

THE EXPANSION OF DEEPENING INSOLVENCY STANDING: BEYOND TRUSTEES AND CREDITORS' COMMITTEES

INTRODUCTION

Deepening insolvency has been defined by the Third Circuit as “an injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.”¹ A defendant becomes liable for this tortious injury by causing an insolvent corporation to incur further debt rather than dissolve or file for bankruptcy.²

Deepening insolvency occurs in a variety of circumstances. Although there is no all-encompassing fact pattern that would include every imaginable type of deepening insolvency claim, a simple hypothetical example is useful to illustrate the nature of deepening insolvency. Assume a corporation becomes insolvent. Assume further the officers and directors of this corporation take affirmative steps to conceal that insolvency from the corporation’s shareholders and creditors—for example, by conspiring with an accounting firm to misrepresent corporate finances. Rather than declare bankruptcy, the officers and directors continue to operate the corporation beyond the point of insolvency. Creditors, misled by false representations of solvency, are induced into making further loans to the insolvent corporation, unknowingly risking their assets while further deepening corporate insolvency. In this way, the officers and directors, as well as the accounting firm, have deepened the insolvency of the corporation to the detriment of the unsecured creditors and the corporate entity itself. This is an example of the emerging tort of deepening insolvency.³

This is also fraud. In the continuing debate over whether to accept the tort of deepening insolvency as an independent cause of action at state law, the Bankruptcy Court for the Southern District of New York recently posed a

¹ Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347 (3d Cir. 2001).

² For a defendant to be liable under a theory of deepening insolvency, his conduct in prolonging the life of the corporation and expanding the corporation’s debt must be either fraudulent or negligent. Gregg W. Mackuse, *Damages for “Deepening Insolvency”: A Defendant’s Nightmare?*, PA. B. ASS’N Q., Jan. 2003, at 42, 42.

³ See, e.g., *Askanase v. Fatjo*, No.Civ. A.H.-91-3140, 1996 WL 33373364, at *1-5 (S.D. Tex. April 1, 1996).

pertinent question: what does deepening insolvency do that other causes of action cannot do?⁴ As this Comment will demonstrate, the answer is that deepening insolvency piggybacks⁵ on other causes of action and, in so doing, allows the plaintiff to utilize a theory of damages that is economically devastating to the deepening insolvency defendant, creating an immense pressure on the defendant to settle litigation.

Most jurisdictions have yet to decide a case involving deepening insolvency. Scholarly articles on deepening insolvency focus primarily on two issues: (1) who can be a deepening insolvency defendant⁶ and (2) what kind of damages can be awarded.⁷ An area that remains largely unexplored, and a primary contribution of this Comment, is the issue of standing in deepening insolvency cases. Much of the literature about deepening insolvency has centered on the question of whom deepening insolvency can be asserted against.⁸ This Comment will explore the opposite question: who can assert deepening insolvency? In answering this question, this Comment analyzes the standing of deepening insolvency plaintiffs and concludes a shareholder ought to have standing to bring a claim for deepening insolvency in a shareholder's derivative action.

Following this Introduction, Part I of this Comment traces the historical roots of deepening insolvency in its evolution from a theory of damages to a cause of action.⁹ It will examine the most notable cases recognizing deepening insolvency to date as well as cases from jurisdictions that have rejected the theory.¹⁰ Part I concludes with a discussion of the merits of using deepening insolvency as a cause of action in addition to claims for fraud or breach of

⁴ See *Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group, L.L.C.)*, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004). “[O]ne seeking to recover for ‘deepening insolvency’ must show that the defendant prolonged the company’s life in breach of a separate duty, or committed an actionable tort that contributed to the continuing operation of a corporation and its increased debt.” *Id.*

⁵ Deepening insolvency is a piggyback tort because it always overlaps with other causes of action, such as fraud, fraudulent transfer, breach of fiduciary duty, or alter ego liability. See, e.g., *id.* at 455 (asserting deepening insolvency claim alongside fraudulent transfer claim). There is no conceivable fact pattern in which deepening insolvency alone would apply to the exclusion of other torts. Plaintiffs assert deepening insolvency in their complaint alongside other applicable torts. See, e.g., *Sw. Supermarkets, L.L.C. v. Kohlberg & Co. (In re Sw. Supermarkets, L.L.C.)*, 315 B.R. 565 (Bankr. D. Ariz. 2004) (asserting deepening insolvency claim alongside claims for breach of fiduciary duty, gross negligence, and mismanagement).

⁶ See, e.g., Paul Rubin, *New Liability Under “Deepening Insolvency”*: *The Search for Deep Pockets*, AM. BANKR. INST. J. April 2004, at 50, 69.

⁷ See generally Mackuse, *supra* note 2.

⁸ See Rubin, *supra* note 6, at 69.

⁹ See *infra* notes 15–25 and accompanying text.

¹⁰ See *infra* notes 26–66 and accompanying text.

fiduciary duty including a brief summary of who can be a deepening insolvency defendant.¹¹ Part II discusses damages for deepening insolvency and highlights problems in calculating damages under the theory.¹² Part III explores issues of standing in deepening insolvency and looks toward the possibility of future deepening insolvency claims in shareholder's derivative suits.¹³ The Conclusion discusses the rationale behind the use of deepening insolvency and advocates extending its application into shareholder's derivative suits.¹⁴

I. DEEPENING INSOLVENCY AS A THEORY OF RECOVERY FOR BANKRUPTCY CREDITORS AND TRUSTEES

A. *The Historical Development of Deepening Insolvency*

Deepening insolvency is a relatively new theory. It began as a theory of damages and only recently grew into an independent cause of action.¹⁵ In 1983, the Seventh Circuit recognized deepening insolvency as a theory of damages in *Schacht v. Brown*.¹⁶ In *Schacht*, the plaintiff alleged that by keeping Reserve Insurance Company in business beyond the point of insolvency and incurring additional liabilities, the defendant directors and officers of the debtor corporation caused Reserve's policyholders, creditors, and the company itself damages in excess of \$100 million.¹⁷ Although the plaintiff sought damages under the civil damages apparatus of the Federal Racketeer Influenced Corrupt Organizations ("RICO") statute,¹⁸ the Seventh Circuit implicitly approved deepening insolvency as the applicable theory of

¹¹ See *infra* notes 67–83 and accompanying text.

¹² See *infra* notes 84–138 and accompanying text.

¹³ See *infra* notes 139–226 and accompanying text.

¹⁴ See *infra* notes 227–233 and accompanying text.

¹⁵ See Rubin, *supra* note 6, at 50.

¹⁶ 711 F.2d 1343 (7th Cir. 1983).

¹⁷ *Id.* at 1345.

By concealing . . . Reserve's continued insolvency, the Director alleges, the defendant directors and officers were able to fraudulently obtain approval of the Illinois Department of Insurance If the Department had at any time known of Reserve's actual insolvency, the complaint charges, it would not have permitted Reserve to continue to write insurance and suffer further dissipation of its assets.

Id.

¹⁸ 18 U.S.C. § 1964(c) (2000).

damages by noting “the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.”¹⁹

In 1989, New York recognized deepening insolvency as a theory of damages while inching slightly closer to recognizing deepening insolvency as an independent cause of action.²⁰ In *Corcoran v. Frank B. Hall & Co.*, the Supreme Court of New York, Appellate Division, rejected the defendant directors and shareholders’ motion to dismiss a case brought by the Superintendent of Insurance for the State of New York.²¹ The Superintendent alleged that the defendants operated the Union Indemnity Insurance Company of New York as a “loss leader” for the benefit of their own business.²² This operation resulted in the rapid insolvency of Union; the Superintendent alleged the defendants concealed this fact.²³ The Superintendent sought \$140 million in damages, an amount equal to the full extent of Union’s insolvency.²⁴ While the Superintendent couched his complaint in terms of violations of New York insurance law and breaches of fiduciary duty, the court noted “failure to disclose the insolvency of an insurance company is an injury to that corporation for which the Superintendent may institute an action.”²⁵

B. From a Theory of Damages to an Independent Cause of Action

Beginning with a 2001 decision from the Third Circuit Court of Appeals in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*,²⁶ courts

¹⁹ *Schacht*, 711 F.2d at 1350; accord *Allard v. Arthur Anderson & Co.*, 924 F. Supp. 488 (S.D.N.Y. 1996); *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849 (M.D. La. 1997); *Feltman v. Prudential Bache Sec.*, 122 B.R. 466 (S.D. Fla. 1990).

²⁰ *Corcoran v. Frank B. Hall & Co.*, 545 N.Y.S.2d 278, 283–84 (N.Y. App. Div. 1989). Fifteen years later, in November of 2004, the Bankruptcy Court for the Southern District of New York reconsidered the issue of deepening insolvency in *Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group L.L.C.)*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004). This case is discussed in detail *infra* notes 60–70 and accompanying text.

²¹ *Corcoran*, 545 N.Y.S.2d at 285.

²² *Id.* at 279.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 283 (citations omitted). The court went on to note

[t]he provisions [of New York Insurance Law] which the defendants are charged with violating . . . concern disclosure, accounting and maintenance of assets, liabilities, reserves and surpluses. In addition, they deal with the fairness of transactions between a holding company and a controlled insurer, preferential transfers and *fraudulent insolvency*. Granting a private right of action clearly would further the evident purpose of these sections to protect insurance companies, policyholders and the public.

Id. at 284 (emphasis added).

²⁶ 267 F.3d 340 (3d Cir. 2001).

began to recognize deepening insolvency as an independent cause of action. Following the Third Circuit's recognition of deepening insolvency as an independent cause of action under Pennsylvania law in *Lafferty*, in 2003 the Bankruptcy Court for the District of Delaware in *In re Exide Technologies, Inc.*²⁷ recognized the tort of deepening insolvency under Delaware law. These decisions have paved the way for a growing judicial acceptance of deepening insolvency as an independent cause of action.

In *Lafferty*, the Third Circuit recognized deepening insolvency as an independent tort.²⁸ The insolvent corporations in *Lafferty* were two lease financing corporations allegedly operating as a Ponzi scheme.²⁹ The plaintiffs, the unsecured creditors' committee, brought claims in the District Court on behalf of the two corporations against the management of both corporations and third parties allegedly involved in the Ponzi scheme for fraudulently deepening the insolvency of the corporations.³⁰ Because the committee was suing on behalf of the corporations and managers of the corporations accused of participating in the wrongdoing were also the sole shareholders of both corporations, the district court held the doctrine of *in pari delicto* prevented the committee from asserting this claim.³¹ On appeal, the court of appeals upheld the district court's dismissal of the committee's claims on the grounds of *in pari delicto*,³² but further concluded "'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law and that the committee therefore has standing to bring this action."³³

²⁷ Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732 (Bankr. D. Del. 2003).

²⁸ 267 F.3d at 351.

²⁹ A Ponzi scheme is

[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, [usually] without any operation or revenue-producing activity other than the continual raising of new funds.

BLACK'S LAW DICTIONARY 1180 (7th ed. 1999).

³⁰ *Lafferty*, 267 F.3d at 344.

³¹ *Id.* The doctrine of *in pari delicto* stands for "[t]he principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." BLACK'S LAW DICTIONARY 794 (7th ed. 1999). For a more detailed analysis of the doctrine of *in pari delicto*, see *infra* Part III.B.

³² *Lafferty*, 267 F.3d at 344. The court stated "[a]n analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*." *Id.* at 346.

³³ *Id.* at 344.

