

## Going, Going, Almost Gone

deepening insolvency – a disappearing theory of liability • part II

In our June 2005 newsletter, we examined the then-current state of the law regarding “deepening insolvency.”<sup>1</sup> We discussed the decisions of the Third Circuit in *Off. Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*<sup>2</sup> and the Delaware Bankruptcy Court in *In re Exide Technologies, Inc.*<sup>3</sup> that had predicted that the Pennsylvania and Delaware state courts, respectively, would recognize a claim for deepening insolvency. However, based primarily on the Southern District of New York Bankruptcy Court’s well-reasoned decision in *In re Global Services Group, LLC*,<sup>4</sup> we concluded that, where traditional breach of fiduciary duty or similar state law claims were available, courts likely would shy away from recognizing a new claim of deepening insolvency. In fact, over the past year, courts have generally dismissed deepening insolvency claims for failure to state a claim or as redundant of other claims.

### **Parmalat Litigation**

Shortly after *Global Services*, the *Parmalat Securities Litigation*<sup>5</sup> cases came before the District Court for the Southern District of New York. The *Parmalat* cases arose out of a complex web of purportedly fraudulent transactions that facilitated the company’s growth and existence, allowing the company’s insiders and professionals to profit at the expense of its creditors. In *Parmalat I* and



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*Parmalat II*, the court faced deepening insolvency claims asserted against a company’s former auditors and lender based on allegations that the defendants aided the company in concealing massive amounts of debt from the public. The court declined to rule on whether deepening insolvency was a cognizable, independent tort claim under Illinois and North Carolina law.<sup>6</sup> Instead, following the reasoning of *Global Services*, the court dismissed the claims as duplicative of the professional malpractice and aiding and abetting breaches of fiduciary duty claims already asserted in the actions.<sup>7</sup>

Facing a similar claim arising out of the *Parmalat* scandal, brought by the equivalent of the company’s trustee appointed under Italian law against a lender and another entity with whom the company did business, the New Jersey state court essentially reached the same conclusion. Noting that neither the state legislature nor the state supreme court had recognized such a claim, the court dismissed a deepening insolvency claim.<sup>8</sup>

### **Trenwick**

The Delaware Chancery Court in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*<sup>9</sup> discussed at length the history,

winter 2007

### in this issue

- 1 Going, Going, Almost Gone**  
deepening insolvency – a disappearing theory of liability • part II
- 4 Reprise**  
diversity jurisdiction and national banks
- 6 Recharacterization**  
sleeping parents beware

## supplement

### Recent Noteworthy Decisions

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# Going, Going, Almost Gone

continued from page 1

purported purpose and basis for a claim of deepening insolvency, concluding, contrary to the *Exide* court's prophesy, that there was no need for such a claim.<sup>10</sup> In *Trenwick*, a holding company engaged in the insurance business embarked on an aggressive expansion program, acquiring three companies over a two-year period. Each merger/acquisition was approved overwhelmingly by the predominantly independent board of

recognizes a cause of action for deepening insolvency, the precise issue that the *Exide* court, wearing its prognosticator's cap, had answered in the affirmative. In an obvious reference to *Lafferty* and *Exide*, the court remarked cynically that deepening insolvency had been discussed at length by federal courts because "the term has the kind of stentorian academic ring that tends to dull the mind to the concept's

shaping our state's corporate law."<sup>16</sup> Accordingly, the court rejected deepening insolvency as an independent cause of action, adding that directors remained subject to a myriad of claims serving the same purpose, including breach of fiduciary duty and claims under state and federal fraudulent conveyance laws.

## Other Courts

Racing to the *Exide* court's defense, at least temporarily, one federal court post-*Trenwick* continued to maintain that Delaware law on deepening insolvency is yet unresolved. In *In re Fleming Packaging Corporation*,<sup>17</sup> the Bankruptcy Court for the Central District of Illinois refused to strike a deepening insolvency claim because the Delaware Supreme Court had yet to rule on the issue.<sup>18</sup>

## Racing to the *Exide* court's defense, at least temporarily, one federal court post-*Trenwick* continued to maintain that Delaware law on deepening insolvency is yet unresolved.

directors and by shareholders. The business strategy, however, failed and the holding company and its domestic subsidiary filed for bankruptcy relief. Thereafter, the litigation trust created by the subsidiary's plan of reorganization to pursue estate causes of action commenced suit against the boards of the holding company and its subsidiary and various third-party advisors, challenging the expansion strategy as imprudent and asserting claims of breach of fiduciary duty, fraud and deepening insolvency, among others.

The Chancery Court's frustration with the complaint's Monday morning quarterbacking is evident from its opinion, which granted motions to dismiss. Describing the transactions at issue as "the quintessential transactions subject to the protection of the business judgment rule,"<sup>11</sup> the court repeatedly remonstrated that, as with any business, there is a risk that the company may fail; therefore, boards must be free to pursue business strategies without becoming guarantors of their success.

