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A Measured Response to Critics of Delaware Venue

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David B. Stratton

Some have argued recently that Delaware is no longer the "knee jerk" forum of choice for bank-ruptcy filings.[2] The argument is that recent Third Circuit rulings on substantive consolidation, the absolute priority rule and "deepening insolvency" make the Southern District of New York the better venue choice over Delaware. As discussed below, these criticisms fail to carefully analyze the state of the law in these three areas. This article will present a fair and balanced analysis of these areas of the law, which it is hoped will assist practitioners in properly advising their clients about the proper venue to file chapter 11 cases.[3]

Substantive Consolidation after Owens Corning

Recently, certain observers have asserted that in the Third Circuit substantive consolidation may not be used consensually to achieve a negotiated result

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in a chapter 11 case as a result of the recent opinion in *In re Owens Corning,* 419 F.3d 195 (3d Cir. 2005), *cert. denied,* 126 S.Ct. 1910 (2006).[4] These practitioners have suggested that the Third Circuit standard is narrower than the controlling standard in the Second Circuit, as enunciated in *In re Augie/Restivo Baking Co.,* 860 F.2d 515 (2d Cir. 1988).[5] Closer analysis of each of these precedents reveals that this analysis is wrong, as the two circuit court tests are essentially identical and, therefore, *Owens Corning* should not influence decisions about venue.

Commencement of a chapter 11 case creates an estate comprised of all of the debtor's interests in property, which will be administered by the debtor-in-possession (DIP) and which will be used to satisfy claims against its estate. Generally, these assets are not available to satisfy claims of creditors against affiliates of the debtor. However, the equitable doctrine of substantive consolidation will occasionally result in the treatment of a debtor and one or more of its affiliates as a single entity. Through substantive consolidation, inter-entity claims and guaranties of the debtor and its affiliates are eliminated, the assets of the debtor and its affiliates are treated as common assets, and the claims of creditors against the debtor or any of the affiliates are treated as claims against the common assets.[6]

The doctrine of substantive consolidation is evolving, and there is no uniform consensus as to the method of analyzing cases in which substantive consolidation is sought.[7] This *ad hoc* approach is largely responsible for the unsettled nature of the appropriate standards, relevant factors, the weight to be attached to each factor, and the significance of competing considerations offered by those seeking or opposing substantive consolidation. Although various criteria or tests for determining when consolidation is appropriate have

1 The authors wish to thank the following people for their valuable assistance in this article: Chun Jang of Richards, Layton & Finger and Margaret E. Juliano of Morris, Nichols, Arsht & Tunnell LLP.

2 *See* Mayerson, S., Parlin, B., and Zisser, P., "Forum Shopping in the 21st Century," *Financial World Global Restructuring & Insolvency Review 2006* at 28 (2006) (hereinafter "Forum Shopping at...").

3 This article does not attempt to address other aspects of the chapter 11 practice before the Delaware Bankruptcy Court, nor does this article purport to criticize any other jurisdictions, including those in the Second Circuit as a possible chapter 11 venue. Venue decisions must be made on a case-by-case basis, analyzing not only where venue is proper, but also which proper venue is best for the client.

4 *See Forum Shopping, supra* n.2 at 26.

5 *Id.*

6 *See, generally, In re Augie/Restivo Baking Co.,* 860 F.2d at 518.

7 *See, e.g., In re Eagle-Picher Indus. Inc.,* 192 B.R. 903, 905 (Bankr. S.D. Ohio 1996) (decisions in this area are fact-intensive. and factors considered by other courts are of limited use); *In re Crown Mach. & Welding Inc.,* 100 B.R. 25, 27-28 (Bankr. D. Mont. 1989) ("as to substantive consolidation, precedents are of little value").

been applied by the courts, the two most prominent tests have been the D.C. Circuit's *Auto-Train* test from *In re Auto-Train Corp.,* 810 F.2d 270, 276 (D.C. Cir. 1987), and the Second Circuit's *Augie/Restivo* test.

"Substantive consolidation is considered an extreme remedy"[8] and has commonly been described as a power that should be used "sparingly because of the possibility of unfair treatment of creditors."[9] There are, however, a few cases suggesting a "modern" or "liberal" trend toward allowing substantive consolidation that "has its genesis in...the increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity's corporate umbrella for tax and business purposes."[10]

Against this backdrop, the Third Circuit in *Owens Corning* reversed the district court's decision that permitted the consolidation of Owens Corning of Delaware (OCD) with certain wholly owned subsidiaries, some of which had also filed for protection under the Bankruptcy Code.[11] In that case, a syndicate of banks (the "Banks") extended a $2 billion unsecured loan to OCD and certain of its subsidiaries, which was guaranteed by other OCD subsidiaries.[12] The proponents of substantive consolidation sought to have a deemed consolidation "where the plan process would proceed as though assets and liabilities of separate entities were merged, but in fact they remain separate with the twist that the guarantees to the Banks are eliminated."[13] Thus, the elimination of the guarantees would have significantly reduced the distribution to the Banks while enhancing the distribution to other creditors. The court viewed this as "a ploy to deprive one group of creditors of their rights while providing a windfall to other creditors."[14] Such unraveling of pre-petition expectations and bargaining, the court noted, "would cause chaos in the market place."[15]