The Third Circuit accepted deepening insolvency because it “believe[d] that the soundness of the theory, its growing acceptance among courts, and the remedial theme in Pennsylvania law would persuade the Pennsylvania Supreme Court to recognize ‘deepening insolvency’ as giving rise to a cognizable injury in the proper circumstances.”³⁴ Although the committee’s complaint in *Lafferty* was dismissed on what some have referred to as the “pointless technicality” of *in pari delicto*,³⁵ *Lafferty* is nonetheless a seminal deepening insolvency case because the Third Circuit explicitly recognized (1) deepening insolvency is an independent cause of action and (2) a creditors’ committee’s standing to bring an action for deepening insolvency.³⁶

Two years after the Third Circuit first recognized the existence of a cause of action for deepening insolvency in *Lafferty*, the Bankruptcy Court for the District of Delaware followed suit.³⁷ In *Exide*, the creditors’ committee asserted a deepening insolvency claim against a syndicate of secured lenders that essentially exercised complete control over Exide Technologies.³⁸ The lenders used this control to prevent Exide from filing for bankruptcy while granting themselves security interests in Exide’s valuable assets, thus causing Exide to operate for almost two years at “ever-increasing levels of insolvency.”³⁹ This activity resulted in substantial losses to the plaintiffs—Exide’s other creditors.⁴⁰

The lenders moved to dismiss the claims of the creditors’ committee on grounds that Delaware law does not recognize deepening insolvency as a cause of action.⁴¹ Citing the Third Circuit Court of Appeals’ decision in *Lafferty*, the

³⁴ *Id.* at 352.

³⁵ See Jordan A. Kroop, *A Ponzi Scheme and a “Pointless Technicality,”* AM. BANKR. INST. J., March 2002, at 26, 26.

³⁶ *Lafferty*, 267 F.3d at 344.

³⁷ Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732, 752 (Bankr. D. Del. 2003).

³⁸ *Id.* at 743.

[T]he Lenders required Exide to pledge 100 percent of the capital stock of its domestic subsidiaries, 65 percent of the stock in each of Exide Europe and Exide Asia, which together owned, either directly or indirectly, substantially all of the stock in Exide foreign subsidiaries, and were granted UCC security interests in substantially all of Exide’s assets. . . . The bankruptcy petitions were filed on the first business day falling more than 90 days after the last of the significant collateral grants by the Debtors, ostensibly, to avoid preference claims.

Id. (citations omitted).

³⁹ *Id.* at 750–51.

⁴⁰ *Id.* at 751.

⁴¹ *Id.*

court denied the lenders' motion to dismiss.⁴² The court stated the first two factors used by the Third Circuit in its analysis of deepening insolvency in *Lafferty* were met: (1) the soundness of the theory and (2) the growing acceptance of the theory among other courts.⁴³ Turning to the third factor in *Lafferty*, the remedial theme in Pennsylvania law, the court cited a prior decision by the Delaware Supreme Court holding the "function of a damage award in a civil litigation is to provide just and full compensation to a plaintiff who suffers injury or loss by reason of the conduct of the tortfeasor."⁴⁴ The court thus found the third factor in *Lafferty* was met and the "Delaware Supreme Court would recognize a claim for deepening insolvency when there has been damage to corporate property."⁴⁵

After *Lafferty* and *Exide*, deepening insolvency appears to be a powerful new weapon in the plaintiff's arsenal. Since these two decisions, other courts have issued a variety of opinions dealing with deepening insolvency.⁴⁶ For example, in November of 2003, the Bankruptcy Court for the Eastern District of Pennsylvania denied a defendant accountant's motion to dismiss a count of deepening insolvency on the grounds the theory was precluded by the "economic loss doctrine" or, in the alternative, by the "gist of the action" doctrine.⁴⁷ In August of 2003, the District Court for the District of Maine allowed a jury to consider damages under a claim of deepening insolvency.⁴⁸ While the number of jurisdictions that recognize deepening insolvency as an independent cause of action is relatively small, commentators view this

⁴² *Id.* at 752.

⁴³ *Id.*

⁴⁴ *Id.* (quoting *Maier v. Santucci*, 697 A.2d 747, 749 (Del. 1997)).

⁴⁵ *Id.*

⁴⁶ See, e.g., *Bookland of Maine v. Baker, Newman & Noyes, L.L.C.*, 271 F. Supp. 2d 324, 325 (D. Me. 2003); *Lichtenstein v. Stockton Bates, L.L.P. (In re Computer Personalities Sys.)*, No. 01-14231, 2003 WL 22844863, at *3 (Bankr. E.D. Pa. Nov. 18, 2003).

⁴⁷ *In re Computer Personalities*, 2003 WL 22844863, at *3. The economic loss doctrine "prohibits plaintiffs from recovering in tort economic losses to which their entitlement flows only from a contract." *Duquesne Light Co. v. Westinghouse Elec. Corp.*, 66 F.3d 604, 618 (3d Cir. 1995). The "gist of the action" doctrine similarly distinguishes between tort claims and claims for breach of contract by stating "to be construed as a tort action, the wrong ascribed to the defendant must be the gist of the action with the contract being collateral." *Redevelopment Auth. of Cambria County v. Int'l Ins. Co.*, 685 A.2d 581, 590 (Pa. Super. Ct. 1996). The court in *Computer Personalities* held neither of these defenses were viable because the plaintiff was essentially asserting a professional malpractice claim. 2003 WL 22844863, at *4.

⁴⁸ *Bookland of Me.*, 271 F. Supp. 2d at 325.

practice as a growing trend.⁴⁹ Many courts that do not yet recognize a cause of action for deepening insolvency still accept it as a theory of damages.⁵⁰

C. *The Nay-Sayers: Judicial Rejection of Deepening Insolvency*

Not all jurisdictions look favorably on deepening insolvency as a cause of action or as a theory of damages. In *Askanase v. Fatjo*, the District Court for the Southern District of Texas flatly rejected the theory.⁵¹ In *Askanase*, the debtor corporation's chapter 7 trustee alleged the accounting firm Ernst and Young conspired with the officers and directors of the debtor to hide the debtor's insolvency while the officers and directors transferred assets out of the corporation, thereby deepening the insolvency of the debtor.⁵² In granting Ernst and Young's motion to dismiss, the court held when an insolvent corporation is harmed by the negligence of an auditor, it does not have a claim for deepening insolvency.⁵³ The court reasoned because the debtor was insolvent prior to the alleged acts by Ernst and Young, the trustee could not prove damages.⁵⁴ The court held the debtor "could not have been damaged by [Ernst and Young's] alleged negligence while in an insolvent state. The shareholders, who comprise [the debtor] could not be damaged by additional losses incurred after the point of insolvency because they had already lost their equity interest in the company."⁵⁵

Judicial rejection of deepening insolvency is not limited to rejection of its use against third-party professionals such as accountants and lawyers. In *Steinberg v. Kendig*, the Bankruptcy Court for the Northern District of Illinois held a trustee seeking to assert deepening insolvency against the officers and directors of the debtor failed to state a claim recognized by Illinois law.⁵⁶ The

⁴⁹ See Rubin, *supra* note 6, at 69.

⁵⁰ See, e.g., Schacht v. Brown, 711 F.2d 1343, 1345 (7th Cir. 1983); Allard v. Arthur Andersen & Co., 924 F. Supp. 488, 494 (S.D.N.Y. 1996); Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997); Drabkin v. L & L Constr. Assocs. (*In re* Latin Inv. Corp.), 168 B.R. 1, 5 (Bankr. D.D.C. 1993).

⁵¹ No. Civ.A.H.-91-3140, 1996 WL 33373364, at *28 (S.D. Tex. April 1, 1996).

⁵² *Id.* at *1.

⁵³ *Id.* The court wrote it was "unpersuaded by the plaintiff's 'deepening insolvency' theory." *Id.* at *28.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Steinberg v. Kendig (In re Ben Franklin Retail Stores)*, 225 B.R. 646, 656 (Bankr. N.D. Ill. 1998). The court held that the trustee did not assert a cause of action because

[the trustee] does not allege that any assets were dissipated or diverted or put at undue risk for the benefit of shareholders or preferred creditors. He does allege that the Defendants prolonged the debtors' corporate lives by incurring debt on the basis of misleading financial information. The result was to sink the debtors deeper into insolvency. The Trustee does not allege, however, that

trustee alleged the defendant officers and directors of the debtor misrepresented the value of the debtor's accounts receivable to induce creditors to supply inventory⁵⁷ and other value to the debtor while the debtor was insolvent.⁵⁸ The court dismissed the trustee's claim for deepening insolvency, however, because it was barred by the "economic loss doctrine."⁵⁹

In *In re Global Service Group*, the Bankruptcy Court for the Southern District of New York questioned whether there was a need for an independent cause of action for deepening insolvency.⁶⁰ In *Global Service*, the chapter 7 trustee brought a claim for deepening insolvency against insiders of the debtor and Atlantic Bank alleging the defendants engaged in fraudulent transfers and the artificial prolongation of the debtor's corporate life.⁶¹ In alleging deepening insolvency against the debtor's insiders, the trustee pled that "[b]y prolonging the debtor's corporate life and incurring more debt, the Insider Defendants deepened Global's insolvency, and reduced any potential recovery for the creditors of debtor's bankruptcy estate."⁶²

In granting the insider defendants' motion to dismiss, the court held deepening insolvency was not an independent tort under New York law.⁶³ While recognizing that New York had already recognized deepening insolvency as a theory of damages,⁶⁴ the court declined to recognize deepening insolvency as an independent tort on the grounds

the debtors did not get full value for the debts they incurred, or that they did not use that value in an effort to restore the corporation to financial health. That is, he does not allege that the Defendants did not use the corporate assets in 'an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.'

Id. at 656 (quoting *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, C.A. No. 12150, 1991 Del. Ch. LEXIS 215, at *109 (Del. Ch. Dec. 30, 1991)).

⁵⁷ *Id.* at 649.

⁵⁸ *Id.* The trustee asserted deepening insolvency against the defendants on the behalf of injured unsecured creditors who assigned their claims to the trustee. *Id.* The assignment of claims by the unsecured creditors is discussed *infra* note 161.

⁵⁹ *Id.* at 656. Because the losses were solely of an economic nature, they could not be recovered in a tort action such as a claim for deepening insolvency. *Id.* The economic loss doctrine was adopted by the Supreme Court of Illinois in *Moorman Mfg. Co. v. Nat'l Tank Co.*, 435 N.E.2d 443, 450 (Ill. 1982).

⁶⁰ *Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group L.L.C.)*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

⁶¹ *Id.* at 454. The trustee alleged "Atlantic Bank knew or should have known that the debtor would be unable to repay its loans due to its financial condition, but loaned the debtor money anyway Other creditors extended credit to [the debtor] based on Atlantic Bank's willingness to extend credit." *Id.* at 455-56.

⁶² *Id.* at 456.

⁶³ *Id.* at 458.

⁶⁴ *See Corcoran v. Frank B. Hall & Co.*, 545 N.Y.S.2d 278 (N.Y. App. Div. 1989).

[t]he distinction between ‘deepening insolvency’ as a tort or damage theory may be one unnecessary to make. Prolonging an insolvent corporation’s life, without more, will not result in liability under either approach. Instead, one seeking to recover for ‘deepening insolvency’ must show that the defendant prolonged the company’s life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.⁶⁵

Finding no other tort sufficiently pled, the court ruled the trustee had failed to state a claim upon which relief could be granted.⁶⁶

D. The Unique Utility of Deepening Insolvency

The reasoning applied in *Global Service* cuts to the heart of the debate over whether to adopt deepening insolvency as a cause of action. It indicates that deepening insolvency cannot be an independent cause of action, rather, it can only be asserted as a theory of damages when it piggybacks on some other actionable tort.⁶⁷ This piggybacking requirement, however, also appears in cases recognizing deepening insolvency as a separate cause of action because, in those cases, deepening insolvency is always asserted alongside other actionable torts such as fraud or breach of fiduciary duty.⁶⁸ The difference

⁶⁵ *In re Global Serv.*, 316 B.R. at 458. The next year, however, the Bankruptcy Court for the Southern District of New York stated, in dicta, a party may be liable for the tort of deepening insolvency when the party is “able to foresee that the debtor was being operated for an improper purpose.” *Devon Mobile Commc’ns v. Adelpia Commc’ns Corp.* (*In re Adelpia Commc’ns Corp.*), No. 02-41729, 2005 Bankr. LEXIS 1493, at *20-21 (Bankr. S.D.N.Y. May 20, 2005).

⁶⁶ *In re Global Serv.*, 316 B.R. at 461. The court found no other tort had been sufficiently pled because the insiders had breached no fiduciary duty, stating:

[t]he unspoken premise of the trustee’s ‘deepening insolvency’ theory is that the managers of an insolvent limited liability company are under an absolute duty to liquidate the company, and anyone who knowingly extends credit to the insolvent company breaches an independent duty in the nature of aiding and abetting the managers’ wrongdoing. The assumption is a faulty one.

