

American Bankruptcy Institute



LENDERS UNDER FIRE:

Weapons in the Committee Arsenal; Shields for Lenders

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With the United States now more than 18 months into a recession that promises to be the most severe economic crisis since the Great Depression, businesses are failing at an alarming rate. Even without looking at any official statistics, bankruptcy practitioners all over the country can attest to the severity of this downturn. Credit markets have virtually frozen and the resulting lack of liquidity and unavailability of credit have not only contributed to the general decline of the economy, but in particular have seemingly made reorganizations nearly impossible. As a result, a substantial number of business chapter 11 cases being filed today might be deemed to be "wipeout" cases. These businesses not only have virtually no chance to reorganize, but in many instances have no ability to operate even for a short period of time in chapter 11. Further, regardless of the operational capabilities of a company, or the lack thereof, asset values have declined so precipitously that very often secured creditors are being forced to accept less than full payment. In turn, unsecured creditors and other constituencies are more often than not today faced with the prospect of recovering nothing in the chapter 11 case or other insolvency proceeding.

This new economic reality of plummeting asset values leaving unsecured creditors "out of the money" has forced unsecured creditors and the committees that represent them to become more aggressive and more creative in pursuing recoveries on their claims. The advance sheets report new attacks on lenders with every passing week and month. Even legal commentators are encouraging lender liability suits as the best way for committees to earn their keep.¹ These cases, commentaries,

¹ One example from the ABI itself was a recent two-part series of articles in the ABI Journal entitled "What's Left for Unsecured Creditors?" Brighton, Jo Ann J., and Parrish, Felton E., *What's Left for Unsecured Creditors? Part I*,

and articles provide not only a roadmap, but almost an invitation for creditors committees to get more aggressive in their pursuit of potential actions against lenders. This paper will explore the current state of the law with respect to the primary theories being pursued most vigorously and commonly by creditors and trustees.

Case Study for Discussion: The Yellowstone Mountain Club Case

Before discussing the most common theories of liability, including recharacterization, equitable subordination, aiding and abetting breach of fiduciary duty, and deepening insolvency, it may be instructive to evaluate the types of lender and borrower behavior that lead to such claims in the first instance. A recent high-profile case helps illustrate not only the interplay between the concepts of aiding and abetting breach of fiduciary duty, the *in pari delicto* defense, and equitable subordination, and arguably sets the mark for the most egregious example of the consequences of the overly frothy credit markets of the past few years. In re Yellowstone Mountain Club, LLC, Adv. No. 09-00014 (Bankr. D. Mont., May 13, 2009)(Partial & Interim Order; hereinafter, "Slip Op."). The basic facts as recited by the court are as follows: The Yellowstone Club was founded in 1999 and built as the world's only private ski and golf community, located in the Rocky Mountains in Montana. The Club's founders, Tim and Edra Blixseth, originally planned for a community consisting of several planned residential neighborhoods with more than 850 fee simple homes or condos. In its early years, the Blixseths sold equity interests in the Club to a select group of individuals, but the Blixseths or entities controlled by them maintained a substantial majority interest in the Club.

Am. Bankr. Inst. Journal, Vol. XXVII, No. 9, p. 40, Nov. 2008, and Brighton, Jo Ann J., and Parrish, Felton E., *Is There Anything Left for Unsecured Creditors? Part II*, Am. Bankr. Inst. Journal, Vol. XXVII, No. 10, p. 34, Dec./Jan. 2009.

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Several years into the development, in approximately 2004, bankers from Credit Suisse approached Tim Blixseth pushing a new syndicated loan product, and attempted to convince Blixseth to take out a loan from Credit Suisse under this new product line. Credit Suisse apparently was trying to break into the commercial real estate loan market and doing so in a big way, with syndicated loans that allowed it to make much larger loans than had previously been possible by itself. Credit Suisse touted that it had made such loans to a number of other resort developments, and in each of those cases the loans allowed the equity holders to take out substantial distributions from the loan proceeds on account of their equity interests. Blixseth initially declined the loan, but after a number of months of negotiations agreed to borrow from Credit Suisse. At that time in 2005, Yellowstone Club only had outstanding secured debt of approximately \$25 million under a pre-existing credit line, but Yellowstone ultimately agreed to borrow \$375 million from the Credit Suisse syndicate. The loan proceeds were used first to retire the existing indebtedness and to pay substantial fees to Credit Suisse (\$7.5 million). Importantly, the loan provided that up to \$209 million could be used to make distributions or loans to equity holders of the Club for purposes unrelated to the operations of Yellowstone Club, and an additional \$142 million could be used for investments into other subsidiaries for purposes unrelated to Yellowstone Club. In other words, of the total \$375 million in gross loan proceeds, the loan documents themselves provided that more than \$350 million of that total could be used for purposes unrelated to the business of the borrower itself.

Ultimately, at closing, only approximately \$20 million of the loan proceeds were used to refinance existing indebtedness, but virtually all of the rest of the money was used either to pay fees to Credit Suisse or was taken out of the company by the equity holders for unrelated purposes. Blixseth's company did take a loan of \$209 million from Yellowstone Club out of the Credit Suisse

loan proceeds, nearly all of which was deposited into various personal accounts of Tim and Edra Blixseth, and all of which was spent on activities unrelated to the Yellowstone Club.

Yellowstone Club eventually ended up in chapter 11, and the creditors committee brought an adversary proceeding against Credit Suisse and Tim Blixseth asserting claims for, among other things, breach of fiduciary duty by Blixseth, aiding and abetting in the breach of fiduciary duty by Credit Suisse, and equitable subordination of Credit Suisse's allegedly secured claim. After a lengthy trial, the bankruptcy court on May 13, 2009, issued a preliminary order equitably subordinating Credit Suisse's claim.² After reviewing the facts and discussing the level of due diligence (or lack thereof) performed by Credit Suisse, the bankruptcy court had little trouble determining that equitable subordination was appropriate: "Credit Suisse's actions in the case were so far over reaching and self-serving that they shocked the conscience of the Court." Slip Op. at 15. The court determined from the evidence at trial that the financial analysis, appraisals, and other due diligence undertaken by Credit Suisse clearly suggested that the debtor could in no way sustain a \$375 million debt load. Credit Suisse, however, pushed hard to close that loan, and the court found that the only likely reason for that was the significant fees to be earned by Credit Suisse and its employees if the loans were closed. The skeptical court noted that "this program essentially puts the fox in charge of the hen house and was clearly self-serving for Credit Suisse." Slip Op. at 17. Stating that the fee structure was "shocking," the court expressed its dismay that Credit Suisse made a loan that was not only likely, but in fact clearly designed, to saddle the resort development with unsustainable debt while lining the pockets of its equity owners and reaping huge fees for the bank. Stating further that Credit Suisse's "naked greed" shocked the conscience of the court, the court then

² The May 13th order was entitled a "Partial & Interim Order" and the court therein stated that it would enter a more complete memorandum and order at a later date. As of the date of submission of these materials, the court had not entered a full memorandum decision. To the extent the same becomes available, the authors will supplement these materials prior to the bankruptcy workshop.

found that the only equitable remedy to compensate for "Credit Suisse's overreaching and predatory lending practices in this instance is to subordinate Credit Suisse's first lien position" to the DIP lender's liens and unsecured creditor claims. Slip Op. at 19.

