District Court "Quashes" TOUSA Fraudulent Transfer Decision Providing Some Relief to Lenders

Arlene Elgart Mirsky and Adam J. Glanzman of Sills Cummis & Gross P.C.

In a recent 113 page decision, Judge Alan S. Gold of the United States District Court for the Southern District of Florida quashed a significant portion of a controversial 2009 bankruptcy court fraudulent conveyance decision that had required certain secured lenders to disgorge approximately $480 million received in debt repayments and interest.[1] As described in more detail below, the district court found that indirect benefits such as avoiding default and delaying bankruptcy can serve as "reasonably equivalent value" under the Bankruptcy Code[2] and that lenders have no legal duty to "conduct…extraordinary due diligence with respect to the provenance of the funds with which they were being repaid."[3]

For the time being, the District Court Opinion provides comfort to lenders in situations where loan proceeds benefit only one member of a corporate group even though all members of that group are jointly obligated to repay the loan. However, with fewer unencumbered assets available in major bankruptcy cases, creditors' committees will continue to aggressively pursue avoidance actions, at least until a number of related appeals in the *TOUSA* case are resolved (and if the District Court Opinion is ultimately upheld by the Eleventh Circuit).[4]

Background

TOUSA, Inc. ("TOUSA") and various affiliates and subsidiaries designed, built, and marketed detached single family residences, town homes, and condominiums.[5] The majority of the home-building assets were held by two subsidiaries, TOUSA Homes, Inc. and its wholly-owned subsidiary, Newmark Homes LP.[6] TOUSA grew rapidly between 1995 and 2005, and acquired other home-building companies.

In order to finance its operations, TOUSA and its subsidiaries relied on bonds and a revolving credit facility ("Revolver").[7] Between June 2002 and April 2006, TOUSA conducted six notes issuances under bond indentures. TOUSA was the obligor under the bond indentures, which were jointly and severally guaranteed by many of its subsidiaries (including most of the "Conveying Subsidiaries" referred to below).[8] Under the terms of the indentures, either a bankruptcy filing by TOUSA or its subsidiaries or a judgment of more than $10 million against TOUSA or its subsidiaries would constitute an event of default permitting the note holders to demand full repayment.[9]

A Prospectus, describing the subsidiaries' role in TOUSA's notes repayment and disclosing other debts of the subsidiaries, was issued for each bond offering.[10] The Prospectuses disclosed that TOUSA was mainly responsible for the repayment of the notes, with the actual funds coming from the net operations of TOUSA and its subsidiaries, and that TOUSA's cash flow depended on its subsidiaries.[11]

The Revolver was TOUSA's primary source of liquidity and funded TOUSA's working capital, land acquisitions, and letter of credit and surety bond obligations.[12] The Revolver was capped at $800 million and the amount available was determined monthly based on the combined value of the pledged assets of TOUSA and certain subsidiaries. While TOUSA and its subsidiaries had full access to the Revolver, TOUSA, as "Administrative Borrower," exercised more control and was authorized to give notice on behalf of all of the borrowers, with each of the borrowers appointing TOUSA as their agent for all purposes under the agreement.[13] As with the bond indentures, any bankruptcy involving TOUSA or its subsidiaries or a judgment of more than $10 million against TOUSA or its subsidiaries would constitute an event of default.[14]

When TOUSA experienced financial difficulties, Citicorp, as administrative agent, demanded more security for the Revolver.[15] The Conveying Subsidiaries eventually agreed to pledge assets as security under the Revolver and listed themselves as "Subsidiary Borrowers" under the Revolver.

In June 2005, Tousa Homes LP ("Tousa Homes LP"), a wholly-owned subsidiary of TOUSA, and another builder formed a joint venture to acquire certain home-building assets of Transeastern Properties, Inc., a then-leading developer in Florida.[16] The joint venture was funded with a $335 million senior secured term loan and a $115 million senior secured revolving credit agreement from a group of lenders called the "Senior Transeastern Lenders," a $137.5 million term loan from a group of lenders called the "Senior Mezzanine Lenders," and an $87.5 million loan from the "Junior Mezzanine Lender" (collectively, "Transeastern Lenders").[17]