Id. at 459. The court also found that the insiders were protected by the business judgment rule. *Id.* at 461.

⁶⁷ See, e.g., *Sw. Supermarkets, L.L.C. v. Kohlberg & Co.* (*In re Sw. Supermarkets, L.L.C.*), 315 B.R. 565 (Bankr. D. Ariz. 2004).

⁶⁸ For example, in *Exide*, the creditors argued the lender defendants were insiders of the debtor and owed the debtor a fiduciary duty. They asserted a claim for breach of fiduciary duty alongside their claim for deepening insolvency. *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs., Inc.)*, 299 B.R. 732 (Bankr. D. Del. 2003). Likewise, in *Lafferty*, the creditor’s committee alleged the debtor operated a “Ponzi scheme” and asserted a claim for fraud alongside their claim for deepening insolvency. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 343-44 (3d Cir. 2001).

between *Global Service* and decisions recognizing an independent cause of action for deepening insolvency is the court in *Global Service* viewed deepening insolvency as the damages theory that attaches to the primary tort, while the other courts viewed the primary tort and deepening insolvency as being two separate torts.⁶⁹ The distinction may be trivial. Whether deepening insolvency is asserted as a cause of action or as a theory of damages will probably matter little to a plaintiff's attorney because the only advantage deepening insolvency provides beyond those already conferred by claims such as fraud or breach of fiduciary duty lies in the deepening insolvency damages theory.⁷⁰

Deepening insolvency has neither been unanimously accepted nor rejected. Some courts have recognized deepening insolvency as an independent cause of action⁷¹ while others have construed it as a theory of damages,⁷² and still others have entirely rejected the theory.⁷³ Deepening insolvency remains a theory in its infancy. Because the vast majority of jurisdictions have yet to comment on deepening insolvency either way, and because the damages for deepening insolvency can be crippling, it is a theory practitioners should watch carefully.

E. Deepening Insolvency Defendants: Expanding Liability

In addition to its evolution from a damages theory to a cause of action, the scope of deepening insolvency has also expanded to encompass a broader spectrum of potential defendants. Deepening insolvency is typically asserted against the officers and directors of an insolvent corporation.⁷⁴ The theory in such cases is the defendants have breached a fiduciary duty to the corporation

⁶⁹ See *In re Global Serv.*, 316 B.R. at 458.

⁷⁰ See discussion *infra* Part II.

⁷¹ See, e.g., *Devon Mobile Commc'ns v. Adelphia Commc'ns Corp.* (*In re Adelphia Commc'ns Corp.*), 324 B.R. 492 (Bankr. S.D.N.Y. 2005); *In re Sw. Supermarkets*, 325 B.R. at 429; *In re Exide*, 299 B.R. 732; *Lafferty*, 267 F.3d 340.

⁷² See, e.g., *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983); *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849 (M.D. La. 1997); *Allard v. Arthur Andersen & Co.*, 924 F. Supp. 488 (S.D.N.Y. 1996); *Drabkin v. L & L Constr. Assocs.* (*In re Latin Inv. Corp.*), 168 B.R. 1 (Bankr. D. D.C. 1993).

⁷³ See, e.g., *Askanase v. Fatjo*, No. Civ. A.H. 91-3140, 1996 WL 33373364 (S.D. Tex. April 1, 1996); *Kittay v. Atl. Bank of N.Y.* (*In re Global Serv. Group L.L.C.*), 316 B.R. 451 (Bankr. S.D.N.Y. 2004); *Steinberg v. Kendig* (*In re Ben Franklin Retail Stores*), 225 B.R. 646 (Bankr. N.D. Ill. 1998); *Feltman v. Prudential Bache Sec.*, 122 B.R. 466 (S.D. Fla. 1990); *Coroles v. Sabey*, 79 P.3d 974 (Utah Ct. App. 2003).

⁷⁴ Jo Ann J. Brighton, *Deepening Insolvency – Secured Lenders and Bankruptcy Professionals Beware: It Is Not Just for Officers and Directors Anymore*, Am. Bankr. Inst. J., April 2004, at 34, 34.

by deepening its insolvency.⁷⁵ However, due to deepening insolvency's vague definition, the relative paucity of authority on the subject, and the creativity of plaintiffs' attorneys:

[t]he theory has expanded beyond the realm of officers and directors and has been successfully raised against insolvency professionals, such as accountants, investment brokers and lawyers, with the allegations ranging from fraudulently concealing information that caused the deepening insolvency of the company to some newly created duty of care—specifically, that they knew, or should have known, that the business plans presented, upon which they based their advice, would not work, and accordingly they participated in the deepening of the insolvency of the company.⁷⁶

A great number of courts have held deepening insolvency can be asserted against an accountant who prepares false and misleading financial statements that serve to prolong the insolvent corporation's business and deepen its insolvency.⁷⁷ For example, in *Flagship Healthcare*, the plaintiff alleged the debtor's auditing firm, PricewaterhouseCoopers, negligently prepared an auditing report that both the debtor and its creditors relied upon in acquiring another corporation.⁷⁸ The court, in denying the defendant's motion to dismiss, held deepening insolvency could serve as a theory of damages against PricewaterhouseCoopers, stating that "even if the Debtor may have been insolvent before the [valuation], the additional debt incurred thereafter, and allegedly as a result of the Defendants' negligence, may provide a measure of damages recoverable by the Trustee."⁷⁹

In addition to "insolvency professionals," deepening insolvency has also been asserted against lenders.⁸⁰ Because the lenders in *Exide* exercised such a great degree of control over the debtor corporation, the court held the plaintiffs

⁷⁵ See *Schacht*, 711 F. 2d 1355; *Smith v. Arthur Andersen, L.L.P.*, 175 F. Supp. 2d 1180 (D. Ariz. 2001); *Corcoran v. Frank B. Hall & Co.*, 545 N.Y.S. 2d 278 (N.Y. App. Div. 1989).

⁷⁶ Brighton, *supra* note 74, at 34 (footnotes omitted).

⁷⁷ See *Allard*, 924 F. Supp. at 494; *Lichtenstein v. Stockton Bates, L.L.P. (In re Computer Personalities Sys., Inc.)*, No. 01-14231 (DWS), 2003 WL 22844863, at *5 (Bankr. E.D. Pa. Sept. 8, 2003); Official Comm. of Unsecured Creditors v. Shapiro (*In re Walnut Leasing Co.*), No. 99526, 1999 WL 729267 at *1 (Bankr. E.D. Pa. 1999); *Waslow v. Grant Thornton L.L.P. (In re Jack Greenberg, Inc.)*, 240 B.R. 486, 489 (Bankr. E.D. Pa. 1999).

⁷⁸ *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare)*, 269 B.R. 721, 725 (Bankr. S.D. Fla. 2001).

⁷⁹ *Id.* at 728.

⁸⁰ See, e.g., Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732, 750-51 (Bankr. D. Del. 2003).

had stated a claim the lenders be considered insiders of the debtor corporation.⁸¹ The court also found the plaintiffs stated a claim against the lender for aiding and abetting the directors' breach of fiduciary duty to Exide.⁸² Finally, the court found the lenders' use of their position of control over Exide opened the lenders themselves up to a claim of deepening insolvency.⁸³ As the coverage of deepening insolvency liability expands from officers and directors to lenders, accountants, and other insolvency professionals, the theory will become increasingly important.

II. DAMAGES FOR DEEPENING INSOLVENCY

A. *The Problem of Damages in Deepening Insolvency*

The issue of damages is at once both the most difficult issue for a court to deal with when faced with a claim for deepening insolvency and the most attractive feature of the deepening insolvency cause of action for plaintiffs. Plaintiffs are attracted to deepening insolvency because a defendant's potential liability under the theory can be enormous, leading some scholars to speculate deepening insolvency "may be the latest claim that creditors' committees, trustees and others throw out against officers and directors, secured lenders and professionals in the hope of settlements to avoid litigation."⁸⁴ Others scholars have called deepening insolvency "a nightmare that expands a defendant's potential liability into the hundreds of millions of dollars."⁸⁵ The damages allowed under a deepening insolvency cause of action may be the *sole benefit* of the theory.

⁸¹ *Id.* at 743. The plaintiffs alleged the lenders "exerted financial leverage over Exide, through Exide's indebtedness to the Lenders, in a manner that effectively permitted the Lenders to control Exide." *Id.*

⁸² *Id.* at 750.

⁸³ *Id.* at 752.

Essentially, a claim against a lender for deepening insolvency is grounded in the theory that the lender, by (1) extending credit in exchange for additional security (or other enhancement) to a financially troubled borrower where there is little or no hope of financial recovery and (2) causing the borrower to remain in business for the lender's benefit, is extracting value from the borrower at the expense of its unsecured creditors – that is, the unsecured creditors might have been repaid a higher percentage of their claims had the borrower not been "propped up" with additional secured financing, and may assert that the borrower's deepening insolvency caused them financial harm.

Brighton, *supra* note 74, at 78.

⁸⁴ Brighton, *supra* note 74, at 80.

⁸⁵ Mackuse, *supra* note 2, at 42.

Deepening insolvency is a piggyback claim; there are few, if any, instances where deepening insolvency alone may be applicable to the exclusion of claims for fraud or breach of fiduciary duty. This “piggy back” phenomenon begs the question of whether there is any need for states to recognize a deepening insolvency cause of action at all.⁸⁶ Indeed, it appears the sole advantage offered by deepening insolvency, and one that is not offered by other applicable claims such as fraud or breach of fiduciary duty, is the theory of damages deepening insolvency provides.

The deepening insolvency theory of damages is complex. It presents a unique problem to financial experts who are frequently asked to calculate damages in bankruptcy proceedings. Traditionally, where the corporate entity is injured, the damages are equal to the decline in the corporation’s equity that resulted from the injury.⁸⁷ However, when dealing with a claim for deepening insolvency, the corporate entity must *by definition* be insolvent when the injury occurs.⁸⁸ If the equity of the corporation was nonexistent at the time of the injury, how can the corporation be damaged by deepening insolvency?

B. Damages Theories in Previous Instances of Deepening Insolvency

To some extent, the damages available to each deepening insolvency plaintiff will vary by jurisdiction because the bankruptcy trustee is merely asserting the debtor’s state law claim on behalf of the estate.⁸⁹ We begin with the Third Circuit Court of Appeals decision in *Lafferty* because it is the first reported case recognizing deepening insolvency as an independent cause of action.⁹⁰ The general rules for damages in Pennsylvania are (1) a defendant is fully and completely liable for the consequences of his or her actions as a matter of law,⁹¹ (2) each defendant in a group of joint tortfeasors may be held jointly and severally liable,⁹² and (3) a defendant may be held liable for the

⁸⁶ See *Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group L.L.C.)*, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004) (“The distinction between ‘deepening insolvency’ as a tort or damage theory may be one unnecessary to make.”).

⁸⁷ Allen Michel & Israel Shaked, *Deepening Insolvency: Plaintiff vs. Defendant*, AM. BANKR. INST. J., May 2002, at 32, 33. “In the typical case, the firm is solvent both before and after the bad acts occur. In other cases, the company becomes insolvent as a result of the bad acts. While the latter cases are less frequent, the damage is calculated similarly: the difference in equity value to the wronged party.” *Id.* at 32.

⁸⁸ See *id.* at 32.

⁸⁹ See *infra* notes 212–215 and accompanying text.

⁹⁰ See *supra* Part I.B.

⁹¹ See, e.g., *Wagner v. York Hosp.*, 608 A.2d 496, 501 (Pa. Super. Ct. 1992).

