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A Changing Landscape

Directors and officers insurance writers track the continuing evolution of 'deepening insolvency' as grounds for liability claims.

by John K. Rezac

On Jan. 6, 2005, the board of directors of the Lemington Home for the Aged in Pittsburgh, Pennsylvania, convened a meeting to address the future of the home.

Lemington, founded in the early 1880s, had experienced mounting financial troubles for more than 10 years at the time of that meeting. At its conclusion, the board voted to close the facility, but did not decide to put Lemington in Chapter 11 bankruptcy for another three months.

During that time, according to subsequent court filings, the board concealed the extent of Lemington's financial straits; its decision to close the facility; its plan to transfer substantial assets from Lemington to a new facility; and allowing Lemington to spiral deeper into debt.

Those decisions and actions of Lemington's board would result in years of litigation and a $2.25 million verdict against Lemington's directors and other defendants, as well as punitive damages. The verdict was based largely on claims of "deepening insolvency"—that is, by unlawfully prolonging Lemington's operations, despite increasing debt and no reasonable prospect for recovery, the board materially injured Lemington, leaving it far less able to pay its debts. [That litigation continues as of press time.]

Origins of 'Deepening Insolvency'

Shareholders, creditors and bankruptcy trustees of insolvent corporations, recognizing that repayment of claims against the corporations is likely to come, if at all, from sources other than the corporations, often turn their focus to third parties that were in control of the corporations prior to and during insolvency.

Those targets naturally include corporate directors and officers, professionals including accountants and attorneys, and directors and officers and errors and omissions insurance carriers. Efforts to recover payment from such third parties have routinely proceeded upon theories of negligence, fraud and breach of fiduciary duty.

Additionally, for the past 35 years, courts and litigants have wrestled with the evolving theory of "deepening insolvency." These claims are typically made in connection with additional claims of self-dealing or fraud, and are premised on the contention that the improper continuation of the corporation's business has resulted in damage to its assets and ability to repay its obligations. One of the earliest appearances of the concept of deepening insolvency as a basis for recovery against corporate professionals was in *Bloor v. Dansker (In re Investors Funding Corporation of N.Y. Securities Litigation)*, a 1980 decision of the U.S. District Court for the Southern District of New York. The *Investors Funding* case involved a bankruptcy trustee's claim against the bankrupt corporation's auditor for violations of state and federal securities laws, fraud and negligence. While the trustee did not assert a specific claim of deepening insolvency, the court observed the concept in response to the defenses raised by the auditor.

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Key Points

The Situation: For the past 35 years, courts and litigants have wrestled with the evolving theory of deepening insolvency.

At Issue: Repayment of claims against corporations is likely to come from third parties that were in control of the corporations prior to and during insolvency.

Stumbling Block: There is no uniform agreement among the various jurisdictions as to the proper application, or even the availability, of these claims.

Specifically, the auditor argued that its actions, as well as the resulting public misperception of the company's financial health, enabled the corporation to remain in business an additional three years after it first became insolvent. Therefore, the auditor reasoned, its actions benefited the corporation. The district court disagreed, rejecting any argument that prolonging a troubled corporation's existence by misleading the public should absolve the deceiving party of liability. The court held, "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 concept of deepening insolvency was thereafter embraced by creditors, bankruptcy trustees and courts alike as a specific basis for director/officer or corporate professional liability. An example of this is seen in the 2001 decision, *Official Committee of Unsecured Creditors v. R.F. Lafferty & Company*. In *Lafferty*, the creditors' committee in a corporate bankruptcy case sued certain defendants for their involvement in a Ponzi scheme, whereby the defendants caused and assisted the corporation's issuance of fraudulent debt instruments. In addition to other claims, the committee asserted a claim for deepening insolvency, alleging that the defendants, by misrepresenting the corporation's financial condition, had fraudulently prolonged the existence and operation of the insolvent company, with the result of diminishing what value remained in the corporation. The Third Circuit Court of Appeals, applying Pennsylvania law, recognized deepening insolvency as a separate cause of action against a controlling person who fraudulently prolongs the corporation's life, despite insolvency, resulting in injury to the corporation's property.

The *Lafferty* decision caused considerable concern among corporate directors and officers, as it was construed to impose a possible duty upon those in control of a troubled corporation to liquidate the enterprise rather than attempt to right the ship. The *Lafferty* court arguably encouraged corporate liquidation to avoid future harm, reasoning, "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."

