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Practical Lessons From the 'Tousa Saga'

Dangers lurk in subsidiary's guarantee of parent company's debt.

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For several years now the bankruptcy and lending communities have been abuzz over the now concluded "*Tousa* Saga,"[1] a fraudulent conveyance lawsuit that began with a multi-hundred million dollar disgorgement ordered by the Bankruptcy Court for the Southern District of Florida,[2] reversed by the District Court for the Southern District of Florida,[3] and ultimately reinstated by the Eleventh Circuit.[4] The *Tousa* line of decisions is remarkable and unique due to the amount of money involved, the nature of the transaction at question and the sweeping relief granted by the bankruptcy court. Practitioners, however, should not dismiss the *Tousa* line of decisions as limited to the transactions and factual circumstances involved.

The *Tousa* decisions contain practical guidance and warnings for bankruptcy and finance professionals evaluating what might have seemed like ordinary workout and lending transactions. As the Eleventh Circuit noted in the first of the line of its decision, the *Tousa* Saga is about nothing more than the "transfer of liens by subsidiaries of [a parent entity] to secure the payment of a debt owed only by their parent."[5] The *Tousa* decisions highlight the dangers and uncertainties involved with loans made to a parent company but secured by the assets of its subsidiaries, especially when the subsidiaries are already deeply in debt to unsecured creditors. Lenders seeking to mitigate losses on distressed loans naturally look to any unencumbered assets in an enterprise to secure unsecured portions of existing loans or new advances even in small and middle market situations. Accordingly, the *Tousa* decisions serves as a cautionary tale for lenders seeking to protect themselves in distressed deals and an informative one for unsecured creditors (and their committees)

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evaluating the potential returns from a bankruptcy estate.

This article summarizes the relevant background and outlines some lessons that the bankruptcy and lending communities should take away from the three decisions generated by the fraudulent conveyance action brought by Tousa's creditors' committee following the filing of its Chapter 11 cases in January 2008 during the wake of the housing meltdown.

Background

In July 27, 2007, faced with the immediate entry against it of a $421 million judgment, Tousa (the Parent) entered into a deal to settle a litigation commenced by a group of lenders (the Transeastern Lenders) that had financed a failed joint venture undertaken by the Parent (the Transeastern Settlement). In order to fund the settlement, the Parent borrowed the settlement funds (the New Loan) from a new group of lenders referred to in the decisions as the New Lenders. Both the Parent and a number of its subsidiaries (the Subs) were named as borrowers. Though they were not liable to the Transeastern Lenders, each of the already highly leveraged Subs granted liens on all of their assets to secure the New Loan.

The Tousa group was the 13th largest homebuilder in the United States and had grown rapidly in the years before the failed joint venture funded by the Transeastern Lenders. As the Eleventh Circuit noted, "to finance its growth, Tousa borrowed a lot."[6] The Parent had issued nearly a billion dollars in publicly held unsecured bonds and operated using a large unsecured line of credit. Each of the Subs guaranteed the payment of the bonds and credit line. Accordingly, even before the events involving the Transeastern Lenders, the entire Tousa enterprise was of questionable solvency.

In January 2008, just five months after the New Loan was finalized, the Parent and Subs were forced into bankruptcy by the collapse of the U.S. housing market. The official committee of unsecured creditors (the Committee) commenced an adversary proceeding on behalf of the bankruptcy estates of the Subs against both the Transeastern Lenders and the New Lenders seeking to avoid the New Loan and the liens granted by the Subs to the New Lenders as constructively fraudulent transfers. The Committee asserted that the Subs did not receive any value from the New Loan because they were never liable for the loans made to the failed Transeastern joint venture. The Committee also asserted that the New Loan and the liens granted to secure it rendered the Subs insolvent.

By way of legal and factual defenses, the New Lenders and the Transeastern Lenders (collectively, the Lenders) predictably asserted that the Subs were solvent at the time they incurred the obligations and granted the liens under the New Loan. They also argued that the housing collapse could not be foreseen at the time of the New Loan and attempted to support this assertion through several contemporaneous and later expert opinions. The Lenders also argued that the Subs received reasonably equivalent value because they were able to avoid immediate bankruptcy as a result of the New Loan. The Transeastern Lenders argued that they were not "entit[ies] for whose benefit" the liens were transferred or initial transferees from whom the proceeds of the liens could be collected under Bankruptcy Code §550. The Lenders also asserted the "savings clauses" contained in the loan documents in an attempt to salvage portions of the New Loan and liens.