Within that framework, the Chancery Court addressed whether Delaware law

ultimate emptiness."<sup>12</sup> Citing *Global Services*, the court explained: "Chapter 11 of the Bankruptcy Code expresses a societal recognition that an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around."<sup>13</sup> Thus, under Delaware law, even when insolvent, a corporation is not required to liquidate, and the board remains free to pursue value-maximizing strategies.<sup>14</sup> If those strategies fail, the board is protected by the business judgment rule, as is the board of a solvent corporation. "[T]he mere fact 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."<sup>15</sup>

Because the litigation trust was unable to state a viable claim for breach of fiduciary duty, the court refused to allow it to "escape that failure by seeking to have this court recognize a loose phrase as a cause of action under our law, when that recognition would be inconsistent with the principles

Nonetheless, most recent cases reach a conclusion similar to *Parmalat* and *Trenwick*. Indeed, even the Third Circuit has retracted from its prior decision in *Lafferty*. In *Lafferty*, the court had predicted that Pennsylvania would recognize an independent tort for deepening insolvency.<sup>19</sup> However, in *In re CitX Corporation*,<sup>20</sup> the Third Circuit narrowly interpreted the *Lafferty* decision and rejected both deepening insolvency as a measure of damages for negligence and, in the absence of intentional conduct, negligence as a basis for a deepening insolvency cause of action.<sup>21</sup>

Two opinions issued within the last year by Judge Walsh of the Delaware Bankruptcy Court also confirm the growing shift toward *Parmalat's* and *Trenwick's* reasoning. In *In re Oakwood Homes Corporation*,<sup>22</sup> a decision issued before either *CitX* or *Trenwick*, the court engaged in a fulsome analysis of deepening insolvency, clearly expressing its discomfort with the theory.<sup>23</sup> Nevertheless, noting that it was not the court's prerogative to question the soundness of the Third Circuit's decision, Judge Walsh dutifully followed *Lafferty* in predicting that Delaware, New York and North Carolina would all recognize an independent claim of deepening insolvency.<sup>24</sup> However, more recently in

*In re Radnor Holdings Corporation*,<sup>25</sup> a decision issued post-*CitX* and *Trenwick*, Judge Walsh retracted his prior view and rejected deepening insolvency as either an independent claim under Delaware law or a proper measure of damages.<sup>26</sup>

Similarly, in a case that was issued shortly after *CitX* but before *Trenwick*, the Massachusetts Bankruptcy Court declined to recognize deepening insolvency as an independent cause of action under Delaware law. In *In re Enivid, Inc.*,<sup>27</sup> the court saw no need to predict the viability of such a claim because the plaintiff failed to plead facts to support harm to the creditors and, in any event, the claim was subsumed within the breach of fiduciary duty claims.<sup>28</sup>

Finally, the Bankruptcy Court for the Middle District of Florida also recently dismissed a deepening insolvency claim. In *In re Southwest Florida Heart Group, P.A.*,<sup>29</sup> the court stated that deepening insolvency was only relevant as a potential measure of damages and did not constitute an independent cause of action under Florida law.<sup>30</sup>

## Conclusion

Recent decisions confirm that courts are increasingly reluctant to recognize an independent cause of action for deepening insolvency. As the *Trenwick* court articulated, state and federal law already provide a “toolkit” for plaintiffs to combat

harm done by corporations; thus, there is no need for an independent claim of deepening insolvency.<sup>31</sup> However, some courts remain holdouts in the quest for the litigator’s “holy grail,” and adamantly resist the dismissal of deepening insolvency claims as a matter of law. Thus, all parties — management, professionals, and even lenders — should continue to exercise caution in their dealings with financially troubled companies.

## endnotes

<sup>1</sup> As discussed in the June 2005 article, the theory of deepening insolvency derives from the notion that a corporation suffers damages when its corporate life is artificially and wrongfully extended beyond the current state of its insolvency. *Off. Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001).

<sup>2</sup> *Id.*

<sup>3</sup> 299 B.R. 732 (Bankr. D. Del. 2003).

<sup>4</sup> 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

<sup>5</sup> *In re Parmalat Securities Litigation*, 377 F. Supp. 2d 390 (S.D.N.Y. 2005) (“*Parmalat I*”); *In re Parmalat Securities Litigation*, 383 F. Supp. 2d 587 (S.D.N.Y. 2005) (“*Parmalat II*”).

<sup>6</sup> *Parmalat I*, 377 F. Supp. 2d at 396; *Parmalat II*, 383 F. Supp. 2d at 601-02.

<sup>7</sup> *Parmalat I*, 377 F. Supp. 2d at 396; *Parmalat II*, 383 F. Supp. 2d at 602..

<sup>8</sup> *Bondi v. Citigroup, Inc.*, 2005 WL 975856, at \*21 (N.J. Super. Ct. Law Div. Feb. 28, 2005).

<sup>9</sup> 906 A.2d 168 (Del. Ch. 2006).

