

Client Alert

Financial Restructuring Practice Group

February 15, 2011

***In re TOUSA, Inc.*—District Court Quashes Portion of Widely Criticized Fraudulent Transfer Decision**

On February 11, 2011, in a decision that represents a significant victory for institutional lenders and other proponents of capital market financing, Judge Alan S. Gold of the United States District Court for the Southern District of Florida (the District Court) issued a 113 page opinion overturning a \$480 million fraudulent transfer judgment entered by the United States Bankruptcy Court for the Southern District of Florida (the Bankruptcy Court) against the so-called “Transeastern Lenders” in the TOUSA, Inc. (TOUSA) chapter 11 bankruptcy cases.¹

The Bankruptcy Court’s widely criticized ruling had avoided as fraudulent transfers certain liens and related indebtedness incurred by TOUSA’s debtor subsidiaries (the “Conveying Subsidiaries,” and together with TOUSA, the Debtors) in connection with \$500 million of “rescue financing” incurred by TOUSA and the Conveying Subsidiaries six months prior to the Debtors’ bankruptcy filings (the Refinancing). The proceeds of the Refinancing were used to repay the Transeastern Lenders for obligations of TOUSA that were not guaranteed by or secured by property of the Conveying Subsidiaries. In connection with its ruling, the Bankruptcy Court had also ordered the Transeastern Lenders to disgorge the proceeds of the Refinancing (with interest) on the basis that they were bad faith recipients of the proceeds of a fraudulent transfer (*i.e.*, the Refinancing).

In a scathing opinion, the District Court quashed the Bankruptcy Court’s ruling as it relates to the Transeastern Lenders on the basis that it contained numerous findings of fact and conclusions of law that were “clearly erroneous.”ⁱⁱ In overturning the Bankruptcy Court’s ruling against the Transeastern Lenders, the District Court found, among other things, that (a) the payment to the Transeastern Lenders was not avoidable as a fraudulent transfer because the factual record at trial demonstrated that the Conveying Subsidiaries received “reasonably equivalent value” in exchange for providing secured guarantees of the Refinancing in the form of legally recognized “indirect economic benefits” constituting value (including, among other benefits, the ability to avoid defaulting on over \$1.5 billion of senior loans and bonds owed by TOUSA and guaranteed by the Conveying Subsidiaries, thereby permitting the Debtors to continue their business operations), and (b) the Bankruptcy Court erred in finding that the Transeastern Lenders had acted in bad faith because, among other reasons, the Bankruptcy Court had improperly imposed a “patently unreasonable and

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unworkable” (as well as non-existent) legal duty on the Transeastern Lenders to investigate the internal refinancing structure of the Debtors (and, ostensibly, independently determine that the Refinancing would not result in a fraudulent transfer with respect to any of the Conveying Subsidiaries) before the Transeastern Lenders could receive payment on account of their valid antecedent debts.

We note that the District Court’s decision to quash the Bankruptcy Court’s ruling as it related to the Transeastern Lenders was extraordinary in nature. Ordinarily, the District Court would have remanded the decision to the Bankruptcy Court for further proceedings consistent with the District Court’s opinion. However, Judge Gold was extremely critical of the Bankruptcy Court’s decision to adopt an almost verbatim version of the proposed findings of fact and conclusions of law submitted by the Official Committee of Unsecured Creditors (the Committee) (*i.e.*, the plaintiff)—a version extremely self-serving to the Committee that also contained “significant factual errors.” Judge Gold noted that this practice violated established Supreme Court and Eleventh Circuit precedent, as well as instructions provided to new federal judges. Accordingly, based on Judge Gold’s determination that the “record allows only one resolution of the factual issues at stake,” the District Court took the extraordinary step of quashing the Bankruptcy Court’s decision without remand.ⁱⁱⁱ

Background

TOUSA and the other Debtors were in the business of designing, building and marketing for sale detached single-family residences, townhomes and condominiums under various brand names. Prior to their bankruptcy filing in January 2008, the Debtors financed their operations through a \$700 million revolving working capital facility (the Revolver) and the issuance of over \$1 billion in unsecured bonds (the Bonds). Although TOUSA was the primary obligor with respect to the Revolver and the Bonds, the obligations were guaranteed by each of the Conveying Subsidiaries.

