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Lender's Liability Reach May Be Clarified in *Adelphia Recovery Trust*

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Adelphia Communications Corp. may be a blast from the past for most readers since it has been going on for more than eight years. It seems like ages ago that the collapse of the cable giant was gripping news as the financial fraud underlying the collapse was unraveled. However, on Sept. 22, 2010, the Adelphia Recovery Trust (ART) announced that it reached agreement in principle to settle its claims against Adelphia's pre-petition lenders and investment banks in the suit entitled *Adelphia Recovery Trust v. Bank of America NA, et al.*, No. 05 CIV 9050 (S.D.N.Y.) (bank litigation) for $175 million.[1]

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This announcement indicates that a significant part of the remaining Adelphia story may finally be coming to a conclusion. This follows an earlier pivotal opinion issued in 2009 by the district court in the bank litigation that permitted the action to proceed, which makes it instrumental in the events that have led to the settlement.[2] The opinion also shows the breadth and extremes to which lender-liability claims may extend based on the facts of a particular case. Most of the background information was not discussed in this article, which instead focuses on details not generally known, such as the different tranches of secured debt at issue and were critical to the court's decision.

Background

At the center of the Adelphia fraud was the Rigas family, which had founded the company. In the late 1990s, the Rigases needed billions of dollars to acquire new cable businesses, purchase stock to maintain their ownership of Adelphia and finance an extremely extravagant lifestyle. However, the Rigases did not have the personal capital to fund these items. They turned to the Adelphia balance sheet and a series of banks, led by multiple agent banks and their affiliated investment banks. The Rigases worked with the agent and investment banks and had Rigas family entities (RFEs) enter into co-borrowing facilities with public Adelphia subsidiaries, which permitted the Rigas family to borrow billions of dollars, guaranteed almost exclusively by Adelphia's assets. Adelphia's subsequent disclosure of billions of dollars in liabilities associated with the co-borrowing facilities—approximately $2.2 billion, which had not previously been reported on its balance sheet—led to the collapse of the company and the bankruptcy filing.

After the bankruptcy filing, the creditors' committee appointed in the case commenced an investigation of potential claims against Adelphia's pre-petition lenders. Based on the investigation, Adelphia and the creditors' committee sought leave to commence an action against the lenders and also filed an adversary complaint (as amended) against approximately 400 financial institutions, including the agent banks, investment banks and other banks that participated in the pre-petition loans (collectively, "the banks"). The complaint laid out the alleged looting of Adelphia by the Rigases through three co-borrowing facilities: (1) UCA/HHC in 1999, (2) CCH in 2000 and (3) Olympus in 2001. The complaint further alleged that the banks conceived and structured the co-borrowing facilities that permitted the Rigases' looting, that the banks knew that the purpose of the loans was for the Rigases' personal benefit, and that the loans were concealed from both independent members of the Adelphia board and the public. The complaint asserted a multitude of claims against the banks. The complaint asserted multiple tort claims, including gross negligence, breach of fiduciary duty, adding and abetting breach of fiduciary duty, and aiding and abetting fraud. The complaint further asserted multiple bankruptcy claims, including avoidance and recovery of fraudulent transfers and preferential transfers, equitable subordination and recharacterization of the debt as equity. Finally, the complaint asserted claims for unjust enrichment and equitable estoppel. Additionally, the complaint asserted

1 "Adelphia Recovery Trust Announces Agreement in Principle to Settle Claims Against Adelphia's Pre-Petition Lenders and Investment Banks," *Forbes*, Sept. 22, 2010, www.forbes.com/feeds/prnewswire/2010/09/22/prnewswire201009221207PR_NEWS_USPR_____LA69613.html; "Adelphia Trust in $175 mln Settlement With Banks," Reuters, Oct. 22, 2010, www.reuters.com/article/idUSN2219420720101022.

2 *Adelphia Recovery Trust v. Bank of America, et al.*, 624 F.Supp.2d 292 (S.D.N.Y. 2009); "Bank of America, BNY Mellon Must Defend Adelphia Suit," *Bloomberg News*, May 7, 2009, www.bloomberg.com/apps/news?pid=newsarchive&sid=a0RO7wV0L1_w; "Adelphia Wins Round in Suit Against Banks," Reuters, May 7, 2009, http://uk.reuters.com/article/idUKN0740003720090507.

fraudulent-transfer claims against a certain group of margin lenders to recover payments received by such lenders.