<sup>10</sup> Other state courts have also discussed deepening insolvency but have not definitively decided its viability as either an independent cause of action or a measure of damages. See *Bowler v. Arthur Andersen, LLP*, 2005 WL 2402875, at \*13-15 (Mass. Dist. Ct. Sept. 23, 2005) (discussing deepening insolvency as a theory of damages but finding that it did not apply to the case); *Coroles*

*v. Sabey*, 79 P.3d 974, 983 (Utah Ct. App. 2003) (refusing to recognize deepening insolvency as a harm to the corporation, which was the issue before the court, but acknowledging that it could be a harm to shareholders); *MCA Fin. Corp. v. Grant Thornton, L.L.P.*, 687 N.W.2d 850, 858 (Mich. Ct. App. 2004) (stating that deepening insolvency might be a basis for recovery but that it did not allow application of the adverse interest exception to the wrongful conduct rule (i.e., *in pari delicto*)); *Holland v. Arthur Andersen & Co.*, 571 N.E.2d 777, 782 (Ill. App. Ct. 1991) (acknowledging that other courts have recognized a claim for deepening insolvency but rejecting it in this instance because “plaintiff’s version of the theory appears to be no more than a restatement in different terms of the injuries suffered by [the company’s] creditors”).

<sup>11</sup> 906 A.2d at 173.

<sup>12</sup> *Id.* at 204.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 205.

<sup>16</sup> *Id.* at 206.

<sup>17</sup> 351 B.R. 626 (Bankr. C.D. Ill. 2006).

<sup>18</sup> *Id.* at 639.

<sup>19</sup> Nevertheless, the Court dismissed the claim on the grounds of *in pari delicto*. 267 F.3d at 360.

<sup>20</sup> 448 F.3d 672 (3d Cir. 2006). The Third Circuit also indicated its unease with *Lafferty* in a footnote in which it explained that *Lafferty*’s recognition

of a deepening insolvency cause of action had provoked significant criticism but the issue was not before the court and even if it were, the court could only overrule *Lafferty* if it were sitting *en banc*. *Id.* at 680 n.11.

<sup>21</sup> In a decision issued prior to *CitX*, the District Court for the District of New Jersey read *Lafferty* to hold that deepening insolvency claims applied both in fraud and negligence situations. *Crowley v. Chait*, 2006 U.S. Dist. LEXIS 8894, at \*12-15 (D.N.J. March 7, 2006) (interestingly, the court cites to *Global Services* as supporting its conclusion).

<sup>22</sup> 340 B.R. 510 (Bankr. D. Del. 2006).

<sup>23</sup> *Id.* at 527-35.

<sup>24</sup> *Id.* at 531.

<sup>25</sup> 2006 WL 3346191 (Bankr. D. Del. Nov. 17, 2006).

<sup>26</sup> 2006 WL 3346191, at \*17, \*23 (citing *Trenwick* and *CitX*, respectively).

<sup>27</sup> 345 B.R. 426 (Bankr. D. Mass. 2006).

<sup>28</sup> *Id.* at 453.

<sup>29</sup> 346 B.R. 897 (Bankr. M.D. Fla. 2006).

<sup>30</sup> *Id.* at 898. See also *In re Greater Se. Cmty. Hospital Corp.*, 2006 WL 2793177, at \*3-4 (Bankr. D.D.C. Sept. 26, 2006) (applying only federal law to a Delaware corporation and concluding that deepening insolvency is a measure of damages for both fraud and negligence claims).

<sup>31</sup> 906 A.2d at 205.



# Reprise

## diversity jurisdiction and national banks

by Jay Teitelbaum

In our Spring 2005 newsletter, we reported on the

decision by the Supreme Court in *Wachovia Bank v. Schmidt*,<sup>1</sup> which held a national bank to be a citizen of the state in which its main office, as set forth in its articles of association, is located. In that case, for determining diversity jurisdiction, the Fourth Circuit held that, as a national association, Wachovia would be deemed “located” in (i.e., a citizen of) every state in which it maintained a branch office.

Wachovia petitioned the Supreme Court, asserting that a split of authority necessitated review. Contrary to the holding of the Fourth Circuit,<sup>2</sup> the Fifth and Seventh Circuits held that the citizenship of a national bank should be determined in a manner consistent with the analysis for state-chartered corporations.<sup>3</sup> Thus, these courts held that a national bank is a citizen both of the state identified in the articles of association as the location of its main office (the analogue to the state of incorporation) and the state in which its principal place of business is located.

In *Wachovia*, the Supreme Court did not need to specifically consider any distinction between a national bank’s main office and principal place of business, since, in Wachovia’s case, both were North Carolina. Indeed, the Court did not decide the issue of whether a national bank could be located in (a citizen of) two states. However, in discussing the determination of a national bank’s location or citizenship, the Court did state:

Recognizing that “located” is not a word of “enduring rigidity,” *Citizens & Southern Nat. Bank v. Bougas*, 434 U.S. 35, 44, 98 S. Ct. 88, 54 L. Ed. 2d 218 (1977), but one that gains its precise meaning from context, we hold that a national bank, for § 1348 purposes, is a citizen of the State in which its main office, as set forth in its articles of association, is located. Were we to hold, as the Court of Appeals

did, that a national bank is additionally a citizen of every State in which it has established a branch, the access of a federally chartered bank to a federal forum would be drastically curtailed in comparison to the access afforded state banks and other state-incorporated entities. Congress, we are satisfied, created no such anomaly.<sup>4</sup>

The Court then emphasized that the purpose of the statute was to provide corporate entities with equal access to the federal courts:

To achieve complete parity with state banks and other state-incorporated entities, a national banking association would have to be deemed a citizen of

as in this one, the location of a national bank’s main office and of its principal place of business coincide.<sup>5</sup>

Several courts have followed *Wachovia* in holding a national bank to be located in (a citizen of) the state where its main office, as identified in the articles of association, is located.<sup>6</sup> However, in each of these cases, the national bank, like Wachovia, shared a common location for its main office and principal place of business. Thus, the courts did not address the principal place of business issue.

