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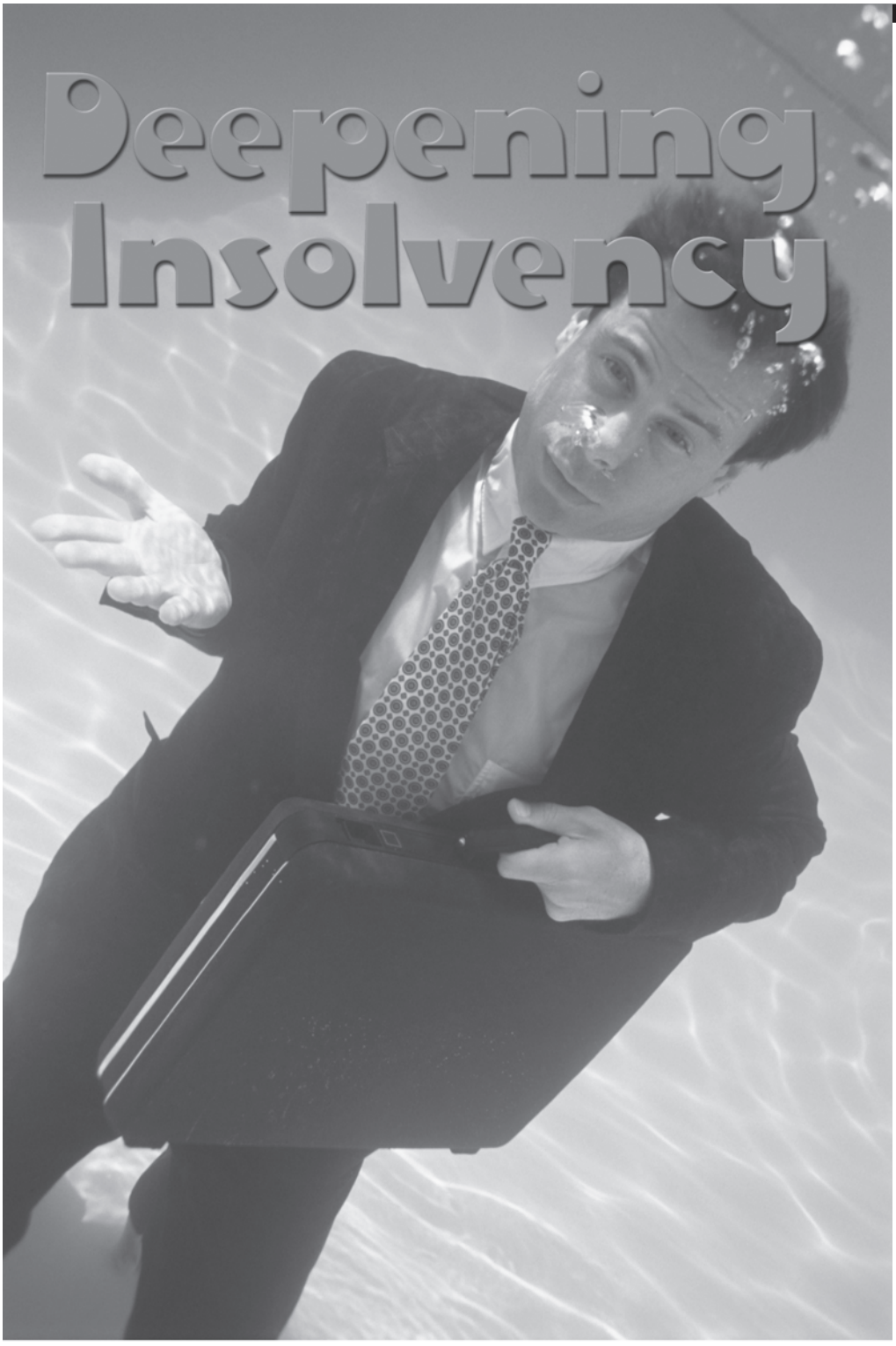

A Cause of Action in Decline

by Benjamin Mintz and Heath D. Rosenblat

The controversial doctrine of deepening insolvency permits a bankrupt entity or its representatives or creditors to recover damages from those who misrepresented the entity's financial condition and, thereby, allowed the entity to artificially prolong its existence and during that time accumulate additional debt to the detriment of creditors and other third parties. Courts throughout the country have reached different conclusions regarding whether and to what extent deepening insolvency should constitute a basis for liability or damages. However, recent decisions on both the federal and state level, including one by the Third Circuit Court of Appeals in *Seitz v. Detweiler, Hershey and Associates (In re CITX Corp., Inc.)* [1] ("*CitX*"), and one by the Court of Chancery of Delaware in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*[2] ("*Trenwick America*"), suggest a trend towards limiting or even the ringing of the proverbial death knell for deepening insolvency claims.

