

DEEPENING INSOLVENCY: WHAT IT IS AND WHY IT SHOULD PREVAIL

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INTRODUCTION

Over the past two decades, the public has witnessed a series of corporate governance failures. These events, or more appropriately scandals, such as Enron, WorldCom, Global Crossing and the savings and loan scandal, have shaken the financial markets and, indeed, the U.S. economy to their very cores. The marked increase in participation by smaller individual investors, through personal accounts and company-sponsored retirement accounts invested in debt and equity securities, has ensured that the direct impact of these events is now felt on all levels of economic strata in the U.S. and abroad. No longer are the trials and travails of these fallen giants solely the interest of money managers who risk delivering substandard returns on their portfolios. They also concern hourly employees who have invested their entire careers into, and based their long-term financial security upon, a single company that has mismanaged its affairs to the point of bankruptcy and rendered such employees' retirement accounts and pension funds, which were often invested into stock of the same company, worthless.

As shocking as the scale and scope of the aforementioned disasters are, the failures are compounded by the fact that not

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only did the management of these corporations, along with their retained professionals, fail to perform their fiduciary duties adequately, but they also actively violated their fiduciary duties for their own financial gain. In many instances, the ravaging of the corporate coffers was so severe that the corporations fell deeper into insolvency, incurring massive losses to the corporations, their creditors and their shareholders.

Under the guiding judicial principle which grants remedy where there is an injury, the judicial community responded to instances of corporate malfeasance by reexamining an old theory once rejected by many courts. This theory, called deepening insolvency, allows recovery from the defrauding management, and those aiding its wrongful conduct, for keeping the already insolvent corporation alive through fraudulent misrepresentation of solvency to the unsuspecting investors and creditors, and thereby causing the corporation to suffer massive injuries.

A good illustration of the deepening insolvency theory is found in *Official Committee of Unsecured Creditors v. R. F. Lafferty & Co.*,¹ a case that involved two lease financing corporations operating as a ponzi scheme.² In order to alleviate the financial difficulties of one corporation, the owner and his family (the "Insiders") formed another corporation. Although the latter was wholly owned by the former, the Insiders marketed the latter as an independent entity in order to raise more debt for the former corporation. When these corporations filed for Chapter 11 protection, the unsecured creditors' committee entered into a stipulation which granted the committee all of the bankruptcy trustee's powers. The committee sued the Insiders, and certain retained professionals, claiming that the defendants deepened the insolvency of the debtor-corporations

1. *Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001).

2. A ponzi scheme is one by which:

[A] corporation operates and continues to operate at a loss. The corporation gives the appearance of being profitable by obtaining new investors and using those investments to pay for the high premiums promised to earlier investors. The effect of such a scheme is to put the corporation farther and farther into debt by incurring more and more liability and to give the corporation the false appearance of profitability in order to obtain new investors.

McHale v. Huff (In re Huff), 109 B.R. 506, 512 (Bankr. S.D. Fla. 1989).

by issuing debt securities.³ The committee alleged that the Insiders perpetrated the ponzi scheme with the assistance of the professional defendants, whose opinions of the corporations' financial status served as the prerequisites for registration of public offerings and debt securities.⁴

In sum, the theory can be defined as "fraudulent prolongation of a corporation's life beyond insolvency, resulting in damage to the corporation caused by increased debt."⁵ Despite the broad recognition it has received, the theory remains difficult to grasp both for courts and practitioners.⁶ Courts tend to recognize a cause of action called deepening insolvency but, as only a few have delved into its analysis,⁷ its elements are not yet well-defined.⁸ Instead, several challenges to the theory have successfully blocked its application.⁹ Indeed, some courts have flatly rejected the theory.¹⁰

This article provides a skeletal picture of what the theory of deepening insolvency entails and argues that deepening insolvency is a legally sound and viable cause of action under which victimized corporations should be granted recovery against defrauding management and retained professionals. Part I explores the theory in general by tracing the theory's origin and evolution over time. Part II lays out a procedural guideline for the standing requirement as applied to the bankruptcy trustees. This section disabuses the notion that the

3. *Lafferty*, 267 F.3d at 344-45.

4. *Id.*

5. *Kittay v. Atlantic Bank of New York (In re Global Service Group LLC)*, 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004) (internal citations and quotations omitted).

6. *Smith v. Arthur Andersen, LLP*, 421 F.3d 989, 1003 (9th Cir. 2005) ("We need not make any general pronouncements on the deepening insolvency theory, not least because it is difficult to grasp exactly what the theory entails"); *Limor v. Buerger (In re Del-Met Corp.)*, 322 B.R. 781, 807 (Bankr. M.D. Tenn. 2005) (noting the "lack of definition of the developing theory of deepening insolvency").

7. *See infra* pp. 10-12.

8. *See* James M. Peck, et. al., *Deepening Insolvency: Litigation Risks for Lenders and Directors When Out-of-Court Restructuring Efforts Fail*, 1 N.Y.U.J.L. & Bus. 293, 299 (Fall 2004); Jo Ann J. Brighton, *Deepening Insolvency: Secured Lenders and Bankruptcy Professionals Beware: It is Not Just for Officers and Directors Anymore*, 23-Apr AM. BANKR. INST. J 34 (Apr. 2004) (hereinafter Brighton).

9. *See Lafferty*, 267 F.3d 340.

10. *Colores v. Sabey*, 79 P.3d 974, 983, 485 Utah Adv. Rep. 3 (App. Utah 2003).

bankruptcy trustees lack standing to bring a deepening insolvency claim on behalf of the corporation, *inter alia*. Part III reviews the deepening insolvency theory in practice by examining it as applied to each group of the third-party defendants. Part IV probes the *in pari delicto* doctrine, the biggest nemesis of the theory to date. It scrutinizes the doctrine in detail and establishes that such doctrine cannot be utilized to bar recovery under the deepening insolvency theory.

I.

DEEPENING INSOLVENCY IN GENERAL

The theory of deepening insolvency can be traced back to the late nineteenth century. In 1896, the Supreme Court of Pennsylvania in *Patterson v. Franklin*¹¹ affirmed a denial of recovery in an action for damages resulting from fraudulent misrepresentation by incorporators and shareholders. In *Patterson*, the insolvent company's incorporators and shareholders filed a certificate with the state representing that a certain sum of money had been paid in cash to the corporate treasurer as required by the state statute. Relying on this certificate, investors extended credit to the company. The certificate turned out to be false. When the corporation could not make the debt payments, it assigned the debts to a third-party for the benefit of the creditors. The assignee in turn sued the incorporators and shareholders of the corporation.

Although the Third Circuit in *Lafferty* found that *Patterson* did not "directly address" the deepening insolvency theory, and was thus not controlling on the issue of deepening insolvency,¹² the assignee's claim in *Patterson* appeared to be a version of the theory. The core of the assignee's claim in *Patterson* is: (1) the incorporators and shareholders inserted a false statement in the certificate of incorporation; (2) the business public invested in the corporation, relying on the false statement; and (3) the corporation became unable to pay its debts, *i.e.*, it became insolvent, and thus, made an assignment for the benefit of the creditors.¹³

Patterson represents the major problems and misunderstandings that the deepening insolvency theory has faced thus

11. *Patterson v. Franklin*, 176 Pa. 612 (Pa. 1896).

12. *Lafferty*, 267 F.3d at 352.

13. *Patterson*, 176 Pa. at 614-15.

far: (1) those who inherit the rights and obligations of an insolvent corporation, *e.g.* the bankruptcy trustees, lack standing to bring a deepening insolvency claim on behalf of the insolvent corporation; and (2) the *in pari delicto* doctrine bars recovery under the claim.¹⁴ According to *Patterson*, the assignee had no right of action, *i.e.* standing, because he “succeed[ed] to all the rights of action [the insolvent corporation] had at the time of the assignment.”¹⁵ At the time of the assignment, the corporation had “no right of action” against the defendants based on the fraud because it suffered no injuries from it.¹⁶ Though the *in pari delicto* doctrine was not explicitly stated, the logic behind *Patterson* in denying recovery to the assignee was that the corporation could not recover because the fraud was “perpetrated for its benefit.”¹⁷ The *Patterson* court found that the corporation was a “gainer, not a loser because of [the fraud].”¹⁸

The *Patterson* rationale dominated American jurisprudence until the advent of *Bloor v. Danskер (In re Investors Funding Corp. of New York Sec. Litig.)*,¹⁹ *Schacht v. Brown*²⁰ and *Laferty. Investors Funding* began the erosion of the concept that any conduct that prolongs a corporate life automatically bene-

14. Even though *Patterson* does not explicitly mention the terms standing or the *in pari delicto* defense, its rulings dealt with these issues. *See id.* at 615-16.

15. *Id.* at 614.

16. *Id.* at 615.

17. *Id.* By the operation of agency law, the *in pari delicto* doctrine bars recovery when an agent perpetrates a wrongdoing for the benefit of its principal within its official capacity. The corporation is considered the principal while the corporate managers are considered the agents. The correctness of this application will be discussed further in *infra* Part IV of this article.

18. *Id.*

19. *Bloor v. Danskер (In re Investors Funding Corp. of New York Sec. Litig.)*, 523 F. Supp. 533 (S.D.N.Y. 1980). The debtor's insiders allegedly induced creditors and shareholders to invest more funds in the company, relying on a false picture of the debtor's financial well-being. Then, they misappropriated a portion of the funds that were raised. The auditor of the debtor argued that the knowledge and wrongful conduct of the insiders should be imputed to the debtor's insiders to bar recovery, refuting the applicability of the adverse interest exception because the wrongful conduct allegedly benefited the corporation. The court rejected the notion that acts that prolong a corporation's existence automatically confer a benefit on the corporation. *Id.* at 541.

20. *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983).

fits the corporation, thus challenging the *in pari delicto* obstacle set forth in *Patterson* and its progeny.²¹ The *Investors Funding* court stated 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.”²² The Seventh Circuit in *Schacht* not only reaffirmed this reasoning²³ but also pronounced that a corporation is “ineluctably damaged by the deepening of its insolvency.”²⁴ Furthermore, the Seventh Circuit declined to “speculate” that the Illinois courts would bar, based on this automatic benefit rule, a corporation from recovering damages resulting from deepening insolvency.²⁵

The breakthrough with respect to the standing challenge came with the Third Circuit’s decision in *Lafferty*, which allowed standing by a creditors’ committee to bring a deepening insolvency action on behalf of the debtor-corporations. The Third Circuit held that the deepening insolvency claim belonged to the corporation since it sustained numerous direct injuries as a result of deepening insolvency.²⁶ The Court ruled that the Pennsylvania state courts, if faced with such a claim, would today recognize the deepening insolvency claim as a legally cognizable cause of action.²⁷ It further found that the injury sustained by the corporation is not illusory by declining to pierce the corporate veil.²⁸

However, the *in pari delicto* doctrine still remains the most formidable hurdle to the deepening insolvency claim, mainly owing to its incorrect application.²⁹ For instance, while the Third Circuit in *Lafferty* correctly allowed standing by the com-

21. See generally *Kittay v. Atlantic Bank of New York (In re Global Serv. Group, LLC)*, 316 B.R. 451, 457 (Bankr. S.D.N.Y. 2004); *Schacht*, 711 F.2d at 1348.

22. *Investors Funding*, 523 F. Supp. at 541.

23. The Seventh Circuit noted that any benefit from deepening insolvency benefited the managers, not the corporation. *Schacht*, 711 F.2d at 1348.

24. *Id.* at 1350.

25. *Id.*

26. Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 348-49 (3d Cir. 2001)

27. *Id.* at 349-52.

28. *Id.* at 353-54.

