

Client Alert

Financial Restructuring Practice Group

May 18, 2012

***In re TOUSA, Inc.*—Eleventh Circuit Reinstates Widely Criticized Fraudulent Transfer Decision**

On May 15, 2012, the United States Court of Appeals for the Eleventh Circuit issued an opinion in the TOUSA, Inc. (“TOUSA”) chapter 11 bankruptcy cases reinstating a \$480 million fraudulent transfer judgment previously entered by the United States Bankruptcy Court for the Southern District of Florida (the “Bankruptcy Court”) against the so-called “Transeastern Lenders.”ⁱ In doing so, the Eleventh Circuit both opened the door to a narrow reading of the term “reasonably equivalent value” in the fraudulent transfer provisions of the Bankruptcy Code and endorsed an expanded view of the entities subject to such fraudulent transfer liability.ⁱⁱ

The Eleventh Circuit affirmed the Bankruptcy Court’s widely criticized ruling, which had avoided as fraudulent transfers certain liens and related indebtedness incurred by TOUSA’s debtor subsidiaries (the “Conveying Subsidiaries,” and together with TOUSA, the “Debtors”) in connection with \$500 million of “rescue financing” incurred by TOUSA and the Conveying Subsidiaries six months prior to the Debtors’ bankruptcy filings (the “Refinancing”). The proceeds of the Refinancing were used to repay the Transeastern Lenders for obligations of TOUSA that were not guaranteed by or secured by property of the Conveying Subsidiaries. Not only did the Bankruptcy Court avoid the transfer of the new liens in favor of the New Lenders, but it also ordered the Transeastern Lenders to disgorge the proceeds of the Refinancing (with interest) on the basis that they were bad faith recipients of the proceeds of a fraudulent transfer (*i.e.*, the Refinancing). On appeal, the United States District Court for the Southern District of Florida (the “District Court”) quashed the Bankruptcy Court’s decision with respect to the Transeastern Lenders. The Eleventh Circuit, however, affirmed the liability findings of the Bankruptcy Court and concluded that the factual record supported the conclusions that: (a) the Conveying Subsidiaries did not receive reasonably equivalent value and (b) the Transeastern Lenders were entities for whose benefit the fraudulent transfers had been made.

BACKGROUND

TOUSA and the other Debtors were in the business of designing, building and marketing for sale detached single-family residences, townhomes and condominiums under various brand names. Prior to their bankruptcy filing in January 2008, the Debtors financed their operations through a \$700 million revolving working capital facility (the “Revolver”) and the issuance of over

For more information, contact:

Sarah R. Borders
+1 404 572 3596
sborders@kslaw.com

W. Austin Jowers
+1 404 572 2776
ajowers@kslaw.com

Mark M. Maloney
+1 404 572 4857
mmaloney@kslaw.com

Michael C. Rupe
+1 212 556 2135
mrupe@kslaw.com

Jeffrey R. Dutson
+1 404 572 2803
jdutson@kslaw.com

King & Spalding
Atlanta
1180 Peachtree Street, NE
Atlanta, Georgia 30309-3521
Tel: +1 404 572 4600
Fax: +1 404 572 5100

www.kslaw.com

Client Alert

Financial Restructuring Practice Group

\$1 billion in unsecured bonds (the “Bonds”). Although TOUSA was the primary obligor with respect to the Revolver and the Bonds, the obligations were guaranteed by each of the Conveying Subsidiaries.

In 2005, TOUSA, together with one of its Debtor subsidiaries, TOUSA Homes, LP (“Homes”), entered into a joint venture called TE/TOUSA LLC (the “Transeastern JV”). The operations of the Transeastern JV were financed with loans made by the Transeastern Lenders to the Transeastern JV—loans that were guaranteed by TOUSA and Homes. When the Transeastern JV defaulted on its debt, the Transeastern Lenders called on the guarantees and litigation ensued (the “Transeastern Litigation”). In settlement of the Transeastern Litigation, on July 31, 2007, TOUSA and the Conveying Subsidiaries borrowed \$500 million pursuant to first and second lien term loans (*i.e.*, the Refinancing) from certain lenders (the “New Lenders”) that were secured by substantially all of the Debtors’ assets, of which, approximately \$421 million was used to pay the Transeastern Lenders.