Recent development and expansion of the doctrine

The doctrine of deepening insolvency developed in the early 1980s, but gained little traction in the late '80s and early '90s; it did, however, re-emerge in the early 2000s with an added twist. Namely, some courts recognized the doctrine as more than a means of measuring damages under another theory of liability (*e.g.*, malpractice claim), but treated deepening insolvency as an independent cause of action. One such court was the influential Third Circuit Court of Appeals with its opinion in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. (In re R.F. Lafferty & Co.)*

("*Lafferty*").[3] In *Lafferty*, the Third Circuit recognized deepening insolvency as a stand-alone claim under Pennsylvania law. Thereafter, other courts in reliance on *Lafferty* have supported and expanded the deepening insolvency doctrine.[4] As a consequence, trustees and other estate representatives have been routinely filing deepening insolvency claims against a debtor's directors, officers, auditors, consultants, lawyers and, with increasing regularity, lenders.[5]

There do remain those jurisdictions, despite *Lafferty* and its progeny, that have not extended the doctrine. In fact, a growing number of courts recently have denounced the use of, and dismissed claims alleging, deepening insolvency or otherwise have taken a skeptical or strict view of such claims. For example, the Bankruptcy Court for the Southern District of New York in *Kittay v. Atlantic Bank of New York (In re Global Services Group, LLC)*[6] held that "one seeking to recover for 'deepening insolvency' must show that the defendant prolonged the company's life in breach of a separate duty,"[7] and thereby rejected the idea that deepening insolvency alone could support an independent cause of action or constitute damages.

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Likewise, the Bankruptcy Court for the Northern District of Texas in *Official Committee of Unsecured Creditors v. Rural Telephone Finance Coop. (In re Vartec Telecom, Inc.)*[8] refused to recognize a deepening insolvency claim brought by a creditors' committee against a secured lender. In its refusal to extend the doctrine, the court held that deepening insolvency was not a stand-alone claim under Texas law. This is particularly notable because Texas courts have often supported relatively aggressive liability theories against lenders.[9]

In a continuation of that trend, the Third Circuit in *CitX* reined in the doctrine of deepening insolvency spawned by its earlier opinion in *Lafferty* as much as it could without actually overruling *Lafferty*. Likewise, in *Trenwick America* the Delaware Chancery Court, in sweeping fashion, held that deepening insolvency is not a valid independent cause of action under Delaware law — "Delaware law does not recognize this catchy term as a cause of action… it does not express a coherent concept."[10] In light of these two recent decisions, *Lafferty*'s influence and the doctrine of deepening insolvency appear to be significantly waning.

In re CitX Corporation, Inc.

The CitX Court narrowed deepening solvency claims in two ways. First, it held that deepening insolvency is *not* a valid theory of damages for any independent cause of action.[11] Second, it held that a mere claim of negligence *cannot* sustain a deepening-insolvency cause of action; a deepening-insolvency claim must be predicated on fraud.[12]

The facts of the *CitX* case

The dispute presented in *CitX* is the product of a dot-com era *Ponzi* scheme that busted when the Internet stock bubble burst. CitX Corporation, Inc. (CitX Corp.) was an Internet company that "linked up with Professional Resources Systems International, Inc. (PRSI) ostensibly to create an Internet shopping mall for home-based merchants who would pay a fee to be featured."[13] Unfortunately, PRSI (essentially CitX Corp.'s only client) was itself a scam so the receivables due from PRSI on CitX Corp.'s balance sheet were of a dubious nature and only served to falsely inflate CitX Corp.'s value.

