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Deepening Insolvency Lender's Victory over Trustee May Have Far-Reaching Implications

By Paul Rubin

The decision by Chief Judge Stuart M. Bernstein of the United States Bankruptcy Court for the Southern District of New York in *In re Global Service Group LLC*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004), provides a sense of relief not only for lenders, but also for various other participants in the bankruptcy arena who may face claims based on "deepening insolvency." This case is especially significant because it helps define the conduct that may subject a party to liability under an amorphous concept that is still evolving.

Why Deepening Insolvency Cannot Be Ignored

Deepening insolvency has attracted the attention of plaintiffs, such as creditors' committees, trustees, and debtors-in-possession, who bring actions for damages allegedly suffered by insolvent businesses. It has already served as the basis for claims asserted against auditors (*Allard v. Arthur Andersen & Co., Inc.*, 924 F. Supp. 488 (S.D.N.Y. 1996)), underwriters (*Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001)), lenders (*In re Exide Technologies*, 299 B.R. 732 (Bankr. D. Del. 2003)), merger and acquisition advisers (*In re Flagship Healthcare, Inc.*, 269 B.R. 721 (Bankr. S.D. Fla. 2001)), attorneys (*In re Precept Business Services, Inc.*, 2004 WL 2074169 (Bankr. N.D.Tex. Aug. 23, 2004)), and a debtor's directors and officers (*In re RSL COM PRIMECALL, Inc.*, 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003)). Accordingly, developments regarding claims involving deepening insolvency deserve the attention of most of the constituencies that are active in Chapter 11 and Chapter 7 bankruptcy cases.

Just What Is Deepening Insolvency?

That is not entirely clear. Deepening insolvency has been described as the "fraudulent prolongation of a corporation's life, beyond insolvency," resulting in damage to the corporation caused by increased debt. *Global Service*, 316 B.R. at 456 (quoting *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir.), cert. denied, 464 U.S. 1002 (1983)). Recovery under this theory is based on the notion that a corporation is not necessarily benefited by any act which extends its life. The corporate body made be harmed by the deepening of its insolvency where an artificial and fraudulently prolonged life causes the corporation to incur increased liabilities to creditors that it cannot repay. See *Schacht*, 711 F.2d at 1350.

Deepening insolvency has been recognized as a theory of damages by some courts, such as *Schacht*, *Flagship Healthcare*, and *In re Gouiran Holdings, Inc.*, 165 B.R. 104 (E.D.N.Y. 1994), and more recently, as an independent cause of action by others, such as *Exide Technologies* and *R.F. Lafferty & Co., Inc.* Notably, some courts have rejected claims based on the theory of deepening insolvency. See *Coroles v. Sabey*, 79 P.3d 974, 983 (Utah Ct.App. 2003), *In re Ben Franklin Retail Stores, Inc.*, 225 B.R. 646 (Bankr. N.D. Ill. 1998) and *Askanse v. Fatjo*, 1996 WL 33373364 (S.D.Texas April 1, 1996).

Though judicial descriptions of deepening insolvency have referred to it as the fraudulent prolongation of a corporation's life, deepening insolvency has also been accepted as a damage theory to support claims of negligence. See, e.g., *Flagship Healthcare*, 269 B.R. at 728; *Gouiran Holdings*, 165 B.R. at 107. In addition, without explicitly using the phrase "deepening insolvency" in their pleading, plaintiffs have utilized the theory to support claims for breach of fiduciary duty based upon the "wrongful prolongation of corporate existence" to the corporation's detriment. See *In re RSL COM PRIMECALL, Inc.*, 2003 WL 22989669 (S.D.N.Y. Dec. 11, 2003). The clear implication of these cases is that a plaintiff may allege a viable claim utilizing a deepening insolvency theory of damages without alleging an actual fraud.

But the precise elements of a tort claim for deepening insolvency, as an independent cause of action, have not been universally recognized or clearly defined. Deepening insolvency became a significant concern for lenders after the Delaware bankruptcy court issued its decision in *Exide Technologies*. There, the court held that lenders may face liability for deepening insolvency where they allegedly gained control over a group of borrowers, forced them to fraudulently continue their business at ever-increasing levels of insolvency, but kept the borrowers out of bankruptcy, thereby causing them to suffer massive

losses and lose substantial value. Exide Technologies suggested that a lender might be liable for making additional (risky) loans to an insolvent borrower and obtaining credit enhancements to improve its position if the lender insists that the borrower remain out of bankruptcy, gains "control" over important decisions regarding the borrower's business, but the workout fails and the borrower's financial position worsens.

Could the mere allegation that the lender knew or should have known that the borrower was hopelessly insolvent and would not be able to repay the debt form the basis of a deepening insolvency claim if the lender's extension of credit caused the borrower to continue in business and incur additional debt? The court's decision in *Global Service* is significant because it sets forth a minimum pleading requirement for claims based on deepening insolvency, regardless of whether one deems it to be an independent tort or a theory of damages.

The Allegations Against the Lender in *Global Service*

Global Service was a New York limited liability company formed in January 2000 that refinished marble, metal and wood. It had a senior secured creditor claiming to hold a lien on all of its assets. The company filed a Chapter 11 case in November 2001, and the case was converted to Chapter 7 in March 2003. The Chapter 7 trustee commenced an adversary proceeding asserting claims against the lender and senior managers of the company.