29. *E.g., id.*; *Baena v. KPMG LLP*, 2005 U.S. Dist. LEXIS 22501, at *13 (D. Mass. Sept. 27, 2005); *Seitz v. Detweiler Hershey & Assoc., P.C. (In re CITX Corp., Inc.)*, 2005 U.S. Dist. LEXIS 11374, at *29 (E.D. Pa. June 7, 2005).

mittee, the Court erroneously continued the prohibition of recovery on the ground of the *in pari delicto* doctrine, based on the sole-actor exception.³⁰

II. WHO CAN SUE

Standing is a basic inquiry in a cause of action and lack thereof is a ground for dismissing any complaint.³¹ In federal proceedings, a claimant must demonstrate a "personal stake in the outcome."³² Standing requirements are comprised of six elements, three constitutional and three prudential.³³ The constitutional requirements are: (1) "injury in fact—an invasion of a legally protected interest which is (a) concrete and particularized, and (b) actual or imminent;"³⁴ (2) injury traceable to the alleged misconduct;³⁵ and (3) redressibility.³⁶ The prudential elements are satisfied if: (1) the plaintiff is not asserting a third-party's rights; (2) the plaintiff is bringing a particularized injury unto itself, rather than a generalized grievance; and (3) the injury lies within the zone of interests contemplated by the statute or constitutional provision.³⁷

As noted earlier, standing becomes problematic when the bankruptcy trustees bring the deepening insolvency actions on behalf of the corporation. This section reviews each standing

30. The corporation is said to be barred from recovery where the agent is the sole, dominant actor in the wrongdoings even if the wrongdoing affected the corporation adversely. *Lafferty*, 267 F.3d. at 359-60.

31. *Brown v. Sibley*, 650 F.2d 760, 771 (5th Cir. 1981).

32. *Baker v. Carr*, 369 U.S. 186, 204 (1962). Bankruptcy is a federally administered process under a federal law. Hence, the bankruptcy trustees must satisfy the standing requirements in order to bring the deepening insolvency claims in bankruptcy for the benefit or on behalf of the debtor-corporation. *Id.*

33. *Valley Forge Christian College v. Americans United for Separation of Church & State*, 454 U.S. 464, 471-76 (1982).

34. *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992); *City of Los Angeles v. Lyons*, 461 U.S. 95, 101-02 (1983)

35. *Valley Forge*, 454 U.S. at 472.

36. *Lujan*, 504 U.S. at 561; *Valley Forge*, 454 U.S. at 472.

37. *Valley Forge*, 454 U.S. at 474-75. The second prudential requirement will be considered together with the injury in fact requirement. The zone of interest is not applicable to the deepening insolvency claims since these claims are brought as a state common law action, not pursuant to any statute. *Id.* at 472-75.

requirement relevant to the deepening insolvency claim and demonstrates that the bankruptcy trustees clearly have standing to bring deepening insolvency claims on behalf of debtor-corporations.

A. *Injury in Fact*

1. *Whether Injury is Concrete, Actual and Particularized*

Under the deepening insolvency theory, mere prolongation of corporate life and increased debt do not by themselves result in liability.³⁸ Concealment of insolvency from the creditors cannot be presumed to have injured a debtor absent a showing of a direct injury to the debtor.³⁹ Thus, in order to bring an action on behalf of the corporation, the bankruptcy trustees must demonstrate direct injuries sustained by the corporate debtor resulting from deepening insolvency.

The corporate entity theory is useful in determining whether such injuries occurred.⁴⁰ The entity theory postulates that a corporation is an entity separate and distinct from its constituency.⁴¹ A corporation has its own rights and duties.⁴² A corporate asset is separate from that of its constituents.⁴³ The sole shareholder of a corporation is not the owner of all of the corporate properties.⁴⁴ The corporate officers who hold shares of the company stocks are not considered the owners of the corporate property.⁴⁵ Therefore, an injury to a corporation is distinct from an injury to its constituents. For in-

38. *Kittay v. Atlantic Bank of New York (In Re Global Serv. Group, LLC)*, 316 B.R. 451, 458-89 (Bankr. S.D.N.Y. 2004).

39. *In re RSL Com Primecall, Inc.*, 2003 Bankr. LEXIS 1635, at *17-18 (Bankr. S.D.N.Y. Dec. 11, 2003); *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (If the financial difficulties were proven to be a result of deepening insolvency, liability can be found).

40. *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 348 (3d Cir. 2001).

41. *Id.*

42. *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995) ("The corporations . . . were in the eyes of the law separate legal entities with rights and duties").

43. *Lafferty*, 267 F.3d at 348.

44. *Id.* (citing *Barium Steel Corp. v. Wiley*, 108 A.2d 336, 341 (Pa. 1954)).

45. *Id.* (citing *Meitner v. State Real Estate Comm'n*, 275 A.2d 417, 419 (Pa. Commw. Ct. 1971)).

stance, embezzlement may be beneficial to the embezzling constituent, yet detrimental to the corporation.⁴⁶

It is well-established that a corporation sustains numerous direct injuries resulting from deepening insolvency. Such injuries include: (1) expenses associated with the defaults; (2) administrative expenses in bankruptcy; (3) bankruptcy derived limitations to the corporation's ability to operate its business profitably; (4) weakening of customers' and suppliers' confidence in the corporation's ability to perform; (5) reduction in the corporate asset value owing to other parties' decreased confidence in the corporation; (6) inability to pay taxes; (7) ensuing layoffs; and (8) dissipation of the corporate assets.⁴⁷

2. *Whether the Deepening Insolvency Claim Constitutes a Legally Protected Interest, i.e., a Legally Cognizable Cause of Action*

Deepening insolvency is a state law question.⁴⁸ The federal courts presiding in the deepening insolvency cases must determine whether the relevant state law would recognize the claim as a legally valid cause of action.⁴⁹ Most states have not yet decided the issue. Thus, federal courts are left to postulate and infer how the relevant state courts would rule.⁵⁰ In determining what state courts would do, the federal courts must look at: (1) what the highest court in the relevant state has ruled on the relevant issues; (2) the "decisional law" of the intermediate courts of the relevant state; (3) federal court

46. See George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 GEO. J. LEGAL ETHICS 597, 600 (1998).

47. *Lafferty*, 267 F.3d at 349-350; In the Matter of Educators Group Health Trust, 25 F.3d 1281, 1284-85 (5th Cir. 1994); *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)* 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) ("additional debt which results in an entity filing for bankruptcy has the potential of creating 'operational limitations which hurt a corporation's ability to run its business in a profitable manner.'") (quoting *Lafferty* 267 F.3d at 349-50)); *Israel Shaked, Deepening Insolvency: Plaintiff v. Defendant*, 21-4 AM. BANKR. INST. J. 32 (May 2002).

48. See generally, *Lafferty*, 267 F.3d 340; *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Technologies, Inc.*), 299 B.R. 732, 751 (Bankr. D. Del. 2003).

49. See generally *Exide Tech.*, 299 B.R. at 751.

50. See *id.*

cases construing the state law; and (4) rulings from other jurisdictions that have analyzed the issue in question.⁵¹

Many courts have recognized deepening insolvency as a legally valid cause of action. The Seventh Circuit in *Schacht* recognized the deepening insolvency claim under a damage theory.⁵² Following *Schacht*, some courts have recognized deepening insolvency as a valid, independent cause of action. A New York district court denied a summary judgment motion in favor of the third-party defendants, overruling the objection that this theory has not been legally recognized.⁵³ A Florida district court denied a motion to dismiss against a bankruptcy trustee, holding that the trustee alleged sufficient facts that may allow recovery under the deepening insolvency theory.⁵⁴ A Louisiana district court denied a motion to dismiss in favor of a third-party defendant, noting that "the aggravation of insolvency or prolonging the life of an insolvent business has been considered to constitute injury to the corporation."⁵⁵

In 2001, *Lafferty* was decided, offering a systematic approach for recognizing deepening insolvency as a valid cause of action even where the state courts have remained silent on the issue.⁵⁶ In holding that the Pennsylvania courts would recognize the theory, the *Lafferty* Court examined the soundness of the theory,⁵⁷ the increasing recognition of the theory

51. *See id.*

52. *Schacht*, 711 F.2d at 1350.

53. *Allard v. Arthur Andersen & Co.* (U.S.A.), 924 F. Supp. 488, 494 (S.D.N.Y. 1996).

54. *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)* 269 B.R. 721, 728-29 (Bankr. S.D. Fla. 2001)

55. *Hannover Corp. of America v. Beckner*, 211 B.R. 849, 854 (M.D. La. 1997) (citing *Schacht v. Brown*, 711 F. 2d 1343, 1347-48 (7th Cir. 1983)).

56. *See generally Lafferty*, 267 F. 2d 340; Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Technologies, Inc.*), 299 B.R. 732 (Bankr. D. Del. 2003); *Limor v. Buerger (In re Del-met Corp.)*, 322 B.R. 781 (Bankr. M.D. Tenn. 2005).

57. *Lafferty*, 267 F.3d at 349-50. The Third Circuit held that *Patterson* was inapplicable to the deepening insolvency theory because it found that *Patterson* did not directly deal with the deepening insolvency issue. It may be so. However, a better explanation in rejecting the *Patterson* ruling can be found in the following part of *Lafferty*:

In the hundred-plus years between that decision [*Patterson*] and the present, the business practices of corporations in the United States have changed quite dramatically. Likewise, society's understanding

among courts,⁵⁸ and the time honored remedial principle that provides “where there is an injury, the law provides a remedy.”⁵⁹

Lafferty led to a wider judicial acceptance of the deepening insolvency theory. A Delaware bankruptcy court in *In re Exide Technologies, Inc.*⁶⁰ adopted the *Lafferty* reasoning in recognizing the theory as a valid cause of action. Similarly, a Tennessee bankruptcy court in *Limor v. Buerger (In re Del-met Corp.)*⁶¹ held that the Tennessee Supreme Court would recognize the theory as an “actionable breach of duty to a corporation.”⁶² Recently, based on *Lafferty*, a Delaware bankruptcy court recognized the theory as a valid cause of action, stating that Delaware, New York and North Carolina courts would do the same.⁶³ A New York bankruptcy court denied dismissal of the deepening insolvency claim, finding that the allegations were sufficient to give rise to possible liability under the claim.⁶⁴ Furthermore, lower courts in Pennsylvania have followed *Lafferty*.⁶⁵

of corporate theory has grown. Therefore, we decline to draw any broad principle from *Patterson*[.]

Id. at 352 (internal citations omitted).

58. *Id.* at 350-51 (citing *Schacht*, 711 F.2d at 1343; *Hannover*, 211 B.R. at 854-55; *Allard v. Arthur Andersen & Co.*, 924 F. Supp. at 494; *In re Gourian Holdings, Inc.*, 165 B.R. 104, 107 (E.D.N.Y. 1994); *Feltman v. Prudential Bache Securities*, 122 B.R. 466, 473 (S.D. Fla. 1990); *Herbert H. Post & Co. v. Sidney Bitterman, Inc.*, 639 N.Y.S.2d 329 (N.Y. App. 1996); *Corcoran v. Frank B. Hall & Co.*, 175, 545 N.Y.S. 2d 278 (N.Y. App. 1989)).

59. *Lafferty*, 267 F.3d. at 351.

60. *In re Exide Tech., Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003).

61. *Limor v. Buerger (In re Del-met Corp.)*, 322 B.R. 781 (Bankr. M.D. Tenn. 2005).

62. *Id.* at 815.

63. *OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, 2006 Bankr. LEXIS 474, *47 (Bankr. D. Del. March 31, 2006) (“In light of [*Lafferty*], this Court holds that Delaware, New York and North Carolina courts would recognize deepening insolvency as a cause of action”).

64. *Nisselson v. Ford Motor Co. (In re Monahan Ford Corp.)*, 2006 Bankr. LEXIS 429, at *75-77 (Bankr. E.D.N.Y. Mar. 20, 2006) (under New York law). However, a New York district court declined to accept it as an independent cause of action since the theory was substantially duplicative of the existing torts under New York law. *Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.)*, 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005).

65. *See, e.g., Miller v. Marcel Dutil the Canam Manac Group, Inc. (In re Total Containment, Inc.)*, 335 B.R. 589 (Bankr. E.D. Pa. 2005); *Seitz v. Det-*

Although the acceptance is not universal, courts that do not accept the theory as a legally cognizable cause of action do not offer any compelling reason in declining to do so. The Court of Appeals of the State of Utah in *Colores v. Sabey* refused to recognize the deepening insolvency claim because it simply did not see how the corporation itself was harmed from deepening insolvency.⁶⁶ It provided no further explanation.⁶⁷ The Fifth Circuit in *Florida Department of Insurance v. Chase Bank of Texas National Association*⁶⁸ refused to speculate whether the Texas Supreme Court would recognize the theory as a valid cause of action.⁶⁹ However, the Court still offered its would-be ruling in case the state court would recognize the theory.⁷⁰

B. Traceability

Acts or omissions by the third-party defendants must be causally related to the fraudulent expansion of corporate life and debt beyond insolvency.⁷¹ A claimant of the theory must prove that the third-party defendants either prolonged the corporate life and increased its debt by breaching a duty or committing a tort that resulted in deepening insolvency.⁷²

weiler, Hershey & Assocs. (*In re* CITX Corp.), No. 03-CV-6766, 2005 U.S. Dist. LEXIS 11374, at *29 (E.D. Pa. June 7, 2005); Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp., 2004 U.S. Dist. LEXIS 17154, at *11-14 (E.D. Pa. Aug. 25, 2004).

