

ABI ANNUAL MEETING 2009

New Wave of Litigation – Fraudulent Transfers,

Broken Commitments, Failure to Fund and Lack of Good Faith

By: Jo Ann J. Brighton¹

In this economic downturn, creditors, and junior lien holders, must search for deep pockets, outside the bankruptcy estate, to find any meaningful recovery for creditors. See generally *What is Left for Creditors – Part II*, Brighton, Jo Ann J., Parrish, Felton, Vol. XXVII, No. 10, American Bankruptcy Institute Journal (December 2008) and *What is Left for Creditors – Part I*, Brighton, Jo Ann J., Parrish, Felton, Vol. XXVII, No. 9, American Bankruptcy Institute Journal (November 2008). One way to generate a return for creditors is to look to the secured creditors (who normally are in much better financial condition than the debtor). When looking at possible causes of action for lender liability, equitable subordination, recharacterization, deepening insolvency and claims emanating from breach of fiduciary duty have been the popular choices in the past five years. It is also not uncommon to seek recovery against the officers and directors under the D&O Insurance Policy. Part A of these materials will explore recent developments with respect to these traditional causes of action. Part B explores recent creative allegations concerning claims based on bad faith lending or enforcement, failure to fund, broken commitments and other miscellaneous claims made against lenders in hopes of generating recovery.

A. Recent Developments – Traditional Lender Liability Actions

1. Equitable Subordination.

Committees can seek to have the claims of the secured creditors equitably subordinated – essentially, moved to the back of the line in the priority scheme, thereby freeing up assets for distribution to the unsecured creditors. However, in order to have a claim equitably subordinated, generally some wrongdoing on the part of the secured creditor must be established. Further, only the amount of established harm will be equitably subordinated. For a more in depth discussion of the requirements of equitable subordination, see the articles titled “Is It a Capital Contribution or a Loan”; “Update: Recharacterization – Practical Pointers in an

¹ Ms. Brighton is Of Counsel with K&L Gates, LLP, Charlotte, North Carolina in the Financial Services Department – Financial Restructuring Group where she practices primarily in the area of bankruptcy, workouts and secured lending. She is a fellow in the American College of Bankruptcy. She served as the Co-Chair of the Business Reorganization Committee for the American Bankruptcy Institute, is a member of the Board of Directors for the American Bankruptcy Institute, a contributing editor for the American Bankruptcy Institute Journal, serves on its Editorial Board, on the Advisory Board for the ABI Law Review, is certified in Business Bankruptcy by the American Board of Certification and is a frequent author and lecturer on bankruptcy related topics.

Evolving Arena”; and “Submicron Developments in Recharacterization: Certainty and Finality, or Further Confusion?”, which are attached as Exhibits A, B, and C hereto.

2. Recharacterization.

Another avenue to pursue which can reduce the claims of the secured creditors is to challenge the structure of what is characterized as a “loan transaction” and seek to have the amount of the secured claim recharacterized as equity (which is last in line in the priority scheme for distributions). Unlike equitable subordination, recharacterization involves recharacterizing the entire amount of the secured creditors’ claim. For example, if a lender has an alleged secured claim for \$100 and someone alleges that the secured creditor did something to cause harm to the other creditors of \$50, if the claim is equitably subordinated, the secured creditor would still have a secured claim for \$50 and an unsecured claim for \$50. However, if the claim is recharacterized as equity, the secured creditor will have no secured claim and an unsecured claim for the entire \$100. Further, no misconduct need be established to have a claim recharacterized – it is merely looking over form to substance – namely, was the transaction truly intended to be an equity investment disguised as a secured lending arrangement? See most recent case in In re Musicland Holding Corp., 2008 WF 5377701 (Bankr. S.D.N.Y. 2008) (even if claim had not been filed against the estate, recharacterization claim could be brought because was sufficient nexus to fraudulent transfer claims alleged against defendant.) For a more in depth discussion of the factors used to analyze a recharacterization claim, see articles titled: “Is It a Capital Contribution or a Loan”; “Update: Recharacterization – Practical Pointers in an Evolving Arena” and “Submicron Developments in Recharacterization: Certainty and Finality, or Further Confusion?” attached as Exhibits A, B and C hereto.

