[Saint Louis University Law Journal](https://scholarship.law.slu.edu/lj)

Volume 51
Number 1 *Fall 2006*

Article 6

2006

Lawyer Liability and the Vortex of Deepening Insolvency

Douglas R. Richmond
Aon risk Servs. - Professional Servs. Group, doug.richmond@aon.com

Rebecca Lamberth
Alston & Bird, LLP, rebecca.lamberth@alston.com

Ambreen Delawalla
Alston & Bird, LLP, Ambreen.delawalla@alston.com

LAWYER LIABILITY AND THE VORTEX OF DEEPENING INSOLVENCY

DOUGLAS R. RICHMOND,* REBECCA LAMBERTH**
& AMBREEN DELAWALLA***

INTRODUCTION

A prominent bankruptcy scholar once opined that "no ethical or rational lawyer should ever willingly represent an insolvent corporation outside bankruptcy," an "absurdity" attributable to the fact that simply by representing an insolvent corporation, lawyers may incur liability to the client's creditors.[1] Lawyers' liability exposure is not created when a business client bottoms out in bankruptcy or receivership, but derives instead from the client's spiraling descent. When a corporation enters the zone of insolvency or becomes insolvent, its directors' and officers' fiduciary duties expand to include creditors.[2] The directors and officers are obligated to protect creditors' financial interest in the company.[3] If through fraud or other tortious conduct they prolong the company's life beyond insolvency and harm the creditors by increasing the corporation's debt or by dissipating its assets, liability may follow on a "deepening insolvency" theory.[4] Some jurisdictions may deem the

* Senior Vice President in the Professional Services Group, Aon Risk Services in Chicago, Illinois.

** Partner, Alston & Bird in Atlanta, Georgia. J.D., University of Virginia School of Law; B.A., Vanderbilt University.

*** Associate, Alston & Bird in Atlanta, Georgia. J.D., Columbia Law School; B.S., Duke University.

1. Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 J. BANKR. L. & PRAC. 403, 403 (1997).

2. Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 603 (Bankr. E.D. Pa. 2005); Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004).

3. *See* Myron M. Sheinfeld & Judy H. Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 BUS. LAW. 79, 88–89 (2004) (discussing "trust fund" and "at risk" theories for imposing fiduciary duties on directors of insolvent corporations).

4. *In re* LTV Steel Co., Inc., 333 B.R. 397, 421–22 (Bankr. N.D. Ohio 2005) (stating that deepening insolvency liability can be predicated on negligence and explaining how fraudulently concealing and incurring debt causes harm).

corporation itself to be harmed by the actions of the directors and officers.[5] Deepening insolvency theory, as with the vortex of any corporate fraud, potentially sucks in the company's lawyers via allegations that they aided and abetted the officers' and directors' breach of their fiduciary duties or that they conspired with them to accomplish their unlawful purposes.

To be sure, a distressed company's acquisition of additional debt, standing alone, is not unlawful.[6] Merely prolonging an insolvent corporation's existence is no basis for liability.[7] Directors and officers of a distressed corporation have no blanket duty to seek bankruptcy protection or to liquidate the company for creditors' immediate benefit.[8] The fiduciaries of an insolvent business, or one that is nearly so, might reasonably conclude that operating through desperately lean times is required to create long-term value.[9] That is often the case with start-up businesses; even many established businesses function in the zone of insolvency.[10] A plaintiff proceeding on a deepening insolvency theory should therefore have to show that a defendant prolonged the company's existence through the breach of a separate duty or the commission of an actionable tort.[11] A plaintiff resting a deepening insolvency claim on fraud allegations must plead supporting facts with particularity.[12]

5. *See, e.g.*, *id.* at 421 (explaining how deepening insolvency harms corporation); Ranalli v. Ferrari (*In re* Unifi Commc'ns, Inc.), 317 B.R. 13, 16–18 (D. Mass. 2004) (finding that bankruptcy trustee had standing to sue because deepening insolvency harmed debtor corporation itself); Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854 (Bankr. M.D. La. 1997) (noting "that the aggravation of insolvency or prolonging the life of an insolvent business has been considered to constitute injury to the corporation").

6. Alberts v. Tuft (*In re* Greater S.E. Cmty. Hosp. Corp.), 333 B.R. 506, 530 (Bankr. D.D.C. 2005).

7. Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 813 (Bankr. M.D. Tenn. 2005); *In re Global Serv. Group*, 316 B.R. at 458.

8. Official Comm. of Unsecured Creditors of RSL COM PRIMECALL, Inc. v. Beckhoff (*In re* RSL COM PRIMECALL, Inc.), Nos. 01-11457 through 01-11469(ALG), Adv. No. 03-2176(ALG), 2003 WL 22989669, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003).

9. *In re Global Serv. Group*, 316 B.R. at 460; *see also* Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (observing that "it is not uncommon for a corporation to revitalize itself and work out financial problems no matter how dire they appear").

10. *See* Robert R. Keatinge, Lawyers' Liabilities in Representing Troubled Organizational Clients, Speech at Ass'n of Prof'l Responsibility Lawyers Mid-Year Meeting (Feb. 10, 2006) ("Lots of companies are in the vicinity of insolvency or zone of insolvency.").

11. Devon Mobile Commc'ns Liquidating Trust v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), No. 02-41729, Adv. No. 04-03192, 2006 WL 687153, at *16–18 (Bankr. S.D.N.Y. Mar. 6, 2006); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005); *In re Greater S.E. Cmty. Hosp. Corp.*, 333 B.R. at 516; *In re Del-Met Corp.*, 322 B.R. at 813; *In re Global Serv. Group*, 316 B.R. at 458.

12. *See* Corp. Aviation Concepts, Inc. v. Multi-Service Aviation Corp., No. Civ. A. 03-3020, 2004 WL 1900001, at *3–4 (E.D. Pa. Aug. 25, 2004) (dismissing deepening insolvency claim

Generally speaking, however, deepening insolvency theory is not clearly defined or limited.[13] As the court in *Smith v. Arthur Andersen LLP*[14] observed, "it is difficult to grasp exactly what the theory entails."[15] Or, as one corporate law scholar recently noted, "[i]t is very difficult right now to know what the law is [in this area]."[16]

Several aspects of deepening insolvency theory are especially disconcerting for lawyers. For example, deepening insolvency theory seeks to hold lawyers representing a distressed corporation liable to non-clients (corporate creditors), to whom they otherwise owe no duties, and whose interests may conflict with the client.[17] If a lawyer represents both the corporation and an insider—a common joint representation—she may face additional liability attributable to her multiple roles. Lawyers may not be able to avoid problems or cure conflicts of interest by withdrawing from an insolvent client's representation because of timing issues or because the client will be unable to secure new counsel given the decreased prospect of payment.

Furthermore, even baseless deepening insolvency claims are expensive to defend and may harm a law firm's reputation. To the extent that representing financially infirm companies is seen as "foolhardy," or the associated risks are perceived to be "too high for any ethical or rational lawyer,"[18] deepening insolvency theory has the undesirable effect of discouraging good lawyers from representing clients that would benefit from their advice. Anecdotal evidence suggests that many lawyers perceive representing financially troubled companies outside of bankruptcy to be a "really frightening area of the law."[19]

This article explores the contours of deepening insolvency theory as it applies to lawyers. Section I examines the history of deepening insolvency

because plaintiffs did not sufficiently allege fraud); Nisselson v. Ford Motor Co. (*In re* Monahan Ford Corp. of Flushing), 340 B.R. 1, 40 (Bankr. E.D.N.Y. 2006) (stating that because deepening insolvency claim rested on the defendants' exploitation and looting of the debtor, the underlying fraud allegations had to be pleaded with particularity); *In re RSL COM PRIMECALL*, 2003 WL 22989669, at *6–7 (discussing constructive fraud allegations forming basis for deepening insolvency claim).

13. Jo Ann J. Brighton, *Deepening Insolvency*, AM. BANKR. INST. J., Apr. 2004, at 34, 79; *see also* Paul Rubin, *New Liability Under "Deepening Insolvency"*, AM. BANKR. INST. J., Apr. 2004, at 50, 69 (noting confusion surrounding elements of deepening insolvency as a cause of action and observing that it is unclear how deepening insolvency damages should be measured).

14. 421 F.3d 989 (9th Cir. 2005).

15. *Id*. at 1003–04.

16. Ann E. Conaway, Professor, Widener University School of Law, Lawyers' Liabilities in Representing Troubled Organizational Clients, Speech at Ass'n of Prof'l Responsibility Lawyers Mid-Year Meeting (Feb. 10, 2006).

17. *See* Berg & Berg Enters., LLC v. Sherwood Partners, Inc., 32 Cal. Rptr. 3d 325, 342–45 (Cal. Ct. App. 2005) (explaining that under California law lawyers do not owe duties to clients' creditors and should not be held to owe duties to third parties adverse to the lawyer's client).

18. Markell, *supra* note 1, at 428.

19. Conaway, *supra* note 16.

litigation. It discusses deepening insolvency as a theory of damages and as an independent cause of action. Section II probes the elements of deepening insolvency claims. Among other things, we contend that deepening insolvency, if anything more than a catch phrase, is at most and only rarely a viable damages theory; we argue that deepening insolvency cannot constitute an independent cause of action; we examine the role of the business judgment rule as a defense in deepening insolvency litigation; and we discuss causation, foreseeability, and damages in deepening insolvency cases. Finally, Section III offers lawyers practical advice on avoiding liability in deepening insolvency cases.

I. BACKGROUND AND THEORETICAL DEVELOPMENT

"Deepening insolvency," whether expressing an independent tort or a theory of damages, is a matter of state law; it is not a creature of the bankruptcy code or other federal law.[20] To the extent the theory is discussed by federal courts, that discussion most often occurs in the context of predicting whether a state's highest court would adopt the theory as a new cause of action, or whether it would recognize it as a measure of damages.[21] Deepening insolvency theory traces back to *Bloor v. Dansker (In re Investors Funding Corp. of New York Securities Litigation)*,[22] in which a bankruptcy trustee alleged that the corporate debtor's insiders looted the corporation and, as part of their scheme, artificially prolonged the corporation's existence to mask their past misdeeds and to raise new capital to steal.[23] In defending against the trustee's allegations that it aided and abetted the insiders' fraud, the debtor's accounting firm raised the adverse inference exception to the general rule that an agent's knowledge is imputed to her principal.[24] Addressing this aspect of agency law, the *Bloor* court stated: "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[25] Because the insiders' artificial extension of the debtor's solvency benefited only them and their confederates and not the corporation, which continued to deteriorate financially as their scheme went on, the court declined to impute the insiders' knowledge to the corporation.[26]

The *Bloor* court could have foregone discussion of the debtor's "deepening insolvency" and still have decided the case in the trustee's favor. The court's

20. Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 638 (Bankr. N.D. Tex. 2005).

21. *See id.* at 638–39 (mentioning only the recognition of a new cause of action).

22. 523 F. Supp. 533 (S.D.N.Y. 1980).

23. *Id.* at 541.

24. *Id.*

25. *Id.*

26. *Id.*

discussion of the subject is therefore dicta.[27] What began as dicta in a portion of a district court opinion discussing a point of agency law, however, developed into much more. Deepening insolvency claims have become standard in lawsuits brought by government regulators arising out of the failure of financial institutions and insurance companies.[28] The thrust in these cases is that by fraudulently creating the appearance that the institution or insurer was solvent, the defendants prevented authorities from timely placing the entity into receivership.[29]

Deepening insolvency claims are now common in lawsuits by bankruptcy trustees and other private litigants arising out of business failures.[30] The implication in these cases is that had the defendants not falsely created the impression that the company was solvent, the shareholders would have dissolved it when they could still salvage their investments, or that creditors could have involuntarily placed the company into bankruptcy before its assets were dissipated.

