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Deepening Insolvency: Developments for Directors

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Deepening insolvency first appeared as a theory of damages. It rapidly expanded into an independent cause of action that threatened directors and officers of insolvent companies. Then, almost as rapidly, many courts abandoned it. Once seen as a potent plaintiff device for suits against officers and directors,[1] deepening insolvency—in the latest stage of its evolution—has faded to a shadow of its former self.

To understand deepening insolvency's current status as an anti-management tool, it is important to explore the theory's history as applied to directors and officers. The evolution of deepening insolvency thus far covers four principal stages: (1) theory of damages; (2) independent cause of action; (3) skepticism; and (4) rejection of the cause of action. During the second stage, deepening insolvency gave directors much reason to worry. But now, in the fourth stage, it poses little threat to directors as a cause of action; it is currently seen either as duplicative of traditional causes of action or as contradicted by basic corporate-governance principles. As a theory of damages, on the other hand, the term "deepening insolvency" adds little to pre-existing damages theories, but courts have approved many of the damages claimed in deepening-insolvency cases.

The Rise of Deepening Insolvency

Stage 1: Theory of damages—the early history

The genesis of deepening insolvency has been given in detail several times before.[2] The generally accepted version runs as follows. The Southern District of New York, in its 1980 Investors Funding case, was deciding a motion for partial summary judgment in a fraud suit.[3] The plaintiff—a bankruptcy trustee—had sued an insolvent corporation's directors and auditors, alleging fraud, misappropriation of funds, and a scheme in which management incurred greater and greater debts to cover up the problems.[4] The parties argued over whether the "adverse interest" exception applied to the general agency principle that the directors' knowledge and conduct would be imputed to the corporation.[5] The auditor defendants argued that the exception did not apply because of the directors' obtaining (though fraudulently) large loans that kept the company alive.[6] That is, the auditors argued that the directors acted in the corporation's interest—not against it—by keeping the corporation afloat through increasing debt. The court rejected this argument, stating 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."[7] The benefit of the corporation's "prolonged artificial solvency" ran only to the directors, the court said, not to the corporation.[8]

Three years later, in *Schacht v. Brown,*[9] the Seventh Circuit picked up on this language. The plaintiff in *Schacht* had sued the directors and officers of an insurance company under RICO for, among other things, fraudulently obtaining approval from the Illinois Department of Insurance by concealing the company's insolvency.[10] The company's management had kept the company in operation "long past insolvency," causing huge losses.[11] The defendants in Schacht made the same argument as was made in *Investors Funding*—that the directors' prolonging the company's existence was a benefit to the company[12]—and they met the same result. The Seventh Circuit held that the company's prolonged existence was a slim benefit compared to the harm "inflicted by the diminution of its assets and income. Under such circumstances, the prolonged artificial insolvency of [the company] benefited only [the company's] managers and the other alleged conspirators, not the corporation."[13]

The defendants then argued that "a corporation may not sue to recover damages resulting from the fraudulent prolongation of its life past insolvency," but the Schacht court held that such a fraudulent prolongation is not automatically a benefit to the corporation, stating—in language often quoted in later cases—that "the corporate body is ineluctably

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damaged by the deepening of its insolvency, through increased exposure to creditor liability."[14]

After *Schacht,* the theory quietly spread. In 1994, the Eastern District of New York approved of a claim that accountants' negligently prepared financial statements let an insolvent company incur loans it could not repay and let its management misappropriate funds, thereby bankrupting the company.[15] In 1996, the Southern District of New York refused to grant summary judgment to a bankrupt corporation's former auditors because other "courts have permitted recovery under the 'deepening insolvency' theory."[16] Citing both *Schacht* and *Investors Funding, Allard* held that loan proceeds may not always be a benefit because they could "provide an illusory financial cushion that lulls shareholders into postponing the decision to dissolve the corporation."[17] When the shareholders delay dissolution because of the "illusory financial cushion," they are vulnerable to the danger of management looting.[18]

Stage 2: Independent cause of action—Lafferty and its aftermath

In its 2001 Lafferty opinion, the Third Circuit Court of Appeals predicted that Pennsylvania would recognize deepening insolvency as a cause of action.[19] It cited "the soundness of the theory, its growing acceptance among courts, and the remedial theme in Pennsylvania law"—that is, where there's a wrong, there's a remedy—as its reasons for doing so.[20] *Lafferty* thus became the leading case for recognizing an independent cause of action for deepening insolvency.[21]

In *Lafferty,* a creditors' committee had sued a company's lawyers and accountants for conspiring with the company's management to run a Ponzi scheme.[22] The Third Circuit held that deepening insolvency—"the fraudulent expansion of corporate debt and prolongation of corporate life"—was a cognizable "injury to the [company's] corporate property."[23] *Lafferty* stated that the theory was sound and listed several ways in which fraudulently incurring debt can harm corporate property: the legal and administrative costs of a forced bankruptcy, the operational constraints on profitability due to bankruptcy, the strain on a corporation's third-party relationships, and the possible dissipation of corporate assets.[24] The court (citing *Schacht* and *Allard,* among others) noted that the "[g]rowing acceptance of the deepening insolvency theory confirms its soundness."[25] Finally, *Lafferty* held that Pennsylvania's principle that; "where there is an injury, the law provides a remedy" necessitated a remedy for the harm to corporate property incurred by deepening insolvency.[26]

Although *Lafferty* purported to predict only Pennsylvania law,[27] it was soon cited by courts across the country.

