Deepening Insolvency

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Despite the recent attention occasioned by certain high-profile decisions, the theory of “deepening insolvency” remains subject to much uncertainty. Courts have not settled on any precise definition of deepening insolvency, nor even whether such a theory exists under applicable law. Indeed, even those courts that recognize the theory do not universally agree whether deepening insolvency is an independent tort or merely a measure of damages. One thing is clear, however: the theory of deepening insolvency is starting to take root in many bankruptcy courts.

Deepening insolvency has been defined by one court as the “‘fraudulent prolongation of a corporation’s life beyond insolvency,’ resulting in damage to the corporation caused by increased debt.” David R. Kittay, Chapter 7 Trustee of Global Service Group LLC v. Atlantic Bank of NY (In re Global Service Group LLC), 316 B.R. 451, 456 (citing Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983), cert denied, 464 U.S. 1002, 104 S. Ct. 508, 78 L. Ed. 2d 698 (1983)). Another source has defined deepening insolvency as a “theory of liability [that] holds that there are times when a defendant’s conduct, either fraudulently or even negligently, prolongs the life of a corporation, thereby increasing the corporation’s debt and exposure to creditors.” Brighton, Jo Ann J., “Deepening Insolvency” 23-APR Am. Bankr. Inst. J. 34 (Apr. 2004) (citing MacKuse, “Deepening Insolvency,” 74 PABAQ 42 (Jan. 2003)).

Viewed as a damage theory only, when a party that has committed an independent, legally cognizable tort, under the theory of deepening insolvency, such party may

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be liable based on the extent to which such party’s actions have contributed to deepening the insolvency of the debtor. See Schacht v. Brown, 711 F.2d at 1345. Viewed as a cognizable tort in its own right, the definition of “deepening insolvency” appears to be an action that results in “an injury to the [d]ebtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” See Official Committee of Unsecured Creditors and R2 Investments v. Credit Suisse First Boston (In re Exide Technologies, Inc.), 299 B.R. 732, 751 n.11 (Bankr. D. Del. 2003) (citing Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 347-48 (3d Cir. 2001)).

Genesis of Deepening Insolvency

The origin of the theory of deepening insolvency has been credited to the court in Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Litig.), 523 F.Supp. 533 (S.D.N.Y. 1980). One of the defendants in Investors Funding was an accounting firm that certified financial statements (that allegedly materially overstated income and assets) that were allegedly used to induce parties to invest in an entity that ultimately filed for bankruptcy protection. Id. at 540. To support certain of its affirmative defenses, this defendant sought to establish that the corporation benefited as a result of its continued existence, which was fueled by the additional funds raised on the coattails of the misstated financial statements. But the court rejected the defendant’s contention that just because a corporation continues to exist, it benefits. Instead, the

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1 While most of the recent debate focuses on whether “deepening insolvency” is a theory of damages or an independent cause of action, some courts have rejected it outright. See, e.g., Coroles v. Sabey, 79 P.3d 974, 983 (Utah App. 2003) (declining to recognize deepening insolvency).

2 Had the defendant been able to convince the court that the debtor benefited, the defendant could then have asserted that the wrongful conduct of management should have been imputed to the debtor. This would have barred the plaintiffs’ claims under an equitable theory. See Investors Funding, 523 F.Supp. at 540.
court found 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.” Id. at 541.

The foundation laid by the court in Investors Funding (and others) was further expounded upon by the Seventh Circuit in Schacht v. Brown. 711 F.2d 1343. In Schacht, the Seventh Circuit explained that it is a “seriously flawed assumption” to believe “that the fraudulent prolongation of a corporation’s life beyond insolvency is automatically to be considered a benefit to the corporation’s interests.” Id. at 1350 (citing Bergeson v. Life Insurance Corp., 265 F.2d 227, 232 (10th Cir. 1959); Kinter v. Connolly, 233 Pa. 5, 81 A. 905 (1911); Patterson v. Franklin, 176 Pa. 612, 35 A. 205, 206 (1896)). The court went on to explain that a corporation is damaged by “the deepening of its insolvency” through increased liability. Id.