On November 27, 2006, in *Excelsior Funds, Inc. v. JPMorgan Chase Bank, N.A.*, the Southern District of New York was faced with a diversity case involving JPMorgan Chase

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both the State of its main office and the State of its principal place of business. See *Horton*, 387 F.3d at 431 and n. 26; *Firststar Bank, N.A.*, 253 F.3d at 993-94. Congress has prescribed that a corporation ‘shall be deemed to be a citizen of any State by which it has been incorporated and of the State where it has its principal place of business.’ 28 U.S.C. § 1332(c)(1) (emphasis in original). The counterpart provision for national banking associations, § 1348, however, does not refer to ‘principal place of business’; it simply deems such associations ‘citizens of the States in which they are respectively located.’ The absence of a ‘principal place of business’ reference in § 1348 may be of scant practical significance for, in almost every case,

Bank, N.A., a national bank whose articles of association identified its main office to be in Ohio, but whose principal place of business was in New York.<sup>7</sup> In analyzing *Wachovia* and the history of 28 U.S.C. § 1348, the district court recognized that the Supreme Court had not decided how the term “located” should be applied where the location of the national bank’s main office and its principal place of business were different. The district court interpreted the Supreme Court’s footnote 9 to be neither an endorsement nor a rejection of the possibility that a national bank could be located in more than one state. Nevertheless, the district court predicted that the Supreme Court would not define “located” to include a national bank’s “principal place of business,” in view of the absence of such term in the statute.<sup>8</sup> Accordingly, the district court held

that JPMorgan was a citizen of the State of Ohio, the location of its main office, and not New York, its principal place of business.

The district court based its conclusion on its interpretation of the word “located” in the context of the specific point in time of § 1348’s enactment. The current version of § 1348 was enacted in 1948, ten years prior to the enactment of 28 U.S.C. § 1332(c)(1), under which corporate citizenship includes both the state of incorporation *and* the location of the corporation’s principal place of business.<sup>9</sup> Prior to the enactment of § 1332(c), state corporations were deemed citizens only of their state of incorporation. The district court also distinguished between the 1882 and 1887 versions of § 1348. In 1882, Congress expressly terminated the automatic access to federal courts:

[T]he jurisdiction for suits hereafter brought by or against any association established under any law providing for national-banking associations . . . shall be the same as, and not other than, the jurisdiction for suits by or against banks not organized under any law of the United States which do or might do banking business where such national-banking associations may be doing business when such suits may be begun.<sup>10</sup>

In 1887, the parity language was removed and, for the first time, the word “located” was inserted:

[A]ll national-banking associations established under the laws of the United States shall, for the purposes of all actions by or against them, real, personal or mixed, and all suits in equity, *be deemed citizens of the States in which they are respectively located*; and in such cases the circuit and district courts shall not have jurisdiction other than such as they would have in cases between individual citizens of the same State.<sup>11</sup>

Finally, the current version of 28 U.S.C. § 1348, enacted in 1948, provides, in pertinent part:

All national-banking associations shall, for the purpose of all other actions by or against them, be deemed citizens of the States in which they are respectively *located*.

The district court, strictly construing § 1348, held:

In this case, there is nothing in the text or legislative history of § 1332(c)(1) to suggest that Congress intended the statute to alter or amend, expressly or impliedly, § 1348 in any way. . .

Therefore, because neither the statutory text nor the legislative history support reading the term “located” in § 1348 to incorporate by reference a concept that did not exist until ten years later, a national bank is not also “located” in the state where it maintains its principal place

of business, when that state is different from the state of the national bank’s main office.<sup>12</sup>

It remains to be seen whether the district court’s construction was too literal. By limiting “located” to mean only the state of a national bank’s main office as identified in its articles of association, the district court has tilted the diversity jurisdiction playing field in favor of national banks, as compared to state-chartered corporations, which can be citizens of two states. While the Supreme Court certainly did not decide the specific issue, arguably, the district court in *Excelsior* did not sufficiently weigh the fundamental purpose behind the 1882 and 1887 statutes, as well as 28 U.S.C. § 1348. Congress intended to eliminate a national association’s greater access to federal courts and to create a scheme of parity with state-chartered corporations. This interpretation would appear to be supported by the Supreme Court’s conclusion that “located” is not a word of “enduring rigidity.”<sup>13</sup> The district court’s interpretation of “located” would appear to be inconsistent with Congress’s intent. Indeed, perhaps a true application of the statutory intent would interpret “located” so as to render a national bank a citizen of the state of its main office location, as identified in the articles of association, *and* its principal place of business. Consistent with Congress’s intent, such an application would provide a national bank with neither greater nor more limited access to federal courts than state-chartered corporations.

