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CONTROVERSIAL FRAUDULENT CONVEYANCE DECISION IN TOUSA REVERSED

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In what has validated lenders' belief in the propriety of a parent corporation's borrowing based in part on the parent company's guarantees and assets of its operating subsidiaries, the United States District Court for the Southern District of Florida, on February 11, 2011,[1] reversed the controversial Southern District of Florida Bankruptcy Court's decision in *In re TOUSA, Inc.*,[2] which dramatically expanded the powers of a bankruptcy trustee to set aside as a "fraudulent conveyance" payments and guarantees coming from operating subsidiaries. In so doing, the District Court rejected the heightened duty of due diligence that the Bankruptcy Court required to meet the requirements of the good faith defense and rejected the extremely narrow definition of "reasonably equivalent value" that the Bankruptcy Court used to find a fraudulent conveyance. Very significantly, the District Court did not follow the customary procedure to remand the matter back to the Bankruptcy Court for further consideration following the appellate decision. In this instance the District Court concluded that nothing more needed to be considered and took the extraordinary step of quashing the Bankruptcy Court's Order.

BACKGROUND

TOUSA and its subsidiaries designed, built and marketed detached single-family residences, town homes and condominiums under various names. In 2005, a group of lenders (the "Transeastern Lenders") loaned approximately $450 million to a homebuilding joint venture involving TOUSA. The downturn in the housing market and the weak overall economy soon threatened the viability of the joint venture. Litigation ensued between TOUSA and the Transeastern Lenders. TOUSA faced three alternatives: litigate the claims, file for bankruptcy, or settle the claims. TOUSA decided to settle the claims, but it needed new financing to do so. The settlement process was in three steps:

> First, TOUSA caused certain of its subsidiaries (the "Conveying Subsidiaries") to grant liens on their real property assets and become obligated to a new group of lenders (the "New Lenders").
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> Second, in exchange for the liens and the obligations, the New Lenders provided funds and credit facilities (the "New Loans") to TOUSA.
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> Third, TOUSA used the funds from the New Lenders in part to satisfy its $421 million debt to the Transeastern Lenders.

More than seven months later, well outside the preference period (but within the one year fraudulent transfer period), TOUSA and the Conveying Subsidiaries filed for bankruptcy. The Unsecured Creditors Committee on behalf of the Conveying Subsidiaries brought suit against the Transeastern Lenders, among others, alleging that the settlement transaction constituted a fraudulent transfer under the Bankruptcy Code. The Committee argued that the transaction rendered the Conveying Subsidiaries insolvent and that the Conveying Subsidiaries did not receive "reasonably equivalent value" for the New Loans and liens because TOUSA used the loan proceeds to finance the settlement of the Transeastern litigation, in which the Conveying Subsidiaries had no stake.

Following a bench trial, the Bankruptcy Court found in favor of the Committee on all of its claims. In essence, the Bankruptcy Court found that the Conveying Subsidiaries had a property interest in the New Loan proceeds that TOUSA

[1] *In re TOUSA, Inc.; 3V Capital Master Fund Ltd. V. Official Committee of Unsecured Creditors of TOUSA, Inc.*, Nos. 10-60017-CIV/Gold, 10-61478, 10-62032, 10-62035 & 10-62037, Slip Op. (S.D. Fla. Feb. 11, 2011).

[2] *In re TOUSA, Inc.; Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc.*, Adv. Pro. No. 08-1345-JKO, Slip Op. (Bankr. S.D. Fla. Oct. 13, 2009).

transferred to the Transeastern Lenders, but they received only minimal value in exchange for relinquishing that property. Further, the Bankruptcy Court found that they were rendered insolvent as a result. Lastly, the Bankruptcy Court rejected the Transeastern Lenders' "good faith" defense for their failure to have investigated the effect of the transactions not only on TOUSA, but on all of its affiliates and subsidiaries as well, greatly broadening the scope of the required due diligence. The Bankruptcy Court voided the entire transfer and ordered the Transeastern Lenders to disgorge the funds they received in satisfaction of the undisputed debt that they were owed. The Transeastern Lenders appealed the Bankruptcy Court's Order to the District Court.[3]

