Client Alert.

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In re TOUSA, Inc.: Commercial Lending and Debt Trading Markets Breathe a Sigh of Relief

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A degree of certainty—for the time being—has been restored for participants in the commercial lending and debt trading markets who have been tracking the appeal of a controversial 2009 fraudulent transfer decision in the TOUSA, Inc. bankruptcy case.[i] On February 11, 2011, Judge Gold of the United States District Court for the Southern District of Florida quashed (or nullified)[ii] the bankruptcy court's decision, which ordered a group of lenders to disgorge $480 million received in connection with loans they extended to a joint venture involving TOUSA, Inc. (the "**Transeastern Lenders**").

If Judge Gold's opinion survives on appeal, it suggests that the loan markets' worst fears arising from the bankruptcy court's decision will not be realized. Also providing comfort to markets is a district court order issued by Judge Jordan[iii] in a parallel appeal involving the lenders who financed the payment to the Transeastern Lenders (the "**First and Second Lien Lenders**"). Judge Jordan's order requests additional briefing on the potential impacts of Judge Gold's opinion, but Judge Jordan expressly requires the parties to assume he adheres to Judge Gold's opinion.

Judge Jordan will not issue his opinion for at least a month. Meanwhile, Judge Gold's opinion may be appealed. Regardless of the final outcome, market participants should take concrete steps to reduce the risks raised by the bankruptcy court's decision.

BANKRUPTCY COURT DECISION

In 2005, TOUSA and Falcone/Ritchie LLC entered into a joint venture funded by the Transeastern Lenders. The joint venture ultimately failed, leading to litigation between TOUSA and the Transeastern Lenders that resulted in a $420 million settlement payable by TOUSA. TOUSA financed the settlement with new loans totaling $500 million (the "**2007 Financing**") from the First and Second Lien Lenders, which were secured by liens on substantially all of the previously unencumbered assets of certain subsidiaries of TOUSA (the "**Conveying Subsidiaries**").

The bankruptcy court found the payment to the Transeastern Lenders to be a fraudulent conveyance because the Conveying Subsidiaries (i) had a property interest in the proceeds of the 2007 Financing that TOUSA transferred to the Transeastern Lenders; (ii) received only minimal value in exchange for relinquishing that property; and (iii) were insolvent. Thus, the bankruptcy court avoided the First and Second Lien Lenders' liens, ordered the Transeastern Lenders to disgorge the proceeds they had received as part of the settlement, and ordered the disgorgement of principal, interest, and fees paid in connection with the 2007 Financing.

In addition, the bankruptcy court held that the Transeastern Lenders acted in bad faith and were grossly negligent in receiving the proceeds of the 2007 Financing "because they knew of or should have known on the basis of publicly available information that TOUSA and the Conveying Subsidiaries were insolvent . . . , or were perilously close to insolvency."[iv] The bankruptcy court reasoned that the Transeastern Lenders had a duty to determine whether the payment to them was a fraudulent conveyance by the Conveying Subsidiaries.

GOLD DECISION

Judge Gold quashed the portions of the bankruptcy court's decision relating to the Transeastern Lenders, rendering the imposition of disgorgement and other remedies as to the Transeastern Lenders null and void. Specifically, Judge Gold held that there was:

- ***No Fraudulent Transfer in the Absence of a Property Interest.*** Payment by TOUSA of the Transeastern Lenders' loans was not a fraudulent transfer because the Conveying Subsidiaries, even as co-borrowers, never had control over the 2007 Financing proceeds extended by the First and Second Lien Lenders, and accordingly had no property interest in such proceeds and made no transfer.
- ***No Duty of Extraordinary Due Diligence.*** "[T]he Transeastern Lenders, as recipients of a debt payment, had no legal duty to conduct such extraordinary due diligence with respect to the provenance of the funds with which they were being repaid."[v] Such a duty, Judge Gold held, would be higher than that imposed on lenders making loans in the first place, and would have a chilling effect on commercial lending markets.[vi]
- ***No Fraudulent Transfer Where Conveying Subsidiaries Received "Reasonably Equivalent Value," Even If Indirect and Intangible.*** Even if the 2007 Financing proceeds were property of the Conveying Subsidiaries, there was "overwhelming evidence" that the Conveying Subsidiaries had received "reasonably equivalent value" (as required under section 548 of the Bankruptcy Code) in exchange for their securing guarantees in connection with the 2007 Financing. This "reasonably equivalent value" included indirect economic benefits such as eliminating the threat of claims against the Conveying Subsidiaries' parent, furthering their viability as going concerns, and continued access to financing. Besides facilitating TOUSA's rehabilitation, Judge Gold noted that the transfer helped avoid a bankruptcy filing, even if such avoidance was ultimately short lived.
- ***No Liability as a Transferee in the Absence of a Voidable Transfer.*** Section 550 of the Bankruptcy Code provides that a transferee may be liable for an avoided transfer, yet distinguishes initial transferees from subsequent transferees. The Transeastern Lenders had no liability under section 550 of the Bankruptcy Code based on their purported status as entities "for whose benefit" the Conveying Subsidiaries transferred the liens to the First and Second Lien Lenders. Judge Gold's opinion holds that the Transeastern Lenders could only have been liable under section 550 if a fraudulent conveyance had occurred. Nevertheless, Judge Gold held that the transfer by TOUSA to the Transeastern Lenders of the settlement proceeds would not trigger liability under Section 550 because it was not a direct consequence of the liens granted by the Conveying Subsidiaries, but rather a separate settlement of a previously contracted and outstanding debt.