## endnotes

<sup>1</sup> 126 S. Ct. 941 (2006).

<sup>2</sup> In a prior decision, the Second Circuit, in dicta, noted that a national bank is deemed a citizen of every state in which it has offices. *World Trade Center Props., LLC v. Hartford Fire Ins. Co.*, 345 F.3d 154, 161 (2d Cir. 2003).

<sup>3</sup> *Horton v. Bank One, N.A.*, 387 F.3d 426, 429 (5th Cir. 2004); *Firststar Bank, N.A. v. Faul*, 253 F.3d 982, 984-85 (7th Cir. 2001).

<sup>4</sup> *Wachovia*, 126 S. Ct. at 945.

<sup>5</sup> 126 S. Ct. at 951, n.9.

<sup>6</sup> See, e.g., *Halifax Corp. v. Wachovia Bank, N.A.*, No. 05-1952, 2006 WL 1818202, at \*1 (4th Cir. June 28, 2006); *Hicklin Engineering, L.C. v. R.J. Bartell*, 439 F.3d 346, 348 (7th Cir. 2006); *Hinton v. Wachovia Bank of Del. Nat’l Ass’n*, No. 05 5750, 2006 WL 1751293, at \*6 n.6 (6th Cir. June 27, 2006); *King v. Union Planters Bank, N.A.*, 2006 WL 2375047, at \*3 (S.D. Miss. Aug. 15, 2006); *Anderson v. Bank of America, N.A.*, 2006 WL 889491, at \*2 (N.D. Cal. Apr. 5, 2006); *J. Walter Thompson U.S.A., Inc. v. Bank of America Corp.*, 2006 WL 476995, at \*3 (S.D.N.Y. Mar. 1, 2006).

<sup>7</sup> 2006 WL 3420625 (S.D.N.Y. Nov. 27, 2006).

<sup>8</sup> *Id.* at \*4.

<sup>9</sup> *Id.* at \*5-6.

<sup>10</sup> *Id.* at \*7; Act of July 12, 1882, § 4, 22 Stat. 163.

<sup>11</sup> Act of March 3, 1887, § 4, 24 Stat. 554-55 (emphasis added).

<sup>12</sup> 2006 WL 3420625, at \*8 (emphasis added).

<sup>13</sup> *Wachovia Bank v. Schmidt*, 126 S. Ct. at 945 (quoting *Citizens & Southern Nat. Bank v. Bougas*, 434 U.S. 35 (1977)).



# Recharacterization

sleeping parents beware

by Rebecca L. Booth • As previously published in *The Bankruptcy Strategist*

In the recent case of *In re Dornier Aviation (North America), Inc.*,<sup>1</sup> the United States Court of Appeals for the Fourth Circuit held that § 105(a) of the Bankruptcy Code provides the bankruptcy court with authority to recharacterize a claim from debt to equity. In upholding the recharacterization of a parent's \$84 million claim against its wholly owned subsidiary, the Fourth Circuit made clear that form will not prevail over substance in the context of intercompany transactions. The Fourth Circuit failed, however, to provide any guidance regarding how intercompany transactions might be structured to avoid recharacterization under § 105(a). This article presents one obvious, albeit not often utilized, solution: parent corporations should collect debts due and owing from their subsidiaries to avoid the possibility of being relegated to the unenviable position of an equity investor in the event of a bankruptcy proceeding.

## I. The Case

Dornier Aviation (North America) ("DANA") was a wholly owned indirect subsidiary of Fairchild Dornier GmbH ("GmbH"), a German aircraft manufacturer.<sup>2</sup> GmbH and DANA had a close business relationship pursuant to which GmbH provided DANA with spare aircraft parts, which DANA either used to provide services to GmbH's customers or resold for a profit.<sup>3</sup> GmbH invoiced DANA regularly for the spare parts it provided.<sup>4</sup> GmbH's invoices provided that payment was due within 30 days unless otherwise agreed by the parties.<sup>5</sup> The parties also performed annual reconciliations of amounts owed from DANA to GmbH as a result of outstanding invoices.<sup>6</sup>

Notwithstanding these formalities designed to ensure that "spare parts transactions" between GmbH and DANA were treated as ordinary course, arm's-length business transactions, evidence adduced at trial established that (i) DANA did not pay its

invoices from GmbH within 30 days, (ii) DANA and GmbH had an informal agreement whereby DANA would not be required to repay its debt to GmbH until DANA became profitable and (iii) GmbH treated DANA "specially" because GmbH viewed DANA as a vehicle for expanding its business into North America.<sup>7</sup> Moreover, an audit report prepared by GmbH's external auditors concluded that

## II. The Substantive Issues

GmbH argued that the Bankruptcy Code does not authorize recharacterization of debt to equity unless the claim at issue (i) is disallowable under § 502(b) of the Bankruptcy Code or (ii) can be equitably subordinated under § 510(c) of the Bankruptcy Code.<sup>11</sup> GmbH asserted that Congress implemented policy

## The Fourth Circuit failed to provide any guidance regarding how inter-company transactions might be structured to avoid recharacterization under § 105(a).

