Making Sense of Fraudulent Transfers, Intangible Benefits, and Lender Liability After TOUSA II

In October 2009, Bankruptcy Judge John K. Olson of the United States Bankruptcy Court for the Southern District of Florida (the "Bankruptcy Court"), issued a controversial decision in In re TOUSA, Inc., ordering that the $403 million paid by TOUSA to settle litigation with certain lenders outside the Bankruptcy Code's "preference" period be avoided and recovered for the benefit of certain of TOUSA's subsidiaries' estates as a fraudulent transfer and awarding prejudgment interest. On February 11, 2011, the district court reversed the Bankruptcy Court without remand, holding that Judge Olson's decision was clearly erroneous. Given the complex facts and the alternative theories asserted by the plaintiff official committee of unsecured creditors, it is instructive for future stakeholders in large chapter 11 cases in which value-shifting is sought through the avoidance powers of the Bankruptcy Code to reflect on those decisions.

Factual Background
TOUSA and its subsidiaries designed, built, and marketed various sorts of residences. TOUSA was obligated on debt incurred to finance the so-called "Transeastern Joint Venture," a very unsuccessful venture that TOUSA undertook in 2005. On July 31, 2007, TOUSA entered into a $500 million loan (the "New Loans") with a group of new lenders (the "New Lenders") to pay $421 million (the "Cash Transfer") to holders of the Transeastern Joint Venture debt (the "Transeastern Lenders") in satisfaction of their claims against TOUSA. Certain of TOUSA's subsidiaries (the "Conveying Subsidiaries") that were not previously liable to the Transeastern Lenders guaranteed and pledged their assets to secure the New Loans (the "Lien Transfer"). Six months later, on January 29, 2008, TOUSA and the Conveying Subsidiaries filed for chapter 11 protection.

The bankruptcy court held that the New Lenders' claims and liens on the Conveying Subsidiaries' assets and the Cash Transfer were fraudulent obligations of, and fraudulent transfers by, the Conveying Subsidiaries. The district court decision reversed the holding that the Cash Transfer was a fraudulent transfer by the Conveying Subsidiaries. Significantly, the opinion included findings that could impact separate appellate proceedings before the district court concerning the avoidance of the New Lenders' claims and liens. The district court declared that the bankruptcy court had erred in concluding that: (1) the Transeastern Lenders were liable to the Conveying Subsidiaries as direct transferees of the Cash Transfer (the "Direct Transfer Holding"); and (2) pursuant to section 550(a)(1) of the Bankruptcy Code, the Transeastern Lenders were liable to the Conveying Subsidiaries as entities "for whose benefit" the Conveying Subsidiaries effectuated the Lien Transfer to the New Lenders (the "§550(a)(1) Holding").

Dispositive Holdings
The district court rejected both premises on which the Bankruptcy Court's Direct Transfer Holding was based. First, it held that the New Loan proceeds had never been the property of the Conveying Subsidiaries because they lacked any dominion or control over the use or disposition of the proceeds. Rather, the funds were clearly owned by TOUSA (the parent company), which had exclusive authority to control where such funds were transferred. Second, the court summarily rejected the Bankruptcy Court's alternative basis, that the Transeastern Lenders had a property interest in the Cash Transfer because the New Loan proceeds were generated, in part, by the Conveying Subsidiaries' agreement to be co-borrowers under the New Loans.

The district court also struck down the §#550(a)(1) Holding that the Transeastern Lenders were liable to the Conveying Subsidiaries as entities "for whose benefit" the Conveying Subsidiaries effectuated the Lien Transfer to the New Lenders, reasoning that the Lien Transfer facilitated the Cash Transfer. Citing Eleventh Circuit authority explaining that the "paradigm case of a benefit under [§ 550(a)(1)] is the benefit to a guarantor by the payment of the underlying debt of the debtor," the district court found that the Transeastern Lenders could not be the entities for whose "benefit" the Lien Transfer was made to the New Lenders because the benefit received by the Transeastern Lenders—the Cash Transfer—was not the immediate and necessary consequence of the lien transfers. Rather, the Cash Transfer was a separate and distinct transfer.

Reasonably Equivalent Value
The district court could have reversed the Direct Transfer Holding and the §#550(a)(1) Holding based solely on the foregoing. Nonetheless, mindful that these issues would likely be appealed to the Eleventh Circuit and "for purposes of full analysis," the district court chose to address whether the Conveying Subsidiaries received "reasonably equivalent value"—another Transeastern Lender defense to liability—in exchange for the Cash Transfer and the Lien Transfer. In doing so, it created the potential for inconsistent rulings because whether the New Loans and the Lien Transfer are avoidable by Conveying Subsidiaries is the subject of an appeal before District Judge Jordan.

Addressing the Direct Transfer Holding, the district court held that even if the Conveying Subsidiaries had a cognizable interest in the Cash Transfer, there was no fraudulent transfer liability because the Conveying Subsidiaries received reasonably equivalent value for the Cash Transfer. The court's analysis is hard to reconcile with its other holdings. It did not focus on what the Conveying Subsidiaries received for the Cash Transfer; rather, the court focused solely on the property interest the Conveying Subsidiaries received for the Lien Transfer (*i.e.*, the New Loan proceeds). In doing so, it therefore found value in the very property interest it held the Conveying Subsidiaries did not own.

Second, as a belt and suspenders holding to the §#550(a)(1) Holding, and notwithstading that that avoidance of the Lien Transfer was the central issue on appeal before Judge Jordan, the court addressed whether the Conveying Subsidiaries received reasonably equivalent value in exchange for the Lien Transfer. The court's theory was that if the Lien Transfer could not be avoided, there could be no §#550(a)(1) liability because recovery under §#550(a)(1) requires avoidance as a prerequisite. Reversing the bankruptcy court's holding that "value" must refer to an enforceable tangible or intangible article, the district court held that the Conveying Subsidiaries received indirect economic benefits constituting reasonably equivalent "value." *See Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635 (3d Cir. 1991). The court found that such indirect benefits included avoiding the triggering of cross-guarantee obligations against the Conveying Subsidiaries and the concomitant disappearance of the Conveying Subsidiaries' existing source of financing, and the resulting need to file for bankruptcy which, in turn, would raise major concerns regarding the whole enterprise's ability to continue operating as a going concern. Notably, the district court found that those indirect benefits constituted reasonably equivalent value and reversed without remand for "quantification" of the benefit to the Conveying Subsidiaries and their unsecured creditors. The district court did not analyze whether the unsecured creditors really were better off being junior to more than $400 million of secured debt than they would have been had there been a mid-2007 bankruptcy filing. Unless the Eleventh Circuit agrees with the court's §#550(a)(1) Holding, the failure to quantify in any fashion the indirect benefits purportedly received by the Conveying Subsidiaries may lead to reversal.

In sum, the court's opinion appears well-reasoned concerning certain dispositive holdings. However, the alternative holdings addressing "reasonably equivalent value" may be subject to reversal, and may have created the potential for inconsistent rulings by Judge Jordan. The bar will be watching closely to see which of these issues Judge Jordan or the Eleventh Circuit chooses to address.