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HOWARD SEIFE

THE "DEEPENING INSOLVENCY" DEBATE

When a borrower finds itself in financial difficulty, one of the steps it is likely to take is to speak with its lending group in an effort to negotiate a debt restructuring. Often, these discussions will result in an agreement among the parties that provides for additional funding from the banks to the borrower.

If this type of out-of-court workout is successful, the borrower will avoid a bankruptcy filing and, indeed, will continue to operate, for the benefit of shareholders, employees, creditors, and customers. A failed restructuring, however, ultimately may end up in bankruptcy court, with the positions of the parties in interest protected and determined by the provisions of the federal Bankruptcy Code.

In recent years, lenders have had to face assertions of another consequence of a failed debt restructuring, or of a borrower that has slowly slipped into bankruptcy: defending claims seeking damages for "deepening insolvency." In essence, claims for deepening insolvency refer to the "fraudulent prolongation of a corporation's life beyond insolvency,"[1] resulting in damages to

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the corporation caused by the increased debt. Put differently, these claims assert that a company was allowed to operate while insolvent and that it incurred additional debt that it could not repay. These claimants then seek to recover their alleged losses from any and all available deep pockets, such as banks or other large creditors as well as insurance companies that provide directors and officers liability insurance policies or other insurance coverage.

Several months ago, the U.S. Bankruptcy Court for the Southern District of New York issued a decision in *In re Global Service Group LLC*[2] rejecting deepening insolvency claims against a bank. Although other courts have reached different conclusions, the *Global Service* ruling and the bankruptcy court's analysis should provide a great deal of comfort to banks dealing with troubled borrowers in formal workouts or other similar scenarios.

Deepening Insolvency: The Case Law

The origin of the phrase "deepening insolvency" has been traced to the case of *Bloor v. Dansker* (*In re Investors Funding Corp. of New York Sec. Litig.*).[3] The complaint in that case alleged that the debtor's insiders had embarked on a scheme to loot the corporate debtor. The complaint further asserted that, relying on a false picture of the debtor's financial well-being, the insiders allegedly induced creditors and shareholders to invest more funds in the company. Thereafter, the complaint continued, the insiders misappropriated a portion of the funds that were raised.

Peat, Marwick, Mitchell & Co. ("PMM") had served as the debtor's outside auditor. The debtor's chapter X trustee sued PMM, charging that the insiders had used the false financial statements that PMM had certified to further their scheme. PMM moved for summary judgment on the pleadings, arguing, among other things, that the knowledge and wrongful conduct of the insiders should defeat recovery.

PMM's argument invoked the "adverse interest" exception to the general rule that the agent's knowledge will be imputed to the agent's principal. The court explained that the "adverse interest" exception applied if the agent acted adversely to the interest of the agent's principal, but did not apply "where the agent is also acting for the principal's benefit, even though the agent's primary interest is inimical to that of the principal." PMM argued that although the

insiders allegedly had been motivated by personal interests, the complaint also alleged that the debtor had benefited from the infusion of the funds.

The district court, in words that heralded the "deepening insolvency" theory, rejected the notion that acts that prolong a corporation's existence automatically confer a benefit on the corporation:

> [E]ven to the extent one focuses upon the artificial financial picture of [the debtor] created by the [insiders] which prolonged [the debtor's] existence several years beyond its actual insolvency, PMM's position is not persuasive. 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 [insiders'] practices, [the debtor's] financial situation was caused to deteriorate even further after 1971. Accepting the allegations of the complaint as true, it is manifest that the prolonged artificial solvency of [the debtor] benefited only the [insiders] and their confederates, not [the debtor].

Differing Views

Since that court decision, a number of courts have accepted the theory that an insolvent corporation suffers a distinct and compensable injury when it continues to operate and incur more debt and that "deepening insolvency" is an independent cause of action.[4]

For example, one case[5] arose out of the bankruptcy of two lease financing corporations, which allegedly were operated as a "Ponzi scheme." To operate the scheme, a number of individuals allegedly caused the corporations to issue fraudulent debt certificates, which were then sold to individual investors. When the corporations lost any reasonable prospect of repaying the outstanding debt, they filed for bankruptcy.

A committee of unsecured creditors brought claims in the district court on behalf of the two debtor corporations alleging that third parties had fraudulently induced the corporations to issue the debt securities, thereby deepening their insolvency and forcing them into bankruptcy. These third parties allegedly conspired with the debtors' management, who were also the debtors' sole shareholders, in engineering the Ponzi scheme.

The dispute reached the U.S. Court of Appeals for the Third Circuit,

which ruled that deepening insolvency constituted a valid cause of action under Pennsylvania state law. The circuit court found that the deepening insolvency theory was "essentially sound." It pointed out that even when a corporation is insolvent, its corporate property may have value — and that the "fraudulent and concealed incurrence of debt" can damage that value, such as by undermining a corporation's relationships with its customers, suppliers, and employees. This harm, it stated, could be averted, and the value of the assets of an insolvent corporation salvaged, "if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt."

