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Eleventh Circuit Reverses *TOUSA* District Court Decision and Holds Lenders Liable for Fraudulent Transfer

MICHAEL L. COOK AND DAVID M. HILLMAN

The authors analyze the decision by the U.S. Court of Appeals for the Eleventh Circuit in TOUSA*, and believe that the bottom line is now the lenders have an uphill fight.*

The U.S. Court of Appeals for the Eleventh Circuit has reversed a district court's February 2011 decision that lenders were not liable on a fraudulent transfer claim. In *In re TOUSA, Inc.,*[1] the circuit court rejected the district court's finding that corporate subsidiaries had received "reasonably equivalent value" when they encumbered their assets to secure a loan made to them and their corporate parent. Agreeing with the bankruptcy court's earlier 2009 decision, the court of appeals held that the "bankruptcy court did not clearly err.... [T]he Subsidiaries did not receive reasonably equivalent value for the liens" they had granted to the so-called "Term Lenders."[2] Also, reasoned the court, "the bankruptcy court correctly ruled that the [defendant] Transeastern Lenders [whose loan was repaid] were entities 'for whose benefit' the liens were transferred," thus making them liable to pay the value of the liens, roughly $403 million.[3]

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RELEVANCE

TOUSA is not the typical upstream guaranty fraudulent transfer case. It essentially holds that a secured "rescue loan" to help a troubled company avoid bankruptcy will probably *not* constitute reasonably equivalent value: "The opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden."[4] Even more provocative was the court's casual warning to lenders generally: "... every creditor must exercise some diligence when receiving payment from a struggling debtor [and] when it is being repaid hundreds of millions of dollars by someone other than its debtor."[5] With no supporting authority, the court ignored the district court's reliance on case law "generally caution[ing] against imposing exhaustive duties to investigate upon banks and other creditors."[6]

FACTS

TOUSA, Inc. (the "Parent"), held a 50 percent equity stake in a joint venture funded by the "Transeastern Lenders" with $675 million in loans, and had guaranteed repayment of the loans. When the joint venture defaulted, the Transeastern Lenders sued the Parent on its guaranty (the "JV Litigation") for $2 billion.[7] To settle the JV Litigation, the Parent paid $421 million to the Transeastern Lenders on July 31, 2007 (the "Settlement Payment").[8]

The Parent raised $500 million of new term loans ("New Loans") from a group of lenders (the "Term Lenders") to fund the settlement.[9] Some of the Parent's Subsidiaries were co-borrowers under the New Loans, securing their obligations with liens on their assets.[10] The Parent used the New Loan proceeds from the Term Lenders to repay the Transeastern Lenders a reduced amount ($421 million instead of the original $675 million loaned).[11] The Subsidiaries had not been liable to the Transeastern Lenders, nor were they defendants in the JV Litigation, and they received none of the Term Loan proceeds. Six months after the closing of the New Loans, on January 29, 2008, the Parent and the Subsidiaries filed Chapter 11 petitions.[12] The creditors' committee, on behalf of the Subsidiaries, sued the Transeastern Lenders and the Term Lenders in the bankruptcy

court, claiming, among other things, that the Term Lenders' liens on the assets of the Subsidiaries were fraudulent transfers because of (a) the insolvency or (b) undercapitalization of the Subsidiaries, *and* (c) the failure of the Subsidiaries to receive "reasonably equivalent value" in exchange for the transfer of the liens.[13] The parties had conceded the insolvency of the Subsidiaries.[14]

The bankruptcy court avoided as fraudulent transfers (a) the obligations incurred by the Subsidiaries to the Term Lenders; (b) the liens on the assets of the Subsidiaries granted to the Term Lenders to secure the New Loans, and (c) directed recovery of, among other things, $403 million plus interest from the Transeastern Lenders as the entities for whose benefit the transfers were made.[15] Only the bankruptcy court's fraudulent transfer money judgment for $403 million against the Transeastern Lenders was the subject of the district court's 2011 ruling. But "[b]ecause the district court ruled on issues ... central to the separate appeals of the [Term] Lenders, the district court allowed [them] to intervene in this appeal.…"[16] Thus, the Term Lenders' liens will probably be invalidated on remand.

BANKRUPTCY COURT'S FACT FINDINGS NOT CLEARLY ERRONEOUS; SUBSIDIARIES RECEIVED NO REASONABLY EQUIVALENT VALUE

The court of appeals held that the bankruptcy court's fact findings were supported by the record, were not "clearly erroneous," and should not have been reversed by the district court.[17] Under Bankruptcy Code § 548(a)(1)(B), because of the admitted insolvency of the Subsidiaries, the plaintiff committee only had to prove that they "received less than…reasonably equivalent value in exchange for" granting liens on their assets.

The bankruptcy court held that the Subsidiaries did not receive "reasonably equivalent value" when they granted liens on their assets to secure their obligations to the Term Lenders. The dispute in the lower courts was whether indirect economic benefits (*e.g.*, avoidance of bankruptcy by the Subsidiaries) constituted "value" and, if so, whether that value was reasonably equivalent to the obligations incurred by the Subsidiaries.

