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BANKRUPTCY UPDATE

Upstream Guaranties, Security Interests Ruled Fraudulent Transfers

Editor's note: This is the second in a two-part series. The first part, published Monday, detailed the background in In re Tousa *and the Bankruptcy Court's ruling.*

BY ANDREW C. KASSNER AND JOSEPH N. ARGENTINA JR.

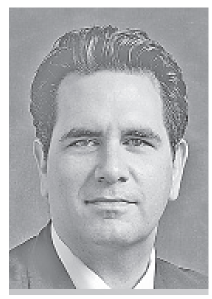
Special to the Legal

The lenders in *In re Tousa* all filed appeals to the U.S. District Court for the Southern District of Florida. The new lenders' appeal was stayed pending the outcome of the Transeastern lenders' appeal. In a sweeping and highly critical 113-page opinion issued in February, the District Court reversed the Bankruptcy Court on nearly every finding and conclusion and held the Transeastern lenders (1) could not be compelled to disgorge the funds paid and (2) were not liable as entities for whose benefit the conveying subsidiaries transferred the liens to the new lenders. In particular, the District Court noted that the Bankruptcy Court adopted virtually unchanged the proposed draft finding and conclusions submitted by the committee.

First, the District Court noted that Section 548 requires avoidance of a transfer of the property of the debtor. The District Court reasoned that because the conveying subsidiaries did not have a property interest in the funds received by the Transeastern lenders, their receipt of the funds could not be a fraudulent transfer and the Bankruptcy Court erred in holding the conveying subsidiaries did not receive reasonably equivalent value in exchange for the funds.

Second, the District Court held that the Bankruptcy Court erred by placing the burden of proof of reasonably equivalent value on the defendants. The District Court examined whether the conveying subsidiaries received any benefits as a result of the settlement and new loan under the "identity of interest rule," which recognizes that "if the debtor and the third party are so related or situated that they share an 'identity of interests,' then what benefits one will, in such case[s], benefit the other to some degree." The District Court observed that despite "extensive trial testimony and briefing on the issue," the "identity of interest rule" was not addressed in the Bankruptcy Court's 182-page opinion.

KASSNER



ARGENTINA

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The District Court opinion stated the Bankruptcy Code does not define the term "reasonably equivalent value," but defines the term "value" for purposes of Section 548 as "property, or satisfaction or securing of a present or antecedent debt of the debtor." The Bankruptcy Court had limited the definition of the term "property" to the *Webster's Dictionary* definition of an enforceable entitlement to some tangible or intangible article and concluded the conveying subsidiaries did not receive reasonably equivalent value as a result of the transaction. The District Court held that the Bankruptcy Court erred by relying on the *Webster's* definition. The District Court wrote: "Congress has left it to the courts to determine the scope and meaning of 'reasonably equivalent value.'" The District Court concluded that "contrary to the Bankruptcy Court's legal conclusion, the 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 proved to be short lived, may be considered in determining reasonable equivalent value."

Unlike the Bankruptcy Court, the District Court concluded that in light of the claims against the conveying subsidiaries, as a result of their guaranties of the bond debt and the revolver loan, the transaction provided reasonably equivalent value to them. The District Court found that the conveying subsidiaries depended on the revolving credit facility to conduct their business. Furthermore, they depended on the continuing viability of the Tousa enterprise as a whole. After reviewing the totality of the circumstances, the District Court concluded that the transaction conferred reasonably equivalent economic benefits on the conveying subsidiaries by preserving their net worth and avoiding an imminent default, thereby preserving, at that point in time, the committee's unsecured creditors' interests by allowing the enterprise to continue to meet its obligations. The District Court said, "This is exactly the kind of case, as supported by applicable case law, that shows that a debtor's opportunity to avoid default, to facilitate its rehabilitation and to improve its prospects of avoiding bankruptcy are precisely the kind of benefits that, by definition, are not susceptible to exact quantification but are nonetheless legally cognizable under Section 548."

The District Court concluded its opinion by deciding that even if the granting of liens and guaranties to the new lenders was a fraudulent transfer under Section 548, the Bankruptcy Court erred as a matter of law when it concluded that the Transeastern lenders were entities for whose benefit the transaction was made. The District Court ruled that the Transeastern lenders could not be initial transferees under Section 550 because the relevant transaction was the granting of the liens and guaranties by the conveying subsidiaries to the new lenders. As such, the Transeastern lenders' benefit was subsequent to the initial transfer. Rather than collapse the two transactions together, the District Court reasoned that only an entity who benefited from the initial transfer can be an entity for whose benefit the transfer was made. The Transeastern lenders did not benefit from the initial transfer (the granting of the liens and obligations to the new lenders). Therefore, they could not be entities for whose benefit the transfer was made.

The District Court added that the Bankruptcy Court's expansion of Section 550 liability to creditors being paid for valid debt would impose a standard of care on lenders that was "patently unreasonable and unworkable," and holding such legitimate creditors accepting payment liable would impose extraordinary and exhaustive duties of due diligence on them.

