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TOUSA: 11th Circuit Affirms Bankruptcy Court's Decision That Subsidiaries Pledging Assets To Repay Parent Company's Debt Did Not Receive "Reasonably Equivalent Value"

A much discussed decision interpreting the fraudulent transfer provisions of the Bankruptcy Code has been revived. In *In re TOUSA, Inc.*,¹ the Eleventh Circuit Court of Appeals reversed a district court decision and affirmed portions of the original bankruptcy court holding that liens granted by TOUSA's subsidiaries to secure their guarantees of new financing to enable their parent company to pay off its existing lenders were avoidable as fraudulent transfers. The Eleventh Circuit also affirmed that the existing lenders were the entities "for whose benefit" the TOUSA subsidiaries granted security interests to the new lenders. This appeal did not address the bankruptcy court's controversial statements that "savings clauses" in guarantees are invalid under Florida law.²

The decision focuses on two aspects of fraudulent transfer law. The Eleventh Circuit held that any indirect economic benefits received by the subsidiaries, such as the ability to avoid default or bankruptcy, did not constitute "reasonably equivalent value" to the liens they granted to support payment of their parent company's

¹ *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, 2012 W.L. 1673910 (11th Cir. May 15, 2012).

² The bankruptcy court's discussion of savings clauses can be found at *Official Comm. of Unsecured Creditors of Touse, Inc. v. Citicorp N. Am., Inc. (In re Touse, Inc.)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009). The savings clause analysis, which was in *dicta*, is the subject of an appeal by the New Lenders that had been stayed pending the outcome of this appeal. For a more complete discussion of the bankruptcy court's decision, you may refer to the previous Shearman & Sterling LLP client publication entitled "The TOUSA Decision: Death of the Savings Clause?" available electronically at <http://www.shearman.com/the-tousa-decision-death-of-the-savings-clause-11-02-2009/>.

obligation. The court did not determine whether such indirect economic benefits do, or do not, ever constitute reasonably equivalent value, nor did the court discuss the reasonably equivalent value of upstream guarantees. Instead, the court noted that under appellate standards of review it could not reverse the bankruptcy court's findings of fact on this issue unless they were based on "clear error." The circuit court analyzed the extensive evidentiary record and did not find clear error. The Eleventh Circuit also affirmed the bankruptcy court's finding that existing lenders receiving the proceeds of a new loan are entities "for whose benefit" the TOUSA subsidiaries granted security interests to the new lenders. This conclusion renders unavailable to the existing lenders any defense that they were subsequent transferees who received the new loan proceeds in good faith and, therefore, were not liable for disgorgement of the settlement payment.

The appellate court also affirmed the bankruptcy court's finding that the pre-existing lenders were liable to the subsidiaries for the value of the liens totaling \$403 million plus prejudgment interest at nine percent. The district court must now consider the appropriate remedy to impose on the lenders who received the fraudulent conveyance. The ruling on remedies will determine how significant the ultimate impact of the TOUSA case is on secured lenders' rights. Nonetheless, the *TOUSA* decision is a warning for creditors who receive payments from distressed borrowers and raises questions about whether indirect economic benefits can be included in the analysis of reasonably equivalent value for fraudulent transfer purposes.

Background

TOUSA, Inc. ("TOUSA") through its subsidiaries was among the largest home builders in the United States. In 2005, TOUSA and a partner formed a joint venture, known as the "Transeastern JV," to acquire homebuilding assets in Florida. A group of lenders (the "Transeastern Lenders") loaned money to TOUSA to finance the acquisition. None of TOUSA's subsidiaries provided a guaranty or collateral to the Transeastern Lenders.

As TOUSA grew, it incurred more debt. The downturn in the housing market impeded TOUSA's ability to service its debts and, by late 2006, it was in default to the Transeastern Lenders. The lenders sued TOUSA (the "Transeastern JV Litigation"), alleging damages of \$2 billion. At the time, TOUSA owed \$224 million on a revolving line of credit secured by substantially all of its subsidiaries' assets and over \$1 billion on unsecured bonds. A judgment against TOUSA in the Transeastern JV Litigation would have triggered cross-defaults under the bonds and revolver, resulting in acceleration of amounts owed by,

and likely causing the bankruptcies of, TOUSA and its subsidiary guarantors. To avoid that result, TOUSA settled the Transeastern JV Litigation for \$421 million.

To fund the settlement payment, TOUSA entered into new first and second lien credit facilities (the “New Loans”) with certain lenders (the “New Lenders”). Some of TOUSA’s subsidiaries (the “Conveying Subsidiaries”) guaranteed the New Loans and granted security interests in their assets to collateralize their guarantees. Less than six months after the execution of the New Loans, TOUSA and most of its subsidiaries filed for chapter 11 bankruptcy protection in the Southern District of Florida.

