Appellate Decision in TOUSA Bankruptcy Protects Secured Lenders

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Key Points

- Appellate court quashes and roundly criticizes bankruptcy court's constructive fraudulent conveyance decision.
- Appellate decision strengthens protections for lenders that fund borrowers with complex corporate structures and borrowers on the verge of bankruptcy.
- Appellate decision clarifies scope of due diligence required by lenders receiving repayment of debt.

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In a recent decision, Judge Alan S. Gold of the U.S. District Court for the Southern District of Florida quashed a controversial ruling from TOUSA, Inc.'s Bankruptcy Court that required secured lenders to disgorge approximately $480 million received from the troubled home-builder prior to its bankruptcy. The Bankruptcy Court found that the settlement payment in question, which resolved ongoing litigation stemming from a failed joint venture, constituted a constructive fraudulent conveyance and was subject to avoidance under Section 548 of the United States Bankruptcy Code and other applicable law. In a ruling with wide-ranging implications for the financing community (discussed below), 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 TOUSA's entire corporate enterprise.

Factual Background

TOUSA designed, built and marketed detached single-family residences, town homes, and condominiums under various brand names. As noted by the District

Court, at one time, TOUSA and its subsidiaries operated the thirteenth largest home building business in America 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. In order to fund the joint venture, certain lenders (the "Transeastern Lenders") provided financing in the amount of $675 million (the "Transeastern Loan"). 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 balance of the Transeastern Loan plus interest. An adverse ruling in the litigation would have caused TOUSA and its subsidiaries to cross-default under the terms of their separate $1 billion unsecured bond indebtedness (the "Bonds"), as well as their secured $700 million revolving credit facility (the "Revolver").

As the litigation proceeded, TOUSA determined that settling the dispute with the Transeastern Lenders was in the company's best interests. To effectuate the settlement, TOUSA undertook a series of transactions, including borrowing $500 million on a secured basis (the "New Loan") to fund the settlement payment to the Transeastern Lenders of approximately $420 million (collectively, the "July 31 Transaction").

As part of the July 31 Transaction, TOUSA's obligations under the New Loan were guaranteed by and secured by liens in the assets of certain TOUSA subsidiaries (the "Conveying Subsidiaries"). Importantly, these Conveying Subsidiaries had not independently guaranteed and were not independently liable for TOUSA's obligations under the Transeastern Loan.

On January 29, 2008, TOUSA and various subsidiaries filed voluntary petitions for relief under Chapter 11 in the Bankruptcy Court for the Southern District of Florida. Various litigation ensued in connection with the bankruptcy proceedings.

The Fraudulent Conveyance Claim

During TOUSA's bankruptcy case, the official committee of unsecured creditors (the "Creditors' Committee"), on behalf of the Conveying Subsidiaries, filed a lawsuit seeking disgorgement of TOUSA's $420 million settlement payment to the Transeastern Lenders. The Creditors Committee also sought to avoid the liens granted by the Conveying Subsidiaries to the lenders (the "New Lenders") funding the New Loan.

The Creditors' Committee argued that the entire July 31 Transaction was voidable pursuant to Bankruptcy Code Section 548 and corresponding state law, which provides, among other things, that a conveyance (a transfer or incurrence of an obligation) is voidable if the debtor receives less than "reasonably equivalent value" "in exchange for" the conveyance, and if the debtor was insolvent when the transaction occurred (or was rendered insolvent by the transaction).

Because the Conveying Subsidiaries did not receive the proceeds of the New Loan and did not have direct obligations to the Transeastern Lenders that were resolved by the July 31 Transaction, the Creditors' Committee argued that the Conveying Subsidiaries failed to receive "reasonably equivalent value" in exchange for securing and guaranteeing TOUSA's obligations to the New Lenders. 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" such financing was undertaken.

In its 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.

The Bankruptcy Court ordered that (i) the liens and obligations granted by the Conveying Subsidiaries to the New Lenders 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) be disgorged

and returned to TOUSA's bankruptcy estates.

