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District Court Reverses Bankruptcy Court's Decision in *TOUSA*

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3V Capital Master Fund LTD. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.), 2011 U.S. Dist. LEXIS 14019 (S.D. Fla. Feb. 11, 2011).

In the decision *3V Capital Master Fund LTD. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.)* the United States District Court for the Southern District of Florida, reversed a bankruptcy court's decision to avoid a multimillion dollar repayment of a valid antecedent debt as a fraudulent transfer. In reversing the Bankruptcy Court's controversial decision, the District Court found that the relevant Debtors had no property interest in the transferred funds as required under Section 548 of the Bankruptcy Code and, further, received reasonably equivalent value in the form of indirect economic benefits as a result of the transfer. The District Court also rejected the notion that lenders have a duty to investigate the financial stability of subsidiaries or affiliates of the borrower before they can accept repayment of a valid antecedent debt. The ramifications of the decision are still unclear, as another portion of the appeal is being heard by a different judge in the Southern District of Florida. Parties believe that the Eleventh Circuit will ultimately rule on the issues presented.

Background

TOUSA[1] involved a fraudulent transfer action brought by the Official Committee of Unsecured Creditors (the Committee) in the bankruptcy case of TOUSA, Inc. (TOUSA), and its various affiliates and subsidiaries (collectively, the Debtors), who build and design homes. The Committee brought the action derivatively on behalf of a smaller group of subsidiaries, known as the Conveying Subsidiaries of TOUSA.

The Debtors funded their operations through successive bond offerings totaling $1.06 billion of senior unsecured bonds, and a revolving credit facility, which was capped at $800 million (the Original Debt). Some of the Conveying Subsidiaries were guarantors of the Original Debt. Both the revolving facility and bond indentures had default provisions which included, as an event of default, any money judgment against a borrower or subsidiary of more than $10 million.

In June 2005, TOUSA became involved in a joint venture (the Joint Venture) with Transeastern Properties, a Florida developer. The Joint Venture was funded by a consortium of lenders (the Transeastern Lenders) with a three-tier structure comprised of

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senior secured debt, senior mezzanine debt, and junior mezzanine debt (the Joint Venture Debt). The Conveying Subsidiaries did not act as guarantors for the Joint Venture Debt; however, in order to obtain requisite consents under the Original Debt, the Conveying Subsidiaries pledged additional assets as security under the Original Debt obligations.

The Joint Venture was not profitable and towards the end of 2006, the agent for the Transeastern Lenders commenced litigation against TOUSA (as guarantor of the Joint Venture Debt), asserting breach of contract and demanding repayment of all of the Joint Venture Debt. Faced with the choice of either litigating or settling, TOUSA decided to settle; all parties believed that if TOUSA lost in litigation any judgment would be in excess of $10 million, thereby creating an event of default under the Original Debt.[2]

To fund the settlement, TOUSA acquired additional financing from a consortium of lenders (the New Debt). Both TOUSA and the Conveying Subsidiaries were listed as borrowers on the New Debt, and the Conveying Subsidiaries pledged their assets (the New Liens) for the New Debt. The terms of the New Debt stipulated that all of the proceeds of the loan would be used to fund the settlement. On July 31, 2007, the deal closed and TOUSA received the funds which it in turn conveyed to the lenders to the Joint Venture Debt.

The Bankruptcy Court's Decision

On January 29, 2008, TOUSA and its subsidiaries and affiliates, including the Conveying Subsidiaries, filed for bankruptcy in the Southern District of Florida. On July 14, 2008, the Committee commenced the fraudulent transfer litigation on behalf of the Conveying Subsidiaries, using the derivative standing it had been granted on May 28, 2008. Following a lengthy trial, the Bankruptcy Court concluded that (i) the New Liens should be avoided under Sections 544 and 548 of the Bankruptcy Code as fraudulent transfers, (ii) the Transeastern Lenders were entities "for whose benefit" the improper transfers were made, and (iii) the transfer of funds made to the Transeastern Lenders pursuant to the settlement should be disgorged. The Bankruptcy Court further determined that the recovery of the amounts repaid to the Transeastern Lenders was authorized under section 550 of the Bankruptcy Code, which provides that where a fraudulent conveyance under section 548 has occurred the estate can recover the asset transferred, or "the value of such property," from the recipient of the transfer or the entity "for whose benefit such transfer was made."[3]