GmbH "assumed" a significant amount of DANA's operating losses as a result of the companies' close corporate relationship, as well as DANA's "financial dependency" on GmbH.<sup>8</sup>

GmbH filed a \$146 million claim against DANA, which included \$84 million in claims relating to spare aircraft parts provided to, but never paid for by, DANA (the "Spare Parts Claim"). The Official Committee of Unsecured Creditors in DANA's chapter 11 proceedings (the "Committee") objected to, *inter alia*, the Spare Parts Claim, asserting that it should be equitably subordinated pursuant to § 510(c) of the Bankruptcy Code or, alternatively, recharacterized as equity pursuant to § 105(a) of the Bankruptcy Code.<sup>9</sup> The bankruptcy court rejected the Committee's equitable subordination argument, but found that the entirety of the Spare Parts Claim should be recharacterized as equity.<sup>10</sup> The United States District Court for the Eastern District of Virginia affirmed the Bankruptcy Court's decision and the case was appealed to the Fourth Circuit. On appeal, the Fourth Circuit affirmed the decisions of the Bankruptcy Court and the district court.

decisions in the Bankruptcy Code by providing specific means by which a bankruptcy court could recharacterize a claim from debt to equity. Specifically, Congress provided that a bankruptcy court could disallow a claim under § 502(b) of the Bankruptcy Code or, upon a showing of "inequitable conduct," equitably subordinate a claim under § 510(c).<sup>12</sup> Accordingly, GmbH alleged that because no section of the Bankruptcy Code other than § 502(b) and § 510(c) specifically authorizes recharacterization of a claim, the bankruptcy court lacked authority to do so.<sup>13</sup> Indeed, GmbH asked the Fourth Circuit to "end the confusion . . . about where recharacterization fits in the Bankruptcy Code or what distinct purpose it serves by holding that bankruptcy courts lack the power to 'recharacterize' a debt claim as equity unless the claim is disallowable under 11 U.S.C. § 502(b) or can be equitably subordinated under 11 U.S.C. § 510(c)."<sup>14</sup>

In holding that recharacterization was well within the scope of the bankruptcy court's authority, the Fourth Circuit did indeed "end the confusion" regarding the two issues presented by GmbH, i.e., (1) what

section of the Bankruptcy Code authorizes recharacterization in the absence of disallowance and equitable subordination and (2) what purpose recharacterization serves, distinct from disallowance and equitable subordination.

## A. Section 105(a) of the Bankruptcy Code Authorizes Recharacterization

The Fourth Circuit addressed GmbH's first argument by holding that a bankruptcy court could utilize § 105(a) of the Bankruptcy Code – which authorizes a bankruptcy court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provision of” the Bankruptcy Code – to recharacterize an allowed claim that is not eligible for equitable subordination.<sup>15</sup> In making this holding, the Fourth Circuit opined that a bankruptcy court needed authority to recharacterize debt as equity under § 105(a) in order to implement the priority scheme established by § 726 of the Bankruptcy Code.<sup>16</sup> Absent this authority, the court explained that “any equity investor could label its contribution a loan and guarantee itself a higher priority – and a larger recovery – should the debtor file for bankruptcy.”<sup>17</sup> By tying the authority to recharacterize a claim from debt to equity under § 105(a) to the priority scheme established by § 726 of the Bankruptcy Code, the Fourth Circuit circumvented the well-established principle that a bankruptcy court may exercise its equitable power under § 105(a) only as a means to fulfill some specific Bankruptcy Code provision.<sup>18</sup>

## B. Recharacterization Serves a Different Purpose from Disallowance and Equitable Subordination

The Fourth Circuit then swiftly disposed of GmbH's argument that recharacterization serves no purpose distinct from disallowance or equitable subordination.<sup>19</sup> The Fourth Circuit first noted that, unlike recharacterization and equitable subordination, disallowance under § 502(b) was “appropriate when the claimant has *no* rights vis-à-vis the bankrupt . . . .”<sup>20</sup> In contrast, “when a bankruptcy court

recharacterizes [or equitably subordinates] a claim, it necessarily recognizes the existence of a relationship between the debtor and the claimant . . . .”<sup>21</sup> The Fourth Circuit next held that while a decision to equitably subordinate a claim rests on the bankruptcy court's assessment of a creditor's *behavior*, recharacterization rests on the bankruptcy court's assessment of the *substance of the transaction*.<sup>22</sup>

## III. The Practical Problem

The Fourth Circuit's analysis and conclusions in *Dornier Aviation* present a practical problem for companies that may have business dealings with affiliates and subsidiaries.

