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The End of Deepening Insolvency Claims: Freeing Directors to Maximize the Value of a Corporation Even in Insolvency

After a relatively brief and checkered stint in Delaware courts, it appears that the cause of action against corporate directors for "deepening insolvency" may have lost its place in Delaware corporate jurisprudence.

The concept of deepening insolvency was a mutation of two well-settled principles. The first principle is that directors are generally protected by the business judgment rule: "[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." *In re Troll Commc'ns*, 385 B.R. 110, 118 (Bankr. D. Del. 2008). To overcome this presumption, a plaintiff must show that the directors violated their fiduciary duties of due care, loyalty or good faith. *Id.*

The second principle is that when a company is insolvent, these fiduciary duties are deemed to flow to the company's creditors. *Trenwick Am. Litig. Trust v. Ernst & Young*, 906 A.2d 168 (Del. Ch. 2006). "By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk bearers." *Id.* at 205 n. 104.

"Deepening insolvency," as it came to be known, developed when Delaware courts held that, in the context of insolvency, the fiduciary duties owed to creditors are somehow inconsistent with, and paramount to, the duties owed to the corporation generally. From this starting place, Delaware courts reached the more profound conclusion that in the context of insolvency, the directors' duty is no longer to maximize the value of the corporation, but to avoid going any further into debt.

The resulting deepening insolvency claims were never well defined, but were based generally on allegations that the directors of an insolvent corporation caused it further injury by incurring additional debt in pursuit of failed business strategies; specifically, that they artificially extended the life of the corporation and thereby allowed it to go even further into the red. *Official Comm. of Unsec. Creditors v. R.F. Lafferty*, 267 F.3d 340 (3d Cir. 2001) (recognizing deepening insolvency as a claim under Pennsylvania law); *In re Oakwood Homes Corp.*, 340 B.R. 510 (Bankr. D. Del. 2006) (holding that Delaware, New York and North Carolina would recognize deepening insolvency as a cause of action).

Although most of the deepening insolvency decisions spoke in terms of "fraudulently" prolonging the corporate existence or included reference to some other form of tortious conduct, the creation of an *independent* cause of action for deepening insolvency resulted in an impression that directors of an insolvent corporation ought to avoid taking on additional debt unless their strategy carried some guarantee of success. Directors were left with the perception that they were precluded from taking steps that would push the corporation further into the red but that could ultimately maximize corporate value.

Not so.

Recent decisions have soundly rejected deepening insolvency as an independent cause of action, finding that traditionally recognized claims for breach of fiduciary duty are sufficient yardsticks by which to measure the conduct of corporate directors, and that an independent claim for deepening insolvency only confuses the analysis and ultimately hamstrings directors' efforts to pursue strategies that might save the company.

In *Trenwick*, plaintiff asserted a claim against the directors for deepening insolvency based on allegations that they caused the corporation to incur additional debt at a time when it was already

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insolvent, pursuing business expansions that ultimately failed. The court rejected deepening insolvency as an independent cause of action:

> The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorious academic ring that tends to dull the mind to the concept's ultimate emptiness. 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. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm . . . If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action.

906 A.2d at 204-05.

In one particularly colorful passage, the court observed, "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." *Id.* at 205; *see also Troll Commc'ns*, 385 B.R. 110.

As explained in *Trenwick*, "[t]he rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty [care, loyalty and good faith] and for fraud." 906 A.2d at 205.

The rejection of an independent cause of action for deepening insolvency has the happy result of confirming that the business judgment rule applies whether the corporation is solvent or insolvent, and that so long as directors pursue business strategies with a good faith aim of maximizing corporate value, they will not be penalized merely because failed strategies ultimately result in a greater shortfall for creditors.

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