

DELAWARE BANKRUPTCY BULLETIN

Delaware Court Of Chancery Holds That No Cause Of Action For “Deepening Insolvency” Exists Under Delaware Law

One of the most debated theories of liability for directors, officers, lenders, professionals and agents in recent years has been “deepening insolvency”. Bankruptcy cases, as well as commentators, have debated whether deepening insolvency is a cause of action, a damages theory or neither. While the cases up until now almost always were presented to bankruptcy courts, deepening insolvency, if it exists, is a matter of state law. In Re CitX, 448 F.3d 672 (3d Cir. 2006).

On August 10, 2006, the Delaware Court of Chancery for the first time addressed a cause of action for deepening insolvency in Trenwick America Litigation Trust v. Ernst & Young LLP, et al., C.A. No. 157-1. In Trenwick, Vice Chancellor Leo E. Strine held that “put simply, 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.” Slip op. at 6. Accordingly, Vice Chancellor Strine granted a motion to dismiss a count for deepening insolvency.

Vice Chancellor Strine explained that “even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.” Slip op. at 62-63. Furthermore:

If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation’s value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy’s success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action.

Slip op. at 63. Accordingly, he held that the business judgment rule protects directors, and that “to conclude otherwise would fundamentally transform Delaware law.” Id.

Because deepening insolvency is a state law cause of action, Trenwick would appear to end the debate as to whether deepening insolvency constitutes a cause of action, at least in Delaware, and unless the Trenwick opinion is appealed.

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