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Are Insolvent Corporations Hurt By More Debt?

Law360, New York (January 18, 2011) -- In the first Pennsylvania state court decision of its kind, the Court of Common Pleas of Allegheny County refused to recognize “deepening insolvency” as a theory or measure of damages in a Chapter 11 liquidation trustee’s professional negligence claim against the law firm K&L Gates LLP.[1]

As a result, the court dismissed the trustee’s complaint for failure to allege any legally cognizable claim for damages resulting from the allegedly negligent conduct. The court reached its decision based on the trustee’s inability to answer satisfactorily a simple question — How is an already insolvent corporation (as opposed to its creditors) damaged by taking on additional debt and becoming “more insolvent”?

Deepening Insolvency

For almost 30 years, courts have grappled with the question of whether a company may “sue to recover damages resulting from the fraudulent prolongation of its life past insolvency.”[2] Whether posited as a cause of action or a measure of damages, the viability of “deepening insolvency” claims is an issue that has vexed the courts. Most recently, bankruptcy and liquidation trustees have used deepening insolvency theories to pursue damages on behalf of the liquidating estate.

In Caplin v. Marine Midland Grace Trust Co. of New York, the U.S. Supreme Court held that a liquidation trustee lacks standing to pursue the direct claims of creditors.[3] Under Caplin, the trustee may assert only those claims that the debtor-corporation could have itself asserted before its insolvency proceedings. By characterizing additional unpaid debt (an injury to creditors) as an injury to the corporation itself, trustees have sought to use “deepening insolvency” to create standing and to assert claims that arguably belong to the company’s creditors.

The Trustee’s Factual Allegations

The trustee’s complaint arose from the collapse of Le-Nature’s, a beverage manufacturer based in Latrobe, Pa. In August 2003, three of the company’s senior financial officers resigned after expressing serious concerns about the accuracy of the company’s sales figures and accounting practices, including the fact that the CEO refused them access to the company’s financial records.

As a result of these allegations, Le-Nature's independent directors formed a special committee to conduct an independent investigation. The special committee retained K&L Gates to conduct that investigation. In December 2003, K&L Gates reported its findings to the special committee, concluding that there was no evidence of fraud, but recommending that the company adopt certain remedial measures to address weaknesses in its internal controls.

In October 2006, it was discovered that Le-Nature's was involved in a massive financial fraud that resulted in hundreds of millions in losses to the company's creditors. An involuntary bankruptcy proceeding was filed and converted to a Chapter 11, ultimately resulting in confirmation of a liquidating plan and the appointment of Marc Kirschner as liquidation trustee. By that time, the estate had few assets other than potential causes of action.

Kirschner sued K&L Gates alleging that it committed professional negligence by failing to discover the company's fraud during the investigation in 2003. With respect to causation and damages, the trustee alleged that K&L Gates' failure to detect the fraud allowed the company's insiders to continue their fraudulent behavior, causing the company to incur more than $500 million in additional debt.

Had K&L Gates discovered the fraud, the trustee alleged, the independent directors would have liquidated the company in 2003, by which time the company was already insolvent. According to the trustee, this additional debt (a deepening of the company's insolvency) was the proper measure of damages for the alleged professional negligence.

K&L Gates moved to dismiss, arguing, among other things, that the complaint failed to allege any losses to the company, as opposed to losses to the company's creditors.[4] Applying Pennsylvania law, the court agreed, dismissing the complaint and holding that an already insolvent company with no prospects for rehabilitation suffers no legally cognizable injury by the incurrence of additional debt.

The court began by noting that a plaintiff in a professional negligence action under Pennsylvania law must establish that the alleged malpractice was the proximate cause of actual damages to the plaintiff. As a result, the court required the trustee to plead "losses which the corporation experienced from K&L's failure to detect [the CEO's] mismanagement."[5] The court made clear that losses suffered by Le-Nature's creditors or shareholders would not satisfy this burden because the trustee lacked standing to assert claims on their behalf.

Focusing on the issue of whether the company itself suffered any loss, the court emphasized the trustee's allegation that Le-Nature's was already insolvent when K&L Gates' report was prepared in December 2003. The court was unmoved by the trustee's argument that Le-Nature's was damaged when it incurred additional debt between December 2003 and when the fraud was uncovered in 2006: "While plaintiff contends that the increased insolvency is an actual corporate loss, plaintiff does not offer any explanation as to how an already insolvent company was harmed because its insolvency increased by more than $500 million between December 2003 and October 2006."[6]

Unable to answer the question the court asked, the trustee focused on a series of federal court decisions that he claimed established that if the trustee can “show that a person, through fraud or negligence, has been responsible for prolonging the life of an insolvent corporation, this corporation is entitled to recover from this person the full amount of the increased insolvency.”[7]

Instead of trying to reconcile this murky precedent from the U.S. Court of Appeals for the Third Circuit and U.S. District Court for the Western District of Pennsylvania, the court dismissed these cases as not offering “any explanation as to how an already insolvent corporation with no hope of survival is damaged by additional debt.”[8] In short, the court concluded that these cases asked the wrong question.

