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MILBANK SECURES ORDER QUASHING KEY ASPECTS OF *IN RE TOUSA*: RELATED RISKS TO LENDERS & CREDITORS QUELLED

In a decision long anticipated by the lending industry, on February 11, 2011, the United States District Court for the Southern District of Florida (Gold, J.) issued a strongly worded 113-page opinion rejecting the highly controversial decision from the Southern District of Florida Bankruptcy Court (Olson, J.) in *In re TOUSA, Inc.*[1] The Bankruptcy Court held that certain lenders (the "Transeastern Lenders") to a joint venture sponsored by bankrupt Florida-based homebuilder TOUSA, Inc. were liable for more than $480 million to the bankruptcy estates of TOUSA's subsidiaries. Their misconduct, in the eyes of Judge Olson, was accepting repayment on account of a valid, antecedent loan. In a startling October 2009 decision, the Bankruptcy Court found that the repayment of the Transeastern Lenders debt in July 2007 constituted a fraudulent transfer.[2] The District Court's opinion rebuked the Bankruptcy Court in stark terms: finding that certain evidence was "clearly and erroneously ignored", legal standards adopted were "patently unreasonable and unworkable", and "findings and legal conclusions were neither 'logical' nor 'consistent with the equitable concepts underlying bankruptcy law.'" In dramatic fashion, the District Court ***quashed***[3] the order of the Bankruptcy Court – instead of reversing and remanding to the Bankruptcy Court – because "the Transeastern Lenders [] raised compelling arguments concerning the near verbatim opinion issued by the Bankruptcy Court [as compared to the plaintiff's proposed order] and its ability to conduct further proceedings in this matter." Milbank, Tweed, Hadley & McCloy attorneys represented the Transeastern Lenders at trial and in the appeal.

The Bankruptcy Court's decision caused great consternation within the lending industry; it had far-reaching implications and greatly increased and reallocated the risks inherent in certain loans. While some significant holdings of the Bankruptcy Court remain unreviewed, the District Court's rejection of the Bankruptcy Court's factual findings and legal reasoning — as they relate to the Transeastern Lenders — should

1 *In re TOUSA, Inc. (Official Comm. of Unsecured Creditors v. Citibank N.A., Inc.)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009) ("Bankruptcy Op.").

2 *In re TOUSA, Inc. (3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors)*, No. 10-cv-60017-ASG (S.D. Fla. Feb. 11, 2011) ("District Court Op.")

3 In exceptional circumstances, a review court will "quash," the decision of the lower court, meaning that it is deemed null and void and set aside without further action or consideration by the lower court.

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provide clarity to the capital markets for many of those risks and remove the much of the uncertainty that was created by the Bankruptcy Court's decision.

Background & Bankruptcy Court Decision

In 2005, the Transeastern Lenders loaned approximately $400 million to finance TOUSA's Transeastern joint venture. After the joint venture faltered, and in settlement of litigation claims asserted against it, TOUSA repaid in full the Transeastern indebtedness on July 31, 2007. TOUSA repaid the debt as part of a broader refinancing in which TOUSA obtained $500 million in new financing, guaranteed by its subsidiaries and secured by liens on the assets of TOUSA and its subsidiaries, from lenders agented by Citibank (the "New Lenders"). The Transeastern Lenders had no grounds to refuse repayment of their debt or to condition it on an investigation of the propriety of the funds being used to repay them. On January 29, 2008, after a dramatic housing market decline, TOUSA and its homebuilding subsidiaries filed for bankruptcy. TOUSA's Official Committee of Unsecured Creditors, primarily representing the interests of more than $1 billion in unsecured bond indebtedness, filed suit on behalf of TOUSA's subsidiaries that had become obligated on the new financing (the "Conveying Subsidiaries") against both the Transeastern Lenders and the New Lenders, alleging preference and fraudulent transfer claims and seeking both to avoid the obligations to the New Lenders and to recover the funds paid to the Transeastern Lenders.

On October 13, 2009, following a 13-day bench trial, the bankruptcy court issued a decision that: (1) avoided the obligations incurred by the Conveying Subsidiaries to the New Lenders and the liens transferred to secure those obligations; (2) held that the Transeastern Lenders were liable as entities "for whose benefit" the transfer of the liens was made; and (3) held that the Transeastern Lenders were "direct transferees" of the New Loan proceeds from the Conveying Subsidiaries. The Transeastern Lenders were ordered to disgorge $403 million plus prejudgment interest of almost $80 million.[4] The well-publicized and unprecedented decision created widespread concern among creditors about how to structure and investigate financial transactions to maximize their protection against avoidance claims and bankruptcy risks, particularly where they, like the Transeastern Lenders, were being repaid a debt.

