The Legal Intelligencer
THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2012
PHILADELPHIA, MONDAY, JULY 30, 2012 VOL 246 • NO. 20 An ALM Publication

BANKRUPTCY UPDATE

11th Circuit Upholds Fraudulent Transfer Ruling in *In re Tousa*

Editor's note: This is the first in a two-part series. The second part is set to run in Tuesday's paper.

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Special to the Legal

No segment of the United States economy was more affected by the Great Recession than the homebuilding industry. Only now, in 2012, are signs of recovery beginning to emerge. It is fitting that one of the most significant bankruptcy cases — if measured by law-firm alerts, panel discussions and email blasts — involves a bankrupt homebuilder. This case also demonstrates how judges can review the same factual record and come to opposite legal conclusions.

In an opinion issued by the U.S. Circuit Court of Appeals for the Eleventh Circuit on May 15 in *In re Tousa*, the court reversed a decision of the U.S. District Court for the Southern District of Florida, which had reversed a judgment entered by the U.S. Bankruptcy Court for the Southern District of Florida holding various refinancing transactions by existing and new lenders of approximately $1 billion in debt constituted avoidable fraudulent transfers. This litigation has now been pending for almost four years, and proceedings before the trial court and two appellate courts have been closely followed by the finance industry and restructuring bar. Because the opinions are lengthy and touch myriad issues, tackling the case in a limited amount of space is challenging.


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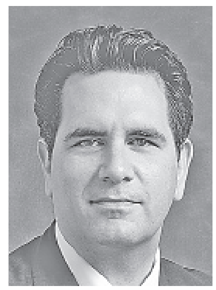
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TOUSA AND THE HOUSING MARKET IN FREEFALL

According to the Eleventh Circuit's opinion, Tousa Inc. was the 13th-largest homebuilding enterprise in the United States. Tousa grew rapidly by acquiring independent homebuilders, who became subsidiaries of the Tousa parent company. Consequently, according to the opinion, the subsidiaries "owned most of the assets of the enterprise and generated virtually all of its revenue."

As of July 2007, Tousa had approximately $1 billion of principal outstanding unsecured debt under public bonds and $224 million outstanding debt under a secured revolving credit facility. As is often the case, Tousa's subsidiaries were guarantors of both the bond debt and the revolving credit facility. Both facility agreements contained customary covenants that provided a bankruptcy filing by or entry of an adverse judgment in an amount greater than $10 million against Tousa or any of its subsidiaries would constitute an event of default, permitting the lenders to accelerate and collect on the indebtedness.

Tousa's troubles began in 2006 as the housing market began to deteriorate. Tousa had formed a joint venture in 2005 to acquire homebuilding assets owned by Transeastern Properties. Tousa incurred debt from the Transeastern lenders to finance the venture. Importantly, only certain of Tousa's subsidiaries guaranteed the Transeastern debt. By December 2006, the joint venture defaulted and the Transeastern lenders commenced an action against Tousa to recover the loan indebtedness.

Tousa and its subsidiaries engineered a transaction to resolve the situation. In July 2007, Tousa entered into a settlement with the Transeastern lenders that required Tousa to pay more than $421 million to the lenders. To finance the settlement, Tousa and some of its subsidiaries borrowed approximately $500 million from a group of lenders led by Citigroup North America, which are referred to in the opinion as the "New Lenders." The new loans were secured by liens on the assets of Tousa and certain of its subsidiaries (the conveying subsidiaries). None of the subsidiaries that granted security interests to the new lenders and guaranteed the new loans were obligors or guarantors under the original Transeastern loan. The new lenders advanced approximately $421 million to another Tousa subsidiary and, as required by the terms of the loan documents, the funds were then transferred to the Transeastern lenders. The opinion notes that the deal made Tousa "the most highly-leveraged company in the industry."

Six months after closing of the new loan facility, Tousa and its subsidiaries filed Chapter 11 cases in the Bankruptcy Court. A creditors' committee was appointed and filed an action to avoid the settlement transaction and new loans as fraudulent transfers and (1) avoid the $500 million in liens granted by the conveying subsidiaries to the new lenders, and (2) recover the $420 million paid to the Transeastern lenders.

THE BANKRUPTCY COURT FINDS A FRAUDULENT TRANSFER

After a 13-day trial in 2009, in a 182-page opinion that sent shockwaves through the commercial lending community, the Bankruptcy Court held the liens granted by the conveying subsidiaries should be avoided as fraudulent transfers and because the Transeastern lenders were entities for whose benefit the fraudulent transfers were made, they must return the settlement payment to the bankruptcy estate.

