed companies generally, and (iv) loans with respect to so-called "three-party transactions" where borrowers seek to extinguish existing obligations to third parties. To be sure, however, all constructive fraudulent transfer causes of action are inherently fact-specific, and the applicability of the District Court's reasoning to future disputes will depend on the specific issues raised in those disputes. In addition, the District Court's opinion may be supplemented or otherwise altered by the Circuit Court on appeal.

1. Protections for Lending to Borrowers with Complex Corporate Structures

When a corporate borrowing group includes multiple businesses, it is common for lenders to require corporate affiliates and subsidiaries to guarantee the obligations of the borrower. Under traditional fraudulent conveyance law, these "upstream" or "cross-stream" guarantees often raise fraudulent transfer concerns because the subsidiaries generally do not receive any direct economic benefit. Judge Gold's decision, however, reaffirms that such subsidiary-guarantees can be appropriate and may provide "value" if the transaction strengthens the viability of the corporate group as a whole, or allows the group to avoid imminent default and/or bankruptcy.

2. Due Diligence Concerns

In disgorging the settlement payment to the Transeastern Lenders (in addition to finding that they had acted in bad faith), the Bankruptcy Court imposed extraordinary and oppressive due diligence obligations on the Transeastern Lenders. Specifically, under the Bankruptcy Court's application of the Section 550 "for whose benefit" language, the Transeastern Lenders would be required to review, analyze and ensure the appropriateness of the entire TOUSA settlement financing. The District Court described the due diligence standard imposed by the Bankruptcy Court to be "patently unreasonable and unworkable." In particular, the District Court determined that a non-debtor lender should not be required to investigate "the debtor's internal re-financing structure" or verify "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." To the contrary, the District Court reaffirmed that the mere receipt of a debt payment imposed "no reason or legal duty to conduct such extraordinary due diligence with respect to the provenance of the funds with which [the lender is] being repaid."

3. Protections for Lending to Distressed Companies

The Bankruptcy Court had concluded that one reason the Conveying Subsidiaries could not have received "reasonably equivalent value" from the transfers in question was because the entire TOUSA enterprise eventually failed. On appeal, the District Court, however, was clear that the inquiry as to value must be taken "as of the date of the transaction" and not "through the lens of retrospection." Moreover, the District Court found that lending to facilitate "a debtor's opportunity to avoid default, to facilitate its rehabilitation, and to improve its prospects of avoiding bankruptcy ***are precisely the kind of benefits*** that, by definition, are not susceptible to exact quantification but are nonetheless legally cognizable under § 548." (Emphasis added). In other words, a loan can constitute "reasonably equivalent value" in sustaining a corporate enterprise even if that enterprise in fact fails thereafter.

4. Protections for Three-Party Transactions

A three-party transaction involves the transfer of funds from a lender to the obligee of the borrower. While the borrower receives the "value" of the satisfaction of its obligations to the ultimate transferee (to the extent of the funds transferred), the borrower does not receive tangible or intangible property *per se*. The District Court's ruling reaffirms that the borrower's receipt of this benefit may constitute "value" for purposes of a fraudulent transfer analysis. In other words, satisfaction of an obligation constitutes value with respect to whether or not the borrower received "reasonably equivalent value" in exchange for the transfer.

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