Who Is Affected by Deepening Insolvency?

The plaintiff in an action alleging deepening insolvency, whether for damages or as a cause of action, is by definition the corporation that was harmed. While the theory began with corporations that were the victims of fraud and looting (see, e.g., Lafferty, discussed below, and Schacht v. Brown, discussed above), it has also been invoked on behalf of debtors who became insolvent (or more insolvent) because of additional debt incurred to fund a failing business (see, e.g., Exide Technologies, discussed below). While the corporation could bring the deepening insolvency action, it also could be brought by a receiver or trustee who has taken over the corporation (see, e.g., Schacht and Investors Funding (brought by Bloor, as Trustee of the Estates of Investors Funding)) or by a creditors’ committee bringing the action on behalf of the debtor-corporation (see, e.g., Exide and Lafferty). In these latter situations, the party bringing the claims does so on behalf of the corporation and “standing in the shoes” of the corporation. See Lafferty, 267 F.3d at 344. Importantly, whether invoking deepening insolvency as a damage
theory or a separate actionable tort, the corporation itself must have sustained damages; the plaintiff cannot seek recovery for damages to the corporation’s creditors. See Mette H. Kurth, *The Search for Accountability: The Emergence of ‘Deepening Insolvency’ as an Independent Cause of Action*, 1 No. 9 Andrews Bankr. Litig. Rep. 6 (Aug. 27, 2004) (citing *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972)).

The list of potential defendants to a claim of deepening insolvency reads like a who’s who of parties involved in corporate transactions, including directors and officers, lenders and underwriters, and professionals. Claims have been made against directors and officers who are alleged to have fraudulently or negligently acted in a manner that prolonged the life of the corporation that continued to accrue more debt. Parties who finance the corporation’s continued existence, both lenders and underwriters, have found themselves on the wrong side of deepening insolvency claims, particularly when they exerted control over the corporation and put themselves in a better position with additional financing, additional collateral, and better financial terms. Additionally, claims have been brought against professionals who advised the corporation or allegedly assisted in prolonging its life while deepening its insolvency, including attorneys, accountants, and other advisors.

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**Affirmative Defense of *in pari delicto***

Because deepening insolvency is a derivative theory, and because the corporation is universally a party to the alleged wrongful transaction or conduct, defendants often raise the defense of “*in pari delicto*” in response to a deepening insolvency claim. The term literally means “in equal fault,” “equally culpable or criminal,” or “in a case of equal fault or guilt.” BLACKS LAW DICTIONARY 791 (6th ed. 1990). The doctrine, asserted as an affirmative defense, “provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim.” Lafferty, 267 F.3d at 354; see also MCA Fin. Corp. v. Grant Thornton, L.L.P., 263 Mich. App. 152, 159, 687 N.W.2d 850, 854-55 (Ct. App. 2004) (accepting defense of *in pari delicto* in case in which damage claim of deepening insolvency is alleged). The equitable doctrine is based on the premise that it is inequitable for a primary wrongdoer to recover damages for conduct it initiated and carried out.

A claim of deepening insolvency is brought by, or on behalf of, the corporation. Where the plaintiff stands in the shoes of the corporation and the wrongdoer’s actions can be imputed to the corporation, the affirmative defense of *in pari delicto* bars recovery on account of the deepening insolvency. But see, generally, Tanvir Alam, *Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How In Pari Delicto Has Been Perverted to Prevent Recovery for Innocent Creditors*, 77 Am. Bankr. L. J. 305 (Summer 2003).

