May 24, 2012

New Appeals Court Decision in TOUSA Case on Subsidiary Guarantees and Fraudulent Conveyance

Abstract

Last week's federal appeals court decision in the TOUSA bankruptcy litigation provides important guidance on the enforceability of subsidiary guarantees and other upstream credit support, especially in distressed refinancing transactions. It also highlights the risk for outgoing lenders that their repayment may be subject to clawback if the new financing is subject to fraudulent conveyance attack.

Background

Last week, a federal appeals court handed down its decision in the TOUSA bankruptcy litigation, available here. The litigation related to the upstream credit support (guarantees collateralized by liens) provided by TOUSA's subsidiaries to the new lenders in a refinancing of parent-only debt. As participants in the leveraged finance market will remember, the original 2009 decision by the Florida bankruptcy court in this matter received a lot of attention at the time because it held the savings clauses in the subsidiary guarantees to be unenforceable. The bankruptcy court also held in 2009 that the upstream credit support provided by the TOUSA subsidiaries was subject to attack as a fraudulent conveyance because the subsidiaries did not receive reasonably equivalent value in return.

In February 2011, the federal district court quashed many of the bankruptcy court's findings. Last week's decision by the Court of Appeals for the Eleventh Circuit reinstated most of the bankruptcy court's findings and represents the latest chapter in this litigation.

Key Takeaways

- ***Treatment of savings clauses unchanged***. Last week's ruling did not address the bankruptcy court's decision on savings clauses in subsidiary guarantees. There is a separate appeal on that topic that was stayed pending last week's decision. That separate appeal now needs to work its way through the federal courts. We therefore do not expect the customary risk factor disclosure about the 2009 decision to change.
- ***May discourage reliance on indirect economic benefits in distressed situations***. The opinion does not decide if the avoidance of bankruptcy constitutes "reasonably equivalent value" to a subsidiary that will insulate a subsidiary guarantee or other upstream credit support from attack as a fraudulent conveyance. The bankruptcy court had found that indirect economic benefits like the ability to operate as a going concern did not constitute "value" at all. The appeals court left this question open, but deferred to the factual determination of the bankruptcy court. The

bankruptcy court had found that, even if this benefit counted as value received by the subsidiaries, it did not match the value upstreamed to the parent and its creditors by providing the credit support for the new financing.

- ***Risk of 20/20 hindsight***. The decision highlights the risk that whether the subsidiary received reasonably equivalent value at the time it provided the upstream credit support will always be judged in hindsight. It did not help that TOUSA incurred over $400 million in secured debt, ostensibly to avoid bankruptcy, and then filed for bankruptcy within six months. The record also included some unhelpful internal emails and presentations that effectively portrayed the capital structure as unsustainable. The bankruptcy court found that the refinancing, rather than giving the business a new lease of life, merely delayed the inevitable.
- ***TOUSA risk is lower if outgoing lenders had upstream guarantees***. The Bankruptcy Code specifically defines "value" to include the repayment of antecedent debt. It appears, therefore, that providing a new upstream guarantee to take out an existing upstream guarantee yields value to the subsidiary guarantor. Accordingly, the fraudulent transfer risk in this context is most acute where, as in TOUSA, significant new upstream credit support is added in the new financing from subsidiaries that did not guarantee the debt that is being repaid.
- ***Risk of clawback from outgoing lenders in distressed refinancings***. The decision also limits the apparent benefit of funding the repayment of the outgoing lenders through the borrower, as was done in TOUSA. This funds flow is often used to enable the outgoing lenders to claim the status of subsequent transferees taking in good faith, and therefore beyond the reach of the avoidance powers of the bankruptcy court. In TOUSA, the outgoing lenders were required to return that repayment because they were the entities for whose "benefit" (within the meaning of the Bankruptcy Code) the fraudulent upstream transfer of the liens collateralizing the guarantees had been made. The court noted that the agreement for the new loan expressly required that it be used to repay the outgoing lenders and that it was not unreasonable to impose a due diligence burden on the outgoing lenders regarding the source of the funds for their repayment.

A memo prepared by our Bankruptcy and Reorganization Group with a detailed legal analysis of the case is available here.

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