The Suit Against the Lenders and the Lower Court Decisions

The unsecured creditors committee (the “Committee”) commenced an adversary proceeding to avoid the liens and guarantees provided by the Conveying Subsidiaries in connection with the New Loans. The Committee relied on section 548 of the Bankruptcy Code, which provides for avoidance of certain pre-bankruptcy transfers made by the debtor. A transfer may be avoided under this provision if the debtor was insolvent (or otherwise suffered from a form of financial distress prescribed by the statute) at the time the transfer was made, and received less than “reasonably equivalent value” in exchange.³ The Committee further alleged that the Transeastern Lenders were the entities “for whose benefit” the Conveying Subsidiaries granted liens to the New Lenders and, as a result, the Transeastern Lenders were liable to the Conveying Subsidiaries for the value of those liens under Bankruptcy Code section 550(a)(1).⁴

The Transeastern Lenders and New Lenders countered that the Conveying Subsidiaries received reasonably equivalent value for granting liens to the New Lenders. They argued that the Transeastern Lenders were likely to secure a judgment of more than \$10 million against TOUSA, which would have put more than \$1 billion in bank and bond debt in default. Absent the liens, the new financing and payment of the settlement, the Conveying Subsidiaries would have defaulted on their bond and bank debt, filed for bankruptcy and jeopardized their collective enterprise value. The Conveying Subsidiaries received other benefits as well, including a higher debt ceiling and certain tax advantages. The Transeastern Lenders further argued that even if there was a fraudulent transfer, they were not the entity for whose benefit the Conveying Subsidiaries granted liens. They argued that they were an “immediate or mediate” transferee of TOUSA, the entity for whose benefit the liens were granted. The Transeastern Lenders pointed to section 550(b) of the Bankruptcy Code, which protects subsequent transferees of fraudulent transfers from recovery if they accepted the payment for value (i.e., the repayment of their debt), in good faith and without knowledge that the granting of the liens was voidable.⁵

³ 11 U.S.C. § 548(a)(1)(B)(i).

⁴ 11 U.S.C. § 550(a)(1).

⁵ 11 U.S.C. § 550(b).

In a controversial decision,⁶ the bankruptcy court issued an opinion in favor of the Committee that, among other things:

- avoided the liens and guarantees granted under the New Loans as fraudulent conveyances because the purported indirect benefits to the Conveying Subsidiaries, including avoiding bankruptcy, did not constitute value reasonably equivalent to the value of the liens securing the New Loans;
- found that the Transeastern Lenders were the entities for whose benefit the improper transfers had been made;
- ordered the Transeastern Lenders to disgorge the funds paid in the settlement;
- held that the Transeastern Lenders were negligent and had acted in bad faith in accepting the settlement payments from TOUSA; and
- held that savings clauses are unenforceable under Florida state law.

The Transeastern Lenders and New Lenders separately appealed the decision.⁷

In early 2011, the District Court for the Southern District of Florida overturned certain portions of the bankruptcy court's decision in a strongly worded opinion.⁸ The district court went so far as to quash (as opposed to merely reversing) the bankruptcy court's order as it related to the Transeastern Lenders, without remanding the case back to the bankruptcy court. The district court found that the bankruptcy court had erred in holding that the Conveying Subsidiaries' transfers were for less than reasonably equivalent value. The bankruptcy court had narrowly construed "value" to exclude the indirect economic benefits associated with TOUSA's ability to finance the settlement of the Transeastern JV Litigation.⁹ Although the bankruptcy court also held that any benefits obtained by the Conveying Subsidiaries were substantially outweighed by the harm caused by the New Loans, the district court rejected that analysis. The district court took a broader view of "value" and included all of the economic benefits received in exchange for the Conveying Subsidiaries' transfers. Value included the opportunity to avoid bankruptcy, facilitate the rehabilitation of the entire TOUSA enterprise, and avoid defaults under the bonds and revolver. The district court held that the value received in exchange for the transfers made under the New Loans was sufficiently equivalent to the value of the security interests and obligations incurred by the Conveying Subsidiaries.

The district court also found that the Transeastern Lenders were not required to return the settlement payments funded from the proceeds of the New Loans because they were not the entities for whose benefit the Conveying Subsidiaries

⁶ *In re Touse, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

⁷ The New Lenders' appeals were stayed pending disposition of the Transeastern Lenders' appeal and remain pending in the Southern District of Florida. The issue of the enforceability of the savings clauses is part of the New Lenders' appeals.

⁸ *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of Touse, Inc. (In re Touse, Inc.)*, 444 B.R. 613 (S.D. Fla. 2011). For a more complete discussion of the district court's decision, you may refer to the previous Shearman & Sterling LLP client publication entitled "District Court Overturns Controversial TOUSA Decision" available electronically at <http://www.shearman.com/district-court-overturns-controversial-touse-decision-02-22-2011/>.

