SINK OR SWIM?
A CASE FOR SALVAGING DEEPENING INSOLVENCY THEORY

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INTRODUCTION

In a recent and stunningly decisive move, the Delaware Chancery Court struck a hard blow against the theory of deepening insolvency, stating that "Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept."[1] The Court's disdain for the perceived absurdity of deepening insolvency is no more evident than in its explanation that "under Delaware law, 'deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent."[2] However, such present disdain belies the popular momentum that has propelled deepening insolvency to such high visibility in the few short years since its inception as to invite the withering scrutiny of the Delaware Chancery Court. . .The swift rise and divisive nature of the theory alone should give pause before discarding something that, until recently, was widely viewed by a number of courts as a significant and workable legal innovation.

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[1] Trenwick American Litigation Fund v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006).

[2] *Id.*

First, as a base-line presumption, debt is not always bad. Neither is increased debt. Companies today frequently take on increasingly leveraged positions to stave off financial distress, a strategy that often works to turn around the company's finances and save it from demise. The debt-to-equity ratio of a company's assets and the cost-benefit implications of taking on increased debt is a pure business decision best left to corporate management and outside the scrutiny of the law. As long as the decision is informed and reasonable, the business judgment rule will protect management from subsequent liability should a good-faith business strategy not pan out. However, there comes a point when the increased burden of additional debt outweighs any possible benefit to the corporation and its stakeholders. In these instances, existing market safeguards (e.g., proxy fights, removal of directors and officers, and involuntary bankruptcy procedures) generally prevent management from continuing such a strategy over the objections of corporate stakeholders. Furthermore, unsecured creditors often protect themselves *ex ante* from such situations through the use of restrictive covenants that limit risky future actions by management. However, when management commits a fraud and pursues a business strategy in secret, without disclosing the true financial peril of the corporation to the public or to its stakeholders, the normal market oversight procedures are frustrated. And when corporate creditors are kept ignorant of the company's impending failure in order to prevent them from calling in their debt, and the company then fails, the unsecured creditors are often left with nothing. This is where "deepening insolvency" comes in.

As a conceptual matter, the theory of deepening insolvency recognizes that different levels of corporate insolvency exist[3] and that the progression of a corporation from barely insolvent to irretrievably insolvent can have devastating effects on the extent of damage to corporate stakeholders.[4] This is not a revolutionary principle; nor is the proposition that those parties-at-interest who are damaged by the *purposeful* and *fraudulent* deepening of a corporation's insolvency should be compensated for the full measure of their financial loss. As Vice Chancellor Strine's scathing indictment of deepening insolvency demonstrates, however, this theory has somehow managed to garner immense criticism over the course of its short life. In the recent backlash against deepening insolvency, its initial popular momentum seems to have been all but forgotten.[5] Nevertheless, it is hard to deny the fact that, initially, there must have been some aspect of the theory that was found compelling; something that resonated that has since been lost. So the question then becomes: *Is there an aspect of deepening insolvency theory, as originally conceived, that may still hold some value?* And if so, where does that value lie?

This article addresses this question directly, and after a comprehensive review of recent case law and of existing causes of action available to creditors in the context of corporate

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[3] Insolvency can be defined in several ways, among them: (i) balance sheet insolvency, where the debtor's total liabilities on paper exceed the fair value of its assets; (ii) cash-flow insolvency, where the debtor is unable to pay its debts individually as they come due; or (iii) formal bankruptcy filings. For purposes of this paper, the term "insolvency" refers to actual balance sheet insolvency. *See* 11 U.S.C. § 101(32) (2006) (Insolvency is defined as the "financial condition such that the sum of [an] entity's debts is greater than all of such entity's property, at a fair valuation.").

[4] *See* Jonathan M. Landers, *Deepening Insolvency Comes of Age*, NEW YORK LAW JOURNAL (Oct. 5, 2006), *available at http://www.nylj.com*.

[5] As recently as 2001, the Third Circuit confidently stated that: "Growing acceptance of the deepening insolvency theory confirms its soundness." Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 350 (3d Cir. 2001).

fraud and mismanagement, answers it in the affirmative. Part I briefly addresses creditor vulnerability to harm from deepening insolvency and the form such harm may take. Part II summarizes the evolution of deepening insolvency case law to date and illustrates common facts and allegations that will and will not support a deepening insolvency claim. Part III reviews the existing causes of action currently available to creditors seeking redress for deepening insolvency harms. Part IV analyzes the inadequacies of the existing causes of action to respond to the complex and nuanced harm of deepening insolvency, and Part V rebuts the primary critiques of deepening insolvency and presents an overview of the ideal model of a deepening insolvency cause of action.

Finally, this article posits that, distilled to its fundamental concept, deepening insolvency fills an ever-widening gap in existing bankruptcy law that has left unsecured creditors increasingly unprotected from complex corporate fraud. In recent years, the rush to apply deepening insolvency to every possible situation where ordinary causes of action fall short has unfairly distorted the theory to such an extent that it no longer resembles its original form.[6] It is this rampant misapplication of deepening insolvency that has encouraged the current backlash against it, not the fundamental merits of the theory. If narrowed back down to its earliest form, it may be possible to rediscover the theory's original value and find an appropriate place for it within modern bankruptcy law.

I. CREDITOR VULNERABILITY

It has become increasingly clear that the rapid growth in finance and technology over the past few decades has given rise to a new level of corporate fraud—one whose complexity and sophistication exists on a previously unforeseen scale. On the heels of the highly visible corporate scandals involving Enron, WorldCom, Tyco Ind. Ltd., and even Martha Stewart, the public pressure for legal remedies to adequately address the damages suffered by the victims of such fraud led to the rapid creation of Sarbanes-Oxley and other similar securities laws to fill a void that had appeared almost overnight. However, these new shareholder protections have not been similarly implemented with regard to corporate creditors. Where corporate equity scandals were the trend of the 1990s, the early part of this century has seen an explosion of corporate frauds in the debt context that have left unsecured creditors equally as devastated when corporations fail.[7] However, these unsecured creditors have been left to

[6] Several courts have recognized this progressive distortion in the theory. *See, e.g.,* Limor v. Buerger (In re Del-Met), 322 B.R. 781, 811-812 (Bankr. M.D. Tenn. 2005) (Although "deepening insolvency was first recognized as a theory for recovery in actions for breach of fiduciary duty alleging that officers or directors deepened the insolvency of the corporation and reduced or eliminated any return for creditors," over a relatively short period of time "the action has morphed, both in form . . . and in scope."); Alberts v. Tuft ("Alberts I"), 333 B.R. 506, 516 (Bankr. D. Dist. Col. 2005) ("Originally a theory of damages, the concept [of deepening insolvency] has taken on a life of its own."); Official Comm. of Unsecured Creditors of VarTech Telecom, Inc. v. Rural Tel. Fin. Coop. (In re VarTec Telecom, Inc.), 335 B.R. 631, 638 (Bankr. N.D. Tex. 2005) ("This [original form of deepening insolvency] makes some sense; however, [the unchecked expansion of the theory to date] . . . is where things start to get a little murky."). *Accord* John J. Rapisardi, *A Tale of Two Cases: Differing Approaches to 'Deepening Insolvency'*, NEW YORK LAW JOURNAL, Sept. 30, 2005 ("*Global Service Group* introduced some sense into an area of law that seemed to be moving far away from its humble origins in *Investors Funding*.").

[7] *See* Russell C. Silberglied & Kimberly D. Newmarch, *Production Resources: A Retreat from the Law on Fiduciary Duties to Creditors of Insolvent Companies or Merely an Explanation of Standing Requirements?*, THE BANKRUPTCY STRATEGIST, Mar. 2005 ("In the current environment of increasing scrutiny of corporate behavior after corporate scandals such as Enron and Worldcom, lawsuits brought by creditors of insolvent

fashion what appropriate remedies they can from a piecemeal set of existing causes of action that are individually ill-equipped to respond to the scope and complexity of the damage at hand. In this context, deepening insolvency may do for unsecured creditors what the new securities laws of the 1990s did for shareholders: protect them from complex corporate fraud. [8]

A. The Specific Harm

Despite recent periods of economic growth, it bears keeping in mind that not all companies are successful. Moreover, not all companies benefit from continued existence or restructuring efforts.[9] When a corporation is at or near insolvency, the benefit to its existing creditors of liquidating its assets to collect on outstanding debt may outweigh the going-concern value of the corporation.[10] In some instances, existing creditors can incur damage through the prolongation of corporate existence where insolvency and liquidation might otherwise have been proper, since the company's continued existence will allow further dissipation of corporate assets until bankruptcy is declared.

Through continuing attempts to salvage the corporation and by failing to declare bankruptcy in a timely manner, corporate management may permit the pool of existing corporate assets to further dwindle such that, if restructuring efforts are unsuccessful, unsecured creditors will be left with much less vis-à-vis an earlier declaration of insolvency. Unsecured creditors are, in effect, harmed by the very deepening of the corporation's

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corporations for breach of the fiduciary duties owed to them by officers and directors have increased significantly.").

[8] Indeed, a comparison of the allegations made by defrauded Enron investors in the consolidated securities class action against Barclays Bank to the allegations that commonly underlie claims of deepening insolvency demonstrates strong similarities between the two situations. *See* Newby v. Enron Corp., 235 F. Supp. 2d 549, 696 (S.D. Tex. 2002):

> The First Amended Consolidated Complaint . . . states the following about Barclays' purported role in the alleged Enron scheme . . . . that Barclays had an extensive and close relationship with Enron, provided commercial banking and investment banking services to Enron, interacted constantly with Enron's top executives regarding Enron's business during the Class Period, and participated in the fraudulent scheme and furthered Enron's fraudulent course of conduct and business by participating in loans of over $ 3 billion during the Class Period and helping Enron to raise almost $ 2 billion from investors in the sale of new securities.

[9] *See* In re Investors Funding Corp. Sec. Litig. (Bloor v. Dansker), 523 F. Supp. 533, 541 (S.D.N.Y. 1980) ("A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."); Scott B. Cohen, *The Deepening Insolvency Doctrine: Does it have a logical conclusion?*, Feb. 2005, *at* http://www.sackstierny.com/articles/insolvency_doctrine.htm. ("At the heart of the deepening insolvency theory is the premise that extending the life of a company is not inherently valuable.").

[10] "The maximization of the economic value of the firm might, in circumstances of insolvency, require the directors to undertake the course of action that best preserves value in a situation when the procession of the firm as a going concern would be value-destroying. In other words, the efficient liquidation of an insolvent firm might well be the method by which the firm's value is enhanced in order to meet the legitimate claims of its creditors." Production Res.Group LLC v. NCT Group, Inc., 863 A.2d. 772, 791 n.60 (Del. Ch. 2004). Furthermore, "the value within an insolvent corporation [can be] salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt." *Del-Met*, 322 B.R. at 813.

insolvency.[11] This scenario is unfortunate. However, it is not illegal. Nor is it what a cause of action for deepening insolvency responds to.

Managers who pursue good-faith restructuring efforts, even against all odds and even where the corporation fails, will be subsequently protected in this decision by the business judgment rule. This is because we as society recognize the benefit of corporate restructuring in the face of collapse and because we believe the market functions most efficiently when managers are given free reign to pursue reasonable business decisions to maximize value to corporate stakeholders. However, what managers are not allowed to do is cook the books and commit fraud to hide the fact of the corporation's impending failure. When managers conceal the company's true financial distress from the very stakeholders they are duty-bound to protect, and the company then collapses as a result, *this* is an actionable tort.[12]

B. What Is The Harm?

The tort of deepening insolvency stems from the premise that impending financial distress is not always harmful to the interests of corporate stakeholders, particularly extant creditors. And where losses occur from the delay of financial distress, it stands to reason that there may be some benefit gained from the encouragement of financial distress.[13] Although in theory the existence of debt should constrain corporate management to proceed with heightened caution to ensure timely repayment of obligations, in reality the easy availability of wiggle-out maneuvers such as continuous infusions of new secured capital to satisfy existing loans and cover operating costs allow management to stave off financial distress for significant periods of time. Without the impending threat of bankruptcy supervision to constrain them, managers are free to prolong the life of the corporation far past the point of insolvency, often at the expense of existing creditors, until assets are so far dissipated that collapse becomes inevitable.[14] A common example of this is an illegal Ponzi scheme.[15]

To the extent that such losses are avoidable, checks on managerial misbehavior such as the threat of takeover, replacement, or scrutiny from independent directors are clearly insufficient to prevent them. In effect, corporate managers often have no incentive to alter their misbehavior in the absence of palpable and immediate repercussion. Financial distress can be a powerful motivator in such situations. Much like the rest of us, "[most managers] seldom respond in the absence of a crisis."[16] It is for this exact reason that the Bankruptcy

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[11] *See* Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983) ("[T]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.").

[12] Prolonging an insolvent corporation's life, without more, will *not* result in liability under [a deepening insolvency] 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.

Kittay v. Atl. Bank of New York (In re Global Serv. Group LLC), 316 B.R. 451, 458-59 (Bankr. S.D.N.Y. 2004) (emphasis added).

[13] *See* Barry E. Adler, *Accelerated Resolution of Financial Distress*, 76 WASH. UNIV. L. QUARTERLY 1169 (1998).

[14] *Id.*

[15] *See* In re CitX Corp., Inc., 448 F.3d 672, 674 (3d Cir. 2006); Breeden v. Kirkpatrick & Lockhart L.L.P., 336 F.3d 94, 97 (2d Cir. 2003); *Lafferty*, 267 F.3d at 343.

[16] *See* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 852 (1993).

Code provides creditors the ability to force an involuntary declaration of bankruptcy upon a debtor where they view bankruptcy as the only way to prevent the further dissipation of corporate value and where management is unwilling to acquiesce.[17] Such forced financial distress can, in some cases, prevent the continuation of managerial mismanagement or fraud leading to the post-insolvency dissipation of corporate assets and leaving unsecured creditors without recourse.

The harm addressed by a cause of action for deepening insolvency occurs when management (often in conjunction with outside advisors) deprives creditors of their ability to oversee their best interests by concealing relevant information about the corporation's true financial state. The result is financial loss to creditors. This loss occurs when the artificial prolongation of the company's existence causes the amount of existing corporate assets that are available to satisfy outstanding creditor claims to diminish. It also occurs where the existing unsecured claims are wrongfully sublimated to new secured debt in efforts to keep the company temporarily afloat.[18]

Specifically, deepening insolvency is best suited for claims that allege an overarching scheme involving the following basic elements: (1) deceptive concealment of a corporation's insolvency, (2) enabling or encouraging new loans to be taken on (3) to stave off bankruptcy supervision, and to artificially prolong the life of the insolvent corporation, (4) which results in the further dissipation of corporate assets available to satisfy outstanding creditor claims, (5) where this could otherwise have been avoided had insolvency been properly and timely disclosed.[19]

C. Who Is Harmed?

When a company continues to operate after it becomes insolvent despite little likelihood of successful turnaround, all relevant stakeholders, including unsecured creditors and the corporation itself, can be damaged.[20] Because unsecured creditors have neither equity nor

[17] "A[n] involuntary bankruptcy petition may be appropriate where the debtor is mismanaging or dissipating its assets or is engaged in other misconduct harmful to creditors generally. If the debtor is dissipating its assets and there is little prospect of payment in any other fashion, an involuntary bankruptcy petition will prevent further dissipation of assets." WILLIAM L. NORTON III & ROGER G. JONES, NORTON CREDITORS' RIGHTS HANDBOOK § 7.5 (2006). *See also* 11 U.S.C. § 549(b) (2005).

[18] *See Schacht*, 711 F.2d at 1350 ("[T]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.").

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> [A]s a result of the fraudulent actions of the various defendants, Reserve's corporate parent was caused to continue Reserve in business even though the latter was insolvent, and was caused to saddle Reserve with additional liabilities and drive deeper into insolvency, all of which consequences resulted in damage to Reserve, as well as its policyholders and creditors. . . . Thus, the 'asset dissipation' alleged was not only that which resulted from the normal operation of the business, . . . but also that which resulted from the bleeding of Reserve which was a part of the underlying scheme to defraud.

Id. at 1345, 1350. *See also Lafferty*, 267 F.3d at 347 ("[Deepening insolvency represents] an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."); *Global Serv.*, 316 B.R. at 456 ("'Deepening insolvency' refers to the 'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt.").

[20] For purposes of this paper, the discussion will focus primarily on harms to unsecured creditors. Because the unsecured creditors are often the ultimate beneficiaries of actions brought by the trustee on behalf of the estate, the availability of actions by the trustee will also be addressed.

secured interest in the corporation, they are often the first party harmed by corporate insolvency and the last to gain recompense under the current priority scheme. Unsecured creditors incur damage from deepening insolvency in two ways: through the dissipation of corporate assets available to satisfy their claims and through the sublimation of their unsecured claims to new secured creditors brought in to extend the life of the insolvent corporation.[21] Although much has been made in deepening insolvency case law of the distinction between the damage to unsecured creditors as separate from the damage to the corporate entity itself, because creditors become the primary corporate stakeholders at or near the point of insolvency,[22] any financial loss to the creditors of an insolvent corporation (in their role as creditors) is necessarily also a loss to the company as a whole. Much like a diminution in share price simultaneously damages individual corporate shareholders and the overall corporate value itself, the harm of deepening insolvency similarly affects corporate creditors *qua* creditors and *qua* the corporate entity. In assessing deepening insolvency harm, this fictionalized separation between "the corporation" and "the creditors" is misplaced and leads to perverse and internally inconsistent outcomes that are increasingly hard to reconcile with basic principles of tort.[23]

D. Who Causes The Harm?

The harm of deepening insolvency is primarily caused by one of three parties, either separately or in conjunction with one another: (1) corporate management; (2) outside professional advisors; and (3) secured creditors. A fraud by corporate management to conceal insolvency and artificially prolong the life of the corporation (either to conceal or continue a scheme of illegal looting, to effect preferential or fraudulent transfers, or to salvage their own employment security and interests in the face of impending financial distress) is the most common element of a deepening insolvency claim.[24] However, management rarely concocts

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[21] Corporate value can be harmed in other ways through deepening insolvency as well, including the unnecessary payment of fees to financial professionals during the corporation's continued existence, unnecessary interest payments on newly-procured loans (which are often far higher than market rate due to the increased risk of default and the company's desperate situation), unfairly favorable loan terms for newly secured lenders, the administrative costs of eventual bankruptcy and restructuring proceedings, and the potential loss of business goodwill stemming from managerial fraud or mismanagement. *Cf. Lafferty*, 267 F.3d at 349-50 (listing harms of deepening insolvency).