In January 2008, less than six months after closing the Refinancing, the Debtors were forced to file their bankruptcy cases due to the catastrophic downturn in the residential real estate market and the related inability of the Debtors and their customers to access the frozen credit markets. Shortly after the filing, the Official Committee of Unsecured Creditors (the “Committee”) brought an action against the New Lenders seeking to avoid the loans and liens related to the Refinancing as fraudulent transfers. The Committee also sought to recover the amounts paid to the Transeastern Lenders from the proceeds of the Refinancing.

Because the Conveying Subsidiaries were not obligated on the Transeastern debt (and were not parties to the related Transeastern Litigation), the Bankruptcy Court held that their borrowing under the Refinancing and their granting of liens to secure that borrowing were without “reasonably equivalent value” and were therefore avoidable fraudulent transfers. Specifically, the Bankruptcy Court held that (a) the Conveying Subsidiaries were insolvent and inadequately capitalized both prior to and immediately after the date of the Refinancing, (b) the Conveying Subsidiaries did not receive “reasonably equivalent value” for incurring the debt or granting the liens, (c) the New Lenders, as well as the Transeastern Lenders, did not act in good faith because it was objectively evident that the transaction was not proper, and (d) the loans related to the Refinancing, the liens securing those loans and the payment of the loan proceeds to the Transeastern Lenders were fraudulent conveyances. Finally, the Bankruptcy Court also found that neither the New Lenders nor the Transeastern Lenders were entitled to the affirmative defense set forth in Sections 548(c) or 550(b) of the Bankruptcy Code.ⁱⁱⁱ

In connection with its ruling, the Bankruptcy Court ordered the unwinding of the Refinancing and, to carry that out, further ordered (a) the Transeastern Lenders to disgorge \$403 million (as the value of the assets subjected to liens by the Conveying Subsidiaries) of the \$421 million in Refinancing loan proceeds paid to the Transeastern Lenders, together with prejudgment interest in excess of \$75 million, (b) the reinstatement of the Transeastern Lenders’ claims to the extent of the disgorgement, (c) the avoidance of the New Lenders’ liens against the Conveying Subsidiaries’ assets, and (d) that the disgorgement payments be placed in escrow to be paid to the New Lenders after payment to the Conveying Subsidiaries of all transaction costs relating to the Refinancing and any loss in value of their assets.

Both the Transeastern Lenders and the New Lenders appealed the Bankruptcy Court’s ruling to the District Court (although the separate appeals were assigned to two different judges). In a scathing opinion, the District Court quashed the Bankruptcy Court’s ruling as it related to the Transeastern Lenders on the basis that it contained numerous findings of fact and conclusions of law that were “clearly erroneous.”^{iv} In overturning the Bankruptcy Court’s ruling against the

Client Alert

Financial Restructuring Practice Group

Transeastern Lenders, the District Court found, among other things, that (a) the payment to the Transeastern Lenders was not avoidable as a fraudulent transfer because the factual record at trial demonstrated that the Conveying Subsidiaries received “reasonably equivalent value” in exchange for providing secured guarantees of the Refinancing in the form of legally recognized “indirect economic benefits” constituting value (including, among other benefits, the ability to avoid defaulting on over \$1.5 billion of senior loans and bonds owed by TOUSA and guaranteed by the Conveying Subsidiaries, thereby permitting the Debtors to continue their business operations), and (b) the Bankruptcy Court erred in finding that the Transeastern Lenders had acted in bad faith because, among other reasons, the Bankruptcy Court had improperly imposed a “patently unreasonable and unworkable” (as well as non-existent) legal duty on the Transeastern Lenders to investigate the internal refinancing structure of the Debtors (and, ostensibly, independently determine that the Refinancing would not result in a fraudulent transfer with respect to any of the Conveying Subsidiaries) before the Transeastern Lenders could receive payment on account of their valid antecedent debts. The District Court also took the extraordinary step of overturning the Bankruptcy Court’s decision without remand.^v