Even after *Lafferty,* there was still uncertainty in the federal courts about what to do with deepening insolvency. Their standard line went something like this: some courts have called it an independent cause of action (citing *Lafferty*); some have seen it as a theory of damages (citing *Schacht*); some have "rejected the theory outright."[28] The concept was "newly created,"[29] and few states had passed judgment on the question.

But *Lafferty*'s imprimatur carried a lot of weight. A Florida bankruptcy court, just one month after *Lafferty,* held that deepening insolvency stated a cognizable claim.[30] Two years later, the court in Exide[31] thought it had no other option: as a Delaware bankruptcy court, it had to follow Third Circuit precedent. Accordingly, it predicted that Delaware would adopt deepening insolvency.[32] A Tennessee bankruptcy court cited *Exide* and *Investors Funding* and—calling *Lafferty*'s analysis "sound"—predicted that "the Tennessee Supreme Court would recognize deepening insolvency as an actionable breach of duty to a corporation."[33] And a bankruptcy court in Ohio, dealing with a New Jersey corporation and a Delaware corporation, looked to *Lafferty* and *Exide* and recognized deepening insolvency.[34]

The doctrine spread quickly, and deepening-insolvency decisions became very frequent (one court counted "eight relevant decisions" in as many months[35]). But not every court was favorably disposed to the theory. One such was the Bankruptcy Court for the Southern District of New York, which issued its *Global Service* opinion in late 2004.[36] Global Service's Chapter 7 bankruptcy trustee had sued Atlantic Bank (which lent to Global) and members of Global's management for the "artificial prolongation of Global's corporate life, resulting in its 'deepening insolvency.'"[37] Global had been insolvent since its creation, but Atlantic continued to loan Global money it could not repay.[38] Global's management knew that Global could not repay

the debts, but they prolonged its life—and possibly siphoned money from the company.[39]

Global Service is known primarily for its skepticism as to whether Atlantic could be liable for Global's deepening insolvency because it knew Global could not repay the loans.[40] Famously, the court stated, "This may be bad banking, but it isn't a tort."[41] The court explained further that it is not inherently wrong to loan money to an insolvent corporation and that US directors are not under a duty to liquidate insolvent corporations.[42] Moreover, running an insolvent company, if done in good faith, is within the business judgment rule.[43] The court held, therefore, that "a manager's negligent but good faith decision to operate an insolvent business will not subject him to liability for 'deepening insolvency.'"[44]

Less often discussed is *Global Service*'s discussion of the deepening-insolvency claim against Global's management. There, the court faulted the plaintiff for failing to include in his complaint allegations that the management "continued to operate the Debtor as a means of siphoning the Debtor's funds for their individual benefit."[45] Had the deepening-insolvency claims included these allegations, the court held, the claims might have been valid.[46] That is, "[t]he prolongation of Global's operations would smack of self-dealing, constitute a breach of fiduciary duty, and open up recovery under the theory of 'deepening insolvency.'"[47] The court therefore dismissed the claims against Global's management "with leave to replead" for the plaintiff to add allegations of a breach of fiduciary duty.[48] *Global Service,* while most known for its questioning of deepening insolvency, thus also promoted the theory's use as a damages piggyback on fiduciary-duty claims.

Implications for directors and officers

As deepening insolvency's popularity grew, directors and officers (and their advisors) got nervous.[49] The theory was being recognized widely, and commentators were discussing the situation in alarming terms.

Granted, some commentators looked askance at the deepening-insolvency juggernaut. Some discounted the entire thing: "'Deepening insolvency' should not develop further—but it might."[50] Some questioned various portions of its application. One, for example, suggesting that recovery for administrative bankruptcy costs was acceptable, called the grant of wrongfully incurred and unpayable debt as damages "either the product of judicial misunderstanding or a judicial attempt to avoid controlling Supreme Court precedent."[51] Another was concerned about deepening insolvency's potential scope, urging courts to view the theory "skeptically until it is better defined so as to exclude negligently made decisions in the face of insolvency."[52]

On the whole, however, commentators perceived deepening insolvency as a threat to management.[53] One expressed concern that, if deepening insolvency were interpreted to allow negligence claims, it would "strike a serious blow against the premise of the business judgment rule" and "severely dampen the market for corporate officers and directors."[54] He noted that deepening insolvency's acceptance in the Delaware federal courts was significant[55] and worried that, as a tort, deepening insolvency would strip directors of the business judgment rule's protection.[56] Another commentator listed directors and officers among the classes of defendants who needed to be concerned about deepening insolvency.[57] She especially cautioned directors and officers of troubled companies, warning that, "in the 'zone of insolvency,' an increased standard of care may be imposed upon officers and directors."[58]

Some commentators looked favorably on deepening insolvency. One in particular welcomed its role as an "economically devastating" theory of damages that could "piggyback on other causes of action."[59] He suggested that deepening insolvency was an appropriate claim for shareholder derivative suits, advocating its application outside the traditional context of trustees' or creditors' committees' suits.[60] Arguing that management are usually the "chief perpetrators of deepening insolvency," and that their actions are often a breach of their fiduciary duties,[61] he concluded that "shareholders should have the right to piggyback a claim of deepening insolvency [on] their claims of fraud or breach of fiduciary duty."[62] And because deepening-insolvency damages can be "'enormous,'" such claims will likely force directors and officers to settle.[63]

