DON'T THROW AWAY YOUR DEEPENING INSOLVENCY MATERIALS JUST YET… DAMAGES UNDER *THABAULT V. CHAIT*, AND HARMONIZING *BROWN SCHOOLS* WITH *RADNOR HOLDINGS* AND POST-*CitX* CASE LAW

By Russell C. Silberglied

In the wake of opinions such as the Delaware Court of Chancery's *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,*[1] the Third Circuit's *In re CitX Corp., Inc.*,[2] and the Delaware Bankruptcy Court's *In re Radnor Holdings Corp.*,[3] many had proclaimed the controversial theory of deepening insolvency to be "dead."[4] Thus a decision issued in April 2008 by the Delaware Bankruptcy Court, *Miller v. McCown De Leeuw & Co. (In re Brown Schools)*,[5] took many by surprise. One law firm's bulletin concerning *Brown Schools* starts with Mark Twain's famous statement, "The reports of my death are greatly exaggerated,"[6] while other articles and bulletins concerning the opinion seem to fear that it will breathe new life into a theory that appeared to be dying.[7]

Aside from the fact that, empirically, in the approximately one year since the *Brown Schools* opinion, there has not been a renewed embracing of deepening insolvency,[8] a closer look at the opinion itself reveals that the concerns were overstated. Although *Brown Schools* permitted, at the pleadings stage, a deepening insolvency damages model with respect to claims against directors for breach of fiduciary duty, as is shown below, that holding is not inconsistent with *Trenwick* and *CitX* and does not constitute a "sea change" in the law. In fact, it was a precursor to the Third Circuit's holding shortly thereafter in *Thabault v. Chait*,[9] that traditional causes of action and traditional theories of damages can remedy the same types of harm that a deepening insolvency theory of damages addresses. Thus even where the law does not recognize a deepening insolvency cause of action, a defendant could be called upon to pay the damages proximately caused by its wrongful conduct under breach of fiduciary duty or negligence theories, including damages arising from increased liabilities, decreased asset value, or lost profits.[10] So long as the requisite elements are established—duty, breach,

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causation, and damages—these traditional principles do not become invalid simply because the alleged harm also has the effect of increasing a corporation's insolvency. In Part I of this article, I will focus on deepening insolvency as a damages model after *Chait*, *Brown Schools*, *Radnor*, and *In re Troll Communications, LLC*.[11]

Another interesting aspect of *Brown Schools* is that while it dismissed at the pleadings stage a cause of action for deepening insolvency, it declined to dismiss traditional claims for breach of fiduciary duty that arose from similar factual allegations as those pleaded in the deepening insolvency count. However, it observed that a traditional cause of action for breach of the duty of care could, in other cases, be dismissed as too similar to a deepening insolvency claim. In Part II of this article, I explore *Brown Schools*' treatment of the "disguised deepening insolvency" theory and how it differs (or possibly does not differ) from similar claims litigated in *Radnor*.

I. DEEPENING INSOLVENCY AS A THEORY OF DAMAGES: *CITX*, *BROWN SCHOOLS*, AND THE *CHAIT* CAUSATION ANALYSIS

A. Brief Overview of Deepening Insolvency

Much has been written about the origins, history, and development of deepening insolvency. It is beyond the scope of this article to describe that history in detail here.[12] However, a very brief background is necessary to aid an understanding as to how *Brown Schools*, *Radnor, Chait*, and *Troll Communications* fit into the paradigm.

Deepening insolvency is a fairly recently created concept. It is defined as "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[13] The theory posits that the defendant—typically the board, a lender, an auditor, or someone else with a "deep pocket"—should have taken action to liquidate or wind down the company and did not; as a result, the company was less valuable at the time that it ultimately was shut down, leaving less money available to distribute to creditors than the company would have provided earlier.

Until 2006, deepening insolvency was gaining "growing acceptance" in bankruptcy courts.[14] However, more recently, federal courts have scaled back deepening insolvency claims and damages assertions.[15] Moreover, in *Trenwick*, the Delaware Court of Chancery rejected deepening insolvency as an independent theory for liability against directors, stating that it no more states a claim than "shallowing profitability" does.[16] The court held that an insolvent company may, "with due diligence and good faith, pursue[] a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt" and that, in doing so, it does not become the guarantor of that strategy's success.[17] Furthermore, "[t]hat the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law."[18] The Delaware Supreme Court affirmed "on the basis of and for the reasons assigned by the Court of Chancery."[19]

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B. Facts and Holdings of *Radnor* and *Brown Schools*

To understand the holdings, and arguably tensions of the holdings, of *Radnor* and *Brown Schools*, it is useful to understand the facts that gave rise to the opinions and their holdings.

