

Client Alert

Latham & Watkins Finance Department

Circuit Court Reverses District Court, Upholds the Bankruptcy Court's Decision in TOUSA

Senior Transeastern Lenders v. Official Comm. Of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.), 2012 US App. LEXIS 9796 (11th Cir. May 15, 2012)

In *Senior Transeastern Lenders v. Official Comm. Of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.)*, the Eleventh Circuit Court of Appeals (the Eleventh Circuit or Circuit Court) reversed the decision of the United States District Court for the Southern District of Florida, which had reversed a bankruptcy court's decision to avoid a multi-million dollar repayment of a valid antecedent debt as a fraudulent transfer. In its decision, the Eleventh Circuit made two rulings. First, it held that the bankruptcy court did not clearly err when it found that certain subsidiary debtors did not receive reasonably equivalent value in exchange for providing secured guarantees of the debt incurred by their parent. Second, the Circuit Court found that the lenders who were repaid with loan proceeds secured by the subsidiary debtors' new secured guarantees were entities for whose benefit the guarantees and liens were transferred. The Circuit Court then refused to consider challenges to the bankruptcy court's remedies or challenges to the bifurcation by the District Court of the appeals from the original decision of the Bankruptcy Court. Instead, the Circuit Court remanded the case to the District Court where those issues will need to be addressed.

Background

The *TOUSA* case involved a fraudulent transfer action brought by the Official Committee of Unsecured Creditors (the Committee) in the bankruptcy case of TOUSA, Inc. (TOUSA), and its various affiliates and subsidiaries (collectively, the Debtors), who build and design homes. The Committee brought the action derivatively on behalf of a group of subsidiaries of TOUSA (the Conveying Subsidiaries), though not on behalf of TOUSA itself.

The Debtors funded their operations through successive bond offerings totaling US \$1.06 billion of senior unsecured bonds, and a revolving credit facility which was capped at US \$800 million (the Original Debt). Some of the Conveying Subsidiaries were guarantors of the Original Debt. Both the revolving facility and bond indentures had default provisions which included as an event of default any money judgment against a borrower or subsidiary of more than US \$10 million.

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In June 2005, TOUSA became involved in a joint venture (the Joint Venture) with Transeastern Properties, a Florida developer. The Joint Venture was funded by a consortium of lenders (the Transeastern Lenders) with a three-tier structure comprised of senior secured debt, senior mezzanine debt and junior mezzanine debt (the Joint Venture Debt). While TOUSA was a guarantor under the Joint Venture Debt, the Conveying Subsidiaries did not act as guarantors for the Joint Venture Debt.

The Joint Venture was not profitable and defaulted under the Joint Venture Debt. Toward the end of 2006 the agent for the Transeastern Lenders commenced litigation against TOUSA (as guarantor of the Joint Venture Debt), asserting breach of contract and demanding repayment of all of the Joint Venture Debt. Faced with the choice of either litigating or settling, TOUSA decided to settle; all parties believed that if TOUSA lost in litigation any judgment would be in excess of US \$10 million, thereby creating an event of default under the Original Debt.

To fund the settlement, TOUSA acquired additional financing (the New Debt) from a consortium of lenders (the New Lenders). Both TOUSA and the Conveying Subsidiaries were included as borrowers on the New Debt, and the Conveying Subsidiaries pledged their assets (the New Liens) as security for the New Debt. The terms of the New Debt stipulated that all of the proceeds of the loan would be used to fund the settlement – namely, the proceeds would be used to repay the Joint Venture Debt. On July 31, 2007, the deal closed and TOUSA received the funds which it in turn conveyed to the Transeastern Lenders as payment for the Joint Venture Debt.

The Bankruptcy Court's Decision

On January 29, 2008, six months after the closing of the New Debt and the repayment of the Joint Venture Debt, TOUSA and its subsidiaries and affiliates, including the Conveying Subsidiaries, filed for bankruptcy in the Southern District of Florida. On July 14, 2008, the Committee commenced a fraudulent transfer action on behalf of the Conveying Subsidiaries, using derivative standing that it had been granted on May 28, 2008. In that action, the Committee asserted that both the incurrence of the New Debt and the repayment of the Joint Venture Debt (as well as certain other payments in connection with the New Debt) were avoidable as fraudulent conveyances by the Conveying Subsidiaries (though no challenge was made as to the repayment of the Joint Venture Debt by TOUSA itself).