Focusing on whether an already insolvent company can suffer “damages” by incurring additional debt, the court noted decisions suggesting that a company could suffer four types of legally cognizable harm resulting from deepening insolvency: 1) increased administrative and legal costs resulting from the bankruptcy; 2) harm to the company’s goodwill by injuring its relationships with customers, suppliers and employees; 3) dissipation of corporate assets; and 4) harms caused by a failure to timely dissolve the company while it still had value.

Entertaining the possibility of such harms, the court concluded that the trustee’s allegation that Le-Nature’s was insolvent and should have been liquidated before K&L Gates issued its report foreclosed any plausible claim of “deepening insolvency” damages. In particular, the trustee failed to allege even that the failure to liquidate in 2003 resulted in a dissipation of assets. Rather, the sole “injury” alleged was the additional debt that the company incurred.

As a result, the court found the complaint was devoid of any allegations that LeNature’s, as opposed to its subsequent creditors, suffered any damages resulting from the company’s increased debt and deepening insolvency. Without damages, the trustee could not state a claim for which relief could be granted.

In the end, the court predicted that Pennsylvania appellate courts would adopt the position taken by Vice Chancellor Leo E. Strine in Trenwick America Litigation Trust v. Ernst & Young [9] and Judge Richard A. Posner in Fehribach v. Ernst & Young LLP.[10] These cases rejected deepening insolvency as a theory or measure of damages.

Beginning of a Trend?

While this result comports with both settled legal principles and common sense, the opinion is significant because, while limited to Pennsylvania, it is among the first state law decisions to definitively reject the theory advanced by trustees that an already insolvent company with no hope of rehabilitation can be damaged by incurring additional debt.

The opinion is also significant because it dramatically limits the types of damages that a trustee may recover from third parties. According to the court, many trustees understandably would like courts to adopt a rule that would transform the company’s law firms, business partners and other entities into insurers for subsequent creditors by requiring them “to make payments to the corporation in an amount that will fully reimburse those post-2003 vendors and service providers left holding the bag when the Ponzi scheme collapsed.”[11]

Even though these arguments may seem facially appealing as a means of compensating creditors, the court noted that there is “not a single case of which I am aware [that] has defended the rule on the ground that this is a purpose that the law should achieve.”[12]

Whether federal bankruptcy or district courts will start giving greater deference to state court opinions like Kirschner or Trenwick remains unclear. However, because state courts are the best expositors of state law, perhaps future federal courts will take note of these cases and continue to narrow the circumstances in which a trustee may recover damages for deepening insolvency to those few cases (if any exist) in which the corporation itself has suffered harm, instead of the corporation’s creditors.

The case is Kirschner v. K&L Gates LLP, No. GD09-015557, in the Court of Common Pleas of Allegheny County, Pennsylvania, and the opinion was issued on Dec. 28, 2010. The case can be located on Westlaw at 2010 WL 5504811 and on Lexis-Nexis at 2010 Pa. Dist. & Cnty. Dec. LEXIS 387.

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[1] The complaint named three additional defendants: the accounting firm of Pascarella & Wiker LLP, K&L Gates partner Sanford Ferguson and Pascarella & Wiker partner Carl A. Wiker. The complaint also contained additional causes of action against all parties that are not relevant to the issues discussed in this article.

[2] Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983).

[3] 406 U.S. 416 (1972).

[4] The court also dismissed the trustee’s professional negligence claim based on the lack of any attorney-client relationship between K&L and Le-Nature’s.

[5] Slip Op. at 14.

[6] Id. at 15.

[7] See, e.g., Marion v. TDI Inc., 591 F.3d 137 (3d Cir. 2010); Thabault v. Chait, 541 F.3d 512 (3d Cir. 2008); In re CitX Corp., Inc., 448 F.3d 672 (3d Cir. 2006); Special Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc., 267 F.3d 340 (3d Cir. 2001); In re Le-Nature's Inc. v. Wachovia Capital Markets LLC, No. 2:09-mc-00162, 2009 WL 3571331 (W.D. Pa. 2009); Official Committee of Unsecured Creditors of Allegheny Health, Education and Research Foundation v. Price Waterhouse Coopers LLP, No. 2:00-cv-684, 2007 WL 141059 (W.D. Pa. 2007).

[8] Slip Op. at 24.

[9] 906 A.2d 168 (Del. Ch. 2006), aff'd 931 A.2d 438 (Del. 2007).

[10] 493 F.3d 905 (7th Cir. 2007).

[11] Slip Op. at 31.

[12] Id.