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Warning to Lenders that Do Business with Distressed Companies

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday June 6, 2012

Editor's Note: The following post comes to us from Harold S. Novikoff, partner in the Restructuring and Finance Department at Wachtell, Lipton, Rosen & Katz, and is based on a Wachtell Lipton memorandum by Mr. Novikoff, David C. Bryan, and Emil A. Kleinhaus.

In a significant decision for lenders to distressed companies, the United States Court of Appeals for the Eleventh Circuit has reinstated a decision by the Bankruptcy Court for the Southern District of Florida to unwind a secured loan transaction on fraudulent transfer grounds. *In re TOUSA Inc., No. 11-11071 (11th Cir. May 15, 2012)*.

As discussed in our prior memos (*Bankruptcy Court Voids Subsidiary Guaranties and Liens as Fraudulent Transfers, November 2, 2009*, and *Controversial Fraudulent Transfer Ruling Reversed on Appeal, February 18, 2011*), *TOUSA* involved a parent company that in July of 2007 caused certain of its subsidiaries to guarantee and secure $500 million in new secured debt, which was used to fund a litigation settlement with a pre-existing unsecured lender group to which the parent had been obligated but the subsidiaries had not. The bankruptcy court determined that the transaction was a fraudulent transfer as to both the new lenders and the lenders who were repaid, concluding that the subsidiaries had not received "reasonably equivalent value" for securing and guaranteeing loans used to repay parent company debt. In the view of the bankruptcy court, because the challenged transaction made it "inevitable" that the subsidiaries would file for bankruptcy, as they ultimately did in January 2008, the subsidiaries did not receive value from the transaction, even though it permitted them to forestall an immediate bankruptcy that would have resulted from an adverse judgment against the parent company triggering defaults on over $1 billion of debt that the subsidiaries had guaranteed. *See In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

The district court reversed the bankruptcy court's judgment against the lenders that received the proceeds of the new loans. (A separate appeal on behalf of the new lenders was stayed pending resolution of the repaid lenders' appeal). The district court concluded that, as a matter of law, each subsidiary received significant value in exchange for the liens and guaranties it granted,

including the “opportunity to avoid default” and “improve its prospects of avoiding bankruptcy,” and strongly criticized the bankruptcy court for reviewing the transaction “through the lens of retrospection.” Separately, the district court also held that the original lenders could not be liable for the liens granted to the new lenders, because they were not recipients of the liens or “entities for whose benefit” the liens were granted, as required for liability under section 550(a)(1) of the Bankruptcy Code. *See In re TOUSA, Inc.*, 444 B.R. 613 (S.D. Fla. 2011).

The court of appeals has now reversed the district court and reinstated the judgment of the bankruptcy court. Contrary to the district court, the court of appeals concluded that the bankruptcy court’s ruling on “reasonably equivalent value” was entitled to deference, because it was “largely a question of fact.” Reviewing the bankruptcy court’s decision for clear error, the court of appeals credited the bankruptcy court’s finding that, at the time of the challenged transaction, TOUSA’s projections were unachievable and a bankruptcy filing was assured. The court of appeals also held that the repaid lenders were indeed “beneficiaries” of the liens granted to the new lenders, because the purpose of the new loan transaction, including the liens, was to facilitate payment to the old lenders. Rejecting the argument that lenders need not investigate the source of funds being used to repay them, including the involvement of their borrower’s subsidiaries, the court of appeals noted that “every creditor must exercise some diligence when receiving payment from a struggling debtor.” Accordingly, the court remanded the case to the district court to consider the proper remedies.

Notably, because the court of appeals accepted the bankruptcy court’s factual finding that bankruptcy was “inevitable” after the new loan transaction, it did not explore the extent to which avoidance of bankruptcy and similar “indirect benefits” may serve as reasonably equivalent value in other factual situations. *TOUSA*, accordingly, is not necessarily at odds with case law, relied upon by the district court, holding that “value” under the Bankruptcy Code can encompass intangible benefits, including the opportunity for a turnaround.

Nonetheless, *TOUSA* represents an important warning to lenders that do business with distressed companies. Although cases in this area are highly fact-dependent, *TOUSA* shows that financing transactions in close proximity to a bankruptcy may be subjected to close scrutiny, where a bankruptcy court may draw conclusions about the debtor’s financial condition based on evidence that was not available to lenders. *TOUSA* also shows that recipients of loan repayments can potentially be sued not only for the repayments themselves, which are often protected because they discharge a valid debt, but also for the borrower’s grant of liens or obligations to new lenders funding the repayments. It is likely that *TOUSA* will be cited by trustees, debtors and creditors’ committees that pursue fraudulent transfer claims or threaten such claims to gain bargaining leverage in Chapter 11 plan negotiations.