

LITIGATION SUPPORT: ARE DISENFRANCHISED
CONSTITUENCIES USING LITIGATION TO OBTAIN A POST
CONFIRMATION RECOVERY

OVERVIEW OF DEEPENING INSOLVENCY

In recent years, the doctrine of deepening insolvency has garnered greater recognition by some American courts.¹ As the theory has been developed to date by those courts, deepening insolvency is an independent cause of action under which a failed company or its representatives may recover damages against third parties (typically officers, directors, professionals and even lenders) for fraudulently or negligently prolonging the company's fiscal life while its assets continue to diminish and its exposure to ordinary course creditors increases. Deepening insolvency claims are often asserted in conjunction with: (i) claims of breach of fiduciary duty to creditors while the company is either insolvent or in the "vicinity" or "zone" of insolvency; (ii) claims of aiding and abetting breach(es) of fiduciary duty; (iii) fraud; (iv) professional malpractice; or (v) negligence. In some jurisdictions, deepening insolvency is an acknowledged measure of damages for one or another of these causes of action.

Development of Deepening Insolvency Theory

In re Investors Funding Corp. of New York Securities Litigation (Bloor v. Dansker), 523 F. Supp. 533 (S.D.N.Y. 1980) is one of the earliest cases to address the theory underlying deepening insolvency without actually naming the cause of action. In that case, the Chapter X trustee brought an action against the principals of IFC and its accountants Peat, Marwick, Mitchell & Co. ("PMM"), among others, alleging that PMM assisted the principals in creating a false image of financial health through a series of sham transactions designed to show artificial profits and conceal losses. The scheme enabled the principals to obtain for IFC (and ultimately themselves) substantial funds from creditors, bondholders and other shareholders. In response to PMM's motion to dismiss the complaint lodged on a variety of counts ranging from securities fraud to state law negligence, the court rejected the main attack on the deepening insolvency theory that a company invariably benefits from an influx of new capital or borrowing ability as follows:

A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it. The complaint plainly alleges that as a result of the Danskers' practices, IFC's financial condition was caused to deteriorate even further after 1971. Accepting the allegations as true, it is manifest that the prolonged solvency of IFC benefited only the Danskers, not IFC.

Id. at 541.

A few years later, in Schact v. Brown, 711 F.2d 1343 (7th Cir. 1983), involving an action brought by the Illinois Director of Insurance on behalf of an insolvent insurance company, the court, citing Investors Funding Corp., expressly upheld the right of the company to recover damages resulting from the fraudulent prolongation of its life past insolvency. It dismissed the state law cases that might have precluded such a claim with the following explanation:

¹ Similar doctrines such as "trading while insolvent" have been widely recognized in Europe.

For each of these cases rests upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation's life beyond a insolvency is automatically to be considered a benefit to the corporation's interests. (cites omitted) This premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.

Id. at 1350. See also Allard v. Arthur Andersen & Co., 924 F.Supp.488 (S.D.N.Y. 1996) (court in the Delorean Motor company bankruptcy denied summary judgment to defendant accountants on deepening insolvency theory opining that in some cases "ostensibly beneficial additional capital may in some cases prove harmful to a corporation.")

In addition to these cases, while the doctrine of deepening insolvency has not yet been uniformly adopted, the theory, either as an independent tort or a measure of damages, has been recognized by a growing number of courts. See e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001) (Pennsylvania); MCA Financial Corp. v. Grant Thornton, L.L.P., 2004 Mich App. Lexis 2056 (Appeals Court Mich., July 29, 2004)(Michigan)(recognizing the cause of action but denying relief); Turoff v Jackson Walker, L.L.P., 2004 Bankr. Lexis 1237 (Bankr. N.D.Tex. August 23, 2004) (deepening insolvency theory as measure of damages); In re Exide Tech, Inc., 299 B.R. 732 (Bankr. D. Del. 2003) (Delaware); Hanover Corp. of Am. v. Beckner, 211 B.R. 849 (M.D. La. 1997) (Louisiana); In re Flagship Healthcare, Inc., 269 B.R. 721 (Bankr. S.D. Fla. 2001); Feltman v. Prudential Bache Sec., 122 B.R. 466 (S.D. Fla. 1996) (Florida); Corcoran v. Frank B. Hall & Co., Inc., 149 A.D.2d 165, 545 N.Y.S.2d 278 (1st Dept. 1989) (New York).