Not all courts recognize deepening insolvency theory.[31] Many courts do recognize it, however, and treat deepening insolvency allegations in one of two ways. First, some courts treat deepening insolvency as a theory of damages.[32]

27. *See* Sarnoff v. Am. Home Prods. Corp., 798 F.2d 1075, 1084 (7th Cir. 1984) (defining dictum as "a statement in a judicial opinion that could have been deleted without seriously impairing the analytical foundations of the holding").

28. *See, e.g.*, Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935 (5th Cir. 2001) (discussing deepening insolvency in this context); Corcoran v. Frank B. Hall & Co., 545 N.Y.S.2d 278, 283–84 (N.Y. App. Div. 1989).

29. *Fla. Dep't of Ins.*, 274 F.3d at 935.

30. *See* Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 549 (2005) (referring to bankruptcy trustees and administrators of bankruptcy estates, and identifying some potential defendants).

31. *See, e.g.*, Bondi v. Bank of Am. Corp. (*In re* Parmalat), 383 F. Supp. 2d 587, 601–02 (S.D.N.Y. 2005) (declining to recognize deepening insolvency as a cause of action under North Carolina law); Alberts v. Tuft (*In re* Greater S.E. Cmty. Hosp. Corp.), 333 B.R. 506, 517 (Bankr. D.D.C. 2005) (rejecting deepening insolvency theory as duplicative of other claims); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 641–46 (Bankr. N.D. Tex. 2005) (rejecting theory under Texas law); Trenwick Am. Litig. Trust v. Ernst & Young, LLP, C.A. No. 1571-N, 2006 WL 2434228, at *28–30 (Del. Ch. Aug. 10, 2006) (rejecting deepening insolvency theory in any form); Bondi v. Citigroup, Inc., No. BER-L-10902-04, 2005 WL 975856, at *21 (N.J. Super. Ct. Law Div. Feb. 28, 2005) (declining to recognize deepening insolvency as a theory of liability); Coroles v. Sabey, 79 P.3d. 974, 983 (Utah Ct. App. 2003) (declining to recognize deepening insolvency as a damage theory).

32. *See, e.g.*, Bondi v. Grant Thornton Int'l (*In re* Parmalat Sec. Litig.), 377 F. Supp. 2d 390, 419 (S.D.N.Y. 2005) (discussing Illinois law); Bookland of Me. v. Baker, Newman & Noyes, LLC, 271 F. Supp. 2d 324, 325–26, 332, 326 n.5 (D. Me. 2003) (leaving open possibility that court might ultimately certify deepening insolvency issue to the Supreme Court of Maine); Rafool v. Goldfarb Corp. (*In re* Fleming Packaging Corp.), 336 B.R. 398, 401 (Bankr. C.D. Ill.

Damages are measured by the failed corporation's increased debt or by the dissipation of its assets after the time it became insolvent. Second, other jurisdictions recognize deepening insolvency as an independent cause of action.[33]

A. Deepening Insolvency as a Theory of Damages

The Seventh Circuit energized deepening insolvency as a theory of damages in *Schacht v. Brown*.[34] In that case, the Illinois Director of Insurance, acting as the liquidator of Reserve Insurance Company, alleged that the defendants carried out a fraudulent scheme in which Reserve's corporate parent continued Reserve's business even though the insurer was insolvent. This saddled Reserve with additional liabilities and drove it deeper into insolvency damaging Reserve, its policyholders, and its creditors in an amount exceeding $100 million.[35] Had the Illinois Department of Insurance known that Reserve was insolvent, the Director alleged, it would have prevented Reserve from continuing to write insurance and would have acted to prevent the further dissipation of the company's assets.[36]

The defendants challenged the Director's standing to sue on Reserve's behalf, arguing that "a corporation may never sue to recover damages alleged to have resulted from the artificial prolongation of an insolvent corporation's life."[37] The *Schacht* court disagreed. First, the alleged harm to Reserve stemmed not only from the extension of its normal business operations, but from specific actions in connection with the extension that crippled the company.[38] Beyond allowing Reserve's assets to be dissipated by its normal business operations, the defendants allegedly siphoned millions of dollars out of the company and drained it of its most profitable and least risky business,

2006) (attempting to predict Delaware law); Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001).

33. *See, e.g.*, Seitz v. Detweiler, Hershey & Assocs., P.C. (*In re* CitX Corp.), 448 F.3d 672, 677 (3d Cir. 2006); Smith v. Arthur Andersen LLP, 421 F.3d 989, 1003–04 (9th Cir. 2005); Rahl v. Bande, 328 B.R. 387, 416–18 (S.D.N.Y. 2005); Nisselson v. Ford Motor Co. (*In re* Monahan Ford Corp. of Flushing), 340 B.R. 1, 39–40 (Bankr. E.D.N.Y. 2006); OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510, 527–31 (Bankr. D. Del. 2006); *In re* LTV Steel Co., Inc., 333 B.R. 397, 421–22 (Bankr. N.D. Ohio 2005); Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 811–15 (Bankr. M.D. Tenn. 2005); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 619–20 (Bankr. E.D. Pa. 2005); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 750–52 (Bankr. D. Del. 2003).

34. 711 F.2d 1343 (7th Cir. 1983).

35. *Id.* at 1345.

36. *Id.*

37. *Id.* at 1349–50.

38. *Id*. at 1350.

thereby deepening its insolvency.[39] In other words, the defendants' "bleeding of Reserve" was part of a fraudulent scheme.[40]

Second, the court rejected the suggestion "that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests."[41] That "premise collides with common sense" because a corporation descending ever deeper into insolvency "is ineluctably damaged" by its increasing obligations to creditors.[42] As the court further explained:

> Indeed, in most cases, it would be crucial that the insolvency of the corporation be disclosed, so that shareholders may exercise their right to dissolve the corporation in order to cut their losses. . . . Thus, acceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible.[43]

Several courts have followed *Schacht*,[44] even when the recognition of deepening insolvency as a theory of damages is counterintuitive, as was the case in *Allard v. Arthur Andersen & Co*.[45] Allard was the bankruptcy trustee for DeLorean Motor Company (DMC).[46] He sued DMC's former auditors, Arthur Andersen & Company (Andersen), for malpractice, negligence, breach of contract, unjust enrichment, fraud, aiding and abetting fraud and/or breach of fiduciary duty, securities fraud, aiding and abetting securities fraud, RICO violations, aiding and abetting RICO violations, and violating a Michigan statute.[47] Among other things, the trustee sought damages based on DMC's indebtedness to trade creditors.[48] Moving for summary judgment, Andersen argued that the trustee could not recover such damages because "DMC could not conceivably have been damaged by further indebtedness because the indebtedness provided a benefit—more capital—to the company."[49]

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

40. *Id*.

41. *Id*.

42. *Id*.

43. *Id*.

44. *See, e.g.*, Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997) (citing Schacht v. Brown, 711 F.2d 1343, 1347–48 (7th Cir. 1983)); *In re* LTV Steel Co., 333 B.R. 397, 422 (Bankr. N.D. Ohio 2005) (quoting Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)); *In re* Latin Inv. Corp., 168 B.R. 1, 5 (Bankr. D.C. 1993) (quoting Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)).

45. 924 F. Supp. 488 (S.D.N.Y. 1996).

46. *Id.* at 490.

47. *Id*. at 491.

48. *See id.* at 494.

49. *Id*. at 494.

Acknowledging that Andersen's argument was "intuitively appealing," the court nonetheless rejected it, relying on *Schacht*.[50]

The *Allard* court observed that credit may be an illusory financial cushion "that lulls shareholders into postponing the decision to dissolve a corporation" before management can squander the company's remaining resources, such that the infusion of capital from creditors does not necessarily benefit a distressed corporation.[51] Furthermore, Andersen's principal attack on the trustee's "deepening insolvency" theory was that it was not legally recognized; Andersen did not attack the factual basis for the theory in the case at hand.[52] The court reasoned that "because courts have permitted recovery on a 'deepening insolvency' theory," Andersen was not entitled to summary judgment on any portion of the trustee's case representing damages attributable to DMC's indebtedness to trade creditors.[53]

Allard should be afforded little weight. First, one of the two cases permitting recovery for deepening to which insolvency the *Allard* court referred in rejecting the defendant's arguments was *Bloor v. Dansker (In re Investors Funding Corp. of New York Securities Litigation)*.[54] As noted previously, the discussion in *Bloor* supposedly advocating deepening insolvency theory was dicta.[55] Second, the *Allard* court was persuaded by the fact that other courts recognized deepening insolvency theory and, conjunctively, that no cases appeared to have explicitly rejected the theory.[56] That basis for decision no longer exists. There are now a number of cases rejecting deepening insolvency claims.[57] Third, Andersen offered no facts to

50. *Allard*, 924 F. Supp. at 494.

51. *Id*.

52. *Id*.

53. *Id*.

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

55. *See In re Investors Funding Corp.*, 523 F. Supp. 533; *supra* text accompanying notes 22–26.

56. *See Allard*, 924 F. Supp. at 494.

57. *See, e.g.*, Askanase v. Fatjo, No. Civ. A. H-91-3140, 1996 WL 33373364, at *28 (S.D. Tex. Apr. 1, 1996) (rejecting trustee's deepening insolvency argument because the insolvent debtor was not damaged by the false financial statements, since the shareholders had already lost all of their equity and there was no allegation of harm to creditors); Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935–36 (5th Cir. 2001) (explaining that the plaintiff had presented no evidence of additional debt incurred by an insolvent insurer and, thus, no evidence of damages); *In re* Parmalat Sec. Litig., 383 F. Supp. 2d 587, 601–02 (S.D.N.Y. 2005) (discussing North Carolina law); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 646 (Bankr. N.D. Tex. 2005) (rejecting deepening insolvency theory as duplicating torts established under Texas law); Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 456–61 (Bankr. S.D.N.Y. 2004); Trenwick Am. Litig. Trust v. Ernst & Young, LLP, C.A. No. 1571-N, 2006 WL 2434228, at *28–30 (Del. Ch. Aug. 10, 2006); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003).

support its argument against deepening insolvency damages. The trustee apparently refused to answer interrogatories that might have provided Andersen with ammunition for its argument, but it never sought to compel the trustee's responses.[58] Although experienced litigators can appreciate how such things happen, this failure is glaring because the trustee offered no specific evidence supporting his deepening insolvency theory.[59] Had Andersen better prepared its defense, the case might have turned out differently.

Finally, there is generally no merit in the *Allard* court's position that further indebtedness may create an illusory financial cushion that lulls creditors into a false sense of security. This is easily illustrated by way of example. Consider a company with no cash and $1 million in debt that borrows an additional $1 million. The company now has $1 million in cash and $2 million in debt. The company's degree of insolvency, however, is unchanged. The creditors remain able to judge the wisdom of allowing the company to operate at that particular level of insolvency. There is, in short, no way that a company's mere borrowing should lull creditors into a false sense of security.[60]

B. Deepening Insolvency as an Independent Cause of Action

Deepening insolvency may be more than a theory of damages. Plaintiffs suing in connection with corporate meltdowns often allege that deepening insolvency theory is an independent cause of action. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*[61] is generally considered the leading case on deepening insolvency as a cause of action.

Lafferty arose out of the activities of the Shapiro family.[62] The Shapiros allegedly operated Walnut Equipment Leasing Company and its wholly owned subsidiary, Equipment Leasing Corporation of America (ELCOA), as a Ponzi scheme.[63] Cogen Skar, LLP (Cogen) served as accountants for the Shapiro family's operations and R.F. Lafferty & Company (Lafferty) served as the family's independent underwriters.[64] Cogen and Lafferty allegedly conspired with the Shapiros "to render opinions replete with multiple fraudulent misstatements and material omissions concerning Walnut and ELCOA's financial statements."[65] When the Shapiros' scheme collapsed, Walnut and

58. *Allard*, 924 F. Supp. at 494.

59. *Id*.

60. *See* William Bates III, *Deepening Insolvency: Into the Void*, AM. BANKR. INST. J., Mar. 2005 at 1, 60 (describing borrowing in this context as "solvency-neutral"); Willett, *supra* note 30, at 552–55.