⁹² See, e.g., *Monzo v. Commonwealth of Pa. Dep’t of Transp.*, 556 A.2d 493, 495 (Pa. Commw. Ct. 1989).

actions of third parties.⁹³ The effect of these rules is to provide the deepening insolvency plaintiff with a ready supply of “deep pockets”: any defendant who contributed to the deepening of corporate insolvency can be liable for the total amount of the loss. This can be a particularly fertile area for a plaintiff’s attorney because large accounting and auditing firms can be held liable for their contribution to the increased insolvency.⁹⁴

While Pennsylvania’s rules on damages are comforting to the plaintiff, they still do not solve the basic problem: calculating the damages for deepening insolvency. A deepening insolvency defendant, however, should not take refuge in the fact that the exact amount of damages for deepening insolvency may be speculative, at least not in Pennsylvania.⁹⁵ The Pennsylvania Supreme Court held uncertainty as to the amount of damages will not act as a bar to recovery.⁹⁶ The court stated “[t]he basis for this rule is that the breaching party should not be allowed to shift the loss to the injured party when damages, even if uncertain in amount, were certainly the responsibility of the party in breach.”⁹⁷ In enumerating the damages caused by deepening insolvency in *Lafferty*, the court noted “[e]ven when a corporation is insolvent, its corporate property may have value”⁹⁸ although the manner of computing that value was

⁹³ The Pennsylvania Supreme Court has explicitly accepted the view of the Restatement (Second) of Torts § 435(1).

If the actor’s conduct has created or increased the risk that a *particular harm to the plaintiff* will occur, and has been a substantial factor in causing that harm, it is immaterial to the actor’s liability that the harm is brought about *in a manner in which no one in his position could possibly have been expected to foresee or anticipate*. This is true not only where the result is produced by the direct operation of the actor’s conduct upon conditions or circumstances existing at the time, but also where it is brought about through the intervention of other forces *which the actor could not have expected, whether they be forces of nature, or the actions of animals, or those of third persons* which are not intentionally tortious or criminal

Ford v. Jeffries, 379 A.2d 111, 115 (Pa. 1977) (quoting RESTATEMENT (SECOND) OF TORTS § 422B cmt. b (1965)).

⁹⁴ See, e.g., *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*, 269 B.R. 721 (Bankr. S.D. Fla. 2001).

⁹⁵ *Delahanty v. First Pa. Bank, N.A.*, 464 A.2d 1243, 1257–58 (Pa. Super. Ct. 1983).

[U]nder Pennsylvania law, damages need not be proved with mathematical certainty, but only with reasonable certainty, and evidence of damages may consist of probabilities and inferences Where the amount of damage can be fairly estimated from the evidence, the recovery will be sustained even though such amount cannot be determined with entire accuracy. It is only required that the proof afford a reasonable basis from which the fact-finder can calculate the plaintiff’s loss.

Id. (citations omitted).

⁹⁶ *Id.* at 1257.

⁹⁷ *Pugh v. Holmes*, 405 A.2d 897, 910 (Pa. 1979).

⁹⁸ Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001).

not specified. The court also noted deepening insolvency can undermine a corporation's relationships with its customers, suppliers, and employers; injuries that are difficult to quantify.⁹⁹ While the amount of damages under a *Lafferty* analysis remains uncertain, the exact amount of those damages may be left to the enlightened conscience of the jury.

Other courts have come closer to articulating a logical standard for computing damages on a deepening insolvency claim. In dicta, the Fifth Circuit concisely stated the damages against a bank that created a false representation of solvency, thus deepening the insolvency of the debtor, "are measured by the dissipation of assets or increased debt load occurring after the false representation of solvency was made."¹⁰⁰ In *Florida Department of Insurance v. Chase Bank of Texas National Association*, the debtor was a foreign insurance company seeking to sell surplus line insurance in California.¹⁰¹ Pursuant to California insurance law, foreign insurers were required to establish a trust containing at least \$5.4 million to provide for the payment of claims in the event the insurer becomes insolvent.¹⁰²

The debtor contacted Chase Bank of Texas to create an acceptable trust, which was formed with a certificate of deposit from the First Asia Development Bank seemingly valued at \$5.4 million.¹⁰³ The Florida Department of Insurance asked Chase for additional information about the trust, and Chase responded with a certification to the Department that the trust had assets with a market value of \$5.4 million.¹⁰⁴ In fact, the debtor's certificate of deposit was completely worthless, and the debtor proceeded to

⁹⁹ *Id.* at 350.

¹⁰⁰ Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935 (5th Cir. 2001). The court chose neither to accept nor reject the theory of deepening insolvency, yet acknowledged

there is a trend toward recognizing 'deepening insolvency' as a cause of action against a party who creates the false appearance of solvency in an insurance company or other financial institution. As a result of this deception, regulatory authorities allow the company to keep operating, and do not place it into receivership in a timely fashion.

Id. (footnotes omitted). Noting deepening insolvency had not been explicitly recognized under Texas law, the court held even if Texas did recognize the theory, the plaintiffs had not sufficiently pled damages under the theory to survive summary judgment. *Id.* at 935–36. "[A] receiver in [the plaintiff's] position might prevail on a deepening insolvency theory In the present case, however, the correct combination of legal theories . . . and evidence on damages is not present." *Id.* at 936.

¹⁰¹ *Id.* at 927.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

issue thousands of insurance policies in California.¹⁰⁵ When the Florida Department of Insurance sought to recover \$5.4 million dollars against Chase Bank on a theory of deepening insolvency, the court granted summary judgment to the bank because, among other things, \$5.4 million did not represent the amount of damages caused by the false representation of solvency. Rather, a correct calculation of damages would require the plaintiff to “quantify how much additional debt, if any, [the debtor] incurred after Chase assisted in establishing the empty trust.”¹⁰⁶ This language seems to indicate an appropriate award of damages would include all potential claims on every policy issued by the debtor in California.

Other courts have disputed the fact that damages in deepening insolvency can be so readily quantified. The Bankruptcy Court for the District of Columbia, in dealing with a charge of deepening insolvency against a debtor bank’s officers, directors, and other insiders, stated the damages for deepening insolvency are compensable and the trustee had standing to recover those damages.¹⁰⁷ The court stated damages would include “damages from the looting itself as well as damages inflicted in perpetuating the debtor’s existence past the point of insolvency in order to loot. (*Proof of damages to any degree of certainty seems to pose serious problems here* but should not in itself affect the decision as to standing).”¹⁰⁸

The most strenuous judicial inquiry into the proper standard for computing damages on a claim of deepening insolvency has been commenced by the District Court for the District of Maine in *Bookland of Maine v. Baker*.¹⁰⁹ In *Bookland*, the trial court rendered a verdict against an accounting firm for

¹⁰⁵ *Id.* The First Asia Development Bank was an unregulated bank located in the South Pacific Republic of Vanautu, a small island between Australia and Fiji. *Id.* The debtor was actually “renting” the certificate of deposit from Europe-America Capital Corporation and the debtor itself had no right to draw on the certificate. *Id.* at 928.

¹⁰⁶ *Id.* at 935–36.

¹⁰⁷ *Drabkin v. L & L Constr. Assocs., Inc. (In re Latin Inv. Corp.)*, 168 B.R. 1, 5 (Bankr. D.D.C. 1993). The trustee in *Drabkin* alleged

[d]efendants and the debtor’s principals worked a classic pyramid scheme to keep the debtor operating despite its insolvency and shortage of cash. The debtor’s principals made intentional misrepresentations in soliciting funds from depositors, misused and dissipated the funds deposited, and paid off depositors with funds deposited by new depositors. Defendants participated in this scheme by providing capital and kiting checks to meet the withdrawal demands of depositors.

Id. at 3 (citations omitted).

¹⁰⁸ *Id.* at 5 (emphasis added).

¹⁰⁹ *Bookland of Me. v. Baker, Newman & Noyes, L.L.C.*, 271 F. Supp. 2d 324 (D. Me. 2002).

professional malpractice in preparing a negligent audit of plaintiff's year-end 1998 financial statements.¹¹⁰

In calculating damages, the court ruled over defendant's objection, "that the jury would be permitted to consider damages under the so called 'deepening insolvency concept.'"¹¹¹ The jury instructions on damages stated the jury could consider two elements in awarding damages to the plaintiff: (1) legal and administrative expenses incurred in the bankruptcy proceedings and (2) "[a]ny loss in the value of Bookland as a company up until May 4, 2000 (the date on which it first filed for bankruptcy) that [the jury finds] was caused by Baker, Newman & Noyses's act or failure to act . . ."¹¹² On the loss in value instruction, the judge instructed the jury that

[L]oss in value can occur in a reduction of a company's value from a positive value to a lower positive value; from a positive value to a negative value; or from a negative value to a greater negative value. *The measure of value is determined by subtracting liabilities from assets.*¹¹³

After closing arguments, the jury returned a verdict for the plaintiff in the amount of \$6,677,267.72.¹¹⁴ Since both parties stipulated the administrative expenses of bankruptcy were \$416,304.72, the jury must have awarded damages of \$6,260,963 for the claim of deepening insolvency alone.¹¹⁵ After the verdict, the defendant moved for a reduction of the damages as a matter of law to the stipulated amount of bankruptcy expenses, or for a new trial on damages, or, in the alternative, for remittitur.¹¹⁶

In response to the defendant's motion, the court ordered a new trial on damages.¹¹⁷ The court stated the jury had erroneously calculated the damages caused by the defendant by listening to the plaintiff's instructions on damages

¹¹⁰ *Id.* at 324.

¹¹¹ *Id.* at 326 n.3. The judge ultimately rejected defendant's motion to certify the issue of deepening insolvency because he did not "believe the issue is ripe for certification to the Maine Law Court until we have a jury verdict on damages that demonstrates that deepening insolvency played a part in the jury's determination." *Id.* at 332. The original jury verdict did demonstrate the jury considered deepening insolvency, but that verdict was vacated and remanded for a new trial on damages. *Id.* at 328.

¹¹² *Id.* at 325–26.

¹¹³ *Id.* at 326 (footnotes omitted) (emphasis added).

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 325.

¹¹⁷ *Id.* at 329.

rather than the instructions from the judge.¹¹⁸ The jury began with the plaintiff's gross assets at the end of the 1998 fiscal year, the time of defendant's negligence.¹¹⁹ Bookland's assets in 1998, according to its attorney, were \$10,241,963.¹²⁰ Here, the court found the first error in the jury's calculation.¹²¹ The jury instructions explicitly stated, "the measure of value is determined by subtracting liabilities from assets."¹²² By failing to subtract Bookland's liabilities as of 1998 (which were undisputed) from its assets at that time, the jury began its analysis with an artificially high number. The jury next took the value of Bookland's assets in 1998, and subtracted from that amount Bookland's value on the petition date, \$3,981,000.¹²³ Again, the jury accepted plaintiff's attorney's valuation of Bookland's worth on the date of filing rather than using the number supplied by the defendant.¹²⁴

The major error by the jury in *Bookland* was it equated the debtor's assets with the debtor's value without taking into account the debtor's liabilities. Since the chief damage caused by deepening insolvency is to increase a debtor's liabilities, the jury clearly missed the mark. The court in *Bookland* concluded its opinion by ordering a new trial that "will be limited to a determination of the difference in Bookland's value between the time Baker, Newman & Noyes conducted its review of Bookland's fiscal year 1998 financial statements and the date Bookland filed in chapter 11, May 4, 2000."¹²⁵

Although the court in *Bookland* attempted to resolve the issue, it seems clear the problem of damages remains an open issue in deepening insolvency. The *Bookland* court can be credited with creating a ceiling for damages (the total loss in value to the company from the time of the defendant's wrongful

¹¹⁸ *Id.* The judge held

the statements made [by plaintiff's attorney] were flatly wrong . . . they were directly relevant, neither [the court] nor opposing counsel corrected them, the case was close, and the misstatements' impact on the jury verdict is direct and obvious. Ultimately, therefore, . . . a new trial on damages is necessary because the jury failed to follow the instructions on how to calculate damages.

Id. at 329.

¹¹⁹ *Id.* at 326.

¹²⁰ *Id.* at 326 n.5.

¹²¹ *Id.* at 328.

¹²² *Id.* at 327 n.6.

¹²³ *Id.* at 326.

¹²⁴ *Id.* at 328.

