DEEPENING INSOLVENCY PART I
A CHALLENGING NEW THEORY OR
JUST THE SEARCH FOR A DEEPER POCKET?*

By: Phil C. Appenzeller, Jr., Esq.
Ross H. Parker, Esq.
Munsch Hardt Kopf & Harr, P.C.
4000 Fountain Place
1445 Ross Avenue
Dallas, Texas 75202

214-855-7500
Pappenzeller@munsch.com
Rparker@munsch.com

TMA 2005 SPRING CONFERENCE
MARCH 9 – 12, 2005

* Phil and Ross have made every attempt to make this article more than an academic exercise by offering personal opinions and insight gained through their litigating the issues discussed herein. Their opinions, however, are just that--their opinions. Phil and Ross do not represent that their opinions are correct or that the authors of future opinions will give a darn about what they think, unless of course they do, in which case Phil and Ross are free to say "I told you so." If an attorney or a judge favorably incorporates one of their opinions in the future, Phil and Ross reserve the right to claim credit and boast to their friends.

The doctrine of deepening insolvency is developing and there are legitimate differences of opinion with respect to its application and operation. Phil and Ross do not know what the future will hold and they acknowledge that they may change their opinions, especially if ordered to do so by a court or a client. Therefore, Phil and Ross should not be constrained or prejudiced in any way by what they state herein. They reserve the right to disavow any statement made herein and to contradict themselves in the future. You are, of course, free to contradict their opinions at any time, but they would prefer otherwise.

DEEPENING INSOLVENCY PART I
A CHALLENGING NEW THEORY OR
JUST THE SEARCH FOR A DEEPER POCKET?*

I. Introduction.

There is a scene in the movie *The Princess Bride*[1] where the hero, Westley, has been tortured to the point of death. Hoping to heal him, Westley's friends take him to the old wizard. The wizard examines Westley and announces that Westley is not all the way dead but only "mostly dead." Much like Westley, many companies teeter on the edge of death but retain the hope that they can survive. In the legal vernacular, a company that is only mostly dead is "in the zone of insolvency." When a company is in the zone of insolvency, potential liability for its officers and directors increases. Creative lawyers, disgruntled shareholders and aggressive trustees and creditors' committees now use zone of insolvency theories to hold corporate management, auditors, professionals and lenders responsible for a company's demise.

The following scenario is an example of this theory at work. Assume you have been hired as the CEO of a struggling company in the professional-services industry. You believe that with proper marketing, the company's services will be in demand. Before you came aboard, the company, in accordance with its roll-up business model, acquired several smaller, similarly-situated companies. The company's plan was to increase its size and scope and develop a nation-wide footprint.

Unfortunately, the by-product of the company's aggressive acquisition plan (and consequent delays in getting its services to market) left the company with a serious cash-flow problem. You call a meeting with the company's CFO to discuss a strategy for improving cash flow so that the roll-up business model be given a chance to succeed.

[1] The Princess Bride (MGM Pictures 1987).

There are two potential sources of funding. First, the company has a credit line of $5 million. The credit line is linked to the company's receivables and work in process ("WIP"). Currently, the company is only using approximately $2 million of its credit line. As you examine the books with the CFO, you determine that there are enough receivables and WIP to maximize the credit line. The CFO expresses concern about the age of the receivables and candidly informs you that he employed aggressive accounting methods when estimating the WIP. He assures you, however, that the company's financials have been thoroughly audited by the company's outside auditors and all the financials were provided to the lender.

The second source of financing is through an investment bank that maintains an equity position in the company. The bank has indicated an interest in loaning the company an additional several million dollars in exchange for a future conversion of the notes to preferred equity. The investment bank also relied on the company's financials when committing to loan additional funds.

As you weigh your options, you see one of two possibilities. First, because the company's liabilities exceed its income, you could recommend that the board vote to declare bankruptcy and seek to restructure the company in Chapter 11. The second alternative is based on your belief that you can make this company succeed. You have done it before. After all, it is your track record that attracted the board to you. In order to do this you need funding. You decide to go with a combination of both option 1 and option 2. The company increases its draw on the credit line and obtains financing from the investment bank.

A year later, you meet with the CFO to discuss the company's financial situation. While the company's gross revenues have been anything but stellar, it certainly should not bleed cash at its current alarming rate. The CFO indicates that the problem is two-fold. First, the receivables are much worse than he thought. Optimistically, he assumed that many of the company's clients were just slow pay. In fact, some were teetering on bankruptcy or had already shut down; the receivables, however, remained on the company's books. Second, he had grossly overestimated the WIP. Current cash levels are insufficient to meet near-term obligations such as payroll and other overhead items, moreover, the company will be unable to service its debt obligations on a go-forward basis. You realize that you must declare bankruptcy and recommend this to the board.

