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Court of Appeals Cautions Creditors to Exercise Due Diligence in Accepting Payoff from a Borrower's Affiliates

Court Affirms Bankruptcy Court Decision that TOUSA, Inc.'s Payoff of Transeastern Lenders Was an Avoidable Fraudulent Transfer

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In a long-awaited decision, the United States Court of Appeals for the Eleventh Circuit on May 15, 2012 upheld a bankruptcy court's ruling that a refinancing and payoff of secured lenders using proceeds of a new loan to financially troubled affiliates that were not obligated on the original loan was a constructively fraudulent transfer that could be recovered from the paid lenders.[1] The decision is important to lenders for at least two reasons. First, the court rejects the notion that a lender automatically provides value by helping prevent a bankruptcy filing. Second, the court rejects the lenders' argument that permitting avoidance would chill markets by requiring even minor trade creditors to conduct extensive due diligence before accepting payment and admonishes lenders who accept a payoff of hundreds of millions of dollars of debt from someone other than their borrower that they must exercise some due diligence.

BACKGROUND

A subsidiary of homebuilder TOUSA, Inc. entered into the Transeastern joint venture with another homebuilder. The joint venture borrowed heavily to finance construction and operations. TOUSA guaranteed the joint venture's obligations, but none of TOUSA's other subsidiaries did. In 2006, the joint venture began to falter, and it defaulted on several obligations. The Transeastern lenders asserted damage claims against TOUSA of over $2 billion. A default on the Transeastern borrowing would have cross-defaulted TOUSA's $1 billion in bonds and its $224 million revolving credit line, which its other subsidiaries had guaranteed. Those other subsidiaries owned most of the company's assets and generated most of its revenues. They were not liable for any of the Transeastern debt.

To preserve its other businesses, TOUSA negotiated a settlement of the Transeastern lenders' claims against itself and the joint venture. To fund the settlement, TOUSA took out a new loan, which was guaranteed by the other subsidiaries and secured by liens on all of TOUSA's and the other subsidiaries' assets. Over $400 million of the loan proceeds were paid to the Transeastern lenders to consummate the settlement on July 31, 2007. Despite the settlement, the homebuilding market's continued deterioration in the remainder of 2007 led to the bankruptcy of TOUSA and its other subsidiaries in January 2008.

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[1] *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, Case No. 11-11071 (11th Cir. May 15, 2012).

THE BANKRUPTCY COURT LITIGATION AND DECISION AVOIDING THE TRANSACTION

After bankruptcy, the creditors' committee sued on behalf of the bankruptcy estate to avoid, as a constructively fraudulent transfer, the new liens on the other subsidiaries' assets granted to the new lenders and to recover the payment to the Transeastern lenders. A bankruptcy estate may avoid a pre-bankruptcy transfer of the debtor's property if the debtor was or became insolvent, had unreasonably small capital or became unable to pay its debts and, in any case, did not receive reasonably equivalent value in exchange for the transfer. The committee alleged that the other subsidiaries were insolvent, had unreasonably small capital at the time they granted the liens to the new lenders or became unable to pay their debts and did not receive reasonably equivalent value in exchange for the transfer of the interest in their assets. The new lenders and the Transeastern lenders denied those allegations and argued that the other subsidiaries received value in several ways. The new loan prevented the cross-default that would have resulted if the settlement had not been funded and thereby enabled the subsidiaries to continue in business. The other subsidiaries also received a higher debt ceiling on the revolving loan, tax benefits, elimination of the distraction of the Transeastern litigation and continued access to centralized corporate services, as well as preservation and strengthening of the corporate group.

In a scathing opinion,[2] the bankruptcy court found that the subsidiaries were clearly insolvent at the time of the new loan and that they did not receive reasonably equivalent direct or indirect value or benefit in exchange for becoming liable on the new loans and granting liens to secure them. Instead, the new loans increased the other subsidiaries' liabilities above the value of their assets and prevented them from accessing needed additional capital as their markets and businesses continued to decline. The subsidiaries might have negotiated a waiver or restructuring of the cross-default, and even if they could not, an earlier bankruptcy would not necessarily have harmed them. Therefore, the transfer of an interest in their assets to secure the new loan whose proceeds were used to pay obligations for which they were not liable was an avoidable fraudulent transfer. The court also determined that the new lenders and the Transeastern lenders knew of the other subsidiaries' precarious financial condition and that the borrowed funds would be used to pay obligations for which they were not liable, so the new lenders did not take their security interests in good faith.