GmbH took steps well beyond those employed in many similar intercompany transactions to ensure that the “spare parts transactions” were ordinary course business dealings that would be honored in the event of a bankruptcy. GmbH regularly invoiced DANA for the spare parts, provided DANA with stated payment deadlines and performed annual reconciliations with DANA regarding amounts due for the spare parts.<sup>23</sup> Nevertheless, utilizing a fact-specific, 11-part test, the Fourth Circuit affirmed the bankruptcy court's finding that, overall, the spare parts transactions were more consistent with a capital contribution.<sup>24</sup> The Fourth Circuit noted that “[t]he [bankruptcy] court found particularly significant (1) GmbH's insider status, (2) ‘the lack of a fixed maturity date’ for the purported loan, (3) the fact that DANA would not be required to pay until it became profitable, (4) DANA's ‘long history of unprofitability and the fact that its liabilities after the corporate restructuring far exceeded its assets,’ and (5) GmbH's assumption of Dana's losses.”<sup>25</sup> Moreover, the Fourth Circuit found that evidence that GmbH regularly allowed several of its customers to defer payments (indicating that DANA was not receiving special treatment by virtue of its relationship to GmbH) was insufficient to “undermine the bankruptcy court's finding that GmbH and DANA had a *special* relationship.”<sup>26</sup> Finally, the

Fourth Circuit summarily dismissed GmbH's contention that a transfer of inventory (such as the spare parts transferred to DANA) could not constitute an equity investment.<sup>27</sup> In so holding, the Fourth Circuit became the first circuit court to authorize recharacterization of a claim from debt to equity where the underlying “investment” was not made in cash.

## IV. The Practical Solution

GmbH's actions in *Dornier Aviation* were not so egregious as to make the outcome of the case obvious. Indeed, GmbH appeared to have taken reasonable steps to ensure the spare parts transactions would be respected by regularly invoicing DANA for the spare

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# Recharacterization

continued from page 7

parts, providing stated payment deadlines and performing annual reconciliations of the amounts owed. Additionally, GmbH's "investment" in DANA was not in cash, which is the traditional form of an equity investment. Based on these facts, GmbH's major failing – like many intercompany transactions of a similar nature – was in its collection efforts. In applying the 11-factor test, the Fourth Circuit relied on several factors directly relating to GmbH's

outweighed by the long-term benefit of such efforts. For example, although GmbH's collection efforts may have hastened DANA's bankruptcy filing, it is obvious that such efforts would not have been the sole cause of the filing. To the contrary, DANA's financial situation deteriorated, and DANA filed for bankruptcy, *despite* GmbH's deferral of DANA's debt. In collecting amounts from DANA, GmbH also may have been faced with

written invoices, stated payment dates and careful and accurate ledgers of account, no longer will suffice to protect a parent corporation's position if its subsidiary files for bankruptcy. To the contrary, the oft-repeated mantra of bankruptcy judges and practitioners alike – that form will not prevail over substance – has found a new application in the form of recharacterization under § 105(a) of the Bankruptcy Code. In practical terms, although a parent that promptly collects debts from its troubled subsidiary may find itself in the unfortunate position of a *creditor* of a bankrupt company, a parent that completely fails to collect debts from a troubled subsidiary may find itself relegated to the even more unenviable position of an *equity investor* in a bankrupt company. To avoid being relegated to this position, parent companies must promptly and consistently collect outstanding debts from their subsidiaries and affiliates.

## In holding that recharacterization was well within the scope of the bankruptcy court's authority, the Fourth Circuit did indeed "end the confusion" regarding the two issues presented by GmbH.

failure to make any effort to collect sums from DANA (lack of a fixed maturity date, the fact that DANA would not be required to pay until it became profitable and GmbH's assumption of DANA's losses). Had GmbH collected or made good-faith efforts to collect even a portion of the amount due from DANA over the years, the Fourth Circuit (and the district and bankruptcy courts before it) may not have been so eager to recharacterize the Spare Parts Claim.

The short-term harm that may have been caused by GmbH's efforts to collect all or a portion of its debt from DANA is seriously

a lawsuit for the return of payments under § 547 and/or § 548 of the Bankruptcy Code. Even if GmbH were to lose such a lawsuit, however, its claim under § 502(h) (which provides the transferee of an avoided transfer, such as a preference, with a claim against the debtor's estate) would be allowed and likely would not be recharacterized as equity, placing GmbH in a better overall position than it found itself in *Dornier Aviation*.

The lesson to be learned for companies and the professionals who advise them is that carefully structured transactions, with

1 453 F.3d 225 (4th Cir. 2006).

2 *Dornier Aviation*, 453 F.3d at 229.

3 *Id.*

4 *Id.*

5 *Id.* at 230.

6 *Id.*

7 *Dornier Aviation*, 453 F.3d at 230.

8 *Id.*

9 *Id.*

10 *Id.*

11 Reply Brief of Appellants at 13.

12 *Id.* at 12-13.

13 *Id.*

14 *Id.* at 13.

15 *Dornier Aviation*, 453 F.3d at 231.

16 *Id.*

17 *Id.*

18 See, e.g., *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1311 (1st Cir. 1993).

### endnotes

19 *Dornier Aviation*, 453 F.3d at 232.

20 *Id.* (emphasis in original).

21 *Id.*

22 *Id.*

23 *Dornier Aviation*, 453 F.3d at 229-30.

24 *Id.* at 234.

25 *Id.*

26 *Id.* at 236 (emphasis in original).