¹²⁵ *Id.* at 331.

act to the time a bankruptcy petition is filed), yet it neglected the floor.¹²⁶ It seems irrational to adopt a rule that a deepening insolvency defendant is always liable for the total loss in value of a company to the exclusion of all other factors. The decision in *Bookland* indicates a great deal of discretion will be left in the hands of the jury and that the damages assessed can be enormous.¹²⁷ Given the potential for an enormous verdict, this is a legitimate cause of alarm for defendants.¹²⁸

C. *Damages Without Causation*

Because the damage inflicted by deepening insolvency results in increased insolvency rather than declining equity, the logic employed by the Court of Appeals for the Fifth Circuit in *Chase Bank* presents a good starting point: a court should measure damages by the dissipation of assets or increased debt load incurred after the tort of deepening insolvency is committed.¹²⁹ The decisions in *Chase Bank* and *Bookland* properly began with this logic. Both courts correctly sought to measure the extent to which the debtor became more insolvent after the defendants' wrongful acts. Neither court, however, conducted a serious inquiry into the degree to which that increased insolvency was caused by the actions of the defendant(s).

For example, in ordering a new trial on damages, the court in *Bookland* stated "[t]he new trial will be limited to a determination of the difference in Bookland's value between the time [the defendant] conducted its review of Bookland's fiscal year 1998 financial statements and the date Bookland filed chapter 11, May 4, 2000."¹³⁰ Even if the change in Bookland's value were calculated perfectly, merely using the change in value over the period in question as a measure of damages assumes all losses occurred as a direct result of the defendant's negligence to the exclusion of all other factors. This failure

¹²⁶ *Id.*

¹²⁷ *Id.* at 330–31.

¹²⁸ Mackuse, *supra* note 2, at 46. Mackuse, commenting on the effects of the *Lafferty* decision, stated:

while a defendant who is alleged to have participated in deepening the insolvency of a failed business may argue that a plaintiff is seeking to expand the limits of tort and contract liability, such damages are permissible under long standing Pennsylvania law. The best defense when faced with exposure to 'deepening insolvency' damages, therefore, is to liability, not damages. Once it finds liability, the jury will be free to assess damages to the full extent of the ever-deepening insolvency.

Id.

¹²⁹ Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935–36 (5th Cir. 2001); accord, *Bookland of Me. v. Baker, Newman & Noyes, L.L.C.*, 271 F. Supp. 2d 324 (D. Me. 2002).

¹³⁰ *Bookland*, 271 F. Supp. 2d at 330.

to determine the extent to which greater insolvency was *caused* by the defendants results in the outcome that makes deepening insolvency so desirable to plaintiffs' attorneys; the damages model assumes that each debt incurred or asset depreciated was solely because of the defendants' actions.

In what is perhaps the most well-reasoned scholarly inquiry into deepening insolvency damages to date, J.B. Heaton analyzes deepening insolvency case law and concludes there are two versions of deepening insolvency damages.¹³¹ The first version, "costs of distress," recognizes "wrongfully-incurred unpayable debt may inflict costs of financial distress on a corporation, including administrative costs of bankruptcy and decline in assets and profits resulting from damage to the corporations reputation" and equates damages with the amount of financial distress caused.¹³² However, the second version focuses on the amount of wrongfully-incurred unpayable debt itself rather than the cost of financial distress inflicted upon the corporation and uses the amount of wrongfully incurred debt as the amount of damages.¹³³ Heaton concludes the "costs of distress" theory of damages is consistent with traditional understandings of corporate injury and represents "a sophisticated application of financial economic analysis."¹³⁴ Heaton derides the latter theory, however, arguing it is "unsupported in financial economics and inconsistent with the traditional understandings and economic functions of corporate injury" and is "either the product of judicial misunderstanding or a judicial attempt to avoid controlling Supreme Court precedent that prohibits bankruptcy trustees from bringing damages claims directly on behalf of defrauded creditors."¹³⁵ While Heaton is correct in his economic analysis, cases such as *Chase Bank* and *Bookland* endorse the latter theory.¹³⁶

It is the latter theory of damages, a theory that ignores the element of causation and holds a defendant liable for the sum total of a plaintiff's increased insolvency, that so attracts plaintiffs' attorneys to deepening insolvency. Damages calculated under such a theory are likely to be immense. However undeveloped the body of law on deepening insolvency may be, academics agree that "one thing is clear: potential liability can be

¹³¹ J.B. Heaton, *Deepening Insolvency*, 30 IOWA J. CORP. L. 465, 478–79 (2005).

¹³² *Id.* at 465.

¹³³ *Id.*

¹³⁴ *Id.* at 500.

¹³⁵ *Id.*

¹³⁶ *See supra* notes 100–28 and accompanying text.

enormous.”¹³⁷ The deepening insolvency damages theory has led some bankruptcy attorneys to remark that “[t]he best defense when faced with exposure to ‘deepening insolvency’ damages, therefore, is to liability, not damages. Once it finds liability, the jury will be free to assess damages to the full extent of the ever-deepening insolvency.”¹³⁸ In other words, once a defendant is found liable for deepening insolvency, the game is essentially lost. For this reason, defendants faced with a deepening insolvency claim are likely to settle.

III. DEEPENING INSOLVENCY PLAINTIFFS: THE QUESTION OF STANDING

A. *Who Can Bring an Action for Deepening Insolvency?*

Actions for deepening insolvency are typically brought by either a trustee in bankruptcy or a committee of unsecured creditors. Many defendants faced with a claim for deepening insolvency will file a motion to dismiss challenging the standing of the party bringing the action.¹³⁹ Two of the most commonly used bases for challenging a deepening insolvency plaintiff’s standing are the doctrine of *in pari delicto* and the requirement of injury.¹⁴⁰ While the outcome of an *in pari delicto* challenge to standing remains the same whether the party asserting deepening insolvency is a trustee or a committee of unsecured creditors,¹⁴¹ the analysis of injury sufficient to confer standing differs depending on the identity of the plaintiff. Therefore, subsection B will examine *in pari delicto* challenges to standing in general while subsections C and D will analyze sufficient injury challenges to standing with respect to trustees and unsecured creditors’ committees, respectively.

While courts have only conferred standing to bring deepening insolvency claims upon creditors’ committees and trustees to date,¹⁴² the outer limits of

¹³⁷ Brighton, *supra* note 74, at 80.

¹³⁸ Mackuse, *supra* note 2, at 46.

¹³⁹ See, e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 346 (3d Cir. 2001); Tabas v. Greenleaf Ventures, Inc. (*In re Flagship Healthcare, Inc.*), 269 B.R. 721, 723 (Bankr. S.D. Fla. 2001); Steinberg v. Kendig (*In re Ben Franklin Retail Stores*), 225 B.R. 646, 648 (Bankr. N.D. Ill. 1998).

¹⁴⁰ See *infra* Part III.B-C.

¹⁴¹ The outcome of an *in pari delicto* challenge remains the same when leveled at both unsecured creditors and trustees, however, in that it cannot defeat the standing of either. See discussion *infra* Part III.B. The outcome differs, however, in that *in pari delicto* is an affirmative defense that can be used against creditors committees while it cannot be used as an affirmative defense against trustees. See discussion *infra* Part III.B.

¹⁴² See, e.g., *Lafferty*, 267 F.3d at 344 (creditors’ committees); Sw. Supermarkets, L.L.C. v. Kohlberg & Co. (*In re Sw. Supermarkets, L.L.C.*), 315 B.R. 565 (Bankr. D. Ariz. 2004) (trustees). In cases involving

deepening insolvency standing remain untested. As this analysis of standing will indicate, other entities potentially have standing to assert deepening insolvency. In particular, in appropriate situations, a shareholder may have standing to assert deepening insolvency in a shareholder's derivative action.

B. *The in pari delicto Challenge*

The doctrine of *in pari delicto* asserts the principle that the law does not allow one to profit from one's own wrong, thus barring recovery to plaintiffs with unclean hands.¹⁴³ Although defendants confronted with deepening insolvency claims often assert this defense, the case law indicates the doctrine of *in pari delicto* cannot be used to attack the standing of either a trustee or a creditors' committee.¹⁴⁴

Often the officers, directors, and managers of the debtor corporation accused of deepening the insolvency of that corporation are also the corporation's sole shareholders.¹⁴⁵ If one of these guilty shareholders were to bring an action against his fellow officers, directors, and managers for deepening the insolvency of the corporation, the doctrine of *in pari delicto* would bar his recovery.¹⁴⁶ However, in *Scholes v. Lehmann*, the Seventh Circuit Court of Appeals held once a trustee or receiver has been appointed for a corporation, the doctrine of *in pari delicto* no longer bars claims of the corporation because "the defense of *in pari delicto* loses its sting when the

insurance providers, insurance liquidators have standing to bring claims for deepening insolvency. See *Arthur Anderson L.L.P. v. Superior Court of L.A.*, 79 Cal. Rptr. 2d 879, 897 (Cal. Ct. App. 1998); *Corcoran v. Frank B. Hall & Co.*, 545 N.Y.S. 2d 278, 280 (N.Y. App. Div. 1989). But see *Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n*, 274 F.3d 924, 926 (5th Cir. 2001); *Holland v. Arthur Anderson & Co.*, 571 N.E.2d 777, 783 (Ill. App. Ct. 1991).

¹⁴³ For a more precise definition of the doctrine of *in pari delicto*, see *supra* note 31.

¹⁴⁴ See *Lafferty*, 267 F.3d at 346; *Scholes v. Lehmann*, 56 F.3d 750, 755 (7th Cir. 1995).

¹⁴⁵ See, e.g., *Lafferty*, 267 F.3d at 343.

¹⁴⁶ See *Scholes*, 56 F.3d at 755. In *Scholes*, Michael Douglas used a number of corporations to run a Ponzi scheme. *Id.* at 752. He pled guilty to fraud and was sentenced to twelve years in prison. *Id.* Regarding the corporations run by Douglas, the court stated

[t]hough injured by Douglas, the corporations would not be heard to complain as long as they were controlled by him, not only because he would not permit them to complain but also because of their deep, their utter, complicity in Douglas's fraud. The rule is that the maker of the fraudulent conveyance and all those in privity with him—which certainly includes the corporations—are bound by it.

Id. at 754.

person who is *in pari delicto* is eliminated.”¹⁴⁷ After the decision in *Scholes*, a defendant cannot successfully use the doctrine of *in pari delicto* to attack the standing of a bankruptcy trustee.

While the logic employed in *Scholes* insulates bankruptcy trustees and court appointed receivers from *in pari delicto* challenges on the grounds the party *in pari delicto* is no longer present, this logic does not provide the same insulation to creditors; thus the *in pari delicto* challenge can still be leveled at unsecured creditors’ committees. An *in pari delicto* challenge may ultimately preclude recovery on a claim for deepening insolvency;¹⁴⁸ however, it cannot defeat the standing of the committee.¹⁴⁹ In *Lafferty*, the Third Circuit Court of Appeals granted the defendants’ motion to dismiss claims brought by the unsecured creditors’ committee on the grounds of *in pari delicto*.¹⁵⁰ The committee brought a claim for deepening insolvency on behalf of the corporations against the corporations’ managers.¹⁵¹ Because the managers accused of wrongdoing were also the corporations’ sole shareholders, however, the court dismissed the claim.¹⁵² Even while dismissing the committee’s claims, the court clarified the committee had standing regardless of the doctrine by stating “[a]n analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*. Whether a party has standing to bring claims and whether a party’s claims are barred by an equitable defense are two separate questions, to be addressed on their own terms.”¹⁵³ In making this decision, the court distinguished claims brought by creditors’ committees from claims brought by bankruptcy trustees.¹⁵⁴ While *in pari delicto* is not a bar to claims brought by the latter, it can bar claims brought by the former.

¹⁴⁷ *Id.*; accord *Hannover Corp. of Am. v. Beckner*, 211 B.R. 849 (M.D. La. 1997). The court in *Scholes* explained the rationale behind the doctrine of *in pari delicto* no longer applied after the appointment of a receiver because

[n]ow that the corporations created and initially controlled by Douglas are controlled by a receiver whose only object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver’s bringing suit to recover corporate assets unlawfully dissipated by Douglas. We cannot see any legal objection and we particularly cannot see any practical objection.

56 F.3d at 755.

¹⁴⁸ See, e.g., *Lafferty*, 267 F.3d 340.

