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Failing firm holds danger for directors

through increased exposure to creditor

In an age of heightened scrutiny of cor-

porate accounting, deepening insolvency

has gained traction as a legal theory under

which creditors can recover damages from

corporate fiduciaries on behalf of the

corporation. The viability of the theory was

solidified in 2001 when the Third Circuit

Court of Appeals (the circuit that includes

Delaware) validated a creditors committee's

The events leading to a company's bankruptcy filing rarely occur suddenly. It's not unusual for a business to slowly erode to the point that it must file for Chapter 11 or cease operations and liquidate. Despite entering the so-called "zone of insolvency," companies often continue to operate for months or years, usually at a loss, hoping EXPERT that business will improve.

Unfortunately, continued existence during this period can harm the company and David its creditors in the form of additional debt Conaway and erosion of asset value. When the company finally liquidates, there are typically few, if any, assets to distribute to unsecured creditors.

It has long been recognized that when a corporation enters the zone of insolvency, the fiduciary duties of a corporate director expand to not only include duties to the corporation and its shareholders, but also to creditors. This expanded duty translates to greater potential liability. However, the exact limits of this expanded duty to creditors have never been clearly delineated. To find an additional source for the payment of claims, unsecured creditors have sought to extend liability to a company's directors or other parties that may have played a role in the decision to unreasonably continue a losing operation after the entity had entered the zone of insolvency.

This is the backdrop of a legal theory known as deepening insolvency. The theory gained credibility in 1983 when the Seventh Circuit Court of Appeals refused to reject the theory as a basis for recovery. Instead, the court rejected the notion that the "fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interest." The court said such an assumption "collides with common sense, for the corporate body is incluctably damaged by the deepening of its insolvency,



liability."

Opinion

claim for deepening insolvency as a standalone cause of action under Pennsylvania law after finding that "growing acceptance of the deepening insolvency theory confirms its soundness." The court noted the following potential harm to a company and its creditors resulting from prolonging an insolvent corporation's life: the incurrence of additional debt that could trigger bankruptcy; the legal and administrative burdens and operational limits in bankruptcy; the erosion of vendor and customer confidence; and the dissipation of corporate assets.

The range of potential defendants of a claim for deepening insolvency extends beyond the management responsible for leading the company into greater insolvency, and has included accountants and auditors who may have negligently or fraudulently issued false financial statements; attorneys and investment bankers who participated in the issuance of additional debt securities; and lenders who granted forbearance agreements and covenant waivers to an insolvent company.

Some courts have rejected deepening insolvency as a new cause of action. As one bankruptcy court recently noted, even in those jurisdictions that have recognized deepening insolvency as a standalone cause of action, none has held that directors have an absolute duty to liquidate an insolvent company. Instead, all of the reported cases where

liability has been found based on the theory of deepening insolvency involve some level of bad faith or breach of a fiduciary duty.

These acts usually involve the use of fraudulently or negligently prepared financial statements,

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concealment of insolvency. looting of corporate assets, or obtaining a preferential transfer and then causing the company to delay filing for bankruptcy in order to avoid preference liability.

Whether the theory of deepening insolvency will ever be extended to allow recovery of damages resulting from a director's unreasonable but good-faith decision to prolong a corporation's life in the zone of insolvency remains to be seen. However, a couple of courts have recently issued opinions limiting the theory of deepening insolvency (as

applied to fiduciaries of insolvent corporations) to cases involving bad faith or fraud.

So far, there are no reported decisions in North Carolina dealing with the theory of deepening insolvency. The few recent reported cases dealing with a director's duty to creditors in the zone of insolvency suggest that N.C. courts are not inclined to impose liability absent a showing of some form of bad faith, insider preference or fraud. •

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