Following a lengthy trial, the Bankruptcy Court issued an order that was “practically a verbatim adoption of the Committee’s Proposed Findings of Fact and Conclusions of Law”¹ and concluded that (i) the New Liens should be avoided under Sections 544 and 548 of the Bankruptcy Code as fraudulent transfers, (ii) the Transeastern Lenders were entities “for whose benefit” those avoidable transfers were made, and (iii) as a result, the transfer of funds made to the Transeastern Lenders pursuant to the settlement should be disgorged. To support that third conclusion, the Bankruptcy Court determined that the recovery of the amounts repaid to the Transeastern Lenders was authorized under section 550 of the Bankruptcy Code, which provides that where a fraudulent conveyance under section 548 has occurred the estate can recover the asset transferred, or “the value of such property,” from the recipient of the transfer or the entity “for whose benefit such transfer was made.”² The Bankruptcy Court also directed the disgorgement of certain payments made to the New Lenders.

The District Court's Decision

The Transeastern Lenders and the New Lenders both appealed the Bankruptcy Court's decision to the District Court for the Southern District of Florida. Those appeals were not assigned to the same judge; rather, the appeals were bifurcated, with one judge (Judge Gold) receiving the appeals filed by the Transeastern Lenders and a different judge (Judge Jordan) receiving the appeals by the New Lenders. On February 11, 2011, Judge Gold reversed the decision against the Transeastern Lenders and took the unusual step of quashing the Bankruptcy Court's order.³ In so doing, Judge Gold determined that (i) the Conveying Subsidiaries did not have any interest in the cash transferred to the Transeastern Lenders and thus there had been no transfer to the Transeastern Lenders at all, (ii) the Bankruptcy Court was incorrect in its factual determination that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for granting the New Liens and (iii) the Transeastern lenders were not entities "for whose benefit" the Conveying Subsidiaries had transferred the New Liens.

Judge Gold found that as a matter of law the Conveying Subsidiaries "never had any property interest in the New [Debt] proceeds," because the New Debt proceeds were explicitly earmarked, by their terms, for the Transeastern Lenders, "thus [the Conveying Subsidiaries] transferred nothing to the Transeastern Lenders"⁴ nor could they under the terms of the New Debt. In his review of the Bankruptcy Court's factual findings, Judge Gold did not apply the clearly erroneous standard. In justifying a more relaxed standard of review, Judge Gold noted that "[t]he 'clearly erroneous' standard of review for factual findings is relaxed in circumstances where a lower court adopted one party's proposed order verbatim."⁵ As to the issue of value, Judge Gold held that, even assuming the Conveying Subsidiaries had an interest in the New Loan proceeds, they received reasonably equivalent value in exchange for the transfer of the New Liens. The District Court noted that in the Eleventh Circuit value can mean "economic benefits" and include indirect benefits like the preservation of the estate, a "debtor's reprieve from foreclosure," and the "opportunity to avoid bankruptcy[.]" *even if short lived.*⁶

Next, the District Court rejected the Bankruptcy Court's attempt to find a benefit flowing to the Transeastern Lenders from the transfer of the New Liens as sufficient to qualify as a "benefit" under Section 550 of the Bankruptcy Code. The District Court held that for a defendant to qualify as an entity "for whose benefit" the transfer was made, the benefit to that defendant must be direct. "Simply put, the 'for whose benefit' language does not apply where the 'benefit' is not the immediate and necessary consequence of the initial transfer, but flows from the manner in which the initial transfer is *used* by its recipient—the 'benefit must derive directly from the [initial] transfer, not from the use to which it is put by the transferee'."⁷

The Committee appealed this decision to the Eleventh Circuit. As part of the appeal, the Eleventh Circuit was asked not only to determine whether the District Court's decision was correct; the Transeastern Lenders also asked that the Eleventh Circuit, if it reversed the District Court, address whether the Bankruptcy Court's remedies against the Transeastern Lenders were appropriate and whether it was appropriate for the District Court to bifurcate the appeals.⁸

The Eleventh Circuit Court's Analysis and Holding

The Circuit Court addressed three issues:

1. Whether the Bankruptcy Court erred by finding that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the New Liens

2. Whether the Bankruptcy Court erred by finding that the Transeastern Lenders were entities for whose benefit the New Liens were transferred;
3. Whether it should consider the challenges to the Bankruptcy Court's remedies or the challenges to the bifurcation of the case at the District Court⁹