⁹ Section 548 defines value as "property, or satisfaction of a present or antecedent debt of the debtor[.]" 11 U.S.C. § 548(d)(2)(A). The bankruptcy court held that under this definition an exchange of property requires the transfer of an "enforceable entitlement to some tangible or intangible article." *In re TOUSA, Inc.*, 422 B.R. at 868 n.55.

provided collateral.¹⁰ Although the New Loan proceeds were backed by the liens and guarantees transferred by the Conveying Subsidiaries, the district court held that the transfer of the subsidiaries' property to the New Lenders was made for the benefit of TOUSA to enable it to repay the Transeastern Lenders. As subsequent transferees of the proceeds from the New Loans, the Transeastern Lenders could not be held liable under section 550(a)(1) for the transfer of property from the Conveying Subsidiaries to the New Lenders.

The Eleventh Circuit Decision

The Eleventh Circuit addressed two issues in the Committee's appeal: (i) whether the Conveying Subsidiaries had received reasonably equivalent value in exchange for the liens and guarantees used to secure the New Loans; and (ii) whether the Transeastern Lenders were the entities for whose benefit the Conveying Subsidiaries had granted the liens.¹¹ After reviewing the bankruptcy court's findings of fact for "clear error,"¹² the Eleventh Circuit upheld the bankruptcy court decision that the Conveying Subsidiaries did not receive reasonably equivalent value. The Eleventh Circuit also held that the bankruptcy court had not erred in finding that the Transeastern Lenders were the entities for whose benefit the transfer of the liens was made. The Eleventh Circuit remanded the case to, and reversed the order of, the district court to review, among other things, the appropriateness of the remedies ordered by the bankruptcy court.

Reasonably Equivalent Value

The Eleventh Circuit's review of the bankruptcy court's findings of fact focused primarily on undisputed evidence demonstrating that the Conveying Subsidiaries' transfer of property under the New Loans "could not have conferred value by giving the Conveying Subsidiaries an opportunity to avoid bankruptcy" because "bankruptcy for the Conveying Subsidiaries was 'inevitable' if TOUSA executed the transaction[.]"¹³ This finding was supported by public data indicating that TOUSA and its subsidiaries were "deeply troubled" as a result of the housing downturn and would only be further harmed by taking on new debt to settle the Transeastern Litigation. The appellate court noted that the bankruptcy court had found that in the months leading up to the consummation of the New Loans, TOUSA experienced a drastic drop in its stock price, its bonds traded at deep discounts and its corporate credit rating dropped. TOUSA's board also had been shown alternatives for financing the settlement of the Transeastern JV Litigation and were informed that the execution of the New Loans would increase TOUSA's risk of failure. The Eleventh Circuit, therefore, affirmed the bankruptcy court's determination that the transfer of the subsidiaries' property was avoidable because "[t]he record supports the finding by the bankruptcy court that, for the Conveying Subsidiaries, the almost certain costs of the [New Loans] far outweighed any perceived benefits."¹⁴

¹⁰ Section 550(a)(1) allows the trustee to recover avoidable transfers of property from "the initial transferee of such property or the entity for whose benefit such transfer is made[.]" 11 U.S.C. § 550(a)(1).

¹¹ *In re TOUSA, Inc.*, 2012 W.L. 1673910.

¹² Under the Eleventh Circuit's standard of review, the factual findings by the bankruptcy court are given considerable deference on appeal and must be upheld unless the court determines that the trier of fact committed a manifest error of law or fact.

¹³ *In re TOUSA, Inc.*, 2012 W.L. 1673910, at *5.

¹⁴ *Id.* at *12.

The Eleventh Circuit declined to decide directly whether the possible avoidance of bankruptcy confers “value” for the purposes of determining the avoidance of a fraudulent transfer. Although the district court had rejected the bankruptcy court’s definition of “value,” the Eleventh Circuit found it unnecessary to adopt either definition since “the bankruptcy court found that, even if all of the purported benefits of the transaction were legally cognizable, they did not confer reasonably equivalent value.”¹⁵ The appellate court, therefore, declined to provide any guidance as to what constitutes “value” for the purposes of section 548 in the context of upstream guarantees.