27 *Id.*

- 1** *In re Carco Electronics*, 346 B.R. 377 (Bankr. W.D. Pa. 2006). Costs incurred by prospective purchaser of debtor's business for completion of purchase orders which debtor had not completed prior to shutting down were incurred for its own benefit and were not entitled to priority administrative expense claim status, even though they enabled the business to be sold as a going concern to another party.
- 2** *Daewoo Motor America, Inc. v. General Motors Corp.*, 459 F.3d 1249 (11th Cir. 2006). The court did not abuse its discretion in granting comity to Korean bankruptcy court order approving sale of auto manufacturer's assets, even though U.S. distributor thereby lost its exclusive right to sell the manufacturer's vehicles. Reciprocity was not an absolute precondition to comity and distributor's interests were outweighed by Korea's interest in regulating internal business activities and court's interest in the equitable and systematic distribution of a debtor's assets.
- 3** *In re Dow Corning Corp.*, 456 F.3d 668 (6th Cir. 2006). Where debtor is solvent, unsecured creditors are presumed to be entitled to interest at contractual default rate.
- 4** *In re Adelpia Communications Corp.*, 348 B.R. 99 (Bankr. S.D.N.Y. 2006). Addressing an issue of first impression, the court held that protocol provisions granting fee committee "the maximum immunity permitted by law from civil action" and designation as "officer of the court" did not provide fee committee immunity from discovery requests. Nevertheless, the court granted protective order because discovery of fee committee should be permitted only as a last resort when truly necessary.
- 5** *In re Sunpoint Securities, Inc.*, 350 B.R. 741 (Bankr. E.D. Tex. 2006). Bank that acted as custodian for brokerage firm customer's IRAs owed no fiduciary duty to such customers, and the bank's alleged opportunities to stop misappropriation of customer funds by firm's CEO did not establish liability in absence of such duty.
- 6** *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006). Claims for damages related to employee stock options that were allegedly rendered worthless by debtor's fraudulent conduct must be subordinated under Bankruptcy Code § 510(b). Whether for fraudulent inducement, fraudulent retention or breach of contract, such claims derived from the ownership of a security and thus were claims "arising from the purchase . . . of a security."
- 7** *In re Oakwood Homes Corp.*, 342 B.R. 59 (Bankr. D. Del. 2006). Insurers could not be compelled to turn over letter of credit proceeds where a letter of credit was issued to secure debtor-insured's performance under its contracts with insurers, and thus such proceeds were not "property of the estate."
- 8** *In re Adelpia Communications Corp.*, 342 B.R. 142 (Bankr. S.D.N.Y. 2006). Where credit agreements entitled oversecured lenders to charge variable rates of interest based in part on debtors' reports regarding their financial condition, lenders were not entitled to additional interest that they could have charged had debtors not misrepresented their financial condition because agreements did not provide for readjustment of the interest rates if financial reports were false, and lenders waived right to default interest in connection with DIP financing.
- 9** *In re UAL Corp.*, 468 F.3d 456 (7th Cir. 2006). Debtor airline's active and retired pilots could be treated differently under the plan of reorganization where active pilots benefited from court-approved agreement that provided them with replacement benefits in exchange for salary cuts and surrender of leverage, but retirees had little or no leverage and had not secured replacement benefits.
- 10** *In re Midpoint Development, L.L.C.*, 466 F.3d 1201 (10th Cir. 2006). LLC does not continue to exist for purpose of winding up its affairs after filing articles of dissolution; subsequent bankruptcy petition was a nullity and subject to dismissal.
- 11** *In re Darby*, 470 F.3d 573 (5th Cir. 2006). In a matter of first impression, the court held that cable television service was not a "utility" within the meaning of § 366, the statute that protects debtors against the termination of utility service. Such protection was intended for services necessary to meet minimum standards of living, which did not include cable service.
- 12** *In re Alterra Healthcare Corp.*, 2006 WL 2946055 (Bankr. D. Del. Oct. 16, 2006). Although disclosure would give claimants who had not yet settled an unfair advantage in extracting higher settlements, information regarding debtor's settlements with tort claimants was not "confidential commercial information," and thus was not protected from disclosure under § 107(b).
- 13** *In re Airway Industries, Inc.*, 2006 WL 3056764 (Bankr. W.D. Pa. Oct. 3, 2006). Prepetition bonus agreements which disincentivized executives from leaving debtor's employment until sale of debtor's assets were an effort to maximize distributions, and were entered into in good faith and for the benefit of the debtor and its creditors. Therefore, bonuses paid by secured creditor from its own pocket were not property of the debtor's estate and were not subject to turnover.
- 14** *In re Quintus Corp.*, 2006 WL 3072982 (Bankr. D. Del. Oct. 27, 2006). Sanction against purchaser of debtors' assets of entry of judgment for all claims listed in the debtors' schedules and on the claims register was warranted where purchaser deliberately destroyed record of the liabilities the debtors had accrued and the purchaser had assumed, at a time when purchaser was aware of a potential dispute as to whether it had paid all assumed liabilities.
- 15** *In re Spiegel, Inc.*, 2006 WL 3040783 (Bankr. S.D.N.Y. Oct. 19, 2006). Where debtor, unable to find purchaser for its bankcard business, wound down such portion of its business and entered into agreement with another financial institution for a new private label credit card program for its stores, no "transaction" – defined as a third party's acquisition of a material portion of the assets, properties or business of debtor's bankcard business – had occurred. Thus, entity retained to find purchaser for the business was not entitled to a \$4 million fee under its engagement letter.