The District Court's Analysis and Holding

The District Court addressed two issues in its analysis:

- Whether the Transeastern Lenders can be compelled to disgorge to the Conveying Subsidiaries funds paid by TOUSA to satisfy a legitimate, uncontested debt, where the Conveying Subsidiaries did not control the transferred funds.
- Whether the Transeastern Lenders are liable for disgorgement as the entities "for whose benefit" the Conveying Subsidiaries transferred the Liens to the New Lenders, where the Transeastern Lenders received no direct and immediate benefit from the Lien Transfer.[4]

Although the clearly erroneous standard is appropriate for review of a bankruptcy court's findings of fact, the District Court noted that "this case presents a distinct issue on appeal because the Bankruptcy Court's Order is practically a verbatim adoption of the Committee's Proposed Findings of Fact[,]"[5] in spite of a Joint Stipulation of Facts that the Bankruptcy Court could have relied upon in issuing

its Order. Thus, the District Court relaxed the clearly erroneous standard in its review of the findings of fact from below.

In its legal analysis, the District Court first noted that Section 548 of the Bankruptcy Code only applies to a transfer "of an interest of the debtor in property."[6] In the Eleventh Circuit a transfer will be avoided where the debtor "actually controls" the property that is transferred.[7] The District Court found that, as a matter of law, the Conveying Subsidiaries "never had any property interest in the New Loan proceeds," because the New Loan proceeds were explicitly earmarked, by their terms, for the Transeastern Lenders, "thus [the Conveying Subsidiaries] transferred nothing to the Transeastern Lenders"[8] nor could they under the terms of the New Loan.

Even assuming that the Conveying Subsidiaries had an interest in the New Loan proceeds, the District Court found that they received reasonably equivalent value in exchange for the transfer of the New Liens. The reasonably equivalent value must match the extent of the debtor's interest in the property that is conveyed.[9] The District Court chastised the Bankruptcy Court's "narrow definition of 'value'"[10] and stated that in the Eleventh Circuit value can mean "economic benefits" and include indirect benefits like the preservation of the estate, a "debtor's reprieve from foreclosure," and the "opportunity to avoid bankruptcy[,]" *even if* short lived.[11] The Conveying Subsidiaries received reasonably equivalent value in the July 31, 2007 transaction because without the settlement their obligations under the Original Debt would have been immediately due and owing, and the Conveying Subsidiaries would have lost their source of operating funds.[12] Furthermore, the District Court found "clear error" in the Bankruptcy Court's determination that the Conveying Subsidiaries could have survived were TOUSA to default on the Original Debt,[13] characterizing the Bankruptcy Court's conclusion that the Conveying Subsidiaries could have found sources of alternative standalone financing as speculative and resulting from erroneous "hindsight" reasoning.[14]

Next, the District Court turned to the Bankruptcy Court's finding that the Transeastern Lenders were liable as entities "for whose benefit" the Conveying Subsidiaries transferred the New Liens, and found that "as a matter of law the Conveying Subsidiaries cannot recover from the Transeastern Lenders pursuant to Section 550 of the Bankruptcy Code."[15] Section 550 of the Bankruptcy Code allows a trustee to recover from three types of entities:

(i) an initial transferee,

(ii) an entity for whose benefit the initial transfer was made, or

(iii) a subsequent transferee.[16]

Generally, it is the guarantors of the underlying debt who are deemed the entity "for whose benefit the initial transfer was made" when there is repayment of the debtor's debt.[17] In this instance, the Transeastern Lenders could not "fit the 'paradigm' classification as an entity for whose benefit a transfer was made because they were not guarantors of the debtor Conveying Subsidiaries."[18] Furthermore, the Transeastern Lenders could not be considered the initial transferees because "the initial transfer for statutory purposes, was the transfer of liens from TOUSA and the Conveying Subsidiaries to the New Lenders *who exercised full legal control over the liens.*"[19] The District Court rejected the Bankruptcy Court's attempt to find a benefit flowing to the Transeastern Lenders from the transfer of the New Liens as sufficient to qualify as a "benefit" under Section 550 of the Bankruptcy Code. "Simply put, the 'for whose benefit' language 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 — the 'benefit must derive directly from the [initial] transfer, not from the use to which it is put by the transferee.'"[20]

