DEEPENING INSOLVENCY: AN EMERGING THEORY OF LIABILITY

By Michael L. Bernstein and Charles A. Malloy***

I. Introduction

In the aftermath of a bankruptcy filing, bankruptcy trustees, debtors and creditors' committees frequently scour the landscape in search of one or more "deep pockets" they can sue in an effort to enhance creditors' recoveries. The most common targets are parties who received avoidable transfers, such as preferences or fraudulent conveyances. But many trustees, debtors and committees will reach beyond this low-hanging fruit. For example, they may seek to equitably subordinate secured lenders' claims, to recharacterize debt as equity, to attack officers and directors for breach of their fiduciary duties, or to sue the debtor's pre-bankruptcy professionals for various alleged wrongdoing. Of course, all of these actions do not appear every case, but they have become sufficiently common to get peoples' attention.

One of the latest trends in the effort to bolster creditors' recoveries through litigation is to assert claims for "deepening insolvency." The idea underlying deepening insolvency is fairly simple: at some point in time, it is better for a corporation to cease operations, liquidate its assets and distribute the proceeds to creditors rather than continuing to operate and incurring additional debt. If the company continues to operate beyond the point when it should have liquidated, it is harmed.

It is easy to see how a deepening insolvency claim might arise when a company facing difficult times continues to operate its business, while incurring additional debt, rather than liquidating. If things work out well, everyone is happy. If things work out badly, however, then after the fact someone (most commonly a trustee or creditors' committee) says "creditors would have been better off if you had liquidated; you made the

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wrong decision and you should be liable for the resulting damages." To a cynic (or a defendant) this is unfair Monday-morning quarterbacking. To a plaintiff, it is simply a way of requiring that parties who have influence over the debtor make business decisions that are reasonably calculated to maximize value, even if value is maximized through liquidation.

Deepening insolvency claims have been asserted against all sorts of parties who may have played a role in the debtor's decision to continue its operations, including officers and directors, professionals and advisors, banks and other lenders, and customers. Sometimes deepening insolvency is pled as a stand-alone cause of action. Alternatively, it may be pled as a theory of damages – a way of measuring the harm caused by breaching a fiduciary duty or a duty of care. Despite the increasing number of deepening insolvency claims that are asserted, the law is not very well settled – in part because most of the cases settle. Thus, there remains a substantial question as to whether deepening insolvency is a viable theory, and if it is what must be shown in order for a plaintiff to recover.

This article looks briefly at the background and origin of deepening insolvency, then moves to a discussion of what constitutes deepening insolvency, who it may be asserted against, and what are the primary defenses.

II. Deepening Insolvency's Origins

Deepening insolvency is a relatively new theory that involves allegations that an officer, director, professional (such as an accountant, lawyer or financial advisor), lender or other party acted to prolong a company's existence, thereby causing the company to incur additional debt and deepen its insolvency, reducing the ultimate return to creditors upon liquidation.[1] Some courts embrace the theory as a separate cause of action, other courts recognize it as a measure of damages to be applied where there is an independent tort or breach of duty, and others reject it entirely.

The early cases that gave rise to the concept of deepening insolvency involved officers and directors who were alleged to have fraudulently prolonged the life of a corporation in order to benefit themselves, and who argued that there was no harm to the corporation in their doing so because any act to further the corporation's life must have benefited it. Courts rejected that argument, refusing to presume that it is always better for a corporation to continue to exist. As one court stated, "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[2] Instead, courts held that

1. *See, e.g.*, *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001); *see also* Jo Ann J. Brighton, *Deepening Insolvency*, 23-APR Am. Bankr. Inst. J. 34 (2004).

2. *Bloor v. Dansker* (*In re Investors Funding Corp.*), 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

at some point in time a corporation should cut its losses, stop incurring additional debt, and liquidate.[3] Without establishing deepening insolvency as a distinct cause of action, these early cases recognized that when a corporation continues to exist beyond the point when it should have been liquidated, and its insolvency deepens, the corporation is harmed.[4]

Today, deepening insolvency is no longer just a counterargument to the view that a corporation is always better off continuing to exist. It has been transformed into a separate cause of action, or at least a theory of damages to be applied in connection with other claims. Two leading cases recognizing deepening insolvency as a viable independent cause of action are the Third Circuit's opinion in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Company*[5] and the United States Bankruptcy Court for the District of Delaware's decision in *Official Committee of Unsecured Creditors v. Credit Suisse First Boston* (*In re Exide Technologies, Inc.*).[6] As discussed below, the Third Circuit recently revisited *R.F. Lafferty & Company* in *Seitz v. Detweiler, Hershey and Assocs., P.C.* (*In re CitX Corp.*).[7]

In the *Lafferty* case, a creditors' committee brought suit on behalf of the debtor against the debtor's officers and directors and certain professionals who the committee alleged assisted the officers and directors in running a Ponzi scheme. The defendants included the debtor's underwriter, R.F. Lafferty & Company. The committee alleged that in connection with the public offering and sale of the debtor's securities, R.F. Lafferty and others had conspired with the debtor's officers and directors to render opinions with fraudulent misstatements and material omissions regarding the debtor's financial condition. Among other things, the committee argued that R.F. Lafferty injured the debtor by "'wrongfully expand[ing] the [D]ebtors' debt out of all proportion of their ability to repay and ultimately forc[ing] the [D]ebtors to seek bankruptcy protection.'"[8] The Third Circuit described the alleged injury as the "fraudulent expansion of corporate debt and prolongation of corporate life" and referred to it as deepening insolvency.[9]

The issue before the Third Circuit was whether deepening insolvency was a viable cause of action that would be recognized under Penn-

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3. *See Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983) (noting that it is a flawed assumption that "the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests.").

