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In Destabilizing Decision for Secured Lenders, 11th Circuit Reverses TOUSA District Court

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On May 15, 2012, the Eleventh Circuit Court of Appeals issued a fraudulent transfer ruling in TOUSA, Inc.'s chapter 11 case with wide-ranging implications for the financing community. As discussed herein, this decision weakens protections for secured lenders, especially when extending credit to distressed borrowers.

The dispute arose out of a new $500 million loan TOUSA received months prior to its bankruptcy. TOUSA used the loan proceeds to settle claims of secured lenders stemming from a failed joint venture. A three-judge panel for the Eleventh Circuit unanimously reversed the district court and reinstated the bankruptcy court's ruling that the transaction constituted a constructive fraudulent transfer under section 548 of the Bankruptcy Code. The Eleventh Circuit affirmed that TOUSA's subsidiaries, which granted liens to secure the new debt, did not receive reasonably equivalent value in exchange. Although the Eleventh Circuit remanded as to remedies, the decision will likely permit the bankruptcy estate to recover over $420 million from the secured lenders that received the settlement payment out of the proceeds of the new loan. *In re TOUSA, Inc.*, No. 11-11071, --- F.3d ---, 2012 WL 1673910 (11th Cir. May 15, 2012).

Factual Background

TOUSA designed, built and marketed detached single-family residences, town homes, and condominiums under various brand names. As noted by the Eleventh Circuit, at one time TOUSA and its subsidiaries operated the 13th 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. The joint venture was funded with $675 million from various lenders (the "Transeastern Lenders"). Although TOUSA—the corporate parent—was the obligor on the secured loan from the Transeastern Lenders, this financing was independent of the financing for the remainder of the TOUSA enterprise.

As the housing market weakened, the joint venture failed. In turn, the Transeastern Lenders commenced litigation against TOUSA seeking the immediate repayment of their loan. An adverse ruling in that litigation would have caused TOUSA and several subsidiaries to cross-default under the terms of the enterprise's separate financing, which included $1 billion in unsecured bonds and $700 million in a secured revolving credit facility.

As the litigation progressed, the parties agreed to a settlement in which TOUSA would pay approximately $421 million to the Transeastern Lenders. To fund the settlement, TOUSA borrowed $500 million on a secured basis from new lenders (the "New Lenders"). Certain of TOUSA's subsidiaries also granted liens to the New Lenders to secure TOUSA's obligations on the new loan (the "Conveying Subsidiaries"). These Conveying Subsidiaries, however, had not previously guaranteed and were not otherwise independently liable for TOUSA's obligations to the Transeastern Lenders.

The settlement with the Transeastern Lenders and the related financing from the New Lenders were both consummated on July 31, 2007 (the "July 31 Transaction"). Consummating the July 31 Transaction involved several stages. Initially, the agent for the New Lenders transferred approximately $476 million to Universal Land Title, Inc. ("Universal"). Universal was a wholly owned subsidiary of TOUSA, but was not a Conveying Subsidiary. Next, Universal transferred approximately $426 million to CIT, the agent for the Transeastern Lenders. CIT transferred approximately $421 million to the Transeastern Lenders to settle the litigation against TOUSA. CIT then paid the remaining balance to cover professional, advisory and other fees.

On January 29, 2008, TOUSA and various subsidiaries, including the Conveying Subsidiaries, filed voluntary petitions for relief under chapter 11 in the United Stated Bankruptcy Court for the Southern District of Florida. TOUSA filed for chapter 11 relief a mere six months after the July 31 Transaction.

The Fraudulent Transfer Claim: Lien Avoidance and Proceeds Recovery

During TOUSA's bankruptcy case, the official committee of unsecured creditors (the "Creditors' Committee"), on behalf of the Conveying Subsidiaries, filed a lawsuit seeking to avoid the July 31 Transaction. The Creditors' Committee sought both to avoid the liens granted by the Conveying Subsidiaries to the New Lenders, and to recover the $421 million settlement payment from the Transeastern Lenders. The Creditors' Committee argued that the entire July 31 Transaction was voidable as a constructive fraudulent transfer under section 548 of the Bankruptcy Code. A transfer (or incurrence of an obligation) is constructively fraudulent if the debtor receives less than "reasonably equivalent value" in exchange. The debtor must also be insolvent when the transaction occurs, be rendered insolvent by the transaction, or be left with unreasonably small capital or assets to carry on its business as a result of the transaction.