[22] *See, e.g., Production Res.*, 863 A.2d at 786 (granting post-insolvency creditors equal rights of standing as shareholders to pursue claims against management derivatively on behalf of the corporation and affirming the fiduciary duties owed by management to creditors at or near the point of insolvency).

[23] The legal fiction of corporate existence corresponds with the view that an injury to the

> corporate body is legally distinct from an injury to another person. . . . Simply because the creditors of an estate may be the primary or even the only beneficiaries of [any] recovery does not transform the action into a suit by the creditors. Otherwise, whenever a lawsuit constituted property of an estate which has insufficient funds to pay all creditors, the lawsuit would be worthless since under *Caplin* it could not be pursued by the trustee.

Lafferty, 267 F.3d at 348-49 (citing Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 434 (1972) (holding that a trustee may not assert claims on behalf of creditors)). *But see* Mediators, Inc. v. Manney (In re Mediators Inc.), 105 F.3d 822, 826 (2d Cir. 1997) ("The [Official Unsecured Creditors'] Committee, while not a trustee in bankruptcy, is in a position analogous to a trustee because it is suing on behalf of the debtor.").

[24] *Cf. Schacht,* 711 F.2d at 1345; *Lafferty,* 267 F.3d at 343; *Production Res.,* 863 A.2d at 792-93; *Del-Met,* 322 B.R. at 790-92; Smith v. Arthur Andersen L.L.P. (Ex rel Boston Chicken), 421 F.3d 989, 995 (9th Cir. 2005);

such a scheme on its own. More often, managers recruit accomplices in the form of outside professional advisors (such as auditors, accountants, bank employees, financial professionals, or attorneys) or interested lenders who help enable and conceal the ongoing fraud.[25] Think Arthur Anderson's role in the Enron collapse. However, because of the various parties potentially involved in a deepening insolvency claim, the availability and efficacy of existing causes of action to address the harm often differ significantly with respect to each.

II. FROM *BLOOR* TO *TRENWICK*: A BRIEF HISTORY

The concept behind deepening insolvency first emerged in the context of a suit brought in 1980 by a Chapter X Trustee against the insolvent corporation's management and outside auditors in conjunction with a fraudulent scheme to conceal the corporation's true insolvency from its creditors and investors.[26] However, the term "deepening insolvency" itself was not coined until three years later by the Seventh Circuit in *Schacht v. Brown.*[27] Even so, it wasn't until two decades after its original conception that that the theory really exploded into the mainstream with the Third Circuit's now-infamous opinion in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co*.[28] This decision acted as a catalyst for the legal recognition of deepening insolvency at a time when the threat of large corporate bankruptcies (e.g., Enron) and resulting investor harm was just crashing into the public consciousness in a very noticeable and highly unpleasant way. Through the evolution of the case law, a coherent framework for the type of allegations underlying a claim for deepening insolvency began to emerge.

The concept of "deepening insolvency" is widely considered to have originated with the statement from *Bloor v. Dansker* that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[29] The suit in *Bloor* arose from allegations by the Chapter X Trustee for Investors Funding Corporation of New York ("IFC") that IFC principals had orchestrated a deliberate scheme to conceal IFC's deteriorating financial condition, resulting from poor managerial decisions and the misappropriation of funds for personal use, through a series of secret and sham transactions that created artificial profits and hid the corporation's actual losses. As a result, the Trustee alleged that IFC was able to continue operating far past the point of true insolvency and to obtain huge quantities of additional investor and debt funding which was then used to perpetuate and further conceal the fraud.[30] The effect of all this was to drive the corporation to inevitable and irredeemable demise, to the detriment of its various stakeholders.

The statement that gave rise to the concept of deepening insolvency—that a corporation could in fact be harmed by the artificial extension of its existence—was made in dicta in response to an *in pari delicto* defense asserted by the defendant auditors, whose certification

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Tabas v. Greenleaf Ventures, Inc., 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001); Bondi v. Bank of Am., 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

[25] *Cf. Production Res.,* 863 A.2d at 792-93*; Bondi v. Bank of Am.,* 383 F. Supp. 2d at 587; *Schacht,* 711 F.2d at 1345.

[26] *Bloor*, 523 F. Supp. 533.

[27] 711 F.2d at 1350.

[28] 267 F.3d 340.

[29] 523 F. Supp. at 541.

[30] *Id.* at 536-37.

of the fraudulent financial statements allegedly allowed IFC's principals to perpetuate the fraud.[31] Nevertheless, the concept stuck.

Three years later, in what may now be seen as the original deepening insolvency case, the Seventh Circuit transformed this principle from dicta into a theory of legal consequence by declaring that "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."[32] The crux of deepening insolvency theory as it was originally conceived and intended is well illustrated by the facts of this original case—especially now in the context of *Trenwick*.

A. The Seminal Case: *Schacht v. Brown*

Schacht arose from allegations against the directors of a parent corporation ("ARC") that allowed its subsidiary ("Reserv") to continue in business and to take on additional liabilities despite its balance sheet insolvency. These actions were claimed to have resulted in damage to the subsidiary corporation, its policyholders and creditors in amounts exceeding $100 million. The particulars of the scheme, as alleged, involved a deal by ARC's directors and officers to conceal the true extent of Reserv's insolvency by ceding the majority of Reserv's most profitable and least risky business to an unrelated corporation ("SCOR") in exchange for payments of commissions to Reserv. Most of this business was then covertly retroceded to another ARC subsidiary, and in exchange, ARC's officers and directors secretly agreed to guarantee the subsidiary's obligations to SCOR.

As a result of these covert transactions, Reserv was able to report on paper a smaller volume of business and an increase in surplus, and thus a lower liability-to-surplus ratio, which diverted inquiries into its initial insolvency and allowed it to fraudulently continue operating. Plaintiffs alleged that Reserv's continued and improper post-insolvency operation exacerbated its initial insolvency and allowed the further dissipation of its existing assets. The complaint not only charged various members of management with liability but also claimed that ARC's outside accounting firms knew of Reserv's insolvency. The complaint additionally alleged harm to Reserv caused by the SCOR agreement and that, despite this knowledge, they prepared unqualified opinion letters as to ARC's consolidated financial statements in which the SCOR agreement went undisclosed, thus materially enabling the fraudulent appearance of Reserv's solvency and contributing to the increased damage stemming from its subsequent demise.[33]

Based on these allegations, the *Schacht* court soundly rejected the defendants' assertion of a general rule prohibiting a corporation from claiming damages caused by the prolongation of its life. Relying on *Bloor*, the court opined that "a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body" and would undercut the right of shareholders and other corporate stakeholders to "exercise their right to dissolve the corporation in order to cut their losses"[34]—a right that depends on the timely declaration

[31] *Id.* at 540-41.
[32] 711 F.2d at 1350.
[33] Among the defendant accounting firms was the ubiquitous Arthur Andersen & Co. *Id.* at 1345.
[34] *Id.* at 1350.

of insolvency. Though brought under the auspices of RICO and state civil conspiracy claims, the allegations in *Schacht* form the basis of a paradigm deepening insolvency claim.

B. The *Lafferty* Effect

Despite *Schacht*'s official endorsement of the theory, it took another eighteen years for deepening insolvency to gain full momentum. This was accomplished by the Third Circuit's ruling in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*[35] *Lafferty* arose from allegations that an insolvent corporation's outside advisors—including a lawyer, an accountant, and several underwriters—had conspired with the debtor's management to engineer a Ponzi scheme in order to fraudulently induce the floundering corporation to issue debt securities, thereby deepening the measure of its insolvency and forcing it into unnecessary bankruptcy. Based on these allegations, the court refused to dismiss the plaintiff's claim for deepening insolvency, finding instead that "the theory is essentially sound."[36]

The court went on to explain that an insolvent corporation may still retain value in its corporate property despite its insolvency and that "[t]he fraudulent and concealed incurrence of debt [in this situation] can damage that value in many ways," among which were the dissipation of assets caused by prolonging an insolvent corporation's life through bad debt and the incursion of legal and administrative costs associated with a formal declaration of bankruptcy where it was not already a necessary certainty.[37]

C. *Production Resources Group*

Although *Production Resources*[38] arose in the context of a fiduciary duty claim, it is often viewed as a significant step in the evolutionary chain of deepening insolvency jurisprudence. Ironically in hindsight, it was Chancellor Strine who unwittingly expanded on creditor protection in this area by confirming the right of creditors of an insolvent corporation to bring suit against the firm's officers and directors for breaches of fiduciary duty. Although the opinion emphasized that creditors of insolvent corporations have no greater rights than shareholders of functioning corporations to pursue claims against management, it granted post-insolvency creditors equal rights of standing to pursue such claims, derivatively, on behalf of the corporate entity itself. As such, it affirmed the fiduciary duties owed by management to creditors at or near the point of corporate insolvency and that management's failure to direct the corporation in such a manner as to maximize existing corporate value to the community of corporate interests, of which creditors occupy a majority place in the post-insolvency realm, could result in a sustainable suit against management for a cause of action that "in days past would be deemed to have raised a claim for 'constructive fraud.'"[39]

Since *Lafferty,* courts have vacillated between a tentative acceptance of deepening insolvency and repudiating the idea altogether. Notable decisions have included *In re Exide*

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[35] 267 F.3d 340 (3d Cir. 2001).
[36] *Id.* at 349.
[37] *Id.* at 349-50.
[38] *See Production Res.*, 863 A.2d 772.
[39] *Id.* at 786.

Technologies, Inc.,[40] *In re Global Services Group, LLC,*[41] *In re Flagship Healthcare*,[42] *In re Global Service Group,*[43]and *Florida Department of Insurance v. Chase Bank of Texas National Ass'n.*[44] However, no case by far has proved more influential in the evolution of deepening insolvency theory than *Lafferty*—until now.

D. The Disservice of *Citx* and *Trenwick*

In re CitX and *In re Trenwick* are striking cases if for no other reason than that each represents a swift retreat from deepening insolvency theory by the two courts that had thus far proven the most instrumental in its development: the Third Circuit and the Delaware Chancery Court. They are far more notable, however, for a much more significant reason apart from their actual holdings; a reason that appears to have subtly provoked the courts' ire and likely acted to trigger their about-face retreat on the issue of deepening insolvency: the underlying allegations.

Since its inception, advocates of deepening insolvency have pushed farther and farther to expand the theory's reach, as good advocates will. As these two opinions prove, however, the reaching has gone too far. The failure of deepening insolvency is not a fault of the theory itself, but of its opportunistic misapplication to a host of inappropriate circumstances which has resulted in tipping the balance from tentative acceptance to frightened flight. *CitX* and *Trenwick* represent two of the most egregious misapplications of true deepening insolvency theory, and the inherent weakness of their fact patterns seem to have resulted in the rejection of an otherwise cogent theory.

1. In re CitX

CitX initially appears to state a strong deepening insolvency claim. The suit was brought by the bankruptcy trustee of the insolvent CitX Corporation against CitX's outside accounting firm for its role preparing false financial statements that CitX then used to fraudulently attract investors to a massive Ponzi scheme operated by the corporation. Using these financial statements, CitX was able to incur millions more in debt and, after having spent all its investors' money, filed for bankruptcy protection from its existing creditors. The trustee then sued the accounting firm for professional malpractice and for its role in deepening the corporation's insolvency.[45]

Both claims eventually failed, however, because of the factual allegations behind them. CitX was founded in 1996 basically as a personal funding vehicle for its founder and was suspect from the start. In compiling CitX financial statements, the trustee alleged that the accountants missed several significant "red flags" that should have indicated to them the true

[40] 299 B.R. 732, 752 (Bankr. D. Del. 2003) (holding that where there has been damage to corporate property, Delaware courts would recognize a claim for deepening insolvency).
[41] 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004) (holding that "[p]rolonging an insolvent corporation's life, without more, will not result in liability under [deepening insolvency].").
[42] *Greenleaf Ventures*, 269 B.R. at 728 (sustaining Debtor's claim for damages under a "so-called deepening insolvency theory.").
[43] 316 B.R. at 458 (holding that Tennessee courts would recognize a cause of action for deepening insolvency).
[44] 274 F.3d 924, 935 (5th Cir. 2001) (recognizing deepening insolvency as a cause of action and holding that damages are measured by the decrease of assets or increase of debt holding a false representation is made).
[45] 448 F.3d at 674.

fraudulent nature of CitX operations. By neglecting to discover the fraud, the accountants unwittingly enabled CitX's continued pillaging of investor funds until it was forced to declare bankruptcy. Based on the allegations (plus the fact that the Plaintiff's sole proffer of proof of harm to the corporation, a sworn affidavit, was later discovered by the court to be a sham),[46] the court's actual holding in *CitX*—that deepening insolvency is not a viable theory of damages for negligence—is not unwarranted. The court noted that the accountants were charged only with "compiling" CitX financial statements, which constitutes the lowest level of financial-statement preparation after "auditing" and "reviewing,"[47] and it remains an open question whether deepening insolvency damages *should* even be made available for ordinary negligence.[48] It is not the holding itself that makes the *CitX* opinion so powerful. It is the impact, in conjunction with *Trenwick*, of the fact that this confluence of poor facts[49] gave the *Lafferty* court the opportunity to back off from its previous support of deepening insolvency once it had become clear that the tide of popular support for the theory may be turning.[50]

2. *"This Case Is Unusual"[51]: In re Trenwick*

Trenwick, on the other hand, takes the impact of bad facts to a whole new level. In pursuit of a deepening insolvency claim, not only does the *Trenwick* complaint fail to plead facts that would give rise to any inference that the corporation was actually insolvent at the time of the challenged transactions, but it also rests the entirety of its allegations on conclusory statements of some breach of fiduciary duty without any attempt at factual support.[52] It is easy to see how, in response to what is essentially an attack on the well-established business judgment rule with a claim for deepening insolvency tacked onto the end,, the Delaware Court threw the baby out with the bathwater.

Vice Chancellor Strine's condemnation of the *Trenwick* claims is right on point. However, what both the complaint and opinion have labeled a deepening insolvency claim is no such

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[46] *Id.* at 678. ("The District Court found Marks's affidavit ineffective in creating a genuine issue of material fact, for Marks in a subsequent deposition virtually disavowed the affidavit.").
[47] *Id*. at 675.
[48] The opinion itself recognizes that the trustee's contention that negligence can suffice for deepening insolvency has some support. *Id.* at 680-81.
[49] Such facts included the falsified affidavit of damages, the fact that the "corporation" itself was shown to be nothing more than a vehicle for fraud by its sole owner, that the accounting company had only a minimal duty to compile CitX financial statements rather than the fuller duties of an audit, and that the trustee's counsel conceded that the measure of damages for deepening insolvency in this case were completely identical to those for professional malpractice anyway. *See Id.* at 674, 675 n.3, 678, 678 n.9.
[50] Though *Lafferty* and the economic tort it interpreted Pennsylvania law as approving for fraudulent conduct have provoked much comment,[ ] that issue is not before us. Even if it were, we cannot revisit the correctness of that interpretation of Pennsylvania law. Although some courts in this Circuit have extended *Lafferty*'s reasoning to other states,[ ] nothing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania. . . . We know no reason to extend the scope of deepening insolvency beyond *Lafferty*'s limited holding.

Id. at 680-81 n.11 (internal citations omitted).
[51] The first sentence of the opinion written by Vice Chancellor Strine. *Trenwick*, 906 A.2d at 172.
[52] *Id.* at 172-73 (stating that "[a]lthough the complaint is full of inflammatory adjectival assaults on the motives of the holding company board, they are all of an entirely conclusory and unsupported nature", that in making its case, the complaint "does so by conclusory insult, not by fact pleading", that "[t]he complaint is entirely devoid of facts" and that it "failed to plead facts supporting the inference that either the holding company or its top U.S. subsidiary were insolvent at the time of the transactions challenged in the complaint.").

thing. As much as *Trenwick*'s breach of fiduciary duty claims evince a complete misapplication of existing law, so does its deepening insolvency claim evince a fundamental misunderstanding of the underlying theory. A true reading of *Trenwick* should reveal that what Vice Chancellor Strine rejects is not deepening insolvency itself but an extreme distortion of the type that has become increasingly commonplace in recent years.

The *Trenwick* litigation arose from a series of transactions in which Trenwick, a publicly listed insurance holding corporation, acquired three unaffiliated insurance companies in arms-length transactions as part of an overall growth strategy. The transactions at issue involved the acquisition of publicly traded entities and were approved by a vote of the holding company's stockholders. As a result of these transactions, the holding company redomiciled to Bermuda and reorganized its subsidiaries along national lines. The company's top U.S. subsidiary then became the intermediate parent of all U.S. operations and guarantor of the overall debt.[53] After the claims made by the insureds against the holding company's operating subsidiaries (including the insureds of the companies it had acquired) outstripped the company's capacity to service the claims, the holding company and its top U.S. subsidiary filed for bankruptcy. The Trust then filed suit based on what was essentially, in hindsight, an unsuccessful business strategy pursued by a group of largely independent directors with prior shareholder approval.[54]

The Trust attempted to augment its facially weak claims for breach of fiduciary duty and fraud with the term "deepening insolvency," and thus convincingly attached the term to a set of allegations so deficient as to provoke one of the most notably vehement responses from the Chancery Court in recent history. The root of the complaint's failings and the heart of the Chancery's response can be summed up in the first few paragraphs of the lengthy opinion:

> Had this claim been brought by a stockholder of the holding company, it would be easily stopped at the gate, because the complaint fails to plead a breach of fiduciary duty. This is not surprising given that it is unusual for arms-length transactions approved by majority independent boards and a diverse stockholder base to be subject to attack; after all, they are the quintessential transactions subject to the protection of the business judgment rule.
>
> Here, what the Litigation Trust relies upon to make up for its pleading deficiencies is the later-arising fact of insolvency. But that fact does not aid it.
>
> For one thing, the Litigation Trust has failed to plead facts supporting the inference that either the holding company or its top U.S. subsidiary were insolvent at the time of the transactions challenged in the complaint. For that reason, settled law indicates that the holding company owed no fiduciary duty to the top U.S. subsidiary or that entity's creditors. If the holding company, as controlling stockholder, owed no such duties, it is impossible to fathom how the holding company's directors owed such duties.[55]

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[53] *Id.* at 172.

[54] *Id.* at 174 ("What Delaware law does not do is to impose retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out. That is what the Litigation Trust seeks here, to emerge from the wreckage wielding the club that the holding company's own failed subsidiary can now accuse the holding company's directors of a breach of fiduciary duty. To sanction such a bizarre scenario would undermine the wealth-creating utility of the business judgment rule.").