At one point in time, then, deepening insolvency was seen as stakeholders' newest, best tool for strike suits. But that analysis bears further investigation, because it affords a greater understanding of the overlap between deepening insolvency and traditional causes of action, like breach of fiduciary

duty. Even in deepening insolvency's post-*Lafferty* heyday, many recognized its chief weakness: deepening insolvency is duplicative of traditional D&O claims, like fraud and breach-of-fiduciary-duty claims. Indeed, Gordon, the commentator in favor of the piggybacked deepening-insolvency damages, recognized that "[t]here is little utility in having an independent cause of action for deepening insolvency because deepening insolvency does not punish any conduct other torts do not cover. Deepening insolvency must remain a piggyback claim because it is doubtful whether there is any series of facts in which deepening insolvency would apply alone to the exclusion of other torts, [like fraud, breach of fiduciary duty, and self-dealing]."[64] He thus concluded that its sole advantage is as a damages theory.[65] Other commentators were less charitable about the overlap: "[A]s a cause of action, 'deepening insolvency' is just a catchy phrase. It has added nothing to the law."[66]

The Fall of Deepening Insolvency

Stage 3: Skepticism—cracks in the cause of action

The third stage in deepening insolvency's evolution started with the *Business Lawyer*'s publication of an article by Sabin Willett criticizing deepening insolvency.[67] First, Willett attacks the major tenets of the theory. A new loan, he writes, "however onerous or ill-advised, can *never* 'deepen' balance-sheet insolvency."[68] That is, every new loan involves an infusion of capital that sets off the added debt—so the insolvency remains the same, not deeper.[69] Shareholders are not injured by deepening insolvency; their injury (Willett calls it "death") is total upon the initial insolvency.[70] The dead cannot get deader. Although a corporation's creditors may be harmed by deepening insolvency, the "creditors are not the corporation; that they may suffer harm as a corporation's insolvency deepens does not mean that the corporation does."[71] He notes that, if deepening insolvency were valid, a cause of action would also have to exist for "diminished solvency." "[F]rom the firm's point of view, there is no obvious reason why one diminution in solvency is unlike another, even if one begins in solvent, and the other in insolvent territory. If rightward movement along the continuum constitutes the harm, why wouldn't any equal rightward movement be as actionable as any other?"[72] He also debunks each of the deepening-insolvency rationales listed in *Lafferty.*[73]

Second, Willett points to the other troubling feature of deepening insolvency: its overlap with traditional causes of action. He asks whether the "long years of jurisprudence, statutes and the common law [spent developing] the duty of director to firm" are "to be tossed out because the firm's insolvency happened to be deepening at the time of the delict."[74] Lenders should not be liable for deepening insolvency because, in the end, it is the company's management that spends the money.[75] Instead, breach of fiduciary duty is the correct cause of action. Willett alludes to *Global Service,* noting that plaintiffs may have no deepening-insolvency claim—due to the business judgment rule—unless they can allege bad faith or fraud.[76] But then, he says, if the plaintiffs can allege fraud, they have a fraud claim. So what is the point of deepening insolvency?[77] He also writes that "injury to solvency is an incident to the harm, not the harm itself."[78] The "law already measures damage" in these situations, through "breach of contract, commission of tort, breach of fiduciary duty, or fraudulent transfer."[79] The "insolvency analysis adds nothing to the measure of damages the law already allows."[80]

Willett concludes with a few key points, these among them: (1) "There is no valid 'cause of action' for deepening insolvency." (2) "Where 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." (3) "The law of fraud, equitable subordination, and fraudulent transfer occupy the field in cases where lending to insolvent borrowers is challenged. Where those legal regimes provide no remedy, 'deepening insolvency' should afford none."[81]

Even after Willett's article appeared, some courts continued to adopt deepening insolvency. The Ninth Circuit, six months after the article, recognized deepening insolvency in *Smith v. Arthur Andersen LLP.*[82] The defendants in *Smith,* it was alleged, had kept an insolvent-from-inception company afloat by "misrepresenting (not necessarily intentionally) the firm's financial condition to its outside directors and investors."[83] While the Ninth Circuit admitted that it was "difficult to grasp exactly what the theory entails," it agreed that deepening insolvency was

a harm to corporate property and that "the complaint state[d] a cognizable harm to [the company] when it allege[d] that the defendants 'prolonged' the firm's existence, causing it to expend corporate assets that would not have been spent [had the company been dissolved in a timely manner]."[84]

More common, though, were courts resisting the theory—typically because they saw it as duplicative of already-existing causes of action. One example, *Parmalat,* decided by the Southern District of New York, came out just weeks before *Smith.*[85] The plaintiff in *Parmalat* alleged that Bank of America had helped Parmalat (and several affiliated entities) hide Parmalat's insolvency; help that resulted in Parmalat's bankruptcy.[86] The court was faced with the question whether deepening insolvency was a valid cause of action in North Carolina.[87] It answered no, because it held the deepening-insolvency claim to be duplicative of a fiduciary-duty claim.[88] "If officers and directors can be shown to have breached their fiduciary duties by deepening a corporation's insolvency," the court said, "that injury is compensable on a claim for breach of fiduciary duty."[89]