The trustee's first cause of action against the bank was a deepening insolvency claim. Essentially, the trustee alleged as follows: Since its inception, the company was insolvent or in the vicinity of insolvency and undercapitalized. The bank knew or should have known that, due to its financial condition, Global Service would be unable to repay its loans, but made loans to the company anyway. The bank supposedly based its loans to the company on its relationship with principals of the company and their pledges of personal assets. The banks' loans provided the company with working capital, and other creditors extended credit to the company based on the bank's willingness to do so. As a result, the company was able to continue operating, prolong its corporate existence, and incur debt it could not repay which would have been avoided absent the bank's loans.

Bad Banking Is Not a Tort

The bank made a pre-answer motion to dismiss the trustee's claims,

including the deepening insolvency claim. Addressing that claim, the bankruptcy court began by tracing the origin and development of deepening insolvency. Judge Bernstein observed that New York courts appear to regard deepening insolvency as a theory of damages that may result from the commission of a separate tort. *Global Service*, 316 B.R. at 458. Significantly, he stated that it may be unnecessary to decide whether deepening insolvency is a tort or damage theory, because under either approach, prolong an insolvent corporation's life, without more, will not result in liability. *See Id.* He then held that a plaintiff seeking to recover for deepening insolvency 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.*

Global Service's lender was merely accused of making a loan it knew or should have known could never be repaid. Rejecting the trustee's deepening insolvency claim, the court stated: "This may be bad banking, but it isn't a tort. A third party is not prohibited from extending credit to an insolvent entity; if it was, most companies in financial distress would be forced to liquidate." *Id.* at 459. The court found it significant that the trustee did not allege that the bank made loans to Global Service to enable its principals to siphon off funds or commit another wrong. *See Id.* The court also dismissed the deepening insolvency claim against the bank for lack of proximate cause, as the complaint did not alleged that the bank could have foreseen that the debtor's insiders would misappropriate loan proceeds or operate the insolvent business for an improper purpose. *See Id.* at 461.

A Reassuring Message for an Insolvent's Senior Management

In *Global Service*, the bankruptcy court identified a second defect of the trustee's deepening insolvency claim, and in so doing, also helped clarify issues of deepening insolvency as they relate to directors and officers of an insolvent business. The court labeled as faulty the unspoken premise of the complaint -- that the managers of an insolvent company have an absolute duty to liquidate it, and that anyone who knowingly extends credit to it has aided and abetted the managers' wrongdoing. *See Id.*

Once insolvency ensues, the company's officers and directors have an obligation "to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity." *See Id.* at 460 (quoting *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, at *34 (Del.Ch. Dec. 30,

1991) and citing *Roselink Investors, L.L.C. v. Shenkman*, 2004 WL 875262 at *2-3 (S.D.N.Y. May 19, 2004)). The fiduciaries of an insolvent business might well conclude that the company should continue to operate in order to maximize its long-term wealth creating capacity, or its enterprise value. In fact, the *Global Service* court observed, Chapter 11 is based on the accepted notion that a business is worth more to everyone alive than dead. See *Global Service* at 460.

Thus, unlike the laws of other countries, such as the United Kingdom, there is no absolute duty under American law to shut down and liquidate an insolvent corporation. See *Id.* (citing *In re RSL COM PRIMECALL, Inc.*, 2003 WL 22989669 at *8). Rather, an insolvent's fiduciaries may continue to operate the corporation's business, consistent with the business judgment rule. See *Global Service* at 460. Accordingly, Judge Bernstein stated, the manager of an insolvent business will not face liability for deepening insolvency based on a negligent but good faith decision to operate its business. See *Id.* at 461. To rebut the presumption of the business judgment rule, the plaintiff must specifically allege that the fiduciary acted in bad faith or with fraudulent intent, See *Id.*, or engaged in self-dealing. See *In re Logue Mechanical Contracting Corp.*, 106 B.R. 436, 439-431 (Bankr. W.D.Pa. 1989). This holding is consistent with the ruling in *RSL COM PRIMECALL* that a decision by directors to continue a corporation's existence and postpone a bankruptcy filing to attempt a workout is protected by the presumption afforded under the business judgment rule. See *Id.* at 2003 WL 22989669, at *9.

A debtor's fiduciaries, therefore, need not fear that a good faith decision to continue an insolvent's business in order to maximize its enterprise value will subject them to liability for deepening insolvency if the turnaround effort fails. Moreover, a lender that 1) has no knowledge of wrongdoing planned by an insolvent's managers seeking to extend its corporate life; and 2) does not dominate or control the insolvent, need not refrain from extending credit to an insolvent to avoid the risk of a lender-liability type of deepening insolvency claim should the company end up in bankruptcy.

Concluding Observations

There remain, of course, several unanswered questions regarding claims based upon deepening insolvency, not the least of which is whether other courts will follow the positions adopted in *Global Service*. Nevertheless, this case represents a welcome decision to those trying to grapple with assessing potential liability associated with deepening insolvency, and even to those trying to frame complaints

asserting the claim. The Global Service decision represents a sensible resolution that does not deter lenders from extending credit in arms-length transactions designed to assist insolvent businesses in their efforts to avoid bankruptcy, nor does it penalize the fiduciaries of insolvent companies for making good faith efforts to rescue their troubled companies rather than liquidate them.

The decision does not purport to change the rules governing the conduct of those managing or lending to insolvent businesses. Rather, it provides a clear approach to apply to claims based on deepening insolvency, regardless of whether one views it as an independent tort or a theory of damages.

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