4. *See Schacht v. Brown*, 711 F.2d at 1350 ("[T]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."); *In re Investors Funding Corp.*, 523 F. Supp. at 541 (prolonged artificial solvency of a debtor only benefited principal officers and controlling stockholders of the debtor, it did not benefit the debtor itself).

5. 267 F.3d 340 (3d Cir. 2001).

6. 299 B.R. 732 (Bankr. D. Del. 2003).

7. *Seitz v. Detweiler, Hershey and Assocs., P.C.* (*In re CitX Corp.*), No. 05-2760, 2006 WL 1453117 (3rd Cir. May 26, 2006).

8. *R.F. Lafferty & Co.*, 267 F.3d at 347.

9. *Id.*

sylvania law. The court concluded that it was reasoning that even an insolvent corporation still has some value, and by fraudulently incurring and concealing additional debt, parties can damage this remaining value by: (i) forcing the corporation to incur the administrative and legal costs associated with bankruptcy, (ii) creating operational limitations on the corporation, thereby restricting its ability to be profitable, (iii) undermining customer, supplier and employee relationships, and (iv) causing the dissipation of corporate assets.[10] If, however, a corporation is dissolved in a timely manner, these types of harm can be avoided or minimized and the value remaining in an insolvent corporation can be salvaged. Based on these considerations, growing acceptance of the deepening insolvency doctrine by other courts, and the policy under Pennsylvania law of providing a remedy where there is a harm, the Third Circuit concluded that deepening insolvency was a valid cause of action. However, the court went on to hold that the plaintiff had no claim, because the officers' and directors' misconduct would be imputed to the debtor and, accordingly, the plaintiff was barred from bringing a claim on the debtors' behalf by the doctrine of *in pari delicto,*[11] a defense that is discussed in Section IV below.

The other leading case recognizing deepening insolvency is the Delaware Bankruptcy Court's *Exide Technologies* decision. In *Exide*, a creditors' committee brought an action against the debtor's pre-bankruptcy lenders, who had agreed to requests to amend certain prepetition loan agreements and advance additional funds, taking additional collateral in return, at a time when the debtor was incurring substantial losses and becoming increasingly insolvent.[12] One of the claims brought by the committee was for deepening insolvency, which the committee asserted by arguing that the lenders had caused the debtor to incur additional debt in order to acquire a competitor, that this additional debt provided the lenders with leverage to exert increased control over the debtor, and that the lenders used this leverage to cause the debtor to fraudulently continue its business – and to incur additional debt – over a period of two years. Relying on the *Lafferty* case, the Delaware bankruptcy court held that this conduct harmed the corporation and that deepening insolvency was a valid cause of action under Delaware law.[13]

Since *Lafferty* and *Exide Technologies*, a number of other courts have ruled on the viability of deepening insolvency, reaching inconsistent conclusions. A majority of the opinions discussing deepening insolvency have been issued by federal courts, but it is important to remember that although federal courts can attempt to predict whether deepening insolvency would be recognized in a given state (as the Third Circuit did in *Lafferty*), ultimately the highest court in each state has the final word on

10. *See id.* at 349.
11. *Id.* at 360.
12. *In re Exide Tech., Inc.*, 299 B.R. at 736.
13. *See id.* at 751.

the validity of deepening insolvency.[14] Indeed, different federal courts have written conflicting opinions as to the validity of deepening insolvency as an independent cause of action, even in the same jurisdictions.[15] Thus, there is not a clear answer to the question of whether deepening insolvency exists as an independent cause of action. With this background in mind, the next section discusses what a plaintiff must allege in order to bring a claim for deepening insolvency.

III. The Elements of Deepening Insolvency

Because deepening insolvency is a relatively new theory of liability (or, perhaps, measure of damages), there is a fair amount of variation in the cases regarding the components or the formal elements of a deepening insolvency claim.[16] The courts that accept the theory seem to believe that there's a wrong that needs a remedy, but they are not quite in agreement on how to define the wrong.

In trying to pinpoint the elements, it is important to distinguish between deepening insolvency as a stand-alone cause of action and deepening insolvency as a measure of damages for breach of a duty. For example, in *CitX Corporation*, the Third Circuit, again interpreting Pennsylvania law, held that deepening insolvency is cognizable only as an independent cause of action, and that it is not a valid theory of damages for other causes of action.[17] On the other hand, other courts have denied the validity of deepening insolvency as an independent cause of action, holding

14. Courts in New Jersey and Utah have rejected deepening insolvency as a theory of liability, *i.e.*, an independent cause of action. *See Bondi v. Citigroup, Inc.*, 2005 WL 975856, at *21 (N.J. Super. Ct. Law Div. Feb. 28, 2005); *Coroles v. Sabey*, 79 P.3d 974, 983 (Utah Ct. App. 2003) ("Although deepening insolvency might harm a corporation's shareholders, it does not, without more, harm the corporation itself."). Courts in Massachusetts, Michigan and Illinois, while not expressly validating deepening insolvency, have noted its existence and viability in some contexts. *See MCA Fin. Corp. v. Grant Thornton LLP*, 687 N.W.2d 850, 858 (Mich. Ct. App. 2004); *Holland v. Arthur Andersen LLP*, 571 N.E.2d 777, 782 (Ill. App. Ct. 1991); *Bowler v. Arthur Andersen LLP*, 2005 WL 2402875, at *13 (Mass. Super. Sept. 23, 2005).

