ALERT
MAY 23, 2012

BANKRUPTCY, INSOLVENCY & RESTRUCTURING
News Concerning Recent Bankruptcy Decisions or Developments

COZEN O'CONNOR
www.cozen.com

ELEVENTH CIRCUIT EXPANDS FRAUDULENT TRANSFER LIABILITY IN *TOUSA* DECISION

Eric L. Scherling • 215.665.2042 • *escherling@cozen.com*

In a decision that may greatly expand the level of due diligence required of creditors seeking payment from distressed debtors, on May 15, 2012 the U.S. Court of Appeals for the 11th Circuit (the Circuit Court) issued an opinion in *In re TOUSA*, Inc.[1] that affirmed the original decision of the U.S. Bankruptcy Court for the Southern District of Florida (the Bankruptcy Court), reversed by the District Court, finding that liens granted by certain TOUSA subsidiaries to secure new financing incurred to pay off TOUSA's preexisting indebtedness to its prior lenders were avoidable fraudulent transfers, and that the prior lenders were required to disgorge the new loan proceeds they received.

Background

TOUSA and its subsidiaries designed, built and marketed detached single-family residences, townhomes, and condominiums under various names. In 2005, a group of lenders (the Transeastern Lenders) lent 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, but the parties reached a settlement.

TOUSA required new financing in order to fund its settlement with the Transeastern Lenders. To secure this financing, TOUSA caused certain of its subsidiaries (the Conveying Subsidiaries) to grant liens on its real property assets to the new group of lenders (the New Lenders). In exchange for these liens, the New Lenders provided funds and credit facilities (the New Loans) to TOUSA. TOUSA used the funds from the New Lenders in part to satisfy its debt to the Transeastern Lenders.

Six months later, TOUSA and the Conveying Subsidiaries filed for bankruptcy. The Unsecured Creditors' Committee (the Committee) on behalf of the Conveying Subsidiaries brought suit against the Transeastern Lenders, among others, alleging that the grant of liens by the Conveying Subsidiaries were fraudulent transfers under the Bankruptcy Code. The Committee argued that the transactions rendered the Conveying Subsidiaries insolvent and that the Conveying Subsidiaries did not receive "reasonably equivalent value" for the liens because the Conveying Subsidiaries had no direct stake in the Transeastern litigation that the New Loan proceeds were used to settle.

Following a 13-day bench trial, the Bankruptcy Court found in favor of the Committee on all of its claims. The Bankruptcy Court avoided the liens granted by the Conveying Subsidiaries as fraudulent transfers under Section 548 of the Bankruptcy Code. The Bankruptcy Court also ordered the Transeastern Lenders to disgorge the approximately $403 million that they had received from New Loan proceeds, finding that the Transeastern Lenders were entities "for whose benefit" the Conveying Subsidiaries had granted liens on its assets. As a result, the Transeastern Lenders were liable under Section 550(a)(1) of the Bankruptcy Code for the return of the value of the fraudulently transferred liens.

On appeal, the District Court reversed the holdings of the Bankruptcy Court and it took the extraordinary step of refusing to remand the case for further proceedings. Instead, the District Court quashed the Bankruptcy Court's Order as it related to the liability of the Transeastern Lenders. The District Court was extremely critical of the Bankruptcy Court for adopting practically verbatim the Committee's proposed findings of fact and conclusions of law submitted after trial.[2]

1 *Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re TOUSA, Inc.)*, 2012 U.S. App. LEXIS 9796 (11th Cir. May 15, 2012).

2 The District Court opinion was discussed in our February 18, 2011 Alert, Controversial Fraudulent *Conveyance Decision in TOUSA Reversed*, available at http://www.cozen.com/admin/files/publications/Bankruptcy_021811.pdf.

The District Court, looking to the totality of circumstances, found that the Conveying Subsidiaries did receive reasonably equivalent value in exchange for granting liens to secure the New Loans. "Value" need not mean only tangible, direct benefit, but may also include intangible benefit. An adverse judgment in favor of the Transeastern Lenders against TOUSA, or a bankruptcy filing by TOUSA, would have triggered a default to TOUSA's bond creditors and revolver lenders, which debts the Conveying Subsidiaries guaranteed. Further, while the Conveying Subsidiaries were not similarly indebted to the Transeastern Lenders, the District Court found that by eliminating the threat of claims against their parent, TOUSA, the Conveying Subsidiaries preserved their own viability as going concerns and their continued access to financing through the parent. In the view of the District Court, the definition of value is sufficiently broad so as to include these indirect economic benefits to the Conveying Subsidiaries.

The District Court also held that the Transeastern Lenders were neither the direct recipients of the liens nor the entities "for whose benefit" the liens were granted. Although the Transeastern Lenders received some of the proceeds of the New Loans, the District Court held that it would improperly broaden the scope of Section 550(a) to conclude that the liens were granted for their benefit.

