

Deepening Insolvency Not a Cause of Action in Delaware

COMMENTARY

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Special to DLW

In *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 2006 WL 2333201 (Del. Ch.), the Court of Chancery ruled that under Delaware law “deepening insolvency is no more of a cause of action when a firm is insolvent than a cause of action for ‘shallowing profitability’ would be when a firm is solvent.”

This short column will only focus on key aspects of the case; however, the issues in the case could be, and have been, the topic of law review articles. See Larry Ribstein & Kelli Alces, *Directors’ Duties and Failing Firms*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880074; see also Professor Ribstein’s blog comment at http://bus-movie.typepad.com/ideoblog/2006/08/deepening_insol.html.

The court also cites at footnote 75 the blog comment and law review articles of Professor Stephen Bainbridge. See Stephen Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency* (forthcoming 2006), available at <http://ssrn.com/abstract=832504>; *Duties of Directors of Insolvent Corporations*, http://www.professorbainbridge.com/2006/07/duties_of_direct.html (July 26, 2006).

In its August 2006 opinion, the Chancery Court held that the business judgment rule applied to protect independent directors and that there is no special duty of the board owed to creditors. Rather, “even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm’s operation in the hope that they can expand the inadequate pie such that the firm’s creditors can agree to a

recovery. By doing so, the directors do not become a guarantor of success.” The court reasoned that the “incantation” of the word insolvency, or “even more amor-phously, the words zone of insolvency,

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should not declare open season on corporate directors. Directors are expected to seek profit for stockholders, even at risk of failure.”

The court recites the extensive factual background of *Trenwick* in great detail

even though the court had to in some instances, rewrite the facts or fill in the facts from publicly available documents. The plaintiff was a litigation trust created through a Chapter 11 bankruptcy. The court uses very strong language to reject the attempt by the litigation trust to hold the former directors of a wholly owned subsidiary liable for causing the subsidiary to support the business strategy of the holding company. The court reasoned that to approve “such a bizarre scenario would undermine the wealth-creating utility of the business judgment rule,” and that Delaware law does not impose “retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out.”

In addition to the extensive factual analysis, there are many other important legal issues that are addressed by the court but that cannot be covered within the limited space allotted for this column, but I commend the reader to the whole opinion, including the extensive footnotes, such as footnote 75.

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Pileggi continues on page 6

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Continued from page 3

discussion of other remedies available to creditors in the absence of a claim for deepening insolvency. For example, the court explained that even though it was not pled in the complaint, both state law and federal law allow claims for recovery in connection with a fraudulent transfer. The court discusses other remedies that protect creditors injured by a wrongful conveyance, including attachment, injunctions,

appointment of a receiver, replevin, sequestration, constructive trust, equitable liens and garnishment. In addition, the court concluded that the litigation trust did not have standing based on the terms of the reorganization plan that created it to assert claims against creditors.

In declining to find a cause of action for deepening insolvency, the Chancery Court cited federal cases which reasoned that some courts that "became infatuated with the concept, did not look closely enough at the object of their ardor." The court declined to follow other decisions, includ-

ing the decisions of the Bankruptcy Court for the District of Delaware, which appeared to recognize deepening insolvency. *See* footnotes 105-107.

The court was very critical of the contents of the complaint and in many instances, described the deficiencies in detail. For example, regarding the *ad hominem* allegations against the defendant law firm and accountants, the court said that the relevant and impertinent material "would justify that rarest of judicial orders, an order striking portions of a pleading" (citing Chancery Court Rule 12(f)). The court went so far as to describe the unsupported accusations in the complaint as "frivolous and ... professionally unacceptable pleading practice." The court reasoned that instead of using "the lengthy passages of the complaint it devoted to tarring the defendant advisors with allegations made against them in other contexts, the litigation trust should have done what it was supposed to do to plead a malpractice action," such as stating with particularity what the advisors were hired to do, what they did in those capacities, and how that fell short of the applicable standard of care. The full decision is a must read for anyone interested in this area of the law. •