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Deepening Insolvency Is Sinking Fast

By Paul Rubin

Five years ago, the Third Circuit Court of Appeals opened the door to extensive litigation by holding, in *Official Comm. of Unsecured Creditors v. R.F. Lafftery & Co. (In re R.F. Lafftery & Co.)*, 267 F.3d 340 (3d Cir. 2001) ("*Lafferty*"), that Pennsylvania law would recognize a cause of action for "deepening insolvency." Two years later, a Delaware bankruptcy court held that Delaware law would also recognize a cause of action for deepening insolvency. *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston. (In re Exide Technologies, Inc.)*, 299 B.R. 732 (Bankr.D.Del. 2003). As noted in a prior issue of *The Bankruptcy Strategist* (Paul Rubin, *Lender's Victory over Trustee May Have Far-Reaching Implications*, 22 Bankrupt-cy Strategist 4 (February 2005)(the "Prior Article")), conflicting decisions have been issued by various other courts on whether deepening insolvency should be recognized as a separate cause of action. Since publication of that article, one court noted the "growing acceptance" of deepening insolvency, *In re LTV Steel Co.*, 333 B.R. 397, 422 (Bankr. N.D. Ohio 2005), but a number of other courts have rejected deepening insolvency as a cause of action. *Amato v. Southwest Florida Heart Group, P.A. (In re Southwest Florida Heart Group, P.A.), 2006 WL 2147615 (Bankr. M.D.Fla. 2006)*; *Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Corp.)*, 333 B.R. 506, 517 (Bankr. D.D.C. 2005); *Official Comm. of Unsecured Creditors v. Rural Tel. Fin. Coop. (In re Vartec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D.Tex. 2005).*

Uniformity among courts on this question has not been and may never be reached. Nevertheless, recent decisions from the Third Circuit, the Delaware Chancery Court, and the Southern District of New York reflect an unmistakable and growing trend toward restricting significantly or even rejecting claims for deepening insolvency. This article describes this emerging trend, and demonstrates that each of these cases reflects an approach that appears to have developed

within these respective courts. The common thread underlying these decisions is a concern that recognition of a claim for deepening insolvency would discourage good faith efforts to turnaround a troubled company that qualify for protection under the business judgment rule. This article concludes by identifying serious weaknesses from which deepening insolvency claims suffer in light of these significant rulings.

The Third Circuit Retrenches

In *Seitz v. Detwiler, Hershey & Associates, P.C. (In re CitX Corp., Inc.)*, 448 F.3d 672 (3d Cir. 2006) ("*CitX*"), an insolvent Internet company that was involved in an illegal Ponzi scheme used its financial statements compiled by its accountants to attract investors. The trustee for the company sued the accountants for malpractice and deepening insolvency. The district court granted summary judgment dismissing these claims, and the Third Circuit affirmed. The *CitX* panel did not overrule its holding in *Lafferty*, but it limited *Lafferty's* scope in at least four respects.

First, the court held that deepening insolvency may not be invoked as a theory to prove that a plaintiff suffered damages to support another cause of action. To prove harm to support his negligence claim, the trustee had contended that the company had suffered harm in the form of deepening insolvency. But the *CitX* panel wrote that its statements in *Lafferty* "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice." 448 F.3d at 677. In a footnote, the *CitX* court further stated: "By this we do not mean to imply that deepening insolvency would be a valid theory of damages for *any other* cause of action, such as fraud, and *Lafferty* did not so hold." *Id.* at n.8 (emphasis added)

Second, the Third Circuit proceeded in *CitX* to circumscribe further the potential impact of its holding in *Lafferty* by clarifying that allegations of negligence will not suffice to support a claim of deepening insolvency. *Id.* at 680-681. *Lafftery,* the *CitX* court observed, defined a deepening insolvency injury as a "fraudulent expansion of corporate debt and prolongation of corporate life." *Id.* at 681 (quoting *Lafftery*, 267 F.3d at 347).

Third, in a footnote, the *CitX* court "note[d] in passing" that a deepening insolvency claim can only be a claim under Bankruptcy Code Section 541, and cannot be a Section 544 claim. *Id*. at 676, n.6. In other words, according to the Third Circuit, deepening insolvency can only be a claim for harm to the company, and accordingly a

trustee may not "step into the shoes of certain creditors" to assert a deepening insolvency tort claim for harm suffered by them.

Fourth, to ensure that the *Lafferty* decision would not be relied for any expansive invocation of deepening insolvency under the laws of any other state for any purpose, the *CitX* court added: "[N]othing we said in Lafferty compels any extension of the doctrine beyond Pennsylvania." *Id.* at 680, n.11.

