NECESSITY, THE MOTHER OF INVENTION, STRIKES AGAIN: DEEPENING INSOLVENCY—DISSECTING THE DECISIONS OF DIRECTORS AND OFFICERS IN THE ZONE OF INSOLVENCY THROUGH A REARVIEW LOOKING GLASS

Brad Eric Scheler*

I. INTRODUCTION

Mater artium necessitas. Necessity is the mother of invention. I have always wanted to begin an article with an anonymous Latin phrase. Finally, the perfect opportunity.

The law is replete with theories and doctrines that are the outgrowth of necessity. Perhaps no area of law provides more opportunity and need for invention owing to necessity than does insolvency. Insolvency is an arena in which there is never enough to go around, where there is a gulf between claim amount and recovery and where lack of value and assets has spawned and continues to spawn the quest for the creditors’ Holy Grail: deep third-party pockets of recovery.

In the myriad of judicial decisions generated by bankruptcy courts and other courts of competent jurisdiction, a student of insolvency law will find no shortage of theories asserted in pursuit of this Holy Grail. Some of these theories over time have become part of the fabric of law, by dint of consistent case law precedent or eventual statutory incorporation. Others are raised, are rejected, and fade away. Still others, raised in and embraced by a court as the basis for a decision or dictum, may lie dormant and wait for the right set of facts and the right environment to reemerge. With ideal conditions, these theories leap from relative obscurity to center stage. Once “up in one” and under the lights, these theories find supporters and critics and work their way under the skin of legal analysis, business practice, and corporate governance. This article examines one such theory, “deepening insolvency.”

The theory of deepening insolvency is used as a basis to assert claims arising from the decision by insiders to add incremental debt to an already overleveraged company—at a point in the company’s lifecycle when it should be restructured or liquidated—with the unreasonable

*Fried Frank Harris Shriver & Jacobson LLP
hope of preserving the equity value of the company. These efforts are
directed at deep-pocketed third parties such as officers and directors of
the company, accountants, financial advisors, investment bankers, attor-
eyes, and lenders. At the core of such claims lies the assertion that those
third parties have liability for the wrongful prolongation of a corpora-
tion’s life beyond insolvency, resulting in damage to the corporation
cause by increased debt.\footnote{1}

While the goal of extracting value from third parties has existed for-
ever, legal scholars and practitioners point to an opinion issued in 1980
by the United States District Court for the Southern District of New Y ork
arising from the Investors Funding Corp. bankruptcy case\footnote{2} as the seminal
decision in which the doctrine of deepening insolvency was first consid-
ered and articulated. Twenty-four years and a number of subsequent
court decisions and scholarly articles after this first articulation, the
tenor, integrity, application, and boundaries of the doctrine remain the
subject of argument and speculation. Because the boundaries remain so
undefined, directors and officers of both insolvent companies and com-
panies in the “zone of insolvency”\footnote{3} must consider and account for the
risks they take in deciding to prolong a company’s life outside bank-
ruptcy protection.

II. THE ZONE OF INSOLVENCY

The point at which a corporation becomes insolvent is of tremendous
significance to directors, officers, and their corporate constituencies. Yet
the point of insolvency can also be extremely difficult to determine with
precision. Because of the difficulty in determining when a company
moves from solvency to insolvency, courts and commentators have
increasingly come to regard insolvency as a “zone” that begins prior to
actual insolvency. Upon entering the “zone,” a corporation is effectively
forced to evaluate the interests of its various constituencies.\footnote{4}

Although there is no per se formula for determining when a corpora-
tion has entered the zone of insolvency, courts employ two distinct tests
to determine actual insolvency: the “balance sheet”\footnote{5} and the “cash
flow”\footnote{6} test. If either indicates insolvency, the corporation is considered
insolvent. Further, a court may regard a corporation as being in the zone
of insolvency whenever its management is considering a transaction that
would render the corporation insolvent, even if at the time the decision is
made the corporation is entirely solvent.\footnote{7} To that end, best practice dic-
tates that directors and officers operate as though the corporation is in
the zone of insolvency if either the balance sheet or cash flow test is a
close call or whenever they are considering a business decision that
would raise the specter of insolvency under either test.
A number of recent court decisions and scholarly perspectives have made generalizations about the zone of insolvency and the shifting of the duties of directors and officers a subject fraught with risk and fodder for challenge. For the limited purposes of this article, it is reasonable to note that traditional corporate law principles hold that directors and officers owe fiduciary duties primarily to the company and its shareholders. These duties typically do not run to the creditors of the corporation. While shareholders rely on management to protect their interests, creditors of a solvent corporation may protect their interests adequately through contracts, such as secured financing agreements or other contractual provisions that provide for consequences of default. When a company is insolvent (or in the zone), however, the interests of its creditors in the corporate assets are put at risk to the extent that the claims of creditors exceed the value of the insolvent company’s assets. Thus while most courts recognize continuing fiduciary duties to shareholders even when a company is insolvent, courts also recognize that, when a company is in the zone of insolvency, the rights of creditors must be considered and protected by directors.