In many cases, a bankruptcy trustee (appointed under either Chapter 7 or 11) will pursue an action for deepening insolvency and argue that the defense of *in pari delicto* should

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not apply because the trustee is a separate entity from the corporation that is alleged to have participated in the wrongdoing. See, e.g., Merrill Lynch v. Nickless (In re Advanced RISC Corp.), 324 B.R. 10, 15 (Dist. Ct. D. Mass. 2005). Finding that the trustee inherits the corporation’s legal and equitable interests of the debtor as of the commencement of the case (under Section 541 of the Bankruptcy Code), courts generally agree that the trustee is bound by all defenses to which the debtor was subject. See Advanced RISC, 324 B.R. at 15 (citing Hirsch v. Arthur Andersen & Co., 72 F.3d 1085 (2d Cir.1995); Lafferty, 267 F.3d at 356 (3rd Cir.2001); Terlecky v. Hurd, 133 F.3d 377 (6th Cir.1997); Sender v. Buchanan, 84 F.3d 1281 (10th Cir.1996)). As explained by the court in Advanced RISC, “[c]ourt[s] cannot ignore the plain meaning of the Bankruptcy Code.” Id. at 16; but c.f. In re Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995) (finding that with the “wrongdoer” who masterminded a Ponzi scheme replaced by an appointed receiver, “the defense of in pari delicto loses its sting); see also F.D.I.C. v. O’Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) (equating a receiver with a bankruptcy trustee in that both control the actions of a company as innocent parties pursuant to court order or operation of law without any other identity of interest with the wrongdoer).

Recent Cases on Deepening Insolvency

Two cases that are often cited as recognizing deepening insolvency as an independent tort are Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc. 267 F.3d 340 (3d Cir. 2001) and Official Committee of Unsecured Creditors and R2 Investments v. Credit Suisse First Boston (In re Exide Technologies, Inc.), 299 B.R. 732 (Bankr. D. Del. 2003).

A. R.F. Lafferty & Co., Inc.

In Lafferty, the Third Circuit addressed an appeal of an order dismissing the plaintiff’s claims on the basis that the doctrine of in pari delicto prevented the plaintiff-Committee from having standing. The Third Circuit held that in pari delicto was an affirmative
defense and not a bar to bringing the claims based on the threshold issue of standing. The Third Circuit, however, did agree that \textit{in pari delicto} applied as an affirmative defense and ruled that the claims were barred because the Committee stood in the shoes of the debtors (the parties who had perpetuated the alleged fraud). \textit{Id.} at 360.

The Committee, bringing the action pursuant to a stipulation with the debtors that authorized it to pursue certain litigation, alleged that the debtor-corporations were operated as a “Ponzi scheme” that eventually collapsed under the weight of the ever-increasing debt. \textit{Id.} at 343-45. The Committee claimed that third parties conspired with management (who were also the sole shareholders) and fraudulently induced the debtor-corporations to issue debt securities based on misstated financial statements, thereby deepening the insolvency of the corporations. \textit{Id.} at 344-45. According to the complaint, certain defendants provided professional opinions (that were necessary for the registration of the debt securities) that contained fraudulent misstatements and material omissions. \textit{Id.}

The Committee’s complaint claimed, among other things, that the fraud and participation in a “Ponzi scheme” injured the debtors by “wrongfully expand[ing] the [D]ebtors’ debt out of all proportion of their ability to repay and ultimately forc[ing] the [D]ebtors to seek bankruptcy protection.” \textit{Id.} at 347. In labeling this injury “deepening insolvency,” the court restated the allegation as “an injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” \textit{Id.}

With allegations that all this wrongdoing injured the corporation, the court sought to determine if Pennsylvania law recognized the theory of injury labeled “deepening insolvency.” There was no state or federal case law to follow, so the court was forced to predict what the Pennsylvania Supreme Court would decide based on cases in other jurisdictions and the
policies evidenced in Pennsylvania tort law. Id. at 349. First, the Third Circuit found that the theory of deepening insolvency as a distinct tort was sound. The court reasoned that the fraudulent and concealed incurrence of debt can damage a corporation’s value by, among other things: (1) inflicting legal and administrative costs from eventually forcing the corporation into bankruptcy; (2) creating limitations that impair the ability to operate the business through undermining the corporation’s relationships with customers, suppliers, and employees; (3) creating instability that itself causes a loss of confidence in the corporation; and (4) causing a dissipation of corporate assets. Id. at 350. The court confirmed its conclusion that the theory is sound by referring to a number of cases throughout the country that had held that deepening insolvency may give rise to a cognizable injury to corporate debtors. Id. Finally, the court examined the state’s jurisprudence and its principle that “where there is an injury, the law provides a remedy.” Id. at 351 (citing 37 Pennsylvania Law Encyclopedia, Torts § 4, at 120 (1961)). With this, the court concluded that the Pennsylvania Supreme Court would “recognize ‘deepening insolvency’ as giving rise to a cognizable injury in the proper circumstances.” Id. at 352.

