AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for the Insolvency Professional

New Liability Under "Deepening Insolvency"

The Search for Deep Pockets

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A Delaware bankruptcy court recently concluded in the *Exide Technologies* case that Delaware law would recognize a cause of action brought on behalf of a debtor's estate against a lender for "deepening insolvency."[2] Deepening insolvency has been described as "an injury to the [debtors'] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life,"[3] and has enjoyed growing acceptance among courts as a theory for recovery.[4]

Before *Exide Technologies*, some courts permitted deepening insolvency to be asserted as a theory of damages against accountants who negligently or fraudulently issued false financial statements.[5] In an important development, a federal appeals court held that deepening insolvency would be recognized under Pennsylvania law as a cause of action that may be asserted against investment bankers who participated in the issuance of fraudulent debt securities.[6] The courts accepting the notion of deepening insolvency recognize that where a company's insolvency is fraudulently concealed, the company may be harmed by the artificial prolongation of corporate life and the fraudulent continuation of its business. Where the company's debts are increased and its losses are deepened through concealment of its true financial condition, the company has been damaged if less value will be realized upon liquidation than if the company had shut down earlier without incurring the additional debt.[7]

Though deepening insolvency has not been accepted unanimously,[8] there is now at least some authority holding that deepening insolvency may be asserted as a separate cause of action against a lender that acquires overwhelming control over a borrower and then forces the borrower to "fraudulently continue in business" at increasing levels of insolvency, thereby causing the loss of substantial value that could have been realized had the borrower dissolved in a timely manner. This article examines the facts and holding in the recent Delaware case, discusses the evolution of the deepening-insolvency theory from a theory of damages into what seems to be a new cause of action, and concludes with some observations regarding issues that remain unresolved with respect to this still-evolving claim.

The Facts as Alleged in *Exide Technologies*[9]

In 1997, two lenders led a syndicate of more than 80 banks that established a $650 million credit facility for the lead borrower, Exide Technologies Inc., and many of its subsidiaries (the borrowing group). The net losses of Exide and its affiliates climbed from $9.8 million in 1998 to $129.9 million in 1999. By the quarter ended March 31, 2000, and at all times thereafter, Exide was insolvent on a balance-sheet basis. Later in 2000, the lending group made an additional loan of $250 million to Exide to finance its acquisition of a competitor. In exchange for that financing, the lending group obtained significant additional collateral and guarantees from the borrowing group[10] that were disproportionately more valuable than the consideration provided by the lenders. The lenders allegedly initiated and encouraged the acquisition and provided investment banking services and the financing needed for the transaction. The 2000 transaction significantly increased the lending group's leverage over the borrowing group, to the point of affording the lenders overwhelming leverage and control over Exide and its subsidiaries.

Exide's financial condition deteriorated rapidly after the acquisition. In June 2001, Exide informed certain lenders of the financial problems confronting it, and announced significant layoffs in September 2001. In October 2001, the lending syndicate caused Exide to replace its CFO with a principal from a restructuring advisory firm that allegedly derives substantial revenues from some of the lenders. Over the next few months, the parties negotiated and executed amendments to their loan agreement, including temporary forbearances and covenant waivers, when they knew that a bankruptcy filing was imminent and inevitable. Under these amendments, the lending group obtained liens on the assets and capital stock of all foreign subsidiaries of Exide, as well as additional collateral and guarantees from Exide and some of its subsidiaries. While these amendments were being negotiated, the borrowing group suffered massive losses, and became more deeply insolvent. The lenders caused the borrowers' bankruptcy filings to be delayed until mid-April 2002 in an effort to prevent the new liens they obtained from being voidable as preferences in bankruptcy. When the borrowing group commenced their bankruptcy cases, Exide owed more than $600 million in unsecured notes, and the debtors' trade payables exceeded $150 million.