Other courts have viewed deepening insolvency as a theory of damages, often raised in response to the defense that increased debt injured the creditors, but did not harm (and actually helped) the corporation.[6] For example, in one case,[7] the accounting firm Arthur Andersen & Co. ("AA") contended that the bankruptcy trustee for DeLorean Motor Company ("DMC") could not recover damages from AA based on DMC's indebtedness to trade creditors. AA reasoned that DMC could not conceivably have been damaged by further indebtedness because the indebtedness provided a benefit — more capital — to the company.

The court acknowledged that AA's argument was "intuitively appealing," but declared that ostensibly beneficial additional capital may in some cases prove harmful to a corporation if it provides an "illusory financial cushion that lulls shareholders into postponing the decision to dissolve the corporation." The court stated that shareholders may under these circumstances miss an opportunity to "cut their losses" by shutting down operations "before management can fritter away whatever valuable assets the corporation still possesses." The court then simply ruled that because other courts had permitted recovery under the "deepening insolvency" theory, AA was not entitled to summary judgment on this claim.

Finally, some courts have rejected the theory outright,[8] or raised serious questions about its viability.[9]

The New York Cases

Decisions since the initial New York decision in *Investors Funding* that opened the door to deepening insolvency claims suggest that New York

courts regarded deepening insolvency as a theory of damages that may result from the commission of a separate tort,[10] although no New York court has yet ruled that deepening insolvency is an independent tort. It was within this context that the Bankruptcy Court in the Southern District of New York issued its decision in *Global Service*.

The *Global Service* Ruling

The *Global Service* case involved Global Service Group, LLC ("Global"), a New York limited liability company engaged in the business of marble, metal and wood refinishing. After Global entered bankruptcy, its chapter 7 trustee filed an adversary proceeding against Atlantic Bank of New York and a number of Global insiders, including Alan and Gerald Goldman. The complaint alleged that Global had been insolvent or in "the vicinity" of insolvency and undercapitalized since it had been formed. It also asserted that Atlantic Bank knew or should have known that Global was unable to repay its loans due to its financial condition, but that it loaned money to Global anyway, allegedly based on its relationship with the Goldmans and the strength of their personal assets. The Goldmans had guaranteed loans so that Global could obtain the necessary financing for working capital and to continue operating.

Additionally, the trustee's complaint contended that other creditors had extended credit to Global based on Atlantic Bank's willingness to extend credit, and that the bank's loans had allowed Global to prolong its corporate existence and incur increased debt that would have been avoided without the bank's loans. In essence, the trustee asserted that there had been an artificial prolongation of Global's corporate life, resulting in its "deepening insolvency," for which the bank should be held liable. The bank moved to dismiss the trustee's deepening insolvency claims.

In its decision, the court observed that the complaint alleged, in substance, that the bank should be held liable for Global's deepening insolvency because the bank had made a loan that it knew or should have known Global could never repay. In the court's view, this "may be bad banking, but it isn't a tort." As the court explained, a third party is not prohibited from extending credit to an insolvent entity; "if it was, most companies in financial dis-

tress would be forced to liquidate." Moreover, the court found, although the trustee alleged that the bank made the loan on the strength of its relationship with the Goldmans and their personal assets, this was "neither surprising nor improper." The court noted that banks prefer to lend to those they know, and have the right to insist on guaranties and pledges of personal assets from the corporate principals. The court found it significant that the trustee's complaint had not alleged or implied that the bank had extended loans to enable the Goldmans to siphon off funds or commit some other wrong.

The court also found a second problem with the trustee's deepening insolvency claims. According to the court, the "unspoken premise" of the trustee's deepening insolvency theory was that the managers of an insolvent limited liability company were under an absolute duty to liquidate the company, "and anyone who knowingly extends credit to the insolvent company breaches an independent duty in the nature of aiding and abetting the managers' wrongdoing." The court ruled, though, that this assumption was "a faulty one."

As the court explained, under New York law, the management of a corporation generally is vested in a board of directors that appoints or elects officers who must perform their duties "in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."[11] The court then observed that directors and officers owe their fiduciary duties to both the corporation and shareholders[12] and, once insolvency ensues, to creditors.[13] At that point, the court continued, officers and directors have an obligation "to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[14]

The court pointed out that the fiduciaries of an insolvent business might conclude that the company should continue to operate to maximize its "long-term wealth creating capacity," or its "enterprise value." In fact, the court declared, chapter 11 is based on the "accepted notion" that a business "is worth more to everyone alive than dead." The court then found that there is "no absolute duty under American law to shut down and liquidate an insolvent corporation" and that, in fact officers and directors may "continue to operate the corporation's business." Accordingly, the court found, the cause of action against the bank seeking damages for "deepening insolvency"

had to be dismissed because it "wrongly assume[d] that prolonging the life of an insolvent corporation that continues to incur debt, without more, states a claim for relief."