The Delaware Chancery Court, in its influential decision Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. addressed the new, broader fiduciary duties that directors and officers should honor when in the zone of insolvency. Although the Delaware Chancery Court in Credit Lyonnais did not prescribe a precise mechanism for balancing the interests of creditors and shareholders when making corporate decisions, the court made clear that proper decisions will “not be reached by a director who thinks he owes duties directly to shareholders only.” However, in Production Resources Group, a recent decision by the Delaware Chancery Court, the court stated that Credit Lyonnais only provides directors and officers with a “shield” from stockholders who claim that the directors and officers had an obligation “to undertake extreme risk so long as the company would not technically breach any legal obligations.” In this regard, the court noted that the decision in Credit Lyonnais clearly emphasized that “directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.” While recognizing that directors and officers of an insolvent company do owe fiduciary duties to the company’s creditors, the Delaware Chancery Court interpreted Credit Lyonnais as only indirectly benefiting creditors, by giving them a derivative right of action against directors and officers for a breach of fiduciary duty to the company and not as “creating a new body of creditor’s rights law.”
Courts have repeatedly emphasized that directors and officers must find ways to maximize the long-term value of an insolvent corporation for the benefit of all its constituent groups, without the preference typically given to shareholders of solvent companies or the priority given to creditors in a bankruptcy context. By framing the duty of directors and officers in the zone of insolvency as one of “value maximization,” courts have suggested that corporate property should neither be unduly risked for the benefit of shareholders nor prematurely liquidated to satisfy creditors if there remains a viable alternative. It is often said that hindsight is 20/20, and any challenge brought against directors and officers for a violation of fiduciary duty will have hindsight on its side. Thus some strategies for directors and officers operating in the zone of insolvency include (i) avoiding the incurrence of indebtedness that is unlikely to be repaid; (ii) avoiding risky transactions they seek to realize upon a slim chance of producing high returns to shareholders; (iii) evaluating all decisions with a view to preserving the contractual right of priority enjoyed by creditors in the repayment of debts; (iv) documenting all deliberations concerning decisions or transactions that might adversely impact any corporate constituency; and (v) whenever possible, obtaining solvency and/or fairness opinions provided by investment bankers, risk managers, or other financial experts outside the corporation in connection with any contemplated transaction that may adversely impact the corporation’s creditors or shareholders.

III. DEEPENING INSOLVENCY

A. An Overview

Directors and officers should be held responsible for damage done to a corporation as a result of actions taken to further the wrongful prolongation of a corporation’s life beyond insolvency. Typically, the specter of deepening insolvency surfaces where a company has been allowed to linger in the zone of insolvency for what claimants believe to be too long a period and in the interim incurs additional indebtedness that increases the likelihood of the company’s failure and decreases the assets available to be distributed to unsecured creditors. In this situation, trustees and creditors will often argue that, had the directors and officers sought bankruptcy relief earlier, the company would have preserved more value for its creditors.

B. Establishing Deepening Insolvency

1. A Separate Tort or Theory of Damages

While recognizing the notion of deepening insolvency, courts have differed on the precise nature of a deepening insolvency claim. In such
cases, initially, plaintiffs have asserted deepening insolvency only as a means of satisfying the damage requirements for other torts and causes of action. In many of these cases, the plaintiffs have raised the theory of deepening insolvency in response to the defense that creditors are the only parties harmed by the debtor’s decision to add incremental debt and that the debtor actually received a benefit. Other courts have held that deepening insolvency provides stakeholders and trustees with an independent tort where there is damage to corporate property.