Within a few months after declaring bankruptcy, a lawsuit arrives at your door. You have been sued along with other members of the management team, the auditors and the investment bank. The lawsuit claims you breached your fiduciary duties to the company by deepening its insolvency and the other defendants aided and abetted you in causing the company's demise. You think, "Wait a minute, this company was mostly dead when I took over, I just tried to help it--would it have been better if I just killed it off twelve months ago?" Under the deepening insolvency theory, the answer is, perhaps.

II. What Does Deepening Insolvency Mean?

The deepening insolvency theory derives from the notion that a corporation is injured when its life is artificially and wrongfully extended past its current state of insolvency. "The premise underlying the deepening insolvency theory is that even an insolvent company has some value, which could be salvaged if a company is liquidated or

restructured in a timely manner."[2] Creditors' committees, trustees and shareholders often invoke this theory when there is evidence that company insiders lined their own pockets while simultaneously saddling the company with excess debt. Although the deepening insolvency theory has been around for some time, the recent spotlight on corporate malfeasance has expanded the doctrine. As a result, it now receives increased use and attention; this theory is one of the tools plaintiff's lawyers use to recover for those left holding the bag when a company goes under.[3] As the cases cited herein provide, the deepening insolvency theory is just that – a theory. Courts disagree on how to view the doctrine of deepening insolvency. Because of this, a consistent and developed body of case law has yet to evolve.

Under normal circumstances, a corporation's officers and directors only hold duties to the company and its shareholders, not to its creditors.[4] Once the company goes into a state of insolvency, however, the officers and directors are now obligated to refrain from actions detrimental to the company's creditors. Under the zone of insolvency theory, officers and directors can be liable for money damages to creditors resultant from the directors' and officers' breaches of fiduciary duties to creditors while the company is in the zone of insolvency. This expansion of the duties owed by a company's directors and officers to include creditors while the company is in the zone of insolvency is one of the hallmarks of this cause of action. Further, other third parties that aid and abet breaches of the officers' and directors' fiduciary duties may also be liable. In this manner, the

---

[2] Kyung S. Lee, James D. McCarthy and Erin E. Jones, *Deepening Insolvency Doctrine – An Emerging Remedy Against Contemporary Corporate Malfeasance*, 23rd Annual Bankruptcy Conference; November 18 – 19, 2004.

[3] *Id*. at 3.

[4] *See, In re Ben Franklin Retail Stores, Inc.,* 225 B.R. 646, 652-52 (Bankr. N.D. Il. 1998); *In re Global Service Group, LLC,* 316 B.R. 451, 459-60 (Bankr. S.D.N.Y. 2004).

theory has been used as cause of action and a measure of damages against accountants that damage the company through fraudulent or negligent auditing practices, as well as other professionals and advisors.[5]

As the deepening insolvency doctrine emerges as a cognizable cause of action, the theory behind it is neither fully defined nor universally accepted. What is universally accepted is that this is a pre-petition claim that can be brought on behalf of the debtor entity. The claim does not appear to survive as a post-petition cause of action. While the elements of the cause of action seem to vary by jurisdiction, an analysis of the pertinent case law reveals that the following four factors are required to sustain a deepening insolvency claim: (1) fraudulent or wrongful prolongation of an insolvent corporation's life by hiding its true financial condition; (2) causing the corporation to become more insolvent by incurring additional liabilities or dissipating its assets; (3) value that could have otherwise been realized if the corporation's business activity had not been improperly prolonged is lost; and, (4) the corporation suffers harm distinct from the harm suffered by its creditors.[6]

There exist differing theories as to when insolvency occurs, however, the "balance sheet approach" has emerged as the most accepted and easiest to apply. This insolvency test requires a simple inquiry: do the company's liabilities exceed its assets? If so, then the company is insolvent. Not surprisingly, a broad application of the balance sheet approach leads one to conclude that most companies have been insolvent (or at least on

[5] See, *Allard v. Arthur Anderson & Co. Inc.,* 924 F. Supp 499 (S.D.N.Y. 1996); *In re Gouiran Holdings Inc.,* 165 B.R. 104 (E.D.N.Y. 1994).
[6] Paul Rubin, *New Liability Under "Deepening Insolvency": The Search for Deep Pockets,* 23-3 ABIJ 50, 51.

the verge of insolvency) during their lifetimes.[7] If this is the case, then the follow-up question must be asked: is it fair to hold officers, directors and others liable when they take actions that they believe will revive or sustain a company but the company ultimately fails?