The District Court further rejected the Bankruptcy Court's determination that the Transeastern Lenders acted in bad faith to obtain repayment of their debt because they knew or should have known that the Debtors were insolvent. "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."[21] The District Court warned that the establishment of such an extraordinary duty of care would impose an unfair burden on creditors and have a chilling effect on lenders accepting payment of valid antecedent debts.

In fashioning its remedies, the District Court took the unusual step of declining to remand the case back to the Bankruptcy Court, because "the Transeastern Lenders have raised compelling arguments concerning the near-*verbatim* opinion issued by the Bankruptcy Court and its ability to conduct further proceedings in this matter."[22] Instead, the District Court quashed the order of the Bankruptcy Court, in effect vacating the judgment below and relieving the Transeastern Lenders of their obligation to return the amounts paid (subject to any appeal to the Eleventh Circuit Court of Appeals).

The Implications of *TOUSA*

As discussed above, separate appeals involving the lenders under the New Debt are pending before United States District Court Judge Adalberto Jordan. Part of the appeal was resolved on March 4, 2011, when Judge Jordan affirmed the Bankruptcy Court's ruling that the amendment of the revolving facility (part of the Original Debt) in 2007, and the concomitant granting of liens on existing collateral (*i.e.*, collateral that was pledged in 2006), was not a new "transfer" in 2007, and thus the Committee could not state a claim under Sections 544 or 548 of the Bankruptcy Code. Although there will likely be an appeal to the Eleventh Circuit, lenders have already expressed their approval of the District Court's *TOUSA* decision. In response to the Bankruptcy Court's decision, numerous scholarly articles have been written denouncing it as unfairly burdensome to lenders.[23] However, lenders can take comfort in the fact that as of now they have no heightened duty to investigate the financial viability of a parent's subsidiaries when accepting payment of a valid antecedent debt, which also positively impacts the ability of a borrower to obtain funds.

The District Court's broad consideration of what can be "reasonable equivalent value" is also relevant for practitioners bankruptcy law. As the decision notes, courts have been increasingly willing to view upstream guarantees as part and parcel of contemporary financing practices and legitimate business transactions.[24] These types of guarantees should not be avoided as fraudulent transfers; they are designed to enhance a parent's ability to obtain financing, not subvert creditors trying to obtain repayment of their debt. There is also no rule requiring a "precise mathematical quantification" to demonstrate that a debtor received reasonably equivalent value. Rather, "indirect, intangible, economic benefits, including the opportunity to avoid default" can and should be taken into account in determining reasonably equivalent value for purposes of the fraudulent transfer laws.[25]

Endnotes

1 All references are to the District Court's decision, unless noted otherwise.

2 *3V Capital Master Fund Ltd. v. Official Comm. Of Unsecured Creditors of TOUSA, Inc.(In re TOUSA, Inc.)*, 2011 U.S. Dist. LEXIS 14019 *62-64, (S.D. Fla. Feb. 11, 2011).

[3] 11. U.S.C. § 550.

[4] *TOUSA,* at *70.

[5] *Id*. at *75.

[6] 11 U.S.C. § 548.

[7] *TOUSA*, at *84-6.

[8] *Id*. at *83.

[9] *Id*. at *99.

[10] *Id*. at *116.

[11] *Id*. at *117.

[12] *Id*. at *137-8.

[13] *Id*. at *148.

[14] *Id*. at *150

[15] *Id*. at *156-7.

[16] 11 U.S.C. § 550(a).

[17] *TOUSA*, at *156.

[18] *Id*. at *160

[19] *Id*. at *162 (emphasis in the original).

[20] *Id*. at *168 (citation omitted, emphasis in the original).

[21] *Id*. at *173.

[22] *Id*. at *184.

[23] *Id*. at *175.

[24] *Id*. at *121-3.

[25] *Id*. at *141.

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