Three weeks later, an Illinois bankruptcy court decided *Fleming Packaging.*[90] Certain directors, according to the complaint, had fraudulently prolonged an insolvent corporation's life by meeting secretly with a lender bank to hide the corporation's worsening financial condition from everyone else.[91] The *Fleming* court noted that deepening insolvency "has not been uniformly applied nor universally embraced," and cited Willett's article.[92] It acknowledged *Lafferty* and *Exide,* but it stated that "the adoption of an innovative theory of recovery is better left to the state courts of Delaware or its legislature."[93] Moreover, on a substantive level, the court noted deepening insolvency's "redundancy": is a deepening-insolvency claim "different than an ordinary one for breach of fiduciary duty"?[94] If the elements of the deepening-insolvency claim are the same as those for a fiduciary-duty claim, the deepening-insolvency claim should be dismissed as duplicative.[95] The court opted to leave the motion to dismiss pending, however, because the complaint had made out a self-dealing claim, with the deepening-insolvency angle limited to damages, if anything.[96] *Fleming* did express doubt that "Delaware will ultimately adopt the deepening insolvency theory as an independent cause of action separate from the garden variety breach of fiduciary duty claim,...[because a] director's fiduciary duties already prohibit the kind of conduct that forms the basis for deepening insolvency claims."[97]

Two months later, the Bankruptcy Court of the District of Columbia took up the deepening-insolvency question in *Southeast Community Hospital.*[98] The plaintiff alleged that the debtor's former directors and officers had pushed the debtor deeper into debt "in furtherance of a Ponzi scheme perpetrated by the Debtors' primary lender."[99] The court cited *Parmalat* and opted not to recognize a cause of action for deepening insolvency.[100] "There is no point in recognizing and adjudicating 'new' causes of action," the court held, "when established ones [like those for breach of fiduciary duty] cover the same ground. The [plaintiff's] duplicative claims will be dismissed."[101]

In December 2005, a Texas bankruptcy court rejected deepening insolvency as a separate tort because it was duplicative of preexisting Texas torts.[102] It noted that other cases recognizing a cause of action for deepening insolvency had required the allegation of another tort, like fraud (*Lafferty*) or breach of fiduciary duty (*Del-Met*), so deepening insolvency added nothing by itself.[103]

The Delaware bankruptcy court's 2006 Oakwood Homes[104] case merits special attention. Though the court was—being in the Third Circuit—required to follow *Lafferty,* its reasoning foreshadowed the imminent demise of deepening-insolvency as a cause of action. The plaintiff in *Oakwood Homes* alleged that Credit Suisse First Boston had deepened Oakwood Homes's insolvency, eventually driving it into bankruptcy, "for the purpose of enriching itself, through exorbitant fees and other remuneration."[105] The court held that, following *Lafferty,* the Delaware, New York, and North Carolina courts would recognize deepening insolvency.[106]

But the *Oakwood Homes* court did not follow *Lafferty* quietly. It noted that other courts had refused to recognize deepening insolvency,[107] and several times it referred to its duty to follow Lafferty.[108] It finally resolved to leave the motion to dismiss "pending," leaving the decision up to the state courts: "[D]eepening insolvency, through primarily litigated in federal court proceedings, is a creature of state law. As such, state courts will have the final word."[109]

Stage 4: The rejection of the deepening-insolvency cause of action

The *cri de coeur* of *Oakwood Homes* was not in vain. Just two months later, the tide began to turn. The Third Circuit Court of Appeals decided a deepening-insolvency case called *CitX* in May 2006.[110] CitX did not overrule *Lafferty*—indeed, the court noted that it could not have done so because only the Third Circuit *en banc* can overturn a prior precedential opinion of that court.[111] Nonetheless, *CitX* restricted *Lafferty* in nearly every way possible.

Plaintiff in CitX, a bankruptcy trustee, sued the debtor–corporation's accountants for negligently preparing financial statements that helped the corporation land over $1 million in equity investment.[112] Because CitX had been insolvent at the time of the equity investment, and because CitX's management had spent the $1 million on its way toward bankruptcy, the trustee sued the accountants for deepening insolvency.[113]

The court first explained that *Lafferty* did not hold that deepening insolvency was a theory of damages; if it is anything, it is a cause of action.[114] It also made clear that an equity infusion—just like a new loan[115]—does not deepen insolvency.[116] The harm does not result from the new money, but from management's wrongdoing.[117] Quoting Sabin Willett's article, the Third Circuit noted that the valid damages traditionally represented by "deepening insolvency" are recoverable under pre-existing damages theories.[118]

The *CitX* court's discussion also alluded to management's right to run an insolvent company. Consistent with their fiduciary duties, CitX's management had the "opportunity [to use the equity investment] to turn the company around and transform it into a profitable business. They did not, and therein lies the harm to CitX."[119] In other words, the "harm" of deepening insolvency in *CitX* was simply the "harm" of the breach of management's fiduciary duties.