The Bankruptcy Court's decision was separately appealed by the Transeastern Lenders and the New Lenders.

The District Court Quashes the Bankruptcy Court's Order

In a strongly worded opinion, the District Court quashed the Bankruptcy Court's order with respect to the Transeastern Lenders on all grounds, finding the Bankruptcy Court's decision to be "clearly erroneous." Although the decision issued last week only relates to the liability of the Transeastern Lenders, the District Court's decision also casts serious doubt on the viability of the holdings on the claims against the New Lenders. The District Court's decision is of critical significance for the lending community. The central holdings are discussed below.

No Bad Faith For Accepting Repayment of a Debt. Most notably for the lending community, the District Court forcefully rejected the Bankruptcy Court's conclusion that the Transeastern Lenders acted in bad faith and were grossly negligent in accepting repayment from TOUSA of their undisputed indebtedness owing by the joint venture.[5] In words that shook the lending community and inverted long-held precepts, the Bankruptcy Court had held "that it is 'bad faith' for a creditor of someone *other than the debtor* to accept payment of a valid, tendered debt repayment outside of any preference period, through settlement or otherwise, **if the creditor does not first investigate the debtor's internal re-financing structure and ensure that the debtor's subsidiaries had received fair value as part of the repayment, or that the debtor and its subsidiaries, in an enterprise, were not insolvent or precariously close to being insolvent**."[6] The District Court rejected this conclusion

4 Bankruptcy Op. at 885.

5 District Court Op. at 102-08.

6 *Id.* at 102 (emphasis added).

finding that "[t]his standard is patently unreasonable and unworkable."[7] It reasoned that "if 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."[8] The District Court thus concluded that "the Transeastern Lenders, as recipients of a debt payment, had no reason or legal duty to conduct such extraordinary due diligence with respect to the provenance of the funds with which they were being repaid."[9]

Co-Borrowers Without Control Over Property Do Not Have Right To Recover Funds. The District Court rejected the Bankruptcy Court's holding that by virtue of becoming obligated on the debt to the New Lenders as "co-borrowers", the Conveying Subsidiaries had a property interest in the proceeds of the new loans and could recover the property from the Transeastern Lenders. The District Court held that "[t]he Bankruptcy Court is legally incorrect in its interpretation [that control over the property is irrelevant], and further incorrect in concluding that the Conveying Subsidiaries had a property interest sufficient for the Code requirements because they were co-borrowers on the New Loans." This ruling avoids the necessary implication of the Bankruptcy Court's decision that any co-borrower could demand turnover of loan proceeds that were used by another borrower.

Indirect Benefits Are Cognizable In "Reasonably Equivalent Value" Determination. The District Court faulted the Bankruptcy Court's holding that only physical, tangible property transferred directly to the subsidiary debtor confer "value" that can be considered in determining whether "reasonably equivalent value" was provided in exchange for a transfer from a debtor. (A finding that reasonably equivalent value was exchanged is a complete defense to an avoidance action.) The District Court affirmed the position taken by courts throughout the country, that "indirect benefits" are an important element of the reasonably equivalent value calculus. It held that "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided [sic] to be short lived, may be considered in determining reasonable equivalent value."[10]

Party Must Actually Benefit From Transfer to be Liable As Party "For Whose Benefit" The Transfer Is Made. The District Court also quashed the Bankruptcy Court's drastic expansion of the scope of liability under the Bankruptcy Code to include parties that do not receive a transfer directly and do not benefit from the fraudulent transfer itself. The Bankruptcy Court found that the Transeastern Lenders were liable for the transfer of liens by the Conveying Subsidiaries under the "for whose benefit" language of Section 550 of the Bankruptcy Code because, even though they received no direct benefit from the transfer of liens, the lien transfer was for the "ultimate benefit" of the Transeastern Lenders. The District Court rejected this reasoning and held, consistent with every court that has considered the issue, that "for whose benefit" liability only applies when a benefit flows immediately from the initial fraudulent transfer, not "from the manner in which the initial transfer is *used* by its recipient."[11] In other words, the District Court recognized the following reality: the security interests granted by the Conveying Subsidiaries were never transferred to the Transeastern Lenders. The grant has remained at all times with the collateral agent. The Transeastern Lenders never received the liens, or any other property for that matter, from the initial transferees. Subsequent transferee liability cannot be decoupled from the property being avoided from the initial transferee, but instead must follow it.[12]

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7 *Id.* at 103.

8 *Id.* at 107-08.

