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Eleventh Circuit in TOUSA Reinstates Bankruptcy Court Ruling

BY RICHARD E. FARLEY, JESSE H. AUSTIN, III & JOHN F. HILSON

Lenders Who Are Refinanced With Proceeds of New Debt Secured by Liens on Assets of an Entity, not an Obligor, on the Refinanced Debt Could be Required to Return Those Proceeds to the Extent the Lien Constituted a Fraudulent Transfer

What Can Lenders Do to Protect Themselves Against the "TOUSA Risk?"

On May 15, 2012, the Court of Appeals for the Eleventh Circuit in *In re TOUSA, Inc.*, Case No. 11-11071 (11th Cir. May 15, 2012),[1] reversed the order of the United States District Court for the Southern District of Florida and reinstated the decision of the United States Bankruptcy Court for the Southern District of Florida. Specifically, the Eleventh Circuit held that: (i) the Bankruptcy Court did not clearly err in finding that certain subsidiaries of TOUSA did not receive reasonably equivalent value in exchange for granting liens to secure a new loan, the proceeds of which were used to repay obligations of their parent TOUSA Inc.; and (ii) the Bankruptcy Court correctly concluded that the lenders that were repaid with the proceeds of a new loan secured with the liens were "entities for whose benefit" the liens were granted such that the repayment could be recovered from the lenders under section 550 of the Bankruptcy Code.

I. Background

A. The Transeastern Joint Venture

Prior to its demise, TOUSA Inc. and its subsidiaries were the thirteenth largest homebuilders in the United States. In June 2005, TOUSA Inc.'s wholly owned subsidiary, TOUSA Homes LP ("Homes LP"), entered into a joint venture with a third party for the purpose of acquiring certain assets from Transeastern Properties, Inc. This joint venture was financed with $675 million of debt (the "Original 2005 Loan") from various lenders (the "Transeastern Lenders"). TOUSA Inc. and Homes LP were obligated as guarantors under multiple completion and carve-out guarantees in favor of the Transeastern Lenders. However, TOUSA Inc.'s other subsidiaries were not liable for such debt. In September 2006, the joint venture debt went into default and litigation ensued between, on the one hand, TOUSA Inc. and Homes LP, and, on the other hand, the Transeastern Lenders, which argued that more than $600 million was owing under the joint venture debt agreements and that liability under the completion guarantees was a multiple of the $600 million.

In June 2007, TOUSA Inc. and Homes LP entered into a settlement with the Transeastern Lenders, pursuant to which the Transeastern Lenders would be paid approximately $421 million. To finance this settlement, on July 31, 2007, TOUSA entered into a $200 million first lien term loan facility and a $300 million second lien term loan facility (collectively, the "New Term Loans") with a group of new lenders (the "New Lenders"). The New Term Loans were effectively guaranteed and secured by liens on the assets of many of TOUSA's subsidiaries (the "Conveying Subsidiaries"), the proceeds of which were required to be used to pay the $421 million settlement. It is significant to note that the Conveying Subsidiaries were not parties to the Original 2005 Loan in any manner – they were not direct borrowers, guarantors or pledgors. At the time of these transactions, TOUSA also had unsecured bonds of $1.061 billion principal amount outstanding, guaranteed on an unsecured basis by the Conveying Subsidiaries, and $224 million of revolving credit borrowings, guaranteed on a secured basis by the Conveying Subsidiaries.

Six months after these transactions, TOUSA Inc. and the Conveying Subsidiaries filed for relief under chapter 11 of the Bankruptcy Code. Soon thereafter, the committee of unsecured creditors (the "Committee") brought an adversary proceeding to avoid the liens granted by the Conveying Subsidiaries to secure such subsidiaries' obligations under the New Term Loans as a fraudulent transfer under section 548 of the Bankruptcy Code and seek recovery from the Transeastern Lenders under section 550 of the Bankruptcy Code. The Transeastern Lenders and the New Lenders responded that the Conveying Subsidiaries had received "reasonably equivalent value" in exchange for granting their liens because the failure to refinance the obligations related to the Transeastern joint venture would have resulted in a judgment against TOUSA Inc. that would have constituted an event of default on the bond debt and revolving credit debt guaranteed by the Conveying Subsidiaries and would have likely forced TOUSA Inc. and the Conveying Subsidiaries into bankruptcy. The Transeastern Lenders also argued that they were not "entities for whose benefit" the liens were granted for purposes of section 550 of the Bankruptcy Code.

