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DIRECTORS' AND OFFICERS' LIABILITY

THE DEEPENING INSOLVENCY DEBATE

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Although there is considerable recognition that the "deepening insolvency" of a distressed corporation may give rise to compensable corporate harm, whether deepening insolvency is an independent cause of action or a measure of damages arising from commission of a separate tort has been a fertile source of confusion. What is certain is that directors and officers, as well as lenders, underwriters and professionals, frequently must defend claims alleging that a corporation suffered compensable injury through the fraudulent prolongation of operations after the corporation was insolvent, thereby expanding the corporate debt and exposure to creditors. It is now commonplace for a bankruptcy trustee, committee of creditors or statutory litigation trust formed under a bankruptcy plan to pursue an action on behalf of the corporate debtor under a deepening insolvency theory seeking damages for the estate, which ultimately flow to creditors. The theory is particularly attractive to plaintiffs because, if accepted, its vagueness lends itself to second-guessing of management decisions made while the corporation struggled.

Recently, the concept of director and officer liability for "deepening insolvency" of a corporation has come under withering judicial fire. A growing number of courts have rejected deepening insolvency as an independent cause of action, sensibly concluding that the law does not and should not require a financially strained company abruptly to windup its business affairs and liquidate its assets for the immediate benefit of creditors. Rather, the board of directors should remain free to exercise its informed business judgment to pursue value-maximizing strategies the board and its advisors view as sound to turn the company around. The Delaware Supreme Court heard argument last month in an appeal in which it likely will decide whether a cause of action for deepening insolvency exists in Delaware, and the nature of directors' fiduciary duties when a company is insolvent or in the vicinity of insolvency. The guidance is timely, as last month a Delaware federal court interpreted Delaware law as at least permitting the claim to survive a motion to dismiss.

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Origin of the Deepening Insolvency Theory

The origin of deepening insolvency is traced to a New York federal district court decision in Bloor v. Dansker,[1] where a debtor's trustee sued the outside auditor alleging that false financial statements certified by the auditor furthered a scheme by corporate insiders to loot the corporation. The auditor sought summary judgment, arguing that the knowledge and wrongful conduct of the insiders should be imputed to the debtor to preclude recovery. Asserting that the corporation actually benefited from the infusion of funds from lenders facilitated by the fraud of the insiders, the auditor argued against application of the exception to attribution that when an agent acts adversely to the interest of the principal, his knowledge and conduct are not imputed to the principal. But Bloor applied the exception, and refused to impute the knowledge of the debtor's insiders' wrongdoing to the debtor, rejecting the notion that acts that prolong a corporation's existence automatically confer a benefit on the corporation. Rather, the insiders "created the false appearance of fiscal salubrity to conceal their past acts of mismanagement, and to raise capital for their further plundering... [which was] antagonistic to the interests of [the debtor] ... A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."

What began as a holding that the "adverse interest" exception applied because prolonging a debtor's operations was not necessarily a benefit to the corporation, was expanded by the Seventh Circuit into a theory to recover damages. In Schacht v. Brown,[2] the Seventh Circuit rejected the assertion "that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests." Rather, interpreting Illinois law, the court reasoned that "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability." It concluded therefore that a statutory liquidator could pursue damages under RICO for the fraudulent prolongation of a corporation's life beyond insolvency, resulting in damage to the corporation caused by increased debt.[3] As a measure of damages for a traditional tort recovery, deepening insolvency theory generally calculates loss as the additional debt incurred post-insolvency or the dissipation of corporate assets post-insolvency.

