"DEEPENING INSOLVENCY"

LITIGATION RISKS FOR LENDERS AND DIRECTORS WHEN OUT-OF-COURT RESTRUCTURING EFFORTS FAIL

JAMES M. PECK, DAVID M. HILLMAN AND ELIZABETH L. ROSE*

Unsecured creditors have a novel strategy to use in their perennial search for deep pockets to enhance recoveries in bankruptcy cases. While their litigation targets remain the same—lenders, directors, officers, financial advisors and lawyers—they now have a new weapon in the form of a "claim" for deepening insolvency. Until recently, deepening insolvency had been recognized solely as an *injury* to a corporation for acts that independently constitute wrongful conduct. For example, if a director participated in a fraudulent scheme to raise money by intentionally concealing the company's insolvency from investors, the director might be sued for damages resulting from, among other things, prolonging the company's life beyond insolvency and deepening its insolvency through increased exposure to creditor liability.[1]

Recently, however, this theoretical injury has morphed into an independent tort. This result is unfortunate and troubling for lenders, directors and advisors involved in pre-bankruptcy restructurings. The elements of deepening insolvency are ill-defined but generally involve the wrongful prolonging of an insolvent company's existence to the detriment of the company's creditors. The principal problem with this theory is that it is fashioned after the fact, from the perspective

---

* James M. Peck and David M. Hillman are partners in the Business Reorganization Group at Schulte Roth & Zabel LLP, where they represent secured and unsecured creditors, bank groups, creditors' committees, bondholders, directors and other parties in Chapter 11 cases and out of court restructurings. Elizabeth L. Rose is an associate in the Business Reorganization Group.

1. *See* Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983) (recognizing deepening insolvency damages for claims against directors of insurance company who intentionally failed to disclose insolvency to regulators and permitted insurer to remain in high-risk insurance business while under-reserving and maintaining insufficient surplus for potential claims).

of an insolvency that has already occurred. A lender's prospective decision to work-out a troubled loan and its agreement to make additional financing available to allow the borrower to implement its restructuring plan is a decision that should not be judged with the benefit of hindsight. No liability should be imposed for having supported a legitimate work-out that later fails and is then subjected to the scrutiny of creditors looking for a target. Lenders must be aware of this risk when deciding whether to restructure a troubled credit or accelerate the loan with the likely consequence of precipitating a premature bankruptcy filing.

I.
ORIGINS OF DEEPENING INSOLVENCY

Deepening insolvency has been recognized by some courts as a corporate *injury* resulting from acts that independently constitute wrongful conduct.[2] The cases addressing

2. Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001) (referring to "deepening insolvency" as a theory of "injury"); Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935 (5th Cir. 2001), *cert. denied* 535 U.S. 1097 (2002) (noting "trend toward recognizing 'deepening insolvency' as a cause of action against a party who creates the false appearance of solvency in an insurance company or other financial institution"); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995) (Chapter 11 trustee sued debtors' accountants and lawyers for malpractice and negligence arising out of their participation with the debtors in a "Ponzi" scheme and noted a "theoretical possibility [of] some independent financial injury to the Debtors might be established. . .as a result of alleged professional malpractice."); *Schacht*, 711 F. 2d at 1350 (recognizing deepening insolvency claim for damages based upon RICO liability); Bookland of Me. v. Baker, Newman & Noyes, LLC, 271 F.Supp.2d 324, 326 (D. Me. 2003) (client sued accounting firm for professional malpractice and court instructed jury to "consider damages under the so-called 'deepening-insolvency' concept."); Allard v. Arthur Andersen & Co. (USA), 924 F.Supp. 488, 494 (S.D.N.Y. 1996) (recognizing that under New York and Michigan law, malpractice could damage the corporation by causing it to incur additional indebtedness to trade creditors); *In re* Flagship Healthcare, Inc., 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (the additional debt incurred by debtor as a result of defendant's negligence "may provide a measure of damages"); Hanover Corp. of America v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997) ("aggravation of insolvency or prolonging the life of an insolvent business has been considered to constitute injury to the corporation"); Gouiran Holdings, Inc. v. Desantis (*In re* Gouiran Holdings, Inc.), 165 B.R. 104, 106 (E.D.N.Y. 1994) (reversed grant of motion to dismiss complaint filed by creditors' committee against debtor's accountants for "negligent