Specifically, the Creditors' Committee contended that the Conveying Subsidiaries, insolvent at the time, did not receive reasonably equivalent value in exchange for granting liens to the New Lenders to secure TOUSA's repayment of the $500 million loan. In other words, although TOUSA—the corporate parent—received value in exchange for the $500 million loan (in the form of funds advanced for the satisfaction of TOUSA's debt to the Transeastern Lenders), the Conveying Subsidiaries failed to receive reasonably equivalent value for their liens because they did not receive any funds nor did they reduce any liabilities because they were not independently obligated on TOUSA's debt to the Transeastern Lenders.

The Creditors' Committee also argued that the $421 million settlement payment could be recovered from the Transeastern Lenders under section 550(a)(1) of the Bankruptcy Code. Section 550(a)(1) allows recovery of an avoided transfer from its initial transferee, which includes both the direct transferee and the party "for whose benefit" the transfer was made. Bankruptcy courts have traditionally understood that the clause "for whose benefit" permits a payment in satisfaction of a debt to be recovered from a guarantor of the debt because the guarantor benefits from the payment by having its own potential liability reduced. On the other hand, if TOUSA was deemed to be the initial transferee of the New Lenders' loan, the Transeastern Lenders would qualify as a subsequent transferee under section 550(a)(2). Although section 550(a)(2) permits recovery of a fraudulent transfer from a subsequent transferee, it does not permit recovery from a subsequent transferee that "takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided." This limitation, however, does not apply to recovery against initial transferees under section 550(a)(1).

The Creditors' Committee argued that TOUSA incurred the $500 million of new debt "for [the] benefit" of the Transeastern Lenders, and thus recovery was permitted against the Transeastern Lenders under section 550(a)(1). The Transeastern Lenders responded that the TOUSA enterprise generally (and Universal specifically) was the initial transferee of the New Lenders' loan. From this perspective, the Transeastern Lenders were the subsequent transferees of the funds. If the Transeastern Lenders were deemed to be subsequent transferees, it would permit them to defend against recovery on the grounds that they received the settlement payment in good faith and without knowledge that the New Lenders' loan could be avoided.

The Bankruptcy Court's Decision

In October 2009, the bankruptcy court ruled in favor of the Creditors' Committee and avoided the July 31 Transaction as a constructive fraudulent transfer. The bankruptcy court found sufficient facts to conclude that the Conveying Subsidiaries did not receive "reasonably equivalent value" in exchange for the liens they granted to the New Lenders. The bankruptcy court also held that the Transeastern Lenders were the initial transferees of the New Lenders' loan. Accordingly, 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 under section 550(a)(1). The Transeastern Lenders appealed.

The District Court Decision

In February 2011, the district court overturned the bankruptcy court's ruling. In a sharply worded decision, the district court found that the bankruptcy court committed "clear error" in adopting a narrow interpretation of "reasonably equivalent value." Specifically, the district court rejected the bankruptcy court's conclusion (as interpreted by the district court) that in order to receive any "value" under section 548 of the Bankruptcy Code, the Conveying Subsidiaries had to receive either actual "property"—i.e., some kind of enforceable entitlement to a tangible or intangible article—or indirect benefits susceptible to a "mathematical quantification." To the contrary, the district court asserted that under "well-established" law, value may encompass either direct or indirect benefits, and that "indirect benefits may take many forms, both tangible and intangible."

Thus, from the facts already on record, the district court concluded that the Conveying Subsidiaries had clearly received sufficient "value" from the New Lenders to sustain the July 31 Transaction. This value was evident from, among other things, the Conveying Subsidiaries avoiding immediate cross-default on TOUSA's bonds and revolver, as well as the ability of the corporate enterprise to remain viable and maintain its going-concern value.

Specifically, the district court 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."

The district court's decision under section 548 was sufficient to halt the disgorgement from the Transeastern Lenders (as ordered by the bankruptcy court). Nevertheless, the district court also addressed and rejected as clear error the bankruptcy court's conclusion that because the Conveying Subsidiaries became obligated on the New Loan and pledged their assets "for the benefit" of the Transeastern Lenders, recovery was available against the Transeastern Lenders as initial transferees under section 550(a)(1). Instead, the district court found that the obligations were incurred for the benefit of the entire TOUSA enterprise, which—in turn—resolved its parent's liability to the Transeastern Lenders. In so ruling, the district court noted that under existing case law, section 550(a)(1)'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."