Declining to adopt either lower court's definition of "value," the court

of appeals instead deferred to the bankruptcy court's reasoning. Even if the Subsidiaries received some value in the form of indirect economic benefits in the 2007 settlement, they failed to receive "reasonably equivalent value" for the $403 million in obligations that they incurred.[18]

The Transeastern Lenders and Term Lenders argued that the Subsidiaries had benefitted from the 2007 transaction by avoiding an earlier bankruptcy.[19] According to the court, however, "even assuming that all of the TOUSA entities would have spiraled immediately into bankruptcy without the July 31 Transaction, the Transaction was still a more harmful option."[20] Moreover, reasoned the court of appeals, the evidence supported a finding that the Subsidiaries' bankruptcy filing was "inevitable."[21] Prior to the July 31 transaction, TOUSA's officers had expressed grave concerns about taking on more debt given the severe housing market decline.[22] Based on the circumstances at the time the transaction was contemplated, there was no chance that the 2007 transaction would generate a positive return.[23] Therefore, any "benefits to the…Subsidiaries were not close to being reasonably equivalent in value to the $403 million of obligations…they incurred."[24]

THE TRANSEASTERN LENDERS RECEIVED MOST OF THE LOAN PROCEEDS

Once the liens were avoided, Section 550(A)(1) allows the recovery of property or its value from the initial transferee or "an entity for whose benefit such transfer was made (a "Transfer Beneficiary"). The bankruptcy court held that the Transeastern Lenders were Transfer Beneficiaries because the loan transaction was intended for the benefit of Transeastern Lenders. The Transeastern Lenders argued that they were not Transfer Beneficiaries of the initial transfer (i.e., grant of liens), but were instead subsequent transferees of the loan proceeds. The distinction between Transfer Beneficiary liability and subsequent transferee liability was critical because only a subsequent transferee can avail itself of a good faith defense.

Relying on the language of Bankruptcy Code § 550(a)(1), the court of appeals agreed with the bankruptcy court "that the Transeastern Lenders were 'entities for whose benefit' the liens were transferred."[25] In other

words, the "Transeastern Lenders directly received the benefit of the [New Loans] and the Transaction was undertaken with the unambiguous intent that they would do so."[26]

The court likened the facts here to another Eleventh Circuit case, *In re Air Conditioning, Inc. of Stuart*.[27] "Here, the Subsidiaries granted liens to the Term Lenders to obtain funds necessary to pay the settlement amount owed by the Parent to the Transeastern Lenders."[28] Thus, the Transeastern Lenders were entities for whose benefit the Subsidiaries' pledges were made under Bankruptcy Code § 550(a)(1).[29]

Arguing as subsequent transferees, the Transeastern Lenders asserted the good faith defense under Bankruptcy Code § 550(b). According to the court of appeals, however, the loan documentation showed that when the Subsidiaries granted liens to the Term Lenders, the loan proceeds went through a conduit entity directly to the Transeastern Lenders, but not through the Parent.[30] The Transeastern Lenders, in the court's view, should have questioned the source of the payment, exercised "some diligence," and apparently should have rejected payment.[31]

REMEDIES TO BE DETERMINED ON REMAND

The bankruptcy court had avoided the subsidiaries' grant of liens, and had directed the return of $403 million from the Transeastern Lenders. It also imposed damages and ordered the disgorgement of professional fees. The Eleventh Circuit directed the district court to resolve, in the first instance, "the remedies ordered by the bankruptcy court," plus "matters of judicial assignment and consolidation...."[32] The parties had sought different judges on remand. These matters, according to the court of appeals, were "not ripe for our review."[33]

The litigation will continue on remand. But the lenders here have an uphill fight.

NOTES

[1] ___ F.3d ___, 2012 U.S. App. LEXIS 9796 (11th Cir. 5/15/12).
[2] *Id.*, at *4.

[3] *Id.* The bankruptcy court "credited the expert opinion testimony of an accountant who had calculated that the Conveying Subsidiaries had incurred $403 million of obligations when they granted liens to help secure $500 million of loans" from the Term Lenders. *Id.* at *13.
[4] *Id.*, at *39.
[5] *Id.*, at *46.
[6] 444 B.R. 613, 675 (S.D. Fla. 2011), citing *N.Y. Assets Realization Co. v. McKinnon*, 209 F. 791, 793 (2d Cir. 1913) ("It would be an exceeding great hardship on the debtor if the creditor had the right to refuse to accept payment of the debt after it was due…."); *In re Presidential Corp*., 180 B.R. 233, 239 (9th Cir. BAP 1995) ("A party who receives a subsequent transfer…should not be required to investigate the source of the deposits [or] the source of the funds.").
[7] *Id.*, at *6.
[8] *Id.*
[9] *Id.*, at *6-7.
[10] *Id.*
[11] *Id.*, at *7.
[12] *Id.*
[13] *Id.*, at *8.
[14] *Id.*, at 33.
[15] *Id.*, at * 10.
[16] *Id.*, at *31.
[17] *Id.*, at *32-40.
[18] *Id.*, at *34, *37.
[19] *Id.*, at *35-36.
[20] *Id.*, at 37 quoting *In re TOUSA*, 422 B.R. 783, 847 (Bankr. S.D. Fla. 2009).
[21] *Id.*, at *37-39.
[22] *Id.*, at *39.
[23] *Id.*, at *40.
[24] *Id.*, at *37.
[25] *Id.*, at *40-46.
[26] *Id.*, at *26, quoting *In re TOUSA*, 422 B.R. at 870.
[27] 845 F.2d 293 (11th Cir. 1988), (held, creditor liable for payment received from bank on letter of credit when debtor had given bank collateral to secure its reimbursement obligation to bank; entire transaction intended to benefit creditor).

[28] *Id.*, at *43.
[29] *Id.*
[30] *Id.*, at *44.
[31] *Id.*, at *46.
[32] *Id.*, at *49.
[33] *Id.*, at *46.

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