IMPACTS AND CONTINUING RISK

Creditors Can Sleep Easier Over Co-Borrower Structures.

Credit facilities, like the 2007 Financing, are commonly structured with co-borrowers who are each responsible for the loans extended to each other borrower. The bankruptcy court's decision held that a co-borrower has a potential right to recover, as a fraudulent transfer, loan proceeds of another borrower. The district court's application of the control test described above, and rejection of the bankruptcy court's opinion that the Conveying Subsidiaries had a property interest in the proceeds of the 2007 Financing, provides comfort that co-borrower structures are not inherently subject to heightened avoidance risk as contemplated by the bankruptcy court's decision.

Recipients of Loan Proceeds Can Sleep Easier Too.

The bankruptcy court's imposition on lenders of a duty of care to investigate the source of a loan repayment created risk for lenders accepting debt repayments. This risk extended to participants in the secondary markets who own beneficial and economic interests in the repaid loans, whether through participations, derivative contracts, or otherwise. When lenders receive repayments, they are required to pay such amounts on to the purchasers of beneficial and economic interests in the loans. Secondary market participants started worrying about accepting such payments. Judge Gold's strong rejection of extraordinary diligence steps should comfort commercial lending and debt trading markets.

Subsidiary Obligors Do Not Have Heightened Disgorgement Risk in the Absence of Tangible or Direct Economic Benefits.

Lenders commonly receive credit support from a borrower's subsidiaries, whether from co-borrower structures, guaranties, securities interests, or otherwise. The bankruptcy court's narrow definition of value worried loan markets that, in absence of a subsidiary obligor's receipt of tangible property in exchange for its credit support, indirect benefits need to be sufficiently more robust and quantifiable than previously thought. Judge Gold's confirmation that indirect economic benefits, even if less valuable with 20/20 hindsight, constitute sufficient value should restore confidence in subsidiary credit support structures.

Judge Gold's Opinion Is Not the Final Word.

Judge Gold addresses the Transeastern Lenders' appeal of the bankruptcy court's decision. Judge Jordan is hearing a separate appeal of the bankruptcy court's decision by the First and Second Lien Lenders, and he could conclude differently. In either case, the opinions of both Judges Gold and Jordan could be appealed to the Eleventh Circuit Court of Appeals.

What About Bankruptcy Savings Clauses?

As a way to limit fraudulent conveyance risk, many guaranty and similar agreements issued in connection with credit facilities contain a "savings clause." These require co-borrowers and other guarantors to make contributions among themselves to avoid any one co-borrower or guarantor having to pay more under a guaranty than the value of its assets. The bankruptcy court found savings clauses invalid and called them "entirely too cute to be enforced." Judge Gold did not opine on this issue, so uncertainty continues.

Disgorgement Provisions Deserve Continued Consideration.

Many of the Transeastern Lenders had sold their beneficial and economic interests in their loans. Upon receipt of the proceeds of the 2007 Financing, the Transeastern Lenders distributed amounts to the purchasers of such beneficial and economic interests. Some Transeastern Lenders were alarmed to discover that the transfer agreements they executed with the buyers of beneficial and economic interests did not contain provisions obligating the buyer to disgorge these amounts. While Judge Jordan's opinion relieves the Transeastern Lenders (and the purchasers of beneficial and economic interests) of their disgorgement obligations, we nonetheless encourage secondary loan market participants to carefully consider disgorgement issues when negotiating proceeds agreements.

And So Does Counterparty Risk.

Some Transeastern Lenders who sold beneficial and economic interests in their loans found that their counterparties no longer existed, or were the subject of insolvency proceedings. Secondary loan participants should always consider ways to mitigate counterparty risk by choosing counterparties with care and incorporating appropriate protections in legal documentation.

We will continue to monitor all further developments, including any related appeals.

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[i] *In re Tousa, Inc. (Official Comm. of Unsecured Creditors of Tousa, Inc. v. Citicorp N. Am., Inc.)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009). For a further discussion of this case and its implications, *see* James Hough, Alexandra Barrage, Geoffrey Peck, and Rafael Petrone, *The In re Tousa, Inc. Fraudulent Transfer Decision: Impacts on Debt Trading, Derivatives Trading, and Commercial Lending* (Oct. 28, 2009). <http://www.mofo.com/pubs/xpqPublicationDetail.aspx?xpST=PubDetail&pub=7720>

[ii] *In re Tousa, Inc. (3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of Tousa, Inc.*), No. 10 Civ. 60017 (S.D. Fla. Feb. 11, 2011).

[iii] *Citicorp N. Am., Inc. v. Official Comm. of Unsecured Creditors of Tousa, Inc.*, No. 10 Civ. 60019 (S.D. Fla. Feb. 15, 2011) (order requesting submission of supplemental briefs).

[iv] *In re Tousa, Inc.*, No. 10 Civ. 60017 at 102; *In re Tousa, Inc.*, 422 B.R. at 850-55.

[v] *In re Tousa, Inc.*, No. 10 Civ. 60017 at 103-4.

[vi] *Id.* at 107 ("[I]f the Bankruptcy Court's ruling were to stand, it would pose an unfair burden on creditors to investigate all aspects of their debtors and the affiliates of those debtors before agreeing to accept payments for valid debts owed.").