Then, the Third Circuit limited *Lafferty* by restricting the reach of deepening insolvency to Pennsylvania.[120] Citing *Oakwood Homes,* which had predicted under *Lafferty* that Delaware, New York, and North Carolina would recognize deepening insolvency, the *CitX* court stated that "nothing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania."[121] The judicial response to *Lafferty* had been extensive, but the *CitX* court seemed intent on limiting future reliance on *Lafferty* and curtailing deepening insolvency's adoption.

Less than three months later, the Delaware Court of Chancery weighed in on deepening insolvency in *Trenwick America.*[122] Using no uncertain terms, Vice Chancellor Strine held that deepening insolvency was not a valid Delaware cause of action.[123] Instead of the duplicative-claim analysis used in other cases, *Trenwick* looked to the nature of directors' fiduciary duties and the business judgment rule.

The plaintiff in *Trenwick* alleged that the company's directors had "engaged in an imprudent business strategy by acquiring other insurers who had underestimated their potential claims exposure. As a result of that imprudent strategy, the holding company and its top US subsidiary were eventually rendered insolvent."[124]

The court referred to the "growing body of federal jurisprudence" questioning the theory.[125] It mentioned *CitX,* noting that "the Third Circuit has taken a more skeptical view of the deepening insolvency concept."[126]

Trenwick rejected the concept of a deepening-insolvency cause of action under an analysis of directors' rights and duties. First of all, management's job is to run the company—even if it is insolvent.[127] Delaware does not require a company's management to liquidate an insolvent company,[128] though they are bound to act in the interests of the entire corporation.[129]

Then, *Trenwick* refused to impose, under Delaware law, "retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out."[130] Directors and officers always face the risk of failure. But that is why the business judgment rule was created. It "exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that seem to promise great profit."[131] If failure (that is, "deeper" insolvency) automatically leads to liability, "the business judgment rule will have been denuded of much of its utility."[132] Put another way, "the mere fact of a business failure does not mean that a plaintiff can state claims against the directors [and] officers just by pointing out that their business strategy did not pan out."[133] So as long as

directors and officers exercise their business judgment, the traditional fiduciary-duty claim is the appropriate one, regardless of whether an insolvent corporation gets more insolvent.[134]

For all these reasons, *Trenwick* concluded that "Delaware law does not recognize this catchy term [deepening insolvency] as a cause of action, because catchy though the term may be, it does not express a coherent concept."[135] And thus does deepening insolvency's latest stage in its evolution end: just a "catchy term." It remains to be seen what happens in the next stage, as other states (and the Delaware Supreme Court) take up the issue.

Implications for directors

The latter two stages in deepening insolvency's evolution suggest that directors and officers have far less to fear from the theory than was previously thought. Delaware has flatly rejected the theory as a cause of action, and the Third Circuit seems ambivalent about *Lafferty*'s effect. A number of federal courts have begun resisting deepening insolvency's greater spread, and—although Delaware looms the largest in the bankruptcy and director-litigation contexts—other state courts have also refused to recognize deepening insolvency.[136]

Deepening insolvency's status as a cause of action has weakened because it is merely duplicative of traditional causes of action, like fiduciary duty[137] or fraud. So have said cases like *Fleming, Parmalat,* and *Vartec.* Other cases, like *Global Service* and *Trenwick,* have rejected the theory because it violates the underpinnings of the business judgment rule—that directors are not guarantors of business success.

Deepening insolvency's status as a theory of damages is becoming more predictable. Recent commentary suggests that, although the words "deepening insolvency" add nothing by themselves as a theory of damages, some corporate harm described in deepening-insolvency cases is a valid harm. That harm, however, is already compensable by other, pre-existing theories of damages, so the words "deepening insolvency" are redundant of those pre-existing theories of damages.

For example, *Parmalat* stated that the deepening-insolvency harm is already "compensable on a claim for breach of fiduciary duty."[138] The Third Circuit in CitX refused to allow redundant deepening-insolvency damages that "merely replicate[d] malpractice damages."[139] It held that, "'[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,'" regardless of the words "deepening insolvency."[140] Sabin Willett asked, "Is 'deepening insolvency' superfluous?"—and answered in the affirmative.[141] He argued that the deepening-insolvency "analysis adds nothing to the measure of damages the law already allows."[142]

One recent case demonstrates the trend of allowing the measure of deepening-insolvency damages that overlaps with traditional theories of damages while disallowing the "wrongfully incurred, unpayable debt" damages unique to deepening insolvency. The DC bankruptcy court's September 2006 decision in *Greater Southeast Community Hospital* examined the question of deepening insolvency as a theory of damages.[143] The court had earlier refused to recognize—as duplicative—a cause of action for deepening insolvency,[144] but here it called deepening insolvency "a viable theory of damages."[145] The court held that the plaintiff had made out a viable breach-of-fiduciary-duty claim,[146] and it described the harm that would be compensable—the injury to the corporation from the directors' wrongful conduct.[147] But that harm should also be compensable in a garden-variety case of breach of fiduciary duty, so the term "deepening insolvency" adds little to the calculation. Meanwhile, the court noted that the compensable harm was not the "amount of excess debt acquired by the debtors,"[148] a type of deepening-insolvency damages criticized by other commentators.[149]

Thus, some courts have called "deepening insolvency" redundant as a theory of damages, and some have approved the term while allowing damages that were already compensable under pre-existing theories of damages. Either way, it is becoming clear that the words "deepening insolvency" add little, but that corporate harm from directors' and officers' wrongly prolonging a defective business model is still compensable.