CitX Corp. continued to engage in business, even after the PRSI scandal had been recognized and a receiver appointed, and enlisted the services of Detweiler, Hershey and Associates P.C. (Detweiler) to produce compilations[14] for the fiscal periods (a) June 30, 1998 through June 30, 1999 and (b) July 1, 1999, through December 31, 1999. While the compilations made mention of the situation with PRSI, they still included the PRSI receivable on CitX Corp.'s balance sheet falsely inflating CitX Corp.'s economic position. Both compilations had qualifying language; however, the second compilation went further and advised investors that management "elected to omit substantially all of the disclosures

ordinarily included…[and] these financial statements are not designed for those who are not informed about such matters."[15] Nevertheless, despite the qualified financial statements and even in light of its weakened financial condition, CitX Corp. was still able to raise additional revenue at the time the compilations were produced.

Ultimately, CitX Corp., unable to collect its receivable from PRSI (which was insolvent and dealing with its own legal issues) and due to other poor management decisions, filed for Chapter 11 in July 2001. The case was subsequently converted to a Chapter 7 and Gary Seitz was appointed trustee (Trustee).

The Trustee asserted that by providing CitX Corp. with the compilations, Detweiler enabled CitX Corp. to raise additional investments, which in turn prolonged the company's existence and its ability to incur further liabilities, thus deepening CitX Corp's insolvency. The Trustee commenced a four-count adversary proceeding against Detweiler and a Detweiler employee, Robert Schoen, alleging (1) malpractice, (2) "deepening insolvency", (3) breach of fiduciary duty and (4) negligent misrepresentation.[16] Only the malpractice and deepening-insolvency counts made its way on appeal to the CitX Court; the other counts were disposed of below by the bankruptcy court and district court.[17]

Malpractice claim

The CitX Court noted that for the Trustee to prevail on his malpractice claim he would need to show that (1) Detweiler owed a duty to CitX Corp., (2) Detweiler breached that duty, (3) CitX Corp. was actually harmed, and (4) Detweiler's breach caused that harm.[18]

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Harm: The CitX Court addressed the third requirement of actual harm first. The Trustee's allegation was that CitX Corp. was harmed because the compilations "dramatically deepened the insolvency of CitX [Corp.], and wrongfully expanded the debt of CitX [Corp.] and waste[d] its illegally raised capital, by permitting CitX [Corp.] to incur additional debt by virtue of the compilation statements prepared and relied upon by third parties."[19] Stated differently, according to the Trustee, the compilations enabled CitX Corp. to raise additional equity prolonging its existence and, at the same time, prolonging its opportunity to incur further debt.

It was in the face of this argument that the CitX Court explained that deepening insolvency was *not* a theory of damages (and nothing in *Lafferty* indicates the contrary).[20] In the CitX Court's view, while the *Lafferty* Court used the phrases "theory of injury" and "type of injury" in its opinion, it only concerned "deepening insolvency [the] cause of action" and not deepening insolvency as a theory of damages for an independent cause of action.[21]

Further, the CitX Court explained that the Trustee's harm theory looked at "the issue through hindsight bias".[22] There was no harm to CitX Corp. as a result of the compilations. The compilations in fact enabled CitX Corp. to raise additional equity for its business, thereby increasing CitX Corp.'s liquidity, not deepening its insolvency. CitX Corp. acquired additional debt not because of the compilations or equity raised as a result thereof, but as a result of the poor decisions and actions of CitX Corp.'s board and management.