A multitude of banks filed numerous motions to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, as well as objections to the creditors' committee's standing. The bankruptcy court ultimately dismissed some of the claims but sustained others, and granted leave to re-plead the claims for fraud and fraudulent concealment.[3] The objections to standing were denied, and leave to appeal on certain issues was granted.[4] During this time, Adelphia's fifth amended chapter 11 plan was confirmed by the court. Under the plan, the claims were transferred to the ART. Additionally, the banks filed a motion seeking to withdraw the reference from the bankruptcy court, which was granted. Several rounds of dismissal motions were filed and appeals were undertaken as to the disposition of those motions and the ART further amended the complaint. The result was that several claims were dismissed, including the bankruptcy claims.

By the time the district court issued its opinion on multiple dismissal motions, the following claims in the complaint remained that were the subject of the opinion: (1) fraudulent concealment against the investment banks, (2) several subsets of the fraud claim, (3) the margin loan claim[5] and (4) the remaining tort claims. In the opinion, the district court first addressed choice of law and determined that Pennsylvania state law was the substantive law and that the motions to dismiss would be evaluated under the Rule 12(b)(6) standard, including the need to meet the heightened pleading requirements for fraud claims under Rule 9, which requires that such claims be pled with particularity.[6]

Aiding and Abetting Fraud

The court first addressed the motions to dismiss the claim against the agent banks and their affiliated investment banks for aiding and abetting fraud, which was alleged in the complaint. The banks argued that Pennyslvania law does not recognize the tort of aiding and abetting fraud. The bankruptcy court's decisions on this claim were only to the extent of meeting the Rule 9 standard and it gave the ART leave to re-plead the claim, which the ART did.[7] The district court had to determine whether Pennsylvania recognized such a claim. The Pennsylvania Supreme Court has not directly ruled on whether it recognizes a tort of aiding and abetting fraud.[8] Accordingly, the district court had to predict how the Pennsylvania Supreme Court would rule if presented with the issue, which pursuant to Second Circuit law, means that the court should "defer to the federal court of appeals' interpretation of the law of a state that is within the circuit."[9] Four factors led the court to conclude that the Pennsylvania Supreme Court would recognize a tort for aiding and abetting fraud.

First, the district court found that the Pennsylvania Supreme Court has adopted *Section 876 of the Restatement (Second) of Torts* in an opinion involving a concert of action claim in a products-liability action, which strongly indicated that it would recognize the tort of aiding and abetting fraud.[10] In *Skipworth by Williams v. Lead Industries*, the Pennsylvania Supreme Court held that "[t]his [concert of action] theory provides in pertinent part that 'for harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him.'"[11] The court then discussed a number of Pennsylvania decisions following *Skipworth* and recognizing aiding and abetting tort theories. In addition, the court found that federal courts from around the country have taken a state court's adoption of *Section 876 of the Restatement (Second) of Torts* to mean that the state's highest court would recognize common-law aiding-and-abetting fraud.[12]

Second, the district court determined that lower courts in Pennsylvania have recognized the broad tort of civil aiding and abetting, which is a strong indication that the Supreme Court would recognize the tort of aiding and abetting fraud. Third, it noted that several federal courts have recognized the broad tort of civil aiding and abetting under Pennsylvania state law, including the Third Circuit Court of Appeals, which has recognized a tort for aiding and abetting a breach of fiduciary duty.[13] Finally, the court found that recognizing the tort of aiding and abetting fraud was a "natural extension" of the court's own prior recognition of the tort of aiding and abetting a breach of fiduciary duty in the case.[14]

Next, the district court found that the ART had sufficiently plead claims for aiding and abetting fraud with respect to all three co-borrowing facilities based on the fact that the complaint sufficiently alleged that the Rigases were engaged in fraud when entering into the loans for their own personal use, and that the agent banks knew about the fraud because they had ongoing knowledge that the facilities were being used for the Rigases' own personal benefit.[15] In addition, the complaint further alleged that the agent banks and their affiliated investment banks provided substantial assistance to the Rigas family, which advanced the commission of the fraud.[16] The assistance included drafting the loan termsheets, which omitted key terms and made specific misstatements, including that the loans were in the best interests of Adelphia, the proceeds would only be used for specific business purposes, there were restrictions from working with RFEs, and transactions with affiliates would be prohibited.[17] Accordingly, the district court concluded that, but for these omissions and misstatements, the facilities would not have been approved and the fraud would not have occurred.[18]