[55] *Id.* at 173.

From these first few indictments of the *Trenwick* complaint stems the root of the Chancery Court's rough treatment of deepening insolvency theory. When attached to the allegations that provoked the above rebukes, it is not hard to see why deepening insolvency, as conceived in *Trenwick*, provoked an equally violent response.[56].

In a complaint where insolvency is not even satisfactorily alleged, a claim based on a "theory of deepening insolvency" is completely inapplicable.[57] Had the *Trenwick* complaint not included deepening insolvency among its milieu of easy targets at the precise time when similar misapplications of the concept have garnered increasing criticism around the country, perhaps the Chancery Court would never have staked out such an entrenched position against the theory. Unfortunately, at this point, we may never know.

E. Forging Ahead: *In Re Greater Southeast Community Hospital*

Despite the tidal wave of negative publicity generated by the *Trenwick* opinion, not all courts have since refused to acknowledge the merits of deepening insolvency. One such court is the District of Columbia Bankruptcy Court, which, almost one month to the day after *Trenwick*, reaffirmed the validity of deepening insolvency as a theory of harm, if not a separate cause of action, in *In re Greater Southeast Community Hospital*.[58] After a previous ruling sustaining deepening insolvency as a theory of damages in this case,[59] the court acknowledged the need to reconsider the trustee's theory of harm in light of the Third Circuit's recent *CitX* opinion. Notwithstanding a careful review of *CitX*, the court nonetheless stuck to its guns and declared that "the court remains convinced that it reached the right result in its prior opinion. There is no way to make sense of *Lafferty* . . . otherwise."[60]

The court went further in its indictment of *CitX*, stating that

> [t]he court is equally unmoved by the Third Circuit's decision to restrict recoveries for deepening insolvency to actions involving fraud. If deepening insolvency were treated as a separate cause of action rather than as a theory of harm, it would make sense to require a higher threshold of scienter than mere negligence lest the tort expose directors and third parties to a standard of care that they otherwise would never have owed in the first place. *CitX* attempted to

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[56] *See id.* at 174-75:

> Refusal to embrace deepening insolvency as a cause of action is required by settled principles of Delaware law. So, too, is a refusal to extend to creditors a solicitude not given to equityholders. . . .
>
> The incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries.
>
> The general rule embraced by Delaware is the sound one. So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equity holders. Even when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective.

[57] In contrast to the allegations in *Trenwick*, a glance back at the fundamental deepening insolvency case, *Schacht v. Brown*, should draw a sharp distinction.

[58] Alberts v. Tuft ("Alberts II"), 2006 Bankr. LEXIS 2419 (Bankr. D.D.C. 2006).

[59] *See Alberts I*, 333 B.R. at 516-17.

[60] *Alberts II*, 2006 Bankr. LEXIS 2419, at *13.

> resolve this inherent problem (i.e., the danger that the scienter requirement for the 'tort' of deepening insolvency would be unduly broad) by imposing a fraudulent intent requirement instead.[61]

This *post hoc* solution crafted by the Third Circuit in *CitX* is one that the D.C. court, for one, saw through and refused to go along with.[62] It is this type of eyes-wide-open analysis through which deepening insolvency stands a chance for resuscitation. Hopefully, *Greater Southeast* will act as the first step in rebuilding the theory from the ground-up, as it was originally meant to be.

III. POTENTIALLY RESPONSIVE CAUSES OF ACTION

A claim for deepening insolvency often encompasses different elements of several different existing causes of action. The common criticism of deepening insolvency as its own cause of action is that it duplicates those already existing. However, "what is missing" from the debate thus far "is an analysis of whether a present remedy is actually lacking."[63] This Section responds to that long-unanswered question—and, as further fleshed out below, responds that the answer is yes. In the context of deepening insolvency harms, a present remedy is actually lacking.

Unfortunately, the existing remedies available to unsecured creditors are few and far between.[64] More often than not, in fact, "the only remedy available to the unsecured creditor is to file a lawsuit in an appropriate court, proceed to judgment and execute against whatever property of the debtor may then be found, provided it is not exempt from execution."[65] Moreover, these existing causes of action are often insufficient to encapsulate the full harm caused by deepening insolvency. The effort to force deepening insolvency damages into the

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[61] *Id.,* at *14-15.

[62]
> There is no way to make sense of *Lafferty* without concluding that the deepening of a company's insolvency can be harmful; otherwise, the *Lafferty* court could not have concluded that fraudulent conduct leading to the deepening of a company's insolvency constitutes tortious activity. Nor is this court aware of any common law principle holding that an injury sustained as a result of one tort (fraud) is somehow not an injury when it is caused by a different tort (negligence), as the *CitX* court seems to suggest. The cause of an injury might determine whether a tort occurred, but it does not determine whether the injured person suffered an injury in the first place. . . .
>
> The *Lafferty* court, however, did not fix its star upon the notion that deepening insolvency was a tort. Instead, it concluded that the accumulation of debt by an insolvent entity could, in certain circumstances, be harmful to the corporation. *Lafferty*, 267 F.3d at 349-50. These injuries can occur as a result of management's negligence just as easily as they can due to management's fraud, and management (unlike a third party with no special relationship to the company) owes a duty of care to its corporate client. *The link made by the* CitX *court between deepening insolvency and fraudulent intent is therefore an arbitrary one* unless one makes the equally arbitrary determination that deepening insolvency is a (hitherto unknown) tort of its own, in which case officers and directors who, without engaging in fraud, breach--even grossly breach--their duty of care in a harmful manner would be insulated from their wrongdoing.

See id. at *13-14, 15-16 (emphasis added).

[63] John J. Rapisardi, *A Tale of Two Cases: Differing Approaches to "Deepening Insolvency",* NEW YORK LAW JOURNAL (Sept. 30, 2005). Although this quote refers specifically to the Third Circuit's decision in *Lafferty*, it is equally applicable to the treatment of the topic as a whole since then.

[64] "The remedies available to the unsecured creditor are relatively few and frequently unsatisfactory." NORTON, *supra* note 17, at § 7.2.

[65] *Id*.

current framework of existing causes of action in a patchwork fashion has proven insufficient to address the complexity and nuances of deepening insolvency harm. Nonetheless, there are some causes of action through which unsecured creditors can attempt to gain recompense for certain discrete elements underlying the harm of deepening insolvency.

A. To Preserve Existing Assets

The Federal Bankruptcy Code does supply limited remedy for unsecured creditors, provided they are aware of the true financial state of the corporation and can timely act on that knowledge. Although instituting insolvency proceedings can ensure court supervision over a debtor's existing assets, the relevant procedures involved (such as the appointment of receivers to oversee the process) are often done for the benefit of the debtor to protect the estate from the competing claims of its creditors.[66] Creditors concerned about the further dissipation of corporate assets have the ability to institute involuntary bankruptcy proceedings (in the case of a currently operating corporation)[67] or to request prejudgment garnishment and attachment of the debtor's property or assets (in the case of an insolvent corporation).[68]

However, each action requires a strong showing on the creditors' part and often entails further requirements that make them "cumbersome device[s] to use as a remedy."[69] Involuntary bankruptcy will stay most actions by competing creditors, such as preferred and secured creditors, that will remove more value from the estate than satisfies their claims or that unsecured creditors believe should be sublimated. However, it is a particularly cumbersome procedure and can destroy the ongoing concern of the corporation and its ability to restructure and recuperate. Similarly, to request prejudgment garnishment, creditors often must be able to post of a bond in the amount that would compensate debtor in the event the creditor is unsuccessful and offer proof via an affidavit or testimony that the debtor does not have other property within the state subject to execution sufficient to satisfy the indebtedness, that the debtor is about to remove the property from the jurisdiction, that the debtor is secreting property in order to defraud creditors, or that there exists some other basis to conclude that the creditor probably will be unable to collect upon the debt unless this is permitted.[70]

Both of these remedies, of course, also presume that the creditors are aware and in possession of evidence regarding the possible dissipation of assets. In many situations of deepening insolvency, creditors do not become aware of the corporation's true financial peril

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[66] *See id.* at § 7.4.

[67] A[n] involuntary bankruptcy petition may be appropriate where the debtor is managing or dissipating its assets or is engaged in other misconduct harmful to creditors generally. . . . Further, an involuntary bankruptcy petition may be appropriate where the debtor has made transfers that are preferential or fraudulent that must be recovered in order for the petitioning creditors to receive any recovery.

Id. at § 7.5. *See* 11 U.S.C. § 303 (2005).

[68] NORTON, *supra* note 17, at § 7.3. Whether issuance and service of a garnishment order creates a lien on specific property in the hands of the debtor is determined by the particular state's enabling statutes. *See* In re John Galt Energy, Inc., 75 B.R. 658, 667 (Bankr. E.D.N.Y. 1987) (citing 38 C.J.S. Garnishment § 181 (1943)). *See also* In re Flynn, 238 B.R. 742 (Bankr. N.D. Ohio 1999) (Permitting prejudgment garnishment order obtained by creditor against debtor in state court civil action as debt secured by lien under 11 U.S.C. § 522(c)(2) (2005)).

[69] NORTON, *supra* note 17, at § 7.5.

[70] *Id.* at § 7.3.

until the corporation collapses and there are little or no assets left to divide between the remaining claims—thus compelling the necessity of a separate cause of action to recapture the improperly lost or stolen assets.

B. To Recapture Lost Assets

State fraudulent transfer laws, like all causes of action listed herein, do not technically provide the creditor with a remedy for the enforcement of its claim against the debtor. Instead, they make assets available for subsequent assignment between creditors claims.[71] Fraudulent transfer, fraud, breach of fiduciary duty, professional malpractice, and civil conspiracy are the most closely analogous causes of action to deepening insolvency and are often the most frequently applied.[72] As to claims against management, unsecured creditors, via the bankruptcy trustee, can attempt to void transfers from the debtor estate that are made without sufficient return consideration, are unfairly beneficial to third parties, or are motivated by a desire to avoid creditor claims.[73] The voiding of such preferential transfers can assist unsecured creditors in recouping some of the assets that were improperly dissipated from the estate. This can be a valuable tool since their remedies are generally otherwise quite limited.[74]

Creditors often also allege claims for fraud and breach of fiduciary duty against management in situations of deepening insolvency.[75] In cases where insolvency was concealed and perpetuated through managerial fraud (either together with or in the absence of looting), there often lies a strong claim for common law fraud or breach of fiduciary duty. However, as further discussed below, when brought either by unsecured creditors or the trustee of the insolvent estate, these causes of action are often wholly precluded by issues of standing or affirmative defenses, leaving the creditors and estate without further recourse.

To the extent that a third party, such as an outside professional advisor, assisted management in the fraudulent scheme, the unsecured creditors can attempt to collect damages by bringing a claim for professional malpractice, negligent misrepresentation, or civil conspiracy. Where an outside advisor was knowingly complicit in the fraud, a stronger cause of action for recouping the full measure of resulting asset dissipation will lie. However, where the outside advisor was merely a negligent accessory in the overall scheme, but in breach of contractual duties in not discovering and preventing the fraud, unsecured creditors may only be able to recover some small measure of damages in the amount of fees paid and/or contractual damages.[76] Again, however, problems of standing and affirmative defenses may

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[71] In a liquidation case, it is commonplace for a trustee to pursue an action on behalf of the debtor in order to obtain a recovery thereon for the estate. If the trustee is successful in the action, the recovery which he obtains becomes property of the estate and is then distributed pursuant to the scheme established by § 726(a) [of the Bankruptcy Code].

Lafferty, 267 F.3d at 349 (citing Jack Greenberg, Inc., 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999)).

[72] *Cf. Bondi v. Bank of Am.*, 383 F. Supp. 2d at 601; Nisselson v. Ford Motor Co., 340 B.R. 1, 33 (Bankr. E.D.N.Y. 2006); Marwil v. Grubbs (2004 WL 22787521 (S.D. Ind. Sept. 30, 2004); In re CBI Holding Co., 318 B.R. 761, 766 (Bankr. S.D.N.Y. 2004); *In re Mediators*, 105 F.3d at 825-26; *Breeden*, 336 F.3d at 102; *Lafferty*, 267 F.3d at 340; *Schacht*, 711 F.2d at 1343; *Production Res.*, 863 A.2d at 772; *Del-Met*, 322 B.R. at 781; Pereira v. Farace, 413 F.3d 330, 342 (2d Cir. 2005); Baena v. KPMG, L.L.P., 453 F.3d 1 (1st Cir. 2006).

[73] 11 U.S.C. § 547(b) (2007).

[74] NORTON, *supra* note 17, at § 7.6.

[75] *Id.* at § 7.5.

[76] *Cf. In re CitX*, 448 F.3d at 672 (holding that professional advisors' negligence will not sustain claim for deepening insolvency).

preclude unsecured creditors or trustees from asserting fraud or conspiracy claims against third parties where management was complicit in the scheme.

Lastly, unsecured creditors have lately begun to pursue causes of action against secured lenders who provided debt financing to insolvent corporations in return for unfairly beneficial terms or interest rates. This type of claim should not be confused with a hysterical "lender liability" trend for all post-insolvency loans made in attempt to aid corporate turnaround. Emergency lenders are not liable for loans made in good faith to salvage floundering corporations. Held liable will be only those lenders who are in knowing collusion with management's fraudulent scheme or who attempt to extract unfairly beneficial loan terms in return for emergency capital where there is little hope of success and the corporation is under clear financial duress.[77] Where the harm stems from the unfair subordination of existing creditors' unsecured claims to a newer secured creditor (rather than lender collusion with management in an underlying fraudulent scheme), equitable subordination may be an adequate remedy not to recapture lost assets, but to stake a superior claim in the priority chain to the remaining assets. This claim will only be applied to lenders who have engaged in some sort of inequitable conduct themselves that has resulted in the injury to creditors or has conferred an unfair benefit on themselves.[78] Moreover, where the lender is not a corporate "insider," there is a heightened burden of proof placed on the plaintiff to justify equitable subordination of the defendant's claim.[79]

IV. THE INADEQUACY OF EXISTING CAUSES OF ACTION

The inadequacy of current market incentives and existing causes of action to adequately protect creditors in this situation is not a recently-discovered fact. The idea of debt financing as a discipline on management to tread with caution lest they lose their jobs or their stake in the equity value of the firm that would remain after debt repayment is simplistic and theoretical in today's complex market.[80] Where firms are not bound by the expiry of a single debt load signaling insolvency and the transfer of assets to creditors, but instead finance multiple projects with multiple loans of different source and maturity, the expiry of one does not carry this same gravity.[81] Instead, firms are able to juggle various loan structures, often

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[77] *Cf. Production Res.*, 863 A.2d at 775 (The wife of defendant director provided sufficient debt funding to keep insolvent corporation afloat, though not enough to repay existing creditors, in exchange for securing preferred status over plaintiff and all other existing creditors with right of foreclosure to collect on debt, effectively becoming company's de facto controlling shareholder. Meanwhile, numerous unrelated companies controlled by her family withdrew salaries as "paid consultants" from the corporation). *See also* NORTON, *supra* note 17, at § 8.3.

[78] Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 986-87 (3d Cir. 1998) (To state a claim for equitable subordination, a plaintiff must plead three elements: "(1) the defendant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the defendant; and (3) equitable subordination must not be inconsistent with the provisions of the bankruptcy code [sic].").

[79] Fabricators, Inc. v. Technical Fabricators, Inc., 926 F.2d 1458, 1465 (5th Cir. 1991) (holding that when the defendant is not an insider, the burden on the plaintiff is greater and the plaintiff must prove gross or egregious conduct such as "fraud, spoliation or overreaching" in order to justify equitable subordination.).

[80] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). *See also* Adler, *supra* note 13, at 1171-72.

[81] *See* Adler, *supra* note 13, at 1172 for a thorough analysis of this argument. *See also* Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989).

replacing expiring capital with new debt financing and thus remaining operational despite true insolvency. However, if the pending projects prove unfeasible in the end, it is the existing unsecured creditors who will bear the cost of the new loans.[82] As such, it is then in the best interest of management and equity holders to sustain the corporation via new debt as long as they can still acquire it, "a gamble paid for by the extant early creditors" if these efforts fail.[83]

One proposed solution to this inefficiency lies in adjusting the incentives of management and equity holders of insolvent corporations on the front end by accelerating the process of financial distress and making further over-investment by insolvent firms unfeasible.[84] Moreover, an expansion of the "earmarking doctrine"—a common-law exception to the Bankruptcy Code's voidable preference rules[85] negating voidability where the funds from a new loan were "earmarked" to satisfy a prior loan and were then used for this purpose—may also help direct the benefits of new debt financing to the proper beneficiaries (the prior unsecured creditors) rather than into the bottomless pockets of the failing corporation.[86] On the back end, however, another solution to this problem is a cause of action for deepening insolvency, allowing the prior unsecured creditors to recoup the extent of assets that should have been left to them had management not encouraged the prolongation of insolvency through new debt financing and enabled the resulting dissipation of corporate assets during that time.

Although the following causes of action are currently available to unsecured creditors to recover wrongly dissipated assets, there are major encumbrances to the success of each. Even if successful, these causes of action do not provide any method for enforcing creditor claims against the insolvent estate; they merely recapture additional assets available for later assignment and distribution.[87] Regardless of success, the available causes of action often address only certain elements of deepening insolvency (such as the underlying fraud or certain, identifiable fraudulent transfers) in a piecemeal fashion. None is sufficient to address the full scope and complexity of the harm of deepening insolvency alone, nor to equally target all relevant participants in the overarching scheme.

Before addressing the inadequacies of existing causes of action individually, however, it pays to address two major roadblocks that inhibit the ability of creditors and trustees to recover damages under a majority of those available: the affirmative defense of *in pari delicto* and the issue of standing to pursue a claim.[88] These two problems will continue to arise as a constant theme throughout this analysis.

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[82] "Absent protection for these unmatured obligations, then, management and equity can use new capital to avoid debt's discipline and continue their interest in a firm." Adler, *supra* note 13, at 1172.
[83] *Id.*
[84] *Id.*
[85] *See* 11 U.S.C. § 547 (2007) (The Bankruptcy Code allows an insolvent debtor who fully repays an unsecured creditor within ninety days of the debtor's bankruptcy filing to void such transfers and recoup the funds back to the estate).
[86] *See* Adler, *supra* note 13, at 1174-76.
[87] *See Lafferty,* 267 F.3d at 349.
[88] Although some courts have analyzed the question of *in pari delicto* as a threshold question of standing rather than an affirmative defense, the analysis applied is the same for the purpose of this discussion. Because of the confluence of standing and *in pari delicto* issues in deepening insolvency cases, the questions raised by each often overlap regardless of the framework of the analysis. *See, e.g.,* Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 147, 158 (2d Cir. 2003) (treating *in pari delicto* as an affirmative defense under Texas law); In re Hampton Hotel Investors, L.P., 289 B.R. 563, 574 n.18 (Bankr. S.D.N.Y. 2003) (equating Second Circuit "standing" version of analysis with *in pari delicto* doctrine).