The court acknowledged that the cause of action for deepening insolvency was valid and therefore the committee, standing in the shoes of the debtor, had standing to bring the claims. See id. at 354. Then, after extensive analysis of the doctrine of in pari delicto and its applicability in the case, the court held that because the fraudulent conduct of the debtors’ principals was imputed to the corporations, the doctrine of in pari delicto barred the Committee from pursuing its claims. Id. at 360.

B. Exide Technologies

The Delaware bankruptcy court in In re Exide Technologies was confronted with a motion to dismiss a number of claims, including a claim of deepening insolvency, in an
adversary proceeding brought by the Creditors’ Committee against the debtors’ prepetition lenders. 299 B.R. 732. The lenders began their relationship with Exide in 1997 with a $650 million credit facility. In 2000, the lenders provided a further loan of an additional $250 million that was used by Exide to finance an acquisition. The plaintiffs alleged that the lenders had forced Exide to make the acquisition, which resulted in additional borrowing from the lenders. The plaintiffs alleged that, in connection with the additional indebtedness, the lenders received significant additional collateral and guarantees, which subsequently enabled the lenders to exert additional control over Exide so that Exide would fraudulently continue its business at ever-increasing levels of insolvency. See id. at 736, 750.

The lenders filed a motion to dismiss the Committee’s complaint, including the claim for deepening insolvency. See id. The lenders cited the following arguments to support their request to dismiss the deepening insolvency claim: “(1) a deepening insolvency action is not recognized under Delaware law; (2) the Plaintiffs have not alleged that the Lenders committed an actionable tort; (3) there are no allegations that the Lenders had a duty to Exide or Exide’s creditors; (4) allegations of fraud are not plead in detail and do not comply with Fed.R.Civ.P. 9(b); and (5) the claim is defeated by the in pari delicto doctrine. . . .” Id. at 751.

In response to the motion to dismiss, the Exide court focused on the viability of the claim of deepening insolvency. Like the court in Lafferty, the bankruptcy court was forced to predict how the Supreme Court of the state (Delaware in this case) would rule on the claim, because the Delaware Supreme Court had not addressed the “tort of deepening insolvency.” Id. The bankruptcy court in Exide relied heavily on the Third Circuit’s analysis and holding in Lafferty. The court analyzed the situation it confronted in light of the three factors that persuaded the Third Circuit to recognize deepening insolvency as a cause of action
“(1) soundness of the theory; (2) growing acceptance of the theory among courts; and
(3) remedial theme in Pennsylvania law (when there is an injury”). \textit{Id.} (\textit{citing Lafferty}, 267 F.3d at 352). The court acknowledged that the first two of the three factors had been satisfied in \textit{Lafferty} and therefore were satisfied in \textit{Exide}. With respect to the third factor, the remedial theme of the state law, the court held that Delaware “adheres to the same principle as Pennsylvania.” \textit{Id.} at 752. In denying the motion to dismiss the count of deepening insolvency, the \textit{Exide} court held that the Delaware Supreme Court would recognize the tort when there has been damage to the corporation. \textit{See id.} Unlike in \textit{Lafferty}, the \textit{Exide} court did not address the merits of the defense of \textit{in pari delicto}, and instead determined that the lenders could raise the defense in their answer. \textit{See id.}

\textbf{C. Analysis of \textit{Lafferty} and \textit{Exide}}

While the \textit{Lafferty} and \textit{Exide} opinions should cause parties to evaluate their actions in light of potential claims of deepening insolvency (particularly when the Third Circuit may have jurisdiction), it is certainly not clear that merely participating in a transaction that leads to a corporation’s deepening insolvency is enough to create liability.