66. 79 P.3d 974, 983 (Utah Ct. App. 2003).

67. *Id.*

68. Florida Dept. Ins. v. Chase Bank of Texas Nat'l Assoc., 274 F.3d 924 (5th Cir. 2001).

69. *Id.* at 935. Nevertheless, the Fifth Circuit acknowledged the current "trend toward recognizing 'deepening insolvency' as a cause of action against a party who creates the false appearance of solvency." *Id.*

70. *Id.* at 935-36. However, a Texas bankruptcy court recently declined to accept a deepening insolvency claim against a lender as an independent cause of action, reasoning, *inter alia*, that the Texas Supreme Court would not recognize the claim as an independent cause of action since it is "substantially duplicative" of existing torts. Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Telephone Finance Cooperative (*In re* Vartec Telecom, Inc.), 335 B.R. 631 (Bankr. N.D. Tex. 2005); *see also* Alberts v. Tuft (*In re* Greater Southeast Cmty. Hous. Corp.), 333 B.R. 506, 517 (Bankr. D.D.C. 2005) (same under the D.C. law); *Parmalat*, *supra* note 64 (same under New York law).

71. *CitX*, 2005 U.S. Dist. LEXIS 11374, at *29.

72. *Kittay v. Atlantic Bank of New York (In Re Global Serv. Group, LLC)*, 316 B.R. 451, 458-89 (Bankr. S.D.N.Y. 2004).

The question of whether the deepening insolvency can be characterized as a damage theory or a tort claim is not important.⁷³ In addition, the defendants' conduct causing deepening insolvency must be fraudulent.⁷⁴ In sum, the traceability of deepening insolvency to the injuries can be described as follows:⁷⁵

[A]s a result of the fraudulent actions of the various defendants, [the insolvent company, hereinafter "Reserve"]'s corporate parent was caused to continue Reserve in business even though the latter was insolvent, and was caused to saddle Reserve with additional liabilities and *drive it deeper into insolvency*, all of which consequences resulted in damage to Reserve, as well as its policyholders and creditors . . .

Hence, a negligent decision by the management to continue to operate an insolvent corporation does not constitute deepening insolvency.⁷⁶ A claim of deepening insolvency would fail against auditors who have not participated in the fraudulent scheme and who provide financial statements based on the information provided by a defrauding management.⁷⁷ The auditors' failure to discover a fraudulent scheme without more does not constitute deepening insolvency.⁷⁸ However, a deepening insolvency claim may survive where auditors fail to provide a complete financial picture of a company by presenting only the management's efforts to maintain a positive financial portrayal of the corporation.⁷⁹ The claim

73. *Id.*

74. Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347 (3rd Cir. 2001).; *Schacht v. Brown*, 711 F.2d 1343, 1350; *CitX*, 2005 U.S. Dist. LEXIS 11374, at *31; *Stanziale v. Pepper Hamilton LLP (In re Student Fin. Corp.)*, 335 B.R. 539 (D. Del. 2005); *Global Serv.*, 316 B.R. at 461; *Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp.*, No. 03-3020, 2004 U.S. Dist. LEXIS 17154, at *14 (E.D. Pa. Aug. 24, 2004).

75. *Schacht*, 711 F.2d at 1345 (emphasis added).

76. *Global Serv.*, 316 B.R. at 461 ("a manager's negligent but good faith decision to operate an insolvent business will not subject him to liability for 'deepening insolvency'"); *cf.*, *Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.)*, 383 F. Supp. 2d 587, 2005 U.S. Dis. LEXIS 16112, at *41 (S.D.N.Y. 2005) (including negligent prolongation).

77. *CitX*, 2005 U.S. Dist. LEXIS 11374, at *31-32.

78. *Id.*

79. *In Re Investors Funding Corp. of N.Y. Sec. Litig.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

of deepening insolvency against accountants or auditors who have joined in or conspired in a fraudulent scheme does survive dismissal.⁸⁰

A secured lender who knew or should have known that the corporation would not be able to pay back any loan from it, but nonetheless extended credit to the corporation did not commit deepening insolvency.⁸¹ However, a claim against a creditor who extended credit in order to gain control to prolong corporate life while causing the corporation to incur massive losses, placing it deeper into insolvency and costing other creditors substantial loss, would survive.⁸² The deepening insolvency claim survives dismissal against the controlling customers that placed their agents in key positions in the debtor-corporation in order to exercise and maintain their control over the corporation, thereby deepening insolvency and causing a huge loss to the corporation.⁸³

C. *Redressibility*

Even an insolvent corporation has value.⁸⁴ Although the market value of the company may be negative, an individual may still invest in the company.⁸⁵ For instance, a buyer may still pay a positive value for an insolvent company if he or she believes that the value will increase, resulting in solvency.⁸⁶ Such value may be damaged by the "fraudulent and concealed

80. Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 345 (3d Cir. 2001) (accountants were alleged to have conspired with the insolvent corporation's principals to perpetrate a Ponzi scheme); *Schacht*, 711 F.2d at 1345-46 (denying motion to dismiss where professionals were alleged to have known the insolvency when they issued financial statements and participated in "a multifaceted, fraudulent scheme" to prolong the corporate life past insolvency).

81. *Global Serv.*, 316 B.R. at 459 ("extending credit when it knew or should have known that the corporation could never pay back is "bad banking" but not a tort).

82. Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Tech., Inc.*), 299 B.R. 732, 750-52 (Bankr. D. Del. 2003).

83. See *Limor v. Buerger (In re Del-met Corp.)*, 322 B.R. 781 (Bankr. M.D. Tenn. 2005).

84. *Lafferty*, 267 F.3d at 349; *Corporate Aviation Concepts, Inc. v. Multi-Service Aviation Corp.*, No. 03-3020, 2004 U.S. Dist. LEXIS 17154, at *12 (E.D. Pa. Aug. 24, 2004).

85. *Shaked*, *supra* note 47 at 33.

86. *Id.*

incurrence of debt.”⁸⁷ A timely-commenced bankruptcy or dissolution proceeding could have protected this value and prevented the aforementioned damages.⁸⁸

These injuries can be redressed by awarding the debtor corporation compensation for “the amount of aggravation of insolvency and artificial extension of life” caused by the false appearance of solvency that is “capable of proof.”⁸⁹ Financial deterioration that was not “necessarily forthcoming” but was “proven” to be a result of deepening insolvency constitutes a measure of damage.⁹⁰ Increased debt or dissipation of the assets as a result of deepening insolvency are included in the damage calculation.⁹¹ For instance, let us assume a corporation’s equity, at one point, was valued at negative \$1 million. As a result of the fraudulent expansion of the corporate life and debt, this value fell to negative \$10 million. In this scenario, awarding \$9 million to the debtor would bring the corporation to pre-damage value.⁹²

D. *Whether the Representative is Asserting the Claims of the Insolvent Corporation*

1. *The Bankruptcy Trustees as Representatives of the Estate, not Creditors*

Upon the commencement of a bankruptcy case, an estate is created.⁹³ The bankruptcy trustees represent the bank-

87. *Lafferty*, 267 F.3d at 349-50.

88. *Id.* at 350.

89. See *Hannover Corp. of America v. Beckner*, 211 B.R. 849, 854 (M.D. La. 1997); *In re Latin Inv. Corp.*, 168 B.R. 1, 5 (Bankr. D.C. 1993) (damages “capable of proof” are “compensable”). In this case, the debtor bank and its accounting firm used the bank deposits to make loans and payments to the accounting firm as well as personal loans to the debtor’s principals and their relatives. Though insolvent, the debtor continued its operation by accepting further deposits, incurring additional obligations to depositors in the approximate amount of \$6.5 million. *Id.*

90. *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*, 269 B.R. 721, 728 (“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”).

91. *Id.*; *Hannover*, 211 B.R. at 854.; *Florida Dep’t of Ins. v. Chase Bank*, 274 F.3d 924, 935 (5th Cir. 2001).

92. *Shaked*, *supra* note 47.

93. 11 U.S.C. § 541(a) (2000).

ruptcy estate.⁹⁴ Their powers and duties are broad.⁹⁵ They are "accountable for all property received."⁹⁶ They may investigate the debtors' financial affairs.⁹⁷ They "stand [] in the shoes" of the debtor, and thus, are authorized to sue any party that the debtor could have sued had the bankruptcy proceeding not been commenced.⁹⁸ Any unresolved cause of action at commencement of the bankruptcy case becomes a claim for the trustees to pursue.⁹⁹ For instance, the trustees may bring actions against "officers, directors, and other insiders to recover, on behalf of the estate, fraudulent or preferential transfers of the debtor's property."¹⁰⁰ In short, the trustees have standing to bring claims belonging to the debtor's estate under 11 U.S.C. §541 or actions under the trustees' avoidance powers.¹⁰¹

Courts have dismissed the deepening insolvency actions brought by the trustee for lack of standing, based on the fact that the claims belong to the creditors, not the debtors. Some say that the claim is nothing more than a "restatement in different terms of the injuries suffered by [the debtor's creditors]."¹⁰² Others say because a successful recovery by the trust-

94. 11 U.S.C. § 323(a) (1978).

95. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352 (1985).

96. 11 U.S.C. § 704(2) (1986); 11 U.S.C. § 1106(a) (1978); *Weintraub*, 471 U.S. at 352.

97. 11 U.S.C. § 704(4) (1986); 11 U.S.C. § 1106(a)(3) (1978).

98. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1093 (2d Cir. 1995); *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 356 (3d Cir. 2001) (citing *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1154 (3d Cir. 1989)); *Official Committee of the Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP*, 322 F.3d 147, 156 (2d Cir. 2003) (in context of the creditors' committee as the assignee of the estate).

99. *In re Ozark Rest. Equip. Co.*, 816 F.2d 1222, 1225 (8th Cir. 1987).

100. *Weintraub*, 471 U.S. at 352; 11 U.S.C. § 547(b)(4)(B) (1978); 11 U.S.C. § 548.

101. *Lafferty*, 267 F.3d at 356; *Holland v. Arthur Andersen & Co.*, 212 Ill. App.3d 854 (1984) (a bankruptcy liquidation trustee may bring claims that belong to the estate of the debtor corporation only); *In re Ozark Rest. Equip. Co.*, 816 F.2d 1222, 1225 (8th Cir. 1987).

102. *Holland v. Arthur Andersen & Co.*, 212 Ill. App.3d 645, 652 (1991) (noting that the deepening insolvency theory is recognized by other courts, but finding the injuries alleged are basically a restatement of injuries sustained by the creditors).

tee directly benefits the corporation's creditors, the claim actually belongs to the creditors, not the debtors.¹⁰³

If the deepening insolvency claim belongs to the creditors, then the bankruptcy trustees clearly lack standing to assert them.¹⁰⁴ The bankruptcy trustees are the representatives of the estate, not the creditors. This is evident in the Bankruptcy Code itself. Section 323 of the Bankruptcy Code provides that a bankruptcy trustee is the "representative of the estate."¹⁰⁵ It does not mention the creditors. In addition, Congress deleted from the Bankruptcy Code a provision entitled "Trustee as creditors' representative"¹⁰⁶ which would have granted the trustees a power to "enforce any cause of action that a creditor or class of creditors, or an equity security holder or class of equity security holders, has against a third party."¹⁰⁷ This provision would have overruled the United States Supreme Court decision in *Caplin v. Marine Midland Grace Trust Co.*¹⁰⁸ which held that a reorganization bankruptcy trustee did not have authority to bring suits for damages on behalf and for the benefit of the creditors.¹⁰⁹

103. See generally *Williams v. Cal. 1st Bank*, 859 F.2d 664, 666-67 (9th Cir. 1988) (where a Chapter 7 trustee sued the debtor's depository bank for knowingly participating in the ponzi scheme, the court held that the trustee lacked standing because, despite the assignment of the investors' claims, the investors-creditors remained real parties in interest, not the debtor); cf. *Schelling v. Thomas (In re Agribiotech, Inc.)*, 319 B.R. 207, 213-14 (D. Nev. 2004) (assigned claims become property of estate under 11 U.S.C. § 541(a)(7)); *Southwest Holdings, L.L.C. v. Kohlberg & Co.*, 315 B.R. 565, 570-71 (Bankr. Ariz. 2004)

104. *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 428-29, 434 (1972); *In the Matter of Educators Group Health Trust*, 25 F.3d 1281, 1284 (5th Cir. 1994); *E.F. Hutton & Co., Inc. v. Hadley*, 901 F.2d 979, 987 (11th Cir. 1990) (trustee lacks standing because claims belong to the creditors); *Williams*, 859 F.2d 667-68 (no standing since the creditors were the real parties in interest and because the trustee and estate will receive only administrative costs while the assignors would receive the bulk of any recovery); *Feltman v. Prudential Bache Sec.*, 122 B.R. 466, 474-75, n.13 (denying standing to the bankruptcy trustee and holding that allegation of the injury to the corporation is a maneuver to circumvent the standing requirement).