61. 267 F.3d 340 (3d Cir. 2001).

62. *Id.* at 344.

63. *Id*.

64. *Id.* at 345.

65. *Id*.

ELCOA sought bankruptcy protection in the Eastern District of Pennsylvania.[66] The trustee in their case appointed an Official Committee of Unsecured Creditors (the Committee).[67]

In February 1999, the Committee sued the Shapiros and various companies owned by them, Walnut's and ELCOA's officers and directors, Cogen, and Lafferty, alleging that the defendants "wrongfully expanded the debtors' debt out of all proportion of their ability to repay and ultimately forced the debtors to seek bankruptcy protection."[68] The Committee also sued the Shapiros, Cogen, and Lafferty for federal securities law violations, common law fraud, negligent misrepresentation, mismanagement, breach of fiduciary duty, breach of contract, professional malpractice, and aiding and abetting breach of fiduciary duty.[69] The defendants moved to dismiss.[70] The district court dismissed the claims against Cogen and Lafferty under the doctrine of *in pari delicto*.[71] The court denied the other defendants' motions.[72] The Committee then severed its claims against Cogen and Lafferty and appealed their dismissal.[73] Cogen settled with the Committee, leaving Lafferty as the sole appellee.[74]

On appeal, the Third Circuit was called upon to determine "whether the alleged theory of injury—'deepening insolvency'—[was] cognizable under Pennsylvania law," no Pennsylvania appellate court having directly addressed the issue.[75] The *Lafferty* court concluded that if presented with the issue, "the Pennsylvania Supreme Court would determine that 'deepening insolvency' may give rise to a cognizable injury."[76] As the court explained:

> First and foremost, the theory is essentially sound. Under federal bankruptcy law, insolvency is a financial condition in which a corporation's debts exceed the fair market value of its assets. . . . Even 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. For example, to the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative

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

67. *Id*.

68. *Id*.

69. *Id*. at 345–46.

70. *Id.* at 346.

71. *Lafferty*, 267 F.3d at 355. *In pari delicto* means "in equal fault" or "equally culpable." BRYAN A. GARNER, DICTIONARY OF MODERN LEGAL USAGE 451 (2d ed. 1995). When invoked as an affirmative defense, the doctrine "provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim." *Lafferty*, 267 F.3d at 354.

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

73. *Id.*

74. *Id*.

75. *Id*. at 349.

76. *Id*.

> costs on the corporation. . . . When brought on by unwieldy debt, bankruptcy also creates operational limitations which hurt a corporation's ability to run its business in a profitable manner. . . . Aside from causing actual bankruptcy, deepening 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, thereby damaging the corporation's assets, the value of which often depends on the performance of other parties. . . . In addition, prolonging an insolvent corporation's life through bad debt may simply cause the dissipation of corporate assets. These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.[77]

Moreover, in Pennsylvania, as in most jurisdictions, it is settled that "where there is an injury, the law provides a remedy."[78] The *Lafferty* court thus reasoned that where deepening insolvency damages a corporation's property, the Pennsylvania Supreme Court would provide a remedy by recognizing a cause of action for that injury.[79]

The court ultimately concluded that the Pennsylvania Supreme Court would "recognize 'deepening insolvency' as giving rise to a cognizable injury in the proper circumstances."[80] Unfortunately for the Committee, the court further concluded that the *in pari delicto* doctrine barred the Committee, which stood in the debtors' shoes, from pursuing its claims against Lafferty.[81] The Third Circuit thus affirmed the district court judgment.[82]

Early on, the *Lafferty* court stated that "'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law and that the Committee therefore had standing" to sue the many defendants.[83] Beyond that isolated statement, however, it is difficult to understand why *Lafferty* is thought to be authority for recognizing deepening insolvency as a cause of action. The Committee did not plead deepening insolvency as an independent cause of action; it pleaded federal securities law violations, common law fraud, negligent misrepresentation, breach of contract, mismanagement and breach of fiduciary duty, professional malpractice, and aiding and abetting breach of fiduciary duty.[84] The allegation of deepening insolvency that appears to be the centerpiece of the case—that the defendants "wrongfully expanded the

77. *Lafferty*, 267 F.3d at 349–50.
78. *Id*. at 351.
79. *Id*.
80. *Id*. at 352.
81. *Id*. at 360.
82. *Lafferty*, 267 F.3d at 352.
83. *Id*. at 344.
84. *Id*. at 345–46.

[d]ebtors' debt out of all proportion of their ability to repay and ultimately forced the [d]ebtors to seek bankruptcy protection"—was apparently an allegation made within one of the pleaded causes of action.[85] At most, then, the debtors' deepening insolvency was either a fact supporting one or more of the Committee's causes of action or it was an element of damage.

Key passages of the opinion indicate that deepening insolvency should at most be an element of damage. For example, after donning "the soothsayer's garb" to predict how the Pennsylvania Supreme Court would rule, the *Lafferty* court wrote "that, if faced with the issue, the Pennsylvania Supreme Court would determine that 'deepening insolvency' may give rise to a cognizable injury."[86] That is as much a statement of damages theory as it is anything else.

The court's recognition of the "venerable principle[]" of Pennsylvania law that "where there is an injury, the law provides a remedy,"[87] does not indicate otherwise. The question for the court was whether an insolvent corporation is damaged if it becomes poorer still, i.e., whether deepening insolvency is an injury. If so, the remedies the law provides already existed among the causes of action the Committee pleaded in its complaint. The court went on to state that "an identifiable and compensable injury is essential to the existence of tort liability," and that "where a contractual breach occurs, contract law seeks to give the nonbreaching party the benefit of his or her bargain, to put him or her in the position he or she would have been in had there been no breach."[88] These statements clearly indicate that deepening insolvency is at most an element of damage. With respect to the first, the court could just as easily have written, "identifiable damages are essential to the existence of tort liability," and the second is a hornbook statement of contract damages.

Finally, if the Pennsylvania Supreme Court would recognize a deepening insolvency cause of action, what elements would it require a plaintiff to prove? Duty? Breach? Proximate cause? Reasonable reliance? Scienter? The fact that these elements are nowhere explained in the opinion is compelling evidence that the *Lafferty* court's early statement that "'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law"[89] was in fact an awkward expression of the court's belief that under Pennsylvania law, a plaintiff suing in tort or for breach of contract may recover damages for a company's deepening insolvency.

In summary, a careful reading of *Lafferty* reveals little support for recognizing deepening insolvency as a cause of action. Unfortunately, when recently given the chance to correct the problems with *Lafferty* or to retreat

85. *Id*. at 345.
86. *Id*. at 349.
87. *Lafferty*, 267 F.3d at 351.
88. *Id*. (internal quotations omitted).
89. *Id*. at 344.

from its holding another case involving allegations of deepening insolvency under Pennsylvania law, in *In re CitX Corp., Inc.*,[90] the Third Circuit did not utilize that opportunity. Instead, the court in *In re CitX* rather summarily reaffirmed that deepening insolvency is an independent cause of action under Pennsylvania law, albeit one linked only to fraud.[91]

In *In re CitX*, an insolvent company operating a Ponzi scheme used its financial statements to lure investors.[92] The company burned through the investors' money, incurred millions more in debt, and filed for bankruptcy protection.[93] The bankruptcy trustee sued the company's accounting firm and the partner there responsible for compiling the financial statements for malpractice and "deepening insolvency."[94] The district court entered summary judgment for the defendants on both claims, and the trustee appealed.[95] The Third Circuit affirmed the district court.[96]

With respect to the malpractice claim, the trustee alleged that deepening insolvency was a theory of damages in that the defendants "dramatically deepened the insolvency of CitX, and wrongfully expanded the debt of CitX and waste of its illegally raised capital, by permitting CitX to incur additional debt" by compiling the fraudulent financial statements.[97] The Third Circuit thus had to decide if deepening insolvency is a viable damage theory in negligence cases.[98] Reviewing its decision in *Lafferty*, the court concluded that it was not a viable damage theory.[99] Nothing in *Lafferty*, the court stated, should "be interpreted to create a novel theory of damages for an independent cause of action like malpractice."[100] The court further explained that it did not mean to imply by the quoted language that deepening insolvency was a valid theory of damages in connection with other causes of action, such as fraud.[101]

As for deepening insolvency as an independent cause of action, the court held "that a claim of negligence cannot sustain a deepening-insolvency cause of action."[102] Deepening insolvency under Pennsylvania law requires fraudulent conduct on the defendants' part.[103] Unfortunately, the court in *In re*

90. 448 F.3d 672 (3d Cir. 2006).
91. *See id*. at 681.
92. *Id.* at 674.
93. *Id*.
94. *Id*.
95. *In re CitX*, 448 F.3d at 674.
96. *Id*. at 681.
97. *Id*.
98. *Id*.
99. *Id.*
100. *In re CitX*, 448 F.3d at 681.
101. *Id*. at 677 n.8.
102. *Id*. at 681.
103. *Id*.

CitX did not identify the elements of a fraud-based deepening insolvency claim.

Lafferty and *In re CitX* aside, *In re Exide Technologies, Inc.*[104] is another case plaintiffs often cite for the proposition that deepening insolvency is an independent cause of action. *Exide Technologies* stemmed from events leading to the 2002 bankruptcy of the Exide Group (Exide).[105] In 1997, various banks established a $650 million credit facility for Exide.[106] In 2000, these same banks loaned Exide $250 million to acquire a competitor, GNB Dunlop.[107] Exide's financial condition deteriorated rapidly after it acquired GNB Dunlop.[108] In October 2001, the banks amended the loan documents in return for liens on all of Exide's foreign subsidiaries' assets and capital stock.[109] In December 2001, the parties entered into a third amendment to their loan agreement that granted the banks additional collateral and guarantees, and did so in ways such that the transactions could not be challenged as preferential transfers under federal bankruptcy law.[110] During the time that these amendments were being negotiated and executed, Exide suffered massive losses and allegedly became more insolvent.[111]

The plaintiffs sued the lenders in January 2003. In the twelfth count of their complaint, they pled a claim for deepening insolvency.[112] The plaintiffs alleged that the banks caused Exide to acquire GNB Dunlop so that they could obtain the control necessary to force Exide to continue its business for nearly two years at ever increasing levels of insolvency.[113] The banks' conduct allegedly caused Exide "to suffer massive losses and become more deeply insolvent, costing creditors substantial value."[114] The banks moved to dismiss, asserting that deepening insolvency was not a recognized cause of action under Delaware law, that the plaintiffs did not allege that the banks had committed an actionable tort, that there was no allegation that the banks owed duties to Exide or its creditors, that the plaintiffs had not pleaded fraud with requisite particularity, and that the *in pari delicto* doctrine defeated the claim.[115]

The *Exide Technologies* court first had to determine whether deepening insolvency was a valid claim under Delaware law.[116] The court began its

104. 299 B.R. 732 (Bankr. D. Del. 2003).
105. *Id.* at 735.
106. *Id*. at 736.
107. *Id.*
108. *Id.*
109. *In re Exide Techs.*, 299 B.R. at 736.
110. *Id*.
111. *Id*.
112. *Id.* at 750.
113. *Id.* at 750–51.
114. *In re Exide Techs.*, 299 B.R. at 751.
115. *Id*.
116. *Id.*

analysis by noting that because the Delaware Supreme Court had not spoken on the tort of deepening insolvency, it would have to predict how Delaware's highest court would rule on the issue if given the chance.[117] To do this, the court was required to consider (1) statements by the Delaware Supreme Court in related areas, (2) cases decided by Delaware's intermediate courts, (3) federal court cases interpreting Delaware law, and (4) decisions from other jurisdictions discussing the issue.[118] Because the first two categories yielded no helpful authority, the court turned to federal cases analyzing state law, and thus, to *Lafferty*.[119] The *Exide Technologies* court cited and quoted *Lafferty* at length in analyzing the plaintiffs' deepening insolvency claim:

> The Court of Appeals held that three factors "would persuade the Pennsylvania Supreme Court to recognize 'deepening insolvency'" as giving rise to a cognizable injury in the proper circumstances. *Lafferty*, 267 F.3d at 352. These factors were the: (1) soundness of the theory; (2) growing acceptance of the theory among courts; and (3) remedial theme in Pennsylvania law (when there is an injury). *Id*. The Court found that the theory of deepening insolvency, particularly in the bankruptcy context, was a sound one. *Id*. at 349–50. Furthermore, the Court found that the "[g]rowing acceptance of the deepening insolvency theory confirms its soundness." *Id*. at 350. The Court then cited numerous cases in which deepening insolvency was found to give rise to a cognizable injury. *Lafferty*, 267 F.3d at 350–51. Finally, the court determined that "one of the most venerable principles in Pennsylvania jurisprudence, and in most common law jurisdictions for that matter is that, where there is an injury, the law provides a remedy." *Id*. at 351.[120]

The court reasoned based on *Lafferty* that the first two elements, i.e., the soundness of deepening insolvency theory and its growing judicial acceptance, had been met.[121] As for the third element, being the remedial theme of the forum state's law, the court observed that the Delaware Supreme Court had stated that "the function of a damage award in 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."[122] The court thus concluded, based on *Lafferty* and Delaware's remedial scheme, that the Delaware Supreme Court would recognize a claim for deepening insolvency where there is damage to corporate property.[123] With respect to the defendants' remaining arguments for

117. *Id*.