The Bankruptcy Court adopted other allegations of the Creditors' Committee as well, including (as summarized by the District Court) that the Transeastern Lenders acted in bad faith by engaging in the transfer when "they knew of [sic.] 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." *444 B.R.613, 675.*

On February 11, 2011, the District Court overturned and sharply criticized the Bankruptcy Court's ruling with respect to the portion of the order disgorging the settlement payment to the Transeastern Lenders. As discussed below, a separate appeal is now pending before a different judge with respect to the portion of the Bankruptcy Court's decision concerning the validity of the security interests granted to the New Lenders and the enforceability of the "savings clauses" contained in the New Loan agreement.

In short, Judge Gold found that the Bankruptcy Court committed "clear error" in simply adopting the Creditors' Committee's narrow interpretation of "reasonably equivalent value" under Section 548 of the Bankruptcy Code. *Id.* at 649-53. 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." *Id.* at 666. To the contrary, Judge Gold reaffirmed well-established law that "value" may encompass both direct or indirect benefits and that the "indirect benefits may take many forms, both tangible and intangible." *Id.* at 657.

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. *Id.* at 667.

On the facts already on record, the District Court concluded that the Conveying Subsidiaries clearly had established that they had received "value" in the July 31 Transactions by, among other things, 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.

Specifically, Judge Gold found 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." *Id.* at 663.

Although the District Court's decision with respect to Bankruptcy Code 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 Bankruptcy Code Section 550. The District Court determined that the Bankruptcy Court committed clear error in holding that the Transeastern Lenders were the parties "for whose benefit" the Conveying Subsidiaries undertook their obligations with respect to July 31 Transaction.

The District Court found that the entire TOUSA enterprise, which resolved its liability to the Transeastern Lenders pursuant to the July 31 Transaction, was the party "for whose benefit" the obligations with respect to the New Loan 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." *Id.* at 674.

While the District Court's decision addresses numerous legal issues, three (3) are of particular importance to the financing community. The ruling (i) strengthens protections for loans to borrowers with complex corporate structures, (ii) strengthens protections for loans to distressed companies generally, and (iii) clarifies a lender's due diligence obligations when accepting satisfaction of a debt.

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 provides that such subsidiary-guarantees can be appropriate and may constitute "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. Judge Gold's decision does not set forth the exact methodology for calculating "value" in such a circumstance, instead finding that there was clearly sufficient value with respect to the TOUSA enterprise because the Conveying Subsidiaries "directly linked their own survival as a going concern to that of TOUSA." *Id.* at 667.

Judge Gold's decision also reaffirms protections for so-called three-party transactions involving the transfer of funds from a lender to the obligee of the borrower (or, in this case, the obligee of affiliated entities of the borrower). In other words, the debtor-subsidiary may incur its obligation with respect to the new financing "in exchange for" the satisfaction of the enterprise's obligations to the ultimate transferee (to the extent of the funds transferred), despite the fact that the debtor subsidiary does not receive quantifiable "value" or tangible "property" *per se* as a result of the new financing.

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, however, the District Court 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." *Id.* at 666.

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." *Id.*

Judge Gold's decision reaffirms that lenders do not trigger fraudulent conveyance risk merely because the borrower may be distressed. In addition, a loan can constitute "reasonably equivalent value" in sustaining a borrower's corporate enterprise even if that enterprise ultimately fails.

In addition to requiring disgorgement of the settlement payment to the Transeastern Lenders (and finding that they had acted in bad faith), the Bankruptcy Court effectively imposed extraordinary and burdensome due diligence obligations on the Transeastern Lenders. Under the Bankruptcy Court's application of Bankruptcy Code Section 550, the Transeastern Lenders had the obligation of reviewing, analyzing and ensuring the appropriateness of the entire July 31 Transaction before accepting payment of the settlement amount.

The District Court described the due diligence standard imposed by the Bankruptcy Court to be "patently unreasonable and unworkable." *Id.* at 675. 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." *Id.*

Judge Gold's decision reaffirms that the mere receipt of a debt payment imposes "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." *Id.* at 676.