105. 11 U.S.C. § 323 (1978).

106. H.R. REP. NO. 95-598 at 6326 (1978).

107. *Id.* at 6140; 11 U.S.C. § 544(c) (1978).

108. 406 U.S. 416 (1972).

109. *Id.*

2. *The Deepening Insolvency Claim Belongs to the Debtor*

The deepening insolvency claim is a state cause of action.¹¹⁰ The question whether a state cause of action belongs to the insolvent estate is a matter of state law.¹¹¹ Generally, a cause of action belongs to the estate so long as the state law allows the debtor to bring a particular action even if it alleges an injury to a creditor.¹¹² The bankruptcy trustees may bring an action alleging injury to the creditors in general,¹¹³ but not where the injury is specific to a group of creditors.¹¹⁴ However, where the debtor sustains direct injuries, even if such injuries are also sustained by the creditors in general, the cause of action belongs to the estate.¹¹⁵

As noted previously, the corporate debtors sustain numerous direct injuries that are actual and concrete. These injuries upon the debtor-corporations “necessarily” result in the injury to the general creditor body.¹¹⁶ However, the corporate-vic-

110. See generally *Schacht v. Brown*, 711 F.2d 1343, 1350; Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347-48 (3d Cir. 2001); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Tech., Inc.*), 299 B.R. 732, 751 (Bankr. D. Del. 2003); Florida Dep’t of Ins. v. Chase Bank, 274 F.3d 924, 935 (5th Cir. 2001).

111. *St. Paul Fire and Marine Ins. Co. v. Pepsico, Inc.*, 884 F.2d 688, 700 (2d Cir. 1989); *Lafferty*, 267 F.2d at 348.

112. See *In the Matter of Educators Group Health Trust*, 25 F.3d 1281, 1284 (5th Cir. 1994). If an injury to a creditor is alleged and the debtor could have raised a claim under the applicable state law, then the cause of action belongs to the estate. The Eighth Circuit in *In re Ozark Rest. Equip. Co.*, 816 F.2d 1222, 1225 (8th Cir. 1987), held that the Chapter 7 trustee lacked standing to bring an alter ego claim against the principals of the corporation because under Arkansas law alter ego claims could not be brought by the debtor.

113. *St. Paul Fire*, 884 F. 2d at 701; *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 132 (2d Cir. 1993).

114. See *Hadley*, 901 F.2d at 986 (the trustee cannot bring claims of specific creditors); *Hirsch*, 72 F.3d at 1093-94 (the claims based on the circulation of incorrect private placement memoranda to investors belonged to the investor-creditors and can be asserted only by them); *Bd. of Trs. of Teamsters Pension Fund v. Foodtown, Inc.*, 296 F.3d 164, 170 (3d Cir. 2002) (“absent a general creditors’ interest,” the trustee can only collect the property of the estate).

115. See generally, *Lafferty*, 267 F.3d at 340; *Educators*, 25 F.3d at 1285 (the generality of the injury to creditors does not decide whether the cause of action belongs to the debtor).

116. *Educators*, 25 F.3d at 1285 (the injury to the debtor “necessarily” leads to the general injury to creditors).

tims' injuries are distinct and separate from those of the creditors, particularized unto themselves.¹¹⁷ The fact that the benefit of the recovery would flow directly to the creditors is "irrelevant."¹¹⁸ Therefore, the deepening insolvency claims clearly belong to the debtor-corporations, not to the creditors.

Regardless, in the deepening insolvency actions against directors, officers and controlling shareholders, trustees do not face a challenge to this aspect of the standing requirement. In general, directors, officers and controlling shareholders owe fiduciary duties to the corporation and shareholders.¹¹⁹ When a corporation becomes insolvent, they are said to owe fiduciary duties to "the entire community of interests in the corporation."¹²⁰ Such duties are breached when the directors, officers or controlling shareholders engage in fraudulent conducts in their official capacity. Ordinarily, these fiduciary duties are "enforceable directly by the corporation."¹²¹ In bankruptcy, however, they are enforceable by the trustee on behalf of the debtor-corporation.¹²²

III.

WHO CAN BE SUED

Initially, deepening insolvency was asserted against the directors, officers and controlling shareholders.¹²³ Over time, its reach has expanded.¹²⁴ In *Lafferty*, the theory was asserted against accountants and underwriters. As the use of highly leveraged corporate structures has become prevalent, the the-

117. See *supra* pt. II(A)(2); *Lafferty*, 267 F.3d at 348-49.

118. *Lafferty*, 267 F.3d at 348-49.

119. *Quadrangle Offshore (Cayman) LLC v. Kenetech Corp.*, 1999 Del. Ch. 213, at *23 (Del. Ch. Oct. 13, 1999) (fiduciary duty to shareholders in ordinary times); *Bennett Restructuring Fund, L.P. v. Hamburg*, 2003 LEXIS 61, *63 (Conn. Super. Jan. 2, 2003) (only to corporation and shareholders in normal times).

120. See generally *Pepper v. Litton*, 308 U.S. 295, 307 (1939); *Kittay v. Atlantic Bank of New York (In re Global Serv. Group, LLC.)*, 316 B.R. 451, 459 (Bankr. S.D.N.Y. 2004).

121. *Pepper*, 308 U.S. at 307

122. See *id.*

123. *Brighton*, *supra* note 8; see also *Patterson*, 176 Pa. at 612, 614.

124. *Brighton*, *supra* note 8.

ory now concerns secured creditors as well.¹²⁵ Simply, it has become commonplace in complaints filed in Chapter 11 bankruptcy cases.¹²⁶

A complaint alleging deepening insolvency against these third-party defendants would read as follows:

*[W]ith the substantial assistance of the retained professionals, [the directors and/or officers of the debtors] breached their fiduciary duties of care, loyalty and candor to [the debtors] by, among other things, distorting the true financial condition of [the debtors] and by making material misrepresentations to, and/or concealing material information from [the debtors'] shareholders, outside directors, [the SEC], creditors and the general public. [All defendants [allegedly] created a plan and scheme to create the illusion of growth and prosperity and to conceal their own mismanagement and misconduct.]*¹²⁷

This section will analyze the deepening insolvency claim as applied to each group of the following defendants.

A. *The Directors, Officers and Controlling Shareholders*

In ordinary times, directors, officers and controlling shareholders owe a fiduciary duty to the corporation and its shareholders, but not to its creditors.¹²⁸ This fiduciary duty is owed because the directors, officers and controlling share-

125. *Id.*; see also Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Tech., Inc.*), 299 B.R. 732, 751 (Bankr. D. Del. 2003).

126. Jo Ann J. Brighton, *Secured Creditors Beware: The Latest Tool in the Creditors' Committee Toolbox: Aiding and Abetting in the Breach of a Fiduciary Duty*, 23-Aug. AM. BANKR. INST. J. 36 (Oct. 2004) (hereinafter Brighton, *Secured Creditors*).

127. *Smith v. Arthur Andersen, LLP*, 175 F. Supp. 2d 1180, 1187 (D. Ariz. 2001) (emphasis added).

128. *In re STN Enter.*, 779 F.2d 901, 904 (2d Cir. 1985) (upon insolvency, directors owe fiduciary duty to creditors); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (“[W]hen the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors”); *Simons v. Cogan*, 542 A.2d 785, 786 (Del. Ch. 1987) (“among the duties owed by directors of a Delaware corporation to holders of that corporation’s debt instruments, there is no duty of the broad and exacting nature characterized as a fiduciary duty”); *Bennett Restructuring Fund, L.P. v. Hamburg*, 2003 LEXIS 61, *63-64 (Conn. Super. Jan. 2, 2003).

holders are vested with power to manage the corporate enterprise owned by the shareholders.¹²⁹ The creditors' relationship with the corporation is contractual in nature.¹³⁰ The terms of the investment agreement delimit the relationship between the creditors and the management.¹³¹ So long as the terms of the contract are satisfied, the directors, officers, and controlling shareholders owe no fiduciary duties to the creditors.¹³²

Hence, courts have rejected the idea that during the solvency of the corporation the directors, officers and controlling shareholders owe fiduciary duties to the corporate creditors, absent special circumstances.¹³³ However, the rules and fun-

129. *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 652, n. 10 (Bankr. N.D. Ill. 1998); *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) ("a corporate bond does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties"); Christopher Rebel J. Pace, *Determining Price Inadequacy, Decision Making and Expert Assistance: A Principled Way to "Just Say No,"* 16 DEL. J. CORP. L. 57, 83 (1991) (Corporations are owned by shareholders and the management's purpose is to maximize benefit to the shareholders, during solvency).

130. *RJR Nabisco, Inc.*, 716 F. Supp. at 1524 ("a corporate bond represents a contractual entitlement to the repayment of a debt"); *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("[T]he relationship between a corporation and the holders of its debt securities . . . is contractual in nature"); James Gadsden, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, 24-1 AM. BANKR. INST. J. 16 (2005) (hereinafter Gadsden).

131. *RJR Nabisco, Inc.*, 716 F. Supp. at 1524 (a bondholder "remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture."); *Quadrangle Offshore (Cayman) LLC v. Kenetech Corp.*, No. 16362NC, 1999 WL 893575, at *7 (Del. Ch. Oct. 13, 1999) ("The rights of debt holders are restricted to those provided in the instrument creating the debtor/creditor relationship").

132. *RJR Nabisco, Inc.*, 716 F. Supp. at 1518 ("Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he . . . establishes his rights through contractual provisions set forth in the debt agreement or indenture") (internal citations and emphasis omitted); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del Ch. 1992) ("the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent "special circumstances . . . , e.g., fraud, insolvency, or violation of a statute . . .").

133. *Geyer*, 621 A.2d at 787 ("the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent "special circumstances . . . , e.g., fraud, insolvency, or violation of a statute . . .").

damental relationships change when insolvency becomes a factor, *i.e.* an insolvency exception.¹³⁴

1. *The Trust Fund Doctrine*

This insolvency exception can be traced back to the trust fund doctrine, best described by Justice Story in the early 1800s. When the British captured Washington, D.C., during the War of 1812, a financial panic swept through this country and many banks failed,¹³⁵ including the Hallowell and Augusta Bank (the “Banks”) chartered by the Massachusetts legislature. Some of the unpaid bondholders of the Banks sued the Banks’ incorporators, principals and stockholders to overturn the payment of the liquidating dividend to shareholders during the Banks’ insolvency.¹³⁶ Presiding over an action filed in a federal circuit court in Maine, Justice Story allowed the payment to the creditors from the shareholders and directors to be proportionate to what they received from the dividend:

[T]he capital stock of banks is to be deemed a *pledge or trust fund for the payment of the debts contracted by the bank* . . . The individual stockholders are not liable for the debts of the bank in their private capacities . . . During the existence of the corporation it is the sole property of the corporation, and can be applied only according to its charter, that is, as a fund for payment of its debts, upon the security of which it may discount and circulate notes . . . *The bill-holders and other creditors have the first claims upon it; and the stockholders have no rights, until all the other creditors are satisfied* . . . [Stockholders’] rights are not to the capital stock, but to the residuum after all demands on it are paid . . . On a dissolution of the corporation, the bill-holders and the stockholders have each equitable claims, but those of the bill-holders possess . . . a prior exclusive equity.¹³⁷

134. *Id.*; *Weintraub*, 471 U.S. at 343, 355; *Bennett Restructuring Fund, L.P. v. Hamburg*, 2003 LEXIS 61, *64-65 (Conn. Super. Jan. 2, 2003).

