Bankruptcy Court Finds Equity Sponsor and Directors of Insolvent Company May Be Liable for Actions Benefiting Equity Sponsor's Status as Creditor

On April 24, 2008, the U.S. Bankruptcy Court for the District of Delaware held that affiliates of McCown De Leeuw & Co. ("MDC") and directors of its portfolio company, The Brown Schools, could potentially be held liable in a lawsuit brought by a bankruptcy trustee for the portfolio company as a result of self-interested transactions approved by the portfolio company's board of directors that benefited MDC in its capacity as a creditor of The Brown Schools. The case is noteworthy in holding that the measure of damages in the lawsuit can exceed the amount received by the equity sponsor and may be based upon a theory of "deepening insolvency" that has been rejected as an independent cause of action in Delaware state courts.

In a relatively common set of circumstances, MDC, the 65 percent owner of The Brown Schools, provided subordinated loans to the company totaling $12.5 million in principal amount. After the company defaulted on approximately $100 million of secured debt owed to Credit Suisse First Boston ("CSFB"), the company sold assets in a series of transactions that repaid CSFB in full and also paid MDC $1.7 million. More than a year later, The Brown Schools restructured approximately $18 million of debt owed to Teacher's Insurance and Annuity Association ("TIAA") as well as the balance of the debt owed to MDC. In this restructuring, the debt owed to TIAA was secured by first liens on the company's assets, and debt owed to MDC was secured by second liens. The company agreed to continue selling assets to repay the debt owed to TIAA. TIAA and MDC entered into an intercreditor agreement pursuant to which MDC would share in up to $2.9 million of asset sale proceeds received by TIAA. The Brown Schools thereafter sold more than $18 million of assets and paid the proceeds to TIAA, which in turn shared the proceeds with MDC.

The bankruptcy trustee sued MDC and MDC-affiliated directors of The Brown Schools on the basis that MDC-affiliated directors were not independent and intended to benefit MDC as a creditor of the company, to the detriment of other creditors in self-interested transactions that violated the directors' fiduciary duties of loyalty. The measure of damages sought by the trustees (and that the bankruptcy court determined was legally sufficient to survive a motion to dismiss) was based on the alleged "deepening insolvency" of the company and well exceeded amounts paid to MDC as a result of asset sales.

The Brown Schools case illustrates risks for equity sponsors and directors of insolvent portfolio companies, if the equity sponsor is deemed to have benefited from asset sales or other transactions while other creditors are left unpaid. Use of a court-supervised bankruptcy sale as a means for liquidating assets can immunize board decisions from after-the-fact criticism. In situations where bankruptcy is not a good option, careful planning and the documentation of corporate actions, including possibly the use of independent directors in corporate decision-making, can help preserve the benefits of Delaware's business judgment rule and minimize risk.

If you would like to obtain additional information concerning this Alert or to speak with a lawyer familiar with insolvency risks, please contact any of the following or your usual Ropes & Gray lawyer:

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