Notably absent from the analysis in the court's partial and interim decision is any discussion of the breach of fiduciary duty by Blixseth himself, the claims that Credit Suisse aided and abetted in that breach of fiduciary duty, or Credit Suisse's assertion of the *in pari delicto* defense. The briefs and other papers filed in the case suggest that the parties extensively argued those issues, but the court in its interim decision did not address them. While the facts of this case may have made the decision an easier one for the court, given the extreme disparity in the amount necessary to be borrowed by the debtor to refinance existing debt as compared to the amounts taken for personal use by the owners, the fact nonetheless remains that it was the owners themselves (and not the lenders) who squandered the corporate assets by taking significant distributions in the form of loans and spending the money for their personal use. However, it seems hard to believe that Credit Suisse could not have understood and appreciated the substantial risk presented by their loan structure and that other creditors of the Yellowstone Club would be harmed by the excessive debt layered in a senior priority position.

The court did note that equitable subordination was a remedy that is very infrequently used in a non-insider, non-fiduciary situation, noting the Ninth Circuit's earlier pronouncement that "the level of pleading and proof is elevated: gross and egregious conduct will be required before a court [can] equitably subordinate a claim." In re First Alliance Mortgage Co., 497 F.3d 977, 1006 (9th Cir. 2006). The court cited further cases in its discussion reiterating that the level of proof and conduct required in a non-insider case must be egregious before a court will equitably subordinate the claim, but then went on to find that Credit Suisse's activities in this case easily met that standard.

EQUITABLE SUBORDINATION**A. Framework**

Section 510(c) of the Bankruptcy Code provides that a bankruptcy court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim." The Fifth Circuit has developed a widely adopted three-part test for evaluating when a bankruptcy claim should be equitably subordinated: (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankruptcy or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code. In re Mobile Steel Co., 563 F.2d 692, 699-700 (5th Cir. 1977). A creditor's inequitable conduct need not relate to the claim being subordinated, but a claim should only be subordinated to the extent necessary to offset the harm that creditors suffered on account of the inequitable conduct. Id. Moreover, "satisfaction of this three-part test does not mean that a court is required to equitably subordinate a claim, but rather the court is permitted to take such action." Bayer Corp. v. Masco Tech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726, 744 (6th Cir. 2001).

B. Selected Cases

Wooley v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355 (5th Cir. June 20, 2008) -- The Fifth Circuit overturned the decisions of the bankruptcy court and district court invoking equitable subordination. Certain insiders of the debtor had made secured loans to the debtor as the debtor's financial condition deteriorated. However, even those insider loans proved insufficient to halt the debtor's slide into bankruptcy. The Fifth Circuit held that the critical factor in application of equitable subordination was that a claim should be subordinated only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct. According to the Fifth Circuit,

subordination of the insiders' secured claims was inappropriate because the bankruptcy trustee had failed to show that the defendant insiders' loans to the debtor harmed either the debtor or the general creditors.

Adelphia Communications Corp. v. Bank of America, N.A. (In re Adelphia Communications Corp.), 365 B.R. 24 (Bankr. S.D.N.Y. 2007) -- The official committee of unsecured creditors brought an adversary proceeding on behalf of Adelphia, against Adelphia's lenders and investment banks. The committee's 256-count complaint charged the defendants with wrongdoing in their dealings with Adelphia's former management, the Rigas family, against whom Adelphia had brought suit for looting the company. The committee's numerous counts against the defendants included claims (i) for aiding and abetting the Rigases' breaches of fiduciary duty in connection with "co-borrowing" facilities under which Adelphia became liable to repay the banks for billions of dollars that benefited the Rigases, (ii) for breach of fiduciary duty (asserting that the bank lenders and investment banks themselves had fiduciary duties to the estate), (iii) for fraudulent transfers and preferences related to incurring and/or paying down the debt on borrowing facilities that benefited the Rigases, (iv) to equitably subordinate and/or disallow, and to recharacterize, bank lenders' claims and (v) for violations of the Bank Holding Company Act. In addition to seeking equitably to subordinate the defendants' claims, the committee sought equitable disallowance of such claims. The bankruptcy court ruled that equitable disallowance, whereby a court can completely disallow a creditor's claims based on its inequitable conduct, remains viable despite the enactment of Section 510(c), which authorizes equitable subordination.

Adelphia Recovery Trust v. Bank of America, N.A., 390 B.R. 80 (S.D.N.Y. 2008) -- The creditors' committee brought claims against lenders stemming from the lenders' alleged dealings with Adelphia's former management against whom Adelphia brought suit for looting the company. Notably, the plan provided that unsecured creditors of each of the debtors would be paid in full, in cash, with interest. Upon a motion to dismiss the district court determined that, given that the debtors' creditors received full payment with interest under the plan, the creditors would not benefit from the lawsuit and, therefore, plaintiffs did

not have standing. In dismissing the equitable subordination and disallowance claims, the court noted that the bank defendants would be paid in full even if their claims were subordinated.

Arena Dev. Group, LLC v. Naegele Commns., 2008 U.S. Dist. LEXIS 35628 (D. Minn. Apr. 29, 2008) and Arena Development Group, LLC v. Naegele Communications, Inc., 2007 WL 2506431 (D. Minn. 2007) -- In two related cases, the Minnesota District Court held that there is no cause of action, outside of bankruptcy, for declaratory relief to recharacterize debt as equity or for equitable subordination.