Conclusion

Deepening insolvency has gone through a compressed evolution, from obscure theory of damages to trendy cause of action to object of criticism to,

now, duplicative and disfavored claim. If the latest stage of this process is any indication, the theory poses little threat to directors and officers as an independent cause of action. Of course, the effect of precedent may still cause some problems in the federal jurisdictions that have adopted the theory. But as more states follow Delaware, as seems likely, deepening insolvency will disappear even from the federal courts. Then, as now, directors and officers will be subject to the same, well-developed causes of action as in the past—causes of action like fraud and breach of fiduciary duty. Likewise, courts using the term to refer to a theory of damages nevertheless typically allow only damages compensable under other, traditional theories of damages. Thus, the words "deepening insolvency" should neither add to nor subtract from the causes of action and remedies that have always been available against directors and officers.

Notes

1. *See, e.g.,* David E. Gordon, Comment, *The Expansion of Deepening Insolvency Standing: Beyond Trustees and Creditors' Committees,* 22 Emory Bankr. Dev. J. 221, 227 (2005) (After *Lafferty* and *Exide,* deepening insolvency appears to be a powerful new weapon in the plaintiff's arsenal.).

2. *See, e.g., OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.),* 340 B.R. 510, 530 (Bankr. D. Del. 2006).

3. *Bloor v. Dansker* (*In re Investors Funding Corp. of N.Y. Sec. Litig.*), 523 F. Supp. 533 (S.D.N.Y. 1980).

4. *Id.* at 536.

5. *Id.* at 541.

6. *Id.*

7. *Id.*

8. *Id.*

9. 711 F.2d 1343 (7th Cir. 1983).

10. *Id.* at 1345.

11. *Id.* at 1346.

12. *Id.* at 1348.

13. *Id.*

14. *Id.* at 1350.

15. *Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall* (*In re Gouiran Holdings, Inc.*), 165 B.R. 104, 107 (E.D.N.Y. 1994).

16. *Allard v. Arthur Andersen & Co. (USA),* 924 F. Supp. 488, 494 (S.D.N.Y. 1996).

17. *Id.*

18. *Id.* (Shareholders may under these circumstances miss an opportunity to 'cut their losses' by shutting down operations before management can fritter away whatever valuable assets the corporation still possesses.).

19. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.,* 267 F.3d 340, 352 (3d Cir. 2001).

20. *Id.*

21. *See, e.g.,* Gordon, *supra* note 1, at 224–25; Daniel E. Harrell, Comment, *Pandora's Bankruptcy Tort: The Potential for Circumvention of the Business Judgment Rule Through the Tort Theory of Deepening Insolvency,* 36 Cumb. L. Rev. 151, 154–55 (2006).

22. *Lafferty,* 267 F.3d at 344.

23. *Id.* at 347.

24. *Id.* at 349–50.

25. *Id.* at 350.

26. *Id.* at 351.

27. Actually, the *Lafferty* court also stated that it "believe[s] 'deepening insolvency' is generally a valid theory for federal law claims." Id. at 354. This, even though the "words 'deepening insolvency' are neither contained in the Bankruptcy Code, nor do they arise from other federal law, [and] the courts that consider the theory to be an actionable tort do so by predicting how their respective state courts would rule." *Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop.* (*In re Vartec Telecom, Inc.*), 335 B.R. 631, 638 (Bankr. N.D. Tex. 2005).

28. *Kittay v. Atl. Bank of N.Y.* (*In re Global Serv. Group LLC*), 316 B.R. 451, 457–58 (Bankr. S.D.N.Y. 2004).

29. *In re LTV Steel Co.,* 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005) .

30. *Tabas v. Greenleaf Ventures, Inc.* (*In re Flagship Healthcare, Inc.*), 269 B.R. 721, 728–29 (Bankr. SD Fla. 2001).

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

32. *Id.* at 752 (Therefore, based on the Third Circuit's decision in Lafferty and the Delaware courts' policy of providing a remedy for an injury, I conclude that [the] Delaware Supreme Court would recognize a claim for deepening insolvency when there has been damage to corporate property.).

33. *Limor v. Buerger* (*In re Del-Met Corp.*), 322 B.R. 781, 815 (Bankr. MD Tenn. 2005).

34. LTV, 333 B.R. at 422 (Therefore, the *Lafferty* and *Exide Technologies* cases, decided by courts in the Third Circuit, and in which both the Third Circuit and the Delaware bankruptcy courts indicated their approval of deepening insolvency as a free-standing tort, arguably apply to the proposed lawsuit.).

35. *OHC Liquidation Trust v. Credit Suisse First Boston* (*In re Oakwood Homes Corp.*), 340 B.R. 510, 536 n.8 (Bankr. D. Del. 2006).

36. *Kittay v. Atl. Bank of N.Y.* (*In re Global Serv. Group LLC*), 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

37. *Id.* at 454.

38. *Id.* at 455.

39. *Id.* at 456, 465.

40. *Id.* at 459.

41. *Id.*

42. *Id.* at 459–60.

43. *Id.* at 460.

44. *Id.* at 461 (holding that the deepening-insolvency claim was not cognizable because "the Complaint does not allege facts suggesting that Atlantic Bank could have foreseen that the [management defendants] would misappropriate the loan proceeds, or operate the insolvent debtor for an improper purpose").

