Shipman & Goodwin LLP

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Deepening Insolvency: Is it a tort, a theory of damages, or just an interesting idea?

The recent body of case law that has developed in the area of deepening insolvency highlights the disagreement among the courts on this contentious and important issue. Generally speaking, deepening insolvency has been described as the fraudulent or negligent prolongation of a financially troubled corporation's life that may cause it to slip deeper into insolvency by incurring additional debts or diminishing its assets. Beyond its title, courts are split as to whether deepening insolvency is a theory of damages, an independent tort claim, or either of those things. Until a recent decision was issued by the United States Bankruptcy Court for the Southern District of New York in the case of _In re Global Service Group, LLC_,[1] it appeared that acceptance of the theory of deepening insolvency as a cause of action or a theory of damages was becoming a growing trend.

Although the *Global Service Group* case appears to rein in the expansion of the theory of deepening insolvency, given the lack of uniformity among the courts, parties bearing any fiduciary relationship with a financially troubled debtor that experiences an unnecessarily prolonged corporate life should remain wary of this issue. It is no longer just directors and officers who are the targets for breach of fiduciary duty claims. Secured lenders,[2] lawyers,[3] accountants[4] and other insolvency professionals may find themselves the subjects of deepening insolvency claims where their failure to disclose information regarding a corporation's financial plight leads to the corporation's increased debt or dissipation of assets.

Deepening insolvency claims in their current manifestation can be traced to _Schact v. Brown_,[5] a 1983 decision of the United States Court of Appeals for the Seventh Circuit. In *Schact*, the plaintiff Director of Insurance for the State of Illinois asserted RICO claims against the debtor insurance company's directors and officers for fraudulently causing the debtor to continue to do business despite its insolvency. The plaintiff alleged that the directors and officers should be liable since they allowed the debtor to incur additional liabilities and while going deeper into insolvency, causing millions of dollars of damage to the debtor and the debtor's creditors. In response to the allegations, the defendants argued that the Director of Insurance had no standing to claim any damages since the prolongation of the debtor's corporate life was a benefit to the debtor. The court disagreed and held that "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."[6] Thus, the *Schact* court opened the door for the theory of deepening insolvency to evolve. The decision is often cited for the proposition that deepening insolvency is an injury to the debtor corporation that, importantly, confers standing to a trustee or committee of creditors to pursue such a cause of action.

What began as an exercise to address the issue of standing in *Schact*, progressively evolved into a means to expand the theory of deepening insolvency. That progression culminated in the decision issued by the United States Court of Appeals for the Third Circuit in the case of _Official Comm. Of Unsecured Creditors v. R.F. Lafferty_,[7]. In *Lafferty*, the Official Committee of Unsecured Creditors (the "Committee") sued on behalf of two lease financing corporations that operated as a Ponzi scheme. The Committee alleged that certain third parties, including third-party professionals, fraudulently induced the corporations to issue debt securities, which injured the debtors by the expansion of corporate debt and prolongation of corporate life. The defendants argued that the Committee could not allege any injury separate and distinct from the injury to creditors, and since the Committee could not assert claims on behalf of creditors, it lacked standing to bring the claims at all. The Third Circuit held that not only was deepening insolvency a recognized injury to the debtor which conferred standing upon the Committee, the theory of deepening insolvency also gave rise to an independent cause of action under Pennsylvania state law.[8] The *Lafferty* decision made clear that deepening insolvency, whether as an independent cause of action or as a theory of damages, expanded the scope of what could constitute an injury, who could sue for such an injury, and who could be liable for such an injury.

However, in the *Global Service Group* case, the United States Bankruptcy Court for the Southern District of New York struck back. In *Global Service Group*, the Chapter 7 Trustee (the "Trustee") commenced an adversary proceeding against the debtor's insiders and the debtor's senior secured creditor, Atlantic Bank, for fraudulent transfers and deepening insolvency. With respect to the deepening insolvency claims, the Trustee alleged that the bank made a loan to the debtor that it knew or should have known that the debtor could not repay given its financial condition, which resulted in damage to the debtor caused by the increased debt. Similarly, the Trustee alleged that the insider defendants allowed the debtor to continue to do business and incur indebtedness while the debtor was insolvent and undercapitalized.