The Committee promptly appealed the District Court’s decision to the Eleventh Circuit.^{vi} The issues involved in the appeal were fact-intensive—the Bankruptcy Court heard extensive testimony from expert and fact witnesses during a 13-day trial. Applying the “clear error” standard to the factual conclusions of the Bankruptcy Court, the Eleventh Circuit determined that: (a) the Bankruptcy Court did not clearly err by finding that the Conveying Subsidiaries did not receive reasonably equivalent value and (b) the Bankruptcy Court did not clearly err by finding that the Transeastern Lenders were entities for whose benefit the liens were transferred.

REASONABLY EQUIVALENT VALUE

Recall that a fraudulent conveyance includes a transfer of property or an incurrence of an obligation, made while, or causing the debtor to become, insolvent or without adequate capital, for which the debtor did not receive reasonably equivalent value in exchange for the transfer or incurrence. As mentioned above, the Bankruptcy Court based the fraudulent transfer judgment it levied against the Transeastern Lenders on its finding that the Conveying Subsidiaries failed to receive “reasonably equivalent value” in exchange for the transfers made by the Conveying Subsidiaries in connection with the Refinancing (including the obligations incurred and liens granted by the Conveying Subsidiaries).^{vii}

For purposes of determining whether the Conveying Subsidiaries received equivalent value, the Bankruptcy Court and the District Court differed significantly in their conceptions of what constituted “value.” The Bankruptcy Court concluded that the Conveying Subsidiaries could not have received meaningful “value” as part of the Refinancing because they did not receive direct and identifiable “property” of a quantifiable value as part of the transaction. This District Court, however, rejected this narrow conception of value and concluded that the “value” analysis must include indirect, intangible and prospective future economic benefits. Specifically, the District Court agreed with the Transeastern Lenders’ position that, when dealing with an integrated corporate family, indirect benefits that preserve the net worth and continued operations of the corporate family can constitute reasonably equivalent value to individual subsidiaries, even though such value is indirect, intangible and not precisely quantifiable.

The Eleventh Circuit declined to endorse either of the lower courts’ conception of “value.” Instead, the Eleventh Circuit held that the factual record was sufficient to support a finding that even under the District Court’s broad definition of “value,” the costs imposed by the Refinancing far outweighed any benefit received by the Conveying Subsidiaries.

Client Alert

Financial Restructuring Practice Group

Even assuming the Refinancing had the potential to save TOUSA from bankruptcy, the Eleventh Circuit concluded that this benefit was not sufficient to justify the costs imposed by the Refinancing. The Eleventh Circuit noted that bankruptcy is not a “bogeyman” that must be avoided at all cost and further noted that avoiding or postponing bankruptcy in this case was simply not worth the cost of the Refinancing imposed on the Conveying Subsidiaries. Accordingly, the Eleventh Circuit held that the record supported the Bankruptcy Court’s determination that the Conveying Subsidiaries did not receive reasonably equivalent value and that the new liens constituted a fraudulent conveyance.

SECTION 550 OF THE BANKRUPTCY CODE

The Bankruptcy Court held (and the Eleventh Circuit affirmed) that the Transeastern Lenders were entities for whose benefit the fraudulent transfers were made. Accordingly, the Bankruptcy Court ordered the Transeastern Lenders to disgorge the proceeds of the Refinancing under Section 550(a) of the Bankruptcy Code.^{viii}

On appeal, the Transeastern Lenders argued that they did not directly benefit from the initial transfer, but were instead subsequent transferees of the Debtors. Both the Bankruptcy Court and the Eleventh Circuit rejected this argument, which those courts thought was belied by the fact that the loan documents between the Debtors and the New Lenders required payment of the proceeds to the Transeastern Lenders. The fact that the proceeds first went to a TOUSA subsidiary and then to the Transeastern Lenders was irrelevant.