First, the Court addressed whether the Conveying Subsidiaries received "reasonably equivalent value." Notably, the Eleventh Circuit did not adopt either the Bankruptcy Court's narrow definition of "value" or the District Court's broader definition of the term.¹⁰ Instead, the Court held that it would not reverse as clearly erroneous the Bankruptcy Court's factual finding that "even if all the purported benefits of the transactions were legally cognizable, they did not confer reasonably equivalent value."¹¹ The Circuit Court found that the Bankruptcy Court's decision was not based on hindsight; instead, it was based upon "a thorough review of public knowledge available before July 31, 2007; expert analysis of data available before July 31, 2007; and statements by TOUSA insiders made before July 31, 2007."¹² Thus, the record did not support a ruling that the Bankruptcy Court clearly erred. Unlike the District Court, the Eleventh Circuit was not bothered by the Bankruptcy Court's adoption of the Committee's Findings of Fact and Conclusions of Law. In applying the clearly erroneous standard of review to the Bankruptcy Court's factual findings, the Eleventh Circuit admonished that "[n]either the district court nor this Court is authorized to make independent factual findings; that is the function of the bankruptcy court."¹³

The Court then analyzed whether the Transeastern Lenders were entities "for whose benefit" the transfer was made for purposes of § 550(a)(1). The Court cited to *American Bank of Marin County v. Leasing Service Corp. (In re Air Conditioning, Inc. of Stuart)*, 845 F.2d 293 (11th Cir. 1988) in support of its holding that even though the Transeastern Lenders were not the direct beneficiaries of the secured guaranties of the Conveying Subsidiaries, the Transeastern Lenders nonetheless fell within the reach of § 550(a)(1).¹⁴ *Air Conditioning* was a case involving an alleged preference, not a fraudulent conveyance (though the Eleventh Circuit specifically found this distinction to be irrelevant). In that case, the Eleventh Circuit held that an agreement pursuant to which a debtor gave a lien to a bank to support a letter of credit issued by the bank to a creditor who had previously only had an unsecured claim constituted an avoidable preference under § 547, and that the preference was recoverable from the creditor who had received the letter of credit because the creditor was an entity "for whose benefit" the transfer had been made and thus was liable under § 550(a)(1).

The Court held that the facts of *Air Conditioning* were analogous to the facts of the TOUSA case. The Court focused on the terms of the New Debt and specifically noted that the "new loan agreements required that the loan proceeds be used to pay the Transeastern settlement, and the Transeastern settlement expressly depended on the new loans."¹⁵ Notably, the proceeds of the New Debt did not flow directly from the Conveying Subsidiaries to the Transeastern Lenders. Instead, a wholly-owned subsidiary of TOUSA received the funds and, pursuant to the terms of the loan agreements, conveyed those funds to the Transeastern Lenders. Based on these facts, the Eleventh Circuit felt that *Air Conditioning* compelled a finding that the Transeastern Lenders were entities "for whose benefit" the transfers were made under § 550(a)(1).

Additionally, the Court did not find persuasive the Transeastern Lenders' arguments that they were subsequent transferees of the loan proceeds and thus not subject to § 550(a)(1). The Court held that although a subsidiary of TOUSA was the initial

recipient of the proceeds, it did not have control over those proceeds, and, therefore, could not be considered the initial transferee under § 550(a)(1).¹⁶

Lastly, the Court brushed aside the Transeastern Lenders' concerns that an expansive reading of § 550(a) "would drastically expand the pool of entities that could be liable for any transaction ... [and] impose 'extraordinary' duties of due diligence on the part of creditors accepting repayment."¹⁷ The Court was not moved by this possibility and said that "it 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."¹⁸

The Eleventh Circuit reversed the District Court's decision, affirmed the Bankruptcy Court's findings of liability and remanded the matter to the District Court. In doing so, the Eleventh Circuit refused to consider whether the remedies imposed by the Bankruptcy Court were appropriate or whether the bifurcation of the appeals was appropriate. In both cases, the Court said that as the District Court had addressed neither of those issues in the decision that had been appealed the Eleventh Circuit was not in a jurisdictional position to address them. Instead, both of those issues must be addressed by the District Court in the first instance.

Impact of the Eleventh Circuit Opinion

The impact of the Eleventh Circuit's TOUSA opinion is not yet clear, and consequently its significance should not be overstated. It is important to bear in mind that the only substantive ruling with an immediate impact from the decision is the Circuit Court's expansive view of the meaning of "for whose benefit" the transfers were made under § 550(a)(1). Notwithstanding the Court's broad(er) interpretation of the phrase, and without regard to whether the analogy between preference and fraudulent conveyance that the Circuit Court drew is a proper one, the opinion should not be read to mean that every time a debtor repays a lender on account of an antecedent debt from the proceeds of a new loan, such payment could subsequently be attacked as a fraudulent transfer. The issues raised by the Eleventh Circuit's decision arose in the context of a transaction where the new debt being incurred to refinance the existing debt involved a materially larger group of obligors and an expanded collateral pool in comparison to the old debt. In this regard, it is important to note that the Committee's avoidance action did not challenge whether TOUSA's repayment of the Joint Venture Debt was a fraudulent conveyance. Instead, the action focused on whether the New Liens granted by the Conveying Subsidiaries in connection with the New Debt were fraudulently conveyed under § 548 and avoidable under § 550.