(a) Deepening Insolvency? A Theory of Damages

The theory of deepening insolvency has been raised by trustees and creditors’ committees in response to a defendant’s motion to dismiss for failure to allege an injury. For example, in *Hannover Corp. of America*, the debtors’ trustee commenced a suit against their attorneys and the attorneys’ professional liability insurers, alleging claims of negligence and malpractice arising from, among other things, failing to advise the corporation that the debtors’ main principal was violating securities laws and injunctions by continuing to solicit and raise investor funds and was also looting and mismanaging the corporation’s assets. One of the defendants moved to dismiss the negligence and malpractice claims brought against it on the grounds that the trustee failed to allege that the debtors had suffered an injury. The U.S. District Court for the Middle District of Louisiana found that the trustee had sufficiently established a distinct injury by alleging that the defendant’s malpractice had caused mismanagement, waste, and looting of assets, resulting in the aggravation of insolvency and artificial extension of life.

Similarly, in *In re Flagship Healthcare, Inc.*, the chapter 7 trustee filed an adversary proceeding against the debtor’s prepetition financial advisor. The trustee alleged that the financial advisor’s negligently prepared valuation of the debtor’s assets had caused the debtor to take on additional indebtedness in connection with certain acquisitions, which eventually led to the debtor’s deeper decline into insolvency. The financial advisor moved to dismiss the action on the grounds that the trustee failed to establish that the debtor had suffered any damages as a result of its negligence. More specifically, the financial advisor argued that, since the financial injury stemmed from the debtor’s inability to repay debt, it was the creditors and not the debtor who were injured by any negligence. The U.S. Bankruptcy Court for the Southern District of Florida, however, held that the additional debt incurred by the debtor as a result of the defendant’s negligence might provide a measure of damages recoverable by the trustee on behalf of the debtor’s estate. The bankruptcy court reasoned as follows:
In the world of corporate workouts, turnaround managers and the possibility for a quick change in an economic tide, it is not uncommon for a corporation to revitalize itself and work out financial problems no matter how dire they appear. The financial hardships which possibly resulted from the increased insolvency were not necessarily forthcoming, and if it can be proven that they were a result of the increased insolvency, liability may be found.35

Hence the trustee had satisfied the damage element of its negligence claim by asserting that the negligence had caused the debtor’s deepening insolvency.

(b) Deepening Insolvency—Independent Tort Claim

In the case of *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, the Third Circuit interpreted Pennsylvania law and held that “where ‘deepening insolvency’ causes damage to corporate property, [the court] believe[s] that the Pennsylvania Supreme Court would provide a remedy by recognizing a cause of action for that injury.”36 In *Lafferty*, the creditors’ committee, suing derivatively on behalf of the debtors’ estates, commenced a civil action against the debtors’ officers, directors, and outside professionals, alleging that the defendants, through their operation of a Ponzi scheme, had fraudulently induced the debtors to issue debt securities to investors, thereby deepening the debtors’ insolvency and forcing them into bankruptcy.37 The Third Circuit determined that the Pennsylvania Supreme Court would recognize “deepening insolvency” as giving rise to a cognizable injury after drawing the following three conclusions: first, the court determined that the theory of “deepening insolvency” is a sound one because the fraudulent and concealed incurrence of debt can damage the value of a company in several ways;38 second, after examining various cases in which the theory of deepening insolvency was found to give rise to a cognizable injury, the court concluded that the growing acceptance of the theory by other courts confirmed its soundness;39 and, finally, the Third Circuit concluded that under Pennsylvania jurisprudence, and most common law jurisdictions, where there is an injury, the law provides a remedy.40 Based upon this analysis, the court determined that “deepening insolvency” constituted a valid cause of action under Pennsylvania state law.41

Two years after the Third Circuit decided *Lafferty*, the Bankruptcy Court for the District of Delaware in *In re Exide Technologies, Inc.*, relying in part on the Third Circuit’s analysis in *Lafferty*, concluded that the Delaware Supreme Court would also recognize a claim for “deepening insolvency.”42 In *In re Exide Technologies, Inc.*, the creditors’ committee commenced an adversary proceeding against the debtors’ lenders alleging that by persuading the debtors to acquire one of their competitors
through additional financing and increasingly restrictive covenants, the lenders intended to obtain the necessary control to force the debtors to fraudulently continue their insolvent business for approximately two years. The creditors’ committee further alleged that the lenders’ actions had caused the debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value. In concluding that the Delaware Supreme Court would recognize a claim for deepening insolvency, the court determined that the creditors’ committee had sufficiently pled the “tort” of deepening insolvency.

2. The Elements of Deepening Insolvency

Generally, in their efforts to establish a claim for deepening insolvency, plaintiffs have endeavored to demonstrate the following elements: (i) the debtor suffered a harm distinct from any of its creditors; and (ii) the harm resulted from the breach of a separate duty or actionable tort, that prolonged the life of the financially distressed debtor and (b) caused the debtor to incur additional indebtedness.