15. *Compare Kittay v. Atl. Bank of New York (In re Global Serv. Group LLC)*, 316 B.R. 451, 461 (Bankr. S.D.N.Y. 2004) (deepening insolvency not an independent cause of action under New York law) *and Bondi v. Bank of Am.* (*In re Parmalat Sec. Litig.*), 383 F. Supp. 2d 587, 601-02 (S.D.N.Y. 2005) (deepening insolvency not an independent cause of action under North Carolina law) *with OHC Liquidation Trust v. Credit Suisse First Boston* (*In re Oakwood Homes Corp.*), 340 B.R. 540, 531 (Bankr. D. Del. 2006) (deepening insolvency would be recognized under Delaware, New York and North Carolina law).

16. *See Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1003-04 (9th Cir. 2005) (noting that it is "difficult to grasp what the theory [of deepening insolvency] entails.")

17. *See Seitz v. Detweiler, Hershey and Assocs., P.C.* (*In re CitX Corp.*), No. 05-2760, 2006 WL 1453117, at *3 (3rd Cir. May 26, 2006) (noting that *Lafferty* should not be interpreted to support deepening insolvency as a theory of damages).

that, if anything, it is a measure of damages for other claims, such as those alleging a breach of duty.[18]

To the extent that deepening insolvency is recognized as an independent cause of action, there are two main concepts that function as its underlying elements: (1) fraudulent incurrence of debt, and (2) prolongation of the corporation's life. However, if deepening insolvency is viewed as a measure of damages for a breach of duty, rather than an independent cause of action, then in order to recover, a plaintiff must first establish the existence of an independent duty between the debtor and the defendant, and must also show that there was a breach of that duty. In other words, if deepening insolvency is only a damages theory, rather than a stand-alone cause of action, then in order for a plaintiff to recover it must prove the elements of some other cause of action, such as breach of fiduciary duty, in addition to showing that deepening insolvency occurred.[19]

Finally, the identity of the defendant will, to some extent, inform what allegations are made. For example, where the defendant is an officer or director, the allegations with respect to deepening insolvency will differ from those that apply when the defendant is a lender or a professional, or when the defendant is a customer who assumes control of the debtor and forces the debtor to enter into or maintain contracts with disadvantageous terms. In light of the heightened standards that apply to an insider's transactions with a corporation,[20] a deepening insolvency case may be particularly strong where officers or directors are accused of self-dealing or a conflict-of-interest. For example, in *In re LTV Steel*, the defendant directors were accused of engaging in self-dealing and "improper or careless conduct which caused LTV Steel to incur unnecessary debt and suffer substantial erosion of the value of its assets."[21] That court noted the "growing acceptance" of deepening insolvency as a theory of director liability.[22] Other courts have recognized that, because of the heightened duties of officers and directors, in many cases the allegations underlying a deepening insolvency action will essentially mirror those in a breach of fiduciary duty action, thereby diminishing the need to distinguish between the two theories at early stages of litigation.[23]

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18. *See, e.g.*, *Schnelling v. Thomas* (*In re AgriBioTech, Inc.*), 319 B.R. 216, 224 (D. Nev. 2004); *Official Comm. of Unsecured Creditors v. Rural Telephone Fin. Coop.* (*In re Vartec Telecom, Inc.*), 335 B.R. 631, 635 (Bankr. N.D. Tex. 2005).

19. The viability of deepening insolvency as a theory of damages has been the focus of at least two recent articles. *See* J.B. Heaton, *Deepening Insolvency*, 30 J. CORP. L. 465 (Spring 2005); Sabin Willet, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549 (2005).

20. *See Pepper v. Litton*, 308 U.S. 295, 306-07 (1939) (noting that the fiduciary duties of officers and directors to their corporation require that transactions between officers or directors and the corporation be subject to rigorous scrutiny and evidence good faith and inherent fairness from the point of view of the corporation).

21. *In re LTV Steel Co.*, 333 B.R. 307, 403 (Bankr. S.D. Ohio 2005).

22. *See id.* at 422.

23. *See In re Fleming Packaging Corp.*, 336 B.R. 398, 399 (Bankr. C.D. Ill. 2006).

Assuming that deepening insolvency is an independent cause of action, what does it take to prove the elements of a claim? As noted above, the courts have articulated two elements: fraudulent incurrence of debt and prolongation of the corporation's existence. In addition to these two elements, the basis for a deepening insolvency claim is that the insolvency of a company was deepened or made worse. Accordingly, there is an implicit requirement that in order to bring such an action, the company must be insolvent. The element of insolvency adds an additional burden to the plaintiff's case, because there is more than one method of determining insolvency, and proof of insolvency is itself a complicated factual and legal question that usually requires expert testimony.