Recovery of Loan Proceeds From the Transeastern Lenders

After finding that the Conveying Subsidiaries’ property had been fraudulently transferred, the Eleventh Circuit concluded that the Committee could recover the value of the avoidable transfers from the Transeastern Lenders under section 550(a)(1) of the Bankruptcy Code. The Transeastern Lenders argued that because only the liens had been transferred from the Conveying Subsidiaries to the New Lenders, the Transeastern Lenders could not be held liable as beneficiaries of the initial transfer of the liens. But the Eleventh Circuit cited one of its prior decisions holding that a creditor may be held liable as the beneficiary of a fraudulent transfer, notwithstanding the fact that the transfer was not made directly to the creditor.¹⁶ Because the Eleventh Circuit found that the security interest was issued for the benefit of the Transeastern Lenders, the trustee was permitted to recover the value of the security interest directly from them pursuant to section 550(a)(1). The Eleventh Circuit found that the Transeastern Lenders were also required to transfer the value of the liens to the trustee because “the Conveying Subsidiaries transferred liens to the New Lenders, who transferred funds to creditors, the Transeastern Lenders.”¹⁷

The appellate court also rejected the Transeastern Lenders’ argument that they could not be held liable under section 550(a)(1) because the proceeds of the New Loan were transferred to a subsidiary of TOUSA before being wired to the Transeastern Lenders. The Transeastern Lenders claimed that they benefited from a subsequent transfer of funds from TOUSA and not the initial transfer of the liens.¹⁸ The Eleventh Circuit rejected this argument by stating that the New Loan proceeds had passed through a subsidiary as a mere formality, which “did not make the Transeastern Lenders subsequent transferees of the funds because TOUSA never had control over the funds.”¹⁹

Impact of the Decision

It is unclear whether the Eleventh Circuit’s decision will have a significant impact beyond *TOUSA*. The court did not rule that indirect economic benefits, such as enterprise preservation, cannot be considered, or even constitute, reasonably equivalent

¹⁵ *Id.*

¹⁶ *American Bank of Marin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart)*, 845 F.2d 293 (11th Cir. 1988).

¹⁷ *In re TOUSA, Inc.*, 2012 W.L. 1673910, at *15.

¹⁸ Section 550(a)(1) does not provide for liability against subsequent transferees. 11 U.S.C. § 550(a)(1).

¹⁹ *In re TOUSA, Inc.*, 2012 W.L. 1673910, at *16.

value.²⁰ Instead, the court hewed closely to the “clear error” standard of review and found that, after the bankruptcy court conducted a 13-day trial and carefully weighed evidence, it did not make clear, reversible error. *TOUSA* also may include an extreme set of facts; the loan in question resulted in the incurrence of over \$400 million in secured debt, yet the borrower and guarantors could not stave off bankruptcy for even six months. Additionally, the debtors’ advisors had indicated that incurring the New Loans could adversely impact the company.

While the Eleventh Circuit declined to address what constitutes value for fraudulent transfer purposes, it did affirm the bankruptcy court’s view that the Conveying Subsidiaries had not received value reasonably equivalent to the provision of a significant collateral package. This issue seems particularly important where, as in *TOUSA*, upstream guarantees are part of the financing structure. That risk may be reduced, though, where, unlike *TOUSA*, the upstream guarantors also are obligated on the indebtedness that is being refinanced. The Bankruptcy Code specifically defines “value” to include the repayment of antecedent debt. It appears, therefore, that providing a new upstream guarantee to take out an existing upstream guarantee yields value to the guarantor. Accordingly, the fraudulent transfer risk on new financing is most acute where there was no pre-existing obligation.

The ruling that the creditors receiving the proceeds of the new financing are the ones “for whose benefit” the new money liens are granted is not a departure from Eleventh Circuit precedent. As the court notes, creditors receiving payments from a company in financial distress must conduct “diligence”²¹ on that repayment. The decision also limits the apparent benefit of funding the New Loans to a subsidiary so that the entities ultimately receiving the funds are subsequent transferees taking in good faith. Taken together, creditors being refinanced should recognize the risk that the good faith defense to a fraudulent transfer claim under Bankruptcy Code section 550(b)(1) may not be available to them.

The decision also highlights the risk facing lenders in any court’s fraudulent transfer review; the transactions will be analyzed with the benefit of hindsight. Neither the Transeastern Lenders nor the New Lenders could know for sure how long the *TOUSA* companies could stay out of bankruptcy after the settlement was funded. The bankruptcy court knew the answer with certainty.

What remedies are appropriate against the Transeastern Lenders are still being litigated in this case. The bankruptcy court had disallowed and avoided all obligations of the Conveying Subsidiaries to the New Lenders, all claims of the New Lenders against the Conveying Subsidiaries, and all Liens granted by the Conveying Subsidiaries to secure such obligations. It also directed the Transeastern Lenders to disgorge (with interest) the settlement funds they received and the New Lenders to disgorge any amount paid to them or on their behalf. The ultimate determination as to the appropriate remedy will influence how significant the impact of *TOUSA* will be in the lending community.

²⁰ Courts in both the Third and Second Circuits have defined “value” broadly to include indirect economic benefits. *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L. (In re R.M.L.)*, 92 F.3d 139 (3d Cir. Pa. 1996); *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406 (S.D.N.Y. 2001).

²¹ *Id.*

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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