3. Other Lender Liability Actions.

Rather than attacking the specific claim of the secured lenders, the Committee can also seek to recover damages from the secured lender on a variety of bases which include deepening insolvency and aiding and abetting breach of fiduciary duty. However, it is sometimes difficult to establish causation on the part of the lenders. See discussion in article “Hedge Funds: Lessons Learned from the Radnor Decision,” attached hereto as Exhibit D, which discusses lessons learned from the *Radnor* decision.

(i) Deepening Insolvency.

A claim for deepening insolvency essentially argues that a secured creditor never should have lent the debtor money (or additional money) because, at a certain point in time they knew, or should have known, that the debtor could never repay the loan. Accordingly, the allegation is that the secured creditor should have pulled the plug on the debtor sooner and not artificially “propped” the company up only to keep it running to repay the secured creditor to the detriment of the unsecured creditors. For more in depth discussions of the theory of deepening insolvency, its progeny and its current status, see articles: “Deepening Insolvency – Secured Lenders and Bankruptcy Professionals Beware: It is Not Just for Officer and Directors Anymore”; “Deepening the Blows Against Deepening Insolvency? The Third Circuit’s CitX Opinion and Post-CitX Opinions”; and “The Implications of North American Catholic and

Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?", attached as Exhibits E, F and G hereto.

Many state courts, including those in Delaware, have concluded that there is no separate tort based upon an action for deepening insolvency – it is merely duplicative of a tort claim for breach of fiduciary duty. See also Schoon v. Troy, 2008 De. LEXIS 67 (Sup. Ct. Del 2/12/08). However, a recent case in the Superior Court in New Jersey, concluded that perhaps it is still a viable cause of action. See also NCP Litigation Trust v. KPMG, 945 A.2d 132 (N.J. Super. 2007). Further, the question still remains as to whether deepening insolvency may be used as a theory of damages. The KPMG court in New Jersey recognized deepening insolvency as a theory of damages in New Jersey and the Delaware bankruptcy court held that it can be. In In re Brown Schools, 2008 WL 1849790 (Bankr. D. Del.) (April 24, 2008), the court held that deepening insolvency may be used as a theory of damages when a breach of duty of loyalty claim is brought against officers and directors. For a chart containing a synopsis of the status of claims under deepening insolvency in each state, see Appendix A to the article titled: "The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?" attached as Exhibit G hereto.

(ii) Aiding and Abetting Breach of Fiduciary Duty.

Creditors may be able to bring a claim against secured creditors that they aided and abetted the officers and directors in breach of their fiduciary duty by allowing them to pursue, or not pursue, a particular course of action. For a more in depth discussion concerning the requirement to establish a breach of fiduciary duty claim against secured lenders, and some cases in which it has been litigated, see articles titled "Secured Creditors Beware: The Latest Tool in the Creditors' Committee Tool Box – Aiding and Abetting in the Breach of a Fiduciary Duty" and "Update: Aiding and Abetting in the Breach of Fiduciary Duty The Appellate Decision in Sharp Electronics: A Step In the Direction of Victor for Lenders?" attached hereto as Exhibits H and I hereto. See also In re Brown Schools, 2008 WL 1849790 (Bankr. D. Del.). (Trenwick required dismissal of deepening insolvency claim, but cannot be read so broadly as to require dismissal of breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste, and civil conspiracy claims); In re Musicland Holding Corp., 2008 WL 537701 (Bankr. S.D.N.Y. 2008) (knowing participation an essential element to claim for aiding and abetting breach of fiduciary duty claim).

(iii) Other Possible Sources of Recovery.

Another source of recovery of additional possible funds is for the Committee to bring an action against the officers and directors for their breach of fiduciary duty (which is generally covered, and funded by the D&O Insurance Policy). Particularly, there has been some discussion of additional duties which may be present in the "zone of insolvency" in a corporation. (Trenwick required dismissal of deepening insolvency claim, but cannot be read so broadly as to require dismissal of breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste, and civil conspiracy claims). See also the unpublished decision in Nelson v. Emerson, 2008 WL 1961150 (Del. Ch. May 6, 2008) (secured creditor brought action against two majority stockholders and directors for breach of fiduciary duty for filing bankruptcy petition and for payment of excessive compensation which court held that directors

of Delaware corporations do not commit a breach of fiduciary duty if they have a corporation file a non-frivolous claim because they are protected by the business judgment rule.) For a more in depth discussion on the current status of officer and director liability in the zone of insolvency, see article titled "The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?" attached hereto as Exhibit G. See also Schoon v. Troy, 2008 De. LEXIS 67 (Sup. Ct. Del 2/12/08).

