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TOUSA 3.0: Eleventh Circuit Holds Lenders to High Standards

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In a much anticipated opinion, *In re TOUSA, Inc.*, --- F.3d ----, 2012 WL 1673910 (11th Cir. May 15, 2012), the Eleventh Circuit Court of Appeals has resolved a disagreement between the Bankruptcy Court and District Court for the Southern District of Florida by upholding the Bankruptcy Court's findings—to the chagrin of lenders, who are now arguably exposed to new liabilities and higher standards of due diligence.

The TOUSA saga began during the recent decline of the housing market. In 2005, TOUSA, at the time the thirteenth largest homebuilding enterprise in the country, entered into a joint venture to acquire the homebuilding assets of another company incurring significant debt to do so. By 2006, TOUSA had found itself in dire financial trouble due to the downturn in the housing market, and the joint venture began defaulting on its obligations. TOUSA then entered into a settlement through which TOUSA's subsidiaries (the "Conveying Subsidiaries") granted liens on their assets to secure a loan from new lenders (the "New Lenders"), the proceeds of which funded the settlement payment to the joint-venture's original lenders (the "Transeastern Lenders").

Six months after closing the settlement funding transaction, TOUSA and the Conveying Subsidiaries filed for bankruptcy under chapter 11. In a controversial decision that sent shockwaves through the lending and bankruptcy communities, the Bankruptcy Court, after a 13-day trial, found that the Conveying Subsidiaries did not receive reasonably equivalent value for the liens they granted. The Bankruptcy Court further found that the Transeastern Lenders, who received in excess of $400 million of loan proceeds, were direct beneficiaries for whose benefit the Conveying Subsidiaries transferred their liens, and therefore both the liens and the subsequent repayment were avoidable as fraudulent transfers.

The District Court allowed lenders to breathe a collective, albeit temporary sigh of relief when it overruled the Bankruptcy Court's decision. But the Eleventh Circuit Court of Appeals has now held that the Bankruptcy Court's determination that "reasonably equivalent value" was not received by the Conveying Subsidiaries was not clearly erroneous.[1] The Bankruptcy Court did not err when it found that the transaction did not confer value by, among other alleged benefits, delaying bankruptcy. Therefore the transfers, both the liens to the New Lenders and the loan proceeds to the Transeastern Lenders, were avoidable. "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it," explained the Court, and added that "there is no reason to treat bankruptcy as a bogeyman, as a fate worse than death." At 12-14 (citations omitted). Therefore, "not every transfer that decreases the odds of bankruptcy for a corporation can be justified." At 12.[2] In this case, the Court agreed with the findings of the Bankruptcy Court that at most, the transaction with the New Lenders delayed an inevitable bankruptcy. Refusing to give credence to the financial analyses cited by the lenders for the proposition that the meltdown of the financial markets was a "once in a century credit tsunami" and an "economic Pearl Harbor," the Court used its own colorful metaphors to equate the bankruptcy of TOUSA to a "slow-moving category 5 hurricane," not a surprise but rather "as foreseeable as the bombing of Nagasaki after President Truman's ultimatum." At 14. Thus, the Court affirmed the finding by the Bankruptcy Court that the demise of TOUSA was not only foreseeable, but inevitable. Determining that the Bankruptcy Court's analysis was proper, the Court explained that the lower court "correctly asked, 'based on the circumstances that existed at the time the investment was contemplated, whether there was any chance that the investment would generate a positive return.'" At 14.

Concluding that the transfers of liens and loan proceeds could be avoided on fraudulent transfer grounds for lack of reasonably equivalent value, the Court turned to the question of whether the avoided transfers could be recovered into the bankruptcy estate. The Court upheld the Bankruptcy Court's finding that the Transeastern Lenders were, in fact, entities for whose benefit the Conveying Subsidiaries granted liens, and therefore the transfer to those lenders could be recovered. The Court found compelling the facts that the settlement agreement between TOUSA and the Transeastern Lenders contemplated the new loans and that the new loan documents required the funds to go directly to the Transeastern Lenders. Citing to an earlier decision,[3] the Court explained that when the liens were granted to the New Lenders, the proceeds of the loans, which were secured by the liens, went directly to the Transeastern Lenders, and therefore, there cannot be any dispute but that the Transeastern Lenders were the beneficiaries of those liens and the loan proceeds. The fact that the funds passed from the New Lenders through a wholly-owned subsidiary of TOUSA before being paid over to the Transeastern Lenders did not change the nature of the Transeastern Lenders' liability as initial transferees without any valid defenses, because the subsidiary did not have control over the funds.

Although not binding outside the 11th Circuit, *TOUSA* poses new challenges. The Court cited the key question raised by the Bankruptcy Court which lenders and borrowers in financially distressed situations face: Based on the circumstances that exist at the time an investment is contemplated, is there any chance that the investment would generate a positive return? This decision may usher in a new wave of fraudulent transfer litigation in situations involving "upstream" guarantees and grants of liens. Going forward, both borrowers and lenders will need to consider the issues raised in the Eleventh Circuit Court of Appeal's opinion, including what due diligence is now required to assess the solvency of subsidiaries that are issuing guarantees and granting liens. Potential lenders must now assess whether to perform a cost-benefit analysis before entering a transaction to determine what tangible benefits the investment would generate for the borrowers and subsidiary guarantors. All of these issues likely will have the effect of increasing the cost of credit in distressed situations beyond the current levels. Parties involved in complex lending transactions should consult with knowledgeable bankruptcy counsel before entering into such transactions.

If you have any questions about this decision or its implications, please call your principal Mintz Levin attorney or one of the attorneys noted on this advisory.

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Endnotes

1 This is the appropriate appellate standard of review for findings of fact.

2 It should be emphasized that the Court declined to decide whether the possible avoidance of bankruptcy can confer reasonably equivalent value, but rather upheld the Bankruptcy Court's decision that under the circumstances that existed in this case, the avoidance—or rather, delay—of bankruptcy did not confer such value.

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