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# Eleventh Circuit Reverses Fraudulent Transfer Ruling in TOUSA Bankruptcy Case

On May 15, 2012, the United States Court of Appeals for the Eleventh Circuit issued a ruling in the closely watched fraudulent transfer litigation involving the bankrupt homebuilder TOUSA, Inc. The litigation initially had resulted in a highly controversial and much criticized ruling by the Florida Bankruptcy Court that voided various loan transactions as fraudulent transfers and sent serious ripples throughout the lending community. That ruling was reversed by the District Court in a scathing decision that was highly critical of the Bankruptcy Court. The Circuit Court, in turn, reversed the District Court and reinstated the Bankruptcy Court's original ruling. The upshot is that commercial lenders are at greater risk of being saddled with significantly increased due diligence obligations and having their distressed loan transactions challenged, which in turn could increase lending costs to the detriment of commercial borrowers.

## Overview of the TOUSA Transactions

TOUSA was the ultimate parent company of the TOUSA corporate family. It was obligated on significant unsecured debt owed by one of its joint ventures to various lenders (Transeastern Lenders). This debt went into default, resulting in significant litigation between TOUSA and the Transeastern Lenders that jeopardized the viability of the entire TOUSA enterprise. TOUSA ultimately determined to settle the litigation by paying the Transeastern Lenders approximately $420 million. To finance this settlement, the TOUSA group borrowed $500 million from a separate group of lenders (New Lenders).

The evidence at trial suggested that various officers of TOUSA were gravely concerned about the impact the new loan would have on the company's operations. That evidence also suggested that the new loan was strongly favored by TOUSA's largest shareholders, who were opposed to financing the settlement through an issuance of new equity that would have diluted their holdings. The $500 million loan from the New Lenders was guaranteed by certain of TOUSA's subsidiaries (Conveying Subsidiaries). The Conveying Subsidiaries secured their guarantees by granting liens on substantially all their assets for the benefit of the New Lenders. Significantly, the Conveying Subsidiaries were not obligors on the debt to the Transeastern Lenders, were not defendants in the litigation being settled and received none of the proceeds of the loans from the New Lenders. Indeed, the loan documents specifically stated that the proceeds of the New Loans would be used to satisfy TOUSA's settlement with the Transeastern Lenders.

TOUSA and the Conveying Subsidiaries declared bankruptcy six months after the loan closed. The official committee of unsecured creditors, whose constituency included holders of more than $1 billion in unsecured bond debt who had publicly criticized TOUSA's entry into the New Loan and had claimed that the New Loan left TOUSA and the Conveying Subsidiaries insolvent and unable to honor their obligations on the bonds, brought suit in the Bankruptcy Court seeking, among other things, to avoid the liens that the Conveying Subsidiaries had granted for the benefit of the New Lenders.

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## The Bankruptcy Court and District Court Rulings

After a 13-day trial, the United States Bankruptcy Court for the Southern District of Florida issued a 190-page order sustaining the committee's assertions. The court found, based on the testimony and previous statements of TOUSA's officers and publicly available information, that TOUSA was insolvent at the time it entered into the loan with the New Lenders. It also found that the Conveying Subsidiaries did not receive "reasonably equivalent value" in exchange for their grant of liens on substantially all their assets. The court ruled that "value" must include "some kind of enforceable entitlement to some tangible or intangible article." It found that the Conveying Subsidiaries received no such value because they received none of the proceeds of the loan from the New Lenders and did not otherwise benefit from TOUSA's settlement with the Transeastern Lenders. The court, therefore, voided the liens that the Conveying Subsidiaries had granted to the New Lenders.

The Bankruptcy Court further ruled that the Transeastern Lenders were entities "for whose benefit" the Conveying Subsidiaries granted their liens. This is significant because, under Section 550 of the Bankruptcy Code, an entity "for whose benefit" a transaction was made can be subjected to liability if the transaction is later voided. As a result, the court ordered the Transeastern Lenders to disgorge all the funds they had received as a result of the settlement. The money was to be paid back to TOUSA; the Transeastern Lenders' original claims were to be reinstated; and the money returned to the New Lenders. Significantly, however, the amount to be returned to the New Lenders was decreased by an amount equal to the "diminution in value" of the TOUSA enterprise between the making of the loan and voidance of the New Lenders' liens. This amount was reserved for the benefit of TOUSA's unsecured creditors.

The New Lenders and Transeastern Lenders appealed to the United States District Court for the Southern District of Florida, which "quashed" the Bankruptcy Court's ruling and reversed it in all respects. Of particular significance to commercial lenders, the District Court adopted a broader definition of the term "value," holding that the Bankruptcy Court's definition of the term did not properly reflect the realities of modern commercial lending practices. In particular, the District Court ruled that affiliated members of a corporate family such as the Conveying Subsidiaries can receive "indirect benefits" as a result of transactions that benefit other members of the family; that such indirect benefits constitute "value" for purposes of the fraudulent transfer laws; that such benefits need not be precisely quantified to afford a defense in fraudulent transfer litigation; and that the Conveying Subsidiaries did, in fact, receive such indirect benefits in exchange for their grant of liens because the loan from the New Lenders delayed what would otherwise have been an immediate and catastrophic bankruptcy of the entire TOUSA enterprise, while also affording the Conveying Subsidiaries access to enhanced lines of credit and other business synergies.