deepening insolvency typically have involved directors, officers, accountants, or lawyers who were responsible for negligently (e.g., malpractice) or intentionally (e.g., Ponzi schemes) misrepresenting a struggling company's financial health which, in turn, resulted in the inability of the company's management, shareholders, creditors and/or regulators to gauge accurately the company's financial strength and decide whether the business should be continued.[3] Not all courts, however, have recognized deepening insolvency as either an injury or a separate cause of action.[4]

---

preparation of financial statements [which caused debtor to] incur debt that it otherwise would not have incurred and was thereafter unable to service").

3. *See Lafferty*, 267 F.3d at 344-46 (claims against accountants, brokers, underwriters, lawyers, officers and directors for fraud, misrepresentation, breach of fiduciary duty and malpractice arising out of a Ponzi scheme); *Allard*, 924 F.Supp. at 490-91 (claims against auditor for malpractice and fraud); *Flagship*, 269 B.R. at 724-25 (claims against financial advisors for negligently valuing companies acquired by debtor); *Hanover Corp. of America*, 211 B.R. at 851 (claims against former attorneys and attorneys' professional liability insurers alleging breach of duties of reasonable care and professional responsibility in connection with SEC enforcement action based on the attorneys' failure "to advise the corporation that [management] was violating securities laws. . .looting and mismanaging the corporation's assets. . .drafting and presenting pleadings. . .which failed to disclose ongoing violations of [SEC] law and injunctions, and which understated. . .debt incurred" by the corporation).

4. *See Fla. Dep't of Ins.*, 274 F.3d at 927-28, 931, 935-36 (granting summary judgment in favor of defendant when liquidator of insolvent insurer sued trustee of trust established by insurer to provide readily available pool of assets for payment of policyholders' claims for fraud in failing to properly certify value of such assets and prolonging insurers' existence with the result that its insolvency had allegedly deepened); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 656 (Bankr. N.D. Ill. 1998) (dismissing complaint for failure to state a claim upon which relief may be granted when trustee alleged that "defendants prolonged the debtors' corporate lives by incurring debt on the basis of misleading financial information"); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003) ("We decline [p]laintiffs' invitation to recognize 'deepening insolvency,' the only theory of damages that [p]laintiffs argue on appeal, as sufficient damages. Although deepening insolvency might harm a corporation's shareholders, its does not, without more, harm the corporation itself."); Askanase v. Fatjo, No. Civ.A.H-91-3140, 1996 WL 33373364, at *28 (S.D. Tex. Apr. 1, 1996) (rejected deepening insolvency theory reasoning that equity interest holders "could not be damaged by additional losses incurred after the point of insolvency because they had already lost their equity interest in the company").

The evolution of this theory and the clarity of the discussion of deepening insolvency as a corporate injury are best illustrated by three cases—*Schact v. Brown*,[5] *Allard v. Arthur Andersen & Co.*,[6] and *Official Committee Of Unsecured Creditors v. R.F. Lafferty & Co.*[7]

Schact v. Brown

Schact is one of the earliest decisions addressing deepening insolvency. In this case, the Seventh Circuit refused to dismiss a complaint filed by the liquidator of an insolvent insurer against officers, directors and accountants for damages under the Racketeer Influenced and Corrupt Organizations ("RICO") Act arising out of alleged "fraudulent acts" involving "sham reinsurance, falsification of financial statements and fraudulent dealings with state insurance regulators, which allowed [defendants] to prolong [the insurer's] life beyond insolvency and thus exacerbate its financial woes."[8] To survive a motion to dismiss, the plaintiff had to prove a direct casual connection between the alleged acts and the corporation's injury.[9] The court found that the insurance company was injured by the defendants' conduct because the "fraudulent prolongation of a corporation's life beyond insolvency. . .increased the company's exposure to creditor liability" and denied shareholders "their right to dissolve the corporation in order to cut their losses."[10]

Allard v. Arthur Andersen & Co.