The Eleventh Circuit's seeming imposition of "diligence" requirements on the part of existing creditors accepting repayment on account of antecedent debt is clearly eyebrow raising. The Court states that "every creditor must exercise some diligence when receiving payment from a struggling debtor."¹⁹ The Court goes on to say that it does not believe imposing such an obligation on a creditor that is being repaid "by someone other than its debtor" is onerous.²⁰ Again, however, the exact consequences of such pronouncements are still unknown. Clearly, it is impractical to expect every creditor to investigate the circumstances of the transaction being used to pay off its debt or loan. Moreover, it is unclear as to what "diligence" requirements the Court believes would and should be required and for what purpose – *i.e.*, what should the creditor being repaid be investigating and diligencing, and what actions can and should be taken as a result? The opinion provides no guidance on these points.

Moreover, the real impact, if any, of the Court's "diligence" language will necessarily depend upon the remedy that is ultimately imposed in this case. For example, if at the end of the appellate process the only remedy imposed is the avoidance of the New Liens, then the Circuit Court's opinion is unlikely to have much, if any, effect on the Transeastern Lenders since they would be allowed to keep their repayment under those circumstances.

In this regard, it bears emphasis that the Eleventh Circuit deliberately chose not to rule on whether the Bankruptcy Court's remedy – disgorgement – was correct. The District Court, given that it overturned the Bankruptcy Court's finding of liability, did not address the propriety of the remedy imposed. That issue, however, is now back squarely before the District Court, although it seems unlikely that even that issue can be addressed before the District Court addresses the other issue that the Eleventh Circuit did not decide – whether it was proper to bifurcate the appeals in the first instance. Indeed, it likely will be difficult for the District Court to properly assess the correct remedies to be applied in connection with this avoidance action without having the entire transaction before it – not just the repayment of the Joint Venture Debt but also the incurrence of the New Debt that was used to fund that repayment – so as to permit a comprehensive and holistic approach to assessment of the most appropriate remedies to be applied under the circumstances here. If the District Court is permitted to fashion an appropriate remedy in the context of being able to consider the transaction in its entirety, with all of the relevant parties before it, then it may be that the District Court will choose simply to avoid the New Liens without ordering any disgorgement of the funds paid to the Transeastern Lenders and thereby put the parties in the position in which they would have been had the fraudulent transfers not occurred.

Thus, whether the Eleventh Circuit's TOUSA opinion is a groundbreaking one in the area of fraudulent transfer law is simply not clear at this point in time. What is clear at this juncture, however, is that it is likely to be several more years before the Gordian Knot is cut open and lenders have a real understanding as to whether this case will have a lasting impact or just be a case limited to its egregious facts.

Endnotes

- ¹ *3V Capital Master Fund LTD v. Official Comm. Of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.)*, 444 B.R. 613, 644 (S.D. Fla. Feb. 11, 2011).
- ² 11. U.S.C. § 550.
- ³ 444 B.R. 613.
- ⁴ *Id.* at 646.
- ⁵ 444 B.R. at 644.
- ⁶ *Id.* at 657-658.
- ⁷ *Id.* at 674 (citation omitted, emphasis in the original).
- ⁸ During the pendency of the appeal from Judge Gold's decision, Judge Jordan has stayed proceedings with respect to the New Lenders' appeal. With the Eleventh Circuit decision it seems likely that that appeal will now move forward. It is possible that there may be further delays while the Transeastern Lenders seek a rehearing en banc of the Eleventh Circuit decision and, potentially, seek a writ of certiorari from the Supreme Court.
- ⁹ *Senior Transeastern Lenders v. Official Comm. Of Unsecured Creditors (In re TOUSA, Inc.)*, 2012 U.S. App. LEXIS 9796 at *32 (11th Cir. May 15, 2012).
- ¹⁰ However, notwithstanding its refusal to define "value" for purposes of § 548, the Eleventh Circuit did approve of the test used by the Bankruptcy Court in determining whether Conveying Subsidiaries received value: "based on the circumstances that existed at the time the investment was contemplated, whether there was any chance that the investment would generate a positive return." *Id.* at *39-40.

¹¹ *Id.* at *34.

¹² *Id.* at *37-38.

¹³ *Id.* at *31-32.

¹⁴ *Id.* at *42-43.

¹⁵ *Id.* at *44.

¹⁶ *Id.* at *44-45.

¹⁷ *Id.* at *45-46.

¹⁸ *Id.* at *46.

¹⁹ *Id.* at *46.

²⁰ *Id.*

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