¹⁴⁹ *Id.* at 346.

¹⁵⁰ *Id.* at 343.

¹⁵¹ *Id.*

¹⁵² *Id.* at 360.

¹⁵³ *Id.* at 346.

¹⁵⁴ *Id.* at 358.

Further, the Third Circuit Court of Appeals specifically stated the committee had standing regardless of *in pari delicto*.¹⁵⁵

In *Exide*,¹⁵⁶ the Bankruptcy Court for the District of Delaware followed the Third Circuit's lead. The committee of unsecured creditors asserted deepening insolvency against a syndicate of lenders that exercised total control over the debtor-corporation and caused it to operate in a condition of deepening insolvency for almost two years.¹⁵⁷ The syndicate of lenders filed a motion to dismiss arguing, among other things,¹⁵⁸ the committee was barred from asserting a claim for deepening insolvency by the doctrine of *in pari delicto*.¹⁵⁹ Citing *Lafferty*, the court noted "[t]he tort of deepening insolvency has been pled sufficiently by the [p]laintiffs. *In pari delicto* is an affirmative defense The [l]enders may raise the doctrine in their answer to the Complaint."¹⁶⁰ The court then denied the lenders' motion to dismiss.

In summary, *in pari delicto* defenses against deepening insolvency claims may ultimately succeed as an affirmative defense only when asserted against creditors' committees.¹⁶¹ They cannot, however, deprive the committee of standing to bring the action. An *in pari delicto* defense will not succeed against a bankruptcy trustee. To deprive a bankruptcy trustee of standing, a defendant must allege the bankruptcy estate has not suffered an injury sufficient to confer standing. The efficacy of this challenge is described in subsection D.

¹⁵⁵ *Id.* at 346.

¹⁵⁶ Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732 (Bankr. D. Del. 2003).

¹⁵⁷ *Id.* at 750–51.

¹⁵⁸ The chief argument the lenders put forth for dismissal was the deepening insolvency theory is not recognized by Delaware law. *Id.* at 751. The court dismissed this objection, explicitly recognizing deepening insolvency as being essentially sound. *See supra* Part I.B.

¹⁵⁹ *In re Exide*, 299 B.R. at 751.

¹⁶⁰ *Id.* at 752 (citations omitted).

¹⁶¹ The Bankruptcy Court for the Northern District of Illinois may have supplied a loophole whereby a creditors committee can defeat an *in pari delicto* challenge by assigning its claims to the bankruptcy trustee. In *In re Ben Franklin Retail Stores*, the debtor's unsecured creditors assigned their causes of action to the bankruptcy trustee and the court held the trustee had standing to assert the assigned claims. *Steinberg v. Kendig (In re Ben Franklin Retail Stores)*, 225 B.R. 646, 648 (Bankr. N.D. Ill. 1998). Since a bankruptcy trustee is not vulnerable to an *in pari delicto* challenge, there is an argument that the assignment would sanitize the claims and insulate them from such a challenge. *See id.*

C. *Standing for Committees of Unsecured Creditors: The Damages Requirement and the “Best Interest” Test*

Deepening insolvency directly injures unsecured creditors by reducing the debtor’s assets. Unsecured creditors can only satisfy their claims against the debtor from the limited pool of resources that comprise the property of the estate under 11 U.S.C. § 541.¹⁶² Deepening insolvency harms the unsecured creditors because, as the debtor spirals into an ever deepening insolvency, the pool with which the unsecured creditors may satisfy their claims grows more shallow.

The general rule is a creditors’ committee may bring an adversary proceeding in the name of the debtor when that action is in the best interest of the estate.¹⁶³ The Second Circuit Court of Appeals enunciated this “best interest” test by stating that a creditors’ committee can bring a claim when “(1) the committee has the consent of the debtor in possession or trustee, and (2) the court finds suit by the committee is (a) in the best interest of the bankruptcy estate, and (b) is ‘necessary and beneficial’ to the fair and efficient resolution of the bankruptcy proceedings.”¹⁶⁴

Two seminal cases establishing deepening insolvency as a distinct cause of action, *Lafferty*¹⁶⁵ and *Exide*,¹⁶⁶ confirm the standing of unsecured creditors to bring causes of action for deepening insolvency.¹⁶⁷ In *Lafferty*, the Third Circuit Court of Appeals stated “[w]e conclude that ‘deepening insolvency’ constitutes a valid cause of action under Pennsylvania state law and that the Committee therefore has standing to bring this action.”¹⁶⁸ Likewise, in *Exide*, the Bankruptcy Court for the District of Delaware found the creditors’ committee had standing.¹⁶⁹ In *Exide*, two distinct creditor bodies sought to

¹⁶² 11 U.S.C. § 541 (2000).

¹⁶³ See, e.g., *Glinka v. Fed. Plastics Mfg., Ltd. (In re Housecraft Indus. USA, Inc.)*, 310 F.3d 64, 70 (2d Cir. 2002).

¹⁶⁴ *Commodore Int’l Ltd. v. Gould (In re Commodore Int’l Ltd.)*, 262 F.3d 96, 100 (2d Cir. 2001).

¹⁶⁵ Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

¹⁶⁶ Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732 (Bankr. D. Del. 2003).

¹⁶⁷ See *supra* Part I.B. for a more detailed discussion of *Lafferty* and *Exide*.

¹⁶⁸ *Lafferty*, 267 F.3d at 344. The court also implied that standing was proper as to the debtor itself: “[w]hile the most obvious damages were those sustained by the creditors who purchased certificates . . . the possibility of a distinct and separate injury to the debtor corporations cannot be eliminated at this stage.” *Id.* at 347.

¹⁶⁹ *In re Exide*, 299 B.R. at 739.

assert deepening insolvency.¹⁷⁰ One plaintiff was an individual creditor, R2 Investments, and the other plaintiff was the official committee of unsecured creditors.¹⁷¹ The defendant filed a motion to dismiss R2 Investments' claim for lack of standing on the grounds that one creditor cannot maintain the same action as a committee when the committee is willing and able to maintain that action.¹⁷² In granting the motion to dismiss as to R2 Investments, the court stated "there is significant doubt about whether R2 is an appropriate representative under the circumstances. At the same time, the Committee, *unquestionably an appropriate representative*, remains a plaintiff."¹⁷³

Unsecured creditors' committees have clear standing to assert deepening insolvency and will continue to serve as plaintiffs in future deepening insolvency cases. The only disadvantage of using an unsecured creditors' committee to assert deepening insolvency is that the committee will be vulnerable to the affirmative defense of *in pari delicto*. Because bankruptcy trustees are insulated against this challenge, we turn next to standing requirements for bankruptcy trustees to assert deepening insolvency.

D. Standing for Bankruptcy Trustees: the Damages Requirement

There are two possible bases of standing for a bankruptcy trustee to assert a claim against a third party.¹⁷⁴ In asserting a claim against a third party, a bankruptcy trustee has standing to assert any claim that is property of the estate within the meaning of 11 U.S.C. § 541.¹⁷⁵ The logic behind this rule is the debtor itself has a claim, that claim is a property right, and upon filing a bankruptcy petition that suit becomes property of the estate. Thus, if a debtor has standing to bring an action for deepening insolvency when the bankruptcy proceeding is commenced, that claim is property of the estate and the bankruptcy trustee has standing to assert it. The second basis of standing for a

¹⁷⁰ *Id.* at 735–36.

¹⁷¹ *Id.* at 737.

¹⁷² *Id.*

¹⁷³ *Id.* at 739 (footnotes omitted) (emphasis added).

¹⁷⁴ See *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1342–43 (7th Cir.1987). "Whether the trustee is representing the estate or 'standing in the shoes' of the creditors, he has the duty to marshal the debtor's property for the benefit of the estate, and thus the right to sue parties for recovery of all property available under state law." *Id.* at 1343.

¹⁷⁵ Section 541 of the Bankruptcy Code defines property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (2000). The U.S. Supreme Court has expansively defined the definition of "property of the estate." See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983) (holding causes of action belonging to the debtor are clearly property of the estate).

trustee to assert a claim against a third party is more tenuous. Under some circumstances, the trustee may or may not have standing to assert the claims of the debtor's creditors as a whole.¹⁷⁶

Because a bankruptcy trustee has standing to assert any claim that belongs to the debtor, the dispositive issue becomes whether the debtor has a claim against a third party for the trustee to assert.¹⁷⁷ Thus, for the trustee to assert a claim for deepening insolvency, the debtor must have been able to assert that claim prepetition. This requires a determination of whether the debtor has standing to assert deepening insolvency because "the trustee's ability to bring suit turns on the debtor's rights under non-bankruptcy law."¹⁷⁸ An analysis of the debtor's standing to assert deepening insolvency must begin with a constitutional inquiry, and "[c]onstitutional principles of standing require an allegation that the plaintiff sustained a direct injury that can be traced to the defendant's conduct, and relief from this injury must be likely to follow from an adjudication favorable to the plaintiff."¹⁷⁹

Deepening insolvency defendants typically challenge the standing of the bankruptcy trustee on the basis the debtor has no standing to bring an action for deepening insolvency under applicable state law.¹⁸⁰ In *Askanase*, the District Court for the Southern District of Texas dealt with what was arguably the most stinging blow to the standing of a trustee to assert deepening

¹⁷⁶ *Feltman v. Prudential Bache Sec.*, 122 B.R. 466 (Bankr. S.D. Fla. 1990).

A bankruptcy trustee's dual role as representative of the debtor and of the creditors of the estate clearly gives rise to two possible grounds for asserting that he or she has standing to raise claims against third parties. The trustee's role with respect to the creditors' claims must be analyzed more precisely, however; the trustee may be asserting the right to bring claims either on behalf of all of the creditors or for specific creditors.

Id. at 470.

¹⁷⁷ *Mixon v. Anderson (In re Ozark Rest. Equip. Co.)*, 816 F.2d 1222, 1225 (8th Cir. 1987).

[I]t is clear that causes of action belonging to the *debtor* at the commencement of the case are included within the definition of property of the estate. Any of these actions that are unresolved at the time of filing then pass to the trustee as representative of the estate, who has the responsibility under [11 U.S.C. §] 704(1) of asserting them whenever necessary for collection or preservation of the estate.

Id. at 1225 (citations omitted).

¹⁷⁸ *Feltman*, 122 B.R. at 472.

¹⁷⁹ *St. Paul Fire & Marine Ins. Co. v. Pepsico, Inc.*, 884 F.2d 688, 696 (2d Cir. 1989); *accord* ASARCO, Inc. v. Kadish, 490 U.S. 605 (1989).

¹⁸⁰ *See, e.g., Askanase v. Fatjo*, No. Civ.A.H.-91-3140, 1996 WL 33373364, at *13 (S.D. Tex. April 1, 1996).

insolvency.¹⁸¹ The bankruptcy trustee asserted a claim for deepening insolvency on behalf of the debtor corporation against the accounting firm Ernst & Young, whom the trustee alleged was a co-conspirator with the officers and directors of the debtor in deepening the debtor's insolvency.¹⁸² In granting Ernst & Young's motion to dismiss, the court held the debtor was not damaged by deepening insolvency.¹⁸³ The reasoning the *Askansas* court engaged in would, if adopted universally, prevent any bankruptcy trustee from ever successfully asserting a claim for deepening insolvency. Because the debtor corporation was insolvent at the time of Ernst & Young's alleged negligence, the court reasoned, the debtor did not have a claim since the shareholders who comprised the debtor had already lost their equity and thus could not be injured by the debtor growing more insolvent.¹⁸⁴ Because a debtor corporation is insolvent, deepening insolvency cannot harm the debtor because there is no equity for the shareholders to lose, and loss of shareholder equity is the only cognizable harm to the corporation.¹⁸⁵ Since the theory of deepening insolvency requires the debtor to be insolvent at the time of the injury, no corporate debtor could ever have standing to bring a deepening insolvency claim under this reasoning.