9 *Id.* at 103-04.

10 *Id.* at 73.

11 *Id.* at 100.

12 *Id.* at 101.

Stay Tuned . . .

Despite a 113-page District Court opinion, a number of highly controversial holdings of the Bankruptcy Court remain unreviewed; the most relevant ones are listed below. It is likely that certain of these issues will be addressed by Judge Adalberto Jordan of the District Court in his forthcoming opinion on the New Lenders' appeals. Unless Judge Jordan rejects Judge Gold's conclusion that the Conveying Subsidiaries received reasonably equivalent value in the transactions, it is expected that the New Lenders should prevail in their appeal as well.

- Whether routine "savings clauses", which seek to limit the exposure of lenders to fraudulent transfer claims by reducing their claims, are "entirely too cute to be enforced."
- Whether a method of determining solvency which sums the market value of all outstanding debt and equity securities and compares it to the face amount of liabilities is a reliable solvency analysis.
- Whether courts should require entities to quantify specific benefits to each subsidiary involved in a transaction as the Bankruptcy Court required instead of recognizing the "identity of interest" doctrine that treats closely related subsidiaries, under certain circumstances, as consolidated entities for the purposes of evaluating reasonably equivalent value.
- Whether a contemporaneously issued solvency opinion from a well-respected restructuring advisory firm is irrelevant on the issues both of good faith and as an indication of the solvency of the enterprise, and whether such opinions have to separately value the solvency of each individual subsidiary.

The Bankruptcy Court's decision finding the Transeastern Lenders liable was among the more notorious and criticized bankruptcy court decisions in recent years. The District Court's sound rejection of every aspect of the decision should resolve the uncertainty that ensued. To the extent this represents a "return to normalcy" in risks of distressed lending, it should be welcomed by all members of the lending community.

What's Old Is New Again: Summary of Key Bankruptcy Court Holdings Reversed by District Court

Issue	Bankruptcy Court	District Court
Do creditors owe a duty of care when being repaid on an antecedent debt?	Yes. Found Transeastern Lenders who accepted payment of undisputed debt in full acted in "bad faith" and were "grossly negligent."[13]	No. "[T]he Transeastern Lenders, as recipients of a debt payment, had no reason or legal duty to conduct such extraordinary due diligence with respect to the provenance of the funds with which they were being repaid."[14]
Are indirect benefits an element of reasonably equivalent value?	No. "[A] precise definition of 'value' [ ] encompasses *only* 'property' and 'satisfaction or securing of a present or antecedent debt of the debtor.'"[15]	Yes. "[T]he weight of authority supports the view that indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided [sic] to be short lived, may be considered in determining reasonable equivalent value."[16]
Do co-borrowers have a property interest in the proceeds of loans such that co-borrowers can recover the funds?	Yes. "[E]ach of the co-borrowers has a property interest in the funds" because if that were not true, then the "'property would belong to no one.'"[17]	No. The co-borrowers did not control the funds and "the property involved did belong to someone, *i.e.*, TOUSA."[18]
Can a party be a "for whose benefit" entity and a subsequent transferee?	Yes. The first court to ever find a party to be both an initial and subsequent transferee of the same transfer.[19]	No. "Thus, because the Transeastern Lenders were 'subsequent transferees' of the proceeds backed by the liens, the Senior Transeastern Lenders do not qualify as 'entities for whose benefit.'"[20]
Is the "Observable Market Value" test for solvency valid?	Yes. First court to endorse this as a solvency test.[21]	Although not addressed directly, the court noted the Transeastern Lenders' criticism of the test and declined to employ it.[22]
Are savings clauses invalid?	Yes. Savings clauses were "entirely too cute to be enforced."[23]	Did not reach the issue because it was not central to the Transeastern Lenders' appeal.
Are contemporaneous solvency opinions relevant and reliable?	No. Credited statements from bondholders based on public information as overcoming management and professional solvency views.[24]	Did not reach the issue because it was not central to the Transeastern Lenders' appeal.

13 Bankruptcy Op. at 850-55.
14 District Court Op. at 103-04.
15 Bankruptcy Op. at 868.
16 District Court Op. at 73.
17 Bankruptcy Op. at 872-73 (quoting *United States v. Craft*, 535 U.S. 274, 285 (2002)).
18 District Court Op. at 52.
19 Bankruptcy Op. at 870-71; 872-74.
20 District Court Op. at 101.
21 Bankruptcy Op. at 825-27
22 District Court Op. at 36 n.37
23 Bankruptcy Op. at 864.
24 Bankruptcy Op. at 839-43.

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