Official Committee of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies, Inc.), 299 B.R. 732 (D. Del. 2003) -- In 1997, the pre-petition banks established a \$250 million credit facility for Exide Technologies, Inc. ("Exide") and its borrowing subsidiaries (the "Exide Group"). In 2000, a further loan of \$250 Million was used to finance the acquisition of a competitor -- GNB Dunlop. The official committee of unsecured creditors brought suit against the banks alleging that the effect of the transaction was to increase significantly the pre-petition banks' control over Exide Group. The committee further alleged that the pre-petition banks engaged in inequitable conduct as a result of their (i) promotion and handling of the ill-fated transaction, while receiving substantial transaction fees for its work related to the acquisition; (ii) taking substantial collateral when the lenders knew that Exide's position was deteriorating rapidly and bankruptcy appeared evident; and (iii) delaying the filing of the bankruptcy petitions (and choosing which debtors would file) in order to protect its liens and collateral from avoidance attack. The court found these allegations sufficient to survive a motion to dismiss.

RECHARACTERIZATION

A. Framework

Recharacterization, in contrast to equitable subordination, focuses on whether a debt actually exists or, put another way, whether it is proper to characterize a transaction in the first instance as an investment. In defining the recharacterization inquiry, courts have adopted a variety of multi-factor tests borrowed from non-bankruptcy case law. Ultimately, the tests are designed to answer one question: did the claimant intend to advance a loan or invest equity? The factors that courts generally consider in evaluating a request for recharacterization is highly fact-dependent and includes:

- (1) the names given to the instruments, if any, evidencing the indebtedness;
- (2) the presence or absence of a fixed maturity date and scheduled payments;
- (3) the presence or absence of a fixed rate of interest and interest payments;
- (4) the source of the repayment;
- (5) the adequacy or inadequacy of capitalization;
- (6) the identity of interest between the creditor and the stockholder;
- (7) the security, if any, for advances;
- (8) the corporation's ability to obtain financing from outside lending institutions;
- (9) the extent to which the advances were subordinated to the claims of outside creditors;
- (10) the extent to which the advances were used to acquire capital assets; and
- (11) the presence or absence of a sinking fund to provide repayments.

AutoStyle Plastic, 269 F.3d at 726. See also Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 630 (6th Cir. 1986). The nature of the Autostyle factors tends to make it difficult for a committee to

succeed on a recharacterization claim against a lender. However, committees' continue to pursue the claims.

It is noteworthy that, in Cohen v. KB Mezzanine Fund II (In re SubMicron Systems Corp.), 432 F.3d 448 (3d Cir. 2006), the Third Circuit rejected the "mechanistic" Autostyle approach to the analysis of recharacterization claims holding that the overarching inquiry should be the intent of the parties at the time of the transaction. See In re Radnor Holdings Corp., 353 B.R. 820, 838 (D. Del. 2006).

B. Representative Cases

Official Committee of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies, Inc.), 299 B.R. 732 (D. Del. 2003) -- In 1997, the pre-petition banks established a \$650 million credit facility for Exide Technologies, Inc. and its borrowing subsidiaries (the "Exide Group"). In 2000, a further loan of \$250 million was used to finance the acquisition of a competitor -- GNB Dunlop. Plaintiffs alleged that the effect of the transaction was to increase significantly the pre-petition banks' control over Exide Group. After the transaction, Exide's financial condition deteriorated rapidly. After Exide filed bankruptcy, the Plaintiffs alleged that the \$250 Million loan should be recharacterized as equity. The court dismissed Plaintiff's recharacterization claim upon evaluating the Autostyle factors and concluding that the loan documents were unquestionably "instruments of indebtedness."

In re Outboard Marine Corp., 2003 U.S. Dist. LEXIS 12564; 50 Collier Bankr. Cas. 2d (MB) 931 (N.D. Ill. 2003) -- Quantum Industrial Partners, LDC ("Quantum") was the holder of nearly 100% of the debtor's common stock. Less than three months before the debtor filed its chapter 11 case, the debtor's lender amended its credit agreement with the debtor to add a "Tranche B" loan of \$45 million to the existing indebtedness. In conjunction with that amendment, Quantum purchased a 100% participation in Tranche B, which

Quantum agreed to subordinate to the existing "Tranche A," and also agreed that the lead lender under the facility would have all legal rights of Quantum against the debtor. After the lead lender brought its claim against the debtor, the Trustee counterclaimed and brought a third party complaint against Quantum seeking several remedies, including seeking recharacterization of Quantum's \$45 million "loan" as equity rather than secured debt. Quantum filed a motion to dismiss, and the bankruptcy court granted the motion with respect to the recharacterization count, finding that it did not have the authority to order recharacterization of the debt. On appeal, the District Court reversed, holding that the bankruptcy court does in fact have authority to order debt recharacterized as equity: "Recharacterization is simply a factual inquiry that determines, in the first instance, whether an asserted debt is in fact a debt or a concealed equity contribution." *Id.* at 13. The Court remanded the case to the bankruptcy court to make the determination using the eleven AutoStyle factors, plus two more:

Second, the Court adds to the eleven *Roth Steel* factors two additional factors from *In re Hyperion Enterprises*, 158 B.R. 555 (D.R.I. 1993): (12) the ratio of shareholder loans to capital and (13) the amount or degree of shareholder control. *Id.* at 561. No one factor is to be determinative, and the more the transaction seems like an arms-length deal, the more likely the transaction is a loan and not an equity contribution. *Autostyle*, 269 F.3d at 749.

Id. at 15.

AIDING AND ABETTING BREACH OF FIDUCIARY DUTY**A. Framework**

The general rule is that no fiduciary relationship exists between a bank and its customer merely by virtue of a borrower lender relationship. Southbridge Assocs., L.L.C. v. Garofalo, 53 Conn. App. 11 (Conn. App. Ct. 1999); see also Pardue v. Bankers First Fed. Sav. Assn., 175 Ga. App. 814, 815, 334 S.E.2d 926 (1985) ("there is *particularly* no confidential relationship between lender and borrower or mortgagee and mortgagor for they are creditor and debtor with clearly opposite interests.")(emphasis in original).³ Despite the fact that, absent unusual circumstances, a lender does not itself owe fiduciary duty to its borrower, a lender may nevertheless face claims for "aiding and abetting" a borrower's breach of fiduciary duty to other creditors.

The question of whether a lender may be subject to a cause of action for aiding and abetting a breach of fiduciary duty will generally be answered under state law. In those states recognizing a claim for aiding and abetting, the elements of the claim are (1) a fiduciary duty on the part of the primary wrongdoer; (2) a breach of this fiduciary duty; (3) knowledge of the breach by the alleged aider and abettor; and (4) the aider and abettor's substantial assistance or encouragement of the wrongdoing. Court-Appointed Receiver of Lancer Mgmt. Group LLC v. Lauer, 2008 U.S. Dist. LEXIS 25526 (S.D. Fla. Mar. 31, 2008); see also Restatement (Second) of Torts § 876 (1979)("For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . . gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.")

