The TOUSA Tussle

Recent Decision Could Impact Financially Challenged Borrowers

By JAMES SHEILS

A recent Court of Appeals decision interpreting the Bankruptcy Code may result in limiting the ability of struggling commercial borrowers to obtain replacement financing from a new lender.

TOUSA Inc. was the 13th-largest homebuilding business in the U.S., with operations in Florida and many other states. It incurred significant debt to expand its business, largely through acquisitions; one such purchase involved a Florida entity. While TOUSA had numerous subsidiaries, and those subsidiaries had guarantied other debt owed by TOUSA, the subsidiaries did not guaranty the debt incurred to the original lenders providing the Florida acquisition financing.

The subsidiaries had not received any loan proceeds, but the new lenders argued that the funding they provided allowed TOUSA, and as a result the subsidiaries, to continue in business, even if the business ultimately failed.

The economic downturn, especially affecting real estate, significantly impaired TOUSA's business, including the Florida entity it had acquired. The original lenders who provided the acquisition financing brought suit; as part of a settlement, TOUSA borrowed in excess of $470 million from a group of new lenders, whose funds were used to pay the original lenders. As collateral for the rescue loan, the new lenders obtained guaranties from TOUSA's subsidiaries, secured by the assets of those subsidiaries. Those assets constituted collateral which had not secured the original lenders' financing.

Despite the new funding, TOUSA ultimately sought Chapter 11 protection. The security interests of the subsidiaries were challenged by the creditors' committee as "fraudulent conveyances," based upon a claim that the subsidiaries did not receive "reasonably equivalent value" in exchange for the liens granted to the new lenders. The subsidiaries had not received any loan proceeds, but the new lenders argued that the funding they provided allowed TOUSA, and as a result the subsidiaries, to continue in business, even if the business ultimately failed.

The Court of Appeals endorsed the original decision of the Bankruptcy Court that 'fair consideration' is a fact-based determination, and that the almost-certain costs of the new loan far outweighed any perceived benefits. An argument that the subsidiaries faced an existential threat absent the new loan was rejected; the court stated that not every transfer that decreases the risk of bankruptcy for a corporation can be justified. The decision almost certainly will result in increased caution by lenders where upstream guaranties are an integral component of the financing.

The loss of the liens securing the new lenders' loans was not the only action addressed by the Court of Appeals. The Bankruptcy Court also required the original lenders to 'disgorge' (i.e. pay back) $403 million received from the new lenders. The disgorgement issue involved a discussion of Section 550 of the Bankruptcy Code, which deals with recovery of property if a 'transfer' is avoided, as was the case with TOUSA's subsidiaries. Section 550 allows recovery of a transfer from the initial transferee or from an entity for whose benefit such a transfer was made. The original lenders had argued that, since the liens went to the new lenders, the original lenders were 'subsequent transferees,' not entities that benefited from the initial transfer. The Court of Appeals disagreed; the loan agreements with the new lenders required the loan proceeds to be paid over to the original lenders.

The case was remanded to the District Court for further action regarding damages; if the initial Bankruptcy Court decision is fully upheld, the unwinding of the refinancing will result in the disgorged funds to be first used to repay the transaction costs for the new loan, then the costs incurred by the creditors committee in bringing and prosecuting the challenge and any decline in the value of the collateral, all before any funds are returned to the new lenders.

The TOUSA decision could complicate the ability of financially challenged borrowers to stay out of Chapter 11 because it raises questions regarding the enforceability, in certain circumstances, of upstream guaranties and highlights risks to lenders who are paid off by a borrower. The benefit to the total enterprise can't be assumed to provide sufficient consideration. It's also likely to increase the scrutiny of debtors/trustees in connection with potential claims to include prior lenders who, it will be asserted, are included in the 'for whose benefit' language of Section 550 of the Bankruptcy Code.

It is possible that further appeals may be taken, or that the 11th Circuit Court of Appeals may decide to have the entire court consider the case (a so-called 'en banc' review), but for now, the tussle with TOUSA may have chilled the air a bit for lenders to distressed businesses. ■

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