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It's Alive! Deepening Insolvency Helps Creditors Recover

Often in Chapter 11 cases of recent years, asset values are not sufficient to satisfy even the loans for which they were pledged as collateral. In a liquidation of assets, pursuant to a Section 363 sale or otherwise, often the assets generate proceeds insufficient to cover the lender's debt, much less administrative claims or unsecured claims. In a Chapter 11 case, secured claims normally have priority over administrative claims, which in turn have priority over general unsecured claims. In such cases, there is apparently no possibility of a dividend for unsecured creditors. However, there may be claims that can be asserted by creditors on behalf of the debtor against officers and directors, as insiders of the debtor, that can often fund a distribution to unsecured creditors, particularly if there is a directors and officers liability insurance policy in place.

One such claim, "deepening insolvency", is a theory creditors have used against officers and directors, with mixed success. Recently, creditors scored a major victory in asserting the claim of "deepening insolvency" against the debtor's officers and directors in the case of *In re Lemington Home for the Aged*. *Lemington* is a case from the United States Court of Appeals for the Third Circuit (last stop before the U.S. Supreme Court) which covers the states of Delaware, New Jersey and Pennsylvania.

Most states, including the influential Delaware Court of Chancery, have not adopted "deepening insolvency" as a separate legal claim or as a claim for damages. The courts have reasoned that "deepening insolvency" is duplicative of existing legal theories such as a breach of fiduciary duty and fraud. However, the Third Circuit in *Lemington* has ruled that "deepening insolvency" is a valid legal claim under Pennsylvania state law. "Deepening insolvency" is an injury to a debtor or its property from the expansion of corporate debt and the prolongation of corporate life.

Lemington Home for the Aged (the "Home") was a landmark non-profit in Pittsburgh. Despite continued support from local government and charitable organizations, the Home was deemed insolvent in 1999. The Home was the subject of complaints, investigations, and two patient deaths due to negligence. Despite a recommendation that the Home's Chief Administrative Officer be replaced, she was not. Moreover, it was alleged that the Home's Chief Financial Officer failed to maintain a general ledger, maintained "deplorable" financial records, and had no corporate Treasurer.

In 2004, the Home's Chief Administrative Office recommended that it file for Chapter 11 bankruptcy protection. The Board instead decided to borrow $1 million as additional capital, conditioned on a viability study that was never obtained.

Based on these facts, the unsecured creditors' committee for *Lemington* filed a lawsuit against the officers and directors of the Home alleging breaches of fiduciary duties of loyalty and good care, and for deepening insolvency. The defendants moved to dismiss the complaint based in part on the business judgment rule, which normally entitles an individual director to a presumption that his or her acts are in the best interests of the corporate entity. The Federal District Court granted the defendants' motion for summary judgment, resulting in a dismissal of the claims against the officers and directors. However, the creditors' committee, on behalf of the debtor, appealed. The Third Circuit Court of Appeals vacated the District Court's ruling and remanded the case for trial.

Normally, directors and officers, as fiduciaries of the corporation, owe fiduciary duties to the shareholders of the corporation. However, when a corporation becomes insolvent, the fiduciary duties expand to include all stakeholders including creditors. The fiduciary duty owed includes the duty to act "in good faith, in a manner [the officer or director] reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances." Officers are required to act in the best interests of the corporation, and to exercise such care, including reasonable skill, inquiry and diligence, as would a person of ordinary prudence. Further, directors are entitled to rely, in good faith, on reports and information provided by officers, employees, and professionals "whom the director reasonably believes to be reliable and competent in the matters presented." A director is not considered to act in good faith if the director has knowledge that would cause his reliance on others to be unwarranted.

The court articulated that the business judgment rule is a defense that may be raised by officers and directors of a corporation provided there is no "breach of fiduciary duty, lack of good faith or self-dealing." An individual director may invoke the business judgment rule for a presumption that his or her acts are in the best interests of the corporation. The business judgment rule is "the assumption that reasonable diligence has been used in reaching the decision which the rule is invoked to justify." Whether Board members may rely on the business judgment will in turn depend on whether the Board conducted an adequate investigation, and whether the Board reasonably believed that its decision was in the best interests of the corporation.

In *Lemington*, the lower court found evidence that the Board held official board meetings, was assisted by and relied upon the advice of counsel, and pursued other options prior to filing for bankruptcy to be sufficient to invoke the business judgment rule. On appeal, the Third Circuit Court of Appeals acknowledged that such evidence often supported application of the business judgment rule as a matter of law. In this case, however, the court noted that the Board had numerous red flags as to the competence and diligence of the Home's officers, and knew or should have known that their actions, reports and recommendations should not be followed.

In connection with the deepening insolvency claim, the court observed that the directors knew their actions would further deteriorate the financial condition of the Home. Moreover, the Home's officers continued to do business with vendors despite the officers' knowledge that the Home was insolvent and that there was insufficient working capital to pay vendors for goods or services provided. Based on the evidence presented, the Third Circuit Court of Appeals ruled that the creditors' action against the officers and directors should go to trial.

Time will tell whether *Lemington* will become a lightening rod for the expansion of deepening insolvency claims, or will be limited to its facts, and considered an anomaly of Pennsylvania law. In an era where the recovery opportunities for creditors are diminished, there is incentive to assert all possible claims for recovery, including deepening insolvency. *Lemington* may provide creditors a basis for achieving or enhancing a recovery that would otherwise not be available.

We hope that you have found this information helpful. If you have any questions regarding the foregoing, or any other matter, please feel free to contact us.

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