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After tracing the cases in which courts treated deepening insolvency as an independent cause of action or as a theory of damages, the court in *Global Service Group* rejected both approaches, stating that "[t]he distinction between 'deepening insolvency' as a tort or damage theory may be one unnecessary to make. Prolonging an insolvent corporation's life, without more, will not result in liability under either approach. Instead, one seeking to recover for 'deepening insolvency' 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."[9] The court reasoned that simply because the bank made a loan that it should have known could not be repaid does not make it liable for deepening insolvency, because it "was not prohibited from extending credit to an insolvent entity; if it was, most companies in financial distress would be forced to liquidate." Since there is no absolute duty to liquidate an insolvent corporation, fiduciaries may continue to operate the corporation's business under the standard of the business judgment rule. Rather than creating a new cause of action, the court considered deepening insolvency claims as subsumed by breach of fiduciary duty claims.

Two subsequent Southern District of New York cases have followed the holding in *Global Service Group*. In Bondi v. Grant Thornton International,[10] the plaintiff Extraordinary Commissioner (the Italian equivalent of a trustee) asserted a deepening insolvency claim against an accounting firm for its alleged failure to accurately report the debtor's financial health, which enabled the debtor's insiders to borrow and divert billions of dollars. The District Court declined to decide whether a cause of action for deepening insolvency existed under Illinois state law, and instead dismissed the deepening insolvency claims as duplicative of the plaintiff's claim of professional malpractice.

In Rahl v. Bande,[11] the Trustee asserted that the debtor's directors and officers breached their fiduciary duty by deepening the debtor's insolvency to enhance their own personal wealth. The court cited to *Global Service Group* for the proposition that recovery for deepening insolvency requires a showing that the debtor's prolonged corporate life was in breach of a separate duty. The court held that the facts as alleged were sufficient to survive a motion to dismiss.

Although the *Global Service Group* decision and the cases following it appear to have swung the pendulum away from the expansive reading of deepening insolvency in *Lafferty*, it is possible that the pendulum will swing back. In light of the split among the Circuits, directors and officers, accountants, auditors, secured lenders, and other insolvency professionals would be well-advised to carefully scrutinize the consequences associated with incurring more debt on behalf of, or lending more money to, an insolvent corporation. One commentator has suggested that directors and officers should recognize that there is a heightened standard of care during the "zone of insolvency" and should make decisions accordingly, with an eye toward a realistic projection for filing bankruptcy.[12] Ultimately, whether you agree or disagree with the need for recognizing deepening insolvency as an independent cause of action or theory of damages, it is important to recognize the potential liability for deepening insolvency as part of the calculus in dealing with an insolvent corporation.

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[1] *In re* Global Serv. Group LLC, 316 B.R. 451 (Bankr. S.D.N.Y. 2004).
[2] *See e.g., In re* Exide Tech., Inc., 299 B.R. 732 (Bankr. D. Del. 2003).
[3] *See e.g., In re* RDM Sports Group, Inc., 277 B.R. 415 (Bankr. N.D. Ga. 2002).
[4] *See e.g.,* Allard v. Arthur Anderson & Co., 924 F. Supp. 488 (S.D.N.Y 1996); Official Comm. of Unsecured Creditors v. DeSantis, Prinzi, Springer, Keifre & Shall (*In re* Gouiran Holdings, Inc.), 165 B.R. 104 (E.D.N.Y 1994); Holland v. Arthur Anderson & Co., 212 Ill. App. 3d 645, 571 N.E.2d 777 (Ill. App. Ct. 1991).
[5] 711 F.2d 1343 (7th Cir. 1983).
[6] Schact v. Brown, 711 F.2d at 1350. One earlier case aptly expressed the *Schact* court's reasoning: "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *In re* Investor's Funding Corp., 523 F. Supp. 533, 541 (S.D.N.Y. 1980).
[7] Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).
[8] The court noted that "the soundness of the theory, its growing acceptance among courts, and the remedial theme in Pennsylvania law" were sufficient grounds to recognize deepening insolvency as a cognizable injury. *Id.* at 352. Since *Lafferty*, other courts have recognized a cause of action for deepening insolvency under state law. *See e.g., In re* Exide Techs., Inc., *supra* (construing Delaware law).
[9] *In re* Global Serv. Group LLC, 316 B.R. at 458. Readers of the court's decision may also sense that the court's enclosure of the words "deepening insolvency" in quotes throughout the entire decision is a telling expression of the court's unwillingness to treat with legitimacy the theory of deepening insolvency as an independent cause of action.
[10] Bondi v. Grant Thornton Int'l (*In re* Parmalat Sec. Litigation), 377 F. Supp. 2d 390 (S.D.N.Y. 2005).
[11] Rahl v. Bande, 328 B.R. 387 (S.D.N.Y. 2005).
[12] Jo Ann J. Brighton, *Deepening Insolvency; Secured Lenders and Bankruptcy Professionals Beware: It Is Not Just For Officers and Directors Anymore*, Am. Bankr. Inst. J., Apr. 2004, at 34.