III. What the Courts Are Saying.

The theory of deepening insolvency is developing and gaining a foothold in our jurisprudence. As stated previously, the theory is not universally accepted or defined. Part of the reason is that the doctrine turns on well-entrenched and developed state law theories regarding fiduciary duties; each state's courts must address whether they choose to adopt or reject the doctrine. Because federal courts must apply state law to most common law claims, conflicts arise between the various federal courts as to the applicability of the doctrine.

As a threshold matter, it is important to understand that a director's or officer's duties to a company continue to exist when a company becomes insolvent and when it enters the zone of insolvency.[8] Under Delaware law (and the law of most states), a director does not typically owe fiduciary duties to the company's creditors because the relationship between debtor (the company) and creditor is contractual in nature. At the moment the corporation becomes insolvent, however, this invisible act of crossing over into insolvency increases those duties owed by the directors and officers such that those

---

[7] *See e.g., U.S. Bank National Association v. U.S. Timberlands Klamath Falls, LLC,* 2004 Del. Ch. LEXIS 9, *44 (2004) ("Insolvency means more then late payments. The best inference is the disparity between assets and liabilities. While it can be rightly argued that having liabilities in excess of the book value of assets is not dispositive of the issue of whether a company is insolvent. If it were, many start-up companies would be insolvent. However, the existence of a disparity in assets and liabilities in a mature company is a material fact that the company is in the zone of insolvency.")

[8] *Official Committee of Bond Holders of Metricom v. Derrickson*, 2004 U.S. Dist LEXIS 19494, *7 (N.D. Ca. 2004).

duties now also flow to the company's creditors.[9] Creditors have a right to expect that directors will not divert, dissipate or unduly risk assets that satisfy their claims.[10] The duty, however, does not run only to creditors but to the company's "community of interests." Thus, while this duty does not necessarily place a creditor's interest ahead of the interests of stockholders, it does require the board to maximize the corporation's long-term-wealth-creating capacity.[11]

Now that the underlying duty is defined, the next issue is to examine the potential claims that arise once that duty is breached. Some courts have rejected the theory of deepening insolvency as a cause of action.[12] Other courts expressly recognize it.[13] The theory developed in the 1980's and was born, in part, by the concern that a corporation's management could hide a company's true financial condition from its shareholders and continue to incur debt on its behalf. The Seventh Circuit in *Shacht v. Brown* went so far as to state that this could create, "perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body for as long as possible."[14] This would deprive shareholders of the right to cut their losses and exercise their right to dissolve the company. The *Shacht* opinion is widely followed, "as a seminal case acknowledging deepening insolvency as a corporate injury

[9] *Id*. at *8.
[10] *Id., citing, In re Ben Franklin Retail Stores, Inc.* 225 B.R. 646, 655 (Bankr. N.D. Il. 1988)(amended and superceded by *Steinberg v. Kendig,* 2000 U.S. Dist LEXIS 276).
[11] *Id. at *9.*
[12] *In re Ben Franklin Retail Stores, Inc.* 225 B.R. 646 (Bankr. N.D. Ill. 1998) (complaint dismissed for failure to state a claim where the trustee alleged the defendants used misleading financial information to incur substantial debt and wrongly prolonged the corporation's life).
[13] See, e.g. *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* 267 F.3d 340, 352-53 (3rd Cir. 2001)(this case explicitly recognizes the theory of liability based on zone of insolvency, however, the court dismissed the case for other reasons before applying the doctrine).
[14] *Schacht v. Brown,* 711 F. 2d 1343, 1350 (7th Cir. 1983).

and paving the way for other courts to recognize the theory not only as a measure of damages, but also as an independent cause of action."[15]

One key concern courts faced when initially addressing this issue was determining why a company's officers and directors would deepen the insolvency of their company. Because a corporation may or may not benefit from additional debt, courts reject the notion that prolonged life is always in the corporation's best interest. [16] For example, if the motivation for prolonging the corporation's life is to hide bad acts of the officers and directors, to allow the officers and directors to line their pockets or to allow the officer's and directors to loot the company, then clearly the motivation for prolonging the company's life is nefarious. It is generally in instances where there are overt acts of wrongdoing that one sees deepening insolvency theories applied.

Two recent cases demand further analysis and are illustrate the development on this theory. In *Off'l Comm. Of Unsecured Creditors v. R.F. Lafferty and Co.*, 267 F. 3rd 340 (3d Cir. 2001), the owner of the debtor companies caused them to issue fraudulent debt certificates that were then sold to individual investors. The business operated as a Ponzi scheme and when the companies could not repay the outstanding debts, the debtors filed bankruptcy.[17] The creditors' committee brought claims on behalf of the debtor companies against the company's insiders, its attorneys, accountants and underwriters alleging that they fraudulently induced the companies to incur additional indebtedness

---

[15] Kyung S. Lee, James D. McCarthy and Erin E. Jones, *Deepening Insolvency Doctrine – An Emerging Remedy Against Contemporary Corporate Malfeasance*, 23rd Annual Bankruptcy Conference November 18 – 19, 2004, p. 9.