Aiding and Abetting Breach of Fiduciary Duty

The complaint alleged that the agent banks and their affiliated investment banks aided and abetted breaches of fiduciary duty by the Rigas family toward Adelphia. The arguments raised by the banks were similar to the arguments set forth with respect to the tort of aiding and abetting fraud discussed above. The district court first determined that under Pennsylvania law, a plaintiff must plead the following elements for a claim of aiding and abetting a breach of fiduciary duty: "(1) a breach of fiduciary duty owed to another; (2) knowledge of the breach by the aider and abettor; and (3) substantial assistance or encouragement by the aider and abettor in effecting that breach."[19] The court also determined that since the claim was based on the fraudulent actions of the Rigas family, ART's

3 *Adelphia Recovery Trust*, 624 F.Supp.2d at 305-6.
4 *Id.* at 306-7.
5 The disposition of the motions to dismiss the discrete margin loan claim will not be discussed in this article.
6 *Adelphia Recovery Trust*, 624 F.Supp.2d at 307-9.
7 *Id.* at 309.
8 *Id.*
9 *Id.* at 309-10; *Booking v. General Start Mgt. Co.*, 254 F.3d 414, 421 (2d Cir. 2003).
10 *Adelphia Recovery Trust*, 624 F.Supp.2d at 310.
11 *Id. Skipworth by Williams v. Lead Indus. Ass'n Inc.*, 547 Pa. 224, 690 A.2d 169, 174 (Pa. 1997).
12 *Adelphia Recovery Trust*, 624 F.Supp.2d at 310; *Koken v. Steinberg*, 825 A.2d. 723, 732 (Pa. Cmwlth. 2003)
13 *Adelphia Recovery Trust*, 624 F.Supp.2d at 311; *Huber v. Taylor*, 469 F.3d 67, 79 (3d Cir. 2006).
14 *Adelphia Recovery Trust*, 624 F.Supp.2d at 312.
15 312-18.
16 *Id.*
17 *Id.*
18 *Id.*
19 *Adelphia Recovery Trust*, 624 F.Supp.2d at 319, quoting *Baker v. Family Credit Counseling Corp.*, 440 F.Supp.2d 392, 417-18 (E.D. Pa. 2006).

claim had to meet the heightened pleading requirement of Rule 9. The court then analyzed the specific participation of the agent banks and their affiliated investment banks in aiding and abetting a breach of fiduciary duty using the three co-borrowing facilities. The court found that the pleadings met the requirements for pleading the claim. First, there were allegations that the Rigases breached their fiduciary duty to Adelphia by entering into the co-borrowing facilities.[20] Second, the complaint alleged that the agent banks and their affiliated investment banks were aware of the breach of fiduciary duty by the Rigases regarding the loans.[21] Finally, the agent banks and their affiliated investment banks provided substantial assistance or encouragement to the Rigases in effecting the breach of fiduciary duty with respect to the loans.[22]

Fraudulent Concealment against the Investment Banks

The complaint alleged that the investment banks fraudulently concealed material information about the co-borrowing facilities from Adelphia's independent directors. This claim was originally dismissed by the bankruptcy court because it found that the investment banks' status as underwriters for Adelphia securities offerings did not create a fiduciary relationship and that the investment banks were under no duty to disclose information (thus they could not be liable for concealment).[23] The bankruptcy court permitted the claim to be re-pled. The district court began its analysis by laying out the elements under Pennsylvania law for a claim of fraudulent concealment. Three of the elements were well established under Pennsylvania law: "[p]laintiffs must establish (1) an affirmative act of concealment by defendants, (2) which misled or relaxed plaintiffs' investigation into possible causes of action, and (3) that plaintiffs' ignorance is not attributable to lack of diligence in investigating possible claims."[24] Similar to the issue of the aiding and abetting fraud claims, the fourth element had not been finally determined by the Pennsylvania Supreme Court, so the court looked to the Third Circuit Court of Appeals, which has held that the fourth element for a claim of fraudulent concealment requires that the plaintiff must allege that the defendant had an affirmative duty to "speak" and disclose.[25] The district court found that the complaint met the first three elements required for the fraudulent-concealment claim. The ART identified six areas where the investment banks had knowledge of transactions that they failed to disclose to Adelphia.[26] Further, the investment banks, via their position as conduits for information, had information that the independent directors would not have discovered through a reasonable investigation.[27] However, the fourth element was more problematic.