The Third Circuit's opinion in Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.,[4] was the first to recognize deepening insolvency as a separate cause of action under state law. There, two lease financing corporations were operated as a Ponzi scheme until the companies imploded, resulting in losses to investors and creditors. A committee of creditors, on behalf of the debtor-corporations, sued several third party professionals in the bankruptcy, alleging that they conspired with the debtors' management to fraudulently induce the "corporations to issue . . . debt securities, thereby deepening their insolvency and forcing them into bankruptcy." The Third Circuit ruled that a deepening insolvency cause of action should be recognized under Pennsylvania law, reasoning that the fraudulent extension of a corporation's life beyond insolvency may injure the corporation in many ways: by dissipating its remaining assets, hindering its ability to operate, undermining its relationships with customers and suppliers and, possibly, forcing the corporation into bankruptcy.[5] These harms could be averted or minimized, the court reasoned, by the prompt dissolution of the corporation, rather than sustaining the corporation with "spurious debt." The Third Circuit cited a number of federal and state court decisions holding that "deepening insolvency" may give rise to cognizable injury to corporate debtors. Finally, the court invoked "venerable" common law principles, including that, where there is an injury, the law provides a remedy, to conclude that "where 'deepening insolvency' causes damage to corporate property, we believe that the Pennsylvania Supreme Court would provide a remedy by recognizing a cause of action for that injury."[6] The cases that have followed Lafferty and recognized a deepening insolvency cause of action generally have insisted on particularized allegations and proof of fraudulent intent to artificially prolong the corporation's existence, and rejected a negligence standard.[7]

Last year, the Third Circuit revisited deepening insolvency in In re CitX Corp.,[8] and clarified that "Lafferty holds only that fraudulent conduct will suffice to support a deepening-insolvency claim under Pennsylvania law." The Third Circuit refused to expand the theory, holding that deepening insolvency is not a valid theory of damages in a negligence action, and that allegations of negligence cannot support a cause of action for deepening insolvency.

Recent Developments

As an Ohio bankruptcy court noted last month, the "tide has turned" and a growing majority of courts around the country has declined to recognize a cause of action for deepening insolvency.[9] These courts have reasoned that a deepening insolvency cause of action should be dismissed as duplicative of a claim against directors and officers for breach of fiduciary duty.[10] "There is no need to recognize a new cause of action when the traditional toolkit of claims against directors and officers of a corporation covers the same ground that a deepening insolvency cause of action would tread."[11] Thus, whether recovery for deepening insolvency is sought as an independent tort or a damages theory, plaintiff "must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt."[12]

The Delaware Supreme Court is poised to offer an important contribution to the debate after hearing argument last month in an appeal from a decision in which Vice Chancellor Leo E. Strine forcefully rejected the notion of an independent cause of action under Delaware law for deepening insolvency. In Trenwick America Litig. Trust v. Ernst & Young, L.L.P.,[13] the Vice Chancellor closely examined the proposed cause of action, and concluded that is has "has the kind of stentorious academic ring that tends to dull the mind to the concept's ultimate emptiness." Not only does the proposed cause of action lack a coherent underlying theory, the Vice Chancellor concluded, it collides with traditional concepts of fiduciary duty.

In Trenwick, a statutory litigation trust to which all of a debtor's potential claims had been assigned in bankruptcy asserted a host of claims against the debtor's directors and third-party advisors. Trenwick Group, Inc. ("TGI"), was a holding company whose subsidiaries operated in the specialty insurance and reinsurance businesses. TGI had no controlling stockholder, its stock was widely held, and traded on the New York Stock Exchange. Trenwick America Corporation ("TAC") was a wholly-owned subsidiary of TGI that served as a holding company for TGI's U.S. insurance business. In the late 1990s, TGI pursued a strategy of growth by acquisition, which resulted in TGI acquiring two publicly-traded insurers in stock-for-stock mergers. TGI's business plan and both mergers were approved by a TGI Board composed of a majority of disinterested and independent outside directors. The thrust of the complaint was that the decisions of the TGI and TAC Boards in approving the mergers and a related restructuring were irrational, resulting in the creation of a large insurance holding company with inadequate reserves and assets to cover the claims that were ultimately made against it, thrusting TGI and TAC into bankruptcy. Among numerous other claims that were dismissed, plaintiff sought to allege a claim against the former TAC directors for deepening insolvency, contending that the TAC directors fraudulently prolonged TAC's corporate life by increasing the amount of debt incurred by TAC when the directors knew the debt could not be repaid.

The court noted that Delaware law imposes no absolute obligation on directors to close operations and liquidate upon a corporation's insolvency. Rather, well-meaning directors may continue to take informed business risks and pursue profit-enhancing strategies even when the corporation is insolvent. The strategy, of course, does not always succeed. By taking those risks calculated to reverse the corporation's financial performance, which may include the incurrence of additional debt, the court ruled, directors do not become "a guarantor of that 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." That is the essence of the business judgment rule.