Often where an appellate court reaches a different conclusion than a trial court based on, among other things, its interpretation of a statute (such as Bankruptcy Code sections 548 and 550), the matter will be remanded to the trial court for further proceedings. In contrast, in this case, the district court "quashed" the bankruptcy court's decision and resolved the dispute entirely in favor of the New Lenders and the Transeastern Lenders. In so doing, the district court also criticized the bankruptcy court for having adopted the Creditors' Committee's post-trial submissions almost verbatim. The Creditors' Committee appealed the decision.

The Eleventh Circuit Decision

The Eleventh Circuit reversed the district court. The Eleventh Circuit held that the bankruptcy court's factual findings (specifically, that the Conveying Subsidiaries did not receive reasonably equivalent value in the July 31 Transaction) were not clearly erroneous. In reaching this conclusion, the Eleventh Circuit (i) rejected the district court's conclusion that the bankruptcy court simply adopted the Creditors' Committee's unduly restrictive interpretations of "value" under section 548 of the Bankruptcy Code, and (ii) noted that the bankruptcy court "also issued alternative findings in which it assessed the value the Conveying Subsidiaries received under the broadest definition of 'value' proposed by the Transeastern Lenders and New Lenders." In other words, the Eleventh Circuit relied on the fact that the bankruptcy court had concluded (upon the record before it) that even if all the purported benefits to the Conveying Subsidiaries were legally cognizable, their value—"whether considered individually or as a whole"—fell "well short" of reasonably equivalent value.

It is interesting to note that in upholding the bankruptcy court's decision, the Eleventh Circuit "decline[d] to decide whether the possible avoidance of bankruptcy can confer 'value.'" It did note, however, that the "opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden" and that "not every transfer that decreases the odds of bankruptcy for a corporation can be justified."

On the factual record before it, the Eleventh Circuit agreed with the bankruptcy court that TOUSA's failure was inevitable and that the new loan thus conferred no value to the Conveying Subsidiaries: "The bankruptcy court found that bankruptcy for the Conveying Subsidiaries was 'inevitable' if TOUSA executed the [July 31 Transaction], … so the transaction could not have conferred value by giving the Conveying Subsidiaries an opportunity to avoid bankruptcy." The Eleventh Circuit is less clear, however, as to how

TOUSA's failure could be deemed to have been a foregone conclusion in July 2007. On the other hand, the Eleventh Circuit reviewed significant evidence that TOUSA was financially troubled during that time, including internal company notes and emails. On the other hand, the court discounted evidence that TOUSA's own advisers had concluded at the time that the company could remain viable after taking on the obligations in the July 31 Transaction.

The Eleventh Circuit also upheld the bankruptcy court's decision that the Transeastern Lenders were initial transferees of the New Lenders' loan under section 550(a)(1). Specifically, the Eleventh Circuit adopted the Bankruptcy Code's reasoning that the Transeastern Lenders were the parties "for whose benefit" the constructively fraudulent loan from the New Lenders was obtained. In so ruling, the court viewed the situation before it as not conceptually distinct from the one addressed in *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293 (11th Cir. 1988). In that case, the Eleventh Circuit held that the issuance of a secured promissory note to a bank for the purpose of obtaining a letter of credit in favor of an otherwise unsecured creditor on account of an antecedent debt could be avoided as a preference under section 547(b) of the Bankruptcy Code. It went on to hold that the value of the letter of credit could be recovered from the creditor under section 550(a)(1) because the creditor was the party "for whose benefit" the transfer of the promissory note was made.

The Eleventh Circuit noted that the reasoning in *Air Conditioning* "control[led]" TOUSA's appeal. The court specifically refused to distinguish Air Conditioning on the grounds that preferential transfers and fraudulent transfers present fundamentally different justifications for avoidance. Instead, the Eleventh Circuit concluded that it was compelled to find that section 550(a)(1) permitted recovery against the Transeastern Lenders.

In reaching these conclusions, the Eleventh Circuit dismissed the arguments of the Transeastern Lenders (which had been adopted by the district court) that requiring the Transeastern Lenders to disgorge the settlement payment effectively imposes an unfair and burdensome diligence requirement on lenders to investigate the source of the funds with which they are being repaid and the impact of a repayment or settlement transaction on the continued financial viability of its debtor, even when the legitimacy of the debt being repaid is not in question. The Eleventh Circuit rejected this concern, holding: "It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor."