REJECTION OF THE BANKRUPTCY COURT'S "BAD FAITH" DETERMINATION

The most significant part of the District Court's decision may be the rejection of the Bankruptcy Court's finding that the Transeastern Lenders acted in bad faith and were grossly negligent, because they knew or should have known that TOUSA and the Conveying Subsidiaries were insolvent or close to insolvency at the time of the settlement. As the District Court explained, the Bankruptcy Court held that it was bad faith for a creditor of the parent to accept payment of a valid, tendered debt repayment outside of any preference period, through settlement or otherwise, if the creditor does not first investigate the parent's internal re-financing structure and ensure that the parent's subsidiaries received fair value as part of the repayment, or that the parent and its subsidiaries, in an enterprise, were not insolvent or precariously close to being insolvent. The District Court found this standard to be "patently unreasonable and unworkable": "The net result of the Bankruptcy Court's improper finding is to impose extraordinary duties of due diligence on the part of creditors accepting repayment – duties that equal or exceed those imposed on lenders extending credit in the first place." Finding no such duty under state law or established bankruptcy law, the District Court held that the Transeastern Lenders, as recipients of a debt payment, had no reason or legal duty to conduct such extraordinary due diligence with respect "to the provenance of the funds with which they were being repaid."

The rejection of the heightened scope of due diligence required by the Bankruptcy Court to satisfy the "good faith" defense should bring a sigh of relief to lenders. No longer must they consider whether, in accepting repayment of a legitimate, uncontested debt, they need to investigate the entire capital structure of an enterprise, including the internal arrangements between and among the parent and all its affiliates and subsidiaries, in order to avoid a later fraudulent conveyance claim.

EXPANSIVE INTERPRETATION OF "REASONABLY EQUIVALENT VALUE"

The District Court also rejected the extremely narrow interpretation of "reasonably equivalent value" applied by the Bankruptcy Court. The District Court held that the Bankruptcy Court erred in finding no "reasonably equivalent value" for any direct transfer of the Conveying Subsidiaries' interest in the New Loan Proceeds to the Transeastern Lenders or in the granting of the liens to the New Lenders. The Court held that the Bankruptcy Court had failed to recognize as reasonably equivalent value the *indirect benefits* to the Conveying Subsidiaries from the Settlement Transaction. The Court reconfirmed that "indirect potential, intangible benefits, although incapable of precise measurement and quantification," can confer value for purposes of negating a fraudulent conveyance claim under the Bankruptcy Code.

Specifically, "indirect, intangible, economic benefits, *including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it proved to be short lived*, may be considered in determining reasonable equivalent value… An expectation, such as in this case, that a settlement which would avoid default and produce a strong synergy for the enterprise, would suffice to confer 'value' so long as that expectation was legitimate and reasonable."[4]

Moreover, the District Court said that in measuring reasonable equivalency, the Court need not apply a strictly mathematical formula, but must consider the totality of the circumstances. The Court found the test easily satisfied in this case: An adverse judgment and any filing of bankruptcy by the TOUSA parent would have triggered the Conveying Subsidiaries' guarantees to both bond creditors and revolver lenders. "Eliminating the threat of these claims against the

[3] The Bankruptcy Court made other rulings that are the subject of separate appeals still pending in the Southern District of Florida. One such decision, limiting the efficacy of fraudulent transfer savings clauses in the loan documents, has received much attention and generated great concern among lenders.

[4] Slip op. at 73 (emphasis added).

Conveying Subsidiaries' parent, and indirectly against each of them, constituted an enormous economic benefit to these subsidiaries in terms of their viability as going concerns and their continued access to financing through the TOUSA parent, which, in turn, allowed them, for a period of time, to continue to pay interest to the bondholders." The fact that the settlement did not eliminate all significant risk to the enterprise and assure long term viability for either TOUSA or the Conveying Subsidiaries was not controlling; it was enough that the settlement left the Conveying Subsidiaries in a better position to remain as going concerns than they would have been without the settlement.

This more expansive view of "reasonably equivalent value" to encompass both direct and indirect economic benefits, including the elimination of threats of default and immediate bankruptcy to the enterprise as a whole, makes it more difficult to establish fraudulent conveyance claims against lenders seeking repayment of their loans.

MORE TO COME?

The District Court took the extraordinary step of refusing to remand the case for further proceedings and quashed the Bankruptcy Court's Order as it related to the liability of the Transeastern Lenders. The Court was extremely critical of the Bankruptcy Court for adopting practically verbatim the Committee's proposed finings of fact and conclusions of law submitted after trial. It remains to be seen whether other troubling aspects of the original TOUSA decision, including the Bankruptcy Court's refusal to give effect to a fraudulent conveyance savings clause in the New Loans documents, will survive the other pending appeals from the Bankruptcy Court's decision.

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