³ However, if the lender and its borrower have a longstanding relationship of trust and confidence, or the lender exercises control and dominance over the borrower, then the lender may have fiduciary obligations to its borrower or its borrower's creditors or shareholders. See, e.g., In re Aluminum Mills Corp., 132 B.R. 869 (Bankr. N.D. Ill. 1991)

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Lenders who are the target of a claim for aiding and abetting a breach of fiduciary duty have various defenses available to them. First, of course, the creditors committee or other plaintiff bringing the action must establish the elements shown above, which may not be as simple as it appears. In most instances it likely will be difficult for a debtor, trustee, or creditors committee to prove that a lender had knowledge of the wrongful conduct that may have given rise to the wrongdoer's breach of fiduciary duty.

Further, lenders facing these claims may assert what is sometimes referred to as the "Wagoner Rule", which derives its name and content from the case of Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2nd Cir. 1991). The Adelphia court described the Wagoner Rule as follows:

While the *Wagoner* Rule has not been consistently defined, it is most commonly understood to consist of two prongs, generally providing that (1) a bankruptcy trustee (or other estate representative) steps into the shoes of the debtor and has standing only to assert claims that the debtor could, and (2) (subject to the exceptions that may be applicable here) misconduct by a debtor's personnel is imputed to the trustee.

In re Adelphia Communications Corp., 365 B.R. 24, at note 65 (Bankr. S.D.N.Y. 2007). The first prong of the Wagoner Rule involves essentially a standing issue; that is, does the party asserting the claim in fact have standing to assert a breach of fiduciary duty claim, which has generally been held to be a derivative claim belonging to the corporation? Most courts addressing the first prong of the Wagoner Rule in connection with claims for aiding and abetting a breach of fiduciary duty have no trouble finding that a trustee or creditors committee appropriately authorized does in fact have standing to assert the claim. See Id. at 46 ("there could be no serious question that claims for breaches of fiduciary duty by the [former insiders] would be for injuries to the *corporation*, and claims of aiding and abetting those breaches of fiduciary duty would be likewise" (emphasis in

(denying motion to dismiss by lender based upon alleged fiduciary duties arising from lender's control of borrower's business); F.D.I.C. v. Perry Bros., 854 F. Supp 1248 (E.D. Tex. 1994).

original; footnotes omitted)). Under most state laws, a claim for breach of fiduciary duty by an insider most certainly belongs to the corporation, and therefore a trustee stepping into the shoes of the debtor (or a committee authorized by a court to do so) should have standing to assert those claims. Id.

The real dispute, and one that is hotly contested in these lender liability actions, revolves around the second prong of the Wagoner Rule, which might also be referred to as the *in pari delicto* defense, or the "imputation" defense, or the "unclean hands doctrine." That defense or doctrine generally provides that the court will impute to a corporation the actions of its controlling shareholders, or officers and directors, such that when the debtor or trustee steps into the shoes of the corporation for purposes of asserting the breach of fiduciary duty claim (or a claim for aiding and abetting the breach of fiduciary duty), that claim is subject to the same defenses that would have been assertable against the corporation itself. Id. at 45. Accordingly, where a corporate insider is accused or proven to have breached her fiduciary duty to the corporation through inappropriate acts, those improper acts are imputed to the corporation and provide a basis for a defense. See generally In re Parmalat Securities Litigation, 383 F. Supp. 2d 587, 596 (S.D.N.Y. 2005)(noting that under North Carolina law "the law generally forbids redress to one for an injury done him by another, if he himself first be in the wrong about the same matter whereof he complains. . .no one is permitted to profit by his own fraud, or to take advantage of his own wrong, or to found a claim on his own inequity, or to acquire any rights by his own crime." citing Byers v. Byers, 223 N.C. 85, 25 S.E. 2d 466, 469-70 (N.C. 1943)).

Assertion of this defense by a lender would seem to bar most claims of aiding and abetting breach of fiduciary duty, because, almost by definition, the breach of fiduciary duty will have

occurred as a result of the wrongful acts of a corporate insider. Therefore, if those acts would be imputed to the corporation and assertable as a defense, no recovery would be available. However, where the insider wrongdoer has been removed from the corporation, and a bankruptcy trustee or creditors committee is asserting the claim with the hope of recovering money to distribute to innocent third party creditors, courts have fashioned exceptions to the *in pari delicto* defense.

For example, in the Adelphia case, the court launched into an exceptionally detailed exploration of Pennsylvania law on breach of fiduciary duty, aiding and abetting liability, and the application of the *in pari delicto* doctrine. Ultimately, the Adelphia court found and held that "Pennsylvania's unclean hands doctrine does not deprive trustees of ownership of the causes of action they pursued, and would give courts flexibility to determine whether they should apply agency doctrine to impose equitable defenses that might be asserted in response to such claims." Adelphia, 365 B.R. at 69. The court went on to find that Pennsylvania law would not necessarily wish to "penalize innocent creditors for the conduct of prior management when a trustee sues a third party under state law for otherwise actionable injury to an insolvent corporation," and that it would be required to make factual determinations concerning the propriety of the applicability or inapplicability of the *in pari delicto* defense based upon the specific facts of the case. Id. at 69-74. See also, In re Jack Greenberg, Inc., 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999), wherein the bankruptcy court, agreeing that Pennsylvania law might not allow the imposition of the unclean hands defense against a bankruptcy trustee if such a defense would produce an inequitable result to innocent third parties, was convinced that "there are circumstances when the trustee's position as plaintiff is different from that of the corporation, even when bringing the corporation's claim." The Greenberg court went further to note that "equitable defenses such as the doctrine of imputation that may be sustainable against the corporation may fail to act as a total bar to recovery when the

beneficiaries of the action are the corporation's innocent creditors," and therefore found that, rather than adopting a *per se* rule that the equitable defense can or cannot be raised against a trustee or other plaintiff standing in the shoes of the corporation, "a court applying Pennsylvania law [has] discretion to bar use of the defense when under the circumstances presented, it concludes that its invocation would produce an inequitable result." Id.