1. *Radnor*

In 2005 Radnor Holdings Corp. and its subsidiary, Wincup (Radnor) manufacturers of foam cups, needed funding to build a new plant to make a new type of cup in which large customers, such as McDonalds, were interested. Radnor selected Tennenbaum Capital Partners (TCP) to provide the funding.[20] TCP made three different loans to Radnor totaling $143.5 million that were secured by substantially all of Radnor's assets. As part of these transactions, TCP was permitted to designate one director to Radnor's board and selected one of its own partners, Jose Feliciano, for that role. Unfortunately, Radnor suffered a devastating reversal of financial performance in late 2005, and by July 2006, its revolving credit lenders had cut off their loans, forcing Radnor into bankruptcy.[21] TCP agreed to provide a stalking horse bid for Radnor's assets in a section 363 sale.[22] The creditors' committee filed a complaint against TCP and Mr. Feliciano alleging, among other things, breach of fiduciary duties and aiding and abetting a breach of fiduciary duty by the debtor's board of directors. In essence, the committee argued that the board should not have voted to take on the TCP loans at a time when, according to the committee, the company already was insolvent. The committee argued that the company did so because two of the three directors at the time of the first TCP loan owned most of the company's stock. According to the committee, the stockholder-directors, knowing that their equity would be wiped out in a bankruptcy, took on the loans to "swing for the fences" in the aggressive (and according to the committee, risky) new venture. The committee alleged that TCP aided and abetted this breach so that it could "loan to own" the company and that Mr. Feliciano, who joined the board for the later loan, breached his duties as a board member when the loan was approved.

In what has become somewhat unusual in the current environment, the case went to trial. The court's post-trial opinion rejected all of the committee's claims and entered judgment for the defendants.[23] The court stated that the duty of care claim was akin to a disguised deepening insolvency claim and thus rejected it as invalid.[24] It also dismissed the aiding and abetting claim because the court did not find any breach of fiduciary duties by the Radnor board, so there was nothing for TCP to aid or abet. In doing so, it specifically held that there was nothing wrong with the board's strategy of taking on debt to pursue the new ventures, even if the company was insolvent. The court also held that even if the committee had proved one or more of its claims, it still failed to provide a valid theory of damages because, according to the court, *CitX* stands for the proposition that deepening insolvency is not a valid theory of damages.[25] The court also noted that the proffered damages theory was invalid because the committee's expert admitted that his damages theory did not assume any wrongdoing by the defendants.[26]

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2. *In re Brown Schools*[27]

In 1997 and 1998 the Brown Schools (TBS), a collection of reformative educational institutions, sold 65% of its stock to McCown De Leeuw & Co. (MDC) for $63 million.[28] TBS also arranged for $100 million of loans from various banks, including Credit Suisse First Boston (CSFB) and $15 million of unsecured notes from Teachers Insurance and Annuity Association of America (TIAA), which were subordinated to the CSFB debt and to be used for working capital.[29] TBS defaulted on the CSFB debt in 2000, and thereafter, MDC loaned TBS additional funds: $5 million in 1999 and $7.5 million in 2000. In April 2003, TBS sold all of its residential treatment centers. The proceeds were used to satisfy the CSFB debt, pay TBS's and CSFB's advisors, and pay $1.7 million to MDC. Also in 2003, TBS hired the Winstead law firm at the direction of MDC.[30] In July 2004, TBS's debt was further restructured: TIAA received a first lien and MDC a second lien on all remaining assets. TIAA and MDC entered into an Intercreditor Agreement whereby MDC was entitled to share in payments received by TIAA. TBS then sold $18 million in assets to pay TIAA.[31] Soon thereafter, TBS filed for bankruptcy.

TBS's bankruptcy trustee filed claims against MDC, Mr. Robert Naples, an MDC employee and a Brown Schools board member, and the Winstead law firm alleging, among other claims, deepening insolvency, breach of fiduciary duty, and corporate waste. The court dismissed the deepening insolvency claim against all defendants, acknowledging that under *Trenwick* it is not a valid cause of action in Delaware. However, it denied the motion to dismiss the breach of fiduciary duty and corporate waste claims. The defendants argued that these claims were deepening insolvency claims in disguise, citing *Radnor*, but the court rejected this argument.[32] The defendants also sought dismissal on the grounds that all the damages alleged were predicated on a deepening insolvency model, citing *CitX*. The court rejected this argument as well, holding that deepening insolvency may be a valid damages theory if an independent cause of action, such as breach of fiduciary duty, has been proved, as well as causation.[33]

C. Deepening Insolvency as a Theory of Damages

One of the initial debates in the case law and literature prior to *Trenwick* was whether deepening insolvency was a cause of action, a theory of damages, or neither.[34] Several pre-*Trenwick* and *CitX* cases held that even if deepening insolvency did not constitute an independent cause of action, it could be a valid theory of damages.[35]