Nor does this approach insulate directors of insolvent corporations from all potential liability. The Court of Chancery emphasized that the "traditional toolkit" of claims available to plaintiffs, such as breach of fiduciary duty and fraud, have been "shaped by generations of experience" and provide ample recourse when a director acts disloyally, fraudulently or without due care when implementing a business strategy while a corporation is insolvent. However, "[i]f a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy."

The court did not discount the potential relevance of the fact of insolvency in the evaluation of whether directors appropriately exercised their business judgment. When a company reaches the point of actual insolvency, directors and officers have fiduciary duties to the company's creditors in addition to shareholders. The role of insolvency, however, is "to act as an important contextual fact" in the traditional fiduciary duty analysis.

Adopting Trenwick, the Bankruptcy Court for the District of Delaware recently concluded that no deepening insolvency cause of action exists under Delaware law and a board of directors has no obligation to wind down operations and refuse to take on additional debt simply because the company is insolvent, but rather may decide in the exercise of business judgment to take on additional debt in the hopes of reversing a deteriorating condition.[14] Last month, however, a Delaware federal district court in Royal Indemnity Co. v. Pepper Hamilton LLP, denied a motion to dismiss a deepening insolvency claim because "[c]onsidering the uncertainty of the law in this area and drawing all reasonable factual inferences in the light most favorable to the Plaintiff, the Court concludes that Plaintiff has pled sufficient facts to state a claim for deepening insolvency."[15]

Conclusion

The notion that directors of an insolvent company cannot, without exposure to liability for deepening insolvency, pursue in good faith an informed business strategy to conserve cash and increase the total debt level, is of doubtful validity and bad policy. Nothing in the law supports an absolute duty to liquidate an insolvent corporation. Such an approach is at odds with the basic premise of reorganization under Chapter 11, and would preclude the directors of a possibly insolvent enterprise from trying to solve economic problems through value-maximizing strategies the board and its advisors view as sound to turn the company around. As an Ohio Bankruptcy Judge observed last month, "at its best, the deepening insolvency theory is redundant of traditional causes of action …. [a]t its worst, the theory is inconsistent with principles of fiduciary responsibility and the business judgment rule."[16] It is difficult to envision circumstances where a decision to incur additional debt, knowing it cannot be repaid, in order to deliberately create a false impression of solvency, would not constitute a breach of fiduciary duty. A cause of action for deepening insolvency is therefore unnecessary and would unjustifiably elbow aside established business judgment rule principles once a company becomes insolvent.

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[1] 523 F. Supp. 533 (S.D.N.Y. 1980).

[2] 711 F.2d 1343 (7th Cir. 1983).

[3] Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983).

[4] 267 F.3d 340 (3d Cir. 2001).

[5] Id. at 349-350.

[6] Id. at 351.

[7] In re Oakwood Homes Corp., 340 B.R. 510, 534 (Bankr. D. Del. 2006).

[8] 448 F.3d 672 (3d Cir. 2006).

[9] In re Amcast Indus. Corp., 2007 WL 777704 (Bankr. S.D. Ohio Mar. 12, 2007).

[10] See, e.g., Southeast Community Hosp. Corp., 353 B.R.324 (Bankr. D.D.C. 2006); In re Verestar, Inc., 343 B.R. 444, 475-76 (Bankr. S.D.N.Y. 2006); In re Avado Brands, Inc., 2006 WL 3832806 (Bankr. N.D. Tex. Dec. 28, 2006); In re Parmalat, 383 F. Supp.2d 587, 601-02 (S.D.N.Y. 2005).

[11] In re Amcast, 2007 WL 777704, at *19.

[12] In re Global Service Group, LLC, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

[13] 906 A.2d 168 (Del. Ch. 2006).

[14] See In re Radnor Holdings Corp., 353 B.R. 820, 842 (Bankr. D. Del. 2006).

[15] 2007 WL 881415 (D. Del. Mar. 22, 2007).

[16] In re Amcast Indus. Corp., 2007 WL 777704, at *20 (Bankr. S.D. Ohio Mar. 12, 2007).