In *Allard*, the bankruptcy trustee sued the debtor's former auditor for failing to detect or disclose misappropriation of funds alleging malpractice, negligence, breach of contract, unjust enrichment, common-law fraud, aiding and abetting fraud, securities fraud and violations of RICO. The defendant argued that the trustee could not recover damages based on the debtor's indebtedness to trade creditors.[11] The court, cit-

5. 711 F.2d 1343 (7th Cir. 1983).
6. *Allard*, 924 F.Supp. at 494.
7. 267 F.3d 340, 349 (3d Cir. 2001).
8. *Schact*, 711 F.2d at 1345, 1359.
9. *Id.*
10. *Id.* at 1350.
11. *Allard*, 924 F.Supp. at 494.

ing *Schact*, reasoned that additional debt may in some cases prove harmful to the corporation. "Trade credit may provide an illusory financial cushion that lulls shareholders into postponing their decision to dissolve the corporation. Shareholders may under these circumstances miss an opportunity to 'cut their losses' by shutting down operations before management can fritter away whatever valuable assets that corporation may still possess."[12] The court denied summary judgment because under a "deepening insolvency" theory there can be "damages flowing from indebtedness to trade creditors."[13]

Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.

In *Lafferty*, a creditors' committee sued the debtor's former accountants, attorneys and underwriters for participating in a fraudulent "Ponzi scheme", which had "wrongfully expanded the debtors' debt out of all proportion of their ability to repay and ultimately forced the debtors to seek bankruptcy protection."[14] The committee sued based upon violations of federal securities laws, common law fraud, negligent misrepresentation, mismanagement, breach of fiduciary duty, and professional malpractice.[15] Several defendants moved to dismiss the case, arguing that the committee lacked standing because "the Debtors have not sustained a 'cognizable injury' separate and apart from any injury sustained by investors who had purchased the Debtors' debt securities."[16] The Third Circuit rejected this argument and stated that:

> [e]ven when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. For example, to the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation. . .When brought on by unwieldy debt, bankruptcy also creates operational limitations

12. *Id.* at 494 (internal citations omitted).
13. *Id.*
14. *Lafferty*, 267 F.3d at 343, 345.
15. *Id.* at 345-46.
16. *Id.* at 347.

> which hurt a corporation's ability to run its business in a profitable manner. Aside from causing actual bankruptcy, deepening insolvency can undermine a corporation's relationships with its customers, suppliers, and employees. The very threat of bankruptcy, brought about through fraudulent debt, can shake the confidence of parties dealing with the corporation, calling into question its ability to perform, thereby damaging the corporation's assets, the value of which often depends on the performance of other parties. . .These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.[17]

II.
INJURY MORPHS INTO AN INDEPENDENT TORT

Last year, in *Official Committee of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies, Inc.)*, the Delaware Bankruptcy Court converted the "injury" of deepening insolvency into an independent claim.[18] *Exide Technologies* wrongly recognized deepening insolvency as an independent cause of action (as opposed to an injury) and held that such a claim could be asserted against lenders. In *Exide Technologies,* a creditors' committee sued the pre-petition lenders alleging, among other things, fraudulent transfer, equitable subordination, and a "claim" for deepening insolvency. The complaint alleged that "the Lenders caused the Debtors to [engage in certain transactions] so that they could obtain the control necessary to force the Debtors fraudulently to continue business for nearly two years at ever-increasing levels of insolvency. The conduct by the Lenders caused the Debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value."[19]

While the allegations looked identical to lender-liability type claims, the complaint asserted a count for "deepening insolvency."[20] The lenders moved to dismiss the complaint argu-