The Third Circuit, like other courts before it, emphasized that substantive consolidation is an extreme remedy that should be used only in "compelling circumstances calling equity...into play."[16] The court spoke favorably of the Second Circuit's *Augie/Restivo* test, but was critical of the D.C. Circuit's *Auto-Train* test and any standard that would apply a checklist of factors in determining whether or not to consolidate.[17] Instead, in formulating a standard and in determining whether to consolidate, the court emphasized five principles to be advanced:

> 1. Limiting the cross-creep of liability by respecting entity separateness is a "fundamental ground rule." [citation omitted]. As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.
> 2. The harms substantive consolidation addresses are nearly always those caused by *debtors* (and entities they control) who disregard separateness. Harms caused by creditors typically are remedied by provisions found in the Bankruptcy Code (*e.g.,* fraudulent transfer, §§548 and 544(b)(1), and equitable subordination, §510(c)).
> 3. Mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make postpetition accounting more convenient) is hardly a harm calling substantive consolidation into play.
> 4. Indeed, because substantive consolidation is extreme (it may profoundly affect creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Code).
> 5. While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights).[18]

Applying these five principles, the court set forth the following two rationales for consolidating:

> [W]hat must be proven (*absent consent*) concerning the entities for whom a substantive consolidation is sought is that (1) pre-petition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity or (2) post-petition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.[19]

The court stated that the first rationale for consolidation in this disjunctive standard was "meant to protect in bankruptcy the pre-petition expectations of those creditors." Consequently, a *prima facie* case for consolidation "typically exists when, based on the parties' pre-petition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity."[20]

In applying this standard to the facts of the case, the court noted that there was no pre-petition disregard for corporate separateness and no hopeless commingling of the debtors' assets and liabilities.[21] The court also stated that "substantive consolidation should be used defensively to remedy identifiable harms, not offensively to achieve advantage over one group in the plan negotiation process."[22]

Although the decision, in light of the facts, was rather unremarkable, some commentators have criticized the holding as establishing a standard that is too strict. They have stated that this strictness will prevent the future consensual use of substantive consolidation and has made the Third Circuit, including the Delaware Bankruptcy Court, a less-hospitable forum in that regard.[23] This criticism simply ignores the very words of the *Owens Corning* decision where the court specifically stated that substantive consolidation can be done by consent.[24]

In addition, although the Third Circuit standard is stricter than the *Auto-Train* test, as it deals with a contested

8 *See In re Creditors Servs. Corp.,* 195 B.R. 680, 689 (Bankr. S.D. Ohio 1996); *see, also, In re 599 Consumer Elec. Inc.,* 195 B.R. 244, 248 (S.D.N.Y. 1996) (*citing In re Augie/Restivo*); *In re Smith Corona Corp.,* 205 B.R. 712 (Bankr. D. Del. 1996).

9 *See Chemical Bank New York Trust Co. v. Kheel,* 369 F.2d 845, 847 (2d Cir. 1966); *In re Augie/Restivo,* 860 F.2d at 518; *In re Resorts Int'l Inc.,* 145 B.R. 412, 455 (Bankr. D. N.J. 1990).

10 *Eastgroup Prop. v. S. Motel Ass'n. Ltd.,* 935 F.2d 245, 249 (11th Cir. 1991) (*quoting In re Murray Indus.,* 119 B.R. 820, 828-29 (Bankr. M.D. Fla. 1990)); *see also In re F.A. Potts & Co.,* 23 B.R. 569, 571 (Bankr. E.D. Pa. 1982).

11 *See, generally, In re Owens Corning,* 419 F.3d 195.

12 *Id.* at 199.

13 *Id.*

14 *Id.* Curiously, practitioners critical of the *Owens Corning* case merely state that "creditors favored" the elimination of the guarantee claims, without mention of the $2 billion Bank claims. *See Forum Shopping, supra* n.2 at 26.

15 *Id.* at 216.

16 *Id.* at 211.

17 *Id.* at 205-209.

18 *Id.* at 211.

19 *Id.* (emphasis added).

20 *Id.* at 212.

21 *Id.* at 213, 215.

22 *Id.* at 215.

23 *See Forum Shopping, supra* n.2 at 26.