\textit{First}, the courts in \textit{Lafferty} and \textit{Exide} were confronted with motions to dismiss. While the courts did not dismiss the cause of action—which is to say they recognized that there is a set of facts that would entitle the plaintiff to relief—the courts did not adjudicate whether the plaintiffs had proved their case (and in the \textit{Exide} case, whether defenses might preclude liability).
Second, the Lafferty and Exide courts did not specify the elements of the cause of action, thus leaving open the question of how high the burden may be on a plaintiff to prove a deepening insolvency case.  

Third, while the Third Circuit in Lafferty and the Delaware bankruptcy court in Exide may have recognized the independent cause of action, those courts were also confronted with significant allegations of fraud and wrongdoing by the defendants. For example, the complaint in Lafferty included allegations that: (1) the defendants operated the corporations as a Ponzi scheme; (2) the corporations were operated in a fraudulent manner; and (3) the defendants issued financial statements and legal opinions containing fraudulent misstatements and material omissions. 267 F.3d at 344-45. Similarly, in Exide, the complaint against the lenders contained allegations, including that: (1) the lenders were in control of the debtor and therefore “insiders”; (2) as a result of their control, the lenders were able to: obtain additional collateral, pledges, and guarantees; dictate the bankruptcy filing date and determine which entities would file to prevent liens and guarantees from being voided; and cause the board of directors to make other key decisions favorable to the lenders; and (3) the lenders aided and abetted the debtors’ alleged breach of their fiduciary duties. 299 B.R. at 742-44, 749.

Commentators have reviewed the jurisprudence and suggested some possibilities, but courts have hardly settled on a uniform set of elements. In his article entitled New Liability Under “Deepening Insolvency”: The Search for Deep Pockets, Paul Rubin suggested the following elements: (1) fraudulent prolongation of an insolvent corporation’s life by hiding the corporation’s true financial condition; (2) in a way that causes the corporation to become more insolvent by incurring additional liabilities or dissipating assets; (3) so that the value that could have been realized if the corporation’s business activity had not been improperly prolonged is lost; and (4) the corporation suffers harm distinct from the harm suffered by the creditors. 23-APR Am. Bankr. Inst. J.1 (Apr. 2004). See also Kurth, 1 No. 9 Andrews Bankr. Litig. Rep. 6 (suggesting the following elements from the case law: (1) whether the defendants concealed the deterioration of the corporation’s financial condition, thereby artificially prolonging its life, (2) whether the company suffered harm distinct from that suffered by its creditors; and (3) whether the company’s insolvency was increased by the incurrence of additional liability or the dissipation of assets, or otherwise realizable value was thereby lost).
That the complaints in *Lafferty* and *Exide* contained these allegations is important for two reasons. First, because the courts were ruling on motions to dismiss, and not the merits of the claims, the courts generally accepted the allegations as true. Second, the allegations included claims that the defendants committed a number of torts and breached a number of fiduciary duties separate from any independent tort of deepening insolvency. It is unclear how these courts would have ruled had the allegations only included a claim of deepening insolvency without being coupled with allegations of fraud and other wrongful conduct. If the cause of action requires that the defendant commit a tort (*e.g.*, fraud) or violate an independent duty (*e.g.*, breach of fiduciary duty), then deepening insolvency cannot really be considered an independent cause of action. Indeed, this critical analysis is consistent with a recent opinion from the bankruptcy court for the Southern District of New York (discussed below). *Global Service*, 316 B.R. 451.

