VICTORY FOR LENDERS: THE DISTRICT COURT REVERSES A BANKRUPTCY COURT ORDER IMPOSING FRAUDULENT TRANSFER LIABILITY ON CORPORATE GROUP LENDERS

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On February 11, 2011, the United States District Court for the Southern District of Florida ("District Court") issued its opinion in *3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of TOUSA, Inc*. (*In re TOUSA, Inc.*), Case Nos. 10-60017-CIV/GOLD, 10-61478, 10-62032, 10-62035, 10-62037, -- B.R. --, 2011 WL 522008 (S.D. Fla., Feb. 11, 2011), handing lenders a victory that may prove beneficial to lenders evaluating fraudulent transfer risk and potential liability, provided the District Court's ruling withstands the Eleventh Circuit's scrutiny.[ii]

The Facts. The Official Committee of Unsecured Creditors for TOUSA, Inc.[iii] (the "Committee"), on behalf of certain subsidiaries of TOUSA, Inc. (the "Conveying Subsidiaries"), filed suit in the United States Bankruptcy Court for the Southern District of Florida (the "Bankruptcy Court") against a group of lenders (the "Transeastern Lenders") to avoid transfers under Section 548 of the Bankruptcy Code. The Committee attacked a series of financing transactions pursuant to which (i) TOUSA borrowed $500 million (the "New Loan") to fund a $420 million settlement with the Transeastern Lenders and (ii) certain of TOUSA's subsidiaries (the "Conveying Subsidiaries") granted liens to secure repayment of the New Loan, but received none of the proceeds of the New Loan. Following a bench trial, the Bankruptcy Court held that (i) the Committee could avoid the obligations incurred by the Conveying Subsidiaries and the liens transferred to secure those obligations, (ii) the Transeastern Lenders were entities "for whose benefit" the improper transfer was made, and (iii) the Committee could avoid the transfer of the New Loan proceeds of approximately $420 million to the Transeastern Lenders. In so holding, the Bankruptcy Court found that (i) the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the obligations they obtained by pledging their assets to the lenders financing the New Loan, (ii) the Conveying Subsidiaries received minimal, if any, value as a result of the transaction and such value was nowhere near equivalent to the obligations the Conveying Subsidiaries incurred, and (iii) the Conveying Subsidiaries received no direct benefits from the transaction and only received minimal indirect benefits because the transaction did not, in fact, prevent the bankruptcy of TOUSA and the Conveying Subsidiaries would not have been seriously harmed by an earlier TOUSA bankruptcy filing. *See In re TOUSA, Inc.*, 2011 WL 522008, at *17-18. The Bankruptcy Court also found that the Transeastern Lenders and the new lenders did not act in good faith and were grossly negligent when they engaged in the financing transactions.

The Transeastern Lenders appealed and asked the District Court to consider (i) whether the Transeastern Lenders could 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 (ii) whether the Transeastern Lenders were liable for disgorgement as the entities "for whose benefit" the Conveyed Subsidiaries transferred the liens to the new lenders, where the Transeastern Lenders received no direct and immediate benefit from the lien transfer.

The Holding. In a 113-page opinion, the District Court sided with the Transeastern Lenders, quashed the Bankruptcy Court's order as it related to the liability of the Transeastern Lenders and branded the Bankruptcy Court's imposition of remedies null and void. As outlined in greater detail below, and discussed thoroughly in the District Court Opinion, the District Court ruled on the liability issues that (i) the Transeastern Lenders could not be compelled to disgorge the New Loan proceeds to the Conveying Subsidiaries because the Conveying Subsidiaries never had a property interest in the New Loan proceeds and (ii) the Transeastern Lenders were not entities "for whose benefit" the Conveying Subsidiaries transferred the liens to the new lenders because the Transeastern Lenders received no direct and immediate benefit from the lien transfer.

Lack of Property Interest in the New Loan Proceeds. The District Court found that the Transeastern Lenders could not be compelled to disgorge the New Loan proceeds to the Conveying Subsidiaries because the Conveying Subsidiaries never had any property interest in the funds under the Eleventh Circuit's "actual control" test (which requires that a debtor exercise actual control over the transferred property for purposes of avoidance under Section 548). The Conveying Subsidiaries did not receive the proceeds of the New Loan, did not have the power to distribute the proceeds of the New Loan, and could not designate who would receive the proceeds of the New Loan.

