

The Death of "Deepening Insolvency" as an Independent Tort? Delaware Chancery Court Rejects the Theory

August 15, 2006

In recent years, there has been a large increase in cases alleging the directors and officers of insolvent companies are liable for "deepening insolvency" or for acting improperly while the company was in the "zone of insolvency."

In 2001, the Third Circuit held that "we believe that the soundness of the theory, its growing acceptance among courts, and the remedial theme in Pennsylvania law would persuade the Pennsylvania Supreme Court to recognize 'deepening insolvency' as giving rise to a cognizable injury in the proper circumstances." *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 352 (3d Cir. 2001).

Two years later, a federal bankruptcy court in Delaware, relying heavily on the reasoning of *Lafferty*, predicted that the Delaware Supreme Court would recognize a cause of action for deepening insolvency. *In re Exide Technologies, Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003).

Last week, however, the Delaware Court of Chancery, in an opinion by Vice Chancellor Strine, soundly rejected deepening insolvency as an independent cause of action, stating that "the term has the kind of stentorian academic ring that tends to dull the mind to the concept's ultimate emptiness." *Trenwick America Litigation Trust v. Ernst & Young, LLP*, at 62, No. 1571-N (Del. Chan. Aug. 10, 2006). This decision, as well as a few others earlier this year, suggests that the tide may be turning and the theory of deepening insolvency may be in retreat.

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The case was a suit by a litigation trust established following the insolvency of an insurance holding company. The litigation trust alleged that the directors of the company were liable for engaging in an imprudent business strategy by acquiring other insurers who had underestimated their claims exposure, thereby rendering the holding company insolvent. The litigation trust included in its complaint a count for deepening insolvency.

Vice Chancellor Strine explained in his opinion that such a theory would "fundamentally transform Delaware law" by imposing liability on a board of directors who, "acting with due diligence and good faith, pursue a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt." *Id.* at 63. Instead, the court reasoned, decisions by the board of directors should be evaluated based on "the traditional fiduciary duty ruler." *Id.* at 64. Within that context, the court recognized that the "fact of insolvency" might weigh heavily in a court's analysis and constituted an "important contextual fact in the fiduciary duty metric." *Id.* at 64-65. However, among other things, the fiduciary duty approach provides directors with the protection of the business judgment rule.

The court noted that its opinion was contrary to the results in three cases decided by federal courts within the Third Circuit, including *Lafferty* and *In re Exide*. It criticized those decisions for failing to "explain [] the rationale for concluding that deepening insolvency should be recognized as a cause of action or how such recognition would be consistent with traditional concepts of fiduciary responsibility." *Id.* at 66.

The *Trenwick* decision follows on the heels of a decision by the Third Circuit in June, which constrained the scope of *Lafferty*. *In re CITX Corp. Inc.*, 448 F.3d 672 (3d Cir. 2006). In that decision, which predicted Pennsylvania law, the Third Circuit explained that *Lafferty* held only that fraudulent conduct would suffice to support a deepening insolvency claim. The court expressly declined to extend the "limited holding" of *Lafferty* in order to allow a claim alleging that negligent conduct caused a deepening insolvency. *Id.* at 680. The court also held that deepening insolvency was not a valid theory of damages supporting a professional malpractice claim against an accounting firm.