Can (and should) directors, officers and third-party advisors of an insolvent corporation be held liable for approving transactions that ultimately fail and deepen the corporation’s insolvency? Over the past several years, federal courts have struggled with this basic question, with little (if any) guidance from the state courts. Federal courts thus have been making educated guesses as to whether a particular state would recognize a new cause of action for deepening insolvency in the state’s corporate jurisprudence. The precise elements of this new cause of action are unclear at best, but courts have suggested that some type of fraudulent, and perhaps even mere negligent, prolongation of an insolvent corporation’s life (through the incurrence of additional debt, the liquidation of assets, etc.) that causes corporate injury is necessary.

Although the most recent trend among federal courts appears to disfavor recognizing this new cause of action, some courts have seen some potential utility in the theory and have allowed deepening insolvency claims at least to survive dismissal or summary judgment motions.

Several courts in this latter camp have determined that Delaware would recognize a new and independent cause of action for deepening insolvency. The Delaware Chancery Court, however, recently disagreed with this conclusion in Trenwick America Litigation Trust v. Ernst & Young, L.L.P. and clearly stated for the record “that Delaware law does not recognize this catchy term [i.e., ‘deepening insolvency’] as a cause of action.” In fact, the Trenwick opinion does its level-best to slam the door on future deepening insolvency claims against directors and others involved with an insolvent Delaware corporation at the last stages of its economic life.

The facts underlying the Trenwick case are similar to most fact patterns underlying alleged deepening insolvency claims. The debtor, Trenwick America Corp. (Trenwick America) and its direct parent, Trenwick Group Ltd. (Trenwick), filed for chapter 11 protection in the U.S. Bankruptcy Court for the District of Delaware. Trenwick was the holding company for a family of organizations that issued specialty insurance and reinsurance on an international basis. Trenwick America was a wholly-owned subsidiary of Trenwick and the direct parent of Trenwick’s domestic subsidiaries. Prior to its chapter 11 filing, Trenwick pursued an aggressive expansion strategy that substantially increased its asset holdings and debt obligations. Through various internal restructurings, a portion of the acquired assets and debt was transferred to Trenwick America. Trenwick America also was a primary and secondary obligor on various of the debt incurred by Trenwick to finance the acquisitions.

Under Trenwick America’s confirmed reorganization plan, the power to investigate and pursue claims and causes of action belonging to Trenwick America was transferred to the Trenwick America Litigation Trust. The Litigation Trust eventually filed a multi-count complaint against the former directors of Trenwick and
Trenwick America and certain former advisors to Trenwick alleging, among other things, breaches of fiduciary duty, deepening insolvency, fraud, aiding and abetting and conspiracy to breach fiduciary duties. The defendants filed a motion to dismiss the complaint for failure to state a claim under Rule 12(b)(6) of the Federal Rules of Civil Procedure. After oral argument and for the reasons set forth in an 88-page opinion, the court granted the defendants’ motion.

The opinion contains a very thoughtful analysis of various standing issues and the breach of fiduciary duty and fraud claims. A discussion of these elements of the opinion is beyond the scope of this article; however, highlights include a restatement of the settled principle that a bankruptcy trust or trustee has standing only to pursue claims of the debtor and not the debtor’s creditors; confirmation that, under Delaware law, “a parent corporation does not owe fiduciary duties to its wholly-owned subsidiaries or their creditors” and that the business judgment rule is alive and well, even in the insolvency context; confirmation of the enforceability of exculpatory charter provisions under Delaware General Corporation Law §102(b)(7); and confirmation that fraud cannot be established where the alleged misstatements or omissions were known to the persons in control (e.g., the board) of the entity allegedly relying on those misstatements or omissions.

With respect to deepening insolvency, the Trenwick court starts its analysis with the basic proposition that “Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate.” This proposition in turn means that directors may take good faith, calculated risks to try to save a dying corporation. Indeed, the court emphasizes that this freedom is necessary to serve the underlying goals of chapter 11 of the Bankruptcy Code, which, among other things, recognize societal value in the reorganization (as opposed to liquidation) of a financially distressed corporate entity.

Freedom to take good faith, calculated risks, however, does not equate to complete freedom in the corporate context; directors of an insolvent corporation are, of course, still subject to the traditional principles of fiduciary duty, fraud and fraudulent conveyance law (to name a few). Although not expressly stated, it is clear that the court saw no need for, or value to, adding deepening insolvency to Delaware’s existing corporate jurisprudence.

To press home the illogical nature (in the court’s view) of a deepening insolvency claim, the court analogizes the alleged tort of deepening insolvency to a claim, in another context, of “shallowing profitability.” The latter, hypothesized the Trenwick court, would involve a scenario in which the law would recognize a claim against the directors of a solvent corporation for approving a transaction that failed, thereby decreasing the value of the assets otherwise available for shareholders and creditors of the corporation. “That is, the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one.” The court concluded that the proper analysis of both situations is a fiduciary duty analysis, with insolvency coloring the court’s consideration of whether the directors acted with the appropriate “fidelity and care in deciding to undertake more debt to continue the company’s operations.”

The bottom line is that, at least in Delaware after Trenwick, directors (and presumably officers) and third-party advisors are not guarantors of corporate success and corporate failure is not sufficient to support a cause of action against them. It remains to be seen whether this is in fact the last word on the issue in Delaware and whether other state courts will follow Delaware’s lead. Nonetheless, the Trenwick court’s characterization of a new “deepening insolvency” cause of action as out of step with traditional corporate law principles certainly creates an uphill battle for litigation trusts, trustees and creditors’ committees trying to forge a new path in corporate jurisprudence in states other than Delaware.
1 Prof. Harner currently is working on several projects involving deepening insolvency and corporate governance in the insolvency context and welcomes your thoughts and comments on these issues. Return to article

2 See, e.g., Smith v. Arthur Andersen LLP, 421 F.3d 989, 995 (9th Cir. 2005) ("misrepresenting (not necessarily intentionally) the firm’s financial condition to its outside directors and investors who participated in the firm’s various securities offerings” may be sufficient to support deepening insolvency claim); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347 (3d Cir. 2001) (describing committee’s claim for deepening insolvency as one "alleg[ing] an injury to the debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life"); Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (In re Gouiran Holdings, Inc.), 165 B.R. 104, 107 (E.D.N.Y. 1994) (negligent preparation of financial statements used to secure additional financing may support deepening insolvency claim). Return to article


5 See OHC Liquidation Trust, 340 B.R. at 535; Exide, 299 B.R. at 752. Return to article

6 Trenwick, C.A. No. 1571-N, at 62-67. Return to article

7 This article provides a simplified version of the facts in Trenwick. See Trenwick, C.A. No. 1571-N, at 8-19, for a detailed discussion of the facts. Return to article

8 Id. at 8. Return to article

9 Id. at 19-33. Return to article

10 Id. at 33-34. Return to article

11 Id. at 87-88. Return to article

12 Id. at 35-39. The court also noted that this general principle applies even where the plan of reorganization purports to assign (or allow the assignment of) creditors’ claims to the trust or trustee. Id. at 38-39. Return to article

13 Id. at 39. Return to article

14 Id. at 47 n. 75. Return to article

15 Id. at 45. Return to article

16 Id. at 75-76. Return to article

17 Id. at 62. Return to article