Insolvency Law Committee - Business Law Section of the State Bar of California

Bankruptcy e-Bulletin

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Dear constituency list members of the Insolvency Law Committee, the following is a recent case update:

The United States Court of Appeals for the Eleventh Circuit recently affirmed a Florida bankruptcy court's decision that security interests granted by subsidiaries and payments made to refinance debt owed only by the parent holding company were avoidable as fraudulent transfers. See In re TOUSA, Inc., 2012 WL 1673910 (11th Cir. May 15, 2012).
To read this decision, click Tousa

Factual Background:

TOUSA, Inc. was a national homebuilding concern that achieved rapid growth through a roll-up of independent homebuilders fueled by debt financing. TOUSA was the parent holding company while the acquired subsidiaries held most revenue generating assets.

In 2005, TOUSA entered into a joint venture with Transeastern Properties, Inc. ("TPI"), which ultimately proved unsuccessful. The TPI was financed largely with loans guaranteed by TOUSA, but neither owed by nor guaranteed by TOUSA's other subsidiaries (the" Operating Subsidiaries").

The TPI Lenders sued TOUSA, alleging default, and TOUSA agreed to a settlement requiring it to pay the TPI Lenders $421 million. TOUSA obtained the funds through additional loans from New Lenders, secured by new liens on the assets of the Operating Subsidiaries. Six months later, TOUSA and the Operating Subsidiaries filed for Chapter 11 relief.

The creditors' committee brought an action to avoid conveyance of the liens from the Operating Subsidiaries to the New Lenders, pursuant to 11 U.S.C. section 548(a)(1)(B), and the new loan proceeds that TOUSA paid to the TPI Lenders, based on Section 550(a)(1). The Committee argued that the Operating Subsidiaries received no reasonably equivalent value for the liens, and that the liens were conveyed for the benefit of the TPI Lenders.

The Bankruptcy Court and District Court Decisions:

After a 13-day trial, the bankruptcy court found that: (i) the Operating Subsidiaries did not receive "reasonably equivalent value" for the new liens, and (ii) the payments to the TPI Lenders were "entities for whose benefit" the liens were transferred, and therefore avoidable under Section 550(a)(1). The bankruptcy court rejected arguments that indirect benefits, such as the opportunity to avoid bankruptcy, constituted reasonable equivalent value.

On appeal, the district court reversed, holding that the bankruptcy court erred when it determined that: (i) alleged indirect benefits were not reasonably equivalent value for the transfer of the liens, (ii) the payments to the TPI Lenders were transfers of property of the Operating Subsidiaries; and (iii) that the TPI Lenders were entities for whose benefit the liens were transferred.

The 11th Circuit Decision:

The 11th Circuit reversed the district court, and affirmed the bankruptcy court's decision. It reviewed the factual findings of the bankruptcy court using the clearly erroneous standard, and determined that the bankruptcy court did not clearly err in concluding that the Operating Subsidiaries did not receive reasonably equivalent value for the lien conveyance. Noting that, "not every transfer that decreases the odds of bankruptcy… can be justified" and that the bankruptcy court found that the potential benefits of the transaction were "nowhere close to its expected costs," the 11th Circuit determined that the bankruptcy court correctly considered "whether at the time the investment was contemplated, there were any chances that the investment would generate a positive return," and concluded that the record supported the bankruptcy court's negative conclusion.

The Court of Appeals found that even though the funds technically passed through a TOUSA subsidiary before being disbursed to the agent for the TPI Lenders, neither the subsidiary nor TOUSA ever had control over the funds; the transfer was effectively made directly to the TPI Lenders. This rendered them entities for whose benefit the liens were transferred. The TOUSA Court affirmed the bankruptcy court's decision to avoid the liens conveyed to the New Lenders, and the requirement that the TPI Lenders pay back the funds they received from TOUSA. Under the bankruptcy court's ruling, the funds in question were repaid to the New Lenders, after reduction of various fees and damages incurred or suffered by the debtor's estate and the creditors' committee.