135. Theodore Dinsmoor, *Director Decision Making in the Zone of Corporate Insolvency*, 47 B.B.J. 18 (2003).

136. *See, e.g., Vose v. Grant*, 15 Mass. (1 Tyng) 505, 517-18 (1819); *Spear v. Grant*, 16 Mass. (1 Tyng) 9, 15 (1819).

137. *Wood v. Dummer*, 30 F. Cas. 435, 436-37 (1824) (emphasis added).

In other words, when a corporate entity becomes insolvent, the corporate assets of the corporation become a trust for the creditors' benefit¹³⁸ and directors become fiduciaries to the creditors under the trust.¹³⁹ According to Justice Story, the creditors have rights to the trust that are superior to those of the shareholders, and shareholder interests become suspended until the creditors are paid in full.¹⁴⁰

The doctrine, however, should not be construed to mean that the directors, officers, and controlling shareholders should cash in the corporate assets and disseminate them to the creditors.¹⁴¹ First of all, in American bankruptcy law, there is "no absolute duty . . . to shut down and liquidate an insolvent corporation."¹⁴² Secondly, under the law of trust, a trustee has a duty to "invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard."¹⁴³ In bankruptcy, the bankruptcy trustees are allowed to operate the debtor's business in reorganization cases.¹⁴⁴ Even in a liquidation scenario, the trustees can operate the

138. *Geren v. Quantum Chem. Corp.* No. 95-7454, 1995 U.S. App. LEXIS 39912, at *3 (2d Cir. Dec. 13, 1995) ("Under New York law, directors of a corporation may become trustees of the creditors when the corporation is insolvent"); *Automatic Canteen Co. of Am. v. Wharton*, 358 F.2d 587, 590 (2d Cir. 1966) ("we hold [the directors of an insolvent company] trustees of the corporation's property on behalf of the creditors"); *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) ("the fact which creates the trust is the insolvency . . .").

139. *New York Credit Men's Adjustment Bureau v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953) ("If the corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditors-beneficiaries") (internal citations omitted).

140. See also *Weintraub*, 471 U.S. at 355 ("One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors"); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982) ("when a corporation becomes insolvent . . . the officers and directors no longer represent the stockholders") (quoting *Davis v. Wolf*, 147 F.2d 629, 633 (4th Cir. 1945)); *First Options of Chicago, Inc. v. Polonitza*, 1990 U.S. Dist. LEXIS 9449, at *12 (N.D. Ill. July 31, 1990).

141. *Gadsden*, *supra* note 130, at 56.

142. *Kittay v. Atlantic Bank of New York (In Re Global Serv. Group, LLC)*, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004); *In re RSL Com Primecall, Inc.*, 2003 Bankr. LEXIS 1635, at *28 (Bankr. S.D.N.Y. Dec. 11, 2003).

143. N.Y. Est. Powers & Trust Laws § 11-2.3(a) (McKinney 2003).

144. 11 U.S.C. § 1108 (1978).

business if it is in the “best interests of the estate and consistent with the orderly liquidation of the estate.”¹⁴⁵

2. *Community of Interests*

The United States Supreme Court first mentioned the phrase “community of interest” in the context of the director and controlling shareholder’s fiduciary duty in *Pepper v. Litton*.¹⁴⁶ Over half a century later, the phrase “community of interest” returned with a bang when Chancellor Allen used it in *Credit Lyonnais Bank Netherland, N.V. v. Pathe Communication Corp.*,¹⁴⁷ expanding the application of the insolvency exception to the period in which the corporations operate in the “vicinity of insolvency.”¹⁴⁸ Chancellor Allen stated that “[a]t least where a corporation is operating in the vicinity of insolvency, [the directors are] not merely the agent[s] of the residue risk bearers, but owe [their] duty to the corporate enterprise.”¹⁴⁹ They owe their duty to the “community of interest that sustain[] the corporation.”¹⁵⁰ Although the term “vicinity of insolvency” has been used in connection with deepening

145. 11 U.S.C. § 721 (1978).

146. *Pepper v. Litton*, 308 U.S. 295, 307 (1939).

147. *Credit Lyonnais Bank Netherland, N.V. v. Pathe Commc’n Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

148. *Id.* at *108 n.55. At this juncture the meaning of insolvency need be addressed. A company becomes insolvent when its debts exceed the fair market value of its properties. 11 U.S.C. § 101 (32) (1978); *Pereira v. Cogan*, 294 B.R. 449, 501 (Bankr. S.D.N.Y. 2003), *rev’d on other ground by Pereira v. Farace*, 413 F.3d 330 (2d Cir. 2005); Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 349 (3d Cir. 2001); *In re Healthco Inter’l, Inc.*, 208 B.R. 288, 301 (Bankr. D. Mass. 1997) (“insolvency in the bankruptcy sense”). This is called the “balance sheet test,” also referred to as “insolvency in the bankruptcy sense.” Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent Or In The Zone of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & C.L. J. 295, 307 & n.63 (2004). A company is also insolvent when it cannot pay its debts as they become due. *Pereira*, 294 B.R. at 501; *Odyssey Partners, L.P. v. Fleming Cos. Inc.*, 735 A.2d 386, 417 (Del. Ch. 1999); *LaSalle Nat’l Bank v. Perelman*, 82 F. Supp. 2d 279, 290 (D. Del. 2000). This is called the “cash-flow” or “equity” test. Sherri Morissette, *Director’s Duties in the Zone of Insolvency: the Quandary of the Nonprofit Corp.*, 23-2 AM. BANKR. INST. J. 12 (2004). The commencement of a dissolution or insolvency proceeding does not demarcate the point of insolvency. *Geyer v. Ingersoll Publ’ns, Co.*, 621 A.2d 784, 789 (Del. Ch. 1992).

149. *Id.* at *108.

150. *Id.* at *109.

insolvency,¹⁵¹ this article will not discuss it any further since it is a concept distinct from deepening insolvency, further discussion of which deserves separate treatment.

Hence, upon insolvency or within the zone of insolvency, the directors, controlling shareholders and officers have fiduciary obligations to the community of interest.¹⁵² In the deepening insolvency context, the directors, officers and controlling shareholders are said to have deepened insolvency by committing, *inter alia*, a breach of fiduciary duties owed to this community of interest.¹⁵³ Of course, such a community includes the corporation itself, and “creditors as well as stockholders.”¹⁵⁴

3. *What Constitutes Fiduciary Duty Upon Insolvency*

Ordinarily, the directors, officers and controlling shareholders owe a triad of duties to the corporation and its shareholders: duty of care, duty of loyalty and good faith.¹⁵⁵ Duty of care simply means that the directors, officers and controlling shareholders exercise reasonable care in executing their management responsibilities.¹⁵⁶ Duty of loyalty means the opposite of self-dealing.¹⁵⁷ It subjects the corporate managers to

151. See *Ben Franklin*, 225 B.R. at 649. The complaint there alleged that “[the directors and officers of the debtors] while the debtors were ‘in the vicinity of insolvency,’ owed fiduciary duties of care to creditors. [They] breached those duties by redating the receivables, misrepresenting the [debtors’] financial condition and prolonging the [debtors’] corporate lives beyond insolvency.” The bankruptcy court then recognized that “[i]n an appropriate case . . . directors who cause their corporation to incur debt may be in breach of duties enforceable by creditors. *Id.* at 656.

152. *Kittay v. Atlantic Bank of New York (In Re Global Serv. Group, LLC)*, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004); *In re Mid-State Raceway, Inc.*, 323 B.R. 40, 58 (Bankr. N.D.N.Y. 2005).

153. See generally *Global Service*, 316 B.R. at 460; Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 345-46 (3d Cir. 2001) (the complaint included breach of fiduciary duty).

154. *Pepper*, 308 U.S. at 307; *Weintraub*, 471 U.S. at 343, 355.

155. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

156. See *Roselink Investors LLC v. Shenkman*, 2004 U.S. Dist. LEXIS 6905, at * 10 (S.D.N.Y. May 19, 2004); Gadsden, *supra* note 130, at 16.

157. *Clements v. Rogers*, 790 A.2d 1222, 1248 (Del. Ch. 2001) (“as traditionally conceived, the duty of loyalty is implicated when conflicted directors propose a self-dealing transaction”).

“absolute fidelity” to the corporation.¹⁵⁸ It prohibits the directors, officers and controlling shareholders from placing their personal interests above the corporate interests, such as misappropriation and self-interested transactions.¹⁵⁹

Although this triad of fiduciary duties extends through insolvency, it is not clear exactly what constitutes such fiduciary duty during insolvency.¹⁶⁰ At the very least, the directors are prohibited from protecting their interests to the detriment of the creditors’ interests.¹⁶¹ They have an “obligation . . . to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity.”¹⁶² What constitutes fiduciary duty upon insolvency is best answered when analyzed in conjunction with the business judgment rule.

4. *The Business Judgment Rule*

Directors’ conduct is generally protected by the so-called business judgment rule.¹⁶³ The business judgment rule was created by courts to afford the directors some protection from shareholder actions claiming that they breached their fiduciary duties by making unprofitable business decisions.¹⁶⁴ The rule seeks to balance two competing interests: (1) the policy of judicial noninterference with respect to the authority and decisions of corporate managers; and (2) the policy of holding

158. *Demoulas v. Demoulas Super Mkts Inc.*, 677 N.E.2d 159, 179 (Mass. 1997).

159. *In re Toy King Distribs. Inc.*, 256 B.R. 1, 171 (Bankr. M. Fla. 2000); *Broz v. Cellular Info. Sys. Inc.*, 673 A.2d 148, 155-56 (Del. 1996).

160. See generally *In re Southwest Supermarkets*, 315 B.R. 565, 575-76 (Bankr. D. Ariz. 2004) (“upon insolvency the officers’ and directors’ fiduciary duties change and must satisfy a higher standard”); *In re Toy King Distrib’s. Inc.*, 256 B.R. 1, 171-72; *Credit Lyonnais Bank Netherland, N.V. v. Pathe Commc’n Corp.*, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).

161. *Toy King*, 256 B.R. at 171; *Davis v Woolf*, 147 F.2d 629, 633 (4th Cir. 1945); *Fed. Deposit Ins. Co. v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982).

162. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *109.

163. *Shapiro v. Rockville Country Club, Inc.*, 2004 N.Y. Slip Op. 50079(U), at 9 (N.Y. S. Ct. Feb. 23, 2004).

164. *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003).

directors accountable for their decisions.¹⁶⁵ It presumes that the directors of a corporation make informed business decisions in good faith and with a belief that these decisions are in the best interests of the corporation and further a “rational business purpose.”¹⁶⁶ The presumption can be rebutted by demonstrating fraud, self-dealing, conflict of interest, abuse of discretion, unconscionable conduct, illegality, gross overreaching, lack of a lawful and legitimate corporate purpose or malfeasance.¹⁶⁷

The business judgment rule functions as a procedural guide and substantive rule of law.¹⁶⁸ Procedurally, it is a rule of evidence that puts the initial burden of proof on the plaintiff.¹⁶⁹ The plaintiff must prove at the pleading stage that the directors violated their fiduciary duties.¹⁷⁰ If the plaintiff satisfies this burden, the burden shifts to the director-defend-

165. *Rosenfield v. The Metals Selling Corp.*, 643 A.2d 1253, 1262 (Conn. 1994); *Janssen*, 662 N.W.2d at 881-82.

166. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Emerald Partners v. Berlin*, 787 A.2d at 90; *Janssen*, 662 N.W.2d at 882; Dennis J. Block, et al., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 18 (5th ed. 1998).

167. *Janssen*, 662 N.W.2d at 882 (finding directors not liable so long as an informed business decision was made by disinterested directors, in good faith, without an abuse of direction); *Cuker v. Mikalauskas*, 547 Pa. 600, 608-9 (1997) (courts will not second-guess business decisions made by corporate managers “in the absence of fraud or self-dealing or other misconduct or malfeasance”); *Shapiro*, 2004 NY Slip Op 50079(U), at *9 (“Absent a showing of fraud or lack of good faith, the actions of corporate directors must be respected by the courts”); *Fink v. Codey (In re PSE & G S’holder Litig.)*, 173 N.J. 258, 277 (N.J. 2002) (“The business judgment rule protects a board of directors from being questioned or second-guessed on conduct of corporate affairs except in instances of fraud, self-dealing, or unconscionable conduct.”); *Cookies Food Prod. v. Lakes Warehouse Distrib.*, 430 N.W.2d 447, 453 (Iowa 1988) (self-dealing); *Fields v. Sax*, 123 Ill. App. 3d 460, 467 (Ill. App. Ct. 1984) (bad faith, fraud, illegality, or gross overreaching); *Desaigoudar v. Meyercord*, 108 Cal. App. 4th 173, 183 (Cal. App. 2003) (fraud, breach of trust and conflict of interest).

168. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

169. *Id.*; *In re Unitrin, Inc. S’holders Litig.*, 651 A.2d 1361, 1373 (Del. 1995); *Rosenfield v. Metals Selling Corp.*, 229 Conn. 771, 787 (Conn. 1994) (ones attacking the “wisdom of a business decision taken by management must overcome the business judgment rule”).

170. *Emerald Partners*, 787 A.2d at 90; *Heritage Healthcare Servs., Inc. v. The Beacon Mutual Ins. Co.*, 2004 R.I. Super. LEXIS 29, at *19, 21 (R.I. Super. Jan. 21, 2004); *Warren v. Bankcorporation Inc.*, 741 P.2d, 846, 849 n.5 (Okla. 1987).

ants.¹⁷¹ Their actions face “close scrutiny” and, in order to avoid liability, they must prove that their actions were fair, in the best interest of the corporation and taken in good faith.¹⁷² If they fail to so prove, “the equity will set [the directors’ actions] aside.”¹⁷³

In deepening insolvency cases, the business judgment rule can be easily rebutted. By definition, deepening insolvency is an injury to the corporation by the fraudulent expansion of corporate debt and life, clearly falling under the ban of fraud.¹⁷⁴ In addition, such cases often involve self-dealing, looting and conflict of interests which, coupled with direct injuries to the corporations, demonstrate that their decision to deepen insolvency was neither fair nor in the best interest of the corporation.¹⁷⁵ Further, no lawful and legitimate corporate purpose could be served by the fraudulent misrepresentation to the creditors and investors where the directors, officers and controlling shareholders knew that these debts could never be repaid and that reorganization was impossible.¹⁷⁶ Additionally, a decision to incur additional debt, while portraying a false picture of solvency, by providing false financial statements, cannot be said to have been made in good faith.

In short, the directors, officers, and controlling shareholders breach their fiduciary duties by failing to exercise business judgment through fraudulently prolonging the corporate life beyond insolvency, dissipating the corporate assets and failing to use the corporate debt to regain the corporation’s financial well-being.¹⁷⁷

171. *Emerald Partners*, 787 A.2d at 91; *PSE & G S’holder Litig.*, 173 N.J. at 277.

172. *Phoenix Airline Servs., Inc. v. Metro Airlines, Inc.*, 260 Ga. 584, 587 (1990); *Cookies*, 430 N.W.2d at 453.

173. *Pepper*, 308 U.S. 295 at 306-7.

174. See Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001) (the claims alleged under the deepening insolvency theory included fraud).

175. See, e.g., *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 510 (N.D. Ill. 1988); *Lafferty*, 267 F.3d at 343-46; *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849, 854 (M.D. La. 1997); *In re Latin Inv. Corp.*, 168 B.R. 1, 5 (Bankr. D.C. 1993)

176. See *Comm. of Unsecured Creditors v. Logue (In re Logue mech. Contracting Corp.)*, 106 B.R. 436, 440-41 (Bankr. W.D. Pa. 1989).

177. See generally *id.*; *In re Ben Franklin Retail Stores Inc.*, 225 B.R. 646, 656 (Bankr. N.D. Ill. 1998).

B. *The Retained Professionals and Others*

Deepening insolvency claims against retained professionals and secured lenders differ, depending on which group of defendants is being targeted. In general, these defendants are said to have deepened insolvency by committing fraud or breach of fiduciary duty¹⁷⁸ or by aiding and abetting the breach of fiduciary duty by the primary wrongdoers, *i.e.*, the directors, officers and controlling shareholders.¹⁷⁹

1. *The Accounting Professionals*

The accounting professionals have been regularly exposed to professional liability claims.¹⁸⁰ Claims against them can contain causes of action such as aiding and abetting, breach of fiduciary duty, acting in concert, professional malpractice/negligence, negligent misrepresentation, breach of contract, preferential transfer, or fraudulent transfer/fraudulent concealment.¹⁸¹

Deepening insolvency claims against accounting professionals generally involve fraudulent misrepresentation, concealment, breach of contract or aiding and abetting breach of fiduciary duty.¹⁸² They are alleged to have "acted in concert with the [directors and officers] to increase [the debtor's] insolvency by falsely and unlawfully misrepresenting the true financial condition of [the debtor], while . . . concealing the [directors' and officers'] misconduct and breaches of fiduciary duty."¹⁸³ They allegedly "assisted the [debtor's directors and officers] in maintaining the façade of growth and solvency while allowing [the debtor] to become more insolvent over time as [the debtor] was increasingly encumbered with obligations . . . that could not be repaid."¹⁸⁴ Thus, they are said to have deepened insolvency through their "misstatement and concealment of [the debtor's] true financial condition," and

178. *Brown v. Citigroup Global Mkts., Inc.*, AP No. 03-5415 (ASH) (Bankr. S.D.N.Y. 2003).

179. *Lafferty*, 267 F.3d at 345; *Smith v. Arthur Andersen*, 175 F. Supp. 2d, 1180, 1186 (D.Ariz. 2001).

180. Robert K. O'Reilly, *Targeting the Wrong Deep Pocket: Professional Liability Claims in Insurance Company Insolvencies*, 1996 Wis. L. Rev. 123, 125 (1996).

181. *Smith*, 175 F. Supp. 2d at 1186-87.

182. *Lafferty*, 267 F.3d at 345-46; *Smith*, 175 F. Supp. 2d at 1186.

183. *Smith*, F. Supp. 2d. at 1191.

184. *Id.*

by assisting the directors and officers in obtaining "the capital necessary to perpetuate their misconduct and drive the company deeper into insolvency."¹⁸⁵

Accounting professionals increasingly face liability under the theory of deepening insolvency. *Schacht*, one of the first decisions favoring this theory, included accountants as defendants.¹⁸⁶ *Lafferty*, a defining case in deepening insolvency, was brought against, *inter alia*, accountants and underwriters.¹⁸⁷ A New York district court recognized the theory against accountants.¹⁸⁸ Several courts have refused to dismiss the cases brought under the deepening insolvency theory against accountants.¹⁸⁹

2. *The Secured Lenders*

In *In re Exide Technologies, Inc.*,¹⁹⁰ the official committee of unsecured creditors, along with a creditor, filed a complaint against a group of pre-petition secured lenders, alleging, *inter alia*, deepening insolvency. Initially, the lenders created a \$650 million credit facility for the debtors. Later, another loan was advanced in order for the debtors to acquire one of the debtor's competitors. After the acquisition, the debtors' financial condition deteriorated rapidly. The parties later twice amended the loan agreements to forbear compliance process in exchange for additional liens on the debtors' assets and capital stock.

The committee alleged that the lenders deepened the debtors' insolvency by causing the debtors to make the acquisition in order to gain control over the debtors in the fraudulent extension of the corporate life, driving the debtors further into the insolvency and costing creditors substantial value. The lenders refuted these allegations by arguing, *inter alia*, that a deepening insolvency action was not cognizable under

185. *Id.*

186. *Schacht v. Brown*, 711 F.2d 1343, 1345-46 (7th Cir. 1983).

187. *Lafferty*, 267 F.3d at 345.

188. *Allard v. Arthur Andersen*, 924 F. Supp. 488 (S.D.N.Y. 1996).

189. *See, e.g., Smith*, 175 F. Supp. 2d at 1180; *Waslow v. Grant Thornton LLP (In re Jack Greenberg, Inc.)*, 240 B.R. 486 (Bankr. E.D. Pa. 1999); *Allard*, 924 F. Supp. at 488.

190. *In re Exide Tech., Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003).

Delaware law and the *in pari delicto* doctrine barred the committee from bringing this claim.¹⁹¹

Following *Lafferty*, the bankruptcy court held that the Delaware Supreme Court would recognize deepening insolvency as a valid cause of action.¹⁹² As to the *in pari delicto* defense, it held that the doctrine is an affirmative defense, which the lenders can raise in their answer. It found that the complaint was pled sufficiently to survive the motion to dismiss.¹⁹³

As to the claim of aiding and abetting the breach of fiduciary duty, the *Exide* court denied the motion to dismiss the claim because it found that the complaint alleged sufficient facts to support the claim. In order to find the lenders liable under the claim, the claimants must show: (1) the primary wrongdoers, *i.e.* the directors and officers, were fiduciaries to the corporate-victim; (2) the directors and officers breached the fiduciary duty; (3) the retained professionals and secured lenders knowingly participated in the breach; and (4) damages were proximately caused by the breach.¹⁹⁴

The recovery under this claim is not so easy. As applied to the deepening insolvency cases, the first two elements can be easily established. The third and fourth elements, however, make the recovery difficult. As to the third element, the actual knowledge of the breach of fiduciary duty of the primary violators must be shown.¹⁹⁵ Constructive knowledge is not sufficient.¹⁹⁶ With respect to the fourth element, substantial assistance by the defendants to the breach must be shown.¹⁹⁷ Proximate cause is found if the damage was a direct result of the breach or reasonably foreseeable from the breach.¹⁹⁸

191. *Id.* at 751.

192. *Id.* at 752.

193. *Id.*

194. *Sharp Int'l. Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l. Corp.)*, 403 F.3d 43, 49 (2d Cir. 2005); *Exide Tech.*, 299 B.R. at 749; *Sharp Int'l. Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l. Corp.)*, 302 B.R. 760, 770 (E.D.N.Y. 2003); Brighton, *supra* note 8.

195. *Sharp*, 403 F.3d at 49; *Lesavoy v. Lane*, 304 F. Supp.2d 520, 526-27 (S.D.N.Y. 2004) (allegation of defendant's knowledge or recklessness in their failure to know did not satisfy the actual knowledge requirement for aiding and abetting).

196. *Sharp*, 302 B.R. at 770.

197. *Id.* at 774.

198. *See Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61 (2d Cir. 1985); *Szymanski v. Columbia Transp. Co.*, 154 F.3d 591, 601

In *Exide*, the claim of aiding and abetting the breach of fiduciary duty was brought independently from the deepening insolvency claim.¹⁹⁹ This was also the case in *In re Global Service Group LLC*. In *Global Service*, the deepening insolvency claim against a pre-petition secured lender was dismissed because the court found that the facts did not sufficiently allege proximate cause.²⁰⁰ The aiding and abetting claim was dismissed because the court found no primary violation by the directors and officers.²⁰¹

Aiding and abetting the breach of fiduciary duty has become a regular claim in the “kitchen sink” complaint against pre-petition secured lenders.²⁰² Whether alleged within the deepening insolvency claim or by itself, the claim appears in most major chapter 11 cases, posing a great threat to these lenders.²⁰³

3. *The Investment Advisors*

On November 14, 2003, in relation to the bankruptcy case of *Metromedia Fiber Networks, Inc.* (“Metromedia”),²⁰⁴ the litigation trustee of Metromedia filed an adversary proceeding against Citigroup, Inc. and its subsidiaries (“Citi”),²⁰⁵ Citi was Metromedia’s pre-petition primary investment advisor as well as sole advisor, lead arranger, administrative agent and sole book manager for a \$150 million pre-petition loan.²⁰⁶ The trustee alleged that the defendants engaged in a five-year scheme under which they sold their clients’ investment banking products of dubious value by giving illegal gratuities to the

(6th Cir. 1998); *Kittay v. Atlantic Bank of New York (In Re Global Serv. Group, LLC)*, 316 B.R. 451, 461 (Bankr. S.D.N.Y. 2004).

199. *Exide Tech.*, 299 B.R. at 749.

200. The court there stated that the facts were not sufficiently alleged to establish that the secured lender could have foreseen that the directors and officers would misappropriate the loan proceeds or operate the debtor for an improper purpose. *Global Serv.*, 316 B.R. at 461.

201. *Id.* at 462.