A. "In Pari Delicto"

Often, the most difficult hurdle to overcome in actions based on an underlying deepening insolvency scheme (such as breach of fiduciary duty, fraud, or civil conspiracy) is the defense of *in pari delicto*.[89] Case law in this area is very well developed. *In pari delicto* evolved from the principles of agency to prevent a party who shares responsibility for wrongdoing to collect damages from a co-conspirator for the result of their joint actions.[90] In the legal fiction of corporate personhood, actions performed by directors and officers in their capacity as corporate agents are generally imputed to the corporate principal.[91] Where these actions include fraud, the imputation of managerial fraud to the corporate principal can prevent a corporate plaintiff from later suing management or third party conspirators for damages stemming from that fraud.[92] Both managers and third parties can assert this privilege as an affirmative defense to liability by arguing that *in pari delicto* precludes the corporate plaintiff's claims.[93]

The sole recognized exception to this doctrine allows a corporate plaintiff to recover for the actions of its managers where these actions are adverse to the interests of the corporation.[94] This exception affords that

> [W]hen an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person, the presumption that knowledge held by the agent was disclosed to the principal fails because he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose.[95]

However, *in pari delicto* generally enjoys a wide latitude of application, and the "adverse interest" exception has been restricted to cases where management's actions are *completely* contrary to corporate interests.[96] Courts have found that "[t]o come within the exception, the

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[89] The full maxim, *in pari delicto potior est conditio defendentis*, is derived from Latin, meaning "[i]n a case of equal or mutual fault ... the position of the [defending] party … is the better one." Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985) (citing Black's Law Dictionary 711 (5th ed. 1979)).

[90] *In pari delicto* "is a doctrine commonly applied in tort cases to prevent a deliberate wrongdoer from recovering from a co-conspirator or accomplice." *KPMG*, 453 F.3d at 6. *See also Bateman Eichler*, 472 U.S. at 306 ("The defense is grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.").

[91] *KPMG,* 453 F.3d at 7 (citing RESTATEMENT (SECOND) OF AGENCY § 257 (1958)).

[92] Because managerial decisions are imputed to the corporation according to the laws of agency, the corporation is prohibited from in effect suing itself. *See KPMG*, 453 F.3d at 7 (citing RESTATEMENT (SECOND) OF AGENCY § 257 (1958)). *See also Bondi v. Bank of Am.*, 383 F. Supp. 2d at 596 ("This straightforward principle would appear to bar recovery by [the trustee] from [the defendant bank] . . . .").

[93] When creditors or trustees sue third parties on behalf of a corporation, state law provides the rule of decision and determines whether the conduct of wrongdoing managers shall be imputed to the corporation. *See* O'Melveny & Myers v. F.D.I.C., 512 U.S. 79, 83 (1994).

[94] RESTATEMENT (SECOND) OF AGENCY § 282(1) (1958). *See also KPMG*, 453 F.3d at 7; *Lafferty*, 267 F.3d at 359.

[95] *See* Center v. Hampton Affiliates, Inc., 488 N.E.2d 828, 829 (N.Y. 1985).

[96] *Bateman Eichler*, 472 U.S. at 307 (recognizing that "[n]otwithstanding these traditional limitations [of the adverse interest exception], many courts have given the *in pari delicto* defense a broad application to bar actions where plaintiffs simply have been involved generally in 'the same sort of wrongdoing' as defendants."). *See also* Wight v. BankAmerica Corp., 219 F.3d 79, 87 (2d Cir. 2000) (holding that the "adverse interest exception" is

agent must have totally abandoned his principal's interests and be acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." Where managerial actions exhibit any slight benefit to the corporation whatsoever, even inadvertently so, *in pari delicto* will apply to preclude the "adverse interest" exception.[97] Despite the Seventh Circuit's original analysis in *Schacht*, that "[c]ases [that oppose deepening insolvency] rest[] upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests,"[98] courts have repeatedly found that the extension of corporate life, even in perpetuation of fraud and even when resulting in corporate demise, extends a temporary benefit to the corporation sufficient for *in pari delicto* to apply.[99] Generally, the only instance in which *in pari delicto* is universally held inapplicable is where the complaint alleges unlawful looting of corporate funds.[100]

While the doctrine makes sense in its original context, it has become distorted in its application to self-dealing insiders as agents of the corporate principal.[101] And even further so in cases of insolvency. Because trustees only assert claims belonging to the corporation before bankruptcy, courts are prohibited from considering that a deepening insolvency cause of action is brought on behalf of a corporate plaintiff now purged of culpable management and operated solely for the benefit of residual harmed creditors—necessarily innocent parties to the scheme and not culpable colluders.[102] Although some courts have recognized the practical fallacy of this result, they are generally reluctant to upset this doctrine.[103]

"narrow."); In re Sharp Int'l Corp., 278 B.R. 28, 37 (Bankr. S.D.N.Y. 2002) (holding that to qualify for the adverse interest exception, the agent must have "totally abandoned" the principal's interests).

[97] *In re VarTec.*, 335 B.R. at 637 (citing *Bloor*, 523 F. Supp. at 541, for the proposition that "the 'adverse interest' exception applied if the agent acted adversely to the interest of his 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.'").

[98] *Schacht*, 711 F.2d at 1350.

[99] *KPMG,* 453 F.3d at 7 (citing Am. Soc'y of Mech. Eng'rs, Inc. v. Hydrolevel Corp., 456 U.S. 556, 575-76 (1982)) ("A fraud by top management to overstate earnings and to facilitate stock sales or acquisitions is not in the long-term interest of the company. However, like price-fixing, it profits the company in the short-term and therefore the company is still civilly and criminally liable for management's actions."); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) (where "a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage to the creditors."). *See also* RESTATEMENT (SECOND) OF AGENCY § 282(1) (1958).

[100] *See Bondi v. Bank of Am*., 383 F. Supp. 2d at 599.

[101] *See Bateman Eichler*, 472 U.S. at 306-307 (recognizing that "[i]n its classic formulation, the *in pari delicto* defense was narrowly limited to situations where the plaintiff truly bore at least substantially equal responsibility for his injury, because in cases where both parties are *in delicto*, concurring in an illegal act, it does not always follow that they stand *in pari delicto*; for there may be, and often are, very different degrees in their guilt.").

[102] *See Lafferty,* 267 F.3d at 357 ("The plain language of section 541 [of the Bankruptcy Code], however, prevents courts from taking into account events that occur after the commencement of the bankruptcy case. As a result, we must evaluate the in pari delicto defense without regard to whether the Committee is an innocent successor.").

[103] *See, e.g., KPMG*, 453 F.3d at 5 (applying *in pari delicto* despite acknowledging that the defense's argument against applying the adverse interest exception is conceptually flawed), stating:

> This is the argument that inflating its earnings cannot have injured [the corporation] itself: at worst, this inflation led [the corporation] to borrow and expend money on the strength of its

B. Standing to Pursue a Cause of Action

The standing problem arises from the confluence of the Article III "case and controversy" requirement, the trustee's role as proxy for the post-insolvency corporate entity, and the recent development of "zone of insolvency" jurisprudence.[104] The result is the legal equivalent of a dog chasing its own tail to no appreciable end. Because the trustee is prohibited in many cases by *in pari delicto* from asserting claims on behalf of the corporation, the solution would seem to be for creditors to assert such claims. The problem is that creditors often lack the required standing to assert many of the available causes of action. For example, creditors by definition lack standing to assert breach of fiduciary duty claims against management since directors and officers owe fiduciary duties only to the corporation's shareholders, not its creditors.[105] Looking briefly ahead, they also lack the required privity of contract to assert professional malpractice and other contract-based claims against outside advisors.[106]

1. The "Wagoner Rule"

Due to the so-called "Wagoner Rule,"[107] trustees are generally prohibited from assuming claims belonging to creditors in order to circumvent the standing issue.[108] This principle is based on the Supreme Court ruling in *Caplin v. Marine Midland Grace Trust Co.*[109] and on the general Article III requirement that "[a] party 'must assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties.'"[110]

> false documents--but for which [it] received valuable assets in the acquisition of [two subsidiary companies].
>
> The intuitive appeal of such arguments is that where a company inflates its earnings, the victims may appear to be only others (who loan it money or buy its stock) and the company may seem to be the culprit rather than an 'injured' party. Yet, if one looks at long-term consequences, the company may suffer as well (witness Enron). Federal courts have been unsympathetic to this kind of "no harm" argument, devising counter-doctrines [such as deepening insolvency] to answer it.

[104] Standing in this analysis refers to the legal requirement under Article III, Section 2 of the Constitution for parties to have a "'personal stake in the outcome of the controversy'" to merit a remedy in federal court. *Wagoner,* 944 F.2d at 118 (citing Warth v. Seldin, 422 U.S. 490, 498-99 (1975)).

[105] This general rule is subject to change once a corporation enters the "zone of insolvency," at which point the corporate managers' fiduciary duties may shift more strongly toward the corporation's creditors. *See* Credit Lyonnais Bank Nederland, N.V., v. Pathe Commc'ns Co., 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. 1991). The implications of this anomaly will be discussed more fully below.

[106] Further discussed in Section IV.E.1, *infra.*

[107] Although *Wagoner* exists as controlling law only within the Second Circuit, the agency principles regarding the imputation of fraud by management to the corporation as a whole are generally held in most jurisdictions. Therefore, although this rule will be referred to as the *Wagoner* holding throughout the discussion, it is understood that *Wagoner* itself may not control in all relevant jurisdictions.

[108] *See Wagoner*, 944 F.2d at 119-20 (bankruptcy trustee lacks standing to bring claim against outside firm for aiding and abetting management "in making bad trades that dissipated corporate funds" because this claim belongs exclusively to creditors).

[109] 406 U.S. 416 (1972) (affirming Second Circuit's ruling that petitioner's powers as a bankruptcy trustee were not broad enough to maintain an action for misconduct on behalf of debenture holders against respondent as debtor's indenture trustee).

[110] *Wagoner,* 944 F.2d at 118 (citing Warth v. Seldin, 422 U.S. 490, 499 (1975)).

Courts have been clear, however, that although the proposition that "where the injury is to all creditors as a class, it is the creditors who lack standing and the Trustee who may bring a claim based on that generalized injury"[111] may be true (because claims that injure all creditors as a class normally belong to the corporation derivatively), this does not imply that the trustee's rights are greater than the rights the corporation itself would have against malfeasant directors.[112] Therefore, the trustee may not assert creditor claims that the corporation itself would have been blocked from asserting based on *in pari delicto*.

Courts have found that claims belonging exclusively to creditors to the exclusion of the trustee include aiding and abetting breach of fiduciary duty,[113] fraud by outside advisors,[114] and negligence by outside advisors in evaluating financial statements.[115] Claims belonging to the corporation to the exclusion of creditors, on the other hand, include breach of fiduciary duty,[116] breach of contract,[117] professional malpractice,[118] and negligent misrepresentation.[119] Although some courts have since attempted to soften this prohibition,[120] it remains largely in effect today both for claims against corporate management and against outside advisors.[121]

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[111] *See Production Res.*, 863 A.2d at 792-93.

[112] *Pereira*, 413 F.3d at 342 (citing Kalb Voorhis & Co. v. Am. Fin. Co., 8 F.3d 130, 132-33 (2d Cir. 1993)).

[113] *See In re Mediators*, 105 F.3d at 825-26 ("Where third parties aid and abet a fiduciary's breach of duty to creditors . . . [the claim] belong[s] to the creditors qua creditors."). *See also Wagoner*, 944 F.2d at 120 ("A claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors.").

[114] *See In re CBI Holding*, 318 B.R. at 766 ("[A] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors."); *Breeden*, 336 F.3d at 102 ("'Even when defrauded creditors assigned to the trustee their claims against another for aiding and abetting the fraud the trustee lacked capacity to sue.'") (citing *Wagoner*, 944 F.2d at 118). *But see Greenleaf Ventures*, 269 B.R. at 728 (Because the complaint "describes [the] financial deterioration of the Debtor, . . . [t]hese facts may support a claim for damages incurred by the Debtor [itself]" that is actionable by the Trustee).

[115] *See* discussion, *infra,* Section IV.E.2. *See also In re CBI Holding*, 318 B.R. at 766-67; *Breeden*, 336 F.3d at 102.

[116] *See Production Res.*, 863 A.2d at 792-93 (holding that breach of fiduciary duty of loyalty and care claims belong to the corporation, not the creditors, and may only be asserted by creditors derivatively through the trustee).

[117] Only the contracting party (e.g., the corporation) has standing to assert a claim based on a breach of that contract. *See* Bd. of Educ. of City of Chicago v. A, C & S, Inc., 546 N.E.2d 580, 591 (Ill. 1989).

[118] Professional malpractice is a claim based on the breach of a contractual duty. *See Wagoner,* 944 F.2d at 114, *supra* note 107.

[119] For negligent misrepresentation, a plaintiff must also allege that the defendant owes a duty to the plaintiff to communicate accurate information. *See Chicago v. A, C & S*, 546 N.E.2d at 591.

[120] *See, e.g.,* Koch Refining v. Farmers Union Central Exchange, Inc., 831 F.2d 1339, 1348-49 (7th Cir. 1987) (permitting Trustees to assert creditor claims where held by all creditors); *Production Res.,* 863 A.2d at 792-93 (holding that claims that injure all creditors as a class normally belong to the corporation and are actionable by the trustee); In re Weisbrod, 138 B.R. 869, 871 (Bankr. S.D. Ohio 1992) (holding that a Trustee has standing to assert creditor claims "[s]ince the Bankruptcy Act has been superseded by the Bankruptcy Code, the statutory basis for the *Caplin* case no longer exists."). *See also* St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc., 884 F.2d 688 (2d Cir. 1989); *Pereira*, 413 F.3d at 342.

[121] *See, e.g., Trenwick*, 906 A.2d at 191 ("bankruptcy law is clear that litigation trusts do not have standing to pursue the direct claims of creditors"). *See also* Rodolakis v. Shadduck, 208 B.R. 1, 5 (Bankr. D. Mass. 1997) (recognizing that although "[s]ome decisions . . . permit a trustee to prosecute claims of creditors if the claims are held by all creditors rather than just some . . . . A trustee's difficulty in these cases is lack of statutory authority to bring any creditor claim, whether the claim is held by some or all creditors"); Steinberg v. Buczynski, 40 F.3d 890, 893 (7th Cir. 1994) (stating that *Koch*'s distinction between "general" and "personal" claims "is not an illuminating usage"); *Wagoner*, 944 F.2d at 118-20 (relying on *Caplin* and not *Koch* in denying trustee standing to assert dissipation claims of creditors).

C. Adding "Zone of Insolvency" Jurisprudence Into the Mix

When a corporation is at or near the point of insolvency, the fiduciary duties owed by managers shift from shareholders alone to the more general "corporate enterprise."[122] In this so-called "zone of insolvency," directors and officers must weigh the interests of all corporate stakeholders (including the stockholders, creditors, employees, and any other group with interests in the corporation) in determining the best course of action for the corporation.[123] Although intended to provide corporate management with a shield against liability for actions taken within the "zone,"[124] this ruling has also created a quasi-affirmative duty to such groups where none previously existed.[125] The danger of which, of course, is that directors and officers may now face an increased risk of liability from creditors for pursuing shareholder-friendly strategies and from shareholders for choosing creditor-friendly strategies within the "zone".[126]

Further complicating the situation is the longstanding principle that, at the point of insolvency, creditors assume the place of equity holders as the corporation's primary stakeholders—and with it the corresponding fiduciary duties owed them by corporate management.[127] However, while creditors assume priority over shareholders at the point of insolvency, insolvency does not grant creditors the full and equal extent of rights previously enjoyed by shareholders.[128] Instead, insolvency simply expands the pool of stakeholder

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[122] [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency,

> circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Credit Lyonnais, 1991 Del. Ch. LEXIS at *108, n.55

[123] *See id.*

[124] Although the Delaware Chancery Court has attempted, in the wake of new "zone of insolvency" litigation, to curb the increased risk of liability to directors and officers from their expanded duties, it is always notoriously difficult to put the genie back in the bottle.

> *Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations. By providing directors with this shield, creditors would derive a clear benefit because directors, it can be presumed, generally take seriously the company's duty to pay its bills as a first priority.

See Production Res., 863 A.2d at 788

[125]

> Creative language in a famous footnote in *Credit Lyonnais* was read more expansively by some, not to create a shield for directors from stockholder claims, but to expose directors to a new set of fiduciary duty claims, this time by creditors. To the extent that a firm is in the zone of insolvency, some read *Credit Lyonnais* as authorizing creditors to challenge directors' business judgments as breaches of a fiduciary duty owed to them. Some cases in the courts of other jurisdictions have embraced this reading.

See id. at 789.

[126] *See* Silberglied & Newmarch, *supra* note 7.

[127] *See* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("When the insolvency exception [arises], it creates fiduciary duties for directors for the benefit of creditors."); *Production Res.,* 863 A.2d at 790-91 ("When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors.").

[128] *See Production Res.*, 863 A.2d at 790 n.57 ("[W]hen a firm is insolvent, creditors do not become residual claimants with interests entirely identical to stockholders, they simply become the class of constituents with the key claim to the firm's remaining assets.").

interests that directors and officers have both the right and duty to consider in charting the course of the corporation, placing the creditors in the primary position.

The emergence of "zone of insolvency" jurisprudence has rendered the question of the duties owed to corporate stakeholders by management of an insolvent corporation increasingly difficult to determine. Not only does established law create an affirmative duty to creditors at the point of insolvency, but there now exists some nebulous realm prior to this point in which management may also have the right (or duty) to consider the creditor interests in the ongoing corporate concern—interests that may well diverge quite significantly from those of shareholders.[129] This has created a confusing and sometimes conflicting set of obligations, further muddying the waters surrounding the question of standing to pursue post-insolvency claims.

The difficulty in navigating the question of standing in the post-insolvency realm has arisen more and more frequently as courts struggle to tow the line between adhering to the traditional precedent and enabling a rational result.[130] Unfortunately, as deepening insolvency continues to be asserted via an inadequate amalgamation of existing causes of action, and various courts continue to apply their own *ad hoc* remedies to resolve the difficulty, this general body of law is becoming increasingly tangled and internally inconsistent.