[16] *See, In re Investors Funding Corp of N.Y. Securities Litigation,* 523 F. Supp 533, 541 (S.D.N.Y. 1980) (where a the company's insiders misappropriated company funds and then caused the company to take on increased debt to hide their fraudulent activities, the court stated "a corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it).

[17] *Lafferty,* 267 F.3d at 344.

thereby deepening the insolvency of the companies and forcing them to declare bankruptcy. [18]

As stated earlier in this article, the issue of whether a plaintiff can proceed under a cause of action based on zone insolvency theory rests on state law. Because the state of Pennsylvania (the state where the companies in *Lafferty* were located) had not explicitly recognized an independent cause of action for deepening insolvency, the Third Circuit had to determine whether deepening insolvency was a cognizable cause of action under Pennsylvania law. According to the Third Circuit, the Supreme Court of Pennsylvania applied three factors when considering whether it would recognize deepening insolvency as a cause of action. These factors are (1) whether the theory was sound, (2) whether the theory was growing in acceptance by the courts; and, (3) what is the remedial theme in Pennsylvania law where there is an injury?[19] Applying these factors, the Third Circuit found that (1) the theory, especially in the bankruptcy context, was sound; (2) there is a growing acceptance of this theory by the courts; and, (3) there are numerous cases in which deepening insolvency was found to give rise to a cognizable injury. In recognizing the cause of action, the court stated that, as in most jurisdictions, the principles of Pennsylvania jurisprudence hold that where there is an injury the law provides for a remedy.[20]

In the second significant case, *In re Exide Technology, Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003), the U.S. Bankruptcy Court in Delaware was faced with the scenario where a lender had extended credit to a financially troubled borrower in exchange for additional security. The lender's credit extension caused the borrower to remain in business,

---

[18] *Id*, at 346.
[19] *Id*. at 349-50.
[20] *Id*. at 350.

essentially for the lender's benefit. The court found that where there was little or no hope for recovery, the lender was extracting value from the borrower at the expense of the borrower's unsecured creditors. The unsecured creditors might have been repaid at a higher percentage of their claims had the borrower not been "propped up" with additional secured financing. Therefore, the court held that the creditors' committee could maintain a cause of action against the lender for deepening the insolvency of the company.[21] Many of *Exide's* background facts can occur in turnaround situations. As such, further elaboration of the *Exide* facts is deserved.

In 1997, two lenders led a syndicate of more than 80 banks that established a $650 million credit facility for the lead borrower, Exide Technologies, Inc., and its subsidiaries. Exide and its affiliates incurred significant losses in 1998 and 1999. By the first quarter of 2000, Exide was insolvent based on a balance-sheet approach. In late 2000, the lending syndicate made an additional loan of $250 million so that Exide could acquire a competitor. In exchange for its second-round financing, the lending syndicate received additional collateral and guarantees from the borrowing group that were more valuable than the consideration they provided. By this time, the lenders had significant leverage and control over Exide and its subsidiaries.[22]

Exide's financial condition continued to deteriorate. In June 2001, Exide informed certain lenders that it was facing financial troubles. In September, Exide announced layoffs. Following the layoffs, one of Exide's lenders forced it to jettison its CFO and replace him with a principal from a restructuring advisory firm used frequently by one of

---

[21] *In re Exide Technology Inc.,* 299 B.R. at 736.
[22] Paul Rubin, *New Liability Under "Deepening Insolvency": The Search for Deep Pockets,* 23-3 ABIJ 50, 51 Apr. 2004 (note that Rubin obtained the recitation of the *Exide* facts from plaintiffs' complaint and from memorandum decisions by the court in that case; see e.g., fn. 9 in Rubin's article.)

its lenders. In the subsequent months, the parties negotiated several amendments to the loan agreements including forbearances and covenant waivers. In order to prevent the new financing from being avoided as preferences in the bankruptcy, the lenders delayed the filing until April 2002. By the time bankruptcy was filed, Exide owed more than $600 million in unsecured notes and the trade payables exceeded $150 million.[23]

Exide's Creditors' Committee brought claims against the lenders for aiding and abetting breach of fiduciary duty, equitable subordination, recharacterization of debt to equity and deepening insolvency. The committee alleged that by intentionally keeping the companies out of bankruptcy, the lenders caused the debtors to suffer massive additional losses and become more deeply insolvent thereby costing the creditors substantial value. As an example, the committee alleged that, "Exide's accounts payable grew by $47 million between October 2001 and the bankruptcy filing and that it suffered a net loss of approximately $85 million in the first quarter of 2002."[24]