17. *Id.* at 349-50 (internal citations omitted).
18. 299 B.R. 732, 752 (Bankr. D. Del. 2003).
19. *Id.* at 735-36, 743, 746, 750-1 (internal citations omitted).
20. *Id.* at 736.

ing, among other things, that no claim for deepening insolvency is recognized under Delaware law.[21]

The *Exide Technologies* court incorrectly observed that the Third Circuit in *Lafferty* had ruled that a *claim* for deepening insolvency was recognized under Pennsylvania law.[22] Accordingly, the bankruptcy court denied the lenders' motion to dismiss and concluded that the Delaware Supreme Court would also recognize a claim for deepening insolvency.[23] The court in *Exide Technologies* misinterpreted the *Lafferty* decision. *Lafferty* did not recognize deepening insolvency as an independent tort but merely as an injury to the debtor resulting from acts that were independently actionable.[24] In effect, the *Exide Technologies* court's misreading of *Lafferty* transformed an injury theory into an independent tort.

Elements

To the extent that deepening insolvency is recognized as a claim, its elements have not yet been defined by the courts. The elements *may* include: (i) an insolvent company; (ii) fraudulent and/or negligent incurrence of additional liability or wrongful dissipation of assets; (iii) prolongation of a company's life through concealment of its deteriorating financial condition; (iv) loss of substantial value that could have been realized if the company's existence had not been prolonged; and (v) harm to the company distinct from the harm suffered by its creditors. Also, courts have not yet addressed whether deepening insolvency is viable on a stand-alone basis or whether the cause of action, even if independent, requires that the defendant commit some other independently recognized predicate act (i.e., malpractice, fraud, breach of fiduciary duty) which causes "deepening insolvency" injuries to the company.

Assuming the plaintiff can prove causation, there is little guidance on how to calculate damages. Potential damage calculations may include: the amount of increased liabilities that would have been otherwise avoided but for the defendant's wrongful conduct, the loss in the value of the company that

21. *Id.* at 751.
22. *Id.* at 751-52.
23. *Id.* at 752.
24. *Lafferty*, 267 F.3d at 349, 352.

was caused by the defendant's conduct,[25] the increase in creditor recoveries that would have been realized if the company had been liquidated an earlier point in time, and the legal and administrative costs incurred in connection with the bankruptcy case to the extent the filing was caused by the defendant's conduct.[26]

Lenders, directors or others sued under a deepening insolvency claim should challenge whether such a claim is legally recognized and the plaintiff's standing to bring the action. The defenses of *in pari delicto* and the business judgment rule may also be applicable.

A. *Standing*

The ability to commence litigation is generally referred to as "standing" and it is a threshold issue in every case.[27] Under section 541 of the Bankruptcy Code, the bankruptcy estate includes "all legal and equitable interests of the debtor in property as of the commencement of the case."[28] These interests include causes of action.[29] The trustee or debtor in possession ("DIP")[30] have the *exclusive* right to assert the debtor's claim.[31] If, on the other hand, a cause of action belongs solely to the estate's creditors, the trustee or DIP lacks standing to assert

25. Bookland of Me. v. Baker, Newman & Noyes, 271 F.Supp.2d 324, 325-26, 330 (D. Me. 2003).

26. *Bookland of Me.*, 271 F.Supp.2d at 326; *Lafferty*, 267 F.3d at 350. *See also* Allen Michel & Israel Shaked, *Deepening Insolvency: Plaintiff vs. Defendant*, 21 AM. BANKR. INST. J. 32 (May 2002).

27. Warth v. Seldin, 422 U.S. 490, 498 (1975) (affirming grant of motion to dismiss for lack of standing).

28. 11 U.S.C. § 541(a)(1).

29. *See, e.g.*, Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131 (2d Cir. 1984) (ruling shareholder's derivative suit for breach of officers' and directors' fiduciary duty passes to the estate); Bauer v. Commerce Union Bank, 859 F.2d 438, 441 (6th Cir. 1988).

