

**TOUSA, INC.—FOR LENDERS, AN ENCOURAGING DEVELOPMENT, BUT THE SAGA CONTINUES**

February 22, 2011

To Our Clients and Friends:

On February 11, Judge Alan S. Gold of the United States District Court for the Southern District of Florida overturned a much-noted 2009 bankruptcy court decision in the bankruptcy of TOUSA, Inc. (“Tousa”) that had, among other things, required certain secured lenders (the “Transeastern Lenders”) to disgorge a \$500 million debt repayment by Tousa, made six months prior to Tousa’s bankruptcy, based on the bankruptcy court’s conclusion that the repayment was a fraudulent conveyance.

This district court decision<sup>1</sup> offers some relief to lenders who had been unsettled by the implications of the bankruptcy court’s 2009 decision. But, as Judge Gold recognized, he will not have the last word on the matter.

Not only is an appeal to the United States Court of Appeals for the Eleventh Circuit likely, but other significant parts of the bankruptcy court’s decision remain on appeal before other judges of the same district court, as Judge Gold was careful to note.

Notably, District Judge Adalberto Jordan is separately considering appeals on a number of the bankruptcy decision’s holdings, including on the enforceability of “savings clauses” in upstream and cross-stream guarantees that we addressed in our November 11, 2009 client update.<sup>2</sup> Last week, Judge Jordan ordered supplemental briefings by mid-March on the effect on the issues before him of the decision last Friday by Judge Gold.

Judge Gold’s decision raises a number of issues of interest to the lending community, two of which are described in this update: (1) whether indirect benefits are sufficient to shield upstream guarantees from fraudulent conveyance risks; and (2) whether prior lenders face special risks when paid from new loans supported by additional guarantees.

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<sup>1</sup> *The cases are 3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of TOUSA, Inc., Nos. 10-60017, 10-61478, 10-62032, 10-62035, 10-62037 (S.D. Fla. Feb. 11, 2011).*

<sup>2</sup> *Our November 11, 2009 update is available at <http://www.debevoise.com/files/Publication/2f9b72d5-b870-447a-a1b6-0081173f2def/Presentation/PublicationAttachment/c646ea8e-04b0-4434-9cad-084577a8c596/TousaIncWhatIsALenderToDo.pdf>.*

## BACKGROUND

Tousa and its subsidiaries are homebuilders operating in Florida, Las Vegas and other Southern markets. In 2005, Tousa Homes LP (“Homes LP”), a subsidiary of Tousa, entered into a joint venture to acquire certain properties from Transeastern Properties, Inc. The acquisition was funded by a loan from the Transeastern Lenders that was guaranteed by Homes LP and Tousa, but not its other subsidiaries. The financial condition of the Transeastern joint venture deteriorated and litigation with the Transeastern Lenders ensued. In 2007, a settlement agreement was reached requiring payment of approximately \$420 million to the Transeastern Lenders. At the time, Tousa had approximately \$1 billion of unsecured debt outstanding and maintained a \$700 million secured revolving credit facility (the “Existing Loans”), guaranteed by many of Tousa’s subsidiaries, but not by Homes LP.

In July 2007, in order to fund the settlement and related costs, Tousa entered into a \$200 million first lien credit agreement and a \$300 million second lien credit agreement (the “New Loans”). Tousa also took over the assets and liabilities of the joint venture, which improved the borrowing base for the existing revolver, increasing available credit to Tousa and subsidiaries by about \$150 million. The New Loans were guaranteed by all of Tousa’s subsidiaries. With the consent of the already-secured revolving lenders, the new lending was secured *pari passu* by substantially all assets of Tousa’s subsidiaries. Soon, waivers were required in connection with the credit agreements. Six months after closing, Tousa and its subsidiaries filed Chapter 11 petitions.

After a lengthy trial, the bankruptcy court determined that the upstream guarantees supporting the New Loans were fraudulent conveyances because the subsidiaries had not received reasonably equivalent value in exchange for their guarantees and ordered the Transeastern Lenders to return the \$420 million settlement payment, with interest, to Tousa.

## ARE INDIRECT BENEFITS SUFFICIENT TO SHIELD UPSTREAM GUARANTEES FROM FRAUDULENT CONVEYANCE RISKS?

The bankruptcy court’s fraudulent conveyance finding was based chiefly on its determination that the upstream guarantees supporting the New Loans were transfers of value for which the subsidiaries had received little or no property (nor other value) in return.

The district court disagreed, holding that it was not necessary that the subsidiaries receive literal property in return for their guarantees so long as they received reasonably equivalent value, even if indirect. The district court found that the subsidiaries had received sufficient value, specifically “indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise’s rehabilitation, and to avoid bankruptcy, even if it prov[ed] to be short lived.”