The lenders sought to have the claims dismissed claiming that "deepening insolvency" was not a cause of action recognized under Delaware law. The court disagreed with the lenders and held that both Delaware law and the law of the Third Circuit support a claim for deepening insolvency where there has been damage to corporate property. [25]

Because the matter ultimately settled through a consensual plan of reorganization providing a $190 million recovery for the unsecured creditors, *Exide* left many questions

[23] *Id.*
[24] *Id.*
[25] *Id.* at 51.

unanswered.[26] For example, must a party bringing a deepening insolvency claim also bring a fraud claim, or is mere negligence sufficient? Arguably, the deepening-insolvency doctrine is recognized as a viable cause of action in cases where only negligence is asserted.[27] Thus, if intentional concealment (i.e. fraud) of a company's true financial condition is not a prerequisite for liability under deepening insolvency, then the practical effect of *Exide* is that it may keep lenders from participating in corporate restructurings for fear of being accused of deepening the insolvency of those respective companies.[28] The case law continues to develop in this regard.

Recently, the Delaware Court of Chancery issued an opinion that is not so remarkable for its outcome as it is for its discussion of the issues related to when an officer or director is liable for breaching fiduciary duties when the company is in the zone of insolvency. In *Production Resources Group, L.L.C. v. NCT Group, Inc.,* 2004 Del. Ch. LEXIS 174 (2004), the plaintiff, Production Resources Group, L.L.C. ("PRG"), was a creditor of the defendant NCT Group, Inc. ("NCT"). PRG obtained a judgment against NCT for approximately $2,000,000 but PRG was unsuccessful collecting the judgment. NCT, however, continued to incur debt in the form of preferred debt and warrants. NCT's primary creditor was the wife of one of NCT's directors. She obtained liens on NCT's assets and thus had a claim superior to PRG and other NCT creditors.[29]

---

[26] Kyung S. Lee, James D. McCarthy and Erin E. Jones, *Deepening Insolvency Doctrine – An Emerging Remedy Against Contemporary Corporate Malfeasance*, at 2, 23rd Annual Bankruptcy Conference November 18 – 19, 2004, p. 13.

[27] Paul Rubin, *New Liability Under "Deepening Insolvency": The Search for Deep Pockets,* 23-3 ABIJ 50, 51 Apr. 2004, citing, *In re Gourian Holdings Inc.,* 165 B.R. at 107 ("Nor can the court say it is impossible that under some set of facts two years of negligently prepared financial statements could have been a substantial cause of Gourian's incurring unmanageable debt and filing for bankruptcy protection").

[28] *Id*.

[29] *Production Resources Group,* 2004 Del. Ch. LEXIS 174 at *2.

NCT's own public filings revealed that it was balance-sheet insolvent and was unable to service its debts as they came due. NCT compromised these debts by issuing shares of stock in excess of what was authorized by its charter. PRG sued NCT and its officers and directors alleging that the officers and directors committed breaches of fiduciary duty and alleging that because NCT was insolvent at the time of these breaches, PRG could bring these claims directly. The defendants moved to dismiss the complaint on the basis that PRG's claims belonged to the company not to its creditors. The defendants further asserted that these claims could not be brought by the creditors because of an exculpatory provision within NCT's certificate of incorporation.[30]

Thus, the court had to address the issue: to whom does the breach of fiduciary duty claim belong? PRG argued that because the company was in the zone of insolvency, it had a direct claim against the officers and directors and under Delaware law its claims could circumvent the exculpatory provision contained in the corporate charter.[31] The court did not entirely agree. The court stated that if one were to adopt PRG's argument then insolvency, "fundamentally transforms the liability threat that directors face."[32] The court found that some of PRG's fiduciary duty claims rested largely on generalized and conclusory assertions that NCT's board and officers had mismanaged the company. Further, the court asserted that these claims are, "classically derivative, in the sense that they involve an injury to the corporation as an entity and any harm to the stockholders and creditors is purely derivative of the direct financial harm to the corporation."[33]

---

[30] *Id*. at *9.
[31] See, 8 Del. Code § 102(b)(7)(2004).
[32] *Production Resources Group,* 2004 Del. Ch. LEXIS 174 at *7.
[33] *Id.* at *8.

