

Tousa Roller Coaster

The bankruptcy case of TOUSA, Inc. and its various subsidiaries (collectively “Tousa”) is one where lenders have seen their fortunes rise and fall. On March 15, 2012, they fell again when the Eleventh Circuit¹ (the “Circuit Court”) reversed the District Court’s opinion and reinstated the Bankruptcy Court’s order, which had disgorged over \$400 million from Tousa’s senior lenders and avoided certain guarantees and liens granted to them by the Conveying Subsidiaries (defined below). Specifically, the Circuit Court found: (i) the Tousa Bankruptcy Court did not err when it found the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the new liens provided to the New Lenders; and (ii) the Transeastern Lenders were the direct beneficiaries of the new liens and as such subject to the avoidance powers of section 550(a).

Tousa Facts Reviewed

Tousa and the Conveying Subsidiaries were an integrated and consolidated enterprise that designed, built and marketed homes. Tousa was initially financed by bonds and a revolving credit facility (the “Revolver”). In June 2005, TOUSA Homes LP (“Homes”) and Falcone Ritchie joined forces to acquire certain homebuilding assets owned by Transeastern Properties, Inc., a leading real estate developer in Florida (the “Joint Venture”). A syndicate of lenders financed the Joint Venture (the “Transeastern Lenders”) with \$450 million under three agreements: (i) a senior credit agreement; (ii) a senior mezzanine credit agreement; and (iii) a junior mezzanine debt (the “Transeastern Loans”). As part of their collateral package, the Transeastern Lenders required carve-out and completion guarantees (the “Guarantees”). Certain subsidiaries were not initially a party to the Transeastern Loans (the “Conveying Subsidiaries”).

The downturn in the real estate market caused Tousa to default on the Transeastern Loans. The Transeastern Lenders demanded repayment of the Transeastern Loans under the Guarantees and the revolving lenders required Tousa and its subsidiaries to increase their obligations under the Revolver before they would continue to lend. In an effort to hold off the revolving lenders and the Transeastern Lenders and to get cash to Tousa from the Revolver, the Conveying Subsidiaries agreed to pledge their assets as security under the Revolver and provide additional guarantees listing themselves as subsidiary borrowers.

The agent for the Transeastern Lenders filed an action against Tousa and Homes for damages and breaches of the Guarantees (the “Transeastern Litigation”). Tousa faced three options: (i) litigate; (ii) file for bankruptcy; or (iii) settle. Tousa decided to settle. A syndicate of lenders (the “New Lenders”) provided Tousa with a first and

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¹ The Circuit Court comprises Florida, Georgia, and Alabama.

second lien credit agreement (all naming Conveying Subsidiaries as subsidiary borrowers) in order to fund the settlement (the “New Loans”). Touse and the Conveying Subsidiaries pledged their assets as security to the New Lenders, who in turn placed liens on the Conveying Subsidiaries’ assets. The New Lenders (in exchange for these liens) disbursed \$500 million in funds to Touse, the net proceeds of which went to settle the Transeastern Litigation (the “Settlement Payment”). And, as so often happens in such situations, six months after the Settlement Payment, Touse and the Conveying Subsidiaries filed for bankruptcy.

Fraudulent Transfers: Section 548

Section 548 of the Bankruptcy Code provides in pertinent part:

a debtor may avoid any transfer. . .**of an interest of the debtor in property** . . .that was made or incurred on or within 2 years before the date of the filing of the petition, **if the debtor voluntarily or involuntarily received less than a reasonably equivalent value in exchange for such transfer or obligation.** . . .

When a transfer is avoided under section 548, section 550(a) allows a trustee to recover the property, or its value, from the initial transferee or from an entity for whose benefit such transfer was made. 11 U.S.C. § 550(a)(1). Here, the Committee of Unsecured Creditors argued on behalf of the Touse estate (the “Committee”) that the Conveying Subsidiaries’ transfer of the new liens to the New Lenders was a fraudulent transfer because, among other things, they did not receive reasonably equivalent value in exchange for the transfer. The Committee argued the Bankruptcy Court should thus avoid the liens and order the Transeastern Lenders to disgorge the Settlement Payment because they were the entities “for whose benefit” the transfer was made. The Transeastern Lenders and the New Lenders countered by saying the Conveying Subsidiaries had in fact received reasonably equivalent value by avoiding default and bankruptcy, and receiving: (i) a higher debt ceiling on the revolving loan; and (ii) certain other tax benefits. The Transeastern Lenders also argued they could not be liable as entities for whose benefit the transfer was made because they received the Settlement Payment from Touse and not the entities that benefited from the transaction.