The creditors' committee formed in the borrowing group's bankruptcy cases commenced an action against the lenders seeking to avoid alleged fraudulent conveyances and preferential transfers, and asserting a variety of other claims against the

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2 *See Official Committee of Unsecured Creditors and R2 Investments LDC v. Credit Suisse First Boston and Salomon Smith Barney Inc. (Exide Technologies)*, 299 B.R. 732 (Bankr. D. Del. 2003).

3 *See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc. (Lafferty)*, 267 F.3d 340, 347 (3d Cir. 2001)).

4 *See Exide Technologies*, 299 B.R. at 751-752; *Lafferty*, 267 F.3d at 350-51.

5 *See, e.g., Allard v. Arthur Andersen & Co. Inc.*, 924 F.Supp. 488 (S.D.N.Y. 1996); *In re Gouiran Holdings Inc.*, 165 B.R. 104 (E.D.N.Y. 1994).

6 *See Lafferty*, 267 F.3d 340 (3d Cir. 2001). Notably, a divided panel ruled in this case that the creditors' committee was barred from asserting a deepening-insolvency claim in that situation based on the *in pari delicto* doctrine. *See Id.* at 358-360.

7 *See Id.* at 349-350.

8 *See Steinberg v. Kendig (In re Ben Franklin Retail Stores Inc.)*, 225 B.R. 646 (Bankr. N.D. Ill. 10998) (dismissing complaint for failure to state a claim upon which relief may be granted where trustee alleged that defendants prolonged debtors' corporate lives by incurring debt on the basis of misleading financial information); *Askanse v. Fatjo*, 1996 WL 33373364 (S.D. Texas April 1, 1996) (dismissing negligence claim against auditors based on deepening-insolvency theory).

9 This factual recitation is based on the plaintiffs' complaint and the memorandum decision by the court in the *Exide Technologies* case.

10 The additional collateral that the lenders obtained in exchange for financing the acquisition included pledges of 100 percent of the stock of Exide's domestic subsidiaries and 65 percent of the stock of the Exide entities that owned substantially all of Exide's foreign subsidiaries, and security interests in substantially all of Exide's assets.

lenders on behalf of the debtors' estates, including aiding and abetting breach of fiduciary duty, equitable subordination, recharacterization of debt to equity and deepening insolvency. The committee alleged that (1) the lenders caused the debtors to make the acquisition so they could obtain the control necessary to force the debtors fraudulently to continue their business for nearly two years at ever-increasing levels of insolvency, and (2) by keeping the debtors out of bankruptcy, the lenders caused the debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value. For example, the committee alleged that Exide's accounts payable grew by $47 million between October 2001 and the bankruptcy filing, and that it suffered a net loss of approximately $85 million in the first quarter of 2002.

The Delaware Bankruptcy Court's Holding

The lenders moved to dismiss the complaint, including the deepening-insolvency claim, arguing that no such claim is recognized under Delaware law. In considering the motion, the Delaware court was required to accept as true the factual allegations in the committee's complaint. The court noted the lack of a decision by Delaware's highest state court or any of its intermediate courts as to whether Delaware law recognizes a claim for deepening insolvency.[11] But the court also observed that the Third Circuit Court of Appeals had previously opined that a claim for deepening insolvency should be recognized under Pennsylvania law, even though no Pennsylvania court had ruled on the question.[12] The Third Circuit found that the theory for liability for deepening insolvency is sound, enjoying growing acceptance among courts and furthers "one of the most venerable principles in Pennsylvania jurisprudence, and in most common-law jurisdictions...that where there is an injury, the law provides a remedy."[13] Accordingly, the Delaware bankruptcy judge concluded that the Delaware Supreme Court would also recognize a claim for deepening insolvency where there has been damage to corporate property.[14]

A Look at the Evolution of Deepening Insolvency

Only recently has deepening insolvency been expressly recognized as a separate cause of action. Initially, some courts recognized that the corporate body is damaged by the deepening of its insolvency where an artificial and fraudulently prolonged life results in increased exposure to liability to creditors.[15] Indeed, in most cases, it would be crucial for a corporate insolvency to be disclosed so that shareholders may promptly dissolve the corporation and cut their losses.[16] Thus, for example, claims against auditors for negligently or intentionally issuing false financial statements were sustained on the theory that the erroneous financial statements caused a corporation to incur unmanageable debt and file for bankruptcy protection.[17] Similarly, claims against officers, directors and corporate parents for allowing an insurer to continue its business beyond the point of insolvency, while the defendants drained the corporation of assets or divested it of profitable business as part of a scheme to defraud, were upheld on appeal, following the denial of motions to dismiss, based in part on the deepening-insolvency theory.[18] In these cases, deepening insolvency was recognized as a theory of damages but not as an independent cause of action.