Additional Highlights of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)

Sweeping changes to the Bankruptcy Code took effect October 17, 2005. As we explained in the previous edition of *Creditors' Rights Quarterly*, many of these changes will impact business bankruptcy cases. In addition to our previous summary, below is a brief analysis of two additional provisions that are certain to raise issues in business bankruptcy cases filed after October 17, 2005.

New Section 366(c)—Adequate Assurance of Payment for Utility Services

New Section 366(c) of the Code significantly alters the relationship between debtors and utility providers from the outset of a bankruptcy proceeding.

Under the old Code, a utility could not alter, refuse or discontinue service or otherwise discriminate against a debtor solely on the basis of the filing of a bankruptcy petition or the existence of outstanding indebtedness to the utility based upon pre-petition services. However, a utility could stop providing services to the debtor unless within 20 days after the bankruptcy filing, the debtor provided the utility "adequate assurance of payment" for post-petition services. Such "adequate assurance" may be "in the form of a deposit or other security." This provision has in the past been interpreted to mean that adequate assurance make take the form of an administrative expense priority where the estate appears to be administratively solvent. As such, there was not the urgent and immediate need for added liquidity at the outset of the debtor's bankruptcy case to provide ongoing payment to its utility providers.

However, Section 366(c) of the Code places significant new burdens on debtors that consume utility services and provides substantial new protections to such utilities. Specifically, Section 366(c) expressly defines "assurance of payment" as being limited to only a cash deposit, letter of credit, certificate of deposit, surety bond, prepayment of utility consumption or another form of security that is mutually agreed to between the parties. More significantly, Section 366(c)(1)(B) states that "an administrative expense priority *shall not* constitute an assurance of payment." In fact, when considering the adequacy of a proposed assurance of payment, the amended Code explicitly precludes the court from even considering the availability of an administrative expense priority.

The additions to Section 366 afford utilities added leverage in the early stages of a bankruptcy proceeding and impose more substantial liquidity requirements on debtors. The issue of adequate assurance of payment to utilities will thus likely take on added significance in the pre-petition negotiation of DIP financing.

New Section 363(b)(1)—Use, Sale and Lease of "Personally Identifiable Information"

Personal information - name, address, email address, telephone number, birthdate, social security number and credit card account information - collected by any number of companies in the context of consumer transactions has unquestionable valuable to such companies. Indeed, in today's marketplace, it is often the case that customer lists and databases may represent a company's most valuable assets; valuable to the company and its lenders, as well as other parties including marketers and creditors.

It is likely then that when a business whose customer information represents a significant majority of its value files a bankruptcy case, a sale of that information is contemplated as a necessary mechanism for providing a recovery to the company's creditors.

But what if the company's privacy policy promises its customers that it will not share their personal information with others? The new Code provision limits a debtor's ability to transfer customer lists and databases containing "personally identifiable information" to non-affiliated third parties if such a transfer would violate the debtor's existing privacy policy.

This new section, Section 363(b)(1), prohibits the sale or lease of "personally identifiable information" where a privacy policy is in effect as of the commencement of the case unless: (i) the sale or lease is "consistent with such policy" or; (ii) after the appointment of a "consumer privacy ombudsman," the court approves the sale or lease after giving due consideration to the facts, circumstances and conditions of the sale or lease, and no showing was made that the sale or lease would violate applicable nonbankruptcy law. The consumer privacy ombudsman is to be a disinterested person who will review and report on the company's privacy policy and the potential gains or losses to consumer privacy if the transaction is approved.

The aim of the new section is to protect consumers' expectations that their personal information will be maintained in accordance with a company's privacy policy even if the business fails and seeks to liquidate its assets or reorganize its operations through the bankruptcy process.

Companies that collect personal information in connection with consumer transactions may wish to review and revise their existing privacy policies as necessary to provide for the sale or other disposition of such information in the context of a bankruptcy proceeding. Likewise, lenders to such companies may wish to analyze the value of customer lists and databases and also review potential borrowers' privacy policies in order to craft loan documents that contemplate the application of new Section 363(b)(1) in the event of a bankruptcy.

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