One gets the distinct impression that the *CitX* panel would have preferred to overrule *Lafftery*'s recognition of deepening insolvency as a separate cause of action. But after acknowledging that *Lafferty* has "provoked much comment" and citing articles critical of the theory, the court specifically noted that only the Court *en banc* could overrule a precedential decision. *Id.*

The Third Circuit's holding in *CitX* continues a trend in that court's recent bankruptcy jurisprudence, led by Judge Thomas L. Ambro. The author of the *CitX* decision, Judge Ambro is also the author of Third Circuit's decisions in *In re Owens Corning,* 419 F.3d 195 (3d Cir. 2005) and *In re SubMicron Systems Corp.*, 432 F.3d 448 (3rd Cir. 2006). In *Owens Corning,* the court severely limited the circumstances in which the assets and liabilities of a debtor may be substantively consolidated with those of another entity, and instead the court respected the structural seniority that lenders had negotiated for themselves in what the court described as the "kind of lending that occurs every business day." 419 F.3d at 212. In *SubMicron,* the court made it more difficult to re-characterize debt to equity even where a lender having representatives on the board of a distressed company has extended new loans to the company in order to protect its existing loans. *CitX* continues the Third Circuit's trend of protecting third parties who deal with, or perform services for, companies that are or may become insolvent, and who may later find themselves constituting the "deep pocket defendants" in litigation commenced by a trustee, debtor or creditors' committee. That the judge who wrote the *Lafferty* decision served on the unanimous panel in *CitX* could be viewed as an indication of the extent of Judge Ambro's influence regarding bankruptcy and insolvency issues.

The Delaware Chancery Court Rejects Deepening Insolvency Under Delaware Law

Despite what it recognized as "the mounting pile of authority" rejecting deepening insolvency as a cause of action, the court in *OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes*

Corp.), 340 B.R. 510, 531 (Bankr. D.Del. 2006) predicted, in light of *Lafferty*, that the Third Circuit would recognize deepening insolvency as a cause of action under Delaware law. This conclusion was consistent with the holding of the court in *Exide Technologies*.

But observing that in *CitX*, the Third Circuit "has taken a more skeptical view of the deepening insolvency concept," the Delaware Chancery Court held in *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*, 2006 WL 2434228 (Del. Ch. August 10, 2006) that "Delaware law does not recognize this catchy term as a cause of action, because … it does not express a coherent concept." *Id.* at *3. According to Vice Chancellor Strine, 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." *Id*. Notably, the *Trenwick* court observed that existing causes of action for breach of fiduciary duty, fraud, fraudulent conveyance and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations. *Id*.

Trenwick involved an action against directors of a publicly traded holding company. The court explained that even when a company is insolvent, its directors may, in the appropriate exercise of their business judgment, take actions that might, if they don't pan out, result in the company "being painted in a deeper hue of red." *Id.* In other words, if directors, acting with due diligence and good faith, pursue a business strategy that they believe will increase an insolvent firm's value but which involves the incurrence of additional debt, the directors do not become guarantors of that strategy's success. *Id.* at *29.

The court in *Trenwick* did not mince words. It found that the plaintiff had failed to state a viable cause of action for breach of fiduciary duty, and it could not escape that failure by asking the court "to recognize a loose phrase as a cause of action under our law, when that recognition would be inconsistent with the principles shaping [Delaware] corporate law … In so ruling, I reach a result consistent with a growing body of federal jurisprudence, which has recognized that those federal courts that became infatuated with the concept, did not look closely enough at the object of their ardor." *Id*.

The *Trenwick* court added that: "The incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries." *Id* at *4. This statement continues the theme permeating a line of recent Delaware Chancery Court decisions that tend to protect directors of

corporations that are insolvent or in the zone of insolvency from expanded liability for breach of fiduciary duty. For example, in *Production Resources Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del.Ch. 2004), Vice Chancellor Strine explained that the famous footnote 55 in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, at *34 (Dec. 30, 1991) attempted to emphasize that directors have discretion to temper the risk that they take on behalf of equity holders when the company is in the "zone of insolvency." Thus, directors would be protected by the business judgment rule if they pursue in good-faith a less risky business strategy out of fear that a more risky strategy might render the company unable to meets its obligations to creditors and other constituencies. *Production Resources,* 863 A.2d at 788. Similarly, in *North American Catholic Educ. Programming Foundation, Inc. v. Gheewalla*, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006), Vice Chancellor Noble held that creditors may not assert direct claims (as opposed to derivative claims) against directors of a Delaware corporation for alleged breaches of fiduciary duty while the corporation is insolvent or in the "zone of insolvency."

Another NY Bankruptcy Court Dismisses a Claim As Duplicative

Before *Trenwick* was decided, Bankruptcy Judge Gropper faced, in *Official Comm. of Unsecured Creditors v. American Tower Corp. (In re Verestar, Inc.)*, 343 B.R. 444 (Bankr. S.D.N.Y. 2006), the question of whether, under Delaware law, a director could be liable for breaching an independent duty by prolonging the life of a financially troubled or insolvent corporation without violating any other duty, such as the duty of care, despite a provision in the company's charter exculpating directors for breach of duty. There, a creditors committee asserted various claims, including breach of fiduciary duty and deepening insolvency, against a debtor's directors.