(a) Standing—Debtor Suffered a Harm Distinct From Its Creditors

Case law discussing deepening insolvency suggests that it is a derivative claim that may be brought only on behalf of a debtor. Typically, bankruptcy trustees or creditors’ committees are the parties asserting claims for deepening insolvency. It is well settled that, for a bankruptcy trustee or creditors’ committee to assert standing to bring a derivative claim on behalf of the debtor, it must first establish that the company itself sustained damages distinct from those of its creditors. As this concept is often difficult to prove, defendants frequently move to dismiss “deepening insolvency” claims brought by trustees and creditors’ committees on the grounds that the plaintiff lacks standing because the company did not sustain any damages distinct from those of its creditors.

In Lafferty, the Third Circuit provided a number of examples of ways in which the “fraudulent and concealed incurrence of debt” can cause a distinct harm to the value of a corporation. According to the Third Circuit, the decision by directors and officers of an already financially distressed company to incur additional indebtedness instead of implementing an out-of-court restructuring can result in the company being forced to unnecessarily file for bankruptcy relief. As a result, the company will be forced to incur costly administrative and legal fees, restricting its ability to run its business as a result of certain operational limitations imposed by the Bankruptcy Code. In addition, the Third Circuit explained that the incurrence of additional debt by an already
financially distressed company can seriously undermine its relationships with its customers, suppliers, and employees, while causing other third parties to lose confidence in the company’s ability to perform, thereby contributing to a decline in the value of the company’s assets.\footnote{52} Further, to the extent that the life of a company is artificially extended, the company will continue to use valuable company assets to operate the business, pay fees and interest on debt obligations, and satisfy other obligations. This dissipation of corporate assets brought on by prolonging an insolvent corporation’s life through bad debt can significantly undermine that corporation’s ability to continue as a going concern.\footnote{53} Moreover, the satisfaction of obligations related to the added debt (either through asset sales, the use of free cash, or otherwise) can significantly reduce those assets available to the company that are necessary to implement an inevitable restructuring.

(b) Breach of Separate Duty or Actionable Tort

It is unclear whether discrete allegations of actual or constructive fraud are required to establish a claim for deepening insolvency or whether allegations of negligence and/or inequitable conduct will suffice.\footnote{54} This lack of certainty is the result of the Third Circuit’s decision in \textit{Lafferty}, as well as several cases since then, which articulates the theory of deepening insolvency as the “fraudulent expansion of corporate debt and prolongation of corporate life.”\footnote{55} In contrast, the theory of deepening insolvency has also been articulated as “wrongfully prolonging the corporate existence” without any express requirement of fraud.\footnote{56} For instance, in \textit{In re Gouiran Holdings, Inc.}, the court allowed the plaintiff to assert the theory of deepening insolvency where it was alleged that the defendant’s negligently prepared financial statements had caused the debtor to incur unmanageable debt and file for bankruptcy.\footnote{57} Interestingly, in reaching its holding in \textit{Lafferty}, the Third Circuit relied on cases such as \textit{Gouiran Holdings} and similar cases involving deepening insolvency claims arising from malpractice and negligence.\footnote{58}

Moreover, the Bankruptcy Court for the Southern District of New York recently elaborated on the type of conduct required to establish a claim for deepening insolvency. In \textit{In re Gouiran Holdings, Inc.}, Chief Judge Bernstein held that “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 its increased debt.”\footnote{59} Notably, the court did not limit the theory to cases in which there is “fraud.” Chief Judge Bernstein provided the following examples of the type of conduct required to
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establish a claim for deepening insolvency: (i) using fraudulent financial statements to raise capital in the debtor’s name, thereby deepening the debtor’s insolvency and causing bankruptcy;60 (ii) parent company and directors continuing to operate an insolvent company by fraudulently concealing the company’s insolvency;61 (iii) negligently preparing financial statements or valuation reports that cause the debtor to incur unmanageable debt and to file for bankruptcy;62 and (iv) lender obtaining control over a debtor and causing it to artificially prolong its life and delay filing for bankruptcy while conducting business and entering into transactions so as to favor lender to the detriment of the debtor and its other creditors.63

