



JONES DAY
COMMENTARY

TOUSA: ELEVENTH CIRCUIT UPHOLDS FRAUDULENT TRANSFER OPINION AGAINST LENDERS

On May 15, 2012, the United States Court of Appeals for the Eleventh Circuit issued a decision¹ in the much-watched litigation involving the residential construction company, TOUSA, Inc. (“TOUSA”). The decision reversed the prior decision of the District Court,² reinstating the ruling of the Bankruptcy Court.³

BACKGROUND

The litigation involved the transfer of liens by certain subsidiaries of TOUSA (the “Conveying Subsidiaries”) to secure approximately \$476 million in debt incurred by TOUSA to a syndicate of lenders (the “New Lenders”). The proceeds of the transfer were used primarily to pay a settlement of approximately \$421 million in respect of unsecured debt to another group of lenders (the “Transeastern Lenders”). The

settlement was entered into by TOUSA as a guarantor of loans made by the Transeastern Lenders to a joint venture between a TOUSA subsidiary and a third party after the Transeastern Lenders alleged TOUSA was in default of its obligations and owed the Transeastern Lenders approximately \$2 billion.

As part of the settlement transactions, TOUSA entered into new second and first lien credit facilities with the New Lenders and used \$421 million drawn under the new credit facilities to pay the settlement amount owed to the Transeastern Lenders. The new credit facilities were guaranteed by the Conveying Subsidiaries, and these guarantees were secured by liens on the assets of the Conveying Subsidiaries. The Conveying Subsidiaries, however, had not been obligors under the debt originally owed to the Transeastern Lenders.

1 *Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re TOUSA, Inc.)*, Slip Op. No. 11-11071 (11th Cir. May 15, 2012).
 2 *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).
 3 *In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

After TOUSA and the Conveying Subsidiaries filed for bankruptcy, TOUSA's unsecured creditors' committee brought an action challenging the liens granted to the New Lenders as fraudulent transfers, maintaining that the Conveying Subsidiaries had not received reasonably equivalent value in exchange for such liens. The unsecured creditors' committee sought to recover the value of the liens from the Transeastern Lenders under section 550(a)(1) of the Bankruptcy Code on the grounds that the Transeastern Lenders were the entities for whose benefit the transfer had been made.

In its October 30, 2009 ruling, the Bankruptcy Court, finding that the Conveying Subsidiaries did not receive reasonably equivalent value, avoided the liens granted by the Conveying Subsidiaries to the New Lenders as a fraudulent transfer and ordered the Transeastern Lenders to "disgorge" \$403 million in loan proceeds because the transfer was for the benefit of the Transeastern Lenders. The Bankruptcy Court also awarded damages (including litigation costs, professional fees incurred in connection with the transaction, and diminution in the value of the liens) to the Conveying Subsidiaries. On appeal, the District Court quashed the orders of the Bankruptcy Court.

In its decision, the Eleventh Circuit held that the Bankruptcy Court did not clearly err when it found that the Conveying Subsidiaries had not received reasonably equivalent value for the granting of liens to the New Lenders. In addition, the Eleventh Circuit held that the Bankruptcy Court correctly ruled when it found that the Transeastern Lenders were entities "for whose benefit" the liens to the New Lenders had been granted within the meaning of section 550(a) of the Bankruptcy Code.⁴

REASONABLY EQUIVALENT VALUE

In its decision, the Bankruptcy Court ruled (after a 13-day trial in which the Bankruptcy Court heard extensive fact and expert testimony and admitted more than 1,800 exhibits) that the transfer of liens by the Conveying Subsidiaries to the New Lenders was a fraudulent transfer under section 548(a)(1)(B) of the Bankruptcy Code because (i) the Conveying Subsidiaries were insolvent before and after the transfer, had unreasonably small capital, and were unable to pay their debts when due; and (ii) the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for their transfer.⁵

In its assessment of whether the Conveying Subsidiaries had received reasonably equivalent value from the transaction, the Bankruptcy Court noted that "value" is defined in section 548 of the Bankruptcy Code as being "property" or "satisfaction or securing of a present or antecedent debt of the debtor." Accordingly, it held the Conveying Subsidiaries could not have received "property" unless they obtained some "enforceable entitlement to some tangible or intangible article."

On appeal, the District Court rejected the Bankruptcy Court's definition of "value" as too narrow and potentially "inhibitory of contemporary financing practices."⁶ The District Court further ruled that the indirect benefits received by the Conveying Subsidiaries as subsidiaries of TOUSA, as a result of their parent's settlement with the Transeastern Lenders, constituted reasonably equivalent value. The Eleventh Circuit expressly declined to adopt either definition of "value" but instead deferred to the Bankruptcy Court's factual finding that, even if the indirect benefits to the Conveying Subsidiaries were legally cognizable, they did not constitute reasonably equivalent value.⁷

4 Slip opinion at 3.

5 422 B.R. 866.

6 444 B.R. at 659, 660.