In connection with each of these loans, TOUSA and Tousa Homes LP provided a completion guarantee that obligated the guarantors to complete work on the properties where construction had commenced at the time of the loan, and a carve-out guarantee requiring the guarantors to indemnify the lenders from losses due to the joint venture's fraud or other wrongful conduct.[18] Each carve-out guarantee also required the guarantors to make full repayment of the loans in the event that the joint venture filed for bankruptcy protection.[19]

The joint venture began experiencing financial difficulties and, 14 months after the financing agreements for the joint venture were executed, the administrative agent for the Transeastern Lenders alleged that TOUSA and Tousa Homes LP were liable under the completion and carve-out guarantees.[20] Litigation then ensued regarding the guarantors' liability under the completion and carve-out guarantees.[21] TOUSA feared that the amount of liability under the completion guarantee would far exceed the amount required to resolve the action and decided to settle the litigation.[22] In order to fund the settlements with the Transeastern Lenders, TOUSA entered into a First Lien Term Loan in the amount of $200 million and a Second Lien Term Loan in the amount of $300 million (collectively, "New Loans").[23] These loans named many of TOUSA's subsidiaries ("Conveying Subsidiaries") as "Subsidiary Borrowers" and required the Conveying Subsidiaries to pledge their assets as security.[24] The District Court Opinion noted that "[c]ertain of the lenders served as both Transeastern Lenders and First or Second Lien Term Loan Lenders."[25]

Bankruptcy Filing

Approximately six months after entering into the new settlements and financings, TOUSA and most of its subsidiaries filed voluntary bankruptcy petitions under chapter 11 of the Bankruptcy Code. An official committee of creditors ("Committee") was appointed. The Committee then brought suit (on behalf of the Conveying Subsidiaries) against the

Transeastern Lenders and the lenders for the New Loans ("New Lenders"), alleging that the New Loans constituted fraudulent transfers under 11 U.S.C. § 548 because they rendered the Conveying Subsidiaries insolvent and that the Conveying Subsidiaries had not received "reasonably equivalent value" because the proceeds were used to pay off litigation in which the Conveying Subsidiaries were not defendants. The Committee, also sought to recover the $420 million paid to the Transeastern Lenders under the settlement from the proceeds of the New Loans.

After holding a bench trial for over 13 trial days, the bankruptcy court ruled in favor of the Committee and avoided the liens held by the New Lenders against the assets of the Conveying Subsidiaries, as well as their obligations to the New Lenders. In so ruling, the bankruptcy court found that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for pledging their assets since the Conveying Subsidiaries exercised no control over the loan proceeds that were transferred to Universal Land Title, Inc., a wholly-owned subsidiary of TOUSA, to fund the TOUSA settlement.[26] Additionally, according to the bankruptcy court, the settlement did not benefit the Conveying Subsidiaries since they did not owe an antecedent debt to the Transeastern Lenders.[27] The bankruptcy court also found that the settlement did not improve the day-to-day business operations of the Conveying Subsidiaries or prevent a TOUSA bankruptcy. Furthermore, as the bankruptcy court declared, "even assuming the Transaction did not prevent (or at least postpone) a TOUSA, Inc. bankruptcy, it still conferred no substantial benefits on the Conveying Subsidiaries because the Conveying Subsidiaries would not have been seriously harmed by such an earlier bankruptcy."[28] The bankruptcy court reasoned that the "Conveying Subsidiaries—which held some 95% of TOUSA's assets—could have obtained their own financing even if the parent were in bankruptcy."[29]

The bankruptcy court further determined that "[a] reasonable assessment of TOUSA's finances prior to the July 31 Transaction would have shown that the Conveying Subsidiaries were already insolvent and were going to be left with unreasonably small capital if the Transaction went through."[30] Moreover, the bankruptcy court found that "there was overwhelming evidence that TOUSA was financially distressed beginning in 2006 and that its financial problems rapidly worsened in the first seven months of 2007."[31] The bankruptcy court also held that the Transeastern Lenders were entities "for whose benefit the transfer was made" under 11 U.S.C. § 550(a)(1) and ordered the Transeastern Lenders to disgorge approximately $403 million in principal received and pay prejudgment interest on the full amount of that disgorgement.[32]

District Court Opinion[33]