Holding that claims against officers and directors for breach of duty of care belong to the company and stating that the fact that the company is insolvent does not turn such claims into direct creditor claims, the court opined, "it simply provides creditors with standing to assert those claims." According to the court, these claims belong to the corporation, even if the corporation is insolvent. The court then turned to the corporation's measure of damages, "The acts injure the firm by reducing its value. Damage to the creditors is indirect in that diminishing the company's value ostensibly diminishes the assets from which the creditors can satisfy their claim."[34]

Unfortunately, the above decisions do not address fundamental questions: When is an officer and director going to be liable for deepening a company's insolvency and what is the standard for holding third parties, such as auditors and lenders, liable for aiding and abetting the officers and directors? The Bankruptcy Court for the Southern District of New York recently attempted to create a universal standard for deepening insolvency claims. The case of *In re Global Service Group, L.L.C.,* 316 B.R. 451 (Bankr. S.D.N.Y. 2004), is another lender case brought by the Chapter 7 trustee of a New York limited liability company, Global Service Group. The Trustee asserted claims against the company's lender for deepening insolvency. The trustee alleged that the bank knew or should have known the company was insolvent and had been in that financial state since its inception. According to the trustee, because the lender knew or should have known about the debtor's finances it also should have known that the company would be unable

[34] See generally, *Id.* at * 7 - 8 (Holding that the company's exculpatory provision in the corporate charter precluded the claims for breach of the fiduciary duty of care. PRG, however, brought other claims for acts such as self dealing and fraudulent and illegal conduct. The court declined to preclude these claims holding that even though PRG pleaded these claims in its capacity as a creditor, so long as the claims were treated as derivative claims of the corporation, the claims could proceed. The court also noted that one particular creditor may be able to bring an individual breach of fiduciary duty claim against an officer and director if it can show that the conduct was to frustrate its particular right as a creditor).

to pay its debts. Despite this knowledge, the bank continued to loan money based on its relationship with the company's insiders and pledges by the insiders of their personal assets.[35]

The bank moved to dismiss the claim. The court examined the origin of deepening insolvency theory and noted that it can be both an independent theory of liability and a measure of damages. The court, however, declined to create a distinction. The court stated that under either approach, prolonging a corporation's life, without more, will not result in liability.[36] The court stated that in this instance, Global Service's lender was accused of making a bad loan, nothing more. The allegation simply stated that the lender knew or should have known that the company was insolvent and therefore should have refused to make the loans. The court concluded, "This may be bad banking, but it isn't a tort . . . a third party is not prohibited from extending credit to an insolvent entity. If it was, most companies in financial distress would be forced to liquidate."[37] The court found it significant that the trustee did not allege that the loan was made to enable insiders to siphon off funds or otherwise commit wrongful acts.[38]

While the case focused on the lender's liability for making loans while the borrower was insolvent, the court also addressed the issue as it relates to officers and directors of an insolvent corporation. The court found fault with the complaint's unspoken premise that managers of an insolvent company have an absolute duty to liquidate. Further, the court took issue with plaintiff's assumption that anyone who aids or abets the managers

---

[35] *In re Global Crossing*, 316 B.R. at 455-56.
[36] *Id.* at 458.
[37] *Id*. at 459.
[38] *Id.*

in their wrongdoing are liable.[39] The court reasoned that once insolvency occurs, the company's officers and directors have an obligation to exercise their business judgment to maximize the corporation's long-term wealth. Maintaining a company's enterprise value is the obligation of a fiduciary, and the court noted that Chapter 11 is based on the notion that a business is worth more alive than dead.[40] Therefore, according to the court, an officer or director of an insolvent company will not face liability for deepening insolvency based on a negligent, but good faith, decision to operate the business. To rebut the presumption, a plaintiff must show either bad faith, fraudulent intent or self dealing. [41]

In sum, the relevant cases attempt to define the deepening insolvency claim. It appears that officers and directors can continue to operate an insolvent corporation as long as they rely on their business judgment and not engage in fraudulent or self-dealing conduct. Further, third parties such as lenders and accountants will not be liable for aiding and abetting unless they know or should have known that the company is insolvent and know or should have known that the company's managers were engaging in

---

[39] *Id.* at 459.

[40] *Id.* at 460 (To illustrate its point, the court compared principles of bankruptcy under U.S. law to those in the U.K., "Unlike in the U.K., there is no absolute duty in the U.S. to shut down an insolvent company. Rather, an insolvent company's management, can under the business judgment rule, choose to continue to operate the company.")

[41] *Id*. at 460 – 461 (This approach seems consistent with the holding of *In re Logue Mechanical Contracting Corp.*, 106 B.R. 436, 439 (Bankr. W.D. Pa. 1989); *See also, Continuing Creditors' Committee of Star Telecommunications, Inc. v. Edgecom,* 2004 U.S. Dist LEXIS 25807 , *36-37 (U.S. Dist. Of Delaware 2004) (Creditors brought their own claims against the officers and directors of a corporation on the basis that management made a series of decisions that deepened the insolvency of the company, including a merger, the sale of a subsidiary and an increase in credit. The court stated that the fact that these acts were made while the company was insolvent did not change the fact that these claims are derivative in nature and must be brought on behalf of the company. Therefore, the claims must show breach of loyalty, self dealing or some other wrongful conduct to rebut the business judgment exception. The court held that the company's exculpatory clause protected the acts of the officers and directors who were utilizing business judgment).

wrongful conduct. Assuming, however, that there is liability, the remaining issue is how to measure the damages?

