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Creditor's Rights: Commercial Lenders Can Breathe Easier After *In re Tousa Inc.*

BY RONALD S. GART AND TOBI L. PINSKY

In a case profound for what the court did not do, the U.S. District Court for the Southern District of Florida in *3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of Tousa Inc. (In re Tousa Inc.)*,[1] permitted commercial lenders to breathe a collective sigh of relief. In short, the district court reversed the earlier and controversial decision of the bankruptcy court and found that (i) commercial lenders (existing Tousa lenders) who obtained proceeds of new loans made by third-party lenders (new lenders) to Tousa Inc. (Tousa) and certain of its subsidiaries, who themselves were not the beneficiaries of or liable on the repaid indebtedness, were not obligated to disgorge those proceeds on a theory of fraudulent transfer under Bankruptcy Code Section 548, and (ii) new liens granted in favor of the new lenders were not voidable transfers.

Since October 2009, when the U.S. Bankruptcy Court for the Southern District of Florida ordered the existing Tousa lenders to return the proceeds used to repay their defaulted loan and voided the security interests granted to the new lenders, the financial community has remained on edge.[2] At the time, commercial lenders were already unsettled. The title insurance industry had pulled in its reigns by refusing to issue ''Creditors Rights Endorsements,'' lenders had to cope with a growing portfolio of distressed assets, and then, suddenly lenders had to face a new reality: disgorgement.

Facts and Procedural History

Tousa (along with several subsidiaries) borrowed funds from the existing Tousa lenders under a $675 million loan facility for the purpose of land development and home building (Tousa facility). Ultimately, this loan went into default and a settlement agreement was reached whereby Tousa and other subsidiaries of Tousa (subsidiaries) borrowed $500 million under a new credit facility from the new lenders and used those proceeds to pay the Tousa facility. Tousa required that the

Ronald S. Gart is a partner in the Real Estate Practice Group of Seyfarth Shaw. He is the Chair of the Washington, D.C., Real Estate Practice and focuses his practice on the intricate aspects of commercial real estate. Gart has extensive knowledge in real estate development, real estate finance, real estate lending, asset management, asset purchase and sales, commercial leasing, mixed-use development and planned communities, including condominium ownership. Gart counsels investors in joint ventures and providers of mezzanine debt, as well as participants in the community development investment arena.

Tobi L. Pinsky is an associate in the Chicago office of Seyfarth Shaw. She concentrates her practice in transactional real estate law and represents institutional property owners, investors, and developers in all aspects of acquisition, financing, development, and leasing of various property types, including retail, office, multifamily residential, industrial, hospitality and healthcare facilities locally and throughout the United States.

[1] S.D. Fla., No. 10-60017-CIV/GOLD, 2/11/11 (23 BBLR 245, 3/3/11).

[2] *Official Committee of Unsecured Creditors of Tousa Inc. v. Citicorp North America Inc. (In re Tousa Inc.)*, Bankr. S.D. Fla., Adv. Pro. No. 08-1435 (JKO), *order entered* 10/13/09 (21 BBLR 1483, 10/22/09).

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loan proceeds be paid to the existing Tousa lenders while the subsidiaries pledged their assets to the new lenders pursuant to the new credit facility (subsidiaries' facility).

Following a Chapter 11 filing by Tousa Inc. and the subsidiaries, Tousa's unsecured creditors sought to invalidate (i) approximately $500 million in liens that the subsidiaries granted to the new lenders, (ii) over $400 million paid to the existing Tousa lenders, and (iii) other relief.

The unsecured creditors won on all claims in the bankruptcy court. The bankruptcy court found that the subsidiaries did not receive (i) ''property'' in exchange for their financial obligations because the proceeds of the subsidiary's facility were delivered directly to the existing Tousa lenders or (ii) ''reasonably equivalent value'' in exchange for their obligations by pledging assets to the new lenders.

District Court to the Rescue

On February 11, 2011, the district court decided that (i) the existing Tousa lenders could not be compelled to disgorge to the subsidiaries funds paid by Tousa to satisfy legitimate uncontested debt where the subsidiaries did not control the transferred funds, and (ii) the new lenders were not liable for disgorgement of liens where the existing Tousa lenders received no direct and immediate benefit from the transfer of the security to the new lenders.

In short, the district court determined that even though Tousa and the subsidiaries were co-borrowers under the subsidiaries' facility, Tousa directed the proceeds to be paid to the existing Tousa lenders, and, as such, the subsidiaries did not have ''control'' over the funds. Because there was no control over the funds by the subsidiaries, there could be no voidable transfer of the funds to the existing Tousa lenders.

The district court also determined that the liens in favor of the new lenders were not voidable. Critical to the district court's ruling was its analysis that the subsidiaries received indirect benefits from the subsidiaries' facility sufficient to be considered of ''reasonably equivalent value.''[3] As such, even though the subsidiaries may have been insolvent as a consequence of the subsidiaries' facility, there was no fraudulent transfer. As part of its analysis, the court, relying on the Third and Eleventh Circuits, concluded that ''property'' could be in the form of economic benefits and need not be tangible.[4]

The district court concluded that the bankruptcy court incorrectly lumped the transactions among the subsidiaries and the new lenders, Tousa, and the existing Tousa lenders into one transaction when there were three distinct transactions (a) Tousa causing the subsidiaries to pledge collateral, (b) new lenders providing funds to Tousa in exchange for the collateral, and (c) Tousa repaying its lenders. Because the court distinguished between the three aspects of the transaction, it distinguished between direct and indirect transfers. Finding there were no direct transfers (i.e., liens) by the subsidiaries to the existing Tousa lenders, but rather a transfer only to the new lenders, the existing Tousa lenders received no benefit from the pledge of security and the liens to the new lenders could not be avoided.

Conclusion

While it is likely that the ruling will be appealed (there are several issues already on appeal and being considered by other courts), this ruling is instructive on the premium to be paid in conducting due diligence on the sources of repayment and in structuring workouts. *In re Tousa Inc.* is no small lesson on managing risks for commercial lenders.

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[3] Indirect benefits included the following: avoidance of default, avoidance of bankruptcy and, ultimately, the ability to continue operations.

[4] The court also agreed with the existing Tousa lenders that only ''minimal'' value was necessary because the loan proceeds were not within the subsidiaries' control.

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