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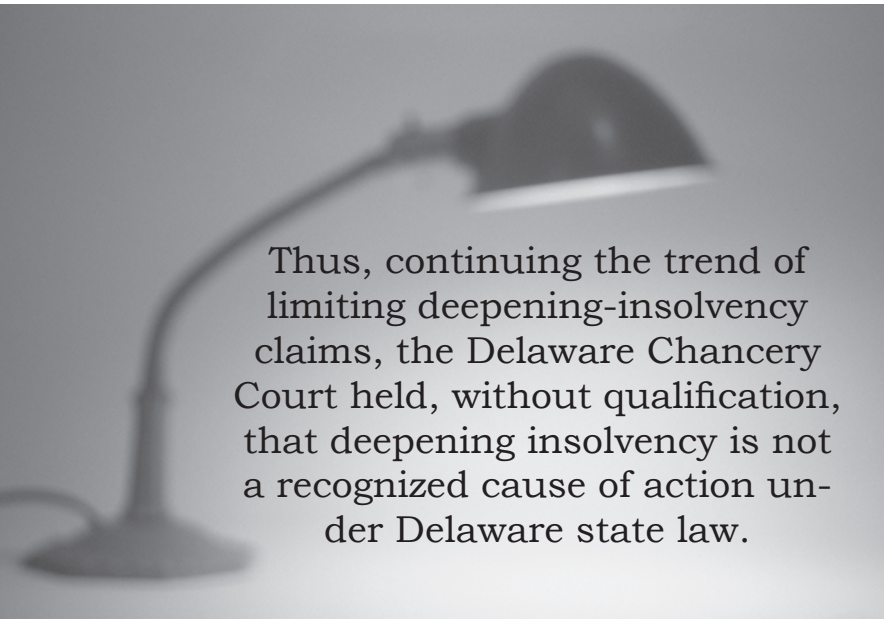
Causation: Next, the CitX Court addressed the fourth element of a malpractice cause of action: causation. The Trustee's argument focused on the fact that Detweiler failed to investigate CitX Corp.'s actual financial position, which in turn may have provided CitX Corp.'s board of directors with the "chance to 'safeguard the remaining assets of CitX [Corp].' Thus, whatever harm occurred to CitX [Corp.] was '[a]s a result of the damage caused by [Detweiler].'"[23] In support of this argument the Trustee provided an affidavit from the chief operating officer and former board member of CitX Corp. The affidavit generally stated that the COO did not have sufficient knowledge regarding the situation and had he known he would have acted differently — to wit, he would not have raised additional capital from investors and instead would have started the dissolution process. However, in a subsequent deposition, the COO recanted and directly contradicted the statements made in his affidavit. The CitX Court spent considerable time affirming the district court's position that the affidavit was "ineffective in creating a genuine issue of material fact[.]"[24] And without the affidavit the Trustee had no other means to demonstrate the Detweiler compilation statements caused any harm to CitX Corp.

Deepening insolvency

The CitX Court concluded by addressing the deepening-insolvency claim. The CitX Court dispensed with the

Trustee's assertion that Detweiler should have known about the errors in the financial statements as support for the deepening-insolvency claim. There was very little support in the complaint and nothing in the record concerning any fraudulent acts by Detweiler so the Trustee's assertion rested solely on the theory that Detweiler negligently contributed to CitX Corp.'s deepening insolvency. While the CitX Court recognized that there is authority for permitting negligence to support a claim for deepening insolvency in other jurisdictions,[25] that was not the holding in *Lafferty* and the CitX Court saw no reason to extend *Lafferty* and permit negligence to support a deepening insolvency claim.[26] In the CitX Court's view, only fraudulent conduct will support a claim for deepening insolvency.[27]

Further, the CitX Court made a point of limiting this cause of action to one permissible under Pennsylvania law only. The CitX Court emphasized that "nothing [] in *Lafferty* compels any extension of the doctrine beyond Pennsylvania[,]"[28] effectively admonishing the lower courts in the Third Circuit not to automatically extend deepening-insolvency claims when other state law may be applicable.[29]



Trenwick America Litigation Trust v. Ernst & Young, L.L.P et al.

In *Trenwick America*, a litigation trust (Litigation Trust) created as part of a chapter 11 reorganization plan, asserted claims against the Trenwick companies' former directors and professionals including fraud, breach of fiduciary duty, malpractice and deepening insolvency. The court dismissed all of the Litigation Trust's causes of action including particularly its deepening-insolvency claim.[30] Thus, continuing the trend of limiting deepening-insolvency claims, the Delaware Chancery Court held, without qualification, that deepening insolvency is not a recognized cause of action under Delaware state law.

The facts of the *Trenwick America* case

Trenwick Group, Ltd. (Trenwick) was a publicly traded specialty insurance and reinsurance holding company with five (5) direct subsidiaries. In 1999, Trenwick undertook a growth strategy that included the acquisition of similarly situated entities; Trenwick acquired three entities within a two-year time frame. In connection with its acquisitions, Trenwick also undertook a corporate restructuring pursuant to which subsidiaries in the corporation chain, including Trenwick America Corp. (Trenwick Corp.) a wholly owned subsidiary of Trenwick, were realigned. The Litigation Trust's theory of liability was predicated on Trenwick's acquisition and restructuring strategies.[31]

As a result of these acquisition and reorganization efforts, Trenwick Corp. became the intermediate parent of all of Trenwick's U.S. operations.[32] In connection therewith, Trenwick Corp. assumed a greater amount of indebtedness as guarantor of Trenwick's line of credit and other debt obligations.