This line of reasoning has been followed by other courts (see, e.g., In re Parmalat Securities Litigation, 383 F. Supp. 2d 587 (S.D.N.Y. 2005)), but it does raise an important issue about the true nature of the concept of aiding and abetting claim as a derivative claim. A trustee or creditors committee bringing such claim is deemed to be standing in the shoes of the corporation. If that plaintiff is deemed not to hold a direct claim against the lender, then a court's refusal to allow the defendant to assert the unclean hands or *in pari delicto* defense, which could be asserted against the corporation itself, may have the effect of converting the claim into a direct claim of the creditors against the lender, rather than a derivative claim on behalf of the company. The Jack Greenberg court recognized that potential, but dismissed the concern as follows:

The trustee's assertion that this action will benefit creditors is not an admission that this action is being brought on their behalf. In a liquidation case, it is commonplace for a trustee to pursue an action on behalf of the debtor in order to obtain a recovery thereon for the estate. . . simply because the creditors of a [*sic*] estate may be the primary or the only beneficiaries of such a recovery does not transform the action into a suit by the creditors. Otherwise, whenever a lawsuit constituted property of an estate which has insufficient funds to pay all creditors, the lawsuit would be worthless since under Kaplan [previously cited case] it could not be pursued by the trustee. . . . Such a result would be nonsensical. It would provide a windfall to the defendant without any justifiable reason.

240 B.R. 486 at 506-507. This litigation over the applicability or inapplicability of the *in pari delicto* defense will likely only increase to the extent these sorts of aiding and abetting claims are pursued against lenders.

B. Selected Cases (and the *In Pari Delicto* Defense)

Sharp Intl Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.), 302 B.R. 760, 770 (E.D.N.Y. 2003) -- At some point prior to 1997 and continuing until October 1999, the officers of Sharp International Corp. ("Sharp") inflated sales and revenue reports to raise money from banks while looting Sharp of more than \$44 million. During that same period, Sharp's former secured lender, State Bank and Trust Company ("Bank"), allegedly became aware of the fraudulent activity and took a number of steps to investigate the credit (such as placing the credit with a troubled loan specialist and contacting certain of Sharp's customers to determine whether they were legitimate). Despite its alleged concerns about Sharp, Bank said nothing to Sharp's noteholders when the noteholders purchased additional notes, the proceeds of which were used to pay off Bank's loans. When the noteholders later learned of the fraud, they filed an involuntary bankruptcy proceeding against Sharp. In the bankruptcy proceeding, Sharp filed an adversary complaint against Bank alleging aiding and abetting breach of fiduciary duty claims. The complaint clearly alleged a breach of fiduciary by Sharp's officers and that the breach had caused damage, but the court questioned whether the complaint adequately pled that Bank had actual knowledge of the breach of fiduciary duty or whether Bank had assisted or encouraged the breach. In pleading a claim for aiding and abetting a breach of fiduciary duty, one must plead that the defendant had actual knowledge of the fiduciary's breach of the duty, and "constructive" knowledge is insufficient. One must also adequately plead that the defendant "actively participated," "induced" or "instigated" the breach. In this case, the court ultimately held that the plaintiff adequately pled that Bank had actual knowledge of the breach of fiduciary duty, but the facts did not show that Bank assisted or encouraged the breach. Rather, Bank benefitted from its inaction. While perhaps repugnant, Bank had no duty to act and thus was not liable for aiding and abetting a breach of fiduciary duty.

Official Committee of Unsecured Creditors v. Lafferty & Co., Inc., 267 F. 3d 340 (3d Cir. 2001). The Shapiro family, aided by other third-party professionals, operated Walnut Enterprise Leasing Company, Inc., ("Walnut") and its wholly owned subsidiary, Equipment Leasing Corporation of America ("ELCOA"). In 1986, Walnut was experiencing financial difficulties and could not raise sufficient capital through the sale of debt securities. In an

effort to secure more capital for Walnut, the Shapiro family organized ELCOA to provide a platform to sell debt security through a new company with a clean financial image and marketed as an independent business entity. Investors purchased the ELCOA debt securities which the Shapiros allegedly funneled into Walnut while continuing to receive salaries and fees from both corporations. Ultimately, the scheme collapsed and both companies went into bankruptcy. After filing Chapter 11 petitions, the debtors' management, which included members of the Shapiro family and their co-conspirators, were removed and the court appointed a trustee. In 1999, the committee commenced a civil action against the debtors' officers, directors and outside professionals (Lafferty), citing a number of claims including breach of fiduciary duty and aiding and abetting breach of fiduciary duty. The Third Circuit held that while the committee had standing to sue, it was barred from recovering due to the equitable doctrine of *in pari delicto*.

The court held that the application of the doctrine hinges on whether the wrongdoer's conduct (in this case the Shapiro family) can be imputed to the claimants (in this case the debtors and thus the committee). In evaluating the claim, the court had to decide whether it should consider post-petition events (such as the removal of the Shapiros) and whether in light of those facts the wrongdoer's act should be imputed to the debtors to bar the committee's claim. Ultimately, the court reasoned that section 541 of the Bankruptcy Code prevented it from taking into account events that occurred after the start of the bankruptcy case and as such the committee stood in the same shoes as the Shapiros regardless of their status as an innocent successor. Additionally, the court concluded under the law of imputation that the Shapiro family's conduct should be imputed to the corporation. Reasoning that the adverse interest exception⁴ was itself subject to the sole actor exception⁵, the court held that the fraudulent conduct of the Shapiros should be imputed to the debtors because the wrongdoing was perpetuated during the course of their employment and they were the sole actors engaged in the allegedly fraudulent conduct. Consequently, because the committee was standing in the shoes of the debtors, and the alleged fraudulent conduct was

⁴Under this exception, fraudulent conduct will not be imputed if the officer's interest were adverse to the corporation and not for the "benefit" of it.

⁵If an agent is the sole representative of a principal, then that agent's conduct is imputed to the principal regardless of whether the conduct was adverse to the principal's interest. The reasoning behind this exception is that the corporation must bear the responsibility for allowing an agent to act without accountability.

imputed to the corporation, the *in pari delicto* doctrine barred the committee from bringing its claim against Lafferty.

In the dissenting opinion, however, Judge Cowen noted a number of problems with the majority's reasoning. First, Judge Cowen pointed out that even though *in pari delicto* is an equitable doctrine, the majority's inflexible application of the Bankruptcy Code injected "a pointless technicality" which works to thwart recovery for innocent creditors. Judge Cowen next pointed to the fact that the majority's opinion denied the plaintiffs equitable relief, thus achieving the opposite result of what an equitable doctrine is in fact supposed to do. The dissent also noted that while a trustee takes the place of the debtor and assumes the same causes of actions and defenses, the rule does not dictate that post-petition events can never be considered in evaluating a trustee's claims on behalf of an estate. Judge Cowen concluded observing that the majority opinion "retards the normal goals of tort law, misinterprets equitable doctrine, and reads the [B]ankruptcy [C]ode too narrowly".