118. *Id.* at 751 (citing Wiley v. State Farm Fire & Cas. Co., 995 F.2d 457, 459–60 (3d Cir. 1993)).

119. *In re Exide Techs.*, 299 B.R. at 751–52 (citing and discussing Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001)).

120. *Id*.

121. *Id.* at 752.

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

123. *Id*.

dismissal, the court stated that the plaintiffs had sufficiently pleaded their deepening insolvency claim, leaving the other issues for another day.[124]

Exide Technologies is not at all persuasive. Although it may have been true at the time the case was decided that some courts recognized deepening insolvency as an independent cause of action, what about those that did not?[125] What about courts that had recognized deepening insolvency only as a damages theory?[126] The *Exide Technologies* court stated that the *Lafferty* court "cited numerous cases in which deepening insolvency was found to give rise to a cognizable injury,"[127] but of the seven cases the *Lafferty* court cited, three recognized only that deepening insolvency is a theory of damages, and another three involved New York law.[128] "No reported New York case, however, has ruled that 'deepening insolvency' is an independent tort."[129] How then did the cases cited in *Lafferty* compel the conclusion that the Delaware Supreme Court would recognize deepening insolvency as an independent cause of action? Given that the court was being called on to predict Delaware law, it should have analyzed the decision in *Lafferty* as well as the cases the Third Circuit cited; the *Exide Technologies* court specifically noted that in predicting Delaware law it was required to "examine" decisions from other jurisdictions discussing deepening insolvency.[130] The term "examine" does not mean "read uncritically" or "acknowledge and ignore," nor in this context does it suggest that a court should read only one case from another jurisdiction.

The *Lafferty* court was predicting Pennsylvania law; the *Exide Technologies* court, being asked to predict Delaware law, was not obliged to follow *Lafferty* simply because it was decided by the highest court in the same judicial circuit. Indeed, because the court was predicting Delaware law, special analytical care was in order.

The *Exide Technologies* court's embrace of Delaware's remedial scheme, like the *Lafferty* court's embrace of Pennsylvania's remedial scheme, should have caused the court to conclude that the plaintiffs' deepening insolvency claim was at most a theory of damages. The Delaware Supreme Court's statement that "the function of a damage award in civil litigation is to provide

124. *See In re Exide Techs.*, 299 B.R. at 752.

125. *See, e.g.*, Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924, 935 (5th Cir. 2001) (interpreting Texas law).

126. *See, e.g.*, Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983); Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997); Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721, 728 (Bankr. S.D. Fla. Nov. 2001); Latin Inv. Corp. v. L & L Constr. Assocs., Inc. (*In re* Latin Inv. Corp.), 168 B.R. 1, 5 (Bankr. D.C. 1993).

127. *In re Exide Techs.*, 299 B.R. 752, 752.

128. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 350–51 (3d Cir. 2001).

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

130. *In re Exide Techs.*, 299 B.R. at 751.

full and just compensation to a plaintiff who suffers injury or loss by reason of the conduct of the tortfeasor" cannot be read to license the recognition of a new cause of action, especially where the plaintiffs had pleaded eleven other causes of action arising out of the same factual nucleus.[131] *Exide Technologies* is in all pertinent respects an analytical mess.

C. Rejecting Deepening Insolvency Theory

The best analysis of deepening insolvency theory is found in *Kittay v. Atlantic Bank of New York (In re Global Service Group LLC)*,[132] decided under New York law. In that case, Global Service Group filed for bankruptcy. The bankruptcy trustee then sued Global's insiders (the Goldmans and Cohen) and Atlantic Bank. The trustee alleged that Global was insolvent, or nearly so, and was undercapitalized from the time of its formation.[133] The trustee further alleged that Atlantic Bank knew, or should have known, of Global's condition but loaned it money anyway based on "its relationship with the Goldmans and the strength of their personal assets."[134] Atlantic Bank's willingness to extend credit to Global influenced other creditors to do likewise.[135] Long story short, by extending credit to Global, Atlantic Bank allowed it to "prolong its corporate existence and incur increased debt."[136]

Similarly, the trustee alleged that the Goldmans and Cohen allowed Global to do business while it was insolvent and undercapitalized.[137] By prolonging Global's existence and continuing to incur debt, they deepened the company's insolvency and reduced creditors' potential recovery from the bankruptcy estate.[138] The trustee alleged that the "expansion of Global's debt was the proximate cause of damage to Global and its creditors."[139]

The defendants moved to dismiss the trustee's complaint. One of the issues was the trustee's cause of action for deepening insolvency, which the court described as "'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt."[140] The court carefully analyzed whether deepening insolvency should be treated as a theory of damages or as an independent cause of action,[141] noting in the process that New York case law suggested that deepening

131. *See id.* at 752 (quoting Maier v. Santucci, 697 A.2d 747, 749 (Del. 1997)).
132. 316 B.R. 451 (Bankr. S.D.N.Y. 2004).
133. *Id.* at 455.
134. *Id.*
135. *Id.* at 455–56.
136. *Id.*
137. *In re Global Serv. Group*, 316 B.R. at 456.
138. *Id.*
139. *Id.*
140. *Id.* (quoting Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)).
141. *Id.* at 457–58.

insolvency was a theory of damages resulting from the commission of a separate tort, and observing that no reported New York decision had ever suggested that deepening insolvency was an independent tort.[142] In any event,

> [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.[143]

Against this backdrop, the trustee's deepening insolvency cause of action fell short. The fact that Atlantic Bank made a loan to Global that it knew or should have known the company could not repay may have been bad banking, but it was not a tort.[144] Lenders are not prohibited from extending credit to insolvent companies; were that the case, most insolvent companies would be forced to liquidate.[145] As for the fact that Atlantic Bank loaned money to Global based "on the strength of its relationship with the Goldmans and their personal assets," that was "neither surprising nor improper."[146] Banks prefer to lend money to people they know, and they routinely insist on personal guarantees and pledges of personal funds.[147] Importantly, the trustee did not allege that Atlantic Bank loaned money to Global for the purpose of allowing the Goldmans to "siphon off" those funds or to engage in other wrongdoing.[148]

"The unspoken premise of the trustee's 'deepening insolvency' theory [was] that the managers of an insolvent" company have an "absolute duty" to liquidate it, and that "anyone who knowingly extends credit to the insolvent company breaches an independent duty in the nature of aiding and abetting the managers' wrongdoing."[149] This is a flawed assumption, as the *In re Global Service Group* court properly noted.[150]

The directors and officers of a corporation owe fiduciary duties to both the corporation and its shareholders.[151] Once the corporation becomes insolvent, their duties extend to creditors.[152] At that point, "the directors and officers owe duties to multiple constituencies whose interests may diverge," and they are

142. *In re Global Serv. Group*, 316 B.R. at 458.
143. *Id.*
144. *Id.* at 459.
145. *Id.*
146. *Id*.
147. *In re Global Serv. Group*, 316 B.R. at 459.
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *In re Global Serv. Group*, 316 B.R. at 460.

obligated to all concerned to act in good faith to maximize the corporation's long-term capacity for creating wealth.[153] As a result,

> [t]he fiduciaries of an insolvent business might well conclude that the company should continue to operate in order to maximize its "long-term wealth creating capacity," or more generally, its enterprise value. In fact, chapter 11 [of the Bankruptcy Code] is based on the accepted notion that a business is worth more to everyone alive than dead. . . . [T]here is no absolute duty . . . to shut down and liquidate an insolvent corporation. The fiduciaries may, consistent with the business judgment rule, continue to operate the corporation's business.[154]

In short, directors' and officers' negligent but good faith decision to operate an insolvent business will not expose them to liability on a deepening insolvency theory.[155]

To overcome the business judgment rule,[156] a plaintiff must specifically allege that directors acted in bad faith or with fraudulent intent.[157] Although the trustee alleged elsewhere in the complaint that the Goldmans were engaged in self-dealing, he did not allege that Global's insiders prolonged the company's existence to misappropriate loan proceeds.[158] The trustee's incorrect assumption that merely prolonging the existence of an insolvent corporation and thereby incurring additional debt and stating a claim for relief was fatal.[159]

The *In re Global Service Group* court further noted that the trustee's complaint failed to allege proximate cause.[160] The trustee's allegation that but for Atlantic Bank's loans Global would have liquidated before its insolvency deepened was insufficient.[161] The gravamen of the trustee's case was that the Goldmans had received fraudulent transfers from Global and that they used some of the Atlantic Bank loan proceeds in their scheme.[162] But while it arguably was foreseeable that the Atlantic Bank loans would permit Global to

153. *Id.* (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991)).

154. *Id.* (citations and footnote omitted).

155. *Id.* at 461.

156. "The business judgment rule 'is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 656 (Bankr. S.D.N.Y. 1992) (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

157. *In re Global Serv. Group*, 316 B.R. at 461.

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *In re Global Serv. Group*, 316 B.R. at 461.

continue doing business, there were no facts suggesting that Atlantic Bank could have foreseen that the Goldmans would misappropriate loan proceeds or operate their insolvent business for an improper purpose.[163] The court therefore dismissed the trustee's deepening insolvency claim.[164]

In re Global Service Group is well reasoned and courts should follow it, as some already have.[165] The court made several points worth remembering. First, "deepening insolvency" may be nothing more than a statement of corporate condition.[166] The directors and officers of a company may have to operate through desperately lean times if the company is to recognize its long-term financial potential.[167] "A firm still can be economically viable even if it is insolvent."[168] This is well evidenced by the Bankruptcy Code itself, which permits bankrupt businesses to pursue rehabilitation (which necessarily entails deepening insolvency) rather than liquidating.[169] Second, no matter how deepening insolvency theory may be described, it must be tempered by and subject to the business judgment rule.[170] Courts following that rule uphold corporate directors' decisions so long as they reflect rational business purposes.[171] By logical extension, because a corporation's lawyers are its agents,[172] lawyers should not face liability on a deepening insolvency theory

163. *Id.*

164. *Id.*

165. *See, e.g.*, Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 641–46 (Bankr. N.D. Tex. 2005) (finding that Supreme Court of Texas would not recognize deepening insolvency as a cause of action); Trenwick Am. Litig. Trust v. Ernst & Young, LLP, C.A. No. 1571-N, 2006 WL 2434228, at *28–30 (Del. Ch. Aug. 10, 2006) (rejecting deepening insolvency as an independent cause of action and citing *In re Global Services Group* among other cases).

166. *See In re Global Serv. Group*, 316 B.R. at 460 n.7.

167. *See id.*

168. Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1498 (1993).