Bankruptcy Court Decision

Based upon extensive findings of fact, the bankruptcy court rejected each of the Lender's defenses and ruled in favor of the Committee. The court held that the Tousa Subs were insolvent at the time of the transfers and rejected all of the expert testimony gathered by the Lenders at the time of the New Loan and before trial. The bankruptcy court found that the Lender's experts' opinions were merely self-serving and at odds with reality. The court also held that the Subs did not receive any direct tangible benefits from the New Loan and, accordingly, could not have received reasonably equivalent value.

The bankruptcy court rejected the Transeastern Lenders' argument that they were not "entities for whose benefit" the liens were transferred. The court stated that "[t]he plain meaning of the statutory language encompasses the Senior Transeastern Lenders. The new loans, and the liens securing those loans, were undertaken for the express purpose of resolving the claims of the Transeastern Lenders [and payment of those claims] was expressly required by the loan agreements…."[7]

Much to the dismay of many in the lending community, the bankruptcy court also held that the "savings clauses" in the loan documents were invalid. Savings clauses are commonly included in commercial loans and usually provide that to the extent a court finds a transfer is constructively fraudulent, either because the borrower was rendered insolvent or did not receive reasonably equivalent value, that the transaction should be enforceable to the extent that it was not a fraudulent transfer. The bankruptcy court did partially base its decision to invalidate the savings clauses in the New Loan on its narrow finding that the Subs were already insolvent at the time of the New Loan and, therefore, the savings clause could not save any value for the Lenders. The court, however, also made the sweeping holding that savings clauses are per se invalid under §541(c)(1)(B) of the Bankruptcy Code as ipso facto provisions and are void and against public policy as an impermissible attempt to draft around fundamental portions of the Bankruptcy Code.

The bankruptcy court ordered sweeping remedies against the Lenders totaling nearly $500 million dollars in disgorgements and penalties. Specifically, the court required that the Transeastern Lenders disgorge the over $400 million dollars they were paid through the Transeastern Settlement, that the New Lenders disgorge all of their fees, avoided each of the liens granted by the Tousa Subs to the New Lenders and that the New Lenders compensate the Subs estates for any diminution in value that the liens caused.

District Court Decision

On appeal, the District Court for the Southern District of Florida issued an unusually forceful reversal and quashed the bankruptcy court's opinion. The district court criticized the bankruptcy court for overly narrowing the definition of "value." It held that "value" is not solely measured by the tangible benefits received by a borrower, but can also include intangible benefits such as the ability to avoid bankruptcy. Using this broad definition of value, the district court found that the Subs received reasonably equivalent value in exchange for the liens securing the New Loan.

The district court also held that the transfer of the loan proceeds from the New Lenders to the Transeastern Lenders was not a transfer of property of the Subs but rather a transfer of property of the Parent. Accordingly, the court determined that the Committee, could not prove that the relevant transfers were transfer of property of the debtor and could thus not avoid the transfers to the Transeastern Lenders. The court also rejected the bankruptcy court's reading of §550 and held that the Transeastern Lenders subsequent transferee was protected by the defense of "good faith."

Eleventh Circuit Decision

The U.S. Court of Appeals for the Eleventh Circuit reversed the district court and reinstated the bankruptcy court's holdings. The Eleventh Circuit did not wholly reject the district court's holding that subsidiaries can receive value in the form of indirect benefits. It found, however, that, in this particular case, the bankruptcy court did not err in finding that the Tousa Subs did not receive reasonably equivalent value. According to the Eleventh Circuit, Tousa was already too distressed to save at the time of the New Loan and, accordingly, the Subs did not receive any benefit from the New Loan. The court stated that a corporation is not "a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[8]

The Eleventh Circuit also held that the Transeastern Lenders were "entit[ies] for whose benefit" the transfer of the liens was made and, therefore, entities from which the proceeds of such transaction could be recovered. Like the bankruptcy court, the Eleventh Circuit relied on the "plain language" of the statute in making the §550 holding and noted that the loan documents required the payment of the loan proceeds to the Transeastern Lenders. The Eleventh Circuit also summarily dismissed the Transeastern Lenders' argument that the bankruptcy court's reading of §550 would "drastically expand the pool of entities that could be liable for any transaction" calling the argument "unsubstantiated."

The Eleventh Circuit remanded to the district court the question of the appropriateness of the bankruptcy court's remedies.