202. Brighton, *Secured Creditors*, *supra* note 124.

203. *E.g.*, *Exide Tech.*, 299 B.R. at 749; *Dibbern v. Adelpia Commc’n Corp. (In re Adelpia Commc’n Corp.)*, 331 B.R. 93 (Bankr. S.D.N.Y. 2005); *Conn. Res. Recovery Auth. V. Enron Corp. (In re Enron Corp.)*, No. 01 B 16034 (AJG) WL 1571719, at *1 (Bankr. S.D.N.Y., March 27, 2003).

204. Bankr. Case No. 02-22726 (ASH) (Bankr. S.D.N.Y. 2002).

205. Brown, *supra* note 179.

206. *See id.* compl. at ¶ 14.

clients' executives and by using artificially inflated financial projections.²⁰⁷ Thus, Citi allegedly deepened Metromedia's insolvency by failing to disclose the true state of Metromedia's financial condition and by encouraging it to incur an unnecessary and large loan that only delayed a timely bankruptcy filing resulting in massive losses to Metromedia. The case was settled.

4. *The Controlling Customers*

In *In re Del-Met Corp.*,²⁰⁸ the bankruptcy court declined to dismiss a deepening insolvency claim brought by the bankruptcy trustee against, *inter alia*, controlling customers. It was alleged that the controlling customers took over, put their agents in charge of management and operations of the debtors and pushed out the existing officers and managers for their benefit, causing great injury to the debtors.²⁰⁹

5. *The Lawyers*

Lawyers are prone to professional liability suits. Recently, a U.S. district court in *In re Crown Vantage, Inc.*²¹⁰ dismissed, *inter alia*, a deepening insolvency claim against a law firm as well as other defendants on the basis of the *in pari delicto* defense.²¹¹ Although not a strict deepening insolvency case, the Second Circuit, in *Hirsch v. Arthur Andersen & Co.*,²¹² affirmed a dismissal in favor of the third party defendants, including a law firm, on the grounds of lack of standing and *in pari delicto*.²¹³ However, in an action brought by a receiver against a lawyer, a U.S. district court, in *Hannover Corp. of America v. Beckner*,²¹⁴ denied a motion to dismiss by the lawyers.²¹⁵ In that case, the receiver alleged that the lawyer of the insolvent company breached his duty as an attorney to exercise reasona-

207. *Id.* at ¶ 2.

208. *Limor v. Buerger (In re Del-Met Corp.)*, 322 B.R. 781, 815 (Bankr. M.D. Tenn. 2005)

209. *Id.* at 820.

210. *In re Crown Vantage, Inc.*, 2004 U.S. Dist. LEXIS 13810, at *1 (N.D. Cal. July 14, 2004).

211. *Id.*

212. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995).

213. *Id.* at 1094-95.

214. *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849 (MD. La. 1997).

215. *Id.* at 860.

ble care and follow professional responsibility. The defendant challenged the receiver's standing and raised the *in pari delicto* defense. The *Hannover* court recognized deepening insolvency as an injury to the debtor and stated that *Hirsch* did not postulate that a corporation could not sustain injury resulting from "fraudulently extended life, dissipation of assets, or increased insolvency."²¹⁶

IV. THE NEMESIS

As the representatives of the estate, the bankruptcy trustees inherit the rights and claims that the debtor may have as well as any defense that may be asserted against the debtors.²¹⁷ One of these defenses is the *in pari delicto* doctrine.²¹⁸

A. *Whether In Pari Delicto is an Element of the Standing Analysis*

Before analyzing the doctrine, a procedural question as to whether the doctrine should be treated as a part of the standing analysis must be addressed.²¹⁹ Some courts look at the *in pari delicto* defense as a part of the standing analysis. The Tenth Circuit in *Sender v. Buchanan (In re Hedged-Investments Associates, Inc.)* denied standing on a bankruptcy trustee because it found that "to the extent [the trustee] must rely on 11 U.S.C. §541 for his standing in this case, he may not use his status as trustee to insulate the partnership from the wrongdoing of [the debtors' principal and the debtor]."²²⁰ On the question of standing, the Second Circuit follows the so-called *Wagoner* rule, which incorporates the *in pari delicto* analysis into the standing analysis.²²¹

216. *Id.* at 854-55.

217. S. REP. NO. 95-989, at 82 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5868; *Sender v. Buchanan (In re Hedged-Inv. Assocs., Inc.)*, 84 F.3d 1281, 1285-86 (10th Cir. 1996); Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356-57 (3d Cir. 2001); *In the Matter of Educators Group Health Trust*, 25 F.3d 1281, 1286 (5th Cir. 1994).

218. See *Hedged-Inv.*, 84 F.3d at 1285; *Lafferty*, 267 F.3d at 356-57.

219. See *Lafferty*, 267 F.3d at 346.

220. *Hedged-Inv.*, 84 F.3d at 1285.

221. *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991).

In *Shearson Lehman Hutton, Inc. v. Wagoner*, the trustee alleged that the trade account holder “aided, abetted, and unduly influenced [the debtor’s sole stockholder-principal] in making bad trades that dissipated corporate funds.”²²² The Second Circuit denied standing to the trustee, stating that “when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage to the creditors.”²²³ It further held that a “claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.”²²⁴

In *Hirsch*, the Second Circuit stated that it was “persuaded that the *Wagoner* rule should be applied” and held that the trustee was barred from bringing professional malpractice claims because of the debtors’ “collaboration” with the third-party defendants’ wrongdoing.²²⁵ *Hirsch* involved a ponzi scheme that later resulted in criminal convictions of the debtors’ general partners. The trustee in *Hirsch* brought an action against accountants and lawyers, alleging that by disseminating false documents to investors and providing improper services to the debtors and the debtors’ general partners, the defendants committed fraud, negligence, professional malpractice, breach of fiduciary duties, breach of contract, and RICO violation.²²⁶ Although the Second Circuit dealt separately with standing and the *in pari delicto* defense, the fact that both were analyzed in a section entitled “Standing of the Trustee” indicates that the Second Circuit maintained its position that the *in pari delicto* defense is a part of the standing analysis.

A bankruptcy court clearly explained the Second Circuit’s approach to the standing *in pari delicto* issue: “*Caplin, Wagoner, and Hirsch* . . . set out a two-step test [for standing.] First, the relief sought must be [one that the debtor-corporation could have sought had it not filed for bankruptcy]. Second, the debtor . . . would not have been precluded by its own conduct

222. *Id.* at 120.

223. *Id.* at 119.

224. *Id.* at 120.

225. *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085, 1094 (2d Cir. 1995).

226. *Id.* at 1092.

from suing the [defendants] prior to [the filing of its] bankruptcy."²²⁷

Other courts have treated standing and the *in pari delicto* defense independently.²²⁸ In *In the Matter of Educators Health Group Trust*,²²⁹ the Fifth Circuit dismissed the objection by the plaintiff that the debtor could not bring a cause of action that may be effectively invalidated by the *in pari delicto* defense. It stated:

[There is no] support for the proposition that a defense on the merits of a claim brought by the debtor precludes the debtor from *bringing* the claim. That the defendant may have a valid defense on the merits of a claim brought by the debtor goes to the resolution of the claim, and not to the ability of the debtor to assert the claim.²³⁰

The Third Circuit in *Lafferty* found "flawed" the lower court's ruling that the doctrine of *in pari delicto* was a part of the standing inquiry.²³¹ It stated that "[a]n analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*" because "[w]hether a party has standing to bring claims and whether a party's claims are barred by an equitable defenses are two separate questions, to be addressed on their own terms."²³² This separation seems consistent with

227. *Breeden v. Sphere Drake Ins. PLC (In re The Bennett Funding Group, Inc.)*, 1999 Bankr. LEXIS 1857, at *32 (N.D.N.Y. Aug. 6, 1999). The Second Circuit later separated the *in pari delicto* analysis from that of standing in *Official Committee of the Unsecured Creditors of Color Tile v. Coopers & Lybrand, LLP*. Official Comm. of the Unsecured Creditors of Color Tile v. Coopers & Lybrand, LLP, 322 F.3d 147, 152 (2d Cir. 2003). After holding the committee had standing to bring an action against an accounting firm, alleging breach of fiduciary duties and breach of contract, it affirmed the district court's dismissal of the action on the ground of the *in pari delicto* doctrine. *Id.* at 156-57 & 165-66. However, four months later, it went back to the same *Wagoner/Hirsch* inclusive method in *Breeden v. Kirkpatrick & Lockhart, LLP (In re Bennett Funding Group, Inc.)*. *Breeden v. Kirkpatrick & Lockhart, LLP (In re Bennett Funding Group, Inc.)*, 336 F.3d 94, 100 (2d Cir. 2003).

228. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 346 (3d Cir. 2001); *In the Matter of Educators Group Health Trust*, 25 F.3d 1281, 1286 (5th Cir. 1994).

229. *Educators*, 25 F.3d at 1281.

230. *Id.* at 1286.

231. *Lafferty*, 267 F.3d at 346.

232. *Id.*

Caplin. In denying standing on the reorganization trustee, the Supreme Court there reasoned, *inter alia*, that no “advantage” could be gained in granting standing because the debtor and the indenture trustee were in *pari delicto*.²³³ It did not state that the reorganization trustee lacked standing because of the *in pari delicto* doctrine.

B. *The Doctrine of In Pari Delicto*

The doctrine is derived from the Latin *in pari delicto potior est conditio defendentis* which means that when both parties are equally at fault, the defendant has a stronger position.²³⁴ Justice Gray in *St. Louis Vandalia & Terre Haute R.R. Co. v. Terre Haute & Indianapolis R.R. Co.*²³⁵ explained the *in pari delicto* doctrine as follows:

The general rule, in equity, as at law, is *In pari delicto potior est conditio defendentis*; and therefore neither party to an illegal contract will be aided by the court, whether to enforce it or to set it aside. If the contract is illegal, affirmative relief against it will not be granted, at law or in equity, unless the contract remains executory, or *unless the parties are considered not in equal fault*, as where the law violated is intended for the coercion of the one party, and the protection of the other, or where there has been fraud or oppression on the part of the defendant.

When the parties are *in pari delicto*, and the contract has been fully executed on the part of the plaintiff, by the conveyance of property, or by the payment of money, and has not been repudiated by the defendant, it is now equally *well settled that neither a court of law nor a court of equity will assist the plaintiff to recover*

233. *Caplin v. Marine Midland Grace Trust Co. of NY*, 406 U.S. 416, 429-30 (1972).

234. *Knauer v. Jonathon Roberts Fin. Group, Inc.*, 348 F.3d 230, 236 (7th Cir. 2003) (quoting W.M. Moldoff, Annotation, *Purchaser's Right to Set Up Invalidity of Contract Because of Violation of State Securities Regulation as Affected by Doctrines of Estoppel or Pari Delicto*, 84 A.L.R.2d 479, 491 (2005)); Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP, 322 F.3d 147, 158 (2d Cir. 2003).

235. *St. Louis Vandalia & Terre Haute R.R. Co. v. Terre Haute & Indianapolis R.R. Co.*, 145 U.S. 393, 407 (1892).

*back the property conveyed or money paid under the contract.*²³⁶

Traditionally, the doctrine applies in proceedings predicated on actions that involve statutory violations.²³⁷ Courts have recognized the doctrine in contract, tort and private actions for damages.²³⁸ They have expanded the doctrine to circumstances comparable to those covered by the "unclean hands doctrine."²³⁹

So far, the doctrine has been the most formidable obstacle to the deepening insolvency claim. The Seventh Circuit in *Cenco Inc. v. Seidman & Seidman* held that the Illinois laws allowed the auditors of a corporation to raise the issue of the corporation's officers' misconduct as a defense against claims of breach of contract, professional malpractice, and fraud.²⁴⁰ The Third Circuit in *Lafferty* held that under the Pennsylvania law the *in pari delicto* doctrine barred recovery to the committee because the sole shareholder dominated the ownership and control of the debtors. Thus, the corporation was responsible for giving such responsibility to an agent.²⁴¹

However, the reliance on this doctrine in denying recovery under the deepening insolvency claim is misplaced. First, the doctrine is narrowly applied to situations where the plaintiff has "equal" or "at least substantially equal responsibility for his injury."²⁴² The plaintiff "must be an active, voluntary participant in the unlawful activity that is the subject of the

236. *Id.* (internal citations omitted and emphasis added).

237. *Pinter v. Dahl*, 486 U.S. 622, 634 (1988).

238. *Id.* (strict liability cases); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (a private action alleging security violations); *Terre Haute*, 145 U.S. at 407 (contract cases).