169. Bates, *supra* note 60, at 60; *see also* Elizabeth M. Bohn, *Time to Reorganize: But How?*, BUS. LAW TODAY, Mar./Apr. 2006, at 43, 44 (explaining that it is a core bankruptcy principle that preserving a business rather than liquidating it is usually in the best interests of the company's creditors, employees, and business partners).

170. *See In re Global Serv. Group*, 316 B.R. at 460.

171. Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 656 (Bankr. S.D.N.Y. 1992) (quoting CRTF Corp. v. Federated Dep't Stores, 683 F. Supp. 422 (S.D.N.Y. 1988)).

172. The attorney-client relationship is an agency relationship. *See, e.g.*, Wentland v. Wass, 25 Cal. Rptr. 3d 109, 117 (Cal. Ct. App. 2005) (quoting Schafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone, 131 Cal. Rptr. 2d 777 (Cal. Ct. App. 2003)); Seaboard Sur. Co. v. Boney, 761 A.2d 985, 989, 992 (Md. Ct. Spec. App. 2000); Multilist Serv. of Cape Girardeau, Mo., Inc. v. Wilson, 14 S.W.3d 110, 114 (Mo. Ct. App. 2000); Crane Creek Ranch, Inc. v. Cresap, 103 P.3d 535, 537 (Mont. 2004); Daniel v. Moore, 596 S.E.2d 465, 469 (N.C. Ct. App. 2004) (quoting Johnson v. Amethyst Corp., 463 S.E.2d 397, 400 (N.C. Ct. App. 1995)); State *ex rel.* Okla. Bar Ass'n v. Taylor, 4 P.3d 1242, 1253 n.39 (Okla. 2000); McBurney v. Roszkowski,

for assisting or implementing the legitimate business decisions of the directors and officers of an insolvent company. Third, deepening insolvency theory should at most be considered to express a category or type of damages awarded only upon proof of a separate tort, typically a species of fraud or closely linked to fraudulent conduct.[173]

II. THE LEGAL VIABILITY OF DEEPENING INSOLVENCY CLAIMS

When a deepening insolvency claim looms, the entity involved typically is in bankruptcy or receivership, and a trustee or receiver is administering the entity or its estate with a principal goal of maximizing its value. Achieving this goal enhances the company's chances to reorganize and operate successfully going forward or, at a minimum, increases disbursements to creditors and shareholders. Consequently, trustees and receivers frequently scrutinize as a potential source of recovery the failed company's fiduciaries, including lawyers who advised and assisted the company while it was in the zone of insolvency.[174]

The issue here is whether and when deepening insolvency theory is a valid arrow in a trustee's or receiver's quiver. Unlike claims for legal malpractice, breach of fiduciary duty, and aiding and abetting fraud or breach of fiduciary duty, deepening insolvency lacks the definition of elements essential to independent causes of action.[175] Even as a damages theory, deepening insolvency generally suffers from unprovable causation and fatally imprecise elements. For example, a company's mere increase in debt is not an economic injury.[176] Only if company insiders loot the new loan proceeds does the increased debt load become a damages factor, and even there the harm is attributable to the looting, not the borrowing.[177] The fact that a company's deepening insolvency may shake creditors' confidence, and thus impair the company's assets, is likewise no basis for assessing damages because deepening insolvency involves the fraudulent prolonging of an entity's existence through the concealment of its true financial condition, meaning that "no one's confidence will be shaken because no one knows that bankruptcy

875 A.2d 428, 437 (R.I. 2005) (quoting State v. Cline, 405 A.2d 1192, 1199 (R.I. 1979)); Hill & Griffith Co. v. Bryant, 139 S.W.3d 688, 696 (Tex. App. 2004).

173. Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005).

174. *See* Brighton, *supra* note 13, at 34 (noting that deepening insolvency claims are commonly asserted against an insolvent company's accountants, investment advisers, and lawyers); J.B. Heaton, *Deepening Insolvency*, 30 J. CORP. L. 465, 470 (2005) (stating that a defunct corporation's professional service firms often are "preferred targets" in litigation).

175. *See In re Vartec Telecom*, 335 B.R. at 645 ("If 'deepening insolvency' were a tort, what would its elements be?").

176. Bates, *supra* note 60, at 60.

177. *Id.*

beckons."[178] Nonetheless, if it is anything other than a catch phrase, deepening insolvency is recognizable only as a limited theory of damages in narrow circumstances.

A. *Deepening Insolvency Should Be Judicially Recognized Only in Limited Circumstances*

In the face of severe financial challenges, corporate fiduciaries must strive to maximize a company's "economic value."[179] To this end, corporate directors and officers often undertake, with the assistance of lawyers and other professionals, efforts intended—but not ensured—to increase revenue and to enhance assets or reduce liabilities. But no matter how well planned or well intentioned, such efforts are inevitably risk-laden.[180] Even the most carefully designed and executed efforts carry the very real possibility that the endeavor may fail. When that occurs, the company may be deeper in debt; it may experience decreased profitability and value; it may be faced with additional expenses; it may be constrained by operational limitations; and it may suffer strained relationships with creditors, customers, lenders and other outsiders critical to its business. Even when such risks materialize, however, they do not necessarily evidence corporate malfeasance for which those acting on the company's behalf or counseling it should be liable.

It is only where corporate fiduciaries and the outside professionals assisting them have acted fraudulently to plunge the company further into insolvency in breach of their fiduciary duties that deepening insolvency theory may properly attach.[181] Bad faith, personal benefit, and complicity with culpable corporate fiduciaries are indispensable requirements. Otherwise, lawyers, their corporate clients' officers and directors, and other professionals may believe that liquidation is the only safe alternative for a company facing

178. *Id.*

179. Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004).

180. Courts fashioned the business judgment rule to address precisely this hazard, as it recognizes the need for corporate officers and directors to take reasoned risks to promote a company's interest in the absence of perfect certainty as to the potential success of the effort. *See* Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 656 (Bankr. S.D.N.Y. 1992) (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

181. A useful example of the limited conduct that should be actionable and incorporate deepening insolvency as a theory of damages may be found in *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004). There, the defendant allegedly diverted funds to favor a particular creditor related to the company's insiders. *Id*. at 780. Although the company continued to operate and pay hefty salaries to insiders, it claimed to be insolvent, refused to hold an annual meeting, and issued shares to raise capital outside avenues permitted by the SEC. *Id.* at 774–81. While this case did not involve outside professionals, it arguably models the type of conflict-of-interest laden conduct suitable for damages based on deepening insolvency theory.

severe financial challenges.[182] To retain lawyers' incentives to provide the expertise that distressed companies require, any rational liability regime must not punish bona fide attempts to salvage value.

A claim for deepening insolvency must not serve as a vehicle for a 20/20 hindsight evaluation of either the prudence of corporate decision-making or the ultimate perfection of legal advice given a corporate client. Instead, a deepening insolvency claim must be sustainable only on the recognition that a "fraudulent and concealed incurrence of debt can damage [corporate] value . . . ."[183] Only such fraud-based requirements[184] duly recognize the delicate tensions facing corporate fiduciaries and counsel attempting to steer a company out of rough financial waters. Only such limited availability of deepening insolvency theory can ensure that proper incentives exist to encourage qualified lawyers to continue to provide their expert services in a manner that is truly in the organizational client's best interests.

B. An Independent Deepening Insolvency Claim Adds Nothing

Deepening insolvency is an increasingly popular cause of action. But on close scrutiny, deepening insolvency theory—lacking any definition—adds nothing to the gallery of established torts that have traditionally played important roles in holding professionals and other corporate fiduciaries responsible for fraudulent conduct.[185] For this simple reason alone, efforts to establish a deepening insolvency cause of action should cease.[186]

---

182. *See* Jay R. Bender, *Deepening Insolvency in Alabama: Is It A Tort, A Damages Theory or Neither of the Above?*, 66 ALA. LAW. 190, 198–99 (2005) (explaining that recognizing deepening insolvency as a cause of action or damage theory is bad policy because it deters legitimate corporate restructurings, discourages banks from entering into consensual workout agreements, and, thus, encourages premature business liquidations).

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

184. *See* Seitz v. Detweiler, Hershey & Assocs., P.C. (*In re* CitxX Corp.), 448 F.3d 672, 680–81 (3d Cir. 2001) (holding that negligence will not support a deepening insolvency cause of action; fraud is required); OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510, 534 (Bankr. D. Del. 2006) ("The plaintiff, therefore, is required to show fraudulent conduct—not mere negligence."); Nisselson v. Ford Motor Co. (*In re* Monahan Ford Corp. of Flushing), 340 B.R. 1, 39–40 (Bankr. E.D.N.Y. 2006) (explaining that deepening insolvency theory is based on fraud); Stanziale v. Pepper Hamilton LLP (*In re* Student Fin. Corp.), 335 B.R. 539, 548 (Bankr. D. Del. 2005) ("In order to state a claim for deepening insolvency, then, the trustee of a bankrupt debtor must allege that the defendant defrauded the debtor."); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 620 (Bankr. E.D. Pa. 2005); *see also* Devon Mobile Commc'ns Liquidating Trust v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), 324 B.R. 492, 501 (Bankr. S.D.N.Y. 2005) (recognizing that a valid claim for deepening insolvency requires that the defendant have "wrongfully" prolonged the life of the now-insolvent entity).

185. *See, e.g.*, Bondi v. Grant Thornton Int'l (*In re* Parmalat Sec. Litig.), 377 F. Supp. 2d 390, 419 (S.D.N.Y. 2005) (dismissing deepening insolvency claims against accounting firms as

The duplicative nature, and thus worthlessness, of deepening insolvency theory is illustrated by the decision in *Alberts v. Tuft (In re Greater S.E. Cmty. Hosp. Corp.)*.[187] In that adversary action against a defunct corporation's officers and directors and its former law firms, Epstein, Becker & Green and Kutak Rock, LLP, the court rejected deepening insolvency as a tort cause of action on the ground that it duplicates several recognized causes of action, including breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and legal malpractice.[188] "There is no point in recognizing and adjudicating 'new' causes of action," the court correctly reasoned, "when established ones cover the same ground."[189] Similarly, a bankruptcy court in Texas rejected deepening insolvency as a cause of action because it is "substantially duplicated by torts already established in Texas."[190]

1. Legal Malpractice and Breach of Fiduciary Duty Claims Sufficiently Police the Attorney-Client Relationship

When a lawyer fails to properly exercise her duty of care to the client and that failure leads to the client's injury, the lawyer may be liable for malpractice. In general, a claim for legal malpractice requires: (1) an attorney-client relationship giving rise to a duty; (2) a violation or breach of duty by the attorney; (3) a breach of duty as a proximate cause of injury to the client; and (4) actual injury, loss or damage sustained by the client.[191]

In addition to being obligated to conduct themselves in a competent and diligent manner reasonably calculated to promote the client's interests—obligations enforceable via a legal malpractice claim—lawyers also owe certain fiduciary duties to their clients, the violation of which may give rise to

duplicating malpractice claims); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) (finding that Texas would not recognize deepening insolvency as an independent tort "because the injury caused by the deepening of a corporation's insolvency is substantially duplicated by torts already established . . .").

186. Courts have declined to allow causes of action that are mere "disguises" of one another to proceed. *See* Gen. Sec. Ins. Co. v. Jordan, Coyne & Savits, LLP, 357 F. Supp. 2d 951, 961–62 (E.D. Va. 2005).

187. Alberts v. Tuft (*In re* Greater S.E. Cmty. Hosp.), 333 B.R. 506 (Bankr. D.D.C. 2005).

188. *Id.* at 516–17.

189. *Id.* at 517.

190. *In re Vartec Telecom, Inc.*, 335 B.R. at 644 (footnote omitted).

