

**DEEPENING INSOLVENCY AS A CAUSE OF ACTION AND AS
A THEORY OF DAMAGES**

“Shell Games” Ponzi Scheme Cases: The Liability of Investors,
Sales Agents, Professionals and Others

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I. Introduction

Some courts permit claims against professionals under the theory of "deepening insolvency," as either an independent cause of action or as a theory of damages. Deepening insolvency has been defined as "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 347 (3d Cir. 2001). Below is a summary of how the leading cases have decided the issue.

II. Cases Recognizing Deepening Insolvency as Independent Cause of Action

Third Circuit: *Lafferty* held that the creditors' committee had standing to pursue claims for deepening insolvency against the debtor's lawyers, accountants and underwriters for conspiring with the debtor to fraudulently issue debtor securities as part of a Ponzi scheme.

However, in *Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)*, 448 F.3d 672 (3d Cir. 2006), the Third Circuit limited the scope of its prior recognition of deepening insolvency to situations in which the defendants engaged in fraud and refused to recognize deepening insolvency as a theory of damages.

Ninth Circuit: *Smith v. Arthur Andersen LLP*, 421 F.3d 989 (9th Cir. 2005) recognized deepening insolvency when the allegations were that the defendants misrepresented the firm's financial condition to its outside directors and investors. The court agreed with the Third Circuit's statement in *Lafferty* that "prolonging an insolvent corporation's life through bad debt may" dissipate corporate assets and thereby harm the value of corporate property; however, the

Smith court did not need to decide the issue of the appropriateness of the deepening insolvency theory.

Other Cases: *Forman v. Salzano (In re Norvergence, Inc.)*, 405 B.R. 709, 758 (Bankr. D.N.J. 2009) (predicting that the New Jersey Supreme Court “would recognize a claim for deepening insolvency when there has been harm or damage to the corporate debtor.”)

Generally speaking, courts that have permitted a cause of action for deepening insolvency require the following elements to establish the cause of action: (1) fraud, (2) which causes the expansion of corporate debt, and (3) which prolongs the life of the corporation. *Official Comm. Of Unsecured Creditors v. Foss (In re Felt Mfg. Co., Inc.)*, 371 B.R. 589 (Bankr. D.N.H. 2007). These courts have required a finding of fraud and have refused to extend the scope of deepening insolvency liability to negligent acts. *Citx Corp.*, 448 F.3d at 681; *Dixon v. Am. Cmty. Bank & Trust (In re Gluth Bros. Constr., Inc.)*, 424 B.R. 379, 390 (Bankr. N.D. Ill. 2009) (if Illinois were to recognize the theory of deepening insolvency, it would only do so in the context of a claim of fraud"); *OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, 340 B.R. 510, 534 (Bankr. D. Del. 2006) (interpreting *Lafferty* to hold that only fraudulent conduct will suffice for deepening insolvency claim).

However, some courts have found that negligence is sufficient and that the defendant need not have engaged in actual fraudulent behavior. *See, Smith*, 421 F.3d at 995 (recognizing deepening insolvency where allegations were that the defendants "misrepresent[ed] (not necessarily intentionally) the firm's financial condition to its outside director and investors").

In addition to the requirement of either fraud or negligence, causation of damages must be established. The Third Circuit recently found that there was no proximate causation established between the infusion of cash into the debtor and the increased insolvency of the

debtor. *Marion v. TDI Inc.*, 591 F.3d 137, 150 (3rd Cir. 2010). The Third Circuit explained, "Between the initial act (the injecting of money into the business) and the end result (the expansion of the company's debt relative to where it was prior to the cash infusion) stand the intervening acts of the company's management (i.e., what it chose to do with the money)."

III. Cases Rejecting Deepening Insolvency as Independent Cause of Action

Fifth Circuit: *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355, 363 (5th Cir. 2008), rejected the theory of deepening insolvency as an independent cause of action and as a theory of damages.

Torch Liquidating Trust v. Stockstill, 561 F.3d 377 (5th Cir. 2009), held that Delaware does not recognize cause of action on behalf of corporation for deepening insolvency.

Seventh Circuit: *Fehribach v. Ernst & Young LLP*, 493 F.3d 905 (7th Cir. 2007), rejected a deepening insolvency claim against debtor's auditors because it was not based on an existing legal duty.

See also, Alberts v. Tuft (In re Greater Se. Cmty. Hosp. Corp.), 333 B.R. 506 (Bankr. D.D.C. 2005) (Under District of Columbia law, there was no separate cause of action for the tort of deepening insolvency based on directors' and officers' alleged breach of their fiduciary duties to corporations by allowing the corporations to fall deeper into debt for the benefit of lender, directors, and officers.).

Trenwick Am. Litigation Trust v. Ernst & Young, LLP, 906 A.2d 168, 204-205 (Del. Ch. 2006), *aff'd*, 931 A.2d 438, (Del. 2007) (holding that deepening insolvency is not recognized as a separate cause of action under the law of Delaware); *Official Comm. of Unsecured Creditors of*

Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.), 353 B.R. 820, 842 (Bankr. D. Del. 2006) (dismissing causes of action for breach of fiduciary duty and aiding and abetting breach of fiduciary duty because “simply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster.”).

IV. Cases Recognizing Deepening Insolvency as a Theory of Damages

Many courts find that, to the extent that a party has committed an independent, legally cognizable tort, they may be liable to the extent that the misconduct led to the deepening insolvency of the debtor, even though they may not recognize deepening insolvency as an independent cause of action. *Thabault v. Chait*, 541 F.3d 512, 522 (3d Cir. 2008).

Silverman v. KPMG, LLP (In re Allou Distribs., Inc.), 395 B.R. 246, 264-65 (E.D.N.Y. 2008) (“Courts in this Circuit have considered deepening insolvency as a basis for damages that may result from the commission of a separate tort.”)

Vieira v. AGM II, LLC (In re Worldwide Wholesale Lumber, Inc.) 378 B.R. 120 (Bankr. D.S.C. 2007) (South Carolina would recognize deepening insolvency as a theory of damages if asserted in connection with a breach of fiduciary duty claim.)

Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139 (Bankr. E.D. Va. 2007) (Virginia Supreme Court would not recognize tort of deepening insolvency, but would recognize it as a theory of damages.)