Universal Builders, Inc. v. Moon Motor Lodge, Inc., 244 A.2d 10 (Pa. 1968). On August 16, 1961, the plaintiff ("Universal") entered into a written contract with the defendant ("Moon") for the construction of a motel and restaurant. Among other things, the contract specified that a certain proportion of a re-inforcing substance be used in the walls, yet the masonry subcontractor failed to use the specified proportion. When Moon discovered the defect, they withheld payment and induced Universal to enter into a supplemental agreement that had a number of onerous provisions. On September 1, 1962, Universal substantially completed performance and left the construction site a month later. After filing suit against Moon, Universal went into bankruptcy and the trustee prosecuted the action and won a final decree in the lower court. On appeal, Moon contended that Universal had unclean hands because Joseph V. Pizzuti, an officer and executive of universal during the performance of the contract, allegedly manufactured evidence to support Universal's case. The court decided that even if the allegations were true, the doctrine of unclean hands should not be applied in this case.

First, the court reasoned that the evidence was manufactured not by the plaintiff but by an officer of the plaintiff corporation and that for improper conduct to be relevant it has to touch and taint the plaintiff personally. Noting that the imputation of one party's unclean

hands to another is not based on simple agency principles, the court concluded that Moon had offered no persuasive reasons for imputing Pizzuti's conduct to the bankrupt corporation. However, even assuming that the conduct should be imputed to Universal, the court observed that the application of the unclean hands doctrine to deny relief is within the discretion of the court. The court asserted that to deny plaintiff recovery in the case would enrich Moon at the expense of innocent creditors of the bankrupt corporation thus leading to an inequitable result. Finally, the court concluded that the doctrine generally operates only to deny equitable and not legal remedies and the plaintiff had been granted a money decree, not a specific equitable remedy. Thus, ultimately the court was not persuaded that the unclean hands doctrine should be applied in the case.

In re Jack Greenberg, Inc., 240 B.R. 486 (Bankr. E.D. Pa. 1999). Fred Greenberg ("Greenberg") was the Vice-President of Jack Greenberg, Inc., a corporation whose business was the wholesale and retail sale of domestic and foreign meat and cheese products. Beginning sometime in 1987 or 1988, Greenberg began to discard delivery receipts and substitute new receipts in order to overstate the company's financial health. Grant Thornton, a public accounting firm, discovered the fraud and informed the president and controller of the company. In 1995, the company went into chapter 7 bankruptcy and the trustee sued Grant Thornton on a variety of counts including negligence, fraud and negligent misrepresentation. Grant Thornton responded arguing that Greenberg's conduct must be imputed to the debtor thereby precluding any recovery by the trustee standing in the debtor's shoes.

In examining whether Greenberg's conduct should be imputed to the debtor, the court considered whether an equitable defense could be raised to bar a suit brought by a bankruptcy trustee. The court relied heavily on Universal Builders, Inc. v. Moon Motor Lodge, Inc., 244 A.2d 10 (Pa. 1968), and held that the *in pari delicto defense* was inapplicable reasoning that imputation of Greenberg's conduct to the debtor would not serve the primary objectives of tort liability of deterring wrongful conduct and compensating the victims of harm. Grant Thornton argued that allowing the trustee to recover would signal that a company's auditor could always be sued to repay the creditors who had been injured by a breach of fiduciary duty, but the court considered Grant Thornton's concern overstated.

None of the debtor's shareholders would gain from the litigation since after paying everyone else there would be no excess funds for shareholders. As a result, the only beneficiaries of a recovery would be the innocent victim creditors. Thus, if anything, the court believed its decision would motivate shareholders and officers of similar corporations to adopt procedures that would protect the accuracy of their financial statements.

In re Parmalat Securities Litigation, 385 F. Supp. 2d 587 (S.D.N.Y. 2005). Since December, 2003, Enrico Bondi ("Bondi") served as what is roughly the equivalent of a chapter 11 bankruptcy trustee for Parmalat Finanziaria S.p.A. and some 21 affiliated entities (the "Parmalat Debtors"). Bondi brought suit against Bank of America Corporation and affiliates (the "Bank") claiming that the Bank had structured transactions that operated to defraud the Parmalat Debtors and their investors. The thrust of the allegations stated that the Bank had assisted the Parmalat Debtors, their affiliates (collectively "Parmalat") and these companies' managers in structuring and executing a series of complex financial transactions that were deliberately designed to conceal Parmalat's insolvency and make Parmalat appear healthier and more credit-worthy than the Bank knew that it was. The complaint against the Bank asserted some twelve different counts, most of which were dismissed by the court because either they were duplicative, there was insufficient evidence, or because they were barred by the doctrine of *in pari delicto*. The court noted that Parmalat engaged in a massive fraud and that the Bank assisted in some respects. Thus, the court then reasoned that the allegations regarding the challenged transactions made it clear that the Parmalat entities were crucial actors in these transactions and were not permitted to bring many of the claims due to their unclean hands.⁶ The plaintiff, Bondi, alleged that the wrongdoing on Parmalat's end was to be attributed to a group of "culpable insiders," but the court concluded that the attribution of wrongdoing to culpable insiders did not prevent the application of *in pari delicto*. The court observed that the acts and knowledge of a corporate officer or agent are imputed to the corporation where the officer or agent was acting within the scope of their employment. Because the complaint made it clear that the agents were acting for the company as well as themselves, the relevant actions must be imputed to the company.

Plaintiff, in an attempt to make use of the adverse interest exception,⁷ insisted that the acts should not be imputed because the insider's actions did not benefit Parmalat. However, the court refused to recognize what it deemed to be a narrow exception and concluded that whether the company had benefited or not was immaterial. It reasoned that agents often make decisions that prove to disadvantage their principals and so the question was not whether the officer's actions were beneficial or harmful but rather whether they were conducting their own business or the corporation's. Unconvinced that the insiders were acting solely for themselves rather than the company, the court concluded that their actions were to be imputed to Parmalat and the defense of *in pari delicto* applied. However, the court did note that the vague allegations of looting by Parmalat insiders were not barred by *in pari delicto*. The court explained that theft from a corporation by insiders is self-dealing by the insiders and not in any sense in the interests of the entity. Thus, the insider's actions and knowledge in engaging in such conduct cannot be imputed to the company and to the extent that the Bank assisted the insiders in stealing from Parmalat, the doctrine does not apply.