7 Slip opinion at 29.

ENTITY FOR WHOSE BENEFIT THE TRANSFER WAS MADE

Section 550(a) of the Bankruptcy Code provides remedies for fraudulent transfers. Pursuant to section 550(a)(1), the trustee may recover fraudulently transferred property from “the initial transferee of such transfer or the entity for whose benefit such transfer was made.” The Bankruptcy Court, noting that the explicit purpose of the transactions was to pay the settlement with the Transeastern Lenders, found that the Transeastern Lenders were the entities for whose benefit the Conveying Subsidiaries granted liens to the New Lenders.⁸

The District Court rejected the Bankruptcy Court’s reasoning, holding that because the Transeastern Lenders did not directly benefit from the transfer itself, but rather from TOUSA’s use of the proceeds of such transfer, the Transeastern Lenders should not be treated as the beneficiaries of the liens. The District Court concluded that to hold otherwise, as the Bankruptcy Court had done, would “have a profoundly chilling effect on the acceptance of payment by lenders of valid antecedent debts” and “place an impossible burden on holders of antecedent debt that would undermine their ability to settle valid debts outside any preference period, and, instead, would encourage the proliferation of wasteful debt-resolution litigation.”⁹

The Eleventh Circuit disagreed, holding instead 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.”¹⁰

REMEDIES NOT YET DECIDED

The remedies ordered by the Bankruptcy Court included avoidance of the Conveying Subsidiaries’ guarantees and liens, recovery of \$421 million from the Transeastern Lenders, and substantial other damages. The Transeastern Lenders had maintained that the Bankruptcy Court improperly awarded a double remedy by ordering recovery both from the New Lenders and from the Transeastern Lenders. The Eleventh Circuit declined to address this issue but instead remanded the matter back to the District Court.¹¹

IMPLICATIONS

The *TOUSA* litigation has been closely followed by the loan market because of the significant implications for both lenders and borrowers when structuring loan transactions with comparable structural features.

Guarantees by operating company subsidiaries of loans made to holding companies have long been fairly common in the loan market, even in situations in which the guaranteeing subsidiaries directly receive little or none of the loan proceeds distributed to their parent. Although this structure inherently presents fraudulent conveyance risk because of the nonreceipt of the loan proceeds by the guarantors, the lenders may argue that the guarantors received “indirect value.”

The *TOUSA* holding does not address indirect value generally but rather narrowly addresses only the question of whether thwarting a bankruptcy is “reasonably equivalent value.” The *TOUSA* decision leaves open what other kinds of intangible benefits that may flow to a subsidiary that guarantees financing provided to a financially sound parent could be considered sufficient to withstand a fraudulent conveyance attack. In the future, when relying on upstream guarantees from subsidiaries that will receive none of the proceeds

8 422 B.R. at 870.

9 444 B.R. at 677-79.

10 Slip opinion at 39.

11 *Id.*

of a loan, lenders should ensure that the subsidiary guarantors will either receive some significant and quantifiable direct benefit from the loan (such as direct receipt of loan proceeds) or are clearly and demonstrably solvent at the time the loan is made.

In addition, lenders being repaid with the proceeds of a secured transaction with upstream guarantees face additional risk, as under the *TOUSA* ruling they may be determined to be the “entity for whose benefit the transfer was made,” exposing them to the possibility of remedies under section 550(a) of the Bankruptcy Code. The Eleventh Circuit suggests that lenders accepting payment could perform diligence to determine the source of such payment to protect themselves.

This diligence may provide lenders cold comfort, however, because even if the lender through its diligence becomes concerned about the structure of a transaction through which its loans will be repaid, loan documentation typically does not grant lenders an option to refuse payment when tendered by or on behalf of the borrower. Lenders that refuse to accept tendered repayment may put themselves at risk for other liabilities, such as breach of contract or lender liability claims by the borrower. The best advice to lenders that are to be repaid with the proceeds of a loan that presents significant fraudulent transfer risk is to accept the repayment while at the same time being prepared for a battle if the borrower ultimately files a bankruptcy petition within the statutory limit for fraudulent conveyances.

Finally, note that because the issue was never directly relevant to the litigation, neither the District Court nor the Eleventh Circuit ruled on whether the fraudulent conveyance savings clause, the standard provision contained in upstream guarantees—to document the parties’ intent that the guaranteeing of the parent’s debt should not in and of itself render the subsidiary insolvent—is problematic.

Nothing in the *TOUSA* decision suggests either that savings clauses are ineffective or that they should be removed from upstream guarantees.

The *TOUSA* facts are those of a true “fallen angel” situation and are somewhat narrow. The holding company parent had previously guaranteed on an unsecured basis its affiliate’s debt that was to be refinanced with new secured financing. The Bankruptcy Court also noted that several of the New Lenders were themselves Transeastern Lenders—reinforcing its conclusion that the granting of the liens constituted a fraudulent transfer. As a result, the most direct impact of the *TOUSA* holding will be on distressed borrowers for which rescue financing closely mirroring the *TOUSA* structure is implemented.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

Robert J. Graves

Chicago

+1.312.269.4356

rjgraves@jonesday.com

Vanessa G. Spiro

New York

+1.212.326.7864

vspiro@jonesday.com

Barry A. Jacobs

Dallas

+1.214.969.4841

bjacobs@jonesday.com