

Beware of Debtors Bearing Gifts: Eleventh Circuit Upholds TOUSA Bankruptcy Decision

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Sleep better at night knowing that the loan you made to your borrower is supported by collateral from the borrower's subsidiaries? You may want to keep one eye open. On May 15, 2012, the U.S. Court of Appeals for the Eleventh Circuit upheld a bankruptcy court opinion that reinforces lender liability for fraudulent transfers in subsidiary-supported loans. The Eleventh Circuit upheld the opinion of the U.S. Bankruptcy Court for the Southern District of Florida in *In re TOUSA, Inc.*, and overruled a contrary opinion by the U.S. District Court. The Eleventh Circuit's opinion should give pause to lenders that rely on subsidiary liens for loans made to parent companies.

The facts of TOUSA are fairly simple: TOUSA, a nationwide manufacturer of housing, was deeply in debt after issuing more than \$1 billion of public bonds, most of which were guaranteed by certain of its subsidiaries (Conveying Subsidiaries), as well as having borrowed funds under a revolving line of credit for which the same subsidiaries were jointly and severally liable. TOUSA further incurred debt as part of a failed joint venture for which it borrowed substantial funds from a series of lenders (dubbed the "Transeastern Lenders" by the Eleventh Circuit).

When the real estate market downturn occurred in 2007, the Transeastern Lenders pressed for repayment from TOUSA and its joint venture partner, alleging total damages in excess of \$2 billion. TOUSA then executed settlements with the Transeastern Lenders that required TOUSA to pay more than \$421 million to them. In order to pay the settlement, TOUSA incurred even more debt in the form of two new syndicated loans, one for \$200 million and the other for \$300 million, each to be secured by first and second liens on the assets of the Conveying Subsidiaries and TOUSA. The new debt funds were received by a TOUSA subsidiary, but per contracts controlling the transaction, the subsidiary directly forwarded \$421 million of these funds to the Transeastern Lenders. The Conveying Subsidiaries were not previously liable on the debts owed by TOUSA to the Transeastern Lenders. Six months later, TOUSA and the Conveying Subsidiaries filed for bankruptcy.

As part of the bankruptcy case, the Committee of Unsecured Creditors (Committee) challenged as a fraudulent conveyance the grant by the Conveying Subsidiaries of collateral to support the \$500 million in additional debt incurred by the TOUSA parent company. The U.S. Bankruptcy Code allows a committee (or a bankruptcy trustee) to challenge and undo any transfer made prior to the bankruptcy for which the debtor received "less than a reasonably equivalent value in exchange for such transfer" and during which the debtor "was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation."

The Bankruptcy Code also allows the same parties to recover, for the benefit of the debtor's estate, property transferred, or the value of such property, from "the initial transferee of such transfer or an entity for whose benefit such transfer was made." The Committee challenged the grant of otherwise-unburdened collateral by the Conveying Subsidiaries to support the new loan, and also challenged the receipt of the loaned funds by the Transeastern Lenders as an entity "for whose benefit" the transfer was made.

The Bankruptcy Court agreed with the Committee, finding that the Conveying Subsidiaries received less than equivalent value for the collateral that they provided in support of their parent company's loan obligations. The Bankruptcy Court questioned what value the Conveying Subsidiaries received when compared to the binding of all their assets in support

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of loan funds that they ultimately never controlled or received. The Bankruptcy Court also found that the Transeastern Lenders were entities from whom the Committee could recover the value of the property transferred (namely, the \$421 million in loan funds). The result of the Bankruptcy Court's opinion was that the liens on the assets of the Conveying Subsidiaries were undone, and the Transeastern Lenders were forced to disgorge over \$400 million to the debtors' bankruptcy estates, plus interest and fees.

On appeal, the U.S. District Court reversed the Bankruptcy Court, noting that the Conveying Subsidiaries received a number of benefits from their pledge of their assets in support of the parent's loan. These included the avoidance of numerous other defaults and an ultimate bankruptcy should the TOUSA parent company default in its obligations to the Transeastern Lenders. The District Court notes that "reasonably equivalent value" can include indirect benefits such as an entity's continued existence as a going concern and the avoidance of bankruptcy. The District Court also found that the Transeastern Lenders could not be liable for receiving the loan funds as they were subsequent, and not direct, transferees of the funds.

The Eleventh Circuit reversed the District Court and affirmed the Bankruptcy Court's ruling. The Eleventh Circuit upheld the Bankruptcy Court's finding that the Conveying Subsidiaries did not receive equivalent value for providing their assets as collateral. In doing so, the Eleventh Circuit noted that "not every transfer that decreases the odds of bankruptcy for a corporation can be justified" and that the potential benefits of the transaction were nowhere near the expected costs. "The opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden. After all, there is no reason to treat bankruptcy as a bogeyman, as a fate worse than death." The Eleventh Circuit reiterated the Bankruptcy Court's notion that the mere avoidance or delay of default and/or a bankruptcy was not enough of an "equivalent benefit" to justify the massive amount of leverage that the Conveying Subsidiaries took on in support of their parent company.

The Eleventh Circuit also found that the Transeastern Lenders were entities from which the value of the transfers could be recovered. Irrespective of the fact that the loan funds were received by a TOUSA subsidiary and then forwarded to the Transeastern Lenders, the Eleventh Circuit held that the Transeastern Lenders were entities "for whose benefit such transfer was made," a phrase that expands the reach of fraudulent transfer (and preference) laws to recipients beyond the initial transferee.

The Eleventh Circuit makes clear its intent in a passage found late in its opinion: "[E]very creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars from someone other than its debtor." In other words, if you are a creditor, beware of subsidiaries bearing gifts.

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