Adelphia Communications Corp. v. Bank of America, N.A. (In re Adelphia Communications Corp.), 365 B.R. 24 (Bankr. S.D.N.Y. 2007) -- The official committee of unsecured creditors brought an adversary proceeding on behalf of Adelphia, against Adelphia's lenders and investment banks. The committee's 256-count complaint charged the defendants with wrongdoing in their dealings with Adelphia's former management, the Rigas family, against whom Adelphia had brought suit for looting the company. The committee's numerous counts against the defendants included claims for aiding and abetting the Rigases' breaches of fiduciary duty in connection with "co-borrowing" facilities under which Adelphia became liable to repay the banks for billions of dollars that benefited the Rigases. The defendants asserted that the Rigas family's own breaches of fiduciary duty should be imputed to Adelphia such that the defendants could assert an *in pari delicto* defense against the committee (who was standing in the shoes of Adelphia). The court held that the *in pari*

⁶ It must be noted that though the court dismissed many of the counts because of the *in pari delicto* defense, it did not dismiss count four of aiding and abetting breach of fiduciary duty but the court does not explain why the *in pari delicto* defense does not apply to count four as well.

⁷ Under this exception, fraudulent conduct will not be imputed if the officer's interest were adverse to the corporation and not for the "benefit" of it.

delicto defense is grounded in state law and in equity such that state law would determine whether it was fair to allow a lender to assert *in pari delicto*. The court criticized the Lafferty court's opinion and focused instead on Universal Builders and Jack Greenberg finding that, in the bankruptcy context, equity very well may dictate that a committee representing innocent creditors should not be subject to the *in pari delicto* defense when asserting aiding and abetting breach of fiduciary duty claims against a lender that participated in the wrongdoing.

DEEPENING INSOLVENCY

A. Framework

Deepening insolvency has been defined as "the fraudulent prolongation of a corporation's life beyond insolvency, resulting in damage to the corporation caused by increased debt." Kittay v. Atlantic Bank (In re Global Serv. Group, LLC), 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004). The theory of deepening insolvency holds that the acquisition of debt by an insolvent company can harm the company and its creditors by making it more difficult for the company to run a profitable business without resorting to bankruptcy. Recently, a Delaware chancery court rejected the theory of deepening insolvency as a theory of recovery explaining:

If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.

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. If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.

Moreover, the fact of insolvency does not render the concept of "deepening insolvency" a more logical one than the concept of "shallowing profitability." That is, the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one. If in either setting the directors remain responsible to exercise their business judgment considering the company's business context, then the appropriate tool to examine the conduct of the directors is the traditional fiduciary duty rule. No doubt the fact of insolvency might weigh heavily in a court's analysis of, for example, whether the board acted with fidelity and care in deciding to undertake more debt to continue the company's operations, but that is the proper role of insolvency, to act as an important contextual fact in the fiduciary duty metric. In that context, our law already requires the directors of an insolvent corporation to consider, as fiduciaries, the interests of the corporation's creditors who, by definition, are owed more than the corporation has the wallet to repay.

Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006).

In the short time since the Trenwick decision was published, the decision has been followed by courts Ohio⁸ Virginia,⁹ Texas,¹⁰ New York,¹¹ Tennessee¹² and Pennsylvania,¹³ such that the

⁸ Liquidating Trustee of the Amcast Unsecured Creditor Liquidating Trust v. Baker (In re Amcast Indus. Corp.), 365 B.R. 91 (Bankr. S.D. Ohio 2007).

⁹ Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139, 2007 Bankr. LEXIS 159 (Bankr. E.D. Va. 2007).

¹⁰ Kaye v. Dupree (In re Avado Brands, Inc.), 358 B.R. 868, 2006 Bankr. LEXIS 3631 (Bankr. N.D. Tex. 2006); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Telephone Fin. Coop., 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005).

¹¹ Kettay v. Atlantic Bank (In re Global Service Group, LLC) 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

¹² Official Committee of Unsecured Creditors of Propex Inc. v. BNP Paribas (In re Propex), Adv. No. 08-1136 (Bankr. E.D. Ten. March 4, 2009).

¹³ Miller v. Santilli, 2007 Phila. Ct. Com. Pl. LEXIS 252 (2007).

viability of deepening insolvency claims remains suspect at best. Although the existence of deepening insolvency as a separate tort is slowly being eradicated, it is noteworthy that courts are likely to continue to apply the theory as a measure of damages. Indeed, the United States Bankruptcy Court for the District of Columbia recently stated:

Rather than attempt to "discover" a separate common law tort which must then be neutered, this court prefers to treat deepening insolvency as the theory of harm that it was always meant to be, and will rely on other, more established (not to mention less convoluted) common law causes of action to ascertain whether the defendants in this case have engaged in a legal wrong for which [plaintiff] is entitled to recover. Unless and until this court is told differently by a higher court in its own circuit, **deepening insolvency will remain a viable theory of damages in this jurisdiction regardless of whether the injury occurred as a result of negligence or fraud.**

Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Corp.), 353 B.R. 324, 338 (Bankr. D.D.C. 2006) (emphasis added); but see NCP Litigation Trust v. KPMG, 945 A.2d 132 (N.J. Super. 2007) (stating "the artificial prolongation of an insolvent corporation's life can harm a corporation. Where there is a harm, the law provides a remedy.")

B. Representative Cases

Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.), 383 F. Supp. 2d 587 (S.D.N.Y. 2005) -- The district court dismissed the plaintiff's deepening insolvency claim against the debtor's lender as duplicative. While stating that North Carolina courts have barely considered the issue of whether deepening insolvency is a claim under North Carolina law, the court noted that North Carolina recognizes a cause of action against a third party that aids a company's officers and directors in breaching their fiduciary duties by deepening their company's insolvency. Because the plaintiff's lawsuit against the lender included a cause of action for aiding and abetting the breach of a fiduciary duty, the court declined to rule on whether North Carolina recognizes an independent tort of deepening insolvency.

OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corporation), 340 B.R. 510 (Bankr. D. Del. 2006) -- The bankruptcy court denied the secured lenders' motion to dismiss the liquidating trustee's claims against them, including claims for deepening insolvency. The bankruptcy court concluded that the Third Circuit Court of Appeals would recognize a cause of action for deepening insolvency under the laws of Delaware, New York and North Carolina. In this case, the court noted that the liquidating trustee's complaint sufficiently alleged that the secured lender's inducement of the debtor to continue to borrow resulted in the financial condition that prompted it to file for bankruptcy protection. The court also cited the growing acceptance of deepening insolvency among the courts, as well as its remedial theme.