B. The Bankruptcy Court Decision

The Bankruptcy Court ruled in favor of the Committee and avoided the obligations and liens under the New Term Loans as fraudulent transfers.[2] The Bankruptcy Court found that the Conveying Subsidiaries were insolvent at the time of the transfers, had unreasonably small capital, and were unable to pay their debts when due. Moreover, the Bankruptcy Court found that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the obligations incurred and liens granted in connection with the New Term Loans. In its ruling, the Bankruptcy Court took a narrow view of "value," limiting it to "property" or the "satisfaction of a present or antecedent debt of the debtor." In the alternative, the Bankruptcy Court also found that even under a more expansive view of "value" and taking into account other intangible benefits proffered by the New Lenders and the Transeastern Lenders (including tax benefits, control over certain property, and access to continued corporate services of their parent), the Conveying Subsidiaries did not receive reasonably equivalent value when balanced against the obligations incurred by the Conveying Subsidiaries under the New Term Loans. The Bankruptcy Court also rejected the argument by the New Lenders and the Transeastern Lenders that the Conveying Subsidiaries benefited from the Transeastern settlement by avoiding an earlier bankruptcy of TOUSA Inc.

Further, the Bankruptcy Court concluded that the Transeastern Lenders were "entities for whose benefit" the Conveying Subsidiaries granted the liens under the New Term Loans. The Bankruptcy Court ordered the Transeastern Lenders to disgorge $403 million (the value of the liens), together with prejudgment interest. From the disgorged funds, the Bankruptcy Court awarded the Committee damages to cover the transaction costs relating to the July 31, 2007 transaction, the costs relating to the adversary proceeding, and the diminution in value of the liens between July 31, 2007 and the date of the decision (October 15, 2009). Any remaining disgorged funds were to be distributed to the New Lenders.

C. The District Court Decision

The Transeastern Lenders and the New Lenders appealed the decision of the Bankruptcy Court to the District Court.[3] The District Court quashed the decision of the Bankruptcy Court.[4] The District Court noted that the Bankruptcy Court's view of "value" was too narrow and failed to take into account indirect, intangible economic benefits. Based on its more expansive view of "value," the District Court ruled that the Bankruptcy Court had clearly erred in finding that the Conveying Subsidiaries had not received reasonably equivalent value. Specifically, the District Court found that the Conveying Subsidiaries received "immense economic value" in the form of the opportunity to avoid bankruptcy, continue as a going concern, and make further payments to their creditors.

The District Court also held that the Transeastern Lenders were not "entities for whose benefit" the transfers (i.e., the grant of the liens by the Conveying Subsidiaries) were made within the meaning of section 550(a)(1) of the Bankruptcy Code. Specifically, the District Court held that section 550(a)(1) only permits recovery from "entities for whose benefit" the initial transfer was made. Here, in the District Court's view, the initial transfer was the transfer of the liens by the Conveying Subsidiaries to the New Lenders, which transfer must be separated from the subsequent transfers of the loan proceeds to TOUSA Inc. and then to the Transeastern Lenders. The initial transfer, the District Court concluded, was not made for the benefit of the Transeastern Lenders, and thus the Transeastern Lenders, as subsequent transferees, could not be entities for whose benefit the initial transfer was made.

The District Court did not remand the matter to the Bankruptcy Court, but simply quashed the order of the Bankruptcy Court and declared all proceedings regarding the Transeastern Lenders closed. The Committee appealed the matter to the Eleventh Circuit.

II. Decision of the Eleventh Circuit

The Eleventh Circuit framed the appeal before it as presenting the following two issues:

- whether the Bankruptcy Court clearly erred when it found that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the liens to secure loans used to pay debt owed only by Tousa, Inc.; and
- whether the Transeastern Lenders were entities "for whose benefit" the Conveying Subsidiaries transferred the liens.

On both issues, the Eleventh Circuit sided with the Bankruptcy Court and accordingly reversed the decision of the District Court.

A. Reasonably Equivalent Value

On the first issue, the Eleventh Circuit held that the Bankruptcy Court did not clearly err when it found that the Conveying Subsidiaries did not receive reasonably equivalent value. In so holding, the Eleventh Circuit did not decide whether the Bankruptcy Court's narrow view of "value" or the District Court's more expansive view was the correct one. The Eleventh Circuit simply concluded that the Bankruptcy Court, in its alternative findings of fact, had also considered the other intangible economic benefits, including avoiding an immediate bankruptcy filing, and concluded that even under an expansive view of "value" (including any benefit from delaying a bankruptcy filing) the settlement transaction did not come close to being reasonably equivalent value to the obligations incurred and liens transferred by the Conveying Subsidiaries in connection with the New Term Loans. The Eleventh Circuit held that these findings of fact were not clearly erroneous.

B. "Entities For Whose Benefit"

On the second issue, the Eleventh Circuit held that the Bankruptcy Court correctly concluded that the Transeastern Lenders are entities for whose benefit the Conveying Subsidiaries transferred their liens. The Eleventh Circuit rejected the argument by the Transeastern Lenders that they were subsequent transferees and thus could not be liable as entities for whose benefit the initial transfer was made under section 550(a)(1) of the Bankruptcy Code.