In 2005, TOUSA, together with one of its Debtor subsidiaries, TOUSA Homes, LP (Homes), entered into a joint venture called TE/TOUSA LLC (the Transeastern JV). The operations of the Transeastern JV were financed with loans made by the Transeastern Lenders to the Transeastern JV—loans that were guaranteed by TOUSA and Homes. When the Transeastern JV defaulted on its debt, the Transeastern Lenders called on the guarantees and litigation ensued (the “Transeastern Litigation”). In settlement of the Transeastern Litigation, on July 31, 2007, TOUSA and the Conveying Subsidiaries borrowed \$500 million pursuant to first and second lien term loans (*i.e.*, the Refinancing) from certain lenders (the First and Second Lien Lenders) that were secured by substantially all of the Debtors’ assets, of which, approximately \$421 million was used to pay the Transeastern Lenders.

In January 2008, less than six months after closing the Refinancing, the Debtors were forced to file their bankruptcy cases due to the catastrophic downturn in the residential real estate market and the related inability of the Debtors and their customers to access the frozen credit markets. Shortly after the filing, the Committee brought an action against the First and Second Lien Lenders seeking to avoid the loans and liens related to the Refinancing as fraudulent transfers. The Committee also sought to recover the amounts paid to the Transeastern Lenders from the proceeds of the Refinancing.

Because the Conveying Subsidiaries were not obligated on the Transeastern debt (and were not parties to the related Transeastern Litigation), the Bankruptcy Court held that their borrowing under the Refinancing and their granting of liens to secure that borrowing were without “reasonably equivalent value” and were therefore avoidable fraudulent transfers. Specifically, the Bankruptcy Court held that (a) the Conveying Subsidiaries were insolvent and inadequately

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capitalized both prior to and immediately after the date of the Refinancing, (b) the Conveying Subsidiaries did not receive “reasonably equivalent value” for incurring the debt or granting the liens, (c) the First and Second Lien Lenders, as well as the Transeastern Lenders, did not act in good faith because it was objectively evident that the transaction was not proper, and (d) the loans related to the Refinancing, the liens securing those loans and the payment of the loan proceeds to the Transeastern Lenders were fraudulent conveyances. Finally, the Bankruptcy Court also found that neither the First and Second Lien Lenders nor the Transeastern Lenders were entitled to the affirmative defense set forth in Sections 548(c) or 550(b) of the Bankruptcy Code.^{iv}

In connection with its ruling, the Bankruptcy Court ordered the unwinding of the transaction and, to carry that out, further ordered (a) the Transeastern Lenders to disgorge \$403 million (as the value of the assets subjected to liens by the Conveying Subsidiaries) of the \$421 million in Refinancing loan proceeds paid to the Transeastern Lenders, together with prejudgment interest in excess of \$75 million, (b) the reinstatement of the Transeastern Lenders’ claims to the extent of the disgorgement, (c) the avoidance of the First and Second Lien Lenders’ liens against the Conveying Subsidiaries’ assets, and (d) that the disgorgement payments be placed in escrow to be paid to the First and Second Lien Lenders after payment to the Conveying Subsidiaries of all transaction costs relating to the Refinancing and any loss in value of their assets.

The Transeastern Lenders and the First and Second Lien Lenders appealed the Bankruptcy Court’s ruling. A brief summary of the District Court’s ruling on the Transeastern Lenders’ appeal is set forth below.

Reasonably Equivalent Value

Recall that a fraudulent conveyance includes a transfer of property or an incurrence of an obligation, made while, or causing the debtor to become, insolvent or without adequate capital, for which the debtor did not receive reasonably equivalent value in exchange for the transfer or incurrence. As mentioned above, the Bankruptcy Court based the fraudulent transfer judgment it levied against the Transeastern Lenders on its finding that the Conveying Subsidiaries failed to receive “reasonably equivalent value” in exchange for the transfers made by the Conveying Subsidiaries in connection with the Refinancing (including the obligations incurred and liens granted by the Conveying Subsidiaries in connection therewith).^v

In overturning the judgment against the Transeastern Lenders, the District Court held that the Bankruptcy Court’s findings with respect to the “value” (or purported lack thereof) received by the Conveying Subsidiaries in connection with the Refinancing were based on a flawed legal standard that was unsupported by applicable case law and legislative history—namely, that the Conveying Subsidiaries could not have received meaningful “value” as part of the Refinancing because they did not receive direct and identifiable “property” of a quantifiable value as part of the transaction. In crafting this dubious legal standard, the Bankruptcy Court inexplicably and erroneously relied on the WEBSTER’S DICTIONARY definition of “property” (*i.e.*, “some kind of enforceable entitlement to some tangible or intangible article”) in order to determine what constituted “value” in the context of a fraudulent transfer analysis.

