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Don't Throw Away Your Deepening Insolvency Materials Just Yet

Harmonizing *Brown Schools* with *Radnor Holdings* and Post-*CitX* Case Law: Part II

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In the last issue of the ABI Journal, I described how the Brown Schools[1] opinion dismissed a cause of action for deepening insolvency, but declined to dismiss a traditional cause of action for breach of fiduciary duty. In doing so, the court determined not to dismiss what the defendants called a "disguised" deep-ening insolvency claim, though the earlier decision of Radnor Holdings[2] did just that. In this issue, I will focus on a different issue that these two cases both addressed and, once again, came to conclusions that at least on their face seem to differ: whether deepening insolvency may be a valid measure of damages for a separate tort.

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Deepening Insolvency as a Theory of Damages

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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.[3] 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.[4]

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 negli-gence/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."[5] It held that it is not, distinguishing its prior opinion in Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.[6]: "In 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 cause of action."[7] It held that Lafferty "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice."[8] Apparently recognizing that some might argue that the words "like malpractice" would limit the holding, the court added in a footnote: "By 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."[9]

Prior to Brown Schools, the case law seemed to interpret CitX as barring deepening insolvency as a measure of damages for any type of claim. For example, in Radnor, the U.S. Bankruptcy Court for the District of Delaware rejected the creditors' committee's damages formulation 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."[10] Thus, the court rejected it because the "Third Circuit recently held that deepening insolvency is not a recognized form of damages."[11] Similarly, in

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1 Miller v. McCown De Leeuw & Co. (In re Brown Schools), 2008 Bankr. LEXIS 1226, at *19-23 (Bankr. D. Del. Apr. 24, 2008).
2 Official Committee of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners LLC (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006).
3 See, e.g., William Bates III, "Deepening Insolvency: Into the Void," Am. Bankr. Inst. J. at 1, March 2005; J.B. Heaton, "Deepening Insolvency," 30 J. Corp. L. 465 (2005).
4 See, e.g., In re Global Serv. Group LLC, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).
5 CitX, 448 F.3d at 677.
6 267 F.3d 340 (3d Cir. 2001).
7 CitX, 448 F.3d at 677.
8 Id.
9 Id., n.8.
10 Radnor, 353 B.R. at 849.
11 Id.

Troll Communications, the Delaware Bank-ruptcy Court cited CitX for the proposition that "the Third Circuit Court of Appeals rejected the use of deepening insolvency as a theory of damages."[12] In doing so, it seized upon the following language from CitX: "The 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.[13]

At first blush, this seems to create a bright-line test: Deepening insolvency is not a valid theory of damages for any claim. But 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 plaintiffs in Brown Schools alleged claims for breach of fiduciary duty.[14]

In doing so, the Brown Schools court also credited the reasoning of a post-CitX case from outside the Third Circuit, Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Corp. I),[15] 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."[16] Essentially, the plaintiff argued that causation for the loss of value of the debtor would be easier to demonstrate if the cause of action was the debtor's breach of fiduciary duty, rather than the 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. If one were to attempt to harmonize the case law, a better candidate would be to focus on causation. Brown Schools itself observed that lack of causation was an important component the CitX court's opinion. The Third Circuit noted in CitX that the malpractice (if it was malpractice) of the accounting firm allowed it 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 million investment) was wrought by CitX's management, not by [the accounting firm]."[17] "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."[18] 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."[19] The court held that without evidence of "causation between the harm and the damages alleged," it would not award deepening insolvency damages.[20]

In the wake of Brown Schools' permitting the use of deepening insolvency as a damages model in certain circumstances, commentators have been bemoaning that private equity firms could be at risk of owing as damages more than they invested in a company.[21] But if one were to focus on causation as the key to when deepening insolvency damages are available, 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. 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. And 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. And 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."[22] It so held precisely because plaintiff failed to produce any evidence that the deepening of Radnor's insolvency was caused by TCP, a private equity firm.[23] 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 Com-munications 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.

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.[24]

In Radnor, the court held that even if some breach were proved, it would not

12 In re Troll Communications, 385 B.R. 110, 122 (Bankr. D. Del. 2008).
13 Id.
14 Brown Schools, 2008 Bankr. LEXIS 1226, at *22.
15 353 B.R. 324, 333 (Bankr. D. D.C. 2006).
16 Brown Schools, 2008 Bankr. LEXIS 1226, at *22.
17 CitX, 448 F.3d at 677.
18 Id. at 678.
19 Radnor, 353 B.R. at 849.
20 Id. at 849 n. 4.
21 See, e.g., Jo Christine Reed, "Deepening Insolvency: Pitfall for Private Equity Firms," Bankruptcy Law360 July 16, 2008; Cleary Gottlieb Stein & Hamilton LLP, "Deepening Insolvency & Sponsor Deals" at pp. 1-2, June 3, 2008.
22 Radnor, 353 B.R. at 848-49.
23 Id. at 849.
24 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).

have given rise to such a measure of damages due to the lack of causation. But 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"[25] is a time-honored method of computing damages. 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 from the Western District of Pennsylvania seems to take this approach.[26] 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."[27] While the 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 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.[28]

Professional negligence, of course, was the very cause of action that the CitX court held did not entitle a plaintiff to deepening insolvency damages. The Allegheny court thus sidestepped the issue by concluding 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 says are permissible.

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. It remains to be seen whether courts, in future cases, will focus on this issue or simply attempt to choose which of the cases follows CitX more closely. ■

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25 CitX, 448 F.3d at 678.
26 Official Committee of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PriceWaterhouseCoopers LLP, 2007 U.S. Dist. LEXIS 3331 (W.D. Pa. Jan. 17, 2007), rev'd on other grounds, __ F.3d __ (3d Cir. 2008).
27 Id. at *20.
28 Id. at *20 and 22.