On appeal, the district court quashed the Bankruptcy Court Opinion.[34] The district court noted that the central issue under 11 U.S.C. § 548(a)(1)[35] is whether each transfer constituted property of the debtors.[36] The district court concluded that the Conveying Subsidiaries never had control over the proceeds of the New Loans since the First Lien Term Loan Agreement and the Second Lien Term Loan Agreement required that the proceeds be used to pay the Transeastern Lenders, and that only TOUSA, as the primary borrower, had authority under the loan documents to control the distribution of the loan proceeds.[37] The district court held that under the Eleventh Circuit's control test,[38] the transfer was "not the property of the debtor and the transfer is not avoidable under a 'direct transfer' theory."[39] Rather, the district court noted that "[t]he transfer was part of a larger, complicated scheme involving numerous entities, and that "[t]o conclude otherwise would confer on the Committee a windfall at the expense of a valid antecedent lender who was innocent of any intent to diminish the assets of the debtor."[40]

Additionally, the district court decided that the bankruptcy court had erred as a matter of law and fact by not recognizing the indirect benefits received by the Conveying Subsidiaries from the July 31 Transaction as reasonably equivalent value.[41] The district court explained that "[t]he Bankruptcy Code does not define 'reasonably equivalent value'" and that "[i]n order to determine whether a debtor received 'reasonably equivalent value,' a court must look at what 'value' the debtor received in return for the transfer."[42] The district court also pointed out that reasonably equivalent value must be evaluated as of the date of the transaction and not by using hindsight.[43]

As the district court stated, "the weight of authority supports the view that 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, may be considered in determining reasonable equivalent value."[44] The district court observed that the "legislative history for the Bankruptcy Reform Act of 1978 provides that '[a]lthough 'property' is not construed in [11 U.S.C. § 102], it is used consistently throughout the Code *in its broadest sense*, including cash, all interests in property, such as liens, *and every kind of consideration* including promises to act or forbear to act as in section 548(d).'"[45] Citing the Third Circuit's opinion in the case of *In re R.M.L. Inc.*,[46] the district court explained that "[w]hat is key in determining reasonable equivalency 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."[47]

Ultimately, the district court concluded that the "Conveying Subsidiaries themselves, as compared to only the TOUSA Parent, had received indirect economic benefits, constituting reasonably equivalent 'value,' in exchange for their lien transfers."[48] The district court remarked that the Conveying Subsidiaries' existence was "contractually tied through their pre-existing guarantees to the outcome of the claims in the Transeastern Litigation against the TOUSA parent which had guaranteed the debt."[49] As the district court reasoned, an adverse judgment in litigation with the Transeastern Lenders would have forced TOUSA and the Conveying Subsidiaries to file for bankruptcy and would have led to the disappearance of the Revolver, which was the Conveying Subsidiaries' primary source of liquidity, and therefore, "eliminating the threat of these 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."[50] The district court also pointed out that "[b]y virtue of the Transeastern Settlement, the Conveying Subsidiaries' 'net worth' was preserved and imminent default was avoided, thereby preserving, at that point of time, the interests of the Committee's unsecured creditors by allowing the enterprise to continue to meet its bond interest obligations and Revolver loan payments."[51] Furthermore, the district court found that the Conveying Subsidiaries' assets would not have been able to obtain alternative financing without the TOUSA parent since their assets secured the Revolver.[52]

Moreover, the district court decided that the Transeastern Lenders were not liable under 11 U.S.C. § 550(a).[53] Specifically, the district court commented that under § 550(a), a trustee may only recover an avoidable transfer from an initial transferee, an entity for whose benefit the transfer was made, or a subsequent transferee.[54] The district court held that the Transeastern Lenders were neither "initial transferees" nor "entities for whose benefit the transfer was made," but instead were "subsequent transferees," and as such, the transfers were not avoidable.[55] As the district court resolved, even if the Transeastern Lenders were an "immediate transferee," 11 U.S.C. § 550(b)(1)[56] prevented the transfers from being avoided since the Transeastern Lenders took for value, in good faith, and without knowledge of the voidability of the transfer.[57]