**D. Del-Met Corp.**

Most recently, a bankruptcy court in Tennessee followed the *Exide* and *Lafferty* courts and recognized deepening insolvency as an independent tort. *Limor v. Buerger (In re Del-Met Corp.)*, 322 B.R. 781 (Bankr. M.D. Tenn. 2005). Like most of the cases addressing deepening insolvency, the bankruptcy court ruled on a motion to dismiss a complaint against a number of defendants. The plaintiff, the trustee for the chapter 7 debtors, made allegations that included the following: (1) certain customers (named as defendants) threatened to withhold payments unless the debtor-corporations allowed the customers to bring in their own third parties (named as defendant) to control operations and accounting functions; (2) these third parties took over the corporations’ business, managed and operated it for the benefit of the customers (even though these third parties were paid by the corporations); (3) while these third parties ran the operations, the corporations’ unsecured debt increased dramatically; and (4) the customers
influenced the debtor-corporations to shift their assets and business operations to a different entity that ultimately sold the assets and operations to a third party so that the customers would be assured of a continued supply of product. *Id.* at 791-793.

With respect to the plaintiff’s claim of deepening insolvency, the court acknowledged that the “deepening insolvency claim is cognizable only if the Defendants owed duties to the debtor corporations under nonbankruptcy law by virtue of their domination and control such that the run up of debt, the performance of unprofitable contracts, the selective payment of vendors and other allegations in the complaint are actionable breaches.” *Id.* at 808 (emphasis added). The court found that the allegations supported a cause of action for breach of fiduciary duties by the customers.

In determining whether to accept deepening insolvency as an independent tort, the court quoted extensively from *Global Service* (316 B.R. at 456-459) and *Lafferty* (267 F.3d at 349-351). *See id.* at 812-815. Ultimately, the *Del-Met* court followed the same three-factor test set forth in *Lafferty* (and followed in *Exide*) to determine whether it should accept the theory as an independent tort. With respect to the first two factors in the test, the court accepted the *Lafferty* court’s conclusion that the theory is sound and its acceptance is growing. *See id.* at 815. The court then reviewed Tennessee law and concluded that “the Tennessee Supreme Court has adopted the same jurisprudential principle as the Pennsylvania high court: where there is a tortious injury, the law will provide a remedy.” *Id.* (citing *McFarlane v. Moore*, 1 Tenn. 174 (1805)). The court ruled “the Tennessee Supreme Court would recognize deepening insolvency as an actionable breach of duty to a corporation.” *Id.*

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9 Interestingly, the Del-Met court suggests that the New York bankruptcy court in Global Service recognized deepening insolvency as an independent tort. *See id* at 815. (“The courts of both New York and Delaware have (Continued…)”)
the claims of deepening insolvency. With respect to the defendants’ defense of *in pari delicto*—like the *Exide* court—the court would not adjudicate the strength of the defense but stated that the defendants could raise the defense when appropriate. *See id.* at 820.

**E. Global Service Group LLC**

After the *Exide* and *Lafferty* decisions, but before the *Del-Met* decision, the bankruptcy court for the Southern District of New York decided that plaintiffs pursuing a claim of deepening insolvency must prove a breach of a separate duty. This decision was regarded by a number of commentators to support an interpretation that merely participating in a transaction that leads to a corporation’s deepening insolvency is not enough to create liability. The impact of the *Global Service* decision is unclear in light of the more recent *Del-Met* decision.

The complaint in *Global Service* asserts that the defendants engaged in fraudulent transfers and the artificial prolongation of the corporation’s life, resulting in its deepening insolvency. *See Global Service*, 316 B.R. at 453. The complaint alleges that (1) the lenders knew or should have known that the corporation would be unable to repay the lenders’ loans, and (2) the management continued the business and continued to incur debt knowing that the corporation would be unable to repay the indebtedness. *See id.*

recognized that deepening insolvency can be a breach of the fiduciary duties owed to a corporation by its officers and directors.” (*citing Global Services*, 316 B.R. 451)). This view is different from most of the commentary that has reviewed *Global Services* and concluded that *Global Services* required a separate, independent tort upon which to base a deepening insolvency theory. *See, e.g.*, Paul Rubin, *Deepening Insolvency: Lender’s Victory Over Trustee May Have Far-Reaching Implications*, The Bankruptcy Strategist 1-2 (Feb. 2005).