The first explicit element of deepening insolvency, fraudulent incurrence of debt, requires an allegation that a corporation incurred debt of some sort. Situations that have given rise to allegations of deepening insolvency have included: an officer or director pursuing credit on behalf of a corporation;[24] a lender causing a borrower to incur new commercial debt when a corporation is already carrying substantial debt;[25] a lender agreeing to the amendment of loan agreements in order to permit the borrower to obtain additional debt;[26] a supplier causing a customer to acquire more inventory than the customer could sell or finance;[27] accountants causing or permitting the use of accounting methods or the issuance of misleading financial reports that permit the borrower to obtain additional debt;[28] and officers actively concealing the corporation's true financial condition.[29]

But not all incurrence of new debt (even by an insolvent company) will give rise to a deepening insolvency claim. Instead, the majority of reported cases require that the incurrence of debt be done wrongfully, or with the intent to defraud, rejecting negligence as a basis for a deepening insolvency claim.[30] For example, in *CitX Corporation*, the Third Circuit rejected negligence, stating that "a claim of negligence cannot sustain a

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24. *See Rafool v. Goldfarb Corp.* (*In re Fleming Packaging Corp.*), 2005 WL 2205703, at *7 (Bankr. C.D. Ill. Aug. 26, 2005).

25. *See In re Oakwood Homes Corp.*, 340 B.R. at 532.

26. *See Official Comm. of Unsecured Creditors v. Rural Telephone Fin. Coop.* (*In re Vartec Telecom, Inc.*), 335 B.R. 631, 635 (Bankr. N.D. Tex. 2005).

27. *See Nisselson v. Ford Motor Co.* (*In re Monahan Ford Corp.*), 340 B.R. 1, 17-18 (Bankr. E.D.N.Y. 2006).

28. *See Rahl v. Bande*, 328 B.R. 387, 397 (S.D.N.Y. 2005); *Bondi v. Grant Thornton Int'l* (*In re Parmalat Sec. Litig.*), 377 F. Supp. 2d 390, 418 (S.D.N.Y. 2005); *Schnelling v. Thomas* (*In re AgriBioTech, Inc.*), 319 B.R. 216, 224 (D. Nev. 2004).

29. *See In re LTV Steel Co.*, 333 B.R. 397, 418 (Bankr. N.D. Ohio 2005).

30. *See, e.g.*, *Seitz v. Detweiler, Hershey and Assocs., P.C.* (*In re CitX Corp.*), No. 05-2760, 2006 WL 1453117, at *6 (3rd Cir. May 26, 2006); *R.F. Lafferty & Co.*, 267 F.3d at 347; *In re Oakwood Homes Corp.*, 340 B.R. at 534 (plaintiff is required to show fraudulent conduct, not mere negligence); *Rahl v. Bande*, 328 B.R. at 416; *Limor v. Buerger* (*In re Del-Met Corp.*), 322 B.R. 781, 812-13 (Bankr. M.D. Tenn. 2005); *Corp. Aviation Concepts, Inc. v. Multi-Service Aviation Corp.*, 2004 WL 1900001, at *4 (E.D. Pa. Aug. 25, 2004).

deepening-insolvency cause of action."[31] A prior decision from the Delaware bankruptcy court, *In re Oakwood Homes, Inc.*, similarly held that the plaintiff in a deepening insolvency action "is required to show fraudulent conduct-not mere negligence."[32] Accordingly, under the rule followed by a majority of courts, the procedural requirements of alleging deepening insolvency will include the more stringent pleading requirements that apply to claims of fraud.[33] The *Oakwood Homes* court described fraud as generally containing five elements, " 'a representation of material fact, falsity, scienter, reliance and injury,' " and noted that, in a deepening insolvency action, the fraudulent conduct must be suffered by the debtor and not by an individual creditor.[34] *Oakwood Homes* illustrates the type of allegations that might satisfy the requirement of fraud. The plaintiff alleged that the debtors' lender was in a fiduciary position of trust and control, and that the lender made knowing misrepresentations to the debtors about the sustainability of certain practices under a loan securitization program operated by the debtors. The lender was alleged to have done this with the intent of inducing the debtors to continue an unsustainable loan program in order to generate fees that enriched the lender at the debtors' expense. The plaintiff also alleged that the debtors relied on the lender's misrepresentations and were injured as a result.[35] The court held that these were sufficient allegations of fraud to support a deepening insolvency claim.

However, while most courts require allegations of fraud, a few courts have recognized the possibility that negligently permitting a corporation to incur debt that deepens its insolvency may give rise to a deepening insolvency action.[36] Thus, it is not clear that fraud will always be required, and, at least in some jurisdictions, a lesser showing of wrongful conduct may suffice.

The second element of deepening insolvency is that the corporation's life was prolonged, suggesting that the corporation existed beyond the point at which it was a viable enterprise, and that the failure to cease operating and liquidate harmed the corporation. In other words, the plaintiff must allege that the corporation continued to operate past the point when it should have been liquidated, and that this prolongation of life caused the loss of value that would not have occurred if the corpora-

31. *In re CitX Corp.*, 2006 WL 1453117, at *6.

32. *See In re Oakwood Homes Corp.*, 340 B.R. at 534.