30. Generally, a trustee is appointed to run the debtor's business in circumstances of fraud, dishonesty, incompetence or gross mismanagement. 11 U.S.C. § 1104(a)(1). In most chapter 11 cases, however, a trustee is not appointed. Instead, the debtor's management remains in place and is generally referred to as the "debtor in possession." A debtor in possession has all the rights and powers of trustee, including the rights to sue on the estate's behalf. *See* 11 U.S.C. § 1107(a).

31. Schertz-Cibolo-Universal City, Indep. Sch. Dist. v. Wright (*In re* Educators Group Health Trust), 25 F.3d 1281, 1284 (5th Cir. 1994).

claims on behalf of an estate's creditors.[32] Because deepening insolvency alleges an injury suffered by the company, not its creditors, courts have held that only the trustee or DIP has standing to bring the claim.[33] A creditors' committee, equity committee, individual creditor or shareholder lack standing to file such a suit unless authorized by the bankruptcy court.[34]

B. In Pari Delicto

The doctrine of *in pari delicto* (which means "of equal fault") bars a plaintiff from asserting a claim against a defendant when the plaintiff is deemed to be at fault for the injury. In other words, "a plaintiff's recovery may be barred by its own wrongful conduct."[35] Therefore, if a debtor either directly or indirectly engages in conduct that causes deepening insolvency, then the trustee or creditors' committee standing in the debtor's shoes cannot recover damages for such injury.[36] Some courts have used *in pari delicto* to deny standing,[37] and others treat it as an affirmative defense.[38]

Whether the debtor will be considered to be at fault for causing deepening insolvency depends on whether the mis-

---

32. *See* Caplin v. Marine Midland Grace Trust Co. of New York, 406 U.S. 416, 429 (1972); Stevenson v. J.C. Bradford & Co. (*In re* Cannon), 277 F.3d 838, 853 (6th Cir. 2002) ("[i]f a cause of action belongs solely to the estate's creditors. . .then the trustee has no standing to pursue the claim.").

33. *See Lafferty*, 267 F.3d at 347-48.

34. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429 (1972); Housecraft Indus. USA, Inc. v. Murad (*In re* Housecraft Indus. USA, Inc.), 310 F.3d 64, 70-72 (2d Cir. 2002); *In re* Perkins, 902 F.2d 1254, 1257 (7th Cir. 1990) ("The authority to collect the debtor's assets is vested exclusively in the trustee"); Unsecured Creditors Comm. v. Noyes (*In re* STN Enterprises), 779 F.2d 901, 904-905 (2d Cir. 1985).

35. Pinter v. Dahl, 486 U.S. 622, 632 (1988).

36. *See Lafferty*, 267 F.3d at 358-60; Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991) (barring claims of trustee, standing in shoes of debtor, against third parties without regard to the trustee's status as innocent successor); *In re* Hedged-Investments Assocs., Inc., 84 F.3d 1281, 1284 (10th Cir. 1996) (barring trustee's claims against third parties because "one who has himself participated in a violation of law cannot be permitted to assert. . .any right founded upon. . .the illegal transaction").

37. *See Wagoner*, 944 F.2d at 120 (holding trustee lacks standing to bring claim against third parties for defrauding corporation with the cooperation of management because claim accrues to creditors, not guilty corporation); *accord Hirsch*, 72 F.3d at 1094.

38. *Lafferty*, 267 F.3d at 346 ("analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*").

conduct of its directors and officers can be imputed to the debtor and to estate representatives such as a trustee or a creditors' committee.[39] Generally, management's misconduct can be imputed to the corporation when its acts are both within the scope of employment and in the interests of the corporation.[40] Conversely, when a manager acts solely in his or her own interests or in the interests of a third party, and adversely to the interests of a corporation, misconduct is not imputed and the defense does not apply.[41]

Some courts have also held that the *in pari delicto* defense may not be asserted against trustees or creditors' committees. The reasoning behind these holdings is that a trustee's ability to recover for an estate and its innocent creditors should not be denied on account of the debtor's wrongful conduct.[42] The doctrine of in *pari delicto* may be a valuable defense against claims for deepening insolvency, but there are still questions as to whether it will be allowed in the bankruptcy context and which parties will be able to take advantage of it.