In In re Global Service Group, LLC, the chapter 7 trustee commenced an adversary proceeding against, among others, principals of the debtor. The trustee alleged that the defendants had caused the artificial prolongation of the debtor’s corporate life, resulting in its “deepening insolvency.” The court explained that while fiduciaries of an insolvent corporation have an obligation to the community of interests that sustained the corporation, which includes it creditors, fiduciaries may, consistent with the business judgment rule, “conclude that the company should continue to operate in order to maximize ‘long term wealth creating capacity,’ or more generally, its enterprise value.”64 Following from that, the court held that a manager’s negligent but good-faith decision to continue to operate a company will not subject such manager to liability for deepening insolvency.65 Rather, the court required allegations that the fiduciary had breached some type of separate duty, committed an actionable tort, acted in bad faith or with fraudulent intent, but, notably, it did not limit the theory to cases in which there is “fraud.”66 Interestingly, however, the court noted that although the trustee did not allege any breach of fiduciary duties in its complaint, the trustee, in its response to the defendant’s motion to dismiss, had alleged that the debtor’s members and insiders continued to operate the debtor’s business as a means of siphoning the debtor’s funds for their individual benefit.67 The court indicated that, if the trustee’s complaint had included this allegation of siphoning, “[t]he prolongation of [the debtor’s] operations would smack of self-dealing, constitute a breach of fiduciary duty, and open up recovery under the theory of ‘deepening insolvency.”68 In light of this finding, the court granted the trustee the right to replead its claims against the debtor’s members and insiders.69

(c) Increase in Debt as the Result of Breach of Separate Duty or Tort

Claimants should not overlook the fact that courts require that the breach of fiduciary duty or tort results in increased debt. Consequently,
failure to allege this element can potentially lead a court to dismiss the claim. For example, in both *Corporate Aviation Concepts, Inc.* and *Florida Dept. of Ins. v. Chase Bank of Texas Nat. Ass’n,* the court dismissed the plaintiff’s claims for deepening insolvency because, among other things, the plaintiffs failed to provide any evidence that the defendant’s alleged fraudulent conduct had caused an increase in indebtedness.

While most cases involve an increase in indebtedness through additional loans or the sale of debt securities, the decision in *Corporate Aviation Concepts, Inc.* suggests that the incurrence of indebtedness in the ordinary course of business can potentially give rise to a deepening insolvency claim if the other elements of the theory have been established. *Corporate Aviation Concepts, Inc.* involved a credit card processing company, as plaintiff, that issued corporate aviation credit cards to qualified businesses in the aviation industry; they were used to purchase fuel and services. The credit card processing company asserted claims against certain affiliates of the debtor for deepening insolvency. The court noted that the only debt at issue was the debtor’s unpaid credit card bills, which had existed prior to the occurrence of the conduct alleged to have resulted in the debtor’s deepening insolvency. Because the credit card processing company failed to allege that the debtor’s affiliates had caused this credit card debt to be increased as a result of the conduct that allegedly caused the debtor’s deepening insolvency, the court dismissed the plaintiff’s claim. The court’s holding implies that the credit card company could have satisfied the “increased indebtedness” element of deepening insolvency if it had been able to establish an increase in the amount of the credit card debt as a result of the alleged wrongful conduct.

IV. THE EFFECTS OF DEEPENING INSOLVENCY ON CORPORATE DECISIONS

A. Positive Implications—Deterring Bad Faith and Self-Interested Decisions

For many companies in the zone of insolvency, there is no “quick fix”; a major overhaul of the company’s capital structure, along with relief from, among other things, burdensome contracts, leases, and lawsuits, is necessary. In many cases, however, directors and officers resist filing for bankruptcy, oftentimes contrary to the advice of their financial and legal advisors. For debtors and their directors and officers, hope springs eternal; the most consistent goal and desire of officers and directors is to make every effort to restore their company’s financial health out of court. While in some instances this resistance may be attributed to
management’s well-intended but unfounded optimism in the company, in other instances, it may result from either increased pressure by the company’s shareholders or management’s own self-interest (e.g., where management holds stock and would prefer a risky endeavor to restore value to shareholders rather than having their own shares wiped out in bankruptcy). Whatever the reason, for companies that require a comprehensive restructuring under the protections afforded by the Bankruptcy Code, the presence of claims and the threats related to deepening insolvency should pervade the thought process and decisions of board members and management alike, encouraging them to reflect on the consequences of their actions.