The Bankruptcy Code provides that a trustee may avoid as fraudulent any transfer of an interest of the debtor if, among other things, the debtor (1) received less than reasonably equivalent value in exchange for such transfer and (2) the debtor was insolvent or rendered insolvent on the date of or as a result of the transfer. To the extent a fraudulent transfer is avoided under Section 548, the trustee may recover the property transferred from the initial transferee or an entity for whose benefit such transfer was made.

The Bankruptcy Court concluded the conveying subsidiaries received less than reasonably equivalent value in exchange for the obligations they incurred as guarantors of the new loan and grants of liens they made in the transaction. Specifically, the Bankruptcy Court found that the conveying subsidiaries did not receive any direct benefit from the new loan because they received none of the loan proceeds they were obligated to repay. Instead, most of the proceeds were paid to the Transeastern lenders and Tousa's joint-venture partner to settle claims and lawsuits brought against Tousa and other of its subsidiaries, but not the conveying subsidiaries.

The Bankruptcy Court also found that the conveying subsidiaries received, at most, minimal indirect benefits from the transaction. The Bankruptcy Court rejected the defendants' contentions that the conveying subsidiaries received indirect benefit by avoiding the negative effects of the ongoing Transeastern litigation on the conveying subsidiaries.

The defendants argued the settlement and new loan provided benefits to the conveying subsidiaries because it kept Tousa and the conveying subsidiaries out of bankruptcy and a bankruptcy filing by Tousa would have eliminated Tousa's ability to support the subsidiaries. The Bankruptcy Court rejected these arguments. First, the Bankruptcy Court found the settlement and new loan did not ultimately prevent Tousa's bankruptcy. The Bankruptcy Court wrote, "There is no reason to believe that the replacement of a contingent litigation liability with a massive amount of secured debt rendered Tousa better able to weather the extreme downturn in the housing market."

The court observed that assuming the transaction did prevent or postpone a Tousa bankruptcy, it still conferred no substantial benefits on the conveying subsidiaries because they would not have been seriously harmed by a Tousa bankruptcy at that time and failure to enter into the transaction would not have caused a bankruptcy filing by the subsidiaries.

The Bankruptcy Court also concluded the subsidiaries were insolvent at the time of the transaction. The defendants argued that Tousa and its subsidiaries should be viewed as a single "common enterprise." The court noted that the statute only requires that the "debtor" be insolvent at the time of a challenged transfer, and only when debtors are substantively consolidated or alter egos of each other does the law treat multiple entities as one debtor.

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The lenders tried to rely on insolvency "savings clauses" in the loan documents and asserted these clauses reduced the subsidiaries' obligations to the extent necessary to prevent their insolvency. Insolvency savings clauses, which are common boilerplate provisions in commercial loan and security documents, state that the obligor's liability and liens granted as security are enforceable only to the maximum extent permitted by law. Such clauses are included in loan documents to reduce the value of the liens granted to an amount that would preserve the obligor's solvency. In this case, the court concluded that the subsidiaries were insolvent at the time of the transaction and received no value at all for the obligations incurred. Therefore, any lien or liability would have been avoidable under Section 548. The court held the savings clauses had no effect.

The court went on to hold that even if the subsidiaries became insolvent as a result of the settlement and new loan, the savings clauses would be unenforceable under Section 541(c)(1)(B) of the Bankruptcy Code, which provides that any interest in property of the debtor becomes property of the estate notwithstanding any provision in an agreement that is conditioned on the insolvency or financial condition of the debtor. Enforcement of the savings clauses, the court reasoned, would defeat the debtors' causes of action for fraudulent transfer, and the causes of action are unquestionably property of the bankruptcy estates. The court stated that savings clauses are unenforceable because efforts to contract around the core provisions of the Bankruptcy Code are invalid. The court noted that Section 548 ensures anyone who wishes to "saddle" an insolvent business with new liabilities must provide reasonably equivalent value in return, or face avoidance. The effect of a savings clause is to ensure that the transferee of an avoidable transfer can preserve its claim to "every last penny" of a debtor's remaining assets. The court said such clauses are "a frontal assault on the protections that Section 548 provides to other creditors. They are, in short, entirely too cute to be enforced." The holding that savings clauses are unenforceable is significant and was not addressed on appeal.

Next, the Bankruptcy Court held that the Transeastern lenders were entities for whose benefit the settlement and new loan was made. The court reasoned that the new loans, and the liens securing the loans, were undertaken for the express purpose of resolving the claims of the Transeastern lenders against Tousa. The lenders received $421 million of the loan proceeds. The court concluded that: "The senior Transeastern lenders directly received the benefit of the transaction and the transaction was undertaken with the unambiguous intent that they would do so." Therefore, the committee was entitled to recover the value, as measured at the time of the transfer, of the liens granted from the Transeastern lenders. The result of the decision was the original lenders had to give the money back and the new lenders lost their security interest and were rendered unsecured creditors.

The second part of this series will cover reversals at the District Court and Eleventh Circuit. •