The court then added that the deepening insolvency claim also had to be dismissed because it failed to allege "proximate cause." The court said that the trustee's complaint implied that "but for" Atlantic Bank's loans, Global would have liquidated before its insolvency became deeper. However, the court said, although it was "arguably foreseeable" that the loans would permit Global to continue to operate, the trustee's complaint did not allege facts suggesting that the bank could have foreseen that an insolvent Global allegedly would have been operated for an improper purpose.

Finally, the court rejected the trustee's "aiding and abetting" claim that alleged that the bank's actions had "contributed" to Global's "deepening insolvency," "resulted" in increased debt, and "allowed" Global to prolong its existence and incur more that that could have been avoided. In the court's view, this claim also implied, "wrongly," the court emphasized, that the "mere continuation" of Global's operations violated a legal duty. Accordingly, the court dismissed the deepening insolvency claims against the bank.

Conclusion

Deepening insolvency claims have targeted not just banks and other lenders, but officers, directors and outside accountants and auditors. Although some courts have expressed a willingness to permit these claims to move forward, the Global Service court seems to have struck the appropriate balance: merely allowing a debtor to continue and to incur additional debt, and even losses, is insufficient to allow recovery under a deepening insolvency theory.

Without a strong indication of fraud or other wrongful conduct, banks simply should not be held responsible under a deepening insolvency theory for losses that others may incur while a corporate debtor endeavors to turn itself around. Banks have long recognized the need to exercise caution when dealing with troubled borrowers. The "deepening insolvency" theory demonstrates the continuing wisdom of that advice.

Notes

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

[2] 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

[3] 523 F.Supp. 533 (S.D.N.Y. 1980).

[4] *See, e.g., Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs., Inc.),* 299 B.R. 732 (Bankr. D. Del. 2003) (construing Delaware law).

[5] *Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co.,* 267 F.3d 340 (3d Cir. 2001) (construing Pennsylvania law).

[6] S*ee, e.g., Schacht, supra; Hannover Corp. of Am. v. Beckner,* 211 B.R. 849 (M.D. La. 1997); *Drabkin v. L & L Const. Assocs. (In re Latin Inv. Corp.)*, 168 B.R. 1 (Bankr. D.C. 1993).

[7] *Allard v. Arthur Andersen & Co. (USA),* 924 F. Supp. 488 (S.D.N.Y. 1996).

[8] *See, e.g., Coroles v. Sabey,* 79 P.3d 974 (Utah Ct. App. 2003) (rejecting "deepening insolvency" as a theory of damages because shareholders rather than corporation suffer harm).

[9] *See, e.g., Florida Dep't of Ins. v. Chase Bank of Texas, N.A.,* 274 F.3d 924 (5th Cir. 2001) (questioning whether Texas recognizes the cause of action, but stating that even if it did, the defendant was entitled to summary judgment because the plaintiff failed to quantify the additional debt or provide evidence of damages that might be compensable under the "deepening insolvency" theory); *Askanase v. Fatjo,* No. Civ. A. H-91-3140, 1996 WL 33373364 (S.D. Tex. Apr. 1, 1996) (rejecting trustee's "deepening insolvency" argument because the insolvent debtor was not damaged by false financial statements since the shareholders had already lost all of their equity and the complaint did not allege that any creditor had been injured); *Feltman v. Prudential Bache Sec.,* 122 B.R. 466 (S.D. Fla. 1990) (rejecting argument that insolvent corporation was harmed by artificial extension of its life where complaint alleged that corporation was a sham, without a corporate identity and served as a conduit for stolen money).

[10] *See, e.g., Allard, supra* (relying on "deepening insolvency" to reject the contention that a bankruptcy trustee could not recover damages in an action based on RICO, federal securities law violations and related state and common law claims); *Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (In re Gouiran Holdings, Inc.),* 165 B.R. 104 (E.D.N.Y. 1994) (reversing grant of motion to dismiss claim for negligent preparation of financial statements which may have resulted in debtor's "incurring unmanageable debt and filing for bankruptcy"); *Corcoran v. Frank B. Hall & Co.,* 149 A.D.2d 165 (N.Y. App. Div. 1989) (liquidator of insurance company stated claims for common law fraud and insurance law violations arising from the concealment of insurance company's financial condition which caused insurance

company to assume additional risks and increase its final financial exposure).

[11] *See* N.Y. Bus. Corp. L. Sections 701, 715(a), 715(h), 717(a).

[12] *See, e.g., Gully v. NCUA Bd.,* 341 F.3d 155 (2d Cir. 2003).

[13] *See e.g., New York Credit Men's Adjustment Bureau v. Weiss,* 305 N.Y. 1 (N.Y. 1953).

[14] *See, e.g., Roselink Investors, L.L.C. v. Shenkman,* 2004 U.S. Dist. Lexis 6905 (S.D.N.Y. May 19, 2004).