Reasonably Equivalent Value. The District Court attacked the Bankruptcy Court's conclusion that the Conveying Subsidiaries did not receive reasonably equivalent value for either the direct transfer of the Conveying Subsidiaries' minimal interest in the loan proceeds or the Conveying Subsidiaries' transfer of the liens. In particular, the District Court took issue with the Bankruptcy Court's finding that the transfer produced no indirect benefits for the Conveying Subsidiaries. According to the District Court, the Bankruptcy Court committed a "compelling legal error" in relying on a dictionary definition of property to conclude that "property" is not "property" for reasonably equivalent value purposes unless the debtor obtains "some kind of enforceable entitlement to some tangible or intangible article." *In re TOUSA, Inc.*, 2011 WL 522008, at *31. The District Court also criticized the Bankruptcy Court's conclusion that "avoiding default" and "bankruptcy" do not constitute "property" and therefore could not constitute "value." These conclusions contradicted the meaning of the term "property" in the Bankruptcy Code (as explained in the legislative history) and well-established case law holding that indirect benefits may take many forms, both tangible and intangible.

The District Court strongly disagreed with the Bankruptcy Court's exclusion of "economic benefits" from consideration as "value" for purposes of Section 548, finding that "[c]ontrary to the Bankruptcy Court's legal conclusion, the weight of authority supports the view that 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. 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." *In re TOUSA, Inc.*, 2011 WL 522008, at *36. For the District Court, the key to determining reasonable equivalency is "whether, in exchange for the transfer, the debtor received in return the continued opportunity to financially survive, where, without the transfer, its financial demise would [have] been all but certain." *In re TOUSA, Inc.*, 2011 WL 522008, at *36. And in the District Court's eyes, the challenged transactions met this test.

If the Bankruptcy Court's missteps in construing what counted as "value" in the reasonably equivalent value analysis was not enough, the District Court also faulted the Bankruptcy Court for failing to consider the "totality of the circumstances" in measuring reasonable equivalency. The District Court noted that the inquiry into reasonable equivalency could be "simplified to whether, based on the totality of the circumstances as the time of the transfer, the result [of the transfer] was to preserve the debtor's net worth by conferring realizable commercial value on the debtor" or in other words, "*but for the transfer*, was there a realistic risk that the Conveying Subsidiaries and the enterprise would not financially continue to survive?" *In re TOUSA, Inc.*, 2011 WL 522008, at *37. In the District Court's view, the record was clear – the Conveying Subsidiaries' very existence was dependent upon the outcome in the claims in the Transeastern Litigation against the TOUSA parent, in which an adverse judgment would have caused defaults under more than one credit facility and triggered the Conveying Subsidiaries' guarantees, and the elimination of the threat of the claims against the TOUSA parent afforded the Conveying Subsidiaries an "enormous economic benefit … 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." *In re TOUSA, Inc.*, 2011 WL 522008, at *38. The Conveying Subsidiaries' legally binding obligations directly tied their fate to the outcome of the litigation with the Transeastern Lenders. Therefore, the resolution of the litigation conferred reasonably equivalent economic benefits on the Conveying Subsidiaries.

Parties "For Whose Benefit" the New Loans Were Made. The District Court also reversed the Bankruptcy Court's holdings under Section 550 of the Bankruptcy Code. The District Court ruled that 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." *In re TOUSA, Inc.*, 2011 WL 522008, at *47. It also clarified what "good faith" means, and does not mean, for purposes of Section 550(b)(2). The District Court labeled the Bankruptcy Court's bad faith determination "patently unreasonable and unworkable" for, among other reasons, imposing "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." *See In re TOUSA, Inc.*, 2011 WL 522008, at *49.

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[ii] On March 8, 2011, the Official Committee of Unsecured Creditors filed its Notice of Appeal to the Eleventh Circuit.

[iii] TOUSA, Inc. ("TOUSA") and the majority of its subsidiaries filed for bankruptcy relief in January 2008.