B. Negative Implications—Premature and Possibly Unnecessary Bankruptcy Filings

Not all companies in the zone of insolvency require the types of protections afforded debtors under the Bankruptcy Code. However, concerns about claims based on deepening insolvency will put added pressure on directors and officers to consider, perhaps prematurely, the commencement of a case under title 11. This threat of personal liability could lead companies away from pursuing potential liquidity sources sufficient to steer the company through temporary rough waters and back to health and viability and into a “free fall” or premature bankruptcy filing based on management’s concerns relating to the incurrence of additional debt.\(^\text{77}\) This concern is exacerbated by the uncertainty surrounding the holding in \textit{Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp.}, which suggests that the incurrence of additional indebtedness, such as credit card debt, in the ordinary course of business could provide the basis for a claim of deepening insolvency.\(^\text{78}\) It remains to be seen whether these concerns will have a chilling effect on negotiations with respect to prepackaged or prenegotiated chapter 11 cases.

C. Additional Leverage

Notwithstanding any perceived positive or negative implications that may flow from the increasing prevalence of deepening insolvency claims, the threat of such claims can be expected to serve as additional leverage for creditors in seeking recovery, which in turn may alter the dynamics of some restructuring negotiations.

V. CONCLUSION

There is an ebb and flow to the use and vitality of all legal theories and doctrines just as there is an ebb and flow to the relationship between a debtor and its creditors. Deepening insolvency is not and will not be a
tool for all cases and for all seasons. Rather, it is another of the myriad
tools used by creditors to extract value. Should it chill the sound busi-
ness judgment of directors and officers of troubled companies? No. Should it result in forestalling out-of-court solutions and result in a stam-
pede of mindless chapter 11 filings? No. Instead, deepening insolvency
should result in better and more even-tempered business judgments dic-
tated by neither self-interest nor self-preservation but driven by the goal
of preserving going concerns and maximizing value for all.

2. In re Investors Funding Corp. of New York Securities Litigation, 523 F. Supp. 533,
4. See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J.
Corp. L. 1099, 1991 WL 277613 (Del. Ch. 1991) (“At least where a corporation is operating in
the vicinity of insolvency, a board of directors is not merely the agent of residue risk bear-
ers, but owes its duty to the corporate enterprise.”).
5. The “balance sheet” test is best explained by the definition of insolvency in title 11 of
the United States Code (the “Bankruptcy Code”): a “financial condition such that the sum
of such entity’s debts is greater than all of such entity’s property, at a fair valuation.” See 11
6. The “cash flow” test is best explained by the definition of insolvency in the Uniform
Commercial Code: “Insolvent means: (A) having generally ceased to pay debts in the ordi-
nary course of business other than as a result of a bona fide dispute; (B) being unable to
pay debts as they become due . . .” U.C.C. § 1-201 (2001); See, e.g., In re Shultz, 208 B.R. 723,
Fla. 1997) (“Defendant knew that if the proposed transactions actually came to fruition that
[the company] would be rendered insolvent; therefore, he knew that [the company] was at the
‘brink of insolvency’ just prior to the transactions.”).
8. See, e.g., Katz v. Oak Industries Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (drawing con-
trast between “high standard of fidelity” owed to shareholders and “contractual” relation-
ship between a corporation and its creditors).
aff’d in part, 1999 WL 982963 (N.D. Ill. 1999), opinion amended and superseded, 43 Collier
Bankr. Cas. 2d (MB) 9, 2000 WL 282266 (N.D. Ill. 2000), (“So long as the corporation is sol-
vent, [creditors] require no additional protection; by definition, a solvent corporation, no
matter how badly managed otherwise, is able to satisfy its contractual obligations [to credi-
tors].”).
(CRR) 253, 53 Collier Bankr. Cas. 2d (MB) 57 (Bankr. S.D. N.Y. 2004) (“Directors and officers
owe their fiduciary duties to both the corporation and the shareholders . . . Once insolvency
ensues, the fiduciary duties of corporate officers and directors also extend to creditors.”)
(citations omitted); In re Buckhead America Corp., 178 B.R. 956, 968 (D. Del. 1994)
(“Where a corporation is operating in the zone of insolvency, a board of directors is not
merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise,

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including the corporation’s creditors.”) (citing Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J. Corp. L. 1099, 1991 WL 277613 (Del. Ch. 1991)).

