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June 2, 2008

In re The Brown Schools: Deepening Insolvency Still Alive

If you thought, like many, that the Delaware Supreme Court's decision in *Trenwick Am. Litig. Trust* v. *Billet*, 2007 Del. LEXIS 357 (Del. 2007), put the theory of "deepening insolvency" to rest, once and for all, well, think again. A recent decision, *George L. Miller* v. *McCown De Leeuw & Co. (In re The Brown Schools),* 2008 Bankr. LEXIS 1226 (Bankr. D. Del. April 24, 2008), from the United States Bankruptcy Court for the District of Delaware shows that "deepening insolvency" endures, albeit in reduced form. The case involved a bankruptcy trustee's suit against an equity sponsor, McCown De Leeuw & Co. ("MDC"), and the directors of, and counsel for, MDC's portfolio company, The Brown Schools (the "Debtor"). The trustee alleged that MDC caused the Debtor to make transfers and restructure debt that improperly favored MDC and its affiliates over other creditors. According to the trustee, such conduct occurred while the Debtor was insolvent and thus, MDC had engaged in self-interested transactions in breach of MDC's fiduciary duties to the Debtor's creditors.

As alleged in the complaint, MDC owned 65% of the Debtor and was also one of the Debtor's principal creditors, having provided the Debtor with $12.5 million of subordinated loans. In addition, MDC, through two of its affiliates, entered into an Advisory Services Agreement with the Debtor to provide financial, advisory and consulting services. After the Debtor defaulted on $100 million of secured debt owed to Credit Suisse First Boston ("CSFB"), the Debtor sold certain assets and used the proceeds to satisfy the CSFB debt and to pay $1.7 million to MDC. A year later, the Debtor restructured the $12.5 million debt owed to MDC, as well as the $18 million of debt owed to Teacher's Insurance and Annuity Association ("TIAA"). As a result of this restructuring, TIAA received a first lien and MDC received a second lien on substantially all of the Debtor's assets pursuant to an intercreditor agreement. Pursuant to that agreement, MDC would receive up to $2.9 million from assets sale proceeds received by TIAA. The Debtor subsequently liquidated more than $18 million in assets and paid the proceeds to TIAA, which shared them with MDC.

A few months later, the Debtor filed for relief under chapter 7 of the Bankruptcy Code. The trustee sued MDC, the MDC-affiliated directors of the Debtor and counsel (which had been selected by MDC), alleging that MDC had used its power as the Debtor's controlling shareholder to engage in self-interested transactions that ultimately benefited MDC as a creditor to the detriment of the Debtor's other creditors.

Defendants moved to dismiss the complaint. They argued that the trustee's claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste and civil conspiracy failed to plead legally cognizable claims or damages. Specifically, MDC, citing *Trenwick*, argued that Delaware does not recognize deepening insolvency. MDC maintained that *Trenwick* required the dismissal of the trustee's claims because they appeared to rely on a theory of deepening insolvency.

The trustee responded by distinguishing *Trenwick*, noting that the complaint in that case did not allege a breach of fiduciary duty or self-dealing, nor did it adequately plead that the company was insolvent at the time of the challenged transactions. The Bankruptcy Court agreed that *Trenwick* did not require dismissal of the trustee's claims. It rejected MDC's reading of *Trenwick* as overbroad, holding that the Delaware high court had clearly acknowledged that plaintiffs could bring traditional claims against defendants for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste and civil conspiracy. It also held that deepening insolvency remained a viable damages theory for the trustee's breach of fiduciary duty claims.

The Brown Schools is noteworthy because it illustrates the risks that equity sponsors and directors of portfolio companies (as well as professional advisors) may face when restructuring an insolvent company. The Bankruptcy Court's ruling makes clear that equity sponsors must be mindful of participating in transactions that could benefit them at the expense of other creditors. It dictates that due regard must be given to the fairness of a proposed transaction on non-insider creditors to minimize exposure to fiduciary claims. *The Brown Schools* is also significant in holding, post-*Trenwick*, that deepening insolvency provides a viable damages theory, even though *Trenwick* rejected deepening insolvency as an independent cause of action.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be addressed to:

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