24 *See Id.* at 211.

substantive consolidation, it is virtually the same as the *Augie/Restivo* test, with the end result being that non-consensual substantive consolidation may not be used unless all creditors would benefit.[25] In *Augie/Restivo,* the Second Circuit established a test involving two critical factors: "(1) whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit'...or (2) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[26] Analyzing the two tests objectively, it is apparent that the Third Circuit has essentially adopted the same criteria as the Second Circuit.[27]

Despite the *Augie/Restivo* test, some lower courts in the Second Circuit have attempted to expand the use of substantive consolidation beyond the holding of *Augie/Restivo* to cases in which a creditor relying on separateness would be harmed and other creditors would get a windfall.[28] Of course, these bankruptcy court decisions are not binding precedent. Indeed, this result from a lower court appears to be a direct departure from the *Augie/Restivo* test and the Second Circuit's decision in *In re Flora Mir Candy Corp.,* 432 F.2d 1060, 1063 (2d Cir. 1970), where the court stated, "[w]e doubt that any showing of accounting difficulties would warrant consolidation under such circumstances."

The Third Circuit standard provides more clarity to the case law. The increased predictability of decisions should make it easier—not more difficult, as some commentators contend—for plan proponents and negotiators to reach agreement. Indeed, clarity in the rules to be applied by a court provides greater certainty for all parties involved in the case to formulate a plan.

Finally, substantive consolidation continues to be a viable remedy in the Third Circuit. The equitable doctrine of substantive consolidation should be used as an extreme remedy to correct a harm that is usually caused by debtors. By limiting nonconsensual substantive consolidation to this purpose, the *Owens Corning* decision has increased the level of pre-petition certainty to lending structures commonly used today. Moreover, that certainty should benefit debtors by improved debt pricing. As the Second Circuit in *Augie/Restivo* noted, "lenders' expectations are central to the calculation of interest rates and other terms of loans, and fulfilling those expectations is therefore important to the efficiency of credit markets."[29] The *Owens Corning* decision provides all parties with greater assurance that their pre-petition interests will not likely be ignored when corporate formalities have been observed. As noted by the court, the lending transaction at issue in *Owens Corning* was "the 'deal world' equivalent of 'Lending 101.'"[30] Indeed, such use of separate and distinct but affiliated entities in commercial lending form the backbone of the commercial mortgage backed securities market that reached more than $160 billion in 2005.[31] These pre-petition transactions should not be disturbed absent compelling circumstances. If, however, corporate formalities are ignored and creditors did not reasonably rely on the separateness of the entities involved, then even nonconsensual substantive consolidation remains a viable remedy in the Third Circuit.

The Absolute Priority Rule after Armstrong

Delaware venue critics have also identified *In re Armstrong World Industries Inc.,* 432 F.3d 507 (3rd Cir. 2005), as overly restrictive and that it will cause difficulty in structuring consensual reorganizations.[32] As discussed below, these criticisms are ill-founded.

One of the cornerstones of American reorganization law is the so-called "absolute priority rule." First articulated almost a century ago by the U.S. Supreme Court in *Northern Pac. R. Co. v. Boyd,* 228 U.S. 482 (1913), the rule now is codified in §1129(b)(2) of the Code, 11 U.S.C. §101 *et seq.* Stated simply, the rule provides that unless a class of creditors or owners of an enterprise are to be paid in full under a reorganization plan or vote in favor of the plan, no class of creditors or owners having a junior priority may receive anything under the plan.[33]

As originally formulated, the absolute priority rule required that all creditors be paid in full prior to any distribution to equity.[34] The absolute priority rule now codified in the Code is more flexible. A junior class is precluded from receiving any distribution under the plan only if a senior impaired class votes to reject the plan.[35]

In *Armstrong,* the Third Circuit reviewed an order of the federal district court in Delaware that denied confirmation of a chapter 11 plan of reorganization filed by Armstrong World Industries Inc. Under the plan, general unsecured creditors (Class 6) were projected to receive approximately 59.5 percent of their $1.651 billion in claims, the holders of unsecured asbestos personal injury claims (Class 7) were projected to receive an initial distribution equal to approximately 20 percent of their claims from $1.8 billion in assets to be placed in a trust for Class 7 creditors, and the debtor's parent company (Class 12) was to receive new warrants valued at up to $40 million. It was clear that if Class 6 voted to reject the plan, the distribution to Class 12 would violate the absolute priority rule. To avoid that problem, the plan provided that if Class 6 voted to reject the plan, the new warrants would be distributed to the holders of Class 7 claims, who would then be deemed, by virtue of voting to accept the plan, to have waived the right to receive the new warrants and agreed to contribute the warrants to Class 12 (equity). Class 6 voted to reject the plan and the plan proponents requested "cramdown" as to Class 6.[36] The bankruptcy court recommended that the plan be confirmed, but the district court, not surprisingly, found that the plan violated the absolute priority rule and denied confirmation.[37] Based on its interpretation of the plain meaning of the statutory language and policy considerations, the Third Circuit affirmed the district court: "Allowing this particular type of transfer would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context."[38]

Some practitioners have suggested that the Third Circuit's holding in *Armstrong* represents an overly restrictive interpretation and application of the absolute priority rule that will make it more difficult to achieve consensual reorganizations in the Third Circuit. A better approach is found, it is argued, in

25 *See In re Owens Corning,* 419 F.3d at 211-12; *In re Augie/Restivo,* 860 F.2d at 519 ("substantive consolidation should only be used after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets") (emphasis added).