In reaching its conclusion that the Transeastern Lenders acted in bad faith by accepting the settlement payment, the Bankruptcy Court (without citing to any provision of the Bankruptcy Code or applicable case law precedent) imposed a legal duty on the Transeastern Lenders to investigate the internal refinancing structure of the Debtors (and determine that the Refinancing would not result in a fraudulent transfer with respect to any of the Conveying Subsidiaries) before the Transeastern Lenders could receive payment on account of their valid antecedent debts. Before the Eleventh Circuit, the Transeastern Lenders argued that this heightened due diligence standard was unreasonable and unworkable—creditors should not be required to investigate all aspects of their debtors and the affiliates of those debtors before receiving payments on account of valid debts. The Eleventh Circuit, however, concluded that the alarm raised over the imposition of such a duty was overstated: “[E]very creditor,” the Court stated, “must exercise some diligence when receiving payment from a struggling debtor.” Similar to the Bankruptcy Court, the Eleventh Circuit failed to cite any provision of the Bankruptcy Code or applicable case law precedent supporting the imposition of such a duty on a creditor.

LOOKING FORWARD

The Eleventh Circuit’s reinstatement of a substantial portion of the widely criticized ruling of the Bankruptcy Court represents a significant challenge to institutional lenders and other capital sources deciding whether to offer “rescue” financing to distressed borrowers. Additionally, the Eleventh Circuit’s decision appears to impose a duty on creditors receiving payments from troubled companies to determine the source of funds for such payments and to weigh the risk of fraudulent transfer liability with respect to such payments—a duty that will no doubt materially undermine the ability of troubled companies to effectively manage and settle their debts in efforts to avoid potentially catastrophic bankruptcy filings.

Client Alert

Financial Restructuring Practice Group

The Transeastern Lenders and the New Lenders are likely to petition for a rehearing *en banc*, and the full Eleventh Circuit may have an opportunity to reconsider the issues presented on appeal. In the meantime, however, the Eleventh Circuit's ruling is a source of concern for institutional lenders and creditors of troubled companies in general.

Celebrating more than 125 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 800 lawyers in 17 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.

This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.

ⁱ See *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re Tousa, Inc.)*, Case 11-11071 (11th Cir. May 15, 2012).

ⁱⁱ See *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re Tousa, Inc.)*, 444 B.R. 613 (S.D. Fla. 2011).

ⁱⁱⁱ Section 548(c) protects against the trustee's avoidance powers a transferee or obligee that takes for value and in good faith to the extent the transferee or obligee gave value in exchange for the transfer or obligation. Section 550(b) protects against the trustee's remedies of recovery transferees that take (from initial transferees) for value, including satisfaction of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided.

^{iv} Note that the District Court's decision quashed the Bankruptcy Court's order *only* as it related to the liability of the Transeastern Lenders.

^v In dicta, the District Court urged the Eleventh Circuit (in the likely event of an appeal) to consider the Transeastern Lenders' arguments that the Bankruptcy Court has repeatedly demonstrated an inability "to approach the Defendant's evidence and arguments fairly"—arguments that the District Court found "persuasive."

^{vi} Because the District Court ruled on issues that were central to the separate appeals of the New Lenders, the District Court allowed the New Lenders to intervene in the appeal and the District Court stayed the appeals of the New Lenders pending disposition of the Transeastern Lenders' appeal.

^{vii} The Eleventh Circuit did not address the Bankruptcy Court's findings that the Conveying Subsidiaries were insolvent and inadequately capitalized at the time of the Refinancing (and it appears that the Transeastern Lenders conceded this issue).

^{viii} Section 550(a) states that "[e]xcept as otherwise provided in this section, to the extent that a transfer is avoided under section ... 548 ... 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."