The *Verestar* court observed that some courts had accepted deepening insolvency, some had rejected it, while others "are waiting for a definition of just what the theory entails." 343 B.R. at 476 (citing *Smith v. Arthur Andersen LLP,* 421 F.3d 989, 1003-04 (9th Cir. 2005)). It concluded that, to the extent a plaintiff alleges only that a director should be liable for permitting the corporation to remain in business and incur unnecessary debt, this is essentially a claim for breach of the duty of care. *See id*. But the plaintiff had not cited any authority for the proposition that directors of an insolvent or financially troubled company may not conserve cash, even if that would increase the company's debt level. "Such a rule would preclude the directors of a

possibly insolvent enterprise from trying to 'work out' a problem." *See Id*. at 477.

Judge Gropper held that, under Delaware law, the exculpatory charter provision precluded a claim for breach of the duty of care, but the plaintiff could still assert claims against the directors for fraud or breach of the duty of loyalty. *See Id*. The deepening insolvency claim was therefore barred either as a precluded claim for breach of the duty of care, or as duplicative of other claims, including breach of the duty of loyalty, already set forth in the complaint. *See Id*. Similarly, the committee's deepening insolvency claim against the debtor's parent company was also dismissed because it added nothing to the committee's claims against the parent for aiding and abetting breach of fiduciary duty and for re-characterization of debt to equity. *See Id*. at 477-478, n.18.

The *Verestar* decision continues the trend set by the other decisions rendered in the Southern District of New York that refused to recognize the "novel tort" of deepening insolvency because the claim was duplicative of other claims asserted by the plaintiff. *See Bondi v. Bank of America Corp. (In re Parmalat Sec. Lit.)*, 383 F.Supp.2d 587, 602 (S.D.N.Y. 2005) ("North Carolina already imposes on every person a duty not to aid and abet a breach of fiduciary duty by another."); *Bondi v. Grant Thornton Int'l (In re Parmalat Sec. Lit.)*, 377 F.Supp.2d 390, 419 (S.D.N.Y. 2005)("Plaintiff's claim of deepening insolvency, then, is nothing more than a claim of professional malpractice."). The Prior Article focused on the importance of the decision of the court in *Kittay v. Atlantic Bank (In re Global Serv. Group LLC)*, 316 B.R. 451, 458 (Bankr.S.D.N.Y. 2004). There, the court held that, in order to recover for deepening insolvency, the plaintiff must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt. *See Id.*; *See also Rahl v. Bande*, 328 B.R. 387., 416-417 (S.D.N.Y. 2005) (Denying motion to dismiss "claim for breach of fiduciary duty for deepening insolvency under Bermuda law," and relying on *Global Service* to define deepening insolvency as the fraudulent prolongation of a corporation's life beyond insolvency, resulting in damage to the corporation caused by increased debt). As the Prior Article noted, the *Global Service* decision did not purport to change the rules governing the conduct of those managing or lending to insolvent businesses. *Verestar*, like the two *Par-malat* decisions, recognize that existing and well-established causes of action amply reach the same conduct that claims for deepening insolvency seek to challenge.

Sinking Feelings About Deepening Insolvency

There is no authority to support the proposition that prolonging an insolvent corporation's life, without more, will result in liability for deepening insolvency. Rather, the business judgment rule protects directors of solvent and insolvent companies.

CitX stands for the proposition that, if viable at all, a claim for deepening insolvency must involve fraudulent conduct resulting in harm to the corporation. According to *Global Service,* a viable deepening insolvency claim requires either prolongation of the company's life in breach of a separate duty, or commission of an actionable tort that contributes to the continued operation of a corporation and its increased debt. The *Verestar* and the *Parmalat* cases require dismissal of a deepening insolvency claim where the challenged conduct is already addressed by another cause of action asserted in the complaint. And *Trenwick* holds that recognition of a claim of deepening insolvency is inconsistent with principles of Delaware corporate law.

Even assuming *arguendo* that *Trenwick*'s rejection of a deepening insolvency claim were not followed, it is very difficult to comprehend how a plaintiff can evade the obstacles posed by the cases discussed above and successfully assert a claim for deepening insolvency. Knowing that there is serious doubt as to the viability of such a claim, the prudent drafter of a complaint will not forego inclusion of claims for well-established torts such as fraud or breach of fiduciary duty in favor of asserting only a deepening insolvency claim. Rather, counsel for a plaintiff drafter will likely take an all-inclusive approach and assert the recognized, garden-variety claims that may apply and that are more likely to survive a pre-answer motion to dismiss. But once all such claims are included in the complaint, the deepening insolvency claim is vulnerable to dismissal as duplicative.

Conclusion

Just over two years ago, deepening insolvency appeared to be a new and promising weapon in the arsenal of trustees and creditors committees, and a new source of concern for lenders and directors, auditors, and other advisors of insolvent companies — especially since there existed doubts as to the elements, and correct method to measure damages, of such a claim. But the emerging trend indicates that claims for deepening insolvency are not even treading water anymore.

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