1. The Application of "Zone" Jurisprudence Evinces Misunderstanding

In this light, the artificial distinction between the "creditors" and the "corporation" for purposes of determining standing to pursue post-insolvency claims against management and outside professional advisors becomes even more confusing. It is well established that creditors have standing to pursue derivative claims against management once a corporation has become insolvent, even for actions taken prior to insolvency that harmed creditor interests.[131] Therefore, if at the point of insolvency, creditors become the key claimants to the firm's remaining assets, then any managerial actions that are adverse to the interests of the corporation are, by definition, adverse to the interests of the creditors as well. In the case of deepening insolvency, this would certainly include the deliberate concealment of insolvency

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> The "zone" issue is an admittedly confusing one. For example, once a firm becomes insolvent, there is little doubt that creditors can press derivative claims arguing that directors' pre-insolvency conduct injured the firm, which makes some of the Bankruptcy Court decisions discussing the zone interesting dictum. The more difficult issue is whether there is a zone in which the directors' duties to the firm fundamentally change and whether creditors can assert fiduciary duty claims (e.g. for injunctive relief) before the firm becomes insolvent. If creditors have standing to bring derivative claims in the "zone of insolvency," they will share that standing with stockholders, leading to the possibility of derivative suits by two sets of plaintiffs with starkly different conceptions of what is best for the firm.

Id. at 790 n.56.

[130] *See, e.g.*, *Pereira*, 413 F.3d at 342 ("Although corporate officers and directors owe fiduciary duties to creditors when a corporation is insolvent in fact, these duties do not expand the circumscribed rights of the trustee, who may only assert claims of the bankrupt corporation, not its creditors.") (citations omitted); *In re Mediators*, 105 F.3d at 826, holding, despite recognizing the Wagoner Rule, that:

> [i]n the instant matter, the [Creditors'] Committee, while not a trustee in bankruptcy, is in a position analogous to a trustee because it is suing [a third party for fraudulent conveyance] on behalf of the debtor. For that reason, the district court treated the Committee as if it were a trustee for the purpose of determining standing.

[131] *See Production Res.,* 863 A.2d at 792 n. 56 ("[O]nce a firm becomes insolvent, there is little doubt that creditors can press derivative claims arguing that directors' pre-insolvency conduct injured the firm").

and resulting dissipation of corporate assets.[132] As such, the imputation of management's fraud to the "corporation" for purposes of applying *in pari delicto* to preclude creditor claims derivatively through the trustee and the concurrent dismissal of creditor actions in their own right for lack of standing evince a fundamental misapplication of existing jurisprudence to deepening insolvency situations.[133]

The Delaware Chancery Court explains the circularity of this position as follows:

> In insolvency, creditors, as residual claimants to a definitionally-inadequate pool of assets, become exposed to substantial risk as the entity goes forward; poor decisions by management may erode the value of the remaining assets, leaving the corporation with even less capital to satisfy its debts in an ultimate dissolution. The elimination of the stockholders' interest in the firm and the increased risk to creditors is said to justify imposing fiduciary obligations towards the company's creditors on the directors."[134] In such a situation, "the directors become trustees tasked with preserving capital for the benefit of creditors who are deemed to have an equity-like interest in the firm's assets.[135]

In the case of a corporation that is at or near insolvency, it is commonly recognized that the interests of the existing creditors may be best served *not* by attempts to salvage the corporation's ongoing existence but by a swift liquidation and division of remaining assets.[136] This notion echoes the recognition of the *Bloor* court that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it,"[137] but is in fact a fictional entity comprised of various stakeholders whose collective interests by definition comprise the totality of the corporation's own. Where the best interests of the creditors, and by definition of the corporation as a whole, are not served by the

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> [E]ven in the case of an insolvent firm, poor decisions by directors that lead to a loss of corporate assets and are alleged to be a breaches of equitable fiduciary duties remain harms to the corporate entity itself. . . . Thus, regardless of whether they are brought by creditors when a company is insolvent, these claims remain derivative, with either shareholders or creditors suing to recover for a harm done to the corporation as an economic entity and any recovery logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets.

See id. at 792

133 *See generally Schacht*, 711 F.2d at 1350; Hannover Corp. of America v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997); *Allard*, 924 F. Supp. at 494; Drabkin v. L & L Constr. Assocs., Inc., 168 B.R. 1, 6 (Bankr. D.C. 1993) (for the proposition that deepening insolvency often initially arose in response to the defense that increased debt injured the creditors, but did not harm (and actually helped) the corporation). *See also Global Serv.*, 316 B.R. at 812 (listing cases).

134 *Production Res.,* 863 A.2d at 791.

135 *Id.*

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> The maximization of the economic value of the firm might, in circumstances of insolvency, require the directors to undertake the course of action that best preserves value in a situation when the procession of the firm as a going concern would be value-destroying. In other words, the efficient liquidation of an insolvent firm might well be the method by which the firm's value is enhanced in order to meet the legitimate claims of its creditors.

Id. at 791 n.60

137 In re Barr Hotel Co., 23 F. Supp. 540, 541 (D. Ohio 1938).

corporation's continued existence but by a timely declaration of insolvency, any actions to the contrary not only harm the existing creditors but concurrently harm the corporation itself.

This is precisely where the circularity of the existing jurisprudence comes in: If at the point of insolvency the creditors in fact *are* the corporation for all intents and purposes (just as the corporation is considered synonymous with the shareholders prior to insolvency), then a harm felt by the creditors is simultaneously a harm to the corporation itself, and vice versa, as their interests now largely overlap.[138] Instead of properly viewing the triumvirate of creditor-corporation-trustee as one of overlapping interests for purposes of standing and the imputation of fraud, courts have primarily attempted to separate out the interests of and harm to the creditors from that of and to the corporation itself.

Management never acts to the benefit of the creditors in concealing insolvency and thereby prolonging corporate existence and dissipating the pool of available corporate assets. Likewise, regardless of any temporary benefit held in the mere prolongation of existence, a corporation itself is neither benefited when this results in bankruptcy nor when it results in diminution of assets. In deepening insolvency situations, what is often labeled a claim exclusive to the corporation and dismissed on *in pari delicto* grounds when asserted by the trustee or on standing grounds when asserted by creditors evidences a misapplication of existing law to an inappropriate set of circumstances. Deepening insolvency as a cause of action first arose as a way around the twin problems of *in pari delicto* and the argument that a corporation lacks standing because it suffers "no harm" separate from that to the creditors, which together perversely acted to bar relief in these circumstances.[139] Keeping those roots in mind, this is where a cause of action for deepening insolvency may once again find its value.

D. Causes of Action Against Management

The failure of the following causes of action to adequately provide relief in deepening insolvency situation is often due to problems of *in pari delicto* and standing, which have been addressed at length in the previous section. However, the full list of causes of action most often pursued in deepening insolvency situations will be individually addressed below.

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[138] *Cf. Production Res.,* 863 A.2d at 792-93 n.65 (citing Brandt v. Hicks, Muse & Co., Inc., 208 B.R. 288, 300 (Bankr. D. Mass. 1997)):

> It is of course true a trustee in bankruptcy is unable to enforce a claim belonging to a creditor. But the Trustee asserts a claim which belonged to [the corporation in alleging that the company] . . . was the victim of poor management causing damage to the corporation which necessarily resulted in damage to its creditors by diminishing the value of its assets and increasing its liabilities. (citations omitted).

[139] *See Global Serv.*, 316 B.R. at 457 (stating that deepening insolvency "began as a justification for recognizing the 'adverse interest' exception" to prevent the application of *in pari delicto*); *KPMG*, 453 F.3d at 5 (asserting that "[f]ederal courts have been unsympathetic to this kind of "no harm" [to the corporation from management's fraud] argument, devising counter-doctrines [such as deepening insolvency] to answer it.").

1. *Breach of Fiduciary Duty of Loyalty*

Breach of fiduciary duty of loyalty is one of the most frequently used claims against managers in cases of deepening insolvency.[140] Courts have almost uniformly restricted this claim to the trustee alone, to the exclusion of creditors.[141] However, because the trustee stands in the shoes of the corporation, the actions of management insofar as they extended corporate life have been generally held to qualify for *in pari delicto*. Though born from a misunderstanding of the applicable law, this problem will stop the claim in its tracks at the Rule 12(b)(6) stage more often than not.

Even if the claim can survive via the "adverse interest" exception, it will then face the nearly as serious hurdle of being unable to state a claim *for which relief may be granted*.[142] Because the trustee may assert any claims held by the corporation had it not petitioned for bankruptcy,[143] many courts fail to see how deepening insolvency has damaged the *pre-bankruptcy corporation itself*, rather than the interests of the residual creditors.[144] Moreover, even where the court can imagine some harm to the corporation from deepening its insolvency,[145] the measure of such damages would not come close to approximating the full extent of damage suffered by the residual creditors as measured by the total amount of corporate assets lost during the fraudulent scheme.

Combined, these two issues will effectively inhibit both creditors and trustees from obtaining much, if any, relief from management for deepening insolvency based on a breach of fiduciary duty claim—an ironic result since there can be almost no doubt in such cases that management has gravely breached these duties, and to debilitating consequence.

2. *Breach of Fiduciary Duty of Care*

Like breach of fiduciary duty of loyalty claims, breach of duty of care claims are also assigned exclusively to the trustee on behalf of the corporation directly or the creditor class derivatively.[146] However, this claim is much more rarely pursued, being both difficult to

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[140] *Cf. Production Res.,* 863 A.2d at 792-93; *Bondi v. Bank of Am.*, 383 F. Supp. 2d at 599 (aiding and abetting breach of fiduciary duty); *Marwil*, 2004 WL 2278751 (S.D. Ind. Sept. 30, 2004); *Pereira,* 413 F.3d at 342; *Lafferty*, 267 F.3d at 346.

[141] *See Bondi v. Bank of Am.,* 383 F. Supp. 2d at 606 ("[S]o much of Counts Four [fiduciary duty] . . . as assert claims or seek recovery on behalf of Parmalat's creditors, are dismissed."); *Production Res.,* 863 A.2d at 792-93; *Pereira,* 413 F.3d at 342. *But see Koch*., 831 F.2d 1339; *St. Paul Fire,* 884 F.2d 688 (permitting the trustee to assert claims that belong to all creditors as a class).

[142] *See* FED. R. CIV. P. 12(b)(6).

[143] "Under the Bankruptcy Code the trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy." *Wagoner*, 944 F.2d at 118 (citing 11 U.S.C. § § 541, 542 (1988)). *See also Caplin*, 406 U.S. at 429.

[144] *But see Lafferty*, 267 F.3d at 348 ("[a] corporation can suffer an injury unto itself, and any claim it asserts to recover for that injury is independent and separate from the claims of shareholders, creditors, and others.")

[145] The injury envisioned, presumably, was the corporation's plunge, at the hands of its own management and outside advisors, into a level of insolvency so deep it had no hope of recovery.

[146] *See Pereira*, 413 F.3d at 342 (applying lower court's reasoning that "where the injury is to all creditors as a class, it is the creditors who lack standing and the Trustee who may bring a claim based on that generalized injury.") (citations omitted).

prove and often precluded by exculpatory charter provisions.[147] This claim will also provide little basis for relief against management in situations of deepening insolvency.

3. *Common Law Fraud*

Although fraud is a key aspect of deepening insolvency, resting a deepening insolvency claim on allegations of fraud alone is deficient for several reasons.[148] This is a claim available to both the trustee and the creditors, although to varying degrees of effectiveness.[149]

Insofar as the creditors or trustee can allege false statements made or constructed by management (with or without the participation of an outside third party) that were intended either to enable the procurement of new loans that would otherwise not have been made had insolvency been truthfully disclosed or to induce creditors *not* to act on knowledge of the corporation's true insolvency to their ultimate detriment, a claim for fraud may lie.[150] Although each individual defendant must be averred to specifically, liability extends to knowing participants of fraud and is not restricted to those who affirmatively made false statements or omissions.[151] This becomes important in situations where fraudulent financial statements were officially prepared and disseminated by outside advisors, though with the knowledge and ratification of management.

However, as with a claim for breach of fiduciary duty, claims by the trustee against management for fraud will usually run into the same *in pari delicto* problem discussed above.[152] Where fraud claims are able to survive *in pari delicto* challenges, they will again face the difficulty of proving damage to the "corporation" itself from the fraud. Based on the current treatment of deepening insolvency in the case law, courts will rarely be willing to see past technical argument that the directed result of the fraud is the procurement of new loans and concealment of insolvency alone, and not the resulting dissipation of assets that followed.

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[147] *See id.* (citing *Production Res.*, 863 A.2d at 793-95, for the proposition that "an exculpatory charter provision precluded creditor claims [asserted by the trustee] predicated on mismanagement—*i.e.*, duty of care violations.").

[148] Although the requirements to state a claim of fraud may differ per jurisdiction, they generally include: "(1) a false statement of material fact, (2) knowledge or belief of the falsity by the party making it, (3) intention to induce the other party to act, (4) action by the other party in reliance on the truth of the statements, and (5) damage to the other party resulting from such reliance." *Chicago v. A, C & S.*, 546 N.E.2d at 591.

[149] It bears noting that even if both the trustee and the creditors have actionable claims for fraud based primarily upon the same acts, the trustee will nonetheless be estopped from asserting the fraud claim belonging to creditors under *Wagoner*, regardless of whether the creditors have assigned these claims to the trustee. *See In re CBI Holding*, 318 B.R. at 766. Although this specific holding pertained to claims against an outside auditor, the same logic may be applied to similar claims against management.

[150] "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." FED R. CIV. P. 9(b).

[151] *See Chicago v. A, C & S*, 546 N.E.2d at 591.

[152]

> [Because] BSI [the trustee] cannot meet its burden of proving that the defrauding managers of CBI [the debtor] "totally abandoned" CBI's interests, and acted "entirely" for their own or another's interest [such to qualify for the "adverse interest" exception]. . . . [t]he Court thus holds that BSI does not have standing to assert CBI's fraud claims. . . .

In re CBI Holding, 318 B.R. at 765. *See also Bondi v. Bank of Am.*, 383 F. Supp. 2d 587 (Fraud and related claims by trustee in Italian bankruptcy proceeding were dismissed because these claims were barred by the affirmative defense of *in pari delicto* and the attribution of wrongdoing to the debtor's culpable insiders did not prevent the application of the *in pari delicto* doctrine).

Creditors who pursue this claim will likewise run into similar problems of standing and demonstrable damages resulting from the fraud. Again, since prior creditors are the indirect objects of damage from fraud and not usually the parties to whom the fraud was primarily directed, the resulting dissipation of assets is often viewed too attenuated to comprise any substantial measure of damage.

Without the underlying theory of deepening insolvency, courts are likely to offset damages stemming from the fraud itself by inserting another proximate cause (e.g., the open spending of new debt, and not its initial fraudulent procurement) between the fraud itself and the resulting dissipation of corporate assets. And although creditors are not barred *per se* from asserting a second cause of action based on managerial looting or waste, this tacking-together of several distinct causes of action to adequately address one general scheme of harm is the very (flawed) method for addressing deepening insolvency that has triggered this critique. Moreover, where the subsequent spending was not a result of looting or egregious mismanagement, but simply legitimate corporate spending enabled by the initial fraudulent acts, damages flowing from these actions will likely be barred by the business judgment rule despite their roots in fraud.

4. Conversion

The tort of conversion refers to the intentional exercise of dominion and control over personal property that so seriously interferes with the right of another to control that property that the tortfeasor may justly be required to pay the other the full value of the property.[153] Although the elements of conversion will differ according to state law, they generally include: (1) the unauthorized assumption and exercise of the right of ownership, (2) over the goods or personal property, (3) of another, (4) to the exclusion of the rights of the true owner.[154]

Corporate management may be liable for conversion where their use of corporate funds so exceeds the scope of their authority that it seriously violates the possessory rights of the corporate stakeholders to that property,[155] regardless of whether management directly benefited from or acquired the misappropriated corporate funds themselves.[156] While conversion may be a useful tool to address certain instances of deepening insolvency, the standard for possessory interference may be a near insurmountable burden in cases where management is the presumptive possessory agent of creditors' interests in the corporate assets. While addressed here for posterity, a cause of action for conversion in such situations does not have much bite.

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[153] 18 Am Jur 2d Conversion § 1. *See also* RESTATEMENT (SECOND) TORTS § 222A(1) (2006).

[154] Yaeger v. Magna Corp., No. 01-80763C-7D 2005 Bankr. LEXIS 1114, at *8-10 (Bankr. D.N.C. 2005) (citing Di Frega v. Pugliese, 596 S.E.2d 456, 463 (N.C. Ct. App. 2004)) (North Carolina law).

[155] *Yaeger*, 2005 Bankr. LEXIS 1114, at *8-10; *See also* 18 Am. Jur. 2d CONVERSION § 1 (2004) (stating that the exercise of ownership rights by the trespasser must so interfere with the property rights of the owner as to be tantamount to an appropriation of property).

[156] "The essence of a conversion is not the acquisition of property, but the wrongful deprivation of that property from its true owner." *Yaeger*, 2005 Bankr. LEXIS 1114, at *8-10 (citing Lake Mary Ltd. P'ship. v. Johnston. 551 S.E.2d 546, 552 (N.C. Ct. App. 2001)).

5. *Securities Fraud*

There have been several attempts to implicate managers for securities fraud under Rule 10b-5 in place of a deepening insolvency cause of action.[157] Because Rule 10b-5(a) and (c) prohibits "any device, scheme, or artifice to defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security,"[158] it does not apply to any fraud that does not affect the purchase or sale of equities in the market. However, courts have held that "[a] plaintiff makes out a sufficient nexus with the purchase or sale of securities when the defendants' deceptive conduct affects a market for securities."[159] This may include schemes that create the appearance of revenue or assets where there are none, thus distorting the prices of the corporation's securities.[160]

However, mere allegations of market price distortion are insufficient to allege the requisite "loss causation" under Rule 10(b) between the concealment of corporate insolvency and the resulting financial damage to the corporation and its creditors.[161] Indeed, the Supreme Court has ruled that mere allegations of fraudulent stock price inflation are insufficient to plead loss causation based on the reasoning that inflated purchase price, without more, does not directly cause economic loss to the purchaser.[162] This reasoning is reminiscent of the oft-repeated

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[157] *See, e.g.,* In re Parmalat, 376 F. Supp. 2d 472, 480 (S.D.N.Y. 2005).