To be sure, the deepening-insolvency theory has by no means been universally accepted. One court rejected it, reasoning that equity interest-holders could not be damaged by additional losses incurred after the point of insolvency because they had already lost their equity interest in the corporation.[19] Another court granted a motion to dismiss, holding that deepening insolvency does not constitute a breach of fiduciary duties owed by a director to creditors of an insolvent company.[20] By granting the motion to dismiss for failure to state a claim upon which relief may be granted, that court implicitly rejected the notion that deepening insolvency could itself constitute a cognizable cause of action. While acknowledging that other courts had recognized the deepening-insolvency theory, a third court affirmed dismissal of a complaint against auditors who allegedly issued false financial statements where the plaintiff relied on a deepening-insolvency theory.[21] In this instance, the appellate court rejected the plaintiff's fraud and breach-of-contract claims based on a deepening-insolvency theory because the plaintiff was unable to identify any injury allegedly sustained by the corporation that was distinct from the injuries suffered by its creditors.[22]

The Third Circuit's decision in *Lafferty* is significant because it represents the explicit recognition of deepening insolvency as a separate cause of action. In that case, the court reasoned that a corporation's property may have value even when its debts exceed the fair market value of its assets.[23] The fraudulent and concealed incurrence of debt can damage that value. For example, it can force a corporation into bankruptcy, which can inflict upon the corporation legal and administrative costs and impose upon it operational limitations that harm its ability to run its business profitably. The Third Circuit also noted that deepening insolvency can undermine a corporation's relationships with its customers, suppliers and employees. In addition, prolonging an insolvent corporation's life through phony debt may cause the dissipation of corporate assets.[24]

Some Unanswered Questions

There is a trend among some courts toward recognizing deepening insolvency as an independent cause of action against a party that fraudulently creates the appearance of solvency to prolong artificially a corporation's life, thereby increasing its level insolvency.[25] The court in *Exide Technologies* relied heavily on the Third Circuit's decision in *Lafferty* to reach its conclusion that a Delaware court would recognize a claim for deepening insolvency. But the *Exide Technologies* court did not specify the precise elements of the claim, and there is no definitive judicial statement that identifies them. Based on a review of the case law, the following factors appear to be essential: (1) the fraudulent prolongation of an insolvent corporation's life by hiding its true financial condition, (2) causing the corporation to become more insolvent by incurring additional liabilities or the dissipation of assets, (3) so that value that could have been realized if the corporation's business activity had not been improperly prolonged is lost and (4) the corporation suffers harm distinct from the harm suffered by its creditors. *Exide Technologies* supports the proposition that a lender may incur liability for deepening insolvency where the lender obtains the ability to dictate the borrower's corporate policy and disposition of assets, and the lender exercises that power such that the foregoing four factors are satisfied.

But important details remain unclear. In *Exide Technologies*, the complaint merely

11 *See Exide Technologies*, 299 B.R. at 751.
12 *See Id.* at 751.
13 *Lafferty*, 267 F.3d at 351.
14 *See Exide Technologies*, 299 B.R. at 752.