B. Broken Commitments, Failure to Fund and Lack of Good Faith.

1. Broken Commitments, Failure to Fund, and Lack of Good Faith.

Generally, all lender liability claims find some basis in a breach of a duty (whether contractual or implied) of good faith. Specifically, that the lender had a duty to act in one way, but acted in another way for an improper motive. However, it should be noted that it is generally accepted that: 1) a lender, without more (such as exercising control over the borrower) does not have a fiduciary duty (in its capacity as lender); and 2) does not act in bad faith or violate any duty merely by acting to protect its own interest.

Another avenue of lender liability can be an allegation for tortious interference with contract. In order to establish a claim for tortious interference with contract, the plaintiff must establish the following: (1) there was a contract subject to interference, (2) the act of interference was willful and intentional, (3) such intentional act was a proximate cause of plaintiff's damage, and (4) actual damage or loss occurred. See, e.g., Eubanks v. CBKS Financial Group, Inc., 385 F.3d 894 (6th Cir. 2004). However, generally, it will be difficult (and expensive) for a plaintiff to establish that a lender's actions were willful and intentional as the lender will assert the affirmative defense that it was merely exercising its contractual rights under the appropriate credit agreements. Other causes of actions against lenders have historically been rooted in negligent misrepresentation, constructive fraud, negligent supervision, and intentional infliction of emotional distress. See, e.g., Id.

2. Anecdotal Reports re: Creativity of New Litigation Claims.

While these cases have yet to reach trial and/or reported decision stage, there is plenty of anecdotal reports (some my own, and some reported to me by others) which clearly indicates a shift in this economic climate toward the more aggressive and creative litigation strategy in order to obtain some sort of recovery for the plaintiffs against lenders. For example, take the lawsuit filed in State Court in New York by Donald Trump against his lenders with respect to a \$640 million loan on the development of a Chicago skyscraper. In the lawsuit, Trump seeks \$3 billion in damages and to extend the repayment of the loan based upon the impact of the credit crisis and, in part, on an allegation that the first lien lenders, by inviting so many into the first lien group, knew or should have known, they never would have been able to get the consent needed under the loan documents, and, accordingly, acted in bad faith. See Wall Street Jnl, 11/8/08, p. B2. Take another lawsuit where the borrower has alleged that the lenders are acting in bad faith in their attempts to recover on their debt and collateral because, in this economy, the lenders should know no one is able to repay their obligations according to a previously negotiated timeline. Another example is a lawsuit filed against lenders for aiding and abetting in the breach

of the directors and officers fiduciary duties because the lenders knew, or should have known, that the borrowers could never repay the obligations and should not have attempted to sell golf course memberships to residents in the development (which was ultimately foreclosed upon for failure to pay).

Real estate development provides a particular hotbed of new litigation claims. In many cases, lawsuits are brought more as a defensive action to stall a pending foreclosure. For example, in Florida where developers of troubled projects have brought claims against lenders: the original developer of the Il Lugano condo hotel in Fort Lauderdale sued KeyBank for allegedly erecting “unreasonable hurdles” as a condition of continued financing; the developer of the Logik 1 office-condo sued Bank of America for pulling financing and allegedly causing construction of the project to stop; and, as a counterclaim in a foreclosure action, the developer of the Promenade Lakes at Doral condo sued Wachovia for failing to fully fund the project’s construction loan. *See Beck, Jared, Developers Suing Lenders: Paving The Way To Lender Liability Claims From Real Estate Buyers?* <http://beckandlee.wordpress.com/2008/08/28/developers-suing-lenders-paving-the-way-to-lender-liability-claims-from-real-estate-buyers>. “This recent trend is certainly no surprise, given the extent to which so many developers are embattled these days. Bringing a claim for breach of a loan agreement against a lender which has initiated foreclosure proceedings is a logical maneuver to deploy in the developer’s defense of the foreclosure itself (with the operative litigation principle being that the best defense is often a good offense).” *Id.*

These are just a few examples, and there are many more. However, the common denominator is obvious: challenging economic times breeds creativity in litigation strategies in order to obtain relief for borrowers. Lenders are sure to be on the defendant side of many such lawsuits in the foreseeable future. However, plaintiffs should be cognizant of the standards to survive a motion to dismiss such lawsuit outlined in Section 3(ii) below.