CitX, decided by the Third Circuit Court of Appeals a few months before the Delaware Court of Chancery issued *Trenwick,* put limits on that trend. In *CitX*, the plaintiff sued an accounting firm for, among other things, professional negligence/malpractice, arguing that if the accounting firm had reported its client's financial results more accurately, the company would not have taken on further debt. The Third Circuit framed the issue as "requir[ing] us to decide whether deepening insolvency is a viable theory of damages for negligence."[36] It held that it was not, distinguishing its prior opinion in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*:[37] "[i]n that opinion, we concluded that deepening insolvency was a valid Pennsylvania cause of action… [but] we never held that it was a valid theory of damages for an independent

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cause of action."[38] It held that *Lafferty* "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice."[39] Apparently recognizing that some might argue that the words "like malpractice" would limit the holding, the court added in a footnote: "[b]y this we do not mean to imply that deepening insolvency would be a valid theory of damages for any other cause of action, such as fraud, and *Lafferty* did not so hold."[40]

Prior to *Brown Schools* and *Chait*, the caselaw seemed to interpret *CitX* as barring deepening insolvency as a measure of damages for any type of claim. For example, in *Radnor*, the Delaware bankruptcy court rejected the damages formulation of the creditors' committee for its claims of aiding and abetting breach of fiduciary duty against TCP and its claims for breach of fiduciary duty against Mr. Feliciano. According to the court, the damages formulation "essentially is a deepening insolvency model, as it calculates the difference between the value that the unsecured creditors would have received if the Debtors filed for bankruptcy in October 2005 and the value available to them in this bankruptcy case."[41] Thus the court rejected it because the "Third Circuit recently held that deepening insolvency is not a recognized form of damages."[42] Similarly, in *Troll Communications*, the Delaware bankruptcy court cited *CitX* for the proposition that "the Third Circuit Court of Appeals rejected the use of deepening insolvency as a theory of damages."[43] In doing so, it seized upon the following language from *CitX*: "[t]he deepening of a firm's insolvency is not an independent form of corporate damage." The court thus dismissed a count for deepening insolvency, holding that it was neither a valid cause of action under *Trenwick* nor a viable damages theory pursuant to *CitX*.[44]

At first blush, this seems to create a bright-line test: deepening insolvency is not a valid theory of damages for any claim. However, *Brown Schools* denied a motion to dismiss, overruling the defendants' argument that to state a claim for breach of fiduciary duty the plaintiff must plead some form of damages, and only had asserted an impermissible deepening insolvency model. Obviously, then, the *Brown Schools* court did not believe a bright-line rule had been created by *CitX*. Rather, it credited the plaintiff's argument that "the Third Circuit's holding in *CitX* was that the company's deepening insolvency was not a viable theory of damages for the particular claim before that Court, a negligence claim for accounting malpractice" and noted that the plaintiffs in *Brown Schools* alleged claims for breach of fiduciary duty.[45]

Presaging *Chait*, which was under advisement when *Brown Schools* was decided, the *Brown Schools* court credited the reasoning of a post-*CitX* case from outside the Third Circuit, *In re Greater Southeast Community Hosp. Corp. I*,[46] which held that a deepening insolvency model could be a valid measure of damages for a cause of action for breach of fiduciary duty. The *Brown Schools* court further agreed with the plaintiff's argument that "the basis of the *CitX* Court's decision was that the plaintiff could not prove actual harm and causation, two necessary elements of a malpractice claim."[47] Essentially, the plaintiff argued, and the bankruptcy court agreed, that causation for the loss of value of the debtor would be easier to demonstrate if the cause of action was the debtor's board of directors' breach of fiduciary duty rather than the

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malpractice of an accountant for failing to render an opinion that would have put the world on notice of illicit acts by management.

While *Brown Schools* is distinguishable from *CitX* in the causes of action that were at issue, *Brown Schools* cannot be distinguished from *Radnor* and *Troll Communications* on that ground: in all three cases, the plaintiff pleaded claims for breach of fiduciary duty and/or aiding and abetting breach of fiduciary duty. Even before *Chait*, if one attempted to harmonize the case law, a better candidate would have been to focus on causation.[48] *Brown Schools* itself observed that lack of causation was an important component of the *CitX* court's opinion. The Third Circuit noted in *CitX* that the malpractice (if it was malpractice) of the accounting firm allowed the debtor to decrease its insolvency by raising additional equity, and held that "[a]ny increase in insolvency (i.e., the several million dollars of debt incurred after the $1,000,000 investment) was wrought by CitX's management, not by [the accounting firm]."[49] "Wrought by," of course, is another way of saying "caused by." The court also states, in a different section of the opinion, that "[e]ven if *CitX's* insolvency deepened between when it issued financial statements… and when it filed for Chapter 11 protection… [plaintiff] must establish that [defendant's] actions caused that condition."[50] Similarly, while *Radnor* was a breach of fiduciary duty and aiding and abetting case, the court "note[d] that [plaintiff's expert witness] opined that he had no opinion as to who caused the damages or any inequitable conduct engaged in connection therewith."[51] The court held that without evidence of "causation between the harm and the damages alleged," it would not award deepening insolvency damages.[52]