15 *See Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983), *cert. denied*, 464 U.S. 1002, 104 S.Ct. 508, 78 L.Ed.2d 698 (1983); *Corcoran v. Frank B. Hall & Co. Inc.*, 149 A.D.2d 165, 545 N.Y.S.2d 278, 283 (1st Dep't. 1989); *Feltman v. Prudential Bache Securities*, 122 B.R. 466, 473 (S.D. Fla. 1990).
16 *See Schacht v. Brown*, 711 F.2d at 1350; *Allard v. Arthur Andersen & Co. Inc.*, 924 F.Supp. 488, 494 (S.D.N.Y. 1996).
17 *See Gouiran Holdings Inc. v. DeSantis, Prinzi, Springer, Keifer and Shall*, 165 B.R. 104, 107 (E.D.N.Y. 1994); *Allard*, 924 F.Supp. at 494.
18 *See Schacht v. Brown*, 711 F.2d at 1350; *Corcoran v. Frank B. Hall*, 545 N.Y.S.2d at 283-84.
19 *See Askanase v. Fatjo*, 1996 WL 33373364 at *28 (S.D. Texas April 1, 1996).
20 *See Ben Franklin Retail*, 225 B.R. at 656.
21 *See Holland v. Arthur Andersen & Co. Inc.*, 212 Ill.App.3d 645, 571 N.E.2d 777 (1st Dist. 1991).

22 *See Id.* at 652, 571 N.E.2d at 782.
23 *See Lafferty*, 267 F.3d at 349.
24 *See Id.* at 350. This may require examination of the applicable test for proximate cause. *See, e.g., Gouiran Holdings*, 165 B.R. at 106-07.
25 *See Florida Dep't. of Ins. v. Chase Bank of Texas N.A.*, 274 F.3d 924, 935 (5th Cir. 2001).

alleged in rather conclusory fashion that the defendants fraudulently continued the debtors' business without explaining how the borrowers' true financial condition might have been concealed. May a defendant be liable for deepening insolvency where there are allegations of only constructive fraud, negligence and/or inequitable conduct, but not actual fraud in the continuation of the business? One could argue that the deepening-insolvency theory has already been accepted where only negligence has been alleged.[26] But if intentional concealment of the corporation's true financial condition is not a prerequisite to the imposition of liability for deepening insolvency, then lenders may be deterred from participating in consensual restructurings for fear of incurring such liability. One would hope that a lender could not be held liable for deepening insolvency where, instead of shutting down an insolvent borrower, the lender permits and carefully supervises a transaction that prolongs the borrower's life, improves the lender's secured position and does not involve an intentional fraud, but fails to reverse the borrower's losses. This is so even though creditors may have recovered more if the unsuccessful transaction had not been attempted.

How to measure damages on a deepening-insolvency claim is another open question. One court has stated that damages are measured by the dissipation of assets or increased debt load occurring after the false representation of solvency was made,[27] while another court has cautioned that, where the corporate existence is perpetuated to facilitate looting the corporation of its assets, measuring damages under a deepening-insolvency theory "to any degree of certainty seems to pose serious problems...."[28] In addition, as previously noted in *Lafferty*, the Third Circuit stated that the harm a corporation may suffer from deepening insolvency includes damages suffered from the loss of confidence of parties who deal with the corporation, such as customers, suppliers and employees, in the corporation's ability to perform.[29] How does one measure the damage to a corporation's assets resulting from the undermining of such relationships?

Conclusion

Though not unanimously accepted, the deepening-insolvency theory has recently gained notable support. Some courts have gone so far as to state that deepening insolvency should be recognized as an independent cause of action. It is clear that the deepening-insolvency theory is not viable where the corporation has not suffered a harm distinct from the harm suffered by its creditors. But the precise elements of this claim and how to measure its damages remain unclear, and will likely be the subject of future litigation. ■

26 *See In re Gouiran Holdings Inc.*, 165 B.R. at 107 ("Nor can the court say it is impossible that under some set of facts two years of negligently prepared financial statements could have been a substantial cause of Gouiran's incurring unmanageable debt and filing for bankruptcy protection.").

27 *See Florida Dep't. of Ins.*, 274 F.3d at 935.

28 *Drabkin v. L&L Construction Associates Inc.*, 168 B.R. 1, 5 (Bankr. D.C. 1993).

29 *See Lafferty*, 267 F.3d at 35.

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