26 *In re Augie/Restivo,* 860 F.2d at 518 (internal citations omitted).

27 *See In re Owens Corning,* 419 F.3d at 210 ("favor[ing] essentially [the substantive consolidation analysis] of *Augie/Restivo*").

28 *See, e.g., In re Worldcom Inc.,* 2003 Bankr. LEXIS 1401 (Bankr. S.D.N.Y. Oct. 31, 2003).

29 *Augie/Restivo,* 860 F.2d at 518.

30 *In re Owens Corning,* 419 F.3d at 212.

31 *See* Domestic CMBS Volume, www.crenewspage.com/cmsa/CMBS.

32 *See Forum Shopping, supra* n.2 at 27.

33 *See, generally,* Klee, Kenneth N., "All You Ever Wanted to Know About Cramdown under the New Bankruptcy Code," 53 Am. Bankr. Law J. 133 (1979).

34 *See Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106 (1939).

35 *See* 11 U.S.C. §§1124, 1126(c), (d) and (f), and 1129(b)(1) and (2). *See, also,* Maloy, Richard, "A Primer on Cramdown—How and Why It Works," 16 St. Thomas Law. Rev. 1, 34 (2003).

36 *Id.* at 509-10.

37 *Id.* at 510-11.

38 *Id.* at 514-15 (citation omitted).

Official Committee of Unsecured Creditors v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305 (1st Cir. 1993), and subsequent cases that approved reallocating distributions from senior to junior classes under a plan or an agreement. We believe that this contention is based on a misunderstanding of the *Armstrong* holding and that their prediction that it will make consensual reorganizations more difficult in the Third Circuit is incorrect.

First, the actual holding in *Armstrong* is fairly limited. *Armstrong* addresses the reallocation of distributions from a creditor class to an equity securityholder class over the objection of a co-equal or intermediate dissenting creditor class. The plan proponents in *Armstrong* argued that the unsecured creditors in Class 7, who were projected to receive a lower percentage of their claims than the unsecured creditors in Class 6, had the right to transfer part of their value to equity so long as Class 6 was not economically prejudiced. This argument, rejected by the Third Circuit, was similar to the argument that had been advanced by the plan proponents (and rejected by the Supreme Court) in *Boyd.* The Third Circuit in *Armstrong* was not presented with a distribution sharing arrangement between two different classes of creditors (*e.g.,* secured and unsecured), as was the case in *In re WorldCom Inc.,* 2003 WL 23861928 *61 (Bankr. S.D.N.Y., Oct. 31, 2003). While the Third Circuit in *Armstrong* did not cite *WorldCom,* the district court had distinguished it on the grounds that "[u]nlike the instant case, *In re WorldCom* did not involve distributions of the debtor's property to a junior class "on account of...equity interests in the debtor."[39]

Second, as noted in a recent Delaware bankruptcy court decision, *In re World Health Alternatives Inc.,* 344 B.R. 291 (Bankr. D. Del. 2006), *Armstrong* distinguished *but did not disapprove* of the cases most often cited as authority for the sharing of distributions by senior classes with junior classes, including *SPM, supra; In re MCorp. Fin. Inc.,* 160 B.R. 941 (S.D. Tex. 1993); and *In re Genesis Health Ventures Inc.,* 266 B.R. 591 (Bankr. D. Del. 2001). In *SPM,* the First Circuit approved the enforcement of an agreement pursuant to which the proceeds from the sale of the collateral of a secured creditor were shared with general unsecured creditors without any provision for priority creditors. The agreement had been made during a chapter 11 case but was enforced after the case was converted to chapter 7.[40] In *Genesis,* a secured creditor "carved out" a portion of its distribution for the benefit of (1) the holders of unsecured and subordinated claims, without including holders of punitive damage claims in the arrangement and (2) the debtor's officers and directors as an employment incentive package rather than on account of their equity interests.[41] In *MCorp.,* a senior unsecured creditor contributed proceeds from its distribution to fund a settlement of pre-petition litigation between the debtor a third party.[42] In *World Health Alternatives,* the bankruptcy court approved a sharing arrangement between a secured creditor and unsecured creditors that excluded priority creditors similar to that approved in *SPM.*[43] The distribution sharing agreements in *SPM, Genesis, MCorp., WorldCom* and *World Health Alternatives* are all presumably still permissible in the Third Circuit.