The District Court also ruled that the Bankruptcy Court erred in concluding that the Transeastern Lenders were entities "for whose benefit" the Conveying Subsidiaries granted their liens. The court reasoned that construing that phrase to impose liability on the Transeastern Lenders would improperly broaden its scope. The District Court also rejected the Bankruptcy Court's ruling that the Transeastern Lenders did not accept the proceeds in good faith simply because they knew of TOUSA's precarious financial position.

## The Circuit Court's Ruling

On appeal by the creditors' committee, the Circuit Court reversed the District Court's decision. It reiterated the long-established rule that appellate courts are to accord significant deference to a lower court's findings of fact; and that an appellate court is to accept the findings of a lower court unless it

is left with the definite and firm conviction that a mistake has been made. The Circuit Court had no such conviction that the Bankruptcy Court had committed any such error and, accordingly, deferred to the Bankruptcy Court's findings in the first instance.

There were two issues on appeal to the Circuit Court. The first was whether the Bankruptcy Court committed clear error when it found that the Conveying Subsidiaries did not receive reasonably equivalent value for the liens they granted the New Lenders. The Circuit Court declined the opportunity to establish a clear definition of the term "value," and therefore did not adopt either the Bankruptcy Court's or the District Court's definition. The Circuit Court also said that it need not decide whether the possible avoidance of bankruptcy can confer "value," as the District Court had concluded, because, even if all the purported benefits of the transaction did in fact accrue to the Conveying Subsidiaries, the costs of the transaction far outweighed "any perceived benefits."

While not adopting any clear rules, the Circuit Court did say that "[t]he opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden," thereby expressing its own skepticism about whether deferral of bankruptcy can constitute value, at least where, as in TOUSA's case, collapse seemed inevitable. Bankruptcy, the Circuit Court observed, is not a "fate worse than death" and may be preferable to certain last ditch efforts undertaken in hopes of staving it off. Indeed, the Bankruptcy Court found that even if TOUSA and all of its subsidiaries immediately would have entered bankruptcy as a result of the cross-defaults associated with a failure to resolve the litigation with the Transeastern Lenders, such an outcome would still have been less harmful to the Conveying Subsidiaries than securing the New Loans. The Circuit Court was not otherwise persuaded that the Conveying Subsidiaries benefited from access to increase borrowing capacity or synergies with their parent.

The second issue on appeal to the Circuit Court was whether the Bankruptcy Court erred in concluding that the Transeastern Lenders were entities "for whose benefit" the Conveying Subsidiaries granted their liens. The Circuit Court made short shrift of this issue, stating that the Transeastern Lenders' argument "is contradicted by the loan agreements, which required that the proceeds of the loans secured by the liens be transferred to the Transeastern Lenders." In response to the Transeastern Lenders' argument that the Bankruptcy Court's interpretation of the phrase would "drastically expand the potential pool of entities that could be liable for any transaction" and hence, would "impose 'extraordinary' duties of due diligence on the part of creditors accepting repayment," the Circuit Court said "[i]t 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."

## The Practical Implications

There appear to be at least four practical implications of these rulings. First, commercial lenders making loans to consolidated corporate entities cannot always assume that a loan to one member of the corporate family benefits all members of the family. Thus, while it is common in the commercial lending context for several related entities to become obligated on a loan, lenders may now need to understand how each individual entity stands to benefit from the loan. In any subsequent litigation, a court may not examine the transaction as though the individual entities constituted a single borrower. Rather, a court may instead examine whether the transaction was a fraudulent transfer based on an entity-by-entity analysis, regardless of whether such entities ever actually operated as such. This risk, of course, may impose significant diligence obligations and costs on lenders and, ultimately, their borrowers.

Second, lenders who receive repayment of their loans from troubled borrowers likewise may need to better perform diligence on the source of the funds and the nature of the transaction that allows the borrowers to honor their obligations. Restructuring and litigation attorneys typically advise creditors

to take repayment and worry about whether it will be challenged later. However, the stakes may be high enough that a lender nonetheless may need to review diligence the matter and perhaps condition repayment on a structure that mitigates risk. There frequently are limited opportunities to do so, however, meaning that some clawback risk may simply be unavoidable.

Third, there is still a lingering question whether a troubled company receives value on account of a deferred bankruptcy filing. This issue often arises where lenders charge a troubled borrower a fee in exchange for their agreement to extend a loan maturity for a period of time while the borrower attempts to restructure its affairs. The case law has been ambiguous regarding whether a borrower receives value when it pays such a fee; the Circuit Court's ruling in TOUSA does nothing to clarify that ambiguity and, indeed, suggests that there may be no such value. This is not to suggest that lenders should forego extension fees — far from it. But it does mean that lenders may need to lower their expectations regarding their ability to retain such fees in litigation, which in turn may mean that other alternatives may need to be considered in connection with extension requests.

Finally, the Circuit Court reinstated the Bankruptcy Court's original holding regarding so-called "savings clauses." Many commercial loan transactions contain clauses that limit the guarantors' liability to an amount that will not render the guarantor insolvent. The Bankruptcy Court's original ruling that such clauses are void as against public policy is the only published ruling on the matter. That ruling ceased to exist once the District Court "quashed" the Bankruptcy Court, but the Circuit Court's reversal of the District Court has allowed the Bankruptcy Court's saving clause analysis to spring back to life.