In 2003, the claims made by the insureds against Trenwick exceeded estimates and outstripped Trenwick's capacity to service the claims and its debt. As a result, on August 20, 2003, Trenwick and Trenwick Corp. filed for relief under Chapter 11 of the Bankruptcy Code.[33] Under Trenwick Corp.'s Chapter 11 plan, the Litigation Trust was created and assigned "all the causes of action that [Trenwick Corp.] owned."[34]

The Litigation Trust then commenced the action that is the subject of the *Trenwick America* decision.

Deepening insolvency analysis

The Delaware Chancery Court concluded that Delaware state law does not recognize deepening insolvency as an independent cause of action and swiftly dispensed with the Litigation Trust's claim.

The Delaware Chancery Court first pointed out that the Litigation Trust failed to properly plead facts evidencing Trenwick Corp.'s insolvent condition at the time it incurred additional indebtedness on behalf of Trenwick, thus implying that the cause of action should be dismissed regardless of whether deepening insolvency is a sustainable cause of action under Delaware law.

Turning to the legal question, in the Delaware Chancery Court's view, Delaware law "imposes no absolute obligation on a board of a company that is unable to pay its bills to cease operations and to liquidate."[35] Moreover, under Delaware law, a board of an insolvent company may,

consistent with its fiduciary duties, pursue alternatives to maximize its value without giving rise to automatic liability for such efforts. The Delaware Chancery Court continued by explaining that, in an effort to increase a company's value, if a board of an insolvent company pursues a business strategy exercising diligence and good faith "it does not become the guarantor of the strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action."[36]

In dispensing with deepening insolvency, the Delaware Chancery Court pointed out that, even though there is no such cause of action, directors are not absolved of their responsibilities to a company. Future plaintiffs can still use the "traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud[,]" but the inability to move under one of these theories will not be cured "simply by alleging that the corporation became more insolvent as a result of the failed strategy."[37]

To further drive home the point, the Delaware Chancery Court analogized to when a company is solvent; the concept of "shallowing profitability" is no more reasonable. The Delaware Chancery Court wrote:

> the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one. If in either setting the directors remain responsible to exercise their business judgment considering the company's business context, then the appropriate tool to examine the conduct of the directors is the traditional fiduciary duty ruler.[38]

Lastly, the Delaware Chancery Court observed that, while other courts had recognized deepening insolvency claims as a theory of liability, the recent trend of other courts was to limit application of such claims.[39]

Conclusion

In a retreat from *Lafferty* and its progeny, the *CitX* Court markedly narrowed deepening-insolvency claims by holding that (1) deepening insolvency is not a valid theory of damages to bolster other causes of action and (2) only a showing of fraudulent conduct (and not negligence) can sustain a deepening-insolvency claim. Moreover, the court emphasized that this was a sustainable cause of action under Pennsylvania law only and that courts should not automatically extend the doctrine beyond Pennsylvania law.

Notably, the narrowing of this doctrine comes from the very court whose *Lafferty* decision was itself the foundation for the doctrine and upon which many other courts subsequently relied. Moreover, the *CitX* panel of judges intimate that, had they been presented with different circumstances, they might have completely overruled *Lafferty*.

The Delaware Chancery Court's conclusion in *Trenwick America* that Delaware state law does not recognize the cause of action of deepening insolvency continued the push-back against this relatively novel liability theory. Further, the *Trenwick America* decision crystallized the need to allow a company's management to conduct business and take risks, even when insolvent, with the protection of the business judgment rule, and without the looming threat of being sued for their unsuccessful efforts.

In sum, the recent court trend, as reflected in this year's decisions in *CitX* and *Trenwick America*, as well as in 2005 in *In re Global Services Group, LLC* and *In re Vartec Telecom, Inc.*, point toward a curtailment and narrowing of deepening-insolvency-type claims. ▲