Causation was even more at front and center stage in the Third Circuit's opinion in *Chait*. *Chait* confirms that proving the elements of traditional causes of action such as negligence and breach of fiduciary duty—which necessarily include causation and damages—can give rise to damages for the harm that is caused by a corporation's deepened insolvency. The critical issue is whether that harm can be proven under traditional state law theories of damages—proving specific and actual harm proximately caused by the wrongdoing, not by merely comparing balance sheets showing that the corporation is more insolvent than it was before the wrongdoing.

In *Chait*, the Insurance Commissioner for the State of Vermont (the Insurance Commissioner) sued the accounting firm Coopers & Lybrand (Coopers) on behalf of a defunct insurance company, alleging that Coopers negligently issued unqualified and unfavorable audit opinions that materially understated the insurance company's loss reserves.[53] The Insurance Commissioner alleged that but for Cooper's negligent audits, the insurance company would not have continued to write new insurance policies, which resulted in its ultimate failure, because the Insurance Commissioner would have acted to protect the company.[54] Because of the inaccurate audits, the Insurance Commissioner did not act until too late.

The case went to jury trial, and the jury rendered a verdict against Coopers for $120 million in damages plus another $63 million in interest. Coopers appealed, arguing that the district court erred in not entering judgment for Coopers as a matter of law for lack of compensable injury on the basis that deepening insolvency cannot be used as a measure of damages for a negligence claim.

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The Third Circuit affirmed the jury verdict. It framed the issue this way:

> Relying on *In re CitX Corp.*, [Coopers] asks us to hold that whenever a plaintiff makes reference to "deepening insolvency" or "an injury to the Debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of its corporate life," as part of its explanation of damages in a negligence action, recovery is not permissible.[55]

The court rejected Coopers' argument because, taken to is logical conclusion, it would invalidate damages arising from harms caused by a defendant's negligence simply because the damages are the same type of damages encompassed by a deepening insolvency theory. Regardless of whether a particular state recognizes deepening insolvency as a cause of action or theory of damages, all states permit traditional negligence causes of action, and therefore, "[w]hen a plaintiff brings an action for professional negligence and proves that the defendant's conduct was the proximate cause of a corporation's increased liabilities, decreased fair market value, or lost profits, the plaintiff may recover damages in accordance with state law."[56] Thus actual damages proximately caused by wrongdoing are recoverable under a traditional theory of damages, even if they are also damages for a company's deepened insolvency.

Chait confirms, then, that a company's deepened insolvency can form the basis of damages in appropriate circumstances if other factors are also present, but that damages cannot be proven simply by pointing to a company's deepened insolvency, i.e., just by demonstrating that a company is more insolvent after the wrongdoing than it was before. The deepened insolvency does not speak for itself; it must be caused by the wrongdoing and proven under a state law cause of action. The Third Circuit noted the difference between deepening insolvency damages and traditional damages this way:

> The question of whether [Coopers] caused [the insurance company's] deepening insolvency was never put before the jury. Rather, on the question of damages, the verdict sheet asked the jurors: "Has the [Insurance Commissioner] proven by a preponderance of the evidence that [Coopers'] breach was a proximate cause of *any damages* that the [insurance company] may have incurred?" The jury responded: "Yes." The jury was then asked to determine the *total damages* incurred by the [insurance company] that the [Insurance Commissioner] had proven by a preponderance of the evidence…. Despite [Coopers'] contention, the jury was not simply presented with a comparison of [the insurance company's] balance sheets at the point of wrongdoing and at the point of insolvency to show the harm done to the corporation and to measure the damages. Instead, the [Insurance Commissioner] proved actual damages: itemized, specific and avoidable losses that [the insurance company] incurred by continuing its operations beyond the date of [Coopers'] negligent audits.[57]

Under New Jersey law, which applied to the case, a plaintiff can recover traditional tort damages proximately caused by the wrongful conduct of a defendant—including, if the requisite causation is proven, damages resulting from increased liabilities, decreased fair market value, or lost profits. These traditional types of damages do not

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lose their validity simply because they also have the effect of increasing a corporation's insolvency.[58]