THE DISTRICT COURT'S REVERSAL

In an equally scathing opinion directed at the bankruptcy court,[3] the district court reversed. It held that the bankruptcy court's definition of "value" was too narrow and that the indirect benefits the lenders cited could be adequate. It then ruled that the bankruptcy court's findings of fact were clearly erroneous, that the opportunity to prevent the cross-default under the revolver and to preserve the other subsidiaries' viability and the strengthening of the corporate group's viability provided reasonably equivalent value to the subsidiaries.

THE COURT OF APPEALS' RULING UPHOLDING THE BANKRUPTCY COURT'S DECISION

The Court of Appeals reversed the district court. Because the lenders did not challenge the bankruptcy court's financial condition findings, the Court of Appeals focused only on the element of reasonably equivalent value. The Court of Appeals declined to determine which lower court's definition of value was correct, because the bankruptcy court found, as a factual matter, that even if the district court's broader definition applied, the benefits that the other subsidiaries received did not confer reasonably equivalent value, and the bankruptcy court's factual findings must be respected unless clearly erroneous. The Court of Appeals disagreed with the district court's ruling that there was insufficient evidence to support the bankruptcy court's findings.

Central to its affirmance of the bankruptcy court's findings was the Court's conclusion that averting bankruptcy was not necessarily of unlimited value. In words that are already being quoted frequently, the Court said, "The opportunity to avoid

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[2] *Official Comm. of Unsecured Creditors v. Citicorp N. Am., Inc. (In re TOUSA, Inc.)*, 406 B.R. 421 (Bankr. S.D. Fla. 2009).

[3] *3V Cap. Master Fund Ltd. v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, 444 B.R 613 (S.D. Fla. 2011).

bankruptcy does not free a company to pay any price or bear any burden. After all, ‘there is no reason to treat bankruptcy as a bogeyman, as a fate worse than death.’”[4]

Finally, the Court addressed the argument that the Transeastern lenders could not be held liable because they were not the initial transferees of the loan proceeds, which were paid through another, nonbankruptcy TOUSA subsidiary. The lenders argued that making them liable would impose "‘extraordinary’ duties of diligence on the part of creditors accepting repayment”.[5] The Court brushed aside the concern in another oft-quoted phrase: “Every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor.”[6]

IMPLICATIONS FOR DISTRESSED LENDING

Lending into a distressed situation always requires special care, in addition to credit underwriting, to protect against preference, equitable subordination and fraudulent transfer risk. The *TOUSA* decision may raise the bar on the level of care that lenders must exercise. Where an entity who is not already obligated on a distressed credit is incurring an obligation to refinance the credit, it will not be enough for a lender to say that preventing bankruptcy for the new borrower provides sufficient value to support its undertaking the new obligation. Rather, the analysis will have to focus on the value provided by the new loan and the possibility it provides to avert bankruptcy, whether for the existing obligor or for the new borrower, as compared with the cost or harm the new borrower and its other creditors might suffer if the loan is not made: would the prospect of an early bankruptcy resulting from the absence of the new loan be significantly more harmful to the new borrower than if the new borrower has a realistic opportunity to remain outside of bankruptcy and recover, even if the new borrower is ultimately not successful and files bankruptcy later?

Typically, lawyers advise their creditor clients in a distressed situation to take the money and worry later about whether it may be recoverable in a later bankruptcy. The *TOUSA* decision suggests that, especially in a major transaction, a more careful calculus may be required if there is a risk that having to return the money may leave the creditor worse off than not having been paid at all.

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

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[4] Slip op. at 33 (citation omitted).

[5] Slip op. at 39.

[6] *Id*.