[T]he opinion, along with the allegations in the complaint, provides a comprehensive road map and information for prosecuting (or defending) complex lender-liability claims and litigation.

Under Pennsylvania law, "a duty to speak arises when a defendant owes a fiduciary duty to the plaintiff or 'as a result of one party's reliance on the other's representations, if one party is the only source of information to the other party, or the problems are not discoverable by other reasonable means.'"[28] The district court found that the investment banks did not have a duty to speak and that they did not have a duty to disclose based on a fiduciary relationship.[29] Even if all of the allegations in the complaint were construed as true, ART was unable to allege that the investment banks were the sole party in possession of information about the fraud[30] because the Rigases primarily had access to the information and knowledge about the alleged fraud, as is alleged in numerous other claims set forth in the complaint.[31] Therefore, no duty to speak arose.

The issue as to whether the investment banks had a duty to disclose based on a fiduciary relationship presented more of an issue, since Pennsylvania courts had not addressed the issue directly. Again, the district court was left to try to predict how the Pennsylvania Supreme Court would rule on the issue. The court looked to federal courts in other jurisdictions and Pennsylvania law on fiduciary relationships in general, which provides that the "critical question is whether the relationship goes beyond mere reliance on superior skill, and into a relationship characterized by overmastering influence on one side or weakness, dependence, or trust, justifiably reposed on the other side."[32] Furthermore, the district court noted that the "[Pennsylvania] Supreme Court and other courts have recognized that those who purport to give advice in business may engender confidential relations if others...invest such a level of trust that they seek no other counsel."[33] However, the court found that the complaint did not plead facts that were sufficient to establish a fiduciary relationship between the investment banks and Adelphia. This was based on myriad reasons, including: (1) there was no allegation that the investment banks exerted overmastering influence and control over Adelphia; (2) the complaint pled that the investment banks assisted the Rigas family, which was the party exerting control over Adelphia; (3) there was no allegation that Adelphia did not look to other resources (seek other counsel); (4) there is no evidence of a contractual term showing a fiduciary relationship; and (5) there was no allegation that the investment banks were aware that they had a fiduciary relationship with Adelphia.[34] Accordingly, the court dismissed the fraudulent-concealment claim against the investment banks.

Fraud

The complaint alleged fraud against the agent banks and their affiliated investment banks, which was structured such that it was comprised of 15 subclaims of fraud. The district court analyzed each subclaim to determine sufficiency of pleading. First, the court discussed the six elements necessary to plead a fraud claim under Pennsylvania law, which are as follows: "(1) a representation; (2) which is material to the transaction at hand; (3) made falsely, with knowledge of its falsity or recklessness as to whether it is true or false; (4) with the intent of misleading another into

20 *Adelphia Recovery Trust*, 624 F.Supp.2d at 319.
21 *Id.* at 320.
22 *Id.*
23 *Id.* at 321; *In re Adelphia Commc'ns*, Adversary No. 03-04942 (REG), 2007 Bankr. LEXIS 2851, 2007 WL 2403553 (Bankr. S.D.N.Y. Aug. 17, 2007).
24 *Adelphia Recovery Trust*, 624 F.Supp.2d at 321; *In re Aspartame Antitrust Litigation*, No. 2:06-CV-1732, 2007 U.S. Dist. LEXIS 16995, 2007 WL 5215231, at *3 (E.D. Pa. Jan. 18, 2007).
25 *Adelphia Recovery Trust*, 624 F.Supp.2d at 322; *Duquesne Light Co. v. Westinghouse Elec. Corp.*, 66 F.3d 604, 611 (3d Cir. 1995).
26 *Adelphia Recovery Trust*, 624 F.Supp.2d at 322.
27 *Id.*
28 *Id.* at 322; *Reichhold Chemicals Inc. v. Millennium Intern. Technologies Inc.*, No. 99-799, 1999 WL 270391, at *2 (E.D. Pa. May 5, 1999).
29 *Adelphia Recovery Trust*, 624 F.Supp. at 323-24.
30 *Id.*
31 *Id.*
32 *Id.* at 323; *MRED General Partner LLC v. Tower Economics Co. Inc.*, No. 2531, 2005 WL 957707, at *2 (Pa. Com. Pl. April 12, 2005).
33 *Adelphia Recovery Trust*, 624 F.Supp.2d at 323; *Basile v. H & R Block Inc.*, 777 A.2d 95, 102 (Pa. Super. 2001).
34 *Adelphia Recovery Trust*, 624 F.Supp.2d at 324.

