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Alert

District Court Reverses Bankruptcy Court's Controversial Fraudulent Transfer Tousa Decision

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United States District Court Judge Alan S. Gold, on February 11, 2011, reversed a Florida bankruptcy court's controversial October 2009 fraudulent transfer judgment[1] against a group of lenders based on their receipt of a $421 million loan repayment in July 2007. *3V Capital Master Fund, et al., v. Official Committee of Unsecured Creditors of Tousa, Inc., et al,* Case No. 10-60017-CIV (S.D. Fla. Feb. 11, 2011).[2] A different District Judge is still considering appeals from another part of the bankruptcy court's ruling against those lenders who provided the funds for the July 2007 payment. As summarized below, the district court reversed the bankruptcy court's decision on the grounds that:

(i) a corporate parent's payment of its own legitimate debt cannot be recovered by creditors of the parent's subsidiaries (the "Subsidiaries") as a fraudulent transfer;

(ii) creditors of the Subsidiaries could not recover the parent's payment to its lenders when the Subsidiaries, as members of the parent's corporate enterprise, received "reasonably equivalent value" by avoiding a default, obtaining a reasonable opportunity to rehabilitate their businesses, and avoiding an imminent bankruptcy; and

(iii) merely because the Subsidiaries had granted liens to other lenders, the Subsidiaries' creditors could not obtain a judgment against the parent's lenders who had been paid.

Relevance
The court rejected the bankruptcy court's "patently unreasonable and unworkable" standard requiring a creditor repaid on a legitimate debt to "investigate the debtor's internal financing structure and ensure that the debtor's subsidiaries had received fair value as part of the repayment, or that the debtor and its subsidiaries, in an enterprise, were not insolvent or precariously close to being insolvent." *Id.* at *102-03. Neither New York nor "established bankruptcy law" impose "a duty of care" on a corporate parent's lenders to creditors of the borrower's subsidiaries. *Id.* at *103. Indeed, the defendants here, "as recipients of a debt repayment, had no reason or legal duty to conduct…extraordinary due diligence with respect to the provenance of the funds with which they were being repaid." *Id.* at *103-04.

This was not a typical upstream guarantee fraudulent transfer case. The defendants here had received only repayment of their loan under a heavily negotiated good faith settlement agreement. Other lenders, the

[1] *In re Tousa, Inc., et al.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

[2] Click here for a copy of the decision.

appellants on a separate appeal, received the benefit of liens on the Subsidiaries' assets. Given this court's holding, however, the other lenders may also avoid liability because the Subsidiaries received reasonably equivalent value.

Facts

TOUSA, Inc. (the "Parent") held a 50% equity stake in a joint venture funded by certain "JV Lenders" with $675 million in loans guaranteed by the Parent. When the joint venture defaulted, the JV Lenders sued the Parent on its guaranty (the "JV Litigation"). *Id.* at *20. To settle the JV Litigation, the Parent paid $421 million to the JV Lenders on July 31, 2007 (the "Settlement Payment"). *Id.* at *25.

To finance the Settlement, the Parent raised $500 million of new term loans ("New Loans") from a group of lenders (the "Term Lenders"). *Id.* at *25. Some of the Parent's Subsidiaries were co-borrowers under the New Loans group, securing their obligations with liens on their assets. *Id*. The Parent used the loan proceeds it received from the Term Lenders to repay the JV Lenders. The Subsidiaries were not liable to the JV Lenders, nor were they defendants in the JV Litigation, and they received none of the Term Loan proceeds. *Id.* at *15.

Six months after the closing of the New Loans, on January 29, 2008, the Parent and the Subsidiaries filed Chapter 11 petitions. *Id*. at *32. The creditors' committee, on behalf of the Subsidiaries, sued the JV Lenders and the Term Lenders, claiming, among other things, that the Term Lenders' liens on the Subsidiaries' assets and the Settlement Payment to the JV Lenders were fraudulent transfers.

After a lengthy trial, the bankruptcy court avoided as fraudulent transfers: (i) the obligations incurred by the Subsidiaries to the New Lenders; (ii) the liens on the Subsidiaries' assets granted to the Term Lenders to secure the New Loan; and (iii) the $421 million Settlement Payment to the JV Lenders. *Id.* at *37. Only the bankruptcy court's fraudulent transfer judgment against the JV Lenders is the subject of District Judge Gold's ruling.[3] *Id.* at *40.

JV Lenders Not "Direct Transferees" of Funds From Subsidiaries

The bankruptcy court held that the JV Lenders were liable as "direct transferees" of the Subsidiaries' property. *Id.* at *47. Because the Subsidiaries were co-borrowers with the Parent on the New Loans, the bankruptcy court reasoned, "[i]f the funds are lent to co-borrowers (rather than to a single borrower), each of the co-borrowers had a property interest in the funds." *Id*. at *52 (internal citations omitted).