Third, the Third Circuit in *Armstrong* seemed to leave open the possibility that "exigent circumstances" may arise where the application of "a more flexible absolute priority rule" based on equitable considerations might be justified.[44]

Fourth, the facts of *Armstrong* were unique. The unsecured creditors' committee in *Armstrong* had initially endorsed the plan but changed its mind and raised the absolute priority rule objection when it appeared that the Fairness in Asbestos Injury Resolution Act (FAIR Act) might soon be enacted, potentially making significantly more money available for general unsecured creditors.[45] In another case, without the prospect of something like the FAIR Act affecting the debtor's estate, there is no reason to believe that the parties would be unable to formulate a consensual plan providing for the sharing of value by creditors in favor of equity on terms that would be acceptable to all voting classes.

Finally, the contention that *Armstrong* will make it more difficult and expensive to achieve consensual reorganization plans is misguided. The argument seems to be that because *Armstrong* has made it more difficult to cram down a plan that provides distributions to equity over the objection of an impaired class of creditors, it will be more difficult and expensive to achieve consensual reorganizations in the Third Circuit. The argument is premised upon a simplistic view of the plan-negotiating process. What is most important for plan negotiators is to have clarity and predictability in the case law. By bringing greater clarity and predictability to one area of reorganization law where there has been little precedent at the circuit court level since the *Boyd* decision, the Third Circuit appears to have made it easier, rather than more difficult, for plan proponents and negotiators to effectively accomplish their objectives.

The So-Called Tort of Deepening Insolvency

The recent criticisms of Delaware's viability as a chapter 11 forum based on the issue of deepening insolvency are unfounded. Those criticisms seemingly gloss over the fact that the law in this area is governed by state and not federal bankruptcy law. Moreover, when determining the applicable state law to apply, very often that state law will be Delaware law. Indeed, in such cases, a bankruptcy court in Delaware must afford directors and officers (D&Os) of a corporation the same protections as the Delaware state courts, such as the Court of Chancery, would provide over allegations of breach of fiduciary duty and the so-called tort of deepening insolvency.[46]

The critics' focus on the federal courts in Delaware belies the state's long tradition of clear and concise jurisprudence on corporate law. Delaware corporate law is renowned for offering clear guidance to D&Os regarding their duties to corporations, shareholders and creditors. This guidance has been supplemented in recent years to offset the national trend of holding D&Os' feet to the fire when the corporation is either insolvent or dangerously close to insolvency. The interplay of guidance to directors and foreclosure on the creative, if illogical, avenues of holding D&Os liable for missteps and gambles while a corporation is insolvent is made clear in two opinions issued this summer by the Delaware Court of Chancery.

Much of the criticism has been focused on the Third Circuit's decision in *Official*

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39 *See In re Armstrong World Industries Inc.,* 320 B.R. 523, 539 (D. Del. 2005), *aff'd,* 432 F.3d 507 (3d Cir. 2005).

40 *SPM,* 984 F.2d at 1310-18.

41 *Genesis,* 266 B.R. at 616-18.

42 *MCorp,* 160 B.R. at 959-60.

43 *World Health,* 344 B.R. at 296-302.

44 *Armstrong,* 432 F.3d at 516 (*citing In re Penn Central Transp. Co.,* 596 F.2d 1127, 1142 (3d Cir. 1979)).

45 *Armstrong,* 432 F.3d at 510.

46 It is important to keep in mind when considering this issue that any federal court, regardless of where it sits, must apply state law to resolve this issue.

Committee of Unsecured Creditors v. R. F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001), where the court construed Pennsylvania law as recognizing the tort of deepening insolvency. This decision is not applicable to Delaware entities. In fact, the Delaware Court of Chancery recently issued a decision which completely rejected *Lafferty*. In a one-two punch, the Chancery Court cut back on creditors' claims against D&Os of insolvent companies by first holding that the tort of "deepening insolvency" does not exist and then knocking out the existence of fiduciary duties to creditors at certain points in a corporation's financial life. The court did so by reinforcing the business judgment rule: the idea that the judgment of D&Os while acting with due care, good faith and loyalty, will not be questioned by a court even if events later show that judgment to be incorrect.

In *Trenwick American Litigation Trust v. Ernst & Young*, 2006 Del. Ch. LEXIS 139 (Del. Ch. Aug. 10, 2006), the Court of Chancery attacked the concept of "deepening insolvency," the idea that improper actions which lead a company farther into debt can subject D&Os to liability. Next, in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 2006 Del. Ch. LEXIS 164 (Del. Ch. Sept. 1, 2006) (*NACEPF*), the Court of Chancery ruled there are no duties to creditors owed by D&Os while the corporation was in the "zone of insolvency."[47] Lingering doubts remain about the viability derivative claims of shareholders or other stakeholders against D&Os for breach of fiduciary duties.