45. *Id.* at 465.

46. *Id.*

47. *Id.*

48. *Id.* at 466.

49. *See, e.g.,* Jo Ann J. Brighton, *Deepening Insolvency,* AM. BANKR. INST. J., Apr. 2004, at 34, 34 (including directors and officers as one of the "three classes of possible defendants that need to be concerned about deepening insolvency actions").

50. William Bates III, *Deepening Insolvency: Into the Void,* AM. BANKR. INST. J., Mar. 2005, at 1, 62.

51. J.B. Heaton, *Deepening Insolvency,* 30 J. CORP. L. 465, 500 (2005).

52. Harrell, *supra* note 21, at 153–54.

53. Though one commentator did think that *Global Service* gave officers and directors some hope by requiring deepening-insolvency claims to include allegations of bad faith or fraudulent intent. Luis Salazar, *Is the Tide Turning on D&O Claims?,* AM. BANKR. INST. J., Apr. 2005, at 1, 45.

54. Harrell, *supra* note 21, at 153.

55. *Id.* at 166–67.

56. *Id.* at 167–68, 175–76; *see also id.* at 177 (calling deepening insolvency "a potential black hole lurking in the realm of corporate governance law").

57. Brighton, *supra* note 49, at 34.

58. *Id.* at 79.

59. Gordon, *supra* note 1, at 222 (footnote omitted).

60. *Id.* at 253–54 (acknowledging, however, that "deepening insolvency has not yet been successfully asserted as a cause of action in a shareholder's derivative suit").

61. *Id.* at 257.

62. *Id.* at 258.

63. *Id.* at 242.

64. *Id.* at 258.

65. *Id.* at 231.

66. Bates, *supra* note 50, at 60.

67. Sabin Willett, *The Shallows of Deepening Insolvency,* 60 BUS. LAW. 549 (2005).

68. *Id.* at 553 (some emphasis omitted).

69. *Id.*

70. *Id.* at 561.

71. *Id.* at 562.

72. *Id.* at 570.

73. *Id.* at 564–66.

74. *Id.* at 551.

75. *Id.* at 557.

76. *Id.* at 561.

77. *See id.* at 564 n.85.

78. *Id.* at 571.

79. Id.

80. *Id.* at 572. It should be noted that, if accepted, this argument weakens Lafferty's insistence on deepening insolvency for the reason that Pennsylvania recognizes a remedy for every wrong, *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.,* 267 F.3d 340, 351 (3d Cir. 2001). If there was already a remedy for this wrong, there was no reason to create a new one.

81. Willett, *supra* note 67, at 575.

82. 421 F.3d 989, 1004 (9th Cir. 2005).

83. *Id.* at 995.

84. *Id.* at 1003–04.

85. *Bondi v. Bank of Am. Corp.* (*In re Parmalat Sec. Litig.*), 383 F. Supp. 2d 587 (S.D.N.Y. 2005).

86. *Id.* at 590.

87. *Id.* at 601.

88. *Id.* at 602.

89. *Id.* at 601–02.

90. *Rafool v. Goldfarb Corp.* (*In re Fleming Packaging Corp.*), 2005 WL 2205703 (Bankr. C.D. Ill. Aug. 26, 2005).

91. *Id.* at 2.

92. *Id.* at 7.

93. *Id.*

94. *Id.* at 8.

95. *Id.* at 9.

96. *Id.* at 9–10.

97. *Id.* at 10.

98. *Alberts v. Tuft* (*In re Greater Se. Cmty. Hosp. Corp.*), 333 B.R. 506 (Bankr. D.D.C. 2005). A more recent opinion by this court on the issue of deepening insolvency as a theory of damages will be discussed later.

99. *Id.* at 513.

100. *Id.* at 517.

101. *Id.*

102. *Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop.* (*In re Vartec Telecom, Inc.*), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005).

103. *Id.* at 643–44.

104. *OHC Liquidation Trust v. Credit Suisse First Boston* (*In re Oakwood Homes Corp.*), 340 B.R. 510 (Bankr. D. Del. 2006).

105. *Id.* at 517.

106. *Id.* at 531. The court, because it believed that the "result would be identical regardless of which law applie[d]," opted not to decide the choice-of-law issue of which of the three states' law applied. Id. at 528.

107. *Id.* at 529 (citing Parmalat, Southeast Community Hospital, Vartec, and Fleming).

108. *See, e.g., id.* at 530–31 (noting that the court was "aware of the mounting pile of authority rejecting [deepening insolvency]," but admitting that "*Lafferty*'s words, though sometimes questioned, are clear"); *id.* at 531 ("It is not for this Court to question the Third Circuit's view of the soundness of the theory."); *id.* at 532–33 (questioning "whether deepening insolvency is continuing to gain acceptance or whether it is now falling into disfavor," but noting that "this Court cannot depart from binding Third Circuit precedent"); *id.* at 533 ("At this point, neither party has called this Court's attention to any state court decision that would alter *Lafferty*'s result. Faced with this silence, *Lafferty* controls.").

109. *Id.* at 537 (citation omitted).

110. *Seitz v. Detweiler, Hershey & Assocs.* (*In re CitX Corp.*), 448 F.3d 672 (3d Cir. 2006).