33. *See* Fed. R. Civ. P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

34. *See In re Oakwood Homes Corp.,* 340 B.R. at 534.

35. *See id.* at 21.

36. *See Smith v. Arthur Andersen LLP*, 421 F.3d 989, 995, 1004 (9th Cir. 2005) (misrepresentations of firm's financial condition need not necessarily be intentional to state claim under deepening insolvency theory); *In re LTV Steel Co.*, 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005); *Tabas v. Greenleaf Ventures, Inc.* (*In re Flagship Healthcare, Inc.*), 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (additional debt incurred as a result of defendants' negligence may provide for recovery under deepening insolvency theory).

tion had been liquidated in a timely manner.[37] While this element may be easy to allege in a complaint, it may be considerably more difficult to prove. The factual proof required to show that a corporation should have dissolved at one time rather than weeks, months or years later could be very complicated, and is likely to involve a battle of expert witnesses reconstructing accounts of the company's financial and operational history and speculating about what decisions should have been made based on the information available at the time. On the one hand, in most cases the plaintiffs' position will be supported by the fact that the company ultimately failed, and the plaintiffs will argue that the resulting loss of value could have been avoided if the company were liquidated sooner. On the other hand, defendants will argue that they exercised sound business judgment in deciding to continue to operate in the hope of effecting a turnaround, and that their decision not to "pull the plug" cannot fairly be judged with the benefit of hindsight.

In addition, some companies will elect to file bankruptcy under chapter 11, and seek to reorganize and emerge as a more viable enterprise. In cases where the debtor is pursuing a reorganization and emergence from bankruptcy, it may be more difficult for plaintiffs to argue that the debtor was harmed by wrongful prolongation of its life and the failure to liquidate its assets. As one court noted in criticizing this aspect of deepening insolvency, "chapter 11 is based on the accepted notion that a business is worth more to everyone alive than dead."[38] This is arguably inconsistent with the notion of deepening insolvency, which is that some corporations are worth more dead than alive. The elements of deepening insolvency do not specifically reference filing a bankruptcy case; however, they do clearly require allegations that the corporation should have been *liquidated*, and that its life was wrongfully prolonged. Accordingly, the second element will be easier to establish in cases where the debtor ceases operating and liquidates than in cases where the debtor is successfully reorganizing under chapter 11.

If a deepening insolvency claim is brought before a court that recognizes it as an independent cause of action, it is likely to be sufficient to allege the elements discussed above. Courts subscribing to this view have made clear that deepening insolvency should be treated as a unique tort that can be pled separately in a complaint.[39]

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37. *See Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1003-04 (9th Cir. 2005) (citing *R.F. Lafferty & Co.*, 267 F.3d at 350); *Devon Mobile Commc'n Corp. v. Adelphia Commc'n Corp.* (*In re Adelphia Commc'n Corp.*), 324 B.R. 492, 500-01 (Bankr. S.D.N.Y. 2005).

38. *Kittay v. Atl. Bank of New York* (*In re Global Serv. Group LLC*), 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004).

39. *See Seitz v. Detweiler, Hershey and Assocs., P.C.* (*In re CitX Corp.*), No. 05-2760, 2006 WL 1453117, at *3 (3rd Cir. May 26, 2006); *R.F. Lafferty & Co.*, 267 F.3d at 344 ("We conclude that 'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law . . . ."); *In re Student Fin. Corp.*, 335 B.R. 539, 548 (D. Del. 2005); *In re Oakwood Homes Corp.*, 340 B.R. at 530-31; *Official Comm. of Unsecured Creditors v. Credit Suisse*

However, as noted above other courts do not recognize deepening insolvency as an independent cause of action. These courts may accept the underlying theory that a corporation can be harmed by continued existence and incurrence of debt, but instead of ending the inquiry there, they require a showing that the defendant had, and breached, an independent duty to the corporation which resulted in damages in the form of the corporation's deepened insolvency. A leading case representing this point of view is *In re Global Services Group LLC*, decided by the United States Bankruptcy Court for the Southern District of New York.[40] In *Global Services*, a chapter 7 trustee brought an action against the debtor's prepetition lender alleging that by making loans that the lender knew or should have known could not be repaid, the lender was liable for deepening the borrower's insolvency. The court held that the lender had no fiduciary duty or similar obligation to the borrower, rejected the trustee's argument, and dismissed the claim, noting that "[p]rolonging an insolvent corporation's life, without more, will not result in liability . . . ."[41]

Nevertheless, there are situations in which a duty may exist which, if breached, arguably gives rise to liability for deepening insolvency damages. For instance, officers and directors have a fiduciary duty to the corporation. The breach of duty by an officer or director may create liability measured by the amount of the corporation's deepened insolvency resulting from the breach.[42] The tort in these cases is not deepening insolvency but instead consists of the breach of a fiduciary duty or duty of care, with the damages calculated based on the deepening of the company's insolvency.[43]

First Boston (*In re Exide Tech., Inc.*), 299 B.R. 732, 752 (Bankr. D. Del. 2003) ("The tort of deepening insolvency has been pled sufficiently by the Plaintiffs.").