The sum of these parts, that federal courts in the Third Circuit (and elsewhere) follow Delaware jurisprudence when dealing with a Delaware entity and will apply the *Trenwick* decision judiciously to thwart deepening insolvency claims raised in the bankruptcy courts in Delaware, can be seen in Judge Walsh's ruling in *Radnor Holdings*, which is discussed below.

Trenwick

The Delaware Chancery Court has criticized "deepening insolvency" as an end run around whatever claims are really at stake in the dispute.[48] While at all times cognizant of the importance of protecting D&Os from frivolous claims based on a lack of success in business planning, the Court of Chancery's conclusion in *Trenwick* points out that:

> the mere fact of a business failure does not mean that a plaintiff can state claims against the directors, officers, and advisors on the scene just by pointing out that their business strategy did not pan out. If simple failure gave rise to claims, the deterrent to healthy risk taking by businesses would undermine the wealth-creating potential of capitalist endeavors. For that reason, our law defines causes of action that may be pled against business fiduciaries and advisors with care, in order to balance society's interest in promoting good-faith risk-taking and preventing fiduciary misconduct.[49]

While the facts of the case are fairly complex, only a cursory review of them is necessary to understand the important aspects of the opinion. Through a series of corporate mergers and reorganizations, Trenwick America became a wholly owned subsidiary of Trenwick.[50] Trenwick caused Trenwick America to engage in additional acquisitions of other Trenwick subsidiaries.[51] These acquisitions proved to be improvident, causing Trenwick America to become insolvent.[52] Trenwick America and Trenwick filed for bankruptcy protection in the U.S. Bankruptcy Court for the District of Delaware in 2003.[53] The court subsequently confirmed a reorganization plan that created a litigation trust (the "Litigation Trust"), assigned it certain causes of action.[54]

The Litigation Trust brought eight claims against the directors of Trenwick and Trenwick America, all with a common basis: "Trenwick's strategy of growing by acquiring [certain businesses] was 'irrational' and resulted from 'gross negligence.'"[55] Among these claims was one for the distinct tort of "deepening insolvency." Specifically, the conduct in question was that "the Trenwick America directors are alleged to have injured the creditors of Trenwick America by causing its assets to be pledged to support other subsidiaries owned by Trenwick, at a time when Trenwick America was insolvent."[56] In response to the alleged claims, the directors of both corporations moved for dismissal of the complaint under Court of Chancery Rule 12(b)(6), an identical procedural rule to Federal Rule of Civil Procedure 12(b)(6).[57]

The "tort" of deepening insolvency as it appears in *Trenwick* is essentially based on the director's gamble in hopes of resuscitating a failing corporation. By knocking out this claim, and relying instead on fiduciary duties, the Court of Chancery grants D&Os greater comfort in their risk taking decisions. This is so because the business-judgment rule acts as both a procedural and substantive bar to fiduciary duty claims.

The Court of Chancery begins by expressing doubt as to whether or not D&Os owe a distinct duty to creditors while in the zone of insolvency through a footnote stating:

> Insolvency does not suddenly turn directors into mere collection agents. Rather, the creditors become the enforcement agents of fiduciary duties because the corporation's wallet cannot handle the legal obligations owed.... In other words, the fiduciary duty tool is transferred to the creditors when the firm is insolvent in aid of the creditor's contract rights.[58]

In sum, the Court of Chancery does not believe that insolvency alters the fiduciary duties owed to creditors, stakeholders, or even, as the court calls it, "the firm." If there are no special duties owed because of insolvency, then there can be no breach of duties when D&Os' actions deepen the insolvency. The court's opinion puts to rest doubts as to the existence of an independent tort of "deepening insolvency" under Delaware law raised by recent bankruptcy and district court opinions in the District of Delaware.[59]

Before *Trenwick* was decided, the U.S. District Court for the District of Delaware predicted that the state courts would find that deepening insolvency was a tort under Delaware law. In *Stanziale v. Pepper Hamilton LLP* (*In re Student Finance Corp*.), the district court held that a crucial element of

47 *NACEPF* is currently on appeal to the Supreme Court of the State of Delaware.

48 *Trenwick*, 2006 Del. Ch. LEXIS 139 at *49, 70 ("What a plaintiff may not do, however, is simply allege that a majority independent board undertook a business strategy that was 'all-consuming and foolhardy' and that turned out badly and thereby seek to have the court infer that the later failure resulted from a grossly deficient level of effort or from disloyal motives.").

49 *Id.* at *139.

50 *Id.* at *27-31.

51 *Id.*

52 *Id.* at *45.

53 *Id.*

54 *Id.* at *56.

55 *Id.* at *50.

56 *Id.* at *51.