Endnotes

1. 448 F.3d 672 (3d Cir. 2006).
2. 2006 WL 2333201, No.CIV.A. 1571 (Del. Ch. Court, June 2, 2006).
3. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co. (In re R.F. Lafferty & Co.)*, 267 F.3d 340, 347, 350-51 (3d Cir. 2001).
4. *See, e.g.*, *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Tech., Inc.)*, 299 B.R. 732, 751-52 (Bankr. D. Del. 2003) (recognized deepening insolvency as a stand-alone claim under Delaware law); *In re Flagship Healthcare Inc.*, 269 B.R. 721 (Bankr. S.D. Fla. 2001) (same under Florida law).
5. Recently, the doctrine has even been extended to allow a committee of administrative claimants, in the context of a failed reorganization, to sue directors and officers for alleged "post-petition" deepening insolvency. *See In re LTV Steel Co.*, 333 B.R. 397, 420-23 (Bankr. N.D. Ohio 2005).
6. 316 B.R. 451, 458-59 (Bankr. S.D.N.Y. 2004).
7. *See also Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.)*, 383 F.Supp.2d 587 (S.D.N.Y. 2005) (questioning duty from a bank to unsecured creditors and whether deepening insolvency can even be a recognizable injury to a corporation).
8. 335 B.R. 631 (Bankr. N.D. Tex. 2005).
9. *See, e.g.*, *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. App. El Paso 1984).
10. *Trenwick America*, 2006 WL 2333201, at *4.
11. *CitX*, 448 F.3d at 677. *Compare with Kittay v. Atlantic Bank of N.Y. (In re Global Serv. Group LLC)*, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004); *Alberts v. Tuft (In re Greater S.E. Community Hosp.)*, 333 B.R. 506, 517 (Bankr. D.C. 2005) ("[t]here is no point in recognizing and adjudicating 'new' causes of action when established ones cover the same ground").
12. *CitX*, 448 F.3d at 680-81.
13. *CitX*, 448 F.3d at 674.
14. As the *CitX* Court noted, "[a] compilation involves '[p]resenting in the form of financial statements information that is the representation of management (owner) *without undertaking to express any assurances on the statements*' by the accountant." *CitX*, 448 F.3d at 675, n. 3 (emphasis in original) (citations omitted).
15. *Id.* at 676, n. 5.

[16] For purposes of the discussion in this article, we will simply refer to both defendants/appellees as Detweiler.

[17] The bankruptcy court dismissed the breach of fiduciary duty count. After the reference was withdrawn from the bankruptcy court, the district court granted summary judgment on the negligent misrepresentation count, along with the deepening insolvency and malpractice counts. *See generally CitX*, 448 F.3d at 676.

[18] *CitX*, 448 F.3d at 677 (citations omitted).

[19] *Id.*

[20] *Id.*

[21] In reaching this conclusion, the *CitX* Court disregarded *Lafferty*'s reliance on a string of cases that specifically recognized deepening insolvency as a damages theory.

[22] *CitX*, 448 F.3d at 678.

[23] *CitX*, 448 F.3d at 678 (citations omitted).

[24] *Id.*

[25] *Id.* at 680-81 (citing *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 995 (9th Cir. 2005); *Bondi v. Bank of Am. Corp.*, 383 F.Supp.2d, at 601; and *Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (In re Gouiran Holdings, Inc.*), 165 B.R. 104, 107 (Bankr. E.D.N.Y. 1994) (relied on in the *Lafferty* opinion).

[26] *Id.* at 681.

[27] *Id.*

[28] *CitX*, 448 F.3d at 680, n. 11.

[29] *See, e.g., OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, Nos. 02-13396 & 04-57060, 2006 WL 8464843, at *16-17 (Bankr. D. Del. Mar. 31, 2006); *Official Comm. Of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Tech., Inc.)*, 299 B.R. 732, 751-52 (Bankr. D. Del. 2003).

[30] *See Trenwick America*, 2006 WL 2333201, at *2. Moreover, throughout the entire *Trenwick America* opinion, the Delaware Chancery Court emphasizes that the Litigation Trust's complaint falls way short of a well-pled complaint insofar as it lacked appropriate factual support, was disjointed and incoherent, and otherwise did not present cogent legal claims.

[31] *Trenwick America*, 2006 WL 2333201, at *1 - 4.

[32] *See generally Trenwick America*, 2006 WL 2333201, at *4-10 (describing the three mergers and internal reorganization of the domestic and foreign operations).

[33] *See generally Trenwick America*, 2006 WL 2333201, at *4-5.

[34] *Id.*

[35] *Id.* at *28.

[36] *Id.* at *29.

[37] *Id.*

[38] *See Trenwick America*, 2006 WL 2333201, at *29.

[39] *Id.*