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The Delaware Court of Chancery Gives the Deep-Six to Deepening Insolvency

In the first state-level decision of its kind, the Delaware Court of Chancery recently refused to recognize “deepening insolvency” as an independent cause of action under Delaware law. In *Trenwick America Litigation Trust v. Ernst & Young LLP, et al.*, the Court of Chancery granted a motion to dismiss a deepening insolvency count against former directors of an insolvent corporation. 2006 WL 2333201 (Del. Ch. Aug. 10, 2006).

The Theory of Deepening Insolvency

The theory of deepening insolvency refers to the “‘fraudulent prolongation of a corporation’s life beyond insolvency,’ resulting in damage to the corporation caused by increased debt.” *Kittay v. Atlantic Bank of New York (In re Global Service Group, LLC)*, 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004) (quoting *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir.), *cert. denied*, 464 U.S. 1002, 104 S.Ct. 508, 78 L.Ed.2d 698 (1983)).

Rather than being a well-established cause of action, however, “deepening insolvency” is an unsettled theory that “courts have struggled with,” *Baena v. KPMG LLP*, 389 F.Supp.2d 112, 117 (D.Mass. 2005) (citing cases), and is “officially in disarray.” Professor Dan Schechter, *Tort Of ‘Deepening Insolvency’ Is Subsumed Within Claim For Breach Of Fiduciary Duty And Is Not An Independent Cause Of Action [In re Greater Southeast Community Hospital Corp. (Bankr. D.D.C.)]*, Commercial Finance Newsletter, 2005 COMFINNL 89 (Dec. 8, 2005).

The theory of “deepening insolvency” was first articulated 23 years ago by the United States Court of Appeals for the Seventh Circuit in *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983). Because there is no federal cause of action for deepening insolvency, the federal courts that have pondered the issue have had to “don the soothsayer’s garb” and predict how a particular state’s highest court would rule if it were presented with the question. And despite the passage of over two decades since the *Schacht* decision, no state court has ever recognized deepening insolvency as an independent tort.

The *Trenwick* decision is noteworthy. Not only is *Trenwick* the first state court decision squarely considering - and rejecting - a cause of action for deepening insolvency, it will also have an immediate impact on how federal courts evaluate deepening insolvency claims due to the strict reliance of the federal courts on state court interpretation of the doctrine.

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Trenwick

Facts

The Trenwick Group Inc., a New York Stock Exchange-listed holding company (and its successors, collectively, “Trenwick”), operated a specialty insurance and reinsurance organization issuing policies around the world. In 1998, Trenwick embarked on a strategy of growth by acquisition. Within two years, Trenwick acquired three unaffiliated insurance companies. The two transactions at issue in *Trenwick* involved the acquisition of publicly-traded entities approved by a vote of Trenwick’s diverse stockholder base.

In connection with the second acquisition, Trenwick redomiciled to Bermuda for tax reasons. Consistent with that objective, Trenwick reorganized its subsidiaries by national line, creating lines of United States, United Kingdom and Bermudan subsidiaries. Trenwick’s top subsidiary in the United States, Trenwick America Corporation (“Trenwick America”) became the intermediate parent of all of Trenwick’s U.S. operations.

Trenwick America also continued (and expanded) its role as a guarantor of Trenwick’s overall debt, including \$260 million of bank debt. It also assumed responsibility for approximately \$190 million of debt securities. Nonetheless, after the reorganization, the financial statements of Trenwick America alone indicated that it had a positive net asset value of over \$200 million.

Trenwick eventually faltered. Both Trenwick and Trenwick America filed for bankruptcy in the United States Bankruptcy Court for the District of Delaware. The apparent cause of the business failure was that the insureds' claims against Trenwick’s operating subsidiaries (including the insureds of the companies Trenwick had acquired) exceeded estimates and outstripped Trenwick’s capacity to service the claims and its debt.

Procedural History

The chapter 11 plan for Trenwick America created a Litigation Trust holding all of the causes of action owned by Trenwick America. The Litigation Trust filed a complaint asserting a host of claims against three groups of defendants, including the former directors of Trenwick, the former directors of Trenwick America and certain of Trenwick’s former professional advisors. The essential premise of the Litigation Trust’s claims was that the majority independent board of Trenwick engaged in an imprudent business strategy by acquiring other insurers with erroneous and understated estimates of their potential claims exposure.

As a result, it was alleged, Trenwick and Trenwick America were eventually rendered insolvent, to the detriment of their creditors. The Litigation Trust also asserted that Trenwick America took on obligations to support the debt of Trenwick (its parent) and actually assumed some of that debt, and therefore, Trenwick America and its creditors allegedly suffered even greater injury than Trenwick and its creditors.

The numerous claims asserted by the Litigation Trust included one for “deepening insolvency” against the former directors of Trenwick America. The deepening insolvency claim

accused Trenwick America's former directors of "coloring [Trenwick America] and its subsidiaries an even deeper shade of red" by increasing the debt of Trenwick America and its subsidiaries in connection with one of the acquisitions.

The Court of Chancery's Decision

The Court of Chancery concluded that Delaware law does not recognize "deepening insolvency" as a cause of action, because "catchy though the term may be, it does not express a coherent concept." Noting that chapter 11 of the Bankruptcy Code expresses the notion that an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to operate and turns things around, the Chancery Court explained that Delaware law imposes "no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate," but rather, the insolvent company's board may pursue, in good faith, strategies to maximize the value of the firm.

The Chancery Court also reaffirmed that the protections of the business judgment rule extend to insolvent companies. The court explained that if the board of an insolvent corporation, acting with due diligence and in good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, the board does not become a guarantor of such strategy's success, nor does it give rise to a cause of action because the directors are protected by the business judgment rule.

In other words, the mere fact of insolvency does not render the concept of "deepening insolvency" a more logical one than the concept of "shallowing profitability." 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."

Indicating its displeasure with federal decisions recognizing the theory, the Court of Chancery stated that "[t]he concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorian academic ring that tends to dull the mind to the concept's ultimate emptiness." Rather, the court sided with "a growing body of federal jurisprudence" rejecting deepening insolvency as an independent cause of action.

In a separate part of the decision, the Court of Chancery held that the Litigation Trust failed to state a viable claim for breach of fiduciary duty. As a result, the Chancery Court concluded that the Litigation Trust could not effectuate an end run around that failure by asserting a cause of action for deepening insolvency – a claim which essentially relies on same elements as one for breach of fiduciary duty.

The Chancery Court cautioned however that its rejection of an independent cause of action for deepening insolvency under Delaware law does not absolve directors of insolvent corporations of responsibility to fulfill their fiduciary obligations. Providing a succinct summary of the litigation "toolkit" available to plaintiffs, the Court of Chancery stated, "[e]xisting equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations."

Conclusion

The rejection of deepening insolvency as an independent cause of action by the very first reported decision by a state court squarely facing the issue may represent the beginning of the end of a theory of liability that has plagued officers, directors, lenders, as well as the professionals who advise them. While it is too early to pronounce the theory of deepening insolvency dead, the Delaware Court of Chancery's decision in *Trenwick* is a significant blow to this unsettled, and unsettling, doctrine.

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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 directed to any member of the Paul Weiss Bankruptcy Group, including:

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