57 Normally, a court reviewing a 12(b)(6) motion is limited to reviewing only those documents which are attached to the complaint or, under Delaware law, are "fairly and fully incorporated" into the complaint. The Court of Chancery departed from this standard slightly by reviewing documents outside of the complaint.

58 *Id.*

deepening insolvency was that a fraud must be visited upon the creditors.[60] Thus, it required a showing of fraud.[61] In *OHC Liquidation Trust v. Credit Suisse First Boston* (*In re Oakwood Homes*),[62] the bankruptcy court focused on the remedial nature of the tort, that is, that deepening insolvency is a tort aimed at remedying the harm to the corporation's creditors for fraudulent acts committed by its directors.

In contrast to the federal courts' approach to deepening insolvency, which focuses on fraud, the Court of Chancery has been careful to analyze the issues based on the existing law of fiduciary duties.

The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud. The contours of these causes of action have been carefully shaped by generations of experience, in order to balance the societal interests in protecting investors and creditors against exploitation by directors and in providing directors with sufficient insulation so that they can seek to create wealth through the good-faith pursuit of business strategies that involve a risk of failure.[63]

The Court of Chancery's view is that the proper analysis of whether the D&Os engaged in behavior for which they should be held fiscally responsible is through a fiduciary duty analysis, not by creating a separate tort of deepening insolvency. "[T]he Litigation Trust has not stated a viable claim for breach of fiduciary duty. It may not escape that failure by seeking to have this court recognize a loose phrase as a cause of action under our law, when that recognition would be inconsistent with the principles shaping our state's corporate law."[64] Logically, this would leave the only avenue of redress for creditors seeking to sue D&Os with a breach of fiduciary duty claim.

The Court of Chancery has also severely restricted a creditor's claim that D&Os breached their fiduciary duties to creditors in *NACEPF*. Courts in Delaware, and courts in other states, have ruled that D&Os owe fiduciary duties to creditors while the corporation is in the "zone of insolvency."[65] Creditors have used those rulings to claim that if a director or officer engaged in a business plan that put the assets of the corporation at risk (*e.g.,* reduced the likelihood that creditors would get paid) while the corporation was insolvent or dangerously close to insolvency, those D&Os are liable for a breach of fiduciary duty. In *NACEPF* the Court of Chancery knocked down this theory, ruling that creditors may only sue for derivative claims—that is, rights that belong to the corporation, not to the creditors.

In *NACEPF*, Goldman Sachs invested in Clearwire, a wireless technology corporation.[66] As part of its investment, Goldman Sachs nominated three individuals, the named defendants, to serve on the board of directors of Clearwire.[67] NACEPF, a broadband license holder, entered into a master license contract with Clearwire.[68] NACEPF argued that the defendants made several material misrepresentations about Goldman Sachs' plans to continue its funding stream to Clearwire.[69] NACEPF argued that the directors had a secret agenda to use the master license contract to gain profits from other companies, such as Sprint.[70] NACEPF alleged that this amounted to a direct breach of fiduciary duties because they engaged in self-dealing by improperly profiting from the corporation's business transactions.[71]

The Court of Chancery first examined whether NACEPF adequately pled that Clearwire was insolvent, or in the "zone of insolvency" at the time of the alleged self-dealing.[72] The court determined that providing a remedy to creditors by imposing a fiduciary duty on D&Os, in addition to the duties they already owe, is unnecessary.[73] While not removing the ability of a creditor, or someone asserting a creditor's rights, to sue D&Os for actions they took while the corporation was insolvent, the court's ruling denies creditors the ability to sue D&Os for actions they took that harmed the creditors under a breach of fiduciary duty claim. That means creditors may still sue D&Os for negligent misrepresentation, breach of contract, conspiracy or intentional interference with contractual relations claims.

Indeed, it would appear that creditors' existing protections—including the protections afforded by their negotiated agreements, their security instruments, the implied covenant of good faith and fair dealing, fraudulent-conveyance law and bankruptcy law—render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary.[74]

Additionally, the *NACEPF* opinion echoes the same concern as the *Trenwick* opinion regarding chilling D&Os' leadership during a crucial time: "An otherwise solvent corporation operating in the 'zone of insolvency' is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."[75]

Radnor Holdings

Delaware Bankruptcy Judge Walsh recently applied the *Trenwick* decision broadly in *Official Committee of Unsecured Creditors of Radnor Holdings v. Tennenbaum Capital Parnters LLC*, Case No. 06-50909 (Bankr. D. Del. Nov. 17, 2006). In that case, the committee

59 In *Lafferty*, the Third Circuit held that under Pennsylvania law, D&Os could be liable for deepening insolvency. In that case, the court was confronted with fraud, a "Ponzi scheme" involving the corporation's issuance of fraudulent debt certificates. 267 F.3d at 344. The tort the Third Circuit examined involved "wrongfully expanding the debtor's debt out of all proportion to their ability to repay and ultimately forcing the debtors to seek bankruptcy protection." *Id.* at 347. In deeming the tort to exist, the Third Circuit carefully pointed out that there was, in fact, harm visited upon the corporation and its ongoing ability to generate revenue. That harm was to the corporation's goodwill —the relationships with the corporation's customers and suppliers. *Id.* at 351. Recently, the Third Circuit has extended and explained its remarks on deepening insolvency, by holding that this tort is an independent cause of action, not a measure of damages under Pennsylvania law. *Seitz v. Detweiler, Hershey & Assocs. PA* (*In re CITX Corp.*), 448 F.3d 672 (3d Cir. 2006).

