

Law Trends & News

Practice Area Newsletter



Spring 2009
Vol. 5, No. 3

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Attorneys Who Prolong the Life of Insolvent Corporate Clients Do So at Their Peril

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• Past Issues

With the current economic climate, attorneys may be called on to prolong the life of corporate clients that are already insolvent—and they do so at their peril. A relatively new doctrine, known as *deepening insolvency*, creates a measure of damages for the deepening insolvency of a corporation, as its name implies. Deepening insolvency is an issue for those who otherwise breach or aid in the breach of duties to an insolvent corporation—such as board members, attorneys, accountants, and the like—because the measure of damages for such a breach may include the worsened financial position of the company that these third parties caused over the company’s financial condition in the absence of wrongdoing. Thus, no longer is it a valid defense to assert that no harm was caused because the company was insolvent anyway. This article focuses on recent developments in the state of deepening insolvency claims under Delaware law.

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Initially, one unclear aspect of deepening insolvency theory was whether it stood as an independent cause of action or merely as a theory of damages. In *Trenwick America Litigation Trust v. Ernst & Young, L.L.P., et al.*, 931 A.2d 438 (Del.Supr. 2007), the Delaware Supreme Court affirmed the Delaware Chancery Court’s opinion that deepening insolvency is not an independent cause of action, where the lower court unequivocally and harshly rejected the concept of deepening insolvency, stating that the term has the “kind of stentorian academic ring that tends to dull the mind to the concept’s ultimate emptiness.” 906 A.2d 168, 204 (Del.Ch. 2006). In affirming this decision, the court reasoned that there was no affirmative duty for a corporation to cease operations when it became insolvent, and that a corporation’s board could pursue, in good faith, strategies to maximize the company’s value. If the strategy resulted in continued, or even worsened, insolvency, no claim against the board arises, the *Trenwick* court reasoned. The *Trenwick* court also took care to point out, however, that the board of an insolvent corporation was not completely insulated from liability, as a plaintiff could still assert the “traditional toolkit” of claims for breach of fiduciary duty and fraud.

It seemed as if the matter was settled firmly against the deepening insolvency theory, until the issuance of a more recent decision by the Bankruptcy Court for the District of Delaware, *Miller v. McCown De Leeuw & Co. (In re The Brown Schools)*, 386 B.R. 37 (Bankr. D. Del. 2008). In *The Brown Schools*, the court reiterated the ruling in *Trenwick* that deepening insolvency is not a separate cause of action, but also ruled that deepening insolvency can be a valid theory of damages.

In *The Brown Schools*, the bankruptcy trustee filed a complaint against a number of entities, including companies that had provided consulting services to the debtor and an attorney for the debtor, alleging breach of fiduciary duty, aiding and abetting breach of fiduciary duty, fraudulent and voidable transfers, deepening insolvency, civil conspiracy, and declaratory relief. Although the court dismissed the deepening insolvency claim, it allowed the claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste, and civil conspiracy to stand, despite the defendants’ argument for dismissal on the basis that the trustee did not plead any actual damages other than deepening

insolvency. In response, the trustee argued, in part, that the amounts it sought were not exclusively based on deepening insolvency.

The trustee further argued, however, that, even if it did seek damages solely on a deepening insolvency basis, such damages are nonetheless recoverable. In so arguing, the trustee distinguished the holding of a Third Circuit case, *Seitz v. Detweiler, Hershey and Associates, P.C. (In re CitX Corp.)*, 448 F.3d 672, 677–78 (3d Cir.2006), which held that deepening insolvency was not a viable theory of damages in a legal malpractice case. The trustee argued that CitX did not hold that deepening insolvency could not be a valid measure of damages for any cause of action, and should be limited to the legal malpractice context. The trustee also cited another decision, *Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Corp. I)*, 353 B.R. 324, 333 (Bankr.D.C.2006), which held that deepening insolvency was a valid measure of damages for a breach of fiduciary duty. The *The Brown Schools* court was persuaded by the trustee's arguments, and declined to dismiss the case based on a failure to plead actual damages, explicitly agreeing with the holding of the *Tuft* court.

Thus, under Delaware law, any potential liability by professionals for causes of action such as breach of fiduciary duty or aiding and abetting breach of fiduciary duty could result in the award of deepening insolvency damages. As such, the fact that a company is already insolvent will be no bar to a damage award. Indeed, parties breaching a duty to an insolvent company could be liable for large sums for further harm caused to that company and its creditors.

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Note

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