11. Most courts find that the rights of creditors should be given increasingly greater consideration by directors and officers as the company slides into the zone of insolvency. Bank Leumi-Le-Israel, B. M., Philadelphia Branch v. Sunbelt Industries, Inc., 485 F. Supp. 556, 559 (S.D. Ga. 1980) (“In the case of an insolvent corporation, the directors and officers stand as trustees of corporate properties for the benefit of creditors first and stockholders second.”); In re Ben Franklin Retail Stores, Inc., 225 B.R. 646, 653 (Bankr. N.D. Ill. 1998), aff’d in part, 1999 WL 982963 (N.D. Ill. 1999), opinion amended and superseded, 43 Collier Bankr. Cas. 2d (MB) 9, 2000 WL 28266 (N.D. Ill. 2000) (characterizing creditors as replacing shareholders as “residual owners” of a corporation during insolvency); In re Healthco Intern., Inc., 208 B.R. 288, 300, 30 Bankr. Ct. Dec. (CRR) 858, 37 Collier Bankr. Cas. 2d (MB) 1445 (Bankr. D. Mass. 1997), (“When a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount.”); Odyssey Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386, 417 (Del. Ch. 1999) (likening an insolvent corporation to a “civilly dead” trust fund for creditors) (quoting Bovay v. H. M. Byllesby & Co., 27 Del. Ch. 381, 38 A.2d 808, 813, 174 A.L.R. 1201 (1944)). Moreover, a small minority of courts have even held that an insolvent company’s directors owe duties solely to creditors. Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) (“[W]hen a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders . . . but, by the fact of insolvency, become trustees for the creditors . . . .”) (quoting Davis v. Wolf, 147 F.2d 633, 639 (C.C.A. 4th Cir. 1945)); First Options of Chicago, Inc. v. Polonitza, 1990 WL 114740 (N.D. Ill. 1990) (“An officer and director of an insolvent corporation has a duty to the corporation’s creditors to . . . act solely for the financial benefit of the creditors in all matters, and to enhance the financial interest of the insolvent corporation.”). On the opposite end of the spectrum, one New York court has held that, under New York law, corporate officers and directors do not owe any duties to creditors when the corporation becomes insolvent. Columbia Forest Products v. Firestone Plywood Corp., 5 Misc. 3d 1018(A), 2004 WL 2672267 (N.Y. Sup 2004) (“New York courts have not extended the fiduciary duty of a director or officer to creditors . . . . (The Court has been unable to locate any cases where a director or officer of a New York corporation has been held to have a fiduciary duty to corporate creditors.”).


14. Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) (“By providing directors with this shield, creditors would derive a clear benefit because directors, it can be presumed, generally take seriously the company’s duty to pay its bills as a first priority.”).


16. Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) (“When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm’s directors are said to owe fiduciary duties to the company’s creditors. This is an uncontroversial proposition and does not completely turn on its head the equitable obligations of the directors to the firm itself.”).

17. Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004). (“Put simply, when a director of an insolvent corporation, through a breach of fiduciary duty, injures the firm itself, the claim against the director is still one belonging to the corporation.”). In Production Resources Group, the Delaware Chancery Court found that
the creditors could pursue a derivative cause of action based on a duty of loyalty claim but found that the exculpatory provision in the corporation's charter insulated directors from personal liability to the corporation for breaches of the duty of care. Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) (citing to 8 Del. C. § 102(b)(7) (2004)).


20. In re Ben Franklin Retail Stores, Inc., 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998), aff’d in part, 1999 WL 982963 (N.D. Ill. 1999), opinion amended and superseded, 43 Collier Bankr. Cas. 2d (MB) 9, 2000 WL 28266 (N.D. Ill. 2000) (“. . . creditors have a right to expect that directors will not divert, dissipate, or unduly risk assets necessary to satisfy claims. That is the appropriate scope of a duty that exists only to protect the contractual and priority rights of creditors.”).


23. See Hannover Corp. of America v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997), (finding that aggravation of insolvency or prolonging the life of an insolvent business constitutes an injury to a corporation where plaintiff alleges mismanagement, waste and looting of assets); In re Global Service Group, LLC, 316 B.R. 451, 458, 43 Bankr. Ct. Dec. (CRR) 253, 53 Collier Bankr. Cas. 2d (MB) 57 (Bankr. S.D. N.Y. 2004) (noting that decisions since In re Investors Funding Corp. suggest that New York courts regard deepening insolvency as a theory of damages that may result from the commission of a separate tort and that no reported New York case has ruled that deepening insolvency is an independent tort).

24. See, e.g., In re Gouiran Holdings, Inc., 165 B.R. 104, 107 (E.D. N.Y. 1994) (arguing that erroneous financial statements could not have harmed the debtor by increasing its userviceable debt and that asserted negligence benefited debtor by raising cash or discouraging redemptions).