Bankruptcy Court, District Court and Circuit Court Rulings

The Touse Bankruptcy Court decided the Settlement Payment was a constructive fraudulent transfer under section 548 because the Conveying Subsidiaries received no direct benefit for the new liens and minimal indirect benefits, and, as such, did not receive reasonably equivalent value for these transfers.² This ruling aroused the ire of lenders working with struggling borrowers as the ruling suggested lenders should be held responsible for diligencing any and all sources of their repayment. It also demonstrated the court’s willingness to unwind complex financing transactions giving out-of-the-money creditors a powerful bargaining chip in negotiating with lenders. The Transeastern Lenders appealed this decision to the District Court.

The District Court disagreed with the Touse Bankruptcy Court finding the indirect benefits, namely enabling the Conveying Subsidiaries to avoid default and bankruptcy and facilitate the enterprise’s rehabilitation, even if such benefits proved to be fleeting, could constitute reasonably equivalent value. After the District Court’s opinion, lenders regained some comfort that the turmoil caused by the Bankruptcy Court decision would not change their way of doing business.

² None of the parties dispute that the Conveying Subsidiaries were insolvent, had unreasonably small capital and were unable to pay their debts when the liens were conveyed. Opinion at 28.

Undeterred, the Committee appealed to the Circuit Court. The Circuit Court held (i) the Bankruptcy Court did not err when it found the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the new liens provided to the New Lenders and (ii) the Transeastern Lenders were the direct beneficiaries of the new liens and, as such, subject to the avoidance powers of section 550(a). The Circuit Court, while not addressing the extent to which indirect benefits could satisfy the reasonably equivalent value test, found “the opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden.”³ As such, the Bankruptcy Court’s original conclusion that such avoidance was not reasonably equivalent value was not clearly erroneous.

When a transfer is avoided under section 548, section 550(a) allows a trustee to recover the property or its value from the initial transferee or from an entity for whose benefit such transfer was made. 11 U.S.C. § 550(a)(1). Because the Transeastern Lenders received their funds not from the Conveying Subsidiaries but rather through a Touse subsidiary, they argued they were neither an initial transferee nor an entity for whose benefit the transfer was made. While the funds passed through a Touse subsidiary before reaching the Transeastern Lenders, this formality did not transform the Transeastern Lenders into subsequent transferees of the funds.⁴ The Circuit Court analogized several cases looking at form over substance and permitting a trustee to recover from a creditor when such creditor received a benefit from the transfer even if they were not the original recipient or the immediate intended beneficiary. Opinion at 35-36. The Transeastern Lenders were repaid by the proceeds of that fraudulent conveyance and were subject to potential clawback litigation as “initial transferees.”

After reinstating the Bankruptcy Court’s ruling with respect to the fraudulent transfer and the ability of the Committee to avoid the transfer, it remanded the case to the District Court to determine the appropriate remedies. When ruling to disgorge both the liens provided to the Transeastern Lenders as well as the Settlement Payment, the Touse Bankruptcy Court relied on the fact that “bankruptcy courts have consistently held that 11 U.S.C. section 550 is designed to restore the estate to the financial condition that would have existed had the transfer never occurred.” See In re Touse, Inc., 422 B.R. 783, 881. On remand, the District Court should consider this statement as well as section 550(d), which provides the trustee is only entitled to “a single satisfaction under section 550(a).” If the District Court takes a conservative reading of section 550(d), the New Lenders may be forced to give up the liens while the Transeastern Lenders keep the cash or vice versa.

While the Circuit Court’s decision does not serve as binding precedent for the Second or Third Circuits (where the bulk of bankruptcies are filed), lenders, who do not carefully structure rescue financing to avoid taking additional liens, collateral, and/or guarantees from insolvent subsidiaries not directly benefited from the financing, may face more litigation by bondholders and other out-of-the-money creditors. Specifically, the Circuit Court’s decision demonstrates the willingness of a court to scrutinize, and avoid, complex financing arrangements. However, lenders who have no other option with respect to a rescue financing can take solace in several statements made by the Circuit Court indicating that Touse was a unique situation. With that uniqueness in mind, the Circuit Court struck a balance between the need for lenders to provide financing to struggling borrowers and the requirement that all creditors are treated fairly and in accordance with the Bankruptcy Code.

³ Opinion at 33.

⁴ Opinion at 38.