191. *See* Spur Prods. Corp. v. Stoel Rives, LLP, 122 P.3d 300, 303 (Idaho 2005) (quoting Estate of Becker v. Callahan, 96 P.3d 623, 627 (Idaho 2004)); N. Ill. Emergency Physicians v. Landau, Omahana & Kopka, Ltd., 837 N.E.2d 99, 106 (Ill. 2005); Stephens v. Denison, 150 S.W.3d 80, 81 (Ky. Ct. App. 2004); Jerry's Enters., Inc. v. Larkin, Hoffman, Daly & Lindgren, Ltd., 691 N.W.2d 484, 491 (Minn. Ct. App. 2005); Kahn v. Morse & Mowbray, 117 P.3d 227, 236 n.16 (Nev. 2005); Tolpo v. Decordova, 146 S.W.3d 678, 682 (Tex. App. 2004); Cox v. Geary, 624 S.E.2d 16, 22 (Va. 2006) (quoting Rutter v. Jones, Blechman, Woltz & Kelly, P.C., 568 S.E.2d 693, 695 (Va. 2002)).

liability.[192] Lawyers must maintain client confidences and property, avoid impermissible conflicts of interest, deal honestly with the client, and refrain from taking advantage of information in a manner adverse to the client.[193] In short, lawyers owe their clients two basic fiduciary obligations: confidentiality and undivided loyalty.[194] Where a claim for breach of fiduciary duty exists independently of a legal malpractice claim, a plaintiff attempting to recover must prove: (1) there existed a lawyer-client relationship such that the lawyer was acting as a fiduciary for the client; (2) the lawyer breached a fiduciary duty to the client; (3) the client incurred injury; and (4) the lawyer's breach of fiduciary duty was the proximate cause of the client's injury.[195] As a result, a lawyer's liability will turn on a particularized showing that he engaged in bad-faith, fraudulent, and self-enriching dealings at the client's expense.[196]

A legally cognizable deepening insolvency claim, properly analyzed, would require proof that the lawyer acted in a fraudulent manner or engaged in other misconduct in violation of the lawyer's professional duties to the corporate client, and that this conduct proximately caused an increase in the client's indebtedness.[197] Recovery would further require that the increased debt constituted an actual, ascertainable injury to the client.[198] Although labeled differently, a deepening insolvency claim equates with claims for legal malpractice or breach of fiduciary duty. Efforts to prosecute a deepening insolvency claim against lawyers would thus necessarily turn on these same showings, although no court has so clearly defined such a claim.

2. Deepening Insolvency Claims Are Likewise Redundant of Aiding and Abetting Claims

Similarly, an independent claim for deepening insolvency asserted against a lawyer by a third party is indistinguishable from a claim for aiding and abetting fraud, breaches of fiduciary duty, or other misconduct by a

192. *See generally* 2 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE §§ 14.1, 14.2 (2005) (discussing lawyers' fiduciary duties and cause of action for their breach).

193. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 16, 50, 52 (2000) [hereinafter RESTATEMENT].

194. MALLEN & SMITH, *supra* note 192, § 14.1 at 485.

195. *See, e.g.*, Chem-Age Indus., Inc. v. Glover, 652 N.W.2d 756, 772 (S.D. 2002); Bennett v. Jones, Waldo, Holbrook & McDonough, 70 P.3d 17, 27 (Utah 2003).

196. *See* Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 780–81 (Del. Ch. 2004) (discussing the fraud-based threshold that directorial conduct must surpass in order for breach of fiduciary duty claims against directors to survive).

197. Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 458–59 (Bankr. S.D.N.Y. 2004).

198. *See* Corp. Aviation Concepts, Inc. v. Multi-Service Aviation Corp., No. Civ.A. 03-3020, 2004 WL 1900001, at *3 (E.D. Pa. Aug. 25, 2004).

corporation's officers and directors.[199] Claims against lawyers for aiding and abetting the tortious conduct of corporate fiduciaries[200] are equally premised on a lawyer's bad faith conduct.[201] Aiding and abetting claims effectively charge lawyers with knowingly participating in primary violators' tortious acts.[202] For aiding and abetting liability to attach, there must be some violation by a corporate fiduciary. A plaintiff must also demonstrate that the lawyer had

199. *See* Bondi v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005) (declining to recognize deepening insolvency as an independent tort under North Carolina law because "North Carolina already imposes on every person a duty not to aid and abet a breach of fiduciary duty by another"); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 641–46 (Bankr. N.D. Tex. 2005) (rejecting deepening insolvency theory as duplicating established torts); *In re Global Serv. Group*, 316 B.R. at 461–62 (discussing overlap between trustee's deepening insolvency and aiding and abetting claims, and dismissing aiding and abetting claim).

200. An officer or director's fiduciary duties to the corporation include good faith, due care, and loyalty. McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998); *see* 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (1994). The duty of good faith may be breached if an officer engages in knowingly illegal conduct that exposes the corporation to harm. *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 966–70 (Del. Ch. 1996); *see also* 2 AM. BAR ASS'N, MODEL BUS. CORP. ACT ANN. § 8.31 at 8-200–201 (3d ed. Supp. 2005). The duty of care may be breached if an officer fails to consider all material information reasonably available in the course of making a decision. Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000). The duty of loyalty prevents an officer from deriving an improper personal benefit at the company's expense through self-dealing. Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988).

201. A claim for aiding and abetting a breach of fiduciary duty is not available in all jurisdictions. *See, e.g.*, Berg & Berg Enters., LLC v. Sherwood Partners, Inc., 32 Cal. Rptr. 3d 325, 341 (Cal. Ct. App. 2005) (discussing California civil conspiracy law). In addition, under the *Wagoner* doctrine, an officer's wrongful conduct is imputed to a corporation, in which case the corporation will either lack standing to bring an aiding and abetting claim against a third party, or the corporation's assertion of such a claim will be subject to the defense that the corporation is *in pari delicto*. *See* Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 117–20 (2d Cir. 1991); Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 80 F. Supp. 2d 129, 136 (S.D.N.Y. 1999). There are two recognized exceptions to the *Wagoner* rule: (1) where the officers of the corporation acted with an adverse interest to the corporation, abandoning the interests of the company; or (2) where there was an innocent decision-maker within the debtor corporation that could have prevented the misconduct of the officers and directors. *See* Smith v. Andersen LLP, 175 F. Supp. 2d 1180, 1199–1200 (D. Ariz. 2001). Under these circumstances, a claim against a lawyer for aiding and abetting a breach of fiduciary duty would be viable. *Id.* at 1200.

202. *See, e.g.*, Anstine v. Alexander, 128 P.3d 249, 255–56 (Colo. Ct. App. 2005) (alleging that lawyer aided and abetted breach of fiduciary duty by company president); Thornwood, Inc. v. Jenner & Block, 799 N.E.2d 756, 768–69 (Ill. App. Ct. 2003) (alleging that lawyers aided and abetted breach of fiduciary duty by partner); Exposition Partner, LLP v. King, LeBlanc & Bland, LLP, 869 So. 2d 934, 942–44 (La. Ct. App. 2004) (aiding and abetting fraud); Chem-Age Indus., Inc. v. Glover, 652 N.W.2d 756, 773–76 (S.D. 2002) (alleging that lawyer aided and abetted breach of fiduciary duty).

actual knowledge of the wrongful conduct and provided substantial assistance[203] in furtherance of that conduct.[204] Such strict evidentiary requisites are both necessary and appropriate for potential liability to attach in the absence of an attorney-client relationship. Prosecution of an independent claim based on deepening insolvency theory can require no less.

Consequently, recognizing deepening insolvency as an independent cause of action only litters established tort law with a poorly-defined, redundant cause of action.[205] Some might argue that this redundancy is harmless. In fact, the harm is immediate and expensive both in terms of actual costs incurred in either prosecuting or defending such a claim, and in terms of the social and judicial costs.

C. The Business Judgment Rule as a Valid Defense Against Deepening Insolvency Claims

Whether deepening insolvency is asserted as an independent cause of action or as a damage theory, lawyers defending against such allegations must be permitted a business judgment rule defense. Based on the very nature of their roles as counselors and advisors, lawyers will not have made the business decisions or exercised the business judgment that occasioned the company's failure. Lawyers are their clients' agents; it is their responsibility to carry out their clients' lawful instructions, not to chart their own course. Yet, those business decisions—rather than merely the lawyers' conduct—are at the center of the evidence that must be litigated. The business judgment rule forces plaintiffs attacking corporate decisions to address the manner in which they were made, rather than whether they proved to be correct. The business judgment rule also requires plaintiffs to overcome a strong presumption against second-guessing the decisions made. As a consequence, the rule can be a robust tool in providing counsel assisting insolvent companies with the

203. *See* Kolbeck v. LIT Am., Inc., 939 F. Supp. 240, 247 (S.D.N.Y. 1996). This substantial assistance requirement implicitly incorporates an element of causation, requiring a showing that the aiding and abetting conduct "proximately caused the harm on which the primary liability is predicated." Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001).

204. *See* RESTATEMENT (SECOND) OF TORTS § 876 (1979).

205. *See* Bondi v. Bank of Am. Corp. (*In re* Pamalat Sec. Litig.), 383 F. Supp. 2d 587, 601–02 (S.D.N.Y. 2005) (dismissing deepening insolvency claim as duplicative of breach of fiduciary duty claim); Alberts v. Tuft (*In re* Greater S.E. Cmty. Hosp. Corp.), 333 B.R. 506, 517 (Bankr. D.D.C. 2005) (discussing deepening insolvency, the court reasoned that "[t]here is no point in recognizing and adjudicating 'new' causes of action when established ones cover the same ground"); Rafool v. Goldfarb Corp. (*In re* Fleming Packaging Corp.), No. 03-82408, 04-8166, 2005 WL 2205703, at *10 (Bankr. C.D. Ill. Aug. 26, 2005) (noting that directors' fiduciary duties clearly prohibit the type of conduct on which deepening insolvency claims are based); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* Vartec Telecom, Inc.), 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005) (rejecting deepening insolvency theory as duplicative of established torts).

freedom needed to act in furtherance of companies' best interests.[206] This is true even when decisions or selected courses of action may be deemed risky or outside the bounds of traditionally accepted conduct.[207]

To conform a lawyer's standard of conduct to that which exists for purposes of legal malpractice and breach of fiduciary duty claims, the business judgment rule must be a defense to deepening insolvency claims. Recognizing this defense better mitigates the risks lawyers face and provides the proper incentives for lawyers to assist financially distressed companies.

The business judgment rule manifests the basic tenet of corporate law that corporate officers and directors must prudently manage the company's affairs, but they are not obligated to avoid all risks. Indeed, a "principal justification" for the rule is to "cause corporations to take on business risks."[208] Accordingly, the rule creates a presumption that "in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest."[209] The rule safeguards directors and officers from liability when certain corporate decisions turn out to be unprofitable or harmful,

> unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.[210]

Corporate decisions carried out by a fiduciary within her corporate authority, in good faith, with due care,[211] and for a rational business purpose[212] cannot

206. *See* 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 18–19 (5th ed. 1998).

207. *Id*. at 84–85 (discussing the abuse of discretion standard which provides "broad latitude" to directors).

208. Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 870 (2005) (discussing Prof. Lyman P.Q. Johnson's recognition of a principal justification for the business judgment rule).

209. BLACK'S LAW DICTIONARY 212 (8th ed. 2004). Delaware courts, frequently the forum for significant corporate litigation, recognize that a decision by a board of directors (1) in which the directors possess no direct or indirect personal interest, (2) that is made (a) with reasonable awareness of all reasonably available material information and (b) after prudent consideration of the alternatives, and (3) which is in good faith furtherance of a rational corporate purpose, will not be interfered with by the courts, either prospectively by injunction or retrospectively by imposition of liability for damages upon the directors, even if the decision appears to have been unwise or have caused loss to the corporation or its stockholders. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927–28 (Del. 2003); Emerald Partners v. Berlin, 787 A.2d 85, 90–91 (Del. 2001); McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000).

210. Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

211. The business judgment rule focuses the duty of care analysis of a business decision primarily on the process by which the decision was reached; that is, whether the defendants

thus be questioned with hindsight for liability purposes. This fact was recently underscored in a deepening insolvency case filed against bankers and various managers of a bankrupt corporation, where the court noted that under the business judgment rule, "a manager's negligent but good faith decision to operate an insolvent business will not subject him to liability for 'deepening insolvency.'"[213]

Where a plaintiff successfully rebuts the presumption set forth in the business judgment rule by showing that the corporate decision was not made with due care, in good faith, or with a rational business purpose, the judicial deference permitted to the fiduciary dissolves. The burden shifts to the fiduciary to prove the fairness of the challenged decision.[214]

The same presumptive protections supplied by the business judgment rule must play a role in deepening insolvency litigation against lawyers, as the rule recognizes "that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions."[215] The role of a lawyer assisting an insolvent corporation is to promote the corporation's best interests within the limits of the lawyer's engagement. In doing so, a lawyer is forced to give advice and make recommendations based on less-than-perfect information and must often do so urgently. In these circumstances, the lawyer's role is to provide prudent and reasoned advice that promotes the corporation's interests, whether those interests are best served by bankruptcy or by entering into risk-laden ventures that may prove beneficial to the company.[216] Where corporate fiduciaries that

considered all material information reasonably available. The rule deflects attention away from the substance of the decision itself (e.g., whether a reasonably careful or risk free course of action was selected), thereby imposing a control for hindsight bias. *See Brehm*, 746 A.2d at 264 ("Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only."). In other words, where the business judgment rule applies, the duty of care may be characterized as simply a duty to exercise informed business judgment. In some jurisdictions, the adequacy of the decision-making process is measured by concepts of gross negligence. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

212. Transactions designed to disguise a corporation's insolvency so that it may continue to conduct business untainted would not constitute a legitimate business purpose. *See* Amfesco Indus., Inc. v. Greenblatt, 568 N.Y.S.2d 593, 594–95 (N.Y. App. Div. 1991).

213. Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 461 (Bankr. S.D.N.Y. 2004).

214. *See* Croton River Club, Inc. v. Half Moon Bay Homeowners Ass'n, Inc. (*In re* Croton River Club), 52 F.3d 41, 44 (2d Cir. 1995); *Emerald Partners*, 787 A.2d at 91; *McMullin*, 765 A.2d at 917.

215. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982); *see* Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 794 (Del. Ch. 2004).

216. If the business judgment rule is deemed inapplicable to deepening insolvency claims against lawyers, the effect is to impose on lawyers who advise companies in the zone of insolvency an absolute incentive to counsel in favor of liquidation. There is no such duty under American law. Instead, fiduciaries are obligated to make a good faith effort to maximize the

approve the advice provided by a lawyer before any action is taken are protected against liability for corporate harm caused by their own mistakes of judgment, the lawyer providing the advice deserves the same protection. The lawyer cannot be left to suffer as the scapegoat. The business judgment rule would not preclude recovery where a lawyer advising a corporation conducts herself in a fraudulent or self-interested manner.[217] Application of the rule, however, would better refine any valid theory of liability or recovery to impose liability on truly culpable counsel rather than punishing counsel for their mere inability to predict the future.

Essential to any analysis of whether lawyers deserve business judgment rule protection is an understanding of the contours of lawyers' duties when representing a company in the zone of insolvency. Like corporate officers and directors, lawyers may never be judged by whether their conduct, decisions, or advice met some intangible standard of perfection or absolute correctness. Instead, and again like corporate officers and directors, lawyers are required to conform their conduct so that it does not fall below a certain standard of care, as reflected by the care and diligence exercised in settling on the conduct, decisions, or advice at issue. Accordingly, deepening insolvency claims against lawyers masquerade as malpractice claims attacking the underlying business decisions affected by the lawyers' conduct, decisions, or advice. Indeed, deepening insolvency claims against lawyers often are made when corporate officers and directors are for some reason judgment-proof. Deepening insolvency theory thus extends lawyers' liability to business decisions, even in the absence of the decision makers.

As a result, lawyers should receive the same business judgment rule shelter that corporate officers and directors receive, so long as the lawyers' advice, conduct, or decisions reflect honest and reasoned analysis, rather than dishonesty and self-dealing. There is no reason to distinguish between a company's leaders and its lawyers in the deepening insolvency context.

Fairly allocating liability for misconduct connected to a company's deepening insolvency also requires recognizing that lawyers, like courts, do not make business decisions and are not positioned to second guess the business leaders who do. This aversion to second-guessing is a central premise

corporation's long-term wealth-creating capacity. *In re Global Serv. Group*, 316 B.R. at 460 (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991)). Maximizing a corporation's wealth-creating capacity may well entail taking current risks in favor of long-term growth. In fact, this duty of corporate fiduciaries to salvage a corporation is written into bankruptcy law in the form of Chapter 11, whose construct is based on the concept that a business is more valuable alive than dead. *See* Official Comm. of Unsecured Creditors of RSL COM PRIMECALL, Inc. v. Beckhoff (*In re* RSL COM PRIMECALL, Inc.), Nos. 01–11457 through 01–11469(ALG), 2003 WL 22989669, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003).

217. *See In re RSL COM PRIMECALL*, 2003 WL 22989669, at *9–10.

for the business judgment rule. In addition, if deepening insolvency theory is intended to penalize lawyers for fraudulently prolonging a company's life, then lawyers are entitled to a corresponding framework for analyzing risks attending their advice. The business judgment rule provides predictability. Insofar as lawyers go, the rule deters misconduct while minimizing artificial disincentives to entrepreneurial risk taking, to independent decision making, and to representing distressed clients in desperate need of good counsel.

Application of the business judgment rule as a defense to a deepening insolvency claim allows courts to properly penalize attorney conduct on the fringes. By better defining the lawyer liability regime, the relevant inquiries for plaintiffs and their counsel can have a more relevant and more precise focus. For instance, where the business judgment rule plays a role, a deepening insolvency claim against a lawyer must be premised on a transaction that was arranged so improvidently and in such a risky, unusual, or unnecessary manner as to offend fundamental legal practices. The query must turn on whether there existed any sound reasons for structuring and conducting the transaction as it was, thereby encouraging lawyers to provide well-reasoned and justifiable counsel to their clients.

In addition, given that a corporation on the brink of insolvency may owe duties to groups that are both internally and comparatively diverse, such as shareholders and creditors,[218] lawyers advising the corporation must be protected from these non-homogeneous interests where their advice was given in good faith, with due care, and in furtherance of a rational business purpose. The lack of such a shield hazards the imposition of contradicting duties on fiduciaries.

D. The Necessity to Establish Causation Is a Significant Obstacle to the Thoughtful Application of Deepening Insolvency Theory

A deepening insolvency claim effectively alleges that the lawyer participated in certain matters, failed to prevent the client from making certain business decisions, or failed to share particular information concerning the company's financial condition with certain players.[219] This conduct, according to typical allegations, assisted the allegedly culpable corporate fiduciaries in further depleting the client's assets and driving it deeper into insolvency.[220] It is plain that this theory suffers from a fatal inability to establish that the lawyer's conduct proximately caused the corporation's alleged injuries.

218. *See* Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 790 n.57 (Del. Ch. 2004); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

219. *See, e.g.*, Complaint at 42–44, Stanziale v. Pepper Hamilton LLP (*In re* Student Fin. Corp.), 335 R.R. 539 (Bankr. D. Del. 2005) (No. 02-11620-JBR).

220. *See, e.g.*, *id.* at 43.

Proximate cause is an essential element of all tort claims. To demonstrate proximate cause, the "mere possibility of causation" is insufficient, and a plaintiff must "introduce evidence that allows for the reasonable conclusion that it is more likely than not that a defendant's conduct was the cause of the injury."[221] Under the traditional conception of proximate causation, if the alleged injury would have occurred without the lawyer's alleged misconduct, a plaintiff cannot show that the lawyer's conduct proximately caused the injury.[222]

By requiring proof that but for a defendant attorney's malpractice a plaintiff would have experienced a more favorable outcome, the proximate cause element of legal malpractice theory prevents "speculative and conjectural claims" and "serves the essential purpose of ensuring that damages awarded for [an] attorney's malpractice actually have been caused by the malpractice."[223] The importance of establishing proximate cause is heightened in a deepening insolvency case, where multiple factors surely contributed to the company's downfall and the lawyers are convenient scapegoats for their client's business misjudgments.[224]

Given the many factors that combine to produce corporate success or failure, the notion that a corporation's demise could have been averted or that its ultimate insolvency could have been materially lessened but for a lawyer's alleged negligence generally defies logic. Lawyers are not guarantors of their clients' business judgment. A lawyer does not have the ability to compel a company's officers or directors to pursue a particular course of action.[225] This fact alone will in most cases turn causation into speculation and thus defeat a plaintiff's claim.

The long and the short of it is that absent exceptional circumstances involving fraud or similar misconduct, a bankruptcy trustee or other representative of an insolvent entity will simply be unable to eliminate with sufficient certainty the effect of other factors contributing to the company's

221. Pettigrew v. Citizens Trust Bank, 229 B.R. 39, 42 (N.D. Ga. 1998); *see* Holmes v. Peebles, 554 S.E.2d 566, 568 (Ga. App. 2001).

222. *See* Ogletree v. Navistar Int'l Transp. Corp., 535 S.E. 2d 545, 548 (Ga. App. 2000); Houston v. Surrett, 474 S.E.2d 39, 41 (Ga. App. 1996).

223. Viner v. Sweet, 70 P.3d 1046, 1052 (Cal. 2003).

224. *See id.* at 1051–52 (quoting John H. Bauman, *Damages for Legal Malpractice: An Appraisal of the Crumbling Dike and Threatening Flood*, 61 TEMPLE L. REV. 1127, 1154–55 (1988)).

225. *Cf.* Drabkin v. Alexander Grant & Co., 905 F.2d 453, 455, 456–57 (D.C. Cir. 1990) (noting that single director lacked the ability to "effect a rescue or pull the plug" as struggling company attempted to deal with tax delinquency, such that bankruptcy trustee could not establish causation in action against accountants).

demise.[226] Such additional factors may include economic conditions, competitive forces, governmental action, and fundamental aspects of the business at issue such as operating or production costs, financing costs, and the like.[227] Of course, a lawyer cannot be held liable for injuries caused by other forces or the actions of others.[228]

Thus, absent fraudulent conduct involving significant self-dealing, a lawyer's advice concerning a particular transaction or business strategy simply cannot be the proximate cause of a company's deepening insolvency. In addition, unless no participant other than the lawyer knew of the corporation's financial condition, or all other key decision-makers lacked substantial critical information, the plaintiff cannot show that a lawyer's alleged misconduct specifically delayed the corporation's decision to dissolve.

Tort claims also carry an element of foreseeability. The concept of foreseeability eliminates a defendant's liability for damages that are remote, speculative, or unconnected to the alleged tort.[229] To this end, certain conduct can be the proximate cause of injury if, by the exercise of reasonable care, the actor could have foreseen or anticipated that some injury might result.[230] A defendant is not liable if "the defendant's conduct and the plaintiff's injury are too remote for the law to countenance recovery."[231]

A plaintiff alleging deepening insolvency must therefore show that it was reasonably foreseeable to the lawyers that their services would result in losses of the type sustained. So long as the facts do not evidence fraud, self-dealing, or conflicts of interest on the lawyers' part, the evidence cannot lead to a rational conclusion that the lawyers should have foreseen that their advice

226. *See id.* at 455, 456–58 (observing that "[b]ad luck both at the company itself and in its market, and perhaps bad management, brought about the losses," and ultimately rejecting trusteee's claim).

227. Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61–62 (2d Cir. 1985) (discussing trustee's failure to demonstrate causation in securities fraud case); AUSA Life Ins. Co. v. Ernst & Young, 119 F. Supp. 2d 394, 402 (S.D.N.Y. 2000) (discussing the many factors that accountants could not have anticipated that affected client's business, including company's unwise acquisition of a failing business, the fact that the company would be hit with a devastating price war, the fact that key executives would leave and that office costs and new store leases would soar, or that the company's business would be harmed by a sharp drop in commercial construction).

