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Legal Alert

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QUESTION: HOW CAN A LOAN RESTRUCTURING WITH NEW COLLATERAL POSSIBLY BE A FRAUDULENT TRANSFER?

ANSWER: LIENS MAY BE SET ASIDE AND LOAN PAYMENTS DISGORGED IF THE PARTIES PLEDGING THE ADDITIONAL COLLATERAL DID NOT RECEIVE VALUE REASONABLY EQUIVALENT TO THE OBLIGATIONS INCURRED.

You would think that curing a $2 billion loan default, restructuring loans and preventing further monetary defaults would be valuable to borrowers. After all, being placed in loan default is seldom a good thing. Nevertheless, certain lenders were chagrined to have their liens set aside and to be required to pay money into the bankruptcy estate of Tousa, Inc. because the entities providing new collateral did not get "reasonably equivalent value" for the new liens. *Tousa, Inc. v. Official Committee of Unsecured Creditors*, 680 F.3d 1298 (11th Cir. 2012).

How did that happen? Well, in 2006, *Tousa* was the thirteenth largest homebuilder in the country. It grew rapidly in the expanding economy. It acquired many smaller homebuilders and paid for the acquisitions with borrowed money.

Unfortunately, by January, 2007, *Tousa* had defaulted on over $2 billion in loans! The subsidiaries of *Tousa* were not responsible for the $2 billion in loans and had not pledged any collateral to secure those loans. Nevertheless, *Tousa* was in danger of having a judgment entered against it for the indebtedness. Such a judgment would have constituted an event of default on more than $1 billion of debt that was guaranteed by the subsidiaries. Triggering a $1 billion default by the subsidiaries seems like something to be avoided!

Tousa settled with the secured lenders and agreed to pay more than $420 million to them. To pay for the settlement, *Tousa* and some of its subsidiaries entered into new loans. Citicorp syndicated two new loans to *Tousa* and some of its subsidiaries. One new loan was for $200 million and was secured by first-priority liens on assets of the subsidiaries and *Tousa*. The second loan was for $300 million secured by second-priority liens. Both loan packages required that the funds be used to pay the $421 million settlement. Bankruptcy for *Tousa* and the subsidiaries was averted (for the time being.)

So why did the original lender have to pay back the money it received and why did the new lenders have to give up their liens?

The Eleventh Circuit Court of Appeals noted:

> Section 548(a)(1)(B) of the Bankruptcy Code provides for the avoidance of "any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred . . . within two years before the date of the filing" of the bankruptcy petition, if the debtor "received less than reasonably equivalent value in exchange for" the transfer or obligation, and the debtor (1) "was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;" (2) "was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;" or (3) "intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured."

In re TOUSA, INC., 680 F.3d 1298 (11th Cir., 2012). The new liens were thus fraudulent transfers and were set aside to the detriment of the new lenders.

The old lenders were benefitted by that fraudulent transfer because they received the funds to pay the old debt. Thus, the court made them pay the money back to the bankruptcy estate. The lenders and the federal district court thought the rulings by the bankruptcy court were crazy! The district court said that the ruling would be "inhibitory of contemporary financing practices. . . ."

There was a great deal of discussion in the case about the meaning of "reasonably equivalent value." Apparently, the bankruptcy court and the court of appeals believed that staving off a $1 billion default was not sufficient value for the loan restructuring!

The Tousa case brings into question every loan modification or restructuring where a third party provides a new guarantee or additional collateral in order to induce the lender to extend or modify the existing defaulted obligation.

The lenders in the *Tousa* case said the ruling "would impose 'extraordinary' duties of due diligence on the part of creditors accepting repayment." The creditors being repaid would need to make sure that the money for repayment was not somehow obtained through a fraudulent transfer. The Eleventh Circuit did not think this was a big deal, however.

> But every 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 by someone other than its debtor.

Really?! I thought the right of a secured creditor to be repaid the money it loaned to the debtor was simpler than that. I guess next time we won't allow any extensions or modifications and will simply foreclose on the collateral. I'm sure that would be better for the debtors!

If you need help with "diligence when receiving payment from a struggling debtor," please let me know.