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IN RE TOUSA: DISTRICT COURT REVERSES BANKRUPTCY COURT'S ORDER REQUIRING LENDERS TO DISGORGE $480 MILLION AS FRAUDULENT TRANSFER

On February 11, 2011, the Hon. Alan Gold of the United States District Court for the Southern District of Florida issued a 113 page opinion and order quashing the bankruptcy court's order requiring the lenders involved in TOUSA, Inc.'s Transeastern joint venture to disgorge, as fraudulent transfers under Section 548 of the Bankruptcy Code, settlement monies that they had received on July 31, 2007 in repayment of their existing debt and to pay prejudgment interest on such monies, for a total disgorgement in excess of $480 million.

Judge Gold's decision signifies a victory for lenders who have criticized the bankruptcy court's order as unduly broadening the scope of fraudulent transfer risk and liability to lenders and for failing to recognize the commercial realities of financing provided to a corporate group. However, whether Judge Gold's decision will withstand the scrutiny of appeal to the Eleventh Circuit remains to be seen.

TOUSA and the July 31 Transaction

In June 2005, TOUSA, Inc. ("TOUSA")'s wholly-owned subsidiary Tousa Homes LP ("Homes LP") entered into a joint venture (the "Transeastern JV") with an unaffiliated entity for the purpose of acquiring certain homebuilding assets. The Transeastern JV was funded primarily by $675 million of financing from various lenders (the "Transeastern Lenders"). TOUSA and Homes LP were obligated as guarantors under multiple completion and carve-out guarantees in favor of the Transeastern Lenders.

In or about September 2006, the TOUSA obligors went into default under the Transeastern credit agreements. In late 2006, litigation ensued between TOUSA and Homes LP and the Transeastern Lenders. The Transeastern Lenders alleged more than $600 million was advanced under the Transeastern credit agreements and that liability under the completion guarantees exceed the full amounts owing under the credit agreements several times over.

In June 2007, TOUSA and its Transeastern JV subsidiaries entered into a settlement with the Transeastern Lenders, pursuant to which the Transeastern Lenders would be paid approximately $420 million. To fund the settlement, TOUSA obtained and caused certain of its subsidiaries not involved in the Transeastern JV (the "Conveying Subsidiaries") to obtain new loans from lenders referred to as the "First and Second Lien Term

Lenders." The new loan agreements named the Conveying Subsidiaries as "Subsidiary Borrowers," and they were required to pledge their assets as security for the new loans. The new loan documents directed that the loan proceeds be used to satisfy the Transeastern settlement.

On July 31, 2007, there occurred an exchange of property interests and funds broken down into three parts (the "July 31 Transaction"). First, TOUSA and the Conveying Subsidiaries pledged their assets as security to the First and Second Lien Term Lenders, which placed liens on those assets. Second, in exchange for those liens, the First and Second Lien Term Lenders disbursed $500 million in funds to TOUSA, the parent. The net funds were wired to Universal Land Title, Inc. ("ULT"), a wholly-owned subsidiary of TOUSA. Third, ULT then wired approximately $426 million to the agent for the Transeastern Lenders.

The Bankruptcy Litigation

Six months after the July 31 Transaction, TOUSA and most of its subsidiaries filed for bankruptcy. The Official Committee of Unsecured Creditors brought an adversary proceeding on behalf of the Conveying Subsidiaries seeking recovery of the settlement funds received by the Transeastern Lenders in the July 31 Transaction. The Committee argued that the July 31 Transaction rendered the Conveying Subsidiaries insolvent and that the Conveying Subsidiaries did not receive "reasonably equivalent value" for the new loans because TOUSA used the loan proceeds to finance the settlement of the Transeastern litigation, in which the Conveying Subsidiaries held no stake because they were not defendants.

On October 30, 2009, the bankruptcy court issued its order holding in the Committee's favor on all of its claims. It held that (1) the obligations incurred by the Conveying Subsidiaries to the First and Second Lien Term Lenders, and the liens transferred to secure those obligations, could be avoided pursuant to 11 U.S.C. §§ 544 and 548; (2) the Transeastern Lenders were entities "for whose benefit" the improper transfer was made; and (3) the transfer of more than $421 million to the Transeastern Lenders could also be avoided pursuant to Sections 544 and 548. The bankruptcy court further found that the First and Second Lien Term Lenders and the Transeastern Lenders did not act in good faith and were grossly negligent when they engaged in the July 31 Transaction on the basis that there was "overwhelming evidence that TOUSA was financially distressed."

The First and Second Lien Term Lenders and the Transeastern Lenders filed separate appeals of the bankruptcy court's order. The First and Second Lien Term Lenders' appeals were assigned to Judge Jordan, and the Transeastern Lenders' appeal was assigned to Judge Gold.

District Court's Reversal as to Transeastern Lenders

With respect to liability, the Transeastern Lenders raised the following issues on appeal to the district

court: (1) whether the Transeastern Lenders can be compelled to disgorge to the Conveying Subsidiaries funds paid by TOUSA to satisfy a legitimate, uncontested debt, where the Conveying Subsidiaries did not control the transferred funds; and (2) whether the Transeastern Lenders are liable for disgorgement as the entities "for whose benefit" the Conveying Subsidiaries transferred the liens to the new lenders, where the Transeastern Lenders received no direct and immediate benefit from the lien transfer.

