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Deepening Insolvency—A Guide for Corporate Boards and Executive Officers

In recent years, officers and directors of bankrupt companies have increasingly become the target of lawsuits by bankruptcy trustees and creditors' committees on various breach of fiduciary duties grounds, aimed primarily to obtain recovery against the company's insurance policies. Included in that arsenal of claims is a deepening insolvency cause of action. Deepening insolvency is generally alleged in situations where fraudulent conduct regarding the disclosure of a company's true financial condition has occurred at a time when the company has incurred additional debt, which conduct causes a loss of company value—and thus harm to the company. As a result of such claims, an issue has developed whether the board of an insolvent company is protected by the business judgment rule when it elects to continue to operate the company in hopes of effecting a successful turn-around.

Deepening insolvency, or the fraudulent prolonging of an insolvent corporation's life through the incurrence of additional debt, first was recognized as a separate cause of action five years ago by the Third Circuit Court of Appeals.[1] Since then, there has been a growing trend among federal courts in favor of such claims against officers and directors, as well as against a corporation's professional advisors. However, in recent months the Delaware courts (both federal and state) have significantly limited, if not eliminated, the theory of deepening insolvency as an independent cause of action. Nevertheless, this rejection by the courts should not be read to absolve officers and directors of insolvent corporations of their responsibilities. Rather, a company's board and management still must operate on an informed basis and in good faith in exercising their fiduciary duties, including those duties to creditors that arise when the company enters or is in the "zone" or vicinity of insolvency.

A few months ago, the Third Circuit Court of Appeals in *In re CitX Corp., Inc.*[2] shed some light regarding the breadth of the claim of deepening insolvency by finding, among other things, that: (i) mere negligence, without any bad act or fraudulent conduct, will not support a claim for deepening insolvency; (ii) claimants must show an injury to the corporation itself and not just to its creditors; and (iii) deepening insolvency is not an independent theory of damages. Despite the clarification, the Third Circuit did not rule on whether deepening insolvency was still a viable independent cause of action against a company's board and management.

Additionally, in a significant decision for Delaware corporations, in August 2006, the Delaware Court of Chancery in *Trenwick America Litigation Trust*[3] became the first state court to weigh in on this issue and, to some courts' and commentators' surprise, rejected deepening insolvency as a separate cause of action under Delaware law. In so doing, the court made clear that Delaware law has never imposed an absolute obligation on an insolvent company's board to cease operations and liquidate. Indeed, the *Trenwick* court determined that the board may under such circumstances take actions, in good faith and with diligence, aimed at increasing company value, even if such actions require the incurrence of additional debt.[4] Moreover, the court held that if such actions prove unsuccessful and the company's insolvency deepens, the board is protected by the business judgment rule.[5]

What does this mean going forward for officers and directors of an insolvent company? We suggest the following:

- The business judgment rule will afford protection where the actions of the directors and/or officers of an insolvent company are made on an informed basis and good-faith belief, even if the strategy proves fruitless and results in the continued insolvency of the company.

- Directors' fiduciary duties with respect to an insolvent company (or one that is in the "zone or vicinity of insolvency") do not require directors to automatically cease operations and to liquidate the company. Rather, such duties, whether the company is solvent, in the zone or vicinity of insolvency or insolvent, remain the same—to maximize the economic value of the corporation. What changes is to which constituency(ies) such duties of care and loyalty are primarily owed (e.g., once insolvent, the primary fiduciary duties run to creditors).

- The elimination of a separate "deepening insolvency" cause of action (under Delaware law) does not increase the protection afforded officers and directors. Rather, the financial condition of the company (i.e., insolvency) is likely to be a material factor in a court's determination whether the board's decision to incur additional debt at the time was undertaken with due care and fidelity and is otherwise protected by the business judgment rule.

- While the *Trenwick* decision is limited to Delaware law, and only binding in the Third Circuit, it serves as a rational guideline for directors and officers to follow in acting on behalf of an insolvent company and its constituencies and reaffirms that the proper means to examine the conduct of officers and directors, especially under workout situations, is the "traditional fiduciary duty rule."[6]

- Claims against officers and directors for deepening insolvency will likely continue, albeit they may be asserted under the context of a more traditional breach of fiduciary duty claim. The decisions recently issued by the Delaware courts, however, offer protection for actions undertaken within the board's business judgment.

[1] *Official Comm. of Unsec. Creditors v. R.F. Lafferty*, 276 F.3d 340 (3d Cir. 2001) (under Pennsylvania law).

[2] 448 F.3d 672 (3d Cir. 2006) (under Delaware law).

[3] *Trenwick America Litigation Trust v. Ernst & Young L.L.P.,* 2006 WL 2434228, at 64 (Del. Ch. Aug. 10, 2006).

[4] *Id.* at 62–63.

[5] *Id.*

[6] *Id.* at 64.

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Authors: Michael Schein and Bridget A. Adaska. Mr. Schein can be reached at our New York office at 212/407-6920 (mschein@vedderprice.com).

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312/609-7500
Fax: 312/609-5005

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Fax: 212/407-7799

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888 16th Street, N.W., Suite 800
Washington, D.C. 20006
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