To the great relief of many plaintiffs' attorneys, the decision in *Askansas* has not been universally adopted. The defect in that decision is it disregards the legal fiction that a corporation is a separate legal entity with its own rights and causes of action. It is possible for a corporation to suffer a cognizable injury without a shareholder losing equity.¹⁸⁶ In *Flagship Healthcare*, the debtor corporation employed the services of Greenleaf Ventures to perform a valuation of the debtor's goodwill on its balance sheet.¹⁸⁷ The valuation allegedly misrepresented the solvency of the debtor.¹⁸⁸ The debtor and its auditor allegedly relied on that valuation in making certain acquisitions that resulted in the deepening insolvency of the debtor.¹⁸⁹ Greenleaf filed a motion

¹⁸¹ *See id.*

¹⁸² *Id.* at *1.

¹⁸³ *Id.* at *28. In addition to finding the debtor was not injured by Ernst and Young, the court also found no creditors were injured because no creditor pled that it had loaned money to the debtor in reliance on Ernst and Young's allegedly negligent audit. *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *See id.*

¹⁸⁶ *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001).

¹⁸⁷ *Id.* at 724.

¹⁸⁸ *Id.* at 725.

¹⁸⁹ *Id.*

to dismiss the trustee's claim for deepening insolvency on the ground the trustee lacked standing because the debtor was not damaged.¹⁹⁰ In rejecting this motion, the court stated "even if the Debtor may have been insolvent before the [valuation], the additional debt incurred thereafter, and allegedly as a result of the Defendants' negligence, may provide a measure of damages recoverable by the Trustee."¹⁹¹ In rejecting the defendant's motion to dismiss, the court in *Flagship Healthcare* implicitly recognized a corporation could suffer sufficient damages to confer standing upon the bankruptcy trustee even when the corporation is insolvent and the corporate shareholders lack an equity interest.¹⁹² Implicit in this holding is the key to a trustee's standing to bring deepening insolvency; the *deepening of corporate insolvency is the injury*, and this injury is sufficient to confer standing.

In *In re Latin Investment Corp.*,¹⁹³ the Bankruptcy Court for the District of Columbia followed the same logic. The bankruptcy trustee brought an action alleging the defendants aided the principals of the debtor in financially ruining the debtor and increasing the debtor's debt beyond the point of insolvency.¹⁹⁴ In rejecting the defendant's motion to dismiss for lack of standing, the court held the trustee had standing to bring an action on behalf of the debtor, the debtor was injured by the defendants, and these damages would include "damages inflicted in perpetuating the debtor's existence past the point of insolvency in order to loot. (Proof of damages to any degree of certainty seems to pose serious problems here but should not in itself affect the decision as to standing.)."¹⁹⁵ The court also affirmed the separation between corporate injury and injury to a shareholder's equity interest by noting "[i]t is no defense to say that the debtor is estopped because not only its principals but also its owners (who were the principals) participated in the fraud. It is a fundamental precept of corporation law that the corporation is a [sic] entity separate from its shareholders."¹⁹⁶ As in *Flagship Healthcare*, the court in *Latin Investment* followed the reasoning that the deepening of corporate insolvency was an injury in itself.

¹⁹⁰ *Id.* at 726.

¹⁹¹ *Id.* at 728.

¹⁹² *See id.*

¹⁹³ *Drabkin v. L & L Constr. Assocs. (In re Latin Inv. Corp.)*, 168 B.R. 1 (Bankr. D.D.C. 1993).

¹⁹⁴ *Id.* at 2.

¹⁹⁵ *Id.* at 5.

¹⁹⁶ *Id.* at 6.

There is an argument that, rather than asserting deepening insolvency on behalf of the debtor, a trustee can assert claims against third parties on behalf of creditors.¹⁹⁷ The availability of this option would be useful in deepening insolvency claims because, in many deepening insolvency cases, creditors have participated in the deepening of the debtor's insolvency. Their claims will therefore ultimately be defeated by the affirmative defense of *in pari delicto*.¹⁹⁸ However, in *Caplin v. Marine Midland Grace Trust Co.*, the U.S. Supreme Court held a trustee does not have standing to bring claims against third parties on behalf of creditors.¹⁹⁹ In *Caplin*, a debtor issued debentures²⁰⁰ to Webb & Knapp, Inc., while pledging in return to maintain a debt to equity ratio of two to one.²⁰¹ This ratio was to be certified annually by Marine Midland Trust.²⁰² When the debtor failed to maintain the debt to equity ratio and filed for bankruptcy, the trustee sought to assert a claim against Marine Midland Trust for fraudulently appraising the debt.²⁰³ In holding the trustee lacked standing to assert this claim on behalf of the debenture holders, the Supreme Court wrote that the claim would be better brought by the debenture holders themselves, whose interest may differ significantly from those of the trustee.²⁰⁴ The court stated:

[t]his does not mean that it would be unwise to confer such standing on trustees in reorganization. It simply signifies that Congress has not

¹⁹⁷ For example, the Court of Appeals for the Seventh Circuit stated:

[t]he trustee represents not only the rights of the debtor but also the interests of creditors of the debtor. Pursuant to 11 U.S.C. § 544 the trustee, in his capacity as a creditor, may bring suit to reach property or choses in action belonging to the estate that will then be distributed to all creditors. The trustee's single effort eliminates the many wasteful and competitive suits of individual creditors.

Koch Ref. v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1342-43 (7th Cir. 1987).

¹⁹⁸ See *supra* Part IV.B.

¹⁹⁹ 406 U.S. 416, 434 (1972); see also 5 COLLIER ON BANKRUPTCY, ¶ 541.08 (15th ed. 2004).

The trustee . . . stands in the shoes of the debtor corporation in prosecuting a cause of action belonging to the debtor, and where applicable law makes such obligations or liabilities run to the corporate creditors personally, rather than to the corporation, such rights of action are not assets of the estate under [11 U.S.C. §] 541(a) that are enforceable by the trustee.

5 COLLIER ON BANKRUPTCY, ¶ 541.08.

²⁰⁰ A debenture is defined as "[a] bond that is backed only by the general credit and financial reputation of the corporate issuer, not by a lien on corporate assets." BLACK'S LAW DICTIONARY 408 (7th ed. 1999).

²⁰¹ *Caplin*, 406 U.S. at 418.

²⁰² *Id.*

²⁰³ *Id.* at 417-20. The trustee, rather than Webb & Knapp, sought to assert the claim because "under petitioner's theory Webb & Knapp is as much at fault as Marine, if not more so." *Id.* at 430. Webb & Knapp was there barred by the doctrine of *in pari delicto* from asserting the claim itself. *Id.*

²⁰⁴ *Id.* at 433.

yet indicated even a scintilla of an intention to do so, and that such a policy decision must be left to Congress and not to the judiciary.²⁰⁵

While *Caplin* seemingly bars all claims by a trustee on behalf of creditors,²⁰⁶ there may be a loophole: assignment. In *Steinburg v. Kendig*, unsecured creditors assigned their claims against third parties to the bankruptcy trustee postpetition.²⁰⁷ Although the Bankruptcy Court for the Northern District of Illinois found the economic loss rule ultimately precluded recovery on the trustee's claims, the court explicitly found the trustee had standing to pursue claims assigned by the creditors.²⁰⁸ The court wrote "[t]he assignments effectively turned the unsecured creditors' causes of action into property of the estates and the Trustee has a duty to marshal those assets for the benefit of the estates."²⁰⁹ The assignment loophole, however, may not be as advantageous to a trustee as it seems. While *Steinburg* allows trustees to assert a creditor's assigned claims, the case makes no mention of *in pari delicto* challenges. Logically, if faced with a claim by a trustee on assignment from a creditor who would be barred by *in pari delicto*, a court would likely apply the doctrine to the trustee's claim because a creditor cannot assign a claim greater than the claim it possesses. In other words, assignment should not serve to sanitize a claim tainted by *in pari delicto*. Since the chief advantage of a trustee, instead of a creditor, asserting a deepening insolvency claim is the trustee's immunity to an *in pari delicto* challenge, the assignment loophole would likely be of little utility.

While *Caplin* has at least partially foreclosed the right of a trustee to bring claims for deepening insolvency on behalf of unsecured creditors, *Flagship Healthcare* and *Latin Investment* confirm a bankruptcy trustee has standing to bring an action against third parties on behalf of the debtor corporation. The trustee can bring this claim not because of an injury to the equity interests of

²⁰⁵ *Id.* at 434.

²⁰⁶ The Supreme Court's decision in *Caplin* may not completely bar claims by a trustee on behalf of creditors because the case was decided under the Bankruptcy Act, which has been superseded by the Bankruptcy Code. See *Harris v. Beneficial Nat'l Bank (In re Weisbrod)*, 138 B.R. 869, 871 (Bankr. S.D. Ohio 1992). To the extent the decision hinged on an interpretation of the Bankruptcy Act, it may no longer be relevant. *Id.*

²⁰⁷ *Steinburg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 648 (Bankr. N.D. Ill. 1998).

²⁰⁸ *Id.* at 650.

²⁰⁹ *Id.* The court stated "[i]t is clear that without the assignments the Trustee would not have standing to pursue claims that belong to creditors." *Id.* at 649 "The trustee is confined to enforcing entitlements of the corporation. He has no right to enforce entitlements of a creditor." *Id.* at 650 (quoting *Stenberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir. 1994)).

corporate shareholders, but because of the injury to the corporation itself.²¹⁰ This distinction is essential because, when a trustee brings an action for deepening insolvency, the shareholders, by definition, have no equity interest in the corporation at the time the tortious acts are committed. The injury caused by deepening insolvency is to the corporation itself, not to the equity interests of corporate shareholders. This distinction becomes critical in the discussion of a shareholder's right to bring a derivative action for deepening insolvency.

E. Towards the Future: Derivative Claims for Deepening Insolvency?

In certain situations, a claim for deepening insolvency is most appropriate in the context of a shareholder's derivative action. A hypothetical fact pattern may be illustrative. Assume a corporation is insolvent, and its officers, directors, and managers have colluded with a syndicate of lenders to prolong the life of the corporation as the corporation grows more and more insolvent. Assume also the accountants and auditors of the corporation are complicit in this fraud, and they have misrepresented the financial situation of the corporation. The corporation has not filed bankruptcy, so there is no trustee to assert a claim for deepening insolvency. There are no creditors to assert the claim because the syndicate of lenders is a co-conspirator in the fraud and the innocent creditors are relying on false financial figures. The doctrine of *in pari delicto* would defeat the claim of any creditor that knew about the fraud. Must we wait until the fraud comes crashing down and the corporation is pushed into bankruptcy for the trustee to rectify the situation?

In this situation, a shareholder's derivative action is appropriate. And in that action, the shareholder should have sufficient standing to assert a claim for deepening insolvency against the corporate officers and directors, the syndicate of lenders, and the accounting firm.²¹¹ Although deepening insolvency has not

²¹⁰ See *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001). The court in *Flagship Healthcare* distinguished the injury to the corporate debtor from the injury to shareholders, stating "even if the Debtor may have been insolvent before [the defendant's valuation], the additional debt incurred thereafter . . . may provide a measure of damages recoverable by the Trustee." *Id.*; see also *Rabkin v. L & L Constr. Assocs. (In re Latin Inv. Corp.)*, 168 B.R. 1 (Bankr. D.D.C. 1993). The court in *Latin Investment* stated the injury was not to the debtor's investors, but rather "the gravamen of [the trustee's complaint] relates to harm done to the debtor distinct from that inflicted on the depositors." *Id.* at 2.

²¹¹ Derivative actions are not limited to officers and directors.

The identity of the defendants in a derivative suit depends on the nature of the claim asserted by the shareholder-plaintiff [T]he range of possible defendants in derivative litigation is not

yet been successfully asserted as a cause of action in a shareholder's derivative suit, the foregoing analysis of a trustee's standing to bring deepening insolvency on behalf of the debtor indicates a shareholder would have standing to assert the claim.