Ironically, the leading case on the issue of deepening insolvency--the Third Circuit Lafferty decision-- is a case where the creditors committee's claim for relief on that cause of action was dismissed. In Lafferty, the owner of a financially distressed company created a second company to issue debt certificates which secretly benefited the ailing corporation. The *Ponzi* scheme eventually collapsed and the two companies filed for bankruptcy. The creditors' committee subsequently brought actions against the owner and certain of its professionals alleging they had fraudulently induced the second corporation to issue debt securities which deepened the insolvency of the first corporation and forced both companies into bankruptcy. Id. at 344-46.

The Third Circuit evaluated several factors in determining whether the tort of deepening insolvency would be recognized by the Pennsylvania Supreme Court, including whether: (i) the theory was sound; (ii) the theory was growing in acceptance, and (iii) the policies underlying Pennsylvania tort law would provide such a remedy. Id. at 350. Because all three elements were present, even though there was no state law decision recognizing the cause of action, the Third Circuit held the Pennsylvania Supreme Court would recognize a cause of action based on deepening insolvency. The factors considered in Lafferty were used by the court in Exide to predict whether Delaware law would recognize deepening insolvency as giving rise to a cognizable injury.

The holding in Lafferty is expressly premised on the assumption that corporate property may have a value even where the corporation is insolvent. The incurrence of additional debt can detrimentally impact that value. In that regard, the Third Circuit noted deepening insolvency can force a corporation into bankruptcy thereby increasing the legal and administrative costs of the

debtor as well as imposing certain operational limits which could undermine the company's ability to run its business profitably. *Id.* at 349-50. The Third Circuit also indicated that deepening insolvency can injure a corporation's relationships with its customers, vendors and workforce. *Id.* at 350. Finally, continuation of an insolvent corporation's life may result in a waste of corporate assets. *Id.* "These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt." *Id.*

Notwithstanding Lafferty's recognition of deepening insolvency as a common law tort and its elaborate discussion of the contours of the as-then largely undefined theory, the Third Circuit upheld the dismissal of the creditors committee complaint based on the doctrine of *in pari delicto*, which provides that a plaintiff who has participated in the wrongdoing may not recover damages from the wrongdoing. The court held that the fraudulent conduct of the corporation's principals would be imputed to the debtors and from the debtors to creditors committee, standing in the shoes of the debtors and suing to recover for injuries to the corporation.²

The Third Circuit in Lafferty, focusing exclusively on the injury to the debtor corporation itself, did not contemplate a claim for deepening insolvency by or on behalf of an unsecured creditor. Such a claim was asserted in Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corporation, 2004 U.S. Dist. Lexis 17154 (E.D.Pa. August 25, 2004). The district court dismissed the claim for failure to allege facts to show prolongation of an insolvent corporation's life through bad debt, not on standing grounds.

The case of Exide, 299 B.R. at 732, in which Sonnenschein Nath & Rosenthal LLP served as special litigation counsel to the Official Committee of Unsecured Creditors, further extended the application of the doctrine of deepening insolvency. The complaint in Exide was jointly filed by the creditors' committee and an individual creditor, R2 Investments LDC ("R2"). The court granted the lenders' motion to dismiss R2 as a party plaintiff in the adversary proceeding based upon R2's questionable standing to bring the action. Exide, 299 B.R. at 739. The creditors' committee alleged, among other things, that the lenders continued to loan money to the debtor in exchange for "significant additional collateral and guarantees" while cognizant of the debtors' deepening financial woes and that the lenders forced the company to make an acquisition to prolong its existence. Exide, 299 B.R. at 736.

The court ultimately denied the lenders' motion to dismiss the creditors' committee allegation of deepening insolvency although it acknowledged that the claim had been sufficiently pled. *Id.* at 752. It appears the key allegations supporting the court's determination were: (i) the lenders' installation of a turnaround consultant as chief financial officer; (ii) the lenders' waiver of compliance with financial covenants in exchange for additional collateral of considerable value; and (iii) the lenders' control of the petition dates of the various debtors, with a number of the bankruptcy filings falling outside the 90-day preference period thereby limiting the avoidance exposure of the lenders.