Rather than remand the case for further proceedings in light of its opinion, the District Court simply reversed without remand. The court noted the "compelling arguments" raised by the Transeastern lenders that the Bankruptcy Court was unable to conduct further proceedings in the matter, and remand was unnecessary where the record allows only one resolution of the factual issues at stake. The District Court quashed the Bankruptcy Court's order as it related to the Transeastern lenders, declared the remedies contained in the order null and void and discharged the bonds posted by the Transeastern lenders on appeal.

The decision was a resounding victory for the Transeastern lenders. Lenders and their lawyers across the country applauded and exhaled a sigh of relief.

THE ELEVENTH CIRCUIT REVERSES THE DISTRICT COURT

The lenders' victory was short-lived. The creditors' committee appealed the District Court decision to the U.S. Court of Appeals for the Eleventh Circuit. The Eleventh Circuit began by reciting the factual findings of the Bankruptcy Court are reversed only if there is clear error. The court noted there was no dispute the conveying subsidiaries were insolvent at the time of the transaction, and the only issue was whether the subsidiaries received "reasonably equivalent value" as a result of the transaction. The court declined to decide whether to adopt the District Court's expanded or Bankruptcy Court's more limited definition of "value," because the Bankruptcy Court had found that even if all the purported benefits of the transaction were available as value, they did not confer reasonably equivalent value to the subsidiaries. The opinion concludes that because the Bankruptcy Court's findings were not clearly erroneous, "they settle this matter."

The court stated whether fair consideration is given for a transfer is "largely a question of fact" and deference should be given to the trier of facts. In this case, the record supported the Bankruptcy Court's finding that "the almost certain costs of the transaction ... far outweighed any perceived benefits." The court did not find that the record compelled the finding that the transaction permitted the subsidiaries to avoid bankruptcy and that the avoidance of bankruptcy was reasonably equivalent value to the obligations the subsidiaries incurred as a result of the transaction. The opinion observes: "The record supports a determination that the bankruptcy of Tousa was far more like a slow-moving category 5 hurricane than an unforeseen tsunami."

The court's opinion states: "The opportunity to avoid 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." The relevant question was whether there was any chance the transaction would generate a positive return. The opinion recites that in this case, both external observers and Tousa insiders acknowledged the housing markets were in freefall. The court said, "In contrast with the surprise attack at Pearl Harbor, the warnings about the collapse of Tousa made that event as foreseeable as the bombing of Nagasaki after President Truman's ultimatum." That being said, the Eleventh Circuit's decision does not address how, in the future, parties to restructuring or settlement transactions with distressed debtors should value the ability to avoid bankruptcy or remain afloat.

> *Other than credit bidding, no bankruptcy case has attracted more attention over the past three years than* Tousa, *and it is far from over.*

The Eleventh Circuit also held the Transeastern lenders were parties for whose benefits the transaction had occurred. The court rejected the District Court's holding that the Transeastern lenders were subsequent transferees, not entities that benefited from the initial transfer. The court noted the new loan agreements required the proceeds be transferred to the Transeastern lenders. Therefore, under the plain language of Section 550(a)(1) and Eleventh Circuit case law, the Transeastern lenders were entities for whose benefit the subsidiaries had transferred the liens. Like the Bankruptcy Court, the Eleventh Circuit perceived the transfer of loan proceeds to the Transeastern lenders to be part of the same transfer as the granting of liens by the conveying subsidiaries. As such, the Transeastern lenders were not subsequent transferees, but direct beneficiaries of the transaction.

The Eleventh Circuit also rejected the District Court's observation that ordering a legitimate creditor to disgorge repayment of legitimate debt because a loan securing the money used to repay the debt involved a fraudulent transfer would impose extraordinary due diligence duties on the creditors accepting repayment. The court dismissed these concerns by noting "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." The court did not provide any guidance on how much diligence is required, or how large the repayment must be to impose such diligence obligations.

The Eleventh Circuit reversed the decision of the District Court and remanded the case to the District Court for further proceedings related to the remedies imposed by the Bankruptcy Court. Both parties argued the case be assigned to a judge other than the one who had issued an opinion unfavorable to them. The court declined to reassign the case on remand to the District Court. On June 5, the Transeastern lenders filed a petition for rehearing en banc. As of press time, no ruling has been issued.

ONGOING INTEREST IN *TOUSA*

Other than credit bidding, no bankruptcy case has attracted more attention over the past three years than *Tousa*, and it is far from over. The new lenders' appeal on avoidance of their liens is still pending, the petition for en banc review has yet to be decided and the remand proceedings will ensue. The stakes here are high. Finance lawyers are unclear whether savings clauses will be enforced and how to counsel clients on refinance transactions. So many questions remain unanswered. In an era where lenders and stakeholders are using extraordinary efforts to avoid expensive bankruptcy cases, should a lender being refinanced require a bankruptcy filing to bless the transaction? Must large suppliers make inquiry any time an invoice is paid by anyone other than the entity listed on the purchase order? What due diligence should be performed? Will courts collapse transactions and in effect consolidate companies or respect the structure of transactions? Or, in the end, was *Tousa* merely a classic case where one should expect that if a company fails only six months after a refinancing in a foundering industry, the consequence should be anticipated by highly sophisticated financial institutions? Many CLE credit hours will be earned discussing these issues.

Stay tuned. •