In the wake of *Brown Schools* permitting the use of deepening insolvency as a damages model in certain circumstances, but before *Chait* was decided, commentators bemoaned that private equity firms could be at risk of owing as damages more than they invested in a company.[59] Of course, that has always been a risk of doing business since at least 1854, when in the hornbook case of *Hadley v. Baxendale* a court found a carrier liable for damages proximately caused by its failure to deliver equipment—damages far in excess of its carrier fees.[60]

Moreover, if one were to focus on causation as the key to when deepening insolvency damages are available, as the *Chait* court did, one might conclude that the concern is overblown. Rarely would a private equity firm direct the day-to-day management of a company. In many cases the private equity firm will take a seat on the board of directors, but it will be a minority of the directors—as was the case in *Radnor*.[61] Thus where the board's decisions lead to disastrous results and are found to be a breach of fiduciary duty, it would be difficult for the private equity firm to be said to have "caused" the disaster. Also, if the "harm" was the lending of money itself from the private equity firm, presumably that will have occurred before the private equity firm took its seat on the board. Indeed, this fact pattern is almost precisely the facts of *Radnor*. In that case, the Delaware Bankruptcy Court held that TCP could not be assessed with deepening insolvency damages "[e]ven if [it] were to hold that the Committee had prevailed on one or more of its claims for breach of fiduciary duty."[62] It so held precisely because the plaintiff failed to produce any evidence that the deepening of Radnor's insolvency was caused by TCP, a private equity firm.[63] In contrast, if the board itself or its advisors are charged with breach of fiduciary duty, the causal connection between the breach and the deepening of a firm's insolvency seems much more plausible, at least at the pleadings stage. Indeed, the Third Circuit in *CitX* contrasted the accounting firm's lack of connection to the harm with management's, stating that the harm that befell the company was caused by management's squandering of an opportunity that arose when the accounting firm's work allowed the company to obtain more equity than it should have. However, it should be noted that *Troll Communications* also involved allegations of breach of fiduciary duty against primary alleged wrongdoers on similar theories as those alleged in *Brown Schools*, but the result was different. It is more difficult to credit different levels of causation for this disparity in result. Of course, *Troll Communications* was issued before *Chait* and *Brown Schools* and conceivably could have been decided differently in their wake.

Another way of looking at this issue is to see it as more of a debate about whether to call a traditional damages model "deepening insolvency" than a substantive dispute. The Third Circuit acknowledged in *CitX* that while:

> [t]he deepening of a firm's insolvency is not an independent form of corporate damage[, w]here an independent cause of action gives a firm a remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits, then the firm may recover, without reference to the incidental impact upon the solvency calculation.[64]

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In *Chait*, it stated that:

> Under the facts of this case, we are satisfied that a jury could properly hold [appellant] liable for damages under traditional negligence and malpractice principles. Accepting [appellant's] invitation to prevent a plaintiff from recovering damages in a negligence action where there has been reference to deepening insolvency would require us to ignore well-settled New Jersey tort law doctrine, which we are not inclined to do. We hold that traditional damages, stemming from actual harm of a defendant's negligence, do not become invalid merely because they have the effect of increasing a corporation's insolvency.

The well-settled doctrine of negligence requires proof of duty, breach, causation, and damages. Claims brought under a fiduciary duty cause of action also require proof of causation. It is these elements—causation and damages—that can explain the different results of *Radnor* and *Brown Schools*. In *Radnor*, the court held that even if some breach were proved, it would not have given rise to such a measure of damages due to the lack of causation. However, in *Brown Schools*, the court held that where the allegation is that the board took on debt in a fiscally irresponsible manner while insolvent, it makes sense that the ensuing increased insolvency—or, in the words of *CitX*, "increase in its liabilities [or] decrease in fair asset value, or lost profits"[65]—is a time-honored method of computing damages. The fact that these damages also may be labeled deepening insolvency damages does not change the fact that they can be classic damages too; despite the similarity, the difference is in the proof: not just a comparison of balance sheets, but proof of specific, actual, itemized damages proximately caused by the wrongdoing:

> Despite [appellant's] contention, the jury was not simply presented with a comparison of [the corporation's] balance sheets at the point of wrongdoing and at the point of insolvency to show the harm done to the corporation and to measure the damages. Instead, [appellee] proved actual damages: itemized, specific, and avoidable losses that [the corporation] incurred by continuing in its operations beyond the date of [appellant's] negligent audits.

Thus it may well be that the present debate about "deepening insolvency" as a damages model is more of one about labeling than substance.

