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Deepening Insolvency Is Alive And Relevant in New Jersey

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The phrase "deepening insolvency" appears to have its origin in the 1983 case of *Schacht v. Brown*, when the U.S. Court of Appeals for the Seventh Circuit observed that "[t]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability," and described it as "an injury to the [debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." 711 F.2d 1343, 1350 (7th Cir. 1983).

Since then, helped by its amorphous nature, deepening insolvency has transformed from being generally considered a theory of damages to being acknowledged as a separate cause of action and, in the more recent past, back to its origins as a cause of action. While deepening insolvency has lost its luster almost as rapidly as it gained its popularity in many jurisdictions, it remains a viable theory of damages under New Jersey law and continues to be recognized to a certain extent by the Third Circuit Court of Appeals.

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Whether deepening insolvency constitutes a valid theory of corporate damages or an independent tort depends upon the applicable state law that governs the duties corporate officers, directors and shareholders owe to the corporation and third parties. By focusing on the corporation's conduct upon becoming insolvent, the concept of deepening insolvency has a direct effect on how a company, its stakeholders, advisors and counterparties should act when the company is insolvent or nearly insolvent. Thus, imposing liability for debts incurred while trying to turn the company around may have a significant impact on future reorganizations.

Typical plaintiffs asserting deepening insolvency are Chapter 11 debtors, and Chapter 7 or 11 trustees, creditors committees, litigation trusts, receivers and other parties authorized to act on behalf of the corporate entity. Their targets have included directors and officers, advisors to companies (accountants, auditors, investment bankers, financial advisors), lenders, controlling shareholders and major contract counterparties.

Courts that consider deepening insolvency a separate cause of action generally define it as the undertaking of actions and decisions by officers, directors and other third parties in furtherance of the continued operation of an insolvent corporation that directly or indirectly results in damage to the corporation by incurring additional debt obligations without any prospect of ability to repay. In certain jurisdictions, negligence may be sufficient to sustain a cause of action for deepening insolvency, while in others allegations of fraud are required.

As a theory of corporate damages, deepening insolvency is used as a means of recovery for injury sustained by an insolvent corporation from independent tortious conduct. In this context, deepening insolvency attaches to a separate tort and provides a means of measuring the harm resulting from extending the life of an insolvent corporation through, for example, fraud, negligence or a breach of fiduciary duty, that results in a decline in the value of a corporation.

Normally, an injury to a corporation is measured by the decline in its equity value and, under such approach, once the corporation becomes insolvent there is no longer any equity in the corporation, and the equity holders may not be injured any further. However, under the deepening insolvency theory of damages, the measure of damages extends beyond a calculation of the equity loss and may include damages sustained by noninvestor stakeholders such as suppliers, distributors, employees and taxing authorities, among other creditors.

The deepening insolvency theory of damages has been utilized to measure the damage to a corporation by its increased debt load, costs associated with third parties' decreased confidence in the company's ability to operate as a going concern and the costs associated with filing for bankruptcy. Courts applying the deepening insolvency theory of damages have not been able to reach a consensus as to the precise method of calculating the damages beyond the general notion that the plaintiff should be able to recover for losses caused during the period of wrongdoing.

Much of the criticism engendered by the theory of deepening insolvency has focused on the courts' failure to clearly state the essential elements of the cause of action, or a coherent method of calculating the damages sustained from deepening insolvency separate and apart from the traditional tort elements and measures of damages caused by such torts.

The law of deepening insolvency in New Jersey is not precise, but a review of the law demonstrates that deepening insolvency is viable as a measure of damages and may be available as a separate cause of action. In its most recent case addressing deepening insolvency, *Thabault v. Chait*, the Third Circuit Court of Appeals observed that "[a]lthough neither the New Jersey legislature nor the New Jersey Supreme Court has authorized a 'deepening insolvency' cause of action, … there has been a trend among the state's courts toward recognizing 'deepening insolvency' damages." 541 F.3d 512, 521 (3d Cir. 2008). The Third Circuit further held that:

> Whether courts term it 'deepening insolvency' or describe in detail the gamut of destruction that the term is meant to embrace, the bottom line is the same. Harm is harm. Where there is harm, the law provides a remedy . . . The artificial prolongation of an insolvent corporation's life can harm a corporation. Where there is harm, the law provides a remedy.

The Third Circuit reiterated, however, that it did not create a new theory of damages for a state law negligence claim that would allow a plaintiff to simply compare two balance sheets to determine the amount by which the insolvency had increased. The court specifically analyzed the components of the debtor's damages calculation and concluded that the damages proven to the jury consisted of "itemized, specific, and avoidable losses that [the debtor] incurred by continuing its operations beyond the date of [defendant's] negligent audits." Even though those damages had an "impact on [debtor's] solvency" (i.e., deepened the insolvency), the calculation measured the specific losses that were proximately caused by the defendant auditor's negligence, not simply the amount by which the debtor became more insolvent. Thus, in essence, these damages were traditional tort damages, recoverable under New Jersey state tort law. The Third Circuit also disposed of the defendant's argument that corporate losses below the solvency threshold belong only to the company's creditors, and not the company itself. The court succinctly stated: "Today we hold that an increase in liabilities is a harm to the company and the law provides a remedy when a plaintiff proves a negligence cause of action."

The Third Circuit's holding in *Thabault* did not put an end to these issues in New Jersey. One court examining the issue has predicted that, if the New Jersey Supreme Court were to examine the issue, it "would recognize a claim for deepening insolvency when there has been harm or damage to the corporate debtor." *In re Norvergence, Inc.*, 405 B.R. 709, 758-59 (N.J. 2009). Subsequent to that decision, the United States District Court for the District of New Jersey ruled that neither the New Jersey legislature nor the New Jersey state courts have recognized an independent cause of action known as "deepening insolvency." *Stanziale v. Sun National Bank, et al. (In re Dwek, et al.)*, Civ. No. 3:09-cv-5046 (March 26, 2010).

A significant issue in deepening insolvency litigation is showing that the harm (whether by negligence or the cause of action of deepening insolvency) was the proximate cause of the damages. In the case of *Marion v. TDI, Inc.*, the Third Circuit made it clear that a plaintiff must establish that the harm caused by the defendant was in turn the proximate cause of the economic loss suffered by the corporation. In many instances (such as the facts of *Marion*), there may be intervening or superseding acts creating an impediment to a successful deepening insolvency claim. The complexity and difficulty in litigating deepening insolvency claims lie in linking the harm caused by the defendants to the increase in liabilities or decrease in assets.

The bounds and utility of deepening insolvency have yet to be formally defined, as the framework will need to be established by a court. The elements of causation and quantification of damages are not fully established, but as case law emerges those issues will be clarified. At least in New Jersey, deepening insolvency is not dead yet.■