111. *Id.* at 680 n.11 ("Even if [*Lafferty*'s issue] were [before us], we cannot revisit the correctness of [Lafferty's] interpretation of Pennsylvania law.")

112. *Id.* at 674.

113. *Id.* at 674–75.

114. *Id.* at 677 & n.8.

115. Willett, *supra* note 67, at 553.

116. *CitX*, 448 F.3d at 677 (Assuming for the sake of argument that [the accountants'] financial statements allowed CitX to raise over $1,000,000, that did nothing to 'deepen' CitX's insolvency. It did the opposite.)

117. *Id.* at 677–78.

118. *Id.* at 678; *see also id.* at 678 n.9 (noting that "even [plaintiff's] counsel acknowledged that deepening insolvency as a measure of damages merely replicates malpractice damages.")

119. *Id.* at 678.

120. *Id.* at 680 n.11. CitX also limited the deepening-insolvency cause of action to include only fraudulent conduct. Id. at 681 (We know no reason to extend the scope of deepening insolvency beyond *Lafferty*'s limited holding.) Negligence no longer suffices to state a claim of deepening insolvency in the Third Circuit.

121. *Id.* at 680 n.11.

122. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P,* 906 A.2d 168 (Del. Ch. 2006).

123. *Id.* at 206 (In this case, the [plaintiff] has not stated a viable claim for breach of fiduciary duty. It may not escape that failure by seeking to have this court recognize a loose phrase as a cause of action under our law, when that recognition would be inconsistent with the principles shaping our state's corporate law.)

124. *Id.* at 172.

125. Id. at 206 & n.105 (citing *Parmalat, Southeast Community Hospital, Vartec, Global Service, CitX,* and Sabin Willett's article).

126. *Id.* at 207.

127. *Id.* at 174–75.

128. *Id.* at 204 (Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.)

129. *Id.* at 205.

130. *Id.* at 173.

131. *Id.* at 193.

132. *Id.*

133. *Id.* at 218.

134. *Id.* at 205.

135. *Id.* at 174.

136. *See, e.g., Bondi v. Citigroup, Inc.,* 2005 WL 975856, at *21 (N.J. Super. Ct. Law Div. Feb 28, 2005); *Coroles v. Sabey,* 79 P.3d 974, 983 (Utah Ct. App. 2003).

137. As this article was going to press, the Delaware Bankruptcy Court added a twist: an ineffective fiduciary-duty claim cannot be made effective by treating it as a deepening-insolvency claim. *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC* (*In re Radnor Holdings Corp.*), No. 06-10894 PJW, slip op. at 29 (Bankr. D. Del. Nov. 16, 2006) (Walsh, J.). Because directors are not under a duty to wind down an insolvent corporation, the Court held, there was no breach of fiduciary duty. *Id.* at 29, 32. And "simply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster." *Id.* at 29.

138. *Bondi v. Bank of Am. Corp.* (*In re Parmalat Sec. Litig.*), 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005); *see also Kittay v. Atl. Bank of N.Y.* (*In re Global Serv. Group LLC*), 316 B.R. 451, 465 (Bankr. S.D.N.Y. 2004) (noting that plaintiff's allegations could have "open[ed] up recovery under the theory of 'deepening insol-

vency,'" but not explaining how that recovery would be any different from the recovery for a fiduciary-duty claim).

139. *CitX,* 448 F.3d at 678 n.9.

140. *Id.* at 678 (quoting Willett, *supra* note 67, at 575)

141. Willett, *supra* note 67, at 572, 572–74; *cf. also* Heaton, *supra* note 51, at 490 (suggesting that the legitimate damages available under the deepening-insolvency theory already "fit with traditional understandings of corporate injury," while noting that those are not the damages typically sought by deepening-insolvency plaintiffs).

142. Willett, *supra* note 67, at 572; *see also* Bates, *supra* note 50, at 61 (Neither the corporation's damage measure (dissipated assets) nor the creditor's measure (out-of-pocket loss) is novel. These have long been the damage measures in fiduciary breach and fraud suits.)

143. *Alberts v. Tuft* (*In re Greater Se. Cmty. Hosp. Corp.*),—B.R.—,2006 WL 2708017 (Bankr. D.D.C. Sept. 21, 2006).

144. *Id.* at 3. See also the discussion supra notes 98–101.

145. *Alberts,* 2006 WL 2708017, at 4.

146. *Id.* at 8.

147. *Id.* at 4 n.12 [Alberts will need to quantify the impact of the debt accumulated by the debtors due to the defendants' actions on the debtors' business operations, not the amount of debt incurred. Specifically, he will need to show that the debtors' chances of falling into bankruptcy increased due to the defendants' actions (and then quantify the costs of bankruptcy for the debtors), that the defendants' conduct prevented the debtors from performing in a profitable manner (and then quantify the cost to the debtors caused by that impairment), or that the defendants' actions forced the debtors to dissipate corporate assets that would have been retained otherwise (and then quantify the value of those assets)].

148. *Id.* at 4; *see also id.* at 4 n.12 (excluding from the compensable harm the "amount of debt incurred).

149. *See, e.g.,* Heaton, *supra* note 51, at 496, 500 (arguing that the "common sense appeal" of this measure of damages is "largely fallacious" and possibly the "product of judicial misunderstanding").