IV. What is the Measure of Damages?

This discussion begs an overriding question--if the corporation is insolvent and mostly dead, how can it be damaged? In typical litigation, a company is solvent when the bad act occurs and either becomes insolvent as a result of the act or there is a quantifiable measure of damage that can be attributed to the bad act. In a deepening insolvency situation, the analysis is more complicated. Arguably, there are no damages because the net value of the company is zero. Courts have been increasingly proactive in trying to address this valuation issue. There appear to be two different damages theories for insolvent companies that are harmed while in the zone of insolvency: (1) Dissipation of assets or increased debt load and (2) impact on business operations and relationships.[42]

Some courts have embraced the first theory simply because it is an easier approach. Under this theory, damages are calculated by quantifying the assets dissipated or the debt load increased subsequent to the tortious conduct.[43] The problem with this theory is that if the company would have incurred the same amount of debt, or the company's assets would have dissipated at the same rate irrespective of the occurrence of the bad act, the model may not be an accurate measure of damages. In legal jargon, there is a causation problem. Further, increase in debt in and of itself does not necessarily reflect damage to the value of a company.

---

[42] Kyung S. Lee, James D. McCarthy and Erin E. Jones, *Deepening Insolvency Doctrine – An Emerging Remedy Against Contemporary Corporate Malfeasance*, 23rd Annual Bankruptcy Conference November 18 – 19, 2004, p. 13.

[43] *Id.*, citing, *Florida Department of Insurance v. Chase Bank of Texas National Assoc.,* 274 F.3d 924, 935 (5th Cir. 2001).

If the motive for the bad conduct can be tied to the result, then the causation issue is less problematic. For instance, if the directors and officers caused false financials to be prepared so the company could take on more debt and management could line its own pockets, then the causal nexus exists and there is no proof problem. The same analysis would obtain for dissipation of assets where a claimant can show that wrongful conduct resulted in an officer or director looting or misappropriating corporate assets.

The second approach, the impact on business operations and relationships, is more difficult to calculate but more logical as it relates conduct to the value of the company. The underlying premise is that wrongful or tortious conduct diminishes the company's chance to restructure and also diminishes the value of the company.[44] To employ this analysis, one has to accept the fact that even an insolvent company has value and that but for the deepening insolvency the value would have been greater.[45]

This latter approach to damages is also problematic. On the one hand, debt may be a necessary component to restructure a company—debt can increase a company's value if it results in allowing the company time to recover, implement its business plan and increase revenue. On the other hand, the increased debt load can also create operational limits on a company, restrict cash flow and result in harm. For these reasons, measuring damages in these cases is often a hotly contested issue subject to much expert evaluation and speculation.

VI. Conclusion: How to Avoid Being a Defendant.

Creditors, creditors' committees and shareholders continue to look for ways to hold a company's management and advisors responsible for a company's demise. One

---

[44] *Id*. at 16.
[45] *See, Lafferty* 267 F.3d at 349 – 350; *In re Flagship Healthcare, Inc.* 269 B.R. at 728.

tool in their arsenal is the deepening insolvency theory. Whether used as a means of measuring damages or as its own cause of action, it is something of which officers and directors must be cognizant when making decisions for a company on the brink of, or passed the point of, insolvency.

What can you do to safeguard yourself from claims based upon decisions you make on behalf of the mostly dead company you serve? There are some basic steps that officers and directors can take to insulate themselves, at least partially, in this situation:

1. Always use your best business judgment; make no decision haphazardly.
2. Surround yourself with competent advisors (accountants, auditors, investment bankers, turnaround experts, market experts, bankruptcy consultants, lawyers, etc.) who can help you make responsible and informed decisions.
3. Refrain from any sort of self dealing. Keep your hands off of any monies that should arguably go to creditors. This does not mean you have to work for free, but you should be cautious when setting compensation, benefits and bonus structures. Create an executive compensation committee that oversees those issues and, if necessary, employ advisors to offer opinions on proper methods of compensation.
4. Do not loan money in exchange for preferred liens or equity interests if the value for the consideration exchanged can be challenged as unequal.
5. As a general rule, do not sell corporate assets to insiders. If you do, obtain third-party valuations of that property and be sure that the company is receiving fair market value.

6. Do not reject valid offers to purchase the company or its assets if they are in the best interests of the company's shareholders and creditors.