A trustee has the ability to bring an action for deepening insolvency because the debtor had such a claim prepetition and the claim became property of the estate.²¹² If a trustee has standing to bring a claim for deepening insolvency on behalf of the debtor corporation, then a shareholder should have standing as well. In *Lafferty*, although the deepening insolvency claim was brought by an unsecured creditors' committee, the court stated the committee was essentially "suing on behalf of the bankrupt debtor corporations . . . not on behalf of the creditors themselves."²¹³ In holding the chief injury was to the corporation itself, and not to the creditors, the court stated "it is the corporate body that possesses the right to sue Thus, 'an action to redress injuries to the corporation cannot be maintained by an individual shareholder, but must be brought as a derivative action in the name of the corporation.'"²¹⁴ While this language was used in *Lafferty* to assert the concept that the right of the creditors' committee to assert deepening insolvency as a cause of action was derivative in the sense that it was derived from the rights of the debtor corporation, it follows from that language that a shareholder would have standing to assert those same derivative rights in a shareholder's derivative action.

restricted to persons who owe fiduciary duties to the corporation. Thus, a derivative action may assert a claim against a third party on behalf of the corporation.

DEBORAH A. DEMOTT & DAVID F. CAVERS, *SHAREHOLDER DERIVATIVE ACTIONS LAW AND PRACTICE* § 1:1 (2004).

²¹² See COLLIER ON BANKRUPTCY, *supra* note 199, ¶ 541.08[6].

The estate created pursuant to section 541 succeeds to any right of action the debtor corporation may have to recover damages for misconduct, mismanagement, or neglect of duty by a corporate officer or director. Thus, it has been held that the trustee may prosecute a cause of action based on the fraud of the officers, directors, or shareholders for fiduciary misconduct, unlawful diversion of assets, or upon a statutory liability created by the law of the state of incorporation. The trustee, however, stands in the shoes of the debtor corporation in prosecuting a cause of action belonging to the debtor.

Id. (footnotes omitted).

²¹³ Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co, 267 F.3d 340, 347 (3d Cir. 2001).

²¹⁴ *Id.* at 348 (quoting John L. Motley Assocs., Inc. v. Rumbaugh, 104 B.R. 683, 686–87 (Bankr. E.D. Pa. 1989)).

When a corporation declares bankruptcy, the deepening insolvency claim becomes property of the estate, thus allowing the trustee to assert it. It is impossible for a trustee to have standing to assert deepening insolvency postpetition when the debtor did not possess the claim prepetition.²¹⁵ Since a shareholder can assert claims on behalf of a corporation in a shareholder's derivative action, a shareholder should be able to assert this claim for deepening insolvency outside of bankruptcy. In discussing the manner in which the trustee acquires causes of action belonging to the debtor upon commencement of a bankruptcy case, the Court of Appeals for the Eighth Circuit noted the trustee has authority "to bring an action for damages on behalf of a debtor corporation against corporate principals for alleged misconduct, mismanagement, or breach of fiduciary duty, because these claims could have been asserted by the debtor corporation, *or by its stockholders in a derivative action.*"²¹⁶ Likewise, the Court of Appeals for the Seventh Circuit stated:

[i]t has also long been held that rights of action against officers, directors and shareholders of a corporation for breaches of fiduciary duties, which can be enforced by either the corporation directly *or the shareholders derivatively* before bankruptcy, become property of the estate which the trustee alone has the right to pursue after the filing of a bankruptcy petition.²¹⁷

When a trustee has standing to assert deepening insolvency, the corporation had standing to assert deepening insolvency prepetition; thus, the relevant question becomes whether there is any reason not to allow that claim to be brought in a shareholder's derivative action prior to bankruptcy. Section 7.41 of the Revised Model Business Corporation Act sets forth the standing requirements for a shareholder's derivative suit. That section provides:

A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

- (1) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and

²¹⁵ See COLLIER ON BANKRUPTCY, *supra* note 199, ¶ 541.08.

²¹⁶ *Mixon v. Anderson (In re Ozark Rest. Equip. Co.)*, 816 F.2d 1222, 1225 (8th Cir. 1987) (emphasis added).

²¹⁷ *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1343 (7th Cir. 1987) (emphasis added).

(2) fairly and adequately represents the interests of the corporation in enforcing the rights of the corporation.²¹⁸

While the first prong can be easily met, the second requires more analysis.

Because a corporation is, by definition, insolvent at the time when deepening insolvency occurs, the harm is arguably to the corporation's creditors, not to the corporation itself.²¹⁹ While it may be in the interest of the creditors that the corporation liquidate rather than incur more debt, it is often not in the interest of the corporation. Often, the corporate body and its shareholders would prefer the officers and directors "roll the dice" and take a chance at producing equity at the risk of deepening the corporation's insolvency. Thus, a shareholder would not fairly and adequately represent the interest of the corporation by bringing an action for deepening insolvency because the risks imposed by deepening insolvency are borne by the corporation's creditors, while the potential rewards would accrue to the corporation. However, this view neglects the possibility that the corporation could successfully emerge from insolvency.

In *Flagship Healthcare*, the court noted an insolvent company need not necessarily face liquidation by stating "[i]n the world of corporate workouts, turnaround managers and the possibility for a quick change in an economic tide, it is not uncommon for a corporation to revitalize itself and work out financial problems no matter how dire they appear."²²⁰ Further, in *Lafferty*, the Third Circuit stated:

[e]ven when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. . . . [D]eepening insolvency can undermine a corporation's relationships with its customers, suppliers, and employees. The very threat of bankruptcy, brought about through fraudulent debt, can shake the confidence of parties dealing with the corporation, calling into question its ability to perform,

²¹⁸ REV. MODEL BUS. CORP. ACT § 7.41 (2005).

²¹⁹ This argument, however, runs counter to cases holding the harm caused by deepening insolvency is harm to the corporation itself. See, e.g., *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)*, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001); *Drabkin v. L & L Constr. Assocs., Inc. (In re Latin Inv. Corp.)*, 168 B.R. 1, 2 (Bankr. D.D.C. 1993).

²²⁰ *In re Flagship Healthcare*, 269 B.R. at 728.

thereby damaging the corporation's assets, the value of which often depends on the performance of other parties.²²¹

Deepening insolvency does not always benefit the debtor corporation at the expense of the corporation's creditors. Often, when a debtor's principals conspire with third party professionals to deepen the insolvency of the debtor, the only benefit is to those principles and third party professionals. For example, in *Latin Investment* the court stated:

[b]ecause the principals were stealing for the benefit of the debtor, their conduct would be imputed to the debtor, which would be estopped from suing other participants in the fraud. . . . But what the trustee is suing on, is what happened after the monies were deposited. This involved theft from, and looting of, the debtor. It did not benefit the debtor in any way, but only defendants and the debtor's principals.²²²

In this type of situation, a shareholder plaintiff would adequately represent the interests of the corporation by remedying a wrong inflicted on the corporation from which the corporation itself derived no benefit.

Deepening insolvency can damage both a corporation and its creditors. The officers and directors of the corporation are often the chief perpetrators of deepening insolvency.²²³ When the officers and directors of an insolvent corporation negligently or fraudulently expand a corporation's debt, they do so in breach of a fiduciary duty to their shareholders.²²⁴ If officers and directors breach a fiduciary duty to their shareholders, a shareholder may properly bring a derivative action for breach of fiduciary duty.²²⁵ Likewise, when creditors and bankruptcy professionals conspire to deepen corporate insolvency, their fraud damages the corporation by increasing its insolvency. The shareholders may properly bring a derivative action against the third parties for fraud.²²⁶ In jurisdictions that recognize deepening insolvency as a cause of action separate from breach of fiduciary duty and fraud, or as an applicable theory of damages

²²¹ Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–50 (3d Cir. 2001); see also Heaton, *supra* note 131, at 478–79.

²²² *In re Latin Inv. Corp.*, 168 B.R. at 5 (citations omitted).

²²³ See, e.g., *id.*

²²⁴ See *Schacht v. Brown*, 711 F. 2d 1343, 1355 (7th Cir. 1983); *Smith v. Arthur Andersen, L.L.P.*, 175 F. Supp. 2d 1180, 1209 (D. Ariz. 2001); *Corcoran v. Frank B. Hall & Co.*, 545 N.Y.S. 2d 278, 283 (N.Y. App. Div. 1989).

²²⁵ *Koster v. (Am.) Lumbermens Mut. Cas. Co.*, 330 U.S. 518, 522 (1947).

²²⁶ *Allright Mo., Inc. v. Billeter*, 829 F.2d 631, 637 (8th Cir. 1987).

for those torts, shareholders should have the right to piggyback a claim of deepening insolvency to their claims of fraud or breach of fiduciary duty in the same manner that trustees and creditors piggyback the claim in bankruptcy.

CONCLUSION

Deepening insolvency remains a relatively new theory. The theory has been accepted by some courts, rejected by some courts, and qualified by others.²²⁷ More importantly, the theory has yet to be tested in many jurisdictions. Because deepening insolvency is essentially a state law tort that is commonly asserted in bankruptcy, rather than a creature of the Bankruptcy Code itself, its efficacy will depend upon state court decisions that either accept or reject it as an independent tort or theory of damages.

The debate over whether to accept deepening insolvency as an independent cause of action is largely pointless; deepening insolvency does the same thing as a theory of damages that it does as a cause of action because the damages theory is the sole benefit of deepening insolvency as a cause of action. There is little utility in having an independent cause of action for deepening insolvency because deepening insolvency does not punish any conduct other torts do not cover. The Bankruptcy Court for the Southern District of New York has correctly characterized deepening insolvency as being a piggyback claim.²²⁸ Deepening insolvency must remain a piggyback claim because it is doubtful whether there is any series of facts in which deepening insolvency would apply alone to the exclusion of other torts. Fraud, breach of fiduciary duty, self-dealing, and alter ego claims always encompass whatever wrong is alleged by a deepening insolvency plaintiff. Indeed, the chief motivation behind a plaintiff's use of deepening insolvency is the damages theory associated with it, a theory that exposes defendants to crippling liability and powerful incentives to settle.²²⁹

While the damages model for deepening insolvency provides the main attraction to the theory itself, that model is overly simplistic. A more nuanced theory of damages should tackle the problem of causation in deepening insolvency cases. The model should start with the formula implicitly

²²⁷ See *supra* notes 71–73 and accompanying text.

²²⁸ See *Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group L.L.C.)*, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

²²⁹ See *supra* Part II.

employed in *Chase Bank* and *Bookland* by measuring the degree to which assets were dissipated or greater debt incurred after the tort of deepening insolvency was committed.²³⁰ After arriving at this base number, the court should whittle it down by determining the degree to which this amount was caused by the defendant(s)' wrongful acts. This inquiry must necessarily be fact specific. The court should also take into account intangible injuries not reflected on an asset-to-liability balance sheet analysis such as the legal and administrative costs of bankruptcy, operational limitations that hurt the debtor's profits, and damages caused to the debtor's relationships with its customers, suppliers, and employees.²³¹

A shareholder should be able to assert deepening insolvency in a shareholder's derivative action. An analysis of standing in deepening insolvency cases indicates deepening insolvency is a state law claim belonging to the debtor corporation. Thus, it should be possible for entities other than bankruptcy trustees and creditors' committees to assert it. It is reasonable to expect there will soon be direct assertions of deepening insolvency outside of bankruptcy by corporations against third parties. It is also likely there will be shareholder's derivative actions for deepening insolvency against corporate officers and directors.²³² Jurisdictions that recognize deepening insolvency as a theory of damages or cause of action should similarly recognize the right of a shareholder to avail him or herself of deepening insolvency in a derivative action.

²³⁰ See *supra* Part II.B.

²³¹ These intangible injuries were all enumerated by the Third Circuit in *Lafferty*. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–50 (3d Cir. 2001).

²³² See *supra* Part II.E.

The future of deepening insolvency remains uncertain. The theory may begin to enjoy widespread acceptance as decisions such as *Lafferty* and *Exide* are adopted in other jurisdictions. Alternatively, courts may remain “unpersuaded by the plaintiffs’ ‘deepening insolvency’ theory,” as was the case in *Askanase*.²³³ Whatever the future may hold, the current model of damages for deepening insolvency can subject a defendant to debilitating damages. As such, deepening insolvency is a theory that corporate officers and directors, third-party professionals, and bankruptcy attorneys should watch with great attention.

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²³³ *Askanase v. Fatjo*, No. Civ.A.H.-91-3140, 1996 WL 33373364, at *28 (S.D. Tex. April 1, 1996).

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