[158] *See* 17 C.F.R. § 240.10b-5. *See also In re Parmalat*, 376 F. Supp. 2d at 491:

> To state a claim based on a misrepresentation or omission in violation of Rule 10b-5(b), plaintiffs must allege that a defendant (1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) that plaintiffs' reliance was the proximate cause of their injury.

(citing Lentell v. Merrill Lynch & Co., 396 F.3d 161, 172 (2d Cir. 2005)) (internal quotations omitted).

[159] *See In re Parmalat*, 376 F. Supp. 2d at 505-506 (citing In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp.2d 319, 329 (S.D.N.Y. 2004)); *See also* In re Initial Public Offering Sec. Litig., 241 F. Supp.2d 281, 385 (S.D.N.Y. 2003); In re Blech Sec. Litig., 961 F. Supp. 569, 582 (S.D.N.Y. 1997).

[160] *Cf. In re Global Crossing,* 322 F. Supp.2d at 335-37; *Newby v. Enron Corp.*, 235 F. Supp. 2d 549; In re Worldcom, Inc., 294 F. Supp. 2d 392 (S.D.N.Y. 2003).

> arrangements involving the regular factoring and securitization of worthless invoices were deceptive devices or contrivances for purposes of Section 10(b). These were inventions, projects, or schemes with the tendency to deceive because they created the appearance of a conventional factoring or securitization operation when, in fact, the reality was quite different.

In re Parmalat, 376 F. Supp. 2d at 504

[161]
> Loss causation, by contrast, is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff . . . Similar to loss causation, the proximate cause element of common law fraud requires that plaintiff adequately allege a causal connection between defendants' nondisclosures and the subsequent decline in the value of the [the] securities . . . . Of course, if the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established.

Newby v. Enron Corp., 310 F. Supp. 2d at 830-32 (citing Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 196-97 (2d Cir. 2003). *See also* Caremark Inc. v. Coram Healthcare Corp., 113 F.3d 645, 648 (7th Cir. 1997) ("'To plead loss causation, the plaintiff must allege that it was the very facts about which the defendant lied which caused its injuries."); Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd on other grounds*, 459 U.S. 375 (1983), (In the Fifth Circuit, the plaintiff must prove loss causation by showing that "the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation [or omission] touches upon the reasons for the investment's decline in value.").

[162] Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 344-45 (2005). The court further explained that:

criticism against deepening insolvency, that the fraudulent extension of corporate existence does not directly cause harm to the corporation or its stakeholders—one which several courts have themselves pointed out makes no realistic sense.[163]

To state a claim for securities fraud under Rule 10(b) based on a deepening insolvency scheme, the creditors or trustee will have to allege something more than a fraudulent concealment of insolvency leading to the corporation's increased debt load since, pursuant to this reasoning, the additional procurement of debt, even by fraudulent means, did not directly cause the subsequent dissipation of assets. The harm caused by management's later spending of those funds, without more, does not implicate the purchase or sale of securities and will thus be outside the purview of securities laws. Without the overarching framework of deepening insolvency to tie the two separate acts—(1) of committing market fraud to encourage lending, and (2) of spending and/or looting the newly procured funds—causationally together, the damage to creditors caused by deepening insolvency will likely remain unaddressed by current securities laws, despite the clear parallels to the market frauds such laws were designed to prevent.

6. RICO & Unlawful Civil Conspiracy

Where there is a common scheme or conspiracy between two or more parties that results in harm to a third party, federal and state RICO[164] and civil conspiracy[165] laws may be implicated. Although civil conspiracy laws present a somewhat lower bar, a federal or state RICO claim must allege a violation of one of the statutorily-enumerated offenses constituting "racketeering activity."[166] For purposes of deepening insolvency liability, the relevant

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> When the purchaser subsequently resells such shares [that were bought earlier at an inflated price due to misrepresentation], even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. . . . Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will sometimes play a role in bringing about a future loss. It may prove to be a necessary condition of any such loss, and in that sense one might say that the inflated purchase price suggests that the misrepresentation . . . "touches upon" a later economic loss. But, even if that is so, it is insufficient. To "touch upon" a loss is not to cause a loss, and it is the latter that the law requires.

Id., at 342-43.

[163] *Cf. Schacht,* 711 F.2d at 1350 ("[T]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."); *Bloor*, 23 F. Supp. at 541 ("A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."); *KPMG*, 453 F.3d at 5 ("The intuitive appeal of such arguments is that where a company inflates its earnings, the victims may appear to be only others (who loan it money or buy its stock) and the company may seem to be the culprit rather than an 'injured' party. Yet, if one looks at long-term consequences, the company may suffer as well (witness Enron).").
[164] *See* 18 U.S.C. § 1962 (2007).
[165] Generally, the elements of a civil conspiracy are: (1) an agreement between two or more individuals; (2) to do an unlawful act or to do a lawful act in an unlawful way; (3) resulting in injury to plaintiff inflicted by one or more of the conspirators; and (4) pursuant to a common scheme. *See* Privette v. University of North Carolina, 385 S.E.2d 185, 193 (N.C. Ct. App. 1989); *accord* Stetser v. Tap Pharm. Prods., Inc., 598 S.E.2d 570, 581 (N.C. Ct. App. 2004).
[166] *See* 18 U.S.C. § 1961 (2007).

offenses would most likely include mail fraud and/or wire fraud,[167] bank fraud, money laundering, engaging in transactions with money derived from unlawful activity, traveling in aid of racketeering enterprises, or transporting stolen money through channels of interstate commerce.[168] These laws may be, and have been, used to address a fraudulent and intentional course of conduct between corporate managers and outside advisors that results in deepening a corporation's insolvency. However, especially in the case of federal and state RICO actions, such usages have generally not met with wide success.[169]

In addition, to the extent that the common scheme was enabled with help of corporate insiders, the *in pari delicto* doctrine will again come into play.[170] Similarly, where RICO actions rely on allegations of fraud, the creditors or trustee must be able to assert a "reasonable reliance" by the plaintiffs on the defendants' words or actions in furtherance of the fraudulent scheme. Again, where a scheme is partly composed of company insiders, such "reasonable reliance" cannot be established.[171] The most successful RICO and civil conspiracy claims for purposes of deepening insolvency will likely be those based on a conspiracy to unlawfully loot the company of assets for personal gain.[172] All other forms of resulting asset dissipation will not be so generously regarded.

E. Causes of Action Against Outside Advisors

Although a crucial part of most deepening insolvency claims involves corporate managers, the real meat of the theory in justifying a separate cause of action involves the participation of outside advisors with management in the overall scheme. While many of the following causes of action are closely analogous to those discussed in Section D above, several present unique hurdles when applied to third-party professionals.[173] As such, only issues new to this discussion will be analyzed below.

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[167] The elements of mail and wire fraud are (1) a scheme to defraud, (2) the use of the United States mails or interstate wires for the purpose of executing the scheme, and (3) a specific intent to defraud. To base RICO liability on the violation of either statute, "the defendant must have made misrepresentations that are material to the harm to the victim" as part of the scheme to defraud. The plaintiff must demonstrate also "the purpose of the mailing [or wire communication] within the [ ] fraudulent scheme." Moreover, the allegations must comply with the heightened pleading standard of Federal Rule of Civil Procedure 9(b) relating to allegations of fraud. Bondi v. Bank of Am. ("Bondi v. Bank of Am. II"), 412 F. Supp. 2d 392, 402 (S.D.N.Y. 2006). *See also* McLaughlin v. Anderson, 962 F.2d 187, 191 (2d Cir. 1992).

[168] *See* 18 U.S.C. § 1961 (2007).

[169] *See, e.g., Bondi v. Bank of Am. II*, 412 F. Supp. 2d at 395 (dismissing state and federal RICO claims for failure to plead claim with particularity and to plead "reasonable reliance").

[170] *See, e.g., Bondi v. Bank of Am.*, 383 F. Supp. 2d at 602 ("To the extent that the civil conspiracy count is based on the [defendant]'s role in the challenged financial transactions, Parmalat was a member of the conspiracies set forth in the complaint. That claim therefore is barred by *in pari delicto*.").

[171] *See id.* at 604. ("'In order to prevail in a civil RICO action predicated on any type of fraud . . . the plaintiff must establish 'reasonable reliance' on the defendants' purported misrepresentations or omissions.' For the reasons discussed above . . . (e.g. *in pari*), Parmalat cannot establish reasonable reliance.") (quoting Bank of China v. NBM LLC, 359 F.3d 171, 178 (2d Cir. 2004)). *See also Bondi v. Bank of Am. II,* 412 F. Supp. 2d at 395-96 ("While the *in pari delicto* doctrine barred the federal and North Carolina RICO claims, those claims were defective also because Parmalat's own participation in the fraud and the imputed knowledge of the insiders precluded reasonable reliance.").

[172] *See id.* at 603 n.77 ("Looting a corporation is a sufficient predicate activity for a claim of civil conspiracy.").

[173] For purposes of this analysis, the terms "outside advisors," "third-party professionals" or "outside professional advisors" all refer to the general group of professionals including auditors, accountants, financial advisors, banks, and lenders who act as advisors to the corporation and/or corporate management.

1. *Professional Malpractice & Negligent Misrepresentation*

To sustain a claim of professional malpractice, a plaintiff must allege that the defendant owed the plaintiff a duty of reasonable professional competence, that it breached this duty, and that the plaintiff's injury was proximately caused by that breach.[174] Because outside professionals owe professional duties only to their corporate clients with whom they are in privity of contract, this claim is unavailable to creditors. Moreover, where a corporation's management and outside advisor collaborated in a fraudulent scheme, the trustee can sue the advisor for breaching its professional duties to the corporation only if he can establish that the breached caused damage to the corporation itself apart from the damage to the creditors.[175] This is the same old problem seen with several causes of action against management, and the analysis follows along the same lines.

This, combined with the "case and controversy" requirement,[176] will effectively bar most claims brought pursuant to a theory of deepening insolvency where the argument that a corporation can suffer no harm to itself past the point of insolvency and that all resulting damages naturally accrue only to its creditors continues to persist. Moreover, where an outside professional engages in a scheme to defraud the corporation with the participation or knowledge of management insiders, *in pari delicto,* and the imputation of fraud to the corporation will again prevent the trustee from asserting damages on behalf of the corporate entity.[177]

2. *Common Law Fraud & Negligence*

Where an outside professional affirmatively colluded with management in a fraudulent scheme or was grossly negligent in its professional duties in failing to uncover the scheme, both the trustee and creditors may pursue a cause of action against the advisors for the damages sustained as a result. However, the *Wagoner* rule will still apply to estop a trustee from asserting any claim considered "belonging" to creditors.[178] Again, where courts determine that the harm from deepening insolvency accrues only to creditors, the trustee may not pursue these causes of action on behalf of the corporation.[179]

Where the trustee has a separate claim against outside professionals for fraud, if management was complicit in the fraud, *in pari delicto* will again apply to estop the trustee's

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[174] *See* Hills v. Bridgeview Little League Assoc., 745 N.E.2d 1166, 1178 (Ill. 2001).

[175] *See Breeden*, 336 F.3d at 100 (citing *Wagoner*, 944 F.2d at 118-19); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995).

[176] *Breeden*, 336 F.3d at 101-02 (dismissing claim against defendant law and accounting firms for professional malpractice because:

> the trustee overlooks the rule whereby without a personal stake in the outcome of the controversy, the suit fails the case or controversy constitutional requirement. . . . Put another way, "[a] claim against a third party for defrauding a corporation with the cooperation of management, accrues to creditors, not to the guilty corporation."

(citing *Wagoner*, 944 F.2d at 120) (internal quotations omitted).

[177] *Id*. at 101 (where managers' conduct amounted to acquiescence in the fraud perpetrated by outside professionals, the trustee consequently lacked standing to sue the law firm and accounting firm defendants for professional malpractice arising from that fraud).

[178] *See In re CBI Holding*, 318 B.R. at 766.

[179] *See supra,* note 146.

claims.[180] Where a claim for negligence, negligent misrepresentation, or professional malpractice is based largely upon the same allegations and conduct as precluded fraud claims, these are also precluded.[181] Moreover, some courts pointblank refuse to sustain damages from deepening insolvency against outside professionals based on negligence alone.[182]

3. Conversion & Fraudulent Transfer

Because the tort of conversion focuses solely on the deprivation of property from its owner and not the acquisition of property by the wrongdoer, outside professionals can be liable for conversion directly if they participate or aid management in a looting scheme, regardless of whether they actually receive any benefit to themselves.[183] However, in a deepening insolvency situation where the professionals' actions lead to the dissipation of corporate assets or the sublimation of existing creditor claims to those of newly secured lenders absent the element of theft, conversion will not address these damages.

Fraudulent transfer, on the other hand, pertains to a transfer made or obligation incurred by a debtor that is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: (1) with intent to hinder, delay, or defraud any creditor of the debtor, or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: (a) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (b) intended to incur, or believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.[184].

Where such transfers can be specifically identified as to whom and when money was transferred, creditors or the trustee may be able to void such transactions and return the funds to the estate.[185] To the extent the wrongful transactions can be characterized as "fraudulent

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[180] *See, e.g., Hirsch*, 72 F.3d at 1094 (holding that even though "there [was] at least a theoretical possibility that some independent financial injury to the Debtors might be established," the *Wagoner* rule precluded standing "because of the Debtors' collaboration with the defendants-appellees in promulgating and promoting the Colonial Ponzi schemes.").

[181] *See In re CBI Holding,* 318 B.R. at 766 (dismissing trustee's negligence and breach of contract claims because:

> [t]he factual allegations giving rise to [the corporation] CBI's negligence and breach of contract claims are virtually identical to the allegations giving rise to CBI's fraud claims; all of CBI's claims are premised on allegedly deficient auditing by Ernst & Young that failed to discover fraudulent acts committed by certain members of CBI's management. The only difference among the claims is the legal rubric within which the same conduct will be analyzed (was the conduct (1) in breach of the contractual agreement between CBI and Ernst & Young, (2) negligent and in contravention of Generally Accepted Auditing Standards, and/or (3) reckless and/or fraudulent). The claims assert "a single form of wrongdoing under different names" for purposes of the standing analysis.

Id.

[182] *Cf. In re CitX*, 448 F.3d 672.

[183] *See* Nat'l Acceptance Co. of Am. v. Pintura Corp., 418 N.E.2d 1114, 1117 (Ill. App. Ct. 1981); DeKalb Bank v. Purdy, 562 N.E.2d 1223, 1233 (Ill. App. Ct. 1990).

[184] N.C. GEN. STAT. § 39-23.4 (2006).

[185] Assignments of standing for fraudulent transfer is a matter of individual state law. *Cf. In re Mediators*, 105 F.3d at 825 ("Section 720 of New York's Business Corporation Law . . . allows a corporation 'to set aside an unlawful conveyance, assignment or transfer of corporate assets where the transferee knew of its

transfers" to third parties under bankruptcy law, *in pari delicto* will not bar a corporate plaintiff from recovery from those third parties.[186] However, to the extent that the fraudulent concealment of insolvency allowed management to bleed assets from the corporation through other means than *specifically identifiable* fraudulent transfers, these assets remain non-recoupable.[187]

4. Aiding & Abetting Liability, Generally

It is an open question whether aiding and abetting liability will be recognized in cases where the same or similar conduct would also give rise to the primary tort. Although certain jurisdictions permit actions against third-party actors under the rubric of aiding and abetting liability, others find such actions superfluous and duplicative of the underlying cause.[188] This is especially true with claims involving fraud, conversion, and breach of fiduciary duty.[189] However, where aiding and abetting liability cannot be asserted, outside professionals can usually be held liable for violating the underlying tort directly. Even where aiding and abetting liability is asserted, the same standing and *in pari delicto* standards will exist as they would for the underlying claim itself.[190]

a. Aiding & abetting breach of fiduciary duty

Courts will recognize a claim for aiding and abetting breach of fiduciary duty where it can be proved that management breached its fiduciary duties to the corporation and that an outside professional (1) committed a tortuous act in concert with management or pursuant to a common design; or (2) knew that management's conduct constituted a breach of duty and

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unlawfulness.'") (citations omitted); *Bondi v. Bank of Am*., 383 F. Supp. 2d at 601 ("The North Carolina Uniform Fraudulent Transfer Act makes certain transfers by a debtor, or obligations incurred by it, fraudulent as to its creditors. The statute, however, assigns the remedies for a fraudulent transfer to creditors, not to the debtor, its estate, or a bankruptcy trustee.") (citing N.C. GEN. STAT. §§ 39-23.4, 39-23.5 (2005)).

[186] *See* In re Leasing Consultants, Inc., 592 F.2d 103, 110 (2d Cir. 1979) (power of trustee to avoid fraudulent transfers is not barred by in pari delicto because trustee stands in shoes of creditors, not debtor corporation, when exercising avoidance powers); *see also* In re Personal & Bus. Ins. Agency, 334 F.3d 239, 246-47 (3d Cir. 2003) (bankruptcy trustee's powers to avoid pre-petition transfers pursuant to 11 U.S.C. § 548 are not subject to in pari delicto defense).

[187] In some jurisdictions, a claim for conversion must be accompanied by the specific and identifiable amount of money allegedly converted. Allegations of a general property interest will not suffice. *See* NatTel, L.L.C. v. SAC Capital Advisors, 2005 U.S. Dist. LEXIS 20179 (D. Conn. 2005); Newbro v. Freed, 409 F. Supp. 2d 386, 394-395 (S.D.N.Y. 2006) ("[T]he conversion claim must be for recovery of a particular and definite sum of money, although the specific bills are not identified . . . .") (citing ADP Investor Commc'n. Servs. v. In House Attorney Servs., 390 F. Supp. 2d 212, 224 (E.D.N.Y. 2005) (internal quotations omitted).

[188] *Cf.* Cenco, Inc. v. Seidman & Seidman 686 F.2d 449, 452-536 (7th Cir. 1982) (holding that Illinois does not recognize a tort of aiding and abetting fraud because any person who would be liable for aiding and abetting fraud would be liable also as a primary violator); Bondi v. Grant Thornton Int'l., 377 F. Supp. 2d 390, 413 (S.D.N.Y. 2005) (recognizing that, in certain cases, " a separate tort of aiding and abetting would be superfluous as the same conduct can give rise to liability for [the underlying cause of action].").

[189] *But see* Hefferman v. Bass, No. 04C5748, 2005 WL 936900 *3 (N.D. Ill. Apr. 15, 2005) (applying Illinois law and recognizing claim for aiding and abetting breach of fiduciary duty); *Nisselson*, 340 B.R. at 33 (recognizing the tort of aiding and abetting fraud under New York law).

