

Client Alert

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11th Circuit Reinstates *Tousa* Fraudulent Transfer Decision

Litigation arising from the Tousa, Inc. fraudulent transfer claims has been working its way through the legal system since 2009, and the recent decision issued by the 11th Circuit Court of Appeals (the “11th Circuit”), has significant ramifications for any party holding debt, whether that debt is secured, unsecured, original issue or purchased on the secondary market. Regardless of the type of debt, or its source, Tousa illustrates that lenders must heighten their due diligence efforts to protect themselves from the risk of a lawsuit alleging fraudulent transfer liability.

Facts

Tousa, Inc. was a developer/builder of residential homes in Florida that had fallen on hard times after a failed joint venture. To settle litigation with the lenders for the joint venture (the “Transeastern Lenders”), Tousa agreed to pay the Transeastern Lenders \$420 million (the “Settlement”).

In an attempt to avoid a bankruptcy filing, Tousa approached a second set of lenders (the “New Lenders”) about obtaining a loan to fund the Settlement. The New Lenders agreed to fund the Settlement and required certain of Tousa’s subsidiaries (the “Conveying Subsidiaries”) to pledge unencumbered assets as collateral for the new loan. Both Tousa and the Conveying Subsidiaries agreed to these terms and pledged their assets to the New Lenders.

After the housing market in Florida collapsed, Tousa found itself facing bankruptcy again. In January, 2008, Tousa and its subsidiaries (including the Conveying Subsidiaries) filed voluntary chapter 11 bankruptcy petitions in the U.S. Bankruptcy Court for the Southern District of Florida (the “Bankruptcy Court”). Ultimately, the official committee of unsecured creditors (the “Committee”) filed suit, alleging that (a) liens granted by the Conveying Subsidiaries to the New Lenders to secure repayment of the loan were avoidable as fraudulent transfers, and (b) the Transeastern Lenders received the benefit of the fraudulent transfer in the form of the Settlement Payment.

Fraudulent Transfer Standard

To successfully avoid a transfer as a fraudulent transfer under Section 548 of the Bankruptcy Code, the Committee had to prove the following:

- The transfer to be avoided was of an interest in the debtors’ property;
- The transfer was made on or within 2 years before the filing of the bankruptcy;
- The transferor received less than “reasonably equivalent value” in exchange for the transfer; and
- The transferor was insolvent on the date of the transfer, or became insolvent as a result of the transfer.

If any of the transfers were avoided under Section 548 of the Bankruptcy Code, the Committee could recover the property transferred or the value of the property transferred under Section 550 of the Bankruptcy Code from either the initial transferee or any entity for whose benefit the transfer was made.

Bankruptcy Court Finds Lenders Liable

After a lengthy trial, the Bankruptcy Court found that the liens granted by the Conveying Subsidiaries to the New Lenders were avoidable as fraudulent transfers because (a) the liens had rendered the Conveying Subsidiaries insolvent, and (b) the Conveying Subsidiaries did not receive “reasonably equivalent value” in exchange for having their assets “liened-up” for the benefit of the New Lenders. The Bankruptcy Court ordered that the New Lenders’ liens should be avoided.

The Bankruptcy Court further found that the Transeastern Lenders received the benefit of the fraudulent transfers in the form of the Settlement Payment. Thus, the Bankruptcy Court ordered the Transeastern Lenders to return the Settlement Payment.

Lenders Appeal to District Court

The Transeastern Lenders and the New Lenders appealed. The U.S. District Court for the Southern District of Florida (the “District Court”) reversed the Bankruptcy Court, finding that (1) the Settlement Payment itself was never property of Touse’s subsidiaries, but instead belonged to Touse itself, (2) the Conveying Subsidiaries received “reasonably equivalent value” in exchange for the liens placed on their assets (because they avoided default on unsecured debt and eventual bankruptcy through Touse’s funding of the Settlement Payment), and (3) the Committee could not maintain its 548 avoidance claims because it could not meet the predicate elements of those claims.

11th Circuit Reverses the District Court

The Committee appealed to the 11th Circuit. On appeal, the Committee argued that because the Settlement Payment had been procured by Touse for the ultimate benefit of the Transeastern Lenders (in an effort to fund the Settlement), it could be avoided under Section 548. Pointing out that a lender is not required to examine the source of funds used to pay off an obligation, the Transeastern Lenders argued that the Committee’s line of reasoning would impose an extraordinary duty to perform due diligence prior to accepting payment on a valid debt.

The 11th Circuit agreed with the Committee, and reversed the District Court, noting that “every creditor must exercise some diligence when receiving payment from a struggling debtor.” The 11th Circuit reasoned that the sheer dollar amount of the Settlement Payment (over \$400 million) made such diligence “far from a drastic obligation” upon the Transeastern Lenders, especially when the funds are being received from “someone other than its debtor.”

The 11th Circuit also held that (a) the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the liens granted to the New Lenders, (b) the Conveying Subsidiaries were rendered insolvent by the liens granted to the New Lenders, and (c) the Transeastern Lenders received the benefit of the transfers. Accordingly, the 11th Circuit concluded that the liens granted by the Conveying Subsidiaries to the New Lenders were avoidable as fraudulent transfers and that the Transeastern Lenders could be made to repay the Settlement Payment.

Touse’s Impact on Creditors

This decision certainly raises concerns for lenders. Now lenders cannot merely be content to receive payment on a valid debt. Instead, parties may now be required to perform due diligence as to the source of funds used to repay the debt, and whether the payment from that source might be avoidable as a fraudulent transfer.

Even up-stream guarantees and pledges are not safe, unless a party has concrete proof that the subsidiary signing the guaranty or pledge received consideration, or was not rendered insolvent by the signing of the guaranty or pledge.

Additionally, the Touse decision is a reminder to the purchasers of corporate debt that they must evaluate the liens granted by subsidiaries to ensure that the subsidiaries received reasonably equivalent value in exchange for liens granted to secure a loan that is ultimately for the benefit of its parent or the general corporate group. If the subsidiaries did not receive reasonably equivalent value in exchange for the granting of the liens, the liens may be at risk of avoidance as fraudulent transfers.

If you have any questions, please feel free to contact any of the attorneys listed below:

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