Thursday, February 17, 2011

3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.), (S.D. Fla. Feb. 11, 2011):

"Value" is not enough.

On February 11, 2011, District Court Judge Alan S. Gold overturned a widely discussed bankruptcy court order requiring lenders to Tousa, Inc. (the "Transeastern Lenders") to disgorge, as fraudulent transfers, monies that they received in repayment of an antecedent debt, and to pay prejudgment interest for a total disgorgement of more than $480 million dollars.

Perhaps the most notable aspect of the District Court's opinion was Judge Gold's finding that a group of related debtors, known as the "Conveying Subsidiaries," received reasonably equivalent value in exchange for granting liens that supported new loans. The proceeds from the new loans were paid to TOUSA, the ultimate parent of the Conveying Subsidiaries. TOUSA, in turn, paid the proceeds to the Transeastern Lenders. The Conveying Subsidiaries had no outstanding debts to the Transeastern Lenders, but the District Court nevertheless found that the Conveying Subsidiaries received reasonably equivalent value for the grant of the liens and the incurrence of more than $450 million of debt, the proceeds of which it did not retain.

In our view, that conclusion was wrong.

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Reasonably Equivalent Value: A Two-Step Inquiry

The District Court relied heavily on the often-cited opinion of the Court of Appeals for the Third Circuit in *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L. (In re R.M.L.)*, 92 F.3d 139 (3d Cir. 1996). There, the Third Circuit observed that, "so long as there is some chance that a contemplated investment will generate a positive return at the time of the disputed transfer, we will find that value has been conferred." *Id*. at 152.

Guided by *In re R.M.L.*, the District Court in *TOUSA* found that the Conveying Subsidiaries received value because the payment to the Transeastern Lenders left TOUSA, and hence the Conveying Subsidiaries "in a better position to remain as going concerns than they would have been without the settlement." Op. at 80.

But *In re R.M.L.* stresses that determining "reasonably equivalent value" is a two-step inquiry. First, determine if the debtor received value. Second, determine if the value is reasonably equivalent to the transfer. *Id*. at 149.

In *In re R.M.L.*, the Third Circuit upheld the bankruptcy court's finding that the "value," while it existed (satisfying the first step), was not reasonably equivalent (failing the second step): "The bankruptcy court concluded that while a debtor reasonably might pay $390,000 in fees for a *real chance* to obtain a $53 million credit facility, the commitment letter at issue in this case was so conditional that it provided Intershoe with little chance, if any, to obtain the loan it sought." *Id.* at 154.

In *TOUSA*, by contrast, the District Court provided virtually no reason to believe that the value the Conveying Subsidiaries received was "reasonably equivalent" to the transfer. It might be worth something to hold off bankruptcy, but is it worth incurring $450 million in debt?

In finding that the Conveying Subsidiaries received "an enormous economic benefit," Op. at 80, from the increased chance of survival, the District Court essentially assumed that survival out of bankruptcy is

almost priceless, worth any cost. That view stems from the intuitive, but wrong, notion that bankruptcy always destroys value, which is not so. *See, e.g.*, Gregor Andrade and Steven N. Kaplan, "How Costly is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed," *Journal of Finance* 53, October 1998, 1443-1494.

No doubt there are administrative costs associated with bankruptcy, and avoiding such expenses is value enhancing, all else equal. But the District Court never quantified the costs of bankruptcy to the Conveying Subsidiaries, and it is extremely unlikely that such costs could approach $450 million.

And the relevant benchmark is not even the total costs of bankruptcy. Rather, it is the value of the expected reduction in those costs that the new loans provided. It is almost inconceivable that the expected reduction was within even an order of magnitude of $450 million.

Empirical estimates, such as those made by Andrade and Kaplan, cited above, of the costs of financial distress rarely exceed 10-20% of the firm's value before entering financial distress. Discounting by the small additional chance of survival that the new loans provided, it is virtually certain that the Conveying Subsidiaries did not receive "reasonably equivalent" value. While the District Court was surely correct to reject a demand for mathematical precision in the calculation of reasonable equivalence, Op. at 84, there was no apparent support for the assertion that the Conveying Subsidiaries received benefits of "immense economic value." Op. at 85.

On appeal, the Eleventh Circuit might remand to the bankruptcy court to determine whether avoiding bankruptcy was worth agreeing to incur a $450 million liability. This poses a factual question that the District Court was poorly equipped to decide in the first instance.

Otherwise, findings such as the District Court made here risk becoming the evil twin of "deepening insolvency." In that theory, debtors have argued that additional debt that prolongs the life of the company is always bad for the company. *See, e.g.*, J.B. Heaton, Deepening Insolvency, 30 Iowa J. Corp. L. 465 (2005). The District Court's finding stakes out the opposite view: additional debt that prolongs the life of the company is always good for the company. Neither view is well grounded in law or fact.

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