Circuit Court Analysis

In its May 15 opinion, the Circuit Court addressed two key issues: (1) first, did the Bankruptcy Court clearly err in finding that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for granting liens to secure the New Loans, the proceeds of which were used to pay a debt owed only by TOUSA; and (2) second, were the Transeastern Lenders entities "for whose benefit" the Conveying Subsidiaries granted the liens?

Reasonably Equivalent Value

The Circuit Court determined that it did not need to choose between the narrow definition of value applied by the Bankruptcy Court and the much broader definition adopted by the District Court. Instead, it limited its review to the factual record that was before the Bankruptcy Court. The issue of fair value is "largely a question of fact"[3] and, accordingly, the Circuit Court observed that "considerable latitude must be allowed to the trier of facts."[4] The Circuit Court agreed with the Bankruptcy Court that, at least on the facts before it, the New Loans merely delayed a bankruptcy that nonetheless remained inevitable. Even if all the purported indirect benefits of the New Loans for the Conveying Subsidiaries were legally cognizable, the Bankruptcy Court did not clearly err when it found a lack of reasonably equivalent value under the circumstances.

For Whose Benefit Was Transfer Made

Having found that the granting of the liens by the Conveying Subsidiaries constituted a fraudulent transfer, the Circuit Court turned to the extent to which the Transeastern Lenders were liable for return of the New Loan proceeds. Section 550(a)(1) of the Bankruptcy Code permits the trustee [or debtor in possession] to recover the property fraudulently transferred, or the value of such property from, among other persons, "the entity for whose benefit such transfer was made."[5] Significantly, the good faith defense that is available to subsequent transferees of fraudulent transfers under Section 550(b) is not available to initial transferees or the entity for whose benefit a fraudulent transfer was made. The Circuit Court took an expansive view of what is meant by "for whose benefit" in Section 550(a)(1), and held that when a debtor grants a lien to a lender to secure a loan, a creditor who receives the proceeds of that secured loan may be subject to liability if the grant of the lien is later avoided.

The Circuit Court acknowledged that its ruling will require greater diligence on the part of creditors who receive payment from a financially distressed debtor. The court demonstrated little sympathy for creditors faced with this burden, however, stating that "[i]t 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."[6] A creditor assumes the risk that it will be regarded as the beneficiary of a fraudulent transfer, and it therefore falls upon the creditor to investigate the circumstances behind its payment.

A New Worry For Creditors?

The Circuit Court's decision in *TOUSA*, while expressly based on the particular set of facts involved in that case, raises some troubling questions for lenders and other creditors. First,

3 Circuit Court opinion, *35.

4 *Id.*

5 11 U.S.C. § 550(a)(1).

6 Circuit Court opinion, *46.

although the Circuit Court did not need to reach the legal issue of what benefits may constitute value, its opinion at the very least suggests that lenders who rejoiced in the earlier District Court *TOUSA* decision should again be questioning whether the supposed indirect economic benefits flowing to subsidiaries will shield their upstream guaranties from fraudulent transfer attack.

Second, the Circuit Court has confounded the general belief among creditors that, while a creditor may face preference liability for transfers received in satisfaction of a debt, a creditor should not be concerned about fraudulent transfer risk. Given the 90-day lookback period (one year for insiders) for preferences, on the one hand, and the 2-year lookback period under the Bankruptcy Code for fraudulent transfers (up to six years under state fraudulent transfer statutes that may also be invoked), this is a significant distinction. A creditor cannot obtain total comfort in the knowledge that it received payment in satisfaction of a valid debt; the creditor perhaps must also understand the transactions that have made its receipt of that payment from the debtor possible.

Although the Circuit Court was rather sanguine about the burden its holding may impose on creditors, not every case will have the facts present in *TOUSA*. Unlike the Transeastern Lenders, creditors may have no knowledge as to how and where a debtor has acquired the means to pay its debts and, for that matter, creditors may not have the opportunity in any event to perform the level of due diligence required by this decision. The *TOUSA* opinion, if extended into other factual contexts as well as into other jurisdictions, indicates that the pool of potential fraudulent transfer defendants in any given bankruptcy case may be wider than has been previously recognized.

To discuss any questions you may have regarding the issues discussed in this alert, or how they may apply to your particular circumstances, please contact:

Eric L. Scherling at 215.665.2042 or escherling@cozen.com

© 2012 Cozen O'Connor. All Rights Reserved. Comments in the Cozen O'Connor Alert are not intended to provide legal advice. The analysis, conclusions, and/or views expressed herein do not necessarily represent the position of the law firm of Cozen O'Connor or any of its employees, or the opinion of any current or former client of Cozen O'Connor. Readers should not act or rely on information in the Alert without seeking specific legal advice from Cozen O'Connor on matters which concern them.