[190] *Wagoner*, 944 F.2d at 118 ("Even when defrauded creditors assigned to the trustee their claims against another for aiding and abetting the fraud the trustee lacked capacity to sue"). *See also In re CBI Holding,* 318 B.R. at 766-67; *Breeden*, 336 F.3d at 102.

gave substantial assistance or encouragement to management to so conduct themselves; or (3) gave substantial assistance to management in accomplishing the tortious result and the professional's own conduct, separately considered, constituted a breach of duty to the corporation; and where harm to the corporation resulted.[191]

In such cases, *in pari delicto* may not apply to preclude claims against third party professionals where such claims are based on allegations that the third party;s actions contributed to a breach of fiduciary duty.[192] However, if the breach of duty did not fully result in unlawful looting, the damages stemming from the aiding and abetting of such breach may not include the full measure by which the overall insolvency of the corporation was deepened. Damage to the corporation from the aiding and abetting itself will be especially difficult to prove since the trustee is precluded from arguing any damage to the creditors separately from the corporation itself.

b. Aiding & abetting securities fraud

There is no private right of action for aiding and abetting under Securities Law 10(b) for fraudulent misevaluation or accounting of assets, nor does such conduct qualify as a primary violation of the law.[193] Likewise, auditors cannot be held liable as aiders and abettors of another's primary securities law violation nor can they be subject to liability as controlling persons under §20 of the Securities and Exchange Act of 1934.[194] As such, outside professionals involved in wrongfully contributing to the deepening of a corporation's insolvency must have engaged directly in conduct sufficient to qualify as a primary violation of the securities laws in order for the corporation or its creditors to obtain relief.[195]

Because fraudulent inflation of market price (and, in all likelihood, the similar fraudulent concealment of insolvency), does not itself constitute a primary securities violation, outside professionals will be exempt from such laws unless they have directly participated both in the market fraud and in the direct causation of any resulting corporate harm: e.g., the spending and/or looting of the fraudulently-procured new loans. Moreover, the two acts would have to be very closely linked, causationally, in order to get securities laws to cover what would

[191] *See Bondi v. Bank of Am.,* 383 F. Supp. 2d at, 600 (holding that North Carolina recognizes a tort of aiding and abetting breach of fiduciary duty); RESTATEMENT (SECOND) TORTS § 876 (2006)

[192] *See id.,* at 596 (stating that *in pari delicto* "would appear to bar recovery by Bondi from BoA except to the extent that the complaint alleges that BoA aided and abetted a breach of the Parmalat insiders' duties to the Company.").

[193] *Newby v. Enron Corp*., 439 F. Supp. 2d 692 (dismissing suit by existing stakeholders in post-collapse Enron against accounting firms for securities law 10(b) violation based on their role in Enron's collapse).

[194] *See Bloor*, 523 F. Supp. at 543; Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (holding that there is no private civil liability for aiding and abetting a violation of Section 10(b) and Rule 10b-5).

[195] Third-party professionals can be found liable for primary securities fraud violations if their actions so warrant. It is not the actor that is determinative as to primary versus secondary liability, but the actions themselves. *See Central Bank*, 511 U.S. at 191 ("[T]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.").

otherwise be ordinary corporate waste or theft, if not for the *but-for* fraudulent procurement of such funds.[196]

Because outside professionals often play a significant role in constructing or enabling the fraudulent concealment of insolvency through auditing, advising or preparing corporate financial statements, but are unlikely to be involved in any subsequent corporate spending, the existing securities laws, which lack the extended reach of secondary aiding and abetting liability, will be incapable of holding them liable for the resulting damage.[197]

c. RICO & Unlawful Civil Conspiracy

Federal or state RICO and civil conspiracy claims will probably fail in most cases, except where a complaint alleges that an outside advisor conspired with corporate insiders to loot the company of its assets.[198] Where looting is alleged as an element of the conspiracy, the imputation of the fraud to the corporation is avoided, and the adverse interest exception will apply to block an *in pari delicto* defense.

To the extent that a complaint instead alleges that the outside advisors conspired not with the company and its constituent entities but rather with individual corporate insiders, the claim is essentially identical to one for aiding and abetting breach of fiduciary duty and is therefore superfluous.[199] Moreover, even where the element of looting allows a claim to survive, any resulting damages will be measured not by the total dissipation of corporate assets resulting from the conspiracy, but only by the amount identifiably and demonstrably looted. Therefore, apart from situations in which both the fact of looting and the amount looted is provable and where the amount looted comprises the total measure of damages caused by the fraudulent scheme, RICO and civil conspiracy claims will not sufficiently cover the total measure of harm derived from deepening insolvency.

F. Causes of Action Against Complicit Lenders

As previously stated, the act of emergency lending to insolvent corporations will not trigger deepening insolvency liability. Only cases in which lenders are complicit in the scheme or exploit the company's desperation to extract unfairly preferential loan terms will liability attach.[200] These cases are few and far between,[201] and the available causes of action to

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[196] *Cf. Dura Pharm.*, 544 U.S. at 336 (holding that to plead loss causation adequately under § 10(b), a plaintiff cannot merely allege that he purchased securities at a price that was inflated because of misrepresentations by defendant(s); plaintiff must allege an actual causal connection between a defendant's misconduct and plaintiff's resulting monetary damages).

[197] This is despite the fact that, prior to *Central Bank*, several courts held banks liable under securities laws for exactly such conduct. *See, e.g.,* Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir. 1978); Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985). *See also In re Parmalat*, 376 F. Supp. 2d at 496-497 (acknowledging that several pre-*Central Bank* decisions sustained aiding and abetting liability where the financiers allegedly knew that their counterparties would defraud others, and where they assisted or even encouraged their counterparties in connection with those frauds, but where there was nothing inherently dishonest about their own acts, and likening such allegations to present deepening insolvency claims).

[198] *See Bondi v. Bank of Am.*, 383 F. Supp. 2d at 606 ("Count Nine [civil conspiracy] except insofar as it rests on allegations that Parmalat insiders looted the Parmalat Debtors . . . [is] dismissed.").

[199] *See, e.g., id.* at 603.

[200] For example, the allegations in *In re First Alliance Mortgage Co*. demonstrate an instance in which lender liability may be appropriate. No. 01-971, 2002 U.S. Dist. LEXIS 5858 (C.D. Cal. 2002). The allegations

address them (such as common law fraud and fraudulent transfer)[202] have been adequately covered above. While a general cause of action for deepening insolvency should apply to complicit lenders when necessary, they will rarely be the primary intended targets of such an action.

V. A PLACE FOR DEEPENING INSOLVENCY

Where existing causes of action fall short in fully compensating the parties harmed by deepening insolvency, a separate cause of action based on this theory has something to offer. Unfortunately, the theory's nascency and its lack of definition have allowed its use in cases that are wholly inappropriate to the theory's original function. Because of this, many courts, initially reluctant, are now fed up.[203] The prevalence of the abuse of deepening insolvency claims to target peripheral but lucrative defendants and the related possibility of windfall damages has caused a turning of the tide against the theory, both in the courts of law and in the court of public opinion.

However, if the theory is boiled down once again to its initial concept, it appears that something salvageable may still remain. Despite the many criticisms, there is clearly something about the theory that appeals to and resonates with our fundamental system of justice. As with its misapplication in the courts, the most prevalent criticisms of deepening insolvency are based on a fundamental misunderstanding or misconstruction of the theory. When analyzed with this in mind, many of the toughest criticisms melt easily away.

A. Debunking The Criticisms

There has been much commentary on the pitfalls of deepening insolvency from both a legal and a practical policy perspective. The following criticisms are the most frequently cited and significant of these.

1. It Discourages Lending

One of the most vehement criticisms of deepening insolvency is the supposition that the risk of imposing liability on third-party lenders for extending an emergency loan to insolvent corporations—which are then misused by management to push the corporation deeper into insolvency—will discourage the practice of extending such loans and thus hamper the possibility of corporate turnarounds generally.[204]

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include: an underlying breach of fiduciary duty where the debtor's directors repeatedly favored lenders to the detriment of unsecured creditors; that the lenders knowingly participated in these breaches by inducing the acquisition of the debtor's competitor; that the lenders provided the necessary investment banking services and financing in connection with it; and prevented the debtors from filing insolvency petitions. *Id. See also Production Res., supra* note 77 (where defendant director's wife became corporation's de facto controlling shareholder through post-insolvency debt financing and was permitted to unfairly sublimate claims of all existing creditors to her own).

[201] *See, infra,* note 209 (comparing cases brought against lenders with all others).

[202] NORTON, *supra* note 17, at §§ 7.6, 8.2 ("Probably the most frequently alleged cause of action [by debtor estates] against lenders is common law fraud.").

[203] *Cf. Trenwick*, 906 A.2d at 174.

[204] *See* Rapisardi, *supra* note 6 ("If left unchecked, the theory of 'deepening insolvency' presents the potential for a great deal of mischief and will impede the willingness of financially distressed entities, including their

This problem has been analogized to the need for a Good Samaritan Doctrine to protect those who attempt to rescue a person in imminent peril from facing a lawsuit should their efforts fail.[205] As a society, we protect these "good Samaritans" because we want to encourage, and not deter, such rescue attempts. Similarly, with respect to the turnaround professional, investment banker, or accountant, the law should protect them from the kind of liability arguably posed by deepening insolvency if we truly want to encourage corporate turnaround in the face of impending bankruptcy.[206]

While this is indeed sound advice, it misconstrues the true nature of deepening insolvency. The act of lending, in itself, does not contribute to a corporation's insolvency. Lending, without subsequent spending, is a solvency-neutral act.[207] Courts and critics alike agree that good-faith lending is not the proximate cause of a corporation's deepening insolvency and should not result in liability.[208] This article does not dispute such reasoning. It argues instead that this criticism misconstrues the true nature and purpose of a deepening insolvency claim.[209] Deepening insolvency was never intended as a *post-hoc* penalty for the innocent participants of a failed reorganization effort.[210] Its application should be, and originally was,

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professionals and lenders, to take prudent and rational risks in attempting to preserve and maximize the company's asset value for the benefit of all stakeholders."); Scott B. Cohen, *The Deepening Insolvency Doctrine: Does it have a logical conclusion?*, BANKRUPTCY, REORGANIZATION AND CREDITORS' RIGHTS (Sacks Tierney, P.A.), Feb. 2005, http://www.sackstierney.com/articles ("[W]ithout a coherent limitation on damages, the deepening insolvency theory, if recognized and expanded, risks deterring the very professionals most companies need when in financial distress.").

205 *See* Cohen, *supra* note 9.

206 *Id.*

207 Insolvency-in-fact occurs at the point at which a corporation's on-paper liabilities exceed its assets. Although a one million dollar loan to a corporation would increase the corporation's debt liabilities by one million, it would also increase its assets by one million, therefore having zero net effect on its overall insolvency. *See* Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549 (2005).

208 *See, e.g., Nisselson*, 340 B.R. at 39-40 (Rejecting defendant's argument "that the trustee's claims of deepening insolvency and lender liability must be dismissed because making a bad loan is not actionable" because "the complaint alleges that [defendant] made a loan to enable Ford to defraud the debtor.").

209 It should be noted that a majority of cases alleging deepening insolvency have targeted corporate managers and outside professional advisors engaged in a fraudulent scheme; rarely lenders. *See, e.g.,* Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983) (auditor/accountant and management defendants); Hannover Corp. of Am. v. Beckner, 211 B.R. 849 (M.D. La. 1997) (legal counsel defendants); Tabas v. Greenleaf Ventures, Inc., 269 B.R. 721 (Bankr. S.D. Fla. 2001) (bank/financial advisor defndants); Bookland of Maine v. Baker, Newman & Noyes, L.L.C., 271 F.Supp.2d 326. (D. Me. 2003) (auditor/accountant defendants); Ex rel Boston Chicken , 421 F.3d 989 (9th Cir. 2005) (financial advisor, auditor/accountant, management, and legal counsel defendants); In re Del-Met, 322 B.R. 781 (Bankr. M.D. Tn. 2005) (auditor/accountant, management, and shareholder/customer defendants); In re LTV Steel Co., 333 B.R. 397 (Bankr. N.D. Ohio 2005) (management defendants). *Compare* Lafferty, 267 F.3d 340 (3d Cir. 2001) (auditor/accountant, management, legal counsel, shareholder/customer, and underwriter/lender defendants); In re Exide Techs., Inc., 299 B.R. 732 (Bankr. D. Del. 2003) (management, shareholder/customer, and underwriter/lender defendants); In re Total Containment, Inc., 335 B.R. 589 (Bankr. D. Pa. 2005) (management, shareholder/customer, and underwirter/lender defendants).

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> In the world of corporate workouts, turnaround managers and the possibility for a quick change in an economic tide, it is not uncommon for a corporation to revitalize itself and work out financial problems no matter how dire they appear. The financial hardships which possibly resulted from the increased insolvency were not necessarily forthcoming, and if it can be proven that they were a result of the increased insolvency, liability may be found.

Greenleaf Ventures, 269 B.R. at 728.

limited to situations in which such emergency capital was procured through the fraudulent means and not through the full disclosure of a reorganization effort.[211]

2. It Circumvents The Bankruptcy Process

Much of the bankruptcy-related literature surrounding deepening insolvency focuses on the criticism that deepening insolvency circumvents both the goals and the structure of bankruptcy process by disincentivizing reorganization and providing a route by which certain creditors can go directly after damages from individual defendants in contravention of their determined priority level in the bankruptcy process.[212] Both these arguments again fail to grasp the true idea of deepening insolvency.

A proper fully-disclosed reorganization effort will not result in deepening insolvency liability, neither for lenders nor for corporate management. Rationally speaking, deepening insolvency liability should have no deterrent effects on legal reorganization efforts. Indeed, properly used, the imposition of deepening insolvency liability should, in fact, further the goals of the bankruptcy process by enabling corporate stakeholders to make rational decisions regarding their collective welfare in response to the corporation's true financial state. When the corporation's insolvency is concealed, corporate stakeholders are deprived of the opportunity to determine the direction of the corporation in their collective best interest, which directly controverts the clear intent of the Bankruptcy Code.[213] By depriving creditors of the opportunity to compel (or decline to compel) bankruptcy and reorganization proceedings at the proper point, it is the concealment of insolvency itself, and not the responding cause of action, that thwarts the very policy goals that bankruptcy law was designed to protect.[214]

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[211] The *In re Monahan* court hit the nail on the head with the following distinction:

> [Defendant lender] relies on *Global* and asserts that it stands for the proposition that making a loan, knowing that a debtor would not be able to repay, is not actionable. However, *Global* specifically states: "Notably, the Complaint does not allege or imply that [the lender] extended the loans to enable the [directors of the debtor corporation] to siphon off the funds or commit some other wrong." *Global*, 316 B.R. at 459. Here, unlike in *Global*, the complaint alleges that [Defendant] made a loan to enable [the debtor's directors] to defraud the debtor. *Therefore, although the general rule is that making a bad loan will not expose a lender to liability, the complaint alleges claims which may expose [Defendant] to liability under the deepening insolvency theory*.

340 B.R. at 40 (emphasis added).

[212] *See* Cohen, *supra* note 6 ("At the heart of the deepening insolvency theory is the premise that extending the life of a company is not inherently valuable. While this may be true, it runs counter to the strong presumption under the Bankruptcy Code and bankruptcy laws that reorganization is preferred over liquidation.").

[213] *See* 11 U.S.C. § 549(b) (2005) (involuntary bankruptcy).

[214] The Seventh Circuit's initial justification for deepening insolvency liability in *Schacht* was in fact premised on this very idea.

> [A] rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body" and prevent corporate stakeholders from "exercis[ing] their right to dissolve the corporation in order to cut their losses."

Schacht, 711 F.2d at 1350

The second half of this criticism misunderstands the procedural posture by which deepening insolvency arises. Deepening insolvency does not represent an effort by certain creditors to unfairly snatch a larger piece of the pie of existing corporate assets from the remaining creditors in a bankruptcy proceeding. To the contrary, it is a method through which all unsecured creditors of the estate act to expand the pie for their collective benefit. Deepening insolvency is properly brought either within ongoing bankruptcy proceedings as an adversary action, or once they are concluded as a separate suit in tort, in order to recoup the wrongfully dissipated assets no longer in the estate's possession. It does not involve the allocation of existing assets between creditors—as is the purview of bankruptcy proceedings—but the expansion of the general pool of assets in an ancillary, related proceeding done without regard at this stage to their eventual assignment.

3. It Negates The Business Judgment Rule

This criticism piggybacks on the previous two and, accordingly, the counterargument follows along the same lines. Where managers of insolvent corporations take on additional debt in a good-faith effort to salvage the going-concern of the business and mismanage these funds through a series of (in hindsight) poor decisions, the business judgment rule protects such actions.[215] Deepening insolvency does nothing to threaten this existing rule. Moreover, where such misguided applications of deepening insolvency have been attempted, courts have returned swift and unkind responses, demonstrating that not only are such misapplications of deepening insolvency legally untenable but that they will not be tolerated.[216]

The imposition of deepening insolvency liability in such an instance is inappropriate and in direct contravention of well-established law. An action for deepening insolvency is not intended to punish management for bad decisions with the benefits of hindsight; it is intended to address the deliberate obscuring of the corporate decision-making process through the fraudulent concealment of insolvency and the consequences of continued operation based on fabricated and inaccurate financials. The business judgment rule certainly does not protect managerial misconduct, nor was it intended to. The risk of managerial liability in such cases does not threaten the business judgment rule insofar as the prohibited conduct occurs outside the bounds of its protection.[217] As such, the argument that deepening insolvency will threaten or negate the business judgment rule, and thus quash the ability of corporations to pursue high-risk, high-return strategies without fear of liability, is merely a straw-horse that evinces either a misunderstanding or a deliberate manipulation of the true concept.

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[215] *See Trenwick,* 906 A.2d at 174 ("What Delaware law does not do is to impose retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out. . . . To sanction such a bizarre scenario would undermine the wealth-creating utility of the business judgment rule.").

[216] *See id.* at 173-75.

[217] *See, e.g.,* Rapisardi, *supra* note 6

> According to *Global Service Group*, the business judgment rule will protect such a decision [to take on additional debt in a good faith turnaround attempt], unless the fiduciary was acting in bad faith or with fraudulent intent. In the latter instance, the prolongation of operations would "smack of self-dealing, constitute a breach of fiduciary duty, and open up recovery under the theory of deepening insolvency."

Id.

