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Bankruptcy and Creditors' Rights

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TOUSA Fraudulent Transfer Decision Reversed by District Court

Reversing a controversial decision and judgment of the bankruptcy court, the United States District Court for the Southern District of Florida has held that a group of lenders who received payment in settlement of their defaulted debt from the proceeds of new loans secured by the assets of certain subsidiaries of TOUSA, Inc. which were not themselves liable on that debt, did not receive fraudulent transfers.

The district court found that because the TOUSA subsidiaries in question never controlled the loan proceeds from the new loans, the settlement payment to the lenders was not a direct transfer made by the subsidiaries, and, accordingly, the subsidiaries could not avoid the transfer. The subsidiaries also sought recovery based on avoidance of the liens they granted to secure the new loans. The district court found, however, that the subsidiaries received reasonably equivalent value for whatever minimal property interest they had in the new borrowing proceeds that were paid to the lenders.

Specifically, the district court found that indirect benefits, though difficult to value with precision, provided reasonably equivalent value for the liens the subsidiaries granted, even if the subsidiaries' interest in the proceeds of the new loans had been directly transferred to the lenders. Using a "totality of the circumstances" test, the court held that such indirect benefits included avoiding default, avoiding bankruptcy (for the time being), and having continued access to financing under a revolving credit agreement that would otherwise have been in default. It found that the bankruptcy court's use of the dictionary definition of "property" as the measure of whether value was received was incorrect, and that, in this context, the mere opportunity to receive an economic benefit in the future constituted value under the Bankruptcy Code. Thus, a reprieve from foreclosure and the right to continue operations could confer an indirect economic benefit. The district court reasoned that an expectation that a settlement which would "avoid default and produce a strong synergy for the enterprise" would suffice to confer "value" so long as the expectation was legitimate and reasonable. The touchstone, the court held, was whether the transaction conferred "reasonable commercial value" on the debtor.

The district court also found error in the bankruptcy court's holding that, because the lenders were entities "for whose benefit" the subsidiaries transferred liens to secure the new loans, the subsidiaries could recover under section 550 of the Bankruptcy Code. It rejected the argument that the lenders received a benefit "flowing from the use to which the initial lien transfer was put; namely the further transfer of [proceeds of the new loans] to TOUSA, which, in turn, transferred the proceeds to the [lenders] in

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settlement and payment of a valid, antecedent debt." The court held that only an entity who receives a benefit from the initial transfer can be an entity "for whose benefit the initial transfer was made." It found that the settlement payment was not the immediate and necessary consequence of the initial transfer, but flowed from the manner in which the initial transfer *was used* by its recipient.

Finding that the lenders would have had a valid "good faith" defense in any event, the district court rejected the bankruptcy court's "good faith" standard requiring lenders receiving payment on a bona fide debt from an entity *other than the debtor* to investigate the debtor's financing structure, including whether its subsidiaries received value and whether the debtor was insolvent. It found such a standard "patently unreasonable and unworkable."

A second appeal stemming from the portion of the bankruptcy court's decision avoiding the liens of the lenders which provided the new loans is still pending before another district judge in Florida. These actions are likely to be appealed to the U.S. Court of Appeals for the 11th Circuit.

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