The district court found it a virtual certainty that Touse and Homes LP would have faced an adverse judgment had they not quickly settled with the Transeastern Lenders, and that this judgment would have put Touse into immediate default under the terms of the Existing Loans. Those defaults, under the circumstances, would have forced Touse and its subsidiaries into bankruptcy without delay. The district court determined that the settlement, made possible by the New Loans and upstream guarantees, had given Touse and its subsidiaries a chance to avoid bankruptcy altogether and actually had given them several extra months.

The district court's willingness to see equivalent value in intangible benefits is clearly more favorable to contemporary financing practices such as upstream guarantees and finds support in the opinions from the Second, Third and Seventh Circuits that the district court quoted at length. But the district court was candid in acknowledging that the Eleventh Circuit itself has not yet ruled on whether such indirect benefits can constitute "reasonably equivalent value."

The Eleventh Circuit has made general comments approving of transfers that, in the end, preserve a debtor's net value and do not injure its other creditors. But it remains to be seen whether the Eleventh Circuit will agree with the district court on the law or regarding the sufficiency of the indirect benefits received by Touse's subsidiaries. Even in the circuits cited by the district court, such indirect benefits usually must be fairly concrete and quantifiable to be considered reasonably equivalent value for fraudulent conveyance purposes. And, although the district court carefully distinguished them, the Eleventh Circuit has made rulings that may suggest a relatively traditional, concrete view of what constitutes value or property.

### **DO PRIOR LENDERS FACE SPECIAL RISKS WHEN PAID FROM NEW LOANS SUPPORTED BY ADDITIONAL GUARANTEES?**

The district court separately held that, even if there *had* been a fraudulent conveyance, the Transeastern Lenders still would not have to return the amounts they were paid because they had acted in good faith and without knowledge that the transfer was a fraudulent conveyance (assuming there was any) and they were merely subsequent beneficiaries of the subsidiaries' liens to the new lenders.

Bankruptcy policy generally favors effective recovery of fraudulent conveyances for the benefit of the estate. However, the Bankruptcy Code does protect subsequent recipients (or "transferees") who gave value for what was received, so long as the transfer was received in good faith and without knowledge that it was voidable as a fraudulent conveyance. By contrast, *initial* transferees as well as entities for whose benefit the fraudulent transfer was made are liable for return of the conveyance, regardless of good faith or knowledge.

The bankruptcy court had held that the Transeastern Lenders were not subsequent but direct recipients of the fraudulent conveyance. The court separately made clear its view that the

Transeastern Lenders knew that Touse was rapidly deteriorating and had knowingly involved themselves in an effort to improve their position by means of the settlement, New Loans and upstream guarantees, all in an effort to “elbow past” the unsecured bondholders.

The district court disagreed entirely, finding that the New Lenders, not the Transeastern Lenders, were the initial transferees of value from the upstream guarantees. The district court held that Transeastern Lenders were also not the entities for whose benefit the upstream guarantees had been given. “Simply put,” the district court held, “the ‘for whose benefit’ language does not apply where the ‘benefit’ is not the immediate and necessary consequence of the initial transfer, but flows from the manner in which the initial transfer is *used* by its recipient.”

Thus, the district court held, the Transeastern Lenders were merely *subsequent* recipients (or transferees) of the proceeds of the new lending that were therefore protected by the Bankruptcy Code, so long as the Transeastern Lenders took repayment in good faith, with no knowledge of the “voidability” of the payment (as a fraudulent conveyance), requirements the district court found satisfied. The district court therefore concluded that the Bankruptcy Code protects the Transeastern Lenders from disgorgement of the settlement even were the Eleventh Circuit to determine that the upstream guarantees were themselves fraudulent conveyances.

Again, the position of the Eleventh Circuit remains to be seen. Courts have sometimes examined a complex series of formally separate financial transactions and determined to treat them as a single whole for purposes of identifying an initial transferee. The factual record on the settlement with the Transeastern Lenders and the New Loans that supported the settlement is now very substantial, and received extended consideration by both the bankruptcy and district court, which reached contrary conclusions. The same facts also remain before other judges of the district court in related proceedings.

The eventual outcome and long-term implications of the Transeastern Lender cases will not be known for some time, but Judge Gold’s district court decision is both an encouraging development for the lending industry and loan market in the ongoing Touse saga, and also a continuing reminder of the bankruptcy risks that should be considered in connection with upstream guarantees and distressed refinancings.

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Please feel free to contact us with any questions.

Steven R. Gross  
+1 212 909 6586  
srgross@debevoise.com

Michael E. Wiles  
+1 212 909 6653  
mewiles@debevoise.com

Richard F. Hahn  
+1 212 909 6235  
rfhahn@debevoise.com

George E.B. Maguire  
+1 212 909 6072  
gebmaguire@debevoise.com

My Chi To  
+1 212 909 7425  
mcto@debevoise.com

Jasmine Ball  
+1 212 909 6845  
jball@debevoise.com