Commercial Financial Services Brief: Subsidiary Liens Securing Debt of Corporate Parent Avoided as Fraudulent Transfers

May 21, 2012

On May 15, 2012, the Court of Appeals for the Eleventh Circuit affirmed two key rulings made by a Florida Bankruptcy Court in the long-running bankruptcy case of TOUSA, Inc., once one of the largest homebuilders in the country. The Bankruptcy Court had avoided—as fraudulent transfers—the liens granted by TOUSA's subsidiaries (the Subsidiaries) to new lenders (the New Lenders) that provided $500 million in financing for TOUSA to payoff debt that was owed by TOUSA, but not the Subsidiaries, to then existing lenders (the Old Lenders).

The first key Bankruptcy Court ruling that was affirmed was that the Subsidiaries had not received reasonably equivalent value for the liens they had granted to the New Lenders to secure the loans to payoff the existing debt to the Old Lenders, for which the Subsidiaries had no liability. The Court of Appeals acknowledged that, for fraudulent transfer purposes, the "value" received by the Subsidiaries could be interpreted narrowly (i.e., only direct value to the Subsidiaries), or more broadly to include indirect value such as preventing the immediate bankruptcy of the parent, in determining whether the Subsidiaries had received reasonably equivalent value. Ultimately the Court of Appeals declined to adopt either interpretation of value because the Bankruptcy Court had found that, even if all of the purported benefits of the transaction were legally cognizable as value, the Subsidiaries still had not received value that was reasonably equivalent to the value of the liens they had granted. The Court of Appeals noted that the Bankruptcy Court's finding of a lack of reasonably equivalent value was "largely a question of fact" which would be accorded considerable deference by the Court of Appeals. In upholding the Bankruptcy Court's finding regarding value, the Court of Appeals affirmed the avoidance of liens granted by the Subsidiaries to the New Lenders.

The second key ruling affirmed by the Court of Appeals was the Bankruptcy Court finding that the Old Lenders, who were paid with the proceeds of the loans from the New Lenders, were entities who received the benefit of the liens granted by the Subsidiaries to the New Lenders. The Bankruptcy Court had rejected the Old Lenders' primary argument that they were merely subsequent transferees of the proceeds of the loans secured by the liens from the Subsidiaries and therefore not truly someone "for whose benefit" the

liens had been granted. The Court of Appeals affirmed the Bankruptcy Court's conclusion noting that, among other things, the loan agreements with the New Lenders expressly required that the loan proceeds be used to payoff the Old Lenders. In affirming the Bankruptcy Court's ruling regarding the Old Lenders as beneficiaries of the Subsidiary liens, the Court of Appeals affirmed that the payments received by the Old Lenders on the then existing debt would be returned.

While the Eleventh Circuit ruling does not resolve all aspects of the Bankruptcy Court's decision, it certainly will renew the debate over structural risks for lenders providing financing to businesses which are part of a larger corporate group. Lenders are encouraged to discuss these and other risks with their legal advisors prior to making loans within a group of related corporate entities.