4. *It Creates A Remedy Where No Harm Exists*

The debtor's situation in a deepening insolvency claim is often analogized to that of an individual who sits in the rain all day and simply cannot get any wetter.[218] Once already insolvent, many argue, further insolvency can do no further harm to the corporation itself since, at the point of insolvency, the corporation as it was previously defined (i.e., as the shareholders) has ceased to exist. While this argument may at first seem persuasive, further examination shows that it is nothing more than a misunderstanding of the theory.

Deepening insolvency, at its core, is rather more like a boxer with one black eye who, despite being injured, might still persevere and win the fight.[219] If that boxer (the debtor corporation) winds up losing the fight and landing in the hospital (bankruptcy court), a doctor (judge) might still be able to treat his injuries (restructuring) and, in time, the boxer may recover sufficiently to return to the ring and continue his career—perhaps even win the title. However, if the boxer's manager (corporate insiders) acts to conceal the boxer's injuries from both the boxer himself and from the tournament officials, and the boxer continues to fight ignorant of the true extent of his injuries, incurs severe internal bleeding as a result of sustaining additional blows, and dies, the doctor (judge) may find that it was the additional injuries (deepening insolvency) that killed him.

To the boxer, is there not a significant difference between a black eye and death? Likewise to the debtor corporation, there is a significant distinction among different levels of insolvency.[220] The damage sustained between the point at which the corporation first became insolvent, a point at which restructuring and rebirth may have still been possible, and the point at which a deepening insolvency fraud falls apart and often leads not only to millions in unrecoverable corporate assets but to unsalvageable corporate demise is that difference.[221] It is here that deepening insolvency stands alone among existing causes of action to compensate for such losses; and it is this specific harm that the concept of deepening insolvency was first conceived to address.[222]

5. *It Targets Unlimited Potential Defendants*

After the Third Circuit's acknowledgment that an insolvent corporation still retains some value that can be damaged by the fraudulent and concealed incurrence of additional debt,[223] both plaintiffs' and defense attorneys began seeing potential targets everywhere. Not only

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[218] *See Greenleaf Ventures*, 269 B.R. at 728 n.4.

[219] *Id.*

[220] "Loss in value can occur in a reduction of a company's value from a positive value to a lower positive value; from a positive value to a negative value; or from a negative value to a greater negative value." *Bookland of Maine*, 271 F.Supp.2d at 326.

[221] Moreover, even though a corporation may have a negative book value, there remains some market value associated with the corporation's assets and business. The more those assets are dissipated, the more a corporation's ability to satisfy creditors' claims is impaired, the lower the market value of those creditors' claims, and the lower the so-called "enterprise value" of the corporation.

[222] *See Greenleaf Ventures*, 269 B.R. at 728 (Because the complaint "describes [the] financial deterioration of the Debtor, . . . [t]hese facts may support a claim for damages incurred by the Debtor [itself] under the so-called 'deepening insolvency' theory" that is actionable by the Trustee. "The financial hardships which possibly resulted from the increased insolvency were not necessarily forthcoming, and if it can be proven that they were a result of the increased insolvency, liability may be found.").

[223] *Lafferty*, 267 F.3d at 349-50.

could directors and officers face liability, but also any number of outside parties involved in such transactions: auditors, accountants, financial advisors, banks, lenders, attorneys, underwriters, business partners, corporate customers—the list stretches on and on.[224] Much like the wave of panic that enveloped outside directors in the wake of the Enron and WorldCom class-action settlements against outside directors, independent corporate advisors and institutions began to express concern that any unsuspecting institution or employee who had the ill-fortune to work in conjunction with a failed corporate venture could be slammed with a multimillion dollar judgment merely for performing the ordinary functions of their job.

As has been shown, at least in the case of outside directors, such occurrences are, in reality, strikingly rare despite the overwhelming public perception of the extreme new risk they might pose.[225] Such "perfect storm" scenarios in which personal out-of-pocket liability is imposed on outside directors in the wake of corporate collapse occur in such rare and extreme circumstances that the practical risk to ordinary participants in the corporate process is close to nil.[226] Moreover, incentives are such that lead plaintiffs will rarely attempt such a radical course of action without an exceedingly strong case, even with which they may not succeed.[227]

This finding has been corroborated by market participants themselves in the years following the Enron collapse. Counter to the prediction that the highly publicized fate of Enron's outside directors, though appeasing to the public's sense of social justice in the short-term, would damage public welfare in the long-run by discouraging qualified industry leaders from serving as corporate directors in the future, industry has not suffered from a shortage of willing directors despite the possible wariness of some.[228] Similarly, the courts' increasing limitations on deepening insolvency in recent years should put to rest the fear of a situation in which bankruptcy trustees are granted unlimited power via the tool of deepening insolvency to extract revenge for corporate mismanagement on unwitting participants whose only faults are bad luck and deep pockets. Further, the reaction of the courts to advocates of deepening insolvency based on nothing more than the bystander-splash effect has been swift and

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224 *See, e.g., Del-Met*, 322 B.R. at 812 (Opining that in the relatively brief time since its emergence, "[t]he action [for deepening insolvency] has morphed, both in form—from a breach of statutory duty claim to a form of common law tort liability—and in scope—now reaching lawyers, accountants, bankers and other financial and insolvency professionals."). *See also* Deepening Insolvency, 23-4 AM. BANKR. INST. J. at 34 (citing cases)).

225 *See* Bernard Black, Brian Cheffins and Michael Klausner, Outside Director Liability*,* 58 STAN. L. REV. 1055, 1058-59 (2006) ("Fear of liability has for some time [even before WorldCom and Enron] been a leading reason [identified for] why potential candidates turn down board positions . . . . [However, after] an extensive empirical investigation of outside director liability[,] [w]e find that out-of-pocket payments by outside directors are rare.").

226 *Id.* at 1063-64 (finding that from 1980-2005, there were over 200 securities class actions filed per year but only thirteen instances over the entire period resulting in outside directors making out-of-pocket payments).

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> Absent a perfect storm, a lead plaintiff in a securities class action can pursue personal payments from outside directors only by sacrificing the interest of the class in maximizing the net present value of the eventual recovery, thus likely violating a duty owed to the class . . . . [E]ven in a perfect storm [directors] may not face out-of-pocket liability.

Id. at 1061

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> [After Enron,] [m]any companies are being forced to widen their searches for directors. This means reaching out to people who have never before served on a board, executives below CEO level, and specialists. . . instead of generalists. This is a massive shift and an opportunity to create the kind of engaged, critical and creative board that every company should have had in the first place.

Jyoti Thottam, *Crashing the Boards*, TIME, Feb. 5, 2003, available at http://www.time.com/time/insidebiz/printout/0,8816,418568,00.html unforgiving.[229] It is not innocent defendants who should fear the consequences of such frivolous suits but rather the imprudent attorneys who bring them.

6. It Duplicates Existing Causes of Action

That deepening insolvency duplicates existing causes of action is by far the most convincing criticism of the theory, and cannot be as easily dismissed. Previously, article covered each purportedly duplicative cause of action in turn and addressed why, as a group, existing causes of action are insufficient to fully address the harm of deepening insolvency. Although it is true that existing causes of action can be applied, in a piecemeal fashion, to remedy elements of conduct underlying deepening insolvency, no existing cause of action has the necessary framework to encompass all aspects of deepening insolvency harm in a concise manner.[230]

The problem arises because the harm of "deepening insolvency" is not just the damage to corporate stakeholders from fraud, nor is it the mere taking on of additional debt through deceptive means, nor even the subsequent wasting or looting of the newly-procured funds. The true nature of the harm revolves around the related acts of fraudulent concealment of insolvency to enable the acquisition of additional debt to enable the further concealment of insolvency and resulting dissipation of corporate assets, and often leading to corporate demise. If viewed in a piecemeal manner under existing causes of action, the crux of the theory is lost. The value of a cause of action for deepening insolvency is that it cleanly encapsulates all harms done to all relevant stakeholders by all parties engaged in the scheme and provides a correspondingly simple measure of corresponding damages.

What has become apparent upon examining the evolution of deepening insolvency in the courts is that the forced packaging of the underlying elements of deepening insolvency into the framework of existing causes of action has created a practical dissonance in which the existing law has been applied traditionally to a non-traditional claim, leading to an inconsistent and unjust result.

B. The Model Cause of Action

Deepening insolvency addresses an indisputable wrong. Much like the newly-constructed civil remedies (e.g., Sarbanes-Oxley) enacted for the protection of shareholders, deepening insolvency may protect creditor victims of similar corporate frauds. Where the existing civil remedies have proven incapable of compensating the victims of the very sophisticated and deliberate type of corporate fraud that deepening insolvency describes, a separate cause of action may be used not to overlap, but to supplement the law in this area.[231] Despite the existence of piecemeal remedies culled from existing case law, none presents the narrative

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[229] *Cf., In re CitX*, 448 F.3d at 674.

[230] At least one court has recognized that an implied private right of action under the Securities Exchange Acts is similar in many ways to several common law causes of action, such as deceit and fraudulent misrepresentation, but nonetheless exists independently of them. Why, then, should deepening insolvency be any different? *See Newby v. Enron Corp*., 439 F. Supp. 2d at 700.

[231] The Supreme Court has pointed out that an implied securities fraud right of action under the Securities and Exchange Act of 1934 "resembles, but is not identical to, common-law tort actions for deceit and misrepresentation." *See Dura Pharm*, 544 U.S at 341. Nonetheless, such a right exists and is frequently utilized.

framework necessary to string together all relevant aspects of such a claim nor provides a single coherent theory to underlie the exact complexities of the harm alleged. The parameters of a deepening insolvency cause of action that does connect the relevant elements may be gleaned from early case law, as alleged in *Schacht,*[232] *Lafferty,*[233] and *Production Resources*.[234] A broad sketch of how such a cause of action might be constructed going forward is outlined below.

1. Plaintiffs & Standing

As eluded to above, because deepening insolvency can damage both creditors and the corporation itself, the proper plaintiffs in a deepening insolvency action are either the Official Committee of Unsecured Creditors of a debtor estate, the Trustee or Liquidator of a debtor estate, or perhaps a single or single class of unsecured creditors where they have sustained particular damage to the exclusion of remaining creditors.

Because a fundamental element of a deepening insolvency claim is that the scheme were undertaken often to the detriment of both the corporation and its existing creditors, a presumption against the imputation of fraud and the availability of an *in pari delicto* defense should apply where individual managers have undertaken this scheme without the general knowledge or participation of the corporation at large. This inverted burden of proof in the form of a rebuttable presumption against *in pari delicto* should counteract the convoluted effects that the misapplication of existing principles of agency to deepening insolvency claims has thus far wrought.

2. Defendants

The proper defendants to a deepening insolvency cause of action are directors and officers of a debtor corporation, outside advisors such as accountants, auditors, banks, financial institutions, and underwriters, and, in rare instances, complicit creditors.[235]

3. Pleading Standard & Jurisdiction

Because a primary element of deepening insolvency is fraud,[236] a claim for deepening insolvency should be held to the same particularized pleading standards of Federal Rule 9(b).[237] Deepening insolvency claims should be initially brought either as an adversary proceeding in bankruptcy court or in the relevant state trial court as a separate tort action.

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[232] As to a trustee action against management and outside accountants, *see* discussion in Section II.A., *supra.*
[233] As to a creditor claim against management and several outside professionals, *see* discussion in Section II.B., *supra*.
[234] As to a creditor claim against management in conjunction with a complicit creditor, *see Production Res.,* 863 A.2d at 774 (where the wife of a defendant director "has allegedly been permitted to secure her status as a creditor by obtaining liens on NCT's assets and therefore to stake out a claim superior to [plaintiff] and other NCT creditors. . . . [E]ven more problematic because NCT's own public filings reveal that it is balance-sheet insolvent and that it has been unable to pay several debts that came due.") (emphasis added).
[235] The author is not aware of any deepening insolvency claims sustained against outside attorneys and, at the present time, declines to advocate that result here.
[236] *Cf. Nisselson*, 340 B.R. at 40 (recognizing that "[t]he deepening insolvency claim is based on the fraud that enabled the defendants to 'exploit and loot the debtor for [the defendants'] own purposes'").
[237] *See* FED. R. CIV. P. 9(b).

4. Scienter

The scienter requirement for a deepening insolvency action should be knowing and willful conduct or complicity. Although in some situations a case may be made for extending this to grossly or recklessly negligent conduct, this is something that should grow organically from the case law if justified, with due caution as to the possible slippery slope such an extension presents, and is not necessarily advocated here.

5. Elements

As demonstrated by the allegations presented in early deepening insolvency cases and as has already been specified above, a cause for deepening insolvency may take several different forms. At bottom, though, a cause of action for deepening insolvency should include four main elements: (1) fraudulent concealment of insolvency; (2) procurement of additional loans despite insolvency; (3) artificial prolongation of corporate existence enabled by these means; and (4) resulting dissipation of assets or unfair sublimation of existing creditor claims, and any other appreciable harm to the corporate entity. Whether the resulting asset dissipation is due to actual looting or simply to regular corporate expenditure or waste is immaterial. Unless the capital from incoming loans is used to satisfy the outstanding creditor claims, any subsequent dissipation of corporate assets that would not have occurred had insolvency been disclosed or declared in a timely fashion is a direct result of the scheme and is liable as such.[238]

6. Measure of Damages

Courts have generally held, and several damage and accounting experts concur, that the injury to the corporation is not restricted to the damage incurred between solvency and insolvency. On the contrary, the "[l]oss in value can occur in a reduction of a company's value from a positive value to a lower positive value; from a positive value to a negative value; or from a negative value to a greater negative value."[239] What is relevant for the measure of harm is not the solvency status of the corporation at the point at which deepening insolvency began (except, of course, insofar as deepening insolvency by definition assumes existing insolvency) but that "[t]he measure of value [be] determined by subtracting liabilities from assets" at both points in time surrounding the relevant period of deepening insolvency, regardless of where that period begins and ends.[240]

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[238] *See Alberts I*, 333 B.R. at 523 n.17:

> The harm to the corporation comes from the artificial prolongation of the defective business model employed by the company, which ultimately causes the company to go further "into the red" rather than dissolve or reorganize itself to be a productive, profitable business. Where the corporation is capable of paying off the loan, there is no undue prolongation of the company's current business model at the expense of its future potential and therefore no real "deepening" of the company's insolvency.

[239] *Bookland of Maine*, 271 F. Supp. 2d at 326.
[240] *Id.*

There appear to be primarily two recognized theories by which damages may be calculated for deepening insolvency: (1) as a measure of the diminution of corporate assets or increase in the unpaid debt load either (a) from the point at which insolvency reasonably should have been declared, or (b) from the point at which the first bad act in an overarching scheme of corporate malfeasance took place, until the point of bankruptcy or the filing of suit;[241] and/or (2) as a measure of the legal and administrative costs stemming from the unnecessary declaration of bankruptcy due to the corporation's insolvency having been needlessly deepened past the point of return.[242] Other, less recognized theories include the measure of lost profits or loss of business and client relationships resulting from the threat or encumbrance of bankruptcy and some measure of punitive and compensatory damages for the unnecessary declaration of bankruptcy and the death of a corporation that might otherwise have been salvaged.[243]

Where the most harm occurs from deepening insolvency, and where the focus of the damages should lie, is in the dissipation of corporate assets measured from the point at which insolvency should have reasonably been disclosed and/or declared until the point at which the deepened insolvency was discovered and/or bankruptcy filings were made. A majority of courts and experts alike have found support for this calculation of deepening insolvency damages, as does the construction of the cause of action itself.[244]

CONCLUSION

At bottom, deepening insolvency is merely one possible method of responding to a failure in the law that is proving increasingly unsuited to adequately protect the creditor victims of insolvency fraud. Imperfect though it may be, however, it is the only method yet to have gained any noticeable traction in recent years. Although the theory is far from universally accepted, it has been so systematically distorted in recent case law that the true concept has become effectively lost. As such, the fitness of deepening insolvency as a new cause of action should be judged not by recent manifestations of the theory, but by its original scope and purpose at the time of its emergence. Its recent misapplications and resulting unpopularity

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[241] *See Lafferty*, 267 F.3d at 350 (Among the ways in which the value of a corporation may be damaged from deepening insolvency are: "(4) through the dissipation of corporate assets brought about by the prolongation of an insolvent corporation's life through bad debt."); *Fla. Dept. of Ins*., 274 F.3d at 935 ("Damages [from deepening insolvency] are measured by the dissipation of assets or increased debt load occurring after the false representation of solvency was made."); *Greenleaf Ventures*, 269 B.R. at 728 ("[E]ven if the Debtor may have been insolvent before the Greenleaf Valuation, the additional debt incurred thereafter, and allegedly as a result of the Defendants' negligence, may provide a measure of damages recoverable by the Trustee"); *Bookland of Maine*, 271 F. Supp. 2d at 325-26 (Damages from deepening insolvency are calculated from "any loss in the value of [the] company up until . . . the date on which it first filed for bankruptcy . . . , that you find was caused by Baker, Newman & Noyes's act or failure to act; and . . . [a]ny legal and/or administrative expenses that Bookland incurred in the Bankruptcy Court proceedings that you find were caused by Baker, Newman & Noyes's act or failure to act. . . . . Loss in value can occur in a reduction of a company's value from a positive value to a lower positive value; from a positive value to a negative value; or from a negative value to a greater negative value. The measure of value is determined by subtracting liabilities from assets.").

[242] *See Lafferty,* 267 F.3d at 349; *Greenleaf Ventures*, 269 B.R. at 728 (The measure of damage to the corporation under a theory of deepening insolvency may be calculated as the sum of the "financial deterioration of the Debtor" plus any "operational limitations which hurt a corporation's ability to run its business in a profitable manner.").

[243] *See Lafferty*, 267 F.3d at 349-50.

[244] *See* Cohen, *supra* note 9.

notwithstanding, when viewed in the context of existing causes of action available to compensate creditors for the type of large-scale bankruptcy fraud that Sarbanes-Oxley and other securities laws were created to remedy in the context of securities frauds, a cause of action for deepening insolvency may still hold some value.

Despite the Delaware Court's recent pronouncement in Trenwick, a cause of action for deepening insolvency, if carefully and consciously tailored to these objectives, may have something to offer in terms of providing much needed protection to a class of creditors who are in a similar position today as were the victimized shareholders of the post-Enron fury of the late 1990s. The form of harm may be new, but it is no less real, and the causes of action currently available to respond are not enough. In opportunistic response to the failings of the law, the problem of insolvency fraud has and will continue to evolve and manifest itself in ever-more-creative ways. All that remains now is for the law to catch up—and deepening insolvency may be just the route to take.