40. *Kittay v. Atl. Bank of New York* (*In re Global Serv. Group LLC*), 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

41. *Id.* at 458; *see also Bondi v. Bank of America* (*In re Parmalat Sec. Litig.*), 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005); *Alberts v. Tuft* (*In re Greater Southeast Cmty. Hosp. Corp.*), 333 B.R. 506, 516 (Bankr. D.D.C. 2005) ("the *sine qua non* of the concept [of deepening insolvency] is that the defendant breached some preexisting duty of care owed to the corporation in deepening its insolvency.")

42. *See Rafool v. Goldfarb Corp.* (*In re Fleming Packaging Corp.*), 336 B.R. 398, 400 (Bankr. C.D. Ill. 2006); *Collins v. Kohlberg and Co.* (*In re Southwest Supermarkets, LLC*), 325 B.R. 417, 429 (Bankr. D. Ariz. 2005).

43. One may legitimately question whether deepening insolvency is a proper measure of damages in these cases. Why not instead measure damages in the traditional way – by actually quantifying the harm suffered as a result of actions taken by the defendant? Occasionally this may be the same as the amount by which the company's insolvency has increased, but often it will not be. There may, for example, be other factors – positive or negative – that affect the extent of the company's insolvency during the relevant time period, but have nothing to do with the defendants' actions. Moreover, why should the damage calculation differ between (1) a company that is insolvent and then rendered more insolvent by wrongful conduct, and (2) a company that begins solvent but is rendered insolvent by the same conduct – or for that matter a company that is solvent and is rendered less solvent (but not insolvent)? Shouldn't the damages in each of these cases be measured simply by the losses imposed as a result of the wrongful conduct? Yet,

In addition to the fiduciary duties that officers and directors owe to a corporation, accountants, attorneys and other professionals may owe a duty of care to a corporation. Where a professional breaches this duty and a malpractice claim arises, deepening insolvency may provide a measure of damages. For example, in one case an accountant was alleged to have breached its professional duties to its client, a corporation, by aiding in fraud being perpetrated by insiders of the corporation leading to the fraudulent prolongation of the corporation's life and the incurrence of increased debt. The court found that a deepening insolvency claim could be pursued against the accountants.[44]

The risk of liability for deepening insolvency is not limited to directors, officers and professionals. It also extends to other entities that exert control over the operations of an insolvent corporation in such a way that a duty to the corporation arises. This is illustrated by a recent case, where major customers who had a large amount of leverage over an insolvent corporation were alleged to have taken control of that corporation's business operations solely in order to preserve their rights under an important and valuable supply contract, even though continued operations, and performance under the contract, were economically detrimental to the corporation.[45] When an outsider exerts sufficient control over an insolvent corporation, such control can give rise to duties that, if breached, may lead to damages calculated based on the resulting deepening insolvency of the corporation.[46] Finally, a lender that dominates and controls a borrower may be found to have a fiduciary duty to the borrower, and if that lender extends credit to the borrower in order to prolong the corporation's life by means of a fraudulent transaction, the lender may be liable under a theory of deepening insolvency.[47]

There are many situations in which deepening insolvency may arise, either as an independent cause of action or as a theory of damages where some other claim for breach of duty is alleged. While the theory was originally applied against officers, directors and overreaching lenders, courts have shown a willingness to expand it to other defendants.

IV. Defenses to Deepening Insolvency

The defenses to a deepening insolvency claim will depend on whether deepening insolvency is being asserted as an independent cause

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deepening insolvency seems to imply a different measure of damages in the case when the company begins insolvent and then is rendered more insolvent. Because of these and similar questions, there will continue to be doubt about the validity of deepening insolvency as a measure of damages.

44. *See Schnelling v. Thomas* (*In re AgriBioTech, Inc.*), 319 B.R. 216, 224 (D. Nev. 2004).

45. *See Limor v. Buerger* (*In re Del-Met Corp.*), 322 B.R. 781, 815 (Bankr. M.D. Tenn. 2005).

46. *See id.* at 808.

47. *See Nisselson v. Ford Motor Co.* (*In re Monahan Ford Corp.*), 340 B.R. 1, 39-40 (Bankr. E.D.N.Y. 2006).

of action or, alternatively, as a measure of damages arising from the breach of an independent duty.

If a plaintiff brings an action alleging deepening insolvency as an independent cause of action, the first challenge will often be that the claim must be dismissed as a matter of law because it does not state a claim upon which relief can be granted. The jurisdiction in which the claim is brought, and the question of which state's law applies, will be key factors influencing whether a deepening insolvency cause of action will survive such a challenge. For example, the Delaware bankruptcy courts have made it fairly clear that deepening insolvency is a recognized cause of action under Delaware law, and the Third Circuit Court of Appeals upheld a deepening insolvency claim under Pennsylvania law. On the other hand, there are conflicting views as to the viability of deepening insolvency under New York law, and it has been rejected as a cause of action by federal courts interpreting North Carolina law and Texas law, and by state courts in Utah and New Jersey. In light of the lack of uniformity in this area, a defendant should ordinarily challenge the viability of deepening insolvency as an independent cause of action in an answer or motion to dismiss, unless there is clear and binding precedent to the contrary.