Authors' Commentary:

The proposition that a lien or guaranty granted "upstream"– of a liability of its parent – may be subject to avoidance as a fraudulent transfer is not particularly remarkable or novel. The key issue in assessing whether a burden on the affiliate for the debt of its parent (collateralized or not) is avoidable as a fraudulent transfer is whether the subsidiary received reasonably equivalent value for taking on the liability. That value need not be funds received directly by the subsidiary, but the benefit must be demonstrable. That is apparently where the TPI Lenders failed in this case.

While other benefits were claimed, it appears that the principal "indirect benefit" urged by the TPI Lenders as reasonably equivalent value was the "opportunity" to avoid bankruptcy. That argument proved to be unpersuasive to the bankruptcy court for several reasons:

- TOUSA and the Operating Subsidiaries where in bankruptcy within six months of the financing. It may be hindsight, but nothing discounts the value of an opportunity to avoid bankruptcy like a prompt bankruptcy.

- There was substantial evidence that TOUSA senior management believed that the debt financing – rather than an equity transaction – would leave TOUSA and its subsidiaries overburdened.

- Evidence of both the deteriorating home market conditions as well as senior management internal assessments strongly suggested that bankruptcy was inevitable if the debt financing was consummated.

- Many of the original prospective new lenders dropped out and some of the TPI Lenders participated in the loans used to pay their existing debt, thereby converting their debts from unsecured TPI debt to a debt secured by the Operating Subsidiaries.

The TOUSA decision may represent a unique set of circumstances, but the same might be said of any "rescue" financing provided to a distressed concern. TOUSA will not cause all lenders to cease making loans to corporate groups - -distressed or otherwise - - but it may cause lenders to structure and price such loans differently. Possible lender responses to the increased risk suggested by the TOUSA decision may include:

- Discounting the value of upstream guarantees. Lenders could simply discount the value of upstream and cross-stream guarantees and related collateral based on the risk of avoidance. That could result in significantly smaller loan commitments (because of reduced reliable collateral coverage) and higher pricing.
- Funds directed to subsidiaries. Lenders may structure the loans to achieve a flow of funds directly to the subsidiaries, leaving it to the subsidiaries to determine where the funds go after receipt. This involves giving up a measure of control, but

in many transactions the increased risk may be minimal.

- Fairness opinions. It is possible that in some circumstances lenders could require a fairness opinion. Fairness opinions are typically associated with mergers and acquisition transactions and function to advise the board of directors that the consideration given and deal structures are fair. There is no reason why in a large debt financing of a corporate group, involving significant upstream or cross-stream collateralization, a lender could not require a fairness opinion to support its position that the terms of the financing are fair to the subsidiaries that are encumbering their assets. Particularly in financings where the reasonably equivalent value to support the grant of the liens on the subsidiaries is comprised of "indirect benefits," lenders might conclude that they are best served by having those indirect benefits articulated by a third party at the outset of the transaction.

Implications of Stern v. Marshall:

The bankruptcy and district court decisions were rendered before the United States Supreme Court issued its opinion in Stern v. Marshall. An open issue remains under Stern whether a bankruptcy court may issue a final decision in a fraudulent conveyance action. A very different result might have occurred if the TOUSA Court of Appeals had reviewed the district court ruling as a de novo review of a report and recommendation from the bankruptcy court. Applying Stern, the appellate court might well have concluded that, under the same "clearly erroneous" standard of review, the district court's decision had to be affirmed.

These materials were prepared by Patrick M. Costello, of Vectis Law Group, in Palo Alto, and Dennis Wickham, of Seltzer Caplan McMahon Vitek, in San Diego, with editorial contributions from ILC member Uzzi O. Raanan, of Danning, Gill, Diamond & Kollitz, LLP, of Los Angeles. Mr. Costello and Mr. Wickham are members of the ILC.

Thank you for your continued support of the Committee.

Best regards,

Insolvency Law Committee

*The Insolvency Law Committee of the Business Law Section of the California State Bar provides a forum for interested bankruptcy practitioners to act for the benefit of all lawyers in the areas of legislation, education and promoting efficiency of practice. For more information about the Business Law Standing Committees, please see the **standing committees web page**.*