The District Court held that the narrow definition applied to “value” by the Bankruptcy Court was clearly erroneous and constituted reversible error because the applicable case law and legislative history both indicate that indirect, intangible and prospective future economic benefits can constitute “value” in the context of a fraudulent transfer analysis. Specifically, the District Court agreed with the Transeastern Lenders’ position that, when dealing with an integrated corporate family, indirect benefits that preserve the net worth and continued operations of the corporate family can

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constitute reasonably equivalent value to individual subsidiaries, even though such value is indirect, intangible and not precisely quantifiable.

In applying the correct definition of “value” to the analysis of the Refinancing transactions, the District Court held that the settlement of the Transeastern Litigation conferred reasonably equivalent economic benefits on the Conveying Subsidiaries by enabling all of the Debtors (including the Conveying Subsidiaries) to avoid defaulting on obligations in excess of \$1.5 billion arising from the Bonds and the Revolver,^{vi} thereby enabling the Debtors to continue their integrated business enterprise. As a result of the Refinancing, the Debtors were able to continue their integrated business enterprise for an additional six month and were able to make significant scheduled payments on both the Bonds and the Revolver after the settlement of the Transeastern Litigation. The ability to continue making these payments enabled the Debtors (including each of the Conveying Subsidiaries) to continue operating as a going concern until the residential real estate industry took an unforeseeable turn for the worse in late 2007.^{vii} The District Court held that, under these circumstances, “no further proof of ‘quantification’ was required to establish reasonably equivalent value,” as these were “precisely the kind of benefits that . . . are not susceptible to exact quantification but are nonetheless legally cognizable” under Section 548 of the Bankruptcy Code.

Section 550 of the Bankruptcy Code and Good Faith

In its ruling, the Bankruptcy Court required the Transeastern Lenders to disgorge the proceeds of the Refinancing under Section 550(a) of the Bankruptcy Code on the theory that the Transeastern Lenders were entities for whose benefit the purported fraudulent transfer were made.^{viii} The District Court rejected this erroneous conclusion on numerous grounds. First, the District Court held that the Transeastern Lenders were neither “initial” nor “subsequent transferees” under Section 550 of the Bankruptcy Code because they did not receive the initial transfer (*i.e.*, the grant of liens to the First and Second Lien Lenders by the Conveying Subsidiaries), nor did they receive a subsequent transfer of the initial transfer from the First and Second Lien Lenders (*i.e.*, the liens granted by the Conveying Subsidiaries)—they merely received the *proceeds* resulting from the initial transaction. Second, in applying Section 550(b) of the Bankruptcy Code, the District Court held that, even if the Transeastern Lenders were subsequent transferees, they took for value (*i.e.*, the satisfaction of TOUSA’s antecedent debt and settlement of the Transeastern Litigation). Finally, the District Court held that the Bankruptcy Court had inappropriately shifted the burden of establishing “good faith” under Sections 548(c) or 550(b) of the Bankruptcy Code to the Transeastern Lenders and that the Committee had not established that the Transeastern Lenders had acted in bad faith or with knowledge of the (potential) voidability of the Refinancing transactions.

As mentioned above, in reaching its conclusion that the Transeastern Lenders acted in bad faith by accepting the settlement payment, the Bankruptcy Court imposed a legal duty on the Transeastern Lenders to investigate the internal refinancing structure of the Debtors (and determine that the Refinancing would not result in a fraudulent transfer with respect to any of the Conveying Subsidiaries) before the Transeastern Lenders could receive payment on account of their valid antecedent debts. The District Court called this heightened due diligence standard “patently unreasonable and unworkable” and held that the Bankruptcy Court erred as a matter of law in seeking to “pose an unfair burden on creditors to investigate all aspects of their debtors and the affiliates of those debtors before agreeing to accept payments for valid debts owed.” The District Court held that the imposition of a heightened duty to investigate a borrower or borrowers’ (often complicated) internal capital and financial structure was improper with respect to holders of valid antecedent debts, and further noted that such investigatory duty was not supported by applicable law.