Nisselson v. Ford Motor Co. (In re Monahan Ford Corp.), 340 B.R. 1 (Bankr. E.D.N.Y. 2006) -- The bankruptcy court denied the lender's motion to dismiss the co-trustee's claim of deepening insolvency. The co-trustee's complaint alleged not only that the lender made a bad loan to the debtor, but also that the loan was made for the purpose of defrauding the debtor. As a result, the lender had exposed itself to potential liability for a deepening insolvency claim. Furthermore, the court concluded that the co-trustee stated with sufficient particularity the fraud allegations underlying its deepening insolvency claim, in accordance with Federal Rule of Civil Procedure 9(b).

Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Telephone Finance Cooperative (In re VarTec Telecom, Inc.), 335 B.R. 631 (Bankr. N.D. Tex. 2005) -- The bankruptcy court dismissed a deepening insolvency claim brought by the plaintiff creditors' committee against the debtor's pre-petition lender. The court concluded that because the injury caused by the deepening of a company's insolvency was substantially duplicated by torts already established in Texas, the Texas Supreme Court would not recognize an independent tort of deepening insolvency. Furthermore, assuming there was a cause of action for deepening insolvency, the liquidating trustee failed to demonstrate the requisite existence of an independent tort by the lender. Under Texas law, there is generally

no fiduciary relationship between a borrower and lender, such as to impose any extra-contractual duties on a lender.

Kittay v. Atlantic Bank of New York (In re Global Serv. Group LLC), 316 B.R. 451 (Bankr. S.D.N.Y. 2004) -- The bankruptcy court granted the bank's motion to dismiss with regards to the trustee's claim that the bank and its insiders allowed the debtor to continue to do business and become further insolvent. The court stated that the prolonging of a company's life, without more, will not result in liability for deepening insolvency. Rather, a claimant must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a company and its increased debt. With regard to the bank in this case, the court stated that the bank could not be liable for deepening insolvency solely by (1) its making of a loan it knew or should have known that the debtor could not repay or (2) its making of the loan on the strength of its relationship with the debtor's members and insiders.

LENDER LIABILITY UNDER LABOR LAWS (WARN ACT)

A. Framework

An obvious symptom of the current economic crisis is the striking number of jobs being lost in the U.S. economy. Many of these layoffs obviously are associated with companies going out of business, or with companies otherwise filing for bankruptcy protection. In those instances, unfortunately many times employees may be unpaid, or may receive little notice of the demise of their employer.

Under the Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-2109 ("WARN Act"), Congress provided generally that an employer must provide 60 days notice of any "mass layoff" or other planned closing. This timeframe was designed to allow employees to make adjustments or to seek other employment if their job was being eliminated. The WARN Act further

provides that any employee who receives less than the requisite 60 days statutory notice may assert a claim for up to 60 days of severance pay from the employer. The WARN Act, of course, provides certain exceptions, including what is known as the "faltering company exception," but by and large, if a company engages in a mass layoff or plant closing without providing sufficient notice, employees may have a substantial claim for unpaid severance pay. In a more typical reorganization case, employees frequently argue about whether or not such claims were entitled to priority under Section 507 of the Bankruptcy Code, requiring that those claims be paid in full as a part of confirmation of a plan. In the current economic climate, with liquidating chapter 11 cases seemingly becoming the norm, and with little, if any, unencumbered assets remaining even for priority creditors, employees have likewise begun to search for deep pockets, and have attempted in many instances to seek recovery of the statutory severance under the WARN Act from the company's lender.

At least three circuits have held that a lender might be liable for WARN Act claims in appropriate circumstances.¹⁴ But absent a situation in which the lender was deemed to be in control of the debtor and therefore in control of the decision to terminate employees, courts have fairly consistently held that there is no liability for lenders for the WARN Act severance payments.

B. Selected Cases

Coppola v. Bear Stearns & Co., 499 F.3d 144 (2d Cir. 2007) -- In dismissing a lender liability class action, the Second Circuit found that the lender was not an "employer" within the meaning of the WARN Act, and thus, could not be found liable. The Second Circuit determined that the appropriate test for imposition of liability under the WARN Act was

¹⁴ See generally Chauffeur, Sales Drivers, Warehousemen & Helpers Union Local 572 v. Weslock Corp., 66 F.3d 241, 244 (9th Cir. 1995)(stating that the issue is whether the lender was "responsible for operating the business as a going concern" at the time of the mass layoff or plant closing); Adams v. Erwin Weller Co., 87 F. 3d 269 (8th Cir. 1996)(following a similar test as the Weslock court); and Pearson v. Component Tech. Corp., 247 F. 3d 471 (3d. Cir.), *cert. denied*, 534 U.S. 950 (2001)(using the Department of Labor factors test to determine whether lender was liable

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whether the lender's conduct amounted to operation of the debtors' business. Its ruling followed the Eighth and Ninth Circuits. The Second Circuit declined to follow the Third Circuit's reliance on criteria developed by the Department of Labor in determining whether independent contractors and subsidiaries are to be treated as separate employers or as part of the parent or contracting company.

Zawlocki v. Rama Tech, LLC, 2005 WL 3358855 (E.D. Mich. 2005) -- The district court found that, while the plaintiffs' claims survived the secured lender's motion to dismiss, it was not sufficient to withstand summary judgment. Noting that liability under the WARN Act attaches only to the party that orders a plant closing, the court focused on degree of control exercised by the secured lender with respect to the closing. The secured lender presented unrefuted evidence that its control was limited to protecting its security. Due to the absence of evidence that the secured lender supervised or hired employees, the court held that summary judgment was appropriate.

Smith v. Ajax Mannathermic Corp., 144 Fed. Appx. 482 (6th Cir. 2005) -- The plaintiff appealed dismissal of his claim that defendant lenders were liable for violation of the WARN Act. The Sixth Circuit noted that, although the Department of Labor's regulations do not explicitly authorize suits against lenders, three circuits - the Third, Eighth and Ninth - have recognized that lenders may be liable under the WARN Act. Thus, the Sixth Circuit found it "inappropriate" to dismiss the plaintiff's WARN Act claim for failure to state a claim, and it reversed the lower court's ruling.

under WARN Act, examining whether there was common ownership, common officers or directors, *de facto* common ownership, unity of personnel policies emanating from a common source, and dependency of operations).