Lessons From 'Tousa'

Many practitioners and commentators have expressed great alarm in response to the Eleventh Circuit's *Tousa* decision, asserting that it intrudes on the common practice of subsidiaries incurring obligations for the benefit of their parent corporations. The decision, however, is really about nothing more than transfers of liens from already insolvent or questionably solvent subsidiaries to pay off an indebtedness of a parent teetering on the brink of bankruptcy. Even if it is a common practice for solvent subsidiaries to incur debt solely for the benefit of their parents, the notion that upstream guarantees and lien transfers by subsidiaries are fraudulent if the subsidiary is insolvent or rendered insolvent and does not receive reasonably equivalent value is not novel. The Tousa decisions should serve to reinforce the reality that lenders must conduct serious investigations into the solvency of an entire corporate enterprise and ensure that all insolvent parties obligating themselves on a loan or pledging assets receive value when lending to troubled companies.

Specifically, the *Tousa* decisions reinforce these practical lessons for lenders and bankruptcy practitioners:

• ***Subsidiaries that are insolvent or are rendered insolvent must receive sufficient value.*** Any party lending to a parent corporation based on the assets of its subsidiaries should ensure that any insolvent subsidiary is either receiving "money or money's worth" in tangible benefits or "indirect benefits" equal to the value the subsidiary is transferring, such as a material difference in the subsidiaries' ability to stave off bankruptcy or receive other benefits like reduced taxes. Courts following the Eleventh Circuit's *Tousa* decision do not have carte blanche to disregard all arguments that debtor subsidiaries received indirect benefits. If the *Tousa* decisions are any indication, however, courts will not entertain sweeping assertions of indirect benefits.

• ***Savings clauses are of questionable value.*** The bankruptcy court's holding that all savings clauses are invalid ipso facto clauses or void against public policy initially seems drastic. Until another court addresses the issue, however, lenders should be careful not to rely on the effectiveness of savings clauses. Regardless whether the savings clause holding of the bankruptcy court is overturned, as its opinion demonstrates, savings clauses will never save a loan or guaranty where the debtor is insolvent at the time of the transaction or receive no value from the transaction.

• ***The corporate form matters.*** The *Tousa* decisions place great importance on the separateness of the Subs from the Parent. There is no reason to believe that bankruptcy courts will not apply the same formality when evaluating the solvency of each member of a corporate group. The solvency of one subsidiary, or even the group as a whole, will not prevent a court from avoiding a transfer from a separate insolvent subsidiary.

• ***Loans to insolvent corporate families are not without risk.*** Although bankruptcy courts generally encourage pre-bankruptcy efforts by lenders to extend financing to struggling debtors in a good faith effort to avoid bankruptcy, if the Eleventh Circuit's *Tousa* decision is any indication, courts will not be sympathetic to arguments based on sweeping public policy declarations that lenders must be free from risk. Courts will not rewrite the Bankruptcy Code simply to protect secured lenders that do not think they should be subject to fraudulent transfer attacks.

• ***Lenders' fees are at risk.*** Although not addressed in the district or circuit court decisions, the remedies imposed by the bankruptcy court should serve as a warning to all parties to a fraudulent transfer will face liability. A particular item of worry should stem from the fact that is that the bankruptcy court required the New Lenders to give up all of their fees and found them liable for the diminution in value the subsidiaries suffered as a result of the avoided liens.

• ***Lenders being repaid also need to perform diligence.*** In view of *Tousa*, lenders being repaid on outstanding loans must understand the source of their repayment to assess the risk of disgorgement. The Eleventh Circuit held that the Transeastern Lenders should have known the lien transfers in question were made for their benefit because both the New Loan and the Transeastern Settlement required that the New Loan proceeds be used to fund the settlement and, therefore, were not entitled to the good faith defense as a subsequent transferee. The Eleventh Circuit was unconcerned that this ruling imposes too high a burden on existing lenders, stating that "[i]t 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."[9] If the *Tousa* decisions are any indication, at least in the Eleventh Circuit lenders will not be able to assert a defense based upon their willful blindness when they are repaid from the proceeds of a fraudulent transfer specifically made for their benefit.

1. Although some portions of the *Tousa* case remain active in the Southern District of Florida, on July 23, 2012 the Eleventh Circuit declined to rehear the *Tousa* appeal en banc, ensuring that the defendant will face some liability for the claims asserted by the creditors' committee.

2. *Official Committee of Unsecured Creditors of Tousa v. Citicorp North America (In re Tousa)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

3. *3V Capital Master Fund v. Official Committee of Unsecured Creditors of Tousa (In re Tousa)*, 444 B.R. 613 (S.D. Fla. 2011).

4. *Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re Tousa)*, 680 F.3d 1298 (11th Cir. 2012).

5. Id. at 1301.

6. Id.

7. *In re Tousa*, 422 B.R. 783, 870 (Bankr. S.D. Fla. 2009).

8. *Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re Tousa)*, 680 F.3d 1298, 1312 (11th Cir. 2012).

9. *In re Tousa*, 680 F.3d at 1315.