Another central holding in the TOUSA Bankruptcy Court's 2009 decision was the court's invalidation of the "savings clauses" contained in the New Loan's documentation. A savings clause is a typical contract provision that seeks to maintain the enforceability of the remaining provisions of a contract—to the extent permissible by law—in the event that certain other provisions of the same contract are deemed unenforceable.

The savings clauses at issue with respect to the New Loan provided that:

> Each Borrower agrees if such Borrower's joint and several liability hereunder, or if any Liens securing such joint and several liability, would, but for the application of this sentence, be unenforceable under applicable law, such joint and several liability

> and each such Lien shall be valid and enforceable to the maximum extent that would not cause such joint and several liability or such Lien to be unenforceable under applicable law, and such joint and several liability and such Lien shall be deemed to have been automatically amended accordingly at all relevant times.

The savings clause was designed to insulate the New Loan form fraudulent conveyance vulnerability. In the event that a Conveying Subsidiary was deemed to have undertaken obligations in excess of the reasonably equivalent value received in exchange—which (as discussed above) would subject such transaction to potential avoidance—the obligation incurred by the Conveying Subsidiary would be automatically reduced to the maximum enforceable amount.

In its decision, the TOUSA Bankruptcy Court found this provision, which is typical in complex lending arrangements with upstream and/or cross-stream subsidiary guarantees, to be facially unenforceable. The Bankruptcy Court then avoided the liens granted by the Conveying Subsidiaries to the New Lenders finding them to be part of the fraudulent conveyance notwithstanding the savings clause.

Among other things, the Bankruptcy Court reasoned that such provisions violated Bankruptcy Code's prohibition against *ipso facto* clauses (i.e., clauses that provide for an event of default upon insolvency). *Id.* at 863-64. The Bankruptcy Court further concluded that the savings clauses at issue constituted a "frontal assault on the protections that [S]ection 548 provides to other creditors" and were "entirely too cute to be enforced." *Id.* at 864.

The Bankruptcy Court's saving clause rulings—which have received heavy criticism from practitioners—are currently on appeal before Judge Jordan of the U.S. District Court for the Southern District of Florida. After Judge Gold's fraudulent conveyance opinion was issued, Judge Jordan permitted parties with respect to his appeal to submit supplemental briefs explaining how Judge Gold's opinion and reasoning, if adhered to, would affect the issues presented in the savings clause appeal.

Conclusion

To be sure, all causes of action alleging constructive fraudulent conveyances are inherently fact-specific, and the applicability of the Judge Gold's reasoning to future disputes will depend on the specific issues raised in those disputes. In addition, Judge Gold's opinion (as well as Judge Jordan's forthcoming savings clause opinion) may be supplemented or otherwise altered by the Circuit Court on appeal.

Nevertheless, the unfolding appeals in TOUSA's bankruptcy case will present an illustration of how courts are working through the tensions implicit in constructive fraudulent conveyance law with respect to complex financial transactions. Namely, Section 548 of the Bankruptcy Code (and similar state law) balances two competing sets of interests: (i) the interests of the lending community, which provides essential funding to troubled companies, in protecting the validity of such loans so long as the borrower receives objectively reasonably equivalent value in exchange for the enterprise's obligation to repay the debt; and (ii) the fear that lenders will overreach by demanding security, perhaps via assets held by guaranteeing subsidiaries, out of proportion to the funds they provide.

How courts resolve these tensions will shape the contours of complex secured financing transactions. Judge Gold's District Court ruling is the first major TOUSA appellate decision and takes a decidedly pro-lender tone. On the other hand, future courts could reverse the District Court's decision or limit it to it facts.

Other questions also remain. For example, it is unclear how a court would rule had the Conveying Subsidiaries not been direct obligors with respect to (and dependent upon the liquidity provided by) the Bonds and Revolver, a default under each of which was prevented by the July 31 Transaction.

Until clarity is achieved with respect to these issues, all transactions involving multiple subsidiary guarantors must be carefully considered and analyzed.

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