Indeed, one post *CitX* opinion in addition to *Chait* seems to agree with this approach.[66] There, defendants argued that the plaintiff's damages formulation was "similar to" a deepening insolvency model. The court denied a motion for summary judgment on this ground in part because "the Committee has not claimed a cause of action based upon a deepening insolvency theory."[67] While defendant's argument that the damages alleged were "similar to" deepening insolvency gave the court "serious concerns," the court held:

> In the instant action, the Committee alleges "independent caus[es] of action" in the form of professional negligence, breach of contract, and aiding and abetting breach of fiduciary duty, which, if viable, give AHERF a "remedy for the

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> increase in its liabilities, the decrease in fair asset value, or its lost profits." Therefore, PwC is not entitled to summary judgment based upon the holding in *CitX*.[68]

Like the *Chait* court, the *Allegheny* court concluded that the damages model was in fact not deepening insolvency and that these types of traditional causes of action do, traditionally, entitle a plaintiff to the types of damages that *CitX* and *Chait* say are permissible.

II. DISGUISED DEEPENING INSOLVENCY

As the brief descriptions above of *Radnor* and *Brown Schools* note, there is some tension between the way the two opinions approached legal theories that were termed "breach of fiduciary duty" but that could also have been labeled deepening insolvency. The court in *Radnor* rejected the Committee's attempt to paint its deepening insolvency claim as one for breach of fiduciary duty, writing:

> The Committee tried this case as if it were a "deepening insolvency" case. Presumably, none of the Counts of the Complaint were denominated "deepening insolvency" due to the recent rejection of such a cause of action under Delaware law. *See Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006); *see also Seitz v. Detweiler, Hershey & Assoc. (In re CitX Corp.)*, 448 F.3d 672 (3d Cir. 2006) (rejecting deepening insolvency as a theory of damages). *However, simply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster*. As I conclude below, the *Trenwick* opinion made quite clear that under Delaware law, a board is not required to wind down operations simply because a company is insolvent, but rather may conclude to take on additional debt in the hopes of turning operations around.… I further conclude that deepening insolvency fares no better as a cause of action directly against Tennenbaum than it would against Radnor's board.[69]

The defendants in *Brown Schools* argued that the trustee in their case was doing the same thing as the creditors' committee did in *Radnor*—calling a deepening insolvency cause of action by a different name, i.e., breach of fiduciary duty. Thus they argued for dismissal. While the court did dismiss a count labeled "deepening insolvency," it disagreed with defendants' *Radnor* theory, noting that the "Chancery Court [in *Trenwick*] clearly acknowledged that plaintiffs could bring traditional claims against defendants under the latter theories," i.e., breach of fiduciary duty, aiding and abetting and the like.[70] The passage in question from *Trenwick* reads:

> The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud. The contours of these causes of action have been carefully shaped by generations of experience, in order to balance the societal interests in protecting investors and creditors against exploitation by directors and in providing directors with sufficient insulation so that they can seek to create wealth through the good faith

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> pursuit of business strategies that involve a risk of failure. If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.[71]

Brown Schools' holding that *Trenwick* does not preclude a cause of action for breach of fiduciary duty certainly follows from this passage. Indeed, part of *Trenwick*'s rationale for not recognizing a cause of action for deepening insolvency was that such a cause of action is superfluous, given that the "traditional toolkit" includes breach of fiduciary duties. One therefore might think it circular to rely on *Trenwick* to dismiss a claim that is styled breach of fiduciary duty rather than deepening insolvency.

Yet *Radnor*'s holding is consistent with other portions of *Trenwick*, which discredit the underlying thesis of any claim—whether called deepening insolvency or something else—solely based upon the fact that an insolvent business became more insolvent: "The mere fact that a business in the red gets redder when a business decision goes wrong and a business in black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one."[72] The *Radnor* court found this to be decisive:

> As the Court of Chancery acknowledged in *Trenwick*, Delaware law does not impose an absolute obligation on the board of an insolvent company to cease operations and liquidate. *See Trenwick*, 906 A.2d at 204. Rather, directors of an insolvent company may pursue strategies to maximize the value of the company, including continuing to operate in the hope of turning things around. *See id.*; *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) (permitting board of company within days of a bankruptcy filing to incur new secured debt in aid of funding risky but promising new products over the objection of preferred stockholders with liquidation preference). Specifically, the Court in *Trenwick* stated as follows:
>
>> 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. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.[73]

Thus "the business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and that the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm."[74] <P>Accordingly, *Brown Schools* correctly declines to dismiss a cause of action solely on the basis that the analogous deepening insolvency claim

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was dismissed, but *Radnor* is also correct to look behind what has been alleged and recognize that the very same legal concepts that led to the ruling in *Trenwick* that a cause of action for deepening insolvency does not exist also may justify dismissal of a breach of fiduciary duty claim if facts underlying such a claim are inconsistent with the principles emphasized in *Trenwick*.