The court in *Global Service* recounts the origin of deepening insolvency and
discusses the current state of the law with certain courts treating deepening insolvency as an
independent cause of action (*citing Lafferty* and *Exide*), other courts viewing it as a damage
theory (*citing, e.g., Schacht and Allard*), and other courts rejecting or questioning the viability of
the theory (*citing, e.g., Coroles, 79 P.3d 974; Florida Dep’t of Ins. v. Chase Bank of Texas Nat’l
Ass’n, 274 F.3d 924, 935-36 (5th Cir. 2001)). *See id.* at 457-58. The court then explains that
New York cases have recognized deepening insolvency as a damage theory, but not as an
independent tort. *See id.* at 458.

Finally, the *Global Service* court states that the distinction between deepening
insolvency as a tort or damage theory may be a distinction without a difference because under
either theory, the plaintiffs must prove that prolonging the life of the corporation was in breach
of a separate duty. *See id.* (“one seeking to recover for ‘deepening insolvency’ must show that
the defendant prolonged the company’s life in breach of a separate duty, or committed an
actionable tort that contributed to the continued operation of a corporation and is increased
debt.”) (*citing Lafferty, 267 F.3d at 345; Schacht, 711 F.2d at 1350; Allard, 924 F.Supp. 494;
Gouiran Holdings, 165 B.R. at 107; Exide, 299 B.R. at 750-52; Flagship Healthcare, 269 B.R. at

The facts in *Global Service* did not support the theory of deepening insolvency. The court found that, with respect to the lenders’ actions, “[t]his may be bad banking, but it isn’t
a tort. A third party is not prohibited from extending credit to an insolvent entity; if it was, most
companies in financial distress would be forced to liquidate.” *Id.* at 459. Here, the court was
persuaded by the fact that the complaint did not allege that the lenders provided the loans to
enable management “to siphon off funds or commit some other wrong.” *Id.* The court refused to accept the assumption in the plaintiff’s claims, “that the managers of an insolvent limited liability company are under an absolute duty to liquidate the company, and anyone who knowingly extends credit to the insolvent company breaches an independent duty in the nature of aiding and abetting the managers’ wrongdoing.” *Id.* The court explained that while the parties to whom officers and directors owe their duties may change as a company moves towards insolvency (from equityholders to multiple constituencies), the officers and directors may correctly conclude that operating the insolvent enterprise still maximizes the enterprise value. *See id.* Under the laws in the United States, “a manager’s negligent but good faith decision to operate an insolvent business will not subject him to liability for ‘deepening insolvency.’” *Id.* at 461. The court found that a judgment of the manager’s actions would be subject to the business judgment rule.

With respect to the management-defendants, the court dismissed the counts, with leave to replead. The court suggested that the claims might be viable if coupled with allegations that the management-defendants prolonged the corporation’s life to enable themselves personally to continue to receive fraudulent transfers. *See id.* at 466. In other words, the claims of deepening insolvency might be sustainable if there were also a separate tort. *See id.* at 465 (suggesting that if the management-defendants operated the debtor to siphon funds for their individual personal benefit, that might constitute self-dealing, a breach of the defendants’ fiduciary duty as officers of the corporation); *see also Devon Mobile Communications Liquidating Trust v. Adelphia Communications Corp. (In re Adelphia Communications Corp.), 2005 WL 1199051, *5-6 (Bankr. S.D.N.Y. May 20, 2005) (citing Global Services, 316 B.R. at
461, for the proposition that deepening insolvency requires that the party must be able to foresee that the debtor was being operated for an improper purpose).\textsuperscript{11}

F. Bondi v. Citigroup, Inc.

The court in \textit{Bondi v. Citigroup, Inc.} considered a motion to dismiss a count of deepening insolvency related to a debtor’s financial problems for failure to state a claim. \textit{2005 WL 975856, *21 (N.J. Super. L. Feb. 28, 2005)}. Like in many other opinions, the court recounted the range of court opinions on deepening insolvency from acceptance as a tort, to a damage theory, to complete rejection of the theory. \textit{See id.} Ultimately, the Bondi court held that in New Jersey “[t]here does not appear to be any reported authority . . . that validates deepening insolvency as an independent tort.” \textit{Id}. The court found that it would be an abuse of discretion to recognize such a theory of liability and dismissed the count. \textit{Id}. (holding that “a new cause of action should be created by legislative enactment or by the Supreme Court rather than by an intermediate appellate court.”) (citation omitted).