While the bankruptcy court held that the Transeastern Lenders had acted in bad faith and were grossly negligent since they knew or should have known that TOUSA and the Conveying Subsidiaries were insolvent on the date of the transfer, the district court found that the Transeastern Lenders had no duty to conduct "such extraordinary due diligence with respect to the provenance of the funds with which they were being repaid."[58] As the district court reasoned, such a standard would "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."[59]

Conclusion

The central pillar of the district court's holding was its belief that the Transeastern Litigation threatened the entire TOUSA enterprise, including the Conveying Subsidiaries, and that the settlement strengthened the viability of the TOUSA corporate group. The District Court Opinion identified several factors that led it to conclude that TOUSA and the Conveying Subsidiaries were one enterprise. First, the district court stressed that the Prospectuses stated that TOUSA's corporate structure consisted of a "highly integrated and consolidated enterprise" and that TOUSA's ability to service its debt was dependent upon the cash flow of the Conveying Subsidiaries.[60] Second, the district court emphasized that the Board of Directors of each Conveying Subsidiary, which contained directors not on the board of the TOUSA parent, concluded that the settlement was in the best interest of the TOUSA enterprises and approved using the proceeds of the New Loans to pay off the Transeastern Lenders.[61] Third, the district court noted that the Revolver benefited the entire TOUSA corporate group, serving as the main source of liquidity for the Conveying Subsidiaries.[62]

While not the final word on the TOUSA case and fraudulent transfer law, in nullifying some of the holdings in the Bankruptcy Court Opinion, an opinion many in the lending community had found very troubling, Judge Gold's rulings and the factors that he cited in analyzing "reasonably equivalent value" may prove helpful to lenders in other cases, even though all fraudulent transfer cases are, for the most part, fact-specific. Moreover, by correcting what he 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,"[63] Judge Gold removed an additional risk for lenders in accepting debt repayments created by the Bankruptcy Court Opinion. However, until the appeals are resolved,[64] we will have to wait to see the long term effects on future lending practices of the District Court Opinion and other related issues raised by the TOUSA bankruptcy case.

Arlene Elgart Mirsky (amirsky@sillscummis.com) is a Member in the Sills Cummis & Gross P.C. Corporate, Securities & Banking Department, resident in the firm's Newark, NJ office. Her practice focuses on corporate and bankruptcy law and the structuring, negotiation and documentation of a wide variety of business and financial transactions. Her corporate practice involves her in every aspect of mergers and acquisitions, including strategic alliances, auctions, acquisitions of troubled companies, and advice on corporate governance matters. In the reorganization and bankruptcy areas, Ms. Mirsky advises a broad mix of creditors, institutional investors, trustees, official creditors' committees and others in all aspects of business and debt restructuring and bankruptcy law. She also has served as a legal consultant to The World Bank and to the U.S. Agency for International Development, providing advice to the sovereign governments of 16 Central and Eastern European countries. She is a frequent lecturer on legal and business topics and is the author of numerous publications on legal, business and international economic issues.

Adam J. Glanzman (aglanzman@sillscummis.com) is an Associate in the Sills Cummis & Gross P.C. Creditors' Rights/Bankruptcy Reorganization Practice Group, resident in the firm's Newark, NJ office.

Any views or opinions expressed in this article are not intended to be attributable to our clients, and are not intended to bind Sills Cummis & Gross P.C. or our clients to any positions expressed herein. This article is intended only as a general discussion of issues and should not be relied upon as legal advice.

---

1 *See 3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of TOUSA (In re TOUSA, Inc.)*, No. 10-60017-CIV/GOLD, slip op. (S.D. Fla. Feb. 11, 2011) [hereinafter District Court Opinion]; *see also Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am, Inc. (In re TOUSA, Inc.)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009) [hereinafter Bankruptcy Court Opinion].