The court's dicta caused worries that corporate directors who try unsuccessfully to resuscitate troubled corporations could face deepening insolvency claims, despite their best intentions and efforts. Numerous subsequent rulings by courts of various jurisdictions, including the *Lemington* court, however, have addressed such concerns, by requiring a showing of fraud to support any deepening insolvency claim.

Fraud sufficient to support a deepening insolvency claim comes in many different forms. Frequently, corporate officers or professionals will intentionally misstate earnings or other indicia of corporate health, misrepresenting the corporation's financial strength to induce further investment in the corporation. In other instances, corporate insiders will conceal or ignore a corporation's insolvency, simply to continue corporate operations until some future date more beneficial to the insiders. Common to most deepening insolvency claims, however, is the aggravated harm to the corporation caused by the failure to cease operations once it becomes clear that the business is insolvent and recovery through continued operations is not a realistic possibility.

Because deepening insolvency liability is based in tort (and despite the occurrence of many of these disputes in federal bankruptcy court), the availability of the cause of action and resolution of claims is subject to state law. Consequently, there is no uniform agreement among the various jurisdictions as to the proper application, or even the availability, of these claims.

For example, courts are not in agreement on the significance of an insolvent corporation's taking on additional debt. Under the laws of certain jurisdictions, an insolvent corporation's incurring additional debt would be evidence of deepening insolvency, and could be deemed to have increased the corporation's likelihood of failure. The rationale is that the additional debt has harmed the corporation by placing a greater burden on the corporate assets.

Other courts, however, recognize additional debt as a "balance sheet neutral" event, because the borrower receives assets equal in value to the debt incurred. Thus, the corporation is not harmed simply by taking on new debt, but rather by the mismanagement of the funds or property borrowed in connection with the additional debt.

Courts of various jurisdictions disagree further about whether deepening insolvency constitutes a separate cause of action in and of itself. Pennsylvania and Tennessee, for example, recognize the cause of action, provided there is a showing of fraud, and not mere negligence, to support the claim. Other courts, including those applying Delaware, Idaho and New Jersey law, have rejected deepening insolvency altogether. Still others decline to recognize an independent cause of action for deepening insolvency, but will consider it as evidence of damages, once a separate, independent tort has been established.

'Deepening Insolvency' Today

On Jan. 26, the United States Court of Appeals for the Third Circuit affirmed the $2.25 million verdict in the *Lemington* case. On Feb. 9, the defendants filed a petition for rehearing. The defendants argue that the time has come for courts applying Pennsylvania law to depart from the precedent established by the *R.F. Lafferty & Company* decision, and reject deepening insolvency as an independent cause of action. The defendants further maintain that "the legal landscape has changed dramatically" since the commencement of the *Lemington* litigation 13 years ago, as evidenced by the numerous courts that have since qualified, limited or themselves rejected claims based on deepening insolvency. Those courts now include the Commonwealth Court of Pennsylvania, which the defendants point out rejected deepening insolvency as an independent tort in its 2008 ruling in the case of *Ario v. Deloitte & Touche LLP,* where the court held, "[W]e do not recognize the deepening insolvency theory as an independent cause of action. . . ."

The *Lemington* defendants made that same argument unsuccessfully in the most recent appeal to the Court of Appeals. Time will tell whether the court takes a different view of the position if and when it grants the defendants a rehearing, and what influence any decision will have in other jurisdictions. To the extent that a trend can be identified respecting courts' treatment of deepening insolvency claims over the past few years, that trend is likely away from recognition of deepening insolvency as an independent cause of action. In many instances, these claims are deemed to be redundant, duplicative of breach of fiduciary duty, self-dealing and fraud claims.

Additionally, absent fraud, corporate directors and officers continue to be protected in their official activities under the business judgment rule, and that is true as well regarding decisions to seek, or to not seek, bankruptcy protection. Nevertheless, the prudent corporate director, officer or professional will be diligent and cautious in ongoing activities on behalf of insolvent corporations, particularly with respect to representations to investors about the corporation's financial condition and decisions to incur additional debt. Depending on the jurisdiction and the relevant state law, those representations and decisions are likely to receive considerable scrutiny where the corporation winds up in worse condition. BR