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The court disregarded the argument that the committee was an innocent successor in interest and focused on the explicit language of Section 541 that the estate is comprised of the interests of the debtor.

Subsequently, there was an attempt by the debtors and the lenders to settle the cause of action through the plan of reorganization for approximately \$7 million, but confirmation of that plan, as originally proposed, was denied. A revised consensual plan providing for a recovery pool of approximately \$190 million was ultimately confirmed showing that use of the deepening insolvency theory materially enhanced unsecured creditor recoveries in the Exide case.

Key Elements of Deepening Insolvency

For now, it appears that causes of action alleging deepening insolvency can safely be brought by the representatives of a failed company (a trustee, creditors committee or liquidator) against three classes of possible defendants:

- (i) directors and officers who may have taken actions to preserve the corporation's existence while deepening the insolvency and injuring creditors;
- (ii) secured lenders who may have taken a more active role in restructuring the underlying loan when confronted with the possible collapse of their borrower while effectively injuring other unsecured creditors of the debtor; and
- (iii) professionals, particularly accountants and other financial advisors, who assist and advise the corporation in actions that may be interpreted as deepening the insolvency.

The elements of a claim for deepening insolvency might include:

- (i) An insolvent company with assets of some value;
- (ii) fraudulent or negligent incurrence of additional liability;
- (iii) concealment of the company's deteriorating financial condition; and
- (iv) loss of the value of the company as a result of the incurrence of additional liability and the prolongation of the company's life outside of a dissolution or bankruptcy.

Defenses To The Tort Of Deepening Insolvency

The Business Judgment Rule

Officers and directors may be able to seek protection against a deepening insolvency claim under the business judgment rule. See Official Committee of Unsecured Creditors of RSL Com Primecall, Inc. v. Beckoff (In re RSL Com Primecall, Inc.), Nos. 01-11457, *et al.*, 2003 WL 22989669, at *1, (S.D.N.Y. Dec. 11, 2003) (officers and directors successfully invoked business judgment rule vindicating their decision to continue the business despite its financial woes). This judicially created presumption provides that, when making a business decision, directors and officers of a corporation are presumed to have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation. The business judgment rule prevents a fact finder from second guessing the decisions of a director in hindsight. See Galef v. Alexander, 615 F.2d 51, 57 (2nd Cir. 1980). This presumption may be lost, however, either: (i) upon a showing of improper director or officer interest in a transaction

that is not approved by a majority of disinterested directors; or (ii) where the director has not become adequately informed before voting to allow such a transaction. See Healthco Int'l, Inc., 208 B.R. 288 (Bankr. D. Mass. 1997).

In Pari Delicto

A second defense *in pari delicto* (discussed in greater detail below) holds that a plaintiff may not recover on account of a violation of law in which it has also participated. Lafferty, 267 F.3d at 358. In Lafferty, the defendants asserted that the creditors' committee could not bring the deepening insolvency cause of action because the committee, as successor-in-interest to the debtors under 11 U.S.C. § 541, stood in the shoes of the debtor and the debtor had itself participated in the acts that led to the ultimate insolvency. The defendants argued, therefore, that the prepetition misconduct of the debtor should be imputed to the creditors' committee. The Third Circuit agreed with the defendants and found that the fraudulent conduct of the debtors' sole shareholder could be imputed to the corporation (and thus to the creditors' committee) because the shareholder perpetrated the fraud in the course of its employment and, although the shareholder may have acted adversely to the debtors' interests, it was the "sole" actor engaged in the alleged fraudulent conduct. Id. at 358.

It should be noted, however, that the *in pari delicto* defense may not always be successful in a bankruptcy action. For example, certain courts have rejected the defense where the underlying action was brought under 11 U.S.C. §§ 544(a), 544(b) or 548. See Sender v. Porter (In re Porter Mcleod, Inc.), 231 B.R. 786 (D. Colo. 1999); See also Podell & Podell v. Feldman (In re Leasing Consultants), 592 F.2d 103 (2d Cir. 1978); McNamara, 334 F.3d at 239.

The use of the deepening insolvency doctrine by trustees, creditors' committees and other estate representatives is clearly gaining momentum. Although the doctrine is still in its formative stages, cases such as Lafferty and Exide cast a degree of uncertainty on the use of out-of-court solutions as a low risk alternative and provide new grounds for post confirmation litigation.

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