2 District Court Opinion, at 73.

3 Id. at 103-04.

4 The District Court Opinion concerned only the appeals filed by the Senior Transeastern Lenders and, as such, did not address the validity of the savings clauses in the New Loans, an issue of great importance to lenders since such clauses provide that the obligations and liens of co-obligors are deemed reduced to the extent necessary to prevent the insolvency of each obligor. On March 4, 2011, Judge Adalberto J. Jordan of the United States District Court for the Southern District of Florida entered an order affirming the bankruptcy court's dismissal of the Committee's fraudulent conveyance claims against the lenders for the Revolver. *See* Order Affirming Decision of Bankruptcy Court, *In re Tousa, Inc.*, No. 09-60589 (S.D. Fla. Mar. 4, 2011). The Administrative Agents and certain lenders for the First Lien Term Loan and the Second Lien Term Loan filed appeals (*Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc.*, No. 10-cv-61731 (S.D. Fla.) and *Wells Fargo Bank, N.A. v. Official Committee of Unsecured Creditors of TOUSA and TOUSA, Inc.*, No. 10-cv-60018 (S.D. Fla.)), which are pending before Judge Jordan. On March 28, 2011, Judge Jordan entered orders staying those appeals pending the appeal of the District Court Opinion to the Eleventh Circuit.

5 District Court Opinion, at 2.

6 Id. at 3-4.

7 Id. at 4.

8 Id. at 6.

9 Id. at 8.

10 Id. at 4.

11 Id. at 5.

12 Id. at 10.

13 Id. at 12.

14 Id. at 13.

15 Id. at 11.

16 Id. at 14-15.

17 Id. at 16-17.

18 Id. at 17.

19 Id. at 18.

20 Id. at 19.

21 Id. at 20.

22 Id. at 22.

23 Id. at 25.

24 Id. at 26.

25 Id. at 25, n.24.

26 Bankruptcy Court Opinion, at 844.

27 Id. at 875.

28 Id. at 846.

29 Id.

30 Id. at 850.

31 Id. at 851.

32 Id. at 886.

33 Due to the length of the District Court Opinion and the complexity of the underlying facts, we have summarized only the most noteworthy aspects of Judge Gold's ruling.

34 Rather than choosing to reverse the bankruptcy court and remand, Judge Gold found the bankruptcy court's analysis so legally and factually deficient that he decided to quash (nullify) the Bankruptcy Court Opinion instead, stating that the bankruptcy court had improperly adopted the Committee's proposed findings of fact and conclusions of law nearly verbatim. District Court Opinion, at 111.

35 11 U.S.C. § 548(a)(1) provides that: "The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily— (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a

result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business."

[36] District Court Opinion, at 41.

[37] Id. at 52.

[38] As explained by the district court, "[t]he Eleventh Circuit's control test encompasses two elements: (1) the power to designate which party will receive the funds, and (2) the power to actually disburse the funds at issue to that party. In other words, control means control over identifying the payee, and control over whether the payee will actually be paid." Id. at 52 (citing *Tolz v. Barnett Bank of S. Fla. (In re Safe-T-Brake of S. Fla., Inc.)*, 162 B.R. 359, 365 (Bankr. S.D. Fla. 1993)).

[39] District Court Opinion, at 53.

[40] Id. at 53-54.

[41] Id. at 62.

[42] Id. at 65 (citing *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.)*, 92 F.3d 139, 149 (3d Cir. 1996)).

[43] Id. at 85 (citing *Corporation Liquidation Trust v. Chang (In re Joy Recovery Tech. Corp.)*, 286 B.R. 54, 75 (Bankr. N.D. Ill. 202) ("Courts will not look with hindsight at a transaction because such an approach could transform fraudulent conveyance law into an insurance policy for creditors.")).

[44] Id. at 73.

[45] Id. at 67 (citing Statement by Legislative Leaders, 124 Cong. Rec. 11,089 (1978), reprinted in 1978 U.S.C.C.A.N. 6439, 6508).

[46] *R.M.L., Inc.*, 92 F.3d at 152.

[47] District Court Opinion, at 74.

[48] Id. at 63-64.

[49] Id. at 78.

[50] Id. at 80.

[51] Id. at 83.

[52] Id. at 90.

[53] 11 U.S.C. § 550(a) provides that: "(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) 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."

[54] District Court Opinion, at 93.

[55] Id. at 101.

[56] 11 U.S.C. § 550(b) provides that: "(b) The trustee may not recover under section [subsection] (a)(2) of this section from— (1) a 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; or (2) any immediate or mediate good faith transferee of such transferee."

[57] District Court Opinion, at 102.

[58] Id. at 103-04.

[59] Id. at 103.

[60] Id. at 82.

[61] Id. at 58.

[62] Id. at 81.

[63] District Court Opinion, at 107.

[64] *See* supra note 4.