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Suit for Deepening Insolvency

Courts are divided over whether to allow lawsuits based on the legal theory of "deepening insolvency". This theory permits recovery against insiders of and advisors to a corporation for prolonging the corporation's life beyond the point of insolvency. A Delaware bankruptcy court recently upheld a suit against Credit Suisse First Boston ("CSFB") seeking to recover under this theory.

A debtor was in the manufactured housing business. CSFB was the debtor's underwriter and financial adviser. The lawsuit alleged that CSFB encouraged the debtor to adopt and continue a risky strategy for financing operations, knowing that the strategy was not sustainable. CSFB advised the debtor to continue this ruinous financing strategy for the purpose of generating fees to CSFB. The result was deeper insolvency.

The potential impact of this new legal theory is unclear. However, advising shaky companies to pursue risky turnaround strategies now carries its own risk.

OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.), 340 B.R. 510 (Bankr. D. Del. 2006).

Broad Bankruptcy Release

The federal bankruptcy statute releases only the debtor from the obligation to pay creditors' claims in full. However, a Maryland bankruptcy court recently enforced a broader release written into a plan of reorganization, which sought to prohibit lawsuits against non-debtors.

Notwithstanding the statutory limitation on the scope of the release, the court explained that a broad release protecting officers of the debtor contained in the plan would

be valid and enforceable, if the plan was overwhelmingly approved by creditor vote and the release was essential to a workable reorganization. Additionally, if a creditor voted in favor of the plan or failed to object to the broad release, later attempts to sue the officers would be turned back.

Creditors voting whether to accept or reject a proposed Chapter 11 plan of reorganization should read closely and consider the release provisions, which may seek to protect officers, lenders, asset purchasers and others.

Hoge v. Moore (In re Railworks Corp.), 345 B.R. 529 (Bankr. D. Md. 2006).

Letter of Credit outside Bankruptcy

A Delaware bankruptcy court recently reaffirmed a long-standing principle that a letter of credit and its proceeds are not part of a bankruptcy estate. Thus, suppliers can use a letter of credit to "bankruptcy proof" a transaction. If the letter of credit is used to secure a debtor's obligation to pay for goods or services, the debtor's bankruptcy will not prevent the creditor from collecting payment from the bank that issued letter of credit. The bank is left to attempt to reimburse itself from the debtor's bankruptcy estate.

OHC Liquidation Trust v. Discover Re (In re Oakwood Homes Corp.), 342 B.R. 59 (Bankr. D. Del. 2006).

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This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

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