\textbf{Deepening Insolvency as an Independent Tort}

To the extent the tort of deepening insolvency requires that a defendant must have breached a duty to the corporation, a threshold question is whether the defendant owes any such duties to the corporation. State laws generally recognize fiduciary duties owed by directors and officers, but the recent cases accepting deepening insolvency as a tort have included defendants that were neither directors nor officers. In \textit{Del-Met, Exide,} and \textit{Lafferty}, most of the defendants were entities that are not generally considered to have fiduciary or other duties to the

\footnote{The Court in \textit{Adelphia} also cites Sabin Willett, \textit{The Shallows of Deepening Insolvency}, 60 Bus. Law. 549, 565 (2005), to describe the deepening insolvency as requiring that “the defendant ’wrongfully’ prolong[] life, or worse, participate[] in a scheme to cover up debtor’s true financial condition during the period when insolvency deepened.”}
corporation. For example, the defendants in *Del-Met* included customers and third parties brought in to manage operations and accounting functions, 322 B.R. at 791-92, and the defendants in *Exide* included lenders. 299 B.R. at 736. In both *Del-Met* and *Exide*, the court determined that there were sufficient alleged facts to support the argument that the defendants exercised dominion and control over the debtors. See *Del-Met*, 322 B.R. at 811; *Exide*, 299 B.R. at 744.

If a claim of deepening insolvency does not require that a defendant breach an independent duty to the corporation (e.g., duty of care, duty of loyalty), parties who do not traditionally owe such duties to a corporation (e.g., lenders and customers) are likely to be much more affected than parties who have well-recognized duties to a corporation under state law (e.g., directors and officers). If the plaintiff is required to prove that a lender or customer breached an independent duty to prevail on a deepening insolvency claim, the plaintiff will have to prove as a threshold matter that such party owed a legally recognized duty to the corporation (e.g., by proving that the party had “dominion and control” or that the party was an “insider”), then prove that such duties were breached, and then prove that the breach resulted in damages to the corporation.

**Conclusion**

For the foreseeable future, it is inevitable that the present uncertainty regarding the theory of deepening insolvency will continue, including whether courts will decide that deepening insolvency remains a damage theory when a party commits an independent tort or is a separate cognizable tort. Until more courts address the issue—including cases addressing the elements of a claim based on the theory—it is difficult to even define the parameters of deepening insolvency, let alone how to adapt one’s behavior to avoid liability. Notwithstanding these uncertainties, it is reasonable to conclude at this time that parties are likely more at risk if
any of the following are present: (1) the party is involved in a transaction with a corporation while knowing that another party may be in breach of its fiduciary duties to the corporation in a way that is related to the transaction; (2) the party has control (or will be deemed to have control) of the corporation so that if the corporation is deemed to have committed a tort, the action will be imputed to the party; (3) the party acts in bad faith or breaches its fiduciary duties; or (4) the party makes unreasonable decisions that prolong the life of the corporation and increase its indebtedness.
Secondary Sources to Which Authors Referred:

(a) Brian J. Redding & Deborah G. Shortridge, *The “Zone of Insolvency,” “Deepening Insolvency,” and Lawyer Liability - Where Are We and Where Might We Be Going?*, ALAS Loss Prevention Journal (Fall 2004).


(h) Paul Rubin, *Deepening Insolvency: Lender’s Victory Over Trustee May Have Far-Reaching Implications*, The Bankruptcy Strategist 1-2, 6-7 (Feb. 2005).