3. Miscellaneous.

(i) Trading Claims – Take Caution. Lenders should be aware that just because they sell a claim, does not mean that they can no longer be subject to a lawsuit for equitable subordination, recharacterization and the like. The factual analysis will ultimately lead plaintiffs to the original lender. Lenders would be wise to include indemnification language in trade documents.

Plaintiffs should be aware that they should sue the appropriate party, i.e., the original lender and not the subsequent transferee. The transferee should be ready to file a motion to dismiss if they are named in such a lawsuit.

(ii) Motion to Dismiss – Pleading Standards. New pleadings standards for motions to dismiss established by the United States Supreme Court could make it more difficult for “creative” lawsuits to survive. In adversary proceedings, the general factual standard for pleading a cause of action for recharacterization, equitable subordination, or any other cause of action not otherwise governed by a special rule of pleadings is found in Rule 8(a) of the Federal Rules of Civil Procedure, made applicable by Bankruptcy Rule 7008: a “short and plain statement of the claim showing that the pleader is entitled to relief.” That standard is not often

tested under Rule 12(b)(6) in the context of a motion to dismiss for failure to state a claim upon which relief can be granted. For at least 40 years prior to 2007, that standard, as interpreted and articulated in Conley v. Gibson, 335 U.S. 41, 45-46 (1957), mean that “a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.”

In 2007, the Supreme Court abrogated the Conley standard in Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 127 S.Ct. 1955 (2007). In so doing, it characterized Conley’s “no set of facts” phrase as having “earned its retirement” and “best forgotten as an incomplete, negative gloss on an accepted pleading standard.” Twombly, *supra*, 127 S.Ct. at 1969. In the Court’s view, the application of the Conley standard had become too literal, and was under increasing criticism from both lower courts and commentators:

[O]n such a focused and literal reading of Conley’s “no set of facts” [standard], a wholly conclusory statement of claim would survive a motion to dismiss whenever the pleadings left open the possibility that a plaintiff might later establish some “set of [undisclosed] facts” to support recovery.

Id. at 1968.

The new general pleading standard announced in Twombly is a “plausibility” standard. A complaint will now survive a motion to dismiss under Rule 12(b)(6) if it contains “enough facts to state a claim for relief that is plausible on its face.” Id. at 1974. The complaint need not plead sufficient facts to establish a prima facie case, so long as it alleges “enough to raise a right to relief above the speculative level, on the assumption that all the allegations are true (even if doubtful in fact),” and if it contains something more than “labels, conclusions or a formulaic recitation of the elements of a cause of action.” Id. at 1965.

Opinions applying the Twombly standard to complaints alleging equitable subordination include Miller v. Parker, 390 B.R. 532 (Bankr. E.D. Pa. 2008); Interstate Structures, Inc. v. Heritage Bank (In re Thurston), 2008 WF 852611 (Bankr. D. Neb. 2008); Delphi Corp. v. Appalossa Mgmt. L.P. (In re Delphi Corp.), 2008 WF 3486615 (Bankr. S.D.N.Y. 2008); Nat’l Emergency Servs. V. Williams, 371 B.R. 166 (W.D. W.Va. 2007); Official Committee of Unsecured Creditors v. Foss (In re Felt Mfg. Co., Inc.), 371 B.R. 589, 604-07 (Bankr. D.N.H. 2007); and Adelphia Communications Corp. v. Bank of America, N.A. (In re Adelphia Communications Corp.), 365 B.R. 24, 33 (Bankr. S.D.N.Y. 2007). Opinions discussing the Twombly standard in other bankruptcy contexts include Buckley v. Merrill Lynch & Co., Inc. (In re DVI, Inc.), 2008 WL 4239120 (Bankr. D. Del 2008) (breach of fiduciary duty; fraudulent transfer; preference); and Connolly v. Pillsbury Winthrop Shaw Pittman LLP (In re Sonicblue, Inc.), 2008 WF 2875407 (Bankr. N.D. Cal. 2008) (breach of fiduciary duty; legal malpractice).