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Deepening Insolvency and Sponsor Deals

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"The reports of my death are greatly exaggerated."

\- Mark Twain

A recent Delaware bankruptcy court decision gives new life to "deepening insolvency" claims and at the same time raises concerns for LBO sponsors. The court in In re The Brown Schools, 2008 WL 1849790 (Bankr. D. Del. April 24, 2008), held that a sponsor may be liable for "deepening insolvency" damages arising out of a breach of the duty of loyalty when a portfolio company makes payments or transfers value to a sponsor while in the zone of insolvency.

Deepening insolvency generally refers to increasing the debt load of a troubled company to the detriment of the company and its creditors. Although some jurisdictions recognize the theory, deepening insolvency is not an independent cause of action under Delaware law. Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168 (Del. Ch. 2006). Although many believed that deepening insolvency in Delaware was dead or at least dying after Trenwick, the Chancery Court left open the door to use deepening insolvency as a theory of damages. The Brown Schools decision walks through that door.

The Facts

McCown De Leeuw & Co., Inc. ("Sponsor") indirectly acquired 65% of the stock of The Brown Schools, Inc. (the "Portfolio Company") through a LBO, which included an advisory services agreement between the Portfolio Company and several Sponsor entities. Later $15 million in unsecured notes were issued to a third party (TIAA) and $5 million in subordinated PIK notes were issued to Sponsor entities.

Following a default under the original secured LBO debt, the Portfolio Company agreed to sell assets to reduce the secured debt and to issue $7.5 million in PIK notes to the Sponsor. The company's financial condition continued to deteriorate, leading to a series of asset sales, the proceeds of which were used to retire more of the secured debt, and to pay $1.7 million to the Sponsor for fees not contemplated by the advisory services agreement. As part of these transactions, the Sponsor received a second lien on substantially all of the company's assets and sale proceeds of up to $2.9 million under an intercreditor agreement with TIAA. Less than a year later, the Portfolio Company was a chapter 7 debtor.

The Bankruptcy Court's Decision

The chapter 7 trustee sued the Sponsor, its affiliates and its attorneys, as well as certain directors and officers of the Portfolio Company, alleging that the Sponsor (as controlling shareholder with board representatives), breached the duty of loyalty by wrongfully prolonging the Portfolio Company's existence to engage in transactions that preferred the Sponsor over non-insider creditors.

The Sponsor moved to dismiss, arguing that the claims were mere deepening insolvency claims of the sort rejected by Trenwick. The Brown Schools court denied the motion and ruled that:

- Although Trenwick required dismissal of a separate deepening insolvency claim, the duty of loyalty claims (i.e., self-dealing) and corporate waste claims survived, even though they resembled deepening insolvency claims.

- Deepening insolvency may be used as a theory of damages for a claim based on a breach of the duty of loyalty. The trustee's $22 million damage claim survived dismissal where the Sponsor insiders received (i) $1.7 million in fees, (ii) new liens on existing debt, and (iii) up to $2.9 million under an intercreditor agreement. The complaint alleged that the Sponsor's actions increased (deepened) the company's insolvency by more than $22 million.

Key Lessons

- Deepening insolvency is not dead. Plaintiffs will aim to allege breaches of fiduciary duty that give rise to deepening insolvency damages and may seek damages that exceed amounts actually received by the sponsor. Valuing these damages will be difficult and require expert testimony and litigation.

- Any transfer of value to a sponsor from a portfolio company in financial distress will be scrutinized in a subsequent bankruptcy, and challenged, if possible, as a duty of loyalty claim where the business judgment rule is not available as a defense and where the burden of proof can shift to the defendant. Duty of care claims more closely resemble the deepening insolvency claims rejected in Trenwick and are subject to the business judgment defense (and gross negligence standard).

- When restructuring a financially distressed portfolio company, sponsors should (i) observe corporate formalities and procedures governing affiliated transactions, (ii) document the fairness and benefits of the transaction to the portfolio company, and (iii) consider whether additional protective steps are advisable.

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