Indeed, the *Brown Schools* opinion appears to recognize this. In what seems to be the first such analysis in a reported opinion, the court contrasts claims for breach of the duty of care and for the duty of loyalty in determining how each relates to the deepening insolvency concept:

> Duty of care violations more closely resemble causes of action for deepening insolvency because the alleged injury in both is the result of the board of directors' poor business decision. To defeat such an action, a defendant need only prove that the process of reaching the final decision was not the result of gross negligence. Therefore, claims alleging a due care violation could be viewed as a deepening insolvency claim by another name.[75]

The *Brown Schools* court determined that whereas the *Radnor* court found that the plaintiffs' claims "at best would have implicated the duty of care, not the duty of loyalty,"[76] the trustee in *Brown Schools* alleged duty of loyalty claims that could not be dismissed.[77] This further explains what, at first blush, appears to be an inconsistent outcome between the two opinions' views as to whether a "disguised deepening insolvency claim" should be dismissed.

CONCLUSION

To those who had believed that deepening insolvency "died" with *Trenwick* (together with cases like *CitX*, *Radnor, and Troll Communications*), *Brown Schools* was a surprise. However, given that *Brown Schools* dismissed a cause of action for deepening insolvency and expressed a willingness to dismiss claims pleaded as a breach of the duty of care as disguised deepening insolvency claims, an argument that the case constitutes a sea change appears to be overblown. While *Brown Schools* permitted deepening insolvency to survive at the pleadings stage as a damages formulation where two Delaware cases before it did not, the discrepancy can be seen more in terms of a direct causation than an inconsistency in the case law. After the Third Circuit's recent holding on the issue in *Chait*, it remains to be seen how courts, in future cases, will resolve this issue.

NOTES

1. Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), judgment aff'd, 931 A.2d 438 (Del. 2007).

2. In re CitX Corp., Inc., 448 F.3d 672, 46 Bankr. Ct. Dec. (CRR) 156, Bankr. L. Rep. (CCH) P 80602, 23 A.L.R.6th 891 (3d Cir. 2006).

3. In re Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006).

4. See, e.g., Francis J. Lawall & James C. Carignan, High Court Decision Shows Deepening Insolvency Is Dead In Delaware, Legal Intelligencer, Sept. 7. 2007.

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5. In re The Brown Schools, 386 B.R. 37 (Bankr. D. Del. 2008).

6. Cleary Gottlieb Stein & Hamilton LLP, "Deepening Insolvency and Sponsor Deals," (June 3, 2008).

7. Linda M. Leali & Cheryl L. Tedeschi, Deepening Insolvency Claims in Disguise, Bankr. Law 360, May 14, 2008 ("*Brown Schools* tells us that any sigh of relief following the *Trenwick* decision may have been premature").

8. See, e.g., In re Propex, Inc., 2009 WL 562595, *5 (Bankr. E.D. Tenn. 2009) (rejecting deepening insolvency and noting that it no longer is "growing [in] acceptance").

9. Thabault v. Chait, 541 F.3d 512 (3d Cir. 2008).

10. Thabault v. Chait, 541 F.3d at 522-23.

11. In re Troll Communications, LLC, 385 B.R. 110, 49 Bankr. Ct. Dec. (CRR) 236 (Bankr. D. Del. 2008).

12. For a more complete history, see, e.g., Hugh M. McDonald, Todd S. Fishman & Laura Martin, Lafferty's Orphan: The Abandonment of Deepening Insolvency, Am. Bankr. Inst. J., Dec. 2007/Jan. 2008, available online at http://findarticles.com/p/articles/mi_qa5370/is_200712/ai_n21300137.

13. Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 347, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001).

14. See, e.g., In re LTV Steel Co., Inc., 333 B.R. 397 (Bankr. N.D. Ohio 2005); In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003).

15. See, e.g., In re CitX Corp., Inc., 448 F.3d 672, 46 Bankr. Ct. Dec. (CRR) 156, Bankr. L. Rep. (CCH) P 80602, 23 A.L.R.6th 891 (3d Cir. 2006) (limiting deepening insolvency to claims of actual fraud and limiting its availability as a damages model); Radnor, 353 B.R. at 849 (rejecting deepening insolvency as a damages model); In re SI Restructuring, Inc., 532 F.3d 355, 50 Bankr. Ct. Dec. (CRR) 36, 59 Collier Bankr. Cas. 2d (MB) 1723, Bankr. L. Rep. (CCH) P 81264 (5th Cir. 2008) (same).