228. *See* Hicks, M.D. v. Talbott Recovery Sys., Inc., 196 F.3d 1226, 1243 (11th Cir. 1999) (discussing intervening causes generally) (quoting Harrison v. Jenkins, 510 S.E.2d 345, 346 (Ga. App. 1998)); *Drabkin*, 905 F.2d at 457 (discussing trustee's failure to establish causation); Walker v. Hammock, 541 S.E.2d 439, 441 (Ga. App. 2000) (explaining when intervening acts defeat causation).

229. *See* WM. LLOYD PROSSER & W. PAGE KEETON, PROSSER AND KEETON ON THE LAW OF TORTS § 43, at 280–81 (5th ed. 1984).

230. *See* Comeau v. Rupp, 810 F. Supp. 1172, 1176–77 (D. Kan. 1992).

231. Atlanta Obstetrics & Gynecology Group, P.A. v. Coleman, 398 S.E.2d 16, 17 (Ga. 1990).

would lead the corporation deeper into debt. In addition, foreseeability "turns on fairness, policy, and . . . a rough sense of justice. A reasonably foreseeable act might well be regarded as an act that a reasonable person who knew everything that the defendant knew at the time would have been able to know in advance with a fair degree of probability."[232] When lawyers provide services, they do not guarantee success, but attempt only to contribute to the client's chances of success. Thus, lawyers acting in line with their ethical and professional mandates cannot be said to have foreseen an injury if the business fails.

In short, to promote fairness and the needed incentives for appropriate legal and business ingenuity and risk-taking, foreseeability must be assessed in the pragmatic context of lawyers' duties. It is only when a lawyer acts outside these bounds that foreseeability may be proven.[233]

E. Deepening Insolvency Theory Inherently Relies Upon Speculative Damages Allegations

The causation and foreseeability problems that plague deepening insolvency claims lead to alleged damages that are speculative or remote and hence not recoverable. A plaintiff may not recover for damages that are merely a possible result of an act, or that are traceable to the act but are not its legal or natural consequence. Rather, a plaintiff may seek only those damages that she can prove to have been the legal and natural result of the act done.[234]

The damages sought under deepening insolvency theory cannot meet this standard. Such claims against lawyers cannot distinguish with credibility or the necessary level of certainty whether other factors caused the injury alleged or what portion of the injury was a direct result of the lawyers' fraudulent conduct. Likewise, any assertion that an absence of the conduct would have steered the corporation away from insolvency is speculative, as is any assertion that other opportunities or destructive events would not have come to pass even had the transaction at issue not occurred. Speculation may not form the basis of a cognizable claim for damages.

Furthermore, any damages calculation based on deepening insolvency relies on a multitude of inconstant variables and cannot be sufficiently specific. Again, "mere speculation of a loss resulting from an attorney's alleged [acts

232. AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 217–18 (2d Cir. 2000) (internal citations omitted).

233. *See* Lytle v. McClain, No. 03CA008400, 2004 WL 1932975, at *3–4 (Ohio App. Sept. 1, 2004) (explaining that lawyer acted within accepted bounds of conduct and that damages resulting from client's intervening conduct were not foreseeable for purposes of legal malpractice claim).

234. *See* Drabkin v. Alexander Grant & Co., 905 F.2d 453, 457 (D.C. Cir. 1990); Resolution Trust Corp. v. Stroock & Stroock & Lavan, 853 F. Supp. 1422, 1427–29 (S.D. Fla. 1994); Stratton v. Miller, 113 B.R. 205, 210 (D. Md. 1989).

or] omissions is insufficient,"[235] and courts cannot presume that alleged damages are attributable to lawyers' conduct.[236] Deepening insolvency theory rests on so many variables that are susceptible to "minute perturbations . . . [that] there is a universe of alternate positions with few constants. Such alternative analysis . . . entails an inquiry into what the plaintiff would have done, with the slightest deviation in the particular hypothesized decision producing substantially different results."[237] A plaintiff cannot show with reasonable certainty that the corporation's directors would have taken any one of a number of alternate courses that may or may not have spared the company additional indebtedness, either during the lawyers' involvement with the company or after.

Even assuming that a deepening insolvency claim was based on sufficiently specific and certain damage estimates, however, recovery must nonetheless be barred under traditional legal and equitable defenses.[238] Any damage assessment is subject to all defenses available to defeat a direct claim, including *in pari delicto*, contributory and comparative negligence, assumption of risk, and apportionment of damages, among others.[239] As lawyers cannot act to injure a corporation without cooperation and assistance from insiders, these defenses are unavoidable.

VII. BEST PRACTICES FOR LAWYERS IN A WORLD OF DEEPENING INSOLVENCY ALLEGATIONS

Deepening insolvency, either as an independent claim or as a theory of damages, poses a significant hazard to all lawyers serving clients in the zone of insolvency so long as courts fail to scrutinize its shortcomings at the initial stages of litigation. So what are lawyers who represent financially troubled

235. Luniewski v. Zeitlin, 591 N.Y.S.2d 524, 526 (N.Y. App. Div. 1992); *see, e.g.*, *Resolution Trust Corp.*, 853 F. Supp. at 1428–29 (rejecting speculative damage claim); Pettigrew v. Citizens Trust Bank, 229 B.R. 39, 42 (N.D. Ga. 1998) (same).

236. N. Ill. Emergency Physicians v. Landau, Omahana & Kopka, Ltd., 837 N.E.2d 99, 107 (Ill. 2005) (discussing legal malpractice actions).

237. *Resolution Trust Corp.*, 853 F. Supp. at 1425 n.2.

238. *See* Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 379–80 (6th Cir. 1997) (recognizing *in pari delicto* defense in action by bankruptcy trustee); Sender v. Buchanan (*In re* Hedged-Investments Assoc., Inc.), 84 F.3d 1281, 1285 (10th Cir. 1996) (same); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093–94 (2d Cir. 1995) (recognizing lack of standing as a defense in trustee's action against accountants).

239. *See, e.g.*, Baena v. KPMG LLP, 389 F. Supp. 2d 112, 117–21 (D. Mass. 2005) (recognizing *in pari delicto* as a complete defense to a deepening insolvency claim); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Nickless (*In re* Advanced RISC Corp.), 324 B.R. 10, 15–16 (D. Mass. 2005) (recognizing *in pari delicto* as a complete defense to a deepening insolvency claim made by bankruptcy trustee); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 620 (Bankr. E.D. Pa. 2005) (recognizing *in pari delicto* as a defense to a deepening insolvency claim made by bankruptcy trustee).

clients to do when it comes to shielding themselves and their firms against deepening insolvency allegations?

Lawyers have been conditioned as to the perils of creating a paper trail when managing their own risk. In this context, however, documenting interactions with business leaders and diligent follow-through on troublesome developments are critical to resisting misconduct allegations. Lawyers must be especially careful to communicate to corporate clients all options for addressing a particular situation. These communications must be documented accurately. It falls upon counsel to reasonably anticipate issues that could foreseeably go awry and to ensure that corporate officers and directors know about and account for these possibilities in planning any course of action. Again, these forewarnings must be fair, informed, and reliable, and must be documented.

Some commentators suggest that lawyers who document their advice face a conflict of interest because a bankruptcy trustee or examiner will use the lawyers' letters, memoranda, etc., to hang the directors and officers who ignored the advice or who took contrary action.[240] In other words, the lawyers are documenting their advice to the board or to the company's officers not because it is in the company's interest that they do so, but because it is in the lawyers' personal interest to document their advice to minimize their potential liability. In this way the lawyers' personal interests are materially limiting their representation of the company, which is a conflict of interest.[241] But that simply is not so. The corporation's officers and directors should be interested in acting lawfully, and the corporation's lawyers should be interested in steering them that way. The fact that officers and directors may disregard the lawyers' advice does not mean that the lawyers' acts of documenting their advice manifests a conflict of interest. To the extent the lawyers' advice itself is ultimately placed at issue, a trustee, examiner, or receiver can simply waive the corporation's attorney-client privilege and depose company insiders or the lawyers about the advice.[242]

In the same vein, lawyers must be mindful to provide advice and make decisions that predictably fall under the protective umbrella of the business judgment rule. Defensive measures include appropriate documentation, encouraging detailed board minutes, attention to procedural formality and thoroughness, careful attention to requisite approvals from independent directors, and deliberated retention of independent advisors. Moreover,

240. *See* Conaway, *supra* note 16 ("It is all these CYA memos by lawyers that make it easy for plaintiffs to tear these organizations apart.").

241. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(2) (2004) (discussing conflicts of interest with current clients).

242. *See* Douglas R. Richmond, *The Attorney-Client Privilege and Associated Confidentiality Concerns in the Post-Enron Era*, 110 PENN ST. L. REV. 381, 441–46 (2005) (discussing the ability of trustees, receivers, and liquidators to waive a corporation's attorney-client privilege).

lawyers must be sensitive to signs of insider dealing, fraudulent conveyances, or the involvement of any relationships that risk appearing too close and hence not disinterested. Because deepening insolvency charges implicitly accuse lawyers of aiding and abetting client misconduct, lawyers must act responsibly when signs of improper or fraudulent activity by corporate insiders appear. This may require lawyers to report up the ladder, withdraw from the representation, or take any number of other appropriate actions. Feigned ignorance or willful blindness will not do.

Lawyers can also take additional protective steps in advance of engaging a client to minimize the strength of a future trustee's potential deepening insolvency claim against the lawyer. Lawyers should review and analyze the corporate charter, bylaws, and employment agreements governing the employment terms and liabilities of the various directors and officers that are likely to be the primary decision makers. In particular, lawyers should look for and encourage the inclusion in these documents of exculpation provisions, thwarting liability for directors and officers within certain parameters. This strategy is particularly valuable because such provisions impede primary liability claims against directors and officers, and can therefore impede secondary liability claims against lawyers, to the extent that deepening insolvency claims effectively allege that a legal professional assisted a director or officer's fraudulent conduct.

Furthermore, lawyers can attempt to steer clear of deepening insolvency charges by being aware of the situations in which hindsight-driven bankruptcy trustees or receivers have an incentive to pursue lawyer liability claims. For instance, where a company has inadequate directors' and officers' (D & O) liability insurance, a recovery-driven trustee or receiver is more likely to initiate claims against other actors who may, in the form of their malpractice insurance, carry with them funds that are more easily accessible. Hence, lawyers are well-advised to ensure that their clients are covered by suitable D & O policies.

An additional strategy may be to deepen the pool of defendants potentially available to a trustee. To this end, lawyers should evaluate the benefits of strictly limiting their engagement to legal advice and of retaining independent, specialty professionals to fill the gaps of providing complementary, but non-legal, advice. Although this strategy may have its drawbacks, it may well function, at the end of a bad situation, to divert a plaintiff's attention to other deep pockets.

Unfortunately, where the client is distressed, claims against lawyers may devolve to an inquiry into whether the lawyer was sufficiently cautious, far-sighted, and risk-averse. Protecting against this reality compels lawyers to create a reliable and accurate record of what the client and its agents knew before choosing a certain course of action.

CONCLUSION

Deepening insolvency theory poses greater costs than benefits. There may, on the fringes, be some accuracy to the notion that a "corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[243] This underlying logic is superficially appealing because it appears to create a subjective field in which lawyers and other corporate fiduciaries are compelled to assess the likely impact of their advice and actions rather than abiding by absolute duties which may be vulnerable to disclaimers and manipulation. But this initial theoretical appeal disregards the practical implications of creating normative standards of conduct.

The pragmatic consequence of deepening insolvency claims or damages against lawyers may well be that they will instill uncertainty and confusion in the standards for legal services to clients in the zone of insolvency. The further and natural consequence is a significant disincentive to lawyers to pursue and advise in favor of all well-considered risks necessary to salvage a client on the brink of insolvency. These consequences are all undesirable.

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