C. *Business Judgment Rule*

The essence of the deepening insolvency claim (at least as against directors) is to challenge the board's decision to continue incurring debt, rather than liquidating or filing for bankruptcy relief. Directors may be able to defend their business decision by relying on the business judgment rule.[43] This rule shields their decisions from judicial scrutiny by providing an

---

39. *See id.* at 355.

40. *See In re* Mediators, Inc., 105 F.3d 822, 827 (2d Cir. 1997); FDIC v. Ernst & Young, 967 F.2d 166, 171 (5th Cir. 1992) ("Because a corporation operates through individuals, the privity and knowledge of individuals at certain levels of responsibility must be deemed the privity and knowledge of the organization").

41. *See Mediators*, 105 F.3d at 827; *Ernst & Young*, 967 F.2d at 170.

42. *See* Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P., 212 B.R. 34, 44 (S.D.N.Y. 1997) (when trustee argued that the *in pari delicto* defense does not apply to a bankruptcy trustee, court specifically refused to address the question and determined the defense could not be upheld on other grounds); *see also In re* Wedtech Corp., 88 B.R. 619, 622 (Bankr. S.D.N.Y. 1988) ("trustee's ability to obtain a recovery for an estate and its blameless creditors may not be denied by the pre-petition wrongful conduct of the debtor").

43. *In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669 at *9-10 (Bankr. S.D.N.Y. Dec. 11, 2003) (applying business judgment rule to deter-

evidentiary presumption that in making decisions, they were informed, acted in good faith and honestly believed that their decision was in the best interests of the corporation.[44] Under this rule, courts will not review a decision by directors even if it was a poor one, keeping the focus on the decision making process, and not the actual decision.[45] The business judgment rule applies only when there has been appropriate board action, not when directors abdicate their functions or fail to act.[46] The rule has been aptly described as encompassing three elements: a "threshold review of the objective financial interests of the board whose decision is under attack (i.e., independence)"; a "review of the board's subjective motivation (i.e., good faith)"; and an "objective review of the process by which it reached the decision under review (*i.e.*, due care)".[47] The presumptions of the business judgment rule can be rebutted if the plaintiff—who has the burden of proof—can show: gross negligence in the decision making process; that the decision was irrational or had no business purpose; that the action was *ultra vires* or constituted waste; that the director or officer had a conflict of interest; or that there was fraud, bad faith or illegality in the decision.[48]

III.
ADEQUATE REMEDIES ALREADY EXIST

Courts do not need to create a new cause of action for deepening insolvency because creditors and shareholders of insolvent companies already have well established remedies. The creation of a claim without defined elements or established parameters is not warranted and serves only to promote wasteful and abusive litigation.

For example, if directors or officers of an insolvent company cause the company to fraudulently incur additional liabil-

---

mine if directors had breached their fiduciary duties by deciding not to liquidate and to continue corporation's existence).

44. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

45. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

46. Pereira v. Cogan, 294 B.R. 449, 531 (S.D.N.Y. 2003).

47. RODMAN WARD, JR., FOLK ON THE DELAWARE GENERAL CORPORATION LAW, § 141.2 (4th ed., Supp. 2004-2)

48. *See* Arthur R. Pinto & Douglas M. Branson, UNDERSTANDING CORPORATE LAW 192 (1999).

ity or waste corporate assets, the appropriate remedy is a claim for breach of fiduciary duty.[49] If third parties (*e.g.*, auditors, third-party professionals or lenders) knowingly participate in a breach of fiduciary duty, the appropriate remedy is a claim for aiding and abetting a breach of duty.[50]

If a third-party professional negligently misrepresents the true financial state of the company, the appropriate remedies are claims of misrepresentation and professional malpractice.[51]

If a lender exercises excessive controls, dominates a borrower's affairs in a manner that harms the borrower or its creditors or otherwise engages in equitable conduct, then the appropriate remedy is a claim under the numerous common law lender liability theories, including breach of fiduciary duty.[52]

Additionally, a creditor that engages in inequitable conduct causing harm to other creditors can have its claim in a

---

49. *See, e.g.*, Glazer v. Zapata Corp., 658 A.2d 176, 183 (Del. Ch. 1993) ("Directors are guilty of corporate waste, only when they authorize an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.").