16. Trenwick, 906 A.2d at 174.

17. Trenwick, 906 A.2d at 205.

18. Trenwick, 906 A.2d at 205.

19. Trenwick America Litigation Trust v. Billett, 931 A.2d 438 (Del. 2007).

20. Radnor, 353 B.R. at 827-30.

21. Radnor, 353 B.R. at 829-35.

22. Radnor, 353 B.R. at 835-36.

23. Radnor, 353 B.R. at 826.

24. Radnor, 353 B.R. at 842-45.

25. Radnor, 353 B.R. at 848-49.

26. Radnor, 353 B.R. at 848-49.

27. In re The Brown Schools, 386 B.R. 37 (Bankr. D. Del. 2008). Unlike Radnor, Brown Schools was an opinion on defendants' motion to dismiss. Thus the facts set forth herein and in the opinion were taken from the complaint.

28. Brown Schools, 386 B.R. 37.

29. Brown Schools, 386 B.R. 37.

30. Brown Schools, 386 B.R. 37.

31. Brown Schools, 386 B.R. 37.

32. Brown Schools, 386 B.R. 37.

33. Brown Schools, 386 B.R. 37.

34. See, e.g., William Bates III, Deepening Insolvency: Into the Void, Am. Bankr. Inst. J., at 1, Mar. 2005; J.B. Heaton, Deepening Insolvency, 30 J. Corp. L. 465 (2005).

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35. See, e.g., In re Global Service Group, LLC, 316 B.R. 451, 458, 43 Bankr. Ct. Dec. (CRR) 253, 53 Collier Bankr. Cas. 2d (MB) 57 (Bankr. S.D. N.Y. 2004).

36. CitX, 448 F.3d at 677.

37. Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001).

38. CitX, 448 F.3d at 677.

39. CitX, 448 F.3d at 677.

40. CitX, 448 F.3d at 677 n.8.

41. Radnor, 353 B.R. at 849.

42. Radnor, 353 B.R. at 849.

43. Troll Communications, 385 B.R. at 122.

44. Troll Communications, 385 B.R. at 122.

45. Brown Schools, 386 B.R. 37.

46. In re Greater Southeast Community Hosp. Corp. I, 353 B.R. 324, 333 (Bankr. D. D.C. 2006), as amended, (Sept. 26, 2006).

47. Brown Schools, 386 B.R. 37.

48. See Russell. C. Silberglied, Don't Throw Away Your Deepening Insolvency Materials Just Yet… Harmonizing Brown Schools with Radnor Holdings and Post-CitX Caselaw, ABI Journal (Oct. 2008).

49. CitX, 448 F.3d at 677.

50. CitX, 448 F.3d at 678.

51. Radnor, 353 B.R. at 849.

52. Radnor, 353 B.R. at 849 n.4.

53. Chait, 541 F.3d at 515-16.

54. Chait, 541 F.3d at 516.

55. Chait, 541 F.3d at 520.

56. Chait, 541 F.3d at 520.

57. Chait, 541 F.3d at 519 (emphasis in original) (internal citations omitted).

58. Chait, 541 F.3d at 523.

59. See, e.g., Jo Christine Reed, Deepening Insolvency: Pitfall for Private Equity Firms, Bankruptcy Law 360 (July 16, 2008); Cleary Gottlieb Stein & Hamilton LLP, Deepening Insolvency & Sponsor Deals, at pp. 1-2 (June 3, 2008).

60. Hadley v. Baxendale, 9 Exch 341 (1854).

61. If it determines to take a majority position on the board, the private equity firm could indeed take on a greater risk, and it should consider that risk in determining whether it desires to control the board.

62. Radnor, 353 B.R. at 848-49.

63. Radnor, 353 B.R. at 849.

64. CitX, 448 F.3d at 678 (quoting Sabin Willett, The Shallows of Deepening Insolvency, 60 Bus. Law. 549, 575 (2005)). See also Troll Communications, 385 B.R. at 122 (quoting same).

65. CitX, 448 F.3d at 678.

66. Official Committee of Unsecured Creditors of Allegheny Health, Educ. and Research Foundation v. Pricewaterhouse Coopers, LLP, 2007 WL 141059 (W.D. Pa. 2007).

67. Allegheny, 2007 WL 141059.

68. Allegheny, 2007 WL 141059.

69. Radnor, 353 B.R. at 842 (emphasis supplied).

70. Brown Schools, 386 B.R. 37 (citing Trenwick, 906 A.2d at 205).

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71. Trenwick, 906 A.2d at 205.
72. Trenwick, 906 A.2d at 205.
73. Radnor, 353 B.R. at 843 (emphasis supplied).
74. Radnor, 353 B.R. at 843.
75. Brown Schools, 386 B.R. 37.
76. Radnor, 353 A.2d at 842.
77. Brown Schools, 386 B.R. 37.

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