26. See also discussion at II.B.2.(a).
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34. In re Flagship Healthcare, Inc., 269 B.R. 721, 729, 38 Bankr. Ct. Dec. (CRR) 174 (Bankr. S.D. Fla. 2001). The court compared an already insolvent debtor harmed by increased indebtedness to a “boxer with one black eye, who, despite being injured, might still persevere and win the fight. If that boxer (the debtor) winds up losing the fight and landing in the hospital (bankruptcy court), a doctor (judge) might find that it was the additional injuries (deepening insolvency) which put him there.” In re Flagship Healthcare, Inc., 269 B.R. 721, 728 n. 4, 38 Bankr. Ct. Dec. (CRR) 174 (Bankr. S.D. Fla. 2001).
38. Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 349-50, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001) (explaining that, even when a corporation is insolvent, its assets may have value that can be damaged in a number of ways by the fraudulent and concealed incurrence of debt).
trustee could never sue the debtor’s insiders on account of their own wrongdoing.”). The applicability of the doctrine of in pari delicto and the arguments for and against its application in the context of claims arising from deepening insolvency is a subject for an entirely separate article.


43. In re Exide Technologies, Inc., 299 B.R. 732, 750-751 (Bankr. D. Del. 2003). In In re Exide Technologies, Inc., the debtors borrowed $650 million from a syndicate of lenders five years prior to its bankruptcy filing. Three years later, the debtors borrowed an additional $250 million from the same syndicate of lenders in order to finance the acquisition of a competitor. In exchange for this additional financing, the debtors granted the lenders significant additional collateral and guarantees. Shortly after the acquisition, the debtors’ financial condition deteriorated rapidly. Thereafter, allegedly at the direction of the lenders, the debtors replaced their chief financial officer with a person designated by the lenders. After this appointment, the parties amended the loan documents to temporarily suspend compliance with certain financial covenants in return for liens on all of the debtors’ foreign subsidiaries’ assets and capital stock. The parties further amended the loan documents so as to provide the lenders with additional collateral and guarantees, and, in exchange, the lenders agreed to forbear from exercising their right to hold the debtors in default under their credit agreement. In re Exide Technologies, Inc., 299 B.R. 732, 736 (Bankr. D. Del. 2003).


49. See, e.g., Schacht v. Brown, 711 F2d 1343, 1347, Fed. Sec. L. Rep. (CCH) P 99160 (7th Cir. 1983) (arguing, on motion to dismiss, that insurance company “lacks standing to sue, either derivatively or through a receiver to recover damages resulting from fraudulently extended life of corporation and its concomitant dissipation of assets”); Hannover Corp. of America v. Beckner, 211 B.R. 849 (M.D. La. 1997) (moving to dismiss action on grounds that damages alleged were sustained, if at all, by investors and not debtor); In re RSL COM PRIMECALL, Inc., 2003 WL 22989669 (Bankr. S.D. N.Y. 2003) (explaining, on motion to dismiss, that “absent an allegation of direct injury to the corporation, or a diversion of goods or services from the company, it cannot be presumed that the alleged wrongful concealment of [debtor’s] insolvency from creditors harmed or injured [the debtor]”); In re Flagship Healthcare, Inc., 269 B.R. 721, 38 Bankr. Ct. Dec. (CRR) 174 (Bankr. S.D. Fla. 2001) (raising issue of whether complaint sufficiently alleges that debtor, distinct from its creditors, was damaged by alleged negligence).


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71. See Florida Dept. of Ins. v. Chase Bank of Texas Nat. Ass’n, 274 F.3d 924, 935-936 (5th Cir. 2001).


74. Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp., 2004 WL 1900001 (E.D. Pa. 2004) (“...the only ‘debt’ at issue in this case is the unpaid credit card bills, a debt which was incurred through the purchase of aviation fuel on legitimately extended credit.”).


76. One commentator suggests that in some cases directors may not intend to harm the company, but may not act in the best interests of the company either, because of “overconfidence bias” (the belief that there is a greater chance that a positive event will happen to them rather than a negative or because they may be “path dependent” (i.e., people will be overcommitted to decisions they made and, consequently, will often ignore or discount new and contradictory information rather than question whether their initial decision was unwise). A. Mechele Dickerson, A Behavioral Approach to Analyzing Corporate Failures, 38 Wake Forest L. Rev. 1, 5-6 (2003).

77. Similarly, lenders with possibly deepening insolvency exposure may be hesitant to provide incremental funding and may require that a company file for bankruptcy prior to having an opportunity to appropriately prepare.

78. See Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp., 2004 WL 1900001 (E.D. Pa. 2004) (finding that plaintiff did not establish the “increased indebtedness” element of deepening insolvency where credit card debt was incurred prior to the occurrence of the conduct alleged to have resulted in deepening insolvency); See also discussion, at II.B. 2.(c).