For one, the Eleventh Circuit noted that the New Term Loan agreement required that the proceeds therefrom be used to pay the Transeastern settlement, and the Transeastern settlement expressly depended on the New Term Loans. The Eleventh Circuit also found that even though the New Term Loan proceeds technically passed through a wholly-owned subsidiary of TOUSA Inc. prior to being wired to the Transeastern Lenders, the subsidiary in question did not have the requisite control over the funds to make the Transeastern Lenders subsequent transferees. Moreover, the Eleventh Circuit heavily relied on its previous decision in *American Bank of Marin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart)*,[5] a case which the Eleventh Circuit considered to be controlling precedent in this matter.

The Eleventh Circuit also rejected as unsubstantiated the concerns raised by the Transeastern Lenders that the court's reading would impose extraordinary duties of diligence on the part of creditors accepting repayment. The Eleventh Circuit noted that "every creditor must exercise some diligence when receiving payment from a struggling debtor. It 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."[6]

At the heart of the Eleventh Circuit's ruling was its affirmation of the Bankruptcy Court's finding as to the "foreseeability" that the Conveying Subsidiaries would never see a return on their investment, noting that

> even though Alan Greenspan and Warren Buffet could not foresee the general economic downturn that began in earnest in August 2007, numerous external observers and insiders at TOUSA recognized that the relevant housing markets for TOUSA had begun their free fall before the July 31 transaction. In contrast with the surprise attack at Pearl Harbor, the warnings about the collapse of TOUSA made that event as foreseeable as the bombing of Nagasaki after President Truman's ultimatum.[7]

The fact that the Bankruptcy Court found that the syndication process for the July 2007 loans "reflected the perilous position of TOUSA" also weighed heavily in the Eleventh Circuit's ruling.[8] The Bankruptcy Court had noted that "lenders were dropping out" of the deal as early as July 24 while one of the lead bankers was urging TOUSA to close immediately because "things were looking ugly out there" and "the [market] has completely dried up."[9]

Having reversed the decision of the District Court, the Eleventh Circuit remanded the case back to the District Court.[10]

III. Consequences of the Decision for Leveraged Lending

If a lender's loan is being repaid with the proceeds of debt, which is secured by a lien on assets of an entity that is not an obligor on the loan, the lender is at risk for disgorgement of the proceeds if the granting of the lien is a "fraudulent transfer." This set of facts would be most likely to arise when a holding company bond issue or holding company loan were refinanced with operating company subsidiary secured debt. Since most loan agreements and indentures as currently drafted do not permit a lender to refuse an otherwise permitted prepayment or redemption or payment at maturity, there is little that can be done to mitigate this risk with respect to existing loans and debt securities. It would be possible to mitigate this risk in new instruments, for example, by requiring that payments with such proceeds at a time when credit deterioration had met a predetermined level (i.e., a ratings downgrade trigger) be permitted only if a reasonably acceptable solvency opinion or certificate with respect to each such entity is provided to the lenders to be repaid.

In prospectus and offering memoranda for holding company notes (i.e., where guarantees subsidiaries are not provided), consideration should be given to appropriate risk factor disclosure regarding disgorgement risk in a refinancing of the holding company notes with the proceeds of debt secured by assets of subsidiaries of the issuer, particularly where that method of repayment is not unlikely.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

New York

Richard E. Farley
1.212.318.6434
richardfarley@paulhastings.com

Atlanta

Jesse H. Austin, III
1.404.815.2208
jessaustin@paulhastings.com

Los Angeles

John F. Hilson
1.213.683.6300
JohnHilson@paulhastings.com

1 *In re TOUSA, Inc. et al.*, 2012 U.S. App. LEXIS 9796 (11th Cir. May 15, 2012).

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

3 The District Court stayed the appeal of the New Lenders in favor of moving forward on the appeal of Transeastern Lenders.

4 *3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of TOUSA, INC.* (*In re TOUSA Inc.*), 444 B.R. 613 (S.D. Fla. 2009).

5 845 F.2d 293 (11th Cir. 1988). In *Air Conditioning*, the Eleventh Circuit permitted a trustee to recover $20,000 as a preferential transfer from a creditor, who had received a letter of credit from a bank, to which the debtor had granted a lien on certain of its assets. In that case, the Eleventh Circuit had explained that section 550(a) of the Bankruptcy Code allowed the trustee to recover from the creditor because such creditor was an entity for whose benefit the transfer (i.e., the grant of a lien in favor of the bank) was made.

6 *In re TOUSA, Inc. et al.*, 2012 U.S. App. LEXIS 9796, at *46.

7 *Id.* at *33.

8 *Id*. at *21.

9 *Id*.

10 The Eleventh Circuit refused to consider the Transeastern Lenders' challenge to the remedies imposed by the Bankruptcy Court, but remanded for the District Court to consider that issue.