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Looking Forward

Judge Gold's decision to quash a substantial portion of the widely criticized ruling of the Bankruptcy Court represents a significant victory for institutional lenders and other proponents of capital market financing. The District Court's opinion exposed numerous factual errors and legal flaws contained in the Bankruptcy Court's decision and should serve as road map to both Judge Jordan (in his consideration of the appeal of the First and Second Lien Lenders) and to financial institutions and other lenders (in their defense of existing and future fraudulent transfer claims brought by creditors' committees espousing the virtues of the Bankruptcy Court's decision). However, as noted by Judge Gold, his decision is likely to be appealed to the Eleventh Circuit by the Committee and is not binding on Judge Jordan with respect to the parallel appeal of the Bankruptcy Court's decision by the First and Second Lien Lenders. In addition to addressing the critical issue of whether the Conveying Subsidiaries received reasonably equivalent value as part of the Refinancing transactions, Judge Jordan will also have the opportunity to address a number of additional controversial rulings made by the Bankruptcy Court, including, among others, the Bankruptcy Court's refusal to enforce a standard market "savings clause" contained in the loan documents related to the Refinancing. In the meantime, however, the District Court's ruling is certainly cause for celebration and cautious optimism by institutional lenders and the capital markets in general.

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ⁱ See *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re Touse, Inc.)*, Case 0:10-cv-60017-ASG [Dkt. No. 131] (S.D. Fla. Feb. 11, 2011).

ⁱⁱ Note that the District Court's decision quashed the Bankruptcy Court's order *only* as it relates to the liability of the Transeastern Lenders. In the decision, Judge Gold clearly states that his ruling with respect to the Transeastern Lenders does not affect (and is not binding on) the related appeal of the first and second lien lenders (*i.e.*, the lenders that provided the Refinancing) currently pending before District Court Judge Adalberto J. Jordan.

ⁱⁱⁱ In dicta, Judge Gold urges the Eleventh Circuit (in the likely event of an appeal) to consider the Transeastern Lenders' arguments that the Bankruptcy Court has repeatedly demonstrated an inability "to approach the Defendant's evidence and arguments fairly"—arguments that Judge Gold found "persuasive."

^{iv} Section 548(c) protects against the trustee's avoidance powers a transferee or obligee that takes for value and in good faith to the extent the transferee or obligee gave value in exchange for the transfer or obligation. Section 550(b) protects against the trustee's remedies of recovery, transferees that take (from initial transferees) for value, including satisfaction of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided.

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^v The District Court did not address the Bankruptcy Court’s findings that the Conveying Subsidiaries were insolvent and inadequately capitalized at the time of the Refinancing.

^{vi} Each of the indenture agreements governing the Bonds and the loan agreements governing the Revolver contained provisions stating that all obligations owed thereunder would become immediately due and payable upon the entry of a judgment in excess of \$10 million against TOUSA. As mentioned above, each of the Conveying Subsidiaries fully guaranteed the obligations owed by TOUSA under the Bonds and the Revolver. The District Court noted that the undisputed record at the trial demonstrated that TOUSA clearly owed in excess of \$10 million to the Transeastern Lenders and that entry of a judgment in excess of that amount in the Transeastern Litigation was a foregone conclusion.

^{vii} It is important to note that the District Court held that “value” in the context of a fraudulent transfer analysis must be measured as of the time of the transfer and not with the benefit of hindsight. Accordingly, the Debtors’ bankruptcy filing six months after the closing of the Refinancing should not be considered in the Bankruptcy Court’s analysis of the “value” received by the Conveying Subsidiaries.

^{viii} Section 550(a) states that “[e]xcept as otherwise provided in this section, to the extent that a transfer is avoided under section ... 548 ... of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made or (2) any immediate or mediate transferee of such initial transferee.”