

Collateral Granted by Subsidiaries to Secure Parent's Debts is Avoided in Bankruptcy: A Cautionary Lesson for Lenders

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TOUSA was a homebuilder that invested in a joint venture known as Transeastern in 2005. Transeastern borrowed \$560 million in a syndicated loan from certain lenders ("Transeastern Lenders"). Later, Transeastern defaulted, and in an effort to settle the default, TOUSA borrowed \$500 million from Citicorp. In connection with the Citicorp loan, TOUSA's subsidiaries (which were not liable to the Transeastern Lenders) pledged their assets to Citicorp. The loan proceeds were used to pay the Transeastern Lenders.

Six months after closing, TOUSA and its subs filed bankruptcies, and the Creditors Committee sought to avoid the security interests by the subsidiaries as fraudulent transfers, as well as the payments to the Transeastern Lenders, alleging that TOUSA and its subsidiaries were insolvent at the time and the subs received no value for the transfers. The bankruptcy court had no difficulty finding that both TOUSA and the subsidiaries were insolvent at the time of the transaction.

The court found that the subsidiaries had not received reasonably equivalent value for their pledges, as is required to sustain the transfers under the fraudulent transfer law. The court rejected arguments that the subsidiaries had received various indirect benefits from the transaction. The court therefore ordered the Transeastern Lenders to return the payments they received.

The court also found that Citicorp had not acted in good faith because it knew that the debtors were insolvent. The court held that the security interests granted by the subsidiaries to Citicorp were therefore avoidable. After subsequent published appeals, the Eleventh Circuit Court of Appeals upheld the bankruptcy court's decision.

The decision ought to be a cautionary lesson for lenders relying on guaranties or pledges of third party assets. The TOUSA risks exist even when the third parties are in fact the borrower's subsidiaries. In order to

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understand the nature of the risk, it is important for lenders to be represented and advised by competent legal counsel.