The District Court disagreed. Applying the "control test" of *Nordberg v. Sanchez (In re Chase & Sandborn Corp.)*, 813 F.2d 1177 (11th Cir. 1987), the court held that the New Loan proceeds had never been the property of the Subsidiaries because they lacked any control over the use or disposition of the proceeds. *Id*. at *53. The Parent had the control, had agreed, and intended to use the funds to pay off its debt to the JV Lenders. *Id.* The overwhelming evidence, in the District Court's view, showed that "[the Parent], and not the … Subsidiaries, controlled the transfer…" *Id*. The Parent had "control over identifying the payee, and control over whether the payee will actually be paid." *Id*. at *51. "[W]ithout the requisite control, the [New Loan proceeds] could not have been used by the [Subsidiaries] to pay another creditor, and the transfer thus did not decrease the value of the [Subsidiaries'] estate." *Id*. Therefore, no fraudulent transfer claim could be maintained by creditors of the Subsidiaries, because, in effect, no assets of the Subsidiaries were used to pay the JV Lenders.

Subsidiaries Received Reasonably Equivalent Value

The District Court, in a further rejection of the bankruptcy court's analysis, alternatively found that the Subsidiaries had received "reasonably equivalent value" in exchange for the Settlement Payment to the JV Lenders. *Id.* at *55. Criticizing the bankruptcy court's narrow definition of "value," which excluded "economic benefits," *Id*. at *69 (citing *Mellon Bank, N.A. v. Metro Communications*, *Inc.,* 945 F.2d 635 (3d Cir. 1991), the court held that "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprises' rehabilitation, and to avoid bankruptcy, even if it proved to be short lived, may be considered in

[3] Judge Gold strongly criticized the bankruptcy court's near verbatim adoption of the Creditors' Committee's proposed findings of fact and conclusions of law. *Id.* at 43. A court's factual and legal conclusions are undermined, reasoned Judge Gold, when one party's proposed order is adopted verbatim. *Id.* at 46.

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determining reasonably equivalent value." *Id*. at *73. Stressing the integrated nature of the TOUSA enterprise, the District Court found that the Subsidiaries received "an enormous economic benefit [from the JV Lender settlement]…in terms of their viability as going concerns and their continued access to financing through the TOUSA parent, which…allowed them, for a period of time, to continue to pay interest [to their creditors]." *Id*. at *80. In the District Court's view, the bankruptcy court erred by not considering the "totality of the circumstances" in measuring "reasonably equivalent value." *Id.* at *76.

JV Lenders Were Not Indirect Transfer Beneficiaries

The bankruptcy court held that the Subsidiaries' grant of liens to the Term Lenders was a fraudulent transfer under Bankruptcy Code ("Code") § 548.[4] *Id.* at *93. The creditors' committee of the Subsidiaries had sought to avoid the liens and preserve them for creditors under Code § 551. The bankruptcy court went further, holding the JV Lenders liable for repayment of the value of the liens under Code § 550(a). Section 550(a) provides that, to the extent a transfer is avoided, a trustee may recover the properly transferred (and in limited circumstances, its value) from: (i) an initial transferee; (ii) an entity for whose benefit the initial transfer was made; or (iii) a subsequent transferee. According to the bankruptcy court, the JV Lenders had to disgorge the "value of the liens" because the Subsidiaries had granted the liens to the Term Lenders "for the benefit" of the JV Lenders. *Id.* at *93.

The District Court reversed the bankruptcy court's "overly broad interpretation of [s]ection 550(a)." *Id*. Transfer beneficiary liability does not arise when the "benefit is not the immediate and necessary consequence of the initial transfer, but flows from the manner in which the initial transfer is *used* by its recipient – the benefit must be derived directly from the [initial] transfer, not from the use to which it is put by the transferee." *Id.* at 100 (internal quotations and citations omitted). The JV Lenders had not benefited from the granting of liens directly to the Term Lenders. *Id.* at *96. Instead, the JV Lenders benefited only from the New Loan proceeds advanced by the Parent to fund its Settlement Payment. *Id.* at *101. The JV Lenders were "subsequent transferees" of the New Loan proceeds, and able to rely on the good faith defense in Code § 550(a). *Id.* at *101.[5]

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[4] As noted, this issue is still on appeal before another District Judge.

[5] The bankruptcy court had refused to enforce a fraudulent transfer savings clause in the applicable loan documents, but the district court did not have to address this issue in its opinion.

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