In challenging deepening insolvency as an independent cause of action it may be helpful to follow the analysis of one court and ask, "Where's the tort?"[48] In other words, if a claim of deepening insolvency does not satisfy the basic elements of a tort, how can it be an independent cause of action? A tort claim is commonly understood to require: (1) duty; (2) breach of that duty; (3) proximate causation; and (4) injury. But, the argument goes, when deepening insolvency is set forth as a stand-alone cause of action, it cannot satisfy even the first element – the existence of a duty owed by the defendant to the plaintiff.[49] Deepening insolvency alone does not establish the existence of such a duty. Absent a duty, there is arguably no basis to assert deepening insolvency as a separate cause of action. This argument may be particularly powerful where a lender is the defendant, since lenders are not commonly understood to have a fiduciary duty to their borrower. The same would be true with an action against a customer, who is not generally thought to have a fiduciary duty to its vendor. Where an officer, director or professional is the defendant, the existence of a duty may be more clear. But even in those cases the defendant may argue that the plaintiff must allege and prove the elements of an independent tort rather than relying solely on deepening insolvency.

A deepening insolvency claim can also be challenged for failing sufficiently to allege the elements of the claim. Although the cases do not

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48. *See Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop.* (*In re Vartec Telecom, Inc.*), 335 B.R. 631, 644-45 (Bankr. N.D. Tex. 2005).

49. *See id.* at 645.

provide a succinct statement of the elements of a deepening insolvency claim, there are some generally agreed-upon concepts.

First, the plaintiff must allege that the defendant caused or aided in the incurrence of debt. A complaint that merely asserts that the plaintiff continued to incur debt without alleging that the defendant had a role in extending or facilitating the extension of credit would not, on its face, support a deepening insolvency claim. This focus on causation is important, especially in the case of a defendant who did not have first-hand involvement in advancing or borrowing funds.

Second, while some courts may permit a case to go forward based on allegations of negligence, most courts will require allegations of fraud in connection with the incurrence of debt. Thus, the defendant may be able to convince the court that the elements of fraud were not pled sufficiently. This is especially true in light of the particularity requirements of Federal Rule of Civil Procedure 9(b).

Third, the plaintiff must allege that the corporation's existence was prolonged – either that the corporation should have been liquidated but was not, or that it was liquidated too late. In other words, it would not be enough to allege that the defendant played a role in the fraudulent or wrongful incurrence of debt, the complaint must also allege that this lead to the prolongation of the corporation's existence. As noted above, it is far easier to plead than to prove that the company should have liquidated or should have liquidated sooner, so allegations of this element may not often give rise to a successful motion to dismiss. However, at least in those cases where the debtor was able to successfully reorganize, the court may express doubt at an early stage about allegations suggesting the company should have liquidated.

Fourth, as noted above, allegations of insolvency must be made.

Another defense that appears frequently in connection with deepening insolvency claims is *in pari delicto*. *In pari delicto* is an equitable defense that is a corollary of the "clean hands" doctrine and which denies relief to the plaintiff where both parties are alleged to have acted with knowledge as to the wrongfulness or illegality of a transaction.[50] Under this defense, courts have held that wrongful conduct on behalf of the plaintiff is a complete bar to recovery.[51]

Because deepening insolvency actions often allege that the defendant assisted, aided or abetted the debtor or its officers in entering into a fraudulent transaction, it is frequently evident from the face of the complaint that the plaintiff (or its predecessor-in-interest) was equally as culpable as the defendant, if not the primary wrongdoer. Indeed, in *R.F. Lafferty & Co.*, the Third Circuit case that recognized deepening insol-

50. *See* 27A AM. JUR. 2D *Equity* § 132 (2004).

51. *See, e.g., Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand LLP*, 322 F.3d 147, 164 (2d Cir. 2003); *R. F. Lafferty & Co.*, 267 F.3d at 360 (holding *in pari delicto* barred "deepening insolvency" cause of action).

vency, the court went on to hold that the plaintiff's deepening insolvency claim was barred by the doctrine of *in pari delicto*, because the inequitable conduct of the debtor's officers was imputed to the corporation and, ultimately, bound the creditors' committee to whom the claim had been assigned.[52] *In pari delicto* is an effective response to a deepening insolvency claim because even though it is an affirmative defense, where a plaintiff's complaint contains allegations that would be sufficient to establish *in pari delicto*, it is proper to dismiss the action for failure to state a claim upon which relief may be granted.[53]

Finally, deepening insolvency claims may raise standing issues.[54] Several courts have held that the basis of a deepening insolvency claim is that it causes harm to the debtor corporation and, accordingly, that the resulting right of action accrues to the corporation, rather than to creditors or committees.[55] Thus, where the injury is to the debtor company, a creditor or committee is not the proper plaintiff in a deepening insolvency action unless the debtor has assigned or transferred its rights to such action to the creditor or committee, or the court has authorized the creditor or committee to bring the action on the estate's behalf.[56]

Similarly, if a court were to hold that a deepening insolvency claim involved no injury to the corporation, but instead only alleged harm to an individual creditor or group of creditors – such as the creditors who extended credit after the company should have been liquidated – then the action would presumably not be property of the debtor's estate and could only be brought by aggrieved creditors. Limiting standing to individual creditors can be disadvantageous from a plaintiff's point of view because of practical impediments to individual creditors bringing the action, including paying the costs of litigation which otherwise would ordinarily be borne by the estate.