50. *See* Gilbert v. El Paso Co., 490 A.2d 1050, 1057 (Del. Ch. 1984) ("It is well settled that a third party who knowingly participates in the breach of a fiduciary's duty becomes liable to the beneficiaries of the trust relationship") (citations omitted); Sharp Int'l v. State Street Bank & Trust Co., 302 B.R. 760, 767-70 (E.D.N.Y. 2003) ("The cause of action for aiding and abetting a breach of fiduciary duty under New York common law is based on the well-established principle that '[a]nyone who *knowingly participates* with a fiduciary in a breach of trust is liable for the full amount of damages caused thereby'" (*quoting* Wechlser v. Bowman, 34 N.E.2d 322, 326 (1941))).

51. *See generally* Hirsch v. Arthur Andersen & Co., 72 F.3d 1085 (chapter 11 trustee sued debtors' accountants and lawyers for malpractice and negligent misrepresentation arising out of their participation with the debtors in a "Ponzi" scheme); Gouiran Holdings, Inc. v. Desantis (*In re* Gouiran Holdings, Inc.), 165 B.R. 104 (claims against debtor's accountants for malpractice for negligent preparation of financial statements that caused company to incur debt it could not service).

52. Lender liability is made up of a body of common and statutory law covering a broad spectrum of claims. A discussion of the lender liability theory is beyond the scope of this writing. For an excellent and comprehensive discussion of lender liability theories, *see* Gerald Blanchard, LENDER LIABILITY: LAW, PRACTICE AND PREVENTION (2d ed. 2003).

resulting bankruptcy case subordinated to the claims of injured creditors.[53]

IV.
SLIPPERY SLOPE: DEEPENING TROUBLE FOR WORKOUTS

Whether deepening insolvency is an injury, a measure of damages or an independent tort, the theory presents a growing litigation risk for lenders and directors. Until the appellate courts clarify the state of the law, trustees' and creditors' committees will continue, as they have been doing, to assert this "claim" as a litigation tactic to put pressure on defendants. The assertion alone can lead to vexatious and costly litigation. Lenders should not be punished for assisting a distressed borrower's turnaround effort. The lender's conduct should not be judged by hindsight, but instead by the circumstances that existed at the time of the efforts to rehabilitate the borrower and avoid bankruptcy. A good faith effort to provide needed financing or breathing room should not create future liability.

The current litigation trend carries with it an unfortunate corollary—lenders may be reluctant to support a company in distress other than as a post-bankruptcy lender if doing so could be an invitation to future lawsuits. Those who assert these legal claims are usually focused solely on creditor recoveries in a later bankruptcy, but lenders have no way of knowing whether their otherwise innocent conduct may some day end up in the cross-hairs of a lawsuit. The same is true for directors and their advisors. Good faith efforts by the board of a company in distress to explore alternatives that avoid the significant costs, uncertainty and disruption of a bankruptcy may be affected by the shadow of potential future claims if a bankruptcy should become unavoidable. Ironically, a tactic intended to enhance creditor recoveries may have the opposite effect by forcing earlier (and perhaps premature) bankruptcy filings and creating an environment that results in fewer successful out-of-court restructurings. Deepening insolvency is a "hot" claim that carries with it risks to lenders, directors, officers and advisors and that may indirectly harm all stakeholders.

---

53. 11 U.S.C. § 510(c). *See generally In re* Mobile Steel Corp., 563 F.2d 692, 700 (5th Cir. 1977).