Finally, the Eleventh Circuit remanded the matter to the district court on the issue of remedies. The Eleventh Circuit could not determine exactly what amounts should be disgorged from the Transeastern Lenders because that issue had not been determined by the district court. It seems clear, however, that such recovery will total at least the $421 million settlement amount.

Implications for Future Secured Lending Disputes

The Eleventh Circuit's decision addresses numerous legal issues. Three are of particular importance to the financing community. The ruling (i) weakens protections for loans to borrowers with complex corporate structures, (ii) weakens protections for loans to distressed companies generally, and (iii) adds further uncertainty to a lender's due diligence obligations when accepting satisfaction of a debt.

I. 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. These "upstream" or "cross-stream" guarantees often raise fraudulent transfer concerns because the subsidiaries arguably do not receive any direct economic benefit from the credit extended to others in the corporate family. The district court's decision had provided some further precedent for the position that these subsidiary-guarantees would be for "value" if the transaction strengthened the viability of the corporate group as a whole, or allowed the group to avoid imminent default and/or bankruptcy.

In reversing the district court's decision, the Eleventh Circuit has made the ability to rely on this type of intangible, hard-to-quantify consideration to support an upstream or cross-stream guarantee more difficult. As a result, lenders need to consider carefully the "value" of secured guarantees from subsidiaries when extending credit to a borrower, and in particular, the economic condition of the proposed subsidiary guarantor and the quantifiable economic benefits, if any, for the proposed subsidiary guarantor from the extension of credit to its parent.

II. Protections for Lending to Distressed Borrowers

The district court's decision also protected the New Lenders who were willing to finance a distressed company. The district court found that "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). The Eleventh Circuit, on the other hand, "decline[d] to decide whether the possible avoidance of bankruptcy can confer 'value' [under section 548 of the Bankruptcy Code]."

The district court's decision provided that lenders do not trigger fraudulent conveyance risk merely because the borrower may be distressed. The Eleventh Circuit's decision, however, casts significant doubt as to a lender's risk and may likely add to the cost of distressed lending, if a lender is otherwise willing to lend into a distressed situation.

III. Due Diligence Concerns

As noted above, the Eleventh Circuit's decision seems to impose an obligation on parties receiving payment from, at least, a distressed debtor to investigate whether the transaction funding the payment is not the product of a constructively fraudulent transfer. Unfortunately, the Eleventh Circuit fails to give any guidance as to the level or extent of diligence that is required. The court also appears to be conflating section 550(a)(1) with section 550(a)(2) of the Bankruptcy Code. Again, under section 550(a)(2), recovery is permitted against the subsequent transferee of a fraudulent transfer, unless the subsequent 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 transfer avoided." Bankruptcy courts have frequently discussed the knowledge and good faith standards under section 550(a)(2). Good faith and value are not defenses to recovery under section 550(a)(1), so it is unclear whether any level of diligence can in fact shield a creditor from liability where someone other than its debtor pays, contributes or through credit support facilitates the repayment of the amount owed to that creditor.

TOUSA's Pending Savings Clause Appeal in the District Court

Another important holding in the TOUSA bankruptcy court's October 2009 decision was the invalidation of the "savings clause" in the $500 million loan to the New Lenders. A savings clause is a typical contract provision that provides that, in the event certain provisions of a contract are deemed unenforceable, the other provisions of the same contract will remain enforceable to the extent permitted by law. The savings clause at issue in the loan to the New Lenders stated:

> 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.

Among other things, this savings clause was designed to insulate the New Lenders from fraudulent conveyance vulnerability. Specifically, in the event that a Conveying Subsidiary was deemed to be avoidable as a fraudulent conveyance because the Conveying Subsidiaries had undertaken obligations in excess of the value received in exchange, the obligation incurred by each Conveying Subsidiary would be automatically reduced to the maximum enforceable amount.

The bankruptcy court held the TOUSA savings clause was unenforceable on its face. The bankruptcy court found the savings clause to be a "frontal assault on the protections that section 548 provides to other creditors" and to be "entirely too cute to be enforced."

The bankruptcy court's saving clause ruling implicates the enforceability of similar provisions that are typical in complex lending arrangements with upstream and/or cross-stream subsidiary guarantees. The ruling received heavy criticism from practitioners, and is currently on appeal before Judge Jordan of the U.S. District Court for the Southern District of Florida. That appeal had been stayed pending the Eleventh Circuit's ruling discussed above. After the Eleventh Circuit's recent decision, Judge Jordan may be forced to determine what effect the TOUSA savings clause has on the July 31 Transaction.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

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