Judge Gold ruled in favor of the Transeastern Lenders in an opinion severely rebuking the bankruptcy court and reversing the bankruptcy court on both theories of liability at issue. Of note, he criticized the bankruptcy court for lumping all the appellees together for purposes of the fraudulent transfer analysis when "this case actually involved different transfers involving different parties with different legal implications."

(1) Direct Transferee Theory

As to the first theory of liability, Judge Gold held that the Transeastern Lenders could not be compelled to return the new loan proceeds to the Conveying Subsidiaries because the Conveying Subsidiaries did not have a legally cognizable property interest in such proceeds. Under the law of the Eleventh Circuit, a transfer is avoidable under Section 548 only if the debtor exercised actual control over the property transferred, including the power to designate the payee and the power to disburse the funds at issue to the payee. The rationale is that, without the requisite control, the subject property could not have been used by the debtor to pay another creditor, and the transfer thus did not decrease the value of the debtor's estate. Here, the Conveying Subsidiaries did not receive the loan proceeds and did not have the power to direct or disburse the loan proceeds. Since the Conveying Subsidiaries had no right to receive and use the loan proceeds under the loan documents in the first place, the Conveying Subsidiaries and their creditors have no right to seize the loan proceeds from the Transeastern Lenders. Such disgorgement would result in a windfall to the Conveying Subsidiaries and their creditors.

Judge Gold further held that even assuming the Conveying Subsidiaries had a "minimal" property interest in the new loan proceeds as found by the bankruptcy court, there is still no Section 548 liability because the bankruptcy court erred as a matter of law and fact in refusing to recognize as reasonably equivalent value the indirect benefits to the Conveying Subsidiaries from the July 31 Transaction. As stated by Judge Gold, "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided to be short lived, may be considered in determining reasonable equivalent value. . . . The touchstone is whether the transaction conferred *reasonable* commercial value on the debtor." Due to the Transeastern settlement, the Conveying Subsidiaries were able to avoid imminent default on significant bond and revolving credit obligations owing by the TOUSA enterprise and to preserve their net worth. Whether a debtor received reasonably equivalent value must be evaluated as of the date of the transaction and not in hindsight.

(2) "For Whose Benefit" Theory

As to the second theory of liability, Judge Gold held that the Conveying Subsidiaries cannot recover from the Transeastern Lenders under Section 550 of the Bankruptcy Code as entities "for whose benefit" the Conveying Subsidiaries transferred the liens to the First and Second Lien Term Lenders. There are three types of entities from whom or from which a trustee may recover an avoidable transfer under Section 550(a): (1) an initial transferee, (2) an entity for whose benefit the initial transfer was made, or (3) a subsequent transferee. The liability of the initial transferee or the entity for whose benefit the initial transfer was made is absolute, whereas the liability of the subsequent transferee is not strict but subject to the "good faith purchaser for value" defense contained in Section 550(b).

The initial transfer for purposes of this inquiry was the transfer of liens from TOUSA and the Conveying Subsidiaries to the First and Second Lien Term Lenders, who remain the sole holders of such liens. Since the liens remained at all times with the First and Second Lien Term Lenders and were never transferred to the Transeastern Lenders, the Transeastern Lenders could not qualify as either the "initial transferees" or "subsequent transferees." Further, the Transeastern Lenders did not qualify as entities "for whose benefit" the initial transfer was made because the benefit must derive directly from the initial transfer, not from the use to which it is put by the transferee. The paradigm "entity for whose benefit such transfer was made" is a guarantor of the debtor. As explained by Judge Gold, "[s]omeone who receives the money later on is not an 'entity for whose benefit such transfer was made.'"

Judge Gold went further to reverse the bankruptcy court's finding the Transeastern Lenders to have acted in bad faith. As summarized by the district court, the bankruptcy court held that it is "bad faith" for a creditor of someone other than the debtor to accept payment of a valid, tendered debt outside of any preference period, through settlement or otherwise, if the creditor does not first investigate the debtor's internal re-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. The bankruptcy court's standard was "patently unreasonable and unworkable."

Concluding Thoughts

Judge Gold's decision represents a victory for lenders who have criticized the bankruptcy court's order as unduly broadening the scope of fraudulent transfer risk and liability to lenders and for failing to recognize the commercial realities of financing provided to a corporate group. Given the high stakes, it came as no surprise when the Committee appealed the district court's order to the U.S. Court of Appeals for the Eleventh Circuit on March 8, 2011. Whether the district court's opinion will withstand the scrutiny of the Eleventh Circuit remains to be seen.

With respect to the separate appeals of the bankruptcy court's order by the First and Second Lien Term Lenders pending in the district court, on March 28, 2011, Judge Jordan issued an order staying these bankruptcy appeals pending the appeal of Judge Gold's opinion to the Eleventh Circuit. The order noted that Judge Gold's opinion, if upheld by the Eleventh Circuit, would be dispositive in these appeals.

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