239. *Pinter*, 486 U.S. at 632.

240. *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982).

241. *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 359-60 (3d Cir. 2001).

242. *Pinter*, 486 U.S. at 635-36; *Bateman*, 472 U.S. at 306-7; *Harriman v. Northern Sec. Co.*, 197 U.S. 244, 296 (1905) (no relief granted if parties are in equal fault); *Miller v. Interfirst Bank Dallas, N.A.*, 608 F. Supp. 169, 171 (N.D. Tex. 1985) (in order to be *in pari delicto*, "(1) the fault of the parties must be clearly mutual, simultaneous, and relatively equal; (2) the plaintiff must be an active, essential, and knowing participant in the illegal activity; and (3) the effect on the investing public or on the regulatory scheme, caused by permitting the defense, must be so slight that it does not interfere with the objectives of the securities laws"). *Id.*

suit.”²⁴³ “Plaintiffs who are truly *in pari delicto* are those who have themselves violated the law in cooperation with the defendant.”²⁴⁴ Hence, unless the levels of fault are “essentially indistinguishable or the plaintiff’s responsibility is clearly greater,” courts should not apply the *in pari delicto* doctrine and should grant recovery to the plaintiff.²⁴⁵ In determining relative responsibility, courts look at the extent of the cooperation in developing and executing the wrongdoing.²⁴⁶

Clearly, corporations are not “biological entities.”²⁴⁷ They remain “a wholly artificial creation.”²⁴⁸ They cannot think and act on their own. They are controlled by the directors, officers and controlling stockholders. Thus, they cannot be active and voluntary participants in the wrongdoings. Further, mere knowledge of the wrongdoings cannot on its own constitute equal fault.²⁴⁹ Simply put, there is no *in pari delicto* between the victim corporation and the directors, officers, stockholders and other professionals engaging in deepening insolvency. Where there was “inequality of condition” between the parties, the doctrine is clearly not applicable.²⁵⁰

Second, the doctrine is applicable “only if preclusion of suit does not offend the underlying statutory policies.”²⁵¹ By enacting the Bankruptcy Code, Congress sought to counter and reduce the “potential for fraud, for self-dealing, and for diversion of funds” in bankruptcy.²⁵² Deepening insolvency

243. *Pinter*, 486 U.S. at 636; *Banc One Capital Partners Corp. v. Kneipper*, 67 F.3d 1187, 1197 (5th Cir. 1995).

244. *Pinter*, 486 U.S. at 636.

245. *Id.*

246. *Id.* at 637 (“courts frequently have focused on the extent to which the plaintiff and the defendant cooperated in developing and carrying out the scheme to distribute unregistered securities”).

247. *In re Investors Funding Corp. of N.Y. Sec. Litig.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

248. *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 549 (1949).

249. *Pinter*, 486 U.S. 622, 636 (1988) (“a purchaser [of unregistered securities]’s knowledge that the securities are unregistered cannot by itself, constitutes equal culpability, even where the investor is a sophisticated buyer who may not necessarily need the protection of the Securities Act”) (emphasis added).

250. *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 133 (2d Cir. 1993) (The doctrine is not available “where the parties do not stand on equal terms and one party controls the other”).

251. *Pinter*, 486 U.S. at 637-78.

252. H. R. REP. NO. 95-598 at 6050 (1978) (“The practice in bankruptcy is different [from most litigation] for several reasons. First, there is a public

claims specifically allege these concerns. Precluding recovery under these claims by the operation of the *in pari delicto* doctrine would lead to a result in direct contrast to this congressional intent in enacting the Bankruptcy Code.

Third, once again, it is well-established that directors, officers and controlling shareholders are considered fiduciaries of a corporation.²⁵³ Their duties as fiduciaries can be directly enforced by the corporation.²⁵⁴ Imputing to the corporation its agent's wrongdoing in which the corporation was not a voluntary, active participant, and thus, barring recovery under the *in pari delicto* doctrine in the deepening insolvency cases would effectively wipe out the corporation's right to enforce the fiduciary duties owed to it by its directors, officers and controlling shareholders.

Fourth, the "classic formulation of the *in pari delicto* doctrine itself require[s] a careful consideration of [public policy] implications before allowing the defense."²⁵⁵ The *in pari delicto* doctrine has been used to bar recovery in deepening insolvency cases based on either the notion that the prolonged corporate life and additional capital, albeit fraudulent, automatically benefit the corporation (the "automatic benefit notion") or the sole-actor exception.²⁵⁶ The essence of the automatic benefit notion is well explained by Justice Williams in *Patterson*:²⁵⁷

interest in the proper administration of bankruptcy cases. Bankruptcy is an area where there exists a significant potential for fraud, for self-dealing, and for diversion of funds").

253. *Weintraub*, 471 U.S. at 343, 355; *Pepper*, 308 U.S. at 295, 306; *Cohen*, 337 U.S. at 549.

254. *Pepper*, 308 U.S. 295 at 307.

255. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

256. See *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 358-60 (3d Cir. 2001). In a deepening insolvency case, the *in pari delicto* doctrine comes into play by the operation of agency law, which includes the law of imputation which provides that an agent's wrongdoing is imputed to the principal when the wrongdoing in the "course of his employment" and "for the benefit" of the principal. The sole-actor exception imputes the wrongdoing of the dominant and sole-controlling agent to the corporation even if the wrongdoing adversely affected the corporation. *Id.*; see also *supra* notes 17 & 30.

257. *Patterson*, 176 Pa. at 612, 615.

But how can the corporation complain? The fraud was perpetrated for its benefit . . . It was given a considerable credit by the statement . . . Let it be conceded that this statement was absolutely false, still no one could legally complain of it who was not injured by it. If A falsely represents to B that C is worth a certain sum of money and is therefore worthy of credit; B if misled, and a loser because of the fraud upon him, might justly complain; but C, who benefited by the fraud, could have no just complaint against A growing out of his false representation to B.

Courts have repeated the same sentiment throughout the relevant legal history.²⁵⁸ Recently, a district court in New York stated that the debtor benefited from the use of the fraudulent financial statement because it received goods and services as a result of this use.²⁵⁹

The automatic benefit notion simply “collides with common sense.”²⁶⁰ It cannot be presumed that any conduct that

258. *See, e.g.*, *Kinter v. Connolly*, 233 Pa. 5, 2 81 A. 905 (1911).

If the defendants [officers and directors of an insolvent corporation] published statements which they knew, or ought to have known, to be false, with the result that their company gained a fictitious credit at the expense of those thus encouraged to do business with it, the wrong was suffered by the latter, and not by the corporation, and gave rise to no liability on the part of the defendants that the corporation or its receiver can enforce.

See also *Bergeson v. Life Ins. Corp. of Am.*, 265 F.2d 227, 232-33 (10th Cir.). In a shareholder derivative action against directors, officers and accountant, the Tenth Circuit affirmed a summary judgment in favor of the defendants, and found “wholly fallacious” the argument that the corporation was harmed by the defendants’ failure to disclose the corporation’s true financial nature, thereby allowing the corporation to exist as a stock insurer without the statutorily required capital and reserve, holding that, “[w]hateyer improprieties there may have been, the result was not a legal injury to the corporation,” but a benefit to it by enabling it to achieve the corporate objective to qualify as a stock insurer.” *Id.* at 233 The Tenth Circuit stated:

The company has lost nothing. The fact that it may have gained something to which it was not entitled does not lead to the conclusion that it was thereby deprived of anything. The company received a benefit, the grant of the desired authority. The detriment, if any, was suffered by others.

Id. at 232.

259. *Colotone Liquidating Trust v. Bankers Trust N.Y. Corp.*, 243 B.R. 620, 622 (S.D.N.Y. 2000).

260. *Schacht*, 711 F.2d at 1343, 1350.

prolongs the corporate life automatically benefits the corporation.²⁶¹ “[O]stensibly beneficial additional capital may in some cases prove harmful to a corporation.”²⁶² The corporation clearly suffers direct injuries resulting from deepening insolvency.²⁶³ The Third Circuit has declined to apply *Patterson* to the deepening insolvency issue, considering the passage of time, changes in business practices and development of corporate theories since *Patterson*.²⁶⁴

The doctrine of *in pari delicto* is an equitable doctrine.²⁶⁵ Therefore, in applying the doctrine, equity is “crucial.”²⁶⁶ Barring recovery under the doctrine of *in pari delicto* in the deepening insolvency cases would render the wrongdoers immune from liability so long as they remain directors, officers or controlling shareholders or obtain the aid of such individuals of the corporate victim.²⁶⁷ It would give “perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible,” while the company sustains massive losses.²⁶⁸ It would lead to an absurd result: denying equity by the operation of a doctrine that is designed to achieve equity.²⁶⁹ The prudent words of Justice Cardozo should be remembered: even the “logical consistency. . . will indeed be sacrificed at times when the sacrifice is essential to the end that some accepted public policy may be defended or upheld.”²⁷⁰ In sum,

261. *In re Investors Funding Corp. of N.Y. Sec. Litig.*, 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

262. *Allard v. Arthur Andersen v. Co.*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996).

263. *See supra* pt. II(A)(1).

264. *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 352 (3d Cir. 2001)

265. *Id.* at 354.

266. *Limor v. Buerger (In re Del-Met Corp.)*, 322 B.R. 781, 819 (Bankr. M.D. Tenn. 2005) (quoting *Baker O’Neal Holdings, Inc. v. Ernst & Young LLP*, NO.1:03-CV-0132-DFH, 2004 WL 771230 (S.D. Ind. Mar. 24, 2004)).

267. *Baker O’Neal Holdings, Inc. v. Ernst & Young LLP*, 2004 U.S. Dist. LEXIS 6277, at *29-30 (S.D. Ind. March 24, 2004).

268. *Schacht*, 711 F.2d at 1343, 1350.

269. *See generally In re Jack Greenberg Inc.*, 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999) (“[e]quitable defenses such as the doctrine of imputation that may be sustainable against the corporation may fail to act as a total bar to recovery when the beneficiaries of the action are the corporation’s innocent creditors . . .”).

270. *Berkey v. Third A.R. Co.*, 244 N.Y. 84, 95 (N.Y. 1926).

the deepening insolvency cases, other than fraudulent transfer ones, are “the best case[s] for not applying the *in pari delicto* defense.”²⁷¹

V. CONCLUSION

The deepening insolvency theory is not a novel concept. It can be traced all the way back to the time of horses and buggies. Over the years various versions of the theory have been asserted although they have not fared well under the blade of the misguided concept that expansion of corporate life and debt, albeit fraudulent, automatically benefits the corporation. Lately, such misconception has been disproved by many courts. The challenge to the bankruptcy trustees' standing to assert a deepening insolvency claim against the third-party defendants has lost its luster. All of the standing requirements are easily satisfied and thus, the bankruptcy trustees, as the representatives of the bankruptcy estate, can bring the deepening insolvency claim on behalf of the debtor-corporation. The affirmative defense of the *in pari delicto* doctrine simply does not bar recovery under this claim because: (1) the offending third-party defendants and the debtor-corporation are clearly not *in pari delicto*; (2) barring recovery by the application of the doctrine in the deepening insolvency cases contradicts the congressional intent in enacting the Bankruptcy Code; (3) barring recovery would result in an absurd result of denying equity under a doctrine used to achieve equity; and (4) application of the doctrine would wipe out the corporation's right to enforce fiduciary obligations owed to it by the directors, officers and others.

In the era following Enron, WorldCom and the savings and loan scandal, enforcing business ethics should not remain a distant regulatory function. Most U.S. and foreign citizens delve into investing in U.S. corporate bonds and equity. If the investing public is misled by fiduciaries, the U.S., if not the world, economy will again face downturns like those witnessed as recently as in the year 2000. Leaving the enforcement of

271. *Baker*, 2004 U.S. Dist. LEXIS 6277, at *30 (Aside from the fraudulent transfer cases, “the best case for not applying the *in pari delicto* defense is where the insider and the third-party tortfeasor were essentially acting as co-conspirators”).

corporate ethics to regulatory agencies alone will not achieve the level of corporate responsibility necessary for the growth of the U.S. and world economy and the restoration of public faith in corporate leadership.

Since the 1980s, the deepening insolvency theory has been accorded wide judicial recognition. Such recognition coupled with the correct understanding and application of the theory and the relevant doctrines would certainly provide a strong tool in enforcing corporate ethics by encouraging responsibility and adherence to business ethics.