relying on it; (5) justifiable reliance on the misrepresentation; and (6) the resulting injury was proximately caused by the reliance."[35] In analyzing the complaint against the required elements, the court determined that nine of the subclaims for fraud were not pled sufficiently and should be dismissed. These subclaims against the agent banks and their affiliated investment banks were:

- fraud for improperly transferring Adelphia's assets and funds for the benefit of the Rigases' own interests;
- concealing wrongful transactions through, for example, the improper use of "netting" and reclassification procedures;
- falsely and fraudulently representating that Adelphia's stock sales had the effect of deleveraging the company, when in fact they had the opposite effect;
- using or permitting to-be-used funds drawn down from the co-borrowing facilities into the Adelphia cash management system (CMS) to pay the Rigases' or RFE's personal margin calls;
- failing to disclose that the Rigases' purchase of Adelphia stock was financed with loans guaranteed by the company;
- working with the Rigases to allow the purchase of $800 million worth of Adelphia's debt and equity by simply recording journal entries;
- issuance of securities by investment banks to the Rigases, paid for by the Rigas family or RFEs through the use of Adelphia funds, and knowing the provenance of such funds;
- assisting the Rigases in perpetuating control over Adelphia through the acquisition of Adelphia stock; and
- aiding the Rigases' fraud by crafting materials for Adelphia's debt and equity offerings that contained material misstatements and omissions regarding Adelphia's financial condition.[36]

The district court determined that six of these fraud subclaims met the pleading requirements and could proceed in the litigation. These subclaims against the agent banks and their affiliated investment banks were:

- misrepresenting Adelphia's finances in offerings materials by excluding more than $2 billion in off-balance-sheet debt that was borrowed by the Rigases or RFEs for their own benefit, and for which Adelphia was nevertheless jointly and severally liable;
- allowing the Rigases to use proceeds from the co-borrowing facilities to purchase Adelphia stock that had the effect of artificially reducing Adelphia's reported debt while at the same time artificially increasing reported equity;
- assisting the Rigases in using the co-borrowing facilities and the CMS to loot billions of dollars from Adelphia;
- conducting fraud by designing, implementing and funding the co-borrowing facilities and making it possible for the Rigases to use the co-borrowing funds for their own benefit;
- participating in a fraudulent scheme by permitting the RFEs to draw upon the co-borrowing facilities when they had insufficient capital to secure the funds allocated to them; and
- Salomon Smith Barney participating in the Rigas family's fraudulent schemes by providing a "fairness opinion" as to the Rigas family's or the RFEs' purchases of Adelphia securities, when such purchases were inherently unfair to Adelphia.[37]

Conclusion

The district court's decision is important for several reasons. By allowing a large number of ART's claims against the agent banks and their affiliated investment banks to proceed, the opinion was important for the ultimate resolution of the bank litigation, which will be a significant step toward closure of the Adelphia affair. Furthermore, the opinion includes significant discussion and determinations of important lender-liability claims under Pennsylvania law. Finally, the opinion, along with the allegations in the complaint, provides a comprehensive road map and information for prosecuting (or defending) complex lender-liability claims and litigation. ■

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35 *Id.* at 325-26; *Gibbs v. Ernst,* 538 Pa. 193, 647 A.2d 882, 889 (1994) (footnote omitted); *Debbs v. Chrysler Corp.*, 810 A.2d 137, 155 (Pa. Super. 2002).

36 *Adelphia Recovery Trust,* 624 F.Supp.2d at 326-29.

37 *Id.* at 328-32.