7. Do not be afraid to declare bankruptcy if that is in the best interest of the company and its creditors. Set your pride aside and make correct and informed decisions.

8. If you decide that declaring bankruptcy is in the best interest of the company and its creditors, examine the venue alternatives before filing. Choose your venue wisely--as illustrated above, the zone of insolvency theory is still widely debated and developing. Some jurisdictions are more favorable then others in regard to the application of the theory.

PHILLIP C. APPENZELLER, JR. **e-mail: pappenzeller@munsch.com**

Phil is a Shareholder in the Litigation/Dispute Resolution practice group at Munsch Hardt. Phil joined the Firm in 2000 after serving three years in the Judge Advocate General Corp. and more recently, three years at McKool Smith in Dallas.

Phil obtained a Bachelor of Science Degree in Government and Public Administration, with honors, from Evangel University. He received his Juris Doctorate degree from the University of Missouri-Kansas City in 1992 where he was Administrative Editor of the *UMKC Law Review*. Phil also practiced for three years in the U.S. Army Judge Advocate General Corp. where he obtained the rank of Captain and tried cases in the United States District Court, Middle District of Georgia and U.S. Courts Martial.

Phil's experience involves large commercial/complex litigation cases. Recently his practice focus has been representing bankruptcy trustees and creditors' committees in litigation against former officers and directors and other professional advisors of failed companies. Phil also has experience in large breach of contract disputes, commercial mortgage backed securities litigation, patent infringement litigation, stockholder derivative litigation, officer & director liability, professional negligence partnership disputes, and governmental contract disputes. He frequently represents clients in the technology, manufacturing, banking and financial industries.

Recently, Phil tried a large real estate fraud dispute on behalf of an appraiser in Dallas and received a complete defense verdict. He also represented a publicly traced bankrupt technology company, Piranha, Inc. in the Northern District of Texas Bankruptcy Court and defeated a Shareholder take-over attempt. Phil represented Excel Telecommunications in an JAMS proceeding and successfully defended the company in a large breach of contract dispute.

Phil represents a large commercial mortgage backed securities firm on various litigation matters. He also represents the trustee of a large failed telecommunications company, SmarTalk Teleservices, Inc. in various pieces of litigation around the country. Phil was recently named as lead trial counsel on behalf of the litigation trustee of ETS Payphones, Inc. in the Northern District of Georgia in a $400,000,000 Ponzi scheme case against the officers and directors and attorney/advisors of that company. ETS was previously the second largest payphone company in the nation and the Ponzi scheme case is currently one of the largest in the country. Phil also serves as lead trial counsel for the creditors committee and/or the bankruptcy trustees of Horizon Pharmacies, Amresco, Inc., and Crescent Machinery in various claims against the officers and directors and professional advisors of those companies. Phil has tried cases in the federal courts for the Northern District of Texas, the Western District of Missouri, and the Northern District of Georgia. His state trial experience includes litigation in both Texas and Missouri. Phil also serves on the Criminal Justice Panel in Dallas.

Phil was named a 2004 Texas Rising Star by the *Texas Super Lawyer* publication.

ROSS H. PARKER **e-mail: rparker@munsch.com**

Ross joined Munsch Hardt's Litigation/Dispute Resolution practice group as an associate in September, 1998. His general area of practice is complex commercial litigation. In that capacity he has been responsible for handling a broad range of disputes focusing on securities litigation, director and officer litigation, and general complex commercial litigation. Ross has significant experience in bankruptcy-related litigation representing litigation trustees and creditors' committees. A unique area of practice in which Ross also has significant experience is collaboratively working with the United States Securities and Exchange Commission ("SEC") and the Federal Trade Commission ("FTC") in receivership matters. Ross acts as counsel to court-appointed receivers in numerous securities fraud investigations. As a corollary to this practice area, Ross also represents targets of these investigations and parties with interests in assets subject to SEC and FTC receiverships.

Ross received his Juris Doctorate from Southern Methodist University School of Law in May 1998, where he graduated *cum laude*. While a student at SMU School of Law, Ross was a Chief Justice for the Jackson Walker Moot Court Program, President of Golden Gavel National Legal Honor Society, and dedicated much time to the School's Public Interest Law Program. He received a Bachelor of Arts degree with, a major in Philosophy and a minor in Biology, from Southern Methodist University in 1994. While an undergraduate student, he also completed a pre-medical curriculum and was a member of Alpha Epsilon Delta--the pre-medical Honor Society.

Ross currently serves as the Firm's chairman for law school recruiting. Ross is a member of the State Bar of Texas and is admitted to practice before all federal courts in Texas and before the Fifth Circuit Court of Appeals. He is also a member of the Texas and Dallas Bar Associations, and the Dallas Association of Young Lawyers.