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52. *See R.F. Lafferty & Co.*, 267 F.3d at 356. The assertion of *in pari delicto* may carry two additional twists. First, *in pari delicto* will not apply if the plaintiff can establish the "adverse interest" exception, which provides that the wrongful conduct of an officer or other agent of the plaintiff will not be imputed to the plaintiff corporation if it is shown that the agent's actions were adverse to the interests of the corporation and not for the benefit of the corporation. However, there is also an exception to the adverse interest exception: the "sole actor" exception. The sole actor exception provides that the adverse interest exception will not apply when the agent is the sole representative of the corporation, such that there is no one from whom the sole actor could have concealed his wrongdoing. *See R.F. Lafferty & Co.*, 267 F.3d at 359.

53. *See Color Tile*, 322 F.3d at 164; *see also Official Committee of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A.*, 80 F. Supp. 2d 129, 138 (S.D.N.Y. 1999).

54. Some courts treat *in pari delicto* as a standing issue, rather than an affirmative defense. *See Baena v. KPMG LLP*, 389 F. Supp. 2d 112, 118 (D. Mass. 2005).

55. *See R.F. Lafferty & Co.*, 267 F.3d at 347 (committee suing on behalf of bankrupt corporations); *Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp.*, 2004 WL 1900001, at *3 (E.D. Pa. Aug. 25, 2004) ("[T]he Third Circuit clearly imagined the 'injury' in a deepening insolvency case to be suffered by the debtor corporation itself . . . .").

56. *See Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp.*, 2004 WL 1900001, at *3.

As discussed above, deepening insolvency may also appear as a measure of damages under a separate cause of action. In such cases, the defenses are likely to focus largely on the elements of the underlying cause of action, which will vary depending on what the underlying cause of action is – breach of fiduciary duty, professional malpractice, conspiracy, lender liability, etc. The particular defenses that may apply to each of these causes of action are beyond the scope of this article. Nonetheless, prior cases involving deepening insolvency as an alleged measure of damages suggest some defenses that may apply more generally in these situations.

The Third Circuit's recent decision in *CitX Corporation*, which rejects deepening insolvency as a measure of damages, is particularly instructive. In *CitX Corporation*, the court explained that a tort claim consists of four elements: (i) the existence of a duty, (ii) a breach of that duty, (iii) harm to the plaintiff, and (iv) the defendant's breach caused the harm.[57] The plaintiff asserted a cause of action for professional malpractice against the bankrupt corporation's former accountant, and alleged that the third element of the malpractice tort – harm or damage to the plaintiff – was satisfied by the corporation's deepened insolvency.[58] The plaintiff argued that misleading data in financial compilations prepared by the defendant accountant permitted the corporation to obtain additional equity investments, which in turn allowed the corporation to continue to exist and incur debt, thereby deepening its insolvency and damaging the corporation. The Third Circuit disagreed.

First, the court rejected the plaintiff's attempt to use deepening insolvency as a form of harm or measure of damages to satisfy that element of the professional malpractice claim, noting that the *Lafferty* case "never held that [deepening insolvency] was a valid theory of damages for an independent cause of action" and that *Lafferty* "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice."[59] Second, the court rejected the plaintiff's deepening insolvency argument on grounds of causation: even if the misleading financial statements permitted the corporation to obtain additional equity investments, the receipt of such additional equity did not itself damage the corporation. Indeed, the additional equity lessened the corporation's insolvency rather than deepening it.[60] Accordingly, the court held that the plaintiff's claim failed.

This decision suggests that, in cases where the plaintiff alleges an underlying tort, and deepening insolvency as the form of damages, a defendant may – in addition to disputing the underlying tort claim – argue that deepening insolvency is not a valid damage theory. A defendant's

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57. *See Seitz v. Detweiler, Hershey and Assocs, P.C.* (*In re CitX Corp.*), No. 05-2760, 2006 WL 1453117, at *3 (3rd Cir. May 26, 2006).

58. *See id.*

59. *Id.*

60. *See id.* at *3-4.

counsel should also look carefully at whether the alleged conduct of the defendant caused the increased insolvency, or whether other actions – such as the conduct of management – may have been the cause.

V. Conclusion

Deepening insolvency is a developing theory. Some courts view it as an independent cause of action, while other courts do not accept it as an independent cause of action but may use it as a measure of damages where there is a breach of a separate duty. Still, some courts dismiss the theory altogether. And many courts have not yet ruled on the issue. Given this lack of uniformity, the venue in which the action is filed may be the most important factor in determining the outcome.

While a number of well-reasoned recent cases suggest a trend toward limiting deepening insolvency to situations where there is an independent breach of duty or separate tort, until there are more binding precedents from appellate courts, there will remain substantial uncertainty.

In the meantime, officers, directors, lenders, professionals and their advisors need to be cognizant of the deepening insolvency issue when companies they are dealing with are in the zone of insolvency. Lenders should minimize their involvement in the borrower's business decisions. Directors and officers of companies that are insolvent or in the zone of insolvency should consider cessation of operations and liquidation as an alternative to continued operations, particularly where continued operations will – as is typical – require incurrence of additional debt. And they should document their analysis of the alternatives in a way that will show careful consideration was given to the various options. In some cases, it will be appropriate for management or the board to call upon independent advisors to assist with this analysis. Finally, attorneys and other professionals advising officers and directors must inform their clients as to the shifting duties that arise in an insolvency situation, and explain the deepening insolvency risk.