60 335 B.R. 539 (D. Del. 2005).

61 *Id.*

62 340 B.R. 510, 534 (Bankr. D. Del. 2006).

63 *Trenwick*, 2006 Del. Ch. LEXIS 139 at *100-01.

64 *Id.* at *103.

65 *See Credit Lyonnaise Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). In contrast, New York courts deny the existence of a fiduciary duty to creditors once a corporation is in the zone of insolvency. *See Columbia Forrest Prods. v. Firestone Plywood Corp.*, 2004 N.Y. Misc. LEXIS 2300 (N.Y. Sup. Ct. Nov. 23, 2004).

66 *NACEPF*, *Slip Op.* at 1.

67 *Id.* at 7-8.

68 *Id.* at 8.

69 *Id.* at 9.

70 *Id.* at 11.

71 *Id.* at 26.

72 *Id.* at 30. The Court of Chancery's examination in *NACEPF* was less searching than the court's examination in *Trenwick*. The *NACEPF* court found that to meet a 12(b)(6) standard, NACEPF pled facts "permitting a reasonable inference that Clearwire operated in the zone of insolvency" when it stated that Clearwire had $29.2 million in cash, $24.3 million of that amount was dedicated to certain payments, leaving an excess of $4.9 million of operating cash, and noting that Clearwire spent $2.1 million per month. *Id.* at 31-32.

73 To determine whether NACEPF could assert claims for a direct breach of fiduciary duties, the Court of Chancery examined two theories as to why D&Os could be liable for breaches to creditors while the corporation was in the zone of insolvency: first, the "incentive to enforce rationale," the idea that a derivative claim may be brought by the individual with the incentive to pursue the claim on behalf of the corporation, and therefore, confer a benefit upon the corporation (*Id.* at 37), and second, the "trust fund theory." *Id.* at 36. Under the incentive to enforce rationale, a creditor's assertion of direct claims does not benefit the corporation as relief for those direct claims flows to the creditor, not the corporation. *Id.* at 39. In contrast, under the trust fund theory, a claim by a corporation's creditor could benefit the whole, if the corporation is insolvent, but not if the corporation is in the "zone of insolvency." *Id.* at 40.

74 *Id.* at 42.

75 *Id.* at 43.

filed a complaint against Tennenbaum Capital Partners LLC. This complaint differed from that in *Trenwick* or *NACEPF* because it was not aimed at the D&Os, but rather at a third party. Judge Walsh ruled that such a difference was immaterial.[76] "Deepening insolvency fares no better as a cause of action directly against Tennebaum than it would against Radnor's board."[77] Finally, Judge Walsh took the *Trenwick* opinion a step further, ruling that the claim of deepening insolvency could not be hidden by creative pleading.[78]

Conclusion

The *Owens Corning* and *Armstrong* decisions addressed extreme situations in which debtors were "pushing the envelope" in their efforts to confirm plans around the opposition of significant creditor groups. These decisions do not reflect an "anti-debtor" sentiment on the Third Circuit. The decision on where to file a chapter 11 case is a very complex and important one for a company and its constituents. This decision should never be a made on "knee-jerk" basis. Certainly, in making that decision consideration must be given to numerous factors, including the controlling precedent in the circuit where the bankruptcy court sits. When advising clients in this regard, it is important that a balanced analysis of such precedent be provided. Hopefully, the discussion of Third Circuit precedent in the three areas of law presented above will help in making venue decisions in an informed manner. ■

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76 Other courts have held that deepening insolvency is a whole other tort when pled against nondirectors. *See Rafool v. The Goldfarb Corp.* (*In re Fleming Packaging Corp.*), 336 B.R. 398 (Bankr. C.D. Ill. 2006); *Limor v. Buerger* (*In re Del-Met Corp.*), 322 B.R. 781 (Bankr. M.D. Tenn. 2005).

77 *NACEPF*, *Slip Op.* at 31.

78 *Id.* at 30 ("Simply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster."). This harkens to the wisdom of Judge Kent that "at the end of the day, even if you put a calico dress on it and call it Florence